Economics and Politics:

Preliminary Observations on the Feasibility of Stabilization Attempts and Redemocratization

by

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Introduction

The economic circumstances of the Southern Cone countries are far from encouraging. They have fallen victim to the reversal in international conditions after 1979, the rise in the price of oil and in interest rates, and of recession and uncertain recovery in the industrialized countries. They also show significant internal disequilibrium, of which the inflation rate is a dramatic symbol reflecting the inconsistency of public policies and private claims on income. All find themselves in the midst of stabilization programs, and negotiations with the IMF and foreign banks. The principal accomplishment thus far has been the ability to remain current on their interest obligations.

All except Chile are in the midst of opening their political systems and amplifying the receptivity to popular opinion. And even there, the range of voices with regard at least to economic policy has broadened. Nowhere has the reputation of technocrats been untarnished by the turndown of recent years and the apparent inability to devise policies adequate to the needs. Everywhere there are evidences of dissatisfaction, not only internally, but also of external agencies. Domestic promises and letters of intent are equally difficult to satisfy.

The present circumstances in these countries, and elsewhere in Latin America, raise two general issues about the relationship of economics and politics that I want to explore in this brief paper. First is the question of what is the "right" model to employ. Second is how to determine and implement the "right" policies. The treatment here is general, but is intended to facilitate discussion of the specific country cases.

The "Right" Model

There is no shortage of presumed solutions to the present crisis. Every IMF stabilization program is designed as one. Heterodox critics offer their own, typically structured to avoid immediate costs of lower production and income. *The Economist* on 13 July 1985, enunciated its view, popular among many, in a lead editorial: "...Latin America needs to accept that most of its salvatio can come only through export-led growth. That means realitic exchange rates, liberalised trade and curtailed bureaucracy. It also means putting out the welcome mat for foreign investors, not merely foreign creditors, as south-east Asia has do and revisionist China and India are starting to do. Most of theig debtors of Latin America are unconverted."

One cnot help be struck by two characteristics of the economic picy debate of recent years. One is the certainty with whicconflicting technical positions are maintained. The other is universalism of the models that are advanced.

The is far too little differentiation among the diverse circumences confronted by different countries. Although there is a deproblem that pervades Latin America, there are important ferences in how individual countries got into trouble, and cespondingly, in how they can be expected to get out of it.

he Southern Cone alone, the motivation for indebtedness was q different among the four countries. In Brazil it was an e decision to sustain inflow of imports to prevent even more se consequences upon economic growth. In the others, the major accumulation comes much later in the 1970's, after interest rates had already risen, and was part of an integral strategy of combatting inflation through pre-fixed exchange rate devaluation; that required convertibility, and open capital markets, to make it credible.

The consequences of indebtedness were equally distinct. In Argentina, for example, capital flight of perhaps $25 billion or more than one-half external liabilities occurred. Proportions in the others are much smaller. There are therefore counterpart real assets to help produce the interest that must be paid on the loans. But again there are useful distinctions between the productive effects of the construction boom in Chile at the end of the 1970's and early 1980's and the building of Itaipu in Brazil.

Nor is the mix of adverse external effects versus domestic policy errors after 1979 identical in all the countries. The role of the increased price of oil differs significantly among the four countries, encompassing Argentine self-sufficiency and substantial Brazilian dependence. Recession and the consequent deterioration of the terms of trade took a different toll: the accumulated decline from 1981 to 1984 in the four countries range from 8.4 percent to 28.0 percent. On the other side, overvaluation of the exchange rates was again quite distinct among the countries, as well as the incentives to unessential imports that flooded in.

These are elementary observations. But the universalism of the debt crisis in the region tends to push them to the background, and to promote universal solutions. The limitation of the IMF model is not its lack of applicability anywhere but rather the inistence upon a demand-centered explanation of balance of payments problems everywhere. Export-led growth is now very much appealing because of the impressive success of some Asian countries. But no distinction is made between resource-poor, low wage countries there and resource rich Latin American countries where indiscriminate export promotion can crowd out non-traditional exports and have adverse income distribution effects. Structuralism, and its advocacy of import substitution, was equally faulty: Brazil and Uruguay were each supposed to benefit equally from a strategy of industrialization.

Such universalism is related to a second point: the continuing espousal of contradictory economic models. It is the role of ideology, necesarily general, to interpret empirical evidence so as to make it consistent with a priori advocacy. To put it another way, there is no objective, technical set of economic relationships that can adequately be inferred from the past. No single description will satisfy all and put an end to the debate. Ultimately, the strategy selected for implementation therefore necessarily involves political considerations rather than pure economic consistency. Those policies in turn affect not only outcomes, but the underlying relationships themselves. That is what makes applied economics a handmaiden of politics rather than a pure science.

This characterization contradicts the still popular theory of economic policy pioneered by Jan Tinbergen that produces a strong separation between economics and politics. In that formulation, economic theory and econometrics yield a single underlying model specifying the interaction of economic variables, including their response to policy instruments. The task of politics is to choose a preferred solution among feasible outcomes by weighting goals like growth, price stability, income distribution, etc. Values enter explicitly only in the choice of weights in the objective function.

Reality is not so neat, and this abstraction is highly misleading. The economic behavioral relationships are not known with certainty. An a priori model is. It is not subject to easy abandonment because it is inherent in a particular ideological world view. Accumulated information may alter the presentation of strongly maintained positions, but rarely leads to their rejection: the twisting and turning of the monetarist-Keynesian controversy of the last 50 years, each bound up within a broader conception of the role of the state, is a prominent example, of which the Latin American structuralist-monetarist debate is a subset. Evidence cannot be decisive because there is never a crucial experiment whose results determine the outcome. There are always additional factors that are not held constant, and econometrics is not able to identify the true structure. Ideology does.

Under identification is endemic not merely because of complexity, but also because policies themselves influence behavior. This is one of the insights of the new rational expectations school of economics, arguing for the importance of expectations of policy interventions upon private decision-making. The analysis is especially applicable to Latin American settings subject to frequent and far-reaching changes in development strategy, and hence the context within which private agents must operate.

Although some of these advocates of rational expectations go further and insist that the perfect anticipations of the private sector offset government intervention, that conclusion is not inevitable. Expectations can be important, but also imperfect and irrational. The public is not always right or omniscient. Indeed, effective policy makers also play upon and shape expectations rather than being constrained by them. It is another link between politics and economics. Changing behavioral responses promises an additional and welcome degree of freedom permitting, and justifying, policies that evade undesired conventional tradeoffs. Latin American politicians have long understood the principle: Peron was a master in ignoring past evidence; Alfonsin invokes the cooperation of all Argentines in altering response patterns that have worked, at least personally, for more than a decade in order to facilitate an end to accelerating inflation. Now supply side economics has imported the same principle to North American policymaking.

In a world further complicated by an inability to predict accurately the evolution of exogenous variables like international interest rates, world demand, terms of trade, supply disruptions, etc., there is incentive to invert the Tinbergen policy process. Political leaders commit themselves to implementation of particular policies because these instruments become the focus of the debate: tight money, taxes, wage policy, tariffs and quotas, exchange rates, etc. Values emerge in the choice of means that are regarded favorably for their immediate consequences and distribution of benefits: one can hire economists to defend the model that rationalizes their use as consistent with a full range of goals. For no one sustains that they will accomplish single objectives: balance of payments equilibrium but no growth; redistribution of income, but inflation; growth but high external debt. Economic policies promise more.

Values become further complicated by the differential capacity of different groups not only to be heard, but also to defend themselves. Market weights are unequal: both internally, and between countries and their private and public commercial counterparts. There is an asymmetry in the ability to enforce one's preferred position. Alan Garcia may speak of his obligation to 20 million Peruvians rather than to the banks, but the threat of cutting off trade credits gives special priority to the latter. Whatever the values, and however they are aggregated, it may be impossible to enforce them, save by changing the underlying structure of economic relationships through a radical reallocation of power. That is what Sandinist Nicaragua and Pinochet Chile share in common: the direct use of intervention to accomplish what is otherwise infeasible. Note moreover that the use of the power is rationalized as necessary to the successful implementation of a particular economic model. Politics and economics remain linked even when sharp societal ruptures occur.

There is no single, "right" economic model, therefore, whose elaboration can be, or will be, left to technicians. Politics is an integral part of its determination, as well as implementation.

And it, like economic conditions, differs even among neighboring countries. Groups and classes differ in their importance; technocrats offer different alternatives; understandings of the range of allowed disagreement vary.

The absence of an absolute standard does not imply the opposite conclusion, however, that anything goes. Not all policies work, as the experience of the Southern Cone in the last decade patently reveals. Inflation does not decline, despite austerity; domestic output of wage goods does not increase markedly, despite increases in the wage share; import requirements do not diminish, despite investment in domestic industry; exports do not boom, despite real devaluation. Economic principles trip up policy makers, not because they are always binding and predictable, but because they are only sometimes constraining. There is a chance to get away with something for nothing, particularly over short stretches, and possibly even to convert initial success into behavior modification that is self-fulfilling. Conversely, doses of what should be the right medicine seem to aggravate the illness.

The luxury of experimentation is not unlimited, economically or politically. The more open the economy is, the more immediate and restrictive any internal disequilibrium becomes, spilling over quickly to the balance of payments. Heterodoxy is correspondingly riskier and rarer in small, open economies. At least if one is following orthodox policies, there is surer international assistance. It is not surprising why a structuralist-populist orientation tends to be more comfortable with an emphasis on inward-looking strategies. Insulation from the world economy facilitates increases in nominal wages and larger public sector expenditures. The deception is that inward-looking strategies may not achieve insulation.

The conclusion that there is no invariable and reliable economic model makes the second issue even more difficult: what are the "right" policies and how should they be implemented.

The "Right" Policies

In a conventional framework, the "right" policies follow directly from the "right" model and social preferences. That is exactly how many view the stabilization efforts currently being undertaken in the Southern Cone. That is why there is little tolerance for the failure to meet targets. Politics is seen as a nuisance, the more so since there is clear priority in favor of a single objective -the external imbalance is what counts. At best, politics can be exploited to explain what is being done, and to elicit support for sometimes unpleasant outcomes. If there should be lack of success, it is almost invariably blamed upon inadequate implementation, or lack of a long enough time for policies to work. Moreover, evidences of success like record trade balances are taken as indication of the correctness of what is being done overall, even when the achievements are more meager.

In the more open political climate that now characterizes Argentina, Brazil and Uruguay, and even in Chile, the orthodox stabilization model has been, and is, subject to considerable criticism. More than a self-interested unwillingness to accept the rigors of sacrifice is involved. There is a long structuralist tradition in these countries, and therefore a ready challenge to the conventional wisdom. In addition, Southern Cone countries share an unfortunate, and recent, experience in all with the global monetarist, market-oriented approach that has many similarities with the IMF model.

That structuralism in part has its origins in two realities recently emphasized by Robert Kauffman. One is the rationality of zero-sum reactions by individual groups keen on defending their distributional position. Long experience with inflation helps to learn the logic of averting the large declines in real incomes that might otherwise occur. The second is the privileged position of entrepreneurs in the contest. In the last analysis they determine prices and can avert loss of profit in downturns; and in an upswing dependent upon investment for its continuation, profits gain a special advantage. Stabilization must then meet resistance from workers as soon as it affects such principal variables as output and inflation, as it almost certainly does.

To overcome that opposition, Kauffman outlines three strategies that have been tried from time to time within open political circumstances: containment, social pact and an alternative policy package. Both his analysis, and Skidmore's before him, make clear the limited success achieved. Skidmore points out that "since 1945, not a single major Latin American nation has been able to maintain a competitive political system and, at the same time, achieve sustained control of inflation once the latter exceeded 10% per year for three years or more."

Kauffman's only glimmer of hope is that the variety of programs in Argentina and Brazil, although they all failed, did so "in different ways and for different reasons."

That record is cause for sober reflection. Yet the present situation may hold out more hope for two reasons. One is the virtual destruction of the legitimacy of authoritarian, technocratic policies in Argentina, Brazil and Uruguay, if still not in Chile. Civilian stabilization efforts are not going to be simply substituted by new military interventions in a way that was characteristic of the past. There is more of a learning opportunity, and also one that begins to convert zero-sum instincts. The second is that there is a new degree of freedom in the present crisis. Countries are transferring in excess of 5% of their gross products in interest, surpluses that can be mobilized in behalf of recovery under more favorable international conditions. They have demonstrated an adjustment potential that many doubted.

This means that appeal to an alternative stabilization model need not be an irresponsible way out. Its essential characteristics are three-fold. One is an attack on inflation that incorporates some kind of incomes policy, one that may fall short of a literal social pact, but that recognizes the need for restraint on profits as well as wages. The second is conservative fiscal policy that trims the size of the public sector. The third is reduction of net transfers abroad, with a consequent ability: to lower real interest rates and brake the deterioration in income distribution that has occurred in recent years; to stimulate higher levels of capital formation with the resources kept in the country; to lower the public sector deficit resulting from interest payments, and thereby permitting its most important stimulative functions to be sustained.

In the past, alternative models have leaned more toward an inconsistent eclecticism, ambitious in its many goals designed to satisfy a broad range of domestic opinion, but lacking the instruments to do so. They have attempted to promise too much, in part because opposition to the status quo helped to achieve electoral success. The reluctance of Alfonsin to design an effective policy is perhaps proof of the proposition that it is less binding in Brazil and Uruguay.

The feasibility of an alternative is given support by two recent Latin American initiatives. There has been a short-term frontal attacks on internal disequilibrium, a la the Argentine effort, and a Peruvian limitation on external interest payments. They are similar in two important characteristics: they go directly to large imbalances that undermine the capacity to pursue a continuous and consistent policy; and they each contain significant political content as an essential element of their implementation. Instead of politics being the source of the problem through proliferation of inconsistent demands, these initiatives seek to make it part of the solution by narrowing the objectives, and enlisting popular support to aid in implementation.

These are central elements in the search for the right policies and their successful implementation. What characterizes the Southern Cone economies are an accumulation of substantial imbalances: high percentages of product, and still higher of domestic saving, are being transferred abroad to meet interest obligations; real interest rates are high, as the counterpart of the public sector need to attract resources from the private to finance its deficit, and a lack of capital inflow; monetary expansion is large enough to sustain high rates of inflation, despite evidence of unutilized capacity and unemployment; real wages are low, relative to past levels, without inducing large increases in exports as a continuing basis of dynamism.

The stabilization policies of the IMF actually accentuate and justify some of these imbalances -like the trade surplus and interest rates- while expecting significant progress in reducing inflation and reactivating private investment. Some of the proposed alternative policies differ only in preferring a different set of imbalances: higher wages and public deficits but limited interest payments abroad. Both presume that the initial imbalances are necessary to permit a subsequent equilibrating course. Each reaches that conclusion with the aid of an underlying model.

But the discussion of the last section suggests an alternative and more conservative approach to policy-making: paying heed to economic principles and political preferences by leveling down internal and external imbalances simultaneously. The Southern Cone economies are not going a establish a sustainable basis for economic recovery while they are subject to runaway inflation <u>or</u> while they are achieving large trade surpluses; while they have large public sector deficits <u>or</u> while they have to make do with inadequate capital flows.

Stabilization is a politico-economic project. So long as no one is willing to make it part of a political platform, but only to accept its inevitability, the economic measures will be viewed as temporary, and not to be taken seriously. That is what is wrong with the view that external pressures can serve a positive function by having governments do what they otherwise would not: it leaves out of the equation the probable continuity of the policies and the corresponding domestic reaction. To achieve wider support for adjustment measures, and thereby contribute to their durability, requires a greater sensitivity to burden sharing and to prospects for transition to economic growth.

The burdens are of two kinds. One is international. Southern Cone countries cannot be expected to make net transfers of resources of recent magnitudes for much longer. It is well to remember that German reparations, fixed at around 2.5% of gross product, were feared to be intolerable; they became so only while compensating loans from the United States made Germany a net receipient of resources. As part of a cyclical adjustment, the transfer is feasible. The danger is that new capital flows do not appear on the horizon. On the contrary, everything points to a lesser future role for commercial banks and the lack of a private or public substitute.

The other side of the coin is domestic political capability in arbitrating competing claims. That has been the graveyard of many efforts. Where demands for higher wages have their origin in long periods of deprivation, and in circumstances that contribute to greater class consciousness, if not polarization, the problem is more severe. There is no <u>deus ex machina</u>. But it is much easier to make distribution policy in the context of anticipated expansion than to allocate losses: that is why recovery and stabilization, and the interest transfer and sound domestic policies are linked.

<u>Concluding Comments</u>

What I have sought to dispel is the notion that there is a single formula for economic success. On the contrary, I have stressed that the difficulty arises precisely because there are multiple solutions, and it is not always evident which is, or is not, valid. That reinforces the importance of political choice and the role of competitive parties and open debate in arriving at the right decision. At the same time such circumstances reveal the potential limitations of parties that polarize options and create opposition to losses of any kind. That is likely to encourage pursuit of solutions that promise too much, on the one side, and to foster zero-sum blocking coalitions on the other.

I have also emphasized the importance, at the present time, of economic policies that see the burden of the debt and the stabilization problem as a single whole, both from the standpoint of the politics of sustaining adjustment as well as the economics. But that must be true nationally as well as internationally. Opposition to payment of interest as a means of avoiding continuing domestic efforts makes equally little sense.

Finally, one must note the fragility of the present situation. Economic management is now a tightrope act: continuing rigid stabilization will arouse discontent just as surely as irresponsible and premature reflation. That is what *The Economist* fails to credit when it insists upon its special way out and speaks of "the populist nonsense" of Brazilian planning minister, Joao Sayad. It is a difficult test. How well Brazil, Argentina and Uruguay perform will surely influence the evolution of the very different Chilean model.