

Diaz-Alejandro, Carlos F.

Working Paper

Southern Cone Stabilization Plans

Center Discussion Paper, No. 330

Provided in Cooperation with:

Yale University, Economic Growth Center (EGC)

Suggested Citation: Diaz-Alejandro, Carlos F. (1979) : Southern Cone Stabilization Plans, Center Discussion Paper, No. 330, Yale University, Economic Growth Center, New Haven, CT

This Version is available at:

<https://hdl.handle.net/10419/160257>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

ECONOMIC GROWTH CENTER

YALE UNIVERSITY

Box 1987, Yale Station
New Haven, Connecticut

CENTER DISCUSSION PAPER NO. 330

SOUTHERN CONE STABILIZATION PLANS

Carlos F. Diaz Alejandro

November 1979

Note: Center Discussion Papers are preliminary materials circulated to stimulate discussion and critical comment. References in publications to Discussion Papers should be cleared with the author to protect the tentative character of these papers.

Southern Cone Stabilization Plans

Carlos F. Díaz Alejandro*

Yale University

This paper deals with stabilization plans whose costs raise the question as to whether the remedy is worse than the disease, or what may be named the Southern Cone case, after the experience of countries located at the bottom of South America. At the outset, however, it should be noticed that not all stabilization plans are accompanied by sharp falls in output and massive income redistributions. And not all such benign stabilizations occur in Asia or Africa; within Latin America there are also examples of relatively small short-term costs of stabilization followed by rapid growth. Colombia in 1967 is one such case, but there are more.^{1/}

The first section of the paper will outline the initial conditions and the historical background to Southern Cone stabilization plans. The typical package of policy measures will also be discussed briefly. The second section will describe a stylized scorecard of the consequences of the plans. The third section will discuss some fresh complications introduced into stabilization plans by the high degree of international capital mobility observed in the late 1970s. Normative sections will close the paper, covering both the national and international dimensions of the Southern Cone case.

The topic at hand is controversial. In its purely economic dimension it deals with an area, short-run macroeconomics, which during the late 1970s was unsettled. Debate in the industrialized countries echoes

issues discussed in Latin America at least since the 1950s; just as in those old debates, it is often difficult to establish where scientific economics ends and political preference begins. Judgments about the speed of adjustment in different markets and evaluation of the social costs of alternative dynamic paths are still based mostly on hunches and sketchy evidence. The eclecticism of this paper reflects the troubled state of macroeconomics.

It would be disingenuous to hide one's political preferences behind the technicalities of stabilization plans, at least when discussing the Southern Cone case. The awesome events of the 1970s in that part of Latin America rule that out. The reader is warned that what follows reflects a perplexed centrist political position, which to reject the horrors of the Bureaucratic Authoritarian State^{2/} finds it unnecessary to cover up the economic "chien-lit" of Populism. The key underlying assumption will be that a mixed economy is a desirable and feasible model for most Latin American countries.

Many will find the combination of eclectic economics and centrist politics comfortable only for a fence-straddling academic critic. Perhaps. For what it is worth, the hope that the 1980s will see that messy and undramatic formula gaining ground in Latin America encourages the writing of this paper.

I. Historical Background and Initial Conditions

The post-Second-World War economic history of Southern Cone countries is littered with failed stabilization plans; in some cases the

failures go further back. The basic failures are the inability to bring inflation down to U.S. (or in earlier days, U.K.) levels, and to eradicate tendencies toward disequilibrium in the balance of payments. A plausible hypothesis is that, ceteris paribus, the longer the history of failed stabilization plans, the smaller will be the chances of success (and/or the greater the costs of success) of any new plan. Besides reading daily newspapers, economic agents carry in their heads an economic history inducing them to discount any claim that "inflation will be down to zero within a year", regardless of how fiercely those claims are backed up. The expectations forming their behavior are based less on textbook models than on memories of previous failures within their own country. If, as it appears to be the case, the private cost of erring on the low side is greater than that of too high an estimate of inflation, the stage is set for a viscous inertia in the inflation rate.^{3/} Inflation turns out to be more like Sisyphus' rock than like Alexander's knot.

A typical Southern Cone stabilization plan will be preceded, say during the one or two years before its announcement, by an acceleration of the chronic inflation. That acceleration will be accompanied by an increased variability in relative prices, a variability having little justification from the viewpoint of economic efficiency. Both the rate of inflation and relative prices become less predictable at this stage. Part of the erratic fluctuations in relative prices will arise from government attempts to control inflation by sporadically freezing some prices regarded as strategic, such as those for foreign exchange, necessities, public utilities, transport and credit, followed by abrupt upward adjustments. As those adjustments are only partial, most of those

prices including interest rates will move far away from plausible equilibrium values.

Deficits in the balance of payments, vanishing foreign exchange reserves and difficulties in servicing the foreign debt will be of more immediate concern than the acceleration of inflation and the growing variability and distortion of relative prices to governments which for short will be called Populist in this stylized description of events.

Both internal and external factors contribute to bring about this lamentable state of affairs. The early stages of Populist governments are likely to have witnessed substantial expansion in government expenditures not financed by tax collections, either because the opposition blocks efforts to raise taxes or because the government regards fiscal and monetary management as less important than structural reforms. Fiscal deficits are more likely to be financed by borrowing from the Central Bank than from either the domestic or foreign private sectors. Increased public expenditure will be channelled more towards consumption than investment, although in human capital formation important advances may be registered. Across-the-board massive wage increases also accompany the early stages of Populist governments. Because these measures will be felt first in output expansion, especially of wage-goods, rather than an acceleration of inflation (which may even decline during the early stages of Populism), the government will be confirmed in the wisdom of its heterodoxy. Pressure on the balance of payments in those early times can be handled by strengthening administrative import-repressing mechanisms, drawing down reserves and seeking foreign loans. Even sympathetic observers warning of future dangers due to excesses in fiscal, monetary, exchange rate and income policies will be dismissed by the remark that "now the economy works

differently". Under those euphoric circumstances concern for economic efficiency, export-promotion and a minimum of concern for fiscal and monetary prudence will be regarded as prima facie evidence of "reactionary positions" not only by most Populist politicians, but also by government economists giving top priority to achieving structural reforms, or seeking a rapid transition to a centrally planned economy, or simply believing that economic efficiency, export-promotion, and prudent fiscal and monetary policies are of little consequence for the welfare of most people in the country.

External events may or may not add to the euphoria of the early stages of Populism but frequently add to its closing troubles. The external shocks may come from a deterioration in the terms of trade, or from hostile foreign governments intending to "make the (Populist) economy scream." Even when the external shocks (or an exogenous domestic one, such as a drought) are relatively minor, they can seriously destabilize an economy already weakened by the consequences of Populist economic policies.

During the last stages of Populism there will be general agreement that "things cannot go on like this" and that something must be done. Within the Populist coalition some will argue for a bold move toward centrally planned socialism, thus further encouraging capital flight and a slump in private investment. Moderate Populist technocrats may be able to attempt their own stabilization plans, which will come too late. The opposition will move for the kill, culminating in a military coup.

The new government then launches its stabilization plan, usually in consultation with the International Monetary Fund. A first thing to note is that the plan will have several targets: a restoration of balance of payments equilibrium and the orderly servicing of the foreign debt; control and elimination of inflation; and the creation of a structure of relative prices conducive to an efficient allocation of resources. Plans undertaken most recently are more emphatic, and even radical, regarding the need for basic policy reforms, especially in the areas of foreign trade and domestic financial markets. Earlier plans, say those of the 1950s, focused mostly on short term balance of payments and inflation targets, leaving the system of protection and "financial repression" largely unaffected.

The instruments are well known: strict limits on the expansion of overall banking credit; reduction in the share of that credit expansion claimed by the public sector; adjustment, often large and abrupt, in the prices which had lagged behind inflation, especially the price of foreign exchange and interest rates; the removal of distortions, such as import controls and excessive tariffs; and, somewhat inconsistently with the new dominant philosophy, a special kind of incomes policy consisting primarily of tough limits on money wage increases. Once-and-for-all steps will accompany the stabilization package, such as the renegotiation of the foreign debt. Naturally, each plan will have sui generis targets and instruments, but for a given epoch their differences are less remarkable than their similarities.

The circumstances under which these policies are undertaken will not allow for much "fine-tuning" of the instruments, nor a careful phasing of the different measures through time. The "something-has-

to-be done" syndrome, however, will give the new authorities some room to maneuver; for a considerable time they can blame economic difficulties on the deposed Populists, and a relieved bourgeoisie, with their property rights confirmed, will contemplate short term economic hardships with equanimity. Entrepreneurs, in particular, will find the reestablishment of their authority within factories ample compensation for sluggish sales. Social groups openly opposing the new policies will be handled manu militari.

The coherence and steadiness of application of the stabilization plans should not be exaggerated. Authoritarian regimes are not free of hesitations, internal divisions nor personality clashes. Even when The Minister does not change, policies may be significantly modified, as in Argentina since 1976. Two different views of the exchange rate, for example, may claim the mantle of orthodoxy: one advocating a fair degree of flexibility, another wishing to use the exchange rate to guide the price level toward stability. The former or "old orthodoxy" regards the money supply as the main determinant of the domestic price level and orients the exchange rate toward balance of payments targets. The "new orthodoxy" will favor manipulation of domestic credit expansion as the key for achieving balance of payments targets, sharing with old structuralists the belief that the exchange rate cannot influence relative prices, but only the price level. While the "old orthodoxy" relied on models developed for large industrialized countries, the "new orthodoxy" views Southern Cone circumstances as not very different from those of Benelux and Central America. What follows will necessarily abstract from changes and countermarches in stabilization plans, but will return to the variety of views on exchange rate policies.

II. The Scorecard

The stabilization plans achieve their clearest and quickest success in the Balance of Payments. Within months international reserves will be on the rise and foreign creditors becalmed. Developments in the capital account, having to do with financial flows, explain a good share of the short-run turnaround. Debt renegotiation, IMF credits, the end and reversal of capital flight and the end of speculation against a previously overvalued exchange rate all contribute in the same direction. These considerations, which were already important in stabilization plans adopted during the 1950s, have become even more so under the circumstances of the late 1970s. Some special characteristics of stabilization plans undertaken in a world of high financial capital mobility will be discussed in the next section.

Help from the current account will be modest in the short run. However, a drop in the quantum of merchandise imports may contribute something to balance of payments equilibrium even in the very short run. A number of conflicting forces influence the import quantum: the levels of domestic output and capital formation; the new domestic relative price of importables (itself subject to contradictory influences from devaluation versus liberalization and tariff cuts); the cost and availability of foreign export credits; and the levels of domestic inventories of importables at the time of the launching of the plan. The net result of these influences will be in doubt, and will provide a clue as to whether the stabilization plan is having severe short term costs: a steep drop in the import quantum is likely to signal a severe slump in real output and investment.

An increase and diversification of exports has been a major secondary target of stabilization plans, with some variety in the instruments brought to bear for that purpose. An increase in the real exchange rate applicable to exports is a common feature; its greater stability has also been sought by a crawling peg policy. In addition, some plans introduce or expand selective tax, credit, and other subsidies as part of the export-promotion package, in spite of IMF disapproval. In the very short run these measures are unlikely to be reflected in an increase in the export quantum. But their success in increasing non-traditional exports in the medium run, often aided by the excess capacity created by a fall in domestic demand, has been a more noteworthy feature, and one of the most impressive successes of stabilization plans. Evidence indicates a clear victory for export-optimists.

Inflation has proven to be more stubborn than the authors of stabilization plans expected. Before the start of the plans hyperinflation was often at hand; it is unclear whether, ex post, this provides a good explanation for the disappointing results obtained in this front, as it could be argued that hyperinflation provides conditions making its abrupt termination possible, as in the Central European cases of the 1920s. No Southern Cone stabilization plan has attempted a currency reform, and in the very short run the adjustment of lagging strategic prices has in fact frequently led to an acceleration of inflation. After the burst of "corrective inflation", authorities will take pride in the deceleration of price increases, even if the deceleration does not match official

forecasts. Even the consolation of ever declining rates of inflation comes to an end after four years or so, before reaching, say United States levels. Very seldom is the rate brought down below the 15-20 percent per annum range; it may remain above what the country had historically experienced in what the new authorities depict as the "bad old days". Ironically, at this late and frustrating stage, there may be moves to further squeeze inflation by delaying not just wage adjustments, but also the crawling peg and other key prices, such as public utility rates. Standard price indices may be revised, leaving out items experiencing the largest price increases. As under Populism, these tactics will contribute to expectations opposite to those the authorities had hoped for.

Even in cases where excess demand was a plausible explanation for the high rates of inflation during the pre-plan period, its explanatory power declines as the months go by and excess capacity and foreign exchange reserves pile up. Remaining fiscal deficits and/or high rates of increase in the money supply provide weak explanations under conditions of declining output and shrinking real credit and cash balances. Excessive trade union power can hardly be blamed when real wages collapse and union leaders are jailed, or worse. One is left with still imprecise references to lags and expectations, to increasing mark-ups, to monopoly power in industry and commerce or to imported inflation. This state of affairs is also found in industrialized countries; what makes the Southern Cone case unique is the bewildering quantitative dimensions of the stagflation problem.

The failure of import liberalization and tariff reductions to contain price increases in the very short run has been disappointing; far from competitive commercial firms or recalcitrant custom officials may block a result expected a priori and emphasized with hope in the 1960s literature. The upward thrust provided by exchange rate devaluation works faster than the downward pressures generated by tariff cuts and the elimination of import quotas. More generally, the Law of One Price, so important for models underpinning the new orthodoxy, appears to work better on the side of exportable goods than elsewhere; the line between importable and non-traded goods is blurry, especially in countries which have lived under rigorous protection for many years. An Argentina is not quickly turned into a Netherlands (nor a Guatemala).

It can be argued that the inflation persisting after the start of the stabilization plan may be surprisingly stubborn, but at least it is accompanied by less distortions and less erratic relative price changes than the prestabilization one. The payoff to a more rational structure of relative prices in terms of increased real output, however, will be slow in coming. Indeed, either stagnation or a decline in output has been more usual in the Southern Cone. Given the restructuring of incentives one could have expected a decline in production of some sectors, such as those producing highly protected importables and some non-traded goods. But their decline is often not only speedier than the expansion of sectors now enjoying favorable incentives but also unnecessarily drags down the output of many non-traded goods.

In spite of continuing price increases, one may diagnose this situation as arising from a reduction in aggregate demand going beyond what is required to make room for an expansion in the production of

exportables and those importables and non-traded goods benefitting from the new constellation of relative prices. This overkill is one of the more puzzling economic features of Southern Cone stabilization plans, and perhaps cannot be fully explained without reference to the new authorities' wish to "discipline" the labor force partly by creating a soft labor market. The high priority given to a quick restoration of balance of payments equilibrium and smooth foreign debt servicing also contributes to the overkill.

The cut in real aggregate demand arises partly from policies already mentioned, such as the reduction in domestic credit expansion for both the public and the private sectors, as well as from redistributive effects generated by the policy package, which have asymmetrical spending consequences. The most spectacular of these is a reduction in real wages of the (previously) best organized segments of the urban working class, which are quickly reflected in a fall in consumption of wage goods. Real wage rates in these economies influence aggregate demand as well as profit rates and international competitiveness; in the short run the output depressing effect of wage cuts outweigh their expansionary impact via the latter mechanisms.

The success achieved in the fight against inflation, modest though it may be, is to be credited to a large extent to the wage-repressing incomes policy, while the balance of payment success derives support from the sagging real aggregate demand.

The restructuring of relative prices generates many other short run redistributive effects. A priori there is no reason why they should influence overall income distribution in a systematic way: losers in highly protected industries, those who had access to artificially cheap credit or cheap imports, etc., are likely to have been

in high-income groups, while producers of exportables could include small farmers. Consumers of previously subsidized foodstuffs in the cities may have income levels higher than those of rural food producers. In the Southern Cone case, however, the net effect of the policy package appears to have a regressive effect on income distribution, although the general picture is murky. Open urban unemployment, for example, has been substantial in the post-1973 Chilean case and relatively minor in the post-1976 Argentine plan. Argentina, like Germany, seems to have exported its unemployment to neighboring countries. The decline in real wages in Argentina and Chile, which had started before the change in government, was so steep as to raise questions as to how households managed their budgets; in the Chilean case the combination of falling real wages with increasing unemployment for a non-trivial length of time has been particularly striking. The workings of formal and informal labor markets under these peculiar conditions remain unclear, but it appears that structural changes have occurred and that wage dispersion has increased.

During the early stages of stabilization plans asset markets will be especially volatile, as expected changes in relative prices and in the rules of the game are capitalized. Those well-informed and with access to national or international institutional credit can make large sums in a short time. The long-run efficiency gains from such financial speculation, especially when it is based on privileged knowledge of future public policy, are moot. Sensational capital gains by a few will not improve willingness by the many to tighten their belts.

A cut in consumption is less painful when accompanied by an increase in investment. Perhaps the most disappointing feature of many of the Southern Cone stabilization plans is the weakness shown by capital formation, particularly when the public sector leads in reducing its investment, as in the Chilean case (in contrast with the more pragmatic Brazilian example). A skeptical private sector shows caution in undertaking long term commitments, particularly when the newly liberated financial markets offer fairly liquid investment outlets with high yields. Excess capacity in many industries producing importables and non-traded goods provide little encouragement for capital formation, but even in those sectors where incentives are favorable and capacity limits output entrepreneurs with long memories prefer to wait until the dust settles. Foreigners will act not very differently from domestic entrepreneurs: they will show more interest in buying paper than in installing machinery and equipment. The new open door policies will reap only modest results, at least in the short and medium runs, in direct foreign investments; the new investments are more likely to go into natural resources and finance than into manufacturing. From the viewpoint of the balance of payments, however, the sluggishness in overall capital formation will be most clearly reflected in a decline in imports of machinery and equipment.

Even a perfectly rational constellation of prices and investment incentives cannot fully convince entrepreneurs that such edifice will be in place tomorrow. When economic rationality is built upon an arbitrary political regime, which may depend on one General's heartbeat,

entrepreneurs will not be easily persuaded that today's relative prices are good predictors of future ones. While the economic team builds policy on the assumption that households and firms behave rationally and process information intelligently, the political team assumes citizens cannot be trusted to choose their leaders nor to read an uncensored press.

III. Some Additional Complications of the Late 1970s

Stabilization plans differ in design and consequences not only from one country to another, but also for the same country at various times. For example, external circumstances changed between the 1955 and the 1976 Argentine stabilization plans in some crucial aspects. During the 1970s inflationary impulses coming from abroad made domestic disinflationary efforts even more difficult. Indeed, it is frequently argued that inflation in the dollar prices of the basket of tradable goods relevant for Southern Cone countries has been far greater than the inflation registered in standard U.S. price indices. Volatility in external terms of trade has also risen during the 1970s; for some countries, especially oil importers such as Chile and Uruguay, there have been sharp deteriorations in terms of trade at crucial stages of their stabilization plans. The 1970s have also witnessed a large increase in international short-term capital mobility; this section will focus on how this fact has influenced Southern Cone stabilization plans.

As noted earlier, these plans have coupled more liberal trade and exchange rate policies with some liberalization of domestic financial markets. Complete liberalization of those markets has not been

usually achieved^{4/}, but enough has been done to generate fresh dilemmas.

The major dilemma can be sketched as follows. Trade-liberalization reforms have sought a higher and more stable real exchange rate, so as to expand and diversify exports, and to reduce reliance on import controls and tariffs. The liberalization of local financial markets tends to increase real returns on domestic financial assets, even when the stabilization plan achieves only modest results fighting inflation. Restrictions on domestic credit expansion typically accompany the policy reforms, so that local interest rates can go substantially beyond those abroad plus the expected exchange rate depreciation. Domestic and foreign wealth owners will increase their net holdings of local financial assets, while local entrepreneurs will seek foreign loans. Some of these tendencies were already present in stabilization plans of the 1950s; since then, however, the interest-elasticity of the international supply of financial funds has increased dramatically and the local financial markets have become more fluid and sophisticated.

With an unrestricted link between the domestic and the international financial markets, large portfolio adjustments will occur, and a capital infow will result. The real exchange rate will appreciate relative to what it would have been without such an inflow. The liberalization of the domestic financial market and of its links with those abroad will work at cross-purposes with export promotion. If at the same time the authorities are dismantling import-repressing mechanisms, the import-competing sector will be doubly damaged. Eventually the portfolio adjustment should be completed and a larger net debt will have to be serviced so that the real exchange rate, to the delight of exporters, will have to depreciate relative to the days of the capital inflow.

In a growing world some gross inflows will persist, but pressures on the exchange rate will be similar to those outlined.

In practice the transition is proving to be far from smooth. Many imperfections remain: some segments of the local financial market are still controlled, leading to a high variance in interest rates. Most transactions are short term; efforts to build a local market for financial instruments with maturities of more than a few months have met with little success. High reserve requirements introduce a large wedge between active and passive interest rates when the Central Bank pays no interest on those reserves. Even when the passive rate eventually becomes equal to the foreign interest rate plus the expected depreciation of the exchange rate, those borrowers who have no international financial links must pay the often extravagant local active rates. Such differentiation between entrepreneurs, according to their borrowing facilities, will have both equity and efficiency consequences.

Southern cone authorities have been reluctant to allow the exchange rate to fluctuate freely; they either maintain a crawling peg whose formula is only vaguely known, or announce what the gradually depreciating exchange rate will be for several months in advance. In either case capital inflows will be reflected in changes in official foreign exchange holdings, which will swell the money supply. An increasing share of the expansion in local money will come from changes in exchange reserves, at the expense of domestic credit expansion. The more fluid the link between domestic and international financial markets, the greater the loss of control over the money supply will be. While Southern Cone monetary authorities hesitate between the old and new orthodoxies, the management of domestic credit, exchange rates and international

financial flows can become erratic.

Argentine experience during 1978 and 1979 illustrates most clearly some of the troublesome short run dynamic processes which can occur under the new circumstances.^{5/} Argentine authorities have announced the exchange rate with respect to the U.S. dollar for several months ahead of time, hoping that such information will help to cluster inflationary expectations around a lower path.^{6/} At the start of this policy, domestic interest rates, or at least a significant group of them, substantially exceed foreign dollar interest rates after adjusting for expected devaluation of the peso relative to the dollar. Massive financial inflows occur, expanding Central Bank reserves and the money supply. This injection of liquidity will relieve at least some agents pressed by ceilings on domestic credit expansion. If future devaluation schedules are sensitive to accumulating foreign exchange holdings, so that there is a slowdown in the pace of peso devaluation, certain instability will be introduced, as that slowdown will further increase the attractiveness of domestic financial assets, thus leading to an even greater capital inflow. Exporters and previously protected producers of importables will find these short run dynamics singularly perverse, and will clamor for faster devaluation or subsidies. Authorities will point to bulging reserves as evidence that faster devaluation is unnecessary, a proposition which net borrowers from abroad, importers and outflowing tourists will find very sound. Those in charge of battling inflation will also look kindly upon the revaluation trend, as under the new orthodoxy the exchange rate is expected to determine the price level, while money supply is regarded as endogenous (domestic credit expansion being the policy variable under the control of the authorities).

Even if the pace of devaluation is not adjusted downward because of large reserves, producers of tradable goods will face a difficult period of transition, during which it is likely that the prices of non-traded goods will rise at a faster pace than those for traded goods. In countries historically concerned with foreign exchange shortages, the Swiss-type embarrassment of riches brought about by capital inflows is a novel situation, and a bitter surprise to exporters who expected that the new policies would encourage their activities.

Debates as to whether a given currency is overvalued or not have become more complex in the 1970s than they were in earlier years. Even if one takes a simple purchasing-power-parity (PPP) approach to what the exchange rate should be, one has to agree on the relevant index for "rest-of-the-world" price increases. One problem, already noted, is that world prices for the Southern Cone basket of tradables seem to have behaved differently from standard U.S. (or U.N.) indices. Then one has to take into account fluctuations among key currencies to devise a suitably weighted effective exchange rate. Moving beyond a simple PPP approach, allowances would have to be made for the effect on equilibrium exchange rates of changes in external terms of trade as well as in domestic commercial policies which are considered permanent. Tendencies in long-term capital flows, as well as judgments about productivity growth in different sectors of the economy (e.g., has there been a permanent change in Pampean rural productivity growth?) also have to be taken into account. Reasonable people can disagree on a number of these judgments, a disagreement encouraged by erratic world market conditions and compounded by faulty data. The urge to "let the market decide" is checked by doubts as

to the desirability of a clean float in countries where, in spite of recent reforms, domestic financial markets remain limited.

It was noted earlier that in several Southern Cone countries local interest rates have remained substantially above those abroad plus exchange rate depreciation, even when large capital inflows have been registered. A number of hypotheses, which cannot be explored here, are compatible with this stylized fact. Note, however, that domestic interest rates can be negative, defined with respect to local inflation, yet incentives could remain for an inflow of short term capital. Such a situation, which prevailed in Argentina sporadically during 1978-1979, is quite plausible when prices of non-traded goods are rising faster than the pace of exchange depreciation and/or when the "world" nominal interest rate is lower than "world" inflation. Note further that under these circumstances the indexing of public debt instruments so as to make their interest rates positive with respect to local inflation will introduce downward stickiness to domestic interest rates. That indexing will also encourage speculative shifts among different financial assets depending on inflationary expectations. A generous indexing of public debt could then be said to be "crowding out" not only private capital formation, but also the production of tradable goods via the induced capital inflow and the resulting real appreciation of the exchange rate. Public expenditures financed by such borrowing are less likely to involve capital formation in some cases (e.g., Argentina) than in others (e.g., Brazil). The future servicing of such public debt could raise serious problems.

The important role played by indexed public borrowing in the liberalization of domestic capital markets coupled with the also

extensive public sector borrowings in international capital markets raise the issue of the optimal mix of both types of borrowing, both from a narrow public finance viewpoint as well as from that of strengthening and developing local capital market institutions. So far, domestic capital markets appear unable to compete with international ones in medium and long-term maturities; it is often asserted that in Southern Cone (and other Latin American) countries international capital markets are still used to intermediate between domestic residents except for short term and marginal transactions.

Even authorities as committed to laissez-faire as those in Chile have been unable to handle pressures arising from international short-term capital flows without recourse to ad hoc compulsory deposit requirements for foreign loans to the private sector, raising their effective interest costs. The more pragmatic Brazilian authorities have frequently used those measures as well as other forms of exchange controls, plus a crawling peg which keeps speculators guessing, all limiting the short-term links between domestic and international capital markets.^{7/}

IV. Are these Hardships Really Necessary?

To what counterfactual situation should one compare Southern Cone stabilization plans? Earlier sections have emphasized the difficult economic and political conditions under which they are undertaken; it will not do to criticize those plans in a spirit of self-confident ahistorical perfectionism. The present state of macroeconomic theory would make such pretension doubly rash. Furthermore, these stabilization plans include measures, particularly in the area of foreign trade, whose details and timing may be debated, but whose major thrust was long overdue in the Southern Cone. It would

be tragic if those justifiably revolted by the political excesses of the Bureaucratic Authoritarian State were to make a one-to-one association between, say, export-promotion policies and those regimes. At least when evaluating economic policies, a spirit of selectivity and restraint should guide the critique. The architects and apologists of Southern Cone stabilization plans would also benefit from this stance; their strident triumphalism, and claims to scientific superiority, facilitated by the suppression of domestic criticism by brute force, are at best ridiculous. It is indeed a melancholy spectacle to see those trained in free debate and fierce contempt for economic irrationality becoming meek political minions of Madmen in Authority.^{8/}

Accepting that some sort of stabilization plan was necessary, one can discuss the importance given to different targets, the use made of various instruments and the time frame adopted in the use of instruments and to achieve targets.

It was seen earlier that major costs of Southern Cone stabilization plans have included a reduction in output and a lag in capital formation. Austerity in consumption has not necessarily led to more investment, but to underutilization of the labor force and installed capacity. It is difficult to accept that this waste is necessary either as atonement for past excesses or for future efficiency. Too simple a diagnosis of inflation leads to an excessively sharp reduction in aggregate demand, using credit, fiscal and incomes policies. A doctrinaire faith in private as compared with public investment contributes to these costs. Here one can contrast the Brazilian and Colombian practice with that

of Chile; the former have maintained fairly active public investment programs even during stabilization plans. The more those public investments contribute to expand capacity in bottleneck sectors, or the more they fit with the restructuring of the economy along more efficient lines, the better; but even that old employment-generating standby, public construction, could be preferable to severe underutilization of labor and capacity.

Even while proclaiming faith in laissez-faire, Southern Cone stabilization plans have adopted incomes policies, albeit of an unbalanced sort. Official action has tended to directly repress wages more than prices. Some argue that competition, particularly that coming from abroad, will be enough to restrain prices, but that state power is needed to countervail that of trade unions. Blaming Southern Cone trade union power seems ghoulish in the late 1970s; faith on the speedy competitive discipline overly optimistic. As noted earlier, countries which for many years have had fairly closed economies are likely to take some time before developing commercial channels which effectively enforce the Law of One Price between foreign and domestic markets. At least during the transition period there is room for price guidelines covering the largest industrial and commercial firms, guidelines which could be based on projected changes in exchange rates, tariffs and foreign prices. Those guidelines could help cluster private expectations about future inflation better than exaggerated claims often heard at the start of harsh stabilization plans. Given the historical record, the goals of more rational, less volatile relative prices, and a more predictable overall inflation rate deserve

greater weight than "whipping inflation now". In countries with a tradition of price stability it makes much sense to take extraordinary measures to suppress the beginning of inflationary pressures, yet for countries with long histories of chronic inflation sporadic fits of monetary machismo will buy few positive tangible results.

Reliance on a preannounced and declining rate of exchange rate devaluation as the key instrument to lower inflation also appears as excessively risky. Stubborn inflation in the prices of non-traded goods can lead to overvaluation. The real prices of exportables could be both less favorable and more unstable than under a crawling peg regime whose devaluation pace is not announced, as in the Colombian and Brazilian cases. The latter system has the virtue that while it signals that the government will maintain "reasonable" and steady real prices for exportables over the medium and long run, it keeps speculators guessing, thus helping to reduce short-term capital flows which may be destabilizing. Preannounced exchange rates reduce the uncertainty of financial speculators while increasing that of exporters, a peculiar trade-off. It could be argued that for the sake of maintaining the momentum of export expansion and diversification the Colombian-type crawling peg adopts an accommodating stance toward inflation. Yet, if the preannounced and slower devaluation pace fails to reduce inflation fairly quickly, expectations will grow that sharper devaluations lie ahead. The government will be faced with the 1950s dilemma of giving in to such expectations, rekindling after all the inflationary spiral and losing any remaining credibility, or adopting very contractionary policies to validate the overvalued exchange rate.

Stabilization plans have usually improved the fiscal machinery of the public sector: tax-collection has been tightened up and prices of public enterprises have been raised. Generally, however, even the most authoritarian regimes have been timid in using selective fiscal measures improving both efficiency and income distribution, such as land taxes, or in taxing windfall profits and luxury consumption. These measures could help to spread austerity more evenly without harming efficiency and growth.

The combination of steadier real aggregate demand, larger capacity-augmenting capital formation and firmer and more balanced incomes policy may result in higher or lower overall rates of inflation than those actually registered. Improvements in the balance of payments and reserve accumulation, however, would clearly be less dramatic than those observed. Looking just at the results of Southern Cone stabilization plans one could conclude that the Balance of Payments target has been the one authorities really care about. Such a stance makes more sense for the International Monetary Fund and foreign creditors eager to see punctual debt servicing than for domestic authorities. Maintaining higher levels of real demand and capital formation would lead to substantially higher imports than those observed, and it could marginally reduce the upsurge in non-traditional exports. An easier credit stance could mean lower real interest rates, and a less frantic pace of financial capital inflows; direct foreign investment, however, could be more buoyant. On the whole, balance of payments and reserve targets will have to be more modest, and a different mix of private and public debt may be necessary.

Policies redressing the balance of incentives as between exports and import-substitution were long overdue. During the 1960s steps had been taken in this direction by some centrist Southern Cone governments, such as those of Presidents Frei and Illia, but not boldly enough. More recent efforts to open up the current account cover a variety of approaches, from the eclectic Brazilian and Colombian policies to the fiercely textbookish Chilean ones. The former have included, besides exchange rate policy, selective export incentives, such as tax and credit subsidies, direct deals with large companies, etc., while never completely dismantling import controls nor reducing tariffs to almost free trade levels. It is unclear to what extent the very rapid elimination of import-repressing mechanisms in Chile and Argentina have contributed to short-run output and investment sluggishness independently of cuts in real aggregate demand; it could be that the latter have been much more powerful than the former. What is clear is that the Brazilian and Colombian policy packages have been compatible both with reasonable growth rates in output and investment, and with significant expansions in non-traditional exports. In the Colombian case import liberalization came after substantial progress had been registered in export promotion.

While foreign trade policies of semi-industrialized countries have been exhaustively studied and discussed for at least twenty years, less efforts have been invested in the study of the capital account of their Balance of Payments, besides those related to obsolete discussions of foreign aid and inconclusive debates on costs and benefits of direct foreign investment. As noted in Section III, the interaction of liberalization of domestic financial markets with a highly efficient and ubiquitous international capital market

generates pressures which policy makers could safely ignore during the exchange-control-riddled world of the 1950s. While much additional work is necessary in this area, it appears that a liberalization of the current account should take precedence over liberalizing the capital account. This approach is similar to that of the Bretton Woods charter, and is consistent with the post-war practice of a number of small open European economies, such as Denmark and Finland, which have maintained restrictions on the freedom of domestic residents to choose their financial portfolios among all international assets, and have also exercised market as well as non-market controls over financial inflows. In some cases the exchange rate applicable to capital transactions has differed from that used for current account operations. These policies may be discussed as to efficacy (can they be enforced?) as well as to their long-run effects on economic efficiency. But their presence even in sophisticated economies indicates the seriousness of the concern that capital flows can generate disruptive short-run macro-economic disturbances. Given the magnitude of domestic disequilibria during the implementation of Southern Cone stabilization plans, and the weakness of the monetary tools available to the authorities, the real costs of the disturbances which could follow a premature lifting of controls over international financial flows could be substantial.

One may also wonder whether without some "infant market" protection, local financial markets will be able to grow beyond marginal short-term intermediation. Note also that even in the United States there are troublesome inequities in the fact that smaller domestic banks and their customers have less access to the Euro-currency market than the large international banks and their customers;

the former are said to absorb a disproportionate share of the burden of restrictive policies^{9/} In the Southern Cone this dichotomy will overlap with that involving domestic firms and transnational enterprises.

Both in Argentina and Chile the rebirth of a variety of financial instruments offering handsome returns has probably contributed to a sluggish rate of real capital formation. Indeed, the coexistence of high real interest rates with mediocre output and investment performance, as in Chile, raises the question as to which are the projects or activities generating returns sustaining the interest charges. The liberalization of the domestic financial market appears to have shifted the burden of the "inflation tax" from savers towards marginal investors, with substantial deadweight losses in the process. A more expansive domestic credit, at the expense of capital inflows, could reduce those losses while maintaining the gains domestic financial liberalization has brought to savers, especially small and medium ones.

V. The International Framework

The rest-of-the-world provides credit to a country with a current account deficit. It may do so in a variety of ways: buying its short or long term paper, which may originate in its public or private sector; buying real assets, etc. Under normal circumstances these arrangements can be made following standard market procedures, i.e., foreign finance will be hired paying the going market rate. At Bretton Woods it was

thought that such a mechanism should be supplemented by an internationally controlled public source of short-term finance, cheaper and more stable than alternative private sources. Under the assumption that these funds would have a non-trivial social opportunity cost, access to them could not be automatic, so that the International Monetary Fund, acting as the agent for the rest-of-the-world, would impose conditions to ration their use. Presumably the rest-of-the-world would have two major concerns when dealing with a given country: how that country's policies affect world economic conditions, and getting the money back. In dealing with small countries one at a time, the latter consideration would be paramount. Longer-term interactions between the small country and the rest-of-the-world would presumably be handled via other mechanisms and institutions, such as the World Bank.

These broad notions, which probably command widespread support, in practice can be implemented with different degrees of liberality. Not all countries are equally likely to be borrowers from the IMF, so differences will arise regarding "conditionality." This was already true in 1944 and was reflected in the contrasting British and U.S. approaches about access to the Fund. Since then, the creditors' view has been reinforced, so that less developed countries as a whole regard the IMF as a niggardly source of credit. Semi-industrialized countries confident of their ability to obtain private finance on their own have bypassed the Fund; Brazil has been an example of this attitude. Other countries have attempted such a stance, but either because of bad luck or internal mismanagement have had to return to

the IMF as a lender of last resort and dispenser of an internationally-credible "Good Housekeeping seal"; Peru is the obvious example.

Under the latter circumstances harsh conditions will be likely, in turn reinforcing the Fund's Gothic image.

Regardless of who is to blame for this state of affairs, the consequence has been an underutilization of IMF credit, prima facie evidence that something is amiss in the international framework within which the balance of payments adjustment of semi-industrialized countries occurs. Within the Southern Cone context there is tangible evidence of this point. The Fund's purpose includes not only supplying adequate credit flows while adjustment takes place, but also the provision of a prudent stock of international liquidity. Even those semi-industrialized countries adopting somewhat more flexible exchange rate policies have maintained a strong demand for international reserves. Indeed, world economic conditions during the 1970s, from the floating of key currencies to the increase in the probability of various shocks, may have increased that demand. During 1977 and 1978, for example, the ratio of international reserves to merchandise imports in both Argentina and Brazil reached levels substantially above averages for the last twenty years.^{10/} Even if this ratio had remained at average levels, rising world prices would have induced an increase in the demand for reserves. The contributions of SDRs and Fund credit in the increase in Argentine and Brazilian reserves have been small; most of the increase in liquidity has been obtained by a more expensive and precarious fashion, i.e., expanding the foreign debt, mainly to private banks.

Fund-generated increases in international liquidity may improve the environment for stabilization plans, but they will not drastically help to minimize their short-term costs. Traditionally the Fund viewed stabilization plans within a one-year horizon, which tended to increase the chances of severe cuts in output and capital formation. In recent years this position has gradually changed, and stabilization plans have come to be viewed with a longer-term horizon. New credit facilities have been used to support stretched-out adjustment programs, which attempt to parcel out blame for balance of payments disturbances between exogenous shocks (i.e., those arising from worsening terms of trade or earthquakes) and those created by domestic policies. Analysis has expanded beyond the simplest versions of the monetary approach to the balance of payments, which assume away underutilization of capacity and sectoral imbalances.

These positive, although modest, changes come after many years of criticism of the Fund's encouragement of stabilization plans whose only targets appeared to be the punctual servicing of the foreign debt and balance of payments equilibrium, at whatever cost. During the early years of the Alliance for Progress and then later in the 1960s, at the time of the Pearson Report, the advice was frequently heard that stabilization efforts should be placed within the framework of development plans, and that the IMF and the World Bank should cooperate to this end.^{11/} The changes which have occurred in the international economy during the 1970s, including the greater bargaining power of some developing countries, have also contributed to the modification of the Fund's advice.

The crawling peg and export subsidies have been two of the most successful policy instruments used by South American countries during the 1960s and 1970s. The Fund's predilection for exchange rate adjustments which were massive and presumably "once-and-for-all" and its hostility to any semblance of multiple exchange rates made the IMF (or its Western Hemisphere department) oppose or at least frown on the use of those policy instruments. In these areas it appears that many in the Fund's staff are reluctant to abandon their old views, although it is difficult to document this conjecture. Indeed, the exact IMF role and advice in stabilization plans have remained shrouded in mystery, as its officials are reluctant to disclose details and documentation, pleading the need to protect the confidential nature of their links with governments. Permission to scholars to consult documents older than, say, ten years would contribute to clarify the IMF role in stabilization plans.

Regardless of the explanation for the Fund's modifications in its stabilization advice and facilities, its views could be expected to have declining influence in the policy making of, say, Argentina and Brazil, in contrast to Jamaica and Zaire. Only gross mismanagement could place the former type of economy at the mercy of more-or-less enlightened Fund advice on short-run policy. Rather, the larger Southern Cone countries could be expected to have a greater voice in discussions about the Fund's role in such systemic issues as international liquidity, exchange rate surveillance, and supervision of international capital markets. It remains to be seen how these influential developing countries, with strong voices at the Fund's board of directors, will view staff proposals for stabilization plans in countries such as Jamaica and Zaire.

Footnotes

*I gratefully acknowledge comments from Edmar Bacha, Mario Brodersohn, Guillermo Calvo, William Cline, Albert Fishlow, Paul Krugman, Jorge Braga de Macedo, Juan Carlos de Pablo, Pedro Pou, Gustav Ranis, Carlos Rodriguez and John Sheahan. They cannot be blamed for the opinions and possible errors in this paper.

1/ See Thomas M. Reichmann and Richard T. Stillson, "Experience with programs of Balance of Payments adjustment: Stand-by arrangements in the higher tranches, 1963-72", I.M.F. Staff Papers, Volume 25, Number 2, June 1978, pp. 293-309; and Anne O. Krueger, Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences, Volume X, National Bureau of Economic Research; Cambridge, Massachusetts, Ballinger Publishing Company, 1978.

2/ This label, coined by Guillermo O'Donnell, seems more accurate than others, such as fascist, for referring to Southern Cone military regimes.

3/ See Joseph Ramos, "Inflación persistente, inflación reprimida e hiperinflación. Lecciones de inflación y estabilización en Chile", Desarrollo Económico, Volume 18, Number 69, April-June 1978, pp.3-49.

4/ For a helpful review of the evidence until 1976 see Vincente Galbis, "Inflation and interest rate policies in Latin America 1967-76", I.M.F. Staff Papers, Volume 26, Number 2, June 1979, pp. 334-366.

5/ This experience is being analyzed formally by Guillermo Calvo, Ana Maria Martirena-Mantel and Carlos A. Rodriguez.

6/ In 1975 Chilean authorities used an unexpected revaluation to attempt breaking inflationary expectations, generating windfall losses to exporters and windfall gains to those with foreign debt.

7/ See Business Latin America, April 25, 1979, for a description of recent Brazilian measures designed to increase the cost of foreign borrowing (p.129), and similar Chilean policies (p.135).

8/ After months of bizarre military posturing, war between the Armed Forces of Argentina and Chile was narrowly averted by Papal mediation in December 1978. Public expenditures backing this display of irrationality must have been substantial. Economic officials on both sides are known to have been unhappy. Their public utterances, however, showed little evidence of that.

9/ See statement by Henry C. Wallich to the Committee on Banking, Finance and Urban Affairs of the U.S. House of Representatives, July 12, 1979, processed, page 9.

10/ According to data on international reserves and imports reported in the International Financial Statistics published by the I.M.F.

11/ See Partners in Development, Report of the Commission on International Development; Lester B. Pearson, Chairman. New York: Praeger Publishers, 1969, page 220.