MACROPOLICIES FOR THE TRANSITION FROM STABILIZATION TO GROWTH

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Executive Summary

The main objective of this paper is to analyze macropolicies from the perspective of growth and development. Although the analysis focuses on these real objectives, it does not lose sight of the fact that the primary objective of stabilization policies is to achieve macro equilibrium. The way to overcome the incorrect dichotomy between stabilization and development policies cannot be by ignoring the constraints posed by the need to ensure the coordination of diverse economic activities at the macroeconomic level. Indeed, the problem is to select from the set of policies capable of ensuring macrostability, those that best improve employment and foster innovation and investment. Such a set of feasible macropolicies heavily depends on the specific characteristics of the macroeconomic situation of the country at hand.

The first section of the paper tries to define the characteristics of the macroeconomic problem and its relationship with other policies oriented to fostering growth and productivity. Two points follow from this discussion. First, macropolicies are relevant when there exists a coordination failure and coordination failures are likely to be pervasive in developing countries. Second, stabilization and structural reform policies are not independent. It is necessary to take into account the interactions between macroeconomic failures, market failures, income distribution and dynamic effects, not only because some stabilization policies can be damaging to development but also because overcoming some structural deficiencies (like the inexistence of a strong capital market or the weakness of the fiscal structure) is crucial for ensuring a sustainable stabilization.

The second section reviews the most salient features of the recent macroeconomic evolution of the Latin American region as compared to the doomed 1980s. The objective is to briefly show the main macroeconomic problems that the region is now facing and the constraints that they posed to development policies.

The third section is devoted to analyzing specific macropolicies (namely, fiscal, monetary and financial, and exchange rate policies) and their relationships with the creation of employment and incentives for investment and innovation.

Introduction[1]

Economics has been called the dismal science. To a certain degree, macroeconomics as a subdiscipline, can be blamed for this. The central message of macroeconomics is not a popular one among either citizens or economists from other subfields. And this is so for at least two reasons. On the one hand, macroeconomics plays the role of the Freudian superego: its most important task is to tell us what should not be done. On the other hand, the results of following macroeconomists' advice can be particularly disappointing: macroeconomic equilibrium itself once achieved does not guarantee economic development.

In the Latin American context, however, this lack of popularity of macroeconomic policies has been greatly enhanced by the characteristics of many of the stabilization packages that were implemented after the debt crisis. They not only reduced growth by inducing significant falls in investment but also deteriorated income distribution.

Macropolicies, i.e. exchange, fiscal, monetary, financial and income policies, mainly focus on the management of short-run disequilibria. But every combination of macropolicies has its own impact on the growth performance of the economy. For example, the more favorable external financial conditions that Latin America is facing in the 1990s have given room for stabilization policies based on the instrumentation of the exchange rate as a nominal anchor of the price system. While these policies have been successful in curbing inflation, they have also caused a real appreciation that has had significant impact on the allocation of investment (i.e. favoring non-tradable sectors).

After the debt crisis, however, the issue of the relationship between policies oriented to achieving macroeconomic stability and those aimed at augmenting investment, innovation, and employment has been rarely raised in the Latin American context. The macroeconomic instability

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that followed the crisis was deep and long lasting and, in such a context, it was taken for granted that nothing could be done regarding growth without stabilizing the economy first. This led to an increasing divorce between short-run stabilization and development policies, creating a situation where the latter were completely subordinated to the former.

The contention that stability is a necessary condition for restoring growth is basically correct. But, given this constraint, there was no systematic analysis of the kinds of stabilization policies which could minimize the negative consequences on investment, employment and the process of learning and innovation.

It should be mentioned, however, that this divorce between short-run and long-run policies was not new in the Latin American region. What was new in the eighties was the intensity and consistency with which this divorce influenced the policymaking process. Indeed, it was during the fifties that stabilization policies began to be conceived of as being independent of development policies. In those years, the conception of independent stabilization policies was associated with the appearance of external bottlenecks, budget disequilibria and the acceleration of inflation. Likewise, in that period, the first stabilization plans under the surveillance of the IMF were implemented.

This origin of stabilization policies in Latin America made the approach to macropolicies differ from the conception of stabilization adopted in developed countries (and in macroeconomics textbooks). In developed countries the objectives of fiscal, monetary and exchange-rate policies were always assumed to be those of achieving full employment and stabilizing investment rates in order to smooth cyclical movements. Only in the post-war period was inflation included as an important target for macropolicy while current account disequilibria were never in the forefront. In Latin America, on the contrary, employment, investment (and sometimes even inflation) have not been the primary goals of stabilization packages. The priority had usually been (and still is) to reduce short-run current account disequilibria. And since the public sector is normally blamed when absorption is too high, an additional objective has always been to achieve fiscal budget equilibrium. When there was a trade-off between employment and inflation on the one hand and fiscal and external equilibria on the other -for example, because of the inflationary and recessive consequences of devaluations and increments in public prices- the objective of closing the fiscal and external gaps was usually privileged.

The main objective of this paper is to analyze macropolicies from the perspective of growth and development. Although our analysis will focus on these real objectives, we will not lose sight of the fact that the primary objective of stabilization policies is to achieve macro equilibrium. The way to overcome the incorrect dichotomy between stabilization and development policies cannot be by ignoring the constraints posed by the need to ensure the coordination of diverse economic activities at the macroeconomic level. Indeed, the problem is to select from the set of policies capable of ensuring macrostability, those that best improve employment and foster innovation and investment.

Such a set of feasible macropolicies heavily depends on the specific characteristics of the macroeconomic situation of the country at hand. Regarding this, it should be kept in mind that the evolution of the Latin American countries in the eighties showed a series of different disequilibria and that some of them gave room for explosive paths. In the eighties, in countries like Argentina, Peru and Bolivia (or presently in Brazil), the amplitude of the existing disequilibria and the perverse characteristics of the dynamic paths (that tended to lead the economy toward hyperinflation) made it extremely difficult to even conceive of a consistent and viable stabilization package, not to mention viable industrial or social policies.

In such a context, the degrees of freedom of economic policy making are basically constrained by the number of disequilibria, their magnitude, and the features of the dynamic paths. The first aim of economic policy turns into that of urgently reducing the disequilibria deactivating possible explosive paths. Under other circumstances the margins for choosing policies are wider. However, in all cases, there is a set of macroeconomic constraints that must be taken into account in order to ensure that the decisions that are being taken at the microeconomic level will be consistent when aggregated.

The present study is organized as follows. In the first section we try to define the characteristics of the macroeconomic problem and its relationship with other policies oriented to fostering growth and productivity. In the second, we briefly review the most salient features of the recent macroeconomic evolution of the Latin American region as compared to the doomed 1980s. The objective is to briefly show the main macroeconomic problems that the region is now facing and the constraints that they posed to development policies. The third section is devoted to analyzing specific macropolicies (namely, fiscal, monetary and financial, and exchange rate policies) and their relationships with the creation of employment and incentives for investment and innovation.

I. Macroeconomic balances and growth oriented policies.

If the functioning of markets were perfect, economic policy would be redundant. The only task that the government would have to perform would be that of organizing the institutional setting of economic activity (i.e. to ensure the enforcement of contracts, property rights, and so on). Leaving aside extreme positions, however, there is a consensus that, in the real world, markets do not perform all the tasks with the same degree of efficiency. This is so mainly because there are market failures, short-run rigidities and transaction costs, income distribution problems and **coordination failures at an aggregate level**. Specific economic policies are designed to tackle each of these specific problems. For example: industrial policies cope with market failures such as the existence of externalities; social policies aim at a targeted distribution of welfare, and so on.

The specific task of **macroeconomic policies** is that of managing coordination failures. The main advantage of a market economy is to allow for the decentralization of economic activity and economic decision making. But one of its most important weaknesses is related to this virtue: it may occur that when aggregated, the decisions taken at a microeconomic level are inconsistent at the macro level[2]. When this occurs, it will not be possible for all economic agents to carry out their planned transactions at the existing prices and, at the macroeconomic level, disequilibria in some key markets will be observed. There are ex-post market disequilibria because there are ex-ante coordination failures. And there are macroeconomic policies because it is believed that

[2] One of the most significant coordination failures in the eighties resulted from the behavior of domestic savers and international banks. As a consequence of uncertainty and instability, the domestic savers' preference for liquid assets in international currency rose, i.e. deposits held in international banks. At the same time and in response to the same incentives, the international banks reduced the availability of credit to governments and potential domestic private investors. As a result of the combination of capital flight and credit rationing, effective investment was lower than the potential investment that could have been financed by domestic savings. Another example of coordination failure is given by the effects of capital inflows in the nineties. In some countries capital inflows establish a significant trend to real appreciation, signalling, then, an allocation of resources inconsistent with the long-term sustainability of external equilibrium.

government intervention can more efficiently correct the disequilibria than can the mechanisms built into the market system[3].

In principle, one could think that coordination failures are more likely to occur in developing countries. Not only because the developing economies suffer from the same market distortions which impede macroequilibrium from being achieved in developed countries (for example, price rigidities or wrong market signals stemming from capital markets) but also because markets in general are less developed and the development process itself tends to generate structural imbalances and pervasive market disequilibria. In the context of the typical developing country, capital markets are usually extremely thin and rationed; the public sector tends to generate unsustainable deficits because of the rudimentary character of the system of taxes and expenditures; and the productive structure usually shows a lack of flexibility that makes macroeconomic equilibrium much more vulnerable to external shocks. In the recent "mainstream" literature on stabilization the issue of the effects of stabilization policies on the growth process is downplayed. It is considered that the most important coordination failures are due to government-induced distortions and, consequently, the most important task of stabilization policies is that of removing such distortions. Likewise, there is a sharp distinction between stabilization and growth-oriented structural reform policies.

Behind these arguments, there is a strong presumption among mainstream economists: regardless of the kind of disequilibrium that the economy is experiencing, a market equilibrium always exists and there is a stable path that the economy can follow to reach it if government distortions are removed. Although this may be true in developed economies, in the highly distorted Latin American context this a priori assumption can be misleading. The economies of the region

[3] Since the "rational expectations revolution", there have been some discussions in the literature on macroeconomic policies for developed countries on the true existence of coordination failures. Some authors affirmed that macropolicies are, to say the least, redundant. This discussion, nonetheless, was not important for developing countries. There is consensus among economists that stabilization policies are necessary and relevant in the developing world, at least during the transitional path to a fully developed market economy.

experienced persistent disequilibria -specially after the debt crisis- and sometimes it was not at all clear whether or not an equilibrium existed and, likewise, whether the economy was on a stable path.

Indeed, in the economic policy recommendations stemming from multilateral organizations such as the IMF or the World Bank, there is a certain contradiction in the treatment of this question. The contradiction stems from the fact that, on the one hand, it is assumed that an equilibrium exists and that it can be reached with the appropriate stabilization measures but, on the other, it is said that deep structural changes (i.e. fiscal reform, the opening of the economy, market liberalization) are needed for stability to be sustainable. If under the existing conditions stability cannot last unless key parameters defining the economic structure are changed, then there is no attainable equilibrium under the present circumstances. In fact, stabilization-cum-structural reform is recommended precisely for this reason.

If this is true, it is very difficult to uphold the argument that stabilization and growth policies are independent[4]. If, for stabilization to be sustainable, it is necessary to **reform the economic structure**, it is crucial to take into account the longer- run consequences of stabilization on the economic structure and the effects of structural reform on short-run stability.

When stabilization and structural problems are considered together, many complicated questions arise, basically because in the policy-making process it is necessary to take into account the interactions between income distribution, market failures and coordination failures, in addition to the specific problems that arise in the transition period from stabilization-cum-structural-reform to stable growth[5].

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[4] On the relationship between stabilization and structural reform from the market-friendly approach viewpoint, see World Bank (1991).

[5] In the literature there has recently been a discussion of the transition period under the heading of "sequencing", but the arguments have been rather inconclusive. In another paper we focus on this problem, see Fanelli and Frenkel (1993). The relevant literature is cited there.

The kind of questions that are posed to macroeconomic policy making can be shown by means of an example. A well known rule of policy says that for maintaining macrostability, "countries should try to keep their spending consistent with their permanent income". This means that in order to maintain full employment and avoid coordination failures -taking into account the necessary intertemporal consistency between income and absorption- countries should borrow in bad times and rescue debt or accumulate financial assets when the good times come. However, this cannot be implemented when some **market failures are present in the economic structure**. To be more specific, if the market failure consists in the inexistence of a long-run capital market, (because the domestic credit market is too thin and access to international markets is rationed as it was in the 1980s) this policy advice is useless.

In the absence of a long-term capital market, the proper constraint for a country facing, say, a short-run balance of payments disequilibrium is not that implicit in the intertemporal consistency between future incomes and expenditures but rather the point-in-time liquidity constraint posed by the maximum available amount of external financing. In such a context, macropolicies must be directed at adjusting the financing needs of the economy to the short-run availability of funds. Typically, at least in the Latin American experience, this means that the real exchange rate will be adjusted to the point at which the demand for external credit originating in the current account disequilibrium equals the given supply.

If the balance of payments problem were due to a **temporary** fall in the terms of trade or to a **temporary** increase in capital flight originating in political turmoil, the previously-mentioned exchange rate policy would lead to an **over**shooting of the long-run equilibrium level of the exchange rate. When terms of trade return to their "equilibrium" level or flight capital is repatriated, if the narrowness of the domestic capital market does not allow for the sterilization of part of the increased capital inflows, there will be an **under**shooting of the long-run level of the exchange rate in the short run.

The consequences on macroeconomic stability of this kind of dynamics are obvious. However, the consequences on development are no less important. These dynamics will result in ample changes in income distribution (because of the effects on employment and real wages), wide fluctuations in relative prices (specially regarding the real value of tradable vis-a-vis non-tradable goods) and huge variations in the real value of government deficits.

In this special case, then, stabilization, must take into account not only the need to match income and absorption but also the need to develop a stronger capital market. This means that it is necessary to seek stabilization policies that, at least, do not worsen the existing fragility of the financial system, not only because it is necessary to ensure that investment be financed but also to make macropolicies more efficient.

The lack of attention to the problems presented by structural imbalances is related, to a certain extent, to the recent evolution of development economics. Up to the seventies, development economics had always emphasized market imperfections and the potential for Pareto-improving government intervention. According to this view, governments could seek out dynamic externalities and exploit divergences between private and social rates of return to investment (Fishlow,1990).

In the last two decades, however, there has been an increasing criticism of interventionist policies and their theoretical underpinnings. The opportunities opened to "rent seeking" (Krueger, 1974) and the inward-oriented character of some of the development strategies adopted have received the bulk of such criticism. But, in spite of the correctness of some of the critics to the import- substitution strategy adopted in Latin America, the supporters of the market-friendly approach have not been able to decisively show that government intervention is always and under any circumstance distorting. From the empirical point of view, "no one has yet shown that the failure of government intervention **necessarily** outweighs market failure" (Fishlow, 1990) and, specifically, it has been especially difficult to show that government intervention has been either damaging or redundant in explaining the successful evolution of countries like Japan, Korea and Taiwan[6].

On the other hand, adopting the a priori view that market imperfections and dynamic effects cannot be exploited in order to foster development can be theoretically sterile even from the point of view of the neoclassical paradigm. Krugman (1992), for example, after considering that the market-friendly counter-revolution went too far, calls for a counter-counter-revolution in development theory in order to retain for economic analysis the role that the pioneers of development economics had assigned to economies of scale and externalities. He believes that it is probably time once again to focus on market as well as government failures.

In brief, two important points follow from our previous discussion. First, macropolicies are relevant when there exists a coordination failure and coordination failures are likely to be pervasive in developing countries. Second, stabilization and structural reform policies are not independent. It is necessary to take into account the interactions between macroeconomic failures, market failures, income distribution and dynamic effects, not only because some stabilization policies can be damaging to development but also because overcoming some structural deficiencies (like the inexistence of a strong capital market or the weakness of the fiscal structure) is crucial for ensuring a sustainable stabilization.

[6] Stiglitz (1993) has recently made a similar point regarding financial markets. Based on analytical arguments and on the experiences of Japan, Taiwan and Korea, this author emphasizes that the relevant policy questions relate to the appropriate design of regulations. Stiglitz argues that government regulation, no less than markets, is beset by problems, but the conclusion, on that account, that there should be less government regulation, is incorrect. The problem arises from the incorrect design of government regulations.

II. Life after the debt crisis: macroinstability and changing external constraints.

Disequilibrium and Gaps

In order to avoid the a priori assumption about the existence and stability of market equilibrium and stress the structural origin of many of the imbalances present in Latin American countries, we will analyze the recent experience utilizing the concept of gaps.

A gap represents a disequilibrium situation at the macroeconomic level, but one that is not necessarily self-correcting. Disequilibria can be lasting and can also show amplifying tendencies. The dynamics of an economy in disequilibrium depends on the specific structural characteristics of the economy and on the measures authorities can implement to change the trend (in this sense, the description of macropolicies is as important as the characterization of the gaps).

In principle, any macroeconomic disequilibrium qualifies as a potential gap. However, in the recent Latin American experience, two gaps are identified as **basic**: the **external** gap and the **fiscal** gap. Negative shocks originating in either the external or fiscal sectors, or both, account for most of the destabilizing tendencies. Regarding the dynamics, two main mechanisms transmit and eventually amplify the policies and shocks originating in the basic gaps. One refers to the behavior of labor and goods markets and consequently to the behavior of inflation and unemployment and the other to the characteristics of money and financial markets.

The characterization of gaps and transmission mechanisms in the eighties and early nineties is, then, the first element that we need in order to set the background of our analysis of economic policies in Latin America. In accounting for the evolution of the macroeconomic disequilibria experienced by Latin America, particular emphasis will be placed on the effects of the changing situation in the international capital market.

The eighties

During the eighties Latin America experienced the worst economic crisis of the post-war period. This crisis was triggered by the worsening of the foreign variables faced by the region. However, the magnitude of the negative external shock was widened, at the domestic level, by the extreme weakness of the macroeconomic setting. In the period that preceded the shock, the public sector was typically running huge deficits, the financial sector showed a marked fragility and there was a tendency for the economy to generate unsustainable current account deficits. These macroeconomic imbalances, in turn, were to a large extent a consequence of the exhaustion of the development model based on both import substitution and the state as the engine of growth that most countries of the region had been following, at least, after the Second World War. In fact, the impact of the debt crisis was so huge because it took place in such a context.

At a more specific level, the anatomy of the crisis and its effects on growth can be succinctly described in terms of the fiscal and external gaps and in terms of the transmission mechanisms that tended to amplify the disequilibria represented by these gaps.

Obviously, the first impact of the negative external shock was to open the external gap. The worsening of the terms of trade, together with the increase in the interest rates in the early eighties, induced a huge imbalance in the current account. Most countries, with the only important exception of Chile, were unable to finance the increased disequilibria because of the lack of access to voluntary sources of credit and the scarcity of funds stemming from multilateral organizations. Consequently, the possibility of smoothing the adjustment by increasing indebtedness in the short run was precluded and the main objective of macropolicy became that of generating a trade surplus of a magnitude similar to the deficit in the financial services account.

The consequences of trying to generate a trade surplus at any cost were perverse from the point of view of stability and growth. Particularly, because the exchange rate policy was oriented to increasing the real exchange rate via nominal devaluation. This led to an impressive acceleration of inflation and many countries (Peru, Bolivia, Brazil, Argentina) were put on the brink of or directly experienced hyperinflation.

The fact that in most Latin American countries the bulk of the foreign debt is held by the public sector determined that the external shock had a direct impact on the fiscal accounts. The increase in the international interest rate exogenously augmented public expenditures in a context in which the government was already facing severe problems financing the existing public deficit. This meant that there was a simultaneous widening of the fiscal gap together with the opening of the external gap. This had two important consequences at a macroeconomic level. In the first place, given the narrowness of the domestic financial system and the difficulties to accede to external financing, most governments resorted to inflationary finance. This rendered monetary policy passive and greatly helped to validate the inflationary pressures stemming from nominal devaluation. In the second place, the attempts to reduce the deficit fell basically on public investment. The reduction of these kind of expenditures entail the lower degree of political conflict in the short run. This behavior of public expenditures is one of the most important causes of the observed reduction in the investment rate. In addition to its direct effects on global investment, the fall in public investment induced a reduction in private investment because of the existence of a "crowding-in" effect that relates the two.

On the other hand, the increase in the real exchange rate and the public imbalance, together with the acceleration of inflation and the existing indexation mechanisms, acted as transmission belts of the crisis into the weak existing financial sector. Many countries (e.g. Argentina, Chile, Brazil, Mexico, Uruguay) experienced a financial breakdown that made the financing of investment projects extremely difficult.

In this scenario of extreme macroeconomic uncertainty, there was an important reduction in the private savings and investment rates and, together with investment, the process of learning and innovation and the international competitiveness of the economy greatly suffered. Likewise, the process of growth was additionally hampered by the fact that this environment favored capital flight as a defensive tool against inflation and financial instability.

By the end of the eighties it was clear that important structural changes would be necessary if the growth process were to regain momentum in the region. In the context of extreme instability, however, it was very difficult to articulate the stabilization efforts with policies oriented toward growth and structural change. Furthermore, the context of the debt crisis was not propitious for re-thinking the development strategy since economic policy was almost completely determined by the need to achieve a minimum level of stability. Growth and development lost ground in the economic policy agenda.

The nineties

The economic situation of the region, however, has greatly changed in the present decade. Most Latin American countries have shown a positive growth rate and a fall in the inflation rate. The main exceptions were Brazil, where macroeconomic instability and political turmoil led to high inflation and a drop in the GDP, and Peru, where the stabilization policy proved to be ineffective at overcoming the ongoing recession despite a decline in the inflation rate.

What is it that changed in Latin America between the 1988-89 period, when the average growth rate fluctuated around zero and many countries were suffering from inflation rates approaching hyperinflation, and the 1991-92 period, characterized by positive growth and falling inflation? In answering this question, the role of the structural reforms programs is usually emphasized. However, the most remarkable difference between the afore-mentioned periods concerns the evolution of the external sector. First, there was a significant fall in the international interest rate. Second, there was a sudden and marked reversion in the direction of capital movements.

The downturn in the interest rate had a very important and positive income effect in terms of the national income of the region and also induced a softening in the external gap via a reduction in the financial services account deficit. While in the 1988-89 period the net payments of interest and profits abroad amounted to 36 billion dollars, in 1991-92 these payments totaled 30.2 billion dollars. This positive effect, nonetheless, was compensated to a certain point by the decrease in the terms of trade. So, despite the fact that the situation would have been worse if the interest rate had not been declining, it seems that the income effect of the diminishing interest rates was not strong enough to explain the improvement in the Latin American situation as a whole.

It must be taken into account, however, that the fall in the international interest rate has had a substitution effect too. And it surely has had a bearing on the observed reversion in the direction of capital flows. It was via substitution effect that the reduction in the foreign interest rate made the investment in financial assets issued within the region more profitable. This greatly helped to stop capital flight. Likewise, with a lower interest rate, the net return of investments in productive assets rose. This second factor may be very important in explaining not only the spurt in foreign direct investment flowing into various countries of the region, but also the success of privatization in countries like Argentina, where there was an active participation of multinational firms in the process. The figures regarding the reversion of capital flows are impressive; they grew by more than six times in a very short period. As a consequence of the fall in interest payments abroad and the increase in capital inflows, for the first time in nine years (since the debt crisis of the early eighties), the net transfer abroad effected by the region became negative in 1991 and again so in 1992. While Latin America sent 56.7 billion dollars abroad in the doomed years of 1988-89, in 1991-92 it received 35.8 billion dollars.

The softening of the extreme credit rationing that the region was facing during the eighties allowed many countries to finance a higher current account deficit and, consequently, there was a strong reduction in the trade surplus that the region had been generating during the eighties in order to finance the net transfer abroad. Indeed, in 1992, for the first time since 1983, Latin America generated a trade deficit.

With the relaxation of the external gap many of the afore-mentioned mechanisms which contributed to the amplification of the disequilibria during the eighties were deactivated. First of all, the availability of external credit permitted an expansion of domestic absorption. Indeed, the reversion in capital inflows was so abrupt and significant that there tended to be an excess supply of foreign exchange in many countries, even though the trade and current account deficits were increasing fast. Consequently, the region as a whole accumulated international reserves during the period and most of the countries faced a revaluation of their domestic currencies.

Beyond its consequences on the balance of payments, the expansion of the activity level and the lagging exchange rate proved to have beneficial consequences on macroeconomic stability. Fiscal revenues in many countries showed an upward trend because of the recovery of the activity level. Besides, the overvaluation helped to improve the fiscal balance because an appreciated exchange rate in real terms implies a lower real value for the interest payments on the outstanding public debt. If the positive income effect of the fall in the international interest rate is added to this, it is not surprising that there was an extraordinary improvement in the fiscal equilibrium all throughout Latin America in the last two years. Many countries in the region are now running a fiscal **surplus**.

The lagging exchange rate also played an important role in the observed process of disinflation. In most of the countries this is one of the key factors explaining the significant fall in the inflation rate even in a context of expansion of domestic absorption.

The recovery process, however, is showing two important weaknesses. In the first place, in most cases -and particularly in Argentina and Mexico-, the positive evolution of the GDP was more the result of an increasing rate of utilization of existing capacity than a consequence of the widening of it. In the second place, the increase in the activity level was accompanied by a widening in the trade deficit and this could be a source of macroinstability if the international situation worsened.

III. Macropolicies and Development in the nineties.

As compared to the eighties, nowadays the region is in a much better situation for facing the challenge of designing economic policies suitable to both stabilization and growth. However, it should be taken into account that history matters and, consequently, many of the sequels of the crisis still remain.

There are a set of key constraints that deserve to be mentioned. First, the rate of investment and domestic savings, which were severely affected by the crisis, are still too low and the recovery has not yet been strong enough to restore the pre-crisis levels. Second, financial systems and capital markets are still weak and small. The degree of monetization is remarkably low while the term maturity of financial instruments is very short. Third, the closing of the fiscal gap does not seem to be sustainable in many countries, either because it is based on the "repression" of public investment in economic and social infrastructure (Mexico) and/or because it heavily depends on the proceeds coming from privatization (Argentina). Besides, there are countries that did not even attain budget equilibrium in the short run (Brazil). Fourth, the interruption of the growth process, in itself, has had long-lasting and permanent negative consequences on the development process, specially regarding employment generation and increases in productivity.

Indeed, the principal problem confronting the countries of the region is that of designing a new development strategy capable of restoring employment creation, investment, and innovation. And, policies normally classified under the heading of stabilization (fiscal, monetary and exchange rate policies) will surely play a crucial role in such a strategy. In what follows, we will try to show the main features that these macropolicies should have in the present Latin American situation.

The alternatives open to the selection of the instruments of a specific stabilization package heavily depend on the kinds of macroeconomic disequilibria that the economy at hand is experiencing and the best policies regarding employment and investment should be chosen taking into account these important facts. For example, there exist situations in which it is very difficult for the public sector to have access to capital markets, either foreign of domestic. Under such circumstances, the objective of stabilization will require measures oriented toward the elimination of the existing fiscal deficit and, consequently, the best policies regarding employment and investment should be selected in such a way that fiscal equilibrium is guaranteed.

It is a fact that the Latin American economies greatly differ from the macroeconomic point of view. There exists a spectrum with Brazil at one end and Chile at the other. It is also a fact that the evolution of each national economy showed significant and frequent changes in the last twenty years and that the situation will not be very different in this regard in the near future. If these differences are ignored, incorrect generalizations may be made[7].

In order to classify the kinds of problems that economic policies face in Latin America, in another paper (Fanelli, et. al. 1990) we distinguished three problems that should be resolved in order to restore the growth process. In the first place, to sustain growth, it is necessary to generate sufficient savings -the feature of the process emphasized by the classical or Smithian tradition of thought: the "wealth of nations" is explained by the thriftiness of their populations. In the second place, it is necessary to ensure that the non-consumed flow of income be invested because one cannot count on savings being automatically channeled into capital formation. This problem is highlighted by the Keynesian tradition, which focuses on two determinants of growth. One is the state of investors' animal spirits, primarily affected by their expectations regarding the future evolution of the economy. The other takes the form of marginal productivity decisions in the

[7] Monetary policy can be used to show this point. The degrees of freedom of monetary policy are a function of the amplitude and robustness of the domestic demand for financial assets. This is usually not even mentioned because in the standard textbook exercise the existence of such a demand is taken for granted. However, in some economies of the region, the crises have induced strong changes in the agents' financial behavior, basically because the crises fueled capital flight and there was a strong demonetization as a counterpart. But the intensity was not the same in each country and consequently there are different degrees of disarticulation of the financial systems. It is not sensible to expect that the same policy tool (for example, sterilization) will have similar effects in economies that greatly differ in this respect.

allocation of a given flow of savings between real and financial assets. These choices among different possible components of asset-holders' portfolios heavily influence the degree of capital deepening and hence the long-term rate of growth. A third factor influencing the growth rate is the efficiency with which given real resources are allocated. This can be called the neoclassical approach to growth because neoclassical models concentrate on allocative efficiency.

When confronting problems related to development as an evolutionary process -different from mere growth, and where innovation is crucial-, however, it is necessary to add a fourth problem hi
23'33'3Shumpeterian tradition: the need for establishing an economic setting able to generate the incentives and the means for exploring new potentially better ways of doing things (Nelson, 1991). In this regard, ensuring competition and appropriate public policies related to the education system is crucial.

Fiscal policy[8]

There are many reasons why **fiscal policy will play a key role** in solving the four previously-mentioned problems and hence in restoring growth and development. First, in the process of fiscal adjustment public investment has been taken to extremely low levels. Second, in most countries of the region, public savings represent a good part of overall savings. Third, the rate of savings, the allocation of real and financial resources and the incentives for innovation faced by the private sector are affected by both tax and expenditure policies.

Fiscal policy, however, cannot be designed with the only objective of recovering investment and savings and helping the process of innovation. It also has to ensure macrostability. At present, many countries are generating a primary fiscal surplus that is viewed as a necessary

[8] The proposals regarding fiscal policies are based on Fanelli et. al. (1992)

condition for maintaining the recently achieved macrostability. The question is, then, that there are trade-offs and complementarities between policies oriented to fulfilling these objectives. Indeed, in the policy recommendations that appear below, we have taken into account the experience of countries like Chile, which succeeded in recovering savings, investment and stability while adjusting the public sector, as compared with others like Mexico or Argentina, where the adjustment of fiscal accounts was not accompanied by the restoration of pre-crisis rates of savings and investment.

It is because of its role in fostering growth and ensuring stability that fiscal policy cannot ignore the interrelationships between stabilization and development. The constraints stemming from such interrelationships, however, do not exhaust the difficulties for designing fiscal policy. An additional and extremely important complication is that the state itself needs to be reformed, and the reform entails not only restructuring but also reconstructing the economic institutions of the public sector. In some countries, the distortionary effects of the crisis and its permanence have been so strong that the public sector has lost a good part of its administrative and management capacities. To make the state more efficient would, obviously, greatly help in attaining growth and stability. However, the state not only has to be economically efficient, it must also be institutionally strong, whatever be its size.

This is not an abstract contention. Empirical evidence shows that countries like Colombia and Chile, where the state did not renounce its role as a major investor and where the state institutions suffered a much lower degree of erosion during the adjustment process, had the most successful experiences.

The need for ensuring macroeconomic stability places severe constraints on government behavior. Although the state has to apply aggressive policies to restore growth, it cannot generate significant deficits as it did in the past. In fact, in many Latin American countries, such as Argentina, Brazil and Peru, the government cannot run fiscal deficits higher than the sum of the available flow of external financing to the public sector plus the proceeds coming from privatization. This is so because today's real flow demand for new issues of domestic assets in the form of either "bonds" or "money" is still very low. To preserve financial stability, the rate at which the authorities increase the supply of nominal domestic assets cannot be greater than the sum of the rate of growth plus the rate of inflation. And by assumption, in a stable macroeconomic context the latter must be reduced.

Usually, the policies regarding the reduction of expenditures are much more emphasized than those regarding the revenues side of the government balance sheet as means of reducing fiscal deficit. It is assumed that an increase in the ratio of tax revenue to GDP would have serious deterrent effects. However, when the overall macroeconomic setting is taken into account, it is possible that the positive effects of an increase in public savings might largely compensate any worsening in the incentive structure, thus, heavily contributing to softening the Smithian restriction. Likewise, a disincentive effect on private savings does not mean that the available funds for domestically financing investment would decline because part of the resources saved by the private sector is allocated either to foreign assets or to extremely short-run domestic deposits that cannot sustain long-term credit for investment.

From our point of view, in the present Latin American situation, the first task of fiscal policy should be that of increasing the tax revenue/GDP ratio. A necessary condition for this to be possible is to rationalize and simplify the existing tax structure. In most Latin American countries the tax system shows severe disadjustments for two reasons. One is that the tax systems have been abusively used to attain objectives relating to the allocation of resources and to obtain loosely defined distributional aims. The other is that the present structure has resulted from many ad-hoc modifications over the adjustment period that were closely related to short-run stabilization objectives with little or no concern about the long-run effects on both the efficiency of the tax structure and the amount of taxes collected. In this way, a greater degree of buoyancy of the tax system in the short run was obtained at the cost of a fall in the income-elasticity of taxes. In addition, the recurrent resort to tax handles to fill temporal gaps in the fiscal accounts (that usually induced negative effects on income and wealth distribution) severely affected the community's sense of fairness and in some countries gave rise to a sort of "fiscal rebellion" that contributed to widening the size of the underground economy.

The principal elements of the needed tax reform should be, firstly, the strengthening of the ability of the government to collect. This calls for a higher amount of resources allocated to improving the financial management, the monitoring, and controlling systems of the central tax bureau. In addition, the administrative and controlling capacity of the tax bureau could be greatly improved by both eliminating those taxes that are unproductive and minimizing the use of multiple rates. This should lead to a decrease in tax evasion and a widening of the tax base. Secondly, the elimination or reduction to a minimum of temporary or ad-hoc taxes to make both the amount of taxes that the private sector expects to pay and the amount of government revenues less uncertain. Thirdly, the share of total tax collection made up by direct taxes on income and wealth should be significantly raised. In many Latin American countries, the first objective should be to return to the share observed during the pre-crisis period. Such a policy would heavily improve not only the equity of the tax system but also its income elasticity. In fact, to ensure a high income elasticity of the tax structure is very important because, otherwise, a self-sustained growth process would lead to a renewed fiscal imbalance. Fourthly, the use of the tax system to grant incentives to the private sector should not necessarily be avoided but carefully planned and implemented. The tax policies implemented under the import substitution strategy of development, providing general incentives for real investment and specific incentives intending to foster investment in selected industries or regions, showed mixed results. More often than not, these resulted in tax evasion because of loopholes in the tax legislation. Analogous results showed other policies intending to stimulate savings in the domestic financial system, such as tax exemptions on interest earned by financial assets and on investment in equities. In many cases these policies induced perverse portfolio decisions and fueled capital flight. However, it must be mentioned that the worst results were observed during periods of high inflation and instability because these conditions both weakened the ability of the state to manage the policies and led to the distortion of the incentives. Even so, a complete reformulation of tax incentives is clearly needed and it could be based on lessons provided by some successful experiences. Tax incentives for savings, investment and allocation in selected activities have been intensively implemented in most of the East Asian cases of rapid industrialization (Tanzi and Shorne, 1992). Three characteristics seem to differentiate East Asian policies from those implemented in Latin America (Amsden, 1991,1993). The first is targeting: in the East Asian cases incentives have been explicitly related to the achievement of concrete, monitorable performance standards (i.e. exports, investment in R&D, worker training.) The second is effective monitoring: the governments have been able to monitor and enforce the commited targets preventing rent-seeking behavior. This characteristic depends not only on the policy design but on the quality and power of the administration in broader terms (Tanzi and Shorne, 1992). The third characteristic is a stable macroeconomic environment: low inflation and stable relative prices stressed the importance of tax structure in the allocation of resources and precluded the distortions observed in Latin America. The stability of the macroeconomic framework in the East Asian countries seems to have been crucial not only regarding the effectiveness of tax incentives but also regarding the efficacy of other policies, particularly with respect to the financial policies favoring investment in selected industries. This characteristic is one of the most salient features of the East Asian experience vis-á-vis Latin America.

On the expenditure side, after more than a decade of adjustment, there is not that much room for further dramatic reductions of government outlays. In fact, in some items such as public investment or those related to the improvement of the public sector staff skills, there should be significant raises. Thus the policy reform should aim at significantly improving the allocation of existing expenditures. There are many institutional obstacles, however, that will appear while performing this task. The most important is the existence of a variety of interest groups (industrial and commercial chambers, trade unions, political lobbies, etc.) acting in their own interests. This is one of the most important reasons calling for a strengthening of the state autonomy built on the basis of a democratically generated consensus.

The restructuring of expenditures should be directed at increasing the amount of resources allocated to public investment and antipoverty programs. In addition, the structure and design of subsidy policies should be greatly modified in order to reinforce the basis for the process of innovation.

The recovering of the public investment rate should start by heavily supporting well-designed strategies to increase maintenance and operation expenses. The second step to be taken should aim at financing public infrastructure projects. Particularly, projects for improving the infrastructure closely related to exports expansion and the competitiveness of the economy (roads, harbors, storage capacity, etc.), to transport, and to social policies (health, education and poverty reduction). That is, the main purpose of public investment policies should be to stop the process of deterioration that the public sector infrastructure has undergone during the last ten years. Besides, public investment should be increased not only to stop the deterioration of public infrastructure but also to "prime the pump", thereby reducing the probability that the economy falls into a bottom-of-the-well equilibrium in the post-stabilization period.

One of the much criticized aspects of the growth-promoting policies of the postwar period is that it was very difficult to calculate the costs of such policies because the necessary subsidies were carefully hidden in the budget. We think that such criticism is fairly accurate. The restructuring of the public-sector expenditures should induce a radical modification in the form in which subsidies are allocated and recorded in the budget. As we mentioned, the reestructuring should be oriented by the successful experience of the East Asian cases. On the one hand, the granting of subsidies should be tightly attached to clearly defined performance criteria and, on the other, the rules for implementing them should neither leave much room for discretionary case-by-case decision making nor absorb as many fiscal resources as in the past. Obviously, the reorganization of the mechanisms for allocating public spending is closely related to the reorganization of the state. Better design and implementation calls for a much more efficient budgeting staff. Many of the mistakes in the past were made precisely because it was administratively easier to grant massive subsidies through public enterprises or the banking system.

The alternative to bad subsidy policies is not a no-subsidy policy but a more efficient one: the problems posed by market failures and income distribution do not disappear just because implementing efficient fiscal policies is a difficult task. In fact, one of the main challenges stems from the fact that while selective promotion policies are needed for development, the policy tools used in the past for growth promotion are now obsolete, either because the economic situation has changed or because they proved to have perverse consequences on both micro incentives (work, investment and efficient portfolio selection) and macro equilibrium. So, the reformulation of promotion policies following the lines suggested above should be a high priority task because they are a neccesary condition for the recovery of growth.

Monetary and financial policy

In order to preserve stability most Latin American countries are now trying to follow tight monetary policies, specially regarding the financing of the public deficit by means of issuing money. Likewise, most of them are now trying to liberalize the financial system and in some cases, like in Argentina, Peru and Bolivia, this has led to the development of a parallel financial system based on dollar-denominated assets and liabilities. In spite of these measures, however, the financial system has been unable to generate a market for long-term borrowing and lending which is badly needed to foster investment and to increase the savings rate.

This recent Latin American experience with the management of monetary and financial policies seems to suggest that the consequences of such policies on growth and stability are ambiguous. Tight monetary policies have recently led -via increment in the domestic interest rate- to an exacerbation of capital inflows and this provoked a further appreciation of the real exchange rate that hindered competitiveness while the increase in the interest rate acted against the objective of increasing investment. Likewise, a good part of the credit generated in the dollar-denominated segment has gone to finance consumption and non-tradable activities. If there were an upward correction of the real exchange rate, there could be an increment in the level of financial fragility of the economy.

We have remarked many times that one of the most important market failures, pervasive throughout the region, is caused by the absence of a long-term capital market. This fact has several consequences on both stabilization and growth.

It makes stabilization policies difficult because it implies that capital markets cannot be used in order to smooth cyclical variations in the activity level by means of a coordination of the short-run evolution of income and expenditures taking "permanent income" as a standard. When the financial system is fragile and "bonds" markets are weak, it is very difficult to implement open market operations and sterilization measures which are the primary tools of monetary management.

If the monetary authorities do not have at their disposal the instruments needed to offset the impulses originating in the balance of payments and the fiscal budget, to maintain short-run monetary stability the stabilization policy should avoid huge fluctuations in the current account deficit and in the public-sector borrowing needs. The impossibility of pursuing an independent monetary policy because the needed instruments are not available put strong constraints on the set of fiscal and exchange-rate policies which are compatible with monetary and financial stability. The best way to ensure monetary stability is to have a sustainable exchange rate and a sustainable evolution of fiscal imbalances.

The stability in the evolution of monetary aggregates, however, not only depends on the current account and the budget. One important source of turbulence is the volatility of external capital movements. As previously mentioned, the problems generated by such volatility has been particularly important in the recent Latin American expe' +(*32*3erized by a marked reversion in the sign of capital movements.

The core of the problem raised by capital movements lies in the fact that the size of the domestic capital markets is too small as compared to the size of capital outflows and inflows. For example, in Argentina, while the total stock of domestically generated financial assets slightly exceeded 25 billion dollars, in only one year, in 1992, the country received capital inflows of about 12 billion dollars. If the authorities had tried to sterilize such an amount of capital inflows, there would have been an increase in the stock of government bonds inconsistent with financial stability. Given that the monetary authorities did not resort to sterilization and adopted a passive monetary policy, the outcome was a strong and unsustainable overvaluation of the real exchange rate.

What the Argentine experience makes clear is that, in a context where the domestic capital market is weak and there is a complete opening of the economy to capital movements, the monetary authorities may have to choose between financial instability and overvaluation of the domestic currency. There are no easy ways to escape from this fate. Nonetheless, the experience of countries like Chile, which combined direct intervention in order to smooth capital inflows (such as fixing minimum terms for foreign lending) and an exchange-rate policy oriented to increasing short-term uncertainty (while guaranteeing the real level in the long run), seems to be better than the alternative chosen by Argentina of passively adapting the evolution of monetary aggregates and the exchange rate to capital inflows.

Looking at the past Latin American experience, it seems clear that private markets have never generated a flow of financial intermediation high enough to support a significant rate of investment in productive activities. The available alternatives to correct this market failure are very contro

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(s possible that the best policy will be that of avoiding the implementation of extreme "solutions" via either, generalized government intervention or financial liberalization.

In the post-war period, the lack of long-term segments led to the creation of development banks. Likewise, public guarantees and other forms of financing long-term investment projects made up the set of policy tools to promote growth during the successful industrialization period until the mid 70s. Even at the cost of efficiency losses and distributional biases, the system performed fairly well for forty years. Nonetheless, it proved not to be robust to the conjunction of macroeconomic instability -specially to inflation-, misleading budgetary policies, and rent seeking.

On the other hand, the experience with radical financial liberalization policies has not been better. There are some recent examples of financial crises -such as those that occurred in the so-called Southern Cone liberalization experiences- which were self-generated by the volatility of deregulated and private financial systems.

In spite of the negative consequences of financial liberalization, in the present Latin American context, it is not possible to return to "repressed" systems. In the first place, the financial systems have already been deregulated and, in the second place, the existing degree of integration between domestic and international capital markets renders aggressive interventionist policies impossible.

But, as experience has shown, deregulated capital markets has not been a viable "first best" solution to the lack of a long-run capital market. Consequently, in order to correct this market failure, government intervention is necessary. One way of doing this is to recover the capacity to channel public, private and external savings to finance private investment by means of development banks or specific investment funds. Carefully administered public development banks could be efficiently used for evolving screening devices for the selection of private investment projects. This was an important feature of the growth strategy in Latin America in the past and in other developing experiences as well. Although many specialists have a negative view of this role of the state because they see it exclusively as a subsidy that worsens resource allocation, we believe that this kind of policy action is badly needed for overcoming a serious market failure.

Exchange rate policy.

The level of the **real** exchange rate and its stability is crucial in determining the evolution of the real side of the economy. In the first place, it plays a fundamental role in determining the degree of external competitiveness of the economy and, consequently, in influencing the allocation of resources between the tradable and non-tradable sectors. This, in turn, affects not only the position of the current account in the long run but also the evolution of productivity since external competitiveness has a bearing on changes in technology and the organization of firms. In the second place, because of the importance of trade taxes and public foreign indebtedness, the real exchange rate contributes to determining the real size of public expenditures and revenues and hence the real burden of government deficits. In the third place, specially in developing countries, there is a close relationship between income distribution and the real exchange rate, mainly because of the effects of the latter on real wages. Likewise, in a setting where the existence of "specific factors" makes the reallocation of resources costly in the short run, changes in the level of the real exchange rate may induce severe losses in terms of employment.

In addition to its role on the real side, the spot and expected **nominal** exchange rate heavily contribute to determining the level and the rate of change of domestic nominal prices on the one hand and the domestic nominal interest rates on the other.

Because of these relationships with the evolution of both **nominal** and **real** variables, the exchange rate policy is a key tool influencing not only short-run stability but also growth. It is not surprising, then, that very frequently the authorities confront difficult trade-offs when setting real vis-a-vis nominal targets for the exchange rate.

Another complication with the exchange rate from the point of view of economic policy making is that it is directly influenced by variables that are not under the control of the authorities. An additional complication is that these variables may be highly volatile. Among such variables, fluctuations in international interest rates, changes in the access to external financial markets and the evolution of terms of trade play a central role in Latin America.

Given the many objectives and exogenous variables that have a bearing on the exchange rate policy, there are no clear-cut and general rules that could be followed. Nonetheless, on the basis of the experience of Latin American countries, some remarks could be made about the best policies for augmenting employment and investment while maintaining an acceptable degree of macroeconomic stability.

The best guide for evaluating the level of the real exchange rate is to take into account that the real exchange rate should be **sustainable** in the long run. From the point of view of macropolicy, even though the sustainability criterion might appear to be rather diffuse, it is more operative than the one provided by the concept of "equilibrium" exchange rate. The equilibrium exchange rate is a theoretical concept that assumes a perfect knowledge of the future state of the economy. Besides, even if such an equilibrium level could be calculated, for the economic policy to sustain the real exchange rate at its equilibrium value, perfect capital markets would be necessary. The sustainability criterion attempts to take into account the imperfections of the financial structure and the existence of disequilibria.

One of the main implications of this criterion for economic policy making is that whenever important changes in the afore-mentioned fundamental determinants of the real exchange rate occur, it is necessary to adapt the level of the real exchange rate to the new situation. It is particularly important to avoid exchange rate policies that imply huge current account disequilibria or perverse effects on the degree of competitiveness of the economy.

Although, in practice, the degree of sustainability of a specific exchange rate can only be assessed on the basis of historical comparisons and uncertain evaluations of the future evolution of the variables which affect the real exchange rate, sustainability as a guide for policymaking would have been strong enough to discriminate against some of the most negative policy experiments implemented in Latin America. This criterion, for example, would have ruled out the Southern-Cone liberalizations of the late seventies: the simultaneous opening of the economy and overvaluation of the exchange rate are not compatible with a sustainable current account equilibrium because they tend to generate trade account deficits that can only be sustained by increasing capital inflows. On the other hand, countries that followed more strict real exchange policies seem to have resisted negative shocks better. Even though the debt crisis affected all the countries of the region, the economies that were more severely affected were those that had heavily appreciated the domestic currency in the previous years while countries like Colombia, which had more stable exchange rate policy, were less affected. Indeed, the present evolution of some Latin American countries should be greatly benefitted if the sustainabilty criterion were to be applied. This is particularly so in the cases of Mexico and Argentina which are now generating increasing and unsustainable deficits in the current account.

Besides ensuring sustainability, the exchange rate policy should be aimed at minimizing the uncertainty of expectations about the future real exchange rate. The expected exchange rate not only influences the allocation of resources between tradable and non-tradable goods but also the investment decisions in general because of its effects on both the activity level and the financial position of agents with different combinations of foreign assets and liabilities in their balance sheets.

However, to set the correct real exchange rate from the point of view of sustainability in a way that minimizes the uncertainty of expectations about the future real exchange rate is not an easy task. Specially because the Latin American economies are highly inflationary according to international standards. If domestic inflation is systematically higher than that of the principal trade partners of a country, it will be necessary to permanently adapt the nominal exchange rate in order to maintain the real exchange rate at the targeted level. In other words, an indexing rule will be necessary and hence, the credibility of the real exchange rate will become a function of the credibility of the real parity rule based on the indexation of the nominal rate.

More or less explicit real parity rules have been followed in Chile and Bolivia. These countries have managed to sustain the post-crisis stabilization longer. Indeed, in these countries it can be considered that the maintenance of the real exchange rate by using the real parity rule constitutes an indicator of the robustness of the degree of stabilization achieved: unlike the cases of Argentina and Mexico, stability does not depend on the nominal exchange rate as an anchor of nominal prices.

In brief, a real parity rule that ensures the sustainability and the credibility of the future exchange rate appears to be the tool best suited to the objectives of maintaining stability and fostering growth. There is one important caveat, nonetheless. When an economy faces a strong destabilizing shock of the kind the Latin American economies experienced in the early eighties, it could be beneficial to abandon the indexing rule. If the economy is on the brink of hyperinflation with an inertial mechanism built into the price dynamics, recent stabilization experiences strongly suggest that it is worthwhile to use **temporarily** a fixed nominal exchange rate as a nominal anchor for the price system. The discussion of this caveat, however, is beyond the scope of the present paper. With the exception of strong shocks, the real parity rule seems to be the best choice for stability and growth.

Concluding remarks.

In these concluding remarks we want to stress the main points developed in the previous sections. The paper has been organized as an attempt to answer a question: what are the best macropolicies from the point of view of growth and development? Our first answer is that the way to overcome the incorrect dichotomy between stabilization and development policies cannot be by ignoring the constraints posed by the need to ensure the coordination of economic activities at the macroeconomic level. So, the problem is to select from the set of policies capable of ensuring macrostability, those that best improve employment and foster innovation, savings and investment. The second point of the answer is that such a set of feasible macropolicies depends on the specific characteristics of the macroeconomic situation of the country at hand.

The fiscal, monetary, financial and exchange policies discussed in the third part of the paper are focused on the macroeconomic situation of Latin American countries in the nineties. This situation can be broadly described by two characteristics. First, the economies show the long-lasting effects of the crisis of the eighties on their macroeconomic performance and on their development potential. Second, since the early nineties there are new and more favorable international financial conditions. Both characteristics are considered to specify the kind of problems that have to be resolved in order to restore the growth process and to investigate the ways in which macropolicies can contribute to the task. The first problem relates to the generation of sufficient savings needed to sustain growth. The second problem is to ensure that the non-consumed flow of income be channeled into capital formation raising the rate of investment. The third problem relates to the efficiency with which given real resources are allocated. The fourth problem is the need to establish an economic setting favoring innovation, i.e. an environment able to generate the incentives and the means to explore new potentially better ways of doing things.

The set of macropolicies presented and discussed in the paper should contribute in complementary ways to the resolution of the mentioned four problems of development. The ideal macroeconomic framework generated by the successful implementation of those policies should

be characterized by, first, stability, i.e. a relatively low and more or less predictable rate of inflation and a smooth cycle and, second, right and stable rate of exchange and relative prices[9]. None of these attributes are attainable as an isolated effect of any specific policy (such as fiscal or exchange policies) but have to result from the combined effects of the whole set of macropolicies. A third attribute should be a more comfortable fiscal situation needed to give room for policies fostering higher rates of savings and investment. Both savings and investment would be directly favored by the positive effects of a stable macroeconomic framework and should also be stimulated by fiscal and financial incentives. Fiscal policy, particularly the reconstruction and strengthening of the tax system, is essential to this purpose, not only to give room for macroeconomic sound tax and credit incentives to the private sector, but also to recover the public sector's own capacity to save and invest. Lastly, a fourth attribute should be a more efficient allocation of investment. A lower degree of uncertainty regarding inflation and the sustainability of relative prices, specially the rate of exchange, should have in itself positive effects on the efficiency of investment. But, as in the case of general incentives to
savings and investment, a stronger fiscal position is also essential to the sound instrumentation of fiscal and financial incentives to foster innovation and to compensate for market distortion in specific industries.

[9] These attributes are the most salient features in the comparison between Latin American and East Asian countries. The conditions show analogous relevance in comparing Latin American growth performances across more and less stable periods (i.e. before and after the mid-seventies) and also in comparing growth performances between individual Latin American countries after the debt crisis.

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