Why crises can be good for growth

Shocks often lead to crises—crises of negative growth, inflation, and debt. Countries that experience high inflation with negative growth show an immediate recovery in growth following stabilization. Countries that experience a large buildup of debt with negative growth do not show a recovery in growth after debt rescheduling.

In the past twenty-five years the international economy has witnessed a series of unusually large external shocks: oil and commodity price shocks, the debt crisis of the 1980s, the breakup of the Soviet Union, and several, mostly local, wars. External shocks often lead to growth crises—and these can show up as balance of payments and external debt crises. Moreover, growth crises often come together with high inflation or the buildup of foreign debt. Even so, the path to recovery is different for each combination—negative growth with high inflation or negative growth with rapid growth in debt.

There is a marked difference between average growth following high-inflation crises and growth following debt crises. Countries that experience high inflation show an immediate recovery in growth; countries that experience debt crises generally do not. This finding suggests that countries that do not experience high inflation have negative growth immediately following their crises. In fact, per capita growth in these countries is still zero, on average, fourteen years after the growth crisis. Thus the recovery of growth following inflation stabilization is not just a mechanical reversion to trend.

What triggers deep crises of negative growth, inflation, and debt? Which combinations of macroeconomic policies and structural reforms have brought about recovery in growth? What do we know about the speed of recovery? Given that for some class of crises (the high-inflation ones) adjustment policies have been shown to work quickly, why are reforms delayed for so long? What is the role of foreign aid in these processes? These questions form the backdrop to this analysis.

Beneficial crises

Over the past twenty years fifty-five developing countries had external debt crises. Of these, fourteen that suffered prolonged high inflation—that is, running at more than 40 percent a year—later stabilized and introduced structural reforms, including opening up their economies. Nineteen of the fifty-five, however, never had inflation above 20 percent, and most did not reform until recently. These economies also remained closed. For the high inflation-stabilization and structural reform group, per capita income went down then recovered during 1980–94 (figure 1). All these economies but one enjoyed positive per capita growth in 1991–94. The median per capita income of the low-inflation group fell steadily until 1993 and then stabilized. Most of these economies (fourteen of nineteen) continued to contract in 1991–94.
Latin America's experience with adjustment and reform is a prime example of seemingly beneficial deep crises. The region's response to high inflation included stabilization, trade reform liberalization, and other reforms. The franc zone in West Africa is, unfortunately, a counter example. These countries (tied for forty years to the French franc) had low inflation. They borrowed abroad to finance public deficits and suffered a substantial real appreciation of the exchange rate. This approach resulted in low inflation, but it also blocked adjustment and led to successive debt crises. Inflation followed by stabilization versus inflation with no adjustment is not, however, a story of Latin America versus Africa. It is one of relative incentives.

There is a close correlation between stabilization and trade liberalization in resolving high-inflation crises. The high inflation-stabilization economies become unusually open post-crisis. But what about the low-inflation group? Of the sixteen low-inflation countries, eleven were closed in 1994. Low inflation should follow from low budget deficits unless the inflationary pressures of budget deficits are diverted instead to an external imbalance and creditors are willing to finance the deficit through capital inflows. This is what happened in the low-inflation economies.

Public sector deficits were worse in the high inflation-stabilization group in the first half of the 1980s—and this had much to do with their

**Figure 1. Comparing debtors with high inflation and stabilization and debtors with low inflation**

*Note: Samples include 13–14 countries for high inflation and stabilization and 16–19 for low inflation. Source: Bruno and Easterly 1996.*
subsequent inflation crises. But in the late 1980s and the 1990s these deficits fell more than those in the low-inflation group.

- Current account deficits were higher in the low-inflation group during 1980–93. Budget deficits showed up as current account deficits rather than as inflation.
- Grants increased sharply in the low-inflation group but were modest in the high inflation-stabilization group.

In sum, for the low-inflation countries the lack of adjustment is associated with their access to soft external finance—foreign aid. High- and low-inflation countries started with similar access to such finance, but foreign aid as a share of GDP fell throughout the 1980s and the 1990s for the high inflation-stabilization economies while it generally rose for the low-inflation economies.

The role of foreign aid

Does foreign aid delay adjustment? It can. The debt crisis left Latin America without access to market-based foreign finance, and official finance did not fully close the gap. Attempts to tap domestic finance led to high inflation and crisis. Only adjustment could restore equilibrium. And, after adjustment, these economies required access to global capital markets. The same is not the case for low-inflation countries. After the debt crisis, they relied increasingly on official external flows to finance their unadjusted economies.

There is another lesson here: that a severe crisis forces countries to act, rather than muddle along as they might under moderate crises. That is, high inflation today could lead to lower inflation tomorrow.

Official foreign aid and grants to low-inflation economies started to fall in 1990, and current accounts stabilized. This marked the beginning of change. After much delay, the franc zone in Africa undertook major reforms in January 1994, starting with a 50 percent devaluation. It is too early to assess the full impact, but output growth is already positive, fueled in part by rising exports. Fiscal deficits have been reduced and are expected to drop further in 1996. Wage increases have been moderate, and inflation fell from an average of 33 percent in 1994 to 4–16 percent by mid-1995. On the flipside, structural reforms, including trade liberalization, have lagged and fiscal cuts fell disproportionately on social spending and investments. But although the quality of adjustment is still unsatisfactory, it is at least going in the right direction.

What ingredients are necessary for reform?

Two major sets of policies are required for growth recovery after crisis—stabilization and liberalization. The success of stabilization is measured by the rate of inflation, and the main policy instrument is fiscal restraint. Liberalization is measured by economic openness and the policy instrument is trade liberalization.

First, consider stabilization and fiscal behavior going into and out of crisis. In Latin America in 1970–94, the average central government deficit went from near balance in 1974 to about −9 percent by 1983, and the variability across countries then increased dramatically until about 1986. By 1994, when the region's inflation wave had abated, the average deficit and its variance had returned to their 1974 levels (figure 2). More than anything else, fiscal consolidation accounts for the stabilization of these economies. And this turning to fiscal consolidation cannot be explained only by the hyperinflation seen in a few countries. Contagious reform swept the continent.

Figure 2. Central government fiscal balance in Latin America, 1970–94

![Figure 2](image-url)

Note: Dotted lines indicate standard deviations. Source: Alesina and others 1995.
Given the empirical analysis it could be alleged that once inflation falls below 40 percent (or maybe even 20 percent) growth recovers, and so there is no need to worry about inflation below these levels or about the independence of central banks. Such thinking is wrong. Inflation, like smoking, is addictive. And an independent central bank pursuing price stability introduces an important safeguard beyond basic fiscal prudence. It ensures that inflation is kept as low as is consistent with sustainable growth, especially in countries that have come out of deep inflation crises.

Is Latin America special? No. The importance of the links between inflation and stabilization, liberalization, and growth is seen vividly in the crises and reform experiences of countries in Central and Eastern Europe. Because their entire institutional, political, and economic foundations were being uprooted, the collapse in growth and output was that much greater, with inflationary outbursts at times as high as in hyperinflation economies. The collapse in output was worsened by shifts in consumption, for both inputs and final goods. The initial high inflation followed price liberalization in the aftermath of repressed inflation (that is, in the presence of a large monetary overhang). In this context, reform and liberalization involved a more comprehensive agenda than anything seen in Latin America and certainly in Africa. Yet the basic inflationary process is not that different; nor is there a major difference in the links between stabilization, liberalization, and growth.

Important as they are, however, stabilization and liberalization cannot explain the outcomes in transition economies. Another key element is institutional—the introduction of the basic rules and instruments of a market economy. Three aspects that are central to this change are redefining property rights, adopting an independent legal authority (based on well-defined contractual obligations), and the elementary functioning of government as an efficient provider of services.

—Michael Bruno

Further reading


