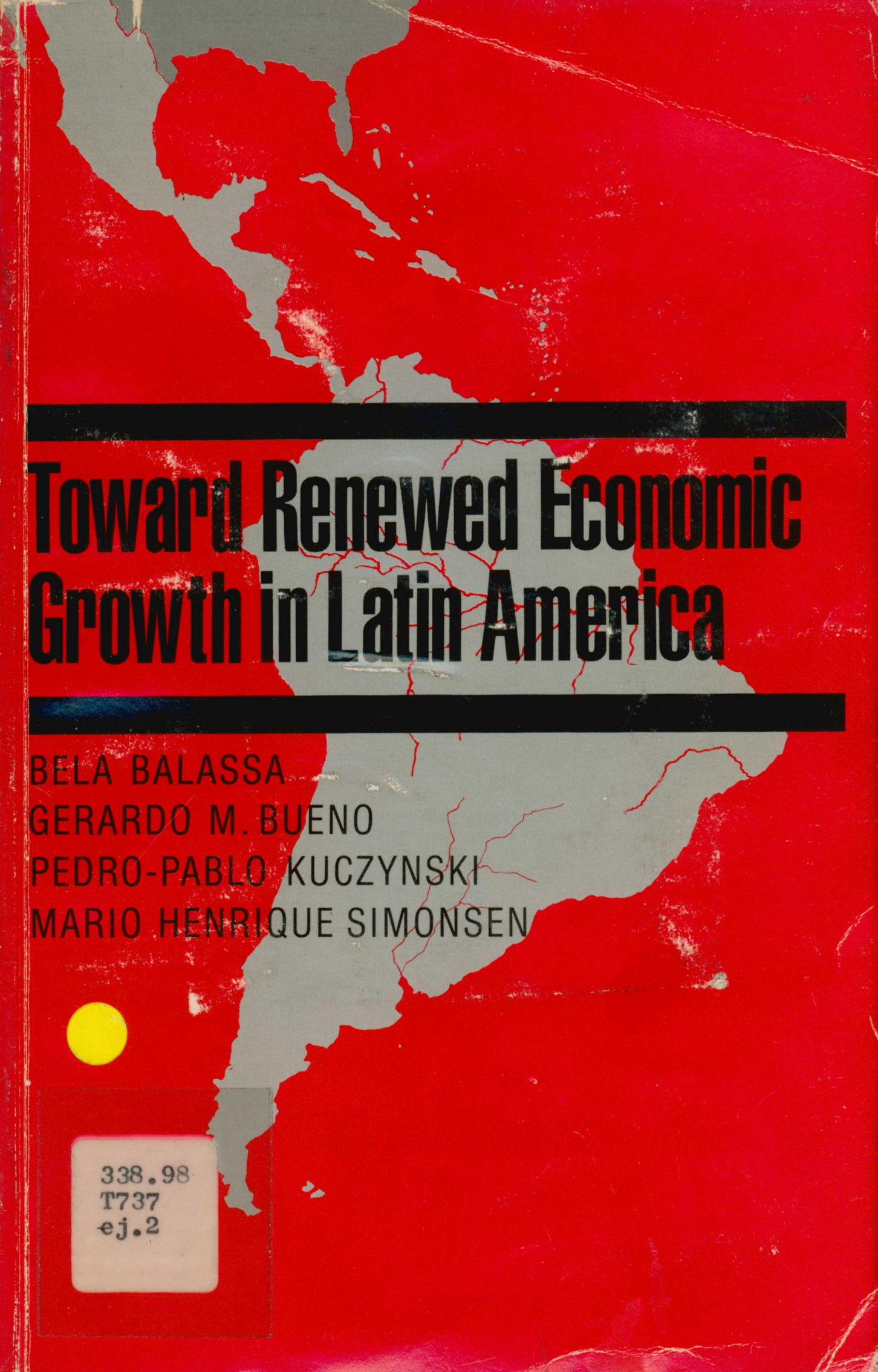

Toward Renewed Economic Growth in Latin America

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Contents

Preface

The countries of Latin America face a historical turning point. Their present crisis has five dimensions: economic, social, political, institutional, and international. Each offers immense challenges to the peoples and policy makers of the Western Hemisphere, the United States and Canada as well as Latin America itself. Each aspect must be addressed effectively if the crisis is to be resolved.

In *economic* terms, the countries of Latin America must resolve a crucial dilemma. They must find a way to resume self-sustaining growth which provides job opportunities for their rapidly growing populations. Yet they must also restore market creditworthiness through continued timely servicing of their large external debt.

In *social* terms, the present crisis has had devastating effects. Wages and living standards have fallen to levels of ten or twenty years ago in many countries. The new economic policies must have a positive and early social impact. Economic growth and improved distribution of income must go hand in hand.

In *political* terms, the widespread return to democracy must be nourished. This imperative adds enormously to the need for providing stable economic growth and improved income distribution.

Institutional issues are a fourth element of the crisis. The private sector in Latin America—whether small, medium, or large—has been weakened in most countries by the current crisis. Yet the present confluence of economic imperative and political opening seems both to call for, and to permit, a new approach in which entrepreneurial forces are encouraged to provide the jobs and broad-based growth that are needed.

The *international* dimension completes the equation. External events were the proximate source of the Latin American crisis of the early 1980s. A hospitable external environment is essential if

the hemisphere is to achieve the economic and political goals here enumerated. Global economic interdependence requires that the industrial countries, particularly the United States, complement new development strategies in Latin America with sustained and supportive policy efforts of their own.

Our three institutions, based in three different parts of the hemisphere, have sponsored this report in an effort to address several aspects of the challenge—particularly its economic, institutional, and international dimensions—and to offer an action program for responding to them. In suggesting these changes, we fully recognize the substantial differences among countries in the region. Indeed, we will illustrate many of our proposals by reference to these differences. But our primary goal is to establish generalizations that can point the way to a coherent strategy for renewing economic growth in all Latin American countries—although the operational details of any such strategy may have to be tailored quite differently in each country.

We also recognize that our proposed program is ambitious. Some of its components have been attempted before and have foundered in the face of entrenched vested interests. Implementation will not be easy.

But we are convinced that the depth and urgency of the crisis require far-reaching new initiatives. We are encouraged by the movement toward reform which is already apparent throughout the hemisphere. Hence, we offer bold proposals in full realization that they will engender controversy, but with firm conviction that they are both essential and feasible.

The report has been written jointly by a team of authors from Latin America and North America, assisted by Dr. Bergsten in preparing the Overview and Recommendations. It has been informed by extensive consultations throughout the hemisphere with leading personalities in the corporate sector, governments, labor organizations, and universities (listed in appendix A). In addition, two meetings to discuss preliminary drafts were held at the Institute for International Economics in Washington to obtain views from both Latin America and North America. The goal of this report is to offer a new growth strategy for Latin America.

The report was commissioned by the Americas Society, Inc., out of the deep concern of its membership for the future of Latin America and relations between the two parts of the hemisphere.

We wish to express our thanks for the active engagement of the Society, and particularly the Latin American members of its Chairman's Council, throughout the effort (participating members of the Boards of both groups are listed in appendix B). Funding, about half of which came from Latin America, was provided by a number of individual members of the Chairman's Council, the Rockefeller Brothers Fund, and the Tinker Foundation. The Inter-American Development Bank made possible the translation of the report. The help of all those who have supported this effort is deeply appreciated.

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Summary of Conclusions

1. This report proposes a four-part strategy to restore self-sustaining economic growth in Latin America and simultaneously to enable the continent to cope with its external debt problems. The strategy aims to achieve economic growth in a way that produces a rapid expansion of employment, better distribution of income, and an improvement of social services.

2. Three elements of this strategy require action by the Latin American countries themselves: outward orientation of economic policy, with heavy emphasis on exports and efficient import substitution; raising the savings level and allocating those savings more efficiently among alternative investments; and a sharp reorientation of the role of government in economic life. A critical fourth element is supportive policy by the industrial countries, notably the United States.

3. Outward orientation can achieve both growth and an improvement in the debt situation. It requires:

- adoption and consistent maintenance of competitive exchange rates
- avoidance of excessive import protection
- use of internationally acceptable export incentives.

4. To reach the level and competitiveness of domestic production needed to achieve growth and to improve the debt situation, the countries of Latin America must support outward orientation by significantly expanding the level of savings available from both domestic and external sources (including reversal of capital flight)

and substantially improving the efficiency with which those savings are invested. Steps to this end include:

- maintenance of positive (but not excessive) real interest rates
- tax policies that encourage savings rather than consumption
- reduction in budget deficits, which contribute to inflation and "crowding out" of productive private investment
- inducements for renewed inflow of foreign private capital, particularly in nondebt-creating forms, and reversal of capital flight. Specific measures include liberalization of rules governing direct and other foreign equity investment, creation of mutual funds and repatriation funds, and joining the World Bank's new Multilateral Investment Guaranty Agency.

5. These policy proposals in turn call for sharp changes in the role of the state in Latin American economic life:

- substantial deregulation to encourage and support entrepreneurial forces
- reducing the state's role as a producer of goods and services
- emphasizing instead providing education, health care, and other basic services effectively, and setting the overall framework for economic growth with supportive macroeconomic and microeconomic policies.

6. The United States and other industrial countries must adopt policies that will support the proposed strategy for Latin America by achieving:

- steady economic growth of at least 3 percent annually, to stimulate world trade and thus promote the needed expansion of Latin American export earnings
- renewed trade liberalization, and avoidance of new import restrictions and export subsidies

- further declines in real interest rates through cuts in excessive budget deficits (notably in the United States), reductions in spreads charged by commercial banks for countries with effective adjustment programs, and the creation of new defenses (as through a compensatory facility at the International Monetary Fund) against any future interest rate upswings

- substantial infusions of new funds to Latin America, on the order of $20 billion annually for the next few years, from the private sector and, most importantly in the near term, the World Bank and the Inter-American Development Bank.

Overview and Recommendations

The 1980s have been a "lost decade" for the economies of most Latin American countries. Per capita income is lower today than in 1980 in every nation in Latin America and has fallen by nearly 10 percent for the region as a whole. For the entire continent, average per capita income in 1985 barely exceeded the level of 1975. In some countries, per capita income has returned to the level of the mid-1960s.

The Economic Crisis

Unemployment has soared, surpassing 15 percent of the urban labor force in several countries. Underemployment has risen even more. The poorest groups have suffered particular hardship. Yet population growth continues at nearly 2½ percent per year, requiring the creation of five million new jobs annually simply to keep unemployment from rising further.

At the same time, some of the largest countries in the hemisphere have been buffeted by rapid inflation. The annual rate of price increase reached 1,200 percent in Argentina and 500 percent in Brazil before their recent monetary reforms. Even excluding Bolivia's hyperinflation, inflation has averaged 150 percent in Latin America in recent years and has exceeded 100 percent annually in a half dozen countries—despite continuing recession and rising unemployment.

Virtually every country in the hemisphere also carries a severe burden of external debt. Total Latin American debt approaches $400 billion, of which two-thirds is owed to commercial banks. One-third of Latin America's export earnings are devoted to paying interest on this debt. Net capital inflows have nearly disappeared

since 1983. Latin America has thus been experiencing a $30 billion net outward transfer of resources a year—about 5 percent of its combined gross product.

There are, of course, substantial differences among Latin American countries. Colombia, alone among the major countries, did not borrow excessively in the 1970s and has not needed a debt rescheduling. Ecuador undertook far-reaching reforms but has subsequently suffered the effects of a precipitous fall in oil prices.

The most important exception to many of the generalizations made above, and elsewhere in this study, is Brazil. In 1985–86, Brazil appears to have resumed a substantial degree of self-sustaining growth while continuing to service its large external debt. In 1985, the country grew by more than 8 percent and ran a trade surplus of over $12 billion; similar results seem likely for 1986.

Brazil accounts for over one-third of the population, and of the gross economic product, of the entire region. Hence its progress has profound importance for our overall topic—both in evaluating the policies applied and, perhaps, in offering indications for what can be done elsewhere.

To be sure, Brazil has not solved all its problems. Success is not yet assured for its far reaching monetary reform (the "Cruzado Plan"), adopted in response to its principal immediate problem of inflation. Neither has it adequately improved the distribution of the fruits of its economic growth to the population at large. Most important from the perspective of this report, Brazil's achievements do not obviate the depth of the problems faced by the rest of Latin America.

The Causes of the Crisis

The proximate cause of the economic crisis in Latin America was the global recession of the early 1980s. The combination of steep declines in both the volume and prices of their exports and sharp rises in real interest rates pushed Latin America's external balances into deep deficit. Just when most needed, capital inflows—from both commercial banks and foreign direct investment—fell sharply.

Virtually every country in the region, sooner or later, sought to respond to the crisis by adjusting its domestic economy. Radical

alternatives were rejected, except in Peru after 1984. But austerity was required. Initially, imports fell dramatically—by one-third in the region as a whole, by two-thirds in Mexico. Growth was stifled. Unemployment rose and real incomes fell.

Subsequently, some of the countries aggressively promoted exports and began their recovery. But success has been mixed: dramatic progress in Brazil, as noted; an encouraging resumption of growth in Colombia; continuing difficulties in Peru and some smaller commodity exporters; and renewed crisis in Mexico, formerly the most effective adjuster, in large part as a result of the plunge in oil prices in early 1986.

The most profound revelation of the debt crisis, however, was that Latin America faces much deeper economic problems. The global recession and its aftermath exposed the vulnerability of the continent, but the roots of that vulnerability are much more far-reaching. There are three major reasons for this conclusion.

First, many other developing countries were hit at least as hard as Latin America by global recession—yet recovered far more rapidly and far more extensively. The most successful adjusters were the newly industrializing countries (NICs) of East and Southeast Asia, where dependence on world markets is much greater than in Latin America but less reliance was based on foreign borrowing. But some other developing countries, such as Turkey, also recouped rapidly. The only other region that has suffered as long and as much is Africa, which has deep structural problems as well as a much lower level of development, and has been in economic decline since the early 1970s.

Second, Latin America has been experiencing a long-term deterioration in its economic position relative to many other developing countries, and even relative to many industrial countries. The extreme case is Argentina, whose per capita income approached the French level in 1929 but is one-fifth of that today. As shown in chapter 1, however, all of the Latin American countries considered in detail in this report (Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, and Venezuela) had much higher per capita incomes in 1950 than Korea and Taiwan. Venezuela, Uruguay, and Argentina were ahead of Finland, Austria, and Italy. Chile was ahead of, and Mexico was close to, Spain. Most of the Latin American countries surpassed Greece, Portugal,

and Turkey. As late as 1960, several of these countries were ahead of, or roughly equal to, Japan.

Many of these relative economic positions have changed dramatically over the last generation—a very short period for such historical swings. Average per capita income in the nine Latin American countries is now one-third or less that of Japan and the middle-income European countries, one-half that of Mediterranean Europe, and below that of the Asian NICs and Turkey. From 1950 to 1985, per capita income in all these countries more than tripled—while only Brazil approached such a record in Latin America and the rest of the region lagged substantially. The same story emerges from comparing growth of all exports, exports of manufactured goods, and other economic indices. There can be no doubt that Latin America has fallen dramatically behind Europe and East Asia.

Third, Latin America faced serious economic problems even before the debt crisis broke. Substantial capital flight had already reflected a loss of confidence in some countries of the region. The large external borrowings of the 1970s were not used effectively in many countries, thus failing to create the needed debt-servicing capacity. Unemployment and underemployment were already high in some countries. Rapid inflation emerged periodically. Income maldistribution was widespread. The crisis exposed and intensified these difficulties, but many of them were already present—and, in some quarters, recognized.

The sources of Latin America's fundamental problems are analyzed in the individual chapters of this report. Three sources emerge as most important:

- the inward orientation apparent in most countries, especially in their willingness to let currencies become overvalued and trade policies to remain protectionist (or become even more so)
- the lack of needed incentives to savings and efficient investment of savings, both domestic and foreign
- the excessive, even suffocating, role of the state (including state enterprises) and the concomitant weakening of the private sector.

Major changes are needed in each of these areas if Latin America is to meet its present and prospective economic challenges. Our recommendations, summarized below, are developed in the supporting chapters.

The Potential of Latin America

Before presenting the proposed strategy, Latin America's potential for addressing its problems constructively must be assessed. The difficulties discussed are substantial. Many are of long-standing duration. Many have grown much worse in the first half of the 1980s. But we believe that Latin America can meet the challenge successfully for a number of reasons.

First is the enormous potential of the continent, in both human and material terms. Its people have demonstrated considerable entrepreneurial abilities, despite government policies that often discourage their realization. Educational levels are relatively high in many countries.

In material terms, Brazil is the world's eighth largest economy. Mexico and Argentina rank in the top 20. Natural resource endowments—especially arable land, oil and mineral reserves, and hydroelectric power potential—are substantial. The industrial base and economic infrastructure are considerable for a "developing" continent.

Second is the actual record of Latin America. Despite its relative decline, already described, economic growth was quite impressive in several Latin American countries following policy reforms in the mid-1960s. And while growth rates declined over the last decade, manufactured exports rose rapidly—especially in countries that promoted exports after the first oil shock in 1973—although none of them matched the export performance of East Asia.

Even in their response to the adversities of the early 1980s, several Latin American countries revealed considerable economic adaptability and political resilience. The region improved its combined current account position by $40 billion from 1981 to 1984, about 6 percent of its gross domestic product. The predicted political instabilities failed to materialize, and democratization proceeded in several countries.

Third, the relatively greater success of other developing countries and regions demonstrates that better results are possible. There is simply no reason to believe that "the Confucian work ethic" or "the Spanish heritage" mean that East Asia can make it while Latin America cannot (chapter 1). In fact, the rapid growth of the "informal sector" in heavily regulated economies, such as Peru, suggests that the problem is not a lack of business acumen but rather an institutional structure that stifles entrepreneurial spirit in these economies. Policies, and the related economic and social structures, matter substantially, as this and many other studies show.

Even leaving East Asia aside, the growing number of "success stories" in the developing world—many in previously improbable locales—cannot fail to both provide a lesson for Latin America and offer hope for its future. Turkey, the "sick man of Europe" for a century or more, may be the first true "graduate" of the debt crisis with its remarkable turnaround since 1980 as it oriented its policies outward. India, whose economy had suffered from intensive governmental regulation, has recorded steady growth throughout this decade—in the face of global recession—and has shifted from being the world's largest food importer to a net exporter as it improved agricultural incentives. China, whose population of one billion and rigid ideology seemed destined to block its economic prospects, has begun to record high growth rates as it decentralized decision making and increased its reliance on the price mechanism (especially in agriculture).

Fourth, the starting point in Latin America is much better than is frequently realized. Savings rates, despite recent declines, are quite high. Governments are effective providers of social services in Latin America which, despite wide country variations, are comparable to those in other developing countries at similar income levels. The same thing cannot be said about their effectiveness as producers and regulators (chapter 4). Economic infrastructure has been established in the advanced countries of the region. Export expansion has been impressive in several cases: Brazil now sells aircraft to the United States, and Argentina sells turbines for electricity plants in the international market. The successes of the 1960s and 1970s inevitably left positive results, along with the buildup of imbalances and inefficiencies that brought them to a halt.

Fifth, policy change in the needed directions is already beginning to occur. Under the pressure of the crisis, virtually every country in Latin America has at least begun to reevaluate its development strategy and policy. Several countries have adopted competitive exchange rates. Some have begun to consider reducing trade protection. Mexico has joined the General Agreement on Tariffs and Trade (GATT).

Some countries have begun to privatize state-owned industry. Argentina and Brazil have launched sweeping monetary reforms. Several countries are reviewing their laws which deter foreign investment, and some of them have signed the convention establishing the World Bank's Multilateral Investment Guarantee Agency (MIGA).

Finally, improvements have occurred in the global environment which are supportive of reform in Latin America. World inflation is down sharply and seems likely to remain there; this promises greater stability and obviates the need for industrial countries to adopt restrictive economic policies. World interest rates have declined, cutting the cost of debt service and promoting more rapid growth. The fall in the price of oil, while hurting Mexico, Venezuela, and Ecuador, brings substantial direct benefit to the rest of the region and indirect benefit to all its countries by further checking inflation and enhancing prospects for faster growth in the world economy. The large decline in the exchange rate of the dollar brings major benefits to the region.

Moreover, the GATT membership seems headed toward a new round of multilateral trade negotiations which could help reverse the protectionist trend and expand market access for Latin American exports. The "Baker Plan" represents a start toward renewing capital flows to the region. To be sure, there are substantial uncertainties in the global outlook and further measures need to be taken by the United States and other industrial countries to obtain a positive outcome, as suggested in our final section. Nevertheless, the international framework is sufficiently hospitable to add to the prospects of success for a new development strategy for Latin America.

Toward Renewed Growth

A new strategy is thus both urgently needed and demonstrably feasible. Such strategies have worked elsewhere. They have even worked in Latin America. The world environment is reasonably favorable. The overriding issue is to find the proper strategy, and to implement it effectively and on a sustained basis.

Latin America has experimented with several development strategies in the past. The most pervasive was the "import-substitution model," emerging from the experiences of the Great Depression and World War II and espoused by the United Nations Economic Commission for Latin America (ECLA) in the 1950s. This approach worked for a while, partly due to favorable global conditions. But reliance on this model soon confronted market limitations (chapter 1); also, Latin America was slow to adjust to the evolving postwar environment, and new approaches were required.

Several strategies were tried in the 1960s. Elements of outward orientation, to be emphasized below, have appeared in several countries for some periods of time. Statist models from both the political left and right, as well as from the military, represented another set of experiments. Monetarist approaches were tried in Argentina, Chile, and Uruguay in the late 1970s. Economic integration of the continent captivated the imagination of many (but was never effectively implemented).

Our recommendations will draw on previous worthwhile efforts; in this sense, our proposals will not always be "new." But none of them were applied within a coherent, comprehensive framework. Even more important, none were maintained for the extended period essential for self-sustaining development to take hold and prosper. Our goal is to propose an overall strategy that will work economically, prove sustainable politically, improve income distribution and social conditions, and perhaps even capture the imagination of a hemisphere where both need and opportunity are now so great.

One key element in this basic strategy must be underlined: the need for *continuity* of policy. No country can succeed economically if it alters its basic strategy every few years, especially if those alterations are in substantially different directions as in many Latin

American countries over the past several decades. Entrepreneurs can plan with confidence, and invest for the long term, only if they can foresee a reasonably stable policy environment.

The alternative, all too frequent throughout the developing world including Latin America, is radical shifts in policy which destroy any plausible basis for sustained development. Adjustments will, of course, be required as external conditions change and the country itself evolves. But consistency and continuity, of both purpose and overall policy direction, are central to our proposed approach.

A Three-Part Strategy

Our proposed strategy contains three central elements for the Latin American countries themselves: outward orientation of the economy, with emphasis on exports and efficient import substitution; the generation of adequate levels of savings, primarily from domestic sources but from abroad as well, and their efficient investment; and a reorientation of the role of government toward its demonstrated comparative advantage of providing services and a framework for economic activity, limiting its role as regulator and producer. The critical fourth element is supportive policy by the industrial countries, notably the United States. The four parts interrelate closely, and all are essential to launch a successful development strategy for Latin America.

Outward orientation is a system of incentives that stimulates exports and efficient import substitution. Only such a focus will enable the countries of the region to achieve self-sustaining growth and simultaneously to service their external debt, because only such a strategy will generate both the needed foreign exchange and the essential stimulus to domestic production.

Outward orientation is the keystone of the strategies of virtually all the "success stories" cited above—in East and Southeast Asia, in Latin America in certain periods, in Turkey, and elsewhere. Even where success has been limited, as in Africa, relatively outward-oriented countries have done much better than the inward-oriented.

Outward orientation is particularly critical for small countries of

Latin America that have limited internal markets. But the experience of medium-sized countries, such as Argentina and Mexico, also points to the conclusion that sustained outward orientation is a sine qua non for successful development—even without the constraint of a heavy external debt, and certainly in the face of such a constraint. Even Brazil, by far the largest country in Latin America, turned increasingly outward in the mid-1960s and continues to provide extensive incentives to export activity.

Questions are sometimes raised as to whether the industrial countries will be willing to accept enough additional imports from Latin America to make outward orientation a feasible, however desirable, strategy for the continent as a whole. Our answer to this question is firmly positive.

To be sure, there has been a disturbing trend toward increased protection in the United States and some other industrial countries. But the volume of manufactured exports of the developing countries, including those from Latin America, increased at a compound annual rate of 11 percent between 1973 and 1983—despite the "rise in protection." At the end of this period, developing countries still supplied only 2.3 percent of consumption of manufactured goods in the industrial world (3.0 percent in the United States). The share of Latin American manufactured exports in total consumption in the industrial countries was only 0.2 percent (though it is of course higher in some specific sectors). Even if these exports continued to grow by 11 percent a year in real terms until the end of the century, and the industrial countries' consumption rose by 3 percent annually, Latin American exports would still meet only 0.8 percent of final demand for manufactured goods in the member countries of the Organization for Economic Cooperation and Development (OECD).

Moreover, Latin American countries can increase their exports to each other and to other areas of the world outside the OECD. If the forthcoming multilateral trade negotiations further reduce import barriers, and especially if they place effective constraints on the use of safeguard measures, their export prospects will be even brighter. There is much room for expanded exports of manufactured products from Latin America, and the demand side of the equation will not be a major constraint.

Most of the Latin American countries will continue to rely at least partially on export of primary products, however. Hence, the

outlook for commodity prices is also important in assessing the feasibility of export-led growth.

One cannot predict with confidence any early upturn of significance in these prices, although such a development is by no means impossible. It is quite unlikely, however, that future declines will be sizeable if they occur at all. Moreover, the volume of nonfuel primary exports by developing countries has continued to grow in the early 1980s and this trend is expected to persist. In addition, there is considerable scope for diversification within the primary sector. And development itself implies a steady shift away from primary products toward manufactures (as the industrial countries continue to shift from manufacturing to services). The global outlook for commodities should not be a deterrent to adoption of strategies of outward orientation.

Outward orientation requires several specific types of policies. Some of these apply directly to external economic transactions. Others apply to their domestic underpinnings. Both are essential, and both must be carried out on a sustained basis if outward orientation is to succeed.

The first requirement is *the establishment and maintenance of a competitive exchange rate.* An overvalued currency discourages exports and efficient import substitution. Entrepreneurs will not make the investments needed to achieve international competitiveness if they doubt the authorities' commitment to maintain a competitive exchange rate.

It is not enough to bring the currency into line periodically and then let it slip back into overvaluation, as Mexico did after 1982. Maintaining a competitive exchange rate is critical to convey the proper market signals for investment and production decisions. One way to do this is to adopt crawling-peg regimes, in which the domestic currency is linked to a basket of foreign currencies (reflecting its trading patterns, not the dollar alone), with the exchange rate adjusted continuously to offset inflation differentials and any substantial alterations (such as oil shocks) in the underlying competitive position.

Closely related to proper exchange rate policy is the choice of *appropriate trade policies.* Excessive import protection can undermine efforts to achieve successful export orientation, both because needed inputs are unavailable and because incorrect price signals are perpetuated.

Effective exchange rate policies and effective trade policies reinforce each other. Devaluation provides an opportunity to reduce import barriers without undue adjustment cost in domestic industries, and efficient import-substituting activities are encouraged by a competitive exchange rate. Indeed, beyond promoting exports, a devaluation provides incentives for efficient import-substituting activities that have previously received little or no protection, in both agriculture and manufacturing.

Import substitution can thus be an integral part of an outward-oriented trade policy as long as it meets efficiency criteria. Traditional infant-industry considerations also continue to apply: temporary and degressive protection is legitimate, indeed desirable, where it will foster productive enterprises that will be able to compete without such help within a reasonable period of time. Such protection is better extended through tariffs, not quantitative restrictions, to maximize reliance on price signals and avoid excessive costs.

There are also infant activities in agriculture that may need governmental assistance—such as research into new production techniques and extension services. Eliminating controls on agricultural producer prices will also give a boost to output. Furthermore, import competition through trade liberalization will permit the elimination of price controls on manufactured goods which, while intended to subsidize urban consumption or limit excess profits generated by protection, in fact limit production itself.

Internationally acceptable export incentives are also an essential component of a strategy of outward orientation. Export credit must be available on competitive terms. Imported inputs for export production should be freed from all duties and indirect taxes. Export promotion measures, including information services and trade fairs, can be useful. These proposals for outward-oriented exchange rate and trade policies are developed in chapter 2.

Policies of outward orientation aimed at promoting exports and efficient import substitution, while essential, make up only part of the proposed strategy. The rationalization and modernization of the domestic economy further require *generating higher levels of savings*, primarily domestic but also from abroad, and especially *using all savings available much more efficiently* than in the past.

Yet savings from both domestic and external sources have dropped sharply in most Latin American countries in the 1980s,

and new policies to reverse that trend are essential. In addition, comparative capital-output ratios suggest that Latin America uses its resources much less effectively than do rapidly growing developing countries.

Export expansion will generally promote savings, as a higher than average share of export earnings is normally saved. A resumption of growth will itself generate increased savings and could launch a virtuous cycle between the two. But a key part of the proposed strategy is the adoption of new measures to promote higher levels of savings and more efficient investment patterns.

For some time to come, the inflow of new capital may not fully offset interest payments on the external debt, and therefore the net outward transfer of resources will continue. Excess capacity will initially provide the basis for increased exports and domestic growth, but new investment will be needed to expand capacity over time. A resumption of growth thus will require a sustained increase in domestic savings to achieve a sustained increase in domestic investment.

At the same time, policy should aim to induce reversal of capital flight and renewed inflows of foreign capital—particularly in equity and other nondebt-creating forms, to limit any new buildup of external liabilities. As with trade, this will require a series of measures aimed directly at such investment: liberalization of rules governing foreign direct investment and participation in local equity markets, creation of mutual funds (like the Korea Fund and Mexico Fund) to facilitate such investment, perhaps the creation of new "repatriation funds." Latin American countries should join MIGA and accept a wider role for international arbitration in resolving disputes concerning foreign direct investment; such a reversal of traditional attitudes would greatly encourage renewed capital inflows from abroad. However, it must be recognized that sustained and continued capital inflow, be it foreign or flight capital, will occur only over time as a result of consistent application of policies, such as those recommended here, that provide a stable and profitable environment for productive investment.

Foreign direct investment could be a particularly valuable component of an outward-oriented strategy because of the international marketing skills of the multinational companies and their ability to help fight protectionist pressures in their home countries. It is ironic that most countries of Latin America strongly preferred

bank loans to foreign equity investment in the 1970s, in pursuit of greater independence from foreign influence, yet would have suffered much less disruption had they chosen the opposite course. Increased reliance on equity flows is both desirable and essential because alternative sources of private funds are unlikely to be available in the future.

The key to both expanding domestic savings and renewing capital inflows from abroad, as noted, lies in changing financial policies in the Latin American countries. Real interest rates, like real exchange rates, have frequently been permitted to sink below levels needed to generate savings (and keep domestic capital at home)—and have even turned negative for protracted periods. Crises have then prompted swings to interest-rate levels which are much too high to foster adequate investment.

A central element in the proposed approach is to assure that *real interest rates remain sufficiently positive* to induce a stable and substantial level of domestic savings and keep most of those savings at home, but not so high as to discourage productive investment. Such market-oriented interest rates are also central to an efficient allocation of investment and thus to the fundamental goal of achieving international competitiveness.

Improvement in national capital markets and the process of financial intermediation also can help increase the level of savings and the efficiency of their use. At the same time, care must be taken to avoid discrimination against small and medium-sized businesses in the provision of credit. Such firms are major creators of new jobs and are thus critical to any growth strategy.

Tax policy can also boost domestic savings by taxing consumption. While tax incentives to investment should be provided under present conditions, favoritism of capital-intensive activities (as has often occurred in the past) should be avoided to maximize the creation of new jobs.

Another major source of the inadequacy of national savings in many Latin American countries is the dissaving flowing from large and continuing government budget deficits. Private investment, which is essential both for sustained economic growth and improvement of external balances, is often "crowded out" as governments use up too great a share of available resources. Because these budget deficits are often accommodated by monetary policy, they generate rapid rates of inflation which, as noted below,

discourage savings and distort investment patterns. *Reducing budget deficits is thus a crucial ingredient of the proposed strategy* (chapter 3).

The third central theme of our proposed strategy is *reforming the role of the state in the economic life of Latin America.* Public dissaving via budget deficits is one aspect of this problem. But the problem runs much deeper, indeed to the core of the economic difficulties of the region.

Due in part to the historical heritage of Latin America, the role of the state has become pervasive in most of its countries (chapter 4). Correspondingly, the private sector has been weakened as the state has assumed increasing importance. Part of the blame lies with the private sector itself: its leaders have all too often turned to the state in times of trouble, thereby adding to the expansion of state power. The time has come to begin reversing this trend, as an essential part of a new growth strategy.

The state in Latin America has come to play three major roles: as regulator, as producer, and as provider of services. The record is, in many respects, positive regarding the third of these functions, and this is where it should focus its efforts in the future.

Even in this area, however, greater attention needs to be given to the provision of basic services for improving the lives of the poor as well as to laying the foundation for long-term growth. One key lesson of the 1980s is that resources are severely limited. Resources spent subsidizing inefficient production by state enterprises are resources that cannot be spent on improving health, education, or basic infrastructure. Resources spent to administer a welter of rules and regulations cannot be spent on teachers or doctors or adequate systems of justice. A reduced role for the state as regulator and producer is necessary not only to improve economic efficiency but also to enable the state to do a better job of providing services for its people.

The state as regulator has stifled much entrepreneurial initiative throughout the region. In several countries, numerous licenses are needed even to begin exporting—hardly an auspicious framework within which to promote outward orientation. In Peru, it recently took 289 days to register a new corporation—compared with four hours in Miami. Labor legislation makes it impossible, or at least extremely costly, to dismiss employees even when staff

reductions are essential to stay in business—let alone to become internationally competitive.

Costs of doing business are thus greatly inflated. In particular, these costs block much of the potential for creating small and medium-sized firms—which should be major engines of productivity and creativity. Corruption is fostered. Large sums are wasted by the companies in complying with bureaucratic red tape. And large sums are spent by the governments in administering the same bureaucratic procedures.

This environment of pervasive overregulation, documented in chapter 4, is an important element in creating inefficiency in most Latin American economies. The expanding "informal sector" is perhaps the most obvious result. But lacking access to the facilitative aspects of the law, and to credit and insurance, its opportunity to grow and create jobs is limited. Thus entrepreneurial initiative is discouraged.

This same regulatory environment raises prices internally and discourages the flexibility and adaptability needed to achieve international competitiveness and successful outward orientation. Markets abroad will not wait for licenses to be issued and regulations complied with. Meanwhile, somebody else gets the business.

Substantial deregulation is thus a central feature of our proposed development strategy. The state should set the legal framework, assuring private property rights and avoiding abuses of individual freedom. It should adopt a coherent and effective growth strategy, as proposed here, and macroeconomic and microeconomic policies to carry out that strategy. It should promote more equitable distribution of income through improved provision of basic services and the establishment of a policy environment that facilitates the growth and productivity needed to create more and better paying jobs. And it should do all this to the maximum extent through the adoption of laws and regulations which are applied universally, eschewing case-by-case decision making to the maximum extent possible. Indeed, the trend toward political democratization requires such changes—and is fundamentally incompatible with the traditional heavy hand of state regulation throughout Latin America.

Reforms are also needed to reduce the state's role as a producer, and to begin the inevitably lengthy process of revitalizing the

private sector. Public utilities and some state enterprises in basic industries have proved to be efficient in some countries. But the proliferation of state enterprises in the potentially competitive sectors has come to involve substantial inefficiencies. It also conflicts with outward orientation because state firms typically come to rely heavily on the favoritism of the state itself to assure their domestic market shares, discouraging them from competing for markets abroad and instead furthering high import protection to enable them to sell at home.

It is obviously impossible to privatize all state enterprises in the competitive sector overnight, even if that were deemed desirable on economic efficiency grounds. Private capital and management skills are simply not available in sufficient amounts. Some firms, however, can be sold off. A clear movement toward privatization should be set in motion.

The Gains For Latin America

We propose three strategic changes for Latin America—outward orientation, inducements for increased savings and more efficient investment, and a reordering of the role of the state. These changes are interdependent and can be carried out most effectively in parallel. For example, competitive exchange rates and positive real interest rates, along with lower budget deficits and less governmental intrusion into the economy, will raise savings levels and promote their efficient investment. Liberalizing imports will permit abolition of price controls, now needed to avoid excess profits, and investment controls, aimed at avoiding overinvestment in protected sectors.

These changes will support greater international competitiveness, producing growth and jobs as well as export earnings to service foreign debt. Reduced protection and deregulation, together, will also contribute to such results. The stimulus to entrepreneurship attendant upon deregulation, and the increased scope for launching small and medium-sized firms, will create jobs to more than offset the layoffs from cutting back on state enterprises and reducing government regulations.

Furthermore, successful outward orientation will generate eco-

nomic benefits to offset the losses from phasing out unproductive activities. Existing resources and new domestic investment, augmented by increased foreign investment, would shift to more productive and remunerative sectors. This shift, supported by appropriate tax policies, would usually encompass a move from more capital-intensive to more labor-intensive industries—to exploit the competitive advantage of the region. This process would boost employment and wages. Employment and income will also rise in agriculture, which has suffered discrimination in the past. Also, by reducing the role of the state as regulator and producer, more resources will be freed for use in its preferred role as provider of basic services.

In addition to these three sets of policies for renewing the growth process in Latin America, one central element of shorter run macroeconomic management must be stressed—avoiding rapid rates of inflation. The historical record of development reveals an inverse correlation between inflation and economic growth.

The reasons behind this linkage are clear. Rapid inflation distorts price relationships and produces growing inefficiencies. Savings and, particularly, investment are discouraged. Budget deficits become bloated. Capital flight is promoted.

Indexation seeks to prevent these ill effects of inflation, but at best can achieve partial success in doing so. In addition, indexation has ill effects of its own: it locks in inflation at existing levels, usually converts external shocks (such as higher oil prices) into a corresponding rise in domestic inflation, and saps political will to resist ever higher inflation by appearing to obviate its impact on the population.

Hence a successful attack on inflation is an essential prerequisite to permit effective pursuit of the longer run strategies emphasized in this report (chapter 3). In some cases, traditional austerity measures may be essential and may suffice. In cases of extremely high inflation, full-scale monetary reforms may be required—as recently in Argentina, Bolivia, and Brazil. Whatever methods are used, sustained economic growth will hinge on reasonable internal price stability.

The Role of the Industrial Countries

The growth strategy recommended here for Latin America should be pursued under virtually any foreseeable evolution of the world economy. The need for such reform would in fact be even greater if the world economy soured because Latin America would then find it even more difficult to achieve self-sustaining growth, especially in tandem with continued servicing of the external debt, in the absence of reform.

Nevertheless, the industrial countries can play a crucial role in both encouraging the countries of the region to adopt the proposed strategy and in promoting its success. In today's interdependent world, outward orientation for developing countries can achieve far better results if the industrial countries manage the global economy more effectively. This requires them to pursue six closely related outcomes:

- steady world economic growth, averaging at least 3 percent annually
- avoidance of any new import protection and export subsidization, indeed a renewal of steady liberalization of trade
- avoidance of any renewed surges in real interest rates, and preferably their maintenance at historical levels (2 percent to 3 percent) rather than at the much higher levels of the early 1980s
- avoidance of major misalignments among their own currencies, like the massive dollar overvaluation of the early 1980s
- new infusions of capital to Latin American countries that adopt effective adjustment programs
- more effective leadership, and a stronger resource base, for the international financial institutions, particularly the World Bank.

It is in the direct national interest of the industrial countries themselves to pursue these goals vigorously and successfully.

However, the need to provide a hospitable framework for a reorientation of development strategies in Latin America, and in the Third World generally, should add substantially to the impetus for them to do so.

The developing countries are economically very important to the industrial world. Serious economic disruption in those countries might bring debt defaults and could jeopardize the entire global financial network. Political instability in Latin America, borne of economic instability, could threaten the entire hemisphere. The large stakes of the industrial countries in the Third World should encourage them to step up their effort to manage the global economy more effectively, particularly in areas of direct impact such as trade policy and capital flows.

A successful shift to outward orientation in Latin America would be of great economic benefit to the United States and to all industrial countries. Other developing countries that have succeeded in implementing such a strategy have become large and expanding markets for the exports of industrial countries, and Latin America has great potential in this regard. The strategy for Latin America suggested here is decidedly in the interest of the industrial countries as well.

These considerations apply to all industrial countries, not just the United States. More than one-half of Latin America's trade is with countries other than the United States. Only about one-third of private bank exposure in Latin America comes from the United States. Western Europe, Japan, and Canada have extensive direct interests in the region, as well as overwhelming stakes in global peace and prosperity.

The concerns cited apply particularly to the United States, for four additional reasons. First, the United States must clearly take the lead in forging new cooperative efforts to achieve better functioning of the world economy. To be sure, the United States can do so only by working closely with other industrial countries and by using the functional international organizations—especially the International Monetary Fund (IMF), World Bank, and the GATT. But US leadership is critical in promoting the international framework that would spur the adoption of outward-oriented development strategies in Latin America.

Second, the United States has a major stake in a successful resolution of the contemporary dilemma facing Latin America—

the need to restore self-sustaining growth and simultaneously to maintain servicing of the external debt. In a tangible sense, Latin America represented a market for nearly 20 percent of all US exports of goods and services before the debt crisis erupted—and the sharp drop in those exports contributed importantly to the escalation of the US trade deficit. The extensive exposure of US banks in Latin America represents an ongoing threat to the American financial system. In economic terms alone, both the opportunities offered by Latin America and the threats it poses justify a major effort to create the needed global environment.

Third, the United States has a substantial interest in both the social development and continued democratization of the region. More equitable social conditions, opportunity for advancement, and respect for human rights are of vital importance both in and of themselves and as prerequisites for the establishment of stable democratic regimes. If democracy can become firmly established in Latin America, the prospects for the hemisphere's long-term political stability will be greatly enhanced.

The relationship between economic stability and political stability is, of course, not unidimensional, particularly in the short run. The history of Latin America itself, however, reveals that economic difficulties can create social situations ripe for political instability, and even revolution, from both left and right. Achievement of broad-based, self-sustaining economic growth throughout Latin America could solidify the movement toward democracy. A failure to achieve such progress, let alone continuing stagnation or even a relapse into the morass of default and economic conflict, could have incalculable consequences for social justice and hence the stability of the entire hemisphere.

Fourth, adoption by Latin America of the development strategy proposed here would provide a much stronger foundation for constructive interdependence between the two parts of the hemisphere. The strategy places heavy reliance on market forces, on a mixed economy with a strong broad-based private sector rather than one dominated by the state, and on integration into an international economic framework. It is, at its core, quintessentially pragmatic—seeking to apply the lessons of the past and of other countries to contemporary Latin America.

Although the United States itself does not always abide by these principles, they are at the heart of its own economic experience—

and that of most other economic (and political) success stories, in both the industrial and developing worlds. Their adoption in Latin America would represent an important step that could only improve, over time and to a substantial degree, the relationships—and even the similarity of ways of thinking—between the two parts of the Western Hemisphere.

Proposals for Action

To create a world that offers the best prospects for success of the proposed strategy for Latin America, the United States should both make changes in its own policies and renew its efforts to achieve international agreement to act on several fronts. Fortunately, movement in the needed directions has begun. The critical requirement now is to complete the initiatives undertaken, both for their own sake and to demonstrate to Latin America the enhanced prospects for successful resolution of its own economic dilemma.

Over the next few years, *the United States needs to return to a more balanced mix of fiscal and monetary policy.* Doing so would *produce a further reduction of real interest rates,* which in turn could help *achieve and maintain an equilibrium exchange rate for the dollar.* Such a restoration of dollar equilibrium, with the attendant decline in the US trade deficit, will reduce the pressures for trade protection. The countries of Latin America would benefit greatly from all these effects.

At the same time, the *industrial countries outside the United States—especially Japan and Germany—need to expand domestic demand more rapidly.* This is essential to offset the adverse effect on world growth, and thus trade, of the reductions in the US budget deficit, and to reinforce the adjustment of their currencies against the dollar.

More rapid growth, and currency adjustment, in industrial countries outside the United States is essential for another reason. The United States must improve its trade position by more than $100 billion annually over the next few years, to reduce the risk of protectionist trade policies and the threat of renewed international financial instability, which would result (if the United States

sought to maintain annual borrowings of $100 billion or more indefinitely from the rest of the world). Unless other OECD countries, which can afford it, accept the counterpart deterioration in their trade positions, an important portion of that counterpart could fall on Latin America. Its debt problem would then be intensified and its growth prospects adversely affected. A *proper* adjustment of the huge imbalances among OECD countries from the first half of the 1980s is of great importance to Latin America.

In contemplating the adoption of new development strategies, however, the countries of Latin America will look to the longer run and seek to assess whether there are prospects that the proposed approach will work on an enduring basis. This in turn relates to the ongoing effectiveness and stability of the international economic arrangements among the major industrial countries and the attitudes of those countries toward the functioning of such arrangements.

One clear requirement is to avoid further erosion of the international trading system. In light of historical evidence that forward movement toward trade liberalization is needed to avoid backsliding toward protection, it is incumbent on the industrial countries to restart the liberalization process. It is also essential that they begin to enforce GATT rules that seek to avoid or limit trade distortions, and agree on new rules where needed to do so.

The most promising approach is to *launch a new multilateral round of trade negotiations* for the latter 1980s, like the Kennedy Round of the 1960s and the Tokyo Round of the 1970s. Such an initiative would seek to reduce further, and perhaps eliminate over time, the remaining tariffs maintained by industrial countries. It would seek reductions in nontariff barriers, including import quotas, both for sectors that have had controls (such as textiles and steel) and for sectors of newly emerging importance (such as services and intellectual property). It should bring all forms of trade control, including so-called "voluntary export restraint agreements," under international surveillance and limit their use through the institution of a new "safeguards code."

Such reform of the international trading system (chapter 5) could offer substantial assurances to Latin America that its new emphasis on outward orientation would receive support abroad. The regime would retain some preferential treatment for developing countries,

including those in Latin America, such as authorization for infant-industry protection under certain circumstances.

Its emphasis, however, would be on bringing those countries into the mainstream of the regime. Their own policy concerns would then receive much greater ongoing weight in managing the system.

For the new trade round to succeed, the more advanced Latin American countries will have to offer reciprocal concessions of their own—though not to the same extent, and not on the same timetable, as the industrial countries. But Latin America would have much to gain from such a negotiation and such a new regime. It could ally with the United States to reduce agricultural protection and to seek limits on the agricultural subsidies offered by the European Community and Japan. It could ally itself with the United States and the European Community to seek the elimination of informal measures of protection in Japan. It could ally with the European Community and Japan to limit the administrative discretion with which the United States applies its "unfair" trade laws. It could ally with other industrializing countries and Japan to check the tendencies of the United States and European Community to apply "voluntary" restraints on their exports. It could use the negotiations and the new regime, including the need to make "concessions" of its own, to provide better access for its exports, to influence the decision-making process in GATT, and to influence its internal debates over trade policy in the direction of import liberalization, which is an important part of the proposed strategy.

The United States already has taken the lead in promoting the inauguration of a new trade round. Most of the other industrial countries seem prepared to cooperate. Ironically, much of the hesitation has come from developing countries—including Brazil and Argentina—which probably have most to gain from the effort. On the other hand, Mexico has decided to reverse its trade policy of forty years and join the GATT. Concerted efforts by the United States and Latin American countries to launch the round, and bring it to a successful conclusion, could add substantially to the proposed strategy for the hemisphere.

A second major area of needed global reform relates to the international monetary system. The regime of unmanaged exchange

rate flexibility has permitted substantial currency misalignments to develop. For example, the large dollar overvaluation of the early 1980s severely hurt Latin America's trade competitiveness (because most of its currencies are tied to the dollar), damaged demand for its commodity exports (most of which are priced in dollars), and generated strong pressures for trade protection in the United States. *A reform of the international monetary regime* that could limit the extent of such misalignments would substantially brighten the prospects for outward-oriented development in Latin America.

Such trade and monetary steps by the industrial countries would make a considerable contribution to helping the countries of Latin America deal effectively with their external debt. In addition, however, several measures aimed directly at that problem are in order. For reasons developed in chapter 5, we do not advocate defaults, debt forgiveness, unilateral modification of interest obligations by the debtors (as in Peru at present), or other "radical" approaches—because we believe they would not be in the interest of either debtors in Latin America or creditors elsewhere.

But *new credits will clearly be needed on a scale much larger than now seems forthcoming, probably on the order of $20 billion annually for the next few years.* A large part of these credits will have to come from the commercial banks, and the authorities of industrial countries should encourage such flows—through means including partial guarantees offered by their national export credit agencies and by the multilateral development banks. In addition, where warranted by the performance and policies of the borrowing countries, the banks should negotiate long-term debt restructurings and reduce interest-rate spreads as much as possible.

However, it will take some time for voluntary bank lending to Latin America to resume on any substantial scale. Indeed, all private capital flows to the region are likely to remain modest for some time due both to the continuation of crisis conditions in many countries and to the inevitable time lags in implementing new policies in the region which *inter alia* will attract such flows. Hence, alternative means must be sought.

The obvious source of much of the needed lending in the interim is the international financial institutions, notably the World Bank and Inter-American Development Bank. As financial intermedi-

aries, they can expand their lending without burdening the budgets of creditor governments. They can achieve further multiplier effects through cofinancing and partial guarantees of private loans. Moreover, they can link their loans to policy changes of the type proposed here and thus encourage adoption of the new strategy.

The amounts of new lending envisaged for these institutions by the "Baker Plan," an added $3 billion a year for the 15 major debtors (of which 10 are in Latin America), are much too small. Achieving a substantially larger amount will require a sizeable general capital increase for the World Bank by 1990 or sooner; this can prudently be done without any increase in paid-in capital by the industrial countries, thereby avoiding any impact on their budgets. This approach would be preferable to changing the Bank's gearing ratio, which has also been suggested. Substantial increases in the resources of the Inter-American Development Bank are needed as well.

Fortified with such additional resources, the World Bank should assume a greater role in the lending process—in organizing financial packages based on medium-term adjustment programs and monitoring the implementation of these programs. This would involve an explicit linkage between rescheduling of bank debt, additional financing, and the adoption of a comprehensive reform program. Such a procedure, already used with beneficial effects in the recent cases of Chile and Colombia, can ensure that desirable adjustment measures are taken and that they are supported by additional financing. The IDB, too, will need to move into nonproject lending and link it to policy reforms.

Changes in IMF lending are also needed, in three directions. As has been done in the case of Mexico, the Fund should continue its programs in Latin American countries that maintain effective adjustment efforts. It should establish a new facility to compensate for interest-rate shocks, thus providing credits to offset the adverse effects on debtor countries of any new upswing in interest rates. And it should use the existing compensatory financing facility more extensively, particularly to offset shortfalls in *oil* exports.

For the longer term, new forms of private investment in Latin America should be promoted in the form of equity, quasi-equity, and new types of financial instruments, such as indexed bonds and commodity linked bonds. The Latin American countries can readily stimulate more foreign investment in their stock markets and real

estate, for example, by judicious changes in their own policies. (And adoption of the proposed strategy would by itself go far to encourage such investments.) But there will be instances in which industrial countries will need to reduce impediments to such flows from their side of the equation, such as regulatory limitations on the foreign investments of insurance companies and pension funds. The International Finance Corporation can play a particularly useful role in exploring specific possibilities to both the borrowing and the industrial countries, and encouraging the policies needed to exploit them.

There are thus a number of areas in which the United States and other industrial countries can take substantial new initiatives to help foster a welcoming climate for the proposed development strategy in Latin America. All these initiatives are in the interest of the industrial countries themselves. But their adoption could pay substantial dividends in terms of the response from Latin America as well.

Conclusions

Economic reform is imperative in Latin America. A new approach is essential to promote broad-based, self-sustaining growth along with continued servicing of the external debt. A strategy centered on outward orientation, new market incentives for savings and investment, and a fundamental shift in the role of the state can resolve the dilemma.

Adoption of such a strategy will require numerous changes, structural as well as immediate, in both the external and domestic economic policies of the Latin American countries. The prospects for such reform, however, are encouraging. The record of Latin America in the past, and of many other developing countries at present, shows that such policies can succeed. The world environment is improving. Policy changes in the needed direction are beginning to occur within Latin America and in a complementary direction in the industrial countries. The previously entrenched forces of resistance to reform seem to be yielding in the face of crisis.

The stakes for Latin Americans themselves are enormous. The economic future of the continent, and the living conditions of its people for many decades, may be determined by the strategic choices made over the next few years. The prospects for nurturing and extending the move to democracy, and for creating more equitable societies, may rest in the balance.

The stakes for outsiders, particularly the United States, are also extremely high. The national interests of the industrial countries require a stable, prosperous, and democratic Latin America. The proposed strategy could substantially enhance the prospects for achieving these goals on a lasting basis. The industrial countries can contribute greatly to the prospects for adoption and fulfillment of this strategy by modifying their own policies and improving global economic arrangements—all of which are in their own interests in any event.

The two parts of the hemisphere cannot afford not to pursue a strategy along the lines outlined in this report. A failure to resolve the current dilemma constructively could levy huge, lasting costs in both Latin America and the United States. Piecemeal responses to the outbreak of crises, in one country after another, are not adequate. Far-sighted, preemptive, strategic choices must be made soon.

This is our response to skeptics who will observe that several of our proposals have been suggested before, and that some have been tried—however briefly in individual countries. These observers may argue that entrenched advocates of the status quo, or simply inertia, may preclude adoption of our approach.

Such critics, however, would miss the depth and fundamental nature of the crisis of the 1980s. Historic opportunities arise from unprecedented difficulties. Extreme need can overcome deep-seated opposition. We believe that the principles outlined in this report offer a persuasive and feasible strategy for the future and that they can help countries in both parts of our hemisphere to build on the current crisis to forge a new future of success and harmony for all their peoples.

1 The Latin American Experience

In reviewing the policies applied and their economic effects in Latin America, this chapter will examine import substitution strategies in the immediate postwar years, policy reforms of the mid-1960s, policy responses to external shocks after 1973, and policies adopted following the debt crisis of 1982. The chapter will focus on exchange rate and trade policies and will provide the background for chapter 2. In turn, chapters 3 and 4 will consider tax and credit policies and the role of government intervention and state enterprises, respectively.

The discussion of the Latin American experience will proceed in a comparative framework. The record of Latin America on economic growth and export performance will be set against that of countries in other areas of the world, in particular the newly industrializing countries (NICs) of the Far East. These countries, through rapid transformation of their economies, not only reached and surpassed income levels in Latin America but also overcame the two oil crises of 1973–74 and 1979–80 and the debt crisis that began in August, 1982. Turkey's experience with policy changes in the early 1980s is also relevant for the highly indebted countries of Latin America.

Comparisons of countries with different social and cultural milieus are full of pitfalls. But attempts to explain differences in economic performance in terms of differences in social and cultural factors often involve ex post rationalization. Thus, the "Confucian ethic," credited today for having assisted industrial development in China, Korea, and Taiwan, was traditionally considered an obstacle to economic development (Riedel 1985).

Also, in the early 1960s, when Korea, Singapore, and Taiwan

Table 1.1 Education

Country	1960		
	Enrollment in secondary schools (percentage)	Enrollment in higher education (percentage)	Harbison–Myers index
Argentina	23	11	74
Brazil	11	2	21
Chile	24	4	44
Colombia	12	2	22
Ecuador	12	3	27
Mexico	11	3	26
Peru	15	4	35
Uruguay	37	8	77
Venezuela	21	4	41
Austria	50	8	90
Finland	74	7	109
Italy	34	7	69
Japan	74	10	124
Greece	37	4	57
Portugal	n.a.	4	n.a.
Spain	23	4	43
Turkey	14	3	29
Korea	27	5	52
Singapore	32	6	62
Taiwan	30	5	55

n.a. Not available.

Note: Enrollment data have been expressed as a percentage of the respective age cohorts. The Harbison–Myers index is derived as the secondary school enrollment rate plus five times the university enrollment rate. Harbison, Maruhnic, and Resnick (1970), pp. 175–76.

Source: World Bank (1986).

1983		
Enrollment in secondary schools (percentage)	Enrollment in higher education (percentage)	Harbison–Myers index
60	25	185
42	11	97
65	11	120
49	13	114
53	35	228
55	15	130
61	22	171
67	21	172
43	22	153
74	25	199
103	31	258
75	26	205
94	30	244
82	17	167
43	11	98
90	24	210
38	7	73
89	24	209
69	12	129
72	25	197

adopted an outward-oriented industrial development strategy, their educational level was no higher than that of Argentina or Uruguay. The relative standing of the latter two countries has since declined, but other Latin American countries have made considerable improvements in education often without commensurate economic gains (table 1.1).

Neither do country size and market access explain the export

performance of the Far Eastern countries. These countries are not small compared to Latin American countries, except Brazil and Mexico. Korea's population is a third greater than that of Argentina, the population of Taiwan is a third larger than that of Chile, and Singapore's population is only a fifth smaller than that of Uruguay. Furthermore, popular conceptions to the contrary, Korean and Taiwanese exports have not oriented toward the fast-growing Japanese market but toward the United States, which is a natural market for Latin American countries, and this without any preferential treatment compared to Latin America.

At the same time, while it has been suggested that social and cultural factors may have had a bearing on economic policies and performance in Latin America, in particular in the Spanish-speaking countries, the experience of Turkey indicates that important policy changes can occur without changing the social and cultural environment. Turkey went from virtual bankruptcy to creditworthiness for commercial bank lending within a few years after the policy shift in 1980 gave rise to economic improvements and, in particular, rapid export expansion. Yet, it had been argued that the environment in Turkey was not conducive to policy reform, given the long history of paternalism and an educational level at the bottom of the range vis-à-vis Latin American countries.

Historical Background

Rather than attempt to cover all of Latin America, the chapter will concentrate on the larger and the more developed countries of the area, including Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, and Venezuela. In 1985, these countries had 87 percent of the population and 92 percent of the gross domestic product of Latin America, including the Caribbean.

Until the Great Depression of the 1930s, economic development in Latin America was largely based on exports of primary commodities to more developed countries in other areas. In this respect, Latin America shared the experience of the countries in Scandinavia, Central and Eastern Europe, Australia, Canada, New Zealand, South Africa, and, until the mid-nineteenth century, the United States.

In temperate-zone agricultural products, Latin America's main competitors were Australia, Canada, New Zealand, and the United States; in minerals and metals, they were Australia, Canada, South Africa, and the United States; and, in semitropical products, they were the southern United States and other areas with similar climates. Also, tropical agricultural exports from northern South America, southern Mexico, Central America, and the Caribbean competed with the products of countries in Africa and Asia.

The rate of economic development was influenced by this stimulus from primary exports and by the transmission of the stimulus to other sectors of the economy through demand for foodstuffs and for manufactured consumer goods and their inputs as well as through road, railroad, and port construction. Export expansion was particularly rapid in Argentina and Uruguay (cereals and meat), Chile (copper and nitrates), and, toward the end of the period, Venezuela (petroleum). Exports increased more slowly in Colombia, Ecuador, Mexico, and Peru while overall benefits to the Brazilian economy were limited by the relatively low share of exports in domestic output.

Differences in the rate of export expansion and in the ratio of population to natural resources contributed to differential trends in incomes in Latin America during the century preceding the Great Depression. Although there were substantial income inequalities in each country, by 1929 the average income level of Argentina, Uruguay, and Venezuela exceeded that of Austria and Finland and approached that of France; Chile and Mexico approached the per capita incomes of Italy; Colombia had income per head comparable to that of Japan; whereas Brazil, Ecuador, and Peru lagged behind.[1]

The relationships observed in 1937 were about the same as in the last pre-Depression year, 1929. Among Latin American countries for which data are available, only Argentina experienced a decline in per capita incomes between 1929 and 1937 whereas, in Western Europe, decreases occurred in Austria and Italy.

During World War II, Latin American countries were subject

1. Per capita income estimates reported in this chapter are shown in table 1.2, except for earlier years when, for several countries, national income estimates are not available, and approximations are reported in the text.

to conflicting influences. On one hand, they escaped war destruction; on the other, they were largely isolated from continental Europe, even though trade continued with the United States and, to a lesser extent, the United Kingdom. In fact, according to 1950 data, the relative position of most Latin American countries in terms of incomes per head changed little vis-à-vis European countries, which had largely completed their reconstruction efforts by that time. However, comparisons are less meaningful with Japan, where war destruction had been only partially remedied, and prewar income levels had not been restored, in 1950.[2]

All in all, the nine Latin American countries covered in this report were in the middle-income range in 1950. They were far ahead of Korea and Taiwan, with the three high-income countries surpassing also Austria, Finland, and Italy. Purchasing power comparisons further indicate that Mexico approached the per capita incomes of Spain, and seven of the nine Latin American countries were ahead of Greece and Portugal in 1950.

The international standing of Latin American countries changed greatly in one generation (table 1.2). Among the low-income countries of yesteryear, Portugal and Taiwan surpassed, and Korea and Turkey approached, the high-income Latin American coun-

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2. The income comparisons have been based on historical estimates, expressed in 1955 prices and exchange rates, reported in table 1.2. The same table provides estimates of per capita incomes in terms of purchasing power parities expressed in 1975 prices, for the years 1950 to 1980, updated to 1985 by utilizing available information on economic growth rates for 1980–85. The purchasing power of national currencies was calculated for the year 1975 by researchers at the University of Pennsylvania. Estimates for 1950–80 were established by the same researchers utilizing economic growth rates reported in United Nations statistics.

Comparing national income data in terms of the purchasing power of national currencies rather than exchange rates offers advantages, because exchange rates do not allow for international differences in the prices of services and because exchange rates tend to fluctuate over time, with intermittent devaluations. Correspondingly, the ranking of countries in any particular year may differ under the two methods. For example, in 1950 Brazil ranks lower, and Peru higher, in terms of incomes per head at purchasing power parities than at exchange rates. Also, calculations made at purchasing power parities show smaller international income differences than calculations made at exchange rates because service prices tend to rise with per capita incomes. Note finally that both series of data are subject to considerable error for the earlier years and they should not be construed to indicate international differences in living standards that are reflected by consumption rather than income data.

tries, Argentina, Uruguay, and Venezuela, which were far outdistanced by all other European countries and Japan.

Furthermore, although increases occurred after 1966, Latin American countries are far behind the countries of Western Europe and the Far East in terms of manufactured exports (table 1.3). In 1983, these exports ranged between $1,000 and $2,000 per head in the more industrialized West European countries, as well as in Japan and Taiwan, and surpassed $500 in Korea. The same year, they approached $100 per head in only one Latin American country, Uruguay. The Latin American countries also had much lower ratios of exports to value added in manufacturing than countries in Western Europe and the Far East, indicating their relative inward orientation (table 1.4).

Large differences remain even after adjusting manufactured exports for intercountry differences in population size and per capita incomes. According to one estimate, in 1976 the ratio of manufactured exports to gross domestic product in the three Far Eastern countries was four times the cross-country norm thus derived while the three large Latin American countries reached only one-fifth of their export potential (Cline 1982).

The remainder of this chapter will examine the policies Latin American countries applied during the postwar period and the implications of these policies for their economic performance. Apart from comparisons with countries in other areas, in particular in the Far East, consideration will be given to changes in the relative position of individual countries within the Latin American area.

The principal gainer was Brazil, where average per capita incomes grew more than threefold between 1950 and 1985, followed by Mexico and Ecuador, where incomes rose more than twofold, and Colombia, where an approximate doubling occurred. In the same period, incomes per head increased by three-fifths in Peru, by one-half in Chile, by two-fifths in Argentina, and by one-fourth in Uruguay and Venezuela.

It may be objected that the comparisons have been made with the successful countries of Western Europe and the Far East. But among African and Asian developing countries for which data are available, between 1950 and 1985 incomes per head increased three times in Egypt, Israel, and Thailand and more than doubled in Burma, Morocco, Pakistan, and the Philippines. Per capita

Table 1.2 Gross domestic product per capita
(dollars)

Country	In 1955 prices			
	1929	1937	1950	1950
Argentina	540	510	615	1,877
Brazil	105	145	195	637
Chile	245	280	340	1,416
Colombia	155	175	225	949
Ecuador	n.a.	n.a.	n.a.	638
Mexico	n.a.	230	235	1,055
Peru	n.a.	n.a.	145	953
Uruguay	n.a.	n.a.	n.a.	2,184
Venezuela	n.a.	n.a.	635	2,127
Austria	380	370	450	1,693
Finland	345	430	555	1,972
Italy	275	260	360	1,379
Japan	145	185	135	810
Greece	n.a.	n.a.	(296)	905
Portugal	n.a.	230	285	733
Spain	n.a.	n.a.	(351)	1,163
Turkey	n.a.	n.a.	n.a.	701
Korea	n.a.	n.a.	n.a.	(450)
Singapore	n.a.	n.a.	n.a.	n.a.
Taiwan	n.a.	n.a.	n.a.	508

n.a. Not available.

Note: Numbers in parenthesis are estimates derived by applying national data on economic growth rates to estimates for later years.

Sources: 1929, 1937, and 1950 (at 1955 prices and exchange rates), Maizels (1963), table E.2; 1950–1980 (1975 prices and purchasing power parities), Summers and Heston (1984), pp. 207–62; 1985 (at 1975 prices and purchasing power parities), 1980 estimates updated by utilizing national data on economic growth rates.

In 1975 prices					1985
1960	1966	1973	1980	1985	1950
2,124	2,359	3,045	3,209	2,719	1.45
912	985	1,624	2,152	2,072	3.25
1,664	1,984	2,108	2,372	2,135	1.51
1,070	1,195	1,536	1,882	1,878	1.99
758	902	1,190	1,556	1,448	2.27
1,401	1,730	2,170	2,547	2,436	2.31
1,200	1,561	1,740	1,746	1,563	1.64
2,501	2,491	2,653	3,269	2,727	1.25
2,839	3,387	3,468	3,310	2,671	1.26
2,764	3,488	4,837	6,052	6,565	3.88
2,912	3,659	5,129	5,939	6,593	3.34
2,313	2,962	3,971	4,661	4,808	3.49
1,674	2,810	5,025	5,996	7,130	8.80
1,385	2,024	3,334	3,946	3,990	4.41
1,137	1,501	2,615	3,092	3,155	4.30
1,737	2,730	3,841	4,264	4,336	3.73
1,044	1,262	1,586	2,069	2,347	3.35
631	798	1,356	2,007	2,648	5.88
1,054	1,306	2,689	3,948	5,001	n.a.
733	1,005	1,691	2,522	3,160	6.22

incomes rose by two-thirds even in India, bettering the performance of the Latin American countries under consideration except Brazil, Mexico, Ecuador, and Colombia. Only Sri Lanka and a few small sub-Saharan African countries experienced smaller increases.[3]

3. For sources, see table 1.2.

Table 1.3 **Manufactured exports per capita**
(dollars)

Country	1960	1966	1973	1983	1984
Argentina	2	4	29	43	47
Brazil	0	1	12	68	n.a.
Chile	n.a.	5	5	30	n.a.
Colombia	0	2	14	20	19
Ecuador	n.a.	1	2	8	n.a.
Mexico	3	4	20	33	n.a.
Peru	0	0	2	n.a.	n.a.
Uruguay	n.a.	5	18	99	n.a.
Venezuela	n.a.	1	5	n.a.	n.a.
Austria	n.a.	176	571	1,730	1,765
Finland	106	195	568	1,919	2,029
Italy	54	121	336	1,085	1,094
Japan	34	89	320	1,179	1,362
Greece	2	7	60	219	237
Portugal	19	42	143	333	386
Spain	4	17	92	359	416
Turkey	0	0	6	56	80
Korea	0	5	79	556	657
Singapore	14	44	456	2,415	2,911
Taiwan	5	21	238	1,199	n.a.

n.a. Not available.

Note: Manufacturing exports have been defined as Classes 5 to 8 less 68 in the Standard International Trade Classification, thus excluding processed foods, beverages, and tobacco as well as nonferrous metals.

Source: GATT trade tapes.

Import Substitution After World War II

Income growth resulting from the expansion of primary exports led the rise of demand for manufactured consumer goods and their inputs in Latin America. This demand came to be increasingly

satisfied by domestic production that enjoyed the "natural protection" provided by transportation costs, complemented by moderate tariff protection prior to World War II.

The foreign exchange scarcity created by the fall in primary exports during the Great Depression and limited access to foreign goods during World War II subsequently boosted import substitution (Corbo 1986). Only after the war, however, did import substitution become a doctrine, guiding policy making in much of Latin America.

This shift reflected the rise of nationalism, the fear of another depression, and the desire to provide employment. It responded to the doctrine developed at the UN Economic Commission for Latin America (ECLA), according to which Latin America's economic growth would falter owing to a slackening of demand from the industrial countries for their primary exports, the tendency for the terms of trade (the relationship between export and import prices) to deteriorate, and the Latin American countries' inability to develop manufactured exports.[4]

In view of the alleged secular deterioration of the terms of trade in Latin American countries, ECLA called not only for using increments in capital and labor resources in import-substituting industries, but for shifting resources from export activities to these industries through increased import protection or export taxes. The shift was supposed to improve the Latin American countries' terms of trade, permitting them to enlarge their share of the gains from trade. The results of these policies will be considered in the following.

The major Latin American countries reached semi-industrial

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4. By the end of the 1950s, ECLA recognized the importance of exporting manufactured goods but considered protection in the developed countries an obstacle to these exports and focused instead on economic integration in Latin America. [See United Nations, (1959). Subsequently Raúl Prebisch, the first Secretary General of ECLA, criticized high protection in Latin America, for having led to discrimination against manufactured exports, and proposed export incentives, though at a lower rate than import protection (1961, p. 5)]. The authors are indebted to Raúl Prebisch who provided them with the relevant quotations on the eve of his death, in a letter to Bela Balassa dated 22 April 1986. The reader is referred to Prebisch's last published paper (1986) which contains the relevant references. The paper also criticizes remarks made about ECLA in the preliminary version of this chapter.

Table 1.4 **Ratio of manufactured exports to value added**

Country	1960	1966	1973	1983	1984
Argentina	1.1	1.4	3.6	6.3	6.3
Brazil	0	2.0	6.2	17.3	n.a.
Chile	n.a.	2.7	1.6	9.1	n.a.
Colombia	0	4.5	16.3	8.9	8.4
Ecuador	n.a.	1.6	3.0	2.7	n.a.
Mexico	4.8	4.2	8.4	4.3	n.a.
Peru	n.a.	0.4	1.1	n.a.	n.a.
Uruguay	n.a.	4.2	9.2	28.2	n.a.
Venezuela	n.a.	n.a.	2.4	n.a.	n.a.
Austria	n.a.	37.4	50.5	72.9	74.8
Finland	41.4	48.2	58.8	82.2	83.3
Italy	25.6	34.4	39.9	64.5	65.8
Japan	21.4	26.2	23.8	40.3	41.8
Greece	3.3	6.1	18.5	38.4	43.8
Portugal	n.a.	n.a.	n.a.	53.8	52.2
Spain	n.a.	8.2	17.2	n.a.	n.a.
Turkey	n.a.	0.7	6.8	23.0	22.0
Korea	0	21.5	80.5	105.5	112.8
Singapore	28.6	50.0	101.1	149.8	167.9
Taiwan	15.6	33.0	81.2	113.4	n.a.

n.a. Not available.

Note: There are differences in the international systems of classification utilized in regard to manufacturing value added and exports. The former includes and the latter excludes processed food, beverages, tobacco, and nonferrous metals. Also, the ratio may exceed 100 percent if imported intermediate products are used in export production.

Source: Table 1.4 and United Nations, *Yearbook of Industrial Statistics* (various issues).

status by 1950. They established industries producing nondurable consumer goods and their inputs, such as clothing and textiles, shoes and leather, and furniture and wood, and they largely completed the process of import substitution in these industries.

This first stage of import substitution is an "easy" stage, since

the industries in question conform to the production possibilities of developing countries. Thus, the manufacturing process is relatively labor intensive; production does not involve the use of sophisticated technology; the optimum scale of output is relatively low, and costs are not substantially higher at lower output levels; and a network of suppliers of parts, components, and accessories is not needed for efficient operations. Correspondingly, the establishment of these industries does not require much protection and, in fact, protection levels were relatively low in Latin America until the early 1950s.

Continued import substitution beyond its first, or easy, stage was to entail the replacement of imports of intermediate goods and producer and consumer durables by domestic production. These industries have different production requirements, however, than does the manufacture of nondurable consumer goods and their inputs.

Most intermediate goods, such as petrochemicals, paper, and steel, are capital intensive, and for some of them organizational and managerial inefficiencies may absorb the relatively small margin of processing. Also, economies of scale are important because costs rise rapidly at lower output levels.

Producer durables, such as machinery and machine tools, and consumer durables, such as automobiles and refrigerators, are also subject to economies of scale. But, in these industries, economies of scale relate not so much to plant size as to product specialization. Costs can be reduced if a plant specializes in fewer products (horizontal specialization) or, alternatively, if the production process is divided among firms manufacturing parts, components, and accessories, each of which may operate on an efficient scale (vertical specialization). Product specialization requires a large market, a technically sophisticated industrial structure, as well as skilled and technical labor.

The importance of economies of scale in these industries led ECLA to propose the creation of a Latin American Common Market in 1958. Their high technical requirements also prompted proposals for industrial programming at the regional level. In the event, neither of these two initiatives encountered much success.

Latin American countries established a free trade area rather than a common market, so as to maintain their freedom to set national tariffs. And the tariff-cutting process on intraregional trade

virtually came to a halt once tariffs were reduced on products in which producer interests were not at stake, and the volatility of exchange rates also discouraged further trade liberalization. Moreover, tariff concessions could be withdrawn, as was done in some cases, thereby creating uncertainty for intraregional exports.

Regionwide industrial programming did not fare better. For one thing, governments wished to maintain national sovereignty over basic industries. For another, private (including foreign) interests strongly opposed outside interference, fearing for their profits. At the same time, "complementarity agreements," involving interfirm specialization and negotiated by private firms across borders, were few and largely ineffective.

In the absence of regional integration and regionwide industrial programming, industries manufacturing intermediate goods and producer and consumer durables were established within the confines of national markets. The resulting loss of economies of scale, together with the large capital requirements of intermediate goods and the technological sophistication needed in the manufacture of producer and consumer durables, raised production costs in Latin American countries.

These second-stage, import substitution industries thus needed high protection to be established and to survive. High protection was in fact given would-be producers more-or-less automatically, reflecting a policy of "import substitution at any cost." This expression originated with Santiago Macario, the research director of ECLA, who provided evidence of the existence of high tariffs in Latin America, further noting the haphazard nature of tariff setting (Macario 1964, p. 61).

The limited size of domestic markets also led to monopoly positions in some industries, and there was little effective competition in others as a small number of firms divided up the market, pursuing a policy of high profits and low turnover. The subsidiaries of foreign companies attracted by high protection followed similar policies.

The absence of domestic and foreign competition gave little incentive to improve technology. Raúl Prebisch noted in 1964: "An industrial structure virtually isolated from the outside world thus grew up in our countries." He further described the policies that had led to this situation:

The criterion by which the choice was determined was based not on considerations of economic expediency, but on immediate feasibility, whatever the cost of production . . . tariffs have been carried to such a pitch that they are undoubtedly—on an average—the highest in the world. It is not uncommon to find tariff duties of over 500 percent.

As is well known, the proliferation of industries of every kind in a closed market has deprived the Latin American countries of the advantages of specialization and economies of scale, and owing to the protection afforded by excessive tariff duties and restrictions, a healthy form of internal competition has failed to develop, to the detriment of efficient production (Prebisch 1964, p. 7).

By providing easy profits in domestic markets, high protection also hindered the development of manufactured exports that had to be sold abroad at world market prices. At the same time, primary production suffered discrimination as protection and export taxes turned the internal terms of trade (i.e., the ratio of primary to industrial product prices) against primary activities. In Argentina, low domestic prices of beef further reduced the exportable surplus by encouraging home consumption. Several other countries limited exports by fiat to satisfy domestic demand.

Exports were further discouraged by the overvaluation of Latin American currencies and by variations in the extent of overvaluation as inflation proceeded continuously while devaluation occurred only intermittently (chapter 2). The resulting fluctuations in their revenues in terms of domestic currencies created considerable uncertainty and risk for exporters.

Instead of improving the external terms of trade through increases in export prices as had been assumed by ECLA, these policies led to a decline in the Latin American countries' world market shares of their major primary exports. Decreases in export market shares were especially pronounced in temperate-zone agricultural products and metals, benefiting developed countries, including the United States, Canada, and Australia.

Among Latin American countries, Argentina's average market shares in the world exports of its principal primary exports, including beef, wheat, maize, and wool, fell by three-fifths between 1934–38 and 1964–66. In the same period, average export market shares declined by two-fifths in Uruguay. Brazil also had a loss of nearly one-half in the average market shares of its principal export

commodities except coffee, where it had a dominant world market position, and sugar, where it benefited from access to the US market; it experienced a slight gain if sugar is included.[5]

In turn, Chile's share fell from 28 percent in 1938 to 22 percent in 1964–66 in the world exports of copper, accounting for three-fifths of the country's export earnings.[6] Furthermore, notwithstanding its climatic advantages, the trade policies applied forestalled the development of Chilean agriculture, thereby impeding the development of exports and contributing to increased food imports.

Owing to the slowdown in the growth of traditional primary exports, the lack of new primary export products, and the failure to develop manufactured exports, the Latin American countries did not earn enough foreign exchange to sustain their economic growth. By limiting their import capacity, the discrimination against exports associated with the policy of import substitution thus retarded their economic growth.

The situation was aggravated because net import savings declined as the import-substituting industries' need for imported materials and machinery grew. Correspondingly, Latin America's economic growth was increasingly constrained by limitations on the availability of foreign exchange, and intermittent foreign exchange crises occurred as attempts were made to expand the economy faster than permitted by the growth of export earnings.

At the same time, the expansion of high-cost, capital-intensive industries raised the capital requirements of additional output increments, the incremental capital-output ratio, which approached 4 in the 1960–66 period in Latin America, on the average (i.e., a 1 peso increase in output necessitated an investment of approximately 4 pesos). Maintaining earlier economic growth rates would thus have required an ever-increasing savings rate. Yet the loss of

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5. United Nations Food and Agriculture Organization, *Trade Yearbook*, various issues. Toward the end of the period, however, Argentina and Uruguay had to seek new markets for their wheat and beef exports as the common agricultural policy led to increased self-sufficiency within the European Community (EC). Comparable data are not available for the other Latin American countries considered in this chapter.

6. Metalgesellschaft, *Metal Statistics*, various issues.

incomes due to the high cost of protection limited the volume of available savings, as did negative real interest rates, so that the average ratio of domestic savings to GDP did not reach 20 percent in Latin America taken as a whole. This was considerably below the Far Eastern level.[7]

Among the countries for which estimates are available, the cost of protection, inclusive of monopoly profits obtained in import-substituting activities, was estimated at 9.5 percent of the gross national product in Brazil and 6.2 percent in Chile in the first half of the 1960s. This cost was less, 2.5 percent of GNP, in Mexico, where protection levels were relatively low at the time (Balassa and Associates 1971, p. 82).

The high cost of import-substituting policies was supposed to remain temporary, but this was not generally the case. Rather, productivity growth slowed considerably, once the first stage of import substitution had been completed. Based on data for major Latin American countries (LAC), including Argentina, Brazil, Chile, Colombia, and Mexico, it was concluded that "'pure' productivity growth has been virtually zero in LAC in the past decade or so" (Bruton 1967), i.e., between the mid-1950s and the mid-1960s.

As a result, instead of reducing the economic distance vis-à-vis the industrial countries, this lag increased over time. Latin American countries were also surpassed by Japan and had considerably lower growth rates than the Far Eastern NICs and the less industrialized countries of Western and Southern Europe, where per capita incomes approximately doubled between 1950 and 1966.

These conclusions also apply, albeit to a lesser extent, to Mexico and Peru, where relatively low import protection rates contributed to the expansion of exports and to a nearly two-thirds rise of per capita incomes between 1950 and 1966. In the same period, the smallest increase in per capita incomes was experienced in Uruguay (14 percent), whose small economy particularly suffered the consequences of losses in export market shares.

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7. United Nations, *Yearbook of National Accounts Statistics*, various issues. Subsequent estimates of domestic savings rates and incremental capital-output ratios for Latin America derive from the same source. Data for the Far Eastern countries originate in the national accounts statistics.

Policy Reforms in the Mid-1960s

The slowdown of economic growth, associated with continued import-substitution orientation, prompted proposals for policy reform in several Latin American countries from the early 1960s onwards. In Argentina, repeated reform efforts were unsuccessful because of the opposition from vested interests. For one thing, labor unions would not accept increases in food prices that would have encouraged agricultural production and exports. For another, private industrialists and the managers of public enterprises would not accept reductions in domestic protection even if accompanied by export subsidies.

In Brazil, the change in the political environment was propitious for policy reforms in the mid-1960s. The currency was devalued to a considerable extent and a crawling-peg exchange rate system was adopted, linking future devaluations to domestic inflation. Subsidies were granted to nontraditional exports, tariffs were lowered, and import regulations were administered more liberally.

Colombia, too, devalued its currency, adopted a crawling peg, granted subsidies to nontraditional exports, and liberalized imports in 1967. Eventually, Argentina also granted export subsidies, but only for manufactured products and without reducing import protection. To encourage exports, Mexico established a free trade regime for offshore assembly industries on the border with the United States (the *máquila* industries) in the second half of the 1960s and introduced tax rebates for manufactured exports in 1971.

In contrast, despite slow economic growth in the confines of small domestic markets, Chile and Uruguay did not reform their systems of incentives, retaining high levels of import protection. Military governments in Ecuador and, in particular, Peru increased import protection. Having reached high income levels based on petroleum, there appeared to be little interest in policy reforms in Venezuela.

As a result of the measures applied, discrimination against exports was reduced in Brazil and Colombia and, to a lesser extent, in Argentina and Mexico. Nevertheless, they did not go as far as the Far Eastern countries that adopted outward-oriented policies after the first stage of import substitution in the early 1960s.

In Korea, Singapore, and Taiwan, exporters were free to choose

between domestic and imported inputs, they were exempted from indirect taxes on their output and inputs, and they paid no duty on imported inputs. The same privileges were extended to the producers of domestic inputs used in export production. This meant essentially free trade treatment for exports.

With additional subsidies and low import protection, exports and import substitution received, on average, similar incentives in the Far Eastern countries. At the same time, there was little discrimination against primary exports and primary activities in general, the incentives system was uniform across industries, and realistic exchange rates were maintained.

In reforming their incentives system, Brazil and Colombia and, to a lesser extent, Argentina and Mexico reduced the bias against exports. But, apart from materials and intermediate products in Brazil and Colombia, these countries did not let industrial exporters choose freely between domestic and imported inputs. Rather, to safeguard existing industries, exporters were required to purchase domestic inputs manufactured under protection. As compensation for the resulting excess cost, they were granted export subsidies.

These subsidies did not give exporters incentives comparable to the protection of domestic markets. Thus, a bias persisted in favor of import substitution and against exports, though at a reduced rate, and incentives varied widely among industries. Discrimination was especially pronounced against traditional primary exports which did not receive export subsidies and which, in Argentina and Mexico, remained subject to export taxes. Brazil, however, vigorously promoted the exports of soybeans and provided credit and tax incentives to agriculture in general.

The incentives importantly affected export performance in the countries concerned. Between 1966 and 1973, the share of exports in manufactured output rose from 1 percent to 4 percent in Argentina and Brazil, and from 3 percent to 8 percent in Colombia, with smaller increases (from 3 percent to 4 percent) in Mexico. Nonetheless, export shares remained much lower than in the Far East, where the share of exports in manufactured output grew from 1 percent in 1960 to 14 percent in 1966 and to 41 percent in 1973 in Korea; from 11 percent, to 20 percent, and to 43 percent in Singapore; and from 9 percent, to 19 percent, and to 50 percent in Taiwan (Balassa and Associates 1982, chapter 3).

While Colombia and, to a lesser extent, Argentina and Mexico

made gains in nontraditional primary exports, the world market shares of their traditional primary exports continued to erode. In turn, notwithstanding their poor resource endowments, Korea and Taiwan had higher growth rates of primary exports (in particular, fruits and vegetables) than the four Latin American countries. Those growth rates were approached only by Brazil, which gained market shares in traditional primary exports and became a major exporter of soybeans.

Chile, Ecuador, Peru, Uruguay, and Venezuela did poorly in primary exports and their share of exports in manufactured output declined between 1960 and 1973. As a result, Chile's share in the combined exports of manufactured goods by developing countries fell from 4 percent to 1 percent, while the other four countries never provided more than one-fifth of 1 percent of this total.

There is further evidence of the favorable effects of policy reforms on the efficiency of investment. In 1960–73, incremental capital-output ratios were 1.8 in Singapore, 2.1 in Korea, and 2.4 in Taiwan, which consistently followed an outward-oriented strategy. At the other extreme, these ratios were 5.5 in Chile and 9.1 in Uruguay, which continued with inward orientation throughout the period. Incremental capital-output ratios decreased in the four Latin American countries that undertook policy reforms. The decline was largest (from 3.8 in 1960–66 to 2.1 in 1966–73) in Brazil, where the policy changes were the most pronounced and excess capacity could be utilized in exporting.

For Latin America as a whole, the incremental capital-output ratio fell from 3.9 in 1960–66 to 2.8 in 1966–73. At the same time, domestic savings ratios increased, from below 20 percent in 1966 to 25 percent in 1973, responding to positive real interest rates, especially in Brazil, where the indexing of financial obligations was introduced.

These improvements in economic performance cannot be attributed to changes in the world economic environment which was favorable before 1966 as well as afterwards. At the same time, intercountry policy differences largely explain differences in growth performance. The Far Eastern countries continued to have the highest GNP growth rates, while the four Latin American countries that undertook policy reforms improved their growth performance after 1966. The improvement was the largest in Brazil, where the most important policy changes occurred. In turn, per capita

incomes rose by one-tenth or less in Chile, Peru, Uruguay, and Venezuela, which did not reform their incentive systems.

Policy Responses to External Shocks After 1973

Most Latin American countries experienced adverse external shocks in 1973–78. The oil-importing countries suffered the consequences of the quadrupling of oil prices in 1973–74, and all Latin American countries were hurt by the world recession of 1974–75. The pattern of policy responses to external shocks will be considered below, except for Ecuador and Venezuela, which benefited from the rise of oil prices (Balassa 1984).

Chile and Uruguay suffered particularly large external shocks and reformed their incentive systems in response. The reforms involved a large devaluation, reductions in import protection, the liberalization of prices, and decreases in budget deficits. As a result, both countries made large gains in export market shares.

In turn, Argentina, Brazil, Colombia, Mexico, and Peru generally increased import protection, thereby reinforcing the bias against exports. Correspondingly, they lost export market shares in 1973–78, except for Brazil, which had gone the farthest in policy reform in the preceding period and continued with export incentives after 1973.

Apart from Colombia, which benefited from higher coffee prices and imported little petroleum, these countries relied heavily on foreign borrowing to offset the effects of external shocks. Nevertheless, after initial successes, their rates of economic growth declined below the pre-1973 growth rates. By contrast, after an initial slowdown, the earlier growth rates were surpassed not only in Korea, Singapore, and Taiwan but also in Chile and Uruguay, all of which suffered larger external shocks, although in Chile rapid economic growth represented in part a recovery from the recession.

The results again reflect policy differences among the countries concerned. The overvaluation of the currency, supported by foreign borrowing, and high protection impaired investment efficiency in the major Latin American countries, Brazil being a partial exception. The situation was aggravated as their large public investment programs paid too little attention to economic considerations. On

the whole, this was not so in the three Far Eastern countries, Chile, and Uruguay.

Higher levels of investment efficiency, expressed by lower incremental capital-output ratios, were accompanied by superior savings performance in the three Far Eastern countries, which had positive real interest rates and small government budget deficits. Chile and Uruguay, however, continued to have low savings rates as reductions in budget deficits were not accompanied by increased private savings, which were slow to respond to changing policies.

The other five Latin American countries showed a mixed savings performance in 1973–78. Colombia excepted, rising government budget deficits in current transactions, financed in part from foreign borrowing, represented negative public savings. As a result, although private savings rates generally increased, the ratio of domestic savings to GDP declined from 25 percent in 1973 to 23 percent in 1978 in Latin America as a whole. In turn, with the deterioration of investment efficiency, incremental capital-output ratios increased from 2.8 in 1966–73 to 4.4 in 1973–78.

Foreign borrowing substantially increased the external indebtedness of the major Latin American countries, whose debt-service ratio (the ratio of interest payments and amortization to merchandise exports) doubled between 1973 and 1978. This ratio declined in the three Far Eastern countries and in Uruguay; it rose by less than one-half in Chile, which experienced a large inflow of private capital.

Heavily indebted Latin American countries suffered the effects of a threefold increase of oil prices, poor world economic conditions, and a substantial rise in world interest rates in subsequent years. These difficulties extended to Mexico and Peru, which enjoyed the benefits of newly found oil resources but borrowed abroad largely to finance their growing budget deficits. They culminated in the debt crisis that may be dated by Mexico's announcement of its inability to service the debt, in August 1982.

The debt crisis also affected Chile and Uruguay, which again introduced large distortions in their incentive systems after 1978 and late 1980. In failing to devalue to compensate for domestic inflation, the two countries considerably weakened their external competitiveness. In Chile, the situation was aggravated as the

inflow of private capital accelerated in response to the liberalization of capital flows, thereby greatly increasing its overall debt.

Korea, Singapore, and Taiwan were little affected by the debt crisis. Their policy stance remained outward-oriented during the period of external shocks, and the three countries continued to gain export market shares. They increased their exports as fast or faster than their external debt as the borrowed funds were used in large part for investments in export activities.

The unproductive use of at least some of the borrowed funds contributed to the debt crisis in the major Latin American countries. Investment in the public sector, and in the protected private sector, often did not meet efficiency criteria, with incremental capital-output ratios averaging 8 in 1978–82 in Latin America. Average domestic savings ratios declined further from 23 percent in 1978 to 22 percent in 1982, as public-sector deficits rose.

Their continued outward orientation permitted the three Far Eastern countries to regain high rates of economic growth, once they had adjusted to the higher oil prices. In Latin American countries, however, per capita incomes fell between 1980 and 1985. The decrease was especially pronounced in Argentina and Venezuela, where the appreciation of the real exchange rate, together with negative interest rates, contributed to capital flight. Per capita incomes declined to a lesser extent in Brazil, where a substantial devaluation in real terms helped growth to resume in 1984 and 1985. Nevertheless, Brazil lost ground not only to Far Eastern countries but also to the South European countries between 1980 and 1985.

In the latter group, especially interesting is Turkey, which undertook important economic reforms in 1980, involving increased outward orientation and greater reliance on the market mechanism. The reforms included a large devaluation, the granting of export incentives, the liberalization of imports, the freeing of most prices, and substantial increases in real interest rates. From near-bankruptcy in 1979, Turkey became creditworthy for commercial lending in 1984 under difficult world economic conditions. This occurred as the volume of exports nearly tripled between 1980 and 1985, contributing to a 13 percent rise in per capita incomes during the period. Turkey thus provides an example of overcoming the debt crisis through a turn toward outward orientation.

The Present Situation

Most Latin American countries went through three distinct stages after World War II. In the first stage, until the mid-1960s, import-substitution policies predominated, characterized by "protection at any cost," with a considerable bias in the system of incentives against exports as well as against primary production.

The policies applied limited the possibilities for economic growth in Latin America. While relatively low levels of protection allowed a rise by nearly two-thirds in the average income level of Mexico and Peru, and the growth of petroleum exports led to a rise by three-fifths in Venezuela, these countries nevertheless experienced much lower growth rates than the less industrialized countries of Western and Southern Europe and the Far East.

As a result, in 1950–66, Latin American countries (Venezuela excepted) fell behind Austria, Finland, Italy, and Spain, where per capita incomes about doubled, and Japan, where they nearly tripled from the low postwar level. Also, with per capita incomes roughly doubling, Greece caught up with Chile, Mexico, and Peru; Portugal, Singapore, and Turkey surpassed Colombia; and Taiwan reached Brazil's and Ecuador's income level.

In the wake of a far-reaching economic reform, per capita incomes in Brazil increased more between 1966 and 1973 than in the previous 16 years altogether. The economic reforms introduced in Argentina, Colombia, and Mexico also helped to accelerate the growth process, but they could not match Brazil's performance as their reforms were more limited. On the other hand, per capita incomes increased little in Chile and Uruguay, which persisted in applying import-substitution-oriented policies; growth slowed in Peru, where distortions in the incentive system increased again, and in Venezuela, where the high costs of continued import substitution became apparent.

While Brazil approached the economic growth rates of the Far Eastern countries between 1966 and 1973, differences in economic performance increased again during the subsequent period of external shocks. Despite large external shocks, continued outward orientation permitted the three Far Eastern countries to nearly double incomes per head between 1973 and 1985. In the same period, per capita incomes increased by one-half in Turkey, which

increasingly shifted from an inward-oriented to an outward-oriented development strategy from 1980 onward.

External shocks were less severe in the four large Latin American countries (Argentina, Brazil, Colombia, and Mexico) than in the Far East after 1973 (Balassa 1985a). Nevertheless, their growth performance deteriorated as the policy reforms of the earlier period were in large part undone. Also, excessive reliance was placed on foreign borrowing, and the borrowed funds were often used inefficiently.

Brazil was an exception in several respects, as it continued with export incentives through much of the period and had more realistic exchange rates, leading to gains in export market shares. But, after 1973, the exchange rate was sustained by large borrowings, and while investments in some intermediate products brought benefits in Brazil's large market, several public investment projects of doubtful economic validity were undertaken (chapter 4).

Correspondingly, Brazil's economic performance was mixed. Per capita incomes rose more than in any of the other Latin American countries (28 percent between 1973 and 1985), but this represented a considerable deceleration compared with earlier periods. Brazil was followed by Colombia (23 percent), which limited its reliance on foreign borrowing and Ecuador (22 percent), which made good use of increments in oil earnings. Increases were much smaller in Mexico (13 percent), which despite its oil bonanza borrowed extensively abroad largely to finance public spending.

Between 1973 and 1985, per capita incomes fell in Argentina, whose economic situation was aggravated by the lack of consistent macroeconomic policies and the overvaluation of the exchange rate. The appreciation of the currency in real terms also reduced the benefits of the reforms introduced in the mid-1970s in Chile and Uruguay, which suffered large external shocks, limiting increases in per capita incomes. Incomes per head declined considerably in Peru, which failed to undo the adverse effects of the policies applied by successive military governments, and, in particular, in Venezuela, where the policies foreclosed the opportunities offered by increases in petroleum prices.

Increases in international interest rates and the decline in primary product prices greatly aggravated the debt situation of the Latin American countries. The London Interbank Offer Rate (LIBOR) on six-month dollar deposits rose from 8.7 percent in

Table 1.5 **Debt servicing and inflation**

Country	Interest payments as percentage of exports, 1985	Debt-export ratio, 1985	Inflation rate	
			1981	Mid–1985
Argentina	55	5.9	105	1,130
Brazil	44	4.0	106	217
Chile	47	5.3	20	35
Colombia	23	2.7	27	28
Ecuador	25	2.6	13	30
Mexico	37	4.5	28	53
Peru	35	4.5	75	169
Uruguay	36	5.6	34	70
Venezuela	23	2.1	16	13

Source: For interest payments and debt-export ratios, ECLA (1985b); for inflation rates, IMF, *International Financial Statistics,* various issues.

1978 to a peak of 16.8 percent in 1981, before falling to 8.6 percent in 1985. After rapid increases between 1978 and 1980, the average dollar price of the exports of oil-importing developing countries declined every year; the oil-exporting countries experienced decreases from 1982 onwards.

Furthermore, capital flight from Argentina, Venezuela, and Mexico importantly added to the region's external debt. As a result of these developments, in 1985 the external debt of most major Latin American countries exceeded the value of their exports of goods and services several times, and interest payments on the debt took a substantial share of those exports (table 1.5).

The financing of external and internal debt increased public-sector deficits, contributing to inflation. Though reduced from their 1982 peaks, the deficits are still much higher than before the oil crisis. The only exception is Venezuela, where a public-sector deficit amounting to 12.9 percent of GDP in 1982 gave way to a surplus of 5.5 percent in 1984.

Venezuela is also the exception to the rise of inflation in Latin America between 1981 and mid-1985 (table 1.5). Since that time,

however, Argentina and, subsequently, Brazil have adopted far-reaching monetary reforms (chapter 3).

At the same time, the high expectations for creation of new jobs under an import-substitution oriented development strategy in Latin America were disappointed. The establishment of relatively capital-intensive industries did not permit the full absorption of workers released by agriculture, which suffered discrimination under this strategy. Correspondingly, unemployment increased to nearly 10 percent of the urban labor force in 1980 in most Latin American countries, according to official statistics, to which disguised unemployment should be added. Further increases in unemployment and underemployment followed the debt crisis, and exacerbated its social impact.

By contrast, manufacturing employment in labor-intensive industries increased more rapidly than labor could be released by agriculture in Korea and Taiwan. As a result, their unemployment rates declined to less than 3 percent of the labor force. Also, with the growth of productivity, real wages rose fourfold from 1960 to 1983 (table 1.6). Higher real wages, and the rise in agricultural incomes, in turn, led to reductions in income inequalities in these countries.[8] In fact, income inequalities are much smaller in the two countries than in any of the major Latin American countries, with income differentials being the largest in Brazil and Peru.[9]

Among Latin American countries, Brazil experienced continuing increases in real wages, while real wages declined in Argentina, Peru, and Uruguay after 1973 and in Mexico after 1978. But, increases in real wages in Brazil, too, were smaller than in the less industrialized European countries and, in particular, the Far Eastern countries. Thus, manufacturing wages in Korea and Taiwan nearly caught up with Brazil and Mexico in 1983 (table 1.6); they

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8. Estimates on the employment effects of alternative development strategies are reported in Krueger (1981, pp. 277–302), while income distributional effects are examined in Myint (1985).

9. World Bank (1986) and *Taiwan Statistical Yearbook 1984*. In the latest year for which data are available, the ratio of the total income of the upper one-fifth to that of the lower one-fifth in the income distribution was 33 in Brazil, 32 in Peru, 20 in Mexico, 18 in Venezuela, 12 in Chile, and 11 in Argentina, compared with 8 in Korea and 7 in Taiwan. Data for other major Latin American countries are not available.

Table 1.6 **Average wages in manufacturing industries**

	Real Wages Index, 1973 = 100					
Country	1960	1966	1973	1978	1980	1983
Argentina	84.8	103.0	100	31	39	n.a.
Brazil	67.3[a]	76.3	100	127	136	149
Ecuador	59.2[b]	61.2	100	113	163	148[c]
Mexico	62.6	89.1	100	118	115	93
Venezuela	84.1[d]	86.8	100	115	117	111[e]
Peru	n.a.	n.a.	100	66	68	n.a.
Uruguay	n.a.	n.a.	100	67	57	n.a.
Austria	51.2	67.5	100	127	130	137
Italy	42.1	57.7	100	131	127	134
Japan	35.8	49.8	100	112	110	117
Spain	52.9[b]	63.3	100	144	155	168
Turkey	54.6	73.2	100	131	112[f]	n.a.
Korea	50.0	50.7	100	184	191	216
Taiwan	46.6	63.4	100	136	161	186

n.a. Not available.

Source: Department of Labor, *Handbook of Labor Statistics*, *International Financial Statistics*, and United Nations, *Statistical Yearbook*, various issues.

a. 1962; b. 1963; c. 1982; d. 1964; e. 1981; f. 1979.

surpassed the two Latin American countries, which undertook substantial devaluations, by 1985.

Summary

Apart from relatively short episodes in the mid-1960s (Colombia and, to a lesser extent, Argentina and Mexico) and the mid-1970s (Chile and Uruguay), Latin American countries have generally followed inward-oriented policies that have discriminated against exports as well as agriculture. And while Brazil has retained the

Dollars per hour					
1960	1966	1973	1978	1980	1983
n.a.	n.a.	0.64	0.34	0.96	n.a.
0.27[a]	0.44	0.81	1.67	1.70	1.68
0.16[b]	0.19	0.36	0.80	1.43	1.43[c]
0.48	0.78	1.24	2.04	2.95	1.45
0.99[d]	1.06	1.50	2.47	3.44	3.78[e]
n.a.	n.a.	0.63	0.43	0.64	n.a.
n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
0.58	0.95	2.58	6.20	7.84	6.92
0.72	1.29	3.33	6.09	8.14	7.59
0.27	0.53	2.16	5.54	5.61	6.20
0.39[b]	0.60	1.53	3.90	5.96	4.75
0.33	0.29	0.46	1.05	1.11[f]	n.a.
0.17	0.09	0.26	0.86	1.08	1.29
0.08	0.12	0.28	0.80	1.27	1.61

export incentives introduced in the mid-1960s after 1973, it has also increased import protection.

In the manufacturing sector, discrimination against exports has taken the form of high tariffs and quantitative import restrictions, which encourage production for the sheltered domestic market and are offset only in part by export incentives. Discrimination has been especially pronounced against agricultural exports, which rarely receive subsidies and are often subject to taxes. More generally, the system of protection in Latin America has discriminated against agriculture, which has received only partial compensation through preferential credits to farmers in some countries of the region.

Inward-oriented policies have retarded economic growth in Latin America. This is particularly apparent in countries that were at higher levels of development at the beginning of the period

(Argentina, Uruguay, and Venezuela) or had relatively small national markets (Chile and Uruguay).

Growth rates have been above average in Colombia and Ecuador, which have had relatively low protection rates, and in Mexico, which has benefited from the proximity of the large US market and, until the mid-1960s, from exchange rate stability. Growth has been the most rapid in Brazil, where export incentives have reinforced the advantages of a large domestic market. Still, Brazil also has fallen behind the less industrialized European countries of a generation ago and the countries of the Far East in terms of per capita incomes.

Besides enhancing investment efficiency, outward orientation usually encourages savings because of increased opportunities to invest; a higher than average savings propensity from increases in incomes; and a higher proportion of savings from incomes generated by exports.[10] Nonetheless, intercountry differences in investment efficiency explain a much larger proportion of differences in economic growth rates between Latin America and the Far East than the differences in domestic savings ratios. Thus, in 1966–85, domestic savings ratios averaged 22 percent in Latin America and 25 percent in the Far Eastern NICs, while incremental capital-output ratios were 5 and 3, respectively. In the same period, the average GDP growth rate was 4.6 percent in the first case and 8.7 percent in the second.[11]

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10. Weisskopf (1972, pp. 25–38) and Papanek (1973, pp. 120–27). In fact, domestic savings ratios are higher in outward-oriented than in inward-oriented countries, except that oil price increases led to high savings ratios in Venezuela. Additional factors contributing to higher savings ratios in outward-oriented countries have been positive real interest rates and relatively low budget deficits.

11. Nor can one explain intercountry differences in per capita income growth rates by population growth. While it has been suggested that high population growth rates create pressures on domestic resources, among the Latin American and Far Eastern countries under consideration, rapid increases in per capita incomes were associated with rapid population growth, and, Venezuela excepted, countries with the smallest increase in per capita incomes had the slowest rise in population. Finally, although Latin America countries with low rates of military expenditures had relatively high rates of per capita income growth, the faster-growing Far Eastern countries had the highest share of military expenditures in the gross national product. (The relevant data are reported in *World Bank* 1986).

2 Exchange Rates and Trade Policy

The previous chapter set the stage for a discussion of desirable economic policies in Latin America. These policies should aim simultaneously at promoting economic growth, with increases in employment and improvements in the distribution of income, and adjusting to the debt crisis. The elements of such a policy package will be considered in this and the next two chapters, while the international environment in which the policies operate will be the subject of chapter 5. Desirable reforms of the system of exchange rates, incentives to exports and to import substitution, incentives to manufacturing and to primary activities, and price control will be analyzed in this chapter. Employment and income distributional implications will also be examined.

Traditionally, economists have distinguished between expenditure-reducing and expenditure-switching policies for balance of payments adjustment. The former entail the application of deflationary measures that reduce domestic expenditures, leading to a decline in total output; the latter involve the application of measures that promote exports and import substitution, contributing to an increase in total output in a situation of unused capacity and unemployed labor such as at present in Latin America.[1] In the case of expenditure switching, one may thus speak of output-increasing policies that promote both balance of payments adjustment and economic growth.

1. Under full-employment conditions, a devaluation carried out in response to a balance of payments disequilibrium would lead to a shift of resources from nontraded to traded sectors.

A competitive exchange rate policy is a sine qua non of output-increasing policies. Such a policy would aim at ensuring the international competitiveness of a country's products in domestic and foreign markets, with account taken of the balance of payments needs arising out of the shift from foreign borrowing to the payment of interest on the external debt.

At the same time, to secure the best use of domestic resources in earning foreign exchange through exports and saving foreign exchange through import substitution, one should move toward equalizing incentives to production for domestic and foreign markets. This will reduce the anti-export bias of the system of incentives that hinders export expansion by favoring sales in highly protected domestic markets, and it will contribute to the efficient allocation of new investment.

Coping with the debt crisis thus requires a shift from an inward-oriented to an outward-oriented development strategy that provides similar incentives to exports and to import substitution. The application of such a strategy will promote economic growth in Latin America, which has been hampered by inappropriate exchange rate and trade policies—characteristic of an inward-oriented development strategy—in the past (chapter 1).

Adopting competitive exchange rates and providing similar incentives to production for domestic and foreign markets will encourage exports as well as efficient import substitution. In the primary sector, possibilities for import substitution can be realized if the existing bias of the system of incentives against such activities is reduced. Unprotected activities, and activities subject to low protection, in the manufacturing sector will also benefit from a competitive exchange rate policy, as discussed below. At the same time, manufactured exports permit import substitution to take place through the exploitation of economies of scale. And intra-industry specialization permits parallel development of exports and import substitution through the international division of the production process, entailing the exchange of parts, components, accessories, as well as finished products through trade.

Outward orientation is thus a two-pronged approach, under which both export expansion and import substitution lead to improvements in the balance of payments and to economic growth. Such has been the case in the post-1973 period of external shocks,

when more import substitution occurred in outward-oriented, than in inward-oriented, developing countries (Balassa 1986a).

An outward-oriented development strategy offers advantages, first of all, by ensuring resource allocation according to comparative advantage that is impeded by high protection. It contributes to the exploitation of economies of scale by surmounting the constraints of national markets and permits higher rates of capacity utilization through increases in output. The carrot and the stick of foreign competition provide inducements for technological improvements. Outward orientation leads to higher domestic savings (chapter 1).

These considerations have particular relevance for the small and medium-size countries of Latin America. But they also apply to the larger countries. Brazil, for example, benefited considerably from increased outward orientation after 1966 and from the maintenance of export incentives and competitive exchange rates after 1973 when import substitution in the production of intermediate goods was again encouraged.

Brazil's gross domestic product is smaller than Canada's, and the GDP of all of Latin America is less than West Germany's. Yet, for Canada as well as for Germany, foreign trade is very important; exports of goods and services account for 29 percent of Canada's GDP and 36 percent of Germany's. The corresponding ratio is 13 percent for Latin America and 11 percent for Brazil (World Bank 1986). Increased outward orientation would permit raising this ratio, with favorable effects for the Latin American economies.

Exchange Rate Policy

Competitive exchange rates are crucial for the future economic development of Latin American countries. The postwar experience of these countries indicates that overvalued currencies and fluctuations in their real value discourage exports, generate pressures for import protection, and engender capital flight. Conversely, the adoption of competitive exchange rates contributes to export expansion and permits reductions in import protection while creating the prerequisites for a reverse flow of capital.

Table 2.1 **Real effective exchange rates**
(1976–78 = 100)

Country	1971	1972	1973	1974	1975	1976	1977
Argentina	92.1	105.2	98.6	87.2	118.9	90.3	110.2
Brazil	92.0	95.6	103.9	103.0	103.3	98.6	97.9
Chile	67.3	51.1	44.3	86.7	113.2	99.4	92.7
Colombia	112.6	114.1	115.8	109.7	112.6	106.8	96.1
Ecuador	126.4	128.0	136.2	123.4	114.7	103.3	101.8
Mexico	91.9	94.9	95.4	92.1	90.4	93.9	105.2
Peru	74.5	75.7	83.0	82.5	74.6	79.8	94.4
Uruguay	86.4	106.2	94.8	84.4	96.6	101.1	99.9
Venezuela	98.2	99.5	106.7	109.3	104.6	101.2	98.1

n.a. Not available.

Note: Trade-weighted exchange rates, adjusted for changes in wholesale prices at home and abroad, except for Chile where the adjusted consumer price index was used until 1975, because of the lack of reliability of wholesale price indices for the period. (An increase in the index represents a depreciation, a decline an appreciation, of real effective exchange rates.)

Source: IMF, *International Financial Statistics*, various issues.

The reforms of the mid-1960s in Brazil offer evidence in this regard. After a decade of poor export performance, the large devaluation of the currency and the adoption of the crawling-peg exchange rate system led to the rapid expansion of exports while imports were liberalized.

These measures promoted Brazil's nontraditional primary and, in particular, manufactured exports. Between 1966 and 1973, the dollar value of per capita manufactured exports increased tenfold, admittedly from a very low base. Argentina and Colombia also carried out policy reforms during this period, leading to rapid export expansion (table 1.3).

After 1973, Brazil made exchange rate adjustments that compensated for domestic inflation and, except in 1981–82, let the real effective exchange rate depreciate.[2] This policy helped Brazil

2. Indices of the real effective exchange rate, reported in table 2.1, have been calculated as a trade-weighted average of nominal exchange rates, adjusted for changes in wholesale prices at home and abroad. Wholesale prices are preferred

1978	1979	1980	1981	1982	1983	1984	1985
99.4	75.7	67.5	75.6	115.2	103.6	95.7	129.4
103.5	114.9	127.6	103.8	98.3	115.7	109.2	109.6
107.8	98.5	83.8	75.3	83.9	90.5	91.4	103.8
97.1	94.7	95.9	88.9	81.1	79.8	85.3	95.8
95.0	97.5	105.1	102.3	103.0	130.5	152.1	131.2
100.9	96.7	89.0	80.1	115.0	121.0	100.3	98.0
125.9	124.1	114.0	96.5	92.4	100.3	101.1	121.0
99.0	84.7	77.6	73.7	76.9	105.3	96.5	95.4
100.7	104.2	98.6	89.5	81.8	76.6	106.7	96.3

gain market shares for its nontraditional primary and manufactured exports, which also benefited from export incentives.

Correspondingly, between 1973 and 1983, Brazil's per capita exports of manufactured goods increased more than fivefold in dollar terms.[3] In Latin America, this performance was matched only by Chile and Uruguay, which adopted realistic exchange rates and turned outward after 1973.[4] Increases were much smaller in the other Latin American countries, where exchange rate adjustments generally did not suffice to offset domestic inflation (table 2.1). The Central American countries, which failed to devalue in line with inflation, had a similar experience.

In 1979–81, the Southern Cone countries attempted to use the exchange rate as an anti-inflationary device by not devaluing to

for this purpose because the consumer price index also covers services that do not enter international trade. At the same time, for making policy decisions, it would be desirable to refine these indices by adjusting for changes in indirect taxes, eliminating nontraded goods from their coverage and using weights that reflect international competitive positions.

3. Note that the average unit value of manufactured goods exported by the developing countries rose by 58 percent between 1973 and 1983 while the increase had been 55 percent between 1966 and 1973 (United Nations, *Statistical Yearbook* and *Monthly Bulletin of Statistics*, various issues).

4. Toward the end of the period, the appreciation of the real exchange rate led to a deterioration in the export performance of the two countries, however.

compensate for domestic price increases. The ensuing overvaluation of the currency curtailed exports and promoted imports, eventually necessitating a large devaluation to restore balance of payments equilibrium. As a result, inflation again accelerated while the countries in question suffered the adverse effects of the large debt they had accumulated and of declines in industries producing tradable goods.

The overvaluation of the currency had similar consequences in Mexico in the early 1980s. And, although the subsequent devaluations led to considerable increases in nonfuel exports, a reversal occurred after mid-1984 as the exchange rate became overvalued anew.[5] In turn, the large devaluations undertaken in late 1985 and early 1986 again had favorable effects on Mexican exports.

Fluctuations in the real effective exchange rate tend to discourage exports by creating uncertainty about the future. Stability in the real exchange rate is thus a precondition for continued favorable export performance as shown by the experience of Brazil after 1966.

An additional consideration is that the overvaluation of the currency increases protectionist pressures. This is well known from the experience of the United States, the Southern Cone countries, and Mexico. Following the appreciation of their real exchange rate, Argentina and Uruguay not only canceled their scheduled tariff reductions but also raised tariffs again; Chile increased tariffs to 25 percent from a uniform tariff of 10 percent; and Mexico reversed the liberalization of imports and raised tariffs.

An especially pernicious consequence of currency overvaluation is capital flight. Argentina reportedly lost about $20 billion, Venezuela $25 billion, and Mexico $35 billion through capital flight between 1973 and 1982 (Dooley et al. 1986). Venezuela suffered further losses in 1983 and Mexico in 1984–85 as their exchange rates again became overvalued, although the extent of the loss is subject to controversy.[6] In addition, a sizeable portion of the

5. The Banco de Mexico reports that the dollar value of Mexico's nonfuel exports increased by 36 percent between the first six months of 1972 and 1974 and declined by 14 percent over the following 12 months.

6. Thus, estimates in Morgan Guaranty Trust, *World Financial Markets* (March 1986), have been contested.

capital outflow from Mexico has reportedly been invested in more permanent ventures in the United States.[7]

The amount of funds domestic nationals hold abroad may account for one-half the external debt of Argentina, over two-fifths that of Mexico, and it may approximate the external debt of Venezuela. Reversing the outflow of private funds is, then, of great importance for these countries. While the capital flight has been less severe in other major Latin American countries, the threat of an outflow exists if the exchange rate gets out of line.

Experience shows that Latin American countries have often used the exchange rate for purposes other than to make their products competitive in world markets and to attain balance of payments equilibrium. The objectives included the stability of the nominal exchange rate for reasons of national prestige and confidence; but confidence was undermined as prices rose more rapidly at home than abroad. The exchange rate was also used as an instrument for controlling inflation; but the resulting overvaluation of the currency led to increases in imports and losses in export market shares, with prices rising again as a devaluation became unavoidable.

There is need, then, for realistic and stable real exchange rates to ensure rapid export expansion and efficient import substitution and to avoid capital flight.[8] Merchandise transactions as well as tourism and other services have proven strongly responsive to the exchange rate, in both the upward and the downward direction. In Mexico, border trade and the máquila industries, processing US-made inputs for reexport, which are included among service items, are particularly sensitive to changes in the rate.

In the present situation of large external debt, high unemployment, and excess capacity in Latin America, it is particularly important to assure adjustment through economic growth and to reverse the outflow of private capital. Correspondingly, in adopting

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7. *Wall Street Journal*, 11 October 1985.

8. A recent report by the United Nations Economic Commission for Latin America and the Caribbean (ECLA) also underlined the importance of setting and maintaining a competitive exchange rate, adding that "the response of export and of import-substituting activities is sensitive not only to the real level of the exchange rate, but also to its stability" (1986, p. 34). The report further noted the importance of reversing the flight of private capital.

a competitive exchange rate policy, Latin American countries are well advised to devalue sufficiently to allow for the shift from foreign borrowing to the payment of interest on the external debt.

Brazil has successfully applied a competitive exchange rate policy in response to the debt crisis. Its earlier deficit on merchandise trade has turned into a surplus of $12 billion in 1985 as its exchange rate depreciated in real terms by 11 percent between 1982 and 1985. And, while initially the application of import restrictions contributed to improvements in Brazil's merchandise trade account, subsequently the expansion of exports increased in importance. As a result of the measures applied, Brazil has resumed economic growth, with a 4.8 percent rise in gross domestic product in 1984, 7.0 percent in 1985, and a growth rate of similar magnitude expected in 1986.

Once an appropriate exchange rate is established, governments should make a credible commitment that the rate will not get out of line again. Such a commitment may be provided by establishing automatic decision rules for changing the exchange rate in the future. Exchange rate changes should be based on relative rates of inflation at home and abroad, with further adjustments made if structural changes occur in the country's balance of payments. A case in point is the large decline of oil prices in early 1986, which greatly reduced export revenue in Ecuador, Mexico, and Venezuela.

Under present-day conditions, dual exchange rates may provide a safety valve for Latin American countries as they did, for example, in Belgium during the postwar period. But experience shows that large differences in the rates cannot be maintained for long. The adverse effects of a large spread between the parallel market rate and the official exchange rate are indicated by the experience in Mexico in 1985. Such a spread discriminates against activities that receive a less favorable exchange rate, invites evasion, and creates expectations for a further devaluation, thereby discouraging exports and encouraging imports.

Correspondingly, large differences between the parallel market exchange rate and the official rate should be avoided. And, in countries like Mexico and Venezuela where capital movements largely escape control, unification of the rates in the short to medium term would be desirable. This is an appropriate long-term goal for the other countries as well.

A competitive exchange rate policy would need to be accompanied by appropriate macroeconomic policies, so as to ensure the movement of resources into export and import-substitution industries and to prevent the acceleration of inflation. Apart from monetary measures, the use of resources by the public sector should be limited by curtailing its operating deficit mainly by reducing current expenditures and improving the operation of public enterprises while safeguarding essential social services.

The reduction in the public-sector deficit would adversely affect some people, but there will be important gains as conditions in financial markets ease. Lower operating deficits will lessen interest payments on the public debt held by nationals, thereby decreasing public-sector financial requirements and freeing resources for the private sector.

Last but not least, a competitive exchange rate policy will permit the necessary import liberalization to provide the import needs of Latin American countries, to increase competition in domestic markets, and to reduce the bias of the incentive system against exports. This last observation leads to the question of relative incentives to exports and import substitution.

Incentives for Exports and Import Substitution

The adoption of a competitive exchange rate policy will give Latin American producers incentives for exports and import substitution. But exports will not grow rapidly if high profits (and an easy life) can be obtained in highly protected domestic markets. As shown in chapter 1, the antiexport bias of an incentive system associated with high protection has been inimical to export expansion, whereas providing similar incentives to exports and to import substitution have importantly contributed to the growth of exports.

The disadvantages of high import protection have been increasingly recognized in Latin America. This is apparent from a recent appraisal of the policies applied in the postwar period by ECLA (1985a, p. 5):

> One policy that was quite common was that of establishing a close link between industrial development and the domestic market, without

combining this with the conquest of external markets. This policy, which can be understood in the light of the genesis of the process in Latin America and the conditions then prevailing on the international scene, was extended for too long and ultimately contributed to the aggravation of the balance of payments problems of many countries. One of the main reasons for this was that protection was excessive, too general, and too prolonged.

Consensus seems to be emerging, then, on the need for reducing import protection in order to ensure efficient resource allocation and to promote exports and economic growth. Such a consensus seems to disappear, however, once specific measures of trade liberalization are considered.

This is largely because the past policies of *protección a ultranza* [excessive protection] have permitted protected industries to operate at high costs and profits. The powerful vested interests thus created naturally oppose changes in these policies. Yet, the essential long-term objective is to eliminate the antiexport bias and to provide equal incentives to exports and import substitution.

Export Incentives

To equalize the treatment of exports and import substitution, export subsidies would need to be provided at similar rates as import protection.[9] This alternative, however, conflicts with international rules that do not treat import protection and export subsidization symmetrically. Developing countries can apply import protection measures without invoking retaliation, but their export subsidies are subject to countervailing action in the developed countries whose industries are adversely affected by them.

There is a long history of countervailing action against export subsidies, particularly in the United States. Under the Tokyo Round, the United States made the application of countervailing

9. According to ECLA, "ideally the incentive granted to exports should be equivalent to the tariff protection accorded to import substitution. As a first approximation, this implies that the export subsidy for a specific good must be equivalent to the tariff rate protecting that good in the domestic market" (1986, p. 36).

duties conditional on the proof of injury from export subsidies granted by countries that subscribed to the subsidy code, but it is using bilateral channels to get developing countries to phase out their export subsidies. Countervailing action has also been increasingly used by the European Economic Community.

Correspondingly, Latin American countries are well advised to limit export incentives to measures that are acceptable under the rules of the General Agreement on Tariffs and Trade (GATT). These include the duty-free entry of imported inputs for export production and the reimbursement of import duties and indirect taxes paid at earlier stages of fabrication. At the same time, full reimbursement in real terms should be assured, with adjustment made for inflation.

Also, exporters should be given the right to import all inputs freely, even if domestic substitutes are available. Apart from Brazil and Colombia, Latin American countries grant this privilege only to exporters located in free trade zones, which are generally not allowed to sell in the domestic market. Also, the experience of the Far Eastern countries indicates that extending this privilege to the domestic producers of inputs for export production (indirect exports) promotes exports and encourages the use of domestic inputs by reducing costs. Its adoption by Latin American countries would therefore be desirable.

The freedom of choice between domestic and imported inputs for direct and indirect exporters puts them under free trade conditions. A bias against exports and in favor of import substitution would remain, however, owing to the protection of domestic markets. Thus, additional incentives to exports are needed, chosen to avoid retaliation by developed countries.

Export promotion measures such as establishing information services, financing trade fairs, and granting favorable tax treatment for marketing expenditures may be undertaken without risk of retaliation. Furthermore, export credits and guarantees can be provided within the limits acceptable under international rules. Export credits may take the form of prefinancing, the discounting of export bills, medium-term loans for the sale of capital goods, and long-term credits for investment in export activities.

Latin American exports also have been hindered by other forms of "self-inflicted injury," in the form of a welter of administrative procedures that impede export expansion. Some of these proce-

dures are related to exchange controls. Others, such as export licensing, may require proving that domestic supplies are not affected by exports and that the products in question are not of strategic importance. These controls should be ended.

Regulations affecting exporters should also be simplified. Possible models are Far Eastern countries and Turkey, where governments aim to facilitate exports. This is part of an export mentality, when exporters know they will be helped, not hindered, in their efforts.

A final point concerns the availability of infrastructure for exporting activities. The situation varies from country to country, but in several Latin American countries import substitution policies meant, in effect, a lack of concern with export-oriented infrastructure. Special efforts are needed to develop ports, sea, and road transport, handling and storage facilities, as well as communication networks. Projects in export infrastructure tend to have high social rates of return, making them good candidates for financing by the World Bank or the Inter-American Development Bank (IDB).

Import Protection

Rates of import protection in Latin America today far exceed the export incentives that may be provided without inviting retaliation on the part of the developed countries. Import protection thus needs to be reduced, both to encourage exports and to lessen the economic cost of protection. These objectives would further be served by rationalizing the system of protection that often reflects past actions taken at different times and for differing objectives.

Several attempts have been made by Latin American countries to liberalize and rationalize import protection. Their experience shows that success depends crucially on the maintenance of realistic exchange rates. Thus, exchange rate overvaluation led to a reversal of import liberalization in the countries of the Southern Cone and Mexico. Conversely, the devaluation of the exchange rate in Brazil permitted substantial reductions in import protection in the mid-1960s.

The adoption of competitive exchange rates provides an opportunity for lowering import protection in Latin America. This may take the form of a compensated devaluation, where reductions in

the rates of protection offset increases in the domestic prices of protected imports resulting from a devaluation. The application of such measures would promote exports as well as import substitution in industries that are unprotected or have low rates of protection, while limiting domestic price increases.[10]

A sufficiently large devaluation would allow import protection to be eliminated. In Latin America's present situation, this alternative would encounter practical difficulties, however. It would create problems of financing for the public sector and for private enterprises with substantial foreign debt by increasing the domestic currency value of the debt, and it would cause considerable dislocation in highly protected industries which need time to adjust.

Correspondingly, the liberalization and rationalization of protection would have to proceed according to a well-conceived program, designed to minimize the difficulties of adjustment and to surmount the opposition of vested interests that benefited from high protection in the past. Such a program would include the replacement of quantitative import restrictions by tariffs, reductions in the average level of protection, and a move toward uniformity in sectoral levels of protection.

Latin American governments should be unambiguous on two points:

- They are committed to the import liberalization program and will resist pressure against it from vested interests.
- Despite the overall beneficial economic effects of import liberalization, some areas and activities will be adversely affected.

The replacement of quantitative import restrictions by tariffs would need to be given first priority. Quantitative restrictions may

10. More precisely, production will increase in sectors where the initial rate of protection was less than the rate of devaluation, so that full compensation through reductions in protection cannot be made (for example, if the currency is devalued by 20 percent and the initial rate of protection was 8 percent, prices will rise by 12 percent, thereby providing incentives to domestic production. In turn, the domestic prices of products with an initial rate of protection of 20 percent or higher would not change).

be used to advantage in emergencies, but their continued application imposes a cost on the national economy that tends to increase with the level of industrial development.

To begin with, the protective effects of quantitative restrictions are difficult to ascertain while the tariff rate *ipso facto* indicates the extent of protection. Also, case-by-case decision making in providing import licenses creates uncertainty for the user, which is not the case with tariffs. Moreover, tariffs have a lower administrative cost and contribute to government revenue while the difference between the domestic and the foreign price accrues to the importer under import licensing. Such quota profits, reflecting the scarcity of imports, may lead to "overcrowding" in an industry as firms go into business only to share the quota profits and may invite bribery to obtain import licenses.

These considerations point to the need for using tariffs in the place of quantitative import restrictions for the protection of domestic industries.[11] The question arises, then, as to whether tariffs should be raised to offset the loss of quantitative import protection for domestic producers. This alternative has some serious disadvantages. For one thing, producers may clamor for tariffs in excess of the protection provided by quantitative restrictions, and their claims will be difficult to evaluate, given the problems encountered in measuring the price-raising effects of quotas. For another, the higher tariffs may be difficult to reduce afterwards as they become embedded in the import-protection system, unless provisions are made for eliminating the additional tariff protection over a specified period. In Mexico, for example, the replacement of a substantial part of its quantitative import restrictions by higher tariffs and the imposition of import reference prices in July 1985 have apparently increased the overall level of protection.

Quantitative import restrictions should be eliminated according to a predetermined timetable, allowing sufficient time and notice

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11. After replacing quantitative restrictions by tariffs, dumping may be dealt with by antidumping duties. But, to prevent antidumping duties from becoming a cover for increased import protection, procedures for their administration should conform to international rules. In particular, both the meaning of unfair trade practices and the procedure for obtaining relief should be clearly stated; importers should be able to appeal the decisions; and relief should be limited to temporary surcharges.

for adjustment. The first priority should be to free the imports of inputs for export production, including raw materials, intermediate goods, as well as machinery. This could be followed by the liberalization of the importation of inputs used in production for domestic markets. Consumer imports would be liberalized at the next stage; luxury goods, last.

The period for phasing out quantitative import restrictions could be set at three- to five years, depending on the existing economic conditions. It would be appropriately complemented by tariff reform, aimed at reducing the level, and rationalizing the structure, of tariffs.

The reform would involve, first of all, setting a tariff ceiling at a level that does not excessively protect domestic industry. Depending again on the existing situation, the ceiling could be set at 15 percent to 20 percent, to be reached over a period of perhaps five years. Interindustry differences in tariffs should also be reduced, the ultimate objective being to equalize effective protection (the protection of value added) across industries.

The tariff ceiling should also apply to luxury goods, lest their domestic production be encouraged. Rather, luxury goods should be subjected to excise taxes levied at identical rates, regardless of whether the goods are of domestic or foreign origin.

Revenue from excise taxes would thus compensate government for the revenue loss from tariff reductions on luxury goods. Indirect taxes would also need to be raised to offset the adverse revenue effects of lower tariffs. But the extent of the loss would be limited by increases in the volume of imports and the shift from smuggling to legal imports in response to tariff reductions.

Additional protection could be provided temporarily to new industrial activities, "infant industries." Such protection should be granted on a declining scale over time, so as to provide inducement for improvements in operations and reductions in costs. If budgetary considerations permit, infant industries should receive production subsidies offering equal incentives, regardless of whether production is destined for domestic or export markets; otherwise, temporary tariff surcharges could be employed.

Apart from reducing the bias against manufactured exports, adopting competitive exchange rates and lowering rates of import protection will encourage primary activities which may be oriented toward domestic or foreign markets. This, in turn, leads to the

question of relative incentives to primary and to manufacturing activities.

Incentives for Primary and Manufacturing Activities

In assessing relative incentives to primary and manufacturing activities, export products subject to international agreements or quantitative restrictions abroad need separate attention. A country assigned a quota under an international agreement may set an export tax at a level where production equals the quota plus domestic consumption. In Latin American countries, this will be the appropriate policy for coffee, cocoa, and petroleum, provided that international agreements become effective for these commodities.

Export taxes have also been suggested for countries that are large suppliers of a particular commodity, so that changes in export volume would importantly affect the world market price. Apart from coffee, in Brazil, which has been subject to the International Coffee Agreement, however, there are no commodities where a single country in Latin America, or even all countries of the region acting in unison, could gain from imposing an export tax. This conclusion also applies to joint action taken by all developing countries, the major exceptions being tropical beverages and petroleum.

Quantitative import restrictions apply to certain agricultural commodities exported from Latin America in several developed countries. But, as long as other foreign markets are free of such restrictions, export taxes would be inappropriate. This conclusion holds, for example, for Argentina, where export taxes on wheat and beef have reduced the international competitiveness of domestic producers.

Similar considerations apply to textiles and clothing, where Latin American countries have generally not been able to fill their quotas. Once the quotas are filled, however, quota rights could be auctioned among domestic firms.

With few exceptions, then, export taxes will be inappropriate because they interfere with the efficient allocation of economic resources and discourage exports. These adverse consequences are

especially obvious in agriculture, where export taxes have often been used to collect revenue to the detriment of domestic production and exports.

Land taxes are more appropriate for revenue purposes. Such taxes were used to good effect in European countries at a comparable stage of economic development. They have the important advantage of encouraging increases in production, which enhance the farmer's ability to pay taxes that are not linked to production volume.

Agricultural incentives have been shown to importantly affect agricultural output. This may explain the fact that while Latin American countries have certain natural advantages over Asian countries, they have been less successful in expanding agricultural production.

In 1983, per capita agricultural output exceeded the 1961–65 average by only 7 percent in South America and fell short of this level by 3 percent in Mexico, while an increase of 24 percent was experienced in Asia.[12] In the same period, Latin America's trade balance in agriculture sharply deteriorated.

Within Latin America, too, agricultural performance appears to be related to incentives. Output per head increased the most in Brazil, which had a relatively favorable incentive regime for agriculture; it declined in Mexico, where discrimination against agriculture increased over time and the exchange rate was often unfavorable; and the largest drop occurred in Peru, where dislocation, owing to land reform under military governments, aggravated the adverse effects of industrial protection.

Discrimination in the system of incentives against agriculture in Latin America should therefore be reduced. This objective would be served by adopting a competitive exchange rate, lowering industrial protection, and eliminating export taxes on commodities other than those subject to international agreements.

At the same time, infant activities exist also in agriculture, and these activities need support. Such support may be provided in the form of improved seeds, extension services, and government-

12. United Nations Food and Agriculture Organization, *Production Yearbook*, various issues.

sponsored research benefiting all producers of a certain commodity.[13]

Price Control

Agriculture has also suffered from price control in several Latin American countries. Although price control has been considered an instrument of social policy, it has in fact reflected the political power of urban interests and has burdened the poor in the countryside. Besides discouraging production, leading to increased food imports in countries such as Mexico and Peru, agricultural price control has induced people to leave farms for life in the cities and abroad.

Price control has also been employed outside agriculture in Latin America. It has been applied to various products and services, discouraging production. In addition, managerial resources may have been diverted from productive uses to make the case for price increases before the authorities.

Price control often creates difficulties for public firms as well. For one thing, price control makes it difficult to evaluate the operational efficiency of public enterprises. For another, price control has often been instrumental in increasing the public sector deficit, thereby adding to inflationary pressures.

Although across-the-board price control may be used as a first step in conjunction with monetary reform (chapter 3), sustained price control has been ineffective in Latin America. In Peru, for example, the price of controlled foodstuffs has increased more rapidly over time than that of noncontrolled foods.[14]

To avoid its adverse consequences on production, and on resource allocation in general, price control on the production level should be eliminated systematically. This should be done in conjunction with import liberalization, so as to prevent the exploitation of monopolistic positions. Price liberalization should extend to agriculture, energy, manufactures, and services.

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13. Elias (1985) provides evidence on the favorable effects government expenditures had on agricultural output in Latin America, particularly expenditures on research and extension services.

14. *Comercio*, Lima, 19 November 1985.

In agriculture, food and nonfood products should be considered separately. Because nonfood products are inputs into manufacturing, there is no need for price control, which would give excessive protection to the processing activity. Also, price control on staple foodstuffs discourages production and is an inefficient way of helping the poor because it benefits all consumers; income support is a far better alternative. And, while consumption subsidies could be used in a transitional period, prices should be freed at the production level. Finally, on nonstaple foods, there is no rationale for even temporary price control because the share of the poor in consumption is low.

Price control has been applied in Latin America to energy products, including fuel oil, gasoline, and electricity. It has led to wasteful energy consumption, with adverse effects for the government budget and the balance of payments. Yet, there is no reason to maintain energy prices below the levels in the industrial countries.

The prices of manufactured goods should also be liberalized. The elimination of price control on manufactured inputs that are used in the production of nontraded goods (services), such as transportation and communications, would permit the prices of these services to be liberalized as well. Liberalization of the prices of public services is particularly important as the underpricing of these services has encouraged excessive usage and importantly added to the deficit of the public sector.

Income Distributional Effects

The question arises as to how the distribution of incomes would be affected by the proposed measures. It has been claimed, in particular, that in increasing the cost of imports, a devaluation would lead to a decline in real wages. This result will not follow, however, if the devaluation is accompanied by commensurate reductions in import protection, leaving the domestic prices of protected imports unchanged. Also, subsequent reductions in protection rates will lower import prices.

Living costs will nevertheless rise to the extent that a devaluation will lead to higher prices of foodstuffs that are exported as well as

consumed domestically. But income losses to consumers will be more than offset by gains to agricultural producers, most of whom belong to the poorer segments of the population. And even if large farmers benefit, there will be gains to agricultural workers through increased employment.

Furthermore, increases in industrial employment, associated with the growth of exports attendant on the implementation of the proposed policy package, will increase labor incomes in the cities. Also, as the experience of the Far Eastern countries indicates, real wages will rise as a result of sustained economic growth generated by increased exports and efficient import substitution. Devaluation-induced increases in exports and in output also led to higher wages in Brazil after 1966, 1973, and, again, 1984.

The proposed measures will be of especial benefit to small and medium-size businesses, which have particularly suffered the consequences of high protection, the lack of imported inputs, and price control. At the same time, such businesses provide a large potential source of employment creation in Latin America.

These considerations are of particular importance to counter the arguments of vested interests, including highly protected industries, privileged labor groups, and power-seeking bureaucrats, who wish to maintain their special position. Apart from pointing to the gains to society at large, it should be emphasized that the application of the proposed measures over a period of three-to-five years would permit adjustment to take place while limiting the cost of dislocation.

The recognition of the favorable effects of the proposed measures for the large majority of the population would permit mobilizing popular support for their implementation. In fact, the example of Chile in 1973 should not lead one to conclude that a reform of exchange rate and trade policies would require an authoritarian government. Such reforms have been carried out by democratic regimes, as in Colombia, Portugal, and Thailand, or have been reinforced by such regimes, as in Argentina, Brazil, and Turkey. In turn, most authoritarian regimes, whether of the right (for example, Guatemala and Paraguay), or of the left (for example, Cuba and Nicaragua), have followed inward-oriented policies, with adverse economic effects.

Summary

This chapter has recommended the adoption of competitive exchange rates, with account taken of the shift from foreign borrowing to the payment of interest on the external debt. Once an appropriate exchange rate is established, there is need for a credible commitment that the rate will not get out of line again. At the same time, the spread between the parallel market and the official exchange rates should be limited, since such differences invite evasion and create expectations for a future devaluation, with the eventual unification of the two rates.

The adoption of competitive exchange rates should be complemented by export incentives, to be chosen with a view to avoid countervailing action on the part of developed countries. Reducing the bias of the incentive system against exports, necessary for export expansion, would further require lowering the level of import protection, and there is need to rationalize the system of import protection that results from actions taken at different times and for different purposes.

As a first step, import protection could be reduced in conjunction with currency devaluation. Moreover, a program of import liberalization would need to be established, involving the replacement of quantitative restrictions by tariffs, reductions in the average level of import protection, and making the structure of tariffs more uniform, with additional, temporary protection provided to infant industries.

The bias of the incentive system against agriculture would also need to be reduced. At the same time, infant-industry protection in the manufacturing sector should be complemented by government support to agriculture in the form of improved seeds, extension services, and research.

The elimination of price control would also benefit agricultural producers and contribute to higher output. More generally, there is need for price liberalization, to be carried out in conjunction with import liberalization, so as to avoid the exploitation of monopolistic positions.

The last point indicates the need for simultaneous action on several fronts in reforming the system of production incentives in Latin America. The proposed reforms would promote economic

growth and facilitate adjustment to the debt crisis as, under conditions of unemployment and underutilized capacity existing in Latin America, a devaluation *cum* import liberalization would bring immediate increases in output and employment.

Increases in employment will favorably affect the distribution of incomes in Latin America. Improving incentives to agriculture would also help the poor, the large majority of whom live in rural areas. The expansion of manufactured exports would further increase employment in the cities, and the acceleration of economic growth would bring benefits across the board.

3 Financing Economic Growth

In the preceding chapter, recommendations were made for the adoption of an outward-oriented development strategy that would lead to higher exports and output under the conditions of excess capacity prevailing in Latin America. Sustained growth will, however, require new investment as well as the efficient allocation of investment funds.

In 1960–80, investment ratios were relatively high in Latin America. Gross domestic investment approached 30 percent of GDP in Venezuela; it averaged 25 percent in Brazil, and it ranged between 20 percent and 25 percent in Argentina and Mexico. The ratio was slightly below 20 percent in Colombia, Ecuador, and Peru, and about 15 percent in Chile and Uruguay (table 3.1).

The investment ratio declined in every major Latin American country but Colombia after 1980. This decline reflected large decreases in the inflow of capital, resulting in a net transfer abroad (negative net foreign savings), and a fall in domestic savings ratios in most countries.

In 1985, interest and dividend payments ($35 billion) much surpassed the net inflow of capital ($5 billion) in Latin America, taken as a whole, resulting in a net transfer abroad of $30 billion. This compares with 1980, when the net inflow of capital exceeded the payment of interest and dividends by $12 billion (ECLA 1986).

Domestic savings ratios declined in conjunction with the near-stagnation of Latin American economies in the first half of the 1980s. Adverse macroeconomic conditions thus have a lasting effect in reducing future rates of economic growth in Latin America, by lowering savings and investment.

An increased net inflow of capital into Latin America would be desirable (chapter 5). However, for some time to come, this could not fully cover interest payments abroad. Not only are the funds available from abroad limited, but Latin American countries need

Table 3.1 **Savings or investment ratios**
(percentage of GDP)

Country	Savings on investment	1960–66	1967–73	1974–80	1981–84
Argentina	GDS	19.4	21.2	26.4	19.0
	FS	0.2	−1.0	−1.5	−3.0
	GDI	19.6	20.2	24.9	16.0
Brazil	GDS	24.8	24.8	23.9	20.5
	FS	−0.4	0.8	2.6	−1.7
	GDI	24.4	25.6	26.5	18.8
Chile	GDS	13.2	13.9	15.6	10.0
	FS	1.3	0.2	1.3	3.0
	GDI	14.5	14.1	16.9	13.0
Colombia	GDS	16.7	17.8	20.2	16.1
	FS	1.0	1.0	−1.6	3.8
	GDI	17.6	18.8	18.6	19.9
Ecuador	GDS	11.1	14.8	24.1	22.7
	FS	2.6	4.3	1.6	−1.3
	GDI	13.6	19.1	25.6	21.4
Mexico	GDS	18.7	20.2	23.0	28.4
	FS	1.1	1.2	1.3	−5.6
	GDI	19.8	21.2	24.2	22.8
Peru	GDS	23.2	16.4	15.9	15.6
	FS	−0.2	−0.8	0.9	0.3
	GDI	22.9	15.5	16.8	15.9
Uruguay	GDS	14.5	12.5	11.9	12.2
	FS	−0.6	−0.6	3.2	0.2
	GDI	13.9	11.9	15.1	12.4
Venezuela	GDS	35.4	34.7	36.2	25.8
	FS	−13.9	−6.6	−3.3	−6.6
	GDI	21.5	28.2	32.8	19.1

Country	Savings on investment	1960–66	1967–73	1974–80	1981–84
Austria	GDS	28.0	29.4	26.9	24.0
	FS	−0.3	−0.4	0.9	−0.5
	GDI	27.7	29.0	27.8	23.5
Finland	GDS	24.8	26.5	26.6	25.7
	FS	1.2	0.3	0.9	−1.6
	GDI	26.7	26.8	27.5	24.6
Italy	GDS	23.6	22.4	22.1	18.3
	FS	−0.3	−0.8	0.5	0.7
	GDI	23.3	21.6	22.6	19.0
Japan	GDS	34.7	38.2	33.1	31.4
	FS	−0.2	−1.3	−0.2	−1.7
	GDI	34.5	36.9	32.9	29.7
Greece	GDS	14.1	19.0	18.9	15.7
	FS	8.3	8.7	8.1	8.6
	GDI	22.2	27.5	27.9	22.3
Portugal	GDS	18.5	20.2	14.6	16.4
	FS	5.8	5.2	13.5	14.9
	GDI	24.7	26.4	28.8	31.3
Spain	GDS	21.6	23.0	21.0	19.3
	FS	1.1	1.1	2.4	0.3
	GDI	22.6	24.0	23.4	19.6
Turkey	GDS	13.1	16.2	15.4	15.2
	FS	2.6	2.5	6.6	5.7
	GDI	15.7	18.6	22.1	20.9
Korea	GDS	5.4	16.0	24.3	25.8
	FS	9.5	9.0	6.1	2.0
	GDI	15.2	25.1	30.4	27.8

(continued overleaf)

Table 3.1 *Continued*
(percentage of GDP)

Country	Savings on investment	1960–66	1967–73	1974–80	1981–84
Singapore	GDS	8.6	20.4	31.7	40.8
	FS	8.7	13.5	8.5	4.6
	GDI	16.7	33.6	40.5	45.5
Taiwan	GDS	16.6	27.1	32.6	32.1
	FS	3.3	−1.2	−0.3	−7.2
	GDI	19.9	25.9	32.2	25.0

GDS gross domestic savings. FS foreign savings, defined to equal net capital flows, interest payments, and dividends. GDI gross domestic investment. Interest payments and dividends are considered to be part of the gross domestic product, not the gross national product.

Source: IMF, *International Financial Statistics*, various issues.

to adjust their economies instead of substantially adding to their external debt.

An outward-oriented development strategy would increase savings and improve the efficiency of investment allocation (chapter 1). Nevertheless, specific policy measures will need to be taken to do so. Indeed, regaining earlier levels of investment will require higher domestic savings ratios than in the past, since domestic savings will have to substitute for the foreign savings of earlier years that have given place to a negative net foreign transfer.

Lowering budget deficits would add to the availability of domestic savings by increasing public savings (reducing dissavings). In turn, tax and interest rate policies could contribute to private savings. These policies will be considered in the chapter, together with the measures that could be taken to ensure the efficient allocation of savings among alternative investments.

The amount available for domestic investment could further be increased by encouraging the reverse flow of private capital from abroad and foreign investment in domestic activities. The chapter will close with a discussion of possible ways to eliminate rapid

inflation that has adverse effects on the savings-investment process and economic activity is general.

Public Savings

Public savings declined greatly in Latin America after 1973 as current government expenditures increased more rapidly than tax revenues and a number of public enterprises ran substantial losses. And while some improvements have occurred in recent years, reduced access to foreign borrowing has involved a shift to the domestic financing of the public sector. The fall in domestic savings ratios has further reduced the availability of investible funds to the private sector.

Such "crowding-out" may take the form of limiting private-sector access to bank credit and to financing on capital markets. In Mexico, for example, compulsory bank-reserve requirements today are 100 percent of additional deposits, except if the deposits are used to provide agricultural, export, and housing credits, which reduce the ratio to 93 percent. Also, at the end of 1985, the public sector accounted for 73 percent of outstanding bank credit in Mexico, 36 percent in Argentina, and 32 percent in Brazil.

Correspondingly, there is a need for increasing public savings in Latin America. As far as the government budget is concerned, raising revenues and reducing public expenditures represent possible alternatives. While more efficient tax-collection procedures would increase budgetary revenues, emphasis should be given to lowering public expenditures and reducing the losses of public enterprises, since high tax rates tend to discourage work effort, risk taking, and private savings. These effects may explain the negative correlation between the share of taxes in the GDP and the rate of economic growth (Marsden 1983 and Wolf 1986).

Efforts have been made in recent years to limit public expenditures in Latin America. But the reductions have largely involved lowering real wages in the public sector and making marginal changes across the board without major cuts in public administration. Yet, improving economic performance requires deregulation,

which would involve eliminating certain governmental functions (chapter 4).

Public savings could further be obtained through reprivatization, the closing down of hopelessly inefficient public enterprises, the sale of most other enterprises in the competitive sector, and the rationalization of the management of those remaining. Direct or indirect government subsidies, including the underpricing of public utilities, would also need to be reduced. The effects of such subsidies extend much beyond the target groups and are an inefficient way of helping the poor (chapter 2).

Tax Regulations

Improvements in the tax system would encourage private savings and its efficient allocation among alternative investments in Latin America. In this connection, countries with high inflation rates need special attention.

Most Latin American countries do not use inflation accounting in establishing tax liabilities for business enterprises. This does not create a problem as long as investments are financed from borrowed funds, since the loss in the real value of invested capital is compensated by the gain obtained through the decline in the real value of the debt. There is no such compensation, however, if investments are financed from internally generated funds. Correspondingly, the taxable value of profits is overstated and reliance on loan capital is encouraged at the expense of the use of retained earnings for investment.

Revaluing the assets and liabilities of business firms at regular intervals, on the example of the United Kingdom, would avoid these adverse consequences. Revaluation profits should not be taxed, since they do not represent real profits for the enterprise but only offset inflation-generated losses in the value of invested capital. More generally, capital gains taxes should be applied only to inflation-adjusted gains, if at all.[1]

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1. Such taxes are not used in most European countries, to avoid taxing the principal and burdening successful risk takers. Latin American countries would be well advised to forego capital gains taxation, especially because it invites capital flight.

The taxation of dividends does not raise questions of inflation accounting as long as assets and liabilities are adjusted for inflation. Such a problem arises, however, in regard to interest income since the principal loses value as a result of inflation. In Colombia, for example, nominal interest receipts are taxed at a rate of 18 percent but the effective tax rate of real (inflation-adjusted) earnings was 67.5 percent in 1983 (Leechor 1986, p. 20).[2]

Limiting the taxation of interest income to the real interest rate would be necessary to avoid discouraging personal savings and providing inducements to capital flight. Similarly, the tax deductibility of interest payments should be limited to the real interest rate, lest present consumption be encouraged. Nor should it be assumed that such adjustments would excessively burden tax administration as they have been routinely made in Brazil.

Brazil (and more recently the United States) also introduced the automatic adjustment of tax brackets for inflation, so that only inflation-adjusted incomes are taxed. Such has not been the case in other Latin American countries, although tax brackets are adjusted from time to time. Yet, in the absence of continuous adjustment, incomes are effectively taxed at higher rates than intended by tax legislation, and uncertainty is created about the actual tax rate.

The described adjustments would alleviate the adverse effects of inflation on the tax system in Latin American countries. But even if full adjustment for inflation was made or inflation was eliminated, various features of the tax systems of these countries would need reform. In particular, taxing the amount saved as well as the return on savings introduces a bias in favor of present and against future consumption that is the result of today's savings. To ensure that an individual's decision to save is affected only by the

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2. The effective tax rate has been calculated as 1 *less* the ratio of the depositor's actual net rate of return to the real rate of return with no tax on the interest receipts. The actual net rate of return (2.6 percent in the present case) *equals* 1 *less* the tax rate of 18 percent (.82) *multiplied by* the nominal rate of return (30 percent), *less* the rate of inflation (22 percent). In turn, the real rate of return with no tax (8 percent) is the nominal rate of return (30 percent) less the rate of inflation (22 percent). The effective tax rate on real interest earnings would exceed 100 percent, i.e., capital is taxed, if the rate of inflation was 25 percent or higher.

rate of return on savings, ideally consumption, not savings, should be taxed.

In the case of corporate savings, exempting retained earnings from taxation would have such an effect. But this alternative would introduce a bias in favor of self-investment, thereby promoting industrial concentration and limiting choices among alternative forms of investment. A more appropriate alternative would be to follow the European example in applying the integration principle to corporate profits. This may be accomplished if corporate income taxes are paid on retained as well as on distributed profits, with a corresponding rebate given to the shareholders.[3]

Placing increased reliance on indirect taxes would limit taxing personal savings. In recognition of this fact, Uruguay has replaced direct taxes with indirect taxes, thus taxing consumption but not savings.

Under the destination principle, applied by the major Latin American countries, indirect taxes are rebated on exports while imports are subjected to these taxes at the same rate as domestic products. The practical application of this principle nevertheless raises problems in countries using cascade-type indirect taxes. Such taxes are levied at every stage of fabrication and their cumulative effects are difficult to gauge. Also, the burden of taxes on consumption varies according to the number of stages, and vertical integration is encouraged because of the tax savings it generates.

To escape these difficulties, several Latin American countries have introduced value-added taxation, which equalizes the tax burden on all consumer goods as exports are exempted from the value-added tax and receive rebates for taxes paid at earlier stages of fabrication. Under inflationary conditions, however, the real value of the rebate is reduced by inflation. With an inflation rate of 50 percent, for example, the real value of a tax rebate received one year later is about two-thirds of the amount originally paid. The resulting excess cost for exports may be alleviated by indexing tax rebates on the rate of inflation or exempting indirect exporters; i.e., the domestic producers of inputs for export, from the value-added tax.

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3. The elimination of the double taxation of dividends would also reduce the bias in favor of debt and against equity financing.

Elements of progressivity could be introduced in the structure of indirect taxes by imposing excise taxes on luxury goods and, possibly, by taxing basic necessities at lower rates. High excise taxes, however, invite evasion and smuggling. Thus, if tax progressivity is desired, one may use a mixture of indirect and direct taxes while recognizing that highly progressive income taxes, too, are subject to evasion. Progressive income taxes also tend to discourage savings and provide inducement for capital flight. This may explain the recent choice made for a flat income tax rate in Jamaica.

The appropriate mix of taxes will depend on the conditions within each country. While no country, developed or developing, has an ideal system of taxes, improvements may be made, with a view to minimizing the effects of taxation on savings, work effort, risk taking, and capital flight.

Interest Rates

Interest rate policies in Latin America have varied widely over time. Nominal interest rates were traditionally set at levels where they fell short of inflation, thereby giving rise to negative real interest rates. This was the case in most Latin American countries until the late 1970s. Peru and Venezuela were extreme cases; Brazil and Colombia were exceptions.

The policies applied after 1979 led to high positive real interest rates in the countries of the Southern Cone. Real interest rates increased further in conjunction with the stabilization efforts undertaken by these countries in response to the debt crisis. In Argentina, lending rates have been set at 6 percent a month following the application of the Austral Plan when the rate of inflation was about 4 percent a month. Real interest rates are also high in Mexico, with monthly lending rates of 7 percent and prices rising by 5 percent a month.

But real interest rates are often negative on loans to privileged sectors, such as agriculture and housing. In Brazil, for example, the interest subsidy to agriculture was estimated at 3 percent of the gross domestic product in the early 1980s. While lower interest rates provided a partial offset for discrimination against agriculture, the loans were often used for different purposes.

Brazil also exhibited considerable variations of real interest rates over time. Following negative real interest rates in earlier years, interest rates turned slightly positive in the mid-1970s, with subsidized loans provided to agriculture, exports, and import-substituting activities. In 1980, real interest rates again became negative, while a year later orthodox interest rate management led to very high real rates. In 1985, Treasury bills were yielding 15 percent and certificates of deposit 20 percent a year in real terms, with bank lending rates exceeding 30 percent. Little change occurred in these rates following the monetary reform undertaken in February 1986.

There is evidence that negative real interest rates discourage savings (IMF 1983). Also, incentives are provided to hold a large proportion of savings in the form of inflation hedges, such as real estate and consumer durables, and to shift capital abroad. Lastly, self-investment at low, and even negative, returns is encouraged.

As a result, financial savings available for investment are reduced, thus limiting the amount invested.[4] This, in turn, leads to credit rationing and to inefficient credit allocation, irrespective of whether allocation is done by the banks or the government. Import-substituting investments in protected markets usually benefit. Banks favor these investments because they involve lower risk than investments in export activities; governments favor them as part of an inward-oriented development strategy.

Negative real interest rates also provide inducement for investments in capital-intensive activities and the use of capital-intensive production methods. At the same time, firms may borrow at negative real interest rates as an inflation hedge and accumulate inventories rather than undertaking new investments. Limitations on the availability of credit also tend to reduce the utilization of existing capacity (Leff and Sato 1980).

Interest rates should thus be allowed to clear financial markets in Latin American countries. Under present conditions, market-clearing interest rates may, however, be "too high" in the sense that they impair companies' financial conditions.

Reducing government deficits would lead to a decline in market-

4. This conclusion, first stated by Ronald McKinnon (1973), has received empirical verification in a cross-section of 17 Latin American and 7 Asian countries (Blejer and Khan 1984a).

clearing interest rates and generate a virtuous circle of lower deficits and lower interest rates. This is because a fall in interest rates, consequent on reductions in the public-sector deficit, would further lower the deficit, thereby generating an additional decline in interest rates, and so on.

Market-clearing interest rates should apply across the board, so as to avoid inefficiencies in the allocation of investment funds.[5] It would thus be desirable to eliminate preferential credits, unless it can be shown conclusively that the social profitability of an investment exceeds its private profitability.

In the presence of international capital flows, domestic interest rates cannot be out of line with interest rates abroad. In fact, if capital movements are entirely free and a competitive exchange rate policy is applied, real domestic interest rates would equal real foreign interest rates plus a risk premium.

Investment Incentives and Choices

The proposed measures would increase the pool of private and public savings for new investment. Additional investment incentives to promote exports and economic growth in Latin American countries may, however, be necessary under present economic conditions.

Investment incentives should be applied across the board, with higher incentives to exports that are subject to discrimination under import protection. Also, the incentives should be granted in a form that does not encourage capital-intensive activities. An example of perverse incentives is the case of Northeast Brazil, where investment incentives effectively provide capital at a zero cost, giving rise to the expansion of capital-intensive, at the expense of labor-intensive, activities.

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5. Once interest rates clear credit markets, differences in interest rates vis-à-vis curb markets will reflect differences in the riskiness of loans. At the same time, increased savings at higher interest rates will add to the total availability of investment funds. This observation effectively deals with the objection, according to which higher interest rates in the banking system would draw average funds from the curb market. See van Wijnbergen 1983, pp. 433–52.

There is evidence that the growth rate of GDP increases with the rise in the share of private investment in the total.[6] Incentives for private investment will thus favorably affect economic growth. This would necessitate reversing past tendencies that favored public investment. Furthermore, measures should be taken to improve the efficiency of public investments.

Unifying public budgets and eliminating special, off-budget funds would represent a first step in this direction. It would further be desirable to prepare multiannual investment budgets so as to provide continuity in the financing of public investment projects, and to evaluate these projects according to uniform standards. The evaluation of major projects should be made public, including information on any direct and indirect subsidies.

Financial Intermediation

Efficient financial institutions and capital markets play an essential role in channeling funds from savers to investors in the process of economic development. However, under present conditions, Latin America's financial intermediaries do not fully provide for the continent's financing needs.

Taking the broadly-defined money supply (M2) as an indicator, the countries of Latin America are considerably behind countries in other areas of the world in the development of financial intermediation. Thus, the ratio of M2 to the gross domestic product does not reach 30 percent in any of the major Latin American countries while this ratio approaches 40 percent in Korea and surpasses 60 percent in Singapore, Taiwan, and the South European countries.

High rates of inflation have retarded the development of financial intermediation in Latin America. The holders of noninterest-bearing monetary assets incur a loss due to inflation and, in the absence of full indexation, the variability of inflation rates discourages the holding of interest-bearing monetary assets.

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6. This result has been obtained in a cross-section relationship for the same group of countries referred to above. Blejer and Khan 1984b, pp. 26–29.

The inflation tax on noninterest-bearing assets has in part been collected by the banks, thus lessening their need to compete for higher returns. Licensing restrictions and interest ceilings have also reduced bank competition. As a result, the cost of banking is high in Latin America, with large margins as between borrowers and lenders' (depositors') interest rates.

High compulsory reserve requirements vis-à-vis the central bank and taxes on lending and borrowing widen these margins. Savings and investment are thereby discouraged, since lending rates are reduced and borrowing rates are increased by high reserve requirements and taxes on financial transactions.

Curb markets are a response to the high cost of doing business with the banks. But Latin American governments impose legal limitations on curb market activities which, while often evaded, raise costs. There are also limitations on the operation of nonbank financial institutions, which could compete with the banks.

Insufficient information on the operations of financial institutions has further limited the development of financial savings, particularly in Chile, by creating uncertainty for depositors. Chile is also the prototype for the lack of adequate banking supervision that led to bank failures on a large scale in the early 1980s.

Latin American capital markets offer only a limited variety of financial instruments, the major exception being Brazil. Bond markets are not developed and, where they do exist, dealings are largely in government securities. Stock markets are thin and volatile, so that uncertainty is created for would-be investors.

Limitations on the choice of financial assets tend to discourage financial savings, favoring the purchase of consumer durables, self-investment, and the outflow of capital. Improvements in financial intermediation, then, would not only permit the more efficient allocation of funds available for investment but would also increase the availability of financial savings.

Lowering the rate of inflation would importantly contribute to the development of financial intermediation in Latin America. Additional reforms should aim at improving the operation of the banking system, establishing nonbank financial intermediaries, and developing capital markets.

Increased competition and adequate supervision of the banks is a first priority. Competition should replace licensing and interest

ceilings. Regulations for the establishment of foreign-bank subsidiaries should also be liberalized.

At the same time, strict rules need to be established on banking operations, including the preparation of financial statements, the classification of loans, the establishment of loan reserves, and write-offs for nonperforming loans. Financial statements should convey adequate information on the quality of bank assets and should be regularly audited, with rigorous banking supervision put under the aegis of the central bank. Deposit insurance should also be introduced (as practiced in the United States) to provide for risk sharing and encourage banking by the public.

Compulsory reserve requirements should be reduced and taxes on banking transactions eliminated. Besides increasing the efficiency of the banks in transforming savings into investment, this would help to reduce the fragmentation of the banking system through unregulated curb markets.

Curb markets should be integrated into the banking system and provisions made for the establishment and the regulation of nonbank financial institutions. These intermediaries would compete with the banks and increase the scope of financial instruments available to the public.

Capital markets should also be developed further. Apart from adverse effects on capital flows, the shortcomings of these markets have discouraged the growth of indigenous firms and have favored multinational enterprises and publicly owned firms. Together with limits on foreign direct investment in basic industries, the inadequacies of capital markets have also contributed to the predominant role of the state in these industries in most major Latin American countries.

The development of capital markets would require an educational effort. For one thing, family corporations that are dominant in Latin America would need to be convinced of the desirability of issuing bonds and stocks. For another thing, the public would need to be convinced of the advantages of owning such financial instruments.

An appropriate regulatory framework would further need to be established to guarantee the rights of bond- and stockholders. Apart from the regular payment of interest and dividends, bond- and stockholders should be protected against unfair corporate practices. Full disclosure, and supervision by an agency modeled

on the US Securities and Exchange Commission, would provide such protection. This has been the case in Brazil, since the establishment of the Comissão de Valores Mobiliários in 1977.

Capital Flight

The flight of capital has been the scourge of several major Latin American countries over the last decade. Since 1983, a contributing factor has been tax exemptions introduced by the United States, and subsequently applied by some other industrial countries, on the earnings of nonresidents derived from financial assets. Also, commercial banks in the industrial countries with subsidiaries in Latin America have provided facilities for the transfer of funds. Domestic factors, however, have been more important.

Capital flight is encouraged by overvalued exchange rates and by low interest rates. It is also promoted by high taxes on dividends, interest income, other current income, and capital gains, particularly as inflation rates have pushed people into higher income brackets. Uncertainty about future changes in exchange rates, interest rates, taxation, and economic policies in general, too, contributes to capital flight.

The indexing of exchange rates and interest rates in the face of domestic inflation discouraged capital flight in Brazil by creating expectations that exchange rates and interest rates would be maintained in real terms. In turn, fluctuations in these variables and, in particular, episodes of substantial overvaluation contributed to capital flight in Argentina, Mexico, and Venezuela.

Regular adjustments in exchange rates would ensure the maintenance of competitive exchange rates (chapter 2). In turn, increasingly linking domestic interest rates to interest rates on the world market would reduce the incentive to shift funds abroad in search of higher returns.

The need to reduce capital flight also reinforces the desirability of eliminating the double taxation of dividends, the taxation of nominal interest earnings and capital gains, as well as bracket creep due to inflation. And, providing financial instruments of appropriate quality and variety may compensate for the attractions of shifting capital abroad.

If implemented, these recommendations would create incentives to repatriate capital. But, the uncertain tax status of income earned abroad, and of the funds originally transferred, create obstacles for their repatriation. Several measures could be employed to overcome these obstacles.

Countries could follow the example of Argentina in declaring a tax amnesty for the funds repatriated from abroad. The attractiveness of repatriating funds held abroad can be increased further by providing certain advantages for repatriation. These advantages may be financial or may relate to the freedom of foreign exchange transactions.

Chile, for instance, permits local residents holding funds abroad to purchase debt obligations at a discount and to exchange them at face value for local currency to be used for the purchase of equity in local firms, with the investment being immobilized for some years. Several other Latin American countries are introducing such schemes or are contemplating their introduction.

Colombia provides free import licenses without requiring foreign exchange allocation by the central bank. Outside Latin America, India has created a mutual fund for its nationals for the purchase of domestic equity by the use of funds held abroad, with the right of repatriation being assured by entrusting its management to foreign agents (Lessard and Williamson 1985, pp. 96–97).

Foreign Investment

Since the onset of the debt crisis, Latin America has suffered a decline not only in foreign lending but also in foreign investment. Direct investment as well as portfolio investment in the form of the purchase of bonds and stocks by foreigners have declined considerably (table 3.2).

This outcome is hardly surprising. Risk capital is attracted to countries that offer good growth potential, sound balance of payments performance, adequate exchange rate management, and price stability. Latin American countries generally do not meet these tests, hence the apparent shift of direct investments to other

Table 3.2 Foreign investment
(million dollars)

Country	Investment	1978	1979	1980	1981	1982	1983	1984
Argentina	(A)	273	265	788	944	257	183	268
	(B)	101	222	154	1,125	299	649	372
	(C)	374	487	942	2,069	556	832	640
Brazil	(A)	1,882	2,223	1,544	2,313	2,534	1,373	1,556
	(B)	n.a.	660	354	−2	−1	−286	−272
	(C)	1,882	2,883	1,898	2,311	2,533	1,087	1,284
Chile	(A)	177	233	170	362	384	148	67
	(B)	n.a.	50	n.a.	n.a.	n.a.	n.a.	n.a.
	(C)	177	283	170	362	384	148	67
Colombia	(A)	66	103	51	228	337	514	411
	(B)	−2	−11	−3	−2	−7	−2	−3
	(C)	64	92	48	226	330	511	408
Ecuador	(A)	49	63	70	60	40	50	50
	(B)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	(C)	49	63	70	60	40	50	50
Mexico	(A)	824	1,332	2,186	2,537	1,655	459	391
	(B)	737	−393	−74	986	946	−625	−625
	(C)	1,561	939	2,108	3,523	2,601	−166	−234
Peru	(A)	25	71	27	125	48	38	−89
	(B)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	(C)	25	71	27	125	48	38	−89
Uruguay	(A)	129	216	290	49	−14	6	3
	(B)	−9	−31	−7	3	−7	−16	7
	(C)	120	185	283	52	−21	−10	10
Venezuela	(A)	67	88	55	184	253	86	42
	(B)	124	−74	1,310	83	1,582	201	−128
	(C)	191	14	1,365	267	1,835	287	−86

n.a. Not available.

(A) Direct investment; (B) Portfolio investment; (C) *equals* (A) + (B).

Source: International Monetary Fund, *International Financial Statistics*, various issues.

developing countries.[7] For the same reason, net stock purchases have given place to net sales in most major Latin American countries.

Yet, foreign investment offers various benefits to the countries of Latin America over bank loans. To begin with, the investor, rather than the host country, bears the commercial risk, and payments are made only if the investment pays off. Thus, it may be expected that payments would be linked to business conditions in the host country and hence to its ability to pay.[8]

Foreign direct investment offers special interest to Latin America, since foreign investors bring technological and managerial knowledge as well as marketing expertise. This will help the development of exports while foreign investors have an incentive to resist protection in their own countries. And although risk premiums and payments for proprietary knowledge should raise returns on direct investment above the interest rate paid on loans, this relationship may reverse at times of high interest rates.

Also, part of the earnings on foreign direct investment are reinvested, thereby reducing the actual foreign-exchange cost of servicing the investment. In fact, in the five years to 1983, this cost averaged less than 5 percent of the value of investment in developing countries, compared with an average interest rate of 13 percent on bank loans.[9]

The application of the policies proposed here, and in chapter 2, would increase the attractiveness of Latin American countries for foreign direct investment. Further measures would need to be taken, however, to encourage such investments. They include liberalizing ownership rules, eliminating limitations on the repa-

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7. Available data show a decline in the stock of US investments in Latin America from $38.8 billion in 1980 to $28.0 billion in 1984, compared with an increase from $18.3 billion to $25.8 billion in other developing countries (*Survey of Current Business*, various issues). The data make allowance for disinvestments that are not shown in the IMF figures.

8. But changes in profit remittances further depend on the reinvestment of earnings that, too, are affected by economic conditions in the host country. In the early 1980s, for example, remittances of US manufacturing affiliates from the developing countries increased despite declines in their profits (Michalopoulos 1985, p. 67).

9. *Economist*, 15 March, 1986, p. 67.

triation of dividends and invested capital, accepting international arbitration, and simplifying administrative procedures.

Many Latin American countries exclude foreign capital from some industries and limit the share of foreign ownership in others. Several countries have expressed willingness to accept foreign investment in previously closed industries but have not yet done so. It would also be desirable to liberalize regulations on the percentage share of foreign ownership.

The acceptance of international arbitration on contentious issues related to foreign direct investment is a sovereign decision. Refusing arbitration of disputes, however, deflects investments to countries that do accept it.

Participation in the Multilateral Investment Guarantee Authority (MIGA), under the aegis of the World Bank, offers particular advantages to Latin American countries. Initially, MIGA will provide broad coverage for noncommercial risks associated with foreign direct investment. Eventually, coverage is to be extended to management and service contracts, licensing and franchising agreements, and arrangements on technology transfer.

MIGA offers advantages over existing public and private insurance schemes because it relies on an agreement between investor and host countries on the treatment of noncommercial risks. At the same time, MIGA fully recognizes the sovereign rights of member governments and will not conclude any contract of guarantee without the approval of the host government.

Membership in MIGA would increase, and nonparticipation reduce, the attractiveness of Latin American countries for foreign direct investment, thus influencing flows of foreign capital. Bilateral agreements would also be desirable on the arbitration of disputes after exhausting recourse to host-country courts, as provided, for example, in agreements between Mexico and several Latin American countries.

Bureaucratic obstacles to foreign direct investment in Latin America would also have to be surmounted. Thus, while IBM could afford to spend over two years negotiating with the Mexican government on the conditions for an investment, most other firms could not. The simplification of administrative regulations on foreign direct investment is thus of considerable importance. This could be done by establishing a single authority to deal with

foreign investors and imposing time limits for decisions on individual applications.

Investments in the stock markets of Latin American countries are small compared with external financing by commercial banks. In 1983, the foreign equity position in all Latin American stock markets together was less than half that in Hong Kong and in Singapore and barely more than in Kuala Lumpur. In the same year, the ratio of equity capital to net bank debt exceeded one-third only in Chile among Latin American countries (Van Agtmael 1984 and BIS 1984).

These results may be explained by the fact that the stock markets of Hong Kong, Singapore, and Malaysia are entirely open to foreign investors, and transactions on the Santiago stock exchange are also relatively free. By contrast, Argentina and Venezuela impose a minimum holding period on foreign investors; Brazil limits foreign investment to special mutual funds; and Mexico permits investment in only a few companies in addition to a mutual fund established for this purpose.

Governments often try to justify these limitations on the grounds that they prevent domestic firms from falling under foreign control. But this could be accomplished by limiting the share of foreign ownership in individual firms. If such a limit is reached, two classes of shares may be effectively created, with shares above the limit not having voting rights.

Liberalizing existing regulations on the purchase of stocks by foreign investors would promote the transformation of debt capital into equity (chapter 5). Furthermore, investments by the Emerging Markets Growth Fund, established under the auspices of the International Finance Corporation, and the creation of similar funds, as well as investments by mutual funds, pension funds, and insurance companies, should be encouraged.

Foreign investors should also be given opportunities for quasi-equity investments without full risk bearing. Examples include production, revenue, and profit sharing through contractual joint ventures; management and service contracts; and licensing and franchise agreements (Lessard and Williamson 1985).

Anti-inflationary Policies

In the absence of inflation adjustments in the tax system, inflation discourages savings as well as work effort and risk taking by taxing nominal rather than real incomes. Furthermore, incentives are provided for capital flight.

Taxing nominal rather than real incomes increases the government's tax take. Governments also receive the inflation tax on the currency portion of the noninterest-bearing debt, even though at very high rates of inflation a fall in the real value of money holdings and increased use of other currencies reduce the extent of these gains.

The real value of government revenue, derived from tax receipts and the seignorage on currency, thus has a tendency to increase with inflation. However, delays in tax collection will eventually reverse the situation as inflation accelerates. This occurred under the German hyperinflation of the 1920s and the Argentine inflation of 1984–85.

The converse of the virtuous circle of lower budget deficits and interest rates is the vicious circle of inflation, leading to higher interest rates, thereby adding to budget deficits which, in turn, raise interest rates that again increase the budget deficit. In countries with a large domestic debt, this has been the dominating influence, resulting in increases in the nominal budget deficit, expressed as a percentage of the gross domestic product.

Higher nominal interest rates may lead to a larger budget deficit in nominal terms, even if the deficit in real terms is not affected. In Brazil, for example, the 1985 deficit of the public sector was above 20 percent of the gross domestic product in nominal terms and 3 percent in real terms (i.e., after adjustment for the effects of inflation on interest paid on domestic debt). The corresponding figures for Mexico are 17 percent and 2 percent in 1986.

From the point of view of the external accounts, the real deficit matters. However, the nominal deficit influences conditions on the money market, thereby adding to inflationary pressures, except in the unlikely case when the holders of government debt automatically purchase the additional debt issues from their interest receipts. Also, high and rising nominal interest rates may create

self-fulfilling expectations regarding the acceleration of inflation as income-earners attempt to get ahead of inflation.

Supply shocks from abroad may also contribute to the acceleration of inflation unless offset by restrictive monetary measures, leading to recession. Examples are the quadrupling of oil prices in 1973–74 and the two-and-a-half–fold increase of these prices in 1979–80, as well as the large increase in real interest rates in world financial markets after 1980.

Apart from its adverse impact associated with the taxation of nominal rather than real incomes discussed earlier, inflation unfavorably affects economic activity in several respects. First of all, uncertainty is created about nominal incomes, and changes in the rate of inflation add to the uncertainty.

Attempts by income recipients to reduce inflation-induced uncertainty also entail a cost to the national economy. Hedging against inflation is generally done at the expense of productive activity. The situation is aggravated under high rates of inflation, when the gains through speculation often exceed profits from production.

In the realm of productive activity, short-term considerations often prevail over long-time objectives under inflation. Investment activity in general, and investment with a long gestation period in particular, is discouraged, and short-term contracts are preferred over long-term engagements.

Further inefficiencies are created by variations in relative prices and in the profitability of productive activities, which usually accompany inflation. At the same time, variations in real wages in toto, as well as among different industries and labor categories, may—and often do—feed labor unrest. Unrest has at times developed, even after real wage increases, because of uncertainty about the appropriate price index for calculating changes in real wages.

These considerations may explain the negative correlation between inflation rates and the rate of economic growth in developing countries.[10] Such a negative correlation has been observed in a cross-section relationship in developing countries as well as in individual countries over time.

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10. For a summary of the evidence, see Johnson (1984), pp. 636–60. See also Cline (1985–86), pp. 155–72.

Under certain circumstances, the adverse economic effects of inflation may be reduced by indexation. But, indexation remained imperfect even in Brazil, the Latin American country that went the farthest in this direction. Rents were adjusted once a year, wages originally once a year and subsequently every six months, and the exchange rate first weekly and later once a day. Also, controlled prices were modified intermittently and adjustment lags in regard to uncontrolled prices varied. Finally, currency and demand deposits were not indexed.

At the same time, moves toward perfect indexation, aimed at reducing fluctuations in real values, tend to accelerate inflation. In particular, given the importance of labor costs and the use of cost-plus pricing in many Latin American countries, shortening the period of wage adjustment correspondingly raises the rate of inflation. This happened, in fact, in Brazil, where reducing the period of wage adjustment from 12 months to 6 months contributed to an approximate doubling of the rate of inflation in late 1979.

It appears, then, that while indexation may temporarily reduce the adverse economic effects of inflation, attempts to improve indexation lead to more rapid inflation. Inflation also accelerates under indexation if adverse external shocks occur. And, in cases when macroeconomic measures are used to reduce inflation rates, indexation slows the process of disinflation, as in Chile.

After 1973, Chile attempted to reduce inflation rates approaching 1,000 percent a year by using deflationary monetary and fiscal policies while maintaining the indexation of wages and exchange rates. As a result, profits were squeezed and a depression ensued but, after an initial decline, inflation rates remained at between 30 percent and 40 percent.

Then came the fixing of the exchange rate in terms of US dollars in June 1979, together with the strengthening of backward wage indexation. This meant that the inflation rates of the previous period served as a floor for wage increases. Correspondingly, reductions in inflation rates led to a rise in real wages, compromising the international competitive position of Chilean agriculture and manufacturing industries.

In fact, average wages doubled over the next two-and-a-half years in terms of Chilean pesos and, with an unchanged exchange rate, also in terms of US dollars. While inflation was reduced to the US level by 1981, this proved to be temporary. The large

balance of payments deficit resulting from the increasing overvaluation of the currency necessitated a devaluation that rekindled inflationary pressures, which were aggravated by increases in tariffs (Balassa 1985b, pp. 303–38).

The Chilean experience shows the failure of using the exchange rate as an anti-inflationary device. Argentina and, in the Middle East, Israel have fared even worse, with higher inflation rates after than before the breakdown of similar experiments.[11]

Thus, alternative approaches have to be found to reduce very high inflation rates in Latin America. In this connection, the Austral Plan in Argentina, adopted in June 1985, and the Cruzado Plan in Brazil, introduced in February 1986, offer particular interest.

The Austral Plan involved a substantial reduction in the government budget deficit, the nonmonetary financing of the remaining deficit, and the application of price and wage controls, which were preceded by adjustments in public-sector prices and a devaluation of the exchange rate. As a result of these measures, inflation rates declined from 30 percent to 3 percent a month.

Reductions in the budget deficit involved across-the-board cuts in expenditures and increases in taxes, in particular export taxes on wheat and beef. Subsequent reductions in export taxes for the sake of promoting exports, however, have not been compensated by reductions in expenditures. Correspondingly, the budget deficit is estimated to reach 4 percent of the gross domestic product in 1986, contributing to increases in inflation rates to 6 percent a month.

In Brazil, the Cruzado Plan involved reducing the budget deficit, setting wages at their average real value of the preceding six months, with an additional increase of 8 percent (15 percent for the minimum wages), freezing all prices, and instituting unemployment compensation. Immediately, inflation was brought down to zero, but low prices of public utilities added to the budget deficit while the lack of full adjustment of prices for wage increases prior to the introduction of the plan penalized the steel and automobile industries. Also, the 8 percent rise in wages put a

11. This result has also been obtained in a theoretical model (van Wijnbergen 1985).

burden on producers in the public as well as the private sector and added to aggregate demand pressures. They were aggravated by reductions in domestic savings, necessitating the subsequent introduction of compulsory loans, linked to the purchase of automobiles and gasoline, to dampen these pressures.

The adoption of the Austral Plan and the Cruzado Plan reflects the recognition that at very high rates of inflation drastic action needs to be taken to break inflationary expectations. This will involve taking measures in regard to public-sector deficits, money creation, monetary reform, wages, and prices.

Reducing the deficit of the public sector is a first priority. If the deficit is not fully eliminated, its monetary financing would have to cease. Rather, increases in the money supply should respond to the needs of the private sector, which will want to rebuild its real money balances. Monetary reform, involving the replacement of the old monetary unit, can put an end to inflationary psychology.

Indexation, including the indexation of wages, also should be eliminated. And the last wage adjustment, undertaken at the time of monetary reform, should compensate for only part of the inflation since the previous adjustment, so as to reestablish real wages at their average level over the period.

For the deindexation of wages to take hold after a long period of indexation, wage controls would have to be applied temporarily. At the same time, for reasons of practical politics, wage controls will generally be accompanied by price control at the time of monetary reform. But the institution of price control, which should be temporary, would have to be preceded by adjustments in relative prices in the public sector.

Gradualism in combating inflation is appropriate in the case of lower rates of inflation, so as to limit the recessionary effects of the stabilization policy. Another advantage of gradualism is orderly adjustment of wages.[12] If wage adjustments are synchronized, this may be done by forward wage adjustments, linking wage increments to expected inflation. This procedure has recently been used with

12. In the case of staggered wage setting, with adjustments at different times for different industries or different classes of workers, an adjustment rule combining backward and forward indexation should be used as it was done in Brazil in 1965, when the annual inflation rate fell from 92 percent to 34 percent. For a detailed discussion of the process of indexation, see Simonsen (1983).

good effect in France, leading to substantial reductions in inflation rates.

Forward-looking adjustment rules should also be applied to rents and other incomes subject to government control. At the same time, guarantees should be provided in case inflation exceeds projected levels. This could be done by introducing a trigger clause in formulating the rules of adjustment.[13] Once inflation rates decline to an acceptable level, indexation should be abolished and wages and other incomes freed.

In an intermediate zone, inflation rates are not high enough to create substantial dislocation and not low enough to limit the recessionary effects of stabilization policy. This is the case, for example, in Mexico, where the inflation rate averages 80 percent a year.

Reducing inflation rates from such high levels by using traditional anti-inflationary measures may involve a large economic cost. Correspondingly, consideration may be given to monetary reform in such cases as well. At the same time, it should be recognized that this will be successful only if the preconditions are fulfilled, among which reducing budget deficits and their monetary financing are particularly important.

Summary

Changes in existing policies are recommended to encourage the generation of savings and their efficient allocation in Latin America while reversing the capital flight of recent years. Proposals are also made for measures to reduce inflation rates.

The first priority is to increase public savings. Action should be concentrated on cutting expenditures and reducing the losses of public enterprises, rather than raising taxes. At the same time, the tax system should be reformed, so as to encourage private savings. Apart from the introduction of inflation accounting, it would be desirable to tax consumption but not savings.

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13. Trigger points should be determined by reference to changes in prices adjusted for the effects of supply-side shocks.

Adopting positive real interest rates and narrowing the margins between lending and borrowing rates through reductions in compulsory reserve requirements for commercial banks and the elimination of taxes on financial transactions would also increase savings and investment. These changes would further encourage the efficient allocation of savings among alternative investments. Improving the efficiency of financial intermediation and developing stock and bond markets, too, would serve these objectives.

Under present conditions in Latin America, investment incentives would also be needed. Such incentives should be provided across the board, except that investments in export activities would require additional incentives as long as import protection is maintained. The incentives should be granted in a form that does not encourage capital-intensive activities.

The lower taxation of domestic savings and the establishment of positive real interest rates, together with competitive exchange rates, would also provide incentives for the reverse flow of private capital from abroad. Encouragement should be given to foreign direct investment, which is particularly important in promoting outward orientation because of the technological know-how and marketing expertise it brings.

Reducing the deficit of the public sector and the nonmonetary financing of the remaining deficit is a prerequisite for lowering inflationary pressures. A further condition is the elimination of wage indexation. Inflation can be dealt with overnight in the event of monetary reform in countries experiencing rapid inflation, or gradually in countries with lower inflation rates.

In the latter case, then, fighting inflation will take time. The reform of the tax and the financial systems of Latin American countries will also take time. Nevertheless, early action is needed to bring about the requisite increases in savings and improvements in their allocation.

4 The Role of the State and State Enterprise

A central factor that gave impetus to the rapid growth of external debt in the 1970s and to the severity of the economic and social crisis of the 1980s was the pervasive and rapidly expanding role of the state in most of Latin America.[1] The easy availability of foreign loans to governments and their agencies was exemplified by the nearly tenfold growth in the dollar value of the public and publicly guaranteed external debt from 1973 to 1983. Private nonguaranteed debt increased fourfold in the same period.

With the notable exception of Chile, Colombia, and several Central American countries, governments (some of them with a bent for "strategic" projects and industries) were eager takers of foreign credits, which financed growing public-sector deficits. At the same time, foreign lenders, both official and private, indulged their natural aversion to commercial risk by lending to governments and to their enterprises. By 1982, about three-fourths of the region's entire external debt was owed or guaranteed by the public sector, and this proportion has since risen as some governments have taken over the foreign obligations of private companies.

The economic crisis that has engulfed most countries in the region since 1982 has provoked a lively debate on whether state intervention has gone too far. With greater freedom in countries that have moved from military to elected civilian governments, particularly Argentina and Brazil, the discussion appears to be evolving into support for more private initiative and less state control.

1. Although there was already rapid growth in the late 1960s, it was on average lower than in the 1970s.

The state functions as regulator, as investor, and as provider of services. These three aspects are reviewed below, along with the question: who has borne the greater burden of adjustment since 1982?

Historical Background

The rapid expansion of the role of the state in most of Latin America is part of a worldwide phenomenon of the last twenty years, which was accelerated by the inflation and the energy crisis of the 1970s. Latin America has thus not been unique. However, increases in public-sector deficits have been greater in Latin America than elsewhere. This has been the case in particular in Argentina, Brazil, and Mexico, where public-sector deficits reached 15 percent of gross domestic product in the early 1980s.[2]

Over the last decade, the most rapid growth in public expenditure took place in Mexico, Peru, and Venezuela, largely because of the expansion of state oil companies (table 4.1). In Mexico, Uruguay, and Venezuela, transfers to state enterprises also increased considerably, in some cases to subsidize the consumption of energy and basic staples, whereas the growth of public consumption slowed down after rapid increases in several of the countries during the 1960s (table 4.2).

Much earlier, there had been a very large expansion of the role of the state in Argentina when Juan Domingo Perón came to power. There also was a long-term trend toward a larger state role in Brazil and Colombia, but it was much more moderate than in the oil-producing countries. Only in Chile did a reversal occur, after 1973.

Again with the exception of Chile, the state plays a growing role as investor. Despite the shortcomings of official statistics, which generally include capital formation by state enterprises as part of private investment—thus greatly underestimating the govern-

2. The figures, inclusive of nominal interest charges on the domestic debt, indicate the financial requirements of the public sector. However, from the point of view of the effects of the deficit on the external balance, the deficit calculated with real (inflation-adjusted) interest rates will be relevant (chapter 3).

Table 4.1 Growth of the public sector, 1970–82

Country	Public-sector outlays as percentage of GDP		Of which state enterprises		Estimated share of state enterprises in gross domestic investment	Public-sector deficit as percentage of GDP	
	1970	1982[a]	1970	1982	(1978–80)	1970	1982
Argentina	33	35	11	12	20	1	14
Brazil	28	32	6	11	39	2	17
Chile	41	36	5	10	13	5	2
Colombia	26	30	6	10	9	4	2
Mexico	21	48	10	26	24	2	17
Peru	25	57	4	32	15	1	9
Venezuela	32	66	17	45	45	3	4
Weighted average	28	42	9	19	29	2	9
Malaysia	36	53	4	34	33	12	19
Korea	20	28	7	4	23	4	3
France	38	48	6	7	13	0.5	3
Japan	23	27	8	8	11	1.5	6
Sweden	52	66	4	6	11	2	10
United Kingdom	43	49	10	11	17	3	6
United States	22	21	10	9	4	1	2

Note: The peak figures for Argentina were 42 percent and for Brazil 35 percent; both pertain to 1981.

Source: IDB (1984), Appendix on Public Finances; IMF (1985); Short (1984); Cline (1985–86); national statistics for Asian and European countries.

ment's role in the economy—the rough data available suggest that, in several of the largest Latin American economies, government enterprises at the end of the 1970s accounted for a larger proportion of investment than in some of the advanced industrial countries, such as France, Sweden, and the United Kingdom, where the

Table 4.2 **Central government expenditures**
(percentage of GDP)

Country	Expenditure	1973	1982	1983
Argentina	Consumption	6.3	6.1	5.5
	Transfers	8.1	7.1	10.3
	Investment	2.9	2.7	2.1
	Interest	0.5	4.6	2.3
	Total	17.8	20.5	20.3
Brazil	Consumption	4.4	3.9	3.7
	Transfers	9.3	12.3	12.0
	Investment	1.9	1.8	1.7
	Interest	1.1	3.0	3.7
	Total	16.7	21.0	20.1
Chile	Consumption	13.9	10.8	10.1
	Transfers	11.6	20.5	18.4
	Investment	7.2	2.2	2.2
	Interest	0.2	0.5	1.2
	Total	32.9	34.1	31.9
Mexico	Consumption	5.6	7.5	5.9
	Transfers	2.2	11.3	6.1
	Investment	3.7	6.8	4.7
	Interest	0.9	4.4	9.4
	Total	12.4	30.0	26.1
Peru	Consumption	9.7	8.1	n.a.
	Transfers	2.3	2.5	n.a.
	Investment	3.8	4.1	3.6
	Interest	2.0	3.9	3.8
	Total	17.8	18.6	18.9
Uruguay	Consumption	9.8	11.5	10.4
	Transfers	7.3	14.9	11.5
	Investment	1.5	2.2	1.8
	Interest	0.5	1.0	1.2
	Total	19.1	29.6	24.9
Venezuela	Consumption	10.8	11.7	11.5
	Transfers	3.4	6.4	6.7
	Investment	6.7	8.9	6.7
	Interest	0.3	2.1	2.3
	Total	21.1	29.1	27.0

(continued overleaf)

Table 4.2 *Continued*
(percentage of GDP)

Country	Expenditure	1973	1982	1983
Greece	Consumption	17.7	n.a.	n.a.
	Transfers	1.9	n.a.	n.a.
	Investment	7.1	n.a.	n.a.
	Interest	1.1	n.a.	n.a.
	Total	27.8	n.a.	n.a.
Spain	Consumption	9.1	11.5	9.7
	Transfers	7.4	14.0	16.2
	Investment	2.7	3.9	3.7
	Interest	0.5	0.7	1.2
	Total	19.7	30.0	30.9
Korea	Consumption	5.5	7.9	7.8
	Transfers	4.8	6.5	6.4
	Investment	2.5	3.4	2.6
	Interest	0.4	1.2	1.2
	Total	13.2	19.0	17.9
Singapore	Consumption	9.9	13.1	12.4
	Transfers	1.7	0.9	0.8
	Investment	1.6	4.7	5.7
	Interest	1.5	3.2	4.6
	Total	14.7	21.9	23.5

n.a. Not available.

Source: IMF (1985).

public sector has traditionally played a major role in investment (table 4.1).

The tendency to rely on state intervention and enterprise for a wide variety of activities is partly the result of history, especially in Spanish America. In these countries, the Spanish colonial tradition of special concessions and monopolies for particular enterprises dies hard. This tradition has lasted in various forms for over four centuries. Its consequence is a tendency on the part of the state to consider economic affairs as coming under its authority.

Also, large areas of business look to the state for protection.

Personal relationships with the government are often essential to business success. Some large private businesses thus often end up as the keepers of privileges granted by the state, rather than as Schumpeterian entrepreneurs fighting it out in the marketplace. This tends to support the status quo, rather than promote a dynamic economy that would bring rapid employment growth.

These historical reasons, especially important in Spanish America, plus the small size of most domestic markets (the GNP of all Latin America and the Caribbean is about equivalent to that of West Germany while the average Central American economy has a national market comparable to Albuquerque, New Mexico, or Newark, New Jersey), explain in part why the bracing winds of competition and private enterprise are not universally accepted in Latin America.

The shift toward inward orientation in Latin American countries after World War II also contributed to the growing importance of the state as it assumed a larger role as a protector of emerging industries and even as investor. By contrast, under outward orientation, government interventions would interfere with the exploitation of the possibilities available in international markets and such possibilities are generally better utilized by private firms that are more flexible than public enterprises.

The natural coziness of relatively small markets was enhanced in the 1960s and 1970s by an increasing tendency to regulate investment flows and prices. These trends favored larger established enterprises and, especially, state enterprises that had the influence to induce governments to act. At the same time, restrictions on ownership and on profit remittances effectively discouraged investment by foreigners. This was particularly true in the Andean Group in the 1970s.

In addition to restrictive regulations, red tape in implementing the regulations has constricted investment and adds to the cost of doing business, raising prices and compromising international competitiveness. Smaller enterprises, in particular, cannot afford to go through endless *trámites* (bureaucratic red tape). Perhaps even more than taxes and regulations, red tape is responsible for stimulating the development of a large "informal sector" and hindering the natural growth of small businesses into larger enterprises.

Despite these obstacles, since the 1970s an increasing group of

industrialists engaged in exports has been lobbying for the partial opening up and deregulation of economies in countries such as Brazil and Colombia. At the same time, the evident costs of the excessive external borrowing by the public sector have led to widespread criticisms of the state's large role in the economy. The increased freedom of the press and public discussions that accompanied the replacement of military governments by civilian elected regimes, especially in Argentina and Brazil, have heightened the shift against the past, and the governments themselves have come out in favor of reducing the role of the state.[3]

Regulations

Most of the larger Latin American countries are among the world's most regulated market economies, at least on paper. Among the most important economic regulatory mechanisms are controls on the establishment of firms and on new investments, restrictions on inflows of foreign investment and outflows of profit remittance, price controls, import barriers, discriminatory credit allocation, high corporate income tax rates combined with discretionary tax-reduction mechanisms, as well as limits on the firing of employees (table 4.3). In a number of Latin American countries, the web of regulation is administered by underpaid administrators. The potential for corruption is therefore great.

Productive activity may be regulated by legislation, by government decrees, and case-by-case decision making. This latter practice is widespread and pernicious in Latin America as it creates considerable uncertainty and provides opportunities for corruption. It also discriminates against small and medium-sized businesses which, although important creators of employment, seldom have access to the higher reaches of the bureaucracy.

Bureaucratic regulations and controls circumscribe a firm's activities from birth to demise. Establishing a firm involves time

3. In an interview with *Business Week*, President José Sarney Costa of Brazil stated: "Private initiative is the engine of economic development. In Brazil we have learned that every time the state's penetration in the economy increases, our liberty decreases." (11 August 1986).

and perseverance. In Peru, for instance, it reportedly took 289 days, with the help of an administrative lawyer, to register a textile factory.[4] Both mergers and bankruptcies often involve complicated procedures.

Taxation is generally treated separately from regulation. However, in any number of Latin American countries, tax systems encompass a strong regulatory component, partly because nominal profit tax rates are high and often are offset through concessions for particular activities. The state motivates or inhibits certain types of investment, thus attenuating market forces.

Despite the size of the regulatory apparatus, there is widespread avoidance of regulations—for many reasons. One is the natural tendency for controls to set up their own antidotes: price controls generate cartelization and attempts by enterprises to keep price adjustments ahead of cost increases; interest-rate controls create a parallel and frequently usurious nonbank market; foreign exchange restrictions often lead to overinvoicing of imports and underinvoicing of exports; credit allocation systems which consider agriculture to be "good" and services to be "bad" lead to the diversion of funds to other activities so that agricultural credit rises rapidly but real farm output does not; limits on labor dismissals are circumvented by temporary employment; and so on. Also, to avoid excess exposure to controls, business groups in Latin America often keep their operations divided into many separate companies, limiting visibility.

Excessive regulations add to the cost of doing business, especially for small and medium-sized firms that are less able than large companies to work within the regulations. In Peru, for example, extremely complex labor and business regulations have led to the development of an informal sector estimated, perhaps with some exaggeration, as providing more than half of urban employment. The informal sector includes some sizeable industrial operations, concealed by a multitude of small establishments employing hundreds of workers. While this sector provides a considerable part of output, particularly in industry and commerce, firm size and productivity tend to be low, owing to the lack of formal

4. Information on excessive regulations and on the informal sector in Peru originates with the Instituto Libertad y Democracía of Lima.

Table 4.3 State economic regulations

Regulation (1985)	Argentina	Brazil
Price controls, nine basic staples[a] (number)	9.0	9
Price controls, five basic manufactures[b] (number)	5.0	5
Mandatory ceilings on bank interest rates (yes or no)	yes	yes
Foreign direct investment limitation in		
Industrial companies (yes or no)	no	no
Banks (yes or no)	yes	yes
Maximum domestic corporate profits tax rate (percentage)	33.0	35
Withholding on after-tax profits remitted abroad[d] (percentage)	17.5	25
Workers' mandatory profitsharing in industrial companies (yes or no)	yes	yes
Fringe benefits as percentage of average industrial wage	80	80
Limitations on reductions on employment (significant or insignificant)	S	I

Source: "Investing, Licensing, Trading Conditions Abroad," Business International Corporation data for Argentina February 1985, for Brazil January 1985, for Chile October 1985, and for Peru March 1985; "Doing Business in Chile," Price Waterhouse, October 1985; "Doing Business in Mexico," Price Waterhouse, June 1984; "Doing Business in Venezuela," Price Waterhouse, August 1985.

a. Wheat, bread, meat, poultry, sugar, vegetable oil, milk, soft drinks, basic pharmaceuticals.

b. Cement, steel, cars and trucks, fertilizer, and tires.

c. First-category tax of 10 percent levied on income, 30 percent levied on taxable income net of first-category tax.

d. In addition to profits tax.

property rights, the inability to obtain credit, and the need to escape detection.

The cost of the government bureaucracy also burdens the Latin American national economies. In recent decades, this burden increased greatly in Peru, where public employees' share of total employment rose from 7 percent in 1961 to 16 percent in 1981. The same year, governmental employees accounted for 18 percent

Chile	Colombia	Mexico	Peru	Venezuela
0	9	5	9	9
0	5	5	5	3
yes	yes	yes	yes	no
no	yes	yes	yes	yes
no	yes	yes	yes	yes
30	40	42	50	50
40	40	55	40	20
no	no	yes	yes	yes
65	65	60	50	60
I	S	S	S	S

of the nonagricultural labor force in Argentina, and government wages equaled 16 percent of the total wage bill in Brazil.[5]

Despite avoidance and evasion, there is an economic cost to overregulation. Investment is channeled into activities artificially stimulated by tariffs, tax concessions, and special credit allocations instead of responding to unbiased market signals. The car assembly plants set up in most medium-sized Latin American economies in the 1960s and early 1970s are a prime example of this type of uneconomic investment.[6] They created little employment at the cost of large fiscal subsidies and resource misallocation as they

5. Heller and Tait (1983, tables 22 and 26), and for Peru *Caretas*, 24 February 1986, p. 55.

6. Kuczynski (1975, p. 83), calculated that the taxes lost through assembly plants in Peru would have enabled each worker employed in the plants to receive a state subsidy of $10,000 a year.

were encouraged by high duties on finished cars and fiscal incentives for local assembly.

Employment also has been dampened by the labor regulations in effect. Minimum wage legislation and union pressure raised wages above market-clearing levels, thus limiting employment and contributing to the development of a dual labor market. High fringe benefits have had similar effects (table 4.3).

Furthermore, in countries like Argentina, Venezuela, and Panama, reducing the work force is extremely difficult even if economic conditions have deteriorated. In Argentina, for example, the labor law bestows "job security" on employees after only one year and severance payments increase with the length of employment. The situation is similar in Venezuela and it has been estimated that labor legislation raises labor costs by 30 percent, in addition to the cost of social security charges and fringe benefits, totaling 59 percent of the basic wages, in Panama (Fischer and Spinanger 1986, pp. 25–28).

On the whole, labor regulations, especially limitations on reductions in employment, inhibit job creation and economic growth in general in Latin America. They limit hiring during economic upswings while protecting jobs in the formal sectors of the economy during downswings. Combined with the tax advantages of investment in machinery, much of it imported except in the largest economies, labor regulations create an environment that limits Latin America's growth of employment and exploitation of comparative advantage in the availability of labor in manufacturing industries.

Conversely, the lack of restrictive labor regulations helped labor-intensive industries to expand in the Far East. Not only has employment increased, but real wages also have risen fast in contrast to the relatively small increases (and even some declines) in Latin America (table 1.6).

The Far Eastern countries offer a contrast for Latin America, although the differences in their economies and political systems limit the validity of the comparisons. Nonetheless, the disparities between the types of regulation in the Far East and Latin America are thought provoking.

- Far Eastern economies more often use state support and special credit, tax, and import arrangements than prohibitions and restrictions, particularly for export activities.

- Corporate tax rates are lower and labor markets are freer in the Far East.
- Protection in Far Eastern countries concentrates on a limited range of consumer goods that have little effect on production costs in the rest of the economy.
- Most important, in the Far East, state inducements are given within a context of realistic prices, especially the exchange rate, and moderate inflation.

Proper prices may not suffice, however, for sustained growth unless the tax system also promotes growth (chapter 3). High corporate tax rates in most of Latin America (table 4.3) are offset by tax credits for various types of investment, but taxes nevertheless adversely affect employment and economic growth.[7] Tax credits, combined with subsidized state loans and low import tariffs for investment in plant and equipment, lead to excess capacity, slow the growth of employment, and result in high corporate debt-to-equity ratios and hence weak corporate cash flows.

Another feature of Latin American tax regimes is complexity, with a plethora of regional and sectoral incentives. Yet, despite years of apparent tax incentives favoring geographic decentralization, small enterprises, and agro-industry, most economic activity in Latin America—except Brazil and Colombia—remains concentrated around the capitals. Rural industrialization is limited.

The difficulties of administering overcomplex income tax systems with underpaid and undertrained personnel mean that direct taxation provides limited revenue, despite high nominal tax rates. Inflation further complicates the picture. In 1982, for example, only 6 percent of the Argentine central government's current revenues came from income and profits taxes; the comparable proportions were 13 percent in Brazil and 15 percent in Peru; in the latter case, the bulk of revenue is generated by a few oil and mining companies (IMF 1985). As a result, several countries place heavy but easily collected taxes on domestic trade and sometimes foreign trade, which discourage exports.

Describing the regulatory and tax systems of Latin American

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7. *See, for example, the report of a team led by Dudley Seers (ILO 1970).*

economies in these terms is obviously an overgeneralization. Among the exceptions, Chile and Colombia have relatively strong income tax systems, and the Central American economies have traditionally been moderate on trade and investment regulations. On average, however, it is probably not unfair to characterize the 1970s and early 1980s in Latin America as a time of proliferating regulations, which have weighed heavily on economic activity.

Excessive regulation thus costs Latin American economies dearly. Overregulation requires a large government administrative apparatus, imposes a burden on private business in the formal sector, provides incentives but also some disincentives to the informal sector, and contributes to the misallocation of resources. It also hampers rapid and flexible response to market conditions.

The deregulation process should be directed toward reducing this cost and ensuring greater flexibility so as to improve international competitiveness. The regulatory framework should be made conducive to the expansion of production and investment so as to create the conditions for the development of a modern economy.

This would require, first of all, making improvements in regulations on property rights. To ensure the best use of property, which is in the interest of the community, these rights should be exclusive, transferable, partitionable, and perceived to be permanent (Walter 1986). Appropriate rules should also be set for patents and copyrights.

Property rights could be assured by establishing a modern legal framework. The process of registration and licensing should be simplified and speeded up. Contractual rights should be strengthened and an efficient tort system established. There is further need for a modern bankruptcy system that facilitates the transfer of assets of bankrupt companies to more efficient users.

At the same time, rules and regulations have to be formulated and applied generally so as to curtail drastically the scope for discretionary decision making. Stability in the regulations should be ensured, and any new regulations should have to pass a cost-benefit test.

With high population growth rates, the labor force is expanding rapidly in Latin America. Thus, jobs have to be found for the millions of people reaching working age. To this end, labor legislation needs to be reformed in ways that encourage hiring.

This would involve lowering penalties on a firm that lays off workers in times of economic difficulties; setting minimum wages at reasonable levels; and financing a higher share of social-security benefits from general tax revenue than from wage taxes.

Liberalizing labor legislation, together with deregulation, would help small and medium-sized enterprises get started. These enterprises could play an important role in a modern economy by providing goods and services to consumers and furnishing large manufacturers with parts, components, and accessories. Small and medium-sized firms usually need much less capital to create new jobs than do larger companies. Besides increasing total employment, this would compensate for reductions in public-sector employment as deregulation eliminates certain administrative functions.

State "Enterprise"

State-controlled companies in Latin America are said to be inefficient. While the statement is an overgeneralization, the performance of public enterprises in the production and distribution of goods generally has been weak. Exceptions are well-run public utilities and a few successful industrial enterprises, such as CVRD (Companhia Vale Rio Doce, a Brazilian mining and metals processing company) and CODELCO (Coporación del Cobre de Chile, a copper mining, smelting, and refining company). The many inefficient and loss-making state-run companies range from airlines to steel mills.

Some of these companies were established by government. Others, such as state-owned mining companies in Chile and Peru, or the nationalized banks in Mexico, resulted from state takeovers. Still other companies were rescued from bankruptcy by the state, under political pressure to maintain employment. Argentina and Chile have many such examples as does Mexico, where the number of state enterprises grew from 39 in 1970 to 677 in 1982.

Some state enterprises do not incur losses, including most but not all of the state oil companies, but their tax contributions to the national treasury are no doubt less than if they were run as private-sector companies. Most state enterprises have been large contributors to public-sector deficits (table 4.4).

Table 4.4 State enterprise and public investment

	Argentina		
Number of state enterprises (1985)	297[b]		
	Average 1980–81		1983
Public-sector investment (percentage of GNP)	12.7		11.9
Of which state enterprise[f]	4.9		5.0
Private-sector investment	7.7		4.2
Public-sector deficit (percentage of GDP)	5.7		15.7
	1980	1982	1984
Outstanding external public debt of state enterprise (billion dollars)	14.5	28.6	37.6

Source: IDB (1984 and 1985); national statistics.

a. Public investment for Brazil is only for 10 largest state companies. Deficit data for Brazil do not include the cost of indexing public debt.

b. Argentina's largest state enterprises: YPF, Gas del Estado, Segba, ENTEL, Aerolineas Argentinas, Agua y Energia, Ferrocarriles Argentinos, Elma.

c. Brazil's largest state enterprises: Petrobas, Siderbras, Electrobas, Telbras, CVRD, RFFSA.

d. Mexico's largest state enterprises: PEMEX, CFE, (Comisión Federal de Electricidad), CONASUPO, FERTIMEX, SIDALMEX, Empresas Ferroviarias.

e. Estimated.

f. Excluding social security system.

While some large state-owned firms based on natural resources had good financial results and have played an important developmental role in major Latin American economies over the years, two facts stand out:

- the headlong growth of external borrowing by state enterprises to finance a growing proportion of public investment in the 1970s and early 1980s
- their growing contribution to public-sector deficits.

Consistent data are hard to find but, in rough numbers, in the

Brazil[a]			Mexico		
471[c]			677[d]		
Average 1980–81		1984[e]	Average 1980–81		1984
6.7		6.1	11.6		7.6
4.3		3.8	7.6		4.2
15.6		10.2	14.1		10.6
8.1		10.5	11.2		6.9
1980	1982	1984	1980	1982	1984
32.0	46.7	53.3	15.4	32.3	50.6

seven largest Latin American economies, the deficit of state enterprises in the mid-1970s accounted for one-quarter of the public-sector deficit but rose to about one-half in 1980–1982, while the overall public-sector deficit doubled from about 4 percent to 8 percent of GNP. Partly because of price control on basic products, state enterprises thus accounted for three-quarters of the deterioration in public-sector finances.

Deficits and borrowing are, of course, two sides of the same coin. The availability of external credit stimulated public investment in the second half of the 1970s, especially through state enterprises, which were considered attractive borrowers by the lenders. International suppliers can often finance their equipment export sales with credit guaranteed by their own governments. For such exporters, especially in Western Europe, Japan, and Canada, state enterprises in the large, emerging developing countries have traditionally been excellent prospects. At the same time, complex bidding procedures are sometimes a cover to direct the business to a particular supplier, and financing tied to the equipment sale often tips the scale.

For commercial bank lenders, state-enterprise borrowers provided the security of a government-guaranteed loan, combined

with likely cash flow and related business opportunities that generally come with lending to private companies. With the energy crisis and the high commodity prices of the 1970s, natural-resource-based state companies, oil companies in particular, were especially attractive to commercial banks. Petroleos Mexicanos (PEMEX), the Mexican state oil monopoly, was considered the best credit in Mexico after the federal government itself and was often used by the government as a conduit for its own external borrowing; it thus became difficult to disentangle what the borrowing was for.

It mattered little whether the oil company was an exporter or an importer of oil. PEMEX was a favorite well before it became a major oil exporter in 1976, as was the Brazilian state oil company, Petroleos Brasileios (PETROBRAS), an oil importer. As of 1982, almost 40 percent of the medium-term debt of the Mexican public sector to commercial banks was in the PEMEX name. Bankers also were eager to lend to Petroleos de Venezuela, the state oil monopoly that emerged after the foreign company nationalizations of 1974, but the Venezuelan government wisely refrained from borrowing and Petroleos remains debt-free.

Naturally enough, public investment emphasized energy and mining. Substitution of oil imports was an obvious priority, while economic growth was expected to generate rapid growth of demand for electricity. Assuming yearly economic growth at 6 percent, Latin American planners expected electricity demand to increase 50 percent faster, 9 percent a year, a doubling every eight years.

Hydroelectricity was a substantial part of capacity expansion. Hydropower, in which Latin America has a huge potential, made sense to save expensive oil; however, it also has an investment cost about three times higher than conventional oil-using thermal plants. As a result, public investment in energy, which is almost entirely in the hands of the state, ballooned. For Latin America as a whole, public investment in energy may have reached about 5 percent of GNP in 1980–81, up from 3 percent in 1973.

The decisions for this massive investment assumed that growth would go on without major interruptions and that oil prices would remain high. The counterparts to nuclear plants and oil shale projects in the United States were dams and transmission systems in most of Latin America. However, when the world recession came in 1981, and was followed by a gradual but profound weakening of the international oil market, energy projects were

hit hard. The projects were not necessarily worse in Latin America. The main difference has been that uneconomic private-sector projects in North America have subsequently been reorganized or mothballed at very substantial cost to bank creditors, while the state-sponsored investments in Latin America, because they were guaranteed by their governments, still carry the full value of the debt.

The past energy investment has left in place good facilities and a strong base for future growth. But, in the meantime, the costs to the Latin American economies are high. While it would be incorrect to say that public investment in natural resources and energy and related fields on the whole has been inefficient, some major investments have turned out poorly because of inadequate planning or are not needed today because of the downturn in demand for energy in depressed economies.

Other large state industrial investments have been disappointing because of high costs and the worldwide recession and increasing competition in foreign markets. This has been the case, in particular, for metals and a number of chemicals.

Among the state investments that have turned out poorly are:

- the Las Truchas steel complex in western Mexico. Built with the help of loans from suppliers and from the World Bank, its accumulated losses since 1976 probably exceed the original investment of $800 million. The plant's production costs are reportedly twice those of Korean plants.

- the Majes irrigation project in Peru. About $700 million has been spent on a water diversion scheme since 1970, but so far only about 6,000 hectares are irrigated, and no money is left to build the planned hydroelectric plant. If completed, the scheme likely will have the world's highest capital costs per acre of irrigated land.

- the Brazilian nuclear program. About $4.2 billion had been spent since a major nuclear plan was announced in 1975. None of the proposed plants was operating in 1986, and at least another $3 billion is needed, not counting interest, in order to commission the first two medium-sized units in the first half of the next decade.

- the Acominas 2 million-ton steel plant in Minas Gerais, Brazil. It was built in the late 1970s at a cost of more than $2.5 billion. Financed almost entirely with external borrowing, some of these funds were reportedly diverted to financing the central government deficit. While its efficiency is no worse than that of the rest of the state steel sector, Acominas is likely to incur very heavy losses after start-up in 1986, five years behind schedule.

- transport projects. Several large projects, especially subways, have had huge cost overruns. The capital investment on the Mexico City subway, undoubtedly a necessary project, works out to $2,500 per inch of route (Pfeffermann 1985, p.60). In that regard, Latin America is no different from the rest of the world, but it is in no position to afford the costs.

- the Cobriza copper mine in the Central Andes of Peru. The expansion in the late 1970s of this state-owned mine, undertaken with the help of multilateral development banks, faced a different type of problem. After start-up in 1981, the ore reserves were found to be inadequate to sustain economic production for the size of the facilities built with the loans.

While public criticism has focused on recent state investments, public enterprise has a long and checkered history in Latin America. In Argentina, Fabricaciones Militares, the military-industrial complex, which may account for about 2.5 percent of GNP, produces machinery and armaments, but also timber and petrochemicals, at a high cost. In Mexico, government subsidies to its high-cost railways nearly match its expenditures on health care.[8]

Many of the state enterprises' problems are not of their own making. Politicians are ambivalent about them; they like to talk about efficiency but often do not hesitate to reduce managerial compensation, favor price control on the output, and impose all kinds of operating restrictions.

Unrealistically low salaries for high-level professionals encourage

8. *Economist*, 16 February 1985, p. 67.

a brain drain to the private sector and international agencies. Price controls depress the financial results of public enterprises as do operating restrictions imposed on them.

In Mexico, for example, all expenditures by public enterprises, including current expenditures, are subject to government approval. State enterprises prepare annual budget proposals, receive monthly disbursement authorizations with very little room for reallocating funds, and report monthly on their expenditures. At the same time, the supervising agencies focus on the company's compliance with the budget, rather than on its efficiency.

In contrast to Mexico, public enterprise managers in Brazil have considerable freedom of action, which may explain their relative efficiency. But, in the absence of constraints on investment either from the government or the market, they also have been prone to overinvestment.

Every government believes its state enterprises are different ("We do not have these problems here"). With the exception of Brazil, however, the well-run enterprises are along industry lines rather than geographical ones. Most electric utilities have avoided the excesses of other state enterprises, as have some of the oil and mining companies that were originally privately run, mostly by foreign companies. Since the early 1950s, the World Bank has influenced the electric utilities, through its loan requirements, to maintain discipline. The Inter-American Development Bank has supported these efforts since the 1960s. The international financial agencies have had less impact on investment in manufacturing industries. Lending has been smaller, objective standards are more difficult to set, and the state in general is notoriously poor at selling products that have to compete in the market.

Yet public manufacturing enterprises have been granted various privileges vis-à-vis their private counterparts. They receive preferential credit allocations, budget support, and have no dividend obligations. Often but not always exempted from trade liberalization (for example, Argentina in the early 1980s), public enterprises strongly support the maintenance of protection.

Public enterprises frequently hold a monopoly position, as suppliers of inputs to private enterprises, or a monopsony position, as purchasers of products from them. This has put private firms in a tenuous position, with little bargaining strength, because the state stands behind the public enterprises.

Latin American state enterprises have received between $80 billion and $100 billion in foreign loans in 1973–1982,[9] yet the public knows remarkably little about their business and financial affairs. Virtually no consistent information exists over time for such basic numbers as sales, employment, value added, profits, subsidies, or investments. Much can be done to improve information so as to create an awareness of the problems of state enterprises.

Beyond providing information, the question remains of how to solve the problems raised in regard to state enterprises. Recommendations have been made for opening up state monopolies to private industry, for improving competitive conditions for private firms, as well as for closing down public enterprises or streamlining their management and operating procedures.

The subject of "privatization" has been eagerly embraced by a number of international agencies and outside observers. However, in Latin America most of the limited progress so far has been achieved on the initiative of the countries themselves.

In Brazil, General João Baptista de Oliveira Figueiredo's Government offered to sell 89 companies, all of them private firms, mostly small, that had gone broke and been taken over by the state. When he left office, 20 of them had been privatized and 27 merged or taken over by local authorities. President José Sarney Costa added a dozen companies to the list and announced plans to sell or close another hundred state companies from a list of 520. In turn, toward the end of 1985, Brazil sold about $400 million nonvoting equity shares in Petrobras.

In October 1985, Mexico sold the Nacional Hoteleria chain that had been controlled by the Banco Nacional de Mexico, a leading private bank until the nationalization of 1982. It was purchased by a private investment group, backed by two state banks as minority partners, for $84 million. A few months later, the government formally decided to "liquidate, dissolve, merge, transfer or sell" 236 state companies within a year. A number of these companies are not economically attractive, however, and so far few have been sold. In February 1986, a further 80 public companies were put up for sale, including shares in Mexicana de Aviacíon and two publicly owned hotel chains.[10]

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9. The data derive from the sources cited in table 4.4 and from national statistics.

10. *Economist*, 21 December 1985, p. 29, and *Financial Times*, 28 February 1986.

Privatization can be successful if carried out realistically. Politicians must be dissuaded from thinking, as some do now, that assets should necessarily be sold for anything approaching their book value. The disposal of a loss-making asset at "fire sale" prices may cost taxpayers far less than waiting for a turnaround that never comes.

Values can be improved by breaking up enterprises into several parts that may attract particular buyers. The root causes of losses, such as featherbedding, excessive bureaucracy, and price control, are best dealt with before a sale is started. Otherwise the private enterprise might seek government help later on. Avoiding further concentration of ownership is another important goal, which can to some extent be met by liberalizing the excessive restrictions on domestic stock markets or by arranging sales of companies in small units.

Specialized international agencies, such as the World Bank, together with the International Finance Corporation, can help set the stage for privatization. Governments should, however, resist the temptation to involve these agencies as a substitute for action. Lengthy studies and unrealistically complicated bidding procedures often nurture inertia.

The example of the reprivatization in 1983–85 of the nationalized conglomerate Rumasa in Spain should be studied by advocates of privatization in Latin America and elsewhere.[11] A clear political will to carry out the privatization, clear lines of decision making, and realistic valuation and sales methods were some of the key ingredients of this complex divestiture by the state, which involved over two hundred companies of various sizes.

Following the March 1986 election, the new French government has undertaken to reprivatize the companies nationalized after May 1981, when the socialists came to power. At the same time, it wants to go further in also denationalizing the large banks and insurance companies that were taken over by the state in 1945.

The largest laboratory of privatization is, of course, the United Kingdom, where about one-third of the nationalized work force has been transferred to the private sector, with the sale of $29 billion of state assets.[12] This would have been impossible had the

11. *Institutional Investor*, international edition, December 1985.

12. *Wall Street Journal*, 20 February 1986.

government not overcome opposition from the public-sector bureaucracy.

The British example shows that privatization is a long process and needs thorough preparation. First of all, the areas the state wants to retain must be selected. These usually include public utilities, although the United Kingdom and several Asian developing countries have decided to privatize state-owned telephone and telegraph companies.

The state may also wish to retain natural resource-based industries. But the Argentine government has decided to invite bids from foreign oil companies, and Chile is attracting foreign interests in copper mining.

Public and private firms could also operate side by side. This alternative would invite competition, if the operating conditions for public and private firms were equalized. Public firms do not have any special role to play in most processing industries so that their privatization should be envisaged.

The privatization process could begin by the sale of firms that have gotten into public hands through bankruptcy and of subsidiaries of public enterprises whose activities lie outside the enterprise's main productive activity. Public sale of shares in state enterprises that leaves the government with majority ownership cannot be considered privatization. This would divert private funds that might otherwise have been used to finance private firms.

The limited availability of private finance is considered an obstacle to privatization, but sound opportunities in a setting favorable to private investment will attract investors. Also, privatization may provide an opportunity to transform foreign debt into equity (chapter 5).

In hopeless cases, public enterprises should be closed down as the Mexican government did in May 1986 with Fundidora de Monterrey, a large state steel producer once in the private sector. The remaining firms in the competitive sector should be transformed into independent enterprises, with managers held responsible for profits and losses and largely autonomous boards of directors.

Government as Provider of Basic Services

Most Latin American countries have made considerable progress in providing basic public services in the last twenty years. While

there are still large deficiencies in the quality and equitable distribution of services, especially in education and health care, overall progress has been comparable to the average for upper-middle income groups of developing countries and, in some instances, has even surpassed these countries. Thus, adult literacy rates and secondary school enrollment increased to a considerable extent and Latin American countries experienced substantial increases in life expectancy and reductions in infant mortality as health services have improved, including the rise in the number of doctors and medical assistants and the increased availability of clean water.

For the future, the major issue facing governments in providing basic services is the very high proportion of government outlays that has to be spent on debt service, limiting what is left for basic government functions. For the seven largest Latin American countries, interest on domestic and external debt has grown from 8 percent of central government outlays in 1975 to 20 percent in 1984 (IMF 1985). This increase, especially in recent years, when economies have been depressed and tax revenues have stagnated in real terms, does not augur well for the future provision of basic government services. In fact, such services already show signs of deterioration, especially in Mexico. There may thus be a case for the private sector to substitute for the government in providing some services.

The progress of the last two decades can be seen in human longevity, reductions in infant mortality, improvements in diet and in the availability of medical care, higher rates of literacy and enrollment in primary and secondary schools, and better availability of basic services such as electricity and water (table 4.5).

However, the distribution and the quality of these services can be criticized. While the lack of statistics makes judgments difficult, there are obvious regional disparities—between the rich South and the poor Northeast of Brazil, between the Coast and the Sierra in Peru, and between urban and rural areas. Basic services are much less adequate in rural areas, where 30 percent of the people live in the larger countries. This is a lower proportion than in some newly industrializing Far Eastern countries like Korea or Taiwan, where the rural population is close to 40 percent of the total. The paucity of public services in rural areas of Latin America contributed to migration to major cities and the increasing centralization of economic activity through 1982. While a slowdown

Table 4.5 Social welfare indicators

	Argentina		Brazil		Chile		Colombia	
	1960	1980	1960	1980	1960	1980	1960	1980
Average life expectancy at birth (years)	65	70	55	63	57	67	53	63
Infant mortality (per 1,000 live births)	61	45	118	77	114	43	93	56
Population (per doctor)	740	530	2,210	1,700	1,780	1,930	2,640	1,710
Population (per medical assistant)	750	n.a.	2,810	820	640	450	4,220	800
Percentage of minimum daily calorie requirements supplied	n.a.	125	n.a.	109	n.a.	114	n.a.	108
Enrollment in school (percentage of age group)								
Primary	98	116	95	93	109	117	77	128
Secondary	23	56	11	32	24	55	12	46
Adult literacy rate (percentage)	91	93	61	76	84	n.a.	63	81
Energy consumption per capita (kg coal equivalent per year)	1,177	2,161	385	1,102	833	1,137	519	970
Electricity consumption per capita (kw/hour)	513	1,406	325	1,149	598	1,058	244	890
Percentage of population with access to piped water	51	58	32	56	63	78	54	56

n.a Not available.

Source: Government compilations by the IDB; special communications.

in migration occurred subsequently, it would be necessary to increase public services outside the main cities.

There is little doubt that public social services, such as education and public health, are on average of poor quality in much of Latin America. The reason is simple: lack of money. For example, in

Ecuador		Mexico		Peru		Uruguay		Venezuela		Upper middle-income countries	
1960	1980	1960	1980	1960	1980	1960	1980	1960	1980	1960	1980
51	61	58	65	47	58	68	71	57	67	57	60
140	82	91	56	163	88	50	40	85	42	103	62
2,670	760	1,830	1,260	1,910	1,390	960	540	1,510	990	2,606	1,689
2,360	570	3,650	1,420	3,530	970	800	190	2,840	380	2,678	1,010
n.a.	88	n.a.	121	n.a.	99	n.a.	110	n.a.	112	n.a.	115
83	107	80	120	83	112	111	105	100	104	88	104
12	40	11	37	15	56	37	60	21	39	20	48
68	81	65	83	61	80	n.a.	94	63	82	61	76
216	692	786	1,684	433	807	1,020	1,160	3,014	3,039	798	1,677
n.a.	n.a.	313	972	265	567	n.a.	n.a.	601	2,298	n.a.	n.a.
n.a.	57	38	50	45	51	n.a.	80.4	50	80	n.a.	n.a.

1983 with a public school enrollment of 19.2 million and a total annual budget equivalent of $3,340 million, Mexico can afford to spend only $174 per public school student, while Brazil can afford only $74. This compares, for example, with $840 in the case of a recently industrialized country such as Spain. Repeater rates in public schools are high, and retention in rural areas is also low,

because of the paucity of services combined with the pressure to find early employment.

In energy, a major area of public services, electricity generation for public use is almost entirely in the hands of the state. Oil companies are monopolies or major factors in oil production and distribution. On the whole, the state has done a creditable job in stimulating and providing energy and related services. The electricity shortages of fifteen or twenty years ago are over, although part of the comfortable surplus results from economic stagnation since 1982. In oil, the upsurge of prices after 1973 spurred a major effort on the part of oil-importing countries to increase production. Colombia will become a net exporter in 1986 because of a policy to stimulate private producers combined with more realistic domestic oil prices. Argentina, because of the exploration successes of private producers and the state oil company, is now self-sufficient. Brazil has cut its oil import needs from 70 percent of total oil consumption in 1973 to less than 40 percent today, as a result of successful offshore exploration by Petrobras, combined with the equally successful but costly government-sponsored alcohol conversion program, and may become self-sufficient in energy by 1990.

Abundant energy, together with low product prices limiting energy conservation efforts, especially in the oil-exporting countries, have given Latin America a relatively high use of energy in relation to its GNP. Much of this has gone into private transport. Latin Americans have 1 car for every 4 families, compared to 1 for every 20 in the Far Eastern newly industrializing countries (Pfeffermann 1982). The type of development that has taken place in most Latin American countries is illustrated by what has happened in energy: a stimulus to consumer demand through low or subsidized prices; emphasis on consumption rather than savings; an important, though not exclusive, role for government in providing basic services; as well as a major role for it in regulating the economy.

For the future, greater attention should be given to laying the foundation for long-term growth while providing the basic services essential to improve the lives of the poor. This will require improving physical infrastructure, in particular transportation and port facilities for exports, as well as upgrading education and health services.

Table 4.6 Impact of adjustment

1. *GDP per capita, cumulative change (percentage)*	1980–85
Latin America	−8.9
Argentina	−17.7
Brazil	−3.0
Colombia	−0.5
Chile	−9.1
Ecuador	−4.0
Mexico	−3.6
Peru	−14.6
Uruguay	−19.1
Venezuela	−20.8

2. *Gross fixed investment (percentage of GDP)*	1980–81	1983–84
Argentina		
Public sector	12.7	11.1
Private sector	7.7	4.4
Brazil		
Public sector[a]	6.7	7.4[b]
Private sector	15.6	12.4[b]
Mexico		
Public sector	11.6	7.5
Private sector	14.1	10.4

3. *Domestic banking system credit (percentage of GDP)*	1981	1983–84
Argentina		
Public sector	5.3	9.3
Private sector	26.0	13.2
Brazil		
Public sector	2.2	5.5
Private sector	14.5	10.8
Mexico		
Public sector	13.9	18.1
Private sector	13.7	9.4

Source: (1) ECLA (1985b).

a. Only 10 largest state enterprises.

b. 1983.

Who Pays for Austerity?

In the austerity crunch after 1982, Latin American governments squeezed the private sector first and themselves second. While most governments cut deficits, most state enterprises continued to expand, so that the share of the public sector in overall bank credit increased. Thus, domestic credit cuts, designed to reduce import demand and conserve foreign exchange, fell heavily upon the private sector (table 4.6), leading to declines in investment and employment and to de facto bankruptcy of some major corporations. In several countries, large real-wage cuts in 1983 and 1984 accompanied these events.

On the whole, the private sector and its wage earners, as well as the unemployed and the underemployed, have borne the brunt of the belt-tightening in much of Latin America since 1982. There were few exceptions, with public investment declining more than private investment in Mexico and real wages rising after 1984 in Brazil and Colombia, the two economies with the best record of adjustment. In turn, real wages increased between 1982 and 1984 in Argentina, only to be reversed afterwards.

Summary

The opening up of Latin American economies, with the ensuing pressures and incentives for efficiency, can be expected to propel Latin American countries toward more efficient, stronger, less debt-dependent economic expansion. The pursuit of this goal would further necessitate a drastic reduction and redirection of the public sector.

To be sure, the international economic crisis of 1981–82, a major recession in the United States combined with very high international interest rates, precipitated the debt crisis. But it was the internal pattern of development in the debtor countries—inward-oriented economies combined with excessively large public sectors, sustained by a nearly tenfold increase in the dollar value of the external debt from 1973 to 1982—that made most of Latin America much more vulnerable to the international crisis of 1981–82 than

developing countries that pursued outward-oriented policies and borrowed much less abroad.

The historical background of the Spanish-American countries, with relatively small markets and a long tradition of relying on the state for basic economic concessions, makes it difficult to deregulate and privatize their economies. To be successful, both deregulation and privatization need extensive political and administrative preparation. Without this groundwork, privatization would become another brief Latin American fling with a new idea.

5 Policymaking in an Interdependent World

By providing similar incentives to sales in domestic and foreign markets, an outward-oriented development strategy would encourage exports and efficient import substitution in primary as well as in manufacturing activities in Latin America. Increases in exports, in turn, depend on the availability of foreign markets. Especially important is access to the markets of the industrial countries, which take about two-thirds of Latin American—as well as developing-country—exports.

This chapter briefly reviews the industrial countries' trade policies since World War II, examines recent trends in their manufactured imports, and analyzes market prospects for the exports of the developing countries in industrial country markets. It discusses the need for a new round of multilateral trade negotiations and the role Latin American countries could play in the negotiations. Consideration is also given to the possibilities for economic integration in Latin America.

Liberal trade policies in the industrial countries will facilitate the restoration of economic growth and adjustment to the debt crisis in Latin America. The burden of adjustment may be further eased through financial measures taken by industrial countries and by international institutions. These measures, their possibilities and limitations, are examined in this chapter.

Industrial Country Trade Policies

Successive rounds of trade negotiations in the postwar period led to considerable reductions in the tariff barriers of the industrial

countries. The tariff reductions were extended to developing-country suppliers under the most-favored-nation clause, even though these countries did not generally offer reciprocal concessions.

In the absence of such concessions, tariffs were reduced less on products of interest to developing countries than on products of interest to the industrial countries. This is why post-Tokyo Round tariffs are lower on the total imports of semimanufactures and finished manufactures, than on the imports of these commodities from the developing countries. The respective averages are 4.5 percent and 8.7 percent in the United States, 6.0 percent and 6.7 percent in the European Community (EC), and 5.4 percent and 6.8 percent in Japan.

Tariffs escalate from raw materials to finished goods, thereby discriminating against processing activities in the developing countries. Thus, post-Tokyo Round tariff averages on raw materials, semimanufactures, and finished manufactures are 0.2, 3.0, and 5.7 percent in the United States; 0.2, 4.2, and 6.9 percent in the European Community; and 0.5, 4.6, and 6.0 percent in Japan (GATT 1980, pp. 33–37). Tariff escalation is especially pronounced for processed fruits, oilseeds, and hides and skins that are of interest to several Latin American countries (Yeats 1981, pp. 85–94).

Agriculture was an exception to the process of trade liberalization during the postwar period. In fact, rather than declining, agricultural protection in the industrial countries has increased over time. The European Community has encouraged high-cost production by setting domestic prices much above world market prices in the framework of the common agricultural policy (CAP). Agricultural protection has much intensified in Japan. The protection of sugar, as well as subsidies to major crops, have increased in the United States.

Agricultural protection in the European Community and Japan involves raising domestic prices through protection, thus reducing consumption. But for cereals, meat, and dairy products, the principal problem is one of overproduction that spills over onto world markets. The surpluses generated in response to the high domestic prices paid to producers under the CAP are sold at subsidized prices abroad in competition with developing-country suppliers. The recently adopted US farm legislation also threatens

to lead to lower world market prices of cereals through increased supplies (Hathaway 1986). Furthermore, subsidized sales, and increased US protection, have forced down the price of sugar in world markets.

In the manufacturing sector, tariff reductions have been followed by the imposition of import restrictions on certain products. While the Long-Term Arrangement Regarding International Trade on Cotton Textiles (1962) was originally aimed largely at Japan, its successor, the Multi-Fiber Arrangement (MFA), limits imports of textiles and clothing from developing countries. The MFA earlier permitted an annual import growth of 6 percent in volume, but its subsequent renewals and reinterpretations have made it increasingly restrictive.

Japan does not limit imports under the MFA, but it has imposed restrictions on the importation of silk and cotton products from the developing countries. Furthermore, Japan severely limits the importation of footwear from all sources, and several EC countries limit footwear imports from the developing countries alone (Balassa 1986b).

Nontariff measures have also assumed importance in the case of steel. The United States has recently introduced limitations on steel imports from certain developing countries. The European Community has applied such restrictions in the framework of industrial programs for several years. Informal measures limit steel imports from Korea into Japan.

Table 5.1 shows the extent of nontariff barriers applied by the major industrial countries on their imports from other industrial countries, from the developing countries, and from all suppliers. The data refer to agricultural and manufactured imports, with a further disaggregation of the latter category.[1]

The results are indicative of the high protection of EC and Japanese agriculture, where most commodities competing with domestic production encounter nontariff barriers. With protection applying chiefly to temperate-zone products, such barriers pertain to a somewhat higher proportion of agricultural imports from industrial than from developing-country suppliers, although the

1. The data exclude fuels because the nontariff measures applied do not appear to aim at protecting domestic production in the industrial countries.

countries of the Southern Cone of Latin America are adversely affected. The proportions are about the same in the United States, where nontariff barriers on agricultural imports are relatively low.

Data on the share of products subject to nontariff barriers do not, however, indicate the restrictiveness of these barriers. The European Community, for example, imported substantial amounts of wheat and beef from Argentina and Uruguay before 1960, but these imports fell greatly after the implementation of the CAP. Japan severely limits beef imports, although its annual per capita beef consumption was only 5.5 kg, compared with 47.6 kg in the United States and 21.4 kg in the European Community, in 1982 (OECD 1985). An increase in the consumption of beef by 1 kg per head in Japan would translate into an increase in its annual beef imports by 120,000 tons; i.e., a doubling of total imports, of which one-eighth originated in Argentina and Uruguay in 1982.

Also, sanitary regulations often have a protective effect, which may or may not have been intended. According to the Chilean Agricultural Federation, Japan uses the existence of fruit flies in one remote region of Chile as an excuse for prohibiting fruit and vegetable imports from the entire country.

Government support and investment subsidies may also have an effect equivalent to protection. Particular cases are the costly rescue of the major French paper manufacturing firm in 1985 and the investment subsidies granted to the pulp and paper industry by Canadian provincial governments.

In the United States and the European Community, nontariff barriers affect a larger proportion of manufactured imports originating from developing than from industrial countries. This is explained by the restrictions imposed on developing-country exports of textiles and clothing in the framework of the MFA. However, the data do not include the informal measures employed by Japan referred to above.

Despite increasing barriers to trade, the share of imports from the developing countries in the major industrial countries' consumption of manufactured goods continued to rise over time. Table 5.2 shows the relationship between manufactured imports from the developing countries and the consumption of manufactured products, defined as production plus imports less exports, in the United States, the European Community, and Japan. Information

Table 5.1 **Relative shares of imports subject to nontariff measures in the major industrial countries, 1985**
(world trade weighted[a])

Importer	Nonfuel products	Agriculture	Manufacturing
United States, imports from			
All countries[b]	6.4	11.5	5.6
Industrial countries	3.4	11.7	2.7
Developing countries	12.9	11.8	14.4
European Community, imports from			
All countries[b]	13.9	37.8	10.1
Industrial countries	10.5	46.7	5.7
Developing countries	21.8	27.5	21.4
Japan, imports from			
All countries[b]	9.6	33.8	5.4
Industrial countries	9.5	35.7	5.5
Developing countries	10.5	30.2	5.4

Source: Nogues, Olechowski, and Winters (1985).

a. The data collected by Nogues, Olechowski, and Winters for 1983 have been adjusted for the termination of the US-Japanese automotive agreement. Other changes in protection between 1983 and 1985 have been relatively minor. World trade weights are used in calculating the share of imports subject to nontariff measures in order to abstract from the effects of restrictions applied by a particular country on its own imports.

b. All countries include the socialist countries of eastern Europe, hence the overall average does not necessarily lie between the average of imports from the industrial and from the developing countries.

is provided on the developing countries' market shares in 1973, 1978, 1981, and 1983.

There are no signs of a slowdown in the growth of the developing countries' share in industrial country markets, except for the group of other semimanufactures, which are heavily weighted with semiprocessed natural-resource products, such as aluminum, and for the category of textiles and clothing, where market limitations have become more prevalent. Nevertheless, in 1984 the imports of textiles and clothing from the developing countries rose again, in particular in the United States, reflecting the emergence of new suppliers and the introduction of new products by traditional

Textiles and clothing	Footwear	Iron and steel	Electrical machinery	Transport equipment	Rest of manufacturing
47.8	0.1	21.8	0.0	0.0	0.4
25.5	0.0	24.6	0.0	0.0	0.0
65.3	0.1	4.5	0.0	0.0	1.9
42.4	10.2	37.9	4.2	3.9	3.8
13.6	0.3	33.7	3.1	3.8	2.6
65.2	12.5	28.9	4.7	4.6	5.3
14.0	39.6	0.0	0.0	0.0	6.0
14.0	34.3	0.0	0.0	0.0	7.1
14.2	42.2	0.0	0.0	0.0	1.9

suppliers in the face of limitations imposed on increases in volume. Furthermore, developing-country exporters increasingly shifted to the exportation of products that do not encounter barriers, such as engineering goods.

The data further show an increase in the observed differences between the United States and the European Community, on the one hand, and Japan, on the other, in their shares of imports from developing countries in the domestic consumption of manufactured goods. Thus, while this share was 1.1 percent in the United States, 0.9 percent in the European Community, and 0.7 percent in Japan in 1973, the corresponding shares were 3.0, 2.1, and 1.0 percent in 1983.

The data do not show an acceleration of imports in response to the appreciation in the real value of the US dollar after 1981. While the oil shock affected Japan more than other developed countries, its rapid economic growth may have been expected to reduce, rather than to increase, differences in imports from the developing countries vis-à-vis other industrial countries.

Table 5.2 Relative importance of manufactured imports from developing countries

(ratio of imports to the consumption of manufacture of goods, current prices)

Importer	1973	1978	1981	1983
United States				
Iron and steel	0.6	0.9	1.4	2.3
Chemicals	0.4	0.5	0.6	0.9
Other semimanufactures	0.9	1.5	1.7	1.9
Engineering products	0.7	1.3	2.0	2.6
Textiles	1.8	1.6	2.3	2.2
Clothing	5.6	11.3	14.0	15.1
Other consumer goods	1.9	3.7	4.8	5.2
All manufactures	1.1	1.8	2.4	3.0
European Community				
Iron and steel	0.4	0.4	0.6	0.7
Chemicals	0.5	0.6	0.8	1.1
Other semimanufactures	1.3	2.5	1.9	2.3
Engineering products	0.3	0.9	1.3	1.4
Textiles	2.6	3.7	4.1	4.4
Clothing	5.7	11.4	16.4	16.0
Other consumer goods	1.1	1.6	2.9	3.1
All manufactures	0.9	1.6	2.0	2.1
Japan				
Iron and steel	0.2	0.3	1.0	1.6
Chemicals	0.3	0.5	0.8	0.9
Other semimanufactures	1.0	0.9	0.9	0.9
Engineering products	0.2	0.3	0.5	0.4
Textiles	2.2	2.3	2.1	1.9
Clothing	7.6	7.4	8.9	8.2
Other consumer goods	0.8	1.1	1.3	1.5
All manufactures	0.7	0.8	0.9	1.0

Source: GATT, *International Trade;* United Nations, *Yearbook of Industrial Statistics;* and OECD, *Indicators of Industrial Activity*, various years.

The growth of US manufactured imports from developing countries accelerated in 1984, responding largely to rapid economic growth in the United States. The dollar value of these imports rose by one-third, compared with increases of one-tenth in the European Community and three-tenths in Japan, which also experienced rapid economic growth (GATT 1985). Imports of manufactured goods by the industrial countries from the developing countries rose by more than one-fourth overall. With the slowdown in the US economy, these imports increased much less in 1985, but accelerated in 1986.

Increased penetration of developing-country exports in the markets of industrial countries, despite their greater use of nontariff barriers, suggests the possibilities open to developing countries in general, and Latin American countries in particular, even if present protective barriers are maintained. Because protection is concentrated in particular sectors, developing countries could alleviate its impact through product upgrading and export diversification.

Market Constraints on Export Growth

Several authors claim, however, that export-led growth will encounter limitations in industrial country markets. Writing about Latin America, Albert Fishlow speaks of "a fallacy of composition. If all developing countries tried to pursue the strategy at the same time, the ensuing competition would push down the gain for all. Latecomers are likely to obtain less gain in pursuing the policy than those that preceded them" (1985, p. 138).

The first question concerns the meaning of a strategy of export-led growth. Paul Streeten suggests that the proponents of such a strategy advocate discrimination in favor of exports and against import substitution: "Just as protectionists wish to restrict trade below the free trade optimum, so the advocates of outward-looking policies wish to trade beyond it" (1982, p. 416).

These strictures do not apply to the policies advocated in this report. Rather than "an export bias in trade policies" (Streeten 1982, p. 416), the general thrust of the recommendations is to provide similar incentives to exports and to import substitution. Neither is a laissez-faire policy recommended, which is Fishlow's

bête noire (1985, p. 137). Thus, it is proposed that infant industries receive additional incentives in the form of production subsidies or tariff surcharges. The recommendations further call for export taxes where a country is assigned a quota under an international agreement and for the sale of quota rights in markets where quotas limit exports (chapter 2).

Nevertheless, the question remains whether and to what extent the expansion of exports from developing countries in general, and from Latin American countries in particular, is subject to market constraints in industrial countries. In this connection, primary and manufactured exports need to be separately considered.

The developing countries are the only exporters of tropical beverages, among which coffee has been subject to an international agreement, and an agreement is being negotiated for cocoa. For all other primary products, Latin American countries compete with producers elsewhere and their success in exporting will depend largely on their own policies, except for such industrial country markets where quantitative limitations apply.

But the outlook for commodity prices is also important in assessing the feasibility of export-led growth in Latin America. One cannot predict with confidence any significant early upturn in these prices, although such a development is by no means impossible. It is quite unlikely, however, that future declines will be sizeable if they occur at all.

Moreover, the volume of nonfuel exports by the developing countries increased pari passu with the gross domestic product of the industrial countries, and this relationship is expected to continue in the future. In addition, within the primary sector there is considerable scope for diversification. Agriculture, in particular, offers possibilities for shifting from products with poor export prospects and weak price trends to products with more favorable market possibilities.

At any rate, economic development involves a shift from primary products toward manufactures in the export composition of developing countries in general and Latin American countries in particular. Thus, the global outlook for primary commodities should not be a deterrent to adoption of an outward-oriented strategy.

Among manufactured goods, textiles and clothing require special attention. While the exports of these products are subject to quantitative restrictions in the markets of the industrial countries,

the share of the Latin American countries is very small (5 percent in 1983) and they have not generally filled their quotas. Correspondingly, Latin American countries could increase their market share if appropriate policies are followed. The conclusion applies also to new exporters of steel while the growth of exports by existing exporters is circumscribed by voluntary restraints.

And, Latin American countries could greatly increase their share in the markets of the industrial countries in all other manufactured goods that are rarely subject to restrictions. In 1983, Latin American countries provided only 10 percent of the imports of these products originating in the developing countries and little more than 0.2 percent of the industrial countries' domestic consumption.[2]

Taken together, developing countries supplied 2.3 percent of the consumption of manufactured goods in the industrial countries in 1983. Assuming that consumption in the latter countries would grow at an average annual rate of 3 percent and their imports from the developing countries would rise 9 percent a year, the share of the developing countries in the industrial countries' consumption of manufactured goods would only reach 4 percent by 1993. Even if imports from the developing countries rose by 11 percent a year, as in 1973–83,[3] their market share in the industrial countries would remain below 5 percent after 10 years.

Furthermore, the developing countries can be expected to use increments in their export earnings to buy manufactured goods from the industrial countries. With the balance of trade in manufactured goods remaining unchanged, then, industrial activity in the industrial countries would not be affected in toto while resources would be reallocated toward high technology industries.

Such reallocation would not occur instantaneously, however. Policy changes in the developing countries, which are a precondition for the acceleration of their export expansion, would have an impact only over time. Also, a growing part of trade in engineering products between industrial and developing countries involves intra-industry rather than interindustry specialization, so that changes occur in the product composition of the firm rather than in the industrial structure of the national economy.

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2. For sources, see table 5.2.

3. The data are expressed in constant prices and originate in the GATT statistics.

Correspondingly, an 11 percent growth rate of manufactured exports from the developing to the industrial countries could be attained without major disruptions in industrial country markets. With their low market share, Latin American countries could achieve more rapid rates of manufactured export growth than the average for all developing countries. It does not appear, therefore, that their manufactured exports would be seriously constrained by market limitations in the developed countries.

Neither do latecomers face a disadvantage, as Fishlow assumes. In fact, during the 1970s, 12 new exporting countries (NECs) reached higher rates of manufactured export growth than 12 newly industrializing countries (NICs) that had started exporting earlier (Havrylyshyn and Alikhani 1982, pp. 561–67).[4]

Average annual manufactured export growth rates, measured in terms of current dollar values, were 38 percent for the NECs, and 29 percent for the NICs, between 1970 and 1979. These results have been reconfirmed by estimates for the years 1973 to 1983. Using a similar country classification scheme, it has been shown that manufactured export growth rates were nearly one-half higher in the NECs than in the NICs during this period (Hughes and Newbery 1986).

The NECs may follow in the footsteps of the NICs in the product composition of their exports. In this connection, note that the relative share of traditional labor-intensive exports of textiles and clothing in the manufactured exports of the NECs was higher in 1979 (39 percent) than it had been in the exports of the NICs in 1970 (28 percent). In subsequent years, the NICs increased reliance on engineering products that require more skill and technological sophistication, in particular machinery (21 percent of manufactured exports in 1979) and transport equipment (6 percent), with the share of textiles and clothing declining to 23 percent (Havrylyshyn and Alikhani 1982, p. 657).

These results conform to the "stages approach" to comparative advantage, according to which the structure of manufactured

4. The group of new exporting countries includes Colombia, Cyprus, Indonesia, Jordan, Malaysia, Morocco, Peru, the Philippines, Sri Lanka, Thailand, Tunisia, and Uruguay. In turn, Argentina, Brazil, Greece, Hong Kong, India, Israel, Korea, Mexico, Portugal, Singapore, Spain, and Yugoslavia have been classified as newly industrializing countries.

exports changes with the accumulation of physical and human capital (Balassa 1979, pp. 121–56). This approach also permits one to dispel certain misapprehensions regarding the existence of a foreign-demand constraint for the developing countries' manufactured exports.

As developing countries move ahead on the comparative advantage scale, their exports can supplant the exports of countries that graduate to a higher level. When one developing country merely replaces another in exporting particular commodities to the industrial countries, the problem of import adjustment does not arise.

Thus, as Japan increasingly shifts to the exportation of high technology products, countries such as Brazil and Mexico can take Japan's place exporting metal products and transport equipment while Latin American countries at lower levels of development may supplant the exports of commodities from Brazil and Mexico that utilize mainly unskilled labor. Countries at lower levels of development may also export such products to the more industrialized Latin American countries which, in turn, may increasingly replace the exports of developed-country products in their markets. Furthermore, each stage of industrial development offers possibilities for intra-industry specialization.

These considerations point to the potential expansion of trade in manufactured goods among developing countries in general, and among Latin American countries in particular. In fact, prior to the Mexican financial crisis, Latin American exports of manufactured goods to other Latin American countries, as well as to developing countries outside Latin America, were rising more rapidly than to the industrial countries.

A return to this trend may occur in future years. Higher economic growth rates in the developing countries will lead to more rapid increases in their demand for manufactured imports than in the industrial countries. With their increasing technological sophistication, the more industrialized Latin American countries may supply the needs of countries at lower levels of development, in Latin America and elsewhere, in an increasing array of commodities, and buy simpler manufactured goods in return.

There are also possibilities for expanding trade in primary products among Latin American countries. And, if appropriate policies are followed, these countries can supplant developed-

country suppliers of primary products in other developing countries.

A New Round of Multilateral Trade Negotiations

This discussion points to the conclusion that present conditions afford the developing countries in general, and Latin American countries in particular, wide possibilities for increasing their exports to industrial-country markets. Reductions of trade barriers by the industrial countries would further the expansion of these exports.

At the same time, the developing countries need assurances that their exports will not be subjected to new trade barriers; otherwise, the danger of the imposition of restrictions creates a risk for exporters and discourages investment in potential export industries. Also, it is in the mutual interests of the industrial and the developing countries that highly indebted countries be able to service their debt through increased exports, rather than through the application of deflationary policies, which reduce incomes and employment in these countries and dampen industrial country exports.

In fact, the developing countries assumed increased importance as markets for the industrial countries over time, accounting for 6.3 percent of their total sales of manufactured goods in 1981, compared with 2.9 percent in 1973. The subsequent decline of this ratio to 5.5 percent in 1983 reflects the adverse impact of the debt crisis on imports from the industrial countries (Balassa and Michalopoulos 1986, pp. 3–28).[5] These effects were particularly pronounced in Latin America to the detriment of the United States.

The interests of the two groups of countries may be served by undertaking a new round of multilateral trade negotiations that would address issues relating to actual as well as to potential barriers to trade. In the framework of the negotiations, the industrial countries should make a commitment for a standstill in

5. This article was also drawn upon in what follows.

the imposition of protectionist measures; for the liberalization of quantitative import restrictions in agriculture, textiles and clothing, other consumer goods, and steel; and for tariff reductions on processed goods. An effective safeguard mechanism should also be established to limit the application of protectionist measures in the future.

In the case of agriculture, a standstill on export subsidies should be declared, with subsequent reductions in these subsidies. Furthermore, domestic consumption, and imports from the developing countries, could be increased in the European Community and Japan if they shifted from price support, which keeps domestic food prices high, to income support for needy farmers. Finally, agricultural support levels would need to be reduced over time to encourage the shift of resources out of agriculture.

The gradual phasing out of the Multi-Fiber Arrangement would benefit current exporters in developing countries and permit new exporters to emerge among the less developed of these countries. At the same time, existing tariffs on such products would be sufficient to protect efficient producers in developed countries once quantitative import restrictions are eliminated.

In regard to steel, the elimination of production subsidies is a first priority. The liberalization process itself may begin by abolishing quantitative limitations on steel imports from developing countries. Existing import restrictions on certain consumer goods originating in developing countries should also be eliminated.

Tariff escalation in industrial countries discriminates against processing activities in developing countries, including several in Latin America. To foster export expansion from these countries, industrial countries should eliminate tariffs on processed foods and raw materials, including tropical products, where developing countries are major exporters.

At the same time, the participation of the developing countries would be necessary for a new round of multilateral trade negotiations to be successful. In fact, future trade liberalization by the industrial countries would hardly be possible unless the more advanced developing countries, in Latin America and elsewhere, liberalize their own import restrictions.

These restrictions create difficulties for particular export interests in the industrial countries whose support may well be critical to their governments' ability to reduce barriers against imports from

developing countries in general and from the more advanced of these countries in particular. Also, with rapid increases in the exports of the more advanced developing countries in the recent past, it has been increasingly difficult to make a case for unilateral concessions to them.

This does not mean the advanced developing countries would undertake the same obligations and apply the same time schedule in liberalizing their trade as the present-day industrial countries. But they would need to offer reductions in their import barriers to ensure that the industrial countries liberalize their own trade.

The Latin American countries' current difficulties in servicing their external debt should not deter their participation in the negotiations. Multilateral trade negotiations take several years after the preparatory phase, which may require a year or two, and the implementation of the agreement customarily involves a period of four- to five years more. Liberalization would be gradual, and the developing countries would derive important benefits from participation in the negotiations.

Participation in the negotiations is vital for obtaining concessions from the industrial countries on products of interest to Latin American countries and for being involved in shaping trade rules. This is also true of negotiations on services, where potential gains to developing countries have been much underestimated (Bhagwati 1985).

Mexico's joining the General Agreement on Tariffs and Trade (GATT) is an important step toward Latin American participation in trade negotiations, one that other Latin American nonmembers of GATT might well emulate. Latin America is much less represented in GATT than developing countries in other areas. Bolivia, Ecuador, Paraguay, and Venezuela are not GATT members, and in Central America only Belize and Nicaragua belong.

Increased participation in GATT would increase the bargaining power of Latin American countries in the negotiations, provided that they act in unison. Also, Latin American countries have common interests with the United States, Canada, Australia, and New Zealand in the reductions of agricultural trade barriers by the European Community and Japan, and they have common interests with all other countries in trade liberalization in manufactured goods by the industrial countries.

At any rate, apart from the benefits of lower trade barriers on

their exports, Latin American countries would derive important gains from liberalizing their own trade (chapter 2). Trade liberalization need not be postponed until the completion of multilateral trade negotiations, but any unilateral reductions in trade barriers by Latin American countries must be "counted" in subsequent multilateral negotiations.

Trade liberalization by the more advanced Latin American countries would further create opportunities for the less developed countries of Central America and the Caribbean to sell in their markets. But while trade liberalization by the latter group of countries is in their own interest, they may not assume the kind of obligations the more advanced Latin American countries undertake in the framework of a new round of trade negotiations.

Latin American countries also have an interest in preventing the future imposition of trade barriers that creates uncertainty for their exporters. In fact, along with other developing countries, Latin American countries have suffered from nontariff barriers imposed outside the GATT framework in recent years. While GATT Article XIX permits a country to impose trade restrictions temporarily if imports cause or threaten serious injury to domestic producers of a competing product, its application is subject to several conditions and has in practice been bypassed by the industrial countries. Rather, they have employed voluntary export restraints and orderly marketing arrangements.

Despite protracted negotiations, no agreement has been reached on a new safeguard code in the Tokyo Round and thereafter. The establishment of an effective safeguard mechanism is, however, necessary to avoid prolonging a situation in which the industrial countries take measures that do not conform to GATT rules, thereby undoing the benefits of trade liberalization. At the same time, existing nontariff restrictions, whether in the form of voluntary export restraints, orderly marketing arrangements, or any other, should be brought under the new safeguard code and a timetable set for their elimination.

A new GATT safeguard code is thus needed to complement the liberalization of trade in the framework of a new round of multilateral negotiations. Under such a code, the application of safeguard measures would be made dependent on the existence of serious injury to domestic producers that can be attributed, mainly or fully, to increases in imports.

Safeguard measures should preferably take the form of increases in tariffs, with quantitative restrictions applied only in exceptional cases. If quantitative restrictions are employed, imports from developing countries should not be reduced below the level attained prior to their imposition. The measures applied should be temporary and set on a declining scale.

To ensure that safeguard measures remain temporary, they should be brought under the surveillance and the scrutiny of the GATT. While the first imposition of safeguard measures may be left to the discretion of the country concerned, their extension beyond an initial period of, say, three years would be conditional on agreement by the GATT.

The active monitoring and surveillance of such actions by the GATT should be increased and dispute-settlement procedures strengthened. Improvements in dispute-settlement procedures would also be necessary to deal with conflicts that may arise concerning export subsidies, countervailing action to such subsidies, and the application of antidumping duties.

Such improvements could be made in the framework of the new round of multilateral trade negotiations. The participating governments should use the GATT dispute-settlement mechanism as a forum for presenting their grievances and should abide by the recommendations of panels or arbitrators. Whenever these mediators are overruled by national legislation, financial compensation should be made.

The authority of the GATT Secretariat for the surveillance of the trading system should be strengthened. This may take the form of biannual consultations with the member countries on their trade policies, including a review of the application of safeguard measures, countervailing and antidumping actions, and price investigations. A report of the findings could then be discussed by a standing intergovernmental body, consisting of the representatives of GATT member countries.

Such a procedure would also permit facts to be ascertained about any nontariff measures that governments may not have reported to the GATT. In general, the GATT should improve its efforts to obtain information on the application of nontariff measures and should give them considerable publicity.

Economic Integration

Multilateral trade liberalization would contribute to intra-Latin American trade as well. The question arises, however, if trade among Latin American countries could be promoted within a free trade area or common market. Such arrangements have been successful in developed countries, but not in Latin America. Several reasons may be adduced to explain this outcome.

First, there are considerable differences in the level of industrial development among Latin American countries. At the same time, it has been claimed that countries at higher levels may experience more rapid industrial development in an integrated area, partly at the expense of their less advanced partners. This issue contributed to the demise of the Latin American Free Trade Association (LAFTA), and disparities in the distribution of benefits from integration were largely responsible for the regression of the Central American Common Market (CACM).

Second, in Latin American countries the availability and the cost of transportation often favor trade with industrial countries (in particular, the United States) over trade with other Latin American countries. Third, as a sympathetic observer has noted, "Countries find it extremely difficult to relinquish, even partially, their national interests in favor of global interests when there are major disagreements about the desired long-term path for their economies. It is therefore difficult to envisage the successful integration of countries with conflicting views about the social, political, and economic characteristics of economic growth" (Blejer 1984, p. 33).

The same author has "stressed the importance of policy harmonization in any integration framework [when] experience shows that, to some extent, the harmonization of policies is a precondition for success and not an additional stage in the process" (Blejer 1985, p. 33). The lack of policy coordination is especially important in regard to exchange rates, as large devaluations have repeatedly and considerably modified the competitive position of individual countries. Other difficulties include negotiating a common external tariff and agreeing on the location of new industries, as the Andean Common Market and other regional groupings have discovered.

In 1980, LAFTA was replaced by a new organizational structure,

the Latin American Integration Association (LAIA), under whose aegis countries may negotiate bilateral tariff reductions and regional tariff preferences. Bilateral arrangements, however, involve discrimination against other Latin American countries. Also, these countries have widely different and variable tariff levels, so that preferential margins would differ among countries as well as among commodities.

Latin American countries have generally appeared reluctant to offer preferences to other countries in the area that would mean buying at higher prices than the prices of competing imports from industrial countries. Such considerations support the proposition put forward by Arthur Lewis, according to which the route toward increased trade among developing countries is through offering goods to each other on a competitive basis (1980, pp. 555–64).

Nevertheless, the economic integration of the countries of Central America and the Caribbean through the elimination of trade barriers on their intra-area trade would be desirable, given the extreme smallness of their markets. Thus, the combined gross national product of the countries of CACM (Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua) hardly reaches 8 percent, and that of CARICOM (Bahamas, Barbados, Guiana, Jamaica, and Trinidad and Tobago) 5 percent, of Brazil's GDP.

Some observers have contrasted the failure of Latin American integration efforts with the success of ASEAN, which includes Indonesia, Malaysia, the Philippines, Singapore, Thailand, and, since 1984, Brunei among its members. But these countries have not been able to coordinate the location of new investments, and they have not made preferential tariff reductions.

Rather, ASEAN has established a common front vis-à-vis the industrial countries and, in particular, the European Community, and has obtained trade concessions from them. The experience of ASEAN thus indicates the advantages of a coordinated approach to multilateral trade-policy issues, which requires only a loose institutional framework.

Transportation and energy offer further possibilities for regional arrangements with mutual benefits among Latin American countries. The Pan American Highway System in Central America and the Salto Grande hydroelectrical project between Argentina and Uruguay have proven successful, for example.

There may also be opportunities for agreements between indi-

vidual enterprises, such as the financial arrangements negotiated through Latinequip, an institution that finances capital goods exports from Argentina, Brazil, and Mexico. Simplifying customs regulations and procedures, too, would promote trade among the countries of the region.

The July 1986 agreement between Argentina and Brazil, among other things, provides for cooperation in energy development and aerospace and for the promotion of joint ventures by private enterprises. It also calls for eliminating mutual trade barriers on capital goods, to be subsequently selected, between the two countries.

The Debt Problem

The debt crisis was triggered by Mexico's suspension of debt servicing in August 1982. Mexico was also the first country to benefit from a rescue operation, led by the International Monetary Fund (IMF), and to carry out an effective adjustment program. But while it appeared to have overcome the debt crisis in early 1984, Mexico again encountered difficulties as it increased public spending and failed to maintain a competitive exchange rate. And the adjustment measures taken in late 1985 and early 1986 were eclipsed by the precipitous fall in the price of oil, necessitating a new IMF package in July 1986.

In turn, Brazil's large current account surplus may permit it to obtain loans on commercial terms, once the question of the foreign debt of some recently bankrupt private banks is settled. As in other respects, then, Brazil sets an example for other Latin American countries.

Overall, the appropriate objective is a return to borrowing on commercial terms. This will, however, require time and appropriate actions by borrowers, lenders, and the international community. Such actions are examined in the rest of this chapter,[6] following a review of a proposal for limiting debt servicing to a portion of exports.

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6. Further alternatives are discussed in Bergsten, Cline, and Williamson (1985).

In July 1985, President Alan Garcia of Peru declared that his country would not pay debt service in excess of 10 percent of export earnings, and suggestions have since been made that other countries follow his example. On reflection, however, such a scheme has considerable disadvantages from the point of view of the debtor countries.

To begin with, such a move would exclude the possibility of new lending to the countries concerned, thereby reducing net savings of foreign exchange. Also, the country's solvency may be brought into question or, at the least, the size of its debt would increase as interest and amortization accumulate.[7] And the debt-export ratio may rise further, since linking debt servicing to exports tends to favor high-cost import substitution as export earnings are used in part to service the debt.[8]

Nevertheless, it should be recognized that the high interest burden of the external debt limits the capacity of the Latin American countries to import and to invest. This is indicated by the high ratios of interest charges to the exports of goods and services and to domestic savings. In 1985, these ratios were estimated at 55 percent and 38 percent in Argentina, 44 and 30 in Brazil, 47 and 102 in Chile, 23 and 19 in Colombia, 25 and 20 in Ecuador, 37 and 25 in Mexico, 35 and 40 in Peru, 36 and 70 in Uruguay, and 23 and 31 in Venezuela.[9] Despite the decline in interest rates in

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7. In the event that the rate of growth of exports is less than the rate of interest, the amortization of the debt must exceed a certain proportion of exports to prevent an explosive increase in the debt. If, for example, the initial debt-export ratio is 4, the rate of growth of exports is 5 percent, and the interest rate on the debt is 9 percent, the country will become insolvent unless the ratio of amortization to exports exceeds 7 percent (i.e., debt-service payments exceed 16 percent of exports). Even if this condition is met, the debt may increase considerably for a while. Under the stated assumptions, the country will fully pay off its debt after 64 years if 11 percent of export earnings are paid in the form of amortization, but the debt will continue to rise for 27 years, to over twice its initial value, before declining [After this had been written, John Williamson pointed out that the same condition for solvency was derived by Daniel Cohen (1985, pp. 139–56]).

8. In fact, Peru has not been able to obtain new money and its debt-export ratio has increased, both because of the postponement of amortization and interest payments and the decline in exports after mid-1985.

9. The ratio of interest payments to the exports of goods is reported in ECLA 1986, table 9. The ratio of interest payments to exports has been calculated by utilizing national data on the exports of goods and services and on domestic savings for 1984 (1983 for Chile).

the first half of 1986, discussed further below, the interest burden remains heavy.

Yet, the future economic health of these countries is predicated on their ability to import and to invest, with new investment necessitating the importation of machinery and equipment. And, most crucially, the decline in per capita incomes of the last five years must be reversed. Correspondingly, it will be necessary to go beyond loan rescheduling and to provide new funds for Latin American countries to alleviate the effects of their high interest burden.

By increasing the external debt, new lending adds to the future burden of debt service. Therefore, the borrowing countries need effective adjustment programs that permit the productive use of these funds as well as domestic savings. In turn, new capital inflow can support the adjustment programs undertaken by Latin American countries.

It has been suggested that funds be made available through the (partial) capitalization of interest payments, so that bank managers would not have to ask the board of directors to approve new loans. But one should not underestimate the sophistication of boards of directors who may object to the increase in exposure that interest capitalization entails without a scrutiny of the underlying conditions. Furthermore, under the US accounting conventions, this alternative involves deducting deferred interest payments from reported profits, and hence capitalizing interest payments is far more costly for US banks than providing the same amount in new loans. This is not the case, however, in some European countries.

Concerning new lending, several questions arise: what are the external financial needs of Latin American countries; what are the possible sources of additional loans; what are the possible mechanisms of financing; and under what conditions would the loans be provided. These questions are considered below.

The initiative by US Treasury Secretary James A. Baker III calls for additional lending of $29 billion over three years, with commercial banks providing $20 billion, and international institutions $9 billion, to 15 highly indebted countries.[10] Of these countries,

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10. The countries in question include, in addition to the nine Latin American countries cited earlier, Bolivia, the Ivory Coast, Morocco, Nigeria, Philippines, and Yugoslavia.

10 are in Latin America, accounting for about four-fifths of the combined external debt of the 15 countries. A four-fifths share for these 10 Latin American countries would amount to $23 billion over three years. The needs of these countries, and of Latin America in general, are considerably larger, however.

According to A. David Knox, the Vice President of the World Bank for Latin America and the Caribbean, "conservative estimates place the needs of Latin America, from all sources and not only commercial banks, at a net inflow of $20 billion per year in each of the next three or four years."[11] The same figure has been advanced by the United Nations Economic Commission for Latin America and the Caribbean (ECLA) as being necessary for the region to recoup its 1980 per capita income by 1990 (1986, p. 39). It is in line with the July 1986 IMF program for Mexico that calls for new money of altogether $12 billion to be provided to Mexico by the end of 1987.

A projected net capital inflow of $20 billion a year compares with a net capital inflow of $5 billion and net payments of profits and interest of $35 billion in 1985 (ECLA 1986, p. 101). It would be compatible with decreases in debt-export ratios as long as the dollar value of exports rises by at least 5.5 percent a year, which is below expectations.[12]

In turn, the 1986 Report of the Inter-American Dialogue calls for an additional net capital inflow of $20 billion, for reaching economic growth rates of 4 percent to 5 percent a year in Latin America. The report further suggests that approximately $12 billion a year could come from commercial banks, $4 billion from the multilateral agencies, $1 billion to $1.5 billion each from foreign direct investment and bilateral lending, and $1 billion to $2 billion from the return of flight capital (Inter-American Dialogue 1986).

Measures to encourage foreign direct investment and the reversal of capital flight were considered in chapter 3. At the same time, prudential considerations, as well as banking regulations, will limit the growth of new lending by commercial banks.

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11. Speech delivered at the Bankers Club, in Tokyo, on 20 February 1986.

12. According to IMF projections for 1988–91, Latin American exports would grow 4.2 percent a year in volume, and dollar export prices would rise by 4.2 percent a year for primary products and 4.5 percent for manufactured goods (IMF 1986, tables A53 and A56).

Budgetary constraints limit lending by the US government, the major bilateral lender. Budgetary considerations also constrain direct lending by the government of Japan, but its large balance of payments surplus may be utilized to provide financing to highly indebted countries through the banking system, possibly in conjunction with World Bank lending.

While Japanese participation in public-sector projects in Mexico is also being discussed, one should avoid linking such credits to projects of uncertain social profitability. Official export credit agencies ought to emphasize rehabilitation of existing projects, instead of promoting new projects, which may reflect more the desire to export equipment by the donor country than the needs of the recipient.

To provide for Latin's America's financial needs, it will thus be necessary for international financial institutions to step up their lending. This will require using more of the funds they already have for loans as well as being provided with additional funds.

At the end of 1985, the International Monetary Fund had outstanding credits of $2.3 billion to Argentina, $4.6 billion to Brazil, $1.1 billion to Chile, $3.0 billion to Mexico, $0.7 billion to Peru, and $0.3 billion to Uruguay, totaling $12.0 billion; it had no credits outstanding to Venezuela. None of these countries did fully utilize their borrowing potential, which totaled about $30 billion at the end of 1985.

Under programs in effect in mid-1986, the countries of the region had net repayments of $5.9 billion in 1986–88,[13] from which $1.6 billion for the July 1986 standby to Mexico should be deducted. At the same time, the IMF guidelines leave room for continued financial assistance to Latin American countries that need such assistance and are prepared to continue with their adjustment effort.

IMF financing may be provided under standby arrangements and the extended Fund facility. While some Latin American countries may not wish to utilize these facilities, applying the rules on access to Fund credit flexibly would permit the ceiling to be exceeded (a cumulative limit of 400 percent to 450 percent of the country quota) in the case of others. In fact, the IMF Executive

13. Morgan Guaranty Trust, *World Financial Markets* (February 1986, table 11).

Board is empowered to do so for a country with a large balance of payments deficit that makes a serious adjustment effort.

Latin American countries that meet the relevant conditions could draw on the compensatory financing facility (CFF), which makes loans to partially offset export shortfalls. The maximum limit under this program is 83 percent of quota.[14] Net CFF drawings fell in 1984 and 1985, and Latin American countries have substantial repayment obligations in 1986 and 1987. Yet, the oil-exporting Latin American countries would need financing for export shortfalls following the precipitous fall of oil prices in early 1986.

As envisaged under the Baker initiative, the World Bank would make increased use of nonproject lending to countries that have effective adjustment programs. It has further been proposed that the Inter-American Development Bank (IDB) undertake non-project lending.

Apart from increased nonproject lending, raising the cost-sharing limits for project lending by the World Bank and IDB would bring substantial additional funds to Latin American countries. This conclusion is strengthened, considering that budgetary stringency in several countries may preclude some investment projects acceptable to the two international financial institutions.

For the July 1985 to June 1986 period, World Bank disbursements of project loans to Latin American countries are estimated at $3.1 billion, with considerable increases foreseen in the future. The IDB disbursed $2.3 billion to these countries in 1985, and further increases are planned. Taken together, raising the cost sharing of the two banks by 15 percentage points from the present average of about 60 percent may involve an additional transfer of nearly $1 billion dollars a year.

To provide for increased lending, the World Bank's capital would have to be substantially raised. Increasing capital contributions is preferable to raising the gearing ratio that may adversely affect the conditions under which the Bank borrows in financial markets.[15]

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14. CFF can also provide for the excess cost of cereal imports, but the combined limit under the two programs cannot exceed 125 percent of the quota. These limits are additional to the 400 percent limit noted earlier.

15. In April 1986, Standard and Poor assigned a triple-A rating to the World Bank's $500 million of continuously offered long-term securities, making reference

At the discretion of the Board of the World Bank, additional capital contributions do not have to be paid in an arrangement used on some earlier occasions. Increases in the capital of the IDB would also be desirable.

Parallel with its increased lending, the World Bank should assume a greater role in organizing financial packages based on medium-term adjustment programs and monitoring the implementation of these programs. This would entail an explicit linkage between debt rescheduling, additional financing, and the adoption of a comprehensive reform program. Such a procedure, used effectively in Chile and Colombia, can ensure that desirable adjustment measures are taken and that they are supported by additional financing.

It would further be desirable to increase the involvement of the private sector in Bank project lending through cofinancing arrangements. Also, the International Finance Corporation, which lends to and participates in private enterprises in developing countries, should be considerably strengthened.

In a growing economy, loans in the aggregate are not repaid but renewed practically indefinitely. Nevertheless, the external debt of some Latin American countries may be excessive from the point of view of their economic potential. These countries—and any country wishing to alleviate its debt burden—may explore other alternatives to limit borrowing.

To begin with, countries can offer financial inducements for repatriation of private capital (chapter 3). Furthermore, the transformation of debt into equity can be promoted by extending to foreigners the facilities provided to domestic residents (chapter 4) as it is done in Chile[16] and is planned in Brazil. And while

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to the fact that "the Bank's policy of effectively backing borrowings one-to-one with capital and surplus ensures close scrutiny of members, who must approve capital increases for any significant lending expansion." It was further added that the lending increase called for under the Baker initiative "will require another capital injection. This is important since the World Bank's leverage is the highest among triple-A multilateral development banks" (Associated Press–Dow Jones News Service, 2 April 1986).

16. In order to avoid a subsequent reverse flow, after the transformation of debt into equity no profits can be remitted for four years and the capital cannot be repatriated for 10 years.

transforming debt into equity may involve banks accepting the valuation of loans below par, it would be desirable to change regulations in the industrial countries so that these adjustments do not burden the banks' balance sheets.

Countries may also use innovating techniques, introduced in world capital markets in recent years, to improve the management of their external debt. Interest options can be used to protect against short-term increases in interest rates while currency options reduce the cost of a country's debt without affecting its obligations to creditors.

The suggestions put forward in this chapter would not reduce the value of Latin American countries' external debt to their creditors. This would occur, however, under proposals for reducing interest rates on the debt, partial debt forgiveness, or both. Such proposals are contained in the plan put forward by Senator Bill Bradley (D–NJ) as an alternative to the Baker initiative.

While the plan adopts Secretary Baker's proposal to increase lending by international institutions by a total of $9 billion over three years, instead of asking commercial banks to increase their own lending, it imposes an obligation on them, as well as on official creditors, to provide debt relief. This would take the form of reducing interest rates by 3 percentage points and forgiving 3 percent of the principal of these loans annually over a three-year period. According to Senator Bradley, such debt relief would be worth $57 billion to the 15 Baker countries, of which $42 billion would be at the expense of commercial banks, with most US banks losing no more than 3 percent of their capital. However, Senator Bradley appears to underestimate both the cost of his plan and its potential benefits.

To begin with, the plan would eliminate the profits of the nine largest US banks if regulatory authorities required them to set aside loan loss reserves and half of their profits if they were dispensed from such requirements. Losses of interest and principal would reduce the capital of these banks by 17 percent or 15 percent, depending on tax offsets.[17]

At the same time, forgiving part of the debt would not increase

17. William R. Cline, "Bradley's Debt Plan Won't Work," *Washington Post*, 15 July 1986.

the availability of foreign exchange to the developing countries since their debt is regularly rescheduled or rolled over. Also, the cessation of new lending must be weighed against reductions in interest charges. According to calculations by William Cline of the Institute for International Economics, reductions in interest payments to the banks would total $24 billion over three years under the Bradley plan, compared with new money of $20 billion under the Baker initiative. And while debt relief would reduce the developing countries' future repayment obligations, it would postpone their return to international financial markets under normal conditions, and new lending to them would be cut off for a long time to come.

In turn, initiatives such as the July 1986 program for Mexico offer considerable promise for other highly indebted Latin American countries. Nevertheless, further measures would need to be taken to ease the interest burden of these countries and to provide them with a favorable world economic environment.

Market interest rates fell in late 1985 and the first half of 1986; in July 1986, the London Interbank Offer Rate (LIBOR) on six-month dollar obligations was 6.0 percent, compared with an average of 8.6 percent in 1985. The precipitous fall of oil prices allows further reductions in interest rates, which would, however, require coordination by the governments of the major developed countries.

Apart from lower market interest rates, effective adjustment programs by the debtor countries should permit the commercial banks to reduce their margin over LIBOR, as earlier in Mexico and more recently in Brazil. Correspondingly, the interest burden of the debtor countries would decline further. A LIBOR of 5.5 percent, and a decrease in average margins of between 0.3 and 0.5 percentage points, would mean a decline of one-third in interest payments by Latin American borrowers compared with 1985.

Lowering interest rates would have further beneficial effects on Latin American countries by promoting world economic growth without the danger, under present conditions, that inflation will reignite. In particular, the acceleration of economic growth in the industrial countries would boost imports from Latin American countries.

Finally, preparations for contingencies must be made. While declines in export prices can be dealt with through the CFF,

possible increases in interest rates could be handled by establishing an interest equalization scheme in the IMF. The new facility could provide loans to compensate for a substantial part, say two-thirds, of the excess burden of interest payments on loans subject to variable rates, whenever LIBOR rises above a predetermined benchmark calculated in real terms, possibly indexed to changes in the developed countries' export prices.

The introduction of an interest equalization scheme would reduce uncertainty for the debtor countries. The same objectives would be served through the introduction of long-term index-linked bonds and commodity bonds (Lessard and Williamson 1985, pp. 81–84). One may envisage, for example, establishing a link between debt payments and oil prices in the case of the oil exporting countries.

Summary

This chapter has put the outward-oriented development strategy, proposed in chapter 2, in an international context. Having reviewed recent changes in protection in the industrial countries, it has indicated that Latin American countries have considerable opportunities for expanding their exports to the industrial countries under present conditions.

Exports could increase further if trade barriers were reduced in the framework of a new round of multilateral trade negotiations. Import liberalization by the industrial countries in agriculture, textiles and clothing, and steel would be in the interest of the developing countries, including the countries of Latin America. Tariff reductions on processed goods would also benefit exporters of primary goods, among which Latin American countries are important.

The participation of the developing countries would, however, be necessary for the success of a new round of multilateral trade negotiations, and the more advanced developing countries should make reciprocal concessions. Import restrictions by the developing countries create difficulties for the export interests of the industrial countries, whose support is critical if their governments are to reduce import barriers. Also, with rapid increases in the exports

of the more advanced developing countries, it becomes increasingly difficult politically to offer unilateral concessions to them.

Participating in the negotiations would further permit developing countries in general, and Latin American countries in particular, to influence the shaping of the international trade rules. In this connection, particularly important issues are establishing a new safeguard code, tightening procedures for antidumping and countervailing action, improving the dispute-settlement mechanism, and reinforcing the authority of the GATT.

Multilateral trade liberalization would also promote trade among developing countries. Although regional integration schemes have not been successful, goods from the developing world are becoming increasingly competitive in developing-country markets. At the same time, regional integration may offer benefits to small Latin American countries.

Proposals put forward in recent years for unilateral action on the part of the indebted countries, such as linking debt-service payments to exports, would not serve the interests of these countries. Similar considerations apply to proposals for debt relief, such as the Bradley plan. Rather, there is need for new lending, designed to finance a substantial part of the interest charges on the existing debt, in consideration for adjustment programs adopted by the debtor countries. International financial institutions should play a central role in the process.

New lending would increase the debt of the developing countries, although the debt-export ratio is expected to decline. At the same time, commercial banks could reduce the debt burden by lowering the margin over LIBOR for debtor countries with effective adjustment programs. Furthermore, governments of the principal industrial countries should undertake joint action to lower interest rates. Such a policy would provide additional benefits to debtor countries by contributing to world economic growth, with little danger of rekindling inflation under present conditions.

However, the development strategy recommended here for Latin America should be pursued under virtually any foreseeable evolution of the world economy. The need for such reform would, in fact, be even greater if the world economy soured—because Latin America would then find it even more difficult to reconcile achievement of broad-based economic growth with continued servicing of the external debt without far-reaching policy reform.

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The views expressed in this report are not necessarily those of the participants in the study, listed above.

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