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CONTENTS

Note by the Secretariat. 7

International colloquium on new directions for development planning in market economies. 9

Opening addresses. 9

Address by Mr. *Norberto González*, Executive Secretary of the Economic Commission for Latin America and the Caribbean (ECLAC). 9

Address by Mr. *César Miquel*, Chief, Division for the Regional Programme and the English speaking Caribbean countries United Nations Development Programme (UNDP). 10

Address by Mr. *Alfredo Costa-Filho*, Director-General, Latin American and Caribbean Institute for Economic and Social Planning (ILPES). 12

Planning for a fresh social and economic dynamic. *Latin American and Caribbean Institute for Economic and Social Planning.* 19

New directions in planning: an interpretative balance. *Eduardo García D'Acuña.* 25

A note on new directions in planning. *Brian Van Arkadie.* 33

The need for multiple perspectives in planning. *Harold A. Linstone.* 43

Planning in mixed market economies and the paradigms of development: problems and options. *Rene Villarreal.* 51

Macroeconomic models and planning in the context of an uncertain future: the French experience. *Paul Dubois.* 59

Long-range development planning. Notes on its substance and methodology. *Lars Ingelstam.* 69

Beyond indicative planning. *Stuart Holland.* 75

Planning Today. *Yoshihiro Kogane.* 91

Governability, participation and social aspects of planning. *Yehezkel Dror.* 95

Agents of 'development'. *Marshall Wolfe.* 107

The State, decision-making and planning in Latin America. *Carlos A. de Mattos.* 115

Decentralization and regional development in Latin America today. *Sergio Boisier.* 133

Planning and the market during the next ten years in Latin America. *Joseph Ramos.* 145

Planning and government. *Carlos Matus.* 153

New technological frontiers of management in Latin America. *Bernardo Kliksberg.* 171

The validity of the State-as-planner in the current crisis. *Adolfo Gurrieri.* 193

The role of the State in Latin America's strategic options. *Christian Anglade* and *Carlos Fortin.* 211

Recent ECLAC publications

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Planning and the market during the next ten years in Latin America

*Joseph Ramos**

The issue of the relationship between planning and the market has given rise to fruitless theoretical contention over the relative merits of central planning versus a *laissez-faire* market. At the practical level, this disagreement has manifested itself in sharp swings in policy, which at times have favoured State intervention while mistrusting private enterprise, and at other times have curtailed State action on the grounds that it is inherently ineffective and inappropriate. The author argues that one of the major lessons to be learned from the region's postwar economic experiences is that a correct balance must be struck between the market and State action on the basis of an objective analysis of the strong and weak points of each.

Rather than undertaking an exhaustive theoretical inquiry into the relative merits of the market and planning, the author analyses the principal failures and successes of postwar economic policy in order to see what can be learned from them in regard to the relative advantages of each of these two elements. Based on the results of this examination, the author asserts that the main problems in the region during the past ten years have not been in those spheres which have traditionally been points of conflict between the market and planning (e.g., the selection of the most appropriate lines of production for each) or in the areas classified as typical shortcomings of the market (externalities in the actual sector of production). Instead, they have arisen in spheres recognized as being the responsibility of planning (the maintenance of basic macroeconomic equilibria and the progressive distribution of the fruits of development) and in market defects which were not adequately foreseen (excessive external indebtedness and the financial crisis of national capital markets).

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I

The market and planning during the postwar period

The advantages and disadvantages of a free market within the context of a mixed economy are well-known. Its main advantage is that, with only a minimum of parameters (i.e., prices), each individual's efforts are mobilized and channeled towards those sectors where production is in shortest supply (whose relative price is the highest) and use is made of those factors that are in the most abundant supply (whose relative cost is the lowest). Each individual's efforts to further his own interests are therefore channeled by a free and competitive market towards the satisfaction of social needs (the "invisible hand") on an efficient basis (i.e., at a lower cost).

The market's disadvantages come to light when prices cease to reflect social needs for any of a variety of reasons, such as: interference with the market (monopolies and monopsonies), positive externalities (education and technological development) or negative ones (pollution) which are not figured into private costs or benefits; indivisibilities (public goods, price stability, adequate overall demand, streets, public order, defence) which benefit all regardless of their personal efforts; the lack of important markets or their insufficient development (the virtual absence of long-term capital markets and future markets); duplication by the market of the initial distribution of income through an allocation of resources that is not guided by the consideration of whether or not the resulting income is sufficient for a decent life; and the discounting of the future (due to uncertainty about others' plans or to a failure to take the needs of future generations into due consideration). This would appear to be a justification for the existence of a State which not only establishes the "rules of the game" and maintains order, but which also performs fundamental economic functions such as maintaining basic macroeconomic equilibria (price stability, full employment and balanced external accounts); redistributing income (accelerating the trickle-down effect of economic development or minimizing absolute decreases in the incomes of the most needy); promoting development (by intervening in markets in

order to make corrections and to steer them in the direction of the objectives of the development strategy); and producing goods (public, monopolistic or strategic) which involve multiple externalities as regards the economy.

Regardless of whether they view the State's economic role as being *dirigiste* (controlling the private sector) or subsidiary (strengthening or supplementing this sector), all the governments of the region have taken action in these four areas during the postwar period. In most, the central government, together with State enterprises, has directly produced from 20% to 30% of the GDP and accounted for even higher percentages of investment. In all of them, the State has made use of the traditional monetary, fiscal and tariff instruments and controlled the exchange rate. In most, in has either set or guided interest rates and played a large part in the direct allocation of credit. In the majority, it has set at least some prices of essential goods (foodstuffs, fuel, transport, public services) and sometimes a wide range of them, including retail prices and prices by national region. In other words, State intervention has been quite extensive, if not always equally effective.

Nobody has questioned the State's essential, if not exclusive, role in the regulation of macroeconomic variables and distribution. Nonetheless, a number of serious errors have been committed precisely in this traditional and unquestionably State sphere which point to shortcomings in the planning process. With few exceptions inflation has worsened, reaching three digits in various cases, even in countries which had generally had only moderate inflation before. Deficits in external accounts have reached excessive proportions in many countries and, as a result of the stabilization and adjustment policies they have adopted, unemployment has risen to record levels. Basic macroeconomic balances have been managed poorly not only during periods of external crisis (1980-1983) but also, in many instances, during more prosperous times (1960-1973). In addition to all of this, even during such times and even without any intervening macroeconomic disequilibria of major significance, very little has been achieved with respect to income distribution. On the contrary, while absolute income levels have improved in almost all the countries, these increases have tended to favour higher-income groups.

There has also been a great deal of discussion about the scope of the State's promotional and entrepreneurial functions, i.e., what is the best way (or degree of intervention) to promote development and what are the proper limits as regards the State's entrepreneurial activity. For a series of reasons, two ideas have gained sway in most of the countries of the region: that the State should undertake development planning and thus at least rationalize its own activities, if not mobilize all economic agents for the achievement of that goal (a view which has resulted in the proliferation of development plans); and that the State itself should manage these activities, especially in the extractive and basic-inputs industries, which, because they involve such a large volume of sales or because they require a great deal of capital and entail externalities that are just too important for the economy as a whole, should not be left in the hands of domestic or transnational consortia without a proper national counterweight. As a result, from the 1960s onwards, the number and economic importance of State enterprises began to grow at such an extraordinary pace that by the 1980s non-financial State enterprises were producing between 15% and 20% of the GDP in Brazil, Mexico, Argentina, Peru, Chile and Venezuela, even though the number of State enterprises in many of these countries began to drop after 1975. In line with this idea, export-oriented extractive activities have been nationalized or placed under firm State control in various countries.

It is not within the scope of this article to assess these two tendencies, which, for all that, do have a logical justification. What should be pointed out, however, is that in most cases planning has not worked very well. Apart from the publication of a plan, in most instances the planning done has not included the identification of specific measures for achieving the goals that have been set. In contravention of the basic principle of planning —that there is an instrument for each objective— there has been an oversupply of objectives and an undersupply of instruments. Rather than there being true planning, the short-term sectoral programmes of the Ministries, the Central Bank or the Office of the Budget have been relied upon. The operationalization of comprehensive (as opposed to merely sectoral) long-term programmes providing for

concrete and consistent measures has been completely lacking. State intervention has thus tended to be shortsighted, piecemeal and uncoordinated. Be that as it may, since State intervention had been just as or more unco-ordinated, piecemeal, *ad hoc* and inconsistent in the past, it is quite possible that the net effect of this greater awareness of planning has been a positive one during the postwar period. Indeed, between 1950 and 1980 Latin America's economic growth was strong and sustained (over 5% annually) and well above its traditional rate prior to that time.

The expansion of State enterprises was due to both situational and planned factors (e.g., the absorption of bankrupt companies, the provision of services to State enterprises). Although their economic performance has not always been optimal (since they also pursue other ends, such as employment, regional support, and keeping rates low), their expansion nonetheless did result in a sharp increase in investment and national production capacity. However, their great drawbacks has been that a large part of this investment was financed through external borrowing, rather than with internal funds or their own resources, as they took advantage of the high degree of international liquidity and their ability to obtain State-guaranteed loans. It is estimated, for example, that 60% of Brazil's external debt was incurred by State enterprises,[1] although they were often serving only as a foreign-exchange conduit for the Central Bank.

All this led up to the economic hecatomb which began in 1973: the external and internal indebtedness that culminated in the external disequilibria and financial crises of 1981-1983 and the costly (and recessionary) shock adjustment programmes mounted to deal with these external imbalances. This was a resounding failure of the market system which few planners had been able to foresee, at least in its true proportions. In fact, up until de 1970s, the international capital market had been inadequate ever since it had crashed during the Great Crisis 40 years earlier. Internal capital markets, for their part, were fragmented and underdeveloped, especially in so far as long-term instruments were concerned. Thus, much of the allocation of credit was administered and a large part of long-term funds were self-generated.

Under these circumstances, it is not surprising that when international liquidity rose after 1973, capital markets were seen to be highly inadequate. They were able to recycle the inflow of petrodollars (which was the primary need in the beginning), but in doing so they neglected to ensure that the loans were backed by a concomitant expansion in debt-servicing capacity. The international banks contented themselves with guarantees for the huge sums that were involved rather than analysing the viability of the investment projects in question. In their anxiousness to obtain funds so that they could avoid or postpone adjustment programmes, most governments gave these guarantees. Meanwhile, private economic groups which had access to international funds had an enormous incentive to borrow —not so much in order to invest as to recycle the funds internally or to purchase domestic assets.

No agent, then, had a strong interest in ensuring that private gain coincided with society's gain or that this borrowing was accompanied by a complementary expansion in the country's productive capacity to service the debt. Quite to the contrary, a large part of the borrowed funds ultimately went for consumption (once assets had been purchased) or to capital flight (i.e., the gains were privatized while, on the basis of the State guarantee, the financial exposure was socialized) or was spent on armaments. Nor were all the funds that were invested always channeled to projects having a suitable rate of return, either because the projects had been designed before the crisis and had therefore been based on different relative prices and on the assumption of a buoyant domestic market, or because the initial euphoria was so great that there was a willingness to finance even marginal projects.

When the crisis struck, the weakness of both the international and domestic markets was exposed. The international market proved to be entirely pro-cyclical: there was an inflow of capital so long as the terms of trade were favourable, interest rates were low and the centre's demand remained strong, but when these indicators reversed, so did the flow of capital, regardless of how many internal adjustments the indebted

[1]IPEA/ECLAC, Empresas estatais e política económica, *Planejamento e controle do setor de empresas estatais*, Brasilia, 1983, p. 19.

countries made. The domestic markets revealed just how intertwined these loans were among banks and enterprises having interlocking assets and just how little use it was during a time of external crisis to have guarantees which did not generate foreign exchange.

Although these problems appear to have been more serious in the countries which liberalized their financial markets during this period, thereby encouraging external borrowing for domestic intermediation or for the purchase of assets rather than for investment, the problem of overindebtedness has been quite general in the region and has not been confined only to the countries of the Southern Cone which applied a liberalization policy. In the other countries, the State tended to give its guarantee for the bulk of the private external debt, which did not occur in the Southern Cone. With few exceptions (especially Colombia) the countries did not consider it useful to control the flow or use of the funds borrowed. Most of them encouraged it, including those that had the least need to do so, such as the petroleum-exporting countries. The pre-existing regulation of domestic capital markets proved to be inadequate for dealing with the sums in question and the new financial techniques that had come into use, and almost all underwent severe financial crises; ultimately it became necessary for the State to provide strong support for the national banking system or to convert it entirely to State ownership (Mexico).

There are few today who would question the need to link the rate of external indebtedness to its socially productive use. The sad thing is that so few foresaw this need, not only in the countries which were committed to liberalization at all costs, but also in the more *dirigiste* countries. Not even planning's staunchest advocates predicted this enormous failure of the capital market. This was the great sin of omission committed by the planning of the time.

Although the postwar period has been the most prosperous in the region's history (a situation to which the improvement of State and private management has surely contributed), the conclusion to be drawn is that the main problems which have arisen have fallen outside the scope of the traditional canons of analysis and debate concerning the proper roles of the market and planning. Two of the most serious shortcomings have been precisely in spheres recognized as being the exclusive preserve of the State (the maintenance of basic macroeconomic equilibria and the improvement of income distribution) and are therefore attributable to errors committed by planning. The third major failure —the crisis of external indebtedness— was due to a lack of foresight and was hence an error of omission.

II

Lessons of the recent past

In most of the countries of the region, we no longer talk about whether a centrally-planned or market economy is better, but rather about what the best combination of the two in a mixed economy would be. Nor do we discuss whether production and distribution have to be controlled in order to fulfil social aims; the need for this is recognized by almost everyone. What does have to be decided, however, is how much of this control should be carried out by invisible, impersonal or indirect means (by the market) and how much through visible, personal and direct allocation (through an explicit plan).

The general shortcomings of the market are well-known, although it is not always easy to determine their relative importance before the fact. State action also has its flaws. Therefore, what has to be ascertained is how serious the market's defects are, not in relation to some ideal form of State action, but in relation to State action that is not always either effective or disinterested.

1. *Recent lessons concerning planning*

Firstly, it must be remembered that the formulation of plans in not necessarily the same thing as

planning. It is only the beginning of a planning process, not its end. If instruments are lacking or if there are too many objectives, as has been the case so often in the past, or if these instruments are not shaped into concrete measures, then genuine planning will not take place.

Secondly, planning is not measured by the number of interventions undertaken, but by their quality and consistency. In many countries there has often been intervention in a multitude of spheres, but it has not always been consistent. For example, in the late 1970s in Brazil, almost unlimited credit was given to the agricultural sector (an amount equal to 80% of the agricultural GDP, on average) in order to promote this sector's production. Since the interest rates on these credits were markedly negative, the implicit subsidy was enormous. Nevertheless, the sector did not appear to derive any clear benefit from these measures because other policies were working against it, such as the exchange rate, which tended to be undervalued, and industrial tariffs that placed agriculture in a disadvantageous competitive position. Some agricultural prices were controlled (in order to counter inflation), others were supported (to stimulate production), some agricultural exports were taxed (to control their external prices), and the export of other agricultural products was discouraged or prohibited (in order to regulate the domestic market). Given this complex picture of frequently conflicting policies, it was difficult to determine which activities were, in the end, helped and which were harmed (except in the case of the many activities that were subject to the general disincentives but did not enjoy specific benefits) and whether or not these policies served a social purpose. In this case, rather than being an expression of good planning, the large number of interventions which took place hindered this process.

By the same token, a lack of direct controls does not necessarily mean that there is insufficient planning. Chile's stabilization policy, at least since 1976, is a clear example of planned management (effective and consistent in pursuing its objectives) despite the fact that the number of interventions was kept to a minimum. The authorities made use of the market by applying a tariff drawback while fixing the exchange rate in order to hold down domestic price increases, and so did not find it necessary to place direct controls on the vast range of prices in the national market. The government also managed to introduce major structural (as opposed to merely marginal) changes by applying market prices and criteria in many spheres of the economy and society normally removed from these factors (e.g., State enterprises, universities, social security and even many aspects of the health system). Thus, intervention may be held to a minimum and nonetheless have an enormous impact.

Thirdly, direct planning need not cover everything. It can be partial in terms of both its time span and its content. For example, stabilization policies and adjustment programmes are often highly co-ordinated and operative in respect of specific goals even though they may be designed only as short-term programmes or may be limited to a few goals (e.g., to reduce inflation or to place the balance of payments in equilibrium). This indicates that it can be more advantageous to plan (directly) how to eliminate certain critical bottlenecks than to plan (directly) on a comprehensive basis.

Fourthly, planning is not always successful. This is a self-evident truth which is nevertheless often forgotten. Hence, it is frequently more beneficial to improve the planning process in those spheres where it is clearly required (e.g., improving adjustment and stabilization programmes with a view to minimizing their usual regressive and recessionary impacts, or the saving and investment system, or income redistribution) before turning to problem areas in which the market's flaws are more tolerable, inasmuch as the human and information resources available for planning are also limited and the instruments that are at hand are not always suitable, in addition to the fact that each new intervention involves a negative social externality. As the analysis becomes more complex —since the policy can no longer be assessed on a partial basis but instead needs to be evaluated from a balanced, overall vantage point— the probability of error in the actual design of the policy increases.

Fifthly, the fewer and more clearly-defined the objectives are, the more an effort is made to channel (rather than counter) the activities of private economic agents, the more general the policies are, and the smaller the number of direct

controls, the more effective planning will tend to be.

For example, controlling the price of a given foodstuff initially lowers its cost to consumers (the desired effect), but it ultimately creates a shortage by discouraging production. Since price controls do not stop the producer from changing over to a different product, the policy fails. It would therefore be necessary to combine price controls with a compensatory subsidy for producers in order to increase production of the foodstuff in question, since this is the only sure method of lowering its price over the long term. If the objective is to redistribute income, then a tax on all entrepreneurial activity will be more practical than price controls, which will only redistribute income so long as the producers stay in the product line whose price is being controlled. Finally, it is better (from the standpoint of being able to assess the consequences) to control a key price, such as the exchange rate, than to control the prices of a large number of products, whose indirect effects would be difficult to predict and whose administration would be more complicated.

2. *Recent lessons concerning the market*

Firstly, in so far as the efficiency of the market is concerned, the more price inelastic production is, the more costly it will be to use the market and the price system to allocate resources, since extreme changes in prices will be necessary in order to bring output to the desired levels. In order to prevent producers from obtaining such quasi-rents and to speed up production to the targeted levels, planning and the administrative allocation of resources are necessary. This has been one of the major arguments used during the postwar period by advocates of the utilization of price and exchange-rate controls and of direct incentives (credit subsidies, tariffs, minimum guarantee prices) as a means of dealing with the inelasticity of supply that has been said to exist in agriculture and the supposed inelasticity of the supply and demand for exports. The strong expansion seen in the volume of Latin American exports, especially during the 1970s (7% annually for the non-petroleum-exporting countries) casts doubt upon the validity of this hypothesis. In point of fact, exports do appear to be sensitive to prices, inasmuch as a policy of maintaining the exchange rate at realistic levels seems to have been one of the most important factors in accounting for the boom in exports, particularly in non-traditional exports, during this period.

A similar, although less pronounced, trend has been observed in agriculture. The region's output rose at an annual per capital rate of 0.8% in 1950-1980, with growth ranging from 0.7% in the 1950s to 1% annually in the 1970s. The production and export of agricultural products have, then, turned out to be sensitive to prices and to the exchange rate. Brazilian soya and orange concentrate, Chilean fresh fruit, Colombian flowers and Uruguayan rice are some of the new products which have shown rapid growth and a great degree of penetration into external markets.

As production and exports have shown themselves to be more sensitive to prices, and as entrepreneurs have proved to be more capable of penetrating external markets (both achievements of the past few decades), the pricing system, along with its incentives, has become a more suitable means of mobilizing and allocating resources for socially useful purposes.

Secondly, the closer the economy is to full employment and to an external balance, the better the market will function; and it becomes less and less efficient as pivotal indicators (the exchange rate, interest rates, real wages) move further away from their values of equilibrium. This is why it is vital for economic policy to maintain the basic macroeconomic indicators in balance. Sharp fluctuations in the values of these indicators from one year to the next —as have occurred in many countries in recent years— disorient the market and give rise to destabilizing behaviour because these values reflect serious distortions between social and private values which are, in turn, caused by severe imbalances in basic markets. For example, negative interest rates —which have been observed so often during the postwar period— do not even remotely reflect the shortage of capital in the countries of the region; nor do real annual interest rates of 20%-30%, which have also been seen in some countries. Similarly, variations of from 30% to 50% in the effective real exchange rate serve only to completely disorient economic agents as regards the real comparative advantages of the economy. Such sharp variations correspond to transitory situations (e.g., large but

short-lived inflows of external capital or the use of exchange policy for anti-inflationary ends) rather than to balanced positions.

Thirdly, the longer the time period allowed for the achievement of objectives, the better the market will function. The dynamics of transition from one point of equilibrium to another often involve divergent movements (which may either exceed the target or fail to reach it) rather than always taking the form of movements which systematically converge towards equilibrium. During these transitions, the State's orientation is particularly important (the necessary posture being one which furthers these movements towards equilibrium rather than repressing them), and this appears to be especially true in the case of anti-inflationary programmes, in which the values of some variables have so often been seen to hang back while those of uncontrolled variables overshoot the desired levels.

Fourthly, the less distorted prices are, the better the market will function. Although there is an assumption that, over the long term, the free price is the undistorted price (i.e., that the private price measures social value), the free price is not necessarily the same as the social price; indeed, the two may be very far apart due to induced or natural market distortions, to a large number of fragmented markets (the labour and capital markets) or to the absence of a market (a long-term capital market or a futures market). This would be a justification for intervention aimed at improving its operation.

The identification of the free price with the undistorted price of equilibrium has frequently resulted in market prices that are far removed from their equilibrium values. In effect, the market price balances supply and demand in a market, but it is at its point of equilibrium only if the other markets are also in equilibrium. If they are not, the price that balances one particular market may be even further away from its true equilibrium. A typical case in point within the region occurred in relation to the labour market. Even though real wages fell sharply in some countries, unemployment rose, and this tended to depress wages even further (thus distancing them from their long-term equilibrium value). This was due to the fact that the cause of unemployment in this case was not an excessively high real wage, but rather inordinately high price levels, which depressed sales and thus hiring as well. Therefore, unemployment was a reflection of an imbalance in the market for goods (inflated prices) rather than in the labour market. The solution for this unemployment problem was not to lower real wages but to lower prices in order to raise the demand for goods and the consequent demand for labour.

III

General directions for the future

With the blessing of hindsight, it is always easy to win the battles of the past, but the point here is to prepare for those of tomorrow. For example, one of the major failures of the 1970s during the period of great international liquidity was not to have foreseen the external and internal capital markets' inability to recycle and absorb so large an amount of funds efficiently. Today we would be able to rectify that error, but what would we gain by doing so when the problem to be dealt with during the coming ten years will surely not be to control the inflow of capital but rather to increase it?

Although we cannot predict what will happen during the next ten years, the region's future will clearly be influenced by the disequilibrium and the servicing of the external debt. The most critical shortage will be that of foreign exchange, and there will consequently be an urgent need for measures that will increase exports, further import substitution, extend the term or reduce the amount of the debt service, speed up the inflow of capital and prevent capital flight. The foreign exchange market will be the critical one on which all economic policy will have to be focused, since the resolution of all the

other problems (such as unemployment) will in large part be dependent upon this factor.

Furthermore, since private national groups' financial standing with their creditors will presumably continue to be rather poor for a long time to come, most of the intermediation necessary in order to bring external funds into the economy will have to be carried out by the State and with its guarantee.

It is also probable that internal savings will have to be greater than national savings for some time; in other words, in order to service the debt, it will be necessary to save more than is invested. This means that it will be very difficult to raise national savings (and investment) above its level of the past decade; indeed, it is possible that it will decrease in order to ease the current depression of consumption. As a consequence of this obligatory austerity, another national priority will have to be either to increase internal savings as much as possible or to improve the yield of investment, or some combination of the two, if rates of economic growth similar to those of past decades are to be attained.

Moreover, as it may well be more unlikely that the product and consumption will expand as rapidly as they have in the pat, it will be more necessary than ever to base distributive efforts not only on general economic growth but also on complementary measures aimed specifically at raising the consumption levels of the neediest groups.

In addition, the evolution of the international economy over the past 15 years suggests that precautions will have to be taken against abrupt and unstable movements. Sharp fluctuations in the terms of trade, real interest rates, exchange rates and relative prices (energy and other raw materials) may be the rule rather than the exception. This would seem to indicate that emphasis should be placed on responsible and flexible planning systems.

In order to achieve these objectives, it will be essential to maintain the basic macroeconomic equilibria, and particularly the external balance, inasmuch as this is the exclusive responsibility of the State, a good in and of itself, and a *sine qua non* for the effective operation of the market. A further challenge will be to attain this external balance while minimizing the recessionary and distributive costs traditionally associated with stabilization and adjustment programmes. History clearly shows that, even though economic growth does not always ensure a better distribution, the severest declines in living standards have accompanied periods of recession, which are often brought on by stabilization and adjustment programmes.

Finally, planning aimed at promoting dynamic development should focus on a few crucial areas: savings (raising it) and investment (improving its allocation), and shifting production towards tradeable goods. In view of the State's limited capacity for intervention, this activity should be directed towards planning State production and investment rather than the private sector's, since at present the former is not guided by the criteria of the market or of social planning. In regard to the private sector, intervention should, for reasons of feasibility and administrative effectiveness, focus on orienting the key prices in the economy (basically those of the factors markets, interest rates, the exchange rate, effective protection and wages) and, in so far as possible, there should be rules governing such intervention, with intervention in the market for goods being undertaken only in exceptional cases.

It will not be a question, then, of planning versus the market, but rather one of improving the way in which both the markets and State intervention or direct planning function. Quite probably what will have to be done is not to expand the sphere of State intervention, but rather to focus it and refine it within a foreseeable future context of foreign exchange shortages and austerity.