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Growth, integration, and macroeconomic policy design: Some lessons for Latin America

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Abstract

The paper examines government spending that is financed by taxes that distort output and by the inflation tax. High inflation and low output are the consequence of fiscal ambitions that exceed the current capacity of the economy to support. Supply-side growth alleviates this tension, allowing lower inflation, lower tax distortions, and higher output.

In the presence of commitment problems, resolving only the problem of monetary commitment, but not commitment in fiscal policy and supply-side performance, may actually make things worse. Dollarization, when coupled with unresolved fiscal and supply-side commitment problems, may induce permanent stagnation. Unambiguous welfare improvement, therefore requires tackling all distortions simultaneously.

The paper concludes by discussing the practical lessons that may be drawn from these principles for Latin America.

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1. Introduction

Even the richest countries face the ongoing challenge of how to combine monetary and fiscal discipline with sustainable growth. Growth requires not merely factor accumulation, but the appropriate market and political institutions. Rich countries are rich partly because of their past success in resolving these issues. Other countries hoping to catch up, for example, those

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in Latin America or in Eastern Europe, have to build the right institutions as well as adopt the correct policies. Different policy regimes alter the incentive to reform, and the inherited level of structural and institutional reform affects the policies then likely to be adopted.

A quick fix is unlikely to succeed, because it is wrong to think about problems in isolation from one another. Argentina's currency board lasted longer than Russia's pegged rouble exchange rate, but the eventual outcomes were the same. Monetary discipline was not a sufficient condition for either fiscal responsibility or institutional reform and significant supply-side improvement. Not merely was the flagship monetary policy doomed to fail, it may even have delayed progress on other fronts. Analyzing whether or not this was true requires the specification of a suitable model, in which significant failures of monetary, fiscal and structural policy exist and interact.

Viewing the problem in this way emphasizes the economics of the second best. Facing multiple failures, progress in a single dimension may not improve the outcome. Nevertheless, the first-best is unattainable in a single giant step. Although a change of monetary regime, uniquely, can be undertaken almost overnight, other regime changes take much longer. Changing the level and structure of taxation and government spending takes several years, and, as Arthur Okun famously remarked, there is nothing wrong with supply-side economics that dividing by 10 would not cure. Vital as it is, it is a lengthy business that must be sustained over a long period.

Unlike the possible clarity of a change of monetary regime, changes in fiscal policy, and *a fortiori* changes in structural policy, are harder to monitor. For example, despite the need for fiscal commitment, the Euro Area Stability Pact remains ambiguous. Ideally, its constraints on budget deficits should apply to cyclically-adjusted budgets; in practice, uncertainty about the unobservable level of potential output so raised fears of strategic manipulation and moral hazard that the Pact was framed, less desirably, in terms of actual deficits.[1] Those of us who worried about whether this would be enforced *ex post* have been proved correct. The widening German deficit sensibly escaped official censure in January 2002, but the slippery wording of the subsequent communiqué did little to enhance confidence in the commitment technology that the Pact is supposed to provide.

The EU has made progress in both monetary and fiscal commitment. In marked contrast, there has been almost no progress on labor market reform. This may reflect substantial political costs to incumbent policymakers, but it may also have been impeded by the macroeconomic regime in force. Would a different macroeconomic regime have changed the incentive to reform? Again, only a coherent model can answer this question.

Globalization continues apace, undermining the sovereignty of nation states to set interest rates, choose tax rates, levy tariffs, and regulate domestic markets. Logically, this raises the payoff to coordinating some political decisions at a higher level. As the Europeans discovered, this offers a unique opportunity to rethink and redesign institutions and regimes. European examples include not just the European Central Bank and the Stability Pact, whose rules were designed *ab initio*, but also significant evolutionary progress on common regulatory structures and migration policies.

The nation states of Latin America have ridden the rollercoaster of success and failure. Decisive changes in macroeconomic regime, particularly in monetary policy, have grabbed headlines, and have for a time succeeded. Yet they have usually been undermined by fiscal indiscipline and supply-side stagnation. These issues should be considered simultaneously.