

---

# C E P A L

## REVIEW

NUMBER 65  
AUGUST 1998  
SANTIAGO, CHILE

OSCAR ALTIMIR  
*Director of the Review*

EUGENIO LAHERA  
*Technical Secretary*



## CONTENTS

<b>Income distribution, poverty and social expenditure in Latin America</b> <i>José Antonio Ocampo</i>	7
<b>Military expenditure and development in Latin America</b> <i>Eugenio Lahera and Marcelo Ortúzar</i>	15
<b>Growth, distributive justice and social policy</b> <i>Andrés Solimano</i>	31
<b>Equity, foreign investment and international competitiveness</b> <i>Adolfo Figueroa</i>	45
<b>Tensions in Latin American structural adjustment: allocation versus distribution</b> <i>Daniel M. Schydrowsky</i>	59
<b>Competitiveness and labour regulations</b> <i>Luis Beccaria and Pedro Galín</i>	71
<b>Latin American families: convergences and divergences in models and policies</b> <i>Irma Arriagada</i>	85
<b>Free trade agreements and female labour: the Chilean situation</b> <i>Alicia Frohmann and Pilar Romaguera</i>	103
<b>Macroeconomic trends in Paraguay from 1989 to 1997: consumption bubble and financial crisis</b> <i>Stephane Straub</i>	119
<b>The strategies pursued by Mexican firms in their efforts to become global players</b> <i>Alejandra Salas-Porrás</i>	133
<b>Regulating the private provision of drinking water and sanitation services</b> <i>Terence R. Lee and Andrei S. Jouravlev</i>	155
<b>Quality management promotion to improve competitiveness</b> <i>Hessel Schuurman</i>	169
<b>Recent ECLAC publications</b>	

# Tensions in Latin American *structural adjustment:* allocation versus *distribution*

Daniel M. Schydrowsky

*Professor of Economics,  
The American University,  
Washington, D.C.*

In the economic history of Latin America, a growing population demanded jobs; creating more jobs required industrialization; and industrialization made it necessary to cover a productivity differential. There were two feasible options for this purpose: i) to preserve allocative efficiency and generate a major regressive income redistribution process; or ii) to lose allocative efficiency but leave the distribution of income largely unchanged. Governments chose the latter and built in lasting distortions in the foreign exchange market. Import substitution industrialization ended in stagnation. Increased pressure in the labour market could have driven wages sharply downward, but instead the informal market arose and, thanks to its monopolistically competitive structure, segmented the goods markets and ensured a minimally acceptable form of income distribution. No government policy was involved. The market generated a "natural" safety net on its own. However, allocative efficiency was sacrificed and lasting distortions were built into the labour market. Financial development could not keep up with the new needs, and capital market segmentation further reinforced the distortions in the price system. Structural adjustment policies removed some of the price distortions in the foreign exchange and credit markets, and redistribution of property over the years changed the distributive consequences of relative price changes. However, with structural adjustment came an inflow of capital that generated substantial currency over-valuation, while the split in the labour market persisted, affecting even more workers than before. In turn, trade liberalization has shown up on the books of the banks as weakened collateral and bad debts of companies now deprived of protection by lowered tariffs and an overvalued exchange rate. The market price system hence does not provide anywhere near the correct signals for a good allocation of resources. The need to earn some income continues to drive the growth of the informal sector, while domestic capital and labour eye foreign investment with ambivalence, uncertain as to whether it is friend or foe.

# I

## Introduction

Tensions between allocation and distribution in the context of economic growth have traditionally given rise to two main lines of inquiry. On the one hand is the set of concerns summarized by the Kuznets curve: is an initial rise in inequality in the first phase of growth unavoidable, or can it be mitigated or even completely eliminated by a suitable policy mix?

The second line of inquiry has focused on differential saving rates: if the rich save more than the poor, then inequality will produce faster growth than equality. The policy challenge, then, is either to find forms of intervention that can equalize the saving rates or, failing that, to generate sufficient public saving to offset any negative effects arising from greater equality.

A potential conflict between allocation and distribution already exists, however, even in a static context. It is well known that Pareto-optimality does not guarantee distributional acceptability. At the same time, attempts to correct distributive effects by policy interventions almost inevitably distort the efficiency of resource allocation.

The existence of tensions between distribution and allocation during structural adjustment in an economy is thus almost to be expected on *a priori* grounds.

In the Latin American context, the importance of distribution has been highlighted in a number of respects. First, there has been extensive research literature on income inequality in the hemisphere which generally concludes that Latin America has on the whole been much more unequal than other developing areas of the world, particularly Asia. Second, the role of distribution has been high-

lighted as a driving force behind the creation of the traditional social safety nets: public wage setting mechanisms, legislation on fringe benefits, protection of unions, social security legislation, etc. Third, distributive considerations have been identified as integral elements in Latin America's inflationary processes. While some authors have regarded a number of notable cases of Latin American inflation as being the result of distributive fights between different organized sectors of society, there is quite widespread agreement that indexation, both implicit and explicit, has been due to attempts to insulate distributional shares and real incomes from the corrosive effects of inflation.

The purpose of this paper, however, is to focus on quite a different range of topics. It is intended to look at the effects of distributive concerns on the pattern of sectoral specialization, whether explicitly as a result of government policy or implicitly through the functioning of the price system.

We will begin by exploring how fundamental distributive concerns shaped industrialization policy and thereby determined the course of import substitution industrialization (ISI) in Latin America. We then proceed to examine how distributive concerns play themselves out spontaneously in the price system during stagnation, thereby determining the initial conditions for the structural adjustment phase. We go on to examine this latter phase to find out to what extent the earlier tensions continue to exist or have been left behind. Some new sources for distributive tension are also explored. The concluding section provides a summary overview of the above sequence and the arguments put forward.

---

□ An earlier version of this paper was presented at the Southern Economics Association Meetings in Washington, D. C.

## II

### The active industrialization phase

That the various Latin American countries are different is a commonplace. Despite all the differences, however, there is a common pattern to Latin American economic development which is usefully captured in a set of stylized facts. We will ascribe this stylized reality to "Latinia": a "typical Latin American country".

Before active industrialization took place (generally speaking, in the early post-World War II years) Latinia was a country where the principal economic activities were agriculture and mining, both largely for export, although some agriculture was devoted to satisfying domestic food consumption; where industrial products were largely imported, and where the exchange rate was set at a level enabling traditional exports to compete in world markets, while import duties were largely motivated by the need to obtain revenue for the treasury. Export production was concentrated in fairly large units, which were owned by a small number of people, most of them part of the country's elite, which also tended to take turns in governing the country. In addition, some export activities were owned by foreign investors.

Industrialization was driven simultaneously from below and from above. From below came population pressures, fed largely by dramatic improvements in public health. A rapidly growing labour force could not be accommodated in agriculture or mining, since the natural limitations of the mining sector and the declining marginal product of labour on the land set severe limits to the number of additional people who could be employed in the traditional sectors.

Industry, on the other hand, was only subject to man-made limitations to its employment potential. With sufficient replication of factories, any number of additional workers could be employed. Thus, a growing labour force which demanded work presented a cogent argument in favour of industrialization to the ruling elites, who certainly wanted to avoid having their boat rocked.

From above came the concept of modernity. The elites recognized that modern countries were virtually synonymous with industrial countries. Wanting their countries to be modern, therefore, required

industrialization. Since the pressures from below and from above coincided, there was no reason for Latinia's government to resist industrialization as a development strategy.

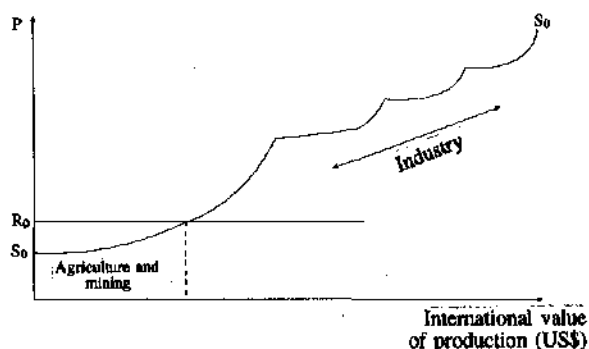
However, developing industry in Latinia meant moving up the comparative advantage cost curve to higher-cost activities. Industrial processes had a higher cost than traditional agriculture and mining for a number of reasons: a) they were new activities, and therefore (during a learning period at least) they were going to have a higher cost than the ones in which the country had experience; b) industrial processes have economies of scale, and Latinia's markets were small, so that once again costs would initially be high; c) new industry would require supplier industries, which were non-existent, therefore making domestic production more expensive, as a natural consequence of the systemic nature of an industrial system; d) infrastructure was not oriented towards industrial production but towards agriculture and mining exports; e) consumer preferences were strongly in favour of imported goods, which were presumed to be of better quality, therefore requiring an artificial price discount on domestic production. In addition, industrial production would involve activities subject to advanced labour legislation, with rules on maximum hours to be worked, minimum wages, fringe benefits, social security, bargaining rights for workers, unions, etc., most of which were not applicable to agriculture and to small- and medium-scale mining.

All these features generated a perceived requirement for the adoption of policies to make the new industrial production competitive.<sup>1</sup>

The problem faced by policy-makers is illustrated in figure 1. The curve SS is the aggregate supply curve showing the cost differentials between the primary sectors of agriculture and mining and the new industrial sectors.  $R_0$  is the level of the exchange

<sup>1</sup> Note that the idea that infant industry protection is really a second-best alternative to perfecting the capital market so that the private sector can finance its own risk-taking was far too sophisticated an argument for the policy-makers of the time to have even remotely considered it.

FIGURE 1



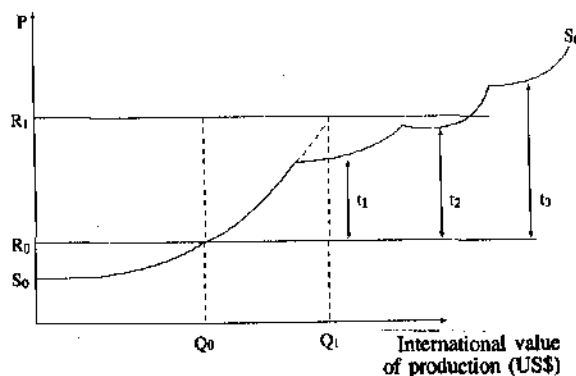
rate, measured in pesos per dollar, which stands at a level which allows traditional production to continue exporting but at the same time is too low to allow the new industrial production to compete with imports. Accordingly, production takes place only on the part of this supply curve corresponding to the primary sectors. The policy problem is how to make the industrial activities competitive.

In these circumstances, Latinia's government has basically three options: i) general devaluation, ii) selective devaluation, or iii) compensated devaluation. Let us explore each one in turn with the aid of figure 2:

i) General devaluation: Under this option, the exchange rate  $R_0$  is devalued to  $R_1$ , giving a larger number of pesos per dollar. Netting out any cost push effect of the devaluation in figure 2, it can be seen that with  $R_1$ , a number of industrial activities become competitive. Moreover, there is expansion of primary production as primary producers move up the cost curve. At the margin, the productivities of the primary and industrial sectors are equal; therefore, there is efficiency in the allocation of resources. In addition, however, there is a massive redistribution of income, as the intra-marginal producers of primary goods obtain significantly greater income for the quantity they originally produced. This additional income comes, directly, from the buyers of food on the domestic market and, indirectly, from the higher exchange rate which leads to higher prices of imported goods for all consumers. In consequence, with a general devaluation, owners of mining and agricultural enterprises obtain a substantial transfer of income from all consumers.

ii) Selective devaluation: This alternative involves raising only the exchange rate corresponding to imports competing with the products to be pro-

FIGURE 2



duced domestically. Under this alternative, domestic production is made competitive with imports by levying import duties which effectively devalue the exchange rate only for the products for which protection is desired. In terms of figure 2, the general exchange rate stays at  $R_0$ , but tariffs are levied on the importation of industrial goods,  $t_1$  and  $t_2$ , in order to cover the cost differentials for those particular products. Under this alternative, there is no expansion in the production of the primary sector and as a result marginal costs of production are different between the primary and industrial sectors, which signifies inefficiency in production. However, there is only a minimal income distribution effect, for in this case the original producers of mining and agricultural goods do not receive any windfall gain. The only redistribution that exists is between buyers of the newly protected domestically produced goods and their producers. This means mostly that high and middle income consumers pay higher prices for goods produced by lower middle class workers and high-income capitalists.<sup>2</sup>

iii) Compensated devaluation:<sup>3</sup> In this case, the exchange rate is devalued as in a general devaluation, from  $R_0$  to  $R_1$ , but import duties are reduced by a similar amount and taxation is levied to pick up the windfall received by primary exporters. In the simple version of compensated devaluation, an export tax is

<sup>2</sup> Low-income consumers are also affected by the higher prices, but in a much smaller proportion, since proportionately they do not consume as much of these kinds of goods.

<sup>3</sup> First proposed by Marcelo Diamand of Argentina in CARTTA (1966), independently proposed by Schydłowsky (1967), later adopted with some changes into the mainstream by Balassa (see Balassa and others, 1982).

levied on traditional exports in order to keep the net exchange rate for traditional exporters at  $R_0$ . In another variant, a Ricardian property tax is levied, designed to pick up the windfall revenue only on preexisting production. In either case, redistributive effects are kept to an absolute minimum, while efficiency of allocation is achieved through a land tax but not an export tax. A final element of the package consists of a mechanism for returning to consumers the additional cost of buying traditional goods resulting from the devaluation which cannot be compensated for by import duty reduction or by export taxation. It follows that compensated devaluation is considerably more complex to design and administer than the other two options.

Seen from the perspective of any government of Latinia at that time, the obvious choice was alternative ii), protection. Alternative iii) was not even within the set of options, since it was far too complex in design, administration and execution. Alternative i) could have been feasible, but even an elite government of Latinia would have been reluctant to undertake a measure so obviously leading to concentration of income, let alone more labour based governments such as those of Perón in Argentina or Vargas in Brazil.<sup>4</sup> Thus, country after country in the hemisphere implemented the stylized logic of Latinia: raising tariffs in order to make the new industrial production competitive with imports.

Once the policy was set, all the well-known consequences of import substitution industrialization began to fall into place:

i) Anti-export bias restricted the new industry to the domestic market;

ii) The "Inefficiency Illusion" made sectors competing with imports appear more inefficient than they really were;<sup>5</sup>

iii) Partly because of the "Inefficiency Illusion", export promotion was mostly weak, with the notable exceptions of Brazil and Colombia, and as a result more import substitution had to be undertaken behind still higher tariffs if further foreign exchange was to be saved;

iv) Vulnerability to balance of payments fluctuations increased, as imports became progressively more essential;

v) Foreign exchange availability determined the business cycle;

vi) Borrowing was undertaken to increase foreign exchange availability, but in the absence of structural changes in relative prices and in the market orientation of production such borrowing only repressed the symptoms; expansion took place, while the foreign exchange borrowed was used to pay for imports, but then came the crash, made even greater by the need to service the debt.

The structure of production in the traditional economy and the differences in comparative advantage between traditional production and industrial activities gave rise to an underlying policy requirement induced by the desire to minimize distributive consequences. The effect was a trade policy which ultimately produced the stagnation in what has become known as the "lost decade" of the 1980s.

### III

#### The stagnation phase

While economic growth ground to a halt, the same did not occur with population growth. New workers continued to enter the labour market but had ever-increasing difficulty in finding jobs. Unable to find wage employment, workers became self employed for want of a better alternative. In essence, they

migrated from the labour market to the goods market. Initially they became street vendors and began to compete with established businesses by differentiating the product: they offered different locations (traffic lights, customers' homes), different packaging (unwrapped, so that customers could examine the merchandise), and even different forms of sale (bargaining instead of fixed prices).

<sup>4</sup> Pedro Beltrán, who acted as effective Premier under the second Prado administration in Peru (1956-1962), brought in the legislation that systematically raised protection to stimulate industrialization.

<sup>5</sup> See Diamand (1973) and Schydrowsky (1972).

The market structure corresponding to this part of the economy was monopolistic competition, with its two characteristics: price equals average cost, and excess capacity exists (see Chamberlain, 1933). In this informal market, total cost equals cost of material plus cost of living. Moreover, since the cost of living is a fixed cost to be spread over the number of units sold, this generates a classical downward-sloping cost curve, with marginal cost below average cost. In turn, excess capacity takes the form of underemployment of labour.

As the population continues to grow, more and more individuals crowd into the informal sector. Three responses then occur: i) there is innovation in the informalization of new sectors, new geographical areas and new products (e.g., car silencers are repaired on the street, informal clothing manufacturers sell their products informally); ii) the segmentation of already existing informal sectors increases, lowering each individual's market share, as foreseen by Chamberlain; and iii) there is a downward adjustment of the target cost of living, accommodating to the straitened market circumstances of participants.

As a result of the combined effect of these adjustment mechanisms, the monopolistically competitive sector of the economy grows, underemployment is rife, market "wages" are increasingly different from the marginal cost of labour, and the non-fulfillment of the Pareto conditions in the economy becomes more firmly anchored.

The development of an informal sector operating with a market structure based on monopolistic competition is a natural adaptation to distributive requirements. With competitive markets, labour income would fall precipitously. Legislation prevents this from happening in the formal sector, but evasion of the rules or their avoidance through informalization could lead to such income falls. In contrast, monopolistic competition spreads the available income. At the same time, the informal sector transfers some income away from the formal sector by product differentiation and even somewhat relaxes the macro foreign exchange constraint by shifting the product mix towards goods whose production is less intensive in foreign exchange. Thus, distributive requirements critically affect the mix of output and the choice of technology. But this occurs spontaneously, by market response. Along the way, the price system becomes firmly distorted, with a strong wedge installed between market wages and the marginal cost of labour.

Developments in the financial market interact with this modification of the productive structure of the economy. During the pre-industrial phase, extending credit is a highly personalized activity. In this phase bankers know most of their clients personally or are even related to them. Borrowing and lending occurs within a small elite where reputation is all-important. Moreover, the purpose of credit is typically a simple business transaction, most usually in the import or export trade.

During the period of active industrialization, the nature of credit changes. Extending credit becomes depersonalized, as banks grow and bankers hire loan officers, whose loss function is asymmetrical in the sense that whereas the banker risks his own money, the loan officer risks somebody else's. A bad loan will get him fired, but not making a good loan will not be noted. Thus, credit is extended in this phase in a much more risk-averse fashion. At the same time, borrowers are no longer known to the lenders. They no longer went to the same school, there are now too many of them to have family relationships or to have widely known reputations. Furthermore, the type of venture for which lending occurs is now much more long-term and much more complicated: for example, industrial production. As a result, collateral becomes the essential element in credit. With no collateral, no credit is extended. This introduces a very clear segmentation between those individuals who have assets to pledge and those who do not.

As stagnation takes place and the economy becomes increasingly informalized, credit is available principally to the formal sector. Members of the informal sector have no collateral, whereas formal firms do. However, the stagnation affects the quality of the collateral of formal firms. First, their cash flows cease to grow because of the stagnation. Second, their cash flows often shrink as a result of the inroads which the informal sector makes on formal markets. Deteriorating cash flows on the part of borrowers translate first into deteriorated collateral, and thence into an increasing number of bad debts. Banks react at first by rolling over credits, expecting things to get better. But as the stagnation lasts, the unpaid bad loans form an increasingly large proportion of the portfolio, ultimately putting the banking system under severe stress.

"Credit layering" is a mechanism by which credit can be transferred from the formal to the informal sector, using as intermediates those formal firms which sell products to the informal vendors. However, the scope



for this is very limited. First, a major part of the informal sector has no stable connection with specific formal firms. Second, the majority of informal vendors have no collateral to pledge: they may be here today and gone tomorrow, prefer to deal in cash, and constitute significant risks to the firms selling to them. For layering to acquire substantial momentum requires a change in the basis of credit. Rather than lending against the security of the collateral, lending (and repayment) must be based on the incentive of gaining access to ever-greater credit as a good payment record is accumulated. In other words, the credit function has to evolve from one based on guarantees to one based on incentives. This has indeed occurred in a number of cases, but it takes a long time to permeate the whole economic system.<sup>6</sup>

The evolution of the capital market described above has two major impacts of macro importance:

i) The access to credit in different quantities and at different prices by the formal and informal sectors reinforces a technological dualism which is quite independent of any labour market legislation. The result is two different labour income levels and two different decision structures.<sup>7</sup> The distribution of credit thus helps to anchor significant distortions in the price system.

ii) The deterioration in the portfolio of the banking system implies an increased operating cost which is not fully recognized on the books of the banks. Accordingly, the true cost of lending in the economy goes up. This is accompanied by an increase in the perceived country risk on the part of foreign investors, which raises the price at which the country re-

ceives capital inflows. Both internal and external factors, then, work to generate domestic interest rates well above international levels. Such capital costs, in turn, affect the international competitiveness of domestic production, consequently weakening the balance of payments, and this feeds back into the system in the form of a lower level of activity, greater informalization and further weakening of formal-sector firms and their banks.

At this point, the price system is affected by distributive factors in its major markets:

i) The foreign exchange market has been segmented by a system of *de facto* multiple exchange rates, constituted by a single financial rate and a large number of "product" or "commodity" rates, due to the existence of a diversified tariff and trade tax structure;

ii) The labour market is severely affected by the difference between the average return to labour in the monopolistically competitive sector and the marginal cost of labour at large, as well as by the increasingly irrelevant but none the less durable labour legislation;

iii) The capital market is deeply segmented due to the requirement that collateral must be provided in order to obtain loans and the weakness of layering.

With the interdependence of markets in the General Equilibrium, it is clear that no market price equals its respective shadow price. Allocation by the market will hence not be Pareto-efficient. However, there is no guarantee that distribution will be satisfactory either, although the structure of the labour market acts as a market-produced safety net.

## IV

### The structural adjustment phase

Structural adjustment policy consists of a basic package of measures intended to correct the existing distortions and composed of the following elements:

- i) Trade liberalization (almost free trade, e.g., low tariffs and no export subsidies);
- ii) A freely floating, "equilibrium" exchange rate;

- iii) Market interest rates;
- iv) Little or no government intervention in markets;
- v) Fiscal balance;
- vi) Privatization;
- vii) Labour market flexibilization.

For our purposes, the most critical elements of this package are in the foreign trade policy area. Almost-free-trade with a flexible exchange rate translates in effect into low tariffs and a high exchange

<sup>6</sup> For a highly illuminating description of the different phases of development of the financial system and its interaction with events in the real economy, see Otero, 1996, section 5.

<sup>7</sup> See Ramos (1980) and Mezzera (1981).

rate. In this sense, it is virtually the same as the general devaluation solution which the Latin American countries failed to adopt in the early stages of their active industrialization phase. The following question then arises: If such a policy of low tariffs and high exchange rates was not adopted in the active industrialization stage because it was not distributionally acceptable, what has happened in the intervening years to make it a feasible policy now?

The answer comprises two kinds of effects: i) differential changes in the productivity of sectors, and ii) changes in the structure of ownership of resources.

Productivity in the different sectors of production of the Latin American economies changed at different rates as a result of a number of interacting factors:

i) Learning by doing: firms move down the learning curve as they gain experience. Since there was more to learn in the newer industrial activities than in the older, more established, primary ones, productivity grew faster in the industrial sectors than in the long-established primary activities;

ii) Export market penetration: Latin American firms learned to market their exports in a number of sectors in which they were originally not capable of selling abroad. This means that they received higher effective FOB prices, which is equivalent to greater productivity per factor unit deployed.

iii) Freight rates and communications costs declined: an independent factor which has raised effective FOB prices and lowered CIF prices for a whole range of products. In addition, as the nature of ocean transportation changed from an emphasis on general cargo to containerization, the relative cost of shipping non-bulk, non-primary commodities came down, translating on balance into higher effective productivity of industrial production.

iv) Violence and insurrection affected rural sectors in a number of countries, notably Peru, El Salvador, Nicaragua, and parts of the jungle areas of Bolivia and Colombia. Such violence increased the cost of production in the primary sectors, making them relatively less productive compared to the more urban industrial sectors.

v) New crops were introduced in some countries, ranging from coca products to kiwi fruit. Although some of these crops were illegal, they helped to establish highly profitable, high-productivity new activities in the primary sector.

The combined effect of all these elements was to flatten the aggregate supply curve, lowering the productivity differentials between the different sectors. This is shown in figure 3, which also shows, for comparison, the original supply curve from the beginning of the active industrialization phase.

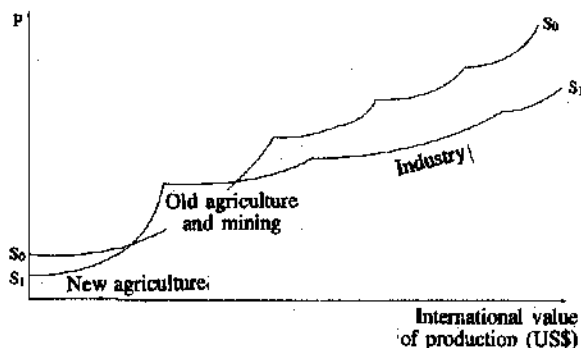
Changes in ownership, for their part, took two main forms:

i) Agrarian reform: in many Latin American countries, systematic efforts were undertaken to transfer the lands of large agricultural estates to smaller producers, and in some instances to cooperatives or producers' associations. More recently, there has been a move to encourage the active functioning of agricultural land markets.

(ii) Mining properties: both metal ore and petroleum extraction activities were systematically transferred to State ownership, most often from foreign owners but frequently also from large domestically owned enterprises. This nationalization had the effect of transferring the profits of a large part of the primary sector to the State, in a manner analogous to what would have been achieved with a 100% tax on the profits of primary producers. In effect, this system implemented a part of the windfall recovery scheme which could have been implemented in the early active industrialization phase through compensated devaluation, but which was beyond the administrative capacity of the time.

When both of these changes are taken together, we find that an almost-free-trade policy under present circumstances would generate a smaller income redistribution effect than in earlier years, and that this redistribution of income would benefit a wider ownership group in agriculture and mainly the State in

FIGURE 3



the mining sector. In consequence, the distributional objections against a low tariff, high exchange rate policy have largely been dissipated. It would therefore appear that a policy which was rejected on distributional grounds several decades ago would indeed be feasible now.

The reality of structural adjustment, however, has been somewhat different from the theoretical predictions. Rather than a low tariff with a high exchange rate, the reality has been a low tariff with a low exchange rate, as indicated in figure 4. The low exchange rate has been the consequence of substantial capital inflows pursuant to a dramatic reduction in the perceived risk of investing in Latin America, as a result of the policy turnaround signified by the adoption of structural adjustment packages, together with the attractive investment opportunities offered by the privatization of public utilities and the high interest rates obtainable in the financial sector.

The lower effective exchange rates have interacted with interest rate liberalization and labour market flexibilization to produce a number of consequences:

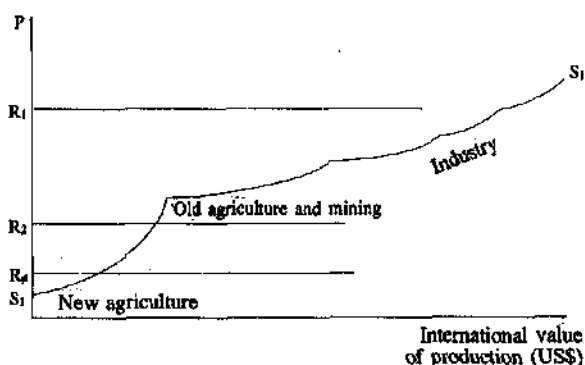
i) The low exchange rate has made a wide range of domestic products uncompetitive. This can readily be noted in figure 4.

ii) As a consequence of the foregoing, an increased number of people have been driven into the informal sector. To the extent to which this sector was able to accommodate this increasing population, through informalization of a greater number of activities, through geographic expansion, or through reduction in target cost of living levels, the gap between the market wage and the marginal cost of labour became still wider.<sup>8</sup> However, in some instances (e.g. Argentina) the informal sector was not able to absorb the influx, and high rates of overt unemployment resulted.

iii) The pressure of foreign competition on formal enterprises due to low tariffs, along with the rise in interest rates following liberalization of domestic capital markets, seriously weakened formal company finances, and this, in turn, weakened the quality of the assets held by the banks and increased their bad loan portfolio. A further consequence was to reduce the capacity of the banking sector to innovate in order to provide the dynamic part of the informal sector with the appropriate depository and credit instruments.

<sup>8</sup> Note also, however, that the reduction in the target income reduces the ratio of market income to the shadow price of labour.

FIGURE 4



iv) The stresses affecting banking systems led to the closure of financial institutions and, in some cases, to losses on the part of depositors.

v) Weakened formal-sector companies sold out to foreign private investors or went bankrupt, thereby making space for new foreign-owned businesses to replace them.

vi) Labour market flexibilization had little impact, since the formal sector was suffering substantial shrinkage, and most of the action took place in the informal sector, where labour market legislation either did not apply or was not effectively implemented.

Parallel to these developments, the privatization programmes generated their own dynamics. Large privatizations were principally of public utilities, which because of their size had perforce to be acquired by foreign investors, or at least by consortia with large foreign participation. Such investors, however, were well familiar with past experience in which government regulated their prices and constrained their profits. Therefore, in this round of privatization, investors made sure that adequate protection was provided in the terms of sale against domestic inflation and/or devaluation and exchange control. In essence, they obtained indexed returns in foreign currency. This created a direct link between the level of activity and profitability in the non-tradeable sector and the outflow of profits on the balance of payments. A similar phenomenon took place in the non-tradeable segment of the private-sector economy, where foreign private investment significantly expanded its share in activities such as retailing (par-

ticularly supermarkets). Here, too, the level of activity and the attendant profitability became directly connected with the outflow of profit remittances on the balance of payments.

The inflow of foreign private investment has therefore given rise to three different important effects:

i) An exchange rate level which is overvalued with regard to the long-term equilibrium rate consistent with the low tariff regime;

ii) A new distribution of property holdings, which may well be the harbinger of future distributional disputes;

iii) A dynamic whereby domestic economic expansion leads to greater profitability of the non-tradeable sectors, which leads to a greater outflow of foreign exchange in terms of remittances, which in turn limits the expansion on the balance of payments side. This amounts to a new form of the old foreign exchange constraint on Latin American growth.

At this stage of the structural adjustment phase, the old distributional problems are interacting with the expectations raised by the structural adjustment policy itself to produce a new set of allocation problems: the capital inflows have generated an exchange rate which does not correspond to long-term balance of payments equilibrium, nor does it accurately reflect either the marginal social cost or the marginal social benefit of foreign exchange in the present. In

the labour market, the informal sector continues to drive a wedge between market wages and the marginal cost of labour, while in the capital market, the combination of collateral requirements and the accumulated weakness of formal-sector firms means that interest rates do not effectively capture the marginal social productivity of investment nor the marginal social cost of savings. No market price reflects the true partial equilibrium of the corresponding market. Even less do market prices reflect the underlying general equilibrium levels of shadow prices.

Moreover, the allocation biases operate in a direction tending to delay convergence towards a more efficient price system. Since the value of foreign exchange is understated and the market cost of labour overstates its true scarcity, production activities will tend to underproduce and overuse foreign exchange while underusing labour. Hence the secular foreign exchange scarcity will be overcome at suboptimal speed, while the excess endowment of labour will be absorbed more slowly than is optimal.

At this stage, the contribution of distributional tensions to the distortions in the price system resides on the one hand in the labour market, as evidenced by the existence and size of the informal sector, and on the other hand in the as yet not clearly visible line of cleavage between domestic factors of production (capital as well as labour) and foreign investors, particularly in the non-tradeable sectors of the economy.

## V

### Summary

More jobs required industrialization, and in order to achieve industrialization it was necessary to cover a productivity differential. There were two feasible options for this purpose: a) to preserve allocative efficiency, while generating a major regressive income redistribution, or b) to lose allocative efficiency but leave income distribution largely unchanged. Governments chose the latter and thereby built in lasting distortions in the foreign exchange market.

Import substitution industrialization turned into stagnation. Increased pressure in the labour market could have driven wages sharply downward, but instead the informal market arose and thanks to its mo-

nopolistically competitive structure segmented the goods markets and ensured minimally acceptable income distribution.

No explicit government policies were involved in this. Distributional requirements drove the market to develop a "natural" safety net, but once again allocative efficiency was sacrificed and a lasting distortion was built into the labour market.

Financial development could not keep up with the new needs, and capital market segmentation further reinforced the distortions in the price system.

Structural adjustment policies removed some of the price distortions in the foreign exchange market

thanks to liberalization. However, they induced capital inflows that gave rise to substantial overvaluation. At the same time, the division in the labour market is still present, possibly even more so than before, while trade liberalization, for its part, has shown up on the books of the banks as weakened collateral and bad debts of companies now deprived of protection by lowered tariffs and an overvalued exchange rate.

The market price system hence does not provide anywhere near the correct signals for a good allocation of resources. At the same time, the urgent need to earn at least some income continues to drive the growth of the informal sector, while domestic capital and labour eye foreign investment with ambivalence, wondering whether to consider it friend or foe.

(Original: English)

### Bibliography

- Balassa, B. and others (1982): *Development Strategies in Semi-Industrial Economies*, Baltimore, MD, Johns Hopkins University Press
- CARTTA (Cámara Argentina de Radio, Televisión, Telecomunicaciones y Afines) (1966): *Proyecto de modificación de la estructura arancelario-cambiaria*, Buenos Aires, September, mimeo.
- Chamberlain, E. (1933): *The Theory of Monopolistic Competition*, Cambridge, MA, Harvard University Press.
- Diamand, M. (1973): *Doctrinas económicas, desarrollo en independencia*, Buenos Aires, Editorial Paidós.
- Mezger, J. (1981): Segmented labour markets without policy-induced labour market distortions, *World Development*, vol. 9, No. 12, Oxford, Pergamon Press.
- Otero, C. (1996): *Propuesta para el financiamiento de las pequeñas y micro empresas a través del mercado de capitales*, Lima, Bolsa de Valores de Lima, mimeo.
- Ramos, J. (1980): *Capital Market Segmentation, Underemployment and Income Distribution*, Monograph No. 16, Geneva, International Labour Organisation (ILO), Regional Employment Programme for Latin America and the Caribbean (PREALC), September.
- Schydrowsky, D. M. (1967): From import substitution to export promotion for semi-grown up industries: A policy proposal, *The Journal of Development Studies*, London, Frank Cass, July.
- (1972): Latin American trade policies in the 1970s, *The Quarterly Journal of Economics*, vol. 86, No. 2, London, Oxford University Press.