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UNITED NATIONS
ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN

SANTIAGO, CHILE, DECEMBER 1988

LC/G.1537-P

December 1988

Notes and explanation of symbols

The following symbols are used in tables in the *Review:*
Three dots (...) indicate that data are not available or are not separately reported.
A dash (—) indicates that the amount is nil or negligible.
A blank space in a table means that the item in question is not applicable.
A minus sign (-) indicates a deficit or decrease, unless otherwise specified.
A point (.) is used to indicate decimals.
A slash (/) indicates a crop year or fiscal year, e.g., 1970/1971.
Use of a hyphen (-) between years, e.g., 1971-1973, indicates reference to the complete number of calendar years involved, including the beginning and end years.
Reference to "tons" mean metric tons, and to "dollars", United States dollars, unless otherwise stated.
Unless otherwise stated, references to annual rates of growth or variation signify compound annual rates.
Individual figures and percentages in tables do not necessarily add up to corresponding totals, because of rounding.

UNITED NATIONS PUBLICATION

ISSN 0251-2920

C E P A L

Review

Santiago, Chile — Number 36

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CEPAL REVIEW No. 36

The genesis of import substitution in Latin America

*Richard Lynn Ground**

The process of import substitution that got underway in Latin America in the train of the Great Depression was principally a spontaneous response to the radical deterioration of the international prices of primary products, to the breakdown of the multilateral international trading system (and the collapse of world trade) and to the abrupt reversal of resource transfers.

The major Latin American economies recovered sooner and more vigorously from the Great Depression than did most developed countries or most other underdeveloped areas. The contrast with the outcomes observed in the wake of the adjustment to the international debt crisis in the 1980s could scarcely be more marked.

In the first and second parts of this study the magnitude of the external shocks is briefly documented, the domestic policy response is examined, and an overview of the growth performance of the Latin American economies during the Great Depression and World War II is presented. In the third part the Prebisch thesis and the origin of price distortions in Latin America are analysed.

*The author was formerly a staff member of the ECLAC Economic Development Division, but now works in the World Bank. Grateful acknowledgement is made for the helpful comments and encouragement provided by Andrés Bianchi and Aníbal Pinto. The views expressed in this article are those of the author and are not necessarily shared by ECLAC or the World Bank. The author likewise assumes full responsibility for any errors or shortcomings in this study.

This article is a slightly modified version of a chapter from the essay entitled "The economic development of Latin America: Towards a contribution to a new synthesis of development theory" which was written by Richard L. Ground and Andrés Bianchi. This essay was presented at a seminar entitled "A Comparative Study of Economic Development in Asia and Latin America" which was held in Tokyo from 22 to 24 February 1988 under the sponsorship of the Institute of Developing Economies.

I

The Great Depression and the genesis of import substitution

Although the terms of trade of most Latin American countries decreased steadily over the course of the 1920s in the wake of the gradual deflation of world price levels and the build-up of massive stocks of primary products following the spectacular rise in international prices (especially of commodities) in the last years of World War I, in general that decade was one of high growth in Latin America as world demand remained buoyant and capital flowed into the region on an unprecedented scale. Thus, in spite of the fact that the average international price of the most traded primary products plunged about 40% between the early and the late 1920s,[1] countries like Argentina and Colombia registered overall growth rates of almost 6% and more than 7%, respectively, over the course of that decade, while in the 1925-1929 period Chile achieved a growth rate of almost 11%, Colombia and Brazil recorded rates of over 7%, and Argentina and Honduras experienced one close to 6% (table 1).[2]

1. *The extent and transmission of the industrial-country depression*

Between 1929 and 1933 the index of the gross domestic product of the industrialized countries as a whole dropped 17%.[3] In the United States, which had become Latin America's most important trading partner in the wake of the First World War, the depression was especially severe. In effect, between 1929 and 1933 output

[1] See D. Felix, "Alternative outcomes of the Latin American debt crisis: lessons from the past", *Latin American Research Review*, vol. 22, No. 2 (1987), table 3. Note that between 1923 and 1929 the world stocks of the major international commodities more than doubled.

[2] See also ECLAC, *Series históricas del crecimiento de América Latina*, "Cuadernos Estadísticos de la CEPAL" series, No. 3, Santiago, Chile, 1978.

[3] B. Eichengreen and R. Portes, "The anatomy of financial crisis", *Seminar Paper No. 375*, Institute for International Economic Studies (University of Stockholm) (January 1987).

Table 1

LATIN AMERICA: EVOLUTION OF GROSS DOMESTIC PRODUCT IN SELECTED COUNTRIES, 1920-1950[a]

(Annual average growth rates)

Country	1920-1929	1929-1939	1939-1945	1945-1950
Latin America	...	...	3.4	5.3
Argentina	5.7	1.6	2.1	3.9
Brazil	3.3	3.0	2.4	6.1
Colombia[b]	7.3	3.8	2.6	4.7
Costa Rica[c]	...	...	...	6.4
Chile[d]	...	...	4.0	2.9
Ecuador	...	...	4.2	9.4
El Salvador	...	...	...	8.8
Guatemala[c]	...	...	...	0.8
Haiti	...	...	...	1.2
Honduras[b]	5.4	-1.1	3.5	4.1
Mexico[e]	1.7	2.1	6.2	6.3
Nicaragua	...	...	...	6.3
Panama	...	...	...	0.5
Paraguay	...	...	0.4	2.1
Peru	...	...	...	4.5
Dominican Republic	...	...	...	8.4
Uruguay	...	...	1.7	5.4
Venezuela	...	...	5.3	10.6

Source: ECLAC, on the basis of official data.
[a] 1970 prices.
[b] 1925-1929.
[c] 1946-1950.
[d] 1940-1945.
[e] 1921-1929.

nosedived, falling by more than 29%. Of the region's other major trading partners, the contraction of economic activity reached 30% in Canada, 16% in Germany and 11% in France, measured between their respective pre-depression peaks and depression era troughs. It was only in Great Britain, which remained the principal trading partner for countries like Argentina and Uruguay, that the downturn was more in the nature of a recession, as output there fell but 5% between 1929 and 1931.[4]

As a result of this involution of economic activity, unemployment simultaneously soared to unprecedented heights. Indeed, in the United States the rate of unemployment skyrocketed from 3% of the labour force in 1929 to more than 22% in 1932, while over the same period in Canada it climbed from less than 2% in 1928 to over 19%, in Germany it more than quadrupled from 3.8% to 17.2%, and in Great Britain it rose from around 7% to over 15%.[5]

Price deflation broadly paralleled the shrinkage of economic activity in North America, but considerably outstripped the contraction of output in the other major industrialized countries. Thus, in the United States the price level, after having declined 15% over the course of the 1920s, dropped 25% between 1929 and 1933, and in Canada it fell almost 30% in the first years of the depression. On the other hand, the average decline in prices in France, i.e., 30%, was almost three times the decrease in gross domes-

[4] A. Maddison, *Phases of Capitalist Development* (Oxford: Oxford University Press, 1982), table A6.

[5] A. Maddison, *op.cit.*, table C6.

tic product; in Germany it was more than double the fall in the product, and in Great Britain it was likewise double the reduction in economic activity, though it was thus considerably less pronounced than in the other developed countries.[6]

As a result, the decline in money demand in the industrialized countries, and hence the nominal value of world trade, far outstripped the contraction of economic activity in these countries and reduction in the quantum of world imports. In effect, the index of the quantum of imports of the industrialized countries, taken together, dropped 23.5% between 1929 and 1932, but the nominal value of the imports of the latter plunged 49%.[7]

Moreover, the extent of the decline in the international prices of primary products was considerably greater than the average decrease in international prices and hence markedly greater than the deflation of the international prices of manufactured goods and of services. Thus, the terms of trade of the developed countries as a whole actually improved almost 15% between the peak level of activity recorded in 1929 and the depths of the Great Depression in 1935.[8]

Also underlying the observed disintegration of world merchandise trade was the violent reversal of resource transfers. Thus, while the United States and Great Britain invested more than US$11.3 billion abroad between the mid- and late 1920s on a net basis, between 1930 and 1934 the industrialized countries repatriated US$8.4 billion of capital from the rest of the world, and in the 1935-1938 period they brought home another US$4.8 billion.[9] The total transfer of resources from debtor to creditor nations over the course of this period was considerably larger, especially during the first part of the 1930s, when a good number of debtor nations continued to effect at least partial payment of interest on their foreign debts. Remittances of profits continued, albeit on a much reduced scale, throughout the period. Consequently, domestic income, and especially domestic absorption, fell significantly less in the developed countries than did output.

The fact that the contraction of the quantum and particularly of the value of the imports of the industrialized countries far surpassed the extent of the decline in their economic activity was due, of course, to the erection of gigantic trade barriers and massive subsidization of commodity production.[10] If these countries had instead resorted mainly to exchange rate policies to adjust relative prices, the extent and duration of the fall in economic activity and especially of world trade would have been notoriously less marked, notwithstanding the decidedly procyclical monetary and fiscal policies most of them pursued until the eve of World War II.[11] In that case, the course of world economic history, and perhaps especially that of the Latin American countries, would have been considerably different.

2. *The magnitude of the external shocks*

The shocks transmitted to the rest of the world thus greatly magnified the impact which the Great Depression had had in the industrial countries themselves. Moreover, the external shocks channelled to the Latin American economies were especially massive, owing especially to the preponderant influence of the United States economy in the region.

Although the decrease of the export quantum for the region as a whole was not much greater than the decline of the import quantum of the industrialized countries, i.e., 27% versus 23.5%,[12] the collapse of the nominal value of Latin America's exports was out of all proportion to the drop in the nominal value of industrial country imports as well as to the deflation of

[6] *Ibid.*, table C3.

[7] Calculated from data in B. Eichengreen and R. Portes, *op.cit.*, 1987, table 3.

[8] *Ibid.*

[9] *Ibid.*, pp. 16 and 19.

[10] For an overview of the radical quantitative trade restrictions imposed by the developed countries in this period see, for example, A.G. Kenwood and A.L. Loughedd, *The Growth of the International Economy 1820-1980* (London: George Allen and Unwin, 1983). Note that between 1928 and 1931 the world stock of the most traded primary products expanded almost 90% (Felix, *op.cit.*, 1987, table 3).

[11] See the analysis presented in B. Eichengreen and J. Sachs, "Exchange rates and economic recovery in the 1930s", *The Journal of Economic History*, vol. XIV (December 1985), pp. 925-946.

[12] B. Eichengreen and R. Portes, *op.cit.*, 1987, tables 3 and 4. Nevertheless, in a few cases the extent of the contraction of the export quantum reached catastrophic proportions, as for example in Mexico, where it dropped over 41%, but especially in Chile, where it actually plunged more than 71% (table 6).

the money value of the industrial countries' gross domestic product. Thus, for example, the current value of Chile's exports plummeted 88% between 1929 and 1933; in the case of El Salvador the value plunged 78% between 1928 and 1932, and in Mexico, Venezuela, Peru and Argentina the drop was between about 70% and 75%, while Colombia's export income fell 67% and that of Brazil, 63%.[13] By way of contrast, the money value of the imports of the industrialized countries dropped somewhat less than 50%.

On the other hand, while the region's import prices also of course declined, the fall was considerably less than the nosedive of the prices of the region's exports. In effect, for the region as a whole the terms of trade collapsed almost 48% between 1928 and 1932 (see table 2). Those of Venezuela deteriorated no less than 65% between 1930 and 1935, those of El Salvador dropped 53% and those of Brazil, somewhat less than 50%. In Chile, Colombia, Peru and Mexico they dropped between 45% and 40% from peak (as early as 1928) to trough (as late as 1934); the declines suffered by Ecuador and Argentina were somewhat less, i.e., 38% and 35%, respectively.[14]

In sharp contrast to the outcome for the industrialized countries, the purchasing power of Latin America's exports contracted much more markedly than the export quantum. On a regional basis the real value of exports dropped 48% between 1929 and 1933, or close to twice as much as the decrease of the export quantum. In this same period the real value of exports of the developed countries declined by only 13%, i.e., less than half the extent of the reduction of their total quantum of exports.[15]

If the ratio of the value of exports to the gross domestic product of Latin America were of the order of 40% in 1929, the direct loss from the radical deterioration of its terms of trade would have exceeded 12% in 1933 alone, while the total drop in domestic income in 1933 as compared to 1929 in consequence of the turnaround in the real value of its exports would have approached 21%. In contrast, if the contribution of exports to gross domestic income were of the order of 10% in the developed countries in 1929, the corresponding losses suffered by them would have been only 1.5% and 2.4%, respectively.

Nevertheless, the magnitude of the depression of the quantum of Latin America's imports was even greater than the compression of the purchasing power of its exports. Indeed, between 1929 and 1933 the region's import quantum plunged more than 60% (see table 3). This additional adjustment was provoked by the violent reversal of resource transfers. As a result of the massive repatriation of foreign capital and the skyrocketing of the *ex-post* real international interest rate in the train of the sustained deflation of world price levels,[16] domestic absorption was compressed 24% between 1929 and 1932 and 26% between the former year and 1933 in Latin America, i.e., almost twice and three and one-half times as much, respectively, as the declines in the region's gross domestic product in those two periods.[17]

But the most remarkable feature of this catastrophic episode is that the decline in Latin America's gross domestic product not only corresponded to merely a small fraction of the massive external shocks it supported, but was also less than the decrease in economic activity in the developed countries, in circumstances in which the (self-inflicted) shocks the latter had to contend with were, as we have seen, much less

[13] ECLAC, *América Latina: relación de precios del intercambio*, "Cuadernos Estadísticos de la CEPAL" series, No. 1, Santiago, Chile, 1976, country tables.

[14] *Ibid.*

[15] B. Eichengreen and R. Portes, *op.cit.*, 1987, tables 3 and 4.

[16] Between 1929 and 1930 the *ex-post* real interest rate (i.e., the nominal U.S. interest rate deflated by the change in the unit value of U.S. exports) rose from about 3% to close to 16%, after which it shot up to 33% in 1931 before descending to around 18% in 1932 and turning negative in 1933, as reflation commenced. However, if we focus on the *ex-post* real international interest rate that Latin America had to contend with (i.e., the nominal U.S. interest rate deflated by the change in the average price of Latin America's exports), the leap was much more dramatic still, since it soared from more than 14% in 1929 to 50% in 1930 and almost 52% in 1931, before declining to around 19% in 1932. In 1933 it rose to 27%, but dropped to 6% in 1934 and became negative in 1935. Can there be much doubt that the interest rate is the ultimate sticky price? (The evolution of the unit values of U.S. exports appears in B. Eichengreen and R. Portes, *op.cit.*, 1987, table 3, although the variation between 1928 and 1929 was estimated on the basis of A. Maddison, *op.cit.*, 1982, table E3, and those of Latin America appear in ECLAC, *op.cit.*, 1976, 14 and country tables.)

[17] This calculation assumes that the ratios of exports and imports to the region's gross domestic product were 40% and 50%, respectively, in 1929. Otherwise, the calculations are based on actual data appearing in ECLAC, *op.cit.*, table 4.

Table 2

LATIN AMERICA: EVOLUTION OF MERCHANDISE TERMS OF TRADE

Year	Export price index	Import price index	Merchandise terms of trade	Export quantum	Purchasing power of exports	Import quantum
1928	100.0	100.0	100.0	100.0	100.0	100.0
1929	90.6	96.2	94.2	103.1	97.1	106.4
1930	62.3	93.3	66.8	87.9	58.7	75.8
1931	41.8	79.2	52.8	93.0	49.1	51.9
1932	36.2	65.1	55.6	77.8	43.3	37.9
1933	29.3	56.6	51.8	81.2	42.1	46.3
1934	28.4	48.1	59.9	91.3	53.9	51.9
1935	31.8	48.1	66.1	105.6	69.8	56.1
1936	33.9	48.1	70.5	109.3	77.1	60.3
1937	38.1	52.3	72.8	120.4	87.7	75.7
1938	34.9	50.9	68.6	96.3	66.1	70.1
1939	33.8	49.5	68.3	101.8	69.5	68.7
1940	35.9	53.3	67.4	90.7	61.1	58.9
1941	40.1	57.6	69.6	94.4	69.2	60.3
1942	44.8	67.7	66.2	88.2	58.4	46.3
1943	49.7	73.5	67.6	96.0	64.9	47.7
1944	53.6	73.5	73.0	101.9	74.4	58.9
1945	54.6	79.2	68.9	111.3	76.7	65.9
1946	71.2	92.2	77.2	119.1	91.9	86.9
1947	89.7	115.3	77.8	121.1	89.7	119.1
1948	99.4	123.9	80.2	121.1	94.2	116.3
1949	93.6	123.9	75.5	111.3	84.0	103.7
1950	110.5	118.1	93.6	115.2	107.8	105.1
1951	130.4	141.2	92.4	115.2	106.4	130.3
1952	93.9	144.1	65.2	111.3	72.6	124.7
1953	93.9	134.0	70.1	123.0	86.2	114.9
1954	97.7	136.9	71.4	123.0	87.8	128.9
1955	87.3	139.8	62.4	130.8	81.6	128.9
1956	85.9	139.8	61.4	142.5	87.5	134.5
1957	88.1	141.2	62.4	146.4	91.4	155.5
1958	80.9	139.8	60.0	148.4	89.0	142.9
1959	73.0	135.4	53.9	162.1	87.4	138.7
1960	74.4	138.3	53.8	166.0	89.3	142.9
1961	74.4	141.2	52.7	171.9	90.6	145.7
1962	71.5	144.1	49.6	187.5	93.0	144.3
1963	72.2	144.1	50.1	195.3	97.8	140.1
1964	76.5	149.9	51.1	197.3	100.8	148.5
1965	75.1	152.7	49.2	211.0	103.8	149.9
1966	76.5	152.7	50.1	218.8	109.6	166.9
1967	75.8	154.1	49.2	220.8	108.6	174.0
1968	76.2	152.7	49.9	230.6	115.1	191.0
1969	78.4	155.6	50.4	246.2	124.1	206.6
1970	84.1	159.9	52.6	254.0	133.6	229.2
1971	79.8	164.9	48.3	275.8	133.2	146.7
1972	110.8	178.1	62.1	251.7	158.2	260.2
1973	129.9	204.2	63.6	304.0	193.3	301.4
1974	216.5	293.8	73.6	264.0	194.3	359.0
1975	218.6	325.3	67.2	240.5	161.6	345.2
1976	234.7	331.5	70.8	260.9	184.7	351.8
1977	269.9	358.0	75.4	271.0	204.3	374.9
1978	278.9	392.9	70.9	281.9	199.9	388.5
1979	340.8	458.7	74.2	310.1	230.1	418.2
1980	424.4	553.4	76.7	329.4	252.6	501.2
1981	418.9	581.6	72.0	358.9	258.4	515.6
1982	379.0	544.4	69.9	362.0	238.6	418.3
1983	341.7	522.3	65.3	401.8	262.4	328.9
1984	354.3	501.8	70.6	432.3	305.2	356.0
1985	337.4	493.5	68.3	427.0	291.6	363.4
1986	291.5	469.8	62.1	417.8	259.5	389.0
1987	311.6	487.6	63.6	438.4	278.8	410.8

Source: For 1928-1970, ECLAC; for 1971-1987, ECLAC data bank.

Table 3

LATIN AMERICA: EVOLUTION OF QUANTUM OF EXPORTS AND IMPORTS OF GOODS IN SELECTED COUNTRIES, 1928-1950

(1963 = 100)

Year	Argentina		Bolivia		Brazil		Colombia		Costa Rica	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
1928	126	150	...	...	49	68	49	76	...	...
1929	127	156	29	...	52	69	51	65	...	...
1930	88	137	26	...	57	41	56	34	...	...
1931	121	96	20	...	61	27	49	29	...	...
1932	111	73	23	...	42	25	50	24	...	...
1933	104	80	43	...	52	35	50	33	...	...
1934	109	88	56	...	58	38	53	41	...	...
1935	115	91	50	...	67	43	58	45	...	...
1936	104	96	37	...	74	44	65	51	...	...
1937	121	126	43	46	67	54	64	59	51	25
1938	78	119	33	57	81	50	67	55	47	28
1939	100	100	38	54	83	46	65	67	42	36
1940	85	86	45	53	69	41	69	47	35	31
1941	76	68	49	71	75	41	53	49	43	30
1942	74	56	56	68	57	30	58	26	39	20
1943	76	37	65	73	58	39	74	31	42	26
1944	83	37	65	71	68	48	48	37	35	28
1945	85	41	65	61	74	47	79	59	37	31
1946	88	81	65	68	91	60	82	73	36	36
1947	96	147	82	68	86	86	79	99	48	44
1948	87	164	89	72	90	77	80	80	62	34
1949	56	112	86	79	87	75	80	64	58	37
1950	72	101	84	54	70	85	70	86	55	42

Year	Chile		Ecuador		El Salvador		Guatemala	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
1928	75	79	23	29	28	26	...	...
1929	80	100	23	29	25	29	...	...
1930	52	92	24	23	31	16	...	...
1931	48	48	18	16	30	13	...	...
1932	23	17	19	12	21	12	...	...
1933	33	19	17	13	30	14	...	...
1934	53	25	26	18	25	18	...	...
1935	54	38	28	23	24	15	...	...
1936	54	43	25	25	28	15	...	...
1937	76	48	26	21	37	17	41	32
1938	71	44	25	23	28	14	43	30
1939	64	56	25	23	33	16	41	30
1940	70	42	25	23	15	14	37	24
1941	77	49	24	19	24	16	37	23
1942	82	41	27	22	30	15	42	18
1943	75	42	34	20	33	16	41	19
1944	78	42	34	27	35	16	41	23
1945	79	45	29	27	31	18	51	25
1946	72	45	29	36	27	19	47	33
1947	72	47	28	42	36	28	56	33
1948	79	62	29	45	37	29	51	48
1949	71	75	26	48	42	29	45	52
1950	69	55	37	46	40	38	44	55

Table 3 (concluded)

Year	Haiti		Honduras		Mexico		Nicaragua		Panama	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
1928	...	...	...	...	106	47	...	...	...	...
1929	...	...	...	...	106	54	...	...	...	...
1930	45	...	...	...	86	40	...	...	...	...
1931	45	...	...	...	87	26	...	...	...	...
1932	47	...	...	...	62	21	...	...	...	...
1933	70	...	...	...	667	24	...	...	...	...
1934	64	...	...	...	90	30	...	...	...	...
1935	49	...	...	...	92	31	...	...	...	...
1936	70	...	...	...	101	36	...	...	...	...
1937	57	...	53	30	119	46	24	115	33	42
1938	60	...	39	38	53	38	19	15	31	36
1939	66	...	54	30	50	35	20	17	32	41
1940	46	...	52	29	43	33	16	16	31	39
1941	56	...	53	29	47	49	14	22	24	52
1942	47	...	50	18	48	36	14	13	13	46
1943	53	...	25	23	56	43	17	23	13	43
1944	77	...	49	25	46	64	18	16	13	37
1945	72	...	61	30	54	76	15	17	19	43
1946	81	...	64	40	55	102	18	19	28	52
1947	77	...	79	49	56	103	17	24	34	58
1948	73	...	89	52	44	69	32	25	33	41
1949	90	...	84	49	50	60	26	27	32	41
1950	79	115	83	48	57	71	37	31	30	46

Year	Paraguay		Peru		Dominican Republic		Uruguay		Venezuela	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
1928	...	...	34	...	...	...	...	...	10	41
1929	...	...	37	30	...	...	...	...	10	41
1930	...	...	34	22	49	22	...	...	12	38
1931	...	...	30	15	45	18	...	...	10	21
1932	...	...	26	11	52	17	...	...	10	16
1933	...	...	32	12	46	20	...	...	10	20
1934	...	...	38	21	51	19	...	...	12	17
1935	...	...	40	244	59	19	122	80	12	13
1936	...	...	42	25	62	19	100	94	13	18
1937	...	...	48	27	58	20	112	110	15	26
1938	57	...	39	27	64	21	107	106	16	28
1939	60	...	38	25	64	23	118	97	16	32
1940	48	...	33	24	59	18	111	97	14	29
1941	64	...	37	25	67	18	110	101	19	22
1942	65	...	30	19	37	15	64	86	12	14
1943	68	...	29	22	62	16	118	68	15	13
1944	66	...	30	26	94	18	111	69	21	29
1945	95	...	34	26	59	17	126	84	27	37
1946	102	...	30	32	73	24	121	113	31	52
1947	57	...	29	36	71	37	99	143	35	88
1948	63	...	29	33	61	42	97	109	41	117
1949	72	...	29	38	52	30	106	96	40	115
1950	76	...	35	39	57	31	129	118	45	98

Source: ECLAC, on the basis of official data.

violent. Whereas the composite index of industria country output dwindled 17% between 1929 and 1933, over the same period Latin America's gross domestic product fell by 13%.[18] Moreover, the depression of output in the region's main trading partner was more than twice as severe as that which Latin America experienced, for the United States gross domestic product tumbled more than 29% in this period. While the decline in activity in other underdeveloped areas like Asia was slight during the Great Depression, thanks, in part, to the fact that the shocks experienced were much less intense than those absorbed by Latin America (for example, Asia's export quantum fell almost as much as Latin America's but its import quantum fell less than half as much as that of the latter region between 1929 and 1933), the subsequent recovery of the Latin American economies was considerably stronger than that of the developed countries as well as that achieved in Asia.

II

The genesis of import substitution and the recovery of the Latin American economies

A number of authors have argued that import substitution in Latin America did not commence with the Great Depression but much earlier, perhaps as early as the nineteenth century in the largest economies of the region. While there is no question that the process of import substitution generated by the Great Depression in fact far surpassed in intensity and scope any prior process of import replacement, it is also true that a limited, gradual and stop-and-go diversification of the major Latin American economies did take place before the 1930s. But these observers are mostly right largely for the wrong reasons, focusing as they usually do on the supposed major role of tariffs in the early process of import substitution in Latin America.

More recently, in the unending debate over whether the terms of trade of developing countries have experienced or will experience a secular deterioration, mainstream critics of Latin America's post-World War II economic policies and performance such as I. Little and A. Krueger[19] have observed that if the terms of trade of developing countries had experienced a secular deterioration, they would have industrialized spontaneously, and therefore would not —and should not in any case according to basic tenets of trade theory— have needed to recur to protective tariffs and quantitative trade restrictions to foment industrialization. The point is, of course, that either the terms of trade of these countries have not deteriorated over time, or else the use of restrictive trade practices has inflicted unnecessary welfare losses without producing any gains associated with industrialization other than those that would have occurred as a result of the free play of market forces.

But this is precisely what happened in the initial phases of the diversification of the Latin American economies. In effect, both prior to the Great Depression and especially from 1930 to the Korean War, import substitution in Latin America was essentially in the nature of a spontaneous process induced gradually at first by a deterioration of the region's terms of trade from the late nineteenth century to the 1920s and then violently by the massive external shocks that pounded the region's economies in the 1930s. Telling criticisms have been levelled at the assertion that there was a secular decline in Latin America's terms of trade from the 1860s to the 1920s, and, the issue remains unresolved, but there is extensive documentary evidence that Latin America's terms of trade suffered a radical

[18] ECLAC, *op.cit.*, tables 3 and 4.

[19] I.M.D. Little, *Economic Development, Theory, Policy and International Relations*, New York, Basic Books, 1982; A.O. Krueger, *Alternative Trade Strategies and Development*, Chicago, National Bureau of Economic Research and the University of Chicago Press, 1983.

and enduring downturn from the later 1920s until the Korean War and that the region transferred a massive amount of resources to creditor nations during the first part of the 1930s after having received huge infusions of capital during the 1920s. Nevertheless, two apparent anomalies have to be addressed, i.e., the gaping hole in the neoclassical critique of the process of import substitution in Latin America, and the progressive build-up of restrictive trade practices in the region after the Korean War. The first of these is dealt with here.

1. *The catalytic role of external shocks*

First, a brief review of the facts is in order. If Latin America's terms of trade in 1928 are set equal to 100.0, the greatest point of deterioration was reached in 1933, when the index settled at a little under 53.[20] This downturn reflected a drop of more than 70% in the average price of the region's exports, and a decline of about 21% in the average price of the region's imports (see table 2).[21]

Between 1933 and 1937 the region's terms of trade registered a sustained recovery, but they continued to be situated far below the 1928 level. In the following three years a renewed, but less intense, deterioration occurred, so that at the beginning of World War II the index stood at 67% of its 1928 level. During the course of the war it fluctuated up and down, and in 1945 was somewhat higher than five years before. Subsequently it recovered strongly in the train of the postwar boom. Nevertheless, when the Korean War broke out it was still about 7% below the level observed in 1928, and from that point until the mid-1970s the region's terms of trade gradually declined more or less year-in and year-out.

[20]In this connection it should be borne in mind that from 1919/1920 to 1928 the relative international prices of the main primary products dropped about 20%, i.e., even by 1928 Latin America's terms of trade were far below previous historical peaks.

[21]The data were calculated by ECLAC, on the basis of two indexes. For the 1928-1970 period the price weights reflect the structure of Latin America's exports and imports in 1963; for the 1971-1987 period 1980 price weights were used, and the two indexes were spliced together. For the years 1928 and 1929 the price indexes for the region as a whole were calculated by the authors from the available country data (i.e., on Argentina, Brazil, Colombia, Chile, Ecuador, El Salvador, Mexico, Peru and Venezuela) published in the 1976 ECLAC study. In this publication regional price indexes were calculated from 1930 onwards.

In the first place, this exceptionally pronounced and for the most part prolonged deterioration (i.e., until the end of World War II) of the region's terms of trade directly altered domestic relative prices between the goods possessing extraordinary comparative advantages and all other tradeables, and between those commodities and non-traded goods and services. In effect, the observed movement of the region's terms of trade directly implied a reduction of almost 48%, on average, in the domestic relative price of traditional exports. That these goods continued to be produced and exported at all suggests just how extraordinary their comparative advantage was. But it also had something to do with the indirect repercussions of the decline of the relative international prices of primary products on domestic relative prices.

Thus, just as a rise in the relative international price of a commodity (or an "autonomous" increase in its profitability) may spark off an export boom and trigger a series of domestic price and quantity adjustments, a major and sustained decline in the relative international price of a heretofore booming export leads, contrariwise, to a proportionate decrease in domestic income, and hence, to an excess supply of non-tradeable as well as tradeable goods and services, at prevailing domestic relative prices. As a result, the nominal price of non-traded goods and services declines and the balance of trade in other tradeables improves. The original drop in the relative domestic price of the erstwhile booming commodity is thus partially offset by this indirect real (i.e., spending) effect of the involution of the boom. On the other hand, the spending effect further increases the domestic relative price of other tradeables, so that both the direct and this indirect real repercussion of the deterioration of the terms of trade enhance the profitability of domestic production of these goods at the expense of profitability in the rest of the economy. Simultaneously, the resource movement effect further squeezes profitability in sectors producing traditional primary exports and non-traded goods and services.

The extent to which the spending effect offsets the direct depression of the domestic relative price of export commodities caused by the shift in relative international prices depends

on the relative factor intensities of the production functions of the various sectors. However, when international relative prices deteriorate, the domestic relative price of traditional primary exports normally must fall, since the nominal prices of other tradeables increase on account of the direct and spending effects.

In addition to the direct and indirect repercussions of the collapse of international commodity prices, the monetary effect of the ensuing radical deterioration of the commercial account balances of the Latin American economies also exercised a powerful indirect impact on domestic relative prices. Thus, like the spending effect, it increased the domestic relative price of tradeables and thereby also partially compensated the direct decline in the domestic relative price of traditional commodity exports, further increased the profitability of production of other tradeables, and additionally depressed the nominal prices of non-traded goods and services. Again, however, such monetary induced adjustments are inherently in the nature of transitory phenomena.

Furthermore, both the depressive spending and monetary effects were exacerbated by the violent reversal of resource transfers. Indeed, the incredible rise in the *ex-post* real international interest rate and the massive repatriation of foreign capital in the first half of the 1930s superimposed another major adjustment of domestic relative prices on top of, and analogous to, those induced through the commercial account. And while capital account shocks also presumably are in the nature of transitory shocks, this particular one endured until well into the post-World War II era.

Finally, the reduction of the region's export quantum brought about by drastic deflation and the massive quantitative trade restrictions applied in the developed countries also induced a counterpart adjustment of domestic relative prices.

For a number of Latin American countries the crisis broke out as early as 1928, when United States banks drastically curtailed their overseas lending in order to participate in the New York stock market boom. At this point, or shortly thereafter, most of the region's economies were no longer able to contend with the effects of already depressed international commodity prices while simultaneously continuing to expand domestic absorption. Also, by this time protectionist sentiment in the developed countries had been translated into considerable tariff hikes as well as growing quantitative trade restrictions, while the rise in United States interest rates provoked by the stock exchange bubble had considerably augmented interest payments on the region's foreign debt. In late 1929 Argentina and Uruguay departed from the gold standard and a host of others followed suit in 1930 and 1931. By 1933, when the depths of the Great Depression had been reached, all of the Latin American countries had either left the gold standard and undergone major devaluations, or remained on a fixed exchange rate, but at a higher real effective level than otherwise would have obtained, since they maintained parity with a US dollar which was devalued by 41% between early 1933 and early 1934.[22]

In the end, all of the Latin American governments thus abandoned the automatic gold standard adjustment process rather than suffer the full magnitude of the enormous loss of well-being that the 50% reduction of domestic price levels on account of the direct impact of the deterioration of the region's terms of trade alone would have entailed, although a few persevered until the public had virtually overpowered the palace guard.

It is of course theoretically possible to re-establish an equilibrium real exchange rate through the deflation of domestic price levels, but the greater the intensity and duration of shocks and/or the more rigid domestic prices, the greater will be the output losses if the nominal exchange rate remains fixed. On the other hand, if the exchange rate is allowed to adjust freely to external shocks like those that Latin America confronted in the Great Depression, or if it is promptly raised towards (and ideally to) the new equilibrium level, unnecessary losses of well-being can be limited if not completely avoided. Either way, domestic relative prices

[22]The sequence of events is described concisely in B. Eichengreen and J. Sachs, *op.cit.*, 1985.

eventually will settle at the value consistent with macroeconomic equilibrium.[23]

Thus, by comparing data on the evolution of international prices, exchange rates and domestic prices, we may gauge roughly the extent and the precise direction of the relative price changes induced in the Latin American economies by the Great Depression, and hence the scope for structural change.[24]

[23]However, there is a fundamental flaw in the automatic adjustment process —whether it is based on the gold standard or, in more recent times, the monetary approach to the balance of payments— that necessarily renders it more costly than an adjustment process based on a flexible nominal exchange rate, even in an economy entirely free of conventionally-defined price distortions. In effect, an automatic adjustment process inevitably generates greater unnecessary losses of well-being than does one fostered through a flexible nominal exchange rate, because even at the limit, the nominal interest rate cannot drop below zero. Therefore, as domestic price levels deflate, the real interest rate must rise to a level that is incompatible with internal balance. Proponents of the automatic adjustment could retort that if prices of goods and all other factors were instantaneously flexible, the ultimate downward inflexibility of the nominal interest rate would be of little import. But let's be honest: no matter how flexible all other prices may be, everything takes place over time.

[24]Before proceeding to comment the data presented in table 4, several caveats are in order. First, while the evolution of relative international prices shows variations with respect to the base year (i.e., 1963) and thus roughly indicates orders of magnitude of the profitability of the domestic production of exports and imports relative to each other, the index of overall domestic prices was set equal to the international index (and hence the domestic price index, in line with the small country assumption) of exports for the 1925/1929 period (i.e., to 100). This procedure was adopted both to permit a consistent transformation of international prices into domestic prices and to reflect the fact that prior to the Great Depression the profitability of the production of other tradeables was perforce below that of non-traded goods and services. However, it undoubtedly overstates the profitability of the production of non-tradeables relative to that of other tradeables. Moreover, since profitability in the production of exports was as a rule considerably higher than in non-tradeables, this method prevents any conclusions as to whether relative profitability as between these two sectors switched over the course of the 1930s, although it does of course allow for the observation of changes in relative prices between them. The nominal exchange rate also was set equal to 100 in 1925/1929 for the transformation of international into domestic prices. Consequently, in the base period the ratio of domestic to international prices, as well as the real exchange rate, usually does not equal 100, but this is of no consequence. Note also that the international prices of imports were used as an indicator of international prices of other tradeables (and transformed into the corresponding domestic prices as per the dependent country assumption), and the domestic consumer price index is taken as the price of non-traded goods and services. While the former procedure is entirely satisfactory the second is not, since tradeables entered into domestic consumer price indexes; however, in this case no other option was available. Finally, in performing the transformation of international prices into domestic prices we have ignored the incidence of any domestic policy-induced price distortions, including multiple exchange rates (i.e., import exchange rates —which were the only ones consistently available— were used).

Let us initially focus on the Brazilian case, as the evolution of that country's terms of trade was broadly representative of trends at the regional level. Between 1928/1929 and 1935/1939, the average price of Brazil's exports fell by 73%. However, as a result of the direct and indirect effects of the multiple external shocks, the repercussions of which were manifested principally through a major rise in the exchange rate rather than a decline in domestic prices once the gold standard was abandoned, the decline in the average domestic price of Brazil's traditional exports was considerably less, i.e., 40% (see table 4). On the other hand, the average domestic prices of other tradeables increased 20% in spite of the 65% reduction in the average international prices of these goods, while the average domestic price of non-traded goods and services declined 3% over this period as a whole. As a result of the Great Depression induced shifts of domestic prices, the average domestic price of traditional exports dropped 50% *vis-à-vis* the average domestic price of other tradeables and about 40% *vis-à-vis* that of non-traded goods and services. Note, in particular, that while the average domestic price of traditional exports was 55% higher than that of other tradeables in 1928/1929, it was 23% lower than the average domestic price of other tradeables in 1935/1939.

The reversal of the ratio of domestic relative prices to those of traditional exports and other tradeables was of roughly similar magnitudes in Peru and Colombia. Whereas the average domestic price of traditional exports was some 52% higher than that of other tradeables in the former country in 1928/1929, it was 17% lower than that of other tradeables in 1935/1939. The corresponding figures for Colombia were +50% and -11%.

The decline in the unit value of Chile's exports was not much less than in the above-named countries, but owing to a much larger exchange rate hike the average domestic price of its exports actually climbed over 70% in the first half of the 1930s and remained 25% above the 1925/1929 level in 1935/1939. Due also to the fact that on the eve of the Great Depression its terms of trade were especially favourable, in 1935/1939 the average domestic price of other tradeables was still some 18% above the average domestic price of traditional exports in

Table 4

LATIN AMERICA: FORMATION AND EVOLUTION OF RELATIVE DOMESTIC PRICES, IN SELECTED COUNTRIES, 1925/1929-1935/1939

(Indexes)[a]

	Argentina			Brazil			Chile		
	1925/1929	1930/1934	1935/1939	1925/1929	1930/1934	1935/1939	1925/1929	1930/1934	1935/1939
Nominal international prices									
Traditional exports	100.0[b]	46.3	40.4	100.0[b]	42.9	26.7	100.0[b]	67.5	36.8
Other tradeables	92.5[b]	58.9	39.8	64.5[b]	46.4	34.6	55.0[b]	42.1	30.5
Nominal exchange rate	100.0	140.0	145.2	100.0	160.5	225.7	100.0	253.7	339.6
Nominal domestic prices									
Traditional exports	100.0	64.8	58.7	100.0	68.9	59.7	100.0	171.2	125.0
Other tradeables	92.5	82.5	57.8	64.5	74.5	77.4	55.0	106.8	103.5
Non-tradeables[c]	100.0	85.7	89.1	100.0	76.9	97.0	100.0	113.0	156.8
Relative domestic prices									
Traditional exports									
Other tradeables	100.0	78.5	101.6	155.0	92.5	77.1	181.8	160.3	120.8
Non-tradeables	100.0	75.6	65.9	100.0	89.6	61.5	100.0	62.5	79.7
Other tradeables									
Traditional exports	92.5	127.3	98.5	64.5	108.1	129.6	55.0	62.4	82.8
Non-tradeables	92.5	96.3	64.9	64.5	96.9	79.8	55.0	94.5	66.0
Non-tradeables									
Traditional exports	100.0	132.3	151.8	100.0	179.3	263.3	100.0	66.0	125.4
Other tradeables	108.1	103.9	154.2	155.0	103.2	125.3	181.8	105.8	151.5
Domestic versus international prices									
Domestic prices[c]									
International prices[d]	99.4	103.0	110.0	99.8	92.8	120.5	97.8	133.6	190.6
Real exchange rate	100.6	135.2	131.2	104.6	180.8	194.2	102.2	189.9	178.3

Table 4 (concluded)

	Colombia			Mexico			Peru		
	1925/1929	1930/1934	1935/1939	1925/1929	1930/1934	1935/1939	1925/1929	1930/1934	1935/1939
Nominal international prices									
Traditional exports	100.0[b]	51.9	29.4	100.0[b]	55.7	52.3	100.0[b]	49.1	25.3
Other tradeables	66.5[b]	43.4	33.0	101.1[b]	83.0	59.2	65.7[b]	42.6	30.6
Nominal exchange rate	100.0	115.7	177.7	100.0	145.5	196.5	100.0	155.6	168.9
Nominal domestic prices									
Traditional exports	100.0	60.0	52.2	100.0	81.0	102.8	100.0	65.2	42.7
Other tradeables	66.5	48.4	58.6	101.1	120.8	116.3	65.7	66.3	51.7
Non-tradeables[c]	100.0	65.9	89.1	100.0	91.0	116.4	100.0	82.5	87.5
Relative domestic prices									
Traditional exports									
Other tradeables	150.4	124.0	59.1	98.9	67.0	88.4	152.2	98.3	82.6
Non-tradeables	100.0	91.0	58.6	100.0	89.0	88.3	100.0	79.0	48.8
Other tradeables									
Traditional exports	66.5	80.7	112.3	101.1	149.1	113.1	65.7	101.7	121.1
Non-tradeables	66.5	73.4	65.8	101.1	132.7	99.9	65.7	80.3	59.1
Non-tradeables									
Traditional exports	100.0	109.8	170.7	100.0	112.3	113.2	100.0	126.5	204.9
Other tradeables	150.3	136.2	152.1	98.9	75.3	100.8	152.2	124.4	169.2
Domestic versus international prices									
Domestic prices[c]									
International prices[d]	100.0	78.5	110.7	94.4	103.8	136.5	105.1	104.8	114.3
Real exchange rate	100.0	147.4	160.5	105.9	132.4	135.9	95.2	148.5	147.8

Source: For international prices of traditional exports and other tradeables, which are those relevant for the exports and imports, respectively, of each country, see ECLAC, *América Latina: relación de precios del intercambio*, *op.cit.*, 1976, country tables; for exchange rates and domestic prices, see C. Díaz-Alejandro, "Latin America in Depression, 1929-1939", in *The theory and experience of economic development (Essays in honour of Sir W. Arthur Lewis)*, M. Gersowitz, *et al.* (eds.) (London: George Allen and Unwin, 1982), tables 20.4 and 20.5.

[a] Average price of traditional exports (1963 price weights) in 1928/1929 = 100, and average nominal exchange rate in 1925/1929 = 100.
[b] 1928/1929.
[c] Domestic consumer price index.
[d] United States consumer price index.

1935/1939, notwithstanding the 51% deterioration of its terms of trade. Nevertheless, the rise in the domestic price of other tradeables over this period was pronounced, i.e., more than 50%. On the other hand, Chile was the only country in which the price of non-traded goods and services relative to the average price of traditional exports declined in this period, owing once again to the exceptionally large devaluation of its currency between 1928/1929 and 1930/1934. In the latter period the relative price of non-traded goods and services in terms of exports was 34% less than in 1928/1929, but in the ensuing four-year period the price of non-tradeables relative to that of exports almost doubled, as the domestic price level shot up, the unit price of exports plunged by another one-third, and the rate of devaluation was slowed. Similarly, the domestic price of other tradeables in terms of non-tradeables rose sharply in the first part of the 1930s (i.e., by 72%) but then fell back about 30% in the last part of the decade.

The decline in the international price of Mexico's exports was appreciably less than that observed in the above cases. But since its terms of trade in 1928/1929 were approximately on a par with the base year (i.e., 1963), the domestic price of other tradeables relative to that of its exports rose about 12% in the 1930s. As in the other countries of the region, the domestic price of other tradeables relative to that of non-traded goods and services increased markedly in the first half of the 1930s, but subsequently declined as the international price of other tradeables continued to drop, the terms of trade partially recovered, and the real exchange rate stabilized.

The major exception to these trends occurred in Argentina. In effect, although the international prices of Argentina's exports naturally declined during this period, by the latter half of the 1930s its terms of trade had recovered strongly from the reversal suffered in the early years of that decade, thanks in large measure to the privileged access it obtained to the protected British market through the provisions of the 1934 Runciman Treaty. Consequently, it was the only country in which the domestic price of other tradeables relative to that of export products did not stand substantially above the 1928/1929 level at the end of the 1930s. And by the same token, the adjustment of the exchange rate was notoriously less marked than in the rest of countries for which comparative data were obtained. Over the course of this period the major shift in domestic relative prices that took place as a result of nominal price changes was thus the rise in the price of non-tradeables relative to that of tradeables.

Clearly, the massive shifts in domestic relative prices provoked by the Great Depression provided an overwhelming stimulus to the reallocation of resources from the sector producing erstwhile booming commodities to the rest of the economy, regardless of domestic policy initiatives, although (as discussed below) on the whole economic policy in Latin America did reinforce structural change yet without introducing major distortions in domestic prices.

In effect, if we compare the changes in domestic relative prices the following pattern emerges. In Brazil the domestic price of other tradeables relative to that of traditional exports more than doubled between 1928/1929 and 1935/1939; in Peru it soared over 84%; in Colombia it climbed 69%; in Chile it rose more than 50%, and in Mexico it increased by 13%. The only exception was Argentina, where it declined some 6%.

Over the same period, the domestic price of non-traded goods and services relative to that of traditional exports shot up by 163% in Brazil; it more than doubled in Peru; jumped about 71% in Colombia; climbed 52% in Argentina; went up 25% in Chile, and increased by 13% in Mexico.

Moreover, in both Brazil and Chile the domestic price of other tradeables relative to that of non-traded goods and services likewise increased substantially over this period, despite the drastic decline in the international prices of other tradeables, owing to the especially large exchange rate hikes in those two countries. In Colombia and Mexico the relative domestic price of other tradeables in terms of non-traded goods and services scarcely changed from the pre-Great Depression years to the late 1930s, while in Peru it declined 10% and in Argentina it dropped almost 30%, owing, again, to the notably less severe external shocks experienced by this country and, hence, the proportionately smaller adjustment of its exchange rate (see table 4).

While the genesis of structural change spawned by the Great Depression in the Latin American economies —more intense in other tradeables in some and greater in non-tradeables in others— was in line with spontaneous mechanisms, domestic economy policy also promoted the reallocation of resources.

2. *The contribution of domestic policy*

In effect, the extent of the decline in the relative domestic price of traditional exports and of other tradeables was more pronounced than could be explained by the available price and exchange rate data alone. In particular, the use of multiple exchange régimes that discriminated against traditional exports, and of quantitative trade restrictions that discriminated against "non-essential" imports increased the movement of resources out of the traditional export sector and channeled then into the production of other tradeables. Precise comparative information on multiple exchange régimes and quantitative trade restrictions in the 1930s is not available, but the relevant data for the situation prevailing around 1950 may be suggestive of the incidence of these policies in that earlier period, although it should be borne in mind that in general, recourse to multiple exchange rates and quantitative restrictions on trade gradually intensified over this period in a number of countries and increased very sharply in others (e.g., in Argentina in the mid- and late 1940s).

a) *Trade policies*

With these caveats in mind, it may thus be noted that in Argentina the spread between the official exchange rate for non-essential imports and that for traditional exports around 1950 was almost 190%, while that between non-essential imports on the one hand and essential imports and non-traditional exports on the other was 92% (see table 5).[25] In Chile the corresponding figure for the spread between non-essential imports and traditional exports was 174%, while that between the former category of imports and essential ones was around 39%. On the other hand, the official exchange rate was the same for non-traditional exports and non-essential imports, so that in this case equal incentives for the production of other tradeables, excluding capital and intermediate importables, were in force. Substantial spreads may also be observed in Costa Rica, Paraguay, Ecuador and Uruguay.

On the other hand, in countries like Brazil, Colombia, Peru, Venezuela and Nicaragua the scope of multiple exchange rates was rather limited. Thus, in Brazil the spreads were few and marginal, and in Colombia much the same pattern obtained, with the notable exception of the use of an exchange rate for non-traditional exports that was 23% higher than that for non-essential imports. In Venezuela there was a small spread between the rate for non-essential imports and the other, common rate, while in Peru there was a single rate for all current account items (see table 5). Finally, in Cuba, El Salvador, Guatemala, Haiti, Mexico and Panama one exchange rate was used for all transactions (see table 6).

We have no quantitative information on administrative trade restrictions, but it may be noted that around 1950 13 of the 18 countries of the region for which qualitative data are available employed import prohibitions and/or licenses, while five of the 12 countries for which such information was obtained required advance deposits for imports (see table 6).

Although quantitative trade restrictions had thus come to be used by the majority of the Latin American countries early in the post-World War II era (if not before), in contrast —and contrary to conventional belief— tariffs were not used to ease the adjustment to the Great Depression. Thus, while import tariffs were, on average, between 23% and 30% in the largest Latin American countries in the late 1920s, they were scarcely raised at all either during the 1930s or the 1940s. Indeed, between 1925/1927 and 1932/1937 the average import tariff dropped from 28% to 17% in Mexico and from 26% to about 24% in Argentina (see table 7). Over the course of the same period average tariffs were

[25] In contrast, in 1934/1936 the spread between average import and export exchange rates in Argentina was about 12% (C. Díaz-Alejandro, "Latin America in depression 1929-1939", *The Theory and Experience of Economic Development: Essays in Honour of Sir. W. Arthur Lewis*, M. Gersovitz and others (eds.). London: George Allen and Unwin, 1982, table 20.6).

Table 5

LATIN AMERICA: EXCHANGE RATE REGIMES IN SELECTED COUNTRIES, AROUND 1950

Country	Essential imports	Non-essential imports	Basic exports	Non-traditional exports	Capital account
Argentina[a]	7.5	14.4	5.0	7.5	14.4
Bolivia[b]	42.4	56.1	55.5	42.0	42.4
Brazil[c]	18.7	19.7	18.4	18.4	18.7
Colombia[a]	2.2	2.6	2.0	3.2	2.0
Costa Rica[d]	9.4	14.5	5.6	5.6	6.2
Chile[a]	31.1	43.1	19.4	43.0	43.1
Ecuador[e]	15.2	25.0	15.0	18.3	13.5
Nicaragua[f]	5.0	6.9	5.0	5.0	5.0
Paraguay[g]	3.1	8.1	4.9	6.0	8.1
Peru[h]	14.8	14.8	14.8	14.8	16.3
Uruguay[a]	1.9	2.5	1.5	2.4	3.1
Venezuela[i]	3.1	3.4	3.3	3.3	3.3

Source: International Monetary Fund, *Annual Report on Exchange Restrictions, 1950-1952.*
[a]Pesos per US dollar.
[b]Bolivianos per US dollar.
[c]Cruzeiros per US dollar.
[d]Colones per US dollar.
[e]Sucres per US dollar.
[f]Córdobas per US dollar.
[g]Guaranies per US dollar.
[h]Soles per US dollar.
[i]Bolívares per US dollar.

Table 6

LATIN AMERICA: SUMMARY OF QUANTITATIVE RESTRICTION ON EXTERNAL TRADE, AROUND 1950[a]

Country	Multiple exchange rates	Exchange controls	Quantitative restrictions[b]	Prior deposits
Argentina	Yes	Yes	Yes	No
Bolivia	Yes	Yes	Yes	No
Brazil	Yes	Yes	Yes	No
Colombia	Yes	Yes	Yes	Yes
Costa Rica	Yes	Yes	Yes	Yes
Cuba	No	No	No	No
Chile	Yes	Yes	Yes	No
Ecuador	Yes	Yes	Yes	Yes
El Salvador	No	No	No	...
Guatemala	No	No	No	...
Haiti	No	No	No	...
Mexico	No	Yes	Yes	...
Nicaragua	Yes	Yes	Yes	Yes
Panama	No	No	No	...
Paraguay	Yes	Yes	Yes	Yes
Peru	No	Yes	Yes	Yes
Uruguay	Yes	Yes	Yes	No
Venezuela	Yes	Yes	Yes	No

Source: ECLAC, on the basis of official data; International Monetary Fund.
[a]Approximately 1948-1950.
[b]Import prohibitions and/or prior import licences.

increased slightly in Colombia, i.e., from 23% to 25%, while in Chile the general tariff was hiked from 25-30% to 35%. In Brazil, for which no earlier data were obtained, the average implicit tariff was under 26% in 1936.[26]

Furthermore, in the 1945/1950 period the average tariff had dropped to 11% in Mexico, 12% in Argentina, 14% in Brazil and 17% in Colombia. In Chile, in contrast, the average tariff appears to have continued to rise. Thus, the average tariff on consumer goods was hiked from 45% in the 1932/1937 period to 62% in 1945/1950 (see table 7).

On the whole, then, it may tentatively be affirmed that although trade policy clearly was fostering the process of import substitution in Latin America by the time the Korean War broke out, its contribution can scarcely be compared to the catalytic role played by the massive domestic relative price changes triggered by the Great Depression in the 1930s. Moreover, the incidence of these discriminatory trade policies in Latin America must also be interpreted in the light of the extensive price distortions provoked in the international economy by the trade policies of the industrial countries in the 1930s and 1940s. It may be noted in this respect that tariff levels in Latin America were considerably lower than those imposed in many developed countries at that time.

On the other hand, the contrast between the relatively low incidence of trade policy-induced price distortions in most Latin American economies during this period and the progressive build-up of such distortions while the international economy experienced an unprecedented expansion in the post-war era goes a long way towards explaining the exceptional economic performance of the region during the 1929-1950 period and the incessant accumulation of macroeconomic disequilibria thereafter.

b) *Macroeconomic policies*

One of the principal reasons why Latin America outperformed the developed countries in the 1930s in spite of the notoriously greater shocks to which it was subjected stemmed from a more timely recourse to policy-guided relative price changes as well as the relatively greater use (or tolerance) of price mechanisms to effect the necessary structural changes.

Thus, on balance, all of the Latin American countries for which data were obtained increased the competitiveness of their economies *vis-à-vis* the industrialized countries through major increases in their real exchange rates, especially in the early 1930s. This was particularly true in countries like Brazil and Chile, where the real exchange rate jumped 94% and 78%, respectively, between 1925/1929 and 1935/1939 (see table 4). In both Colombia and Uruguay the real exchange rate climbed about 60%, in this period;[27] in Peru it rose 53%, in Mexico it went up 40%, and in Argentina it increased 33%.[28]

Although adjustments of relative domestic prices proportionate to the magnitude of the external shocks were inevitable —a point that may be verified by reference to the contrasts among the Latin American countries themselves—, the timing of those adjustments, as well as their division between those effected through the real exchange rate and those realized by discriminatory trade policies, exerted a decisive influence on the extent of unnecessary welfare losses, i.e., on the decline of economic activity and the speed and scope of the recovery.

Thus, in general, the major Latin American countries abandoned the drawn out and highly costly deflation of domestic prices in line with a gold standard policy régime much sooner than did the developed countries. While this partly stemmed from the relative magnitude of the shocks, it also reflected conscious policy decisions, inasmuch as technically speaking all countries could have opted for deflation.

The more opportune and vigorous recovery of the Latin American economies was also promoted by the pursuit of mildly expansionary rather than sharply deflationary monetary policies: a contrast which in turn was related to

[26]The only country for which we have some data on the dispersion of tariffs in the 1930s is Argentina, where tariffs on consumer goods ranged from 23% to 31%, on intermediate goods from 1% to 15%, and on capital goods around 18%.

[27]The data for Uruguay are from C. Díaz-Alejandro, *op.cit.*, 1982, table 20.4.

[28]In all cases the lion's share of the rise in the real exchange rate took place in the first part of the 1930s.

Table 7

LATIN AMERICA: EVOLUTION OF NOMINAL TARIFFS IN SELECTED COUNTRIES, 1925-1986

(Percentages)

Country	1925/1927	1932/1937	1945/1950	1960/1965	1967/1970	1972/1977	1978/1981	1982/1986
Argentina								
Average	26.0[a]	23.8[b]	12.2[c]	148.8[d]	36.0[e]	93.7[f]	34.4[g]	0.0-38.0[h]
Consumer goods	...	22.9-31.4[h]	...	235.0[d]	88.0[e]	100.0[f]	36.5[g]	...
Intermediate goods	...	1.0-15.0[h]	...	243.0[d]	51.0[e]	95.0[f]	0.0-30.0[g]	...
Capital goods	...	18.4[h]	...	156.0[d]	87.0[e]	70.0[f]	36.7[g]	10.0[h]
Brazil								
Average	...	25.6[i]	14.4[i]	85.0[j]	37.0[j]	55.1[k]	99.0[k]	45.0[l]
Consumer goods	...	...	...	132.0[j]	67.0[j]	...	...	...
Intermediate goods	...	...	...	70.0[j]	37.0[j]	...	...	...
Capital goods	...	...	...	56.0[j]	40.0[j]	...	...	...
Colombia								
Average	23.0[r]	25.0[r]	17.0[r]	48.0[r]	13.0[e]	36.0[s]	28.0[s]	...
Consumer goods	...	...	18.0	53.0	49.0[e]	47.0	43.0	...
Intermediate goods	...	...	22.0	40.0	11.0[e]	24.0	22.0	...
Capital goods	...	...	...	...	33.0[e]	28.0	30.0	...
Costa Rica								
Average	...	...	...	...	...	25.8[v]	16.8[v]	...
Consumer goods	...	...	...	58.1[t]	85.5[u]	28.0	18.3	...
Intermediate goods	...	...	...	28.3[t]	32.8[u]	17.3	13.0	...
Capital goods	...	...	...	10.0[t]	11.8[u]	21.0	16.3	...
Chile								
Average	25.0-30.0[m]	35.0[n]	...	89.0[o]	...	94.0-24.0[p]	10.0[q]	20.0[q]
Consumer goods	...	45.0[n]	62.0[c]	204.0[o]	...	...	10.0	20.0
Intermediate goods	...	...	3.0[c]	53.0[o]	...	...	10.0	20.0
Capital goods	...	...	30.0[c]	92.0[o]	...	...	10.0	20.0
El Salvador								
Average	...	...	...	...	...	47.6[w]	...	...
Consumer goods	...	...	...	52.2[t]	79.3[u]	32.9[w]	...	...
Intermediate goods	...	...	...	37.8[t]	38.1[u]	30.4[w]	...	...
Capital goods	...	...	...	9.8[t]	10.2[u]	10.6[w]	...	...
Guatemala								
Average	...	...	...	...	...	50.1[w]	29.8[x]	...
Consumer goods	...	...	...	50.4[t]	79.8[u]	37.0[w]	39.0[x]	...
Intermediate goods	...	...	...	24.4[t]	28.6[u]	26.3[w]	23.1[x]	...
Capital goods	...	...	...	06.0[t]	10.3[u]	10.3[w]	23.3[x]	...
Honduras								
Average	...	...	...	...	...	41.2[w]	21.9	...
Consumer goods	...	...	...	50.0[t]	91.9[u]	30.3[w]	...	...
Intermediate goods	...	...	...	31.6[t]	35.7[u]	38.9[w]	...	...
Capital goods	...	...	...	2.9[t]	9.9[u]	5.7[w]	...	...
Mexico								
Average	18.4[y]	17.0[y]	11.1[y]	20.1[z]	17.7[aa]	28.0[aa]	11.5[aa]	26.5[aa]
Consumer goods	...	...	...	63.9[z]	...	...	...	...
Intermediate goods	...	...	...	33.5[z]	...	...	...	...
Capital goods	...	...	...	10.6[z]	...	...	...	...

Table 7 (concluded)

Country	1925/1927	1932/1937	1945/1950	1960/1965	1967/1970	1972/1977	1978/1981	1982/1986
Nicaragua								
Average	...	...	...	...	...	54.4[w]	...	...
Consumer goods	...	...	...	59.6[r]	92.2[u]	42.4[w]	...	...
Intermediate goods	...	...	...	33.0[r]	56.1[u]	27.7[w]	...	...
Capital goods	...	...	...	14.0[r]	12.6[u]	10.8[w]	...	...
Uruguay								
Average	...	...	...	...	...	139.0[bb]	...	...
Consumer goods	...	...	...	...	...	133.0[bb]	...	0.0-15.0[cc]
Intermediate goods	...	...	...	...	...	70.0[bb]	...	0.0-15.0[cc]
Capital goods	...	...	...	...	...	...	...	0.0-15.0[cc]

Source: World Bank; IBRD; United Nations; ECLAC, International Monetary Fund: *Exchange Restrictions Annual Report* (various years); CIEPLAN; Universidad Católica de Chile: *Cuadernos de Economía*, No. 54-55, Santiago, Chile, 1981; Leave of Nations: *Tariff level indices*, Geneva, 1927; Bela Balassa: *Development strategies in semi-industrial economies*, Baltimore, Md.: The Johns Hopkins University Press, 1982 and *The structure of protection in developing countries*, 1971; Centro de Estudios Monetarios Latinoamericanos, 1972; Carlos Díaz-Alejandro: *Foreign Trade Regimes and Economic Development*, New York: Columbia University Press, 1976; Manuel Martínez del Campo: *Industrialización en México: hacia un análisis crítico*, Mexico City, El Colegio de México, 1985.

[a] Tariff level (1925).
[b] 1927. Consumer goods are cotton and wool manufactures; intermediate goods are agricultural inputs, raw materials, oils, etc.
[c] *Ad valorem* tariff. Specific duties not included.
[d] 1962 (maximum value).
[e] 1969 (nominal protection).
[f] 1976. Manufactured goods.
[g] 1979. Nominal protection.
[h] 1986. Range of tariff rates.
[i] 1936 and 1951 respectively (average incidence of customs duties: customs duties divided by the value of imports).
[j] 1966 and 1967 respectively (nominal protection).
[k] 1977 and 1980 respectively (manufactured goods).
[l] 1986 (import duties).
[m] Before 1928 (basic tariff).
[n] 1932. Consumer goods are luxory goods.
[o] 1961 (nominal protection).
[p] 94.0 corresponds to 1975 and 24.0 corresponds to 1977.
[q] 1979-1982 and 1986 respectively.
[r] 1927, 1936, 1951 and 1959 respectively. Average of nominal tariff rates for all imports.
[s] 1975 and 1979 respectively.
[t] 1959 (national tariffs before the Common Market). Average nominal tariff for selected groups of manufactured products.
[u] 1967 (Common Market tariffs). Average nominal tariffs for selected groups of manufactured products. Figures used for Nicaragua apply to 1960 and 1968 respectively.
[v] 1973 and 1977 respectively (nominal tariff rate). The nominal tariff rate is the nominal tariff divided by imports from outside the CACM.
[w] 1972. *Ad valorem* equivalents of the common external tariff. Intermediate goods are food products.
[x] 1981. Nominal tariff rates.
[y] 1929, 1937 and 1948, respectively (coefficient of customs duties). The coefficient of customs duties is the quotient, at current values, of customs duties and the total imports.
[z] 1960. Nominal tariff protection.
[aa] 1970, 1975, 1979 and 1982, respectively. Tariff level (weighted average).
[bb] 1976 (average tariff).
[cc] 1985-1986 (range).

the more timely abandonment of the so-called automatic adjustment process and permitted the maintenance of real domestic interest rates markedly lower than those of countries, like the United States, that persisted longer in the deflationary route. While the United States money supply contracted 16% between 1925/1929 and 1930/1934, Brazil's money supply rose 18%, Mexico's was augmented by 13%, Chile's expanded 11% and Uruguay's increased about 6%. By way of contrast, close to one-half of Cuba's money supply evaporated over this period.[29]

[29]Carlos Díaz-Alejandro, *op.cit.*, 1982, table 20.7.

In addition, the scope for recovery in Latin America was enhanced considerably by the widespread moratorium on external debt payments in the early 1930s. Indeed, only Argentina and the Dominican Republic continued to effect foreign debt service payments throughout this period. Finally, and also in sharp contrast to the 1980s, the Latin American countries did not have to contend with capital flight.[30]

3. *Overview of recovery and growth*

In Latin America, as in the world at large, the trough of the Depression was reached in 1932. In only two years more, however, regional output had not only recovered but surpassed the 1929 level, and by 1937 it was fully 20% above the pre-Depression peak. By way of contrast, the index of the gross domestic product of the industrial countries taken together did not recover its 1929 level until 1936, and in 1937 it was only 7% above the pre-crisis high. Latin America's performance is all the more remarkable in view of the fact that economic activity in its principal trading partner still remained below the 1929 level as late as 1937. Indeed, in the United States the recovery was not completed until 1939, when the process of rearmament was greatly accelerated.[31]

In addition, regional output in Asia in 1937, although 10% higher than its 1929 level, was only 6% above its 1932 level, whereas the Latin American gross domestic product expanded over 39% between 1932 and 1937. Moreover, when Latin America surpassed its pre-Great Depression gross domestic product in 1934, it did so with a quantum of imports that was scarcely more than one-half its 1929 level, while in that same year, although Asia's output was also about the same as it had been in 1929, its import quantum was only 13% lower than in that year.[32]

Between 1939 and 1945 the Latin American economies continued to achieve growth rates above those observed in much of the rest of the world, notwithstanding the dislocations caused by World War II and the sharp downturn in the United States economy between 1944 and 1948. This sustained expansion was in fact promoted by the marked growth of the United States economy between 1939 and 1944 and, from 1946 onwards, by a strong recovery of the region's terms of trade. Thus, between 1939 and 1945 the regional gross domestic product expanded 3.4% per annum and between 1945 and 1950 it increased 5.3% per year (see table 1). These figures compare with a growth rate of about 2.5% between 1929 and 1939.

For the 1929-1950 period as a whole, the annual growth rate of regional output was 4.4% (table 8), compared with a growth rate of 2.7% per annum for the United States economy over this period.[33]

Finally, it may be noted that while Latin America's share of world exports declined from 8.9% in 1929 to 7.9% in 1938 (which was the same figure recorded in 1913), by 1947 it had climbed to 12.2%, before dropping back to 11.4% in 1950. On the other hand, its share of world imports dropped from 6.8% in 1929 to 6.3% in 1938, rose to a peak of 11.3% in 1947, but dropped sharply to 8.6% in 1950,[34] in spite of a recovery of more than 20% in its terms of trade between 1947 and 1950. Indeed, in 1950 the region's terms of trade stood at a level which was the highest since 1929 (i.e., 93.6 versus 100) and which has not been witnessed again for the region as a whole (see table 2). Evidently, then, by the late 1940s the policies which were to exert a decisive influence on Latin America's post-war economic performance until 1973 and beyond were already taking shape.

We will now consider briefly some of the basic ideas of a Latin America whose economics were directly forged by the experience of the Great Depression, but which exercised their greatest influence in the 1950s and 1960s.

[30] For a comparative historical analysis of these two issues, see Felix, *op.cit.*, 1987.

[31] B. Eichengreen and R. Portes, *op.cit.*, 1987, tables 3 and 4, and A. Maddison, *op.cit.*, 1982, table A7.

[32] Eichengreen and Portes, *op.cit.*, table 4.

[33] Maddison, *op.cit.*, 1982, table A7.

[34] Pan-American Union, *The Foreign Trade of Latin America since 1913*. Washington, D.C., 1952, p. 3.

Table 8

LATIN AMERICA: EVOLUTION OF GROSS DOMESTIC PRODUCT IN SELECTED COUNTRIES, 1929-1950[a]

(Annual average growth rates)[b]

Country	Total	Per capita	Tradeables				Non-tradeables			
			Total	Agriculture	Mining	Manufacturing	Total	Construction	Basic services	Non-basic services
Latin America	**4.4**		**3.9**	**2.1**	**5.4**	**5.8**	**5.2**	**6.8**	**6.6**	**4.8**
Argentina	2.3		2.1	0.9	5.6	3.2	2.7	2.5	3.4	2.6
Brazil	3.6		4.0	2.1	3.2	6.4	3.3	...	...	...
Colombia	3.6		3.3	2.3	2.8	8.0	...	3.0	...	...
Costa Rica[c]	8.0		10.1	10.6	...	8.7	5.4	1.8	5.2	5.9
Chile[d]	3.4		2.7	1.9	-1.0	6.1	3.7	3.8	2.7	3.8
Ecuador[e]	6.5		7.3	8.1	1.7	6.0	5.6	7.8	11.3	4.8
Honduras	1.4		0.9	0.3	3.0	4.0	2.9	4.0	3.1	2.6
Mexico	2.4		2.3	2.2	...	2.3	2.3	5.9	3.6	2.1
Paraguay[f]	2.4		2.3	2.2	...	2.3	2.3	5.9	3.6	2.1
Peru[g]	4.5		4.1	3.9	2.1	5.7	4.9	8.6	[h]	4.5
Uruguay[i]	2.8		2.7	2.2	...	3.0	2.9	8.1	2.5	2.6
Venezuela[j]	7.1		5.9	-0.3	9.4	7.5	6.9	12.8	...	...

Source: ECLAC, on the basis of official data.
[a] Unless otherwise indicated.
[b] 1970 prices.
[c] 1946-1950.
[d] 1940-1950.
[e] 1939-1950.
[f] 1938-1950.
[g] 1945-1950.
[h] Included in other services.
[i] 1935-1950.
[j] 1936-1950.

III
The Prebisch thesis

Raúl Prebisch set out to achieve two goals when he published his pathbreaking, but controversial, 1949 study of the economic development of Latin America.[35] These goals probably did not include the founding of a Latin American school of economic thought, although of course he did achieve this; rather, his purpose was to explain the causes underlying Latin America's economic backwardness *vis-à-vis* the industrialized countries and, above all, to persuade his fellow Latin Americans of the rationale for the intervention of the free play of market forces and lay out a policy agenda for the transformation of the economies of the region. Although we would like to, we can scarcely do justice to his contribution here. Instead, we merely propose to analyse briefly the proposition most closely identified with Prebisch —and the one for which he was most attacked—, both in order to suggest the need for a reappraisal of his basic thesis, and to introduce the ideas that were to have such a remarkable influence on economic policy both in

[35] Raúl Prebisch, *The Economic Development of Latin America and Its Principal Problems* (E/CN.12/89/Rev.1). United Nations publication, Sales No.: 50.II.G.2.

Latin America and in other developing countries in the post-war era.[36]

Over the course of the years Prebisch invoked a variety of arguments to explain his much-criticized 1949 finding that a secular deterioration of the terms of trade of the Latin American economies was observable from the mid-1860s to the mid-1930s.[37] However, the explanation he originally developed in his 1949 study is not only the one that has best withstood the test of time, but subsequently became enshrined as the central proposition on which the rent-seeking literature has been built. Paradoxically, however, the sharp controversy over whether the terms of trade of primary producers ever did, or continue to, exhibit a secular deterioration persists to this very day.[38]

Briefly, Prebisch's original explanation of his finding of an apparent secular deterioration of the terms of trade of the Latin American economies turned on the argument that in the centre of the world economy (to use the nomenclature he coined to refer to the industrially most advanced countries), labour and producer coalitions gradually push the domestic prices of products produced in highly concentrated industries, and hence the international prices of these products (as per a realistic big country assumption), above the market clearing levels over the course of successive economic cycles, mainly by successfully resisting the price and wage reductions warranted to maintain in the manufacturing sector (although not necessarily in the economy as a whole) full employment during cyclical downturns, but also perhaps as a result of obtaining price increases in excess of competitive ones during cyclical upturns.[39]

In the periphery of the world economy (to use the term he introduced for the underdeveloped countries), in contrast, the prices of primary products (and of factors) fall *pari passu* with cyclical downturns in the centre, while they increase in consonance with the rise in demand for these products during cyclical upturns in the centre.

The maintenance of the international prices of primary products at market clearing levels over the course of successive economic cycles reflects, according to Prebisch, the historical dearth of effective producer and labour coalitions in the production of primary products at the world level, which in turn stems fundamentally from the worldwide abundance of most natural resources and, in recent years, from the gradual emergence of a structural labour surplus in the periphery. While abundant natural resource endowments in the world economy as a whole preclude the long-run maintenance of significant degrees of concentration in the production of most primary products in the international economy at large (as per a realistic small country assumption), and hence likewise preclude the establishment of supracompetitive international prices for these products in the long run, the structural labour surplus undermines the maintenance of supercompetitive wages in the production of primary products.[40]

Thus, according as the international prices of manufactured goods produced in concentrated industries gradually rise above competitive

[36]In his original analysis of the economic development of Latin America and other studies written by them in the early 1950s, Prebisch made a number of pioneering, but generally overlooked, contributions to what much later became known as open economy macroeconomics. Economists in the United States unwittingly rediscovered, although greatly extended, his early analyses in this field when they finally became obliged to drop the fiction that the United States continued to be a closed economy. As is discussed below, he also pioneered in his 1949 study what later became the central tenet of the rent-seeking literature.

[37]A year after Prebisch, H.W. Singer also published a similar finding in this study "The distribution of gains between investing and borrowing countries", *American Economic Review*, vol. 40, No. 2, May 1950.

[38]See, for example, the recent debate between H.W. Singer and B. Balassa over this issue: H.W. Singer, "The terms of trade controversy and the evolution of soft financing: early years in the U.N.", pp. 275-303, and B. Balassa, "Comment", in *Pioneers in Development*, G.M. Meier and D. Seers (eds.) (Oxford: Oxford University Press, 1984), pp. 304-311. (A World Bank publication.)

[39]For a detailed historical analysis of the spread and distortionary price effects of macroeconomic coalitions in the developed countries, see M. Olson, *The Rise and Decline of Nations: Economic Growth, Stagflation and Social Rigidities*. New Haven, Connecticut, Yale University Press, 1982.

[40]Nevertheless, labour coalitions could push wages above the social opportunity cost of labour within individual countries according as property rights to natural resources are concentrated at the national level, as was discussed in a previous section. The output prices of the product in question would still be determined competitively in the international market, however. In effect, as the recent evolution of the international price of petroleum suggests, the setting of international prices above competitive levels through producer collusion, even for a commodity for which world demand is highly inelastic, would appear to be unsustainable in the long run.

levels over successive economic cycles, while the international prices of commodities remain at competitive levels, the terms of trade of peripheral countries will deteriorate steadily, as long as peripheral countries continue to specialize completely in the production of tradeables in which they possess extraordinary comparative advantage.[41] Prebisch's analysis simultaneously provides an explanation, as he repeatedly noted in his published work and public pronouncements, for the increasing protection of primary producers in centre countries. It is a well-documented fact that subsidies for producers of commodities in the industrialized countries have increased more or less progressively over time.[42] This trend has at the same time exerted an additional and increasingly powerful depressive effect on the international prices of a growing number of commodities simultaneously produced in both the centre and periphery, as declining international prices of these primary products lead to growing subsidization of primary producers in the industrialized countries, which in turn generates excess supplies of these products, further declines of their international prices and additional subsidies.

If the terms of trade for primary products have not in fact generally declined over the years, one might be hard pressed to explain why the extent and scope of protection of primary producers in industrialized countries has expanded so notoriously over the same period. Yet there is no doubt that farm lobbies have gradually become highly organized and active in most developed countries in spite of considerable (but generally declining degrees of) producer dispersion; perhaps this is how they have managed to obtain supracompetitive domestic prices (i.e., *vis-à-vis* international prices) for their products, even though the secular international terms of trade of their produce have not deteriorated.[43] Perhaps what has happened is that during successive cyclical downturns these lobbies manage to obtain compensatory subsidies, which they are able to retain at least partially during successive cyclical upturns. But if this were the case, the excess supplies thus generated, in conjunction with the attendant barriers to imports of these products from competitors in the periphery, would necessarily lead to a gradual secular decline of the international prices of these primary products.

We have thus come full circle to Prebisch's argument. In effect, even if a secular decline in the terms of trade of primary products did not trigger the progressive expansion of the incidence and scope of protection of primary producers in the industrialized countries, the progressive growth of these subsidies as a result of the lobbying activities of farm coalitions would engender an ongoing deterioration in the international prices of these commodities *vis-à-vis* the competitive levels that would obtain in the absence of protection. In this case, Prebisch's seminal analysis of the impact of producer coalitions in the manufacturing sectors in the centre is equally applicable to the repercussions of farm coalitions in the centre, with the difference that the former push both the domestic and international prices of manufactured products above competitive levels, while the latter inflate the domestic prices of commodities in the centre above the competitive international prices of those same goods but depress their international prices below the competitive levels. This evidently is why Prebisch refrained from lumping together

[41]Contrary to the mistaken assertions of some of his critics, Prebisch did not adduce from this underlying argument, nor from the data that seemed to show a secular deterioration in the terms of trade of Latin American countries from the mid-1860s to the mid-1930s, that the terms of trade of peripheral countries would permanently deteriorate over time. One countervailing tendency of course stemmed from competition among industrialized countries. The other issued from his normative analysis. In effect, he urged the periphery to industrialize precisely to check the secular deterioration of their terms of trade.

[42]See, for example, A.M. Baliscan and J.A. Roumasset, "Public choice of economic policy: the growth of agriculture protection", *Review of World Economics*, 1987, pp. 232-249, and B. Heitger, "Import protection and export performance. Their impact on economic growth", *Review of World Economics*, 1987, pp. 249-261.

[43]Note that the rise of effective national coalitions of farm producers does not invalidate our assertion that the abundance and dispersion of producers on a world scale prevents the maintenance of, if not attempts to form, effective international coalitions of commodity producers.

primary producers in the centre with primary producers in the periphery.[44]

Following Prebisch's original analysis, we have thus traced the genesis of international price distortions and suggested how they may account directly for a considerable part —perhaps the lion's share— of the domestic output price distortions prevailing in Latin America from the 1930s to the mid-1950s, when domestic trade and macroeconomic policies considerably augmented the incidence of output price distortions in the region's economies. Prebisch's analysis again becomes especially relevant in the 1980s, as will be discussed on another occasion.

In contrast to domestic policy-induced output price distortions (the effects of which are essentially limited to internal income transfers if the repercussions of rent-seeking activities are ignored), those provoked by international price distortions like the ones traced above directly inflict a proportional income loss on the periphery. Moreover, this income loss may generate spillover effects on output, since such non-market clearing prices would prevent the maintenance of full employment, unless nominal prices of non-traded goods and services were sufficiently flexible in a downward direction. Alternatively, inflation may result, if adjustment has to be pursued by raising the nominal exchange rate to contend with the prevalence of coalitions. By way of contrast, these international price distortions likewise entail internal income transfers in the centre but translate into a proportional income gain (at the expense of the periphery), which explains why non-market clearing prices may not generate significant unemployment there, although they may occasion inflation. Once the dynamic ramifications of price distortion emerge, however, the output and employment responsiveness of the central economy will gradually be curtailed. Endogenous policy-induced distortions would of course further weaken economic performance in the periphery.

Prebisch's 1949 study of the economic development of Latin America thus presents a pioneering analysis of the implications of the interaction of a fixed-priced sector with a flex-priced sector, in a unified world economy. Moreover (and in contrast to Keynes, for example), his analysis is anchored firmly in a microeconomic explanation of the sources of output and factor market distortions.

The similarities between Prebisch's 1949 paradigm and Olson's celebrated theory of the rise and decline of nations published 33 years later is striking.[45] One main difference stems from the fact that whereas Prebisch focused on the interaction of a downwardly-inflexible-price centre with a flex-price periphery, Olson cast his analysis in terms of fixed and flex-price sectors within individual economies. And although Olson developed a much more rigorous and comprehensive treatment of the microeconomic foundations of macroeconomic coalitions, the decidedly open-economy macroeconomic flavour of Prebisch's analysis was likewise way ahead of its time.

But was Prebisch right? If one were to judge his proposition on the basis of the rationale for the rewards bestowed by the Nobel Prize Committee for creative economic thought, the answer would be yes, since in 1985 J. Buchanan won the Nobel Prize in economics for his seminal contributions to the public choice branch of the rent-seeking literature —contributions which, like many others made to the rent-seeking literature, do not look so pioneering once one reads Prebisch.[46]

[44]Of course, once a former peripheral country rises to the ranks of the industrialized countries, one would eventually expect to observe subsidization of primary producers in that country as well. Japan, and recently Korea, of course come to mind here. See, for example, M.V. Martin and J.A. McDonald, "Food grain policy in the Republic of Korea: the economic cost of self-sufficiency", *Economic Development and Cultural Change*, vol. 34, No. 2, January 1986, pp. 315-331.

[45]M. Olson, *op.cit.*, 1982.

[46]Consider, for example, the following: "Our assertion that markets in excess-supply disequilibrium imply unemployment of resources requires elaboration. In general equilibrium analysis, the normal assumption is that the excluded group will leave the activity and undertake other activities; barriers to entry misallocate resources, but they do not create unemployment. In our coalitional equilibrium, individuals remain involuntarily unemployed, in that they would be willing to accept a job at the same wage that some others with the same endowment of human capital as they have are currently receiving, and even at the marginal revenue product they would have in a coalition-free economy, but sometimes they cannot obtain such a job however much they may search. As Olson (1982) explains, countries in which only a small segment of the economy has fallen under the thrall of special-interest groups will normally not have any significant unemployment, because the much larger

On the other hand, the tally of pro and contra articles on the Prebisch thesis is heavily weighted against his empirical finding of a secular deterioration in the terms of trade of Latin America from the 1860s to the 1930s.[47]

Rather than get bogged down in that debate, let us consider what the evolution of Latin America's terms of trade between the Great Depression and the present crisis looks like. Between 1928 and 1987 the trend rate of change of the price index of Latin America's merchandise exports was -0.3% per annum, while the trend rate of change of the unit value of its merchandise imports was +0.25% per annum. Its gross barter terms of trade therefore deteriorated at the rate of 0.55% per year over the course of this period (see table 2).

Are six decades long enough to speak of a secular deterioration of the terms of trade of the Latin American economies? If not, how does one explain the fact that beginning in the early 1980s authorities like the International Monetary Fund promoted massive adjustments in developing countries partly on the basis of the assertion that the deterioration of the terms of trade they had experienced since the mid-1970s was in the nature of a permanent shock?[48]

Returning to the long run data on Latin America's terms of trade, it should also be noted that the observed deterioration would have been even greater had the region not followed the normative proposition Prebisch derived from his positive analysis, i.e., the promotion of industrialization through the intervention of the free play of market forces. This observation brings us to our final and most important comment on the Prebisch thesis.

In effect, while we consider that Prebisch was on the mark in his positive analysis, the appeal of his approach, combined with his almost exclusive concern with one periphery rather than with the small country aspect of the problem, led to multiple and pronounced policy excesses in Latin America in the post-war years. However, if justice is to be done, it should be noted that he himself was one of the earliest and harshest critics of policies that, ironically, were based (however tenuously) on his analysis.

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flex-price sector will absorb the unemployed with no great reduction in the wages and prices in that sector. If large parts of a country's economy are, by contrast, under the control of distributional coalitions, the exclusion in the controlled sectors will have kept an important part of the factor supply in the whole economy from being employed in the sectors in which they would otherwise have been employed. The shift of resources to the flex-price sector will then be so great that large variations in the returns to homogeneous factors will emerge. So many people will be crowded into the selling apples on the street corners sector that employment in this sector can in depressions come to be regarded as synonymous with involuntary unemployment. At an extreme, the flex-price wage can be driven below the reservation wages of even the relatively industrious, or even to zero.

"The more extensive the special-interest groups and the non-market-clearing prices that lobbying and cartelization bring about, the more extensive are the disparities in the rates of return for homogeneous resources. The greater these disparities, the more it pays to invest in searching and queueing for positions in the distributional coalitions. The extra search in such a case is not, like the search in a purely competitive economy, a socially efficient investment in information; it is a search for rents that would otherwise accrue to others. The extra time spent searching and queueing is a type of social waste or involuntary unemployment arising from the distributional coalitions that created the disparities in rates of return." (D.C. Colander and M. Olson, "Coalitions and macroeconomics", *Neoclassical Political Economy: The Analysis of Rent-Seeking and DUP Activities*. David C. Colander (comp.), Cambridge, Mass.: Ballinger Publishing Company, 1984, pp. 120-121.)

[47]"Two of the main objections are that Prebisch indirectly calculated Latin America's terms of trade on the basis of those of the United Kingdom (i.e., as the reciprocal of Great Britain's terms of trade), and that he failed to take into account the effect of the decline of international transportation costs over the course of this period.

[48]See, for example, "A Conversation with Mr. de Larosière", *Finance and Development*, vol. 19, No. 2 (June 1982), pp. 4-7 and M. Khan and M. Knight, "Determinants of current account balance of non-oil developing countries in the 1970s: an empirical analysis", *IMF Staff Papers*, vol. 30, No. 2 (December 1983), pp. 819-842.