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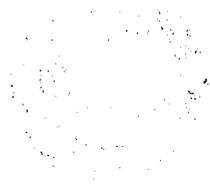
ECONOMIC SURVEY OF LATIN AMERICA, 1974

Part One

WORLD INFLATION AND LATIN AMERICA

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Part One

WORLD INFLATION AND LATIN AMERICA

The object of this part of the Economic Survey for 1974 is to analyse some main aspects of world inflation, especially in relation to the industrialized countries and Latin America.

The importance and topicality of this subject are too evident to make any justification of its examination necessary. All over the world, peoples and governments are concerned at rising prices and at the economic and social consequences of inflation. This concern is felt even in the socialist areas of the world, although the inflationary pressures there may only be transmitted from the exterior. Table 1 illustrates the spread or, as we have called it, the "internationalization" of rising prices and the growing intensity of this phenomenon in the period 1973-1974, although as we shall see there are some interesting exceptions, especially in the case of certain African countries.^{1/}

^{1/} Leaving aside the problems connected with statistical criteria and coverage, it may be assumed that the seriousness of the repercussions of external inflation will depend basically on (a) the size of the sector in which there is relative or absolute self-sufficiency; (b) the degree of openness of the economy towards the exterior; (c) the structure of exports and imports; and (d) the internal policies applied to absorb or contain price rises. This subject will be dealt with further in chapter II.

Table 1

ACCELERATION OF THE INFLATIONARY PROCESS

Annual rates of variation of the consumer price index; 1965-1970, 1972 and 1973 (averages)
and 1974 (with respect to December 1973).

	1965-1970	1972	1973	1974 ^{a/}
Developed countries				
Japan	5.5	4.8	11.7	21.0 (11)
Italy	3.0	5.7	10.8	18.9 (9)
United Kingdom	4.6	7.1	9.2	17.4 (11)
United States	4.3	3.3	6.2	12.2 (12)
Norway	4.9	7.2	7.5	11.3 (12)
Netherland	5.0	7.8	8.0	10.5 (11)
West Germany	2.4	5.5	6.9	5.9 (12)
Developing countries				
Asia:				
India	6.8	5.8	17.4	28.6 (9)
Indonesia	...	6.7	31.5	28.0 (10)
Philippines	6.0	10.3	11.0	26.6 (11)
Thailand	2.6	4.0	11.7	17.9 (8)
Iran	1.4	6.5	9.8	12.2 (11)
Africa:				
Ghana	3.4	13.5	10.2	23.2 (7)
Burundi	2.3	3.6	6.0	19.7 (9)
Kenya	1.8	5.7	9.3	17.7 (9)
Zaire	24.6	15.5	16.0	12.1 (10)
Nigeria	5.6	2.8	6.0	5.7 (7)
Zambia	6.2	5.4	6.4	4.8 (6)
Morocco	0.6	3.7	4.1	4.5 (7)
Latin America				
Long-standing inflation:				
Uruguay	59.9	76.5	97.0	73.5 (10)
Brazil	29.0	16.7	10.9	27.5 (9)
Argentina	19.3	57.8	61.5	11.3 (8)
Irregular inflation:				
Bolivia	5.9	6.5	31.6	38.8 (12)
Colombia	10.0	14.3	22.8	29.3 (11)
Ecuador	4.7	7.9	13.0	17.4 (10)
Peru	9.8	6.9	9.5	13.8 (8)
Recent inflation:				
Guatemala	1.5	0.6	13.8	27.2 (10)
El Salvador	1.1	1.5	6.4	19.5 (10)
Paraguay	1.3	9.2	12.7	18.0 (10)
Mexico	3.5	5.0	11.3	16.5 (10)
Honduras	1.7	3.7	6.0	13.0 (12)
Dominican Republic	1.2	7.9	15.1	8.1 (10)
Costa Rica	2.5	4.7	15.2	26.0 (6)
Caribbean Countries				
Barbados ^{b/}	4.1	11.8	16.9	38.9
Guyana	2.6	5.0	7.5	9.1 (10)
Jamaica	5.3	5.8	19.9	26.5 ^{c/}
Trinidad and Tobago	3.9	9.3	14.8	17.1 (11)

Source: IMF, International Financial Statistics, September 1972, June 1974 and February 1975.

^{a/} Over number of months indicated, with respect to December 1973.

^{b/} Source: United Nations, Monthly Bulletin of Statistics, February 1975.

^{c/} Department of Statistics of Jamaica, Consumer Prices Indices.

/Another feature

Another feature of this state of affairs, which is unusual for many reasons, is that the problem under discussion goes hand in hand with another which is perhaps even more important: the loss of impetus and perhaps even the contraction of the central economies, which is threatening to extend its effects, just like inflation, to the rest of the countries which are linked with and dependent on the central countries in various ways. Furthermore, it is well known that the relative significance of each of these questions tends to change with the passage of time. Thus, for example, whereas in mid-1974 it seemed clear that inflation was considered the outstanding peril,^{2/} towards the end of the first quarter of 1975 (i.e., the date of preparation of the present document) the main danger was economic stagnation and unemployment.

Both these factors are intimately connected, and a fully analysis of the present situation would involve going into both of them in depth simultaneously. Unfortunately, this is outside the scope of the present work, although it may be recalled that in the Economic Survey for 1971 some hypotheses were considered regarding the weakening of the forces of expansion in the industrialized market economies.

We will therefore limit ourselves to discussing inflation, although without forgetting that inflation must be located - especially in the present situation - within a much broader context than that formed by the variables which are usually dealt with or combined in specific studies on this matter.

In Chapter I we will consider the picture presented by the central economies, concentrating our discussion on the obvious and generally recognized crisis of diagnoses, corrective measures and prospects which affects thinking and action on inflation.

^{2/} At the meeting of Governors of IMF and IBRD, the Managing Director of IMF stated that "inflation is the top economic problem all over the world". Press Release No 3, 30 September 1974.

In Chapter II we will deal with the impact on Latin America of the so-called "imported inflation" of recent years, describing its various aspects, the particular form they take in certain countries, and the main lines of existing or possible policies.

Chapter II is actually based on the observations made in the analysis of six specific countries (Costa Rica, Colombia, Ecuador, Brazil, Bolivia and Uruguay), which make up the third and last section of Part One of the present Survey.

Chapter I

INFLATION IN THE DEVELOPED COUNTRIES: CRITICAL POSITION
IN RESPECT OF DIAGNOSES, THERAPEUTICS AND PROSPECTS

In starting this examination, it is desirable to keep two significant aspects in mind: firstly, that the upsurge of inflation in the last two years has roots which go back through almost the entire post-war period, and secondly, that the motive force behind the process, contrary to what is often believed or stated, is located in the industrialized economies.

With regard to the first point, it is well known that the industrialized countries have been showing a persistent tendency towards rising prices, which began in the 1960s with an average annual rate of increase of 3.4 per cent and speeded up markedly in the first years of the present decade (7 per cent in 1972, around 12 per cent in 1973, and over 15 per cent in 1974 with respect to the previous year).^{1/}

From the point of view, then, the generalized and active inflation of the present time must be viewed as a result, or perhaps a qualitative change, of a process which had been taking place and building up reactions and expectations for a long time past. This observation is important for the examination of the various diagnoses, as we shall see later.^{2/}

^{1/} See the statement made by Mr. H.J. Witteveen, Managing Director of the International Monetary Fund, before the American Economic Association in San Francisco on 28 December 1974. The figure for 1974 is taken from OECD, Economic Outlook, 16 December 1974.

^{2/} The evolution and increases in the rate of inflation, together with its relationship with the growth rate, are reflected in the economic terms used to describe the phenomenon in the English-speaking industrialized countries, where a distinction is drawn between creeping inflation, trotting inflation, stagflation and slumpflation. Of all the main countries of OECD, in 1974 only Canada and France showed what could be called growthflation, and even in those two cases the rates of inflation are higher and the growth rates lower than in previous years.

As regards the second aspect, i.e., that of the predominant influence of the central economies, it should be clearly understood from the beginning that this does not mean that this influence explains or acts as the determining factor in every case, or, above all, every degree of inflation in the peripheral countries. This is too obvious to require further discussion.

It is justifiable, however, to hold that the "world tendency" towards the resurgence of inflation originated in the leading industrialized countries. Correspondingly, it would be superfluous to point out that the cases of inflation in the peripheral countries, even in such outstanding cases as certain Latin American countries, have had little or no influence in this general trend.^{3/}

In order to provide more concrete proof of this assumption, all that is necessary is to bear in mind what was stated by the President of the World Bank regarding the increase in the prices of exports of industrial goods. In this respect he said that there had been a significant acceleration in the rate of inflation in the developed nations which had begun before the rise in the prices of petroleum and other primary commodities, so that such price increases could only explain it partially. International prices, he said, which had risen only 6 per cent in the decade prior to 1968 - i.e., less than 1 per cent per year - had risen at an annual rate of nearly 10 per cent in the five years since.^{4/}

This aspect of the problem is worthy of emphasis, because it is obvious that the importance within the overall picture of the

^{3/} "It seems beyond question that controlling world inflation is conditional upon controlling inflation in the industrialized countries. Any change in monetary parities and any programme of domestic monetary stabilization in the main industrial countries can exert an influence on the flows of finance at the world level." Denis C. Lambert, "Les inflation oubliées d'Amérique du Sud", in Economie Appliquée, 1974, No 1.

^{4/} Statement by Mr. R. MacNamara at the Meeting of Governors of IMF and IBRD, 30 September 1974.

increase in the prices of primary commodities in general and petroleum in particular has come to be exaggerated.^{5/}

Following this line of reasoning, it is reasonable to assume that the intensification and wider spread of inflationary pressures will bring about still greater disturbances in the economies of the peripheral countries, while at the same time they will find it more difficult to take defensive measures against these problems. The first reason for this is because the considerable changes in their levels and systems of prices will not be accompanied, in general, by the elaborate compensatory machinery which gives various degrees of protection to those affected by these changes in the industrialized countries. It is sufficient, for example, to think of the many protective arrangements in the central countries which look after the level of wages and the situation of those who may lose their jobs. Unemployment insurance and allowances are an example of this.

The second reason is that inflation itself is either a new problem for many of the peripheral countries, or else it is a very long standing problem, at various levels of latency, which releases vigorous and deep-rooted forces and propensities as soon as there is some change in the equilibrium. It may be noted in passing that even the oil-exporting countries, which are obviously in a more

^{5/} An illustration of the contrast of views on this matter is provided by the statements of the delegates of United States and Iran at the Meeting of Governors of IMF and IBRD. Thus, the United States Secretary of the Treasury said that "Our current inflation developed from a combination of factors: in addition to pressures emanating from cartel pricing practices in oil, we have suffered from misfortune - including bad weather affecting crops around the world; bad timing - in the cyclical convergence of a world-wide boom, and bad policies - reflected in years of excessive government spending and monetary expansion", while the representative of Iran said that: "the record shows that the inflationary spiral was spearheaded by the rapid rise in the prices of industrial products long before the increase in the price of oil ... it is interesting to note that even at its present price the possible share of oil in this year's rate of inflation in the industrial countries, now estimated to reach about 14 per cent, is no more than an average of 1.5 per cent".

favourable position than the others, are facing very complex problems as regards the manner of managing their very large amounts of foreign exchange in such a way as to avoid releasing uncontrollable pressures on price levels (some of these difficulties, as they affect Ecuador and to a lesser extent Bolivia, will be dealt with below).

All the foregoing leaves aside another question of vital importance: the fact that this time, in the great majority of the countries, the spread of inflationary pressures is not accompanied by any reflex effects - through trade and financial flows - tending to give a boost to the economies of the central countries. On the contrary, the shadow of stagflation is looming over the peripheral countries.

It is hardly surprising, then, that the developing countries view with apprehension the picture which has emerged in the developed market economy countries as a whole.

A. THE CRISIS OF DIAGNOSES

The very special nature of the phenomenon of inflation in recent years has severely challenged traditional approaches to this matter, both as regards the diagnosis of inflation and its causes and as regards the corrective measures to be applied.

With regard to the first element, perhaps the most striking feature is what Professor Paul Samuelson has called the crisis of monistic explanations, i.e., the search and preference for a single dominant or responsible cause. In actual fact, however, "the explanation of the varied pattern of ongoing experience calls for a bold combination of causations".^{6/} Moreover, it is usual to refer to a wide variety of causes of very different nature and importance which cannot be combined into an integrated and coherent explanation of the phenomenon.

^{6/} See "Worldwide stagflation" in Morgan Guarantee Survey, United States, June 1974.

The problem, then, is to disentangle, arrange and organize the mass of factors which simultaneously, successively or in turn have been giving the inflationary process its body and rhythm.

There is no need to stress the magnitude of this task and the caution with which it must be approached. It may well be, however, that Latin America's long and rich experience in this matter may enable it to make a contribution to this process, especially as it has been accompanied by an active intellectual discussion which continues to take place.

Indeed, there are numerous references to Latin America in the analysis of this question in the central countries.^{7/} What was sometimes considered previously with some disdain as an eccentricity of the region or of a few countries in it, due basically to their indisciplined monetary and fiscal policies, has now come to hold particular interest because of the durability of the phenomenon and the newly rediscovered complexity of its origins and processes. From the point of view of the investigation of the Latin American situation, it is easy to distinguish right from the start a set of economic, social and institutional elements which form the foundation of the problem, the Procrustean bed in which pro-inflationary tendencies germinate and thrive with greater or lesser vigour depending on circumstances and policies. In short, it was the structural factors which the regional debate on this matter took up and considered with particular attention.

It would be a long and perhaps pedantic business to mention the many social scientists who have been stressing the significance

^{7/} See, for example, the following statement in an important and much discussed article by Peter Wiles, "Cost, inflation and the state of economic theory" in the Economic Journal, June 1973: "The presentation of very large wage demands that are absolutely certain to raise product prices and may perfectly well leapfrog each other forever is both quite new and universal in the capitalist world. Like hijacking and student power it originated in Latin America". See also Denis C. Lambert, "Les inflations oubliées d'Amérique du Sud", op.cit.

of these aspects for some time past in the central countries, although it cannot be said that so far they have found much of an echo at the ruling levels and in academic circles.^{8/} This inclination, of course, is not limited to authors with more or less similar views. Professor Paul Samuelson, who thinks along quite different lines, stresses in an article already referred to the "deep rooted structural changes here and abroad that have created a new bias towards inflation".

Obviously, the basic elements of different types which set their stamp on or feed the inflationary potential are not the same in the industrialized economies as in Latin America and other parts of the peripheral area. Neither the rigidity of agricultural structures, which is characteristic of some Latin American countries, nor the vulnerability of depending almost exclusively on a single primary commodity export, which is something that affects most of the countries of the region, are among the aspects that are of major concern to the central countries. At the same time, however, as we shall see, there are some aspects which are familiar to any Latin American country, and especially those with a long tradition of inflation.

Clearly, the methodological differentiation of the outstanding factors or levels in the diagnosis of inflation does not involve groups of relatively independent phenomena, and still less is there any unilateral type of causation among the components. On the contrary, the actual process involves the simultaneous and combined action of each group of elements and each single element, with their presence and importance depending on the characteristics of each country and each particular situation.

As the long-standing inflationary way of life of quite a number of Latin American countries, shows, the basic structural or

^{8/} Among them, however, mention may be made of J.F. Galbraith in the United States, "Economics and the public purposes", Boston, Houghton Mifflin, 1973; F. Perroux and his followers in France, "Les inflations des années 60", in Economie Appliquée, N° 2, 1971; and Gunnar Myrdal in Sweden, "Against the stream: critical essays on economics", New York, Pantheon Books, 1973.

/institutional factors,

institutional factors, and even the mechanism of dissemination, are relegated to a temporarily secondary place in the phases of resurgence of the inflationary process, and the emphasis consequently shifts to the more immediate connexion and pressures, such as the prices-wages race. As the experience of the region also shows, however, the proper control of the process, even within a scheme of tolerated and manipulated inflation, calls for parallel action on the various different planes. From this point of view, as we shall see later, the Brazilian experience is of particular interest, and it has frequently received the attention of the central countries who are facing the difficult problem of how to overcome or live with inflationary processes. This brings us to the following topic.

1. The structural background

Subject to the risk involved in making any kind of classification, and without pretending that the classification is complete or implies any order of priority, certain factors or groups of factors of outstanding importance can be identified from the examinations made in the central countries.

Firstly, there are three elements which can be taken together for the purposes of the analysis and in the interests of brevity. These are the passage of an extraordinary long period of dynamic growth (by past standards), which has taken place in conditions of virtual full employment and on the basis of growing concentration and organization of the key social groups, including of course the State. Together with and above these facts is a definition of economic policy (and policy in general) which is unequivocally committed to the first two features - growth and full employment. We shall return to this aspect later.

Before going any further, it is essential to emphasize the differences between this picture and the image and reality of what may be called "nineteenth century capitalism". While this was undoubtedly dynamic over a long term, one of its primary characteristics was its cyclic irregularity. With the passage of time it was evident

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that the labour force became more fully employed and its income rose, but waves of unemployment, sometimes on a massive scale, and a stubborn residue of unemployment remained an indisputable feature of this system. Finally, taking into account all the variations of individual cases and situations, as well as of the emerging trends, there was the system of free or imperfect competition, i.e., of the "open market" for labour and the lack of organization or incipient organization of the wage-earners. All this took place under a relatively weak State which limited its activities to maintaining law and order, palliating the most dramatic hardship situations, and defending and promoting national interests.

It should be noted that the negative sides of this contradictory reality were vital ingredients of its functioning and expansion. In other words, the periodic crisis, the rises in unemployment, and the bankruptcy and failure of enterprises at periods of depression and low prices were, as has been pointed out more than once, the harsh but, it was felt, necessary means for "clearing the decks" of the system and making way for its next growth cycle. Government intervention, of course, was conspicuous by its absence, and it was even considered undesirable, since it was felt that it could hamper the operation of the laws of the market.

To a considerable extent, as we have already seen, this "world of yesterday" had little or nothing to do with the reality which took shape and became consolidated in the war and post-war years in the central economies, although a purist could argue that the essential nature of the system of private property, profit and the market has not been changed. However, the implications of this change for the problem under discussion here are obvious. Each of the new elements referred to above contains inflationary possibilities, and the combination of them obviously strengthens this predisposition.

(a) Growth and inflationary potential

By its very nature, a prolonged period of expansion - even with brief, scattered and local pauses like the contractions referred to earlier - implicitly contains such a potential and calls for constant

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changes - in some cases of considerable extent - in the structure of production in keeping with variations in levels of income and patterns of demand or spending. The "signals" from the market and profitability, on the one hand, and public initiatives on the other, are hypothetically responsible for channelling and redistributing resources with the objective of structural readaptation, but any fault in the timing, objective or magnitude of the allocations will result in imbalances of varying importance and duration which usually manifest themselves in the form of partial or general rises in prices if there is a suitable mechanism and suitable conditions for its transmission.^{9/}

From another point of view, the problem is also related to the eventual tendency to rising costs in every process of lasting expansion. This may be due to various causes, such as the higher marginal cost of the factors used (for example, raw materials coming from deposits of lower content or further away), a higher density of investment per unit produced (which could be counteracted or aggravated by the prices of capital goods), or a number of other elements (scarcity of labour, higher taxes, high interest rates, etc.). This aspect is summed up in the diagnosis on overheating of the economy.

Although there have been many references to this point based on many specific cases and situations, the truth is that - especially as regards the United States - the available evidence does not seem

^{9/} In this connexion, the following appraisal of the difficulties anticipated in reactivating the growth of the OECD countries is of interest: "Important sectoral differences have arisen, with capacity still strained until recently in some industries (steel, coal, chemicals) but with large slack developing in others (automobiles, textiles, house building, tourism). The unused capacity partly reflects weakness of aggregate demand but is probably also, in part, the result of recent large changes in relative prices. It is not yet clear, given the coexistence of bottlenecks and of slack which may partly be structural, how far the rate and pattern of future expansion both in the short- and medium-term will need to be modified". OECD, Economic Outlook, December 1974.

to confirm that the expansion of the central system has run into real limits that make it difficult to achieve further progress without abnormal inflationary pressures. For the United States, however, the margin between the "potential product" and the product actually achieved grew considerably narrower between mid-1972 and the beginning of 1973, after having been quite wide between 1969 and the beginning of 1972.^{10/}

In other words, the key inflationary element may not have been excessive overall and generalized demand on the available resources, but rather the inter- and intra-sectoral imbalances deriving from rapid growth and the postponement or total absence of decisions aimed at anticipating or remedying these problems.

Lastly, this aspect of sustained growth and its relationship with inflation can also be viewed in connexion with a characteristic of modern economies in which there are interesting similarities between the market economies and the socialist or centrally-planned economies. Furthermore, it may be noted that it is connected with one of the main lines of analysis of ECLA.

Thus, in contradiction of assumptions which were deeply rooted in academic circles up to the 1930s, the dissemination of the benefits of technical progress deriving from a period of dynamic and lasting growth has taken place principally through the increase in income and not through the reduction of prices.

This point calls for some clarification. It is beyond any doubt, of course, that the technical advances and mass production achieved in certain lines (automobiles and television sets, for example) was generally followed in the central countries in the past by appreciable reduction in prices. This was a precondition for their generalized dissemination, quite apart from another fact of primary importance: namely, that the average levels of income should make such goods accessible to the majority of the population.

^{10/} See First National City Bank, Monthly Economic Letter, November 1974.

It is nonetheless evident, however, that once this stage of the opening and widening of the market was completed, the prices of the products of the industrial society did not continue to go down in keeping with the growing "physical" or real productivity (brought about by improvements in technology and economies of scale). The reason for this is very simple, and has been set forth in analyses based on the most diverse doctrines: what happened was that there was preferential and sometimes total appropriation of the benefits of technical progress by those participating in it or controlling the increases in productivity.^{11/}

In principle, and in itself, this closed or preferential appropriation of the benefits of increased productivity would appear not to have any great influence on inflationary pressures except when it does not permit trends towards lower prices to come into effect. The truth is, however, that it is necessary to take into account the incidence of the relative improvements of income over other groups and the reactions of these latter groups aimed at eliminating or decreasing the gap thus opened. In other words, what we are faced with is the old "demonstration effect", but this time in the domestic conditions of the industrialized countries. In order to go deeper into this matter and into its projections it is necessary to bear in mind the changes which have taken place in the negotiating power of the social groups. This we will do below.

(b) Full employment and "oligopolization"

It is hardly necessary to stress the influence of a situation of virtual full employment on the inflationary phenomenon. Many, of course, have pointed to this as the main element in tendencies towards price rises, because of the strengthening of the negotiating capacity of wage earners in situations of very low unemployment. The

^{11/} The international response to this phenomenon is the retention by the central economies of the gains made through increased productivity, which operates through changes in the terms of trade. Among recent work by ECLA on this matter, see Part One of the Economic Survey of Latin America, 1973 (E/CN.12/974).

often-mentioned "Phillips curve" related the movements of wages to levels of employment and made it clear that, at least in British experience, increases in the former had depended mainly on the state of the latter, i.e., wages tended to rise in accordance with improvements in the employment situation. This seemed to justify a very widespread and generally accepted hypothesis.^{12/}

At all events, this element must be appraised in conjunction with the third factor referred to at the beginning of this section: namely, the increasing concentration and organization of the key social groups. Once again, it would be superfluous to refer to or quote the abundant literature on this matter, which goes all the way back to the writers who anticipated the tendencies towards entrepreneurial concentration and the disappearance of the atomistic structure which predominated for much of the last century and perhaps even up to the great depression. Obviously, of course, these writers did not foresee or include in their analysis the implications of the agglutination and parallel development of the trade associations and the State apparatus.

What we are dealing with is a phenomenon which is just as inevitable as it is irreversible, which has continued unchecked in spite of legislation and other expedients, and which, we may add, is still obscured by the insistence on viewing it through the eyes of the old monopoly theory instead of considering it as a structural reality of the modern industrial economy.

^{12/} Recent experience has cast some doubts on this relationship, although from another aspect: i.e., that increases in levels of unemployment do not necessarily signify a drop in the rates of remuneration of the employed population.

The combination of full employment and of the so-called "Oligopolization" of large sectors where the State is an interested party as well as an uncertain arbiter introduces another markedly inflationary bias or propensity.^{13/}

The most recent experience (first quarter of 1975) - above all in the United States, where there was simultaneously been an unusually high level of unemployment and a serious contraction in production activities - is an eloquent testimony to the considerable resistance to a drop in remunerations and, to a lesser extent, in prices, brought about by the institutional conditions referred to.

Taking the foregoing realities as a whole, a hypothesis has also arisen regarding the "functionality" of inflation as a means of smoothing down antagonisms and achieving certain cardinal objectives for the economic system. On the one hand, the increase in income achieved by certain groups reduces their pressures to reach or recover certain given levels, but on the other hand, the increase in prices soon reduces the real significance of these apparent gains.

This is not all, however. To the extent that more or less generalized increases in remunerations exceed the increases in productivity and diminish the resources needed by enterprises for their renewal and/or expansion, the increases in prices have the effect of making good this deficiency by, for example, redistributing income in favour of the enterprises.

^{13/} Analysing this matter, G. Myrdal noted the following: "The entire system of organizations in a society is in all countries grossly biased [in favour of inflation], and this becomes increasingly important as organizations are also becoming stronger. People are becoming organized as income earners of various sorts or as profit takers, while organizations defending the general and common interest of all consumers are weak in all countries.

The interests of salary-earning employees and of profit-earning employers are not always conflicting. While within an ongoing inflation development the former rationally have to count on higher costs of living and to press for higher wages, the latter can in the same way often count on higher prices for their products or services" from "Against the stream", op.cit.

From this point of view, inflation could be considered not as an abnormal phenomenon, but rather as a mechanism that helps modern market economies to function. Naturally, this analysis does not deny that the process also involves serious disturbances in the progress of the system, which have been adequately dealt with in the literature on this problem.

(c) The internationalization of the processes

The second group of basic elements in the inflationary tendency seems to be linked to the process of world economic integration and particularly to the process of integration between the central countries. We will not enlarge on this general aspect, since its characteristics and tendencies were fully presented in the Economic Survey for 1971.

The last few years have of course witnessed an extraordinary acceleration in this integration process, and a considerable degree of synchronization has now been established in the behaviour of the central economies. In the past, it was frequent for their growth rates and domestic price movements to show significant differences. Thus, more than once the effect of a reduction in the growth rate of the United States, for example, was counteracted to some degree by continued expansion of the European area or Japan, and although prices tended to rise, there were also considerable differences which moderated this long-term trend.

It will readily be understood that the new situation involves an obvious possibility of the intensification and multiplication of any tendency towards inflation or deflation, expansion or depression. Moreover, as has been stated on a number of occasions, it makes it more unlikely that isolated action at the national level can

succeed.^{14/} Indeed, it could be maintained that such action is actually undesirable in view of the possibility that arbitrary measures designed to isolate specific economies from general difficulties may actually help to aggravate the situation of other countries and finally that of the world economy in general. The experience of the 1930s provides typical examples of this.

2. The mechanisms of dissemination

In the Latin American inflationary situation, the machinery and decisions of the fiscal, monetary and foreign trade areas have constituted, so to speak, the second line of elements which affect the rise in prices. More specifically they have generally been considered as "propagating factors".

This is not the place to go again over the foundations of this general hypothesis, which has been opposed and criticised in favour of other interpretations. It is sufficient to repeat two considerations which are of basic importance for the discussion. The first is that obviously in many cases the measures taken in one of those fields or in a combination of them can be identified as visible agents of inflationary imbalance (and price rises). The second is that only rarely can they be considered as really independent or as true sources

^{14/} Consider this view of the matter: "The worldwide character of recent price and wage advances has inevitably focused attention on inflation as an international phenomenon. The authorities in the industrial countries have found internal stability threatened by inflationary forces from abroad. Increasingly, international factors: the expansion in world trade and investment flows, the official efforts in recent decades to eliminate restrictions on private current-account and capital transactions, the growth of multinational corporations and the development of international banking facilities ... have limited the effectiveness of national programmes to protect the internal economy from external disturbances ... In this environment, it no longer seems to make sense to view inflation merely as a collection of individual national phenomena". Samuel Katz, "Imported inflation and the balance of payments", in The Bulletin, New York University, Nos 91-92, October 1973.

of the expansive effect. There is nearly always a more distant reason which is responsible for or encourages the decision on one or all of these fronts. We shall return to this point later.

As regards the possible influence of fiscal and monetary policies on the impulsion of the inflationary process, the industrialized economies are too varied in their characteristics and in time to enable any generalization to be made. The most that can be done is to make general appraisals like the following:

"... The 1972-1973 upsurge of global demand was marked by failures or miscalculations in the conduct of monetary and fiscal policies. In relation to the buoyancy of private demand materialized during the boom period, fiscal policies proved insufficiently restrictive in a number of instances, and rates of monetary and credit expansion permitted by prevailing monetary policies would have to be characterized as excessive from the standpoint of controlling inflation. However, since broadly parallel judgements are applicable also to the boom phases of other major post-war business cycles, it cannot be taken as a certainty that laxity of monetary and fiscal policies contributed more to the excesses of the latest boom than it did to those of previous upswings."15/

There can be little doubt that this cautious appraisal of the role of the fiscal and monetary mechanisms would not be shared by the defenders of the thesis that this is precisely where the basic impulses for inflationary pressure are to be found. It is clear, however, that the experience of recent years, even in Latin America, has reduced the degree of emphasis of former positions.16/ Thus, recent discussions

15/ IMF, Annual Report, 1974. Regarding the United States, which is the country most often quoted in this respect, it is also worth considering the opinion of the November 1974 "Monthly Economic Letter" of the First National City Bank, which states that government spending advances have been modest over the past two years and monetary policy has been restrictive as the authorities have refused to validate double-digit inflation by allowing the money supply to grow fast enough to accommodate both the inflation and a rise in real output.

16/ The prudence of present appraisals is to be contrasted with the tone of the recommendations which used to be made in the 1950s and the beginning of the 1960s regarding stabilization policies in Latin America.

show a subtle shift of judgement regarding the role of monetary expansion. Whereas in previous explanations this factor was given as the primary cause of inflation, in more recent discussions it is held that it would rather or only merely be decisive in making possible the continuance of the phenomenon, which is an obvious reflection, but which fails to shed light on all the antecedents and consequences implicit in such a statement.

From this point of view, it is true to say that the alternative criteria have become considerably more realistic than in the past. At all events, whatever the extreme criteria regarding this matter, it seems clear that while the "independent" or original gravitation of monetary and fiscal action is neither certain nor demonstrable, it is not reasonable either to think that these factors have responded to or permitted, as some would say, the manifestation of the underlying forces favouring expansion on these two planes.^{17/}

(a) Transmission via the foreign trade deficit

There remains to be considered the influence of the action taken in the foreign trade area, which must be appraised in the light of what we said before about the internalization of the problem of inflation.

There are many elements to be considered in regard to this question, but in the interests of brevity we will concentrate on the aspect which was emphasized most strongly in the debate, namely, the possible impact of the United States balance-of-payments deficit.

^{17/} Professor Gottfried Haberler, in a recent article entitled "Inflation as a worldwide phenomenon: an over-view", Review of World Economics, Vol. 110, Book 2, 1974, sums up the question very frankly in the following words: "... In my opinion it is evident that government finances (big budget deficits) and the pressures of the trade associations often exercise strong and sometimes irresistible political pressure on the monetary authorities to increase the supply of money either actively or permissively". He adds in a footnote "H.G. Johnson calls this reproachfully and even contemptuously a political or sociological theory of inflation. Whatever you call it, it is a fact of life that cannot be ignored".

/While the

While the incidence of this phenomenon on international monetary equilibrium cannot be ignored or under-estimated, there is some doubt as to whether it has really been a decisive factor in the inflationary tendencies of the central economies and the world as a whole.^{18/}

In reality, the available figures do not confirm this assumption. As we can see from table 2, up to at least 1973 the ratio between the availability of international reserves and the magnitude of world trade - which is one of the generally employed indices - went down compared with the situation in 1960 and 1965. In contrast, because of the rise in the prices of primary commodities and particularly oil, the reserves of the developing countries showed greater relative growth, and this, although it was undoubtedly an important factor in internal inflation, certainly did not carry much weight at the world level.

It is true, however, that one of the outstanding phenomena of recent years has been the increase in the amount of monetary assets in private hands: Eurodollars, for example. From this point of view also, however, the figures do not back up the hypothesis of excessive international liquidity, and as an IMF document has stated:

"World imports during the period examined (1954-1974) have grown more rapidly than world reserves, and the global ratio of reserves to imports has declined steadily from 1954 to 1970. The inclusion of private holdings does not modify this finding, although the downward trend becomes more stable."^{19/}

^{18/} H.G. Johnson, for example, sees long-standing inflation as "a world-wide phenomenon associated with excessively rapid growth of the monetary base of the international monetary system in the specific form of a rapid growth of foreign official holdings of dollars" ("Secular inflation and the international monetary system", Journal of Money, Credit and Banking, February 1973).

^{19/} See "Total international liquidity: economic devaluation and policy implications", IMF document EBD/72/196, 1972.

Table 2

RATIO OF INTERNATIONAL RESERVES TO WORLD TRADE

	1960	1965	1973	1974 (September)
<u>World trade</u> (imports in millions of dollars)				
Developed countries	81 390	126 530	428 600	391 900
Developing countries	31 130	37 580	96 000	150 600
<u>Total</u>	<u>112 520</u>	<u>164 110</u>	<u>524 600</u>	<u>542 500</u>
<u>International reserves</u> (millions of US dollars)				
Developed countries	50 755	59 445	139 167	139 551
Developing countries	9 470	10 985	44 740	69 920
<u>Total</u>	<u>60 225a/</u>	<u>70 430a/</u>	<u>183 910b/</u>	<u>209 470b/</u>
<u>Ratio international reserves/world trade</u>				
Developed countries	62.4	47.0	32.5	35.6
Developing countries	30.4	29.2	46.6	46.4
<u>Total</u>	<u>53.5</u>	<u>42.9</u>	<u>35.1</u>	<u>38.6</u>

Sources: United Nations, Monthly Bulletin of Statistics, January 1975.
IMF, International Financial Statistics, January 1975.

a/ Gold reserves, position in the Fund, and foreign exchange.

b/ Gold reserves, position in the Fund, foreign exchange and SDR units.

/On the

On the other hand, in connexion with the problem under consideration, it should be recalled that the two countries which accumulated most reserves of dollars, i.e., the Federal Republic of Germany and Japan, were among those which had most success in controlling their inflationary pressures (see table 1). The rise in prices in Japan since 1973 is due to the rise in the prices of commodities and oil. Likewise, insufficient attention has often been paid to the possible deflationary effect in the United States of that country's balances accumulated abroad, with the consequent substantial increase in its imports.

These and other factors go to prove the significance, as far as price rises are concerned, of domestic policies and of the factors which determine them.

There can be no doubt, however, that one of the primary consequences of the United States deficits was of decisive importance in the resurgence of inflation. We refer to the devaluations of the dollar from 1971 onwards. At the level of the international economy, these devaluations had repercussions which were substantially similar to those of changes in the exchange rate in countries affected by inflation, especially where such changes had been held up longer than was advisable.

This does not, of course, refer only to the direct repercussions, but also to the transmitted impact of these devaluations on inflationary expectations.

(b) An inflationary mentality?

The last factor to be mentioned among the elements producing inflation is of a subjective nature, but it is nonetheless important, particularly at a time like the present. We refer to the dissemination and establishment of inflationary expectations.

In this matter, to which growing attention is being given, the anticipated price rise and the "inflationary psychology" take the form of a variety of expedients which, while trying to avoid the distortions and ill-effects of the process, can in fact actually make it deeper rooted and more intensive. In the words of a noted monetary authority:

/"As a

"As a result, we have shorter trade union contracts, linking of wages and social security benefits to the cost of living, flexible rules about interest rates, modifications in accounting practices, and other systems whereby price increases are passed on more rapidly than would be possible in other circumstances."20/

3. The conjunctural elements

One of the clearest recent facts (1973-1974) is the appearance on the scene of certain far-reaching conjunctural changes which exert a powerful effect on a situation where there is already a tendency towards the acceleration of inflation and which release pressures that were either latent or only weakly kept in check. In the highly competent analyses of the process which OECD has been carrying out,21/ it is shown that there is a regular sequence of impulses of promoting price rises.

The first stage in the period in question can be located approximately between mid-1972 and October 1973, and is characterized by "a sharp rise in the price of most primary commodities relative to the general price level of all other goods, brought about by the emergence of a marked imbalance between final demand and current supplies". It will be recalled, for example, that the failure of the harvests in 1972 in some producer countries had particularly marked repercussions on the price of foodstuffs and hence on the wholesale and retail price indexes. It may be noted in passing that, generally speaking, it was developed countries - above all the United States and Canada - which were most favoured by this situation, although this does not mean that they did not suffer from the inflationary effects also.

20/ Statement by the Managing Director of the International Monetary Fund, 28 December 1974, op.cit.

21/ See, inter alia, "Aspects of world inflation" in Economic Outlook, 15 July 1974.

The second dividing point is from October 1973 onwards, as a result of the Middle East War, the initial effect of which, according to the OECD study referred to, was to add a new element of uncertainty to the world situation, followed by physical shortages of oil arising from the embargo and from hoarding, plus substantial increases in oil prices.

While, from the point of view of the central countries, these two "moments" take the form of influences originating abroad, the third point corresponds to the internalization of the impacts and the predominance of domestic impulses. The fundamental aspect is probably the reaction of workers to prior considerable increases in prices. Thus, ... "throughout 1973 ... a general acceleration in the rate of growth of wages took place in most OECD member countries and currently wages are going up extremely rapidly, although often not as rapidly as prices".^{22/} In other words, the centre of attention has now become the well known prices-wages spiral, which is a basic factor in the phases of acceleration of inflation.

B. THE CRISIS OF CORRECTIVE MEASURES

While it is beyond doubt that there is considerable confusion in the industrialized economies as regards the diagnosis of the resurgence of inflation, the situation is even worse when it comes to discussing ways to combat inflation.

The discussions show that the majority of those concerned are fully aware that times have changed and that old formulas are no longer suitable, but there is a marked shortage of opinions on how to deal with the new situation, and the suggestions that have been made are either subject to many criticisms or else raise fresh queries, perhaps of even greater scope, which introduce variables that clearly go outside the limits of the problem of inflation in the strict sense.

^{22/} See "Aspects of world inflation", op.cit.

1. The original success but recent impotence of
the Keynesian approach

The first aspect to be borne in mind is the general disenchantment with the policies that have governed - with various degrees of vigour and efficiency - the development of the central countries in the post-war era: i.e., the policies inspired by the Keynesian school. This involves two questions which are different but not contradictory.

On the one hand, there is no doubt that the policies which are generally called Keynesian, and which are based on the maintenance of effective overall demand and full employment, mainly through government initiatives, have had considerable success in achieving their ends. The vigour and consistency of the growth during the period in question, the low rates of unemployment, and the steady rise in the standard of living (leaving aside any reservations regarding the "quality of life"), are an indisputable proof of this assertion. Of course they are not the only explanation and cause of it. Among the other reasons, paradoxically enough, we should not forget the challenge and stimulus provided to the market economies by the expansion and the sustained development of a competitive area made up of the socialist or centrally-planned economies. Taking into account such factors as this only goes to corroborate, however, the fact that the policies in question were capable of coping with such challenges.

As far as inflation is concerned, the truth is that the Keynesian philosophy did not contemplate any special corrective measures, either because one of its principal hypotheses was that the system had a persistent tendency towards under-utilization of resources, including labour, or because the problem was not very serious during most of the post-war period. When this second aspect changes, attempts were made - above all in Northern Europe and to a lesser extent and with little success in Great Britain - to introduce or intensify the

/so-called

so-called "income policies" designed to discipline and guide movements of prices and wages. At all events, however, as already stated, in the last few years the operational efficiency and interpretative and regulative validity of the Keynesian heritage have been deteriorating.^{23/}

Up to about the middle of the last decade, the prevailing Keynesian policies fluctuated between expansive and restrictive versions of the basic orientation. As soon as the growth rate slackened and the employment situation was endangered, the time came to take off the monetary or fiscal brakes so as to inject new impulses into the system. In contrast, when signs of "overheating" appeared and prices tended to rise, the rudder was swung to the other side, more through monetary discipline than reduction of fiscal expenditure, which is much more difficult to apply in the short term for very well known reasons, such as rigidity of expenditure, etc.

In some countries, particularly Great Britain, this operation had to take into account a third element, namely, the balancing of external accounts. Very fast expansion - at least in the conditions in which it was taking place - not only had repercussions on prices, but also manifested itself in growing balance-of-payments deficits.

There can be no doubt that this analysis is mainly valid for the United States and Great Britain. As we noted earlier, with a few exceptions the European countries have managed to face up to this

^{23/} In some ways this assertion corroborates that made by the Secretary of the Treasury of the United States when he set out the essence of the new situation very concisely in his statement in September 1974 at the Meeting of Governors of IMF and IBRD: "... It is clear that most countries are no longer dealing with the familiar trade-off of the past, balancing a little more or less inflation against a little more or less growth and employment. We are confronted with the threat of inflationary forces so strong and so persistent that they could jeopardize not only the prosperity but even the stability of our societies".

dilemma much better, both because they took into account the institutional factors of the problem and because there was greater continuity in the policies followed.^{24/}

Be that as it may, what is certain is that towards the end of the 1960s the compensatory effect of the systoles and diastoles of the system entered a period of decreasing returns and, in some cases, virtual impotence. If expansive instruments were used, then it was more likely that these would increase the rise in prices rather than impart greater dynamism to production. On the other hand, if restrictive instruments were put into effect, there was a clear possibility that the sluggishness of the system would be made worse and unemployment would rise, without this bringing any kind of commensurate relief as regards the rising price tendency.

In the presence of this dilemma, there are some main criteria regarding the action to be followed.

On the one hand, of course, there are the various different versions of the basic Keynesian doctrine, which has still not been replaced. Up to the end of 1974 the predominant voice was that of the supporters of resolute deflationary action, although the events in

^{24/} Referring to this first aspect, the OECD publication Economic Outlook (16 September 1974) points out the following:

"A number of smaller countries believe that they have, very usefully, supplemented overall demand management by a variety of policies ranging from partial measures like wage indexation or price controls to comprehensive prices and incomes policies, with cases of close co-ordination of fiscal and incomes policies being of particular interest. There is evidence that such a "multi-policy" approach has often helped in combining steady and relatively fast growth with comparative low price increases, and the countries practising it have felt able to react to the oil crisis in somewhat similar manner, reducing the depressive impact on real demand of the oil price increase while limiting the propagation of its inflationary influence through the wage-price spiral."

With regard to the problem of the continuity of policy, it should be recalled that in the last four years the United States has in practice had nine different policies for facing the problems of inflation and growth.

/the United

the United States, where the supporters of this line have significant influence, have cast doubts on the viability of such a policy in the present conditions of marked stagnation, rising unemployment and little relative effect on prices and wages.

Those who favour a turn in the opposite direction, i.e., towards economic reactivation, have in their favour the existing data and the lack of prospects of the present situation and policies, but obviously they cannot give any guarantee that the traditional remedies will give the desired effect and not prove to be simply another stage in the so-called "stop and go" policies, whereby they could merely amount to another impulse to inflation instead of bringing about the redynamization of the economy.

Leaving aside their differences, however, and the fact that the time factor is very important in the decisions to be adopted, there is a common conviction that the choice between inflation, growth and full employment must not imply any substantial sacrifice on the part of either of the two terms of the problem.

2. Monetary orthodoxy (or heterodoxy)

A second current which is doubtless less important than the foregoing ones but is of significant importance in certain academic circles is the so-called monetarist current. Although, at the present moment and in the corrective measures applied, it is close to the restrictive variety of the Keynesian doctrine, it calls for separate comments. The relative ineffectiveness of the approach previously in fashion has given the monetarist approach more currency, although it has still not been taken up in any central countries by the ruling circles. For this reason, rather than considering it an example of orthodox thinking, it should rather be considered as one of the current heterodoxies.

The monetarist criteria extend in various dimensions.

On the most general level there is the contention that the economic system, if left to the free play of market forces and backed

by a suitable but unspecified monetary policy,^{25/} would have achieved better results than the Keynesian orientations, and would have done so without inflationary tendencies.^{26/} We are unable to go here into a lengthy discussion of this point of view, but it is enough to point out that it does not take account of the past evolution of the system, the characteristics of which are recalled in previous pages, for it would be difficult to find any proof that the pre-war economy, which was free of all Keynesian interference, was "inherently stable" (see footnote ^{26/}).

On the other hand, and at a more concrete level, there is the criticism that policies inspired by Keynesian doctrines have generally intensified the tendencies in expansion or contraction phases rather than moderating them. Once again, as in the case of the continuity of policies, this reservation does seem to be quite valid as far as the experience of the United States and Great Britain in recent years is concerned.

But doubtless the most controversial aspect of the monetarist position is its characterization of the control of the supply of money as the main anti-inflation tool. In other words, for followers of this

^{25/} One of the basic proposals is that the supply of money should grow at a regular rate in keeping with the real increase in the product, so as not to introduce any disturbances of an inflationary or deflationary tendency. As we shall see later in the study on Brazil, the growth of the means of payment has kept close to that of the domestic product (although not to price movements), within a picture of active financial and fiscal manipulation and the management of a variety of other non-monetary instruments.

^{26/} According to H.G. Johnson, who is one of the best-known spokesmen of this current, "In a sense the crux of the issue prevailing between Keynesians and monetarists is that while the Keynesian position maintains that the real economy is highly unstable and that the monetary management has both little relevance and little control over it, the monetarist position on the contrary is that the real economy is inherently stable, but can be destabilized by monetary developments, which therefore need to be controlled as far as possible by intelligent monetary policy". See "Inflation and the monetarist controversy", North Holland Publishing Company, Amsterdam, 1972.

doctrine, price discipline can only be obtained if the supply of money is managed so energetically and parsimoniously as to obviate or make impossible a rise in prices.^{27/}

Although exceptions to this principle could be pointed out, above all as regards relatively short periods, its hypothetical validity can be accepted if (and this is a fundamental condition) the monetary authority is in one of the following two extreme positions: (a) it has absolute power to establish the amount of the increase in the supply of money, or (b) it has the complete backing of the authorities and is in a position to discipline and manage all the pressures that are exerted on it. It does not seem that anyone could advocate the first possibility in the light of the conditions of modern society. There therefore remains only the second one.

Taken in the abstract, there is no reason to reject it as a totally unrealistic proposition. If it is taken as a base, however, it will be found as one goes deeper into its significance and implications that the problem shifts from the strictly monetary sphere to other fields or variables outside that sphere.

Thus, when we have to admit the patent fact that the central banks do not have independent and complete control over the supply of money it becomes evident that their decisions are subject to the manner and the degree of success with which the many sources that originate the demand for means of payment are managed. Thus, the dominating factor will be the general spectrum of economic policy and the variety of elements which go to make it up. Essentially then, the decisions of the monetary authority simply give sanction to a reality which is substantially generated and formed outside its orbit, although this should not lead us to forget its important role as a "propagation mechanism" for various types of tendencies or as a key element in the allocation of resources in a market economy.

^{27/} A sign of the times is that the dispute between supporters of shock treatment for stopping inflation and the "gradualists" has lost all significance. Today, it can be said, everyone is a gradualist, except the ultra-monetarists.

If we contrast these observations with the experience of the central economies, it is easy to see that the monetarist view has come into collision with or had to accommodate itself to basic common circumstances such as the commitment to sustained growth and full employment, the strength and balance of the great social groups, the expansion of military and social security expenses, etc. In the final analysis these are the factors which have established the general spectrum of economic policy within which the monetary authorities must operate.^{28/}

C. THE CRISIS OF PROSPECTS

The forecasts of the central countries regarding the course of inflation in 1975 are very cautious and subject to all kinds of reservations.

Following the examination to which reference was made when we were dealing with conjunctural factors, it can be assumed that pressures originating in the exterior - mainly increases in the cost of primary commodities - will lose some importance, while endogenous

^{28/} Analysing the ups and downs of the monetarist position, H.G. Johnson made this very pertinent comment:
"... the real motive force behind the rise of "monetarism" (the quantity theory approach) in popular thinking in recent years has been the failure of the alternative Keynesian approach to deal effectively with the problem of inflation in concrete economic-policy terms ... the triumph of monetarism has been short lived in both countries (i.e., the United States and Great Britain), and the quantity-theoretic approach is again in popular eclipse, partly because in the euphoria of belated popular recognition the monetarists vastly exaggerated the potency - a different matter from necessity - of monetary restraint as a means of stopping inflation once inflation is well under way, in terms of both the amount and the duration of the unemployment required to change inflationary expectations and therefore wage and price determination behaviour ... When the chips are down the political process attaches a relatively low cost to inflation and a relatively high cost to heavy unemployment". See "Inflation and the monetarist controversy", op. cit.

elements will gain it, especially through wage claims aimed at recovering previous levels of real income.^{29/} Thus, while it is anticipated that the rise in the prices of industrial goods will continue at an indeterminate rate varying with the individual countries, the surest and most immediate relief from inflationary impulses will come from steadier and perhaps even lower prices for raw materials.

Various sources seem to confirm these forecasts. In one of them, for example, an analysis was made of the evolution of the prices of various groups of goods in the United States during the whole of 1974.^{30/} If we take only the cases of raw materials and producer finished goods, then we see that whereas the prices of the latter continued to rise during 1974 (albeit slower than in 1973), the price levels of primary commodities began to show reductions from the middle of the year onwards, and by December had fallen by 5.8 per cent.

It is therefore easy to understand the reflection made by the spokesman for most of the Latin American countries at a meeting held at the end of last year: "The anti-inflationary measures of the industrialized countries are having more effect on the prices of primary commodities than on their own manufactures, whose upward tendency shows no sign of slackening".^{31/}

^{29/} In appraising this phenomenon, the most recent issue of Economic Outlook (December 1974), op. cit., stated the following: "By the middle of this year, wage claims in manufacturing were approaching 20 per cent annual rate in the OECD area as a whole, though with considerable divergence between countries. To the extent that these claims are realized, manufactured goods prices will be under considerable pressure that could only partly be alleviated by a shift away from profits, a rise in productivity or a fall in imported input prices".

^{30/} See First National City Bank, Monthly Economic Letter, New York, February 1975.

^{31/} Statement by the President of the Bank of Nicaragua, R. Incer Barquero, speaking on behalf of a large number of Latin American countries at the Meeting of Governors of the International Monetary Fund and the World Bank, 30 September, 1974.

This imbalance which is so disturbing for the peripheral economies must be viewed in conjunction with another negative fact: that most observers are more optimistic regarding the possibility of containing or moderating the acceleration in price rises than in reactivating the economy within a short period or even in the next two or three years, which is the time given in some official estimates for the United States. In fact it is assumed that the first will be facilitated by the second, i.e., that a contraction, even though it may be quite relative compared with the growth rates of the previous period, will favour restriction of price rises.

Viewing the matter more closely and in direct relation to the subject of this document, one unknown quantity is whether the great industrial economies will succeed in obviating inflationary pressures to a significant extent (returning, for example, to inflation rates similar to those of the early 1960s), or if they will have to resign themselves to merely stopping the present spiral and henceforth learning to live with inflation rates of around 10 per cent per year.

The forecasts are situated between these reference points, because in actual fact very few persons fear that the phenomenon will really get out of hand.^{32/}

Whatever the situation which finally emerges, it seems certain that it will differ substantially from previous conditions. It will therefore be all the more necessary to renew conceptual frameworks, to start using other instruments, or to substantially modify the operation of traditional instruments.

^{32/} Professor Paul Samuelson makes the following comment on the prospects which have opened up:

"... it seems only realistic to perceive the outlook for the mixed economies not only as an outlook for stable prices but rather for a series of compromises which will make for creeping or trotting inflation. The problem is how to keep the creep or trot from accelerating. This includes the challenge of finding new macroeconomic policies beyond conventional fiscal and monetary policies that will enable a happier compromise between the evils of unemployment and of price inflation". See "World stagflation", op. cit.

Moreover, it is still difficult to gauge the significance that these changes will have for the developing countries. So far, these countries have only experienced the first effects of world inflation. The analysis of some of these countries may help to give a clearer picture of the new problems which are emerging, and this is the subject of the next chapter.

Chapter II

LATIN AMERICA AND "IMPORTED INFLATION"

In order to examine "imported inflation" in Latin America, it is first of all essential to clarify some points so as to prevent any misunderstanding. Of course, there will always be those who recall with some irony that the inflationary situations prevailing in several countries of the region and in different and sometimes fairly long periods were not precisely "imported", but were mainly due to various internal factors and trends that are amply discussed in the bibliography on the subject. What is more - as noted in the preceding chapter - it is not unusual to find in the analyses of the recent inflation affecting the central economies references to the "Latin Americanization" of their process of rising prices.

There is no reason to differ outright with that point of view. As will be seen later in the country studies, care has been taken to bring out the inflationary history of some countries, as well as the structural and other characteristics affecting this question and the form currently taken by the process. Among them, incidentally, are those of the external sector, its structure and fluctuations, which existed or played a decisive part in many outbreaks of phases of inflation.

It is also clear, however, that these factors have never had such a predominant, widespread and intensive effect on the acceleration of prices as in the present situation.^{1/} Moreover, coming to accentuate the original nature of the process, this time it is the reflection of a considerable expansion of trade and, in particular a sudden substantial increase in export and import prices.

The following analysis deals with the most significant aspects of the country studies included in chapter III, and focuses on 1973

^{1/} Even in countries like Chile and Uruguay where internal circumstances were the main cause of the recent high rates of inflation, the external impact has played an important part in the trends and fluctuations of the phenomenon.

and 1974 which are the most representative years of imported inflation. Needless to say - it has already been pointed out in other parts of this study - this whole picture may prove circumstantial or transitory in the light of the new prospects for the international economy.

The country studies reveal widely differing situations. Sometimes, as in Bolivia and Costa Rica, the renewed acceleration of price increases is taking place after periods of marked stability, although in both cases the external pressure was superimposed on other pressures that had been activated locally. In other countries - Brazil and Colombia, for example - the disequilibria broke out in a context of a precarious control and moderate and, in the former country, declining rates of inflation. Ecuador, to a greater extent than Bolivia, presents the peculiar case of an economy in which petroleum exports raise the problem - not now sui generis - of a qualitative change in the magnitude of the foreign exchange surpluses which must be absorbed. Lastly, there is Uruguay, where imported inflation is linked with domestic inflation which in previous years had led to substantial price increases. As may be seen in table 1, the superimposition of the two processes resulted in a rate of inflation of 100 per cent in 1973, which was reduced to just over 70 per cent in 1974 thanks to a severe policy of restraint.

In this spectrum of contrasting circumstances, consideration must be given to the basic data on past trends and on the socio-economic structures which are exposed to the vicissitudes of the international situation, and to long-term or contingency economic policy directives.

In Brazil, for example, the challenges of the new situation are present in the context of vigorous growth, relative flexibility of the production system, an increasing openness and dependence with respect to the external variables - albeit offset by a not insignificant freedom of manoeuvre in that respect - and an explicit, continuing and pragmatic overall economic policy, whatever reservations may be made regarding its content and weaknesses. On a different and certainly more restricted plane, this model could be applicable to

/Colombia, although

Colombia, although its domestic market is not so large nor its production structure so diversified as Brazil's, and its policy has experienced more variations, besides being considered in a more limited context.

Ecuador and Bolivia have some structural features in common which are observable in their past evolution and are more clearly visualized in a situation such as that which has recently arisen. Without going into details, which are given later in the country studies, these features point to the difficulty of absorbing expansionist waves (particularly of the magnitude of Ecuador's) when they are projected on extremely heterogeneous production profiles in which a major part of the population belongs to the primitive stratum. It is unlikely that this stratum will be able to react to substantial increases in demand, but it does seem more sensitive in the way of adjusting its prices if for any external reason the prices of its imported inputs and foodstuffs rise.

Moreover, in both cases it is difficult to frame suitable policies, either because for Ecuador it is a new problem, in both quantitative and qualitative terms, with respect to the utilization of foreign exchange, or because, in Bolivia's case, the policies adopted in the face of the same problem but at a different level have followed certain basic principles which have not been successful in taking advantage of the potential of the external sector's vigorous growth.

The situations in Costa Rica and Uruguay differ in many respects. There are, however, alike in others which have a significant influence on the issue reviewed here. For example, the external inflationary pressures are unleashed on two economies which in a differing order and degree had encountered difficulties in regaining or reaching satisfactory growth rates and which, moreover, are favoured less than others by the international trade situation.

From another point of view, of course, important differences are observable, such as the relative novelty of the inflationary problem in Costa Rica, in contrast with its duration and severity

/in Uruguay.

in Uruguay. This and other more basic factors are the reason for the different content and scope of the policies adopted.

In the following pages an overall analysis is attempted of the countries selected on the basis of two main questions: the pattern and symptoms of the incidence of imported inflation, and the guiding principles and options of the policies or measures devised to combat it.

A. STRUCTURAL CHARACTERISTICS AND VULNERABILITY
VIS-A-VIS IMPORTED INFLATION

While admittedly inflationary pressures in recent years in the majority of cases mainly originated abroad, it is none the less true that their incidence has depended on a number of factors which have given them greater or lesser force. What it really amounts to is the interaction of many influences, including the external situation, which is the main variable, the particular features of each economy and - last but also highly important - the decisions adopted to contend with the situation. On this interaction will depend the manner and degree in which the inflationary impact is transmitted, imported, multiplied or attenuated, all within a dynamic process of successive actions and reactions.

Among the key factors to be considered in this analysis is, first and foremost, the degree of openness of the economy, i.e., the degree to which it is integrated in world trade and the financial flows.

From this standpoint, there are a number of important points to consider. To begin with, most of the Latin American countries have fairly low coefficients of openness compared with some European countries, such as Belgium, the Netherlands and Norway, whose trade flows represent proportions of over 40 per cent. There are marked differences, however, between the larger and the smaller countries,

as also happens in the case of the industrialized countries.^{2/} Table 3 shows that Brazil's share is very low compared with that of Costa Rica, which is a typical example of an open economy. This merely confirms the well-known assumption that the development of foreign trade and consequent possibilities of specialization acquire more importance in the smaller countries with a smaller market and range of resources.

It seems clear, however, that the developments under review have resulted in a fairly widespread and appreciable enhancement of external relations. This is true of four of the six countries studied (see table 3). As regards Colombia and Uruguay, which have not followed that trend, some special situations affecting them must be taken into account. For example, the unfavourable trend in Colombia's traditional exports in the middle years of the past decade reduced the above share. Therefore, the 1973 figure indicates a recovery as a result of the vigorous growth of new exportable commodities. The situation in Uruguay, which contradicts the aforementioned assumption regarding small countries, is a sign of the external sector's inability to expand from which it has long been suffering, and which is one of the crucial factors of its present stagnation.

^{2/} The coefficients of France (15.6 per cent), Japan (10.7 per cent) and the United States (5.9 per cent) contrast strongly with the Netherlands' coefficient of nearly 50 per cent. Figures for the years 1968-1970, in OECD, "The international transmission of inflation", Economic Outlook, op.cit.

Table 3

LATIN AMERICA: AVERAGE EXPORTS AND IMPORTS OF GOODS
AND SERVICES AS A PERCENTAGE OF THE GROSS
NATIONAL PRODUCT AT CURRENT PRICES

	1960-1962	1973	Percentage variation
Bolivia	20.2	29.7	47.0
Brazil	7.7	8.9	15.6
Colombia	14.5	14.2	-2.1
Costa Rica	24.1	34.2	41.9
Ecuador	18.3	24.1	31.7
Uruguay	14.0 a/	13.6	-2.9

Source: IMF, International Financial Statistics, October 1967
and March 1975.

a/ 1961-1962.

/This question,

This question, however, is linked not only with the qualitative representation of external transactions, but also - to a considerable degree - with their structure, particularly the composition of exports and imports, an aspect which is dealt with in detail later in this study. Here attention is drawn merely to some important facets in the light of recent experience. It is unnecessary, of course, to stress the decisive significance of being a net oil importer or exporter. In each case, the repercussions, apart from being considerable, will show a very different sign in the trend of prices, balance of payments position and monetary implications. In the equally disparate case of countries with exportable agricultural surpluses and those importing foodstuffs, the external situation has a very different impact on each of these groups and the problems that arise are also very different.

As the structural counterpart of the situation as regards the level and quality of openness of the economy, consideration might be given to the representation in the various countries of the subsistence sector - partly or completely outside the money market - which in differing degrees would not be greatly affected by inflation associated with the external sector, nor would it influence the reproduction and spread of this phenomenon locally.

In this respect, reference has been made above to Ecuador and Bolivia, which seem to be the most relevant cases for this discussion. In any case, it would not do to exaggerate the significance of this aspect of the situation in Latin America, although it may be more worthy of consideration in countries or areas with a more typically dual structure and with few links with other countries owing to their very state of underdevelopment. This subject is dealt with more fully in the studies on these two countries.

In addition to these structural characteristics, the impact of imported inflation will largely depend on the policies adopted to combat it, a matter which is examined later in this study. It can be stated in advance that the freedom of manoeuvre and the

/possibilities and

possibilities and choice of action will be decisively conditioned by those structural characteristics and by institutional and socio-political elements which are well-known.

B. CHANNELS OF TRANSMISSION OF IMPORTED INFLATION

Against a backdrop of the foregoing circumstances, the various ways and forms in which external inflationary pressures are disseminated should be identified. The 1973 Economic Survey includes a preliminary study of the question, and other attempts at analysing it have been made since, as inflation took root and spread. They include a special study by the OECD,^{3/} which endeavours to classify the channels of transmission of the process, identifying the factors which are seen to stimulate it in the industrialized countries represented by that Organization.^{4/} A different system is adopted here, which naturally has some elements in common with the aforementioned system, but seems better suited to the circumstances in Latin America. A distinction is made between direct influences and indirect influences, and, among the latter, between those constituting the initial spur to the propagation of inflation and those deriving from such influences.

^{3/} "The international transmission of inflation", Economic Outlook, July 1973.

^{4/} These factors are grouped as follows: (a) price-effects, whether of competitive or non-competitive imports, or of exports that follow the trend of prices; (b) demand-effects, deriving from the increase in exports and the improvement in the external current account, which results in excessive demand in a period of full employment; (c) liquidity-effects of the balance of payments on monetary conditions, and hence on domestic demand and prices; (d) other links, such as those between multinational enterprises and trade union organizations, international inflationary expectations and demonstration-effects.

The most obvious of the direct channels is the rise in import prices. As will be seen in table 4, substantial increases were recorded in 1973 and 1974 in all the countries considered, especially in the latter year. The variations in 1974 range from 22.8 per cent in Bolivia to 57.5 per cent in Brazil.

Unfortunately, the available data are unreliable and usually underestimate of the actual magnitude of the adjustments. There are better classified data for Brazil, which show much sharper contrasts between the trends of prices and quantities in the case of some major groups of products. Table 5 reflects the situation in the first six months of 1973 and 1974.

There is, in fact, a marked disparity between the trends of prices and of the volume of imports (see table 4). Some countries recorded substantial increases in both. In the majority, prices increased much more than the volume. Basically, these disparities are in keeping with the developments in 1974 as regards oil prices (see in table 4 the price increases particularly affecting Brazil, Costa Rica and Uruguay).

These ratios raise some queries regarding the inflationary impact of the larger volume of imports. From one point of view, the bigger inflow of foreign goods might be considered to act as a restraint on price increases, because of its contribution to total supply and, in particular, towards eliminating partial disequilibria within total supply in the face of changes in demand. From a different standpoint, however, opposite repercussions are observable for two main reasons: first, the increases in the volume of imports, to the extent that they increase the share of foreign goods in total supply, extend the area of impact of the rise in external prices; secondly, a varying proportion of the increase in imports may have gone towards increasing the reserves or stocks of private or public enterprises as a safeguard against an uncertain situation, which would cancel out part of their possible contribution to actual supply.

Table 4
 LATIN AMERICA: INDEXES OF PRICES AND VOLUME OF
 IMPORTS IN SELECTED COUNTRIES

(1970 = 100)

Country	Price index				Index of volume			
	1973	1974	Percentage variation		1973	1974	Percentage variation	
			1973	1974			1973	1974
Bolivia	127	156	17.6	22.8	117	150	8.3	28.2
Brazil	134	211	19.6	57.5	177	232	18.0	31.1
Colombia	130	158	18.2	21.5	100	114	8.7	14.0
Costa Rica	128	168	15.3	31.3	109	126	2.8	15.6
Ecuador	128	166	16.4	29.7	144	186	15.2	29.2
Uruguay	133	208	19.8	56.4	92	99	15.9	7.6

Source: ECLA, on the basis of official statistics.

Table 5

BRAZIL: VARIATIONS IN THE VALUE AND VOLUME OF IMPORTS
 (First half of 1973 and 1974)

	Percentage increase in value	Percentage increase in volume
Basic commodities	225	4.3
Processed products	93.8	71.9
<u>Total</u>	<u>122.5</u>	<u>14.7</u>

Source: Conjuntura Econômica, October 1974. See table 33 in the study on inflation in Brazil.

It is not easy to clarify this point without careful research. At all events, it seems that the effect of the increases in the volume of imports remains contradictory, although the increases in import prices certainly is not.

The second and more complex direct channel of transmission of external pressures is that set in motion by export trends. Table 6 shows the trend of exports in terms of prices and volume. Here the increase in prices is considerably larger in all the countries studied, particularly in 1974. Obviously, the disparity is greatest in the case of the two oil-exporting countries (Bolivia and Ecuador), which reduced their volume of exports.

As regards the transmission of inflationary pressures through exports, it is useful to distinguish those products which are mainly or, in some cases, wholly exported from those which in a fairly considerable proportion are absorbed by the domestic market.

Table 6

LATIN AMERICA: INDEXES OF PRICES AND VOLUME OF EXPORTS FOR SELECTED COUNTRIES

(1970 = 100)

Country	Price index				Index of volume			
	1973	1974	Percentage variation		1973	1974	Percentage variation	
			1973	1974			1973	1974
Bolivia	116	245	33.3	111.2	121	117	1.7	-3.3
Brazil	166	214	37.2	28.9	136	136	13.3	0.0
Colombia	125	145	27.6	16.0	132	144	6.5	9.1
Costa Rica	120	143	20.0	19.2	122	129	2.5	5.7
Ecuador	138	329	38.0	138.4	190	173	37.7	-8.9
Uruguay	190	204	45.0	7.4	77	81	-6.8	5.5

Source: ECLA, on the basis of official statistics.

It seems clear that the transmission of price increases is much more direct and widespread in the case of the second group of exports. Note, for example, the countries producing basic foodstuffs: wheat, meat or rice. Irrespective of what a prices policy can - and in practice actually does - accomplish, as will be noted in the country studies included in this Survey, there is no doubt that an immediate link is established between the two spheres, transferring the external increases to prices on the domestic market. Table 7 shows the price trends of some important items in the two categories described.

Table 7

LATIN AMERICA: PRICE INDEXES OF SELECTED
EXPORT COMMODITIES

(1970 = 100)

	1965	1971	1972	1973	1974
Wheat	102	107	119	135	329
Maize	108	112	115	167	306
Rice	92	114	104	141	571
Beef	108	149	180	243	272
Sugar	57	120	198	256	1 300
Coffee	91	78	96	117	121
Bananas	116	108	112	113	140
Cotton fibre	109	134	147	168	206

Source: ECLA, on the basis of official statistics.

In the case of the former group of exports, in contrast, the impact of improved prices is felt indirectly and with some delay through government income and expenditure or through the effects on the demand of those benefiting from the export business. This is generally the case with respect to exports of basic and industrial inputs, such as petroleum itself and mining products. Naturally, products of the two types may be found in some countries. Brazil, for example, is an important exporter of agricultural commodities as well as of iron ore.

1. Indirect internal spread and propagation:
general channels

As regards the indirect effects, attention must be centred first on three areas which act as amplifiers (or dampers) of imported inflation: (a) foreign trade; (b) the monetary field; and (c) the fiscal area.

In foreign trade, under other conditions, the foreign exchange rate and its devaluations were a major factor in raising domestic prices as a result of the rise in the cost of imports and related effects. In the recent situation, matters have taken a different course and this instrument may be said to have had an essentially moderating effect on imported inflation. This assumption applies to three countries in particular - Costa Rica, Ecuador and Bolivia - which have kept their exchange rates stable, in spite of the appreciable increase in domestic prices and, consequently, the actual depreciation of their currencies. By this and other methods, such as tariff reductions and subsidies, the impact of the higher import costs was softened.

The situation is quite different in other countries which, in keeping with their own special characteristics, have followed the system of mini-devaluations. These have permitted the price increases of imported products to filter through to the domestic market. Even in this case, however, the adjustments in the exchange rate generally lagged behind the increase in the price index, as will be seen in

/the country

the country studies, particularly in the case of Brazil in 1973. This subject is referred to again later in discussing economic policy guidelines vis-à-vis imported inflation.

The lesser importance of this channel (the exchange rate) in the recent situation is counterbalanced by the considerable importance acquired by another element which had been of little significance in past inflationary experiences: the movements of foreign exchange reserves and their relationship with monetary expansion.

Table 8 shows that in three countries there were substantial increases in these resources in 1973: 64.3 per cent in Colombia, 53.4 per cent in Brazil, and 68.5 per cent in Ecuador. The increase was more moderate in Uruguay (17.2 per cent), and in Bolivia there was a big jump the following year (164.2 per cent). In 1974, however, except in the case of the oil-exporting countries, they all recorded a drop in their reserves.

These changes had an evident impact on the growth of the means of payment in several countries in different years (see table 9). In Ecuador and Bolivia, for example, the expansion of monetary resources was basically due to the purchase of reserves by the Central Bank. As regards Colombia and Brazil, the violent expansion of reserves in 1973 would account for about one-third of the increase in monetary resources in the former, and approximately one-quarter in the latter.^{5/} In 1974, in contrast, the drop in reserves experienced by the four non-oil-exporting countries helped to curb the increase in the money supply (see table 9).

^{5/} See the country studies for a more detailed analysis of these questions.

Table 8
LATIN AMERICA: INTERNATIONAL RESERVES IN SELECTED COUNTRIES

(Millions of dollars, at the end of each period)

Country	1970	1973	1974 a/	Percentage variation	
				1972- 1973	1974- 1973
Bolivia	45.5	72.1	190.5 (12)	20.8	164.2
Brazil	1 187.0	6 417.0	5 531.0 (10)	53.4	-13.8
Colombia	206.0	534.0	449.0 (12)	64.3	-15.9
Costa Rica	16.3	42.4	14.15 (11)	7.7	-66.7
Ecuador	83.0	241.0	350.0 (12)	68.5	45.2
Uruguay	175.0	232.0	170.0 (10)	17.2	-26.7

Source: IMF, International Financial Statistics, February 1975.

a/ The figures in brackets are the number of months considered in relation to December 1973.

Table 9
LATIN AMERICA: INCREASE IN THE MONEY SUPPLY IN SELECTED COUNTRIES

(Percentages)

Country	1971	1972	1973	1974 a/
Bolivia	15.2	25.2	34.3	32.8 (9)
Brazil	31.3	38.9	48.0	16.9 (9)
Colombia	11.9	27.1	30.7	7.8 (3)
Costa Rica	28.8	14.2	24.1	6.3 (9)
Ecuador	11.4	21.6	30.7	15.1 (8)
Uruguay	51.1	52.1	74.5	62.2 (12)

Source: IMF, International Financial Statistics, February 1975.

a/ The figures in brackets are the number of months considered in relation to December 1973.

/Although the

Although the fluctuations in international reserves and their monetary projections follow a fairly regular pattern in keeping with the structure of the external sector, the same cannot be said for the movements of domestic credit, whose contribution to the money supply and its internal composition varies considerably between one country and another (see table 10).

In Ecuador, for example, the striking feature is the contrast between the increases in this monetary source and the fluctuations in foreign exchange reserves. The rates of expansion are fairly moderate and only the private sector benefited from the increase in credit. Conversely, taking advantage of the oil boom, public credit became independent of the Central Bank and even reduced its debts. A similar process is apparent in Bolivia, although the expansion of credit was only slowed up in 1974, also at the expense of the public sector and with fairly high growth rates for the private sector.

In Brazil, the increases and distribution of credit in the more favourable years were fairly uniform, except in 1974 in the case of the public sector, which shows a negative sign as regards the use of credit. It should be borne in mind, however, that the financial market constitutes an important alternative source of funds for the Government.

In Costa Rica there was an appreciable rise in the rates of increase in domestic credit between 1973 and 1974, especially as regards the public sector. This, however, did not prevent the increase in the money supply from being fairly small in 1974 (see table 9), no doubt as a result of the restrictive effect of the drop in foreign exchange reserves (see table 8).

The figures for Uruguay are evidence of the serious inflation experienced by that country in recent years. Although admittedly the rate of increase in the money supply decreased somewhat in 1974 (see table 9), this was due to the movement of reserves rather than to the development of credit, since the latter rose appreciably in 1974, particularly in support of the private sector (see table 10).

Table 10
LATIN AMERICA: VARIATIONS IN DOMESTIC CREDIT IN SELECTED COUNTRIES

(Percentage annual rates)

	Percentage variations			
	1971	1972	1973	1974 ^{a/}
Bolivia (millions of pesos)	21.2	28.2	31.2	8.5 ^{b/} (12)
To the public sector	18.4	21.2	4.1	-39.4
To the private sector	25.9	39.2	68.1	60.0
Brazil (millions of cruzeiros)	41.4	31.9	46.6	44.8 (11)
To the public sector	12.2	-42.4	22.4	-27.6
To the private sector	48.0	44.6	48.2	48.9
Colombia (millions of pesos)	18.4	17.4	18.8	...
To the public sector	32.0	7.0	12.1	
To the private sector	15.4	20.0	20.4	
Costa Rica (millions of colones)	34.1	17.5	10.2	50.3 (12)
To the public sector	37.6	42.2	1.0	44.7
To the private sector	33.5	12.9	12.3	51.5
Ecuador (millions of sucres)	11.6	3.5	0.0	12.5 (10)
To the public sector	16.8	-18.5	-88.4	- ^{c/}
To the private sector	10.0	10.3	20.5	31.8
Uruguay (thousands of millions of pesos)	66.5	94.0	51.3	86.0 (12)
To the public sector	109.4	80.7	9.8	67.0
To the private sector	56.0	98.3	63.6	94.0

Source: IMF, International Financial Statistics, March 1975.

^{a/} Preliminary estimates. In brackets, the number of months considered.

^{b/} The source of the 1974 figures is the Central Bank of Bolivia.

^{c/} A negative balance was recorded again.

It might be interesting to compare the relationship between the increases in the money supply and the rise in prices; these variables are usually compared in search of some causal relationship. Table 11 presents the respective figures for the six countries considered. It is easy to see that only in Bolivia, Ecuador and Costa Rica 6/ is there a certain parallel relationship between the two indicators. In the other countries the connexion is much more erratic. For example, in Brazil, a considerable expansion of the means of payment in 1973 was accompanied by a substantially lower rise in the price index, in contrast with 1974 when the second indicator increased much more than the first. A similar situation is noted in Colombia, Costa Rica and Uruguay in 1974.

Thorough research would be required to determine the reasons underlying these trends and disparities, and some light is shed on the subject by the country studies which form part of this Survey. Suffice it to say here that the figures reveal scant grounds for an over-simplified or quantitative approach to the relations between monetary expansion and price increases.

2. The fiscal channel

The repercussions of imported inflation on the fiscal area seem to have been less severe than the classic impact of situations of crisis or restraint in the external sector. The obvious exceptions are Ecuador and Bolivia, where the Governments are the main internal beneficiaries of the petroleum export boom. It also seems clear, however, that the repercussions on prices have everywhere affected the public finances, through increases in current or capital expenditure or in spending on imports or domestic goods and services. It is equally true that in the countries enjoying an increase in fiscal revenue, the inevitable tendency towards a parallel increase in public spending involves redoubled pressures on the availability and flexibility of production resources, in addition to which it is much

6/ In Costa Rica's case, only in 1973.

Table 11

LATIN AMERICA: COMPARISON BETWEEN INCREASES IN THE
MONEY SUPPLY AND IN THE CONSUMER PRICE INDEX
IN THE SIX COUNTRIES CONSIDERED

	1973	1974 ^{a/}
<u>Bolivia</u>		
Increase in money supply	34.3	32.8 (9)
Increase in consumer price index	34.7	35.9 (9)
<u>Brazil</u>		
Increase in money supply	48.0	16.9 (9)
Increase in consumer price index	13.6	27.5 (9)
<u>Colombia</u>		
Increase in money supply	30.7	9.5 (7)
Increase in consumer price index	25.1	29.3 (11)
<u>Costa Rica</u>		
Increase in money supply	24.1	6.3 (9)
Increase in consumer price index	26.4	26.0 (6)
<u>Ecuador</u>		
Increase in money supply	30.7	21.1 (10)
Increase in consumer price index	20.5	17.4 (10)
<u>Uruguay</u>		
Increase in money supply	74.5	62.2 (12)
Increase in consumer price index	77.7	107.3 (12)

Source: ECLA, on the basis of official statistics.

a/ The figures in brackets are the number of months considered in relation to December 1973.

/more difficult

more difficult to endeavour to raise domestic taxes, either for anti-inflationary purposes or in order to obtain the domestic saving counterpart of the bigger investments being made or in view. Paradoxically enough, the boom resulting from the foreign trade situation is not a favourable atmosphere for pursuing those aims, although the objective conditions make them more feasible than at any other time.

Table 12 shows the trends of and relationships between the growth of total expenditure and current income in the countries considered. Since the figures represent nominal values, they tend to overestimate the actual growth, but it is nonetheless true that the changes between 1974 and 1973 without exception exceed the rise in prices, sometimes by a considerable amount (see, for purposes of comparison, table 13). This comes on top of what are also significant increases if the situation in 1973 is compared with that of the base year (1970).

It will be noted, moreover, that the expansion of total expenditure in 1974 over 1973 was accompanied fairly flexibly by current income. Except in Uruguay, the latter rose at a higher rate than the former. Furthermore, as regards Ecuador, the growth of income compared with expenditure has been considerable between 1970 and 1974 which is not surprising in view of the impact of the inflows obtained from the development of petroleum.

It should be borne in mind that the evident benefits deriving from petroleum exports have also meant that the fiscal system of the countries thus favoured have become overwhelmingly more dependent on this activity.

Table 12

LATIN AMERICA: EVOLUTION OF CURRENT INCOME AND FISCAL
EXPENDITURE IN THE COUNTRIES CONSIDERED

(Percentage annual variation)

	Variation 1970-1973	1974 (over the same period in 1973)
<u>Bolivia</u>		
(Central government)		
Current income	32.1	106.7
Total expenditure	32.1	92.4
<u>Brazil</u>		
(Federal government)		
Current income	40.2	41.0 (January-October)
Total expenditure	38.1	33.5 (January-October)
<u>Colombia</u>		
(National government)		
Current income	18.8	26.6 (January-June)
Total expenditure	19.5	24.4 (January-June)
<u>Costa Rica</u>		
(Central government)		
Current income	16.2	32.5 (January-September)
Total expenditure	35.0	16.3 (January-September)
<u>Ecuador</u>		
(Central government)		
Current income	29.6	86.7
Total expenditure	16.4	79.8
<u>Uruguay</u>		
(Central government)		
Current income	64.7	63.7
Total expenditure	64.6	80.8

Source: ECLA, on the basis of official statistics.

Table 13

LATIN AMERICA: VARIATIONS IN THE CONSUMER PRICE INDEX
(Percentage annual variation)

		Variation	Variation 1974 c/
		December 1973	December 1973
		1970	
Bolivia (La Paz)	General index	20.8	38.8 (December)
	Food index	24.0	44.7 (December)
Brazil (Guanabara)	General index	18.6	30.9 (November)
	Food index	21.1	38.5 (November)
Colombia (Bogotá)	General index	17.3	16.3 (August)
	Food index b/	20.5	18.7 (August)
Costa Rica a/	General index	12.3	26.0 (June)
	Food index b/	12.2	20.4 (June)
Ecuador (Quito)	General index	13.1	21.8 (November)
	Food index	17.2	30.1 (November)
Uruguay (Montevideo)	General index	72.6	50.7 (August)
	Food index	80.7	45.4 (August)

Source: United Nations, Monthly Bulletin of Statistics, February 1975.

a/ Wholesale prices.

b/ Weighted average for food of animal and vegetable origin, and for beverages and other items.

c/ The last month considered is given in brackets.

3. Prices and wages and salaries

In the wave of pressures and impulses set in motion by imported inflation, another element may be distinguished: the movements or responses of domestic prices and income to the changes analysed above. As regards the above pressures, the direct impact of the rise in import and export prices has already been discussed. It was also stated that in the case of export commodities of which a significant proportion is consumed locally, the impulse is immediately transmitted to the share destined for the domestic market.

Undoubtedly, however, the process of dissemination and possible multiplication of the direct effect only starts here. It is recognized that there is a sympathetic association of changes in prices, which operates and is manifested in many different ways. A rise in the price of the products concerned - whether imports or exports - will trigger increases in the prices of substitutes or competitive products. Spending the additional income - even if with the object of increasing the exploited area or the quantities produced - will in some degree affect the availability of resources and, consequently, their prices. Efforts to use land or materials for activities yielding the highest returns have often resulted in the reduction or insufficient growth of other lines of production, with the resulting price-effects. The reactions are thus linked together and extend indefinitely, compelling the Governments to adopt different measures.

Without going too deeply into this well-known aspect, it is useful to note the asymmetry of this phenomenon, which is of key importance in discussing the behaviour and role of the movements of income.

Another glance at table 1 of this first part of the Survey will show the rates of increase in the price index of the countries under review. Going a step further, table 13 has been prepared in which the general rise is compared with the increases in the foodstuffs between December 1973 and the last month of 1974 for which data were available at the time of writing this study.

It will be seen that at the end of 1973 - compared with the base year (1970) - in all the countries except Costa Rica the increase in food prices was bigger than that recorded for the overall index. This disparity is again evident from a comparison of the changes between 1974 and 1973, although Uruguay and Costa Rica do not follow the prevailing pattern, which is more strongly marked in the cases of Brazil and Ecuador. Naturally, this ratio underestimates the actual difference between the two figures, because the overall index includes the index recorded for foodstuffs.

Moreover, there are well-known inadequacies in coverage and procedures which tend to have the same effect, especially in periods of substantial increases, which make it more difficult to control prices and widen the gap between official prices and actual market prices.

The acceleration of price increases and the asymmetry of these movements have obvious and only too well-known implications in terms of income trends. The more than proportional increase in food prices and the various obstacles preventing or delaying adjustments in the income of large groups of wage-earners encourage the trend towards a regressive income distribution which is in any case a result of any acceleration of the inflationary process.

At least in the countries under review - and for different reasons in each - no great propagating or multiplier effect appears to have been exercised by the pressure of wage-earners to regain former levels of real income, which in the previous chapter was seen to be a very significant factor in the present situation of the central economies. However, the country studies show that in several countries measures have been taken to counteract such deterioration or wage and salary adjustments have been accorded, especially to urban workers. In this respect, it is pointed out that the acceleration of price increases in Brazil led to a change in the approach which had long been in force regarding the movement of wages and salaries.

C. ECONOMIC POLICY OPTIONS AND INSTRUMENTS

It is not possible to review the wide range of positions and instruments which have been adopted by the countries considered in dealing with imported inflation, and which are discussed later in the respective studies. It might, however, be useful to present the problem here in broad terms.

These countries, of course, like the rest of the countries of Latin America, have had to choose between two clear-cut possibilities. First, to accept the rise in external prices and to adjust their domestic prices and price system accordingly, with all the possible drawbacks and advantages involved. This is what some have called the "internalization" of world inflation, which would lead to the search for a new balance at a different level. The other choice would be as far as possible to shut themselves off from the tide of rising external prices in order to curb price increases; but this would also mean, to a considerable degree, maintaining the relation between prices or the price system existing before the situation developed.

Of course, this is merely a hypothetical option. In practice, no country has been or would be able to take either of these opposite courses to extremes.^{7/} What is observable, however, is a tendency in the one or the other direction. This tendency, moreover, depends more on particular and objective circumstances than on the arbitrary or subjective decisions of policy-makers.

The dilemma in the case of a Caribbean country was presented clearly at a recent meeting:

^{7/} In the European discussion of the matter (see Economic Outlook, July 1974, op.cit.) it is clear that the option of shutting themselves off from imported inflation is utterly impracticable for the more open economies. Moreover, experience has shown it to be inadvisable even for the more important economies, even though they certainly have more radius of action.

"Much of the inflation is imported. The prices of basic food which we have to import - flour, rice, meat, animal feeds and textiles - have risen very sharply and continue their uninterrupted rise. To cushion the effect of all these price increases would be very costly; it would further reduce the amount of money available for developmental purposes. Not to cushion would lead to the inevitable demands for high wage increases which will affect our competitive position, and will further add to inflationary pressure. Our dilemma is similar to that faced by many small countries with open economies and an undiversified production structure. The Government has chosen the middle way; it is to keep stable the prices of certain key goods such as flour, rice and internal transportation by means of direct subsidies; and to use other devices, including credit and monetary policy, fiscal concessions to industry, and an improvement in guaranteed prices for local farm production to control price increases originating within the domestic economy."^{8/}

This eclectic approximation seems to have been followed by most of the countries studied. It is easy to see, however, that some countries - Ecuador, for example, which has had an extraordinary amount of fiscal resources - have had more recourse to instruments such as subsidies and tariff reductions in moderating the rise in price of essential imports. Furthermore, to keep the parity of the sucre fixed in the face of a significant increase in domestic prices has in fact meant a revaluation of the exchange rate. This did not, however, jeopardize its basic export commodity (petroleum) or its foreign exchange reserves, although the latter grew less in 1974 than in 1973 (see table 8).

Other countries, in contrast, either for lack of the same possibilities or in keeping with the policy adopted, or a combination of the two, have let the level and system of prices adapt to the changes in the external situation.

^{8/} See the statement by Mr. V.C. McIntyre, Ambassador of Trinidad and Tobago, in the OAS final report of the Sub-Committee of CEPCIES on Trinidad and Tobago, September 1974.

From a different standpoint, two other types or forms of action in dealing with imported inflation may be distinguished in the national experiences reviewed here, as also in the rest of the countries. On the one hand are the cases in which the measures and instruments applied have been placed within or have derived from an overall economic policy framework. On the other hand are the countries which have adopted a number of ad hoc decisions of which the guiding principle may have been to curb the rising prices and mitigate the social and economic impact of the situation.

Neither can a rigid or complete division be established here, but it is clear that Brazil, for example, is a conspicuous illustration of the first group. Not only is it possible to observe a clearly-defined anti-inflationary strategy, which has been implemented for nearly a decade, but this strategy has formed part of an overall approach to development. In fact, it would not be possible to understand the former without having in view the latter, and to a certain extent it might be maintained that the management of the inflation variable has had outstanding significance in the framing and handling of development policy.

Contradicting what has sometimes been maintained in certain circles outside Brazil, those general and specific frameworks do not seem to have involved unvarying or dogmatic commitments through specific instruments and actions. Quite the contrary, As pointed out by some of the foremost leaders of that experience, the basic definitions have gone hand in hand with a considerable dose of pragmatism.^{9/} Thus there has been no reluctance to alter rules or prime directives of the policy being implemented, when circumstances have dictated a different course. Reference was made above to the criteria with respect to wage increases. It is also useful to

^{9//} See M.H. Simonsen, "Inflação: Gradualismo versus tratamento de choque", (Apec, Rio de Janeiro, 1970); and M.H. Simonsen and R. de Oliveira Campos, "A nova economia brasileira" (Libraria José Olympio Editora, Rio de Janeiro, 1974).

recall the moderation involved in the practice of mini-devaluations when external pressures on prices were intensified in 1973, or the abandonment of the adjustability clause in the new Treasury bills.

At the other end of the scale, logically enough, as regards the definition or scope of policies, are those countries which have had less experience in the ups and downs of inflation, or which have had to face substantially novel situations. Costa Rica and Ecuador are clear examples of these two situations. In Uruguay and Bolivia, to a certain degree, the measures against inflation have been conditioned by an overall policy, although this may not, of course, have the radius of the Brazilian policy. Lastly, and at a different level, it is possible that Colombia's policy is closer to that of Brazil, at least as regards the expeditious and practical nature of many of its provisions.

D. PROSPECTS AND QUERIES

At the beginning of 1975, it may already be anticipated without too much risk of error that the conditions prevailing in the dynamic and complex period 1973-1974 are likely to be appreciably modified. As noted in chapter I, the price curve of basic materials is definitely pointing downwards. This trend also includes petroleum, in spite of the special circumstances attaching to it. Although the majority assume that these prices will remain at fairly high levels compared with those recorded at the end or in the middle of the 1960s, nobody can hazard specific forecasts, since a decisive factor in this connexion is the recovery by the central economies of their dynamic impetus.

In any case, from the Latin American standpoint and with the relative exception of the oil-exporting countries, one all-important aspect of imported inflation, which is precisely the advantageous one, has come to an end, since the expansion and rise in the prices of exports has halted, while prices of imports continue to rise.

/This change

This change in the external picture has an evident impact on the inflationary prospects of the Latin American countries, apart, of course, from its more general implications which are also a source of concern.

This means that the effect of the rise in import prices will continue to be felt, in addition to the internal pressures set in motion by the current situation. Furthermore, the possible slowing-up of the inflationary process, as a result of the slackening in the rise of export prices and the channelling of some export commodities to the domestic market, would also mean a deterioration in the balance of payments and in the situation of important sectors of production.

Accordingly, it would not be surprising if in some countries a situation arose which was somewhat similar to the stagnation combined with inflation (stagflation) affecting the central economies. The rise in import prices and the cumulative internal pressures would act as a fillip to inflation, while the weakening of exports and the consequent probable decline in the capacity to import would jeopardize opportunities of growth.

Be that as it may, a new stage seems to be opening up after the fleeting but violent impact of imported inflation, which will once again put the countries' economic policies to the test. No doubt it will not be easy to adapt them in order to contend successfully with a situation which may be more like those arising in earlier periods.

Chapter III

RECENT INFLATION IN SIX LATIN AMERICAN COUNTRIES

The following review of inflationary experiences in six Latin American countries devotes particular attention to events in the years 1973-1974, which have been the most affected by international price trends. As will be noted, however, an attempt has been made to present a retrospective view of the phenomenon, especially in those countries in which its roots go fairly far back.

It was not a simple matter to select the countries. Two criteria predominated here. First, to show cases that differed as regards the impact of the external situation, which has depended basically on the consumption of exports and imports. Thus, side by side with the oil-exporting economies there are others in which the increases in import prices have been more significant than the export boom. Secondly, the idea was to present cases of countries in which inflation had not been very serious until the present situation, together with others in which it has been an important factor of past trends.

It should be borne in mind that the general picture and the specific situations presented in this study are already undergoing appreciable changes as a result of the new circumstances of the world economy, particularly the central countries. It will therefore shortly be necessary to revise observations and even analytical categories which may have been useful in dealing with this transitory situation, but which may not be so in grasping what is happening now.

The data presented in these studies may differ in some cases from those appearing in the country studies on recent economic trends, in which advantage was taken of the revised information on the main economic aggregates that was not available at the time the inflation studies were drafted.

1. BOLIVIA

A. INTRODUCTORY NOTE

The study of recent inflation in Bolivia is of special interest, in that its course would appear to be strongly influenced by the interplay of factors of different types, which go to make up a very individual picture of inflation as far as its origins and final form of expression are concerned.

The situation, moreover, is one of an inflationary cycle preceded by a long period of stability, and this undoubtedly provides a further factor of interest. The contrast between the stability and of the period 1969-1971 and the inflation which appeared in 1972 shows just how decisive structural aspects are in Bolivian development.

Perhaps the main interest of the present case, however, is the simultaneous existence of a wave of prosperity in the external sector which reached heights unknowns previously, and an inflationary process whose origins are deeply rooted in the country's productive system, this process being set off by the increase in the liquidity of the economy and then resurging under the impetus of international inflation. The extent to which inflation has unsettled the taking of decisions, which would have been further-reaching, had circumstances been otherwise, makes the study of this process a matter of high priority.

The present document only attempts to identify the most significant facts and the basic elements of inflation in Bolivia. Further clarification and more exact appreciations would require intensive work in the actual terrain of events, which is outside the scope of this first explanatory document.

/B. BACKGROUND

B. BACKGROUND TO THE NATURE AND EVOLUTION
OF THE BOLIVIAN ECONOMY

1. The general context

The actual evolution of the Bolivian economy in recent years has been marked by modest rates of economic growth. The main macroeconomic indicators show fairly moderate growth rates, the variations in which, generally speaking, do not take the form of downward or upward movements of any great importance. The more substantial variations were restricted to centres of activity whose influence was only secondary in the general framework of the economy. The modest growth rates mainly benefited certain urban groups linked with such services sectors as trade and banking, with some forms of processing such as metal-smelting, with certain manufacturing industries, and with construction activities. The mass of the population of Bolivia, who depend on agriculture for a living, made no major progress in their standard of living.

The great endowment with natural wealth and the fairly low level of economic activity would conceivably make it possible to achieve rather more ambitious margins of growth than those which actually materialized, i.e., the growth potential of the economy should be well above the moderate growth rate which it has shown in the past.

It should be mentioned that, during the period referred to, various development strategies and policies were tried out in different external and internal economic situations, but they did not achieve the changes which they were intended to bring about. The conduct of economic activity, generally speaking, has found obstacles of different types, among which may be mentioned the lack of cohesion in the structure of the economy.

The following description of the overall economy and the interpretation of inflation in Bolivia in recent years call for the identification of a group of basic shortcomings in the economic system which seriously restrict the process of production and distribution on the country's economy.

/The tremendous

The tremendous structural heterogeneity which characterizes the production function is one of the basic explanations why Bolivia is a relatively less developed country. By way of illustration, mining and petroleum must be compared with agriculture and even with incipient industry in Bolivia. The differences in productivity are exceptionally great, and, as already stated, this means an acute lack of interrelation between the sectors of production.^{1/} The absence of a lively manufacturing sector has caused the emergence of enclaves of exports of raw materials severed from the domestic process of production, while on the other hand a large part of the agricultural sector is functioning on the basis of archaic technology, with anti-economic scales of production and with no clear idea of how to plan the allocation of resources, markets and prices. In other countries, industry is the sector which plays an integrating role, but the volume of Bolivia's industrial output and the type of products manufactured show that this sector does not succeed in carrying out this role.

In addition to the lack of integration of the sectors of production, which is in itself a serious problem, there are other manifestations of structural heterogeneity, such as the existence of large geo-economic areas which are potentially very rich but are not linked with the producer and consumer centres of most importance in the country. On the other hand, structural heterogeneity is also manifested in the coexistence of several different cultural patterns in which different races, languages, customs, etc., constitute considerable obstacles to a more harmonious and integrated functioning of the socio-economic system. These structural features in turn are the cause of considerable disparities between the urban centres and the rural areas, and between the strata which make up

^{1/} According to ECLA estimates and the Memoria del Banco Central de Bolivia, 1973, the product per employed person in 1973, measured in Bolivian pesos at 1970 prices, is 1,500 in agriculture, 9,400 in manufacturing industry and 33,200 in mining and petroleum.

each of these categories. On one side are the country dwellers, who form the majority of the population but have no real purchasing power as regards industrial products; on the other are the high and medium-income urban groups whose demand constitutes an incentive only to small-scale industries which respond to their particular spending patterns. In the circumstances, it would be difficult to arrive at a rapid process of industrialization which would integrate the different sectors of production. The narrowness of the consumer market, resulting mainly from the low productivity of a large part of the agricultural sector, is a structural obstacle to any attempt at industrialization.

In view of the importance of the agricultural sector in the Bolivian economy, and in particular in the interpretation of inflation, some additional observations from the point of view of the heterogeneity of productivity would appear to be in order. The levels of production and the growth rates which will be given for the agricultural sector in the analysis of the economy overall, are an aggregate of altiplano and valley output, where chronic stagnation exists, and of the output of the eastern plains where products like cotton, sugar cane, soybean, etc., have excellent external markets, employ more advanced technologies and record fairly high indexes of output and productivity. If agriculture as a whole shows a rate of growth which is considered to be inadequate, how much more drastic such a qualification could be if it only referred to the agriculture of the altiplano and valleys in which the majority of the rural population works. These disparities should be borne in mind in the description and analysis of the performance of the main sectors of the economy given below.

This summary enumeration of the main structural shortcomings suffices to weigh their importance in the economic process in Bolivia in their true context. The disequilibria described are, in fact, the principal source of a series of problems affecting the economy, and of course lie at the root of a group of situational disequilibria which in their turn are expressed in the form of inflationary pressures.

2. Main features of the evolution of the economy

A study of inflation in Bolivia requires the identification of the main macroeconomic phenomena which characterized the recent evolution of the country's economy. The performance of some variables was a direct determining factor of inflation in Bolivia; the disequilibria which separated the physical area of the economy from its financial counterpart resulted in the unbottling of strong pressures on prices. This section therefore endeavours to select the aspects of Bolivia's economic evolution most closely linked with the phenomenon of inflation. In this context it is useful to compare the main variables in 1972 and 1973 (1972 was the year of the initial impetus and 1973 saw the aggravation of inflation) with their performance during the period 1970-1971, and in some cases with the last five years of the 1960s, as a basis for reference.

Of particular importance is the analysis of the main movements of the external sector, the structure of overall supply and demand and the evolution of the product in the main sectors. The main features of the overall evolution of Bolivian economy will be described in terms of these aspects taken in the same order.

(a) The external sector

The very considerable variations experienced by the external sector came to constitute the most important phenomenon of what has elapsed of the present decade. Their repercussions on the production function, income distribution and particularly on the future growth potential of the economy, confers particular importance on them, especially if it is recalled that tremendous importance in respect of the country's state of underdevelopment was attributed to the traditional bottlenecks in this sector. The events of recent years meant a change of some consideration in the scales of operation of external trade; in a brief period of two years, the current values of international transactions more than doubled. This is not just a matter of significant increases, but more than anything else of a situation different from that of the recent past in quantitative and qualitative terms, as is obvious from the description given below.

/(i) The

(i) The performance of exports. The current value of exports of goods showed an extraordinary increase. A comparison of the annual averages for the period 1965-1969 and those for the three-year period 1971-1973 shows a growth of 62 per cent, reflecting a clearly defined trend despite the decline in the value of exports in 1971. The growth rates of 1973 and 1974 are noteworthy; they showed an unprecedented increase when the value of exports of goods amounted to 337 million dollars in 1973, while various estimates for 1974 fluctuate around 680 million dollars (see table 1). These levels imply annual growth rates of 40 per cent in 1973 and 104 per cent in 1974, and show how the value of exports has tripled within the space of two years.

Important changes may also be observed in the structure of exports of goods. While during the five-year period 1965-1969, tin, which at the time was the only really important export item, accounted for 58 per cent of the total value of exports, in 1973 it accounted for only 38.6 per cent. On the other hand, most of the other exports of minerals, particularly oil, increased their share (see table 2).

During the first years of the 1970s a stage of diversification began in exports. A comparison of the structure existing during the last decade with that of 1973 speaks for itself. Products like oil, natural gas, sugar and cotton, accounted for an increasing share. This has made it possible to rise above Bolivia's traditional one-export system which in the past made the country extremely vulnerable to fluctuations in tin prices. Although a large proportion of the present export base is concentrated in a limited number of items, it indicates a definite reinforcement to external trade, especially if the increase in the prices of primary products is taken into account.

Table 1

BOLIVIA: STRUCTURE OF EXPORTS OF GOODS

(Values in millions of dollars at current prices)

Products	1965	Average 1965-1969	Average 1971-1973	1970	1971	1972	1973
Tin	93.0	94.4	116.5	101.9	105.9	113.5	130.0
Copper	3.5	6.9	10.2	12.5	8.3	8.8	13.4
Lead	5.7	5.8	6.7	7.8	5.9	5.8	8.3
Zinc	4.2	4.9	18.8	14.3	15.3	15.4	25.7
Bismuth	1.4	1.9	4.3	8.0	5.8	2.6	4.4
Tungsten	2.2	7.2	11.6	17.6	13.6	10.3	11.0
Antimony	5.9	6.9	11.8	31.0	9.0	9.1	17.2
Sulphur	0.2	1.2	0.6	0.5	0.3	0.5	1.1
Silver	5.3	8.1	9.5	10.5	8.3	7.6	12.6
Gold	2.9	1.6	0.5	0.5	0.3	0.6	...
Crude oil	0.7	15.7	34.8	13.2	23.9	31.7	48.9
Natural gas			14.0 a/			9.9	18.1
Cotton fibre			7.0	3.0	3.8	7.6	9.7
Coffee			4.4	3.8	2.6	4.7	5.9
Sugar			6.4 a/			0.4	12.4
Timber			5.7 a/			3.7	7.7
Total	128.9	162.9	264.4	225.6	215.9	240.4	336.8

Source: ECLA estimates on the basis of official data.

a/ 1972-1973.

Table 2
BOLIVIA: PERCENTAGE STRUCTURE OF EXPORTS OF GOODS

Product	1975	Average 1965-1969	Average 1971-1973	1970	1971	1972	1973
Tin	72.1	57.9	44.1	45.2	49.1	47.2	38.6
Copper	2.7	4.2	3.9	5.5	3.8	3.7	4.0
Lead	4.4	3.6	2.5	3.5	2.7	2.4	2.5
Zinc	3.3	3.0	7.1	6.3	7.1	6.4	7.6
Bismuth	1.1	1.2	1.6	3.5	2.7	1.1	1.3
Tungsten	1.7	4.4	4.4	7.8	6.3	4.3	3.3
Antimony	4.6	4.2	4.5	13.7	4.2	3.8	5.1
Sulphur	0.2	0.7	0.2	0.2	0.1	0.2	0.3
Silver	4.1	5.0	3.6	4.7	3.8	3.2	3.7
Gold	2.2	1.0	0.2	0.2	0.1	0.2	...
Crude oil	0.5	9.6	13.2	5.9	11.1	13.2	14.5
Natural gas			5.3 ^{a/}			4.1	5.4
Cotton fibre			2.6	1.3	1.8	3.2	2.9
Coffee			1.7	1.7	1.2	2.0	1.8
Sugar			2.4 ^{a/}			0.2	3.7
Timber			2.2 ^{a/}			1.5	2.3
<u>Total</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

Source: Table 1.

^{a/} Averages 1972-1973.

/It should

It should, however, be pointed out that the above mentioned diversification exclusively involves primary products with a minimum of industrial processing. This constitutes a basic feature in the interpretation of the entire economic process, and particularly in the analysis of inflation. The export nuclei figure as severed from the rest of the economy, thus determining the alarming disparities in productivity indicated above. This is the root of one of the difficulties which prevents Bolivia from making full use of the wave of prosperity in its external sector in the last two years.

The acceleration of the growth of export values in 1973-1974, and the variations in their structure, were determined to a large extent by the changes in international prices.

Table 3 gives a breakdown of the price and quantum factors which determined the increase in the current value of exports. It may be observed that in 1971 and 1972 export prices were much lower than in 1970, while the considerable increase in the export quantum blurred the adverse effect of the decline in these prices. The situation was inverted in 1973 and 1974: the export quantum increased by 2 per cent in 1973 and decreased by 3.3 per cent in 1974, compared with an annual growth in prices of 33 per cent in 1973 and 111 per cent in 1974. These uneven variations in volume and value should be noted since they will serve in the analysis of inflation.

Table 3

BOLIVIA: INDICES OF PRICES, QUANTUM AND VALUE OF EXPORTS
(Base 1970 = 100)

	1971	1972	1973	1974
Price index	84	87	116	245
Quantum index	111	119	121	117
Value index	93	104	140	287

Source: ECLA estimates on the basis of official statistics.

(ii) Evolution of imports. The current value of imports increased steadily during the three-year period 1971-1973, with an annual increase of 8 per cent in 1971 and 1972 and 28 per cent in 1973 (see table 4). A comparison of the annual average for the period 1966-1970 with that of the three-year period 1971-1973 also shows a steady upward trend. To judge by the rate of changes, however, growth became more pronounced as from 1973. Preliminary estimates for 1974 place the current value of imports of goods at a level bordering on 370 million dollars, which would imply a growth rate of around 57 per cent compared with 1973. The result of these increases was that the current value of imports of goods doubled in the space of two years.

From the point of view of the structure of imports, it is noteworthy that the share of capital goods does not show a more definite upswing. On the contrary, imports of consumer goods increased considerably in 1973, and their share of the total rose by over 25 per cent. Preliminary estimates for 1974 indicate larger-scale growth, especially of consumer durables, which, as is obvious, are destined for a small sector of the population. The dynamism of imports of consumer goods, to the detriment of imports of capital goods and intermediate products, brings to light a basic problem in the growth of the Bolivian economy. The relaxation of external constraints took a rapid and easy route to spending in the form of imports of consumer goods, implying an allocation of resources which was not in keeping with the priorities assigned by the Government to purely productive activities. In addition, imports of capital goods for agriculture, the economy's major sector, were worth only 6 million dollars in 1973, which accounted for 2.3 per cent of total imports (see table 4). The policy of allocating resources, particularly for imports, has very important effects on inflation in Bolivia.

Table 4

BOLIVIA: STRUCTURE OF IMPORTS OF GOODS
(Millions of dollars at current prices)

	1970	Percent age of total	1971	Percent age of total	1972	Percent age of total	1973 ^{a/}	Percent age of total
1. <u>Consumer goods</u>	32.3	29.3	34.2	21.5	34.6	20.1	65.2	25.5
a) Non-durable consumer goods	22.5	14.1	24.7	15.5	26.5	15.4	39.6	15.5
b) Consumer durables	9.8	6.2	9.5	6.0	8.1	4.7	25.6	10.0
2. <u>Raw materials and intermediate products</u>	52.2	37.6	53.4	33.6	51.0	29.6	69.3	27.1
a) Fuels and related products	1.1	0.7	1.2	0.8	1.7	1.0	2.2	0.9
b) Raw materials and intermediate goods for agriculture	2.4	1.5	2.0	1.3	2.1	1.2	2.6	1.0
c) Raw materials and intermediate goods for industry	56.4	35.4	50.2	31.5	47.2	27.4	64.5	25.2
3. <u>Capital goods</u>	66.2	41.6	71.3	44.8	84.6	49.1	119.0	46.4
a) Construction materials	8.8	5.5	15.4	9.7	14.5	8.4	29.0	11.4
b) Capital goods for agriculture	3.2	2.0	3.0	1.9	4.1	2.4	6.0	2.3
c) Capital goods for industry	26.4	16.6	31.3	19.7	31.5	18.3	49.0	19.2
d) Transport equipment	27.8	17.5	21.4	13.5	34.5	20.0	35.0	13.7
4. <u>Miscellaneous</u>	0.8	0.5	0.2	0.1	2.2	1.2	2.0	0.8
Total value GIF	159.2	100.0	158.9	100.0	172.4	100.0	255.5	100.0
Readjustments b/	-	-	9.1	-	13.0	-	-	-
Total value GIF readjusted	159.2	-	168.0	-	185.4	-	255.5	-
Deduction for freight, insurance and others	-24.0	-	-25.2	-	-32.2	-	-48.1	-
Addition for contraband	31.0	-	38.6	-	42.6	-	42.1	-
Total value FOB	166.2	-	181.4	-	195.7	-	249.5	-

Source: Boletín Estadístico del Banco Central de Bolivia, June 1974.

a/ Estimate by the Central Bank of Bolivia.

b/ Including imports of wheat flour and others.

Equally important in this context is the estimated amount of smuggling, which would certainly increase if this estimate, instead of being based on foreign currency sales, were also to take into account illegal two-way operations,^{2/} which, being illegal, do not necessarily imply any purchase of foreign currency.

The variations in the current value and in the structure of imports may be explained by variations in prices and in quantity. Table 5 shows the respective indicators. The trend of import prices showed a sharp acceleration: 2 per cent in 1971, 6 per cent in 1972, 18 per cent in 1973 and 23 per cent in 1974.

Table 5

BOLEIVIA: INDICES OF PRICES AND QUANTUM VALUE OF IMPORTS

(Base 1970 = 100)

	1971	1972	1973	1974
Price index	102	108	127	156
Quantum index	106	108	117	150
Value index	108	117	149	234

Source: OCLA, on the basis of official statistics.

The import quantum also grew at increased rates. Of particular importance is the 1973 rate, which exceeded by 8 per cent the volume of the previous year's imports, and the 1974 rate which resulted in an increase of 28 per cent (see table 5). Although these increases are considerable, export prices rose so much that the trade balance showed a surplus in 1974 and paved the way for large-scale increases in international reserves, as will be seen below.

^{2/} Earnings from illegal exports make it possible to finance external purchases of goods which in turn are smuggled into the country. This traffic does not necessarily assume any purchase of foreign exchange in the Central Bank.

Estimates of the structure of imports in 1974 are still not available. Data of this type will be useful for evaluating to what extent the disappearance of the external bottleneck meant that advantage had been taken of this favourable economic situation. Of particular importance is the performance of imports in analysing the imported inflation which afflicted Bolivia as from 1973.

(iii) The blance of payments. As was seen in the foregoing pages, the real boom in Bolivia's external situation only began at the end of 1973. Up till then, the trade balance showed a continuing deficit. A comparison of the average deficits for the period 1966-1970 and those for the three-year period 1971-1973 shows that they have increased to a fairly considerable extent (see table 6). It should be noted, however, that the deficit, particularly in 1973, was not actually due to external trade difficulties, as was the case traditionally. The traditional deficits were to be explained by the slow growth of exports which did not allow foreign exchange requirements to be met. The situation in 1972 and particularly in 1973 was fairly different; despite an appreciable increase in exports, imports outstripped them. In both cases, then, the importance of the trade deficit has different implications.

The heavy current account deficits are not only to be explained by the disequilibria of the trade balance; the sums corresponding to payments of profits and interests on foreign capital were also considerable (see table 6). These items actually accounted for nearly 50 per cent of the current account deficit during the period 1966-1970, and around 40 per cent during the three-year period 1971-1973. It is to be noted that in 1971 these payments on foreign capital were more than the current account deficit.

The balance of the current account during the three-year period 1971-1973 was a deficit of some consideration, of more than 50 million dollars on average, i.e., more than 20 per cent of the value of exports. In 1973 it exceeded 54 million dollars, although exports showed a growth rate of more than 33 per cent.

Table 6

BOLIVIA: BALANCE OF PAYMENTS

(Millions of dollars at current prices)

	Average 1966- 1970	1970	1971	1972	1973	Average 1971- 1973
Current account						
Exports of goods and services	176.5	210.3	198.3	224.4	298.5	240.4
Goods FOB	163.9	195.7	181.9	203.0	273.3	219.4
Services	12.5	14.6	16.4	21.4	25.2	21.0
Imports of goods and services	199.2	210.7	227.5	260.5	334.4	274.1
Goods FOB	158.3	166.2	181.4	195.7	252.8	210.0
Services	40.8	44.5	46.1	64.8	81.6	64.1
Net external investment income	-19.5	-25.0	-17.0	-21.6	-23.2	-20.6
Profits	-13.1	-17.0	-8.4	-6.0	-6.5	-7.0
Interest	-6.4	-8.0	-8.6	-15.6	-16.7	-13.6
Net private transfer payments	1.0	1.5	2.1	4.9	4.9	4.0
Balance on current account	-41.2	-23.9	-44.1	-52.8	-54.2	-50.4
Capital account						
Net external financing (a+b+c+d+e)	41.2	23.9	44.1	52.8	54.2	50.4
a) Net external non-compensatory capital	49.1	41.7	67.7	104.2	55.4	75.8
Direct investment	-11.6	-75.9	1.9	-10.5	4.7	-1.3
Long-and medium-term loans	66.0	131.2	82.6	140.4	81.6	101.5
Amortization payments	-16.7	-20.4	-22.0	-30.7	-48.5	-33.7
Short-term liabilities	1.9	4.4	0.2	-3.6	6.9	1.2
Official transfer payments	9.5	2.4	5.0	8.6	10.7	8.1
b) Domestic non-compensatory capital or assets	-2.7	-6.1	1.7	-17.0	-0.4	-5.2
c) Errors and omissions	-6.1	-13.0	-31.6	-33.7	-7.1	-24.1
d) Allocation of SDRs	1.0	4.9	4.0	4.2	0.0	2.7
e) Net compensatory financing (increase -)	-0.2	-3.6	2.3	-4.9	6.3	1.2

Source: ECLA, on the basis of official statistics.

The financing of these current account disequilibria meant that debts were incurred abroad; these reached appreciable amounts in the various years of the 1970s (see table 6). This process in turn generated amortization payments and interests which then in the course of time brought pressure to bear on the external trade balance. The 1972 debt is noteworthy; it exceeded 140 million dollars, and nearly tripled the current account deficit.

Direct investment did not reach levels of importance. The disinvestment to be observed in 1970 corresponded to the nationalization of the assets of the Gulf Oil Company. The item errors and omissions particularly in 1971 and 1972, reached considerable proportions; this balancing item summed up the lack of accurate results in other items, particularly the estimates on smuggling commented on above.

Balance of payments estimates for 1974 give a current account surplus of 26 million dollars, and also an increase in international reserves of approximately 53 million dollars. The re-emergence of inflation during this period is closely associated with these movements, among other reasons because of the increase in liquidity which gave rise to the accumulation of reserves as will be seen below.

The evolution of prices and quantities of exports and imports during the three-year period 1971-1973 resulted in an adverse effect, amounting to considerable sums, on the terms of trade. As may be seen below, the main indicators resulting from these developments, reveal situations which had clearly degenerated in comparison with 1970. ^{3/}

^{3/} In order to interpret these indicators it should be recalled that 1970 was a period of a certain upsurge in the export prices of mineral products. On the other hand, it should be noted that in the calculation of the export price index, the structure of exports corresponds to 1973; the share of petroleum increased significantly in 1974 thus changing the structure.

EXTERNAL TRADE INDICATORS

(Millions of dollars at 1970 prices)

	1971	1972	1973	1974
Export quantum	232.1	255.6	264.5	254.5
Purchasing power of exports	194.4	207.8	235.0	400.0
Effect on the terms of trade	-37.7	-47.8	-29.5	145.5
Index of the terms of trade (1970 = 100)	82	81	91	157.1

Source: ECLA, on the basis of official data.

The upsurge in 1974 export prices which resulted in a positive effect on the terms of trade but did not represent a full recoupment, despite the fact that forecasts for 1975 anticipate considerable increases in import prices.

(b) Overall supply and demand

The performance of supply showed no appreciable change if the period 1971-1973 is compared with the five-year period 1966-1970. The annual rate of growth for the first period was 5.9 per cent, and for the second period 5.5 per cent (see table 7). It should be mentioned that in 1972 and 1973 supply grew at rather faster rates than in 1970 and 1971.

The drop in the growth rate of the product recorded in the period 1971-1973, when the annual average rate was 5.1 per cent, compared with 1966-1970, when the annual average rate was 6.3 per cent, was offset by increases in imports, the growth rate of which increased from an annual 3.9 per cent to 7.7 per cent between the two periods. During the three-year period 1971-1973, the product showed considerable fluctuations, while imports grew increasingly rapidly (see table 7).

Table 7

BOLIVIA: TOTAL SUPPLY AND DEMAND

	Millions of pesos 1970	1966-1970	1971-1973	Annual growth rates			
				1970	1971	1972	1973
<u>Total supply</u>	<u>14 604</u>	<u>5.9</u>	<u>5.5</u>	<u>3.1</u>	<u>4.2</u>	<u>6.4</u>	<u>6.1</u>
Gross domestic product (at market prices)	12 080	6.3	5.1	5.2	3.8	6.0	5.4
Imports	2 524	3.9	7.7	-6.1	5.8	8.1	9.2
<u>Total demand</u>	<u>14 604</u>	<u>5.9</u>	<u>5.5</u>	<u>3.1</u>	<u>4.2</u>	<u>6.4</u>	<u>6.1</u>
Exports	2 504	8.6	7.9	-3.5	10.4	10.1	3.5
Gross domestic investment	1 880	5.3	4.0	2.2	-0.7	-11.2	27.6
Gross fixed investment	1 666	5.9	...	0.3	8.8	-17.8	...
Public	1 053	15.2	...	13.8	...	...	...
Private	613	-2.9	...	-16.7	...	...	...
Total consumption	10 220	5.4	5.2	5.0	3.5	8.6	3.7
General Government	1 351	6.9	7.7	17.0	-7.3	28.0	5.4
Private	8 869	5.2	4.8	3.4	5.2	5.9	3.4

Source: ECLA, on the basis of official statistics.

No major changes are to be seen in the structure of supply; only the import coefficient showed a slight tendency to decrease, and dropped from 23.5 per cent in 1965 to 22.1 per cent during the period 1969-1970 and to 21.9 per cent in the three-year period 1971-1973. The low level of the imports in 1970 should be taken into account to give an idea of the real scope of the variations in rate and relative share. As from 1973, however, the country's external situation meant larger increases in this coefficient (see table 8).

Of the components of overall demand, exports showed greatest dynamism, but growth rates were very variable (see table 7). In 1971 and 1972, exports exceeded the annual rate of 10 per cent, while in 1970 they declined and in 1973 increased by only 3.5 per cent compared with the previous year. The trend of the export coefficient is significant: it increased from 18.7 per cent in 1965 to 21.6 per cent in the two-year period 1969-1970 and reached 22.5 per cent in the three-year period 1971-1973.

Gross domestic investment fluctuated somewhat erratically with disinvestments in 1971 and particularly in 1972, and a rate of increase of 27.6 per cent in 1973. Capital formation decreased noticeably during the period 1970-1973 compared with its performance during the five-year period 1966-1970. A drop in the annual rate from 5.3 per cent to 4.0 per cent indicates a decline which is by no means negligible, despite the striking recovery of 1973 (see table 7). Owing to the above trends, the investment coefficient showed a decline compared with the same periods already referred to (see table 8).

Total consumption did not undergo important changes in the average rates of the periods compared. There were, however, fluctuations of some consideration in 1971-1973. In 1971 the growth rate was 5.5 per cent and in 1973 it was 3.7 per cent, contrasting with the growth rate recorded for 1972 which was 8.5 per cent. These fluctuations may be explained in the main by variations in Government consumption: a decrease of 7.3 per cent in 1971 vis-à-vis an increase of 28 per cent in 1972 (see table 7).

Table 8
 BOLIVIA: STRUCTURE OF TOTAL SUPPLY AND DEMAND ^{a/}
 (Percentages)

	1965	Average 1969-1970	1970	1971	1972	1973	Average 1971-1973
<u>Total supply</u>	<u>123.5</u>	<u>122.1</u>	<u>120.9</u>	<u>121.3</u>	<u>121.7</u>	<u>122.5</u>	<u>121.9</u>
Gross domestic product	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Imports	23.5	22.1	20.9	21.3	21.7	22.5	21.9
<u>Total demand</u>	<u>123.5</u>	<u>122.1</u>	<u>120.9</u>	<u>121.3</u>	<u>121.7</u>	<u>122.5</u>	<u>121.9</u>
Exports	18.7	21.6	20.7	22.0	22.8	22.5	22.5
Gross domestic investment	16.4	15.8	15.6	14.9	12.5	15.0	14.2
Gross fixed investment	14.1	14.1	13.8	14.5	11.2	...	
Public	8.2	8.4	8.7	...	...	...
Private	5.9	5.7	5.1	...	...	...
Total consumption	88.4	84.7	84.6	84.4	86.4	85.0	85.2
General Government	10.9	10.6	11.2	10.0	12.1	12.1	11.4
Private	77.5	74.1	73.4	74.4	74.3	72.9	73.8

Source: Table 7, ECLA estimates.

^{a/} 1970 prices.

Of note is the rate of growth of private consumption which reached an annual rate of 4.8 per cent in the period 1971-1973 and only 3.4 per cent in the last of these years. Rates of this order, which are the result of taking the average consumption of sectors and peoples with very different purchasing power, mask particularly delicate situations for those strata whose incomes are close the abject poverty level. Total consumption showed no changes of importance in its share of overall demand in recent years; though private consumption showed a decline in 1973, its relative importance was balanced by the increases in Government consumption (see table 8).

(c) The evolution of the product by sectors

The growth rate of the sectoral product during the three-year period 1971-1973 are, generally speaking, lower than those of the five-year period 1966-1970 (see table 9). Of particular importance is the decline in the growth of the mining product, the rate of which dropped from 11 per cent to 5.4 per cent between the two periods referred to, and that of industry, which during the first-mentioned period increased at an annual rate of 6.4 per cent and during the three-year period 1971-1973 at a rate of 5.3 per cent.

Although the agricultural product had a higher rate of growth (2.7 per cent during the period 1971-1973 compared with an annual 0.2 per cent during the five-year period 1966-1970), its rates of growth have been, generally speaking, rather lower than that of the population. Since this sector is the most important in the country's economy, its lack of dynamism severely affects overall growth and as will be seen below constitutes one of the deepest-rooted causes of inflation in Bolivia.

Among the goods-producing sectors the only activity which showed some dynamism - was the construction sector, which increased its growth rate of 1.8 per cent during the five-year period 1966-1970 to 6.4 per cent during the three-year period 1971-1973.

Table 9

BOLIVIA: GROSS DOMESTIC PRODUCT AT FACTOR COST, BY SECTORS OF ECONOMIC ACTIVITY

	Millions of pesos 1970	1966-1970	1971-1973	Annual growth rates			
				1970	1971	1972	1973
Agriculture	1 901.1	0.2	2.7	4.4	4.0	2.0	2.1
Mining	1 670.0	11.0	5.4	5.2	4.2	9.1	3.0
Manufacturing	1 446.4	6.4	5.3	5.4	2.8	6.7	6.5
Construction	507.0	1.8	6.4	-3.7	4.1	8.0	7.2
<u>Subtotal goods</u>	<u>5 524.5</u>	<u>4.7</u>	<u>4.6</u>	<u>4.1</u>	<u>3.8</u>	<u>5.9</u>	<u>4.0</u>
Electricity, gas, water, and sanitary services	218.0	11.1	8.4	7.4	6.9	8.8	9.6
Transport and communications	995.5	5.6	4.4	2.6	3.3	4.8	5.0
<u>Subtotal basic services</u>	<u>1 213.5</u>	<u>6.5</u>	<u>5.1</u>	<u>3.4</u>	<u>4.0</u>	<u>5.5</u>	<u>5.9</u>
Commerce and finance	1 265.4	7.1	5.1	1.6	1.9	6.4	7.0
Ownership of dwellings	978.0	9.3	6.9	10.7	4.3	10.5	6.0
Government	1 021.0	7.0	6.0	8.5	6.3	3.6	8.2
Miscellaneous services	1 231.6	11.2	4.7	10.8	4.3	4.9	4.8
<u>Subtotal other services</u>	<u>4 496.0</u>	<u>8.6</u>	<u>5.6</u>	<u>7.5</u>	<u>4.1</u>	<u>6.2</u>	<u>6.5</u>
<u>Total</u>	<u>11 234.0</u>	<u>6.3</u>	<u>5.1</u>	<u>5.2</u>	<u>3.8</u>	<u>6.0</u>	<u>5.4</u>

Source: ECLA, on the basis of official statistics.

In the basic services sector it should be mentioned that the electricity, gas, water and sanitary services sectors showed rates of growth on average higher than those of all the sectors of the economy during the three-year period 1971-1973, although the rate was appreciably lower than that of the five-year period 1966-1970. The transport and communications sector, which is of vital importance in view of the geography of Bolivia, was another activity whose growth rate decreased, although there was some degree of recovery in 1972 and 1973 (see table 9).

The loss of dynamism spread to all the services sectors between the periods compared. The annual growth rate for these as a whole was 8.6 per cent during the period 1966-1970, and only 5.6 per cent during the three-year period 1971-1973. As may be observed, in 1972 and 1973 the growth rates of the majority of these activities were higher than those of 1971.

The trend of the different sectors of the economy was towards a fairly generalized loss of dynamism which no doubt constituted fertile ground for the growth of inflation in Bolivia.

Reference was made above to the structural factors which slow down development and feed the roots of the inflationary process. Care should be taken here in analysing the structure of the gross product, which clearly illustrates the lack of integration in the Bolivian economy (see table 10). One of the most striking facts is the small share of the industrial sector. Its contribution to the product does not exceed 13 per cent, and has remained unchanged since 1965. This marked stability in the share of a sector called upon to integrate and reactivate the economy indicates the existence of very deep-seated and complex problems.

Table 10

BOLIVIA: STRUCTURE OF THE GROSS DOMESTIC PRODUCT BY SECTORS OF ECONOMIC ACTIVITY

(Percentages)

	1965	Average 1966-1970	1970	1971	1972	1973	Average 1971-1973
Agriculture	22.8	19.0	16.9	17.0	16.3	15.8	16.4
Mining	12.0	14.6	14.9	14.9	15.3	15.0	15.1
Manufacturing	12.8	12.9	12.9	12.8	12.8	13.0	12.9
Construction	5.6	4.5	4.5	4.5	4.6	4.7	4.6
<u>Subtotal goods</u>	<u>53.2</u>	<u>51.1</u>	<u>49.2</u>	<u>49.1</u>	<u>49.1</u>	<u>48.5</u>	<u>48.9</u>
Electricity, gas, water and sanitary services	1.6	1.9	1.9	2.0	2.0	2.1	2.1
Transport and communications	9.2	8.9	8.9	8.8	8.7	8.7	8.7
<u>Subtotal basic services</u>	<u>10.7</u>	<u>10.8</u>	<u>10.8</u>	<u>10.8</u>	<u>10.8</u>	<u>10.8</u>	<u>10.8</u>
Commerce and finance	10.9	11.4	11.3	11.1	11.1	11.3	11.1
Ownership of dwellings	7.6	8.0	8.7	8.7	9.1	9.2	9.0
Government	8.8	8.9	9.1	9.3	9.1	9.3	9.2
Miscellaneous services	8.8	9.8	11.0	11.0	10.9	10.8	10.9
<u>Subtotal other services</u>	<u>36.1</u>	<u>38.1</u>	<u>40.0</u>	<u>40.1</u>	<u>40.2</u>	<u>40.6</u>	<u>40.3</u>
<u>Total</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

Source: Table 9.

a/ The absolute values which gave rise to these percentages are expressed in pesos at 1970 prices.

As a result of its slow growth, the agricultural sector showed a decrease in its contribution to the product: 22.8 per cent in 1965, 19 per cent on average in the five-year period 1966-1970, coming to a head with 15.8 per cent in 1973. These coefficients and the obstacles of a structural nature which affect the agricultural sector, make further analyses unnecessary in order once again to point out that it is here that the root of a great part of the country's underdevelopment is to be found, and that it constitutes the main source of disequilibria which take the form of inflationary pressures.

The mining sector slightly increased its relative share, while that of the construction sector remained stable. The goods-producing sector had a smaller share in the whole during the three-year period 1971-1973 (48.9 per cent) than during the period 1966-1970 (51.1 per cent). The sectors producing basic services did not undergo any changes, while the share of tertiary activities, which are less important to the country's development, increased.

For the purposes of the description of inflation begun in the next chapter, and with a view to placing in order of importance the problems of the functioning of economic activity in Bolivia, it should be pointed out that, as has been already suggested, the virtual standstill in the agricultural sector and the poor tempo of economic activity in the industrial sector are the most far-reaching problems, to the extent of preventing any real advantage being taken of the dynamism of the external sector; the description of the re-emergence of inflation in Bolivia will come back to this point.

C. THE INFLATIONARY PROCESS IN BOLIVIA

1. Perspective of periods and phases

In order to study the current inflationary cycle in Bolivia which started in mid-1972, some data which help to interpret this new inflationary process must be taken into account.

During the whole of the 1960s and up to the middle of 1972, domestic price trends were exceedingly stable. This long period of stability was directly attributable to the agents of the economic process, although it will be recalled that it was preceded by a period of acute inflation and chronic shortages in the years 1953-1958. In other words, between 1950 and 1972 Bolivia had experienced completely opposite phenomena: great stability and runaway inflation. The behaviour of consumers and producers, of entrepreneurs and wage-earners, from October 1972 onwards is accounted for by such contrasting experiences. It is necessary to assess the true dimension of this type of eminently qualitative factor in attempting to explain inflation in recent years, which clearly had some very special features.

The existence of such pronounced cycles of stability and inflation would seem to be linked with a special form of operation of socio-economic activity within the context of marked structural heterogeneity, as noted above. In fact, structural heterogeneity is a key factor in analysing both types of situations: stability and inflation. The external, internal or combined situations of disequilibria are reflected in pressures on prices rather than in correlative structural changes, precisely because of the production apparatus' limited capacity to respond and, in particular, the inflexible nature of agricultural supply, which undoubtedly constitutes the essence of structural heterogeneity in the economic sphere. The two attempts made to reactivate the economy through public expenditure (in 1952 and 1972) resulted for this reason in acute inflation.

Conversely, the long period of stability starting in 1959 and ending in 1972 was basically the outcome of the structural heterogeneity itself and of the socio-political controls on pressure groups, although

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at the expense of little change in the basic economic structure and the attainment of fairly mediocre rates of growth. With these sacrifices and such an expedient, it was not difficult in the circumstances to control price levels throughout most of the period concerned. Contrary to what happens in more industrialized countries, the lack of co-ordination in the economic system prevents the disequilibria occurring separately in the various activities from spreading too easily to the rest of the system, which, paradoxically enough, is an advantage if the objectives are confined to the achievement of stability. Accordingly, in the period 1969-1971 when attempts were made to attain other additional objectives, the maintenance of price levels entailed a much stricter management of the whole financial system, limiting the possibilities of greater economic growth.

Although the recent inflation in Bolivia differs in nature from previous inflationary cycles, the explanation for it is again mainly the unco-ordinated type of structure which, as well as being the basic factor of inflation, is propitious ground for the spread, in both scope and depth, of another type of internal and external disequilibria in economic activity, as will be seen below.

The kind of perspective suitable for a study of this inflationary process requires, however, that stress be laid on the following questions which have already been described in the development of the overall economy: the problems facing the agricultural sector, the backward state of industry and external sector trends.

It will be recalled that agriculture is the main productive activity of the Bolivian economy, its contribution to the product - while showing significant reductions in recent years - still represents annual proportions of around 16 per cent, and about two-thirds of the labour force is engaged in agricultural activities. It is easy to see the effect of its virtual stagnation on price trends; the type of goods this sector produces is closely associated with basic food consumption.

/It must

It must be borne in mind that industry is of little importance as a productive activity and that the composition of manufacturing output mainly responds to demand from the higher-income strata. Processing methods are fairly primitive and growth is achieved at the expense of heavy dependence on imports of raw materials.

The evolution of the external sector in recent years is another crucial factor in interpreting Bolivia's inflation. As was also shown in the previous section, the extraordinary increase in price of most export and import items led to an external relations situation which, as will shortly be seen, had a direct and indirect incidence on the inflationary process.

2. Overall view 4/

As stated previously, following a long period of stability, a new inflationary cycle was initiated in Bolivia in the middle of 1972. Table 11 shows the contrast between the price increases in both periods. It will be noted that in 1972 the rate of price variations showed an increase over the previous three-year period, although being comparisons of annual averages, the prices still did not reflect the proportions they were likely to reach after the phenomenon itself. In 1973 the rate was already significant and available data for the first eight months of 1974 indicate that an even faster increase may be expected. The figures in table 12 show more precisely that the start of the recent inflation was in the second half of 1972, and more clearly reflect the acceleration process. Prices rose during that period by

4/ It is difficult to classify an inflationary process on the basis of only one price index which, moreover, is clearly inadequate as an indicator of inflation. The more so if an attempt is made to interpret a process that is more complex than previous inflationary cycles, the full effects of which have still to be felt. To analyse a past phenomenon, of which the complete cycle of development and effects are known, is very different from analysing one which is just starting, of which only the broadest effects are known in the light of such scant information. Therefore, the various quantitative assessments made in this study must be taken only as rough figures which are not as accurate as might have been desired. It is not possible to elucidate a number of phenomena, particularly those related to the differences between producer, wholesale and consumer prices, which reflect decisive instances in an inflationary process.

Table 11

BOLIVIA: CONSUMER PRICE INDEX

(Base 1966 = 100)

Year	General index	Annual variation	Food	Annual variation	Housing	Annual variation	Clothing	Annual variation	Miscellaneous	Annual variation
1963	82.5	-	86.6	-	75.8	-	77.8	-	93.9	-
1964	90.9	10.2	88.9	2.7	90.8	19.8	94.2	21.1	94.5	0.6
1965	93.5	2.9	91.6	3.0	92.6	2.0	97.3	3.3	96.5	2.1
1966	100.0	7.0	100.0	9.1	100.0	8.0	100.0	2.8	100.0	3.6
1967	111.2	11.2	116.1	16.1	112.3	12.3	100.4	0.4	102.1	2.1
1968	117.3	5.5	124.7	7.4	118.0	5.1	102.2	1.8	103.8	1.7
1969	119.9	2.2	127.3	2.1	120.5	2.1	105.3	3.0	105.9	2.0
1970	124.5	3.8	133.1	4.6	125.2	3.9	109.2	3.7	107.0	1.0
1971	129.1	3.7	138.4	4.0	130.7	4.4	114.3	4.7	107.6	0.6
1972	137.5	6.5	147.2	6.4	138.1	5.7	124.6	9.0	113.8	5.8
1973	180.8	31.5	198.6	34.9	158.6	14.8	172.8	38.7	147.5	29.6

Source: National Institute of Statistics.

Table 12
BOLIVIA: CONSUMER PRICE INDEX
(Base 1966 = 100)

Periods	General index	Half-yearly variation	Food	Half-yearly variation	Housing	Half-yearly variation	Clothing	Half-yearly variation	Miscellaneous	Half-yearly variation
December 1970	127.6	-	137.0	-	128.0	-	112.2	-	107.2	-
June 1971	128.2	0.4	136.7	-0.2	131.1	2.4	113.7	1.3	107.9	0.6
December 1971	131.8	2.8	141.6	3.6	133.5	1.8	117.3	3.2	107.9	0.0
June 1972	132.1	0.2	140.2	-0.9	136.7	2.4	119.4	1.8	109.9	1.9
December 1972	162.9	23.3	175.9	25.5	151.6	10.9	152.5	27.7	137.5	25.1
June 1973	169.4	4.0	180.8	2.8	158.4	4.5	162.6	6.6	146.1	6.3
December 1973	219.5	29.6	254.7	40.9	172.1	8.6	202.1	24.3	159.2	9.0
June 1974	302.6	37.9	378.1	48.4	187.6	9.0	248.2	22.8	202.0	26.9

Source: National Institute of Statistics.

23.3 per cent in contrast with the small increases in the index for previous six-month periods. The six-monthly variations from June 1973 onwards clearly show the inflationary spiral.

Although the price increases leave no room for doubt regarding the virulence of the inflation, the significant changes in the price system, in their turn, constitute another peculiar feature of the phenomenon. The price trends of the various components of the index show considerable disparities. Whereas food prices rose by 98.6 per cent between the base period and 1973, the increases in housing and miscellaneous items were 58.6 and 47.5 per cent, respectively, over the same period, and in clothing 72.8 per cent (see table 11). Although these variations reflect considerable changes in the price system, it must be borne in mind that they are the result of comparing averages for groups of products. The disparities in price variations for the individual products are much greater.

The changes in the price system became more pronounced from 1973 onwards, as may be noted from the six-monthly variations in the different components of the index (see table 12). The increases in food prices in the last two half-year periods are twice those for clothing and five times those for housing. In view of the size, persistence and progressive nature of the variations in relative prices, there is reason to think that the indicator used (the only one available) does not faithfully reflect the real variation, or that the market mechanisms, which are generally sensitive to this type of phenomenon, are not operating as efficiently as is usually believed, since price controls have gradually lost ground to the laws of supply and demand. This is a situation which merits a thorough field investigation since, however serious the limitations of the index, it does convey an idea of situations connected with the functioning of economic activity, particularly its structural rigidity, which would enable progress to be made in diagnosing Bolivia's inflation.

/The above-mentioned

The above-mentioned changes in the price system and the rise in prices indicate the depth and complexity of Bolivia's inflationary process and its recent acceleration. The Government's efforts to control it have not so far produced the desired results. Note the progressively higher six-monthly rates of increase in prices: 30 per cent in the second half of 1973 and 38 per cent in the first half of 1974. The increase between June 1973 and June 1974 was 79 per cent (see table 12).

The following is an attempt to describe the development of this process and to identify the inflationary factors and the mechanisms reproducing the price increases. For this purpose, two phases in the last cycle of Bolivia's inflation may be distinguished. The first, covering 1972 and the early months of 1973, and the second, comprising the second half of 1973 up to the present (they can both be clearly identified in table 12). As will be seen later, each of these phases developed in a different context: the first responded to essentially internal factors, and the second to inflationary stimuli from abroad as well. It is worthwhile to emphasize, however, that in both these phases structural factors were an underlying constant, added to which was a different type of factors that acted as detonators in a latent explosive situation. In the first phase, the economic structure could not withstand the internal situations of disequilibrium and the interpretation of inflation is clear. The second phase, on the other hand, represents a complex inflationary situation in which the phenomenon operates with all its ingredients, i.e., situations of disequilibrium, structural rigidity and imported inflation, acting upon and simultaneously and mutually influencing one another.

(a) First phase of inflation

The first phase of the recent inflationary process derived primarily from internal factors: a sudden monetary expansion which, because of the serious structural problems confronting the country, was not accompanied by a similar growth in the real supply of goods and services. As will be seen later, the Government's attempts to reactivate the economy and achieve more accelerated growth by increasing

/public expenditure

public expenditure and granting the private sector exceptionally favourable credit facilities caused disequilibria which unleashed a new inflationary process in Bolivia.

By the middle of 1972 a series of financial pressures clearly pointed to an upswing of domestic prices. The liquidity which had been injected into the system did not result in a parallel increase in the real supply of goods and services. The first symptom of this disequilibrium was the steady decline in international reserves caused mainly by essentially speculative operations and only secondarily by larger imports of goods that would really cover domestic needs. The monetary pressure to which the economy was subjected made it clear that a change in the value of the dollar was to be expected shortly. In fact, purchases of foreign exchange by the private sector in August, September and October 1972 were 31.4 per cent higher than those effected in the same months of 1971.^{5/}

In the face of the imminent exhaustion of international reserves at the end of October 1972, exchange parity was raised from 11.38 to 20 Bolivian pesos to the dollar.^{6/} This devaluation is an important milestone in the first phase of the inflationary process. To understand it better, and in view of the considerable effect of this measure on the subsequent course of inflation, it is useful to review the main financial movements which took place in the months prior to devaluation. Table 13 shows the main components of the monetary balance and their variations over the period concerned. Monetary resources increased by 24.3 per cent during this period, as a result of increments of 20.4 and 53.5 per cent in money and quasi-money, respectively, which from a quantitative standpoint are the most important items. Counterpart funds ^{7/} dropped by 30 per cent and other items showed an increase of 20 per cent (see table 13). The 24.3 per cent rise in total liquidity was due to an increase of 31.7 per cent in domestic credit. The private sector increased its credit by 44.2 per cent, and the public sector by 23.3 per cent, both rates being substantially higher than the previous annual increases.

^{5/} Banco Central de Bolivia, Memoria.

^{6/} ECLA, Economic Survey of Latin America, 1973.

^{7/} National currency counterpart funds for United States government credits.

Table 13

BOLIVIA: MONETARY BALANCE

(Millions of pesos at current prices and balances at end of each period)

	September 1971	Structure (percentages)	September 1972	Structure (percentages)	Variation September 1971- September 1972
Structure of monetary resources (overall liquidity)	2 473.3	100.0	3 074.2	100.0	24.3
Money (means of payment)	1 567.6	63.4	1 888.0	61.4	20.4
Quasi-money	437.4	17.7	671.4	21.8	53.5
Counterpart funds	93.7	3.8	65.4	2.2	-30.3
Other items (net)	374.6	15.1	449.4	14.6	20.0
Factors of expansion and contraction	2 473.2	100.0	3 074.6	100.0	24.3
International reserves	181.8	7.4	57.4	1.9	-68.4
Credits	2 291.4	92.6	3 017.2	98.1	31.7
a) To the Government	1 376.5	55.7	1 697.6	55.2	23.3
b) To the private sector	914.9	36.9	1 319.6	42.9	44.2

Source: International Monetary Fund, International Financial Statistics, November 1974.

Although the sharp reduction in international reserves, which was more acute in October 1972, acted as a factor of contraction, its small share in the total caused the financial picture to change only marginally. These sequences in the financial movements necessarily led to one of two crucial options: exchange control or devaluation. The seriousness of the financial situation and the important part played by the private sector in the adoption of decisions resulted in a modification of the exchange rate.

A 68 per cent devaluation of Bolivia's currency was bound to have a tremendous impact on the performance of the country's economic activity, which is heavily dependent on imported supplies. If, moreover, it is recalled that the exchange rate had not been altered since 1959 and that prices, in general, had been very stable, it will be understood that the effects of such a measure caused an upheaval in the whole economic and financial apparatus. As a result of this decision, domestic prices suffered violent increases, which must also be ascribed to subjective motivations in an atmosphere hypersensitized by the memory of the inflationary cycle in the 1950s which had had serious repercussions on the population's standard of living. In the eyes of producers and consumers, devaluation destroyed the principal symbol of confidence in the financial management. Keeping the exchange rate unchanged for 13 years had come to represent a general indicator of stability, even for sectors unrelated to the financial markets, far greater qualities being ascribed to it than it really merited. Such a drastic change seriously altered the behaviour of the agents of the economic process, which accounts for that initial period of upswing in prices.

The group of economic policy measures adopted simultaneously with the change in parity, particularly wage controls, and the lessening of the initial pressures tended to moderate the rise in prices. The consumer price index recorded an increase of 24 per cent in the month following devaluation, whereas in the first few days the increases were over 50 per cent and some as high as 100 per cent.^{8/}

^{8/} It will be recalled that the increases shown by this index are underestimates of the real variations over the short term.

External aid and contingency credit from the International Monetary Fund, which were granted simultaneously with the devaluation, strengthened the reserves position. At the same time, the new single and fixed parity and the elimination of controls on the unlimited purchase of foreign exchange were an attempt to re-establish general confidence, which had effects only in the short term. Thus, the price index showed a small increase in the first half of 1973.

The monetary balance at the end of 1972 compared with that for 1971 reflected more clearly, on the one hand, the sharp increases in overall liquidity and, on the other, the strengthening of reserves owing to the above-mentioned credit. In 1972, monetary resources rose by 43.1 per cent as a result of increases in all their components, including counterpart funds which went up at a rate of 310.8 per cent (see table 14). The extraordinary increase in total liquidity was due to the expansion of credit that year to both the public and the private sector, at rates of 21.2 and 39.2 per cent respectively, which are significantly higher than in previous years. Similarly, there was a considerable expansion of national currency due to the increase of 198.1 per cent in international reserves, whose share among the factors of expansion rose from 8.8 per cent in 1971 to 18.2 per cent in 1972 (see table 14).

It is useful now to examine the reasons why the monetary expansion reached these proportions. The first was the increasing deficit in the fiscal budget, of which the main source of financing was currency issues by the Central Bank; the second was the pressure brought to bear by the private sector to obtain bank financing, which was granted by virtue of the development policy that anticipated a vigorous production response from this sector.

Table 14

BOLIVIA: MONETARY BALANCE

(Millions of pesos at current prices and balances at end of each period)

	1969	Rate	1970	Rate	1971	Rate	1972	Rate
Structure of monetary resources (global liquidity)								
Money (means of payment)	1 361.2	5.8	1 532.3	12.6	1 765.6	15.2	2 210.1	25.2
Quasi-money	305.9	35.7	382.1	24.9	493.1	29.0	634.2	28.6
Counterpart funds	120.8	42.7	146.9	21.6	116.0	-21.0	476.5	310.8
Other items (net)	214.3	19.3	302.1	41.0	376.8	24.7	616.7	63.7
Factors of expansion and contraction								
International reserves	237.7	8.8	292.6	23.1	241.0	-17.6	718.4	198.1
Credits	1 764.5	4.7	2 070.8	17.4	2 510.4	21.2	3 219.1	28.2
(a) To the Government	1 125.5	0.9	1 294.5	15.0	1 532.9	18.4	1 858.1	21.2
(b) To the private sector	639.0	12.1	776.3	21.5	977.5	25.9	1 361.0	39.2
	<u>Structure (percentages)</u>							
Factors of expansion and contraction	100.0		100.0		100.0		100.0	
International reserves	11.9		12.4		8.8		18.2	
Credits	88.1		87.6		91.2		81.8	
Credits	100.0		100.0		100.0		100.0	
(a) To the Government	63.8		62.5		61.1		57.7	
(b) To the private sector	36.2		37.5		38.9		42.3	

Source: International Financial Statistics, november 1974.

Table 15 shows the variations in the items which gave rise to these deficits in the 1972 fiscal year. Budget income rose by 18.7 per cent, and expenditure by 29.9 per cent. A noteworthy fact is the small growth of tax collections and the significant increase in personal services, materials and supplies, and in fixed and financial assets. This uneven growth of income and expenditure resulted in a deficit amounting to 32.2 per cent of total income in 1972, which meant an 84 per cent increase over the 1971 deficit. About 93 per cent of this deficit was financed with credit from the Central Bank, or, in effect through currency issues. It will be noted that the deficit relates only to the current account of the fiscal budget; the total deficit, which includes the capital account, was double that, amounting to 928 million Bolivian pesos, or 67 per cent higher than in 1971.^{9/}

The increase in credit to the private sector referred to above was the other factor with distinctly inflationary repercussions. A growth of 39.2 per cent in this variable was bound to create short-term inflationary pressures, particularly if it had no direct or immediate counterpart in the way of bigger imports or domestic production.

If the increases in total liquidity, especially those deriving from the expansion of credit, are compared with the real trend of economic activity, particularly the supply of goods, it is not surprising that the system itself should have found its own natural corrective mechanisms, first in the reduction of reserves (up to October 1972) and then in drastic changes in the system and level of prices. In fact, in the face of a 45 per cent increase in total liquidity in 1972, the product grew by 6 per cent in real terms and imports by 8.1 per cent, which represents an increase of only 6.4 per cent in supply (see table 7). Such disparities inevitably provided fertile ground for definite inflation.

^{9/} CIAP Sub-Committee on Bolivia, El esfuerzo interno y las necesidades de financiamiento externo para el desarrollo de Bolivia, 1974, table II-11.

Table 15

BOLIVIA: BUDGETARY OPERATIONS

(Millions of Bolivian pesos)

	1970	1971	1972	Percentage variation 1971-1972
<u>Income</u>	<u>1 070.2</u>	<u>1 120.4</u>	<u>1 390.0</u>	<u>18.7</u>
Internal revenue	399.3	511.7	565.3	10.5
Customs revenue	418.0	377.1	418.2	10.9
Revenue from medium- and small-scale mining	174.2	47.5	43.1	-9.3
Revenue from petroleum production	2.7	53.5	68.9	28.8
Other income	76.0	130.6	234.5	79.6
<u>Expenditure</u>	<u>1 248.7</u>	<u>1 353.4</u>	<u>1 758.7</u>	<u>29.9</u>
Personal services	675.1	832.0	1 009.5	21.3
Non-personal services, materials and supplies	157.2	152.7	224.4	47.0
Fixed and financial assets	16.9	6.7	19.0	183.6
Public debt	169.5	192.4	293.5	52.5
Current and capital transfers	227.5	160.9	174.8	8.6
Other expenditure	2.5	8.7	37.5	331.0
<u>Deficit</u>	<u>178.5</u>	<u>233.0</u>	<u>428.7</u>	<u>84.0</u>
<u>Financing</u>				
External credit	17.9	18.5	28.4	53.5
Central Bank credit	155.5	220.0	398.0	80.9
Balance of previous period	17.6	12.5	18.1	44.7
Balance at end of period	12.5	18.0	15.8	-12.2

Source: Ministry of Finance and Office of the Under-Secretary of Financial Administration.

/(b) Acceleration

(b) Acceleration of inflation

The middle of 1973 marked another point of inflexion in Bolivia's inflation, since the consumer price index rose by 29.6 per cent in the second half of the year. The acceleration of inflation continued unabated, with the same index showing price increases of 37.9 per cent in the first half of 1974 (see table 12).

In this second phase of the recent inflation in Bolivia, the inflationary pressures deriving from the growing liquidity in the economy are still active, but in addition there are appreciable external inflationary pressures which find a propitious field for reproducing themselves locally. These two influences are examined below.

From the standpoint of total liquidity in the economy, it will be noted that its most important components - money and quasi-money - increased by 34.3 and 27.2 per cent respectively in 1973, maintaining their accelerated rate of growth. In contrast, counterpart funds and other items decreased appreciably, but, because of their smaller share in the total, they failed to counteract the expansion of money and quasi-money (see table 16). Therefore, monetary resources grew by 13.1 per cent in 1973. In view of this apparently low rate, which is below that of previous periods, two warnings are necessary. First, it represents an increase over a reference period in which there was already exceptional liquidity. It is not easy to determine how far the increased liquidity observed at the end of 1972 was absorbed by the economic system, in particular by prices, in the first few months of 1973. It will be recalled that prices rose by only 4 per cent in the first half of that year. Furthermore, the 13.1 per cent increase in monetary resources was the result of a combination of the growth of components with a greater degree of liquidity (money and quasi-money) and reductions in those with a lesser degree of liquidity (counterpart funds and other items) (see table 16).

Table 16

BOLIVIA: MONETARY BALANCE

(Millions of pesos at current prices and balances at end of each period)

	1972	Rate	1973	Rate	1974 June	Half-yearly rate
Structure of monetary resources (global liquidity)	3 937.5	43.1	4 452.0	13.1	5 641.7	26.7
Money (means of payment)	2 210.1	25.2	2 968.9	34.3	3 639.3	22.6
Quasi-money	634.2	28.6	806.9	27.2	988.6	22.5
Counterpart funds	476.5	310.8	95.0	-80.0	340.6	258.5
Other items (net)	616.7	63.7	581.2	-5.8	673.2	15.8
Factors of expansion and contraction	3 937.5	43.1	4 452.0	13.1	5 641.7	26.7
International reserves	718.4	198.1	228.7	-68.2	1 734.7	658.5
Credits	3 219.1	28.2	4 223.3	31.2	3 907.0	-7.5
(a) To the Government	1 858.1	21.2	1 934.9	4.1	1 044.0	-46.0
(b) To the private sector	1 361.0	39.2	2 288.4	68.1	2 863.0	25.1
	<u>Structure (percentages)</u>					
Factors of expansion and contraction	100.0		100.0		100.0	
International reserves	18.2		5.1		30.7	
Credits	81.8		94.9		69.3	
Credits	100.0		100.0		100.0	
(a) To the Government	57.7		45.8		26.7	
(b) To the private sector	42.3		54.2		73.3	

Source: IMF, International Financial Statistics, November 1974.

/In the

In the first half of 1974, total liquidity once again increased appreciably. It will be noted that monetary resources rose by 26.7 per cent in this period as a result of significant increases in all their components (see table 16).

Monetary expansion in 1973 was mainly due to the expansion of credit, which reached the rate of 31.2 per cent, exceeding the rates in previous years. What stands out once again is the extraordinary increase in credit to the private sector (68 per cent), while credit to the Government rose by only 4.1 per cent. The sharp drop in international reserves to one-third of their value over the period of one year acted as an important factor of contraction. In fact, this decrease meant the sterilization of about 500 million Bolivian pesos, which represented 67 per cent of the increase in money in 1973 (see table 16).

The factors of expansion and contraction followed opposite trends in the first half of 1974. Reserves trebled, while credit dropped by 7.5 per cent over the six months, as a result of a decrease of about 46 per cent in credit to the Government and the continued increase at a rate of over 25 per cent in credit to the private sector.

Monetary expansion in this second phase of inflation in Bolivia was mainly attributable, as stated previously, to the extraordinary expansion of credit to the private sector. The Government's development policy has openly supported private entrepreneurial activity. In this respect, it is highly illuminating to compare the amount and proportion of credit assigned to the private sector at the end of 1972 with the position in June 1974. Whereas in 1972 it amounted to 977.5 million Bolivian pesos, or 42.3 per cent of total credit, in June 1974 it had risen to 2,863 million Bolivian pesos and its share was 73.3 per cent of the total; conversely, the Government's share of total credit decreased considerably (see tables 14 and 16). No more data is required to conclude that the monetary expansion was mainly in favour of the private sector. The increases in credit which successively benefited private activity already as from the end of 1971 were so

/accelerated that

accelerated that they could not but have repercussions in terms of inflation. The trend of this variable is a clear expression of the Government's development policy, which firmly supported the strengthening of private enterprise.

The financial behaviour of the Treasury was another exacerbating factor of the inflationary process.

Table 17 summarizes the fiscal position. Current income rose by 85.7 per cent and expenditure by only 57.3 per cent. The increase in income is basically due to the high prices of export commodities (particularly mining products, petroleum and gas), which meant exceptional increases in production royalties and export taxes. The smaller increase in expenditure is largely attributable to the wages policy under which only moderate wage and salary adjustments were granted. It will be noted that the increase in personal services was only 31.9 per cent and that, if the recruitment of new government officials is subtracted from this, the increase in wages and salaries was considerably lower, while in the same year consumer prices went up by 35 per cent. In spite of this austerity in connexion with wages and salaries and the higher tax revenue obtained, it was not possible to avoid a deficit in the fiscal budget. The current account deficit was 298 million Bolivian pesos in 1973 (12 per cent of the total fiscal revenue for that year). Although lower than in the previous financial year, it continued to represent one of the important reasons for currency issues, with their sequel in terms of inflation.

It should be noted, however, that it was not only the fiscal deficit and its financing by means of currency issues that spurred on inflationary pressures. An increase of 57.3 per cent in expenditure in so rigid a structure as that of the Bolivian economy also caused disequilibria between supply and demand and, therefore, exerted pressures on prices. It will be noted that the considerable increase in income which made such a growth of expenditure possible is mainly attributable to royalties in respect of exports of mining products, petroleum and gas, the export prices of which had soared.

Table 17

BOLIVIA: BUDGETARY OPERATIONS

(Millions of Bolivian pesos at current prices)

	1972	1973	Percentage variation 1972-1973	January- July 1974
<u>Income</u>	<u>1 330.0</u>	<u>2 469.4</u>	<u>85.7</u>	<u>2 635.2</u>
Internal revenue	565.3	769.4	36.1	687.3
Customs revenue	418.2	517.4	23.7	427.6
Mining revenue	43.1	190.7	342.5	488.6
Revenue from gas and petroleum	68.9	278.6	304.4	393.7
Other income	234.5	713.3	204.2	
<u>Expenditure</u>	<u>1 758.7</u>	<u>2 767.3</u>	<u>57.3</u>	<u>2 705.6</u>
Personal services	1 009.5	1 331.7	31.9	1 207.0
Non-personal services, materials and supplies	224.4	361.9	61.3	268.2
Fixed and financial assets	19.0	113.6	497.8	62.3
Public debt	293.5	412.4	40.5	485.8
Current and capital transfers	174.8	473.8	171.1	467.3
Other expenditure	37.5	73.9	97.0	215.0
<u>Deficit</u>	<u>428.7</u>	<u>297.9</u>	<u>-30.5</u>	<u>70.4</u>
<u>Financing</u>				
External credit	28.4	31.0	9.2	-
Central Bank credit	398.0	384.0	-3.5	-
Balance of previous period	18.1	15.8	12.7	132.9
Balance at end of period	15.8	132.9	741.1	62.5

Source: Ministry of Finance, Office of the Under-Secretary of Financial Administration.

This fact was particularly important because the increase in fiscal revenue did not lead to a contraction in spending power in the economic system, but rather to increases in liquidity through the purchase of foreign exchange from exporting concerns.

In the light of the economic situation in the first nine months of 1973, the prospects for the final balance were decidedly gloomy. In October of that year the current account deficit was estimated at 960 million Bolivian pesos (then 40 per cent of estimated income), which was over three times the deficit actually shown at the end of the year. The prices of export commodities distinctly benefited the public finances, which would otherwise have had to face pressing problems.

Be that as it may, the inflationary process was strongly influenced by the difficult situation in the earlier months. The monetary balances recorded at the end of the year, particularly as they underwent significant changes in the last quarter, conceal intermediate situations which it is useful to consider because they determined domestic price trends. Suffice it to say that Central Bank credit to the Government at the end of September 1973 was 18 per cent higher than at the end of 1972, and three months later it was only 4.1 per cent over the same figure. The change in the fiscal situation in those last three months obviously mitigated the quantitative impact of the liquidity recorded previously, but the motivations, both objective and subjective, of the agents of the economic process were more influenced by the expansionist situation in the first part of the year than by the balances at the end.

As in the first phase of inflation, the extraordinary liquidity experienced by economic activity could scarcely be absorbed without drastic changes in the system and increases in prices. If indexes of monetary expansion in that period are compared with the indicators of the real increase in the supply of goods, it will be seen that the real product grew by 5.2 per cent in 1973, the agricultural product by 2.1 per cent and imports by 9.2 per cent, resulting in a 6.1 per cent increase in total supply. Although this is not a really strict

/comparison in

comparison in view of the nature of the physical and financial variables considered, it has sufficient value to show that the two spheres failed to operate in a synchronized manner and their adjustment would necessarily involve an increase in prices.

The acceleration of inflation was closely associated with what has been called imported inflation. Since this factor has only recently made its appearance on the inflationary scene and has particular features which need to be identified, it is dealt with in a separate section.

(c) The incidence of imported inflation

With the purpose of clearly identifying the exogeneous factors stimulating inflation in Bolivia, a study is made of both their nature and their mode of action.

The dynamic impetus of international prices as from mid-1973 had distinctly favourable effects for Bolivia. The high prices of export items alleviated the pressures on the balance of payments and enabled imports to be increased so as to cover the needs which the slow growth of supply of agricultural commodities was unable to satisfy. Concurrently with these benefits, world inflation was transmitted through various mechanisms to the domestic scene with infavourable results.

(i) Import prices. The first direct impact made itself felt through the higher prices of imports of goods and the higher cost of freight and insurance. As noted above, the import price index went up 17.6 per cent in 1973 and 23 per cent in 1974. The increases were bigger in the case of machinery, equipment and spare parts in general, which make up almost half of Bolivia's imports. The new prices of these products indicate price increases well above the rates already mentioned. The effects of these increases, combined with those those produced by the devaluation of the exchange rate, represented severe inflationary pressures on production costs in national currency.

In view of the dependence on imported supplies which is a feature of the Bolivian economy, this exogenous impact spread rapidly inside the country. It is not easy to determine to what extent inflation

may be ascribed to each of the various factors involved. The interaction of some and the essentially qualitative nature of others make an accurate breakdown somewhat difficult. However, an increase in import prices of the magnitude reached in 1973 and 1974 is justification for assigning to this aspect of inflation tremendously important quantitative and qualitative effects in terms of the phenomenon itself, particularly the acceleration which took place between mid-1973 and mid-1974.

(ii) Enlargement of the imported base. In view of the exceptional increase in the volume of foreign trade operations, imported inflation was not only transferred through prices; the increase in volume means an enlargement of the imported base, which offers a wider opportunity for the importation of foreign inflation. From this point of view, the appreciable increase in the import coefficient favours the transfer of external inflationary pressures. This dual effect is, however, partly offset by the bigger supply of goods resulting from the real increase in imports. To determine how far this fact moderates the exogenous pressures would require a detailed knowledge of the structure of demand by income strata and of the composition of imports.

In this respect, too, the change in the scale of Bolivia's foreign trade fostered the spread of imported inflation. A considerable and rapid increase in foreign trade activities, particularly imports, came up against a basic infrastructure which had not grown, and could not grow, at the same rate. The increases in demand associated with this type of activity were naturally an additional source of price increases.

(iii) Export prices. In addition to the higher cost of imports, world inflation had adverse effects of a different type on pricing. The excellent prices of commodities such as meat, sugar and flour prevailing on the external markets caused exports to soar at the expense of covering domestic needs. There were periods in which these movements led to acute local shortages, with the natural repercussions on prices. In the middle of 1973, the Bolivian economy began to feel

/this new

this new impact of external inflation. Paradoxically enough, a situation of excellent export prices had negative internal effects. In the face of foreign markets to which access was difficult in the past, a policy of export promotion and incentives had been developed, which combined with the new foreign trade conditions to obtain large export flows. Not only did this situation, as stated previously, upset the balance between domestic supply and demand, which in itself exerted pressure on domestic prices, but the excellent external market conditions strengthened the position of the exporter groups. Within a general policy of promoting private enterprise, it was not easy to direct entrepreneurial decisions against the market forces. For this among other reasons, the domestic prices of these types of commodities, which have both domestic and external markets, were adjusted.

Among the negative effects of external inflation, mention cannot but be made of the proliferation of illegal export and marketing activities. Although it was impossible to assess the volume of these operations with any accuracy, data obtained from various official sources indicate a considerable scale of illegal trade, including contraband in gasoline.^{10/} The increase in these activities not only meant large transfers of physical resources abroad without any kind of fiscal control, but it fostered imports of essentially luxury goods, also in the form of contraband, with all their pernicious effects. The unrestricted freedom of exchange certainly helped such activities, which in some departments reached very high levels. Contraband had been a big problem for many years, so that it can well be imagined how much more serious it became after it had increased so alarmingly, to the extent that at times it was the focal point of the Government's concern. This was yet another way in which imported inflation passed into the Bolivian economy, obviously with worse consequences than through the legal flows.

^{10/} Estimates of the Financial Administration Department of the Ministry of Finance.

The steady growth of legal or illegal exports meant a considerable concentration of income in the hands of the groups associated with those activities. The sequel of negative effects does not stop there, however. The surpluses accumulated by the exporter sectors boosted their internal and external purchasing power. Prompted by the urgent need to take advantage of the external situation, they stepped up their purchases of inputs, freight and other services, and the behaviour of their suppliers, conscious of the extraordinarily high profit margins obtainable from exports, brought additional pressures to bear on prices.

(iv) Accumulation of reserves. Another phenomenon which clearly had some influence on the recent inflationary process, especially the acceleration of inflation, was the exceptionally rapid growth of international reserves. In view of the foreign exchange policy in force in Bolivia, the expansion of exports and the consequent accumulation of reserves resulted in national currency issues which significantly increased the liquidity in economic activity (see table 16). It will be remembered that the increases in money and quasi-money in the first half of 1974 were 22.6 and 22.5 per cent, respectively. The expansion of total liquidity was 26.7 per cent over the same period, one of the main causes being the increase in reserves, which in June 1974 stood at nearly eight times the end-1973 figure. A violent change is noted in the ratio of credit to reserves as factors of expansion. At the end of 1973 this ratio was 19 to 1, and six months later it was only 2 to 1. Such variations over so short a time can scarcely be harmless in terms of prices. The larger currency issues, albeit motivated by increases in reserves, had inflationary effects. Although the bigger supply of foreign exchange, as already stated, makes for more imports which increase total supply, there is generally a period in which the actual entry of imported products lags behind the increase in liquidity, and degrees of variable incompatibility between the structure of the additional demand and the composition of the new imports. Similarly, the lead time of the investments militates against the achievement of basic equilibria in
/the economic

the economic system. These maladjustments are clearly observable in the second phase of inflation in Bolivia. The price increases in the first half of 1974 took place in a context of a considerable accumulation of reserves, large-scale investment and imports at ever-increasing prices.

(v) Inflationary expectations. Lastly, in thus identifying the inflationary factors associated with the pressures from the external sector, mention must be made of the fact that inflationary expectations played a highly important role. In pricing, profit margins were usually calculated on the basis of replacement costs which more than safeguarded future increases in prices. Similarly, as regards consumers, the expectations of price increases meant the accumulation of stocks and little resistance to the usual speculations in openly inflationary processes. For the one reason or the other, prices soared.

The most important entrepreneurial decision-making centres in Bolivia are generally associated with foreign trade activities and, of course, with banks. Any changes in world commodity prices or currency values are rapidly reflected in these groups. The recent world inflation found in them a direct mechanism for spreading the additional inflation to the quantitative factors reviewed above.

No further explanations are necessary to realize that all these forms of "importing" external inflation were facilitated, extended and magnified by structural factors which have adverse effects whatever the direction of the current movements. In situations of external bottlenecks, these factors aggravated the crises and hamper any plan or programme which under different circumstances would have been able to palliate them. In a boom situation such as that recently occurring in Bolivia's external sector, the structural deficiencies in that economy prevented it from reaping the full benefit and fostered the importation of external inflation.

D. INFLATION AND ECONOMIC POLICY

1. The frame of reference

The first fact which should be stressed is the non-existence of an explicit economic policy. The basis and main features of the development policy in general and the economic policy in particular corresponded to very general principles and objectives. At this level, it is impossible to pin down an overall idea which includes specific intentions and determined policies for the different sectors of the economic system and for the different areas of economic policy.

In a context in which serious structural problems had to be faced and government policy was to give definite support to private initiative, stability and growth objectives were not wholly consistent with such policy. In pursuance of these objectives use was made of economic policy instruments the scope of which was fairly limited, considering the type of underdevelopment to be found in Bolivia. In this context, it would perhaps be relevant to define the radius which conventional action in respect of economic policy has for manoeuvre. In a country ground down by serious structural problems, which consequently suffers from serious deviations in the functioning of socio-economic activity, the use of the classic machinery of economic policy has definite limitations. Just as architectural construction, however boldly and well planned it may be, cannot make much headway in the face of geological faults in the earth's crust, an economic policy which limits itself to action on the surface of the production and distribution system is necessarily restricted. Bearing this in mind, in the case of Bolivia, such a policy will only directly influence a small core of the population, and as far as the economic phenomena which it covers are concerned, the full extent of its influence is to achieve a certain basic balance at the macroeconomic level, and even here, only with serious difficulties. The diversity of grassroot situations which is a result of the structural heterogeneity which has so frequently been referred to, deprives the overall economic policy instruments of their efficacy while serious incompatibilities affect /their use.

their use. In the enumeration of the main economic policy measures below, it is essential that this contrast between the limited area for manoeuvre and the deep-rootedness of the problem which they endeavour to solve should not be forgotten.

On the same lines, there would appear to be a similar lack of adjustment between a development policy which takes its basic support from private enterprise and its main orientation from market forces, and a policy whose objective is to correct the structural disequilibria of which repeated mention has been made.

Despite its major influence, the private sector finds itself before a fairly limited prospect in terms of its scale of production. The small size of the consumer market in Bolivia, in view of the level and distribution of income, limits the expansion of the industrial product. The most vigorous management activities in recent years were those connected with the external sector and those producing goods and services for the wealthiest sectors of society, i.e., those activities which had a safe market ensured for them. The narrow limits of the domestic markets are consequently a visible impediment to any industrialization process of consideration based on efficient private enterprise, with a minimum of competition. This means that the low level of purchasing power of the majority of the population does not provide an adequate stimulus in the form of economic viability to undertaking activities which imply risks and terms of maturity which are not necessarily brief.

It should be observed that the small scale of production of the majority of the enterprises makes for high unit costs, overlaid by large profit margins resulting from the special structure of demand. Price formation was affected by this double influence which inflation and the expectations it aroused became responsible for aggravating.

Another important element in the frame of reference to the economic policy of the last three years which merits a further reference, is the abrupt change in the volume of external trade operations. As has already been said, international inflation has brought to light some of the limitations of public administration. In

/the context

the context of a continuing bottleneck in the external sector the state apparatus had developed certain responses, i.e., its abilities were directed at defending itself from what were generally deficit situations. The increase in export prices has in this sense placed the country in a diametrically opposed situation. Spending capacity on productive investment was not in line with the growing availability of foreign exchange. Similarly, imported inflation signified an entirely new problem, of considerable impact and rapid dissemination in the country's economy; the economic policy aimed at tackling it did not have the amplitude and speed which inflation employed to spread its effects throughout the country.

It should not be omitted that during the same inflationary period being studied here, the structure of economic and political power underwent an appreciable change compared with previous years. The possibilities of regulating the operation of the economic system, especially in a context of inflation, decreased as the influence of the private sector on the decision-making centres increased. Private sector pressures on prices, credits and taxes were powerful limitations on the adoption of government decisions.

The situation outlined above made up a picture which made the conception of a clear and well-defined economic policy very difficult. From the point of view of inflation, the description of which is the aim of the present document, it is impossible to identify any open and continuing policy of stabilization; rather the reverse, State action tended to provide pragmatic responses to economic events. The type of underdevelopment existing in Bolivia, among other reasons, hindered the advance of the socio-economic process and the operation of economic policy machinery basically consisted of a series of responses to the phenomena which materialized and not of a preconceived implementation of the country's development policy.

2. The main measures adopted

The economic policy process which began in 1972 was markedly different from earlier processes. Throughout the period 1959-1971 the high priority objectives of the conception and implementation of the different economic policies which can be identified was to prevent structural disequilibria from coming to the surface of the economic system in their political, social and economically most harmful manifestations. Generally speaking, the handling of the financial variables was in keeping with this aim. It may be concluded from the observation of the increases in money supply, credit, the fiscal budget, etc., that monetary programming throughout this entire period was very much tied to not exceeding annual increases of around 6 per cent in price rises; this objective was, generally speaking, achieved.

The economic policy decisions adopted as from 1972 constituted a basic change, especially in connexion with the expansion of public expenditure and the increase of credits to the private enterprise sector, and the liberal sales of foreign exchange. This change of economic policy meant that the structural disequilibria typical of Bolivia's economy forced their way to the financial scene, in the form of blatant inconsistencies between supply and demand, which the market forces, as has already been stressed, took on the responsibility of correcting by means of changes in the system and increases in price levels. The limited ability of the apparatus of production to respond to stimuli originating in the financial sphere became obvious.

(a) Wages and prices policy

The Government's main concern, once the modification in the exchange rate had been decided upon, was to regulate price increases.^{11/} The maximum limits for the increase in prices were, however, exceeded in fact. The annual target of 25 per cent for the prices increases between October 1972 and October 1973 was unable to resist the pressures from costs and demand which the devaluation and the monetary expansion took upon themselves to activate.

^{11/} A more detailed commentary on the devaluation appears in ECLA, Economic Survey of Latin America, 1973, p. 285 onwards, (E/CN.12/974) mimeographed version.

The policy aimed at controlling the progress of prices had various stages: the freeze decided upon in the first instance was disrupted by the pressures analysed, successive requests by the producers and the market forces themselves were the cause of a further chain of increases, and lastly, the disparity between the prices of some products in the markets of neighbouring countries and those existing in the domestic market encouraged contraband which the Government endeavoured to control on a basis of readjustments which brought some domestic prices close to international levels. These examples clearly show the shifts in price policy, which moved from an attempt at strict control and regulation to an endeavour to follow the pressures of external demand. If it is also borne in mind that the increase in import prices determined increases in the production and distribution costs of products with the whole range of demonstration effects implied, it will be seen that price-decisions were the object of restrictions of the most varied types. The implementation of a stable policy in this respect was therefore not possible.

From the point of view of wages, the policy had more lasting and better-defined trends. On the one hand, the majority of the readjustments were on a basis of fixed sums, in an attempt to benefit the low-income workers, and on the other hand there was considerable control in the handling of this variable, with a view to slowing down the excessive growth of demand and ensuring that the higher costs which would be generated by the larger readjustments should not constitute additional pressures on prices.

Together with the devaluation, a fixed readjustment equivalent to 135 Bolivian pesos per month was granted to all Bolivian wage earners.^{12/} The magnitude of the ensuing price increases resulted

^{12/} As a point of reference, the average monthly salary in the Central Government was estimated at approximately 1,090 Bolivian pesos in 1972. See the Interamerican Committee on the Alliance for Progress (CIAP), Sub-Committee on Bolivia, op.cit., tables IV-5 and IV-6. On the other hand the total remunerations for the Central Government increased in 1973 by slightly over 30 per cent (see table 17).

in grants of subsidies to low-income workers according to the number of dependents: 20 Bolivian pesos per worker plus 25 pesos for each dependent. Later, in mid-1973 as a result of new price increases, an extra payment of one month's wages per worker was decreed. Lastly, following the wake of inflation, a further readjustment of 120 Bolivian pesos per worker was granted in 1973.

Very rough estimates would seem to show that the average wage in the Central Government, thanks to the above-mentioned readjustment, had increased by approximately 45 per cent between October 1972 and October 1973. During this same period prices increased between 52 and 66 per cent according to different sources of information. That year, a large proportion of wage-earners experienced varying degrees of decline in their standard of living. As regards the low-income population, especially the rural population, it is not possible to evaluate their gains or losses owing to the lack of price indicators in rural areas. In view of their low incomes fixed amount readjustments and the output of subsistence farming, it is to be hoped that their standard of living did not deteriorate during this period.

On the other hand, the exporters, importers, the groups closely associated with the financial market and industrialists in general saw an increase of their share in the product generated. External prosperity was mainly concentrated in these nuclei, while, as is usually the case, the inflationary process itself produced larger quotas of surpluses for these groups. There is still no complete data available on the capital formation which may be attributed to these sectors, in order to determine to what extent the retrogressive trend in income distribution was offset by increases in growth potential, or whether the flight of capital once again was the means of taking large sums from them.

(b) Exchange policy

The most important decision in this area was the maintenance of the exchange rate at the level of 20 Bolivian pesos to the United States dollar as from October 1972. Similarly, the free sale of foreign exchange to private persons and the compulsory surrender of foreign

/currency from

currency from exports, were the main complementary measures which made up the exchange policy as from the date mentioned. The maintenance of the exchange rate has constituted a form of subsidizing imports in view of the high level of domestic prices, and, of course, constituted a type of subsidy to hoarding in hard currency. It is the only asset which has not undergone any price increase since then. Only a reasonable supply of foreign exchange can guarantee a liberal policy of this type, in a situation in which there exists a high level of liquidity in the economic system. Up till now, the dynamic forces of external demand were the mainstay of the free sale of foreign exchange and the fixed exchange rate. On the one hand, this resulted in the deadening of the effect of imported inflation, and on the other, it represented a channel for the flight of foreign exchange, and in particular facilitated smuggling to a tremendous extent. Owing to the lack of detailed data on the structure of imports, it is not easy to evaluate the positive and negative results of the way in which this instrument was handled. Considerations along the lines of the above, however, and, better still, clear indications that legal and illegal imports of luxury goods may be reaching levels hitherto unknown, cast doubts on whether this exchange policy is compatible with making the most of the external economic situation which could mean the acquisition of permanent benefits for the country. The following could be taken as an example: while the consumer price index underwent an increase of 126.5 per cent between October 1972 and July 1974, the price of the dollar remained steady.

Since domestic inflation is considerably higher than external inflation, the subsidizing of the exchange rate should have produced a drastic change in the system of prices in the sense of a fairly meaningful reduction in price of imported products. Incomplete data available suggest that such a change did not take place and this would imply that the single, fixed and free sale exchange rate is one of the mechanisms through which the retrogressive distribution of income is channelled to the importer groups.

/The growing

The growing supply of foreign exchange, basically as a result of external prices, provided Bolivia with an important defence mechanism against imported inflation, since it was able to keep its exchange rate unchanged. While its external trade continues along the same lines, it will be able to continue to absorb some of the effects of this foreign inflation. The doubt will remain, however, whether alternative policies would not in fact have had more promising effects. It proves very difficult to evaluate such alternatives while the structure of imports is not known in detail, as has already been stressed. It should also be recalled that the above reflexions basically cover the context of the economy; socio-political restrictions play a basic role in the control of an instrument as sensitive as the exchange rate. A more general appreciation would of course have to take them into account.

(c) Tax policy

At the same time as the currency was devalued, important measures were taken in taxation. Mention should be made of the revaluation of assets, by 60 per cent for imported goods and 20 per cent for buildings and other goods of domestic origin, with a tax of 5 per cent on this revaluation. Measures were taken at the same time to revalue assets in gold and foreign currency at the new rate of exchange, with a tax of 20 per cent on the increase.

Also with a view to attracting the benefits implied in a devaluation, new taxes were created: 60 per cent of the import value of stock of imported articles on sales; 40 per cent of the net value of exports of minerals, hydrocarbons and cotton already produced or exported but pending payment and the compulsory surrender of foreign exchange; 20 per cent on the net value of all new exports of minerals, metals, hydrocarbons, cotton and meat; and 15 per cent on the value of exports of other goods.

A year later in October 1973 a tax reform was introduced, aimed at simplifying tax legislation and exercising a stricter control over the very considerable tax evasion.^{13/}

This tax reform introduced modifications in following taxes: personal income tax, tax on the income of enterprises, sales tax, and selective consumption taxes. The most important feature of the personal income tax was the replacement of a schedule system by a global system in which a single progressive scale was applied. The most outstanding features of the tax on the income of enterprises are: the extension of the universe of contributors to agricultural and livestock enterprises; the distinction made between enterprises with sales exceeding 200,000 Bolivian pesos annually (approximately 1,500) and the smaller enterprises, and the increase from 26.4 to 30 per cent of the rate of tax on profits. It should also be mentioned that clear incentives are given for investment and reinvestment of profits and for the utilization of labour-intensive production techniques.

The results of this modification in taxation cannot be evaluated using available information. From the point of view of its effects on inflation, however, it may be stated that the results were only secondary. The increase in domestic revenue between 1973 and 1974 was less than a general increase in prices; the increase in prices as a result of tax reform was apparently more than compensated for by the reduction in real demand which the reform itself implied. In any case, besides the other factors of inflation which have already been analysed, the effect of taxes as has already been said, had little importance.

^{13/} As an example of this, it should be noted that the most dynamic area in the country, the Department of Santa Cruz, generated less tax revenue in 1973 than in 1972 and contributed a smaller quota to the Exchequer than that of the Department of Cochabamba where economic activity is at an appreciably lower level.

(d) Fiscal finance policy

From the fiscal viewpoint, the traditionally most important items of income did not undergo significant changes. The increases in the sums collected, referred to as internal and customs revenue, were less than increases in prices; tax evasion increased considerably to judge from some partial indicators. The so-called revenue from production and taxes on exports of minerals, gas and petroleum, showed extraordinary increases, however. As may be seen from table 17, during the fiscal year 1973 and particularly throughout the period January-July 1974, their contributions increased significantly. While in 1972 these items accounted for barely 18 per cent of current earnings, in the first seven months of 1974 they came to account for 50 per cent. Obviously, there was a change in this type of source of fiscal financing and dependence on external trade increased. The increases noted meant that the fiscal deficit was considerably smaller and that it reduced to a similar extent Central Bank credit requirements (see table 17). From the point of view of inflation, however, the short-term situation had not changed very much. The greatest increases in earnings were from issues originating in purchases of foreign exchange from exporters. Issues which were not occupied in financing the fiscal deficit were used to accumulate reserves and this meant an increase in the liquidity of the economic system; while this foreign exchange does not become real supply, inflationary pressures will continue to take their course.

The Government's financial requirements benefited from a major inflow of external credit. The increase in the external public debt comparing the balances at the end of 1971 and 1973 was approximately 136 million dollars, which meant an increase in the debt of 23.7 per cent during this period. The external public debt at 31 December 1973 amounted to the sum of 721.6 million dollars, 14/ which was nearly two and a half times the value of exports of goods and services in that year.

14/ See CIAP, Sub-Committee on Bolivia, op.cit., table V-10.

(e) The financing of the private enterprise sector

As regards the financing of the private enterprise sector, it has already been stressed that bank credit underwent extraordinary large increases. Government policy in this respect was exceedingly indulgent with financial requirements, so much so that the increase in liquidity which resulted from the inflationary process described above must be largely attributed to the increases in this form of financial support. Furthermore, the external credit attracted by this sector made up a large share of the country's debt. During 1972, external financing for these entrepreneurial activities was 40.3 million dollars, and in 1973 it was 47.2 million dollars.^{15/}

The traditional problems of the external bottleneck which the Bolivian economy came up against in the past, did not arise in recent times since the private enterprise sector too had access to ample facilities for external finance. In the face of these well defined incentives, the speed of response of private activity would not appear to have manifested itself in as vigorous a form as might have been expected, if the data available for 1972 is taken into account.

In this regard it should be mentioned that private investment in the main sectors of production in 1972 was significantly lower than in 1971 (see table 18). No data is available for investment in housing and the services sectors, which probably increased, but if tentative figures for investment in the basic productive sectors are confirmed, there may be reason to believe that the performance of this sector was far from constituting a dynamic element, despite the major role assigned to it in the beginning. If to this is added the decline in foreign investment during the year, and if these movements are compared with the various types of stimulus given to private enterprise, it will be understood that it is other problems - arising out of structural heterogeneity - which determine the failure of intentions to materialize in more rapid rates of growth.

^{15/} IMF, Balance of Payments.

Table 18

BOLIVIA: ESTIMATED INVESTMENT IN THE PRIVATE SECTOR
(Millions of Bolivian pesos at current prices)

Sector	1970	1971	1972
Agriculture	46	49	38
Mining and quarrying	109	115	89
Industry (manufactures)	71	75	58
Hydrocarbons	199	210	163
Energy	63	66	50
<u>Total</u>	<u>488</u>	<u>515</u>	<u>398</u>

Source: Secretariat of the Consejo Nacional de Economía y Planificación. Dirección de Planificación Global. The original source indicates that some data are estimates and subject to modification.

2. BRAZIL

A. INTRODUCTORY NOTE

Inflation in Brazil must be analysed in a wider setting than would be required for other Latin American countries. It is in fact part of an overall economic policy project which has been applied for the last ten years. Questions relating to manner of growth and matters concerning the inflationary process are thus very closely interrelated. Consequently, the study on Brazil is more lengthy and detailed than those of other countries; this is also because a variety of background facts is provided on features of development during this period, and in particular as from 1968, which marks the beginning of a period of high growth rates in the economy of Brazil.

B. OUTSTANDING FEATURES OF THE EVOLUTION OF THE BRAZILIAN ECONOMY

1. Evolution of the gross domestic product and its components

Table 1 shows the performance of Brazil's gross domestic product by the sectors of economic activity which compose it.

As may be seen, the growth of the economy put on a spurt as from 1968, and the average growth of the product increased from around 7 per cent during the period 1965-1969 to 11 per cent during the years 1970-1973. This increase in tempo was predominantly linked with the favourable performance of the secondary sector, both on account of its importance in the total product (27 per cent of the gross domestic product during the years 1971-1973), and because of the natural repercussion on the growth of other sectors, for example, trade, finance and transport and communications.

The boom in Brazil's economy may largely be explained by the steady growth of industry, with growth rates of 10.2 per cent during the period 1965-1969 and 13.7 per cent in the years 1970-1973.

/Table 1

Table 1
BRAZIL: GROSS DOMESTIC PRODUCT, AT FACTOR COST,
BY SECTOR OF ECONOMIC ACTIVITY

(Growth rates)

	1965- 1969	1970	1971	1972	1973	1970- 1973
Agriculture	2.4	5.6	11.4	4.5	3.5	6.4
Mining	10.1	12.7	11.0	14.3	11.5	12.3
Manufacturing	10.2	11.0	11.3	14.1	15.8	13.7
Construction	9.7	14.9	8.4	12.9	15.5	12.2
<u>Subtotal goods</u>	<u>6.5</u>	<u>8.8</u>	<u>11.3</u>	<u>10.1</u>	<u>10.9</u>	<u>10.8</u>
Electricity, gas and water	9.2	10.1	11.4	11.1	12.5	11.7
Transport and communications	8.7	15.0	8.4	8.1	14.0	10.1
<u>Subtotal basic services</u>	<u>8.8</u>	<u>13.7</u>	<u>9.1</u>	<u>8.9</u>	<u>13.6</u>	<u>10.5</u>
Commerce and finance	7.8	9.1	12.3	11.4	12.5	12.1
Commerce	8.1	8.9	12.8	11.9	13.0	12.6
Finance	7.0	9.5	11.3	10.4	11.4	11.0
Ownership of dwellings	7.0	9.5	11.3	10.4	10.5	10.7
Government	7.0	9.5	11.3	10.4	10.4	10.7
Miscellaneous services	4.2	9.5	11.3	10.4	10.4	10.7
<u>Subtotal other services</u>	<u>6.6</u>	<u>9.3</u>	<u>11.8</u>	<u>10.9</u>	<u>11.4</u>	<u>11.4</u>
<u>Total gross domestic product</u>	<u>7.0</u>	<u>9.5</u>	<u>11.3</u>	<u>10.4</u>	<u>11.4</u>	<u>11.0</u>

Source: ECLA, on the basis of official statistics.

The growth of the sub-sectors which make up the industrial sector, however, was not homogeneous. In fact, a wide disparity is to be observed in rates of growth, and this should be stressed in order to show clearly where the dynamic core of the sector lies and hence the root of the growth of the total product. Table 2 shows that the expansion of the industrial sector was linked to a large extent to the favourable progress of the industries producing "heavy" consumer durables, such as appliances, motor-vehicles, etc., and the basic metals industries. It may be observed that the rates of growth of the metallurgical, engineering, electrical and transport materials industries are very much higher than those of the "traditional" sectors and the sectors producing intermediate articles. Table 3 gives a clearer picture of this phenomenon, and makes it easy to identify the industrial sectors of greatest relative dynamism, by categories of use. Consumer durables grew at an average rate of around 17.6 per cent during the period 1968-1972, and most certainly contributed to the acceleration of industrial growth, followed by the production of capital goods with an annual average growth rate of 15.8 per cent. However, the output of non-durable consumer goods evolved along lines similar to its traditional course and the rates of increase of the output of intermediate goods barely exceeded the total industrial average.

It may be deduced from the foregoing that the growth of the Brazilian economy in recent years was tied up with the higher rates of growth observed in the consumer durables and capital goods industries.

As will be understood, for this dynamic core to have grown rapidly, certain requirements must have been fulfilled:

- (i) favourable evolution of internal and external purchasing power in respect of its product;
- (ii) a finance policy which contributed the resources required for the growth of these industries at the right moment;
- (iii) no narrow limits to import requirements; and
- (iv) investments in supporting infrastructure and in complementary industries.

Table 2

BRAZIL: ANNUAL AVERAGE GROWTH RATES IN MANUFACTURING

(Percentages)

	1966- 1969	1969- 1972	1966- 1972
Non-metallic mineral products	11.0	11.7	11.3
Metallurgical industry	9.8	10.8	10.3
Engineering industry	9.9	23.0	16.2
Electrical material	15.8	13.6	14.7
Transport material	13.0	16.4	14.7
Timber	9.7	...	...
Furniture	-2.5	...	...
Paper and paper products	11.6	4.6	8.0
Rubber	9.5	14.6	12.1
Hides and skins	6.4	...	...
Chemical	10.3	15.0	12.6
Beauty products	13.7	...	...
Textiles	6.0	1.4	3.7
Clothing and footwear	6.0	10.2	8.0
Food products	11.0	7.6	9.3
Beverages	3.3	7.6	5.4
Tobacco	6.0	5.7	5.8
<u>Total</u>	<u>9.5</u>	<u>11.1</u>	<u>10.3</u>

Source: ECLA, on the basis of official statistics.

Table 3

BRAZIL: QUANTUM INDEXES OF MANUFACTURING BY CATEGORIES OF GOODS

(1966 = 100)

Categories of goods	1968	1969	1970	1971	1972	Annual average variations 1968-1972
Capital goods	117.2	124.4	140.1	173.0	210.8	15.8
Consumer durables	125.5	156.9	168.8	198.6	239.9	17.6
Non-durable consumer goods	116.7	125.4	134.5	137.2	147.9	6.1
Intermediate goods	119.9	131.3	150.3	167.6	188.5	12.0
<u>Total</u>	<u>118.9</u>	<u>131.3</u>	<u>145.0</u>	<u>159.6</u>	<u>180.3</u>	<u>11.0</u>

Source: Insitute de Planejamento Económico e Social (IPEA); Ministry of Industry and Trade.

As a matter of fact, it could be said that these requirements for the dynamic sectors of industry were fulfilled thanks to the application of a growth policy which laid the necessary bases for the restructuring of the economy round this key core.

2. The bases for growth

Although the present analysis does not attempt to explain the recent development model of the Brazilian economy, which would be too complicated and outside the scope of the present paper, certain factors which more obviously laid the bases for expansion may, however, be given an explanation. These factors were associated with the reformulation of the finance schemes, the opening-up of the economy to the exterior, public investment policy and the evolution of the structure of income distribution.

(a) The reform of the finance system

During the five-year period 1964-1968 Brazil introduced a reform of the national finance system, which brought profound changes to the finance schemes existing in the economy, in that new forms of attracting and distributing resources were created, and played an important role in activating the system and in particular in speeding up industrial expansion. The main changes introduced with this reform are described below.^{16/}

In connexion with the finance system, an operational modernization of its functions took place, with the diversification of financial instruments and the introduction of some degree of specialization of functions, which meant the more flexible operation of the money and credit market, and the emergence of an institutionalized capital market, as from 1968.

As regards the immediate financing of the private and public sectors, the changes made led to a considerable growth of liquidity which was independent of the primary expansion of the means of payment

^{16/} Tavares, M.C. - Da substituição de importações ao capitalismo financeiro recente, Ed. Zahar, Rio de Janeiro, 1972, pp. 211 et. seqq.

as a result of the development of loans schemes outside the banking system and machinery for the tapping and intersectoral circulation of surpluses, by means of the issue of index-tied bonds and debentures.¹⁷

On the other hand, the financing of capital in the long and medium-term benefited considerably from important government measures aimed at attracting foreign capital in the form of money loans and import financing.

As far as the financing of consumption was concerned, promotion was given to expanding and diversifying consumption of durable goods by the urban middle income classes, and this played an important part in the recovery and growth of the modern sectors of industry.

As regards long-term financing, several special public funds were set up in association with national and regional development agencies.

However, since domestic supply of this type of credit proved inadequate for the needs of the economy, the Government complemented it with external finance (the importance of the external resources used to back up credit in the short, medium and long-term will be analysed below).

As from 1968, the capital market began to develop effectively, with the creation of investment banks, the reorganization of the traditional finance sectors, amalgamations of financial groups, the opening up of entrepreneurial capital and the progressive activation of the direct securities markets, mainly on the exchange.

Lastly, mention should be made of the establishment of specialized sub-systems for financing housing, linking up methods of compulsory savings (guarantee fund of length of service) ^{18/} and voluntary savings (letras inmobiliarias). The Banco Nacional de la Vivienda, the director agency of the system, taps compulsory savings and is the discount house for the real estate credit documents issued by finance or real estate companies.

^{17/} Readjustments in terms of price increases.

^{18/} This Fund was set up in 1966, and consists of a monthly deposit in a special bank account of 3 per cent of the total remunerations paid by the enterprises.

Tables 4 and 5 show some of the changes which took place, for example, the loss of importance of the banking sector and the important diversification of financial institutions. The 80 per cent share of the banking system in total private credit in 1964 decreased to about half in 1973, while the amount of diversified financial intermediation increased to a similar proportion; this was represented in particular by the finance companies (predominantly consumer credit), investment banks (mainly financing for working capital) and the schemes for financing housing.

From another point of view, the new forms of tapping resources significantly changed the structure of the financial assets of the economy (see table 5). A drop in the share of money assets may be observed (from 92 per cent in 1964 to 43.1 per cent in 1973) alongside the increase in the importance of the characteristic instruments of institutions outside the banking system - bills of exchange 19/ (16.9 per cent in 1973), fixed-term index-tied deposits (12.6 per cent) and letras inmobiliarias (3.0 per cent). Also of note is the importance in 1973 of index-tied debentures, which had a share of 17.7 per cent in the total financial assets of the system.

The new structure of the financial intermediation in the economy, briefly summarized here, 20/ contributed to a considerable extent to maintaining high growth rates during the period. Obviously, it implied a viable solution to the basic problem of the current financing of the enterprises, and made for greater fluidity of supply in the more dynamic sectors of the economy.

19/ Credit orders accepted by the borrower, negotiable in the market by the financial institution lending the resources which is jointly responsible for the order. The institution advances the resources to the borrower and replaces its liquidity by selling the order on the market.

20/ For a more detailed analysis, see H.C. Tavares, op. cit.

Table 4

BRAZIL: NUMBER OF FINANCIAL INSTITUTIONS OPERATING AT END OF YEAR

	1964	1968	1971	1973
Commercial banking institutions	336	231	155	115
Development banks	2	4	12	13
Federal	1	1	2	2
State	1	3	10	11
Banco Nacional de la Vivienda	1	1	1	1
Investment banks	-	21	40	45
Saving banks	26	26	6	6
Federal	22	22	1	1
State	4	4	5	5
Finance companies	134	245	170	152
Insurance companies	144	157	157	110
Real estate credit societies	-	25	45	44
Savings and loan associations	-	21	34	36
Brokers' associations	-	377	421	414
Distributors' associations	...	556	572	569
Investment societies	...	6	-	-
Credit co-operatives	-	-	318	324

Source: Banco Central do Brasil, Relatório Anual, 1969 and 1973.

Table 5
BRAZIL: MAIN FINANCIAL ASSETS
(Relative share)

	1964	1968	1970	1973
<u>Monetary assets</u>	<u>92.0</u>	<u>67.0</u>	<u>55.5</u>	<u>43.1</u>
Paper money in power of the public	21.0	12.8	10.5	7.9
Sight deposits	71.0	54.2	45.0	35.2
<u>Non monetary assets</u>	<u>8.0</u>	<u>33.0</u>	<u>44.5</u>	<u>56.9</u>
Savings deposits	...	1.0	3.3	6.7
Fixed-term deposits	2.5	4.5	6.9	12.6
Non index-tied	2.5	1.2	0.2	-
Index-tied	-	3.3	6.7	12.6
Bills of exchange <u>a/</u>	4.2	14.3	15.3	16.9
<u>Letras imobiliarias</u>	-	2.0	3.1	3.0
Federal debentures (ORTN, LTN and others) <u>b/</u>	1.3	11.1	15.8	17.7
<u>Total</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

Source: Relatório de Banco do Brasil.

a/ See note 19/, page 136.

b/ For this classification the traditional criterion was used; as regards the LTN, it may be observed that their degree of liquidity gives them more resemblance to monetary assets.

The growth of consumer credit, mainly represented by the extension of the operations of the finance companies, which showed an annual average rate of real growth of credit of approximately 41 per cent between 1967 and 1973, was a decisive factor in maintaining urban demand, specially in respect of consumer durables.

Mention may also be made of the creation of the schemes for financing housing, which in 1973 accounted for 13 per cent of total private sector financing; it produced an increase in the growth of the civil construction industry, which is highly labour-intensive, and constituted an important source of intersectoral demand in the industrial sector.

The restructuring of the capital market did not only provide support to investment by the enterprises but also - and this was its major contribution - it made possible an increase in the intersectoral mobility of the capital invested in productive activities, and helped to centralize it in the dynamic core of the economy.

However, despite the fact that it was possible to finance consumption, working capital and investment simultaneously and adequately, no appreciable increase would appear to have been achieved to date in the real rate of domestic savings, which was the main explicit objective for reformulating the national finance system.

(b) The changeover to outward-directed growth

Mention should be made here of the important role of the external sector in maintaining the high rate of growth of the economy.

During the period 1968-1972 Brazil changed the direction of its growth model, turning it outwards, and came to depend increasingly on the external sector to provide capital for immediate and long-term financing, as an important source of export demand for some sectors and as a complement to domestic savings, through the increasing deficits in current transactions.

In connexion with imports, a more liberal policy was followed, consistent with the aim of avoiding bottlenecks in the increased rate of growth of the economy. Total imports therefore increased at average rates of around 20.5 per cent during the period 1967-1970, increasing

/to 34.5 per

to 34.5 per cent in recent years (1970-1973), which raised the import coefficient from 4.7 per cent in 1967 to 11 per cent in 1973.

It should be observed that this speeding-up of growth was basically due to the performance of industrial imports which accounted for more than 80 per cent of total imports, and within these, to imports by the most dynamic sectors, e.g., metallurgy, engineering, electrical materials, transport materials and chemicals (see table 6). The importance of these industrial imports in the growth of the domestic supply of the manufacturing sector may be seen from table 7; it is to be observed that the percentage increases in the coefficient are particularly meaningful in the sectors producing capital goods.

It may be noted that the growth of imports in the economy of Brazil, together with the substantial increase in the import coefficient, was unquestionably bound up with the expansion of the dynamic core of industry, which played an important role in ensuring and maintaining high growth rates for the product. While on the one hand this provided a possibility of speeding up growth, on the other it constituted the vulnerable aspect of such growth, in that it began to inflict increasing rigidity on the pattern of imports, which could come to constitute a bottleneck to maintaining growth in the future.

In another area, as from 1964 Brazil began to apply an active policy to attract foreign capital, which was accepted without restriction in any economic activity, with the sole legal exception of the production and refining of petroleum. For this purpose new forms of external borrowing were created and adopted, making possible a broad-based use of external resources. External loans could be directly and freely arranged between enterprises abroad and in Brazil, for medium-term financing, while the commercial and investment banks and the Banco Nacional de Desarrollo Económico (BNDE) were authorized to contract medium and long-term foreign loans, with the guarantee in both cases of the availability of the foreign exchange required for amortization payments and remittances of interests.

Table 6

BRAZIL: IMPORTS CIF BY SECTORS OF ECONOMIC ACTIVITY

(Millions of dollars at current prices)

Sectors of economic activity	1965	Per- cent age share	1970	1972	Per- cent age share
Metallurgical industry	128	11.7	363	514	10.8
Engineering industry	153	14.0	510	1 060	22.4
Electrical material	48	4.3	241	424	9.0
Transport material	72	6.5	277	416	8.8
Paper	19	1.7	60	103	2.2
Chemicals	217	19.8	520	799	16.9
Textiles	4	0.3	35	48	1.0
Feed products	45	4.1	89	98	2.0
Others	47	4.2	211	379	8.0
<u>Total industry</u>	<u>733</u>	<u>67.0</u>	<u>2 306</u>	<u>3 841</u>	<u>81.1</u>
<u>Total imports</u>	<u>1 096</u>	<u>100.0</u>	<u>2 849</u>	<u>4 730</u>	<u>100.0</u>

Source: Instituto de Planejamento Económico e Social (IPEA).

Table 7

BRAZIL: PERCENTAGE SHARE OF IMPORTS IN TOTAL INDUSTRIAL SUPPLY,
BY SECTORS OF ECONOMIC ACTIVITY

(Percentages calculated on the basis of current values)

	1962	1966	1970	1972
Non-metallic mineral products	3.8	3.1	3.2	3.9
Metallurgical industry	12.5	16.9	18.7	18.7
Engineering industry	43.1	28.8	35.6	40.4
Electrical material	15.6	11.1	20.6	24.9
Transport material	17.0	8.8	14.8	14.1
Paper and paperboard	16.3	7.7	11.6	14.6
Rubber	0.5	0.5	1.8	4.0
Chemicals	21.2	16.0	19.6	17.7
Pharmaceuticals	4.9	4.0	5.7	...
Textiles	0.3	0.3	2.0	2.1
Food products	2.0	2.8	2.7	2.2
Beverages	2.0	0.7	1.7	2.4
Printing and publishing	3.2	3.9	3.2	...
Miscellaneous	16.2	14.0	28.8	...
<u>Total</u>	<u>11.1</u>	<u>10.0</u>	<u>13.3</u>	<u>15.2</u>

Source: Instituto de Planejamento Econômico e Social (IPEA).

As a result of the measures adopted and in conjunction with a favourable international economic situation, Brazil received a substantial inflow of capital, especially as from 1968. Table 8 shows the evolution of the inflow of resources in its two main forms: financing of imports (suppliers' credits) and money loans. As a result, Brazil's external debt increased at an annual average rate of 25 per cent, and grew from 3.3 thousand million dollars in 1967 to 12.6 thousand million in 1973; the servicing of this debt accounted for an average of 53 per cent of the value of exports during the three-year period 1971-1973.

The immense inflow of capital made it possible to finance the growing deficits in current transactions, with the result that the economy's balance of payments came to record a surplus which enabled international reserves to be stock-piled over the last two years and reach the sum of 6.4 thousand million dollars in 1973 (see table 8). It came to constitute an important factor in the increase in domestic levels of finance for working capital and investment, although it could be said that the credit granted was to a large extent selective, since it benefited the relatively more dynamic activities or those controlled by foreign capital, or both at once. It should also be observed that the large intake of external resources dangerously increased the external vulnerability of the economy, and also represented a constant factor of inflationary money growth, as will be seen in the second part of the present document.

The external debt and the increasing deficits in current transactions unavoidably came into conjunction with an aggressive export policy, which made it possible to finance the growth of imports and remittances of interests and profits, and also cope with servicing the debt itself. Export dynamism also contributed to complementing domestic markets, resulting in a more active demand and a better use being made of the economies of scale and of the internal patterns of efficiency of the more dynamic enterprises. It is hard to imagine that the high rates of growth observed in recent years could have been maintained without a decisive contribution from exports.

Table 8

BRAZIL: SITUATION OF EXTERNAL DEBT AT END OF PERIOD

(Millions of dollars at current prices)

	1967	1968	1969	1970	1971	1972	1973	Per- cent age
<u>Compensatory loans</u>	...	...	548.4	281.5	7.2	300.6	240.9	2.5
<u>Financing of imports</u>	...	...	1 355.2	1 709.3	22.5	2 201.5	2 783.8	29.3
International agencies	278	306	363.9	456.0	8.7	576.2	762.0	8.0
Government agencies	...	...	340.3	394.4	7.5	469.9	518.7	5.5
Suppliers' credits	437	520	651.0	858.9	16.3	1 155.4	1 503.0	15.8
<u>Money loans</u>	671	1 083	1 604.7	2 284.6	42.3	3 123.0	5 528.3	58.1
Resolution 63	...	...	432.5	653.2	12.4	983.3	2 018.4	21.2
Edict 289	...	...	373.5	381.2	7.2	294.8	207.4	2.2
Act 4 131	...	...	798.7	1 250.2	23.7	1 914.8	3 302.5	34.7
<u>Others</u>	...	...	895.0	219.8	17.0	226.5	268.0	10.1
<u>Total</u>	3 281	3 780	4 403.3	5 295.2	100.0	6 621.6	9 521.9	100.0
International reserves	199	257	656	1 187	1 746	4 183	6 417	6.4

Source: Banco Central do Brasil.

/In order

In order to promote exports, especially of manufactures, a broad-based incentive policy was applied. Exports were exempted from indirect taxes; income tax ceased to be applied to export profits; sales of manufactures were subsidized, special interest-subsidized lines of finance were set up for products for the external market; and as from 1968, a system of periodic devaluations of the cruzeiro was adopted (frequent small adjustments) in order to achieve a stable balance between domestic and external prices.

As a result of this policy, Brazilian exports increased at an annual average rate of 24.5 per cent during the period 1967-1973, and their money value increased from 1.6 thousand million dollars to 6.2 thousand million dollars (see table 9). Of this total, exports of manufactures, which were insignificant in 1964, accounted for 1.9 thousand million dollars in 1973, or 31.3 per cent of total exports.

The real importance of the increase in exports, however, is not to be found in the additional demand which they imply for the system, especially as regards exports of manufactures. Although their share in the industrial product doubled, they accounted for only 6.3 per cent of the product in 1973 (see table 10).

In fact, the success of the export policy was rather in constituting the axis of outward-directed growth, and led to a liberal policy of imports of capital goods and inputs, which were of basic importance to industrial growth, and which came to be the basis for the large intake of internal resources.

(c) The role of the public sector

Among the factors of expansion of the new stage of growth in the economy of Brazil, the evolution of public investment as from 1967 may be mentioned, both in quantitative and qualitative terms.

Table 9

BRAZIL: STRUCTURE OF EXPORTS

(Millions of dollars at current prices)

	1964- 1967	Per- cent age	1968	Per- cent age	1971	Per- cent age	1972	Per- cent age	1973	Per- cent age
Primary products	1 317	82.0	1 492	79.3	1 988	68.6	2 725	68.3	4 096	66.1
Industrial products	281	17.5	380	20.2	821	28.3	1 222	30.6	1 941	31.3
Semimanufactures	139	8.7	178	9.5	240	8.3	310	7.8	476	7.7
Manufactures	142	8.8	202	10.7	581	20.0	912	22.8	1 465	23.6
Others	7	0.5	9	0.5	65	2.2	44	1.1	162	2.6
<u>Total</u>	<u>1 605</u>	<u>100.0</u>	<u>1 861</u>	<u>100.0</u>	<u>2 904</u>	<u>100.0</u>	<u>3 991</u>	<u>100.0</u>	<u>6 199</u>	<u>100.0</u>

Source: Carteira de Comércio Exterior (CACE).

Table 10

BRAZIL: SHARE OF EXPORTS OF MANUFACTURES IN THE INDUSTRIAL PRODUCT

(Millions of cruzeiros at 1960 prices)

Year	Exports of manu- factures (A)	Industrial product (B)	Share (A)/(B)
1968	26.2	849.1	3.1
1969	35.9	940.8	3.8
1970	47.0	1 069.8	4.4
1971	67.2	1 190.7	5.6
1972	83.4	1 358.6	6.1
1973	99.3	1 573.3	6.3

Source: ECLA, on the basis of official statistics.

It is fairly difficult to elucidate this point in the case of Brazil, since there are no official data referring to the public sector as a consolidated whole, including State entrepreneurial activity, especially important in the economy of Brazil, particularly because of the presence of public enterprises in such dynamic sectors of industry, as petroleum, steel, chemicals, mining, electrical energy and transport and communications.^{21/} State presence in the economy can thus only be measured on the basis of Central Government data, including independent public enterprises, foundations and some special funds. Even so, the importance of the central administration is not negligible in terms of its effects on the system, since Government investment accounted for around 17 per cent of the gross fixed capital formation of the economy during the years 1971-1973 and for 35 per cent of the economy's total savings during the years 1972-1973.

As will be understood, the consideration of the public sector as a consolidated whole would greatly increase this influence. It may indeed be estimated that public investment, including Government bodies and public enterprises, could account for between 11 and 12 per cent of the gross domestic product,^{22/} which would be as much as to say that its share in gross fixed capital formation would exceed 40 per cent.

Apart from its volume, public investment played a pertinent role in the recent growth of the Brazilian economy, particularly because it was directed towards the activities with most influence on the system. In this context, as from 1967, the public sector destined resources on a massive scale for investment in electrical energy, transport and communications, petroleum and associated products, mining and steel. The public investment programme, conceived as a complement to and a harmonious part of the growth of the dynamic core of industry, represented a substantial demand aimed at the communications, metal

^{21/} Of Brazil's 20 major enterprises, 11 are state-owned - Simonsen, M.H. and Campos, R. A nova economia brasileira, Ed. José Olympio, Rio de Janeiro, 1974, page 205.

^{22/} Simonsen, M.H. "O modelo brasileiro de desenvolvimento", in Simonsen, M.H. and Campos, R. op. cit., page 14.

manufactures and machinery, electrical materials and chemical industries, and came to be one of the bases for the rapid growth of industry.

(d) The evolution of income distribution

The foregoing pages endeavoured to show that the growth of the Brazilian economy in recent years was basically associated with the rapid growth of some dynamic sectors of industry which coincided with the consumer durables and capital goods sectors.

As will be understood, to propose an increase in growth in some branches of industry means, among other things, proposing an increase in the growth of purchasing power directed at the products of these industries. In other words, in a process of growth, the structure of supply should be consistent with that of demand. The growth of the dynamic sectors of industry must thus have been accompanied by the corresponding changes in the profile of demand.

Some of the mechanisms which contributed to the profile of demand evolving along the same lines as the dynamic sectors of industry were already dealt with when the changes in the system of financing (especially as regards consumer credit), the expansion of industrial exports and the structure of public investment were considered. Although these factors played an important role in the reformulation of demand, they can hardly explain all the changes which took place in recent years. In fact, the profile of demand is conditioned above all by the structure of income distribution and this is where the main basis for its makeup must be sought.

In this respect, table 11 is fairly revealing. It shows that between 1960 and 1970 income distribution in the Brazilian economy underwent a process of marked concentration, with the drop in their share of total income of 80 per cent of the economically active population which would go to show that the dynamic purchasing power of the system was concentrated in the top 20 per cent of the income pyramid. In the case of Brazil, it may be observed that this would represent a pattern of high-level consumption for around 20 million persons.^{23/}

^{23/} Preliminary estimates by ECLA indicate that the top-income 20 per cent had an annual per capita income of over 2,000 dollars in 1972 (expressed in dollars at 1970 prices).

From another standpoint, the same conclusion may be suggested from the observation of table 12, which gives the percentage increase in real per capita income for the different income groups. The annual average rates of growth of real income increase sharply after the seventh decile, showing that income is concentrated in the upper-medium and upper income groups. The data also show that the rate of growth of the real income of the poorest 40 per cent of the population is dynamic, especially in the case of the top 10 per cent. However, the importance of this growth, from the point of view of purchasing power in respect of the products of the dynamic industries is fairly secondary, since absolute levels of per capita income in these groups constitutes a minor market for consumer durables. The rapid growth of purchasing power in respect of goods with a more sophisticated degree of manufacturing is therefore unmistakably associated with the upper income groups which correspond in particular to the top 20 per cent of the economically active population.

The concentration of personal income, with the profile of demand which it influences, therefore played a decisive role in the resumption and maintenance of recent growth in the economy of Brazil.

C. MAIN FEATURES OF ANTI-INFLATIONARY POLICY

The anti-inflationary policy applied in Brazil must be interpreted with reference to a much longer period than is usually taken into account in this type of analysis in Latin America. In effect, the continuity of stabilization efforts has been maintained throughout the terms of office of four governments and extends over the ten-year period 1964-1974.

Although the control of inflation has followed harmonious lines, it is possible to distinguish three major periods, in which the keynotes of stabilization policy have differed, with varying results, attributable to policy implementation or to changes in the international situation, or to a combination of both.

Table 11
BRAZIL: INCOME DISTRIBUTION AMONG THE
ECONOMICALLY ACTIVE POPULATION

Decile of the economically active population	Percentage of total income	
	1960	1970
1 st decile	1.17	1.11
2 nd decile	2.32	2.05
3 rd decile	3.42	2.97
4 th decile	4.65	3.88
5 th decile	6.15	4.90
6 th decile	7.66	5.91
7 th decile	9.41	7.37
8 th decile	10.85	9.57
9 th decile	14.69	14.45
10 th decile	39.66	47.79
Poorest 40 per cent	11.56	10.01
Next 40 per cent	34.09	27.75
Richest 20 per cent	54.35	62.24
<u>Total</u>	<u>100.00</u>	<u>100.00</u>

Source: M.H. Simonsen and R. Campos *op.cit.*, p. 188.

Table 12
BRAZIL: PERCENTAGE INCREASE IN REAL PER CAPITA
INCOME BY CLASS OF INCOME, 1960-1970

Decile of the economically active population	Increase in real per capita income
	1960 - 1970
1 st decile	27.1
2 nd decile	18.4
3 rd decile	16.4
4 th decile	11.8
5 th decile	6.8
6 th decile	3.4
7 th decile	5.0
8 th decile	18.2
9 th decile	31.8
10 th decile	61.5
Poorest 40 per cent	16.0
Next 40 per cent	9.1
Richest 20 per cent	53.5
<u>Total</u>	<u>34.0</u>

Source: M.H. Simonsen and R. Campos, *op.cit.*, p. 189.

/The first

The first of these periods was the triennium 1964-1966, in which stabilization was the primary objective of economic policy, pursued essentially through strict control of demand. Although the rate of increase of prices dropped rapidly (from 91.9 per cent in 1964 to 34.5 per cent in 1965), the concomitant was a severe "stabilization crisis", with mediocre growth rates of the product.

Nevertheless, this crash policy, combined with a strong swerve towards outward-directed development, created the right conditions for combating inflation more gradually, in such a way that the rate of increase of prices declined gently, from 24.3 per cent in 1967 to 20.2 per cent in 1969, 19.2 per cent in 1970 and 15.5 per cent in the two-year period 1972-1973, while the product expanded at annual rates of over 9 per cent. This period of growth combined with decreasing inflation extended from 1967 to 1973, and marked a second phase of policy.

During the last two years of the period under consideration, Brazil's economic development, closely linked as it is to the external sector, was considerably affected by the contraction in the European financial markets; the high growth rates were maintained, but were accompanied by an inflation which resumed its active role in the economy, with prices rising by 34.6 per cent in 1974. On this account, rapid changes had to be introduced in stabilization policy, and thus began the third phase of Brazil's anti-inflationary policy.

1. The crash policy, 1964-1966

As from 1961, inflationary trends sharpened in the Brazilian economy, and although attempts were made to apply stabilization programmes, the process was steadily aggravated up to 1964.

The anti-inflationary policy applied from 1964 onwards was based on the diagnosis that the prevailing inflation was one of demand, and stemmed from three main causes: the cash deficits of the National Treasury; the over-expansion of credits to the private sector; and wage adjustments disproportionate to the increase in productivity.^{24/}

^{24/} Ministerio do Planejamento, Programa de Ação Econômica de Governo 1964-1966, p. 28.

Thus, the chief policy instruments were concentrated in the conventional spheres of fiscal, credit and wage policy, in different degrees of intensity as circumstances dictated. In practice, the primary objective of economic policy was the drastic control of increases in total demand.

(a) Growth patterns of the product and of prices

The evolution of the economic sectors and of the product in 1964-1966 can be traced in table 13, where the slow rate of economic growth is plainly evidenced. It should be noted that the highest rate for the gross domestic product does not exceed 4.4 per cent, and that in the most important sectors of production, such as agriculture and industry, violent fluctuations took place. Although it must be recognized that the previous three years had been a period of economic crisis, development in 1964-1966 was radically affected by the crash anti-inflationary policy. In 1965, for example, manufacturing showed a negative growth rate of about 4.9 per cent, which reflected the profound "stabilization crisis" to which it was exposed. Had it not been for the exceptional results obtained by the agricultural sector, thanks to favourable weather conditions, the rate of increase of the product in that year would not have reached 2.5 per cent, and the per capita growth rate would have been negative. In 1966, in contrast, manufacturing regained its dynamic impetus, and it was in agriculture that the rate of development was negative, with the consequent depressive effect on the increase in the total product. In the following year, agriculture and industry again switched roles, their respective growth rates being 9.6 per cent and 1.8 per cent; manufacturing underwent a second "stabilization crisis", which began at the close of 1966.

From another angle, price trends in the period show how the pace of inflation quickened up to 1965, in which year, as in 1964, the rates of increase reflected in the overall price index exceeded 90 per cent (see table 14). From 1965 onwards, with the adoption of a strict anti-inflationary programme, the process of inflationary expansion was definitely disrupted, and the result was the "stabilization crisis" of 1965.

Table 13

BRAZIL: GROSS DOMESTIC PRODUCT BY SECTORS OF ECONOMIC ACTIVITY
(Annual percentage growth rates)

Sector	1960-1965	1964	1965	1966
Agriculture, forestry and fishing	5.7	1.3	13.8 a/	-2.0
Mining and quarrying	13.5	18.4	12.0	12.2
Manufacturing	3.7	5.1	-4.9	11.8
Construction	-2.8	2.2	0.7	11.7
Electricity, gas and water	6.3	7.0	4.7	11.7
Transport and communications	5.3	3.6	0.8	5.7
Commerce and finance	3.8	3.1	5.0	5.5
Ownership of dwellings	3.6	3.6	3.6	3.6
Public administration and defence	2.4	2.4	2.4	2.4
Miscellaneous services	3.0	3.0	3.0	3.0
<u>Total</u>	<u>4.2</u>	<u>3.1</u>	<u>3.3</u>	<u>4.4</u>

Source: ECLA, Economic Survey of Latin America, 1965 and 1966.

a/ Excluding coffee.

Table 14

BRAZIL: PERCENTAGE VIARIATIONS IN SELECTED PRICE INDEXES

Index	1962	1963	1964	1965	1966
Cost of living in Guanabara	88.5	80.6	86.5	45.3	41.1
Cost of living in São Paulo	61.8	80.5	85.5	41.1	46.3
Wholesale prices in general	50.2	81.9	93.3	28.2	37.4
Wholesale prices excluding coffee	45.7	83.0	84.0	31.3	41.6

Source: ECLA, Economic Survey of Latin America, 1967.

In the following year, the inflexibility of stabilization policy was slightly relaxed, and price indexes rose again, showing the stubborn resistance of rates of inflation to reduction below a limit of about 35 per cent per annum.

(b) Main lines of stabilization policy

Anti-inflationary policy in 1964-1966 pivoted upon measures relating to fiscal, monetary, wages and price policy.

With respect to fiscal policy, the strategy adopted consisted in reducing the deficit through the expansion of income and the restriction of public spending. In view of the inflexibility of the structure of expenditure, despite the partial contraction of public investment achieved, it was an action to increase revenue that emphasis was placed, an emergency tax reform being introduced in the second half of 1964. In real terms, public-sector income expanded at an average annual rate of 8.7 per cent over the three-year period, whereas the annual growth rate of expenditure did not rise above 1.7 per cent (see table 15). What was left of the fiscal deficit was financed through the compulsory and voluntary placement of official securities in the form of the newly-created Adjustable Treasury Bonds, which were safeguarded against devaluations of the currency, and of which the redemption period, originally fixed at three years, was subsequently reduced to one year. It was thus possible to finance 54 per cent of the fiscal deficit in 1965 and to collect revenue in excess of the deficit in 1966, so that the National Treasury became a net source of funds for the monetary authorities (see again table 15).

The implementation of fiscal policy, which was reflected in a substantial increase in income and restriction of expenditure did succeed, on the one hand, in reducing the deficit and thus obviating a primary expansion of the means of payment; but, on the other hand, it had heavily depressive effects on the level of economic activity, causing a greater contraction of total demand than the Government had desired.

Table 15

BRAZIL: NATIONAL TREASURY. EVOLUTION OF FISCAL BUDGET

(Millions of cruzeiros at current prices)

Year	Income	Real income (Cruzeiros at 1964 prices)	Expend- iture	Real expend- iture (Cruzeiros at 1964 prices)	Deficit	Financing of deficit		Deficit as a percent age of gross domestic product
						Monetary authorities	General public	
1964	2 129	2 129	2 857	2 857	-728	736	-3	3.2
1965	3 907	2 491	4 500	2 869	-593	270	323	1.6
1966	5 910	2 733	6 500	3 006	-587	-190	606	1.1

Source: Central Bank of Brazil.

The second front in the anti-inflationary battle was constituted by wage policy. This was based on a diagnosis to the effect that wage adjustments during the post-war period had outstripped the increases in the average productivity of the economy, and that in consequence it was necessary to re-establish the structure of income distribution as between wage-earners and the other groups. A new system of wage adjustments was therefore applied, under which the average real wage for the past twentyfour months was restored, with the incorporation of the increases in productivity achieved in the preceding period **plus** an estimate of the expected rise in prices in the period during which the new wage would be in force ("inflationary residuum"). This method of adjustment considerably reduced the real minimum wage since it was based on rates of inflation projected by the Government (25 per cent, 10 per cent and 15 per cent for 1965, 1966 and 1967, respectively), which fell short of the price increases that actually occurred (see table 16). Thus, wage policy became yet another depressive factor affecting demand in the economy, besides playing an important part in the redistribution of income in favour of the higher brackets, as was shown in the first section of this chapter.

The aim of credit policy was to mobilize the savings of private enterprises for the financing of their current operations. To that end, the credit provided by the Banco do Brasil (which is responsible for one-third of total credit) was severely restricted, and strict control was exercised over the private commercial banks' capacity to expand the means of payment (see table 17). The real value of bank loans during the three-year period was kept far below the average for 1960-1962. Enterprises, in the impossibility of converting their immovable assets (accumulated as a safeguard against inflation) into ready cash, exerted pressure on the financial market, thus forcing up the real rate of interest. In addition, the Government itself aggravated the financing problem by competing on advantageous terms with the private sector in the tapping of savings and of the monetary reserves existing in the system, through the sale of the Adjustable Treasury Bonds.

Table 16

BRAZIL: EVOLUTION OF LEGAL MINIMUM WAGE

Year	Minimum monthly wage (Cruzeiros)	Index of evolution of minimum wage in real terms (1965=100)	
		Guanabara	São Paulo
1964	40.25	108	105
1965	62.00	100	100
1966	81.00	93	90

Source: P. Aubergier, Le modèle brésilien de lutte contre l'inflation.
Problèmes d'Amérique Latine, December 1973.

Table 17

BRAZIL: LOANS TO THE PRIVATE SECTOR

(Thousands of millions of old
cruzeiros at 1960 prices)

Year	Banco do Brasil	Commercial banks	Total
1963	181.4	298.7	480.1
1964	165.0	286.4	451.4
1965	173.5	379.7	553.2
1966	170.8	336.9	507.7

Source: ECLA/ILPES, A evolução recente da economia brasileira,
Rio de Janeiro, 1967.

Aside from these measures, but with no less significant repercussions, an adjustment was made in prices that had remained frozen or had lagged behind during the preceding five-year spell of inflation. The "corrective inflation", as this line of action was termed at the time, affected exchange rates, rents, public utility tariffs, prices of transport and fuels and, in general, prices of the inputs produced by the public enterprises. Its impact made itself felt in pressures on costs, which made their appearance in the economy from 1965 onwards.

The cash programme applied during the three-year period 1964-1966 succeeded in drastically reducing price increases, and definitely checking the advance of inflation. The implementation of anti-inflationary policy, however, had negative effects on the level of economic activity, through the contraction of real disposable income and the consequent insufficiency of total demand. At the same time, other cost pressures emerged in the economy, with the imposition of heavier taxation, the raising of the real rate of interest, and the price increases deriving from the so-called corrective inflation.

2. Growth with relative stability. The gradualist policy applied in 1967-1973

To judge by the rates of inflation and by economic development, the successes of the gradualist policy are obvious. In the evolution of the rate of inflation, measured by the variations in the overall price index, three different periods can be distinguished: the two-year period 1967-1968, in which rates of inflation fluctuated between 24.3 and 25.4 per cent; the triennium 1969-1971, in which annual rates ranged from 19 to 20 per cent; and the years 1972-1973, in which the annual variation in the index was 15.5 per cent. These indicators adequately illustrate the steady diminution of rates of inflation in the period analysed (see table 20 below).

Moreover, the expansion of economic activity, measured in terms of annual growth rates of the product which exceeded 9 per cent from 1968 onwards, reflects the attainment of another objective.

/If the

If the anti-inflationary policy pursued in Brazil as from 1967 is to be correctly interpreted, it must be considered in the broader framework of an economic policy with growth as its primary objective, by which stabilization policy is conditioned.

Although at times both objectives - stability and growth - were furthered by the same expedients (as in the case of the reform of the national financial system and the strengthening of internal credit by means of external loans), they did not always coincide. In the second phase growth became the predominant aim, and in consequence an expansionist monetary policy was adopted, which was intended to stimulate demand and support production, but which, at the same time, constituted an inflationary factor.

It is, of course, plain at a glance that stabilization efforts were greatly favoured by the changes introduced in the financial system, as briefly described in the first section of this chapter. While, on the one hand, the broadening and diversification of the financial system was designed to lay the foundations for the expansion of the dynamic core of economic development, another aim was to put into practice financing programmes which were based on the tapping of private savings and monetary reserves and which would progressively replace the traditional modes of financing, based on inflationary expansion of the means of payment and on the over-dependence of enterprises on their own internal sources of funds. In the last analysis, the reform of the national financial system permitted the creation of liquidity in the economy, independently of primary expansion of the means of payment (see again table 5). Moreover, the flow of external resources was favourable to the proposed expansion of economic activity; the growth of imports, especially of capital goods, was strongly supported by external financing. From the point of view of inflation, however, it must be recognized that the inflow of capital constituted the most dynamic factor of monetary expansion during the period under consideration: an expansion which was offset by the implementation of an active open-market policy.

Access to external credit made enterprises less dependent upon the traditional sources of internal financing, which suggests that without this foreign backing the rate of inflation might have been higher.

With respect to monetary and credit policy, the period was characterized by a relatively tolerant attitude towards the expansion of the means of payment, with a view to ensuring the encouragement of demand. The aim was not to eradicate inflation over the short term, but to compromise with declining rates that would be compatible with the accelerated growth of the product. In this context, stabilization policy was concerned mainly with applying mechanisms to counteract those effects of inflation that made for disequilibrium (periodical devaluation of the exchange rate, generalized monetary adjustments), rather than with stringent measures to prevent a moderately inflationary expansion of the means of payment, although the monetary authorities had at their disposal a great many fiscal, credit, financial and monetary instruments by means of which they could extend their control over the expansion of liquidity in the economy.

From another standpoint, the more drastic stabilization measures sought to keep under control certain cost items considered to be of strategic importance; this enhanced the significance of wage policy, of action taken to stabilize rates of interest, and of price control policy.

(a) Sources of inflationary pressures during the period

The main sources of inflationary pressures through expansion of the means of payment during the period 1968-1970 are shown in table 18. It can be seen that monetary expansion in the period was essentially linked to the increase in credits to the private sector and the national currency counterpart of the increment in international reserves.

The annual rate of expansion of credit to the private sector averaged 38 per cent during the quinquennium, while the growth rate of reserves was 50 per cent per annum between 1969 and 1973.

Table 18

BRAZIL: MONETARY SECTOR OPERATIONS AND MEANS OF PAYMENT

	Absolute variations (millions of cruzeiros at current prices)							Relative variations			
	1968	1969	1970	1971	1972	1973	1968	1969	1970	1971	1972
I. Expansionist factors	13 390	12 356	14 391	20 613	30 869	41 910	56.5	38.2	33.1	35.8	34.8
Loans	6 335	7 603	9 508	13 012	17 254	30 535	56.8	32.0	30.3	33.3	29.5
To the public sector	1 410	-583	173	-3 582	-6 694	-4 400	42.3	-12.0	4.1	-	-834.0
National Treasury	1 075	-1 025	-833	-3 364	-7 670	-5 721	44.0	28.3	-32.1	-	-484.3
State governments, municipal authorities and other public institutions	335	442	1 006	-218	976	1 321	34.5	36.0	60.0	-24.5	-3.1
To the private sector ^{a/}	6 925	8 186	9 335	16 594	23 948	34 935	61.1	43.2	34.4	45.5	49.6
Liquid foreign reserves	36	2 822	3 498	2 246	15 123	14 004	3.2	328.8	137.5	67.2	216.3
Other foreign exchange accounts ^{b/}	391	362	1 803	-1 456	-4 313	-1 001	21.7	8.2	-41.4	-29.4	-1.8
Official securities in hands of commercial banks (adjustable National Treasury Bonds and National Treasury Bills of Exchange)	4 628	706	1 051	1 613	3 033	4 656	76.1	73.4	63.0	59.3	71.7
Other accounts of the Bank system (liquid balance)	6 969	863	2 137	5 228	-228	-6 284	76.1	22.2	61.6	68.9	-24.6
II. Contractionist factors	391	5 368	6 821	9 402	13 713	13 142	79.6	49.0	45.2	43.2	38.2
Time deposits	-	164	629	2 103	2 908	1 748	65.2	21.5	67.9	135.2	77.8
Other deposits	597	582	828	699	1 864	2 559	-	29.6	35.2	20.7	-2.6
Coffee Fund	597	1 377	1 180	479	408	-196	198.9	86.2	41.1	11.4	8.7
Own resources of monetary authorities and commercial banks ^{c/}	5 981	3 245	4 114	6 121	8 533	9 031	66.0	53.6	56.5	48.4	46.6
III. Expansion of liquid money supply (I - II) = (A + B)	6 421	6 968	7 570	11 241	17 156	28 768	43.0	32.6	26.7	31.3	32.6
A. Sight and short-term deposits	5 285	5 658	6 240	9 405	14 164	23 152	44.1	30.4	27.2	32.2	33.1
Private sector	3 978	4 504	5 108	8 304	13 314	19 750	40.6	32.6	27.9	32.0	31.7
Public sector	1 307	1 154	1 132	1 021	850	3 402	61.5	33.0	24.3	33.7	35.1
B. Paper money in hands of general public	1 196	1 310	1 330	1 036	2 992	5 616	38.6	32.1	24.7	27.3	35.1

Sources: Relatórios do Banco Central do Brasil (Reports of Central Bank of Brazil).

^{a/} 1969: excluding coffee.^{b/} Monetary authorities and commercial banks.^{c/} 1960, 1969 and 1970: including counterpart of external resources.

It is of interest to note that these two factors were closely related to the maintenance of the rate of economic development, and served the intention of economic policy in the application of a specific growth model, making it patent that the stability objective was subordinated to the proposed growth targets.

From a different point of view, linked to cost pressures in the economy, a major role was played by the raising of the rate of interest, which from 1967 onwards became increasingly positive. Table 19 shows the evolution of real rate of interest, which from a negative value of about 30 per cent in 1964 rose by 1969 to positive rates of 8.4 per cent and 19.3 per cent on bank loans and bills of exchange, respectively

Special mention must also be made of the expectation factor in the maintenance of rates of increase of prices during the period under consideration. The persistence of an active inflationary process in the recent past had incited enterprises to adjust their prices largely as a function of the rate of inflation expected for the coming period, thus introducing a factor of self-propagation of the inflationary process. This factor, operative in the early years of the period, lessened in importance insofar as the rate of inflation was reduced. By no means negligible, however, was the similar role played in refuelling inflation by such mechanisms as monetary adjustment and the flexible exchange rate, which was established to mitigate some of the effects of inflation.

Lastly, attention must be drawn to the traditional role of the agricultural sector in the Brazilian economy. It operates as an autonomous factor of expansion or contraction of prices in accordance with the variations in agricultural production, exposed as it is to the vicissitudes of weather conditions and to greater price flexibility. Agricultural price fluctuations are reflected directly in the rate of inflation, through changes in the wholesale price index, in which they carry a weight of approximately 37 per cent. It is worth noting, however, that in 1967-1968 increases in agricultural prices were lower than those shown in the other price indexes. As from 1969 the situation was reversed, and agricultural prices rose faster than the rest (see table 2

Table 19

BRAZIL: AVERAGE ANNUAL RATES OF INTEREST ON LOANS, DEFLATED BY THE OVER-ALL PRICE INDEX, 1960-1970

(Percentages)

Year	Commercial Banks	Banco do Brasil	Bills of exchange	Resolution Nº 63 a/
1960	-7.4	-15.2	9.9	-
1961	-11.8	-18.0	10.9	-
1962	-17.5	-25.1	5.5	-
1963	-25.6	-35.0	-2.8	-
1964	-30.1	-37.5	-4.9	-
1965	-14.1	-21.7	14.1	-
1966	-2.3	-9.1	24.2	-
1967	4.5	-5.1	16.1	9.3
1968	7.6	8.4	17.7	28.9
1969	8.4	-	19.3	11.1
1970	-	-	19.9b/	8.6

Source: Donald Syvrud, Estrutura e Política de Juros no Brasil, 1960-1970, January-March 1972.

a/ Resolution of the Central Bank under which domestic enterprises were granted access to external credit, through the commercial and investment banks.

b/ May.

Table 20

BRAZIL: INDEXES OF PRICES

(Percentage rates of variation)

Year	Indexes of wholesale prices			Index of cost of living in Guanabara a/	Index of cost of construction	Over-all price index b/ (internal availabilities)
	Total demand	Agricultural products	Industrial products			
1967	22.5	21.1	23.1	24.1	41.3	24.3
1968	25.0	16.7	34.6	24.5	32.7	25.4
1969	21.8	31.7	15.1	24.3	12.3	20.2
1970	19.3	20.3	18.9	20.9	18.7	19.2
1971	20.2	24.7	16.7	18.1	12.7	19.8
1972	17.5	22.3	15.4	14.0	19.8	15.5
1973	16.7	16.7	16.6	13.7	21.1	15.5

Source: Fundação Getúlio Vargas.

a/ Index of consumer prices.

b/ Synthesis of indexes of total supply (wholesale prices), cost of living in Guanabara and cost of construction, weighted by 0.6, 6.3 and 0.1, respectively.

/Paradoxically enough

Paradoxically enough, the changes in the price system determined by the greater increases in the agricultural prices coincided with the decline of inflation and the speeding-up of the growth rate of the product. The incidence of agricultural price policy on the achievement of the objectives consisting in economic growth and the control of inflation is plain to be seen.

(b) Control of inflation

(i) Fiscal policy. The main concern of fiscal policy in relation to the stability objective was the control and financing of the fiscal deficit.

As had already been shown, the aim of the first line of action, initiated in the preceding period (1964-1966), was to improve fiscal revenue through the implementation of a tax reform, which expanded the sources of taxation and promoted the redistribution of fiscal revenue between the Federal Government and the States. By virtue of these measures, it was possible to increase revenue more rapidly than prices rose, as can be seen in table 21.

This increment made no appreciable difference to the proportion of the gross domestic product represented by the tax burden. The increase in the share of the Federal Government was offset by the decrease in that of the local governments and other public institutions (see table 22).

The real increase in public expenditure was approximately 14 per cent per annum in 1967-1973, which reflects a considerable expansion and a heavier incidence on the Brazilian economy. To analyse the growth of public spending from the standpoint of the interpretation of inflation two important facts must be taken into account: the type of financing of the fiscal deficit and the changes in the structure of public expenditure.

Table 21
 BRAZIL: NATIONAL TREASURY. EVOLUTION OF THE FISCAL BUDGET
 (Millions of cruzeiros at current prices)

	1967	1968	1969	1970	1971	1972	1973
Income	6 614	10 275	13 953	19 194	26 980	37 738	52 863
Percentage rate of variation	15.3	50.7	35.8	37.6	40.5	39.9	40.1
Expenditure	8 039	11 502	14 709	19 932	27 652	38 250	52 568
Percentage rate of variation	22.9	43.1	27.9	35.5	38.7	38.3	37.4
Deficit	-1 225	-1 227	-756	-738	-672	-516	295
Gross domestic product	71 486	99 879	133 117	174 624	234 005	298 902	406 221
Income as percentage of gross domestic product	9.5	10.3	10.5	11.0	11.5	12.6	13.0
Expenditure as percentage of gross domestic product	11.2	11.5	11.1	11.4	11.8	12.8	12.9
Deficit as percentage of gross domestic product	1.7	1.2	0.6	0.4	0.3	0.2	-
Evolution of over-all index of prices	24.3	25.4	20.2	19.2	19.8	15.5	15.5

Source: Central Bank and Fundação Getúlio Vargas.

Table 22
 BRAZIL: EVOLUTION OF TAX REVENUE

	Rates of taxation in relation to gross domestic product	
	1968	1971
Federal government	10.6	12.0
Local governments	10.1	9.1
Other public bodies	7.8	6.9
<u>Total</u>	<u>28.5</u>	<u>28.0</u>

Source: P. Auberger, op.cit.

The maintenance of the policy launched in 1964-1966, which consisted in financing the deficit through the sale of Adjustable Treasury Bonds, obviously meant that there was no direct expansion of liquidity in the economic system under this head. Moreover, the success achieved with these bonds was such that from 1969 onwards the National Treasury was in a position to supply the monetary authorities with funds, as will be shown later.

With regard to the structure of public expenditure, attention must be drawn to the greater expansion of investment, consistent with the desire to keep growth rates high over the period under review. The share of current expenditure, which had been about 75 per cent of total outlays in 1966-1967, decreased to 63 per cent in 1972, so that the capital budget was able to expand more rapidly, especially the proportion allocated to infrastructure, and a safeguard was provided against undesirable increases in the fiscal deficit.

As a result of the changes indicated in both income and expenditure the deficit in question was substantially reduced. Whereas in 1962 it had represented 1.7 per cent of the product, by 1972 it accounted for only 0.2 per cent, and in 1973 had even given place to a small surplus (see again table 21).

(ii) Monetary and credit policy. Monetary and credit policy in the period was subordinated to the maintenance of levels of liquidity in the economy which would be compatible with the attainment of high growth rates. In this connexion, unremitting care was taken to keep the money supply constant as a proportion of the product, thus forestalling, above all, liquidity problems which might have a depressive effect on economic activity. The experience of the previous two years, when monetary policy had gone too far in slowing down the growth rate of the means of payment, counselled the maintenance of an easy flow of operations in the financial sphere. Thus, the monetary supply expanded at an average annual rate of 35 per cent in 1967-1973, and the proportion of the product that it represented hovered between 19 and 22 per cent (see table 23).

Table 23

BRAZIL: EVOLUTION OF MEANS OF PAYMENT

(Millions of cruzeiros at current prices; balances at close of period)

	1967	1968	1969	1970	1971	1972	1973
Means of payment	14 931	21 352	28 350	33 638	44 514	61 550	90 490
Rate of increase	42.6	43.0	32.8	18.6	32.3	38.3	47.0
Evolution of over-all index of prices	24.3	25.4	20.2	19.2	19.8	15.5	15.5
Gross domestic product	71 486	99 879	133 117	174 624	234 005	298 902	406 221
Means of payment as percentage of gross domestic product	20.9	21.4	21.3	19.3	19.0	20.6	22.3

Source: Fundação Getúlio Vargas, Conjuntura Econômica.

The variations undergone by the means of payment and prices during the years 1970-1973 refute assumptions that these variables are closely associated. In actual fact, whereas from 1970 onwards the means of payment expanded at increasing rates, the overall price index, precisely in that period, showed a clearly-defined downward trend, within a framework of thriving economic growth.

It should be recalled, of course, that monetary policy in the period was greatly facilitated by the changes introduced through the reform of the national financial system, which made it possible to give the economy increased liquidity independently of primary expansion of means of payment, as was explained in the first section of this chapter (see again table 5).

Another factor which enlarged the sphere of operation of the monetary authorities was the possibility of avoiding the financing of fiscal deficits through primary issues. As has been stated, fiscal deficits were successfully covered by issues of Adjustable Treasury Bonds which were sold to public institutions, commercial banks and the general public. The growth of these placements is worthy of note, for by 1969 the operations of the National Treasury had already become an important factor of monetary contraction (see table 24). In 1972 the funds collected by this means amounted to 8,282 million cruzeiros, or the equivalent of 20.6 per cent of fiscal revenue in that year, so that in this expedient monetary policy had an efficient instrument for the regulation of liquidity. The contraction of the money supply assumed considerable proportions from 1971 onwards, largely by virtue of the steady improvement in the fiscal situation.

Thus, the expansion of the means of payment in the period was linked to factors which had a bearing on the aim of economic policy: primary expansion as the result of a balance-of-payments surplus and secondary expansion, via a monetary multiplier, through an increase in credits to the private sector.

Table 24

BRAZIL: FINANCING OF FISCAL DEFICIT
(Millions of cruzeiros)

Year	Deficit	Financing	
		Monetary author- ities	General public
1967	-1 225	699	526
1968	-1 227	1 077	150
1969	-756	-1 026	1 782
1970	-738	-833	1 571
1971	-672	-3 368	4 036
1972	-516	-7 766	8 282
1973	295	-6 016	5 721

Source: Central Bank of Brazil.

As was previously shown, the national currency counterpart of the inflow of foreign capital was the most dynamic item among the increases in overall liquidity; so much so, indeed, that as from 1972 deposits of this counterpart in proportions ranging from 25 to 40 per cent of the foreign loans concerned were made compulsory as a means of controlling its inflationary repercussions.

The other expansionist factor - credits to the private sector - although not so highly dynamic as the inflow of foreign funds, because of its relative importance among the expansionist factors (more than 80 per cent) and its steady annual growth, became the principal source of liquidity. Indeed, the quest for a degree of liquidity compatible with high growth rates led to an expansion of bank credit at the real annual rate of 22 per cent in the period 1967-1973, and, in particular, loans granted by the Banco do Brasil, which was more responsive to government policy, increased by 25.5 per cent per annum (see table 25).

Another point to note is the growth of credit extended by the investment banks to finance circulating capital, which in 1973 came to represent 11.8 per cent of total loans to the private sector, with an average rate of expansion of approximately 54.5 per cent. The boom in the operations of the credit and investment companies specializing in loans for consumption purposes is also worthy of comment; by 1973 these associations accounted for 15.2 per cent of total credit to the private sector, with an average growth rate during the period of about 41 per cent in real terms. Lastly, the rapid expansion of the system for financing house purchase is reflected in a share of total loans amounting to roughly 12.9 per cent.^{25/} In the aggregate, these changes highlight the system's capacity to expand liquidity in the economy, keeping demand brisk and reasonably independent of primary expansion of the means of payment.

^{25/} The mechanisms for financing consumption and house purchase played a supplementary role in the process of concentration of income, in the sense that they brought the profile of demand into line with the structure of production, allowing the growth of private consumption to outstrip that of disposable personal income.

Table 25

BRAZIL: FINANCIAL SYSTEM. LOANS TO THE PRIVATE SECTOR

(Millions of cruzeiros at current prices)

	1967	Per- cent age of total	1967, at 1973 prices	1970	1971	1972	1973	Per- cent age of total	Average annual rate of expansion in real terms, 1967- 1973 (percent age)
Bank system	12 008	69.5	34 991	36 002	52 182	78 180	113 831	48.1	22.0
Commercial banks	8 456	49.0	24 641	23 824	34 121	51 330	73 346	31.0	19.9
Banco do Brasil	3 552	20.5	10 350	12 178	18 061	26 850	40 485	17.1	25.5
Development agencies	1 598	9.3	4 657	3 512	5 226	8 018	11 185	4.7	15.7
Credit and investment companies and investment banks	2 276	13.2	6 632	13 185	20 840	37 297	63 989	27.0	46.0
Credit and investment companies	1 579	9.1	4 601	7 850	11 823	19 790	35 946	15.2	41.0
Investment banks	697	4.1	2 031	5 335	9 017	17 507	28 043	11.8	54.5
House purchase financing system	540	3.1	1 574	7 464	12 558	19 393	30 427	12.9	64.0
Others	844	4.9	2 459	4 364	6 594	10 103	17 148	7.3	38.0
<u>Total</u>	<u>17 266</u>	<u>100.0</u>	<u>50 313</u>	<u>64 527</u>	<u>97 400</u>	<u>152 991</u>	<u>236 580</u>	<u>100.0</u>	<u>29.5</u>

Source: Central Bank of Brazil, Relatórios.

As an indispensable complement to this definitely expansionist monetary and credit policy, the Government, as from 1971, initiated open market operations, partly substituting them for the traditional monetary manoeuvres based on rediscounting and compulsory deposits, and thus securing increased flexibility and more effective control of liquidity in the economy.

To this purpose, use was made chiefly of National Treasury Bills of Exchange, securities which were issued weekly, maturing in periods of 91 to 182 days, or monthly, maturing at the end of one year; they were sold chiefly to enterprises and the general public (34 per cent in 1973), and to the commercial banks (25 per cent) (see table 26).

In practice, these operations represented the most important instrument for controlling the money supply in Brazil, and although they were started only recently they can be credited with 60 per cent of the effect produced by the factors making for contraction of the money supply in 1973. Furthermore, to give an idea of the volume of resources handled in these operations, suffice it to say that in 1973 the Central Bank's National Treasury Bills transactions amounted to 114.6 thousand million cruzeiros in absolute terms, and were equivalent to 30 per cent of the monetary value of the gross domestic product in that year.

If Central Bank operations with the National Treasury Bills are taken together with the Adjustable Bond transactions negotiated mainly for the financing of the fiscal deficit, an idea can be formed of their contractionist impact on the liabilities of the monetary authorities, in comparison with the annual expansion of the liquid money supply (see table 27). As will be noted, in 1972 this impact came to represent an amount equivalent to 40 per cent of the annual expansion of the means of payment. In face of the liberality of credit policy and the accumulation of foreign reserves, factors which constantly generated powerful inflationary pressures, the importance of the policy of monetary absorption through open-market operations can be readily understood.

Table 26

BRAZIL: PRINCIPAL HOLDERS OF NATIONAL TREASURY BILLS OF EXCHANGE

(Balances in millions of cruzeiros)

	1970	1971	1972	1973
Central Bank of Brazil	204	1 810	2 150	5 906
Commercial banks	...	683	2 623	4 381
Official	...	167	729	1 571
Private	...	516	1 894	2 810
Federal Savings Bank	...	...	388	831
Social Integration Programme	-	-	57	104
State Savings Bank	-	0	1	14
Federal Development Banks	...	140	183	24
Reinsurance Institute of Brazil	-	8	8	12
Private enterprises and general public	496	1 239	4 794	5 911
<u>Total</u>	<u>700</u>	<u>3 880</u>	<u>10 204</u>	<u>17 400</u>

Source: Central Bank of Brazil, Relatório Anual 1973.

Table 27

BRAZIL: MONETARY AUTHORITIES. IMPACT OF NATIONAL
TREASURY ADJUSTABLE BONDS AND BILLS
OF EXCHANGE ON MONETARY LIABILITIES

(Millions of cruzeiros)

	1968	1969	1970	1971	1972	1973
<u>Contractionist effect</u>	1 307	5 117	13 202	19 802	45 957	96 230
Subscription of National Treasury Adjustable Bonds and Bill of Exchange	1 186	1 962	4 089	11 215	22 531	32 421
Sales of Nation Treasury Adjustable Bonds and Bills of Exchange by the Central Bank	121	3 155	9 113	8 587	25 426	63 809
<u>Expansionist effect</u>	1 153	4 097	11 863	18 045	40 758	93 823
Redemption of National Treasury Adjustable Bonds and Bills of Exchange	1 116	3 775	9 888	13 001	22 594	37 847
Purchases of National Treasury Adjustable Bonds and Bills of Exchange for the Central Bank portfolio	37	322	1 975	5 044	18 164	55 976
<u>Balance</u>	-154	-1 020	-1 339	-1 757	-7 199	-2 407
Expansion of liquid money supply	6 421	6 998	7 570	11 241	17 156	28 768

Source: Annual reports of Central Bank.

From another standpoint, a main objective of monetary policy in the period was the control of the rate of interest, because of its obvious repercussions on the production costs of enterprises. As has already been noted, real interest rates increased continuously from 1964 onwards until they became positive, since the nominal rates decreased at a slower pace than the rate of inflation. This evolution seems to be explained by the rising levels of demand for circulating capital, investment and consumption resources which resulted from the maintenance of high growth rates, and which exerted pressure on the financial resources of the economy, despite the expansionist monetary policy and the reform of the financial system that enabled the degree of liquidity to be increased. This pressure on resources meant that the element of speculation in financial movements was considerable, thus partly accounting for the tenacity with which the real rate of interest withstood reduction.

In these circumstances, the policy of the monetary authorities was mainly directed towards cutting the operational costs of the bank system, through incentives to bank mergers 26/ and to the reorganization or closing-down of branches run at a loss. Furthermore, from 1968 onwards commercial banks were allowed to maintain increasing proportions of their compulsory deposits (55 per cent as from 1971) in the form of National Treasury securities (Adjustable Bonds and Bills of Exchange), by which means, concurrently with the creation of remunerative conditions for a large proportion of the compulsory deposits and the improvement of the bank network's rates of return, the market for public debt securities was expanded and stabilized. Nevertheless, these incentives do not seem to have brought about any significant reduction of the real rate of interest.

Such traditional instruments of monetary policy as rediscounting and compulsory rates of reserves, were somewhat cautiously utilized in the period under review, largely owing to the success achieved in

26/ At the end of 1973 there were 87 commercial banks in existence, with a total of 5,540 branches, whereas in 1969 there had been 164 establishments with 5,659 branches. See Central Bank of Brazil, Relatório, 1973.

open-market operations, by which they were advantageously superseded. Thus, rediscounting was used mainly as an instrument for the sectoral allocation of credits, special rates being established which enabled the banks to refinance credits assigned to the production and marketing of agricultural commodities in general and of certain agricultural export products such as coffee, cocoa, tobacco, etc., and to the production of manufactures for export. With regard to compulsory reserves, rates varied very little during the period, fluctuating around 27 per cent for banks operating in the developed parts of the country and 18 per cent for those in the less developed areas, and no anti-inflationary objectives were pursued.

(iii) Wage policy. The wage policy formulated in the three-year period 1964-1966 was maintained during the period under discussion. As already noted, this policy implied the abandonment of the traditional principle of adjusting wages proportionally to the rise in the cost of living, replacing it by a formula which calculated wage adjustments in such a way that during the twelve month for which the new nominal wage was in force, average real wages were equivalent to the average for the preceding 24 months, augmented by a percentage representative of the increase in productivity. This formula, which took into account a projection of future inflation ("inflationary residuum"), was slightly modified as from 1968, when it was established that if the "inflationary residuum" had been underestimated for the previous twelve months, this would be taken into consideration in the calculation of the new nominal wage levels. Although this change brought the evolution of wages closer to that of the cost of living, real wages continued to decrease up to 1972, and thenceforward began to show increases too modest to restore their 1964 purchasing power (see table 28).

Table 28

BRAZIL: EVOLUTION OF LEGAL MINIMUM WAGE IN THE STATE
OF GUANABARA

Year	Percentage variation in minimum wage	Cost of living in Guanabara	Index of evolution of real minimum wage
1964	91.7	91.5	105
1965	54.0	65.9	100
1966	30.6	41.3	93
1967	25.3	30.6	89
1968	21.6	22.3	89
1969	19.2	22.1	87
1970	20.0	22.7	85
1971	20.6	20.2	85
1972	19.2	16.5	88
1973	16.1	12.7	89

Source: Central Bank, Fundação Getúlio Vargas, Conjuntura Econômica.

The importance of this wage policy formula can be measured not only by its application to the adjustment of the so-called legal minimum wage,^{27/} but also by its utilization in the adjustment of public-sector salaries and in cases of collective wage bargaining, apart from the fact that it constituted the frame of reference for fixing the lowest salary levels in the economy. In other words, wage policy affects a range of remunerations considerably wider than the earnings of recipients of the legal minimum wage.

While it is true that this wage policy was of decisive importance in the gradual reduction of rates of inflation, and enabled the price-wage spiral to be broken down, it had significant effects on the

^{27/} According to estimates prepared by the Ministry of Labour and Social Security, in 1968, 51 per cent of wage-earners in Brazil were earning less than 1.23 times the legal minimum wage. See P. Auberger, op. cit., p. 28.

allocation of resources in the system. As can easily be understood, it was a powerful factor in the concentration of personal income which, as previously pointed out in the first section of this chapter, was one of the bases for the high growth rates recorded in the period. Wage policy had a depressive effect on basic wages in the economy, favouring a redistribution of income which benefited the upper-middle and upper income strata, in whose hands the dynamic purchasing power of the system lay. Only thus is it comprehensible that real private consumption in the economy was able to expand at an average annual rate of 12.1 per cent during the period 1967-1973,^{28/} just at a time when the real minimum wage - the standard of pay for a large proportion of the economically active population - was diminishing.

(iv) Price policy. The price control policy applied during the period may be regarded as a necessary complement of an expansionist monetary policy and a fiscal policy compatible with high rates of growth of the product. In this connexion, it was sought to use mechanisms which without blocking prices would be capable of controlling them, and preventing increases that would anticipate inflation or substantially boost profits. In contrast, the aim pursued was that rising prices should reflect real increases in costs. Thus, price policy was applied to agricultural and industrial products and to the tertiary sector, with varying results.

For the agricultural sector a two-fold objective was pursued. In the first place, price policy sought to protect the sector's income through the fixing of minimum guaranteed producer's prices; secondly, the intention was to keep agricultural prices within a margin compatible with the control of inflation, and prevent them from following international trends, since this might have represented a serious internal inflationary pressure.

With the object of maintaining certain minimum prices, credit policy was directed towards the continued extension of loans by the Banco do Brasil for financing the storage and purchase of products;

^{28/} Primary data taken from Economic Survey of Latin America, 1968 and 1973.

this constituted a factor of monetary expansion in the economy, but did not unduly affect the placements of the monetary authorities.

As regards general agricultural price policy, the principal measures were those applied to exports of certain commodities, such as coffee, cocoa and beef, and the establishment of quantitative export restrictions, which affected, inter alia, cotton, maize, sisal hemp, soya beans, beef, cocoa, etc. The aim of these measures was to prevent internal agricultural prices from rising in consequence of the development of export lines at prices more remunerative than those obtainable in the domestic market (see table 29).

As regards prices of industrial goods, a succession of different types of control was established in the period, reflecting a somewhat wavering policy in respect of the use of various instruments. The first measure adopted was the application of a system of incentives to enterprises that kept their prices within the margins fixed by the Government, guaranteeing them rediscount facilities in respect of their Central Bank credits, supplementary credits from the Banco do Brasil, lengthening of time limits for tax payment, etc. This system was subsequently replaced by another of automatic price adjustments, based on the index of wholesale prices, at intervals of three months. Some months later the type of control was changed again, and as from 1968 adjustments of the prices charged by enterprises were determined by equivalent increases in costs, subject to prior authorization by the Inter-Ministerial Price Commission (IPC). This control is at present applied to about 4,500 industrial enterprises. Failure to comply with the regulations laid down by the IPC may incur sanctions such as the suppression of Banco do Brasil credits, loss of Central Bank rediscount rights, or, in extreme cases, official intervention in the running of the enterprise. Generally speaking, control of industrial prices does not seem to have had unfavourable repercussions on the sector, to judge by the rates of return of industrial enterprises, which have been rising since 1967 (see table 30).

Table 29

BRAZIL: PERCENTAGE VARIATIONS IN PRICES OF AGRICULTURAL PRODUCTS

	1970	1971	1972	1973	1974
Index of wholesale prices of total supply					
Industrial products	16.8	17.5	16.0	14.7	27.9 _a /
Agricultural products	28.7	25.3	22.3	19.0	25.1 _a /
Index of exports prices					
Sugar	7.6	9.2	60.6	2.0	156.6 _b /
Soya beans	-0.8	21.8	8.7	113.2	-10.7 _b /
Cotton	0.8	34.2	9.5	16.7	-36.7 _b /
Coffee	36.1	-23.5	26.5	22.8	14.5 _b /
Beef	...	56.4	-1.9	41.6	...

Source: Fundação Getúlio Vargas, Conjuntura Econômica.

a/ Up to September 1974.

b/ Up to July 1974.

Table 30

BRAZIL: RATES OF RETURN OF INDUSTRIAL ENTERPRISES,
BY BRANCHES OF ACTIVITY

(Percentages)

Branch of activity	1967	1968	1970	1972
Consumer goods (textiles, food products, beverages, tobacco, paper, etc.)	14.9	15.6	17.7	16.5
Intermediate goods (non-metallic ores, products of metallurgical and chemical industries, etc.)	13.5	14.7	17.5	17.5
Capital goods (products of metal manufacturing and machinery industry, electrical appliances, transport media, etc.)	9.4	16.9	16.1	20.8
Miscellaneous	7.9	26.5	9.1	16.1
<u>Total</u>	<u>12.6</u>	<u>16.0</u>	<u>16.5</u>	<u>17.8</u>

Source: P. Auberger, op.cit., on the basis of estimates prepared by the Fundação Getúlio Vargas in respect of the 500 largest enterprises in Brazil.

The controls imposed on other domestic prices, as in the commerce and services sectors, for example, were of a somewhat piecemeal character, and had no significant repercussions on anti-inflationary policy.

(v) Handling of the exchange rate. From another point of view, a feature worth noting in overall price policy during the period is the establishment, as from 1968, of a flexible exchange rate system, one of the basic instruments of the effort to neutralize the effects of inflation.

Up to 1968, it had been the practice of the monetary authorities to move the exchange rate closer to more realistic levels, at intervals of ten to fourteen months, a procedure which was clearly disadvantageous in respect of the deterioration of real export earnings, and, furthermore, favoured speculative movements of capital.

From 1968 onwards, Brazil's economic development became outward-directed, and depended more and more upon a growing inflow of capital, a vigorous expansion of exports and a rapid increase in imports. In these circumstances, the policy pursued in fixing the exchange rate needed to be more flexible and realistic. Thus, in 1968 the system of periodic devaluations was introduced as a necessity imposed by the country's style of development. In essence, the new system was put into practice in the form of frequent small adjustments in the exchange rate, from seven to ten times a year on an average, the devaluations ranging from 0.5 per cent to 2.5 per cent, (see table 31), so as to make for an adjustment between the rate of increase of domestic prices and the trends followed by external inflation. This system was complementary to the policy of incentives to exports and afforded protection for real export earnings, acting as a basic factor in their expansion. Moreover, the fact that devaluations took place so frequently and at intervals of unknown length discouraged speculative movements of capital. In addition, these periodic devaluations played an important part in the policy for tapping foreign resources, since they meant that capital could be repatriated at a real value comparable to that of the original contribution. With regard to imports, the periodic adjustability of the exchange rate obviated the explosiveness of violent devaluations, mitigating their psychological effects and helping the economy to adapt itself better to the new costs.

Table 31
 BRAZIL: VARIATION IN EXCHANGE RATES
 BETWEEN 1968 AND AUGUST 1974

Date	Period (number of days)	Dollar purchasing power of cruzeiros	Annual percentage variation	
			Exchange rate	Prices
04-01-68	236	3 200		
27-08-68	28	3 630		
24-09-68	56	3 675		
19-11-68	20	3 745		
09-12-68	57	3 805		
31-12-68		3 805	18.9	25.5
28-01-72	47	5 750		
16-03-72	53	5 810		
08-05-72	68	5 880		
14-07-72	53	5 930		
05-09-72	42	5 990		
17-10-72	36	6 060		
22-11-72	23	6 130		
15-12-72	61	6 180		
31-12-72		6 180	10.4	15.5
14-02-73	69	5 995		
24-04-73	76	6 060		
09-07-73	73	6 090		
20-09-73	85	6 120		
14-12-73	48	6 180		
31-12-73		6 180	0.0	15.5
31-01-74	20	6 300		
20-02-74	55	6 415		
16-04-74	50	6 515		
05-06-74	20	6 640		
25-06-74	14	6 775		
09-07-74	36	6 845		
15-08-74	34	6 980	12.94	25.6

Source: Central Bank of Brazil.

(vi) Monetary adjustability. As a second mechanism for neutralizing the effects of inflation, ample use was made of the monetary adjustability instituted in 1964. Its application was a cornerstone of Brazil's entire financial policy, and, in particular, paradoxical as it may seem, of anti-inflationary policy too, since it gradually covered a high proportion of transactions in the Brazilian economy. It meant that instruments of indebtedness could be utilized in an inflationary situation, by virtue of the constant updating of liabilities.

Adjustability, which at first covered only the National Treasury's Adjustable Bonds, progressively spread to public utility tariffs, rentals, mortgages, balance-sheets of enterprises, loans, taxes, etc., reducing the volume of speculative operations and consequently weakening one of the causes of inflationary pressures, and safeguarding the real value of savings. At the same time, as was previously shown, it constituted an efficient instrument for regulating the liquidity of the economy, especially where the issue of adjustable securities was concerned (the National Treasury's Adjustable Bonds and Bills of Exchange). It must be borne in mind, however, that although periodic devaluations and monetary adjustability mitigated some of the effects of inflation and permitted a sort of compromise with it, in a certain sense they also tended to institutionalize it. The mechanism of adjustability exercised a pervasive influence on the whole behaviour of the agents of the economic process, encouraging a propensity to expect price increases which came to be taken as a matter of course.

In inflationary situations, in which producers and distributors tend to defer their sales, while consumers seek to spend their earnings in advance, imbalances between supply and demand are generated, and obviously exert pressure on prices. Tendencies to go in for stockpiling and borrowing in national currency likewise undermine the financial savings of individuals and enterprises.

The potency of the propagating effects of the institutionalization of inflation seems to be in inverse ratio to the virulence of the disease. In cases of galloping inflation, with annual rates of over 30 or 40 per cent, deeper-rooted causes exist which detract from the

relative importance of these economically superficial self-propagating factors. On the other hand, when the rate of inflation has been reduced to 10 or 15 per cent per annum, the inertia caused by the adjustability mechanism may become a serious hindrance to the combating of inflation.

D. THE RECRUDESCENCE OF INFLATION (1974)

After almost a decade in which considerable control over inflationary pressures was achieved, in 1974 the upward trend of prices regained momentum; by the end of the year the rate of increase had reached 34.6 per cent, as against 15.5 per cent in the two-year period 1972-1973. Basically, as from the second half of 1973, the resurgence of the inflationary process was linked in two ways to the behaviour of the external sector. In the first place, the economy was affected by the repercussions of the world petroleum crisis and the rise in prices of raw materials, including, of course, the raw materials exported by Brazil; secondly, the increase in the prices of imports struck the Brazilian economy a particular heavy blow, in view of its sensitiveness to the vicissitudes of the external sector.

(a) Sources of inflationary pressures

In analysing the causes of the recent acceleration of the rate of inflation in Brazil, certain trends in the economy during 1973 must be taken into account.

To begin with, it is of interest to note the high balance-of-payments surplus in 1973, which gave rise to a marked increase in foreign currency assets (2.3 thousand million dollars), so that pressure was exerted on the expansion of the domestic monetary supply. This phenomenon had been in evidence since 1972, in which year the surplus had amounted to 2.4 thousand million dollars (see table 32). These surpluses were primarily attributable to the abundant inflow of foreign capital in the form of medium and long-term loans. Although in August 1973 such inflows of funds were to some extent checked by the application of a 40-per-cent rate of retention to the cruzeiro counterpart of foreign loans, the amount they represent remained at practically the same level as in 1972, i.e., about 3,000 million dollars. This was the main factor making for the expansion of the means of payment in 1973.

Table 32
BRAZIL: BALANCE OF PAYMENTS

(Millions of dollars)

	1970	1971	1972	1973	1974
<u>I. Trade balance</u>	232	-363	-244	182	
Exports (FOB)	2 739	2 882	3 991	6 198	
Imports (FOB)	2 507	-3 245	-4 235	-6 016	
<u>II. Services</u>	-462	-538	-730	-846	
Income	328	398	424	569	
Expenditure	-790	-936	-1 154	-1 415	
<u>III. Goods and services (I + II)</u>	-230	-901	-974	-664	
<u>IV. Returns on capital</u>	-353	-420	-520	-662	
Profits and dividends	-119	-118	-161	-191	
Interest	-234	-302	-359	-471	
<u>V. Transfers</u>	21	14	5	36	
<u>VI. Balance on current account (III + IV + V)</u>	-562	-1 307	-1 489	-1 290	
<u>VII. Liquid movements of capital</u>	1 015	1 846	3 492	3 680	
Investment	108	168	318	900	
Loans and financing (medium- and long-term)	767	1 187	3 098	2 937	
Loans (short-term)	77	486	21	-171	
Others	63	5	55	14	
<u>VIII. Errors and omissions</u>	92	-9	436	-63	
<u>IX. Balance-of-payments position</u>	545	530	2 439	2 327	
Arrears and trade credits	-	-	-	-	
International Monetary Fund	-177	-47	-70	-33	
Assets minus short-term commitments	-378	-483	-2 369	-2 294	

Source: Central Bank of Brazil.

The growth rate of credits to the private sector - another important factor of monetary expansion - was 46.7 per cent in 1973, and 52 per cent in the case of credits granted by the Banco do Brasil.

These two principal lines of expansion led to a 47-per-cent increase in the means of payment in 1973, as against one of 38.3 per cent in the preceding year. This expansion, which was much greater than had been envisaged by monetary policy, proved incompatible with the programmed rate of inflation. Thus, pressure on price levels began to make itself felt as early as the second half of 1973, and became more marked in the early months of 1974.^{29/} By the second half of 1973, there was already evidence of speculation in immovable assets, a sharp increase in the volume of imports, shortages of raw materials and basic inputs such as steel, iron and chemical products, speculative stockpiling and other symptoms of renewed impetus in total demand in the economic system.

The second source of inflationary pressures in the recent period was associated with the so-called raw materials crisis and with the development of world inflation; both these generated disequilibria in the economy which became major causes of the inflationary trend of prices.

To begin with, the considerable increases in import products are noteworthy. If the period January-June 1974 is used as reference, it may be seen that imports increased in value by 122.5 per cent compared with the previous year, while the increase in quantity was only 14.7 per cent (see table 33). In the case of basic commodities which include imports of petroleum and wheat, the value of imports increased by 225 per cent.

^{29/} The rate of inflation programmed for 1973 was 12 per cent, whereas in fact it was 15.5 per cent. In the preparation of the overall price index, however, artificially fixed prices were utilized, which were much lower than the real market prices, so that the rate of inflation in that year was underestimated.

Table 33
 BRAZIL: STRUCTURE OF IMPORTS IN THE
 FIRST HALF OF 1973 AND 1974

	Quantities (thousands of tons)			Value (millions of dollars)		
	1973	1974	Per- cent age	1973	1974	Per- cent age
	Basic commodities	18 999.8	19 806.5	4.3	548.9	1 784.7	225.1
Manufactured products	3 445.5	5 921.2	71.9	1 930.4	3 741.7	93.8
Semimanufactures	3 209.2	5 579.4	73.9	855.1	2 177.2	154.6
Manufactures	236.7	341.7	44.6	1 075.3	1 564.2	45.5
Special transactions	6.2	16.5	167.3	21.2	38.4	81.0
<u>General total</u>	<u>22 451.5</u>	<u>25 744.2</u>	<u>14.7</u>	<u>2 500.7</u>	<u>5 564.6</u>	<u>122.5</u>

Source: Fundação Getulio Vargas, Conjuntura Económica, October 1974.

It is important to observe, however, that the share of basic commodities in total imports only accounted for 32 per cent of the value of imports during this period, and thus does not explain the total increase in growth of expenditure on imports. In fact, imports of semimanufactured and manufactured products played a decisive role, with an increase in quantity of the order of 74 per cent in the case of semimanufactured and 44 per cent for manufactures; price increases also affected them, especially in the case of semimanufactures. These imports are to be explained by the large-scale stockpiling of raw materials, as a result of the expectation created as regards future trends in prices in world trade and the possibilities of profit speculation. Still in the context of imports, another source of inflationary pressures should be mentioned, in the form of the upward trend in prices of similar goods produced locally. The lack of consistency between domestic and external prices meant that some local industrial products, which benefited from customs protection, came to have prices lower than those of similar imported goods. When local production proved unable to cope with the entire demand of the domestic market, which was the case in the majority of instances, the price of locally-produced goods tended to increase to the price-levels of imported goods.

From another viewpoint, the increase in international prices also contributed to inflation through the increase in the prices of some products exported by Brazil. In fact, products whose external prices underwent rapid increases (see table 34) shifted part of their supply from the local to the external market, causing problems in domestic supply and a consequent rise in prices. This was the case of meat, soya beans, and cotton, among the most obvious cases, and it became necessary to adopt a series of special measures, such as export quotas, the establishment of fixed proportions of sales to external and internal markets, the fixing of domestic prices, the introduction of export rates, etc. In the majority of cases, however, it was impossible to avoid closing the gap between external and domestic market prices, and this gave rise to pressures to push up prices, which made themselves felt late in 1973 and in the first few months of 1974.

Table 34

BRAZIL: INTERNATIONAL PRICES OF EXPORT PRODUCTS

(Dollars)

Product	Unit	1970	1973	January/ February 1974
Beef	100 pounds	41.32	63.67	...
Cocoa	100 pounds	32.25	61.26	67.05
Coffee	100 pounds	53.94	66.53	69.60
Cotton	100 pounds	25.10	56.10	85.00
Sisal	100 pounds	7.30	24.40	34.00
Soybean	Bushel	2.70	6.00	6.14
Sugar	100 pounds	8.09	10.25	15.01
Wool	100 pounds	27.20	95.90	101.80
Iron ore	Tons	7.47	8.07	9.09

Source: Fundação Getulio Vargas, Conjuntura Econômica, October 1974.

Lastly, the

Lastly, the role of the neutralizer elements of inflation should be stressed, as for example, currency readjustments, the use of which is generalized in the economy of Brazil. As may be understood, the monetary readjustments, which are always a posteriori tend to increase the effects of inflation when this is in the ascendent, exactly as in the case of the recent evolution of inflation in Brazil.

As a result of these major factors, the rate of inflation jumped up from 15.5 per cent in the period 1972-1973 to 34.6 per cent in 1974. Actually, 1973 had the advantage of some arbitrary elements in the economic policy which made it possible to put off until 1974 part of the inflationary pressures which made themselves felt, particularly in the second half of the year. Examples of such measures may be found in the subsidies, the fixed prices, and the policy of the fixed exchange rate adopted in the second half of the year. As may be seen from table 35, the exchange rate was readjusted by only 1.6 per cent between June and December, and the policy of "mini-devaluations" was relaxed in an endeavour to postpone the domestic effects of the increases in prices of imported products.

Table 35

BRAZIL: PRICE OF THE DOLLAR, 1973
(Cruzeiros)

January	6 215
February	6 116
March	6 030
April	6 046
May	6 100
June	6 100
July	6 122
August	6 130
September	6 140
October	6 160
November	6 160
December	6 195

Source: Fundação Getúlio Vargas, Conjuntura Econômica, August, 1974.

/Naturally, these

Naturally, these measures contributed to a later increase in prices in 1974; a particularly active inflationary trend was recorded in the first four months of the year, with rates of growth of the general price index increasing from 2.9 per cent in January to 5.1 per cent in the month of April, and later dropping to 2 per cent in July, with a cumulative growth of 22.6 per cent in the first half of the year.^{30/} However, once the months of readjustment and absorption of the pressures of the previous year were over, the rate of inflation slowed down, and the year came to an end with an increase of 34.6 per cent in the general price index.

(b) Anti-inflationary policy in 1974

In the context of the growth of inflation, the policy introduced during 1974 may be considered as an emergency policy, aimed at dealing rapidly with an economic situation considered to be of a temporary nature. This, however, did not mean the abandonment of the main lines of policy applied from 1967. Although inflation showed upward growth rates, the main objective of maintaining high rates of growth was not lost sight of, and continued to delimit the anti-inflationary policy's area of manoeuvre.

(i) Money and credit policy. Money and credit policy during the period aimed at the implementation of a financial budget which would bring down the growth of the means of payment in the course of the year by 35 per cent this was considered consistent with a high rate of growth of the product and the reduction of the rate of inflation.

The implementation of such a budget, however, pursued rather an irregular course during the year. During the first half of the year when the main effects of inflation sank in, money supply was rigidly controlled. Table 36 shows that the means of payment increase by 13.6 per cent during the period January-July while loans to the private sector increased by 23.1 per cent. If it is considered that during the first half of the year the rate of growth of prices was of the order of 22.6 per cent, it will be understood that the economy found itself involved in a current liquidity crisis.

^{30/} The index refers to the basket of goods which make up domestic supply.

Table 36
 BRAZIL: MONETARY DISTRIBUTION, 1974
 (Millions of cruzeiros)

	Paper money in fewer of public	Sight deposits in commercial banks	Sight deposits in the Banco do Brasil	Means of payments	Loans to the private sector		Total
					Commercial banks	Banco do Brasil	
January	15 815	56 213	14 873	86 901	74 164	37 824	111 988
February	16 086	58 729	16 000	90 815	76 729	38 864	115 593
March	16 317	60 489	17 051	93 857	78 861	40 626	119 487
April	16 575	60 367	18 168	95 010	80 420	41 922	122 342
May	17 160	60 310	19 166	96 636	83 475	43 950	127 425
June	17 192	64 783	18 910	100 885	86 570	47 866	134 436
July	16 712	62 670	19 301	98 683	88 864	48 959	137 823
August	17 653	64 810	21 242	103 705	92 119	50 392	142 511
September	17 109	66 472	19 993	103 574	95 539	53 439	148 978
October	17 399	67 038	21 806	106 243	98 705	56 419	155 124
November	18 984	71 425	29 950	113 359	101 666	...	...
December	20 798	79 788	20 681	121 267	106 910	...	...
December 1973				90 490			

Source: Preliminary estimates of the Banco Central do Brasil, and the Fundaçao Getulio Vargas.

/During the

During the second half of the year, once the main impact of inflation was over, monetary policy was redirected towards a more rapid growth of money supply so as to enable the economy to function in a more dynamic form. The means of payment thus increased by 22.9 per cent during the period July to December while loans to the private sector recorded a growth of 15.4 per cent in the four-month period between June and October. This meant the partial alleviation of the problems of liquidity in the economy.

As a result of the strict application of the monetary policy, the budget was implemented with only slight variation from that programmed, and showed a total annual growth in the means of payment of around 34 per cent. This forced the Government to adopt a series of complementary monetary measures to cope with the strong pressures and constraints of the money supply.

Among the factors which most inhibited the levels of the economy's liquidity were the course of conduct shown by the Treasury and the evolution of the external sector.

An examination of the Treasury's cash flow shows the reduction in the money supply throughout the year. Table 37 shows that with the exception of the months of July, August, October and December, the Treasury's cash flow constituted a major factor in reducing the money supply, especially in the months of February and September, when major increases were recorded, and the economy's liquidity problems were aggravated. This surplus basically derived from Treasury income which increased by approximately 41 per cent during the period January-October 1974, compared with the same period in 1973. This was essentially due to the increase in earnings from the tax on manufactures, which was an ad valorem duty, and benefited from the increasing rates of inflation. Public expenditure increased by 33.5 per cent during the period January-October, as no policies were applied to restrict spending (see table 38).

Table 37

BRAZIL: TREASURY CASH FLOW, 1974 a/
(Millions of cruzeiros)

Month	Value
January	277.6
February	2 870.1
March	3 150.9
April	3 703.5
May	4 103.1
June	4 899.3
July	4 616.4
August	3 541.0
September	5 343.9
October	4 655.0
November	4 998.0
December	2 700.0

Source: Fundação Getúlio Vargas, Conjuntura Econômica, and Banco Central do Brasil.

a/ Flows accumulated in the course of the year up to the month considered.

Table 38

BRAZIL: NATIONAL TREASURY, FISCAL BUDGET
(Millions of cruzeiros)

	1973 <u>a/</u>	1974 <u>a/</u>	Percentage variation
Income	41 576.4	58 602.1	41.0
Expenditure	40 398.6	53 947.1	33.5
Surplus	1 177.8	4 655.0	295.2

Source: Fundação Getúlio Vargas, Conjuntura Econômica, December 1974.

a/ January-October.

/The balance

The balance of payments in 1974 was in deficit by 1.4 thousand million dollars, basically as a result of the vigorous increase in the value of imports which accounted for a decrease in liquidity which was by no means negligible. In order to counter this, and guarantee that the level of liquidity programmed would be met, the Government applied a series of emergency measures in the second half of the year which increased the supply of money in the economy.

From then on, open market operations were intensified, but in the reverse of the traditional direction; this time the aim was to pump money into the system through purchases of Treasury Bills by the Central Bank and the reduction of the quantities on sale to the public.

As table 39 shows, the monetary balances of operations with Treasury Bills increased up to the month of June, with a moderate decrease in the means of payment. However, as from July, open market operations reversed their trend and began to supply the economy with liquidity, with a marked reduction in the money value of the operations.

Table 39

BRAZIL: TREASURY BILLS, 1974 a/
(Millions of cruzeiros)

Period	Treasury bills
January	16 348
February	15 988
March	15 778
April	16 636
May	18 249
June	19 801
July	19 653
August	18 050
September	16 200
October	14 101
November	13 500 b/
December	15 950 b/

Source: Banco Central do Brasil.

a/ End-of-period balances.

b/ Preliminary estimates.

/In addition,

In addition, subscriptions to readjustable Treasury Bonds were suspended, thus avoiding a further flow of resources into the Treasury.

The credit policy sought to increase liquidity by reducing the compulsory loans of the commercial banks, raising the maximum limits for agricultural credit generated by the Banco do Brasil, creating a special Central Bank credit line of approximately 2,000 million cruzeiros for the financial operations of the commercial sector, and establishing another special Banco do Brasil credit line for the industrial sector, of 1.3 thousand million cruzeiros.

Some fiscal policy measures were also introduced, with temporary reductions of the tax on manufactures, affecting electrical domestic appliances, furniture and the textile industry, and the postponement for one month of collections of payments of this tax for the majority of manufactures.

With this group of special measures it was possible to rise above the economy's liquidity crisis and implement an anti-inflationary financial budget, bounded by considerably stricter limits than the budgets of earlier years.

(ii) Price policy. In 1974 the price policy played a rather more flexible and important role than in previous years.

As will be understood, in the face of rising inflation the policy to control prices gained in importance as one of the main instruments for restraining the expectations of price increase which came to exist in the economy, especially during the first half of the year.

Control began to be applied by the Inter-Ministerial Prices Commission (IPC) and by the National Office for the Superintendence of Supply (SUNAB) as from the second quarter of the year, when a more stable level of prices was reached. During the first quarter, the Government was forced to readjust by considerable amounts a group of prices which had been frozen in 1973, in an endeavour to delay the effects of the increases.

In effect, the type of price control practiced by the IPC in particular (industrial prices) was similar to the wage policy

formula 31/ applied as from 1968. The readjustment was based in the following principles: in the first place, it required the enterprises to absorb part of the increases in the cost of inputs by increasing productivity; secondly, the estimates of the increase in the cost of inputs was not made by comparing two readjustment dates, but was based on their average value during the period in which old and new prices were in force; this meant the establishment of a posteriori measures of readjustment in the case of sizeable underestimates. This provided an extra shock-absorber in prices, always provided that the rate of inflation anticipated were less than that observed in the past.

In addition, the prices of goods produced by state enterprises were the object of direct restrictions, and readjustments exceeding 15 per cent in the course of the whole year were prohibited.

The price controls used were sufficiently efficient to disappoint expectations of an upswing in prices and to enable inflation to be slowed in the second half of the year. However, their radius of action continues to be limited to industrial and agricultural prices in particular, with a fairly moderate impact on the marketing of the products.

(iii) Wage policy. In 1974 the same wage policy that had existed in Brazil since 1965 was maintained. A change was introduced, however, in the formula for calculating the readjustments which had been applied since 1968. Since then, the mode of calculation had endeavoured to represent the real average wage of the 24 months previous to the readjustment, taking into consideration the forecast of the future rate of inflation and the correction of the same to allow for underestimation, including in it 4 per cent to account for the increase in productivity. The change introduced in 1974 established that the calculation of the readjustment should represent the real average wage of the 12 months previous to it, maintaining the same formula in other respects. The result of this was a closer approach of trends in wages to increases in the cost of living.

31/ See page 179.

The readjustment of wages took place in two stages, with the grant of a special increase of 10 per cent as from 1 December 1974, while the final readjustment of around 43 per cent came into force as of 1 January 1975 (discounting the emergency 10 per cent).

The new readjustment based on the new calculation formula introduced in 1974, is the largest wage increase which the Government has permitted in the last 10 years, during which time wage policy played an important role in the struggle against inflation.

(iv) External sector policy. The evolution of the external sector in 1974 was characterized by the deficit of 1.4 thousand million dollars recorded in the balance of payments. Basically, this disequilibrium originated in the balance of current transactions, which was a heavy deficit which could not be offset by the inflow of capital (see table 40).

Table 40

BRAZIL: BALANCE OF PAYMENTS, 1974

(Millions of dollars)

<u>Trade Balance</u>	
Exports	7 700
Imports	12 400
Liquid balance	-4 700
<u>Services</u>	<u>-2 300</u>
<u>Current transactions</u>	<u>-7 000</u>
<u>Capital</u>	
Direct investment	1 000
Loans and finance	6 400
Amortization payments	-1 800
Liquid balance	5 600
<u>Deficit</u>	<u>-1 400</u>

Source: Banco Central do Brasil, preliminary estimates.

/From the

From the point of view of the anti-inflationary policy the evolution of the external sector acquired importance in three main aspects. In the first place, as has already been said, this policy tightened up the supply of the means of payment of the system - the opposite of what happened in 1972 and 1973, when it became one of the most important factors of monetary growth. Although in one sense this was of assistance in implementing a strict financial budget in another it caused difficulties because it brought down the level of liquidity in the economy, especially of the existence of an unexpectedly large deficit at the beginning of the year.

Secondly, the rather slow intake of external resources from loans and finance made itself felt particularly in the first half of the year. As a result of large-scale enterprises, particularly those bound up with foreign capital, brought pressure to bear on domestic supplies of credit, jeopardizing in particular small and medium-scale enterprises which were unable to compete successfully for access to the system's sources of finance. A policy which would attract more foreign capital was thus required, together with the abandonment of the restrictions imposed in 1973, so as to cover the deficit in the balance of current transaction and at the same time expand external sources of finance. This was the reason for the elimination at the beginning of the year of the retention of 40 per cent of the cruzeiro counterpart of external loans, while the minimum period of duration for foreign capital was reduced in September from 10 to 5 years. In October, completing the group of the main measures, for attracting foreign capital, the tax on remittances of interest abroad was reduced from 25 to 5 per cent. Although the net inflow of capital was inadequate to cover the deficit in the balance of current transactions, it amounted to 5.6 thousand million dollars, which represented an increase of 52 per cent compared with the level for 1973.

Lastly, with reference to the policy for fixing the exchange rate a return was made to the tradition of periodical devaluations which had been abandoned in 1973, and the economy was readjusted to

/rates of

rates of inflation which showed an upward trend. As may be seen from table 41, the exchange rate was devaluated by 19 per cent in the course of the year and was forced to adapt to an adverse trend in the balance of payments; a level of growth consistent with the emergency anti-inflationary policy applied during the year was, however, maintained, the devaluation of the exchange rate being substantially less than the increase in domestic prices.

Table 41

BRAZIL: PRICE OF THE DOLLAR, 1974
(Cruzeiros)

December 1973	6 195
January	6 224
February	6 381
March	6 455
April	6 505
May	6 555
June	6 690
July	6 867
August	6 959
September	7 068
October	7 142
November	7 262
December	7 371

Source: Fundação Getúlio Vargas, Conjuntura Econômica.

