Stabilization Policies in Developing Countries: Some Policy Considerations

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ECONOMIC STABILIZATION can be defined as an improvement in the balance between supply and demand in an economy, aimed at moderating inflationary pressures and strengthening the balance of payments. The question of how stabilization policies affect economic development has been a subject of controversy since the monetarist/structuralist debate of the 1950s and 1960s.1 Broadly speaking, the "monetarist" view has been that inflation and attendant balance of payments difficulties are usually caused by allowing aggregate demand to run ahead of supply; stabilization can be approached, therefore, only in a framework in which demand is restrained within an economy's supply capacity. Structuralists, on the other hand, contend that rigidities in the pattern of production and demand typically prevent monetary restraint from being smoothly reflected in a moderation of inflationary pressures and a redirection of resources toward the external sector. In this view, demand restraint is reflected in the short run mainly in a drop in domestic output; this drop in turn acts to discourage investment, which reduces the economy's long-run capacity to earn foreign exchange. The conclusion to which such an assessment leads is

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that economic policy should focus on removing supply bottlenecks and other structural rigidities, so that overall output capacity can be raised. In this way, excess demand would be reduced and resources generated for a balance of payments improvement with less need to cut domestic absorption.

The monetarist/structuralist debate has many similarities to the long-running discussion about whether inflation is due mainly to cost/push or demand/pull factors. As a result of that debate, it has become clear that the original question was wrongly posed. A choice between two mutually exclusive theories does not have to be made; inflation is a complex interactive process in which the level of aggregate demand and the economic structure (including the structure of expectations) within which that demand operates both play important roles. Over the long run, inflation can persist only if the monetary authorities continually permit nominal demand to rise faster than real supply; in that sense, Friedman's assertion that "inflation is always and everywhere a monetary phenomenon" can hardly be disputed. But, when the structure of the economy is such that certain economic agents have substantial market power, or when inflationary expectations have become firmly entrenched, pressures on prices can persist for a long time even when conventionally used indicators show no overall excess demand. The existence of strong inflationary expectations increases, at least in the short run, the degree of monetary restraint required to achieve a given moderation of those pressures. And in the longer run, structural factors, as even monetarists would agree, determine the intensity of factor use that is consistent with price stability.

A similar synthesis is possible in the analysis of policies for economic stabilization in developing countries. With a given structure of output and relative prices, the success of an economy in achieving stabilization depends largely on how effectively domestic demand is restrained. However, the extent of the rigidities that exist in an economy will influence the

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transitional loss of output that is entailed in achieving financial balance. To the extent that measures can be introduced that improve economic structure, demand restraint is more likely to be reflected in a moderation of the pressures on prices and in a shift of output toward the external sector, so that the loss of output associated with stabilization will be reduced. The way expectations, in particular, are formed has important implications for the type of demand management policies that will succeed, and for the appropriate speed of adjustment.

Even though it is possible, in principle, to reconcile the monetarist and structuralist views of stabilization, this possibility has not prevented a continuing discussion about the relative importance of excess demand and structural rigidities in generating inflation and causing payments difficulties. Differences in analytic viewpoint on this issue have naturally been reflected in a debate on the appropriateness of particular policies designed to achieve stabilization. This debate has recently been renewed at a conference sponsored by the Brookings Institution. To the extent that an imbalance between demand and supply in an economy results in undesired inflation and payments deficits, structural improvements in supply capacity are obviously a more appealing way of dealing with the situation than measures that simply reduce demand. And indeed, the last decade has witnessed an increasing recognition of the role of the supply side in the design of stabilization programs, as is discussed in more detail later. However, it is an oversimplification of the task facing policymakers to pose the issue in terms of a simple choice between increasing supply and reducing


demand. Improving the supply capacity of an economy is desirable quite independently of the state of domestic inflationary pressures or the balance of payments (although these can, of course, provide a helpful spur to the adoption of needed improvements in economic structure). Limiting the growth of real demand within available supply, however, is a constraint that has to be satisfied, regardless of the efficiency of the pattern of production and demand in an economy. If a balance between aggregate real supply and demand is not achieved as a result of deliberate policy action, it will be achieved either as an involuntary consequence of unanticipated inflation or through additional inflows of foreign resources (i.e., with a higher payments deficit). Such a deficit, however, cannot be long maintained, and eventually policymakers have to ensure that domestic absorption is limited within the capacity of the economy to produce real goods domestically or to attract voluntary saving from abroad.

If foreign creditors are unwilling to underwrite a continued current account deficit through capital inflows, force of necessity dictates a reduction in domestic absorption to correct the imbalance, irrespective of whether the initial cause is felt to be due more to excess demand or to structural rigidity. One could, perhaps, criticize external creditors for not taking a longer-term view of the adjustment process if indeed it was true that more financing in the short term enhanced the prospects of a return to durable external balance in the medium term; however, where an economy has allowed structural disequilibria to build up and persist over a number of years, it is not hard to see why external creditors, particularly institutions that are conscious of obligations to depositors, are reluctant to accept the assertion that “just a little more” balance of payments finance will eventually allow equilibrium to be achieved. The situation would be different, of course, if the policy authorities were able to clearly identify structural weaknesses and to propose a coherent strategy for dealing with them. In such a case, additional balance of payments finance could perhaps be justified in the period before the structural measures bear fruit in an improved payments performance. A demand management strategy would still be needed, however, to ensure that potential higher output was not pre-empted by domestic sources of demand.

The issue of how stabilization policies should be designed has acquired added practical importance over the past year as a result of the large increase in current payments imbalances that
has taken place. The current account deficit of non-oil developing countries, taken as a group, has increased from US$36 billion in 1978 to a prospective US$68 billion in 1980—from approximately 3.2 per cent of their combined gross domestic product to approximately 4.7 per cent. This deficit may well increase further in 1981 and, assuming a low absorptive capacity for the economies in which much of the counterpart surplus is to be found, can be expected to decline only gradually in the years thereafter. According to the usual criteria, the size of the projected deficits would constitute a case for strong adjustment action. However, since the surpluses of the oil exporting countries are likely to remain substantial for some time, it is not clear that the usual criteria remain appropriate. Oil importing countries, as a group, can do little to narrow their aggregate current deficit; and even those countries that have disproportionately large deficits may have difficulty in narrowing them quickly without adverse economic and social consequences. Important questions therefore arise concerning how an adjustment need should be defined, how quickly adjustment should be brought about, and which instruments should be used to achieve the desired result.

The plan of the remainder of this paper is as follows. Section I considers the characteristic features of developing countries that may differentiate their response to the application of conventional macroeconomic demand management measures from that of other countries. Section II analyzes the role of demand restraint in stabilization: the extent of restraint required; the particular instruments of policy that may be employed; and the speed with which adjustment should be brought about. Section III discusses some of the cost/price distortions that tend to impair economic performance in developing countries and describes some of the policy measures that could be introduced to counteract these structural rigidities. Section IV offers some tentative conclusions.

I. Characteristics of Developing Countries

All economies have features peculiar to themselves that need to be taken into account in the design of a stabilization program.

It is clearly not possible to distinguish a set of characteristics that are common to all developing countries, and which at the same time are absent in more advanced economies. Countries fall along a spectrum in terms of their overall degree of development, and some are more advanced in certain respects and less advanced in others. In what follows, an attempt is made to identify economic characteristics that are frequently associated with countries having low per capita income. The focus is on those characteristics that tend to make the problems of balance of payments adjustment different from those faced by more advanced countries.

First, there tends to be low substitutability between export goods, import goods, and nontraded goods. Most developing countries are exporters of primary products. For countries that export raw materials, domestic demand for the export good is often small relative to total output. This is particularly true for producers of industrial raw materials, the demand for which arises mainly in richer countries. It also applies, however, to many exporters of primary agricultural commodities; typical developing country cash crops such as coffee, tea, cocoa, rubber, sisal, bananas, sugar, and spices are directed primarily at export markets. On the import side, most manufactured imports do not compete with domestic output; even over the range where substitution is more likely, product differentiation is often significant, with domestic manufacturing catering to lower-income consumers and imports having more of a luxury or investment character. What this distinction means is that restraint of domestic demand, per se, is less likely to release exportable output than is true in industrial countries, where the product mix of exports more closely resembles that of domestic absorption. While industrial countries can improve their external position by redirecting existing output toward net exports, developing countries need to change the sectoral pattern of output by withdrawing factors of production from the nontraded goods sector and redeploying them in export and import-substituting activities. This additional step in the process of adjustment to a sustainable economic structure may mean that a

9 A good description of the special characteristics of developing countries from a structuralist viewpoint can be found in Lance Taylor, “IS/LM in the Tropics: Diagrammatics of the New Structuralist Macro Critique,” Ch. 13 in Economic Stabilization in Developing Countries (cited in footnote 5), pp. 465–506.
durable external equilibrium takes longer to achieve in developing countries and, in the absence of deliberate measures to offset it, involves more transitional unemployment of factors of production.

Another major distinguishing characteristic of developing countries is that they meet the "small-country conditions," as far as prices paid for imports and received on exports are concerned. With export prices given, expenditure-switching policies, such as devaluation, can affect export earnings only through induced increases in supply. Supply elasticities are notoriously difficult to estimate and frequently depend on country-specific factors, such as the availability of land to expand agricultural production, or the existence of sources of exploitable raw materials. This situation does not make expenditure-switching policies any less important, of course, but it increases the uncertainties that policymakers face concerning the response of an economy to particular measures. A relatively large increase in the selling price of a given crop that still leaves production less profitable than alternative crops may have less effect on output than a smaller price increase that changes the profitability ranking. 10 Expectations also play a role in the supply response to particular measures. In countries that are heavily dependent on remittances (e.g., Turkey, Egypt, Pakistan), large amounts of potentially available foreign exchange may be held abroad if the holders believe there is likely to be a change in the exchange rate. Thus, the change, if and when it comes, can induce stock adjustment as well as flow responses. A similar stock adjustment mechanism can work in goods markets, although perhaps less easily. Producers will tend to hoard output, or divert it to other uses, if they believe that export prices are inappropriate and likely to be changed.

While the foregoing considerations suggest that a rapid response may sometimes occur when a country adopts appropriate stabilization measures, it must also be recognized that important lags can operate in the adjustment process, particularly for primary producing countries. Lags may be quite long when the response being sought is the exploitation of a new mineral resource or the development of new export crops with a

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relatively long growing cycle. This problem tends to differentiate primary producing countries from industrial countries, which face fewer obstacles in adapting their existing manufacturing capacity to servicing additional export demand.

A final characteristic of developing countries that needs to be taken into account in designing stabilization programs is the rudimentary nature of capital markets. Typically, the only important source of financial intermediation in developing countries is the banking system. Often, too, the banking system operates under constraints, such as lending ceilings and limitations on interest rates. This situation makes it much harder to use the financial system to efficiently mobilize and allocate savings, and it means that some of the traditional instruments of monetary policy cannot be used in support of stabilization policy. If, as is true for most low-income countries, the country’s currency is not widely held or used by foreign residents, and if domestic residents have little in the way of foreign claims, monetary policy cannot easily be used as a way of inducing accommodating flows of funds to finance payments imbalances.

In sum, the effect of the characteristics just mentioned, to the extent that they apply, is to make it harder in developing countries to bring about a balance of payments improvement through measures that simply restrain domestic demand. This is so because the resources released through a policy of demand restraint may take time to be reabsorbed in export and import-substituting activities. In the absence of policy measures designed to speed up the reallocation of domestic factors of production, demand management will benefit the payments position in the short run principally through the induced decline in imports. The cost in terms of lost output of bringing about a given external improvement may be heavier than for countries where production can be more easily diverted to the external sector.

In itself, this does not diminish the need for appropriate measures to manage aggregate demand, but it does argue for additional emphasis on supporting policies that facilitate the

12 However, in developing countries with relatively advanced financial systems (e.g., Argentina and Chile), capital flows have been an important part of the mechanism for restoring external payments balance.
switch of domestic resources from servicing consumption needs toward investment and net exports. It also argues for care in the design of a demand management strategy. The following two sections, therefore, deal in turn with demand management policies and the supporting supply side policies that can encourage efficient switching in the pattern of resource use.

II. Demand Management Policies

In attempting to control the growth of aggregate demand under a stabilization program, several types of question have to be answered: By how much should the level of demand be adjusted? Which policies are likely to be most effective in securing a planned moderation in inflationary pressures and switch of output to the external sector? and How rapidly should a desired reduction in domestic demand take place? These general issues may be characterized as (i) defining aggregate demand management objectives; (ii) devising specific instruments that enable the aggregate demand targets to be met consistently with the other goals of economic and social policy; and (iii) determining the appropriate speed of adjustment toward the level and structure of demand that is sustainable in the longer run.

DEFINING OBJECTIVES FOR AGGREGATE DEMAND MANAGEMENT

In a world of fixed exchange rates with a stable price level, the objectives of demand management policy are rather simple to define for a small open economy. Any excess of the rate of growth of nominal demand over the rate of growth of real supply tends to be reflected both in domestic price increases and in a balance of payments deficit, with the relative proportions depending on the degree of substitutability between traded and nontraded goods, and between traded goods of domestic and foreign provenance. Under such circumstances, the objectives of demand management can be defined as achieving a level of nominal demand equal to the value of domestic output plus net capital inflows from abroad, and ensuring that this demand grows only as fast as aggregate real supply. Such a policy simultaneously achieves price stability and balance of payments equilibrium.
In an inflationary world with variable exchange rates, however, a country can (in principle, at least) pursue the objectives of payments equilibrium and the achievement of a particular domestic inflation rate separately. In what follows, little is said about the relationship between inflation and economic development. At a theoretical level, it is well accepted that inflation can lead to misallocation of resources, and thus reduced output, if the money prices of goods and factors of production are not perfectly flexible. The welfare loss from this source, however, depends not only on the rapidity of inflation and its impact on different income groups but also on the extent to which the institutional structure of an economy has become adapted to the continuance of inflation. (In recent years, for example, Brazil, with its widespread indexation system, was better able to adapt to accelerating inflation than was Turkey, where price rigidities were greater.)

Desirable though a reduction in inflation may usually be, it is not an objective that provides generally applicable guidelines about precisely what level of demand will best meet a country’s medium-term development goals. In the present international environment, more pressing questions for developing countries—and for an agency such as the Fund, concerned with promoting international adjustment—are what constitutes a sustainable payments equilibrium, and what level of domestic absorption is consistent with this equilibrium.

Approaching the issue of demand management from this perspective requires, first, a judgment on what net absorption of goods from abroad is compatible with a sustainable payments balance. There are several statistical analogues for the concept of ‘balance of payments equilibrium.’ Current account bal-

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ance has a certain intuitive appeal, but in circumstances where certain countries have large structural surpluses, it is an inadequate prescription for adjustment policies. Such policies need to be framed in the light of the sustainability of a given payments structure, and thus to take full account of the "normal" capital flows that are the natural counterpart of structural imbalances on current account. Demand management policies can then aim at achieving a growth in domestic absorption equivalent to the growth in domestic supply, plus any increase in sustainable capital flows from abroad.

The difficulty comes in attempting to translate the concept of "normal" capital flows into a measurable definition that would allow a judgment to be reached on whether a given level of absorption was sustainable. A distinction has often been made on grounds of the maturity of the associated claim, or on the basis of whether the claim arises through the banking system or outside it. Under this distinction, long-term capital inflows that do not come through the banking system would be regarded as sustainable, or "autonomous" in the Meadean\textsuperscript{16} sense, while short-term inflows through banks would be regarded as "accommodating," and therefore not indefinitely sustainable.

In practice, however, a distinction among capital flows based on maturity does not always correspond to one based on the channel by which funds are transmitted; nor does either adequately capture the distinction between autonomous and accommodating payments flows. This is particularly true in present circumstances. Major oil exporting countries are likely to have large structural surpluses in their current balance of payments for at least the next several years. The counterpart of these surpluses will be structural (that is to say, normal and acceptable) deficits in the current balances of non-oil countries taken as a group. The surplus countries have shown a preference for using short-term banking channels for the placement of their excess funds. This means that, to a considerable extent, current account deficits in the rest of the world are being financed in ways that we are not accustomed to defining as "normal" capital inflows. There is a natural tendency, therefore, to regard most individual countries that are in deficit as being in disequilibrium, even though it is recognized that, in the aggregate, oil

importing countries can do very little about their current account position.

This perception, that deficits financed by short-term banking flows ought to be essentially temporary in nature, works to the disadvantage of developing countries in the recycling process. Industrial countries are regarded as being protected against the possibility of serious foreign exchange shortage by the flexible exchange rate system, their developed financial markets, and a generally strong ratio of external claims to liabilities. Both primary and secondary lenders therefore prefer to acquire claims in the developed countries rather than in countries that do not enjoy similar circumstances. What this means is that industrial countries, largely through private market mechanisms, have much less difficulty in financing higher oil payments than do developing countries. If the private market were the sole agent for recycling, therefore, it is likely that a more rapid adjustment to an external shock of given size would be expected of developing than of developed countries.

If indeed this tendency exists, the question arises whether the Fund and its developing member countries should accept the risk aversion of the private market as given and plan a strategy of adjustment to equilibrium that corresponds to it, or whether mechanisms should be devised to enable larger deficits to be financed for longer periods than would otherwise be permitted. Such mechanisms would almost certainly require the active participation of official agencies. Even though, on the basis of a priori reasoning, it may seem reasonable for a substantial part of the surplus of oil exporting countries to be channeled through banks, to non-oil developing countries, the behavior of the private banking system cannot be mandated by outside observers. It is for this reason that the Fund has indicated its readiness to lend considerably greater amounts in relation to quota than in the past, and to support adjustment programs phased over a longer period. 17

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THE INSTRUMENTS OF DEMAND MANAGEMENT

Once the needed degree of improvement in the balance of payments has been decided upon, and the associated reduction in net domestic absorption determined, the question arises of how this aggregate result is to be achieved. The Fund's approach to the design of stabilization policies has been characterized as monetarist, and it is true that it owes much to the framework proposed by Polak and developed, tested, and refined in a number of subsequent contributions. This framework rests on the assumption of a stable demand function for money, which, in an open economy with a given level of real income, means that any excess monetary creation as a result of the domestic credit expansion activities of the banking system will generate a balance of payments deficit. Although the nature of the money demand function naturally varies between countries, available evidence bears out the contention that it is usually sufficiently stable to act as a useful fulcrum for policy actions.

While the rate of monetary expansion (or the domestically generated component of it) may be a useful shorthand expression of the intended stance of overall demand management policy, it leaves open the question of the particular instruments to be used in achieving this overall goal. The choice of instruments is important, not only for meeting whatever aggregate monetary objective is set but also for reconciling demand management targets with other economic and social objectives.

For the most part, developing countries are not able to pursue monetary objectives by relying solely on the kind of monetary policy instruments that are employed by central banks in countries with highly developed financial systems. As Blackwell

20 Mohsin S. Khan, "Monetary Shocks and the Dynamics of Inflation," Staff Papers, Vol. 27 (June 1980), pp. 250-84; Jose Viñals and Frits van Beek, "The Demand for Money in Latin American Countries, 1964-78" (unpublished, International Monetary Fund, November 21, 1979); Andrew D. Crockett and Owen J. Evans, "Demand for Money in Middle Eastern Countries," Staff Papers, Vol. 27 (September 1980), pp. 543-77.
has noted, the achievement of the complex set of economic objectives embodied in most stabilization programs typically involves the use of a variety of instruments in an eclectic and mutually reinforcing way. In particular, fiscal policy is usually assigned a major role in an overall strategy of demand restraint. 22 While the "fiscal approach" has sometimes been treated as an alternative to the "monetary approach," 23 it is more realistic, particularly for developing countries, to view it as complementary. Because of the limited availability of financing sources outside the banking system, it is frequently not possible for developing countries to achieve a significant deceleration in monetary growth without a reduction in the government's overall deficit—at least, if severe "crowding out" of private sector borrowing is to be avoided.

The central role of fiscal policy as a stabilization instrument leads to the further issue of whether the specific means by which an overall fiscal impact is achieved matters for the success of a program. It is clear that measures affecting taxation and public expenditure have potential implications for income distribution, which in turn bear on the social and political acceptability of a stabilization package. Judgments on these aspects of economic measures must, of course, be left to the authorities directly involved, 24 but it is important for outsiders concerned with the formulation of adjustment programs to be aware of this dimension of the problem.

Beyond the social and political implications of fiscal actions, the choice between different tax and expenditure measures may have an impact on the level and rate of growth of output, on inflationary pressures, and on the balance of payments. Clearly,

24 For this reason, the guidelines on conditionality adopted by the Fund (Mookerjee, cited in footnote 6) explicitly state that performance criteria (i.e., criteria that must be met for a country to have continued access to the Fund's resources) are to concern themselves only with macroeconomic magnitudes. It should be recognized, of course, that the specific measures that enable these macro-objectives to be attained are an intrinsic part of formulating the stabilization program.
it is desirable to concentrate on demand management policies that have the most favorable consequences in these other areas. A general objective would presumably be to employ fiscal measures that improve (or at least do not adversely affect) the structure of relative costs and prices and the efficiency of resource allocation. In a number of countries, this consideration argues for increasing prices charged by loss-making public enterprises. However, if institutional arrangements are such that administered price increases are quickly reflected in upward wage adjustments, such an approach may have adverse consequences for the goal of controlling inflation. In such circumstances, if price adjustments are felt to be desirable to improve the structure of costs and prices in an economy, such adjustments would have to be accompanied by measures that tended to damp down the "pass-through" effect into domestic wage and price determination.

Government expenditure and taxing decisions can have an effect on the structure of output, as well as its aggregate level. Investment expenditure, for example, typically has a large import component. If, as is true in a number of developing countries, the import component of investment expenditure is largely aid financed, then spending cuts in this area will have a proportionately smaller effect on the overall balance of payments. This factor, together with the contribution that investment makes to future growth of output, may be a strong reason for maintaining investment expenditure associated with capital inflows.

Another instrument of demand management policy that typically forms part of a stabilization program is interest rate adjustment. In developed countries, higher interest rates are usually regarded as a means of restraining aggregate demand, and thus are contractionary in their impact. Because their effect is mainly on investment in longer-lived assets, higher interest rates have been viewed as less desirable means of restraining aggregate demand, from a development point of view, than measures that curb current spending more directly. More recently, however, it has been recognized that, in a regulated financial system subject to direct controls on interest rates and on the volume of lending, interest rates are not the main mechanism by which credit is rationed. 25 Higher interest rates do not, there-

fore, necessarily reduce aggregate demand. To the extent that they direct financial resources from consumption to saving, they enable financial intermediaries to finance a higher volume of investment. Also, by discouraging low-yielding investment, they may free resources for higher-return projects, thus improving the efficiency of aggregate investment. In countries where "financial repression" (to use McKinnon's term) has hindered capital formation, higher interest rates—coupled with measures to reduce total absorption—can enable developing countries to maintain overall investment levels while improving efficiency and curbing consumption.

An important instrument of demand management, whose overall impact has also been the subject of considerable debate in recent years, is exchange rate devaluation. In the normal case, exchange rate devaluation tends to increase the demand for domestic output, so that its role in a stabilization program is both to switch demand to the foreign sector so as to improve the balance of payments and to offset, in part, the deflationary consequences of a restrictive demand management policy. The role of devaluation in switching demand from nontraded to traded goods can be regarded as structural, influencing the pattern of relative prices in the economy. As such, treatment of this aspect of exchange rate policy can be deferred to the next section, which deals with structural and supply side factors.

Exchange rate adjustment, however, will typically also have an effect on aggregate demand, which can reinforce or offset demand effects stemming from domestic fiscal and monetary measures. The casual assumption that, by itself, a devaluation is likely to be expansionary has recently come under attack from both monetarist and structuralist quarters. On the monetarist side, Dornbusch, among others, has pointed out that in a small open economy, where the domestic price level is determined entirely by the outside world, an exchange rate change can affect only the purchasing power of financial assets denominated in local currency. By reducing the real money stock, therefore, its impact is unambiguously deflationary. In a more structuralist vein, Cooper and Krugman and Taylor have noted that if

the demand for imports is inelastic, a devaluation will reduce real incomes and, thus, the demand for domestic output. This effect could outweigh the stimulatory effect of devaluation on exports, especially if the supply elasticity for exports is low and, as is often true in developing countries, merchandise exports are smaller than imports.

The monetarist view of devaluation, while perhaps a helpful framework for long-run equilibrium analysis, has relatively little to say about the adjustment path by which an economy moves from one equilibrium state to another. Also, it ignores the practical reality that the rate of change of the money stock will itself be affected by an exchange rate adjustment. As has been noted in Section I, developing economies suffer from structural rigidities that delay adjustment and create short-term disequilibrium. This makes an analysis couched in terms of the equilibrium determinants of demand for and supply of money of limited usefulness for understanding the short-term and medium-term response of an economy to a particular policy measure, such as an exchange rate adjustment. For this reason, there is no satisfactory alternative to an assessment of the impact of a devaluation in the market for goods, taking adequate account of the lags that are likely to operate. Ahluwalia and Lysy 29 have demonstrated how this can be done in a simulation model for Malaysia; their conclusion is that devaluation may be deflationary for a number of developing countries, although they acknowledge that this conclusion rests on the values assumed for the relevant supply and demand elasticities. Since these values are bound to vary between countries, depending on such factors as the level of development, production structure, and degree of openness, the impact of devaluation in particular circumstances needs to be assessed on a case-by-case basis. Only thus can the degree of expansion or restraint caused by an exchange rate adjustment be meshed with the demand impact of more specifically domestic policies.

SPEED OF ADJUSTMENT

A last question affecting aggregate demand is the speed with which a given level of excess demand should be eliminated from

the economy, and external equilibrium restored. In many of the early stabilization programs supported by use of Fund resources, adjustment in the level of demand was envisaged to take place within one year, although repayment of the amounts borrowed could be phased over three to five years. More recently, Fund programs have tended to cover longer periods and have explicitly acknowledged the need to implement structural reforms. The reasons for this change in emphasis are several: the growing proportion of Fund programs dealing with primary producing as opposed to manufacturing countries; greater awareness of the structural impediments to adjustment in these countries; and the larger and more persistent character of payments imbalances in recent years.

There is relatively little empirical evidence on the advantages of gradual as opposed to rapid adjustment, from the point of view of output and growth. As a general rule, it would be widely agreed that incipient payments disequilibria should be corrected at an early stage through measures that could be moderate in their impact. This action is not always possible, however, both because emerging difficulties are not adequately foreseen and because external developments (the oil price increase, for example) may have a sudden major impact on the external position. Where, for whatever reason, a country encounters a need for large adjustments in the growth of nominal demand, the rigidities emphasized by structuralists would seem to imply that resources should be shifted gradually between uses: the relative success of “gradualism” in Brazil and the difficulties encountered in “shock treatment” in Chile can be adduced in support of this proposition. However, if there is resistance to needed shifts in resources, this could also be used as an argument for substantial demand measures initially, so as to create an adequate incentive to ensure that resource reallocation actually takes place. Whatever the economic arguments are between shock treatment and gradualism, the issue of the speed of adjustment is likely to have an important political component. Common sense, as well as experience in a number of countries with difficult adjustment problems, suggests that measures that result in a significant drop

in living standards for politically influential groups are hard to put through, even though their medium-term economic benefits outweigh short-term costs. Similarly, programs with adverse effects on the income levels of the most disadvantaged groups in society are likely to be socially unacceptable. 32

Where countries have been able to marshal an adequate consensus to undertake strong measures to improve the payments situation, the evidence suggests that development does not necessarily suffer. Following the oil price increases in 1973-74, a number of countries in Asia adopted firm measures to restrain domestic demand and sought to switch output to exports through allowing their effective exchange rate to depreciate. As a result, Korea, the Republic of China, Thailand, and Singapore all maintained satisfactory growth rates in the period 1974-76. Among those countries that allowed an acceleration in monetary demand, Argentina, Jamaica, Zaïre, Chile, and Ghana not only had continuing weakness on the external account and accelerating inflation but also had low or negative real growth rates during these same two years.

“Speed of adjustment,” however, when the adjustment referred to is in the balance of payments, is an issue that can be adequately addressed only if the global environment within which adjustment is to take place is known. If world economic conditions are buoyant, and there is no major country or group of countries with a built-in structural surplus, the optimal adjustment path for a deficit country will depend on the ease with which it can divert output from domestic to foreign absorption. In present circumstances, however, with a structural surplus in oil exporting countries and sluggish growth in the industrial world, it must be recognized that the process of adjustment among non-oil developing countries is likely to be prolonged.

It is not easy to devise general guidelines for how much adjustment and how much financing deficit countries should undertake. The amount of financing available from commercial sources is, for the reasons noted, an inadequate guide to how much net absorption of real resources from abroad developing countries should properly assume. Some countries have little

access to commercial borrowing, although it would be widely recognized that rapid adjustment of their current account would result in a disproportionate loss of output. In such cases, the only source of finance to mitigate a cutback in domestic absorption is official balance of payments assistance through the Fund, or bilateral or regional sources. For such assistance to be effective in restoring medium-term payments balance, a path of adjustment to sustainable equilibrium must be planned and supported through appropriate policies. This adjustment path has to be worked out in light of the cumulative payments deficit that the debt service capacity of the economy can withstand, and the level of domestic absorption that is consistent with this deficit and with the output capacity of the economy.

III. Measures Affecting Supply Capacity

The most important influence on "supply"—in the sense of the level of output that is achieved and the rate at which it is expanded through time—are measures on the demand side. Stabilization involves reducing the rate of growth of demand for money relative to real supply and switching some part of output from servicing an actual domestic demand to a potential external demand. In a frictionless world, all this could be achieved without transitional loss of output and simply by regulating the level of domestic demand for money. Where frictions are present, transitional costs are inevitable. A reduction in demand typically results in loss of output before the unemployed resources are absorbed in other uses. This loss could be minimized through measures that enable the reduction in demand for factors of production in declining activities to be more closely matched by an increasing demand elsewhere. One of the more obvious ways in which this can be done is through policies affecting relative prices; devaluation, for example, as already noted, will encourage the expansion of export industries, which will help to counteract slack resulting from restraint of domestic demand. Beyond the role of exchange rate adjustment in promoting switches in demand, however, transitional unemployment of productive factors can be reduced through measures to eliminate specific bottlenecks, through increasing the capacity of the economy to meet changes in the structure of demand, and through designing demand management measures in such a way that they promote efficient allocation of resources.
Particular supply bottlenecks are usually country specific and beyond the scope of this paper. At a more general level, however, supply capacity is impaired by cost/price distortions, which are often quite pervasive in developing countries suffering from excess demand and balance of payments weakness. They arise in part because of the uneven pattern of development that has characterized the growth path of most developing countries. Distortions also occur because of the propensity of governments to intervene in the pricing and allocation of resources. The mistrust of unregulated market forces that gives rise to such intervention may well be justified, but the attempt to regulate prices with political as well as economic ends in view has often resulted in an accumulation of distortions that have undoubtedly impaired economic efficiency. This is particularly true in an inflationary environment when the combination of regulated and unregulated prices can quickly lead to disparities if government-controlled prices and market prices are not harmonized in a timely and appropriate way.

The most obvious, although not necessarily the most harmful, type of cost/price distortion occurs where the price of goods and services provided by or through the public sector is held below the opportunity cost. Where the product in question is an intermediate input—say, energy—the distortion is transmitted to other sectors of the economy. Distortions also often arise in the pricing of factors of production, with subsidies to capital formation (especially through duty-free import privileges), combined with minimum wage laws, generating unemployment that incidentally leads to further pressure for consumption subsidies.

Low interest rates lead to a distortion in the allocation of resources between present and future consumption, which lowers the savings rate and, as McKinnon and others have shown, stifles financial intermediation, reduces capital formation, and thus impairs the rate of growth of aggregate supply. The exchange rate is another price that is a frequent source of

33 Leaving aside for the moment the distortions introduced by an inappropriate exchange rate.
distortion—a disequilibrium rate resulting in shortages and administrative rationing, which not only reflect a balance of payments problem but may, because of fixed production coefficients, also result in output losses several times the value of the unavailable inputs. Recent examples of countries in which domestic output has been severely affected by shortages of imported raw materials and intermediate goods include Turkey, Zaïre, Jamaica, and Sudan.

The adverse consequences of these distortions on economic performance are easy to describe qualitatively, although not easy to measure. The fact that the prices of goods do not properly reflect costs of production (including scarcity rents) means that the utility in consumption of a given market value of expenditure is less than it could be. Distorted factor prices may result in inappropriate technology being used, often resulting in a higher level of unemployment than is necessary. Furthermore, investment is directed toward goods whose prices are free to move, irrespective of the real relative yield of such investment. In extreme cases, nonproductive inflation hedges, such as precious metals, jewels, and real estate, absorb a disproportionate amount of total savings. And the discouragement to efficient investment is likely to be even greater if the future movement of costs and prices is perceived to be unpredictable. Inappropriate interest rates compound the distortion in the allocation of factors of production between consumption and capital formation. Finally, an inappropriate exchange rate diminishes the potential gains to be derived from the exploitation of comparative advantage and requires the external position to be balanced by other means.

The kinds of structural adjustment in relative costs and prices (as well as the liberalization of the price-setting mechanism) that are needed to improve the supply capacity of the economy and to increase the rate of growth are, of course, desirable quite independently of the need for stabilization policy. Thus, the fact that such distortions exist is, in many cases, a reflection of political factors (including inertia), rather than a purely stabilization problem. Outside agencies collaborating with national governments cannot do otherwise than accept the latters’ judgments of the domestic political constraints on the formulation of economic policy—provided always that the government concerned is able to propose a strategy that enables a viable payments situation to be achieved. If the political justification
for the existence of a particular institutional and price structure is regarded as sufficiently powerful, its adverse impact on supply capacity can be offset, from a stabilization point of view, by adequate action to restrain demand. However, in the kind of inflationary environment in which stabilization policies are required, the structural distortions introduced by price rigidities are likely to be more apparent and more harmful. Furthermore, the need for strong measures to correct excess demand and to improve the balance of payments may act as a spur to the adoption of structural price adjustments that had previously been resisted.

The need for comprehensive stabilization programs to pay adequate attention to encouraging supply as well as to managing demand—something that has always been acknowledged—has received increasing attention of late. The difficulty lies in translating general expressions of intent into definite policy actions. As has already been noted, measures to improve supply generally involve difficult political or social decisions; if they did not, they would already have been implemented. Structural price adjustments can, however, be adopted within the framework of a stabilization program by concentrating fiscal measures in those areas where price adjustments are required for allocational reasons. For example, public sector output prices can be raised to commercial levels, as part of a policy of reducing public expenditure (on subsidies) or increasing revenues (through the transferred profits of public enterprises). Taxes can be shifted from a specific to an ad valorem basis to avoid erosion through inflation. Transfer expenditure can be reduced from blanket subsidies on consumption to specific income transfers, limited in absolute amount. In Sri Lanka, a country that has relied heavily on consumption subsidies, the Government's stabilization policy has incorporated major changes in subsidy administration as a means of both improving relative prices and restoring fiscal balance. Egypt has adopted similar, although so far less sweeping, measures. A particular area of policy that has acquired increased importance recently is energy pricing. Higher energy prices can serve a number of useful functions simultaneously:

restraining imports, improving the fiscal position, and providing needed incentive for changes in the pattern of demand and output.

Higher prices can, however, run counter to social objectives, especially when the prices being raised are for basic consumption goods. Therefore, a basic dilemma can arise between policies aimed at improving aggregate output and the desire to at least maintain the living standard of lower-income groups. Although in principle this dilemma could be resolved through the use of different mechanisms of income transfer, the administrative apparatus to apply this solution does not always exist.

Another dilemma is presented when the need to make an upward adjustment in public sector selling prices, to restore fiscal balance, runs counter to the desire to stabilize prices with a view to containing inflationary expectations. From a presentational point of view, it is hard to explain to the public, and its elected representatives, that inflation can be tackled by raising prices. More substantively, however, where the persistence of price increases is due to inflationary expectations rather than to conventional excess demand, upward price adjustments to increase public sector revenues may be the wrong strategy on macroeconomic grounds (even though desirable from the viewpoint of resource allocation). In such circumstances, the appropriate policy may involve direct action to influence the formulation of expectations and to educate public opinion to the relationship between the pricing policies of the public sector and inflation.

Where cost/price distortions have resulted in low levels of capital formation, the balance of incentives between savings and investment can be partially restored by fiscal measures that reduce the deficit (or increase the net saving) of the public sector. This reduces the proportion of private sector saving absorbed in financing the government’s deficit and permits these resources to be directed to financing additional private capital formation. Beyond fiscal measures, however, action to permit interest rates to play a greater role in the determination of savings and investment can help both to mobilize savings and to

more efficiently allocate investment. Korea\(^3\) is a particularly striking example of a country in which higher interest rates led to increased savings and investment in an atmosphere of rapid growth and reasonably stable prices. Other, more recent, instances where stabilization programs have included significant adjustments in interest rates include Chile, Argentina, Turkey, and Israel (all of which have largely removed direct controls over financial intermediation), and Egypt and the Philippines (which have chosen to adjust interest rates upward, while retaining central control).

IV. Summary and Conclusions

This paper has attempted to address the question of how stabilization policies impinge on the basic objective of developing countries to maximize the rate of growth of economic welfare of their populations. It was observed that balance of payments equilibrium is a constraint that cannot be escaped, even if its achievement requires sacrifices in terms of economic development. A cursory survey of country experience in the 1970s, however, suggests that achieving the goals of stabilization policy—balance of payments equilibrium and a moderation of domestic inflationary policy—does not seem to require a sacrifice of growth except in a short-term sense. The countries that were most successful in dealing with the payments shock of 1974 and the countries that have been most successful in moderating inflationary pressures are by and large (and with important exceptions) the ones that have best maintained their real economic growth.

Stabilization policies are inevitably directed primarily to the management of aggregate demand. This is so partly because the demand side is more amenable to macroeconomic management but also because changes in the level of aggregate demand are essential if any incentives to transfer economic resources, or to moderate price pressures, are to be sustained. Beyond measures to influence aggregate demand, it is possible to switch the structure of demand by relative price changes, including those brought about through devaluation and interest rate adjust-

ments, as well as by direct pricing measures. The task of stabilization policy is to achieve the desired shift in demand while at the same time moderating inflationary pressures and avoiding severe unemployment of factors of production.

The choice of demand management measures will be the principal factor determining the transitional loss of output involved in a stabilization program. However, measures more directly addressed to the supply side can facilitate resource transfers, and can improve the overall supply capacity of an economy. If the balance between supply and demand can be restored without any cut in real consumption levels, a program is more likely to find a sufficient political consensus, quite apart from its more satisfactory results in terms of economic welfare. The main supply side measures that can be employed in the context of stabilization programs are those that tend to reduce price distortions, improve the allocation of resources, and mobilize voluntary savings.