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FROM STABILIZATION TO GROWTH

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ABSTRACT

The 1980s were a lost decade for Latin America, will the 1990s also be lost? For some countries stabilization has not even started. In other countries the stabilization accomplishments remain tentative and vulnerable. And even those countries that have established firmly a new path for their economic management are still waiting for economic growth to return.

The hardest part of stabilization is the transition to growth. Even with major adjustment efforts in place, growth does not resume spontaneously. If the lack of recovery is due to a coordination failure than market forces cannot resolve the difficulty, a mechanism must be found to bring about the coordination.

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The 1980s were a lost decade for Latin America, will the 1990s also be lost? For some countries, notably Brazil or Peru, stabilization has not even started. In other countries, for example Argentina, the stabilization accomplishments remain tentative and vulnerable. And even those countries that have established firmly a new path for their economic management are still waiting for economic growth to return. Selowsky (1989) has highlighted the key issue, the return of investment:

"Long run growth can only be achieved when nations prefer to invest domestically instead of abroad and when the productivity of that investment is high both socially and privately, and is expected to remain that way in the future. When such conditions emerge we will state that the country has reached Stage III in the adjustment. Chile and Uruguay can be classified as being at that stage today, Mexico and Bolivia are moving there gradually."

The hardest part of stabilization is the transition to growth. That was the case at the end of European hyperinflation in the 1920s and it is once again today. In an entirely different environment, in the US during the 1930s, economic recovery did not take hold until 1940 when the

export boom of war materiel to Britain provided the required drive.¹ The stark reality is that even with major adjustment efforts in place, countries do not fall back on their feet running; they fall into a hole. That does not make, of course, a case against adjustment. But it does make it urgent to ask whether there are policies or mechanisms that can help recovery and growth and may even be essential. If the lack of recovery is due to a coordination failure than market forces cannot resolve the difficulty, a mechanism must be found to bring about the coordination. The Dawes Loan, League of Nations loans and the Marshall Plan have provided the trigger mechanism in the past.

Before exploring what theory has to say on these issues, we briefly look at some facts. We introduce the discussion by a brief review of the European experience and then turn to the stabilization dilemma.

1. COMPARATIVE PERFORMANCE

How close are the successful countries today to a resumption of growth? the stark decline in per capita income in the 1980s, years after stabilization, dramatizes the single most important question for countries who do stabilize: will economic growth come back, and will it come soon enough before populist demands lead to a reversal.² The issue of a timely return of growth is critical because the incidence of the initial

¹See Gordon and Wilcox (1981).

²On populism in Latin America see Dornbusch and Edwards (1989) and Sachs (1989).

adjustment measures is such that they reduce the welfare of the poor and public sector investment; as such the austerity is politically and economically unsustainable.

Latin America

Real per capita in Latin America today is at the level of the early 1970s. Compared with the 1930s experience, the depression of economic activity is far worse as Figure 1 shows. Moreover, the overall picture is too optimistic in that it reflects the relatively favorable performance of Brazil where per capita income by 1988 had returned to the 1980 level. In addition the performance of aggregate per capita income does not take into account the sharply worsened income distribution.

Table 1 Comparative Per Capita Growth and Investment of LDCs
(Percent per year)

	1970-79		1980-88	
	Inv./GDP	Growth	Inv./GDP	Growth
L.America	23.5	3.1	19.2	-1.4
Brazil	26.8	5.2	21.0	-0.0
Chile	14.7	2.0	15.7	0.1

Source: IMF and Economic Commission for Latin America

Bolivia has tamed a hyperinflation, stabilized public finance and administered a heavy dose of supply side economics. The easy work is done, and now the country waits for recovery and growth: Per capita income, as shown in Figure 2, is no longer plummeting, but it has fallen desperately low and there is no assurance, 4 years after stabilization, of

a major turn of events. Per capita income continues to fall. Moreover, in November 1989, social conflict erupted into the open when the government declared a state of siege and once again jailed striking union leaders. The Bolivian government may have won the war on inflation, but they have now lost the peace. Bolivia's case is so important because there is consensus that the country implemented all those reforms that should be accomplished, did so firmly and by now many years ago. The case confirms the suspicion that stabilization may not be enough. If so, what else needs to be done?

Bolivia is not unique. Mexico is in the same position today. Per capita income is more than 17 percent below the 1981 peak and real wages in manufacturing are below the level of the early 1970s as Figure 3 makes clear. Growth in per capita income is not in sight! And when Argentina or Peru one day stabilize, they too will face exactly the same dilemma: what comes after stabilization? The answer seems to be protracted stagnation. And even in Brazil, where the economic crisis economic deterioration never reached extreme proportions, other than in respect to inflation, one must question whether the austerity of a stabilization might not break the perennial optimism.

The European Experience in the 1920s

World War I, the dismemberment of empires, the hyperinflation and the stabilization had a profound impact on European history; for many the rise of fascism and Hitler's political success were the result of the

economic dislocation and the pauperization of the early 1920s.³ The question that interests us here is the medium term aftermath of hyperinflation; was there a protracted decline in activity? Sargent (1982,1986) has argued that stabilization did not have a major, adverse effect on employment. In fact, he built on this very point his theory of credible stabilization. But his evidence has been challenged.⁴

The unemployment data leave little question that there was a major increase. Figure 4 shows the case of Germany and similar data can be found for Austria, Poland and Hungary, as Wicker (1986) has shown. But three point must be noted. First, the increase in unemployment, while clearly very substantial, did not last at peak rates for a very long period. Second, closer analysis of the data reveals that much of the increase in unemployment is sector specific; it represents structural unemployment arising from the sharp retrenchment in public sector payrolls and in the banking system.

A related point was emphasized by Layton and Rist. To the extent that high unemployment persisted, this was a reflection of a sharp increase in productivity of private sector firms. Output did recover, as shown in Table 2, but productivity gains were so strong that unemployment was not driven down. Layton and Rist (1925,p.16)note on this point:

"The increasing volume of unemployment created keen disappointment both in Austria and abroad. In some quarters it was assumed that Austrian industry had been seriously hit by the financial crisis, while in others it was interpreted as a sign that Austria would not

³See Guttman and Meehan (1976), Ferguson (1975) and Ringer (1969).
⁴See Wicker (1986) and Dornbusch (1988).

be able to cope with the new conditions in which she had been placed. Neither of these deductions is, however, justified. . .The marked rise in unemployment is due primarily to the fact that, since the stabilization, there has been a steady elimination of superfluous workers and to the introduction of more economic methods of working-- a movement which is the counterpart in private business of the regime introduced by the reconstruction scheme in the sphere of public finance. In the industrial world it has been accompanied by a substantial increase in wages, an increase in production per head and in many cases, by a reduction in the cost of production."

Table 2 Europe in the 1920s: Manufacturing Production
(Index 1921=100)

	Austria	Germany	Hungary	Poland	World
1922	119*	128	125	158	123
1923	127	144*	88	152	129
1924	128	136	104*	121*	137
1925	148	151	120	135	149
1926	148	159	130	126	156
1927	166	158	154	163	166

*Stabilization dates: Austria: August 1922; Germany: November 1923; Hungary: June 1924; Poland: January 1924.

Source: League of Nations Industrialization and Foreign Trade, 1945

It is apparent from Table 2 that the economic performance of European hyperinflation countries, taking the entire 1921-27, period is not dramatically different from that of the world economy. True, the table only focuses on manufacturing. Moreover, and perhaps much more seriously, 1921 levels of output were below 1913 levels and hence there might have been room for a stronger recovery and for physical reconstruction of war ravaged towns and physical capital.

Data from German GNP accounts, however, suggest that by 1926-27 these countries had reached again 1913 real income levels. They also

indicate very substantial real growth (as does industrial production) in 1925-27.⁵ All things considered, perhaps even surprisingly, it is difficult to interpret the data in Table 2 as evidence of a deep, protracted decline in activity. That raises much more starkly the question why European countries did so much better than Bolivia, Mexico or even Chile in the 1980s.

TRANSITION TO GROWTH

There is a variety of paradigms about growth. They range from supply side economics to sophisticated models of credibility, from neoclassical growth theory to models of the role of financial intermediation credit and the new economics of coordination under imperfect competition. Before touching on these issues I will review the basic approach.

The IMF model

When countries undergo stabilization they are told that serious stabilization reaps its benefits by providing strengthened foundations for growth. It is instructive to see how the IMF represents this problem; I will draw on the specific study of Khan and Knight (1985). Its extraordinary optimism will come as a surprise.

As developed in Khan and Knight (1985), a serious stabilization does not have lasting adverse effects on economic performance. On the

⁵See Mitchell (1978).

contrary, demand side policies will help improve performance. And if supply side measures are added, as shown in Figure 5 (reproduced from Khan and Knight) then growth performance can improve significantly. Note, and this is central, that the improvement in performance comes about very rapidly, in less than 2 years.

The Model: We now review the details of this IMF model since that discussion, identifies clearly where in the transmission mechanism from stabilization to growth critical steps are missing.

We focus on the real sector where aggregate demand drives the growth of actual output:

$$\Delta y = \alpha \Delta g + \beta \Delta d + \delta \Delta x + \lambda(y^* - y) \quad (1)$$

where lower case letters denote logs of real variables:

y	output
d	real domestic private credit
g	real government spending
x	real exports
y^*	capacity output
$y^* - y$	the GDP gap

The final term in (1) is the percent GDP gap, $y^* - y$, and its role is critical; it assures that any capacity expansion that does take place automatically translates into increased output.

The growth of real exports is governed by capacity output and changes in competitiveness.

$$\Delta x = \gamma \Delta y^* + \theta \Delta \psi \quad (2)$$

Competitiveness is defined as the log of the ratio of exogenous world prices (p^*) to domestic prices in dollars ($e+p$):

$$\psi = p^* + e - p \quad (3)$$

The growth of potential output is driven by labor force growth, n , and by the investment ratio, ω :

$$\Delta y^* = \sigma \omega + (1-\sigma)n \quad (4)$$

Note, that the IMF simulations both the labor force growth and the investment rate are taken as exogenous. Also, there is no credit market so that the interest rate is exogenous and the growth in real credit to the private sector is exogenous. All crowding in occurs, as it were, by fiat.

Inflation is determined by the gap between actual real balances, m , and real money demand, m^d , and by the exogenous rate of increase of traded goods prices in home currency.

$$\Delta p = \mu(m - m^d) + \Delta(p^* + e) \quad (5)$$

Consider now what happens in this model when stabilization takes place.

The model and simulations studied by Khan and Knight focus on a combination of demand and supply side policies, specifically:

- a sustained 10% reduction in the growth rate of nominal domestic credit and nominal government spending and an initial once and for all 10 percent nominal devaluation.
- Supply side policies that increase the growth rate of output by a cumulative 2.5 percent per year. Specifically this includes an increase in the investment ratio. The adjustment path is characterized by the following effects.
 - The once-and-for all devaluation immediately and over time increases competitiveness and thus stimulates aggregate demand.
 - In the short run there is an offsetting restrictive impact of devaluation: it raises inflation and thus reduces, for given nominal credit growth, the growth in real demand.
 - The reduction in the growth rate of nominal total domestic credit and the slowdown in the growth of nominal government spending reduce the growth in real demand in the short run because inflation does not immediately slow down..

The combined effect of restraint and devaluation produce in the short run a downturn of the growth rate. But after a year the expansionary

effect of devaluation and the impact of declining inflation on real credit growth start pushing up the growth rate. Inflation declines over time and ultimately settles down at a rate reduced by 10 percentage points. Along that path the money supply is determined by the balance of payments and the rate of inflation in the long run is set by the exogenous rate of depreciation and domestic credit creation.

Growth in Figure 5 is driven by three factors: first, the progressive crowding in of real exports and the reduction in real imports that derive from the gain in competitiveness. Second, following the initial shock of the slowdown in nominal (and hence, initially, real demand) there is a recovery of real demand growth for the government and the private sector due to declining inflation. Finally, as a result of the exogenous increase in investment, potential output grows increases. The gap, $y^* - y$, initially widens and this stimulates growth until the initial GNP gap is eliminated and output follows the trends of capacity growth. In the long run there is a full crowding in of net exports to make up for a reduction in real domestic demand.

In the IMF simulations the value of λ in (1) is 9; this implies an extremely strong correction toward trend growth and presumably accounts for the fact that the slowdown only lasts one period.

Some Questions: We now have come to the point of raising some issues about the image of stabilization portrayed in this IMF model.

•Strikingly in view of Latin America discussions for a half century, income distribution variables do not play any role in this model.

Successful real depreciation, which almost invariably means a fall in real wages, does not affect real aggregate demand.

- Real wage issues likewise do not affect the inflation process.

There is accordingly no way in which this model would generate the much feared syndrome of a vicious cycle where devaluation brings inflation and recession on more than a short term basis.

- Real depreciation is an assured way of gaining net exports.

The combined long run elasticity of exports and imports is 1.5 and the lag is only three years. Because the export side is modelled as that of a firm facing perfectly elastic demand, the right real exchange rate is the only issue in activating the trade sector as an engine of growth.

- Investment is exogenous and thus can be switched on to produce a more rapid expansion of potential output and hence of actual output and of trend growth. There is no attempt to model the link between credit conditions, confidence and investment. As a result there is a confident prediction that supply side measures can add 2.5 percent to the trend growth rate by fiat.

- There is no discussion in this model of the domestic and foreign saving availability to finance the increased investment. A ready answer might be that trimming budget deficits provides room for nominal growth in credit for the private sector. But the policy of raising interest rates advocated to mobilize saving may also have the effect to slow down investment.

All the serious issues in stabilization are, in fact, glossed over, strategically assumed away or made exogenous. As a result one is

left with a strikingly optimistic outlook. The reality, however, is that attempts to implement these measures fail more often than not. They fail either because the income distribution issues produce a serious inflation and recession problem, or because the financing for supply side policies that raise growth cannot be marshalled, or they fail because the trimming back of credit growth and the devaluation produce a deep recession and no investment boom, not in the first year and not for many years.

If the private sector does not respond with investment and capacity expansion, and if confidence and inflation issues bar a public sector expansion, then of course the policy maker becomes the proverbial emperor without clothes: he has sharply increased profitability in the traded goods sector and the profits are taken out as capital flight; there is no growth, there is social injustice and social conflict.

The simplistic response to this problem is to assert that policy is simply not credible and therefore, to no one's surprise, it fails to deliver the promise. But the response is either tautological or foolish. There is no presumption that the market solves the coordination problems involved in the return of capital flight or the resumption of investment.

In summary then, the IMF model fails to recognize critical empirical linkages and assumes away the key issue of what mechanism brings about the resumption of investment. Disappointingly, it does not teach us anything about adjustment and the return of growth.

III. CREDIBILITY AND THE WAITING OPTION

In this section we develop a conceptual framework to evaluate the critical issues in the discussion of stabilization: why is capital so shy to return (as evidenced by the interest rates required to maintain the exchange rate) and why is investment so slow to respond? The answer to these questions implies a very pessimistic evaluation of the prospects for a rapid turn toward growth in Latin America. The classical prescription of a balanced budget, competitive real exchange rates and supply side policies that promote a better resource allocation are the necessary conditions for a return of growth; but they are not sufficient!⁶ There is an important coordination problem that needs resolution.

Good and Bad Equilibria

The role of coordination, and the possibility of bad equilibria is in fact central to modern growth theory. Classical growth theory does not embody a subtle model of the investment decision. Either all saving are invested, as in the Solow-Swan rendition, or else the real price of capital adjusts to equate saving decisions and investment plans. The equilibrium in such economies is unique and economic progress is dependent primarily on saving and exogenous technical progress. Modern approaches to growth, especially Lucas, Romer, Prescott and Boyd,(1987), and especially

⁶This section expands the argument in Dornbusch (1989). See, too, Blejer and Isze (1989).

Murphy, Shleifer and Vishny (1989a, 1989b)) have changed the emphasis in three directions. First, human capital is given an entirely central role. The reason for human capital to receive emphasis is the inability to explain actual growth performance in industrialized economies and the attempt to put a more specific content to the "residual" which is two-thirds of growth. Second, along with human capital goes a role for "firms" understood as teams or organizations that convey an element of increasing returns.

This third strand of modern growth theory is most interesting from our perspective: it is built around the notion that firms are imperfectly competitive. This implies that their investment decisions become interdependent. Because (unlike in perfect competition) there are profits, the profitability of an investment depends on the state of the economy: if all firms invest there is a boom and profits are high, if other firms do not invest than the individual firm wants to be certain to do the same since profits would be low or negative. This dependence of profits on other firms' actions creates a strategic element that brings with it coordination problems: there will typically be at least two equilibria: the "good" one where investment is high and the economy is booming and the "bad" one where there is slack. Which equilibrium prevails depends on expectations -- Keynes' animal spirits modelled here as the expectations of imperfectly competitive firms.

It is clear that in a small economy (with protection and transport costs) many if not most firms are imperfectly competitive and

hence these considerations should be especially relevant. Consider now the actual story: There are two states of the aggregate economy. In state G for "good" the economy booms and the exchange rate is stable. In this state production and investment have a high payoff. In the other state, B for "bad", demand is low, profits are low or negative and/or the exchange rate may depreciate. If the good state is expected to prevail every firm wants to invest, if the bad state prevails nobody wants to invest. Note how the story can be told about production as much as about investment, the reason being that production itself, because of lags and the resulting need to commit working capital and suffer exposure to controls or depreciation, is an investment decision.

The model is closed by recognizing that if everybody invests there is a self-fulfilling good state and if there is scepticism then nobody or few invest and the scepticism is borne out by a poorly performing economy. It is obvious that this situation is similar to a bank run: if everybody believes banks are unsound then there will be a run and the banks will break. Conversely, if there is detachment or optimism about solvency, then the banks flourish. The story has the right ring, with good microeconomic foundations. It rationalizes why in Chile economic activity flourishes while it stagnates in Bolivia. It dramatizes that stabilization does not, in and of itself, unleash animal spirits. Only in a boom situation would there be a reason to invest in Bolivia, and why should anyone expect a boom?

The animal spirit model highlights that there is an important economy-wide externality; someone has to resolve the coordination problem

that shifts expectations and hence the economy to the good equilibrium. The conventional notion that government can only take the horse to the water by creating a favorable environment through stable financial policies and sensible policies resource allocation, but cannot make it drink is simply mistaken. External capital can provide a powerful umbrella for expectations as we saw in the case of Europe in the 1920s. When it is known that a country is black balled by the world capital market the likelihood of a bad equilibrium becomes far more likely.⁷ We now translate these ideas to the concrete problem of the return of capital flight and the resumption of investment.

The Waiting Option

A common problem in the aftermath of stabilization is the lack of a stabilizing capital reflow. Investors have an option to postpone the return of flight capital and they will wait until the front loading of investment returns is sufficient to compensate for the risk of relinquishing the liquidity option of a wait-and-see position.⁸

The waiting option is present even when interest rates are high and rewarding. Moreover, when capital does return it chooses a highly liquid form, sitting so to speak in the tarmac with the engine running. There is definitely little commitment to a rapid resumption of real

⁷For other applications of the notion of multiple equilibria and the scope for coordination see Calvo (1988a,b).

⁸The conceptual framework is familiar from the option literature and from the applications, especially by Dixit (1989). For an alternative formulation see Dornbusch (1990).

investment. The reason for this is residual uncertainty whether stabilization can in fact be sustained.

In the literature this topic has been addressed in a number of ways, mostly in terms of irreversible investment decisions.⁹ We concentrate here on a very simple two-period example to make the basic point. Suppose that investors have the choice between investing in the US or in Mexico. The return in the US in both periods is $R^* - (1+r^*)$. In Mexico the first period certain return is $R^* + m$. In the second period, with probability p events are good and the return is R^G . With probability $(1-p)$ they are bad and the return is only R^B .

The question now is how much of a first period premium is required to induce investors to accept the uncertainty and invest immediately for two periods. We assume that investors have the choice to postpone the decision to invest until the uncertainty is resolved; they cannot, however, disinvest in Mexico after the first period, upon finding out that a bad state has materialized. The decision then is to invest now or to wait until uncertainty is resolved.

Table 3 Expected Investment Returns

	1st Period	2nd Period
Invest in Mexico Now Irreversibly	$R^* + m$	$pR^G + (1-p)R^B$
Wait and See	R^*	$pR^G + (1-p)R^*$

⁹ See, for example, van Wijnbergen (1985) and especially Tornell (1988).

To sharpen the point we assume that the expected return in the second period is equal to the US return, that is $R^* = pR^G + (1-p)R^B$. The relevant criterion for immediate investment in Mexico then is:

$$(R^* + m)[pR^G + (1-p)R^B] > R^*[pR^G + (1-p)R^*] \quad (6)$$

which, noting that $R^* = pR^G + (1-p)R^B$, this expression reduces to

$$m \geq (1-p)(R^* - R^B) \quad (7)$$

Thus a risk neutral investor requires a premium to make an investment which has the same second period expected return (R^*) as his alternative investment opportunity. The reason is that with waiting an even higher return can be achieved, once uncertainty is resolved (or narrowed down). The premium required for immediate investment is higher the larger is the probability of a bad state and the larger is the discrepancy between the foreign rate of return and that prevailing in an adverse state.

The ideas can be carried a step further if we assume that there is a link between the probability of program failure and the size of capital reflow. Specifically let

$$(1-p) = \theta(K) ; \quad \theta' < 0 \quad (8)$$

where K is the reflow of capital. The excess return on assets in Mexico, m , is taken to be exogenous to the reflow. The criterion for the excess return in Mexico required to induce repatriation now becomes:

$$m > \Phi(K) - \theta(K)(R^* - R^B)$$

(9)

Figure 6 then shows the schedule representing the return on assets in Mexico, m , and the required return ΦK . There are two possible equilibria. If no capital repatriation is anticipated individual asset holders perceive a required return $\Phi(0)$ and see an actual return of w which is insufficient to cover their risk. As a result they do not repatriate and hence the bad equilibrium prevails. Because no capital has returned the equilibrium may be self-fulfilling in its assumption of a high probability of program failure. The other equilibrium is one where the individual investor expects at least K_0 to be repatriated. With so much repatriation the risk assessment drops sharply and every investor repatriates. As a result all capital comes back because the required return is below the actual payoff. The question then is how to trigger his "good" equilibrium.

How can governments reassure investors? The common answer is to bring about a "credible" stabilization. Credibility is the buzz word of

the late 1980s, used to explain vacuously why programs fail or succeed.¹⁰ In practice credibility comes down to high interest rates and an exchange rate so competitive that expected further depreciation is unlikely. But high interest rates are counterproductive from a point of view of growth because they lead to holding of paper assets rather than real investment. A low real exchange rate cuts the standard of living and thus reduces domestic demand and profitability for all investments except in the traded goods sector.

If real depreciation is not sufficient to bring about investment the government faces a very awkward position: income is being redistributed from labor to capital, but because the real depreciation is not sufficient (in terms of (9)), the increased profits are taken out as capital flight. Labor will obviously insist that the policy be reversed. This uncertainty is an important feature in understanding the real exchange rate - capital flight relationships and the post-stabilization difficulties. The option to postpone repatriation and the option to postpone investment in plant and equipment, in export markets or simply in working capital and, even more so, capacity utilization is an overriding obstacle to the resumption of growth. It requires front-end payments (or guarantees) that Latin American countries today find hard to deliver.

It is common to argue that these high front end payments required for investors to relinquish their option is a reflection of poor policies in the past and the projected uncertainty in the future. True,

¹⁰See Andersen (1989), Persson (1988) and Blackburn and Christensen (1989).

but how does one get out of that situation. Understanding the theoretical problems of time consistency and precommitment helps understand why one has a problem, it does not solve the problem.

Implications: The model highlights a critical insight concerning the role of external capital: as long as there is uncertainty about the exchange rate (and the unravelling of programs following an inability to hold the exchange rate) the credibility of a program is sharply reduced.

In the 1920s, almost immediately after the main stabilizations, Europe was flooded by American capital. The massive lending to Latin America that preceded the defaults of the 1930s had a counterpart in vast lending to European countries, from Poland to Germany, Austria and Central Europe. Some countries stabilized outright with the help of foreign loans (See Table 4). Others experienced capital inflows within a few years of stabilization on a scale that turned their currencies hard as a rock even if budgets were unbalanced. And the inflow of external capital, in a virtuous circle, provided the leverage and confidence for repatriation of flight capital.

This massive injection of foreign capital as a critical ingredient in European recoveries cannot be overemphasized. A quote from the 1930s may reinforce that point:¹¹

"Ethical and economic considerations alike were favorable to the export of capital to Germany at the end of the war. Apart from the gigantic industrial reorganization necessitated by the change from

¹¹Royal Institute of International Affairs (1937, p.235).

war to peace, and the need to ameliorate the actual physical distress of many of her inhabitants, Germany was also forced to pay large amounts as reparations to the victors and to attempt to reestablish the former standards of life of her people in a geographical area which had been shorn of some of the richest parts. Only by a long and difficult struggle could she hope to do this with the aid of her own capital accumulation, and she was forced to rely on foreign lenders to obtain the funds necessary for the work of reconstruction. These lenders, especially the United States, were more than willing to assist, and vast sums of money began pouring into Germany. In such circumstances, it is hardly to be wondered that Germany borrowed a larger volume of foreign capital in a shorter space of time than any other country has ever done."

In the period 1924-28 German net inward resource transfers averaged 3 percent of GNP. Much the same evidence holds for the other countries undergoing reconstruction.¹² The presence of capital inflows in the 1920s, and their absence today (and worse, the transfers abroad for interest or premature debt amortization) may explain the very different performance.

If this view is correct, the obvious implication is twofold: first, that suspension of debt service and amortization is a critical ingredient in recovery. Second, that without a significant injection of external capital the initial push for growth may not come. The models above suggest that there is no automatic mechanism that bypasses the option premium; on the contrary, if lack of growth deteriorates the political climate the lack of growth may even lead to a rising option value and hence a fundamentally unstable process of increasing obstacles to recovery.

¹²Calculated from League of Nations International Trade and Balances of Payments 1926-28 and Mitchell (1978).

The Need for a Mechanism

The discussion of the option value of waiting, and the associated credibility issue, highlights the way in which the competitive model fails to address the transition from stabilization to growth: where do the resources for investment come from and why would firms want to invest now. Stabilization by itself is not enough to trigger a virtuous circle. There is a need for a coordination mechanism that overcomes the competitive market tendency to wait.

What markets consider a sufficient policy action may simply be beyond the political scope of democratic governments. In fact, if governments went far enough to create the incentives that would motivate a return of capital and the resumption of investment on an exclusive economic calculation, the implied size of real wage cuts might be so extreme that now, on political grounds, asset holders would consider the country too perilous a location. In the aftermath of major macroeconomic shock there may simply be no equilibrium that is politically safe and economically rewarding on a scale that induces the return of growth as the response of competitive markets. Without the leverage afforded by external capital -- 1920s style or in the form of the Marshall Plan, there may be little prospect of reconstruction.

IV. CONCLUDING REMARKS

What is needed to move from stabilization to growth? Books on "Invest to Get Rich" are plenty; they recommend a habit of steady saving,

investing prudently and, switching off the light when leaving a room. It comes as no surprise that without a good dose of luck that will not be enough.

The profession is much better at negative advice:¹³ large budget deficits financed domestically, significant distortions, corruption, overvalued exchange rates are safe ways to go into deeper trouble. The point I have tried to make is that stabilization in this broad sense is not enough to provide an automatic mechanism of crowding in significant growth. The IMF paradigm plainly lacks credibility. Without substantial public sector support and a heavy dose of external resources growth will not get underway. I do not have the courage to predict that even a heavy dose of supply side economics and financial stability will give Bolivia more than very moderate growth without this essential extra support.

The second layer of growth economics is to create a social and political infrastructure for growth: either the legal institutions must be sound or else there must be an equivalent "system" as Asia practices. Education is a paramount factor, disastrously neglected in Latin America. Political stability requires a significant economic equality.

The third layer is animal spirits: Brazil had this in the 1967-80 period, and Chile has it today. It is fed by a virtuous cycle of external reinforcement. The domestic belief that growth is inevitable and the external belief that a country is doing "all the right things" combine to create over time the virtuous circle of external finance, investment,

¹³See Harberger (1983), Fischer (1988) and Dervis and Petri (1987).

growth and saving. Chile may be able to preserve this process if the coalition government can sustain financial stability; Colombia is there in a quiet way and Mexico may get there if the emphasis shifts from debt service to domestic investment.

To sustain the gains requires financial stability and avoidance of exchange rate uncertainty and uncertainty about the path of inflation. Continued efforts to eradicate public sector inefficiency are also a sine qua non. But above all efforts, ingenuity and resources must be concentrated to break the two bottlenecks of a lack of external resources and a lack of growth optimism.

Even today an excessive amount of attention focuses on debt strategy; this seems a misdirected effort in that the resources that go into debt reduction have an extraordinarily high shadow price; the reserves are the cushion for financial stability and the human resources would more likely produce growth if they were applied to drawing in direct foreign investment.

Contrary to the anti-state spirit of much of current discussion, public sector investment and credit initiatives are an important part of growth, far beyond the immediate alleviation of the extreme incidence of the fiscal austerity.

Finally, and perhaps most importantly, resumption of growth requires an external mechanism to help trigger confidence. This is not an issue of large resource transfers but rather of a confidence transfer. A long term stabilization loan, in the case of Mexico, is all it might take to return growth and even ultimate debt service.

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