

LATIN AMERICA AND THE CARIBBEAN

Policies  
to improve  
linkages with  
the global  
economy



**UNITED NATIONS**

**Economic Commission for Latin America and the Caribbean (ECLAC)**

**LATIN AMERICA AND THE CARIBBEAN:  
POLICIES TO IMPROVE LINKAGES  
WITH THE GLOBAL ECONOMY**



**UNITED NATIONS**

**ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN**

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## FOREWORD

Four years ago, the secretariat submitted to the States members of ECLAC the document entitled *Changing Production Patterns with Social Equity*. It offered general guidelines for the development of the countries of Latin America and the Caribbean, including, in particular, the proposal that production should become more internationally competitive, not only in order to increase exports but also to achieve efficient import substitution. At the same time, the document offered a framework for subsequent activities of the Commission revolving around the study of a number of related topics.\*

The economic panorama of the region has indeed changed considerably in these four years. Although with certain differences among countries, the macroeconomic disequilibria of the past decade have begun to be corrected; the transfer of resources out of the region has turned around to become a huge net inflow of foreign capital; the export sector has grown and diversified; and economic activity as a whole has shown a modest recovery. The Latin American and Caribbean countries are now feeling the need to build on these advances, some of which are still rudimentary and partial,

surmount the difficulty of making headway in highly competitive international markets and overcome the considerable social lags that have accumulated. Their chance of carrying out all these tasks will ultimately depend on establishing better linkages with the global economy.

One of the many conclusions reached in this document is that, notwithstanding the multiple obstacles that impede development in the region, a constellation of potentially favourable factors is also present today which could give this development a strong boost. These include the gradual assimilation of the lessons learned in the process of increasing and diversifying exports; improvement of the quality of macroeconomic management; the chance to fill a gap in public policy instruments in the region -i.e., the implementation of micro- and meso-economic policies- in order to increase productivity in accordance with the best international practices; renewed access to external financing; and a boom in intraregional economic cooperation. Another factor has been the recent adoption of new international trade rules under the Uruguay Round. These rules,

\* Thus, for example, the link between changing production patterns, social equity and the environment was addressed in 1991; in 1992, the existing reciprocal ties between changing production patterns and social equity were examined in further depth; and in 1993, the topic of population was incorporated into this framework. The references for these documents are contained in the bibliography.

although far from meeting all the region's demands, at least represent a step forward in support of multilateralism.

Whether improvements can be made in the participation of Latin America and the Caribbean in dynamic trade flows and in the region's access to technology, foreign direct investment and financing depends in part on exogenous factors which are beyond the control of the countries of the region. However, much remains to be done in terms of both national policies and intraregional cooperation<sup>\*\*</sup> to enhance linkages with the global economy.

The main purpose of this document is to explore the scope of efforts being made to achieve these objectives. It discusses three interrelated types of policies, namely, trade policy, micro- and meso-economic policy in support of production systems, and macroeconomic policy, with specific emphasis on financial flows. The last one is especially relevant in

the current economic environment, in which capital inflows are having a crucial effect on two key variables in the behaviour of exports—interest rates and, in particular, exchange rates.

The document is divided into three parts, one for each type of policy. The first chapter of the summary section not only provides an overview of the contents of these three parts, but also combines their various components into an integrated, coherent presentation in the framework of the systemic proposal that has been put forward by the secretariat.

It should be noted that this document, like those preceding it, does not claim to offer universal recipes, in view of the enormous diversity of situations in the region. Rather, it seeks to promote a debate on areas of key interest to the various countries in their efforts to improve their linkages with the global economy, as part of the agenda of changing production patterns with social equity.

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<sup>\*\*</sup> The potential for economic integration is the subject of a separate but complementary document. See ECLAC, *Open regionalism in Latin America and the Caribbean. Economic integration as a contribution to changing production patterns with social equity* (LC/G.1801/Rev.1-P), Santiago, Chile, 1994. United Nations publication, Sales No. E.94.II.G.3.

## SUMMARY AND CONCLUSIONS

### A. INTERNATIONAL LINKAGES AND DEVELOPMENT

#### 1. Main features of Latin American and Caribbean linkages with the global economy in the 1990s

---

1. The linkages between a number of Latin American and Caribbean countries and the international economy have undergone very significant changes in recent years. These include, in particular, the intensification of efforts to export and to liberalize imports, a process that began during the 1980s in several countries and that is becoming more pronounced in the 1990s. For the region as a whole, the volume of merchandise exports increased by an annual average of 5.4% during the 1980s, and by 7% from 1990 to 1994; these figures compare favourably with the 4.7% growth rate recorded for the volume of world trade during that same 14-year period.

2. None the less, the relative buoyancy of the export sector has not always been reflected in the behaviour of the economies as a whole. In the 1980s, gross domestic product increased by only 1.2% a year; from 1990 to 1994, it registered an average annual growth rate of 3.4%. As a result, the export coefficient rose from 14% in 1980 to 21% in 1990 and to 23% in 1994. In other words, the growing importance of the export sector in the region's economies can be attributed in part to the expansion of this sector, and in part to the poor

performance of the regional economy as a whole.

3. The reason for this phenomenon is that during the 1980s, in a context of burdensome external debt service and a collapse of the flow of fresh funds to make the necessary economic changes, the countries of the region had to make a recessive adjustment. A good part of this adjustment was based on sharp reductions in the money supply and fiscal expenditure, and on devaluations in the exchange rate for the dual purpose of slowing down imports and promoting the production of exportables. In the first stages—marked by high costs of domestic finance and scant improvement in productivity—real wage levels, employment and production activity bore the brunt of the adjustment, and this in turn depressed domestic demand.

4. Thus, although export volumes were frequently dynamic, the opposite was true of production and investment for the domestic market, especially in non-tradables at the international level. Consequently, the performance of the economy as a whole, as well as of investment and total output, tended to be rather lackluster despite the growth of exports.

5. A small portion of this growth was the outcome of a still incipient change in production patterns, based on an

endogenous process of increases in productivity and encouraged, *inter alia*, by the gradual elimination of anti-export biases in economic policy. The restructuring process also enhanced the competitiveness of a growing number of firms and increased their capacity to explore and penetrate external markets, with considerable variation among the countries of the region. This change in production patterns gained momentum in the 1990s.

6. Part of the impact of the push for exports was also neutralized by the deterioration of the terms of trade that was caused not only by negative trends in the international markets for the region's exportable supply, but also by insufficient diversification of Latin America and the Caribbean's trade structures in favour of product lines having a more stable, dynamic external demand.

7. Since the beginning of the present decade, and owing to a combination of factors, the outward transfer of financial resources that characterized the 1980s has reversed itself, and private external finance is once again in abundant supply, with annual inflows averaging US\$ 61 billion for the period 1992-1994. Net inflows, which mirror the universal changes taking place in international capital markets, have been based on more diversified sources of finance than before. In particular, foreign direct investment and portfolio investment have increased in the form of bonds and equities—either directly or as ADRs/GDRs—, and foreign investors are increasingly participating in emerging markets. These phenomena indicate that the region is developing new mechanisms to attract external resources, and that the growing importance of foreign direct investment means not only more funds but also technology transfers in support of the processes involved in changing production patterns.

8. In a situation of increased capital inflows, most of the economies have begun to recover in a context of greater price stability. However, their growth tends to be much slower than the trend in export volumes would suggest. One

reason for this is the deterioration of prices—which fell by an average of 11% just between 1990 and 1994—and the weakness of production linkages between the export sector and the rest of the economy.

9. The reversal of the trend in net external finance from a situation of marked constraint to one of considerable abundance has not been reflected, in general, in investment levels. Available data up to 1993 indicate that gross fixed capital formation stood at over 18% of regional gross domestic product, somewhat higher than the average of 17% in 1983-1990 but much lower than the 24% registered in the five-year period 1976-1980. The growth of the investment coefficient has been significantly slower than the increase in resources from abroad, because part of these resources had to be spent to offset the deterioration of the terms of trade, while another part was used to finance more consumption, especially of imported goods.

10. Because of their high volume, these flows have also had some undesired effects in a number of countries, especially on the exchange rate and money supply, and have increased the countries' vulnerability to external shocks. In some cases, these effects have undermined the objective of promoting the tradables sector of these economies and, as mentioned above, have diverted national saving to the consumption of imported goods.

11. In general, the economic policy adopted by the countries of the region has underlined the need to export more goods and services and to do it better. In a situation where imports are expanding faster than exports, and where there is a growing deficit on current account, the increase in export volume increasingly appears to be a macroeconomic requirement for sustaining the recovery of growth. It would also be useful to strengthen the ties between export sectors and other production sectors, because such linkages lead to intermediate demands for goods, services and labour, quality improvements and absorption of technological progress.

## 2. The international scenario

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12. The international scenario will present new challenges and opportunities for Latin America and the Caribbean in the foreseeable future. Four features of world economic trends in the 1990s stand out: i) slower growth in the industrialized economies in comparison with previous decades, and recession in the transitional economies; ii) stronger trends towards globalization and technological change; iii) realignment of the major markets, with Asia becoming more important in global economic dynamics, and with many developing countries seeking to improve their linkages with international markets; and iv) an impressive expansion of international capital mobility and the creation of mechanisms to facilitate this expansion.

13. One of today's leading trends is globalization, as can be seen from the increase in trade volume compared to global output, the boom in foreign direct investment (FDI) and the enhanced importance of transnational corporations, the much more flexible, dynamic financial system and the new international organization of production and trade characterized by the importance of subcontracting and intra-industry (and intra-firm) trade. This globalizing trend is not immune to the tensions produced by trade imbalances in the countries of the Organization for Economic Cooperation and Development (OECD), especially the high surpluses in

Japan and the deficit in the United States, the persistence of protectionist attitudes and the latent risk that agreements among groups of countries will lead to more closed economic blocs.

14. Technological change, for its part, offers many opportunities and also some risks. In growing economies, it favours the net creation of jobs in the medium term, but may act in the opposite direction in the short term. This risk is higher if global investment is relatively low. It is worth noting that the most important impact of the current technological cycle on employment is the obsolescence of certain skills and know-how. Consequently, some jobs are eliminated and others are created which require new skills that workers who are currently unemployed or those who have been displaced by technical or organizational change do not necessarily have.

15. Notwithstanding the foregoing, the recent signing of the Final Act of the Uruguay Round of GATT, together with the ratification of the North American Free Trade Agreement by Canada, the United States of America and Mexico, constitute (for different reasons) a reaffirmation of multilateralism which is consistent with the globalization process. The adoption of new rules, procedures and institutions to govern contemporary international trade is a promising –although still imperfect– point of departure for the efforts being made throughout Latin America and the Caribbean to improve the region's linkages with the global economy.

## B. POLICY GUIDELINES

### 1. Introduction

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16. To make sustainable changes in production patterns with social equity, the economies of the region must improve their linkages with the international economy, i.e., their participation in dynamic flows of trade, foreign direct investment, technology and finance. These

linkages should enhance the countries' capacity to take advantage of expansive cycles in international and regional trade and to cope with adverse cycles and financial instability by diversifying products and markets, seeking investment and alliances abroad, applying domestic stabilization mechanisms and improving the coordination of exports with other productive activities.

17. What is required in order to make a quantitative and qualitative improvement in the linkages of the Latin American and Caribbean economies with economic globalization is a simultaneous, coherent effort in a number of policy areas, within the framework of the systemic approach proposed by the ECLAC secretariat. These areas include policies on trade, exchange rates, productive development and finance and, in particular, the interaction among the policies themselves. In other words, for these policies to be effective and efficient, none of the areas can be addressed in isolation from the rest.

18. Indeed, in the absence of a suitable macroeconomic environment, the effects of micro- and meso-economic policies designed to promote the development of the production sector will be weakened. To base such efforts exclusively on trade policies, disregarding the expansion of production and the macroeconomic environment, may, at best, promote export growth, but this may not necessarily invigorate the rest of the economy. On the other hand, limiting export promotion to trade reforms and the preservation of macroeconomic equilibrium may lead to stability but not growth, and still less to the stimulation of endogenous processes of improved productivity and competitiveness.

19. There are, of course, no universally valid paradigms for improving international competitiveness; the experiences of East Asia show that, although there may be a common denominator in the general approach, different paths have been taken in terms of the details of policy implementation, instruments and institutions. With this caveat, the subject areas and proposed policy guidelines contained in this document are presented below.

## 2. Integrated trade reforms

### a) *A strategy for enhancing the region's integration with the global economy*

20. The modernization of trade policies requires more, of course, than just

reducing import restrictions: this is, at best, only a starting point. In addition, a strategy must be developed for improving the region's linkages with international markets, which would then be implemented on the basis of a series of coherent guidelines and measures that would persistently and energetically help promote the production of goods and services with export potential.

21. Tariffs, non-tariff measures and incentives to produce non-traditional exports are core components of any trade policy. Together with the exchange rate, they influence the net incentive to export or to substitute imports. The anti-export biases of this combination of incentives must be eliminated. It would even be advisable to introduce temporary biases in favour of non-traditional exports, which would be consistent with a reasonable degree of transitory protection for other activities; this would create a mix of selective policies geared towards overcoming market shortcomings and taking advantage of clear externalities.

22. One expression of the selectivity referred to above is found in the reformed tariff structures in the region in recent years. Many Latin American and Caribbean countries have drastically reduced their high tariffs and have considerably narrowed the distance between minimum and maximum levels. However, the great majority of them have retained a certain moderate differentiation, with only a few brackets, which is justified on the basis of externalities and deficiencies in factor markets (technology, finance and training) and product markets (economies of scale and dynamic externalities).

23. With regard to the production and sale of exportable goods and services, a bias persists in many cases against the value added in their production, although it is clear that this bias has been significantly reduced. The new tariffs, although they tend to be moderate, are usually above zero, and do not always

have an equivalent counterpart in incentives to compensate exporters. In such cases it thus becomes necessary to offset the specific anti-export biases generated by protection. Added to this, in general, is the failure to provide compensation to pioneer exporters for the externalities they generate, even though their activity has all the earmarks of an "infant industry".

24. The first firms to identify a new product which the country can produce efficiently and sell on international markets at competitive prices are real innovators. They become liable to the costs and risks of penetrating a new market; once they have done so, other firms benefit from the innovator's efforts. Pioneer exporters therefore deserve to receive incentives so as to be able to meet the high initial costs of penetrating markets, and should be compensated for the positive externalities they generate for the other firms that imitate them.

25. Promoting the international competitiveness of a country's products and of its non-traditional exports necessarily forms a part of the policy mix aimed at implementing a strategy to change production patterns. Experience shows, however, that incentives—both to enhance international competitiveness in domestic activities and to promote non-traditional exports—should be circumscribed, should be limited in duration, should depart no more than moderately from a point of neutrality and should do so selectively.

26. The outcome of trade liberalization and its evolution are influenced by each country's structural features, its economic situation and the mix and sequencing of policies. However, opening up an economy to imports does not, *per se*, guarantee high export and GDP growth rates. There is a clear need for complementary measures which are directly aimed at promoting exports, easing the restructuring of import substitutes and improving systemic competitiveness.

27. It is important to send out clear signals on the significance of investment and innovation in expanding and improving export capacity, and of restructuring and rationalizing the sectors that produce importables. A well-balanced management of the exchange rate, a gradual overall reduction of protection levels, effective export promotion mechanisms and a productive development policy will be crucial elements in achieving this objective.

28. Exchange rate or investment policies should not respond passively to misleading short-term signals, such as a temporary increase in exports resulting from an initial recession or from the elimination of artificial obstacles, or the failure of imports to react immediately to liberalization, also because of a recession or lack of marketing channels.

29. Reform processes in which decisions are shared with private agents are less traumatic, since they make it possible to adjust to the new conditions at the micro-economic and sectoral levels. If trade liberalization is accompanied by consistent macroeconomic policy and credibility in government action, there are better chances of working together to reduce the costs of adjustment.

b) *Exchange rate policy and trade reforms*

30. Tariff reductions should be accompanied (if not preceded) by a compensatory variation in the real exchange rate. Easing access to imports, associated with an appreciation of the currency (and the use of this policy to stabilize prices), is usually a dangerous combination for the equilibrium of the balance of payments and for productive development.

31. A *sine qua non* for the success of trade reforms, whether these involve a drastic liberalization or a gradual opening and whether they are integrated or only partial, is to avoid exchange rate appreciation. The experience of a number

of Southern Cone countries in the period 1976-1981 illustrates how harmful the dual impact of real exchange rate appreciation and drastic liberalization of imports can be. To enable the Latin American economies to produce tradables, a favourable, stable effective exchange rate must be maintained, i.e., a real exchange rate which, as a reflection of the basket of currencies used in the country's foreign trade, fluctuates on the basis of long-term factors, is relatively independent of temporary economic conditions and is not overly correlated with short-term capital movements.

32. The impact of exchange rate policy on the various sectors is heterogeneous. The greater the diversification and installed capacity of the industry, the more sensitive it will be to exchange rate policy. It has been shown that the elasticity of the manufacturing sector in relation to the level of the exchange rate and equivalent incentives is systematically higher than the elasticity of total exports, in both the long and short terms, and that this sector's velocity of response is also higher, especially in countries where industrial diversification and expansion of production capacity have historically been greater.

33. A number of empirical studies also show that a stable real exchange rate, at a remunerative level for producers of tradable goods and services, is essential to the success of a trade policy geared towards changing production patterns. Exchange rate instability tends to hurt investment, especially in non-traditional exports, since the process of launching products in international markets is usually costly, and investors will not take the risk without being fairly certain that the venture will be profitable.

34. One of the key economic policy challenges in the region, which arose in the early 1990s, is to find a way to maintain trade liberalization together with either the depreciation or stability of the exchange rate in a situation of huge net capital inflows. To do so, countries must

not only encourage domestic saving but must also regulate these inflows in order to maintain the real exchange rate at a competitive level in line with the relevant medium-term factors.

35. Most of the recent liberalization experiences in Latin America have taken place in economies whose exchange rates had previously depreciated sharply as a result of the debt crisis of the 1980s and the shortage of external finance. Under current reforms, however, the effects are being produced in a context of a strong real exchange rate appreciation in the 1990s, associated with voluminous flows of external capital, much of which is short-term. Systematic data for 17 Latin American countries indicate that 12 of them have experienced significant revaluations of their real exchange rates during this decade. It is worth repeating, however, that these revaluations occurred following considerable depreciation. With regard to capital movements, it is noteworthy that net inflows in 1992 and 1993 represented a similar proportion of GDP as in the period 1977-1981, and quadrupled the low average of 1983-1989.

36. To sum up, there are no good substitutes for exchange rate stability, especially in economies such as those of Latin America, for which a qualitative improvement in international linkages is a decisive factor in their development strategy. Hence the importance of linking trade policies with those designed to expand production and gain a better international financial position by stimulating domestic saving, fostering a comprehensive development of the country's capital market, reducing its segmentation, and adapting the level and composition of external capital inflows to the domestic capacity to absorb them.

c) *Anti-dumping regulations,  
countervailing measures and  
safeguard clauses*

37. Liberalizing their trade policies and import regimes has made Latin American

economies more vulnerable to unfair trade practices and the instability of their trading partners. It is therefore essential that the countries of the region adopt or improve anti-dumping regulations, countervailing measures and safeguard clauses, without, however, allowing private interests to use the new provisions in these areas to introduce undue regional protectionism.

38. Under the Uruguay Round, new international regimes have been adopted in each of these fields. Accordingly, the regulations which countries adopt in this area will have to be compatible with the commitments made. While it is true that the new regimes will determine the kind of mechanisms that the countries of the region can establish, they will also limit the arbitrary treatment sometimes faced by Latin American and Caribbean exports in extraregional markets.

39. The issue of fair competition is becoming increasingly relevant in the context of current regional integration agreements leading to total liberalization of the corresponding markets. It is particularly important that the safeguard mechanisms adopted in Latin America and the Caribbean to avoid exceptional short-term problems should not interfere with the long-term benefits that can be expected from intraregional integration programmes (see ECLAC, 1994a).

40. The adoption of the new regulations emanating from the Uruguay Round could limit the possibilities of implementing an active trade policy in the region, particularly for the promotion of non-traditional exports. However, those regulations do make certain exceptions for the developing countries, and the countries of Latin America and the Caribbean should take advantage of them to promote their exports, while taking care to avoid infringing upon multilaterally-established rules.

41. In this connection, the countries of the region should evaluate carefully the new opportunities for market access

afforded by the results of the Uruguay Round, examine the possibilities and restrictions created by the new multilateral regime and rethink many of the issues related to the latitude they enjoy for formulating policies on trade and productive development. For example, such policies must consider their new linkages with the environment and social rights.

42. These observations hold true not only for the action to be taken immediately following the conclusion of the Uruguay Round, but also for future international negotiations, particularly those on free trade agreements with developed nations. They also hold true for making better use of generalized systems of trade preferences, especially in cases such as that of the European Union, which in 1994 will define its new system of preferences for the developing countries.

*d) Export-promotion policies*

43. The countries of the region should have active export-promotion policies. As mentioned above, the main reasons for implementing such measures are the need to offset the anti-export bias inherent in tariffs, alluded to in earlier paragraphs; the positive externalities generated by export activity; the shortcomings in capital markets for financing exports; and the economies of scale and learning opportunities that exporting provides. Without an active export-promotion policy, exports will tend to be concentrated in products for which demand is less dynamic and more vulnerable in global markets.

44. One basic prerequisite for promoting the competitiveness of export firms is to guarantee them access to inputs on competitive terms. These firms should have access to flexible mechanisms for importing inputs on a temporary basis to produce exportables, once certain basic requirements have been met. Other alternatives are tariff exemptions or

drawbacks, with a minimum of red tape. Such mechanisms could also be applied to indirect exporters (domestic producers of inputs for exporters).

45. The governments of the region could support pioneer export firms by providing incentives for exports of new products or for penetrating new markets. One mechanism is a "simplified drawback" for products whose export level is below a given amount for a specific period. These incentives should be moderate (helping to place competitive or near-competitive products in foreign markets), limited in time, and subject to precise results in terms of new products, amounts or markets.

46. The public sector can help improve performance in foreign markets by providing institutional support for export activity, especially in the areas of information, financing and export insurance; management training to encourage businesses to focus on exporting; and promotion of the exportable supply abroad. Pioneering efforts are also being made in such areas as investing abroad to support export activities, marketing chains, joint ventures with firms in target markets and other mechanisms that export-promotion policies are beginning to consider.

47. The development of the exportable supply within the country should also be actively supported, in order to adapt it to the demands of foreign markets. Timely, up-to-date information on the requirements of export markets in terms of quality, environmental regulations, standardization, deadlines and volumes would facilitate this task. It would also be useful to promote ties between domestic firms and international trading companies, particularly in sectors in which the country has export potential. Besides laying the bases for strategic export alliances between domestic and foreign firms, these ties also stimulate steady quality improvement and the development of new products, making domestic firms more flexible in

responding to new commercial opportunities.

48. Past export-promotion policies often neglected sectors based on natural resources. Recent technological advances in microelectronics, data processing, telecommunications and satellite technologies considerably augment the supply of information on the quality and volume of economically available natural resources. This is one more reason for acquiring and strengthening comparative advantages in non-traditional natural resources with significant economic rents.

49. To be effective, an export-promotion system must be somewhat selective. It is impossible to promote everything indiscriminately. The selection of sectors, and export-promotion decisions in general, should be made in close, systematic cooperation between the public and private sectors. To this end, exporters' and producers' trade associations should also be strengthened.

50. Many countries have recognized the advantages of consolidating into one institution the various agencies that support non-traditional exports. These agencies should be financially stable and have qualified professional staff, so that they can have more influence on policy decisions affecting exports.

### 3. Meso- and micro-economic policies for expanding production

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51. One of the main concerns of the ECLAC secretariat throughout the past decade has been to enhance international competitiveness by applying technical progress to the production process. The secretariat has emphasized repeatedly the systemic nature of the effort required to close the present gap between the "best international practices" and the average total productivity of factors in the countries of the region.

52. It has also insisted that becoming internationally competitive, either in

exports or in efficient import substitution, requires not only suitable macroeconomic and trade policies, but also micro- and meso-economic policies; in other words, the enterprise itself must be modernized (technology, equipment, organization, labour relations), as must its environment (factor markets and infrastructure). The pace of restructuring, and in some cases the very survival of the firm, will depend essentially on the information and human and financial resources at its disposal.

53. The more distorted the factor markets and the greater the uncertainty about the seriousness of the adjustment and liberalization process and the stability of the prevailing key prices, the greater the likelihood that potentially competitive firms will fail, for lack of time and resources, to undertake the restructuring needed to acquire a comparative advantage in the domestic or foreign market.

54. This is why it is important that key markets –those for technology, physical capital, human capital and foreign exchange– should function at near-optimum levels. Horizontal policies are needed to achieve this, namely policies designed to fill in the main gaps and resolve the main bottlenecks in those markets. The difference between today's policies for expanding production and the "industrial" policies of the past is, precisely, the importance they attach to improving factor markets, with a view to narrowing or eliminating the gap between the average productivity of the region and that obtained using the best international practices.

55. Latecomers to development like the countries of the region have tremendous latent potential for increasing their productivity. Narrowing the gaps mentioned in the preceding paragraph –in other words, modernizing– demands an active learning and restructuring process in the areas of technology and organization, as well as in quality-control systems and selling on new markets. All of

this entails a major investment in time and capital, both physical and human, especially by firms that are lagging technologically. The essence of a modern policy for expanding production is that it facilitates this learning process, as experiences in other parts of the world and even some in the region show (motor vehicles and parts, wood, paper and pulp, for example).

56. Policies for expanding production are designed to reinforce, rather than replace, market forces. Any incentives should also be temporary. An orientation towards international competition promotes a business attitude centred more on productivity than on short-term profitability, seeks levels of output that result in economies of scale (either because there is a large domestic market, because the original orientation was towards exports or because the activity involves the continuous processing of a natural resource that can easily be exported if domestic demand is insufficient) and tends to adopt relatively advanced but tried and tested technologies (technology is mastered, updated and even adapted, as necessary).

57. Building on the ideas put forward in *Social Equity and Changing Production Patterns: An Integrated Approach* (ECLAC, 1992a), three sets of measures can be proposed, given their special relevance to policies for expanding production in support of international competitiveness. The first set of measures covers technological development policies; the second, manpower training; the third, improvements in long-term capital markets. A practical programme is also suggested for putting the region's entrepreneurs in touch with the best international production practices.

58. The following policy options are proposed for *technological innovation and dissemination*:

- i) Implement domestic competition policies that go beyond mere trade liberalization.

- ii) Partially subsidize firms' technological innovation and development activities, whether these are carried out by them directly or in conjunction with research centres, taking into account the positive externalities generated by these activities.
- iii) Develop and strengthen systematic monitoring of the technologies and management methods available internationally, and integrate firms into the relevant information networks, bearing in mind that each firm should be able to make the most informed choice possible as to the technology it decides to apply.
- iv) Ensure better financing for technological development efforts, paying particular attention to the needs of small and medium-sized firms. Such efforts include the development of prototypes and pilot plants to facilitate the transition from research to application. The sums needed may be relatively small, the main idea being to demonstrate to private banks that this kind of investment can be profitable and to serve as a tool for learning how to evaluate technological risk.
- v) Acquaint businessmen and economic agents in general with the most promising experiences in developing and disseminating technology—technology centres for each branch of industry, think-tanks, industrial parks, links between universities and business and alternative financing mechanisms— in order to increase the impact of these experiences.
- vi) Promote strategic alliances between domestic and international firms that are leaders in technology, management, quality and access to the most important markets, by simplifying administrative procedures, improving information and providing tax incentives.

59. With respect to training, which is sorely lacking in the region despite the demonstrably high returns on investment in human capital, and also despite the fact

that manpower capacity is a key to productivity, the following measures are proposed:

- i) Provide tax and monetary incentives to firms that train their staff, to offset the negative externality that such training creates (training tends to benefit the worker far more than the firm that trains him).
- ii) Undertake promotional and publicity measures to accelerate the use of training incentives and to introduce more efficient human resources management practices and more cooperative industrial relations.
- iii) Reorganize the supply of training, promoting private sources and concentrating public efforts on bringing instruction, and instructors, closer into line with the production system and its future needs; ensure the quality and relevance of the courses offered, establishing mechanisms for certifying the training given; and promote and finance training opportunities for marginal or unemployed workers or those employed by small firms, who are not usually reached by such programmes.
- iv) Promote special basic training programmes for the large segment of the labour force (40%) that have not completed their primary education, and subsidize regular training programmes to help raise the productive potential of this huge group of workers who will be unable to benefit from any educational reforms that are implemented.

60. The lack of a long-term *capital market* means that the extent to which most firms in the region are equipped, modernized and expanded, depends on their ability to finance themselves, not on their future prospects, and this leads to inefficient allocation of capital. This problem is aggravated during periods of restructuring: the fact that a firm has abundant capital (which may be a reflection of its past success) does not always mean that it has a potential for

success in the future, yet firms that have such capital tend to invest it in their own activity. They may even overinvest in obsolete activities, to the detriment of other activities with better chances of being modernized and restructured.

61. Lastly, one specific proposal for narrowing the gap between the productivity of many of the region's firms—except for those on the leading edge of their respective branches—and that of the developed countries is to implement massive *extension programmes*, which would co-finance visits to foreign factories where the "best international practices" are to be found.

62. The proposal involves organizing and helping finance visits by managers, engineers, technicians, supervisors, workers and trade unionists, from various production subsectors, to foreign plants where the best practices prevail. These visits would last for a specific period of time, for instance, six weeks. On their return, participants would write a report on the best practices with respect to equipment and technologies, production methods, organization of work, industrial relations, quality control, marketing and other aspects. Each of them would disseminate the results of their visits among other firms and the respective business associations and trade unions. The programme would be open to any sector willing to pay its share, whether it was involved in exporting or in import substitution.

#### 4. Capital movements and macroeconomic policy

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##### a) *Economic policy and access to international financial markets*

63. In the context of the policies under which trade liberalization was implemented, most governments also applied policies to reduce or eliminate restrictions on international capital movements. This initiative, combined with greater macroeconomic stability,

investment opportunities and, particularly, the differential between interest rates in the countries of the region and those in international financial markets, helped to strengthen the trend in these markets towards the resurgence of a significant flow of private external funds. The combined effect of these changes in the international arena and in the region's economies has led to the re-emergence of net capital inflows in the past three years.

64. International capital mobility plays a number of highly significant roles in development. Two of these are notable for their macroeconomic effects: i) the channelling of external savings towards countries with insufficient capital; and ii) the compensatory financing of external shocks, which helps to stabilize domestic spending. In Latin America and the Caribbean, external capital has played a positive role in both of these areas in the 1990s, even though only a small fraction of net inflows have translated into an increase in productive investment.

65. It is clear, then, that the capacity to attract external financial flows does not, in itself, ensure that savings and investment processes will automatically be strengthened. This is because domestic and external financial markets have serious imperfections, which limit their ability to allocate resources efficiently, especially to investment in tradable sectors. In this context, a coherent, sustained economic policy can play a vital role in achieving more dynamic and stable development.

66. Moreover, the soundness of economic policy cannot be evaluated solely on the basis of access to external flows, especially during cycles when international funds are in abundant supply. Above all, it is important to consider the capacity of national authorities to maintain macroeconomic stability and the incentives for economic agents to take decisions based on sustainable medium- and long-term goals. Intervention to manage the effects of

capital flows is justified in so far as the latter simultaneously affect two key variables for efficient resource allocation: the real exchange rate in the foreign exchange market, and the real interest rate in the money market.

67. In this regard, it should be recalled that Latin American history has been marked by periods of large-scale capital inflows, followed on a number of occasions by periods of debt crisis. This has sparked a wide-ranging debate on the dynamics of the process of opening up the capital account. Today, it is generally agreed that this process should be implemented sequentially, and that it should occur after other liberalization processes, particularly those affecting trade and the domestic financial market, have been consolidated.

68. With respect to the speed at which the capital account should be liberalized, in order to maintain macroeconomic balances and a stable real exchange rate, the process must be tailored to the economy's capacity to absorb and efficiently allocate external resources. It may be desirable to liberalize the entry of long-term capital first, before facilitating transactions involving short-term financial capital. With respect to capital outflows, priority should be given to trade credits for export promotion, and to direct investment abroad by national firms, which is another way of improving their export platform.

69. Capital-account liberalization in the industrialized countries has been fairly slow and gradual, accelerating only in the past 10 years as capital markets have become globalized. However, it is interesting to note that Spain, Portugal and Ireland introduced certain restrictions on capital movements in 1992 to deter exchange rate instability. Once the objectives of stability were achieved, the restrictions were lifted. This highlights the importance of flexible instruments that, according to circumstances, allow some temporary restrictions to be imposed on capital movements to support efforts towards macroeconomic stability.

70. The economic recovery taking place in a number of countries in the region, based on the removal of external restrictions, is obviously limited by available productive capacity. Some countries have been gradually approaching their production frontier. On the one hand, this creates a need to regulate patterns of aggregate demand so as to avoid renewed bouts of inflation or excessive deficits in the external sector. On the other, it heightens the urgency of boosting investment to sustain GDP growth with increases in productive capacity and in the production of tradables. As the debt crisis is resolved, this is the area on which the macroeconomic policies of the countries of the region will have to focus.

71. Promoting a strategy of changing production patterns with social equity also requires, at the strictly macroeconomic level, efforts to manage aggregate demand and its composition. The instruments available for this purpose are fiscal, monetary and exchange rate policies. In the absence of an active fiscal policy, these instruments are reduced to simultaneously controlling the real interest rate (as a monetary policy instrument to stabilize and control aggregate domestic expenditure) and the real exchange rate (as a trade policy instrument to promote the growth of tradables production and influence the composition of aggregate expenditure).

72. A conflict arises when an interest rate consistent with the objective of curbing inflation and stabilizing economic activity (by sterilizing the monetary effects of accumulating reserves) is higher than the international rate, adjusted for expectations of devaluation, thereby providing an incentive for capital inflows and promoting exchange rate appreciation, which jeopardizes the objective of protecting the economy's tradable sector. Conversely, if real domestic interest rates are allowed to fall, both objectives are thwarted, since the higher expenditure induced by lower interest rates will put pressure on prices and rapidly boost the

current account deficit, threatening to cause an unsustainable macroeconomic imbalance. The authorities can resolve this conflict by acting directly or indirectly on capital flows, as some Latin American and Caribbean countries have been doing in the 1990s.

73. One of the main questions faced by the region's governments in designing economic policy concerns the possibility of distinguishing, on the one hand, between domestic and external factors that explain the resurgence of capital movements in the region and, on the other, between short-term capital flows (which tend to be more speculative) and medium- and long-term flows (more closely associated with productive investment). From this viewpoint, it would be desirable for external financing to contribute to the investment process needed to strengthen productive competitiveness, meaning that the entry of long-term capital should be stimulated and that of speculative capital should be discouraged.

74. When the authorities are faced with an unexpected abundance of external financing which they consider to be partly transitory or as flowing too fast for the economy to absorb, they can intervene at three levels. At the first level, they can act to moderate this inflow's impact on the exchange rate through the purchase of foreign exchange (i.e., the accumulation of reserves) by the central bank. At the second level, they can adopt sterilization policies to mitigate the monetary impact of the accumulation of reserves at the first level of intervention. At the third level, they can adopt policies on incentives, surcharges or quantitative controls to regulate inflows of capital, thereby influencing the latter's composition and volume, the aim being to encourage flows whose volume is compatible with the economy's domestic absorptive capacity, channelling them into productive investment projects, and, conversely, to discourage the entry of short-term speculative capital. These measures are more effective when they are coupled with

strict prudential supervision of the financial system.

75. In sum, governments have two options. Some have adopted so-called non-sterilized intervention, meaning that they intervene at the first level by having the central bank buy foreign exchange, without sterilizing the resulting monetary effect. If the authorities choose this option while also liberalizing capital movements and maintaining a nominal exchange rate with a predetermined rate of variation, they may tend to lose control over monetary aggregates. The other option is the so-called sterilized intervention, which broadens the scope of the first option by offsetting the monetary impact of the accumulation of reserves with active operations to regulate the money supply. This is intended to keep the real exchange rate within desirable limits according to medium- and long-term objectives.

76. The sterilization option entails certain costs, since the interest rates which the central bank must pay on its notes are higher than those it obtains on its placements in foreign currency. These costs are not necessarily permanent if the central bank maintains a real exchange rate, pegged to a currency basket reflecting the composition of the country's external trade, that is sustainable in the medium term. The bank can facilitate its task, and reduce its costs or even turn them into profits, by adopting a policy of "dirty" floating within an exchange rate band: it can earn profits by buying and selling foreign exchange, thereby offsetting losses attributable to the interest rate differential.

77. Since most countries in the region have at some point opted for sterilized intervention, they have faced serious conflicts between exchange rate and monetary management. To moderate such conflicts, they have used complementary measures, such as providing for a degree of flexibility in fiscal policy to regulate aggregate demand; stabilization funds for the main export products to soften shocks in their price cycles (as in the case of

Chilean copper and Colombian coffee); and income policies to adapt the relative prices of factors to changes in productivity.

78. As mentioned earlier, when fiscal policy has no instruments through which it can act flexibly, monetary policy (interest rates) and exchange rate policy (exchange rates) are the only means of controlling aggregate demand. To resolve the conflict that may arise in the simultaneous management of these two variables, the authorities have the option of intervening at the third level with measures intended to change the volume and composition of capital flows, giving priority to long-term flows through incentives (reserve requirements or taxes, and exchange rate measures that generate more uncertainty for short-term capital flows) or even via quantitative controls.

79. Direct quantitative controls include requirements as to minimum maturity periods, minimum volumes for bond issues, ceilings on external borrowing by financial institutions, and regulations on the participation of foreign capital in the stock market.

80. In the current circumstances of abundant external funds and comparatively low international interest rates, third-level intervention policies and sterilization measures act on monetary aggregates to prevent excess expenditure (especially private spending), forestalling artificial, temporary increases in domestic spending which could cause severe declines in national savings and excessive increases in external liabilities, without a corresponding increase in the capacity to produce tradables.

*b) Improvement of domestic financial markets*

81. The extent to which flows of foreign capital can further a strategy of changing production patterns with social equity largely depends on the characteristics of domestic financial markets. This

observation is based on the experience of the external debt crisis, which resulted from large-scale inflows of bank credit. On that occasion, capital markets were unable to avoid generating "financial bubbles", adverse selection and moral hazards, features inherent in financial markets.

82. The challenges involved in the prudential regulation and supervision of domestic financial markets become apparent when consideration is given to the speed with which external funds can flow into those markets. Unless financial institutions and instruments –including public regulatory and supervisory institutions themselves– are actively developed, the intermediation of these funds by fast-growing financial systems could cause distortions and macroeconomic instability by channelling them into high-risk credits ("credit bubbles"), sharp increases in the prices of existing shares ("stock market bubbles") and steeply rising prices for real estate and other assets.

83. As suggested in the comments on policies for productive development, the reorganization of financial systems, including the liberalization of capital movements, should give priority to channelling resources into savings and investment, in close coordination with the development of productive capacity. This role has not been sufficiently emphasized in the region's financial reforms. The relationship between the financial system and national savings and investment processes, and between that system and external financial markets, must be considered more carefully.

84. As regards the relationship between financial markets and capital formation for development, an institutional framework is needed to complete or perfect markets according to three criteria. First, it must include a dynamic long-term segment of the financial market in order to finance productive projects. This involves discouraging speculative segments and concentrating on long-term international

capital accompanied by access to technology and to export markets. The impact of capital entering the region through foreign direct investment is important in this context.

85. Second, it must promote access to financing for small and medium-sized firms hurt by the segmentation of the capital market. To that end, this market must operate with some selective criteria that target the training, development promotion and modernization needs of small production enterprises. Credit institutions and guarantee mechanisms are needed to do what the region's capital markets have failed to do spontaneously. The aim is not to subsidize the cost of credit, but to promote access to financing at normal interest rates, as well as the access to technology, inputs and services, marketing channels, long-term financing and infrastructure that will enhance the productive capacity of these sectors.

86. Third, it must recognize that, in countries with "emerging" stock markets, financial liberalization of the capital account by opening it to international portfolio investment runs the risk of creating external over-indebtedness and excessive stock market and exchange rate fluctuations. Large-scale inflows of foreign capital to domestic markets can trigger both "stock market bubbles" and exchange rate appreciations at the same time. The subsequent decline in stock market levels can, in turn, cause capital outflows and upward

pressure on the exchange rate. This means that financial institutions operating in capital markets must be regulated and supervised to ensure their stability.

87. Prudential financial regulation can counter these risks and contribute to an orderly, stable process of attracting portfolio investments from abroad. To that end, as noted earlier, financial regulations can act on two key financial variables –interest rates and exchange rates– by establishing bands for these values, or certain rules governing their behaviour. These variables can also be influenced indirectly by means of regulations affecting the availability or cost of funds, including certain restrictions on access, reserve requirements and taxes. The norms governing a country's capital inflows and outflows, whether of foreign or national funds, are part of these regulations. In order to design such norms, the relevant institutions need to have statistical information on external flows (types of flows, volumes, costs and sources) and on the accumulation of stocks of external liabilities in the national financial market.

88. Prudential regulation focuses mainly on ensuring the solvency of the banks, financial funds, insurance companies and other agents that manage resources or assume third-party risks on a large scale. Since the performance of these functions relies on public confidence, the solvency or stability of financial institutions entails significant macroeconomic externalities.

**Part One**

**TRADE POLICY**

## Chapter I

# TRENDS IN THE INTERNATIONAL ECONOMY

### 1. General considerations

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The international economy has undergone sweeping changes in recent times in such fundamental areas as production, marketing, transport, transfer of technology and international capital movements (Ohmae, 1985; Porter, 1990; United Nations, 1991; and UNCTAD, 1993a). Attention has also been drawn to the challenges posed by the intensely competitive international economy for the countries of Latin America and the Caribbean, and the new opportunities that have opened up (ECLAC, 1990a and ECLAC, 1992a). This chapter discusses some of the more important trends as background for the rest of the volume.

First of all, the international economy as a whole, and the main industrialized economies, have registered very modest growth rates in the last three years. At the time the present document was drafted, the United States economy was finally recovering, but growth rates of only around 3% were predicted for the next few years. Moreover, the difficulties of German reunification were preventing Europe

from expanding as rapidly as had been expected, and the Japanese economy was experiencing a recession without precedent in the post-war era.<sup>1</sup> The economic reforms in Eastern Europe and in the former Soviet Union, originally expected to provide an important new market for the exports of Western countries, now constitute one of the factors explaining the slow evolution of the world economy (see table I.1).

The only area which has avoided these problems is a part of Asia. For more than a quarter century, the economies of East Asia have been growing at a rate well above the world average. Using highly pragmatic economic policies and a strategy based on investment in human capital, close and harmonious relations between business and the public sector, and competitiveness via exports, these nations have come to be ranked among the world's most dynamic economies. Japan, in particular, despite its current difficulties, presents the United States and Europe with challenges that would have been unimaginable a few decades ago. But this is not only a Japanese phenomenon. Four newly industrializing

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1 Markets for the exports of developing countries are still mainly in the industrial world, in spite of the recent increase in trade among the developing countries and the exceptional boom in intra-Latin American trade. In 1992, for example, 59% of the exports of the developing countries went to the United States, Japan, the European Community and eight other industrialized nations. The growth rates in these countries are therefore of great importance because they determine most of the demand for regional exports, the terms of trade and the extent of protectionism.

Table I.1  
**GROWTH ESTIMATES AND PROJECTIONS FOR THE WORLD ECONOMY, 1993 AND 1994**  
*(Annual growth rates, per estimates from different sources)*

	1993			1994		
	United Nations <sup>a</sup>	IMF <sup>b</sup>	OECD <sup>c</sup>	United Nations <sup>a</sup>	IMF <sup>b</sup>	OECD <sup>c</sup>
<b>Output</b>						
World output	1.2	2.3		2.2	3.1	
Industrialized countries	1.1	1.3	1.2	2.6	2.7	2.6
United States	3.1	3.1	3.0	3.8	3.7	4.0
Japan	0.1	0.1	0.1	0.6	0.9	0.8
Germany	-1.2	-1.1	-1.3	2.4	2.3	1.8
European Union	-0.4	-0.3	-0.2	2.4	2.1	1.9
Developing countries	5.1	6.1		4.8	5.6	
Africa	0.7	1.0		2.6	3.3	
Latin America	3.1	3.4		3.3	2.8	
Asia	5.4 <sup>d</sup>	8.5		6.4 <sup>d</sup>	8.0	
Economies in transition	-8.6	-9.0		-10.3	-8.3	
<b>World Trade</b> (volume)	3.9	4.0	3.3	7.1	7.2	6.7

<sup>a</sup> United Nations, "The world economy at the start of 1995", Department of Economic and Social Information and Policy Analysis (DESIPA), New York, 20 December 1994, and *World Economic and Social Survey, 1994* (E/1994/65; ST/ESA/240), New York, 1994. United Nations publication, Sales No. E.94.II.C.1. The aggregate figures for groups of countries have been calculated using market exchange rates. <sup>b</sup> IMF, *World Economic Outlook*, Washington, D.C., October 1994. The aggregate figures for groups of countries have been calculated using exchange rates based on purchasing power parity. <sup>c</sup> OECD, *Economic Outlook*, Paris, June 1994. <sup>d</sup> Does not include China, which grew at rates of 13.4% in 1993 and 11.5% in 1994.

economies (the Republic of Korea, the Chinese Province of Taiwan, Hong Kong and Singapore) have demonstrated great skill in production and trade, and this group has now been joined by China and the countries of South-East Asia (see table I.2). Together, these countries form the region where the greatest dynamism is expected during the rest of the decade.

All of the foregoing is occurring in an environment of increased globalization marked by a rise in the volume of trade *vis-à-vis* world production and great dynamism in foreign direct investment (FDI). It is characterized, likewise, by a growing role for transnational corporations in world production and trade, a much more flexible financial system and a new international organization of production and marketing characterized by an emphasis on

subcontracting and an increase in the magnitude of intra-industry (and intra-firm) trade. At the same time, the intense debate which arose in the last months of 1993 concerning the signing of the Final Act of the Uruguay Round and the ratification by the United States Congress of the North American Free Trade Agreement (NAFTA), as well as the resistance to the deepening of the European Union, show that protectionist pressures and the risks of managed trade remain latent. The external imbalances in the OECD countries, especially the large surpluses in Japan and deficits in the United States, compound those risks.

The effects of technological advances are also ambiguous. Technological change, introduced into dynamic economies, obviously helps to create jobs in the medium term. In the shorter term, it

Table I.2  
ECONOMIC INDICATORS IN ASIA

	GDP (% annual growth)			Domestic savings/ GDP (%)		Gross domestic investment/ GDP (%)		Exports	
	1970- 1980	1980- 1990	1990- 1993	1981- 1990	1991- 1993	1981- 1990	1991- 1993	Billions of dollars	Current annual growth (%)
								1992	1987- 1993
Hong Kong	9.3	7.2	5.0	31.0	30.8	28.2	29.0	119.5	22.6
Republic of Korea	9.0	8.8	6.0	32.0	35.6	30.5	36.4	75.2	11.7
Singapore	7.9	6.3	7.5	42.6	47.1	42.2	40.3	61.6	21.9
Chinese Province of Taiwán	9.3	8.5	6.7	32.9	27.2	22.6	24.0	80.7	9.7
China	7.9	10.4	11.5	34.4	36.6	32.1	35.4	69.6	16.2
Indonesia	7.7	5.5	6.6	31.8	36.9	30.4	34.9	32.5	15.8
Malaysia	7.8	5.2	8.2	33.0	35.0	30.7	34.8	39.6	21.3
Thailand	7.9	7.9	7.8	27.2	35.7	30.6	41.9	32.1	25.6
Pakistan	5.2	6.2	5.4	7.5	14.5	18.7	19.8	6.9	13.6
India	3.7	5.8	3.0	21.4	23.6	22.8	24.7	18.6	13.5

Source: Asian Development Bank, *Asian Development Outlook, 1994*, Oxford, Oxford University Press.

may produce the opposite results. Perhaps the most striking impact of the current technological cycle on employment is that it makes certain skills and know-how obsolete. Accordingly, some jobs disappear while others are created which require skills that differ from those of the currently unemployed or those displaced by technical or organizational change. A scenario of lower growth in the industrialized economies tends to make the short-term negative effects prevail over the longer-term dynamic potential.

The current state of the world economy is characterized by a profound process of transformation. It is plausible that, in the coming years, global economic growth and trade dynamism will be slower than those of the preceding decades. Nevertheless, beyond the aggregate figures, it is clear that better results are obtained by those sectors and activities which accept the technological challenge

of globalization and competitiveness. This is reflected in the Asian dynamism and in the high growth of international trade in services and foreign investment.

Finally, competitiveness based on promoting and disseminating technical change and improving labour skills, with a view to coping with the globalization of the world economy, is the main challenge on the international scene. Accordingly, there is an urgent need for Latin America and the Caribbean to confront the challenges of increasing quality and productivity in order to participate effectively in the dynamic flows and zones of international trade.

## 2. Trends in international trade

Despite the sluggishness of world production and growing concern about the international trade system, in recent years the volume of trade has increased

Table I.3  
INTERNATIONAL TRADE GROWTH  
(Annual average %)

	Total world	Developed countries	United States	Japan	EEC	Developing countries	Latin America	Middle East	Asia	Africa	Economies in transition
<b>1960-1970</b>											
Real GDP	5.2	5.1	4.4	10.3	4.7	5.8	5.5	6.2	5.1	5.4	6.7
Export volume	7.4	8.4	6.6	16.0	8.8	7.9	3.1	9.5	6.5	11.4	...
Export value	9.3	10.1	7.8	16.9	10.4	7.4	5.7	9.3	6.7	9.0	...
Import volume	8.6	9.5	9.3	14.4	8.9	5.3	4.9	6.3	6.0	4.2	...
Import value	9.2	10.3	10.2	15.4	10.1	6.7	6.3	7.4	6.9	5.3	...
<b>1970-1980</b>											
Real GDP	3.7	3.1	2.8	4.4	2.9	5.5	5.4	6.4	6.1	6.2	5.2
Export volume	5.1	6.4	6.2	9.7	5.0	0.4	0.4	-1.3	8.3	-2.7	6.1
Export value	20.3	18.8	18.2	20.8	19.3	25.9	20.8	34.3	25.8	21.7	14.9
Import volume	5.4	4.9	4.7	5.0	5.5	7.8	5.1	16.3	7.6	7.8	8.3
Import value	20.2	19.5	21.2	22.0	19.8	23.8	20.6	33.6	23.5	22.2	13.6
<b>1980-1985</b>											
Real GDP	2.0	2.4	2.9	3.9	1.5	1.9	1.3	0.5	5.3	1.0	2.1
Export volume	2.5	3.4	-0.2	7.4	1.7	-1.4	3.7	-12.3	7.4	-4.8	5.1
Export value	-0.6	0.5	-0.2	6.2	-1.1	-4.4	-0.8	-14.3	2.5	-8.3	0.5
Import volume	2.7	3.2	6.8	1.7	1.8	0.2	-5.8	0.6	4.9	-2.5	3.1
Import value	-0.4	-1.4	7.1	-1.6	-3.0	-2.6	-8.0	-2.0	2.5	-6.3	-1.3
<b>1985-1990</b>											
Real GDP	3.3	3.2	3.0	4.6	3.1	3.4	1.9	1.3	6.9	2.4	0.8
Export volume	6.4	5.3	8.2	2.9	9.9	8.2	3.0	7.9	12.7	2.4	-1.6
Export value	12.1	14.0	12.5	10.3	15.9	11.5	4.5	7.3	18.6	3.1	1.0
Import volume	7.1	6.5	3.7	9.9	7.6	6.4	2.1	-3.5	13.5	0.0	0.6
Import value	12.0	14.6	7.4	12.6	16.1	13.4	7.5	2.9	19.0	5.3	3.5
<b>1990-1993</b>											
Real GDP	1.1	1.1	1.4	1.8	0.5	4.5	2.7	2.6	5.3	1.3	-10.9
Export volume	4.3	3.1	6.7	0.9	1.5	8.5	5.8	7.3	13.7	4.1	-15.1 <sup>a</sup>
Export value	2.1	0.9	5.2	8.0	-1.1	6.9	1.6	-1.4	12.7	-2.9	-14.4 <sup>a</sup>
Import volume	4.4	2.8	7.8	2.0	0.8	12.1	16.6	11.4	12.3	3.4	-13.7 <sup>a</sup>
Import value	2.3	-0.3	5.1	0.9	-2.6	11.6	15.2	10.2	12.1	1.5	-9.4 <sup>a</sup>

Source: UNCTAD, *Handbook of International Trade and Development Statistics, 1988* (TD/STAT.16), New York, 1989. United Nations publication, Sales No. E/F.88.II.D.11, and *Handbook of International Trade and Development Statistics, 1991* (TD/STAT.19), New York, 1992. United Nations publication, Sales No. E/F.92.II.D.6, and *Trade and Development Report, 1994* (UNCTAD/TDR/14), New York, 1994. United Nations publication, Sales No. E.94.II.D.26; United Nations, *World Economic Survey, 1993* (E/1993/60); ST/ESA/237), New York, United Nations publication, Sales No. E.93.II.C.1; *World Economic and Social Survey, 1994* (E/1994/65; ST/ESA/240), New York, United Nations publication, Sales No. E.94.II.C.1., and *Monthly Bulletin of Statistics*, various issues, New York.

<sup>a</sup> Refers to 1990-1992 only.

only slightly less rapidly than during the two preceding decades. As shown in table I.3, trade volume grew at an average rate of 4.3% between 1990 and 1993 compared to an average of 4.9% between 1970 and 1990. Only in the 1960s was the figure strikingly higher (8%).

Although world trade volume has grown at a fairly constant rate, its value has fluctuated considerably. Table I.3 shows that trade value grew by around 9% annually in the 1960s, more than doubled this rate to 20% in the 1970s, but fell 0.5% in the first half of the 1980s.<sup>2</sup> Beginning in

2 These sharp swings are associated with changes in the exchange rate for the United States dollar (the unit of account used for these calculations) and with fluctuations in the rate of inflation registered in developed countries.

1986, the fluctuations continued, with average growth of 12% between 1985 and 1990, but with a drop to 2.2% between 1990 and 1993.

In the 1970s the developing countries performed better than the nations of the Group of Seven as regards the value of exports; this trend slowed during the 1980s, but it revived in the last few years (see table I.3). Nevertheless, if the data on developing countries are disaggregated, it is apparent that their strong performance depended heavily on the Asian newly industrializing economies (NIEs) and on China. Since 1980, exports from the other developing regions (for example, Latin America and Africa) have grown reasonably in terms of volume, but slowly in terms of value. The economies in transition (Eastern Europe and the republics of the former Soviet Union) suffered a spectacular downturn in the volume and value of their trade in 1991 and 1992, and their GDP has continued to fall, especially in the former Soviet Union.

The results of these variations in growth rates may be noted in the differences in regional shares of the value of world trade (see table I.4). The developed countries raised their share from 66% in 1960 to 72% in 1992, whereas the developing countries raised theirs from 22% to 24%. This latter figure is explained partly by the drop in the share of Eastern Europe and the former Soviet Union, but mainly by the good performance of Asia, whereas the Latin American share fell from 8% to 4%, and the African share from 4% to 2%.

Naturally, the difference between the growth of trade volume and that of trade value is due to the behaviour of prices. The 1970s were an exceptional period, in that the price rises increased the value of trade

enormously. Except in that decade, prices generally have had a negative effect on export value for developing countries. In the 1990s, the impact has been particularly negative, since average prices have fallen more than in any other period covered by the present study.<sup>3</sup>

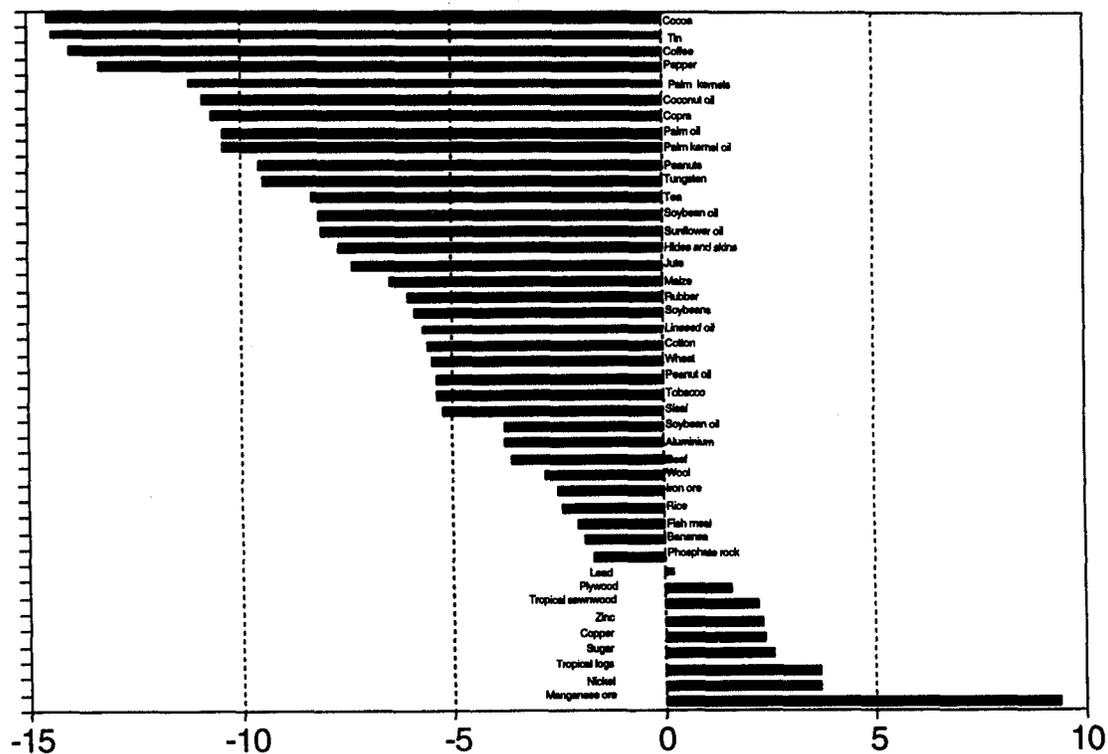
Commodities are particularly vulnerable as regards both trends and volatility of prices. Figure I.1, which covers the period 1983-1992, suggests that there has been considerable divergence among commodity prices: they range from an annual average decline of 15% for cocoa to an increase of 9% for manganese (in constant United States dollars). Nevertheless, the decline in prices far outweighs the increases. Consequently, the efforts to raise the volume of exports have been offset by the behaviour of prices.

The situation of prices for mineral products was largely negative in the past decade. As indicated in figure I.1, most mineral prices tended to fall as demand for these products was weakened by technological changes that led to the use of smaller quantities of raw materials per unit of production. Consequently, minerals and metals significantly reduced their share in world exports. However, in absolute terms, the sector continues to attract new investments and new mines are opening up; thus, countries with high-grade ore deposits and low production costs may benefit from this situation (see box I.1. for further details).

The experience of the agricultural and forestry sectors has been more diverse than that of the mining sector. In the former, the largest trade volume has traditionally been in cereals, which saw a general decline in their growth rate during the 1980s. This trend coincided with

3 A weighted price index developed by the World Bank, which has a 1979-1981 base period and includes 33 commodities, excluding petroleum, showed that 1986-1990 was the worst period in terms of the prices of these products in the post-war period. The data for 1991-1993 indicate an additional downturn of 14% in that price index; 1993 was the worst year, following which a recovery in prices is expected by the year 2000. In that year, according to the projection, the index should show a recovery of 12% with respect to the present level, and thus will not have regained its average level for the 1986-1990 period (Avramovic, 1992).

Figure I.1  
**TRENDS IN THE MARKET PRICES OF THE MAIN NON-FUEL  
 COMMODITIES, 1983-1992**  
*(Annual average growth rate, in constant dollars)*



Source: United Nations Conference on Trade and Development (UNCTAD), *Commodity Yearbook, 1993*, New York, 1993, table A.2.

Table I.4  
**SHARE IN WORLD TRADE**  
*(Percentage in current dollars)*

	Exports					Imports				
	1960	1970	1980	1990 <sup>a</sup>	1992 <sup>a</sup>	1960	1970	1980	1990 <sup>a</sup>	1992 <sup>a</sup>
<b>World</b>	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<b>Developed countries</b>	65.9	70.9	62.6	71.4	71.5	64.9	71.6	68.3	72.3	70.1
Group of Seven	48.9	52.7	46.3	52.8	51.6	41.9	44.8	43.1	54.9	53.3
United States	15.8	13.7	11.0	11.5	12.0	11.1	12.2	12.5	14.6	14.3
Japan	3.1	6.1	6.5	8.4	9.1	3.3	5.8	6.8	6.6	6.0
European Community	32.2	35.5	32.5	36.8	35.7	32.7	35.3	34.6	35.7	35.0
Economies in transition	10.1	9.8	7.7	5.1	4.7	10.2	9.7	7.7	5.5	3.4
<b>Developing countries</b>	21.9	18.4	28.7	21.6	23.9	22.6	17.9	22.9	20.4	23.4
Latin America and the Caribbean	7.7	5.5	5.5	3.9	3.7	7.3	5.5	5.9	3.2	4.1
LAIA	5.6	4.0	4.0	3.3	3.2	5.0	3.5	4.1	2.3	3.2
CACM	0.3	0.4	0.2	0.1	0.1	0.4	0.4	0.3	0.2	0.2
Caribbean countries	0.5	0.4	0.5	0.2	...	0.6	0.6	0.7	0.2	...
Asia <sup>b</sup>	9.5	8.1	8.2	13.3	16.0	9.7	7.8	12.3	14.3	16.6
Newly industrializing economies (NIEs)	3.4	3.0	6.0	10.1	11.5	3.6	3.8	5.8	9.9	11.3
China	2.0	0.7	0.9	1.8	2.3	1.9	0.7	0.9	1.5	2.0
India	1.0	0.6	0.4	0.5	0.5	1.7	0.6	0.7	0.7	0.6
Africa	4.2	4.1	4.7	2.0	1.8	4.9	3.4	3.6	2.1	2.1
Oil-exporting countries <sup>c</sup>	6.8	6.3	16.4	6.0	5.8	4.8	3.5	7.0	3.5	4.2
Non-oil-exporting countries <sup>c</sup>	15.1	12.1	12.3	15.6	17.3	17.9	14.4	15.9	16.9	18.6

Source: UNCTAD, *Handbook of International Trade and Development Statistics, 1991* (TD/STAT.19), New York, 1992. United Nations publication, Sales No. E/F.92.II.D.6; United Nations, *World Economic Survey 1993* (E/1993/60; ST/ESA/237), New York, United Nations publication, Sales No. E.93.II.C.1; International Monetary Fund (IMF), *Direction of Trade Statistics Yearbook*, Washington, D.C., 1993; European Communities, Project LINK, *Short and Medium-Term Development Prospects in the Asia-Pacific Region*, September 1993.

<sup>a</sup> 1990 and 1992, updated on the basis of United Nations, *Monthly Bulletin of Statistics*, New York, July 1993.

<sup>b</sup> Developing Asian countries, including China. <sup>c</sup> ECLAC estimates.

## Box I-1

## WORLD MINERAL MARKET

Owing to the effects of substitution and miniaturization, the growth of the world economy is no longer producing an increase in metal consumption. Substitution results in changes in relative prices with the appearance of new materials, while miniaturization reduces demand for metallic inputs per unit of manufactured output, the automobile being the best illustration. Financial globalization, in turn, accentuates the role of financial variables in inventory accumulation, which increases the volatility of international prices.

The slower growth of world consumption of leading metals contrasts with the striking dynamism which has marked consumption in the Asian NIEs. In the 1980s, the consumption of primary aluminium in the Republic of Korea grew by an average rate of 18%, refined zinc by 13% and refined copper by 12%; in the Chinese Province of Taiwan, the growth rates were 8%, 7% and 12%, respectively.

The world's mineral supply was decentralized in the last two decades, owing to a greater government role as a result of nationalizations, and to increases in the degree

of processing and in smelting and refining capacity. Environmental constraints foster the opening of new deposits in developing countries and promote a relocation of smelting and refining capacities.

Minerals and metals reduced their share in world exports from 7% at the beginning of the 1970s to 4% at the end of the 1980s. In 1985 dollars, however, mineral and metal exports more than doubled in the last two decades, generating around US\$ 84 billion of exports per year. In absolute terms, they form a very large market which continues to stimulate the exploitation of new deposits. Current trends point towards a restructuring of supply through ever-decreasing margins between prices and production costs. Significant changes can be expected in decisions about the opening of new mines, with preference for those having large deposits, low infrastructure costs and, of course, higher-grade minerals. Accordingly, the principal mining districts of the region which meet such requirements will continue to receive large flows of foreign investment in expansions or new mines.

## SHARE OF MINERALS AND METALS IN WORLD TRADE

(% of world totals)

	EXPORTS		IMPORTS	
	1970	1990	1970	1990
Developed countries	59	67	85	76
Developing countries	32	25	7	18
Latin America	14	12	2	2
NIEs	1	2	1	7
Economies in transition	9	8	8	4

## TRENDS IN WORLD CONSUMPTION OF MAJOR METALS

(% of annual average growth)

	1960s	1970s	1980s
Refined aluminium	9.0	4.4	1.5
Refined copper	4.3	2.6	1.4
Refined tin			
Refined zinc	5.0	2.2	1.3
Iron ore	4.0	2.0	0.5
Nickel	6.0	2.0	2.0
Refined lead	4.0	3.0	1.0

In recent years, metal prices have shown a clear downward trend. Between 1983 and 1992, for example, tin prices fell by an average rate of 14% per year, and iron and aluminium prices

dropped at rates of 3% and 4%, respectively. At the same time, lead, zinc and copper prices rose, although at rates of less than 3%.

Source: United Nations Conference on Trade and Development (UNCTAD), *Commodity Yearbook*, 1993, New York, 1993; *Metal Statistics*, 1960-1970 and *Metal Statistics*, 1962-1972, New York, American Metal Market/Fairchild Publications, and *World Metal Statistics Yearbook*, Ware, Hertford, United Kingdom, World Bureau of Metal Statistics, 1984, 1990 and 1993 editions.

greater self-sufficiency in the large countries, including India and China. Similar trends are apparent in other traditional export crops. At least two phenomena have contributed to these problems. One of them is the low income elasticity of traditional foodstuffs. The other has to do with the substantial intervention by industrialized nations in agricultural markets in response to internal political pressures.

Non-traditional products have evolved much more favourably. For example, world fruit imports have grown rapidly in the industrial countries, where meat and carbohydrates now account for a lower share of the average diet. Similarly, imports of forestry products increased when ecology groups focused their attention on maintaining native forests (see box I.2 and chapter II, section 5).

In addition to the downturn in demand and, hence, in prices, the latter

#### Box I-2

### FOOD CONSUMPTION PREFERENCES IN THE DEVELOPED COUNTRIES

In the past three decades, average per capita income in the industrialized countries doubled. According to World Bank figures, per capita GDP in high-income countries—in constant 1990 dollars—rose from US\$ 10,800 to US\$ 19,550 between 1965 and 1990. This rise in living standards has been accompanied by changes in both the composition and the characteristics of families residing in the richest parts of the world. According to a recent study on Europe, among the changes observed as a result of higher incomes are trends towards forming households with fewer members<sup>a</sup> and increased participation by women in the labour force.

In addition to this structural recomposition of households, there has been a change in consumption preferences: foods are healthful, balanced, dietetic, natural and, moreover, diversified and easy to prepare. Thus, the demand for food products available in individual ready-to-serve portions has increased. This has led to the substitution of prepared foods for fresh products, higher consumption of tropical fruits and vegetables out of season and the development of food-marketing chains. At the same time, easily prepared vegetables such as tomatoes and avocados, and substitute products such as

frozen or canned vegetables and ready-to-eat meals, have appeared more often in the markets.

This has opened up possibilities for Latin America to sell new items in industrialized countries. The figure below shows what can be called a "life cycle" for some export fruits. In their first years on the market, these products generally enjoy rapid increases in demand; they then tend to decline. The length of the cycle depends on factors as diverse as the degree of substitution (either with different products or new varieties), the volume of supply, the marketing structure, the status of aggregate demand and more cyclical factors, such as current fashion.

At present many fruits and vegetables that are non-traditional exports for Latin America seem to be in the first stages of the cycle in the industrialized countries, that is, in the stages of introduction and experimentation. Other products, especially those characteristic of temperate climates, could more likely be at the end of the cycle. Nevertheless, it should be kept in mind that the incorporation of several new countries into agricultural exporting has prompted increased competition and therefore shortened the life cycles of these products (a typical example being the kiwi).

<sup>a</sup> It is estimated that one third of the households in some European cities now consist of only one person.

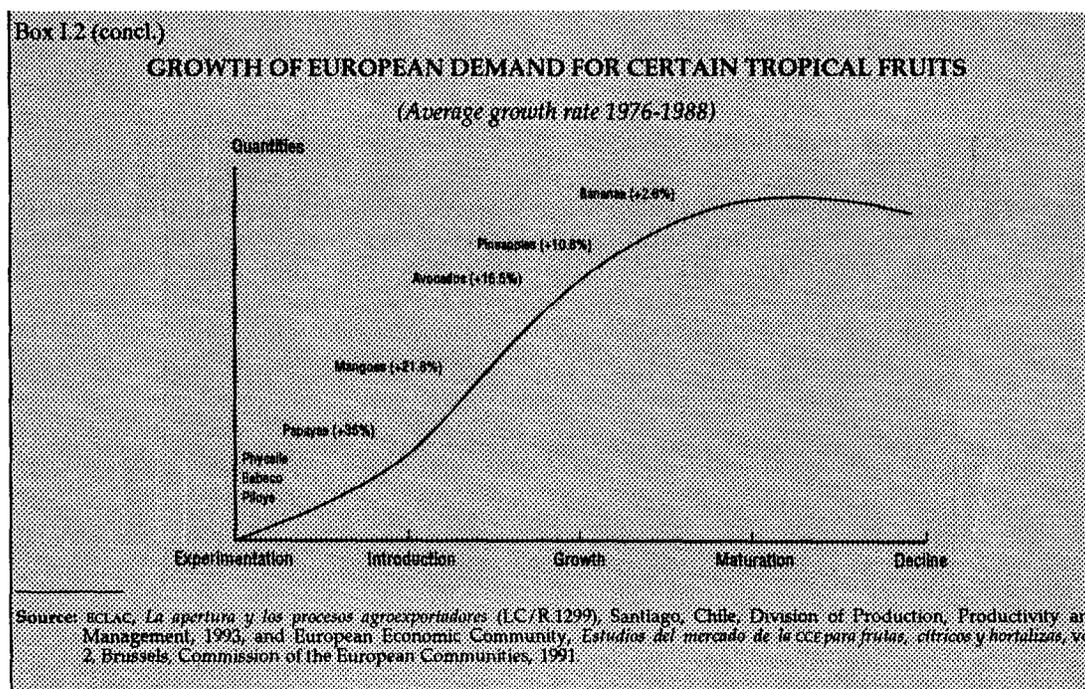


Table I.5  
VOLATILITY OF EXPORT PRICES, 1980-1993  
(Annual average variation)

Product	Percentage
Raw sugar	37.6
Bananas	15.4
Cocoa	12.1
Coffee (mild)	16.1
Beef	5.5
Fish meal	19.5
Maize	14.2
Soya	9.9
Wheat	10.1
Cotton	15.6
Wool	9.6
Copper	13.7
Tin	14.7
Iron ore	9.1
Lead	17.9
Zinc	17.2
Petroleum <sup>a</sup>	21.3
Primary products index <sup>b</sup>	7.1
Manufactured products index <sup>c</sup>	5.5

Source: UNCTAD, *Monthly Commodity Price Bulletin*, Supplement 1970-1989, Geneva, November 1989 and *Monthly Commodity Price Bulletin*, vol. 14, No. 4, Geneva, April 1994; Petroleum Intelligence Group, *Petroleum Market Intelligence*, New York; International Monetary Fund (IMF), *International Financial Statistics, Yearbook*, Washington, D.C., 1993; United Nations, *World Economic Survey*, 1993 (E/1993/60; ST/ESA/237), New York. United Nations publication, Sales No. E.93.II.C.1; and *Monthly Bulletin of Statistics*, New York, June 1986 and September 1994.

<sup>a</sup> International Monetary Fund (IMF) index. <sup>b</sup> IMF index of 34 products (excluding petroleum and precious metals).

<sup>c</sup> United Nations index of unit values of manufactures (SITC sections 5-8).

continue to exhibit a high degree of volatility. If the 17 commodities which appear in the *Economic Survey of Latin America and the Caribbean* are taken as a sample, the annual average price variation between 1980 and 1993 ranged from 5.5% for frozen beef to 37.6% for raw sugar; tin was situated in the middle with a price variation of 14.7%. These figures for specific products compare with an annual average variation of 7.1% for an index of 34 commodities (excluding petroleum) and of 5.5% for an index of manufactured goods (see table I.5). The lower volatility of the commodity index, compared to individual primary products, suggests the utility of diversification, even among commodities themselves. Apart from diversification, producers have sought other ways of dealing with price volatility. Previously, these methods involved establishing buffer stocks and forming cartels; more recently, however, such efforts have tended to centre on futures markets (see chapter II, section 3).

Another way of handling the volatility arising from the problems of export prices has been to shift from commodities to manufactured products. Table I.6 shows that, during the last three decades, the importance of commodities in world trade fell and that of manufactures increased. This trend is seen in developed and developing countries alike. It is particularly apparent in Latin America, given the low level of the region's exports of manufactures at the beginning of the 1960s. Although this level has increased considerably, only 39% of Latin American exports consisted of manufactured goods in 1992, compared to 83% for the Group of Seven and 80% for the Asian NIEs. Naturally, this means that there is plenty of room for the region to upgrade its export basket.

The concept of upgrading export quality is linked to the relative dynamism of the markets for different products. This dynamism, in turn, is related to the current technological revolution, which has brought about a significant change in the relative importance of different branches of production and nations. Although they function unevenly across sectors, the new technologies are cutting down on the use (per product unit) of energy, raw materials, time, capital and manpower, thus eroding the strategies of specialization based on low world prices of those factors.

During the 1980s, for example, knowledge-intensive products saw their demand rising at annual rates of over 9%; natural resource-intensive products grew below the average (5.7% per year).<sup>4</sup> The greatest dynamism was found in the services and manufacturing sectors and, among the latter, the highest growth was in electronic goods.<sup>5</sup>

At the same time there was dynamic growth in some natural resource-based products, such as fish preparations, paper, furniture, wooden manufactures, toys and fruit preparations. In the medium term, however, the growth of natural resource-intensive exports will tend to reach a limit imposed by technological change and by lower income elasticities of demand. Moreover, possible trade barriers based on environmental considerations tend to affect those products in particular. (On the effect of the new emphasis on the environment, see chapter II, section 5.)

In terms of specialization, product "quality" is not only a market concern. Specializing in products having markedly cyclical prices may increase external vulnerability and the probability of macroeconomic imbalances. By relying excessively on primary products with a

4 Information based on figures published in GATT (1990a), for the period 1979-1988.

5 In 1973, commodities accounted for 38% of the world's merchandise trade, including fuels. Manufactures accounted for 60% of world trade. In 1990, the respective shares were 27% and 70%. At present, trade in services amounts to about 20% of the world's trade in goods. Between 1970 and 1990, international trade in services grew at annual rates of 13% (Rosales, 1990).

Table I.6  
STRUCTURE OF EXPORTS BY GROUPS OF COUNTRIES  
(Percentages)

	1962	1970	1980	1990	1992 <sup>a</sup>
<b>Total World<sup>b</sup></b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Food	19.4	14.8	11.2	9.5	10.7
Non-food agriculture	8.8	5.7	3.5	2.9	2.8
Metals and minerals	6.6	7.3	4.6	3.4	2.9
Fuels	9.1	9.1	22.1	7.8	6.0
Manufactures <sup>c</sup>	55.0	61.7	55.1	74.2	75.4
<b>Total Group of 7<sup>b</sup></b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Food	12.8	9.7	9.9	7.4	7.7
Non-food agriculture	5.0	3.5	3.0	2.3	2.0
Metals and minerals	5.3	5.4	4.4	2.8	2.3
Fuels	4.2	3.2	5.4	3.1	2.8
Manufactures <sup>c</sup>	71.0	76.2	75.9	82.2	83.0
<b>Total European Economic Community<sup>b</sup></b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Food	11.1	10.5	10.3	9.8	10.7
Non-food agriculture	3.4	2.5	1.8	1.6	1.5
Metals and minerals	4.0	4.4	4.0	2.7	2.3
Fuels	4.9	3.6	8.6	4.2	3.6
Manufactures <sup>c</sup>	74.7	77.2	73.4	79.9	80.1
<b>Total United States<sup>b</sup></b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Food	20.7	16.0	18.2	11.2	11.0
Non-food agriculture	6.2	4.9	5.1	4.4	3.6
Metals and minerals	4.0	5.2	5.1	3.1	2.3
Fuels	3.8	3.7	3.7	3.2	2.6
Manufactures <sup>c</sup>	62.9	66.7	65.5	74.1	76.4
<b>Total developing countries<sup>b</sup></b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Food	37.1	29.1	14.8	13.0	12.6
Non-food agriculture	18.9	11.5	5.0	3.6	2.9
Metals and minerals	10.0	14.2	6.1	4.5	3.5
Fuels	19.3	18.8	37.0	13.3	10.7
Manufactures <sup>c</sup>	14.5	25.7	29.4	64.4	69.3
<b>Total Latin America and the Caribbean<sup>b</sup></b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Food	40.2	40.5	27.7	24.8	26.2
Non-food agriculture	12.2	6.6	3.5	3.5	3.6
Metals and minerals	13.1	18.2	10.4	11.7	9.7
Fuels	29.1	22.9	40.6	26.5	21.6
Manufactures <sup>c</sup>	5.2	11.5	17.3	32.9	38.5
<b>Total newly industrializing economies<sup>b</sup></b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Food	19.8	15.3	10.2	7.3	7.2
Non-food agriculture	34.6	20.9	9.4	3.4	2.9
Metals and minerals	9.1	7.8	3.6	1.5	1.4
Fuels	11.1	9.2	21.7	9.4	7.7
Manufactures <sup>c</sup>	24.1	45.8	53.5	77.9	80.2

Source: ECLAC, on the basis of official figures.

<sup>a</sup> Estimates. <sup>b</sup> The total includes the disaggregated groups plus SITC section 9. <sup>c</sup> Manufactures include SITC sections 5 to 8, with the exception of chapter 68.

low level of processing, taking advantage of low wages or an unregulated labour market, labour and environmental conditions are adversely affected and the country's achievement of systemic competitiveness is undermined.

Competitive advantages today depend on high-quality services, which incorporate design, know-how and technology. Behind a product traded in international markets is a chain of activities, some involving a high level of value added –research, design, engineering, complex manufacturing, management and marketing strategy– and others involving a lower level of value added, such as storage, low-skill assembly and traditional sorts of unprocessed natural resources. To strengthen the competitiveness of the region, the productive and human resources base must be improved in order to stimulate these chains of activities.

None the less, a simplistic dichotomy should not be set up between commodities and manufactures, whereby the features of quality and export dynamism would be assigned exclusively to the latter. There are cases of recent industrialization where it has been possible to reconcile the dynamic export of manufactured goods with the development of an agro-industrial complex that exports high-quality products.<sup>6</sup> In Latin America also, there are cases of diversification and high export dynamism among non-traditional products in the agriculture, fishing and forestry sectors, which blurs the presumed dichotomy. What is clear is the need to incorporate more knowledge into natural resource products, strengthening backward and forward linkages with manufactured products and services and improving the variety, marketing, presentation, promotion and quality of the product.

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6 In the 1980s, for example, Thailand's exports of canned fish and shrimps grew at annual rates of 29% and wood products at 21%. Malaysia saw growth rates of 33% in exports of manufactures based on rubber and 10% in wood products (ECLAC, 1992b).

## Chapter II

# THE INTERNATIONAL ECONOMIC ORDER

### 1. Trade rules and the GATT negotiations

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The most prominent aspect of the international trade environment is the recently approved Final Act of the Uruguay Round negotiations on new trade rules. In principle, there is virtual consensus –on the part of developed and developing countries alike– on the need for new rules governing key aspects of international trade. This consensus is based on estimates that the successful conclusion of the Uruguay Round will increase international trade by some US\$ 200 billion annually by the year 2002.<sup>7</sup> On the negative side, it is feared that, despite the aforementioned successful conclusion, protectionist sentiments are still strong, especially in industrialized countries.

The Uruguay Round was much more ambitious than previous rounds of negotiations on the General Agreement on Tariffs and Trade (GATT). In addition to traditional negotiations on lowering tariff barriers, the range of issues subject to multilateral rules was broadened. Some related to the inclusion of categories that had previously been excluded from GATT rules, such as agriculture and textiles. Others concerned stricter types of

regulations, such as safeguards designed to forestall or replace the use of “grey area” measures (e.g., voluntary export restraints). Even more unusual was the consideration of some new topics, such as intellectual property or investment rules, that are not strictly trade-related.

The inclusion of some of these new topics on the agenda of the negotiations tends to blur the borderline of the list of regulations that should be discussed in the context of trade talks. Today, trade negotiators are also scrutinizing labour and environmental conditions and have coined expressions, such as “labour dumping” or “social dumping”, whose meaning is highly debatable.

Before the initiation of the Uruguay Round, GATT negotiations had dealt with the growing liberalization of merchandise trade under multilateral, non-discriminatory principles based on the use of tariffs. In addition, efforts were made to replace non-tariff barriers with tariffs calculated to have an equivalent effect. The aim was to reduce and eliminate, through a process of multilateral negotiation, all trade barriers at national borders. Currently, however, the world economic situation is shifting the focus of the negotiations. The ongoing technological revolution is helping in various ways to increase the economic

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<sup>7</sup> This figure was cited at a press conference by Peter Sutherland, Director-General of GATT, 26 September 1993 and is based on Goldin, Knudsen and van der Mensbrugge (1993).

interdependence of nations. The rapid expansion of informatics and telematics has opened up a large and extremely dynamic market in the area of services. International trade in these types of services requires direct investments in building their infrastructure. Consequently, investments related to trade and services became a subject for negotiation under GATT, on the basis of principles such as the right of establishment and the national or non-discriminatory treatment of foreign direct investment. The negotiations in this round were therefore extended to legal regimes whose adoption had traditionally been the prerogative of the individual countries.

From the viewpoint of developing countries, the Final Act of the Uruguay Round produced a number of positive results which, however, fell short of initial expectations. First, the tariff barriers imposed on industrial goods are to be cut by over 30%, although they were already low in general. Most important, however, is the progressive elimination, over a 10-year period, of quotas under the Multifibre Arrangement and the reduction of the corresponding tariffs; these barriers to textile and clothing imports in the developed countries were among the most damaging for incipient exporters of industrial products in developing countries. Second, agricultural subsidies and import barriers will be reduced over a six-year period. National agricultural subsidies will be lowered by 20%, while subsidized exports are to decline by 36% in value and 21% in volume. All import barriers will be replaced by tariffs and lowered by some 36%. Since these subsidies have been used to a lesser degree in developing countries, their reduction in the industrialized world should broaden trade opportunities for efficient developing-country producers. Third, antidumping measures will be made more transparent, thus limiting a country's ability to use them as a threat to its trading partners. Also, the dispute settlement

system was made more automatic and the power to adopt unilateral measures was reduced. Since such measures have most often been applied by industrialized countries in the past, the limits placed on their use should benefit the developing nations.<sup>8</sup>

At the same time, some developing countries are concerned about the possible negative effects of the Final Act. For example, some Governments feel that the developing countries have lowered their tariffs much more than their industrialized trading partners (*Financial Times*, 16 December 1993). The relatively less developed countries, especially the ones that import food, are worried that higher food prices will hurt their economies (Goldin, Knudsen and van der Mensbrugghe, 1993). Some Latin American experts fear that the provisions of the Final Act will severely limit the region's capacity to promote its exports in the future. For example, although the Act recognizes that developing countries have special needs and should be exempt from certain obligations, it eliminates many of the special-treatment measures granted previously, except those applied to least developed nations. Moreover, unlike the Tokyo Round, the Uruguay Round does not allow developing countries the option of not accepting provisions they consider unfavourable. The rules on intellectual property are a particular cause of concern, since they may raise the prices of medicines and other patented products in the short term, but may also limit access to new technologies in the longer term (Agosin and Tussie, 1993; Leiva, 1994).

Beyond these generalizations, it is difficult to analyse the consequences of the Final Act for developing countries as a whole. In addition, a striking feature of the negotiation process was the formation of a new set of coalitions that broke from the traditional alignment of developed countries versus developing ones. For example, the Cairns Group comprised five

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8 An extremely favourable view of the Final Act, from the perspective of the developing countries, appears in GATT (1993a).

Latin American countries and several countries in the developed world. The impact may also vary from one country to another, benefiting some and hurting others. It will be crucial for both the Governments and the private sector of the developing countries to analyse the provisions in detail to identify any new opportunities they offer. The Final Act's main provisions on the treatment of developing countries are set forth in box II.1.

The main benefit of the GATT negotiations probably lies in the fact that they dealt a strategic blow to protectionist postures. This explains why they have had a favourable impact on the expectations of the world economic community, and have been welcomed, despite their limitations and risks, by the developing countries in general and those of the region in particular.

Indeed, an updated set of multilateral rules on trade in goods and services, though imperfect as yet, can yield net benefits for the developing countries in a context of globalization. Conversely, the lack of such rules could lead to conflicts between trading blocs or the unilateral domination of the major trading powers.

The consolidation of this institutional structure is manifested in the establishment of the World Trade Organization, which is to enter into operation in 1995. This organization's aims will be to facilitate the implementation of the legal instruments and arrangements agreed upon during the Uruguay Round, to serve as a forum for all negotiations on such matters, and to administer the mechanisms set up for the settlement of disputes and the analysis of trade policy.

## 2. Special trade regimes

The GATT rules on open multilateral trade based on the most-favoured-nation principle include a number of exceptions; one of these relates to the preferential trade regimes established by the developed countries, based on the

internationally accepted principle of favouring developing nations. The most important of these regimes is the Generalized System of Preferences (GSP), which is supported by all the industrialized countries.

### a) Generalized System of Preferences

In 1971 a large group of industrialized nations granted preferential tariff treatment to manufactures imported from developing countries. The aim was to stimulate the diversification of production in those countries and to incorporate them into the world manufactures trade. Although more than 20 developed countries grant preferences under this system, some 90% of all GSP imports to the countries of the Organization for Economic Cooperation and Development (OECD) go to the United States, the European Community and Japan.

To give an idea of the quantitative importance of the GSP, an "effective impact" index can be defined. This index shows the ratio of the value of goods imported under the GSP to the value of total imports from the country or region benefited. It thereby indicates the effective impact of the GSP on total exports from the beneficiary to the country that grants the preference.

Table II.1 summarizes the benefits thus received by the developing countries in general and the Latin American countries in particular. The degree of effective impact is very similar for the two groups: 15.4% and 15.6%, respectively. For Latin America, the preferences granted by Japan and the European Community have a greater effective impact than those of the United States. However, the absolute value of the exports covered is higher for the United States, since that country imports more Latin American products.

The index reflecting the impact of the GSP may be low for various reasons. On the one hand, many products may be excluded because they enjoy duty-free entry under other systems of exceptions or another general regime (e.g., certain

## Box II.1

## URUGUAY ROUND: TREATMENT OF DEVELOPING COUNTRIES

The provisions on this topic contained in the draft Final Act can be summarized as follows:

- 1) Time-limited exceptions and longer periods for implementing obligations.
  - a. Trade-related aspects of intellectual property rights, including trade in counterfeit goods: compliance with obligations in this matter may be delayed for a further period of four years for developing countries and 10 years for least developed countries.
  - b. Technical barriers to trade: specified and time-limited exceptions in whole or in part from the obligations under the relevant agreement may be granted to developing countries.
  - c. Import licensing procedures: developing countries may delay the application of provisions relating to automatic import licensing by not more than two years from the date of entry into force of the relevant agreement.
  - d. Subsidies and countervailing measures: the prohibition against the granting or maintenance of export subsidies will not apply to the least developed countries. For other developing countries, the phase-out period for export subsidies will be within eight years from the entry into force of the relevant agreement, and two years in the case of reaching export competitiveness in any given product (criteria defining export competitiveness are formulated).
  - e. Implementation of article VII on customs valuation: developing countries may delay application of its provisions for up to five years.
  - f. Agriculture: the least developed countries are exempted from making reduction commitments; other developing countries will have the flexibility to implement their reduction commitments over a period of 10 years.
  - g. Sanitary and phytosanitary measures: longer time-frames for compliance with these measures are granted to developing countries. Specified, time-limited exceptions in whole or in part from the obligations of the relevant decision may also be granted, upon request, to developing countries. The least developed countries are granted more flexible time-frames and conditions.
  - h. Safeguards: developing countries will have the right to extend the period of application of a safeguard measure for up to two years beyond the maximum period of eight years.
- 2) More favourable thresholds for certain commitments.
  - a. Subsidies and countervailing measures: a more flexible application of remedies against subsidization involving products from developing countries is envisaged.
  - b. Agriculture: developing countries will be allowed to make smaller reductions in their tariffs and subsidies, provided that the result is no less than two thirds of that specified for developed countries.
  - c. Safeguard measures will not be applied against a product originating in a developing country as long as its share of imports of the product concerned does not exceed 3%, provided that developing countries with less than a 3% import share collectively do not account for more than 9% of total imports of the product concerned.
  - d. Textiles and clothing: small developing suppliers will be accorded differential and more favourable treatment.
- 3) "Best endeavour clauses", aimed at making a special effort to interpret and favour the interests and rights of the developing countries.
  - a. Intellectual property rights: developed countries will provide incentives for the purpose of promoting technology transfer to the least developed countries.
  - b. Anti-dumping agreement: developed countries must take a more tolerant attitude and explore alternative solutions in order not to affect the essential interests of developing countries.
  - c. Non-automatic import licensing procedures: special consideration should be given to importers of products originating in developing countries and, in particular, in the least developed countries.

## Box II-1 (concl.)

- d. Subsidies and countervailing measures: the relevant committee will seek to ensure that countervailing measures are in conformity with the needs of developing countries.
  - e. Agriculture: developed countries will offer improved opportunities and terms of access to their markets for agricultural products of particular interest to the developing countries, including special treatment for tropical products and products that can be substituted for illicit narcotic drug crops. Measures will also be adopted to ensure that the implementation of the results of the Uruguay Round on trade in agriculture does not adversely affect the availability of food aid, especially for the least developed countries.
- 4) Flexibility in procedures.
- a. Balance of payments: consultation procedures may be simplified, to make them more expeditious, in the case of developing countries.
  - b. Settlement of disputes: there is a wide range of provisions on differential, more favourable treatment of developing countries. They provide, *inter alia*, that where one or more of the parties involved in a dispute is a developing country, the panel's report will explicitly indicate the form in which account has been taken of relevant provisions on differential, more favourable treatment.
- If the case is brought by a developing country, the provisions adopted will take into account not only the trade coverage of measures complained of, but also their impact on the economy of the country concerned. In all dispute settlement procedures involving a least developed country, the developed contracting parties will exercise due restraint in asking for compensation or suspending the application of concessions. Before initiating routine procedures, the Director-General will, upon request by a least developed contracting party, offer his good offices, conciliation and mediation with a view to avoiding a request that a panel be established. In addition, provision of legal advice to developing contracting parties and the organization of special training courses concerning GATT dispute settlement procedures and practices are envisaged.
- c. Functioning of the GATT system: longer intervals of trade policy reviews for developing countries are envisaged.
- 5) Provisions on technical assistance.
- a. Technical assistance for developing countries is envisaged in areas such as pre-shipment inspection, technical barriers to trade, sanitary and phytosanitary measures and dispute settlement.

Source: Prepared on the basis of UNCTAD, *Developments and Issues in the Uruguay Round of Particular Concern to Developing Countries*. Note by the UNCTAD secretariat (TD/B/39(2)/CRP.1), Geneva, 15 March 1993.

minerals) or because of political pressure exerted by producers in the countries granting the preference (e.g., textiles). On the other hand, use of the benefit may be limited, possibly owing to a lack of awareness of the GSP on the part of Governments and entrepreneurs. Another problem is that the countries that grant preferences impose quotas and other barriers to their use. Moreover, they may suspend the benefit for reasons such as the competitive need clause, invoked in some cases by the United States. They have also suspended benefits for non-economic reasons, as a kind of sanction against

certain beneficiaries for alleged human or labour rights violations.

The United States "graduates" countries from the system, excluding them from GSP benefits when their per capita gross national product exceeds a certain amount, which in 1990 was US\$ 10,463. The provisions also stipulate that a country will automatically lose its GSP entitlement for a given product (eight-digit tariff item) if its share of United States imports within that product category exceeds certain pre-set limits and no exception has been granted. In 1990, the general limits were 50% of total imports of

a product and US\$ 93 million. Countries that were already considered sufficiently competitive in 1986 are subject to tighter limits of 25% and US\$ 36 million (GATT, 1992a). Also since 1990, the rules of origin for products imported from the beneficiary countries have been applied more rigorously. Recently, the United States Government requested another extension of the GSP for one year while it considers more thoroughgoing reforms of the system's operation.

Japan, for its part, applies the GSP to all developing countries, without exception. It adopted the GSP in 1971 and enacted 10-year renewals in 1981 and 1991. The system covers most industrial products (except crude oil, some textiles, counterveneered wood, leather garments and footwear) and about half of all dutiable agricultural products. However, ceilings are placed on imports of many industrial products entitled to GSP treatment. The system is revised every year, and recently its coverage was broadened in terms of both products and

beneficiaries. Among the developing countries, the least developed countries receive special treatment, since their duty-free products are not subject to quotas. Of all of Japan's imports entitled to GSP treatment, over half come from the Chinese Province of Taiwan, the Republic of Korea and China. With the addition of imports from the Philippines, Indonesia, Malaysia, Singapore and Thailand, this proportion rises to 72%. Brazil and Venezuela are the main Latin American beneficiaries, with about 7% and 2% of the total, respectively (GATT, 1992b).

The European Community's GSP also dates back to 1971, and was renewed in 1981. In 1990 it was renewed for another 10 years, but will be adapted to the results of the Uruguay Round. Like Japan and the United States, the European Community applies ceilings and quotas in respect of this benefit, as well as a system of graduations according to the degree of competitiveness attained by potential beneficiaries or as a reprisal for restrictive measures

Table II.1  
IMPACT OF GENERALIZED SYSTEM OF PREFERENCES, 1991  
(Billions of dollars and percentages)

Preference-giving country/region	(1) Total imports		(2) Imports under the GSP		(3) = (2)/(1) Effective impact	
	Developing countries	Latin American countries	Developing countries	Latin American countries	Developing countries	Latin American countries
United States of America	96	59	13.7	7.6	14.2%	12.9%
European Community	157	32	30.2	6.2	19.2%	19.4%
Japan	111	9	12.1	1.8	10.9%	20.0%
<b>Total</b>	<b>364</b>	<b>100</b>	<b>56.0</b>	<b>15.6</b>	<b>15.4%</b>	<b>15.6%</b>

Source: UNCTAD, Trade and Development Board, Replies received from preference-giving countries: European Economic Community (EEC). Note by the UNCTAD secretariat (TD/B/C.5/PREF/56), New York, April 1993; Replies received from preference-giving countries: Japan. Note by the UNCTAD secretariat (TD/B/C.5/PREF/52), New York, October 1993; Replies received from preference-giving countries: United States of America. Note by the UNCTAD secretariat (TD/B/C.5/PREF/55), New York, November 1992.

implemented by the other party. Agricultural products exported from relatively less developed countries and included in the GSP enjoy free access to the European market.

*b) Other preferences*

The United States has other kinds of preferences in addition to the GSP. One of these, which applies to the maquila, grants preferential treatment to re-imported articles which have increased in value or been improved in quality abroad. Tariffs are not applied to the total value of the product, but are instead levied only on the value added outside the United States.

These types of concessions for subcontracting or maquila regimes have become extremely important. They apply to over 15% of United States imports and have grown very quickly. About 50% of the country's imports from Mexico come under this regime, which is much more important to Mexico than the GSP granted by the United States.<sup>9</sup> This regime is also very important for some Caribbean and Central American countries (see chapter V, section 3).

The Caribbean Basin Economic Recovery Act applies to the five members of the Central American Common Market, the 13 members of the Caribbean Community, the Netherlands Antilles, Aruba, Haiti, the British Virgin Islands, Panama and the Dominican Republic, and to exports from Puerto Rico to which value has been added in those countries and territories. Tariff exemptions are granted to all products from that area, except those excluded by law (textiles, clothing, footwear, leather manufactures and some timepieces), and are accompanied by other advantages such as technical assistance, tax incentives for United States enterprises and programmes to promote trade and investment. In 1992, the products imported under the Act (excluding those that were also eligible for GSP treatment)

amounted to US\$ 645 million, or 7% of all United States merchandise imports from the Caribbean Basin countries (ECLAC, 1992c).

The system of trade preferences for the Andean countries is intended to help Bolivia, Colombia, Ecuador and Peru in their efforts to combat the production of narcotic drugs, specifically through incentives for producing alternative crops that can be exported to the United States. To that end, tariff exemptions will be granted to a group of products for 10 years. It has been estimated that the programme will affect about US\$ 300 million worth of imports, representing about 5% of total imports from those countries.

The European Community also grants preferences outside the GSP, primarily to African, Caribbean and Pacific (ACP) countries that were once colonies of the nations that make up the Community. A second level of preferences benefits Mediterranean countries, and some preferences are also granted to Latin American countries.

The African, Caribbean and Pacific countries have signed the Lomé Conventions with the European Community. The latest of these agreements, Lomé IV, includes 69 developing countries, which receive institutional, trade and development cooperation benefits. The trade benefits favour two types of products: industrial (which enjoy complete freedom from customs duties) and raw materials. The latter are subject to two specific systems: the Stabilization System for Export Earnings (STABEX) for tropical products, and the special financing facility for ACP and OCT mining products (SYSMIN). When any of these countries experiences a decline in its export earnings, the Community makes transfer payments to offset the deterioration in that country's trade balance.

As regards the countries bordering the Mediterranean, all of them, with the

<sup>9</sup> These benefits will be phased out as a result of Mexico's Free Trade Agreement with the United States and Canada.

exception of Libya and Albania, have concluded bilateral agreements with the Community that provide, *inter alia*, for the elimination of tariffs on industrial products, though with some restrictive exceptions, as in the case of textiles. The Mediterranean countries, however, are excluded from the income stabilization mechanisms applied to the African, Caribbean and Pacific States. Agricultural imports from these countries are also subject to quotas that limit the partial reduction of tariffs.

In 1990 the Community adopted a series of exceptional temporary trade measures in response to the special programme of cooperation proposed by the Colombian Government in the context of the international anti-drug effort. A special trade regime was set up for Bolivia, Colombia, Ecuador and Peru to exempt a special list of agricultural products from quotas and tariffs for a period of four years. In December 1991 these benefits were extended to agricultural products from the Central American Common Market and Panama to stimulate the process of democratization and economic reform.

### 3. Price fluctuations and futures markets

Clearly, a major problem for Latin American exporters is price instability, especially for commodity exports (see chapter I, table I.5). With the general trend towards less State involvement in the economy, market-based solutions, such as futures and options markets, have begun to replace such schemes as buffer stocks or cartels. Indeed, the last two decades have witnessed spectacular growth in conventional commodity futures and options markets and in a variety of related financial instruments. Markets have also become much more complex in this period, thus increasing the risks and difficulties for relatively inexperienced traders, such as those in Latin America and the Caribbean.

Not all products are suitable for futures markets. The commodities that lend themselves best to such operations are those that satisfy certain conditions, such as a large volume of supply and demand, homogeneity and fungibility, and storability. Thus, trading in fuels is by far the largest area, followed by aluminium, copper, gold and silver. The contract volume traded for agricultural commodities, particularly "soft" commodities such as coffee, cocoa, cotton and sugar, is much smaller (UNCTAD, 1993a).

Participation by developing countries, directly or through intermediaries, is limited but increasing. Latin American exporters of soft commodities are among the major developing-country users, hedging about a quarter of the region's cocoa, coffee and sugar exports on the Coffee, Sugar and Cocoa Exchange in New York (López Huebe, 1990). Latin American exporters of cereals and soybeans also hedge on United States exchanges (Regúnaga, 1990). For metals, Latin American exporters are active users of the exchanges. The region's copper producers and processors of semi-finished copper products in Brazil, Chile, Mexico and Peru, have regularly used the London Metal Exchange and the New York Commodity Exchange (COMEX) (Bande and Mardones, 1990), though for a rather small share of their total exports. Mexican and Brazilian authorities have participated actively in oil futures and options.

The exchanges offer two main types of commodity risk management instruments. The first is a *futures contract*, which is an agreement to purchase or sell a commodity at a price determined in the present, for delivery of the merchandise after a given period of time. The most frequently mentioned benefit to be derived from futures contracts is hedging. Hedging allows producers, traders and processors to transfer at least a part of the risk associated with price fluctuations to a speculator, who hopes to realize a profit as a result of price variation.

The other main instrument is an *option*, which gives the purchaser the right, but not the obligation, to buy (call) or sell (put) a commodity at a pre-determined price after a given period of time. While a futures contract is binding on both parties, the purchaser of an option can walk away from the contract if he deems this convenient. Like futures, options can be used by producers to shift the risk of price changes.

Despite the benefits that are often attributed to the futures and options markets, they also pose certain problems. One relates to liquidity: the volume of trade in practically all commodity futures and options, especially for more distant months, is not very high. In general, the commodity exchange options traded have short maturities, with few transactions extending beyond one year. Over-the-counter trade, an active trade in options of up to three years, is developing, but commodity risk management instruments offered by the exchanges with maturities greater than one year are generally difficult to acquire.

Another problem is the high cost of using commodity futures and options exchanges, either directly or through intermediaries. To participate directly, it is necessary to become a member of an exchange. Also, a participant usually needs an office in the city in which the exchange is located, and must meet capital adequacy standards and acquire accounting services to comply with audit and reporting requirements. These costs tend to work to the detriment of smaller firms. Indirect use through intermediaries also involves costs, such as margin deposits and margin calls, commission fees and organizational costs (e.g., staff training and access to daily information). Whether or not commodity buyers and

sellers will consider it worthwhile to incur these costs largely depends on their location, the size of their trade deals and the frequency with which they need to resort to these markets.

In addition to these explicit costs, there are other implicit features that might deter potential traders from using the exchanges. One is the low reliability of futures market prices as predictors of future spot prices. In fact, a growing number of empirical studies tend to reject futures prices as predictors of future spot rates (see Choe, 1990).<sup>10</sup> Typically, commodity futures prices forecast the subsequent spot prices poorly, owing to either market inefficiency or irrational expectations, or the existence of risk premiums (Thompson, 1983; Choe, 1990). It is also clear, however, that they can provide short-run stability, at a cost, to risk-averse producers. In this sense, futures and options are a "good thing".

Futures markets are also said to be partially responsible for the increase in commodity price volatility (Thompson, 1983). Excessive short-term volatility in futures markets may cause the relationship between physical and futures market prices to change frequently, exposing hedgers to excessive risks and higher transaction costs. Many speculators operate on the basis of an analysis that is founded on assumptions about the behaviour of market agents and prices. Basing themselves on information about prices, trading volumes and other indicators, these speculators take various positions in the market. When a large number of them take the same position, their activity tends to bear out their short-run forecasts. They are said to prompt price movements that run counter to trends in fundamental economic variables, thereby distorting long-term

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10 The most commonly used technique for testing for bias in futures prices is to regress changes in spot prices on the futures discount. Choe's analysis, based solely on commodities, clearly rejects the hypothesis that futures markets are good predictors of future spot prices, coinciding with the results of other studies of foreign exchange futures markets. In his test of eight commodities of great interest to Latin America and the Caribbean, for the period 1980-1988, he finds evidence against the rationality of futures prices.

market signals. This distortional effect has increased in recent years owing to the greater incidence of institutional speculators. These speculators take decisions by comparing the risks and returns offered by various instruments, and their reference is eminently short-term. The waves of commodity purchases or sales resulting from this type of reaction exaggerate price fluctuations unrelated to market fundamentals and thus increase volatility.

In addition to these overall constraints at the world level, there are elements that might particularly limit the usefulness of futures markets for developing-country commodity exporters. Two such elements are mentioned here.

i) Price trends on the exchanges of developed countries and in local markets of developing countries can vary substantially. In the case of grain, for example, a temporary imbalance between supply and demand in the major producing countries can lead to competition between local consumption and exports that will be reflected more markedly in f.o.b. prices than on the Chicago Board of Trade (CBOT). The cross-seasonality of the northern and southern hemispheres can cause unpredictable variations in premiums. Such differences are one of the main obstacles to participation by developing countries in futures and options markets.

ii) Lack of information about and experience with futures markets hinders the advantageous use of these markets. For example, the level of optimal hedging can be substantially less than expected output when price and production uncertainties are high. Participants may find that the quantity to be hedged is a decisive variable, instead of always assuming completely hedged positions. Experience is necessary to take such decisions. More generally, developing-country participants are likely to have less information on trends which would enable them to take profitable decisions –or avoid heavy losses.

In so far as futures markets can lower risk and price volatility, they have an important role to play for commodity producers. Their growing use by producers and exporters in developing countries indicates that these actors see benefits to be gained from participation in the markets. Clearly, however, futures markets have not completely solved the problem of risk (actually, they only help to partially reduce short-term risks), and in some instances they may even exacerbate it. Many more institutional measures must be taken to improve the operation of the markets, and economic agents in developing countries need to increase their knowledge of the markets' functioning in order to improve those countries' external linkages.

#### 4. Foreign capital and international trade

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Over the last decade, an increasingly close link has developed between foreign capital and international trade. First, much more foreign direct investment (FDI) has gone into export sectors than in the earlier postwar period. Second, an increasing share of international trade is being carried out by transnational corporations, either as intra-firm trade or through retail chains or trading companies.

During the 1970s, FDI was marginalized as a source of external finance by private bank loans. Indeed, the 1970s were a peak period of economic nationalism, and many foreign firms were nationalized. With the onset of the debt crisis and the cessation of private-bank lending, however, developing countries again became interested in attracting FDI. They not only instituted macroeconomic reforms, but also changed their rules on FDI to create a more hospitable atmosphere. For example, price and exchange controls were reduced, and profit remittance was made easier. Rules limiting the entry of transnational corporations (TNCs) into key industries were cut back, and foreign

investment codes were made more liberal (United Nations, 1991 and 1992).

After a time, transnational corporations began to respond positively. Table II.2 shows the pattern of FDI flows between 1981 and 1993, illustrating the upturn in FDI to developing countries during the second half of the 1980s and the strengthening of this trend in the 1990s. The Latin American share was largely responsible for this stop-go pattern. Initially, FDI in the region picked up as a result of debt-equity swaps and privatizations. In recent years, "normal" FDI flows have also risen significantly (see chapter IX).

An important characteristic of the new investment flows to developing countries is that they have gone primarily into export sectors, rather than production for the domestic market, as in earlier decades. In a few cases, this has meant investment

in natural resources. Chile and Colombia are prime examples of countries where the bulk of recent FDI flows have gone into commodities (copper, forestry and fishing in Chile; oil and coal in Colombia). More often, FDI has gone into manufactures, as in East and South-East Asia. In addition, some Latin American countries—especially Mexico, but also Venezuela and Brazil—have been significant recipients of manufacturing investments. Services, including airlines and telecommunications, have attracted FDI on a large scale in recent years.

Table II.3 links FDI to manufactures exports, focusing on United States and Japanese subsidiaries in developing countries in 1982 and 1989. The absolute value of exports produced by the two countries' TNCs increased rapidly, and export propensity rose from 22% to 33% among United States firms and from 33%

Table II.2  
INFLOWS OF FOREIGN DIRECT INVESTMENT TO DEVELOPING COUNTRIES,  
BY REGION, 1981-1985, 1986-1990 AND 1991-1993  
(Annual averages)

Recipient region and economy	Billions of dollars					Share of total inflows				
	1981-1985	1986-1990	1991	1992	1993	1981-1985	1986-1990	1991	1992	1993
All countries	50	155	162	158	194	100	100	100	100	100
Developing countries	13	25	39	52	80	26	16	24	33	41
Africa	2	3	3	3	-	3	2	2	2	-
East, South and South-East Asia	5	14	20	29	-	10	9	13	19	-
Latin America and the Caribbean <sup>a</sup>	6	8	15	18	19	12	5	9	11	10
Ten largest recipient countries	9 <sup>b</sup>	18 <sup>c</sup>	28 <sup>d</sup>	39 <sup>d</sup>	-	19 <sup>b</sup>	12 <sup>c</sup>	17 <sup>d</sup>	25 <sup>d</sup>	-

Source: ECLAC, on the basis of information presented by the United Nations Conference on Trade and Development (UNCTAD), *World Investment Report, 1993: Transnational Corporations and Integrated International Production (ST/CTC/156)*, New York, Programme on Transnational Corporations, 1993. United Nations publication, Sales No. E.93.II.A.14; and *World Investment Report, 1994: Transnational Corporations, Employment and the Workplace (UNCTAD/DTCI/10)*, New York, Division on Transnational Corporations and Investment, 1994. United Nations publication, Sales No. E.94.II.A.14.

<sup>a</sup> Includes 19 Latin American nations and 17 Caribbean countries or territories. <sup>b</sup> Argentina, Brazil, China, Colombia, Egypt, Hong Kong, Malaysia, Mexico, Nigeria and Singapore. <sup>c</sup> Argentina, Brazil, China, Egypt, Hong Kong, Mexico, Nigeria, Singapore, the Chinese Province of Taiwan and Thailand. <sup>d</sup> Argentina, Brazil, China, Indonesia, Malaysia, Mexico, Republic of Korea, the Chinese Province of Taiwan, Thailand and Venezuela.

Table II.3  
DEVELOPING COUNTRIES: MANUFACTURES EXPORTS BY UNITED STATES AND  
JAPANESE MAJORITY-OWNED FOREIGN SUBSIDIARIES, 1982 AND 1989

Country group	Total manufactures exports by developing countries (millions of dollars)	United States subsidiaries (percentages)		Japanese subsidiaries <sup>a</sup> (percentages)	
		Share	Export propensity <sup>b</sup>	Share	Export propensity <sup>b</sup>
All developing countries					
1982	166,581	6.7	22.0	4.8	32.8
1989	451,986	5.7	33.1	2.9	39.2
Africa					
1982	10,579	1.6 <sup>c</sup>	-	0.2	8.2
1989	16,809	3.4	-	0.2	15.2
Asia and the Pacific					
1982	94,314	6.3 <sup>c</sup>	60.3	6.3	33.6
1989	332,120	4.2	56.2	3.5	40.2
Latin America and the Caribbean					
1982	44,814	10.5	11.9	2.2	18.6
1989	71,315	14.3	21.4	1.1	23.9

Source: United Nations, *World Investment Report, 1992. Transnational Corporations as Engines of Growth (ST/CTC/130)*, New York, United Nations Centre on Transnational Corporations, 1992. United Nations publication, Sales No. E.92.II.A.24.

<sup>a</sup> Figures cover April 1982-March 1983 and April 1988-March 1989, and represent only a sample of subsidiaries in developing countries. <sup>b</sup> Export propensity is defined as the proportion of export sales in total sales by subsidiaries.

<sup>c</sup> Some of the data are omitted by the source to avoid disclosure.

to 39% among Japanese firms. For developing countries as a whole, the foreign share of manufactures exports fell. In the case of United States subsidiaries, the decline in their share of developing country exports (from 6.7% to 5.7%) was entirely attributable to the Asian countries. In Latin America, their share of exports rose significantly (from 10.5% to 14.3%).

In Latin America, data on the 1,000 largest national or foreign firms in the region show that in 1991, TNCs generated 22% of total exports and over 44% of manufactures exports of these firms (Calderón, 1993a). Particularly notable were chemicals, rubber products, electrical and non-electrical machinery and automobiles, industries where foreign firms accounted for over 75% of exports.

Nevertheless, the domestic market continued to be the main attraction for the 1,000 largest firms, since they exported only 17% of their total output. This figure was heavily influenced by Brazil, however, where the export coefficient for TNCs (exports as a proportion of total sales) was only 11%, compared to Chile and Mexico, where it was 33% and 29%, respectively (Calderón, 1993a).

An important sub-category of TNC exports are those sold within the firms themselves, a practice known as intra-firm trade. The growing importance of intra-firm trade is a consequence of efforts to achieve international competitiveness (through economies of scale or the use of specific national advantages).

A recent study shows that more than a third of United States foreign trade in

1989 took place within firms; no overall estimates are available for other countries (OECD, 1992). For Latin America, some data exist on intra-firm trade by United States corporations. In 1989, for example, 27% of Mexico's exports to the United States and 42% of imports from that country were intra-firm operations of United States companies (United Nations, 1992). For Brazil, it is estimated that 14% of manufactures exports to the United States in 1990 were United States intra-firm transactions (Baumann, 1993). The motor vehicle and electronics sectors are especially important participants in this form of trade.

The increasing importance of intra-firm transactions may pose certain problems for developing countries. Such operations involve the replacement of market transactions by those internal to firms. Among other consequences, trade flows may become less sensitive to relative prices, undermining the effectiveness of exchange rate policy, for example. At the same time, customs and fiscal policy can be adversely affected, since firms' internal operations facilitate the use of transfer pricing and make it more difficult to levy taxes and adopt anti-dumping measures.<sup>11</sup>

Direct investment, however, is not the only way in which TNCs have increased exports from developing countries. Especially in East Asia, but also (though to a lesser extent) in Latin America, subcontracting has become increasingly important. Gereffi (1994) distinguishes among three levels of subcontracting. The lowest level is export processing zones (EPZs), which specialize in the assembly of simple manufactured goods, especially apparel and electronics. The second level is "component-supply subcontracting", which involves the manufacture and export of component parts for technologically advanced industries, with final assembly usually carried out in developed countries. The automobile and

computer industries are prominent examples of activities that use this form of subcontracting. Finally, there is "original equipment manufacturing" (OEM) or the production of finished consumer goods by local firms. These goods are tailored to the specifications of large retail chains, which then market them abroad. Most of this kind of activity takes place in East Asia, where many backward linkages with the local economies have made it an important ladder to the highest level of exports: goods produced and marketed under the name of manufacturers themselves in newly industrializing economies (NIEs). (On subcontracting in the footwear industry in Brazil, see box II.2.)

The East Asian NIEs have managed to confront the effects of high wages and import quotas, which could drive them out of subcontracting, by setting up "triangle manufacturing". In this process, retail chains place orders with NIE manufacturers, who then subcontract to factories in low-wage countries, such as China or Vietnam. The triangle is completed when the goods are shipped back to the industrialized country under the quota of the latter countries. These triangle networks are also being extended to Latin America and the Caribbean and to Africa.

Trading companies are yet another means by which foreign capital has promoted developing-country exports. They are mainly an Asian phenomenon, but their impact has spread to other developing regions. The most important trading companies are Japan's giant *sogo shosha*, which have offices in virtually every country in the world and provide marketing, financial and information services to other firms. Initially, they helped Japan's own large manufacturing firms to move abroad, but when these firms outgrew their need for such assistance, the *sogo shosha* turned to smaller Japanese companies and firms

11 Some recent evidence, while not denying that transfer pricing has occurred, plays down its importance as a reason for intra-firm trade (Blomstrom, 1990).

## Box II.2

## SUBCONTRACTING IN BRAZILIAN FOOTWEAR EXPORTS

Brazil has become an important exporter of leather footwear, as can be seen in the following table:

Year	Thousands of pairs exported	Thousands of US\$
1964	133	172
1970	3,778	8,273
1980	49,030	386,872
1989	169,979	1,238,280

There were several factors that led to Brazil's success, when other potential exporters (such as Argentina) failed. First, Brazil has a comparative advantage in footwear because of its leather and cheap labour, although Argentina and Uruguay also have a comparative advantage in leather. Second, Brazilian government policies encouraged exports. These policies included subsidies, an efficient exchange rate policy, credits and marketing assistance. These export policies alone, however, were not sufficient to enable the firms to make major headway into the United States market. Third, and arguably most important, United States importers decided to make Brazil a major source of cheap footwear. Through their agents, they provided the necessary know-how, access to the United States market and protection against attempts by United States producers to limit the entry of Brazilian footwear to that country.

United States agents are involved in every aspect of the production process in Brazilian

footwear firms. They carry out fashion research and make prototypes of particular styles, which are then turned into samples that are sold to wholesalers and retailers in the United States. After these firms place orders, the export agents negotiate with the factories that will produce the shoes. They also ensure that the specified leather is purchased by the shoe factory. They supervise production to make sure that deliveries will be on time and, finally, they ship the shoes.

At the global level, agents and importing firms have managed to prevent protectionist measures from being imposed against Brazilian footwear. This contrasts with the success of United States steel manufacturers in obtaining sanctions against Brazilian producers, which in the case of steel are State firms and local private capitalists. There is no doubt that United States steel firms are more politically powerful than their counterparts in the footwear industry, but having allies in the importing market who have major interests at stake is also important for Brazilian manufacturers.

While Brazilian producers dislike the power of the export agents, most feel they do not have the capacity to market on their own. This is especially true since most footwear firms are small (the average number of employees is under 50). Also, fashions change frequently, demanding constant knowledge of the market. It is also expensive to set up offices in the United States and hire and train staff. The commissions charged by agents are generally low, around 3%, but the highest profits are usually made by global production-marketing chains. As a result, Latin American producers should try to find marketing channels, whether national or international, instead of waiting for their products to be bought.

Source: Jeffrey Cason, "Development Strategy in Brazil: The Political Economy of Industrial Export Promotion, 1964-1990", Ph.D. dissertation, University of Wisconsin at Madison, 1993.

from developing countries (Kojima and Ozawa, 1984).

The Japanese trading companies have been especially active in Asia. Their share in the Asian and Pacific countries' total trade was estimated at 17% at the

beginning of the 1980s (Kuwayama, 1992). In the late 1980s, the largest *sogo shosha* managed an average of US\$ 2-3 billion per year of Latin America's exports and imports, meaning that the trading companies handled over half of the

region's US\$ 18 billion trade with Japan. In addition, during the 1980s these firms began to promote Latin American exports to third countries, including the United States. It is estimated that they were responsible for roughly 10% of Latin America's total trade of US\$ 200 billion in 1989 (Stallings, 1991).

In some cases, the *sogo shosha* simply act as intermediaries, assuming responsibility for shipping and financing goods produced by independent firms. In others, they take a small equity share in a firm in order to secure a source of supply or gain more influence over the quality of the products. A third function has been to discover investment opportunities and bring in other Japanese companies, which provide most of the capital. In the last few years, some of these investments have been joint ventures with United States firms (e.g., for the production of liquid natural gas in Venezuela and copper in Chile). Working through the trading companies has been a better way for developing countries to gain access to the Japanese market.

### 5. International trade and the environment

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Environmental issues are rapidly becoming a major factor in international trade. Often, from the developing countries' point of view, environmental concerns have been regarded as just one more type of protectionism on the part of the industrial nations. However, the issue goes deeper than such an instrumental approach would imply. The environment is becoming an aspect of international competitiveness, which can confer advantages as well as impose costs.

Environmental requirements are becoming increasingly stringent in the 1990s, meaning that economic agents are having to change their strategies and decision-making practices. In the developed countries, clear indications of the direction this process is taking include the lower proportion of natural resources used and waste generated in the

manufacture of the final product, the adoption of strict environmental regulations and increasing consumer concern for the environment. These facts are leading to the redesign of industrial processes, marketing channels and systems for the final disposal of products.

In view of the critical volumes of waste and residues and the growing shortage of dumps and deposit sites, the disposal of a product at the end of its useful life is becoming increasingly costly, and recycling, re-using and minimizing waste therefore appears to be an economically viable option for producers. Consumers, for their part, are beginning to regard environmental quality as a distinctive, desirable product feature. One indication of this trend is that a recent survey in France found that consumers are willing to pay more if they are certain that the processes used in manufacturing the goods they buy are less polluting (France, Ministère de l'environnement, 1993).

Another sign of this trend, which goes beyond the problem of pollution and extends to the conservation of renewable natural resources, is provided by a number of market studies done in Europe on wood products. These studies show that a large and growing proportion of consumers would be willing to pay more for wood products from sustainable forestry sources (World Resources Institute, 1993).

The foregoing trend is in keeping with a process of product differentiation representing a concern for both quality and control. This concern is illustrated by the combative attitude of the consumer in the most highly developed countries, by the action of "green groups" and neighbourhood organizations, and by increased awareness on the part of traditional political parties. In addition, industry itself has exerted pressure on Governments to prevent "unfair competition" from products originating in economies that do not have environmental protection policies. As a result of all these

pressures, Governments are beginning to impose limitations on the movement of goods harmful to the environment.

Indeed, various quality control systems for production and products have been in the pipeline for some time. Two dynamic features of these systems stand out. First, as they are incorporated into the market, they are being standardized and are gradually changing from voluntary to formal and, in some cases, compulsory systems. Second, quality control systems are tending to focus less on product quality than on quality of management, since the former depends on the latter. Standards applying to a product's environmental impact during all phases of its life-cycle, from the production of its natural inputs to the final destination of the waste it generates once it has been consumed or its useful life has ended, are now being formulated.

The fluidity and stability of world trade depend on the existence of a series of rules that have been duly harmonized on the basis of mutually agreed criteria and incorporated into international agreements. One instrument which is gaining in importance is the "environmental quality seal": it represents a new set of standards that are playing a growing role as external determinants of trade and that should be taken into account in any export strategy (see box II.3, on environmental labelling in Europe).

Environmental quality labels are also being used as part of an effort to establish the world-wide certification of timber harvested from well-managed forests ("wood marked with a green label"). One indicator of the possible consequences of this certification is the change that has occurred in the United States market: increasingly aware of the importance of protecting native forests, it has begun to reject furniture manufactured in Malaysia, Thailand and Indonesia with native wood from virtually non-renewable forests. This

new attitude has also had a positive impact on Chilean exports of products made with Monterey pine (from plantations), the demand for which has increased significantly in the United States market. In the case of wood, the "green seal" might even become a factor in the competitive advantage of this product, and wood that does not bear this seal might be excluded from a growing proportion of global markets. It is fairly likely that other goods produced from marine and other renewable natural resources will receive similar treatment, by either Governments or consumers.

In the developed countries, pressures towards better environmental management have produced an internalization of the relevant costs. At the institutional level, these have resulted in the adoption by the OECD countries in 1985 of the "polluter pays principle". The formulation of this principle is intended to quantify environmental impact and classify the generating sources on the basis of this impact, which until now has been uncontrolled economically. In contrast, in the developing countries, including those of Latin America, these costs are generally not included in the price of their main exportable commodity, raw materials (Biggs, 1992). This asymmetry tends to accentuate the deterioration of the terms of trade for such commodities.

One of the causes of this asymmetry is the greater institutional weakness of the developing countries, the fragility of their legal and regulatory framework, and their limited capacity to monitor and control environmental damage. Perhaps a more basic cause is that these countries are less interested in internalizing the environmental costs in their main exports for fear of losing competitiveness in global markets.<sup>12</sup>

The logic of world trade, therefore, is operating in such a way that, through the structure of international prices, all

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12 Strictly speaking, this is a spurious component of competitiveness, since the absence of environmental standards leads them to underestimate or even disregard a real production cost or a negative externality.

## Box II.3

## ENVIRONMENTAL LABELLING IN EUROPE

At the end of 1992, the environment ministers of the European Community agreed to establish a system under which a uniform environmental seal would be used throughout Europe.

Each member State would have an organization responsible for awarding the seal on the basis of a series of principles to be defined by a committee composed of representatives of Community governments, industries, consumers, non-governmental environmental organizations and trade unions.

Currently being discussed is the establishment of these seals for a series of products based on their environmental friendliness, in terms of water and energy consumption and the recyclability of some of their components. These products are washing

machines and dishwashers, light bulbs, hair sprays, paper for general use and toilet paper. The objective would be to label products with a detailed description of their features so that the consumer can choose freely what products he or she will buy on the basis of information on their environmental impact.

This initiative is not immune to criticism. However, most of the arguments seek to correct and perfect the instrument, *inter alia*, by establishing better criteria in relation to product life-cycle and recyclability, suggesting certain assessment procedures and making a sort of life-cycle inventory in the European market. It appears that no one is questioning the need to inform consumers about these aspects of the "environmental quality" of the products they are being offered.

Source: James Salzman, *Environmental Labelling in OECD Countries*, Paris, Organization for Economic Cooperation and Development (OECD), 1991.

countries (all consumers) are bearing the monetary costs of controlling environmental degradation in the industrialized countries internalized in the price of their products for domestic consumption and for export and at the same time financing these countries' efforts to find new ways of adopting clean technologies, minimizing waste and saving energy and raw materials. On the other hand, environmentally related losses in the developing countries are being sustained by these countries alone. Since these costs are not transferred to the price of the product, these products are in fact being subsidized for consumers throughout the world, and this hidden environmental subsidy is discouraging the development and implementation of clean technologies and other environmentally friendly practices.

To obviate this situation, the countries of the southern hemisphere must find a way of including in the prices of their products the costs of environmental protection, i.e., the outlays involved in the

installation of decontaminating equipment, the adoption of clean technologies, and the achievement of sustainable modes of natural-resource use, especially in the case of non-renewable resources. The best solution would seem to be to resort to international negotiation, in which producers of natural resources in both developed and developing countries would be included. This would be a way of mitigating the fear of acting individually and possibly risking the loss of markets.

If multilateral action is not feasible, the countries of the region could in any case begin a process of identifying certain clean products for which they can charge a premium. Agricultural products are especially promising in this sense, since consumers in developed countries are apparently willing to pay more for healthful foods. Moreover, as indicated above, it would be important to initiate a process in the region aimed at improving the countries' institutional capacity to monitor and control environmental

damage and ensure compliance with international agreements.

Obviously, in the near future, these changes will become key components of international competitiveness, and the countries that are first to incorporate them will have an opportunity to acquire competitive advantages. The nations of Latin America and the Caribbean, and of the southern hemisphere in general, have already fallen behind and should not wait

any longer to move ahead in this field. Besides, trade liberalization and export promotion may aggravate the damage to ecosystems that is already being caused by the production system. In considering issues related to changing production patterns as a means of meeting the requirements of a more open, transnational system, special attention should be given to this aspect of sustainability.

## Chapter III

# EXPORT PERFORMANCE IN LATIN AMERICA AND THE CARIBBEAN

### 1. The new outward-looking orientation

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In the early 1980s the countries of the region adopted adjustment policies in order to cope with external constraints (ECLAC, 1984a). Gradually, however, the thrust of these measures came to be an overall reorientation of economic policy which included, inter alia, drastic trade reforms. After having made transitions entailing high social costs, most of the countries have succeeded in boosting their export coefficients and in considerably improving the management of their economic policy. These efforts have been reflected in lower inflation, a better fiscal performance and, since the beginning of the 1990s, somewhat of an upturn in growth rates and, to a lesser extent, in saving and investment rates.

The higher real exchange rates resulting from the external debt crisis and the domestic recessions triggered by the adjustment policies of the early 1980s, followed by trade reforms, paved the way for a significant alteration of the production structure. This process involved the restructuring of some enterprises, the disappearance of others and the emergence of new activities.

This gradual transformation of the production structure has been reflected in a higher ratio of exports to GDP, a

diversification of exports, a greater competitiveness on the part of a growing number of firms, and a substantial improvement in entrepreneurs' ability to explore and gain access to external markets.

This restructuring of production—which has been marked by an increase in the percentage of total output represented by exportable items—has shown signs of increased flexibility in adapting to changes in relative prices and to world market trends. Greater economic stability has encouraged a larger inflow of foreign direct investment and increased access to external financing in general, as well as the repatriation of capital in some economies. As a result, savings and investment rates have been moving upward, although they are as yet still too low. Last but not least, the shift in regional cooperation and integration schemes towards a modality of greater openness has made it possible for countries in the region to conclude a number of trade agreements designed to establish free trade zones or to permit the use of intraregional trade as a tool for improving their economies' linkages with the global economy.

The region's economic performance in the early 1990s demonstrates that there has been some upturn in growth, and this trend has, to a large extent, been associated with the countries' new balance-of-payments position. An element of special

significance in this connection is the net transfer of resources to the region from abroad (amounting to about 3% of the region's GDP), which is helping to finance its deficit on current account (4% of GDP in 1993); this deficit has widening since 1990 in line with a similar trend in the merchandise trade balance (see table III.1).

*a) Exports: A long-term view*

In general, the correlation between the expansion of exports and overall economic growth in the countries of the region was weak during the 1970s and 1980s. The link between the two variables –which was already tenuous, in many cases, in the 1970s– became even more so during the crisis of the 1980s, when the recession dampened the level of domestic activity at the same time that the need to bring about an external adjustment was acting as an impetus for export growth. With very few exceptions, the countries' liberalization processes –which have reduced the anti-export bias of economic policy– and their stabilization programmes –which have coupled export incentives with lower inflation rates and greater fiscal discipline– are still in their early stages. On the other hand, in many cases there has been a tendency for the comparatively high real exchange rates with which these processes were begun to become eroded by the recent abundance of external financing.

Thus, between 1970 and 1994, the region's volume of merchandise exports grew at an

average annual rate of 4.2%. If Venezuela is excluded in order to factor out part of the effect of the changes seen in fuel prices and export volumes, then the rate of expansion was 6.5% per year (see table III.2).

Table III.2 brings out at least two particularly important points. First, in 15 of the 18 countries listed, the export effort (as reflected in the long-term growth rate of export volumes) was greater than the variation in the purchasing power of exports during the same period.

The reasons for this differential are obviously associated with the type of trade specialization pursued by the countries of the region and with its implications in terms of the trends in the relative prices of the region's export basket. The second point is that, for 10 of these countries (and for the region as a whole), the growth rate of merchandise exports was higher than that of GDP during this 20-year period. Here again, however, considerable differences are to be observed between one sub-period and another.

The countries turning in the strongest export performances, with growth rates of over 5% for the period 1970-1994, were (in descending order) Ecuador, Mexico, Paraguay, Brazil, Chile, Costa Rica, Colombia and Uruguay. The expansion of exports has picked up speed in the 1990s, with the average rate for 1990-1994 climbing to 7%. In fact, five countries –Costa Rica, Chile, Bolivia, Brazil and Ecuador– have actually achieved rates of over 9% per year.

Table III.1  
LATIN AMERICA AND THE CARIBBEAN: CURRENT ACCOUNT AND TRADE BALANCES  
(Percentages of GDP)

	1983-1989	1990	1991	1992	1993
Current account <sup>a</sup>	-1.0	-0.5	-1.8	-3.2	-4.1
Trade balance (goods and services) <sup>b</sup>	3.3	2.5	0.7	-1.1	-1.7

Source: ECLAC, in 1980 dollars, on the basis of official figures.

<sup>a</sup> Equal to the net use of external savings. <sup>b</sup> The trade balance, at 1980 prices, plus the terms-of-trade effect.

Table III.2  
**LATIN AMERICA: GROWTH RATES OF EXPORTS AND  
 GROSS DOMESTIC PRODUCT, 1970-1994**  
*(In 1980 dollars; annual growth rates)*

	1970-1980			1980-1990			1990-1994			1970-1994		
	GDP	Exports		GDP	Exports		GDP	Exports		GDP	Exports	
		Vol- ume	Pur- chasing power									
Argentina	2.8	2.1	3.2	-0.9	7.1	2.4	7.4	3.6	2.7	2.0	4.4	2.8
Bolivia	3.9	-1.7	7.0	0.0	1.4	-2.4	3.8	11.0	1.1	2.2	1.6	2.8
Brazil	8.6	8.2	5.3	1.5	6.5	4.2	2.0	9.6	11.0	4.5	7.7	5.8
Colombia	5.4	3.7	5.5	3.7	6.4	4.9	3.8	7.5	4.7	4.4	5.4	5.1
Costa Rica	5.5	3.8	4.1	2.3	4.3	3.9	5.0	13.6	11.8	4.0	5.6	5.3
Chile	2.5	7.4	1.3	2.8	6.6	4.8	6.4	11.1	8.5	3.2	7.7	3.9
Ecuador	8.9	14.6	13.3	1.9	6.2	3.6	3.6	9.5	4.7	5.0	10.2	7.8
El Salvador	3.1	4.6	4.7	-0.1	-3.1	-9.5	4.6	4.8	7.1	1.8	1.3	-1.1
Guatemala	5.7	6.4	6.3	0.8	-0.7	-1.8	3.9	3.7	4.3	3.3	2.9	2.5
Haiti	4.7	6.7	6.5	-0.4	1.7	-3.4	-8.2	-28.0	-27.1	0.3	-2.1	-4.0
Honduras	5.6	4.1	3.9	2.3	1.2	1.3	3.3	-2.4	1.8	3.8	1.7	2.4
Mexico	6.7	10.2	14.4	1.6	8.8	4.8	2.5	5.4	3.0	3.9	8.8	8.4
Nicaragua	0.2	-1.1	-1.6	-1.4	-0.7	-3.2	0.4	4.7	-5.0	-0.4	0.0	-2.9
Paraguay	8.7	7.3	5.2	3.2	11.8	16.1	2.7	2.2	-14.3	5.4	8.3	6.0
Peru	3.9	2.3	1.5	-1.2	-2.3	-4.7	4.3	6.8	3.9	1.8	1.1	-0.8
Dominican Republic	7.1	4.9	3.9	3.0	0.2	-4.7	3.4	-3.1	-5.3	4.7	1.6	-1.4
Uruguay	3.0	5.4	-0.5	0.5	5.0	4.7	4.2	4.8	2.3	2.1	5.1	2.1
Venezuela	1.8	-5.8	10.1	0.4	1.6	-0.7	2.7	5.8	-3.7	1.4	-0.9	3.2
<b>Latin America</b>												
<b>18 countries</b>	<b>5.6</b>	<b>2.0</b>	<b>6.6</b>	<b>1.2</b>	<b>5.4</b>	<b>2.7</b>	<b>3.4</b>	<b>7.0</b>	<b>4.8</b>	<b>3.4</b>	<b>4.2</b>	<b>4.6</b>
<b>Latin America</b>												
<b>17 countries</b>												
<b>(excluding Venezuela)</b>	<b>6.0</b>	<b>6.4</b>	<b>5.8</b>	<b>1.3</b>	<b>6.3</b>	<b>3.5</b>	<b>3.4</b>	<b>7.2</b>	<b>6.2</b>	<b>3.6</b>	<b>6.5</b>	<b>4.9</b>

Source: ECLAC, on the basis of official figures.

Generally speaking, exports rose more sharply than GDP throughout the period in question and in each individual sub-period (see the regional total, excluding Venezuela, in table III.2).

The rapid GDP growth attained in the 1970s was accompanied by an even steeper increase in the volume of merchandise exports (6% and 6.4%, respectively).

The period 1980-1990 was one of recession or slow growth in the entire region owing to the adjustments that were made in domestic demand in order to cope with the debt crisis or for purposes of stabilization. The rapid expansion of exports which was observed in many cases could do little, on its own, to counter the effects of these adjustments on the level of activity.

During the period 1990-1994, there was a gradual resumption of growth, as a result of which the annual average rate of increase in GDP rose to 3.4%, after having been just 1.2% between 1980 and 1990. Six countries registered export growth rates above the 7% regional average, and five of them also recorded GDP growth rates above the regional mean of 3.4% (see table III.2). As the region's macroeconomic environment returns to normal, the link between export growth and the expansion of production appears to be growing stronger. As will be discussed later on (see chapters V through VIII), this change is not a spontaneous phenomenon but instead has to do with the nature and quality of the countries' macroeconomic, trade and production policies.

*b) Recent export performance*

In the 1980s, the countries of the region drastically modified their development strategy. In line with world trends towards economic globalization, they steered their course back towards exports. This change of direction is reflected in the variations observed in their coefficients of export orientation. The most marked increases (over 50% of the coefficient) in export orientation between 1980 and 1993 –although from different starting points in terms of the economies' degree of openness to export trade– were achieved by Argentina, Brazil, Chile, Costa Rica, Ecuador, Mexico, Paraguay and Uruguay (see figure III.1). Chile and Uruguay had already made considerable headway in this direction during the 1970s.<sup>13</sup> The

region as a whole raised its export coefficient from 14% of GDP in 1980 to 21% in 1990 and to 23% in 1994. Although this figure is still low in international terms, when compared to the average for developing countries<sup>14</sup> it represents a rapid increase in a brief time-span, and eight of the countries are now recording export levels equivalent to 30% of GDP or more.

Latin America's reorientation towards exports has not been enough, however, to reverse the deterioration in the region's relative share of world trade (see table I.4).

## 2. Export effort and terms of trade

The considerable export effort made by the region during the 1980s and early 1990s was seriously undermined –in terms of the purchasing power of exports– by the downturn in export unit values, which was the main cause of the deterioration seen in the terms of trade during the period (see figure III.2). Thus, in 1980-1993, while the region expanded the volume of its exports by 103% (5.6% per year), their value increased by only 51% (3.2% per year) owing to a 26% cumulative drop in prices. This situation was largely due to what is still a heavy dependence on commodities involving a low degree of processing, whose prices have exhibited a downward trend along with sharper cyclical fluctuations.

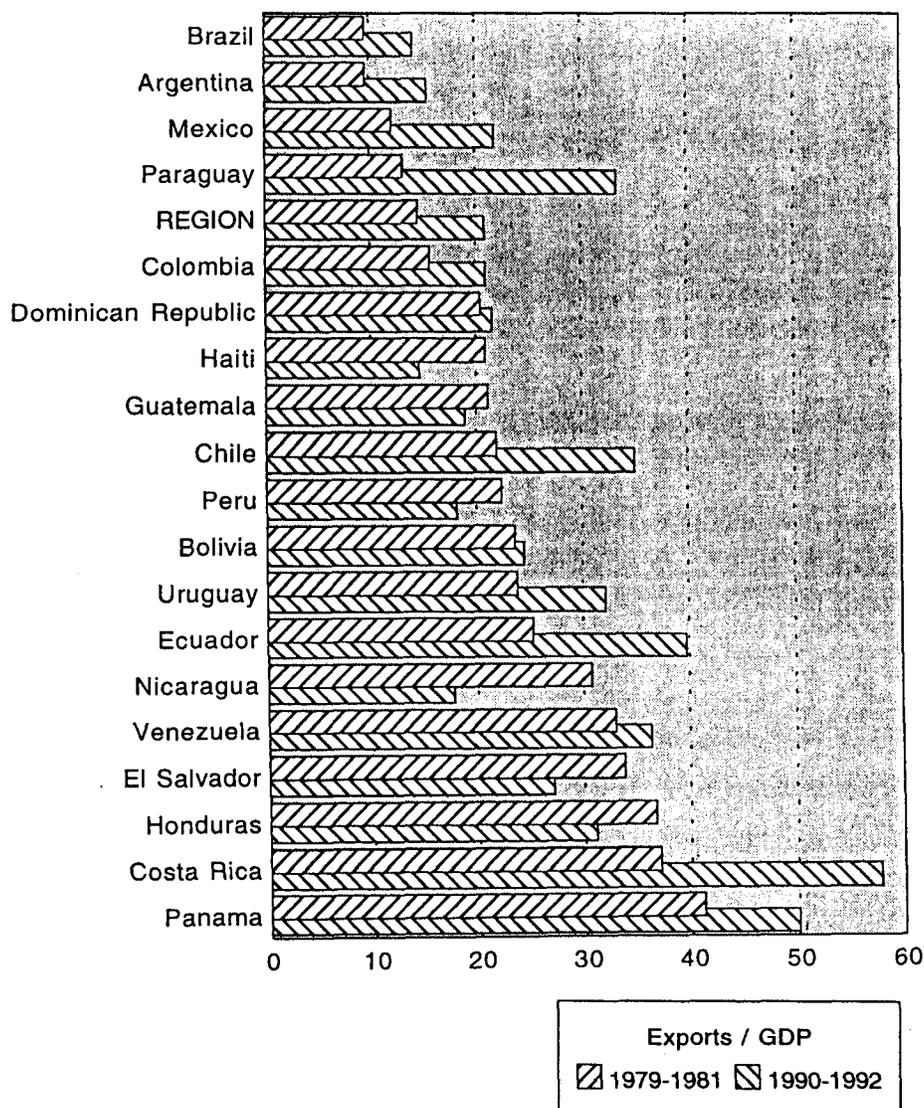
These trends in Latin America's export prices and terms of trade during the 1980s must be viewed within the context of the differing types of behaviour displayed by prices for oil, other commodities and

13 Generally speaking, there is an inverse relationship between the size of a country's economy and its degree of export orientation. This was particularly noticeable in the region during the 1970s, when Argentina, Brazil and Mexico had the lowest export coefficients. In recent years, this relationship has been less direct as the countries have opted for export strategies that seek to boost their export coefficients as an economic policy objective, regardless of the size of the economy. For example, Chile and Mexico now have higher export coefficients than a number of smaller economies.

14 The region's 1990 export coefficient of 21% of GDP is similar to the average export coefficient for the OECD, slightly higher than the average for low-income developing countries and lower than the average for medium- and high-income developing economies (World Bank, 1991a).

Figure III.1

LATIN AMERICA AND THE CARIBBEAN: RATIO BETWEEN EXPORTS OF GOODS  
AND SERVICES AND GDP (%)<sup>a</sup>



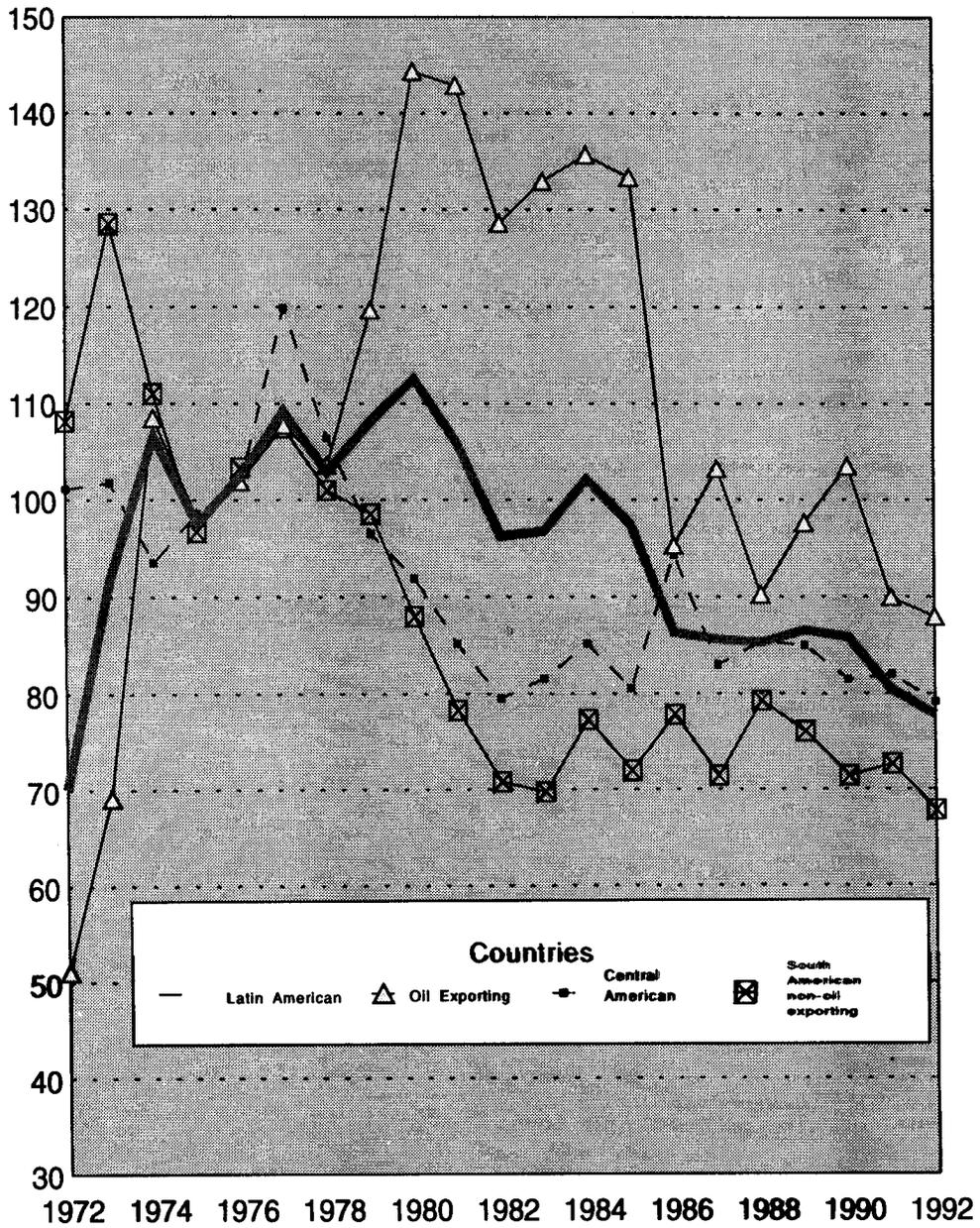
Source: ECLAC, in 1980 dollars, on the basis of official figures.

<sup>a</sup> The countries are listed in accordance with their coefficients for the period 1979-1981.

manufactures on world markets. In the 1970s, after the initial impact of higher oil prices on world inflation, the terms of trade for most Latin American countries hovered around a fairly constant level up to the end of the decade, and the purchasing power of exports increased, for the most part, in step with export volumes.

From 1980 onward, these trends broke down. A second boom in oil prices was followed by a drop to real levels below those recorded during the first. Commodity prices tended to decline, in nominal terms, while the prices of the manufactures imported by the region climbed further, although slowly. The combination of these two trends triggered

Figure III.2  
**LATIN AMERICA: TERMS OF TRADE (GOODS)**  
 Index (1975-1976=100)



Source: ECLAC, on the basis of official figures.

a sharp drop in the terms of trade of the non-oil-exporting countries in the early years of the decade. Between 1986 and 1990 the prices of some Latin American commodity exports did recover, however;<sup>15</sup> this slowed the decline, but could not reverse it.

Later, up to 1993, the prices of most of Latin America's commodity exports (including oil) turned downward once again –quite sharply, in some cases. As a result, the terms of trade of nearly all the countries of the region fell below their 1990 levels (see figure III.2). The decline observed in those last three years (-13%) only compounded the cumulative drop registered between 1980 and 1990 (-21%).

Since the mid-1970s, the decline in the terms of trade has had a greater impact on the non-oil-exporting South American countries than on those of Central America and the Caribbean, and especially than on the oil-exporting countries. The latter, however, witnessed a sharper decrease in the 1980s because of the high level reached by hydrocarbons prices early in that decade (see figure III.2).

In 1994, as is well known, a widespread upturn was seen in export prices. This translated into a 3% improvement in the terms of trade during that same year. This trend in external prices also added further to the abundant supply of funds produced by the copious inflow of capital to the region (see chapters IX and XI).

### 3. Sectoral export trends

During the 1970s, the value of the manufactures exported by the region, with few exceptions, increased at a considerably faster rate than the value of

total exports. A similar trend, although less marked in most cases, was seen in semi-manufactures.<sup>16</sup> During the period 1980-1987, when the value of exports exhibited zero growth or edged up only slowly due to sagging prices, few countries (Brazil, Colombia, Paraguay, Uruguay, Venezuela and, especially, Mexico) were able to maintain a significant rate of increase in their exports of manufactures; instead, most of them had to rely on the growth of external commodity sales in order to prop up the value of their exports.

Between 1987 and 1993, the region's economies saw a general improvement in export growth. Except in El Salvador, Honduras and Nicaragua, which were held back by conflicts in the subregion, the countries recorded an appreciable increase in the value of their exports. In most cases, manufactures led the way, followed by semi-manufactures. In Argentina, Chile, Ecuador and Paraguay, commodity sales were very strong, however. In Chile, commodity sales expanded less rapidly than exports of manufactures but more sharply than semi-manufactures. In Costa Rica, Guatemala, Peru and Uruguay, on the other hand, semi-manufactures were the growth leaders for exports (see table III.3).

To sum up, the greater buoyancy of manufactures exports has become a medium-term feature of nearly all the countries of the region. This is in line with world-wide trends, since the volume of world trade in manufactures has climbed twice as fast as the volume of commodities in the last two decades. During this period world trade in manufactures has increased at an average annual rate of 6.3% and Latin American exports of manufactures have grown by

15 Especially the prices of certain minerals (copper, iron, lead, zinc) and some agricultural raw materials (cowhide, wood, tobacco).

16 During this period, however, Mexico experienced a disproportionate increase in its external sales of commodities due to the expansion of its oil exports, and Chile boosted the value of its commodity exports almost as much as the value of its manufactures, while the growth rate of its semi-manufactures (primarily copper) slowed.

Table III.3  
LATIN AMERICA: MERCHANDISE EXPORT TRENDS  
BY TYPE OF PRODUCT

		Annual growth rates in current dollars (%)			Elasticity in relation to total		
		1970 - 1980	1980 - 1987	1987- 1993	1970- 1980	1980- 1987	1987- 1993
Argentina	Primary products	13.7	-8.3	13.1	0.84	(2.52)	1.03
	Semi-manufactures	18.4	0.2	11.2	1.13	-0.06	0.88
	Manufactures	21.6	0.7	14.4	1.33	-0.21	1.13
	Total	16.3	-3.3	12.8			
Bolivia	Primary products	19.1	-4.9	-4.3	1.17	(0.6)	-0.72
	Semi-manufactures	13.7	-16.1	15.5	0.84	(1.96)	2.58
	Manufactures	5.5	-11.9	53.6	0.34	(1.45)	8.93
	Total	16.3	-8.2	6.0			
Brazil	Primary products	12.8	0.4	2.1	0.58	0.10	0.32
	Semi-manufactures	28.8	1.6	5.5	1.30	0.41	0.82
	Manufactures	36.0	8.1	9.5	1.62	2.08	1.41
	Total	22.2	3.9	6.7			
Colombia	Primary products	16.2	2.9	2.1	0.88	0.83	0.31
	Semi-manufactures	23.0	5.6	3.3	1.25	1.60	0.49
	Manufactures	29.5	3.7	19.2	1.60	1.06	2.83
	Total	18.4	3.5	6.8			
Costa Rica <sup>a</sup>	Primary products	13.5	3.8	6.2	0.87	1.81	0.60
	Semi-manufactures	17.2	-5.4	23.7	1.11	-2.57	2.29
	Manufactures	21.3	-0.3	10.0	1.37	-0.14	0.97
	Total	15.5	2.1	10.3			
Chile	Primary products	19.3	6.9	11.8	1.38	5.31	1.08
	Semi-manufactures	12.5	-1.3	8.8	0.89	-1.00	0.80
	Manufactures	24.7	-0.7	25.4	1.76	-0.54	2.31
	Total	14.0	1.3	11.0			
Ecuador <sup>a</sup>	Primary products	26.8	-1.8	10.5	0.91	(0.62)	1.33
	Semi-manufactures	44.2	-6.7	-11.2	1.51	(2.31)	-1.42
	Manufactures	33.4	-7.2	22.2	1.14	(2.48)	2.81
	Total	29.3	-2.9	7.9			
El Salvador <sup>a</sup>	Primary products	10.5	1.1	-20.8	0.86	-0.48	1.70
	Semi-manufactures	15.3	-4.9	-1.0	1.25	(2.13)	(0.08)
	Manufactures	14.3	-8.9	2.2	1.17	(3.87)	-0.18
	Total	12.2	-2.3	-12.2			
Guatemala <sup>a</sup>	Primary products	17.7	-6.0	1.6	1.00	(0.90)	0.21
	Semi-manufactures	20.8	-9.3	20.4	1.18	(1.39)	2.68
	Manufactures	15.6	-6.7	12.0	0.88	(1.00)	1.58
	Total	17.7	-6.7	7.6			
Honduras <sup>a</sup>	Primary products	17.4	0.3	-1.6	1.02	-0.33	2.29
	Semi-manufactures	12.9	-2.0	-9.2	0.76	(2.22)	(13.14)
	Manufactures	20.7	-16.4	29.3	1.22	(18.22)	-41.86
	Total	17.0	-0.9	-0.7			

Table III.3 (concluded)

		Annual growth rates in current dollars (%)			Elasticity in relation to total		
		1970 - 1980	1980 - 1987	1987- 1993	1970- 1980	1980- 1987	1987- 1993
Mexico <sup>a</sup>	Primary products	37.2	-2.4	-0.3	1.27	-0.59	-0.05
	Semi-manufactures	17.0	9.7	5.0	0.58	2.37	0.86
	Manufactures	16.3	25.0	13.2	0.55	6.10	2.28
	Total	29.4	4.1	5.8			
Nicaragua <sup>b</sup>	Primary products	10.5	1.1	-20.8	0.86	-0.48	1.70
	Semi-manufactures	15.3	-4.9	-1.0	1.25	(2.13)	(0.08)
	Manufactures	14.3	-8.9	2.2	1.17	(3.87)	-0.18
	Total	12.2	-2.3	-12.2			
Paraguay	Primary products	20.2	5.9	9.4	1.18	3.11	0.74
	Semi-manufactures	13.9	-9.0	19.9	0.81	-4.74	1.56
	Manufactures	15.2	7.4	21.1	0.89	3.89	1.66
	Total	17.1	1.9	12.7			
Peru	Primary products	16.9	-8.6	-2.2	1.36	(1.46)	-0.31
	Semi-manufactures	6.6	-4.1	11.2	0.53	(0.69)	1.57
	Manufactures	46.8	-5.4	6.8	3.77	(0.92)	0.95
	Total	12.4	-5.9	7.1			
Uruguay	Primary products	11.4	-1.0	2.4	0.70	-0.53	0.49
	Semi-manufactures	18.2	3.2	7.6	1.11	1.68	1.56
	Manufactures	25.0	3.6	4.9	1.52	1.89	0.99
	Total	16.4	1.9	4.9			
Venezuela	Primary products	19.1	-10.4	4.3	0.97	(1.27)	0.70
	Semi-manufactures	21.0	-6.0	5.6	1.07	(0.73)	0.92
	Manufactures	25.0	14.2	19.9	1.27	-1.73	3.26
	Total	19.7	-8.2	6.1			
Items pro memoria:							
Unit value of Latin America and Caribbean merchandise exports		17.6	-2.6	1.7			
Unit value of developed-country exports of manufactures		11.1	2.2	2.8			

Source: ECLAC, on the basis of official figures.

Notes: 1. Merchandise exports have been classified on the basis of the criterion discussed in ECLAC, "El comercio de manufacturas de América Latina: evolución y estructura, 1962-1989", *Estudios e informes de la CEPAL*, No. 88 (LC/G.1731-P), Santiago, Chile, November 1992. United Nations publication, Sales No. S.92.II.G.12, pp. 30-34.

2. The figures in brackets represent the quotient of negative rates.

<sup>a</sup> For 1970-1992. <sup>b</sup> For 1970-1991; the year 1988 was used in the place of 1987.

11%, although it should be noted that the levels from which the countries of the region started were quite low and that this overall figure was strongly influenced by the scale of Brazil's and Mexico's sales. The fact that, for each percentage point of increase in world output during the last two decades, trade in manufactures has risen by 2% while trade in commodities has climbed by only 0.6% (IDB, 1992) underscores the importance of the role to be played by manufactures in strategies aimed at maximizing the contribution of exports to growth.

*a) Agricultural exports*

During the 1980s, the volume of the region's agricultural exports increased at a rate of 2.3% per year, but their value rose by only 1.4% per year owing to the decline in their unit values. Following sharp price decreases in the early 1990s, the value of these exports as of 1992 was barely on a par with their 1979-1981 average.

This performance stands in contrast to the trend of earlier decades, particularly the 1970s, when the volume of external sales climbed by over 4% per year as exporters took advantage of booming prices. As a result, the value of the region's exports more than quadrupled during the decade. The slower growth of world food demand and the protectionist practices used in connection with traditional crops in the developed countries led to steep decreases in the international prices brought by staple crops, especially in the 1980s (see figures I.1 and III.3). Under these circumstances, the region's exports of traditional crops rose very slowly, and this situation prompted substantial efforts to diversify agricultural exports and to penetrate new markets.

The agricultural export drive launched in the 1980s, in the face of a pronounced downturn in the international prices of traditional products, is noteworthy for the strong expansion of non-traditional exports which it has brought about. A number of countries have succeeded in capitalizing upon new market opportunities for tropical and subtropical fruit and related products, as well as for out-of-season vegetables and fruits. Growers have also made use of advances in food-preservation technologies in order to develop new varieties that are easier to transport and store. With few exceptions, the producers in the modern sector of the economy are the ones who have taken this enterprising approach to non-traditional exports and who have been the main beneficiaries of government export-promotion efforts.

This stronger performance of non-traditional agricultural exports has been made possible both by the improvement in relative prices resulting from currency depreciation, deregulation and, in some cases, tax cuts, and by major advances in extractive and processing technologies, biogenetics and biomass management techniques, which have pushed back the frontier of commercially viable agricultural resources (see chapter VI, section 3).

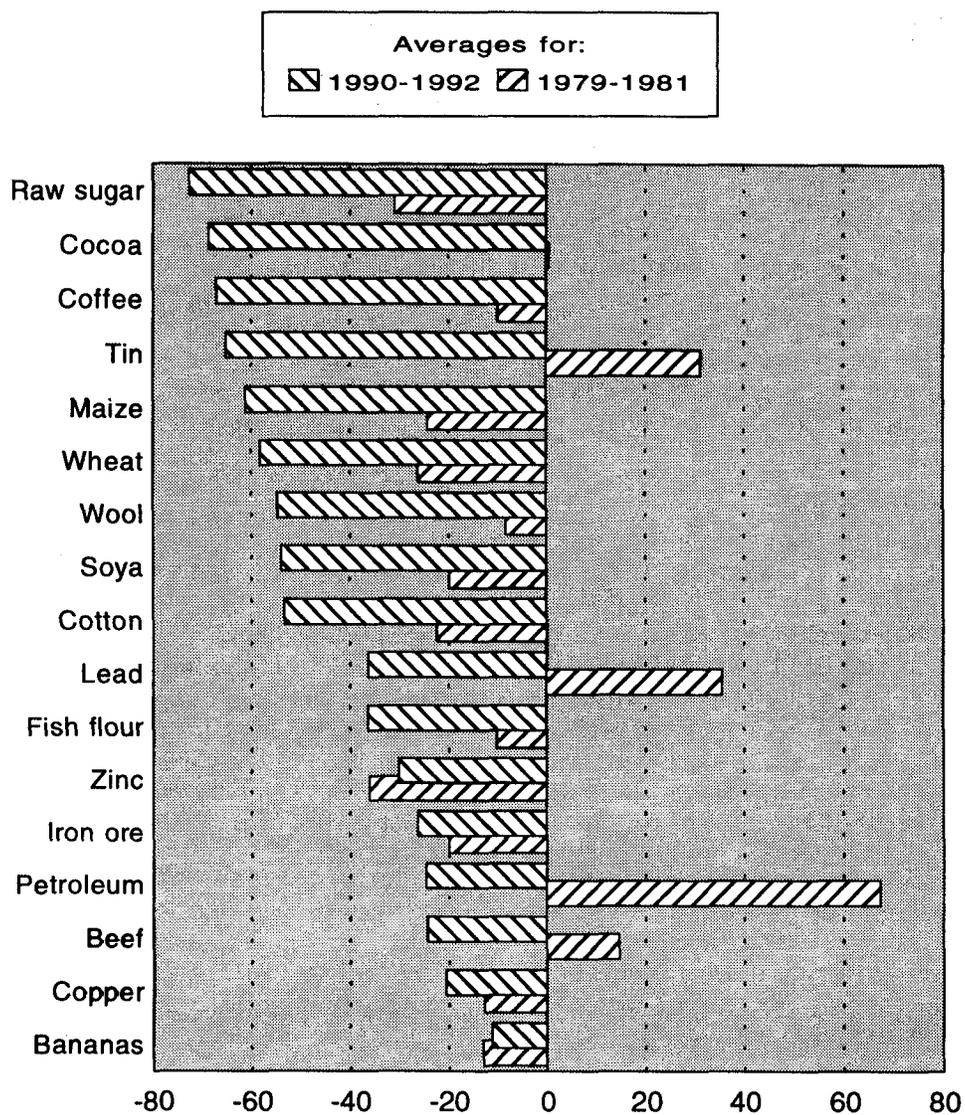
Consequently, substantial changes are occurring in the composition of the region's agricultural exports. The value of non-traditional products (e.g., fresh,<sup>17</sup> frozen and processed fruits and vegetables, flowers, beverages and wine) trebled during the decade, rising from a 20% share of the agricultural exports of the Latin American Integration Association (ALADI) countries in 1983 to one third of the total in 1990 (ECLAC, 1993a).

17 It is important to note that the conventional category of fresh, unprocessed produce does not necessarily entail a lower level of value added. Fresh produce often requires quite complex processes of production, harvesting, selection, classification, quality control, conservation and transportation. Furthermore, the final consumers of these products tend to be very demanding as regards their quality and appearance. This creates a need for a wide range of ancillary services in the production process that add value to the product (ECLAC, 1993a).

Figure III.3

LATIN AMERICA AND THE CARIBBEAN: REAL PRICES OF EXPORT PRODUCTS <sup>a</sup>

(Percentage variations from the 1975-1976 average)



Source: ECLAC, on the basis of figures supplied by UNCTAD.

<sup>a</sup> Nominal prices were deflated by the unit value index for exports of manufactures from developed market-economy countries.

Some of the most outstanding examples of non-traditional exports of products closely related to the region's agricultural resources<sup>18</sup> are fresh, frozen, dried and salted crustaceans and molluscs (Argentina and Panama); soluble meal and similar animal feeds derived from marine species (Chile and Ecuador); frozen shrimp (Ecuador); salmon (Chile); grapes (Chile and Mexico); apples (Chile); pineapples (Costa Rica and Dominican Republic); orange juice concentrate (Brazil); fresh poultry (Mexico); cut flowers (Colombia and Costa Rica); and lumber and cross-ties (Chile). In each of these cases, the increase in these countries' sales during the period 1970-1990 far surpassed the average growth rate for world exports of the products in question (ECLAC, 1992d).

*b) Industrial exports*

Between 1980 and 1992, the value of the region's industrial exports (semi-manufactures and manufactures) rose by 7% annually. In the case of Mexico and Chile, the increases were 14% and 8% per year, respectively, while the rates for Brazil and Argentina were 7% and 5%.

The greatest surge in exports during this period, for the region as a whole, was in basic inputs (14% annually), whose growth rate was twice as high as the average increase in both labour- and capital-intensive traditional and new industries. Semi-manufactures expanded more slowly (4% per year)<sup>19</sup> (see table III.4). Mexico stood out not only because

its industrial exports exhibited the most rapid expansion but also because it achieved the most balanced growth among the various types of industries. In Chile, the steepest increase in exports was in traditional industries, while in Brazil and Argentina basic inputs were the growth leader.

The strong, rapid expansion of exports of basic-input manufactures was due to three factors: i) this was the industrial activity that achieved the greatest gains in productivity in the 1980s (3% per year, which was almost double the productivity growth registered by the manufacturing sector overall during this period); ii) the fall in domestic demand spurred foreign sales because, since this is a capital-intensive production process, its variable costs, regardless of the exchange rate, tend to be much lower than its average costs; and iii) its products are relatively homogenous "industrial commodities" and are therefore easier to sell on world markets.

The fairly strong expansion of the region's industrial exports during the 1980s had two notable features: i) it occurred within a context of slow growth in industrial output (1.1% per year, as opposed to an annual average of 6.4% in the 1970s); and ii) in nearly all cases, it led to an increase in the share of manufactures in total exports.

As a consequence of this latter phenomenon, in two economies –Brazil and Mexico– manufactures accounted for close to half of total exports in 1993. In another two –El Salvador and Uruguay– they amounted to more than one third of

18 These products are defined as those which are not included in the Integrated Programme on Commodities of UNCTAD, do not belong to the category of energy resources, constitute a new export activity for the country in question, involve a new market for the product, may appear outside the traditional season and are of some sectoral importance in the relevant national economy (ECLAC, 1992d).

19 For the purposes of this discussion, the term "manufactured goods" is understood to refer to the articles listed in sections 6, 7 and 8 of the SITC, except for those included in chapter 68. In the remainder of this chapter, products will be categorized as semi-manufactures, traditional industries, basic inputs, new labour-intensive industries and new capital-intensive industries. A more detailed explanation of this classification may be found in ECLAC (1992e), pp. 30-34.

Table III.4  
**LATIN AMERICA AND THE CARIBBEAN: GROWTH TRENDS IN INDUSTRIAL  
 EXPORTS BY TECHNOLOGICAL CONTENT, 1980-1992**  
*(Real annual growth rates)*

	Total	Semi-manufactures <sup>a</sup>	Traditional industries <sup>b</sup>	Basic-input industries <sup>c</sup>	New labour-intensive industries <sup>d</sup>	New capital-intensive industries <sup>e</sup>
Argentina	5.4	5.6	2.2	12.9	3.7	1.9
Brazil	6.6	2.3	8.1	20.8	3.8	2.0
Chile	8.4	8.6	17.8	8.2	10.9	1.4
Mexico	14.0	10.9	14.9	13.9	15.6	16.9
Other countries <sup>f</sup>	4.4	0.6	7.6	11.4	1.9	-0.7
Latin America and the Caribbean	7.2	3.8	7.9	13.6	6.2	6.3

Source: ECLAC, on the basis of information from the COMTRADE database and ECLAC-designed software for the analysis of industrial growth.

<sup>a</sup> Foodstuffs, beverages, tobacco, wood and wood products, paper and paper products, industrial chemicals, petroleum refineries and petroleum and coal products (ISIC groups 311, 313, 314, 331, 341, 351, 353, 354). <sup>b</sup> Textiles, wearing apparel, leather and leather products, footwear, rubber products, ceramic products, glass and glass products, and miscellaneous manufactures (ISIC groups 321, 322, 323, 324, 355, 361, 362, 390). <sup>c</sup> Plastic products, other non-metallic mineral products, iron and steel, and non-ferrous metals (ISIC groups 356, 369, 371, 372). <sup>d</sup> Furniture, printing and publishing, non-electrical and electrical machinery (ISIC groups 332, 342, 382, 383). <sup>e</sup> Pharmaceuticals and other chemical products, metal products, transport equipment, and professional and scientific equipment (ISIC groups 352, 381, 384, 385). <sup>f</sup> Includes Barbados, Bolivia, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Nicaragua, Panama, Paraguay, Trinidad and Tobago, Uruguay and Venezuela.

the total.<sup>20</sup> In the cases of Argentina, Colombia, Costa Rica and Guatemala, more than 20% of total exports were manufactures. On the other hand, in countries such as Chile, Ecuador or Venezuela in which a single natural resource is exploited intensively, exports of manufactures were no more than one tenth of the total (see table III.5).

In terms of the technological content of exports of manufactures, traditional industries were at the forefront in Bolivia, Colombia, Costa Rica, El Salvador, Paraguay, Peru and Uruguay. In the cases of Nicaragua and Venezuela, industrial

exports of basic inputs were the dominant category. In Argentina, Brazil, Chile, Ecuador, Guatemala, Honduras and Mexico, new industries had the largest share, although the levels of these countries' total exports of manufactures varied widely (see table III.5).

The heterogeneity of the region's exports of manufactures from the standpoint of both production and technological content is illustrated by the fact that, as of 1993, Brazil and Mexico accounted for a full 75% of the regional total; if Argentina's, Colombia's and Venezuela's exports of manufactures are

20 In El Salvador, the main such exports were medicines sold to other Central American countries, textiles and manufactures of paper and paperboard; in the case of Uruguay, they were chiefly textiles and hides.

Table III.5  
**LATIN AMERICA (16 COUNTRIES): COMPOSITION OF  
 EXPORTS OF MANUFACTURES (1970, 1980, 1991-1993)**  
*(In percentages and in millions of dollars)*

		Traditional industries	Basic inputs	New industries	Total	Exports of manu- factures (current dollars)	Manu- factures as a % of merchan- dise exports
Argentina	1970	25.9	16.8	57.3	100.0	232	13.1
	1980	36.7	12.5	50.7	100.0	1,645	20.5
	1993	29.7	16.8	53.4	100.0	3,872	29.6
Bolivia	1970	4.6	94.8	0.6	100.0	13	5.8
	1980	24.4	1.5	74.2	100.0	23	2.2
	1993	82.3	0.4	17.3	100.0	127	15.7
Brazil	1970	21.8	36.9	41.7	100.0	312	11.5
	1980	23.6	17.4	58.9	100.0	6,740	33.6
	1993	22.3	27.6	50.0	100.0	20,071	51.9
Colombia	1970	52.9	15.9	31.2	100.0	48	6.6
	1980	54.4	10.4	35.2	100.0	636	16.1
	1993	47.4	16.1	36.5	100.0	2,356	31.6
Costa Rica	1970	34.9	14.4	50.7	100.0	37	16.1
	1980	40.9	13.8	45.3	100.0	253	26.1
	1992	42.0	17.3	40.7	100.0	400	21.8
Chile	1970	0.6	29.6	69.7	100.0	27	2.2
	1980	6.4	40.0	53.6	100.0	241	5.3
	1993	30.7	13.4	55.4	100.0	890	9.5
Ecuador	1970	47.3	0.2	52.5	100.0	3	1.6
	1980	36.5	1.9	61.7	100.0	54	2.2
	1992	40.8	7.2	52.0	100.0	87	3.0
El Salvador	1970	57.6	9.7	32.7	100.0	57	25.2
	1980	57.5	9.9	32.6	100.0	219	30.5
	1991	54.3	7.1	38.5	100.0	125	34.3
Guatemala	1970	49.9	12.9	37.2	100.0	76	26.3
	1980	41.4	10.8	47.8	100.0	326	22.0
	1992	37.4	15.9	46.7	100.0	354	26.9
Honduras	1970	56.0	4.2	39.8	100.0	12	6.8
	1980	35.0	4.4	60.5	100.0	76	9.3
	1992	40.3	7.4	52.3	100.0	78	10.6
Mexico	1970	22.4	11.0	66.3	100.0	326	27.8
	1980	22.5	6.7	70.7	100.0	1,469	9.5
	1992	10.4	11.4	78.3	100.0	12,966	47.6
Nicaragua	1970	45.4	19.7	34.9	100.0	24	13.7
	1980	27.6	45.2	27.2	100.0	46	11.2
	1991	22.5	48.9	28.5	100.0	19	7.2
Paraguay	1970	4.1	7.6	88.3	100.0	5	7.1
	1980	24.7	0.0	75.2	100.0	19	6.1
	1993	67.3	13.2	19.5	100.0	98	13.5
Peru	1970	36.1	36.1	27.8	100.0	11	1.0
	1980	60.9	12.1	27.0	100.0	494	14.7
	1993	73.3	4.8	21.9	100.0	496	14.3
Uruguay	1970	76.9	11.8	11.3	100.0	40	17.4
	1980	71.1	10.3	18.5	100.0	377	35.6
	1993	62.6	7.8	29.6	100.0	643	40.1
Venezuela	1970	4.7	77.2	18.0	100.0	23	0.7
	1980	2.7	59.3	38.0	100.0	216	1.1
	1993	11.5	48.0	40.5	100.0	1,625	10.8

Source: ECLAC, on the basis of official figures. Merchandise exports have been classified on the basis of the criterion discussed in ECLAC, "El comercio de manufacturas en América Latina: evolución y estructura, 1962-1989", *Estudios e informes de la CEPAL*, No. 88 (LC/G.1731-P), Santiago, Chile, November 1992, pp. 30 - 34. United Nations publication, Sales No. S.92.II.G.12.

added in, then this figure rises to 92% of the total. Moreover, the relative weight of Brazilian and Mexican exports grows as the technological complexity of the export item increases: these two countries accounted for close to 60% of traditional exports, three fourths of the region's exports of basic inputs and 85% of the exports produced by its new industries.

As the region increased its industrial exports during the 1980s, it also boosted its share in imports of manufactures by the Organization for Economic Cooperation and Development (OECD) countries from about 2.7% in 1980 to 3.7% in 1990.<sup>21</sup> Inasmuch as OECD may be considered the most demanding and competitive market in the world as regards both price and quality, the fact that the region has been able to expand its share of this market indicates that it has made headway in raising its level of industrial competitiveness. The region's share of both traditional manufactures and basic industrial inputs grew, but its larger share in imports of new low-, mid-range and high-technology manufactures was essentially a reflection of Mexico's performance in that area.

#### c) *Services*

With exports amounting to US\$ 890 billion as of 1991, services constitute one fifth of world trade in goods and services<sup>22</sup> (GATT 1993b). In the period 1970-1991, commercial services expanded at a yearly rate of 13%, measured in current dollars. The main sectors were transport and travel, but the fastest growth rate was seen in the category of other private services.<sup>23</sup>

The countries of the Group of Seven (G-7) accounted for 52% of the world's service exports, while the newly industrializing economies (NIEs) of Asia had a 6% share; only 2.5% of the world total came from the six Latin American countries ranked among the 50 main suppliers of services: Mexico (1.4% of world exports); Brazil (0.4%); Chile, Argentina and Colombia (0.2% each); and the Dominican Republic (0.1%) (GATT, 1993b).

The region's exports of services increased at an average annual rate of 10% between 1985 and 1993, which means that its service exports rose from 15% to 21% of its total exports of goods and services in the space of those eight years (see table III.6).

#### 4. Diversification of exports and patterns of specialization

As a result of the region's search for new markets, the existence of favourable exchange rates, the implementation of promotion policies designed to broaden and diversify the supply of tradables, and the conclusion of trade agreements, the composition and destinations of the region's exports have changed radically.

Indeed, a number of Latin American and Caribbean countries have succeeded in reducing the degree to which their exports are concentrated in a limited number of products. In 1970, the region's 10 main export items represented 56% of the total value of its exports, but by 1990 this figure had fallen to 40%.<sup>24</sup> During this period, the reduction in the relative weight of the 10 main export products was very substantial in Brazil, Uruguay, Chile,

21 Version 1.1 of the Competitive Analysis of Nations (CAN) software was used for these calculations.

22 There is no internationally agreed definition of tradable services. GATT defines "commercial services" as transport, travel and other services and rents in the private sector (see GATT (1993c), p. 68).

23 This category includes insurance, commissions and brokerage services, construction and engineering, communications, consulting, marketing, advisory services and banking.

24 In contrast to the situation as of 1970, this category also includes two industrial products which have a high technological content: motor vehicles (2.3% of total exports) and internal combustion engines (2.1%).

Table III.6  
**LATIN AMERICA (19 COUNTRIES): EXPORTS OF GOODS AND SERVICES**  
*(Millions of dollars at current prices)*

	1980	1985	1990	1993
A. Goods	88.6	92.0	121.9	133.7
B. Services (non-financial)	16.3	16.6	28.7	36.7
C. Total exports	104.9	108.5	150.6	170.4
<b>(B/C)*100<sup>a</sup></b>	<b>15.5</b>	<b>15.3</b>	<b>19.1</b>	<b>21.5</b>

Source: ECLAC, on the basis of official figures.

<sup>a</sup> Percentage of total exports corresponding to services.

Colombia, Costa Rica and Peru (between 21 and 31 percentage points). In fact, in Brazil this proportion was only 37% in 1991, as compared to 68% in 1970. More moderate reductions were observed in Bolivia, Argentina and El Salvador. In a number of other countries, however, the share of total exports accounted for by these major items remained constant and, in some (Mexico, Nicaragua, Paraguay), it actually increased.<sup>25</sup> Thus, whereas the 10 main export products brought in two thirds or more of export earnings in 15 countries as of 1980, in 1991 this was true of only seven countries (Bolivia, Ecuador, Honduras, Nicaragua, Paraguay, Trinidad and Tobago, and Venezuela) (ECLAC, 1993b).

*a) Changes in patterns of specialization*

In the last two decades the countries of Latin America and the Caribbean have made major changes in their patterns of specialization. In a large group of countries (Argentina, Bolivia, Brazil, El Salvador, Guatemala, Mexico, Uruguay and Venezuela), the percentage of total exports represented by commodities has

fallen off sharply while the shares of semi-manufactures and manufactures have risen. In the cases of El Salvador and Guatemala, the ground lost by commodities was taken over by semi-manufactures. In a third group of countries (Chile, Ecuador, Honduras and Paraguay) the relative share of primary exports expanded at the expense of that of semi-manufactures, but there was an increase in the relatively small share represented by exports of manufactures (see table III.7).

Most of the countries that changed their patterns of specialization by shifting their focus towards manufactures and away from commodities or semi-manufactures registered smaller declines in the real prices of their exports<sup>26</sup> over the two decades in question than the countries where this did not occur. This finding supports the hypothesis that the acquisition of competitive advantages in manufacturing improves a country's position within the international economy.

Of the countries that turned in the best export performances in the 1980s, Brazil, Colombia and Mexico did so by

25 In Mexico, this was due to the incorporation of oil exports, which led to a steep rise in the 10 main products' share of the total between 1970 and 1980; this proportion subsequently declined, however.

26 Defined as the ratio between the unit value of the merchandise exports of the country in question and the unit value of the manufactures exported by developed countries.

Table III.7  
**LATIN AMERICA (16 COUNTRIES): COMPOSITION OF  
 MERCHANDISE EXPORTS (1970, 1980, 1991-1993)**  
*(In percentages)*

		Commodities	Semi-manufactures	Manu-factures	Other
Argentina	1970	61.3	25.6	13.1	0.1
	1980	48.9	30.6	20.5	0.0
	1993	34.4	36.0	29.6	0.0
Bolivia	1970	48.4	45.8	5.8	0.1
	1980	61.3	36.5	2.2	0.0
	1993	42.6	32.6	15.7	9.1
Brazil	1970	67.0	21.2	11.5	0.3
	1980	30.2	36.0	33.6	0.2
	1993	18.3	28.7	51.9	0.1
Colombia	1970	85.1	7.7	6.6	0.6
	1980	70.3	11.3	16.1	2.3
	1993	51.5	10.6	31.6	6.3
Costa Rica	1970	72.0	11.9	16.1	0.0
	1980	60.2	13.7	26.1	0.0
	1992	55.8	14.1	21.8	8.2
Chile	1970	12.9	84.9	2.2	0.0
	1980	20.2	74.4	5.3	0.1
	1993	30.9	55.0	9.5	4.5
Ecuador	1970	90.5	7.9	1.6	0.0
	1980	74.3	23.5	2.2	0.0
	1992	90.1	6.7	3.0	0.2
El Salvador	1970	63.2	11.4	25.2	0.2
	1980	54.2	15.0	30.5	0.3
	1991	45.5	20.0	34.3	0.1
Guatemala	1970	60.1	13.5	26.3	0.1
	1980	60.2	17.6	22.0	0.2
	1992	47.6	25.3	26.9	0.2
Honduras	1970	75.0	18.2	6.8	0.0
	1980	77.8	12.8	9.3	0.0
	1992	81.1	7.6	10.6	0.7
Mexico	1970	45.3	26.7	27.7	0.3
	1980	80.7	9.7	9.5	0.1
	1992	38.2	13.5	47.6	0.6
Nicaragua	1970	68.3	18.0	13.7	0.1
	1980	73.1	15.7	11.2	0.0
	1991	68.4	21.3	7.2	3.1
Paraguay	1970	43.7	49.2	7.1	0.0
	1980	56.7	37.2	6.1	0.0
	1993	62.1	24.4	13.5	0.0
Peru	1970	30.5	68.4	1.0	0.0
	1980	44.9	40.3	14.7	0.1
	1993	21.1	57.5	14.9	6.5
Uruguay	1970	61.6	20.9	17.4	0.1
	1980	39.8	24.5	35.6	0.1
	1993	28.1	31.2	40.1	0.6
Venezuela	1970	70.0	29.0	0.7	0.2
	1980	66.6	32.2	1.1	0.0
	1993	50.9	37.0	10.8	1.4

Source: ECLAC, on the basis of official figures. Merchandise exports have been classified on the basis of the criterion discussed in ECLAC, "El comercio de manufacturas en América Latina: evolución y estructura, 1962-1989", *Estudios e informes de la CEPAL*, No. 88 (LC/G.1731-P), Santiago, Chile, November 1992, pp. 30-34. United Nations publication, Sales No. S.92.II.G.12.

reorienting their export profiles towards industrial products. Costa Rica also reduced the share of commodities in its exportable supply and increased the proportion of manufactures and other goods. The solid export performances of Chile, Ecuador and Paraguay were based mainly on a strengthening of their commodity-oriented export profiles, although some diversification of products and markets was also observed (see table III.7).

Within world trade in manufactures, new industries have been comparatively more buoyant. In this respect, there is a marked contrast between different groups of countries. Brazil and Mexico recorded substantial increases in their exports of these types of products, which have come to represent 26% and 37%, respectively, of their merchandise exports. Argentina, Costa Rica, Guatemala, El Salvador and Uruguay occupied an intermediate position, with new industries providing between 8% and 16% of total exports. Venezuela, Paraguay, Chile, Ecuador and Bolivia, on the other hand, as yet have only a very small part of their total exports in this category (see table III.5).

An examination of how selected economies' export specialization profiles have influenced their trading patterns reveals the persistence of trade surpluses in commodity trade which help to finance a net deficit in the industrial sector. Brazil is the exception to this rule, in that it runs deficits in its commodity trade and surpluses in all the other categories except new industries (see table III.8). The country actually does have trade surpluses in agricultural and mining products, but these two positive balances are outweighed by its deficit in energy products. Chile, too, has had a favourable trade balance in industrial products because its surplus in semi-manufactures, especially those based on mining resources, has outweighed its deficit in manufactures.

Of the countries with a trade deficit in industrial products, Colombia and Mexico show a deficit in manufactures and semi-manufactures whereas Argentina runs a deficit only in manufactures. Under the heading of exports of manufactures, Argentina, Brazil and Colombia are net exporters of traditional industrial products and Brazil is also a net exporter of basic inputs. Under the heading of new industries, all the countries considered here are net importers. However, since the mid-1980s Brazil has become a net exporter of the goods produced by new capital-intensive industries.

*b) Diversification of products and markets*

A comparison of the present composition of exports by technological categories and destinations<sup>27</sup> with the export mix that existed in the early 1970s reveals significant changes in the export specializations of the Latin American and Caribbean countries with regard to their various markets (see table III.9).

i) In the region's exports to the United States, the proportion of commodities was reduced and exports of mining products almost disappeared altogether. This change was accompanied by an increase in exports of primary energy products. Semi-manufactures fell off sharply and the share of manufactures nearly trebled. This change was primarily due to an increase in exports of both labour- and capital-intensive new industrial products.

ii) In the case of Europe, too, the share of commodities (particularly agricultural products) declined while the share of manufactures rose. Among the latter, the increase in exports by new industries (mostly those with a mid-range technological content) was particularly notable, as these items climbed from 2% to 10% of the region's total exports to Europe.

iii) In exports to Japan as well, the relative share of commodity exports declined, falling to under 50% in 1992; this

27 For the purposes of this analysis, five destinations were defined: United States, Japan, Europe (EEC and EFTA), Latin America and the Caribbean, and other regions.

Table III.8  
LATIN AMERICA (5 COUNTRIES): TRADE BALANCE AND  
PATTERN OF SPECIALIZATION

(Positive or negative trade balance, by type of product)

	Commodities	Industrial	Semi-manufactures	Manufactures	Traditional	Basic inputs	New industries
Argentina	+	-	+	-	+	-	-
Brazil	-	+	+	+	+	+	-
Colombia	+	-	-	-	+	-	-
Chile	+	+	+	-	-	-	-
Mexico	+	-	-	-	n.s.	-	-

Source: ECLAC, on the basis of official figures. The trade balance sign is the average for the period 1980-1992, in 1985 dollars.

reduction was the result of decreases in exports of agricultural and mining products, since the proportion of energy products rose considerably. In this case, the corresponding expansion of industrial exports was due to an upturn in mineral-based semi-manufactures and basic inputs. New industries increased their share in regional exports to Japan only marginally.

iv) The profile of intraregional exports reflects a drastic shift away from the once-predominant category of primary energy products and towards industrial products, which now account for three quarters of all trade among the countries of the region. One fourth of this amount is represented by semi-manufactures, whose share has remained fairly constant. The notable increase in industrial exports is therefore attributable to manufactured goods (which now account for one half of the total), especially basic inputs and new industries (particularly capital-intensive ones).

v) In sum, the region's exports within Latin America are clearly oriented towards industrial products and especially those from new industries; in the cases of Japan and Europe, they are skewed towards commodities and semi-manufactures, with greater

opportunities for exports from new industries being observed in the European market. However the United States offers the greatest opportunities of all the major industrialized markets for exports from new industries.

The diversification of products and markets has assumed different forms within the region. Brazil and, to a lesser extent, Uruguay and Colombia have achieved the highest degree of diversification. These countries have substantially reduced the relative weight of their 10 main export items in their total external sales, have increased the number and volume of different raw materials and semi-manufactures, have begun to export a succession of different types of manufactures and have diversified the regional destinations of their exports. Mexico concentrated its trade activity on one destination (the United States) but diversified its exports, especially manufactures, by incorporating new products. Argentina's diversification process has been somewhat erratic as a result of the policy changes and recessions of the 1980s. Be that as it may, it has sought—although less intensively than Brazil and Mexico—to incorporate manufactures and to diversify its supply of raw materials and semi-manufactures as well as the

Table III.9  
**LATIN AMERICA (14 COUNTRIES):<sup>a</sup> COMPOSITION OF  
 EXPORTS BY DESTINATION, 1970-1974 AND 1992**  
*(In percentages)*

	United States		Japan		Latin America and the Caribbean		EEC and EFTA		Total	
	1970-1974	1992	1970-1974	1992	1970-1974	1992	1970-1974	1992	1970-1974	1992
A. Commodities	47.0	39.8	66.1	48.3	51.0	25.1	59.6	43.8	53.6	36.3
1. Agricultural products	25.5	15.1	32.8	17.4	11.7	9.4	46.9	26.6	29.9	16.6
2. Mining products	6.3	0.9	31.5	20.0	1.0	2.0	6.7	6.9	6.2	4.4
3. Energy products	15.2	23.8	1.8	10.9	38.3	13.8	6.0	10.3	17.6	15.3
B. Industrial products	52.6	58.9	32.0	50.4	48.8	74.4	40.0	54.1	46.0	62.1
1. Semi-manufactures	40.1	22.1	27.1	38.0	23.3	25.1	33.6	34.2	33.6	28.5
1.1 Agriculturally-based, labour-intensive	5.6	5.1	3.1	7.8	7.5	7.8	15.8	17.0	9.5	10.2
1.2 Agriculturally-based, capital-intensive	8.6	1.8	6.1	6.6	3.1	3.6	2.6	4.6	6.0	3.9
1.3 Mineral-based	6.7	6.2	17.2	23.6	6.4	8.2	13.5	11.1	9.2	9.1
1.4 Energy-based	19.2	9.1	0.7	0.2	6.2	5.5	1.7	1.4	8.9	5.3
2. Manufactures	12.5	36.8	4.9	12.4	25.5	49.4	6.4	19.9	12.4	33.6
2.1 Traditional industries	5.0	8.6	2.0	1.4	4.8	8.4	3.6	6.3	4.3	7.3
2.2 Basic inputs	1.6	4.5	1.1	5.8	4.8	10.7	0.7	3.7	1.9	7.3
2.3 New labour-intensive industries	3.9	11.0	1.5	4.1	8.7	13.0	1.0	5.8	3.6	9.1
a) Low technological content	0.4	1.3	0.1	2.3	1.7	2.1	0.2	0.6	0.6	1.3
b) Mid-range technological content	1.6	5.7	0.2	0.4	4.1	6.7	0.4	3.9	1.6	4.8
c) High technological content	1.8	4.0	1.2	1.4	3.0	4.2	0.4	1.3	1.4	3.0
2.4 New capital-intensive industries	2.0	12.6	0.4	1.1	7.2	17.3	1.1	4.1	2.6	9.8
a) Low technological content	0.3	0.5	0.0	0.4	0.7	1.1	0.0	0.1	0.3	0.5
b) Mid-range technological content	1.3	10.4	0.3	0.5	5.0	14.4	0.6	2.9	1.7	8.1
c) High technological content	0.4	1.6	0.1	0.1	1.5	1.8	0.4	1.0	0.6	1.3
Other	0.4	1.3	1.9	1.3	0.2	0.5	0.4	2.0	0.4	1.6
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

Source: ECLAC, on the basis of official figures.

<sup>a</sup> Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Honduras, Mexico, Paraguay, Peru, Uruguay and Venezuela.

destinations of its exports. Chile's and Peru's exports are concentrated in commodities and semi-manufactures, but these countries have diversified the destinations of their exports. Chile greatly increased its exports of manufactures, but was starting from a very limited base, as well as diversifying its exports of raw materials and semi-manufactures. Peru, for its part, began to sell some manufactures which it had not exported before, but did not modify any of the essential features of its pattern of specialization. Exports from Ecuador, Bolivia and Paraguay were still concentrated in a few commodities and were routed to one major market in each case: the United States for Ecuador, and Latin America for Bolivia and Paraguay. The concentration of products and markets is somewhat less marked in the cases of Costa Rica and Guatemala, but is still considerable.

Mexico constitutes a special case in terms of export diversification by product and destination because virtually all of its exports go to the United States. In all other cases, Europe continues to be a major market for the region's commodities and semi-manufactures. While this market's relative weight has declined (partly as a result of a process of product diversification which, in the case of the bigger countries, has reduced the share of commodities), it continues to be the largest market, absorbing more than 30% of the exports of Argentina, Brazil, Chile and Paraguay and close to that percentage in the cases of Bolivia, Colombia and Uruguay.

The United States is the main buyer of the region's fuel and petrochemical exports, while Europe and Japan are supplied mainly by the Middle East and Africa. Latin America is an important market for natural gas (Bolivia and Argentina).

Latin America and the Caribbean are a very important and rapidly growing market for manufactures. For Colombia, Chile and Ecuador this is by far the biggest market for such goods, regardless of whether they are produced by traditional, basic-input or new industries. This concentration is slightly less marked in the cases of Argentina, Paraguay and Uruguay, which have a fairly diversified range of markets for their traditional industries and, in the case of Argentina, for basic inputs as well. However, Latin America has been and continues to be virtually the only destination for exports from new industries in these countries, as is the subregional market for exports from new industries in Costa Rica and Guatemala. Brazil has channelled its exports of manufactures to different markets. The United States continues to be the main buyer of traditional products, followed by Europe. In the case of basic inputs, other developing regions have displaced Latin America as the main destination, but in the case of new industries, the region is the largest market; Mexico is an exception in this respect, since the regional market is of less importance for it than the United States.<sup>28</sup>

##### 5. Intra-regional trade and technological intensiveness

Forms of development based on growing and sustained international competitiveness are buttressed by the dynamic effects of technological learning processes. For their part, strategies aimed at improving international linkages based on the development of the production sector emphasize the role played by trade in stimulating activities which make intensive use of knowledge and technology. Consequently, trade among

28 Regressions carried out for the period 1970-1991 show a strong positive correlation between the importance of Latin America as a destination and the share of total exports represented by products from new industries in the case of Argentina, as well as a positive but weaker correlation in the case of Brazil. For Chile, these calculations revealed a strong positive correlation for manufactures as a whole. For Mexico, however, no significant correlation was found to exist.

developing countries is generally thought to be concentrated in goods that are more technology-intensive than those traded between developing and industrial countries.

A number of studies which are wholly based on foreign trade data (ECLAC, 1992e; Barbera, 1990) substantiate this argument. It has also been corroborated by a recent ECLAC study (Buitelaar, 1993a) which looks at both foreign trade data and production data. The figures show that products for which a fairly substantial share of demand comes from the regional market are precisely those whose technological characteristics are more likely to generate externalities than those sold on extraregional or domestic markets.<sup>29</sup>

Three main conclusions are to be drawn from the research carried out to date:

a) The production of those goods which are more heavily dependent on intraregional trade is more technologically sophisticated. Such goods primarily comes from the chemical, non-electrical machinery and transport equipment sectors. These sectors are also ones in which international demand tends to be

more dynamic and in which price movements tend to be more stable and more positive over the long term.

b) Sectors that make a strong export effort *vis-à-vis* the regional market also do so (simultaneously or subsequently) in respect of extraregional markets, which suggests that the promotion of intraregional trade is complementary to the promotion of extraregional exports.

c) These are also sectors in which the region is heavily dependent upon extraregional imports; therefore, intraregional trade in the products of these sectors benefits by gaining access to the inputs and equipment that may then be imported from third countries.

In sum, intraregional trade –precisely because of its special characteristics, which have to do with proximity and the contacts of all sorts that facilitate such trade– is complementary to the development of linkages with the global economy and provides an environment that stimulates technological learning processes which, in turn, lead to greater international competitiveness and a more diversified, balanced pattern of specialization in the world economy.

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29 For a thorough discussion of this subject, see ECLAC (1994a).

## Chapter IV

# EXPORTS AND CHANGING PRODUCTION PATTERNS

### 1. Exports and growth

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In the present international context, an increasing ability to compete and to achieve more dynamic linkages with world markets have become essential for sustained growth. In the framework of the proposal put forward by ECLAC (ECLAC, 1990a; 1992a), several conditions are necessary for successfully changing production patterns as an impetus to growth. First, a change in relative prices that favours the production of exportables and the equilibrium of the export sector; a real exchange rate that depreciates *pari passu* with the gradual reduction of protection against imports, incentives and drawbacks for exporters; and safeguard mechanisms to offset unfair competition from external suppliers. Second, a macroeconomic environment favourable to investment and technological innovation; among other requisites, this presupposes a level of economic activity close to the production frontier and

“reasonable” real interest rates which are compatible with the profitability of productive capital. Third, an endowment of production factors which is capable of responding to the demand from producers of exportables and efficient producers of import substitutes. Many of these factors come from markets that are currently imperfect, incomplete or non-existent. Therefore, what is needed is an active, efficient policy of government support so that liberalization will lead to self-sustained growth, which includes improving or creating the markets or institutions needed to steadily enhance productivity.

At least three ways can be distinguished in which exports can help to increase a country's economic growth rate.<sup>30</sup>

The first is the role which export earnings play in generating foreign exchange, making it possible to acquire the imports that every country needs to fuel its economic expansion.<sup>31</sup>

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30 A great number of econometric studies have tried to find a statistical link between export growth and output. A survey of these studies yields no definitive conclusions as to the exact role played by exports in the growth process. Rather, they show a complex link that does not operate in the same way or in the same terms in all cases. Results depend, decisively, on the quality of public policies and the external environment (Moguillansky, 1994; Rivas, 1994).

31 Given the heavy dependence of developing countries on imported machinery and equipment, the availability of foreign exchange can also considerably affect the investment rate (Taylor, 1988; Díaz-Alejandro, 1976).

Only a good export performance can ensure a sustainable supply of foreign exchange over the medium and long term. This entails promoting exports, but bearing in mind that this is not just a question of volume but also of price: what is important from the standpoint of generating foreign exchange is not only the volume of exports but also the return obtained from them. Thus, it is important to promote exports of goods and services whose prices (by unit of inputs) are likely to rise, rather than fall, over time.

It is also important to reduce fluctuations in the supply of foreign exchange, in order to avoid the repercussions that the cyclical nature of international goods markets can have on domestic activity. In this regard, a number of instruments designed to mitigate abrupt fluctuations have been used in recent years to supplement traditional policies aimed at diversifying the basket of export goods and target markets. These new instruments include stabilization funds for products that account for a high percentage of export earnings and the development of incipient futures markets (see chapter II).

The second way in which exports influence development is through so-called "linkages". In a ground-breaking study, Hirschman (1978) identified "backward" and "forward" production linkages. A backward linkage involves the possibility that the development of a particular activity might lead to the emergence or expansion of local suppliers of inputs and capital goods for that activity (for example, the development of canned fruit exports can stimulate the expansion of tin can manufacturing, or the installation of an automotive plant can lead to the development of an automotive parts industry). A forward linkage, on the other hand, involves the possibility of increasing the degree of processing or incorporating more value added into an existing production line (for example, wood pulp production based on the availability of forestry resources).

Obviously, the more highly processed the exports and the more integrated the production chain, the greater the dynamism of the economic activity generated by foreign sales. In this sense, the contribution that exports make to growth will depend on the level of development of the economy's production structures. It is important in this regard to emphasize that linkages represent a potential whose realization is by no means guaranteed. This is where public policy is important –not to establish such linkages artificially, but to provide the technology, training and infrastructure needed to facilitate that process.

Besides production linkages, there are other effects as regards the impact on consumption and fiscal revenues. Thus, the more labour-intensive the export activity (considering the direct and indirect employment created) and the better distributed the income generated within and among firms, the greater the effect on domestic demand. Tax policy can also help to increase the positive effects on output growth when exports produce high economic rents. This obviously depends, however, on what the Government does with the revenues obtained.

The third way in which exports can affect the output growth rate has to do with export activities' greater contact with the international economy and the pressures they face to be competitive. This may not only lead to a more efficient utilization of available resources but also help raise productivity in other areas of the economy. As shown by some studies on the performance of firms in the region, enterprises that export tend to be more innovative than average as regards both technology and management (Guerguil, Macario and Peres, 1993). Although no similar studies have been made of the impact of the experience of export firms on activities geared to the domestic market, certain suggestions can be made as to how that influence might be increased.

Clearly, the more export firms and export-producing sectors there are, the

greater their impact. The number of contacts between exporters and domestic producers increases, and there are more opportunities to share information, designs, management methods, etc. This kind of feedback can take place through explicit channels (such as links with suppliers and agreements with subcontractors) or through more informal channels such as personnel movements and demonstration effects. On the other hand, the more export activity is limited to a few products and producers, with few links to other areas of the economy, and the more it becomes like an "enclave", the more limited its impact is likely to be.

The impact will be proportionately greater when the capacity of the country to absorb the lessons learned by export firms is greater. Innovations will be more easily adopted and stimulated if there are mechanisms to expedite technology transfer, if the educational level of the workforce is high, if there are functioning systems for training and retraining personnel, if business associations are active in promoting exchanges of information and knowledge among their members, in short, if there is an institutional framework which stimulates adaptation and innovation among firms, whether or not they are exporters.

In some cases, export activities are carried out by transnational corporations, which tend to adopt innovations more easily but may have less incentive to pass them on to others. In some countries (the Republic of Korea is a good example), access to foreign investment is tied to technology transfer agreements (Anglade and Fortin, 1987). Even though the basic concern in many Latin American and Caribbean countries today is simply to attract investments, they should still explore ways of encouraging the firms that come into the region to transfer more innovations.

In sum, there are many reasons why a country should increase its exports. In general, exports are the main source of foreign exchange, which is essential for financing imports. Through linkages,

exports can also help activate material and human resources that are available but underutilized because of a lack of demand. Also, resources are likely to be more productive if they are used for export activities, since installed capacity can be used more intensively, economies of scale are easier to achieve (particularly in small countries), and rapid access to imported inputs and external competition lead to greater efficiency and a more rapid adoption of innovations by producers of exportable goods and services. In addition, exports can generate positive externalities for the rest of the economy by demonstrating the benefits to be obtained from the more sophisticated practices used by export firms; by moving to other sectors of the economy managers and employees who have learned to cope with the demands of international competitiveness; and by the actual demands which export firms make on their domestic suppliers in terms of quality and ability to meet deadlines. Lastly, various authors have pointed out that further external liberalization would also have the advantage of promoting more efficient management of overall economic policy (Krueger, 1980; Mussa, 1987). This is because the more linkages there are between the domestic economy and the international economy, the greater the costs of introducing severe market distortions or making mistakes in macroeconomic management.

These various ways in which exports can contribute to economic growth justify the increasing efforts being made to promote them, both in the region and in other parts of the world.

## **2. The transition period of liberalization**

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Generally speaking, trade reforms have taken place in the context of sweeping changes in which international competitiveness and exports play a key role. The main instrument of reform in Latin America has been the more or less indiscriminate and rapid liberalization of

imports. The purpose of opening up the economy has been to expose domestic producers of importable items, who have frequently enjoyed in the past considerable protection to external competition. Liberalization would enhance productivity and reduce inefficiency by allowing the economy to absorb new technologies and increase specialization. In extreme situations, those producers who did not adapt to external competition would be driven out of the market. The resources thus released would be absorbed mainly by the production of exportables.

Indirect export incentives include the lower cost and greater variety of importable inputs to which producers have access, and the eventual depreciation of the national currency which import liberalization would tend to generate in the exchange market.

All of these are effects that tend to occur to some extent. What matters is how fast they occur, and how the positive and negative effects are distributed in the course of the economy's adjustment to the reforms. The outcome is not a single trajectory or goal, since much depends on the point of departure, the other economic policies adopted during the process, and the external context.

The response of producers of import substitutes depends on the magnitude of changes in relative prices, the rapidity of the changes, and the capacity of the producers to adjust. The ideal situation is one in which producers are given enough time to restructure, but only the time strictly necessary, so that they are effectively pressured to increase their productivity. For example, "water" or redundant nominal protection should be removed immediately. However, except for reasons of political feasibility, it is preferable that the phasing out of effective protection should be paced so as to give producers the time they need to introduce innovations, increase specialization and reallocate resources.

The response of exports depends on how much they use importable items and

the trade barriers applied to these items before the reform. Inputs and capital goods imported by exporters have normally enjoyed certain tariff exemptions, but there are also numerous cases where exports were discouraged by an inoperative or arbitrary import regime. More specifically, the development of non-traditional exports was constrained by a lack of access to crucial inputs, since import exemptions were normally available to exporters only in already established activities.

For reform to be successful the net effect of changes in incentives must be to boost the production of tradable goods. One determinant of how production of both exportables and importables will respond is the evolution of the real exchange rate.

The combination of changes in relative prices, their credibility and gradualness, and the macro- and meso-economic context in which reform takes place determines whether the stimuli given to resource allocation are primarily positive or negative, in other words, whether being exposed to competition during the adjustment process is creative or destructive. This in turn determines whether restructuring expands the frontier of production, as it did in the Asian NIEs, or whether its initial effect is a drop in economic activity or a slower recovery of a recessive market, in an adjustment process that moves below the production frontier.

In the last-mentioned case, the stimuli arising from a drop in import substitution are stronger in the beginning than the positive effects of an expansion of exports. The enterprise that survives under the second strategy may be stronger and more dynamic on average than in the first case. However, in the short term there is more destruction than creation: more businesses fail than are set up. Consequently, during the first years of adjustment there will be fewer productive resources available and in full use, since businesses are either failing or cutting back: this could mean further underutilization of resources, and

the stimulus for total investment would tend to be weaker. Therefore, greater "microeconomic efficiency" would tend to coexist with less "macroeconomic efficiency". The hysteresis of the process determines the final outcome. Indeed, what happens during the transition decisively affects the well-being and the production structure attained by the end of the adjustment process. Countries such as Japan, the Republic of Korea and the Chinese Province of Taiwan solved this problem by first promoting exports (which tend to expand capacity) and only later, gradually and in a context of high capital formation, opening up to imports (which during rapid liberalization tend to destroy capacity).

The speed of the adjustment will depend on the credibility of the timing of the change, particularly the initial situation, the initial level and the evolution of the exchange rate, and on producers' access to the resources needed to restructure: available skilled manpower, technology, accessible long-term financing at reasonable interest rates, suitable infrastructure, receptive external markets and a domestic market in a context of macroeconomic equilibrium.

For example, in a highly distorted environment, with imports severely and arbitrarily suppressed by quantitative mechanisms, replacing these mechanisms with tariffs could considerably improve efficiency. Import regime reform could make it easier to expand both exports and import substitution, which had been constrained by an inadequate supply of intermediate goods and services and capital.

### **3. The impact of exchange rate policy on the growth of exportable supply**

One of the main instruments affecting the growth of exportable supply is exchange rate policy. A devaluation increases the net return in local currency to exporters and therefore stimulates export activity. However, it is known that sporadic devaluations alone do not encourage exports. The export sector needs constant

incentives in order to develop, since investment resources must be reallocated.

Large inflows of external capital, a phenomenon of the late 1970s that has resurfaced in recent years, have led many countries to revalue their currencies, which may have helped to stabilize the inflation rate but has also tended to discourage the allocation of resources to export production. However, recent reforms in trade policy have in many cases helped to offset the effect of revaluation on the export sector by lowering tariffs on imported inputs needed to produce exportable goods and services or by granting direct subsidies to such production activities.

Table IV.1 presents, for some countries, trends in the volume of industrial or non-traditional exports (which have shown the most significant growth) and in the exchange rate and trade policy indicators between 1980 and 1993. The table shows steady growth in export volume during the period 1985-1989 in Colombia, Chile and Mexico, and fluctuating trends in Argentina and Brazil. Towards the end of the decade, the real exchange rate and subsidies to the sector declined. Revaluation is clearly seen in Argentina from 1989 onwards, in Brazil between 1987 and 1990, in Mexico from 1988 onwards and in Chile from 1990. However, in all these countries, revaluation took place after a considerable number of devaluations in the preceding years, associated with the external debt crisis, which not only had a short-term impact but also affected long-term trends in exports. In Brazil's case, the real exchange rate had been depreciating since the mid-1970s; exchange rate policy therefore benefited the export sector over a long period of time.

In order to evaluate the impact of changes in the exchange rate and related instruments on export trends in the short and long term, the magnitude of response and speed of adjustment to variations in these policies must be measured. Econometric studies, which have been available for several decades in several countries of the region, can provide that information.

Table IV.1  
**EXPORT VOLUME, REAL EXCHANGE RATE AND TRADE POLICY<sup>a</sup>**  
*(Indexes: 1985 = 100)*

	1980	1985	1986	1987	1988	1989	1990	1991	1992	1993
<b>Argentina</b>										
Industrial exports	84.8	100.0	82.1	82.3	111.5	139.2	184.4	157.2	162.2	193.6
Real exchange rate	62.0	100.0	105.8	129.3	137.0	151.1	105.6	88.2	81.5	77.1
Drawbacks	116.0	100.0	104.0	110.0	106.0	103.0	105.0	111.0	115.0	-
<b>Brazil</b>										
Industrial exports	40.9	100.0	87.3	91.6	114.1	111.9	101.0	107.2	130.1	141.8
Real exchange rate	94.5	100.0	107.2	104.6	95.5	72.3	66.7	78.4	85.8	76.8
Subsidies	91.6	100.0	109.3	111.9	108.9	98.0	88.2	92.6	-	-
<b>Colombia</b>										
Non-traditional exports	99.3	100.0	126.0	142.0	176.7	214.2	265.6	336.7	347.9	387.1
Real exchange rate	87.7	100.0	129.2	143.0	145.3	149.1	167.9	168.4	150.7	141.7
Subsidies	57.2	100.0	69.7	59.1	53.4	56.1	48.1	40.2	-	-
Tariff index	73.3	100.0	94.0	97.7	95.6	93.5	68.0	64.4	54.1	41.2
<b>Chile</b>										
Non-copper exports	71.2	100.0	118.5	130.6	143.6	165.5	184.8	204.9	235.9	247.2
Real exchange rate	71.0	100.0	124.2	135.3	143.3	135.5	140.5	138.9	133.1	135.0
Tariff index	39.1	100.0	77.9	77.5	58.5	58.5	58.5	50.8	43.0	43.0
<b>Mexico</b>										
Industrial exports	51.1	100.0	123.9	146.7	174.0	179.9	193.6	209.3	240.5	281.3
Real exchange rate	80.0	100.0	136.9	142.0	115.5	108.4	105.0	95.9	88.3	82.3

Source: ECLAC, on the basis of official figures.

<sup>a</sup> Export series correspond to volume indexes. The real exchange rate, calculated by ECLAC, corresponds to the nominal exchange rate inflated by the external price index of the main trading partners and deflated by the consumer price index. Subsidies and tariff indexes are calculated on the basis of nominal averages.

A review of these studies reveals certain limitations: i) they use different methodologies to measure the real exchange rate relevant to the export sector, i.e., the one that affects its profitability;<sup>32</sup> ii) there is no homogeneous index of incentives with which to measure the impact of liberalization, tariff reduction or promotional mechanisms; iii) they use

different econometric models and methods,<sup>33</sup> consequently, results are not strictly comparable and could be considered weak. However, a review of these models gives some idea of the effect of these variables on export growth.

Table IV.2 gives the results of recent studies on short- and long-term price elasticities of aggregate exports. These

32 The normal procedure is simply to consider the nominal exchange rate against the dollar, deflated by a domestic price index or by an index of average exchange rates against the currencies of the main export-absorbing countries. This latter index can also be inflated by an index of external prices or by the unit value of exports in order to obtain a measure of relative prices between the external and domestic markets. Some studies have adopted a real effective exchange rate, adjusting it by an index of subsidies and other export incentives.

33 Generally speaking, the model normally used in Latin America, under the small-country assumption, is that of partial adjustment for a supply equation, and the method of estimation used is ordinary least squares. This assumption does not apply to Brazil, where supply and demand equations are estimated through least squares in two and three stages. Also, recent models for correcting estimated errors use the method of maximum likelihood with complete data.

elasticities have been calculated using the real exchange rate, as measured by one of the methods described in footnote 32, and are based on estimates of the supply function for non-traditional exports for some countries.<sup>34</sup>

Table IV.2 shows the difference between the short- and long-term effects of exchange rate policy.<sup>35</sup> Elasticity with respect to an exchange rate variation in the short term is well below one in all the countries, which indicates a certain inelasticity of supply, or little reaction to short-term devaluations or revaluations. However, the reaction is much stronger in the long term, in which elasticity is close to or slightly above one, indicating that in the period in which economic agents take their investment decisions, profitability is an important variable, so that a variation of 1% in the real exchange rate generates a 1% or slightly higher increase in export supply. It should be noted that the effect of exchange rate policy on the trade balance is actually even greater than this, since the observed export elasticities are compounded by the impact on imports.

The behaviour of exports in relation to exchange rate policy in the region contrasts with that of some economies in South-East Asia, such as the Republic of Korea and Hong Kong, where the growth of exportable supply between the late 1960s and the mid-1980s coincided with a competitive, stable real exchange rate in comparison with Latin American rates (Balassa and Williamson, 1987). Studies of those economies show that short-term elasticity of aggregate export supply was very high: Balassa's estimates (1991) for the Republic of Korea fluctuate between 1.9 and 2.2 for the period 1965-1987, while Riedel (1986) estimates a real exchange rate elasticity for Hong Kong of 5.0 for the period 1972-1984.

The first conclusion that can be drawn from the above is that the region's exchange rate policy has a significant long-term impact, although, given the magnitude of the reaction (the elasticity is slightly greater than one), other instruments are needed to promote rapid growth. Likewise, the relatively low elasticities of exports in relation to the exchange rate reveal the problems faced by Latin American exporters, in terms of financing, technology, human resources and infrastructure, in their efforts to take advantage of these better relative prices. Thus, the purpose of a systemic effort to enhance competitiveness is precisely to gradually raise these elasticities. This effect is clearly evident in the countries of East Asia and, to some extent, in the region's more highly developed economies.

Sectoral studies show how important it is to differentiate the effects of changes in profitability by kinds of activity.

Indeed, a comparison of tables IV.2 and IV.3 shows that short- and long-term elasticity in the manufacturing sector is, in every country studied, higher than that of aggregate exports. Adjustment velocity also differs from product to product, with manufacturing being the fastest. An analysis of the results at the level of industrial subsectors shows that the response to exchange rate policy in some of them is very high (an elasticity substantially greater than one), even in the short term, indicating that these export activities can be very negatively affected by a rise in the real exchange rate. This is the case, for example, in the food, textile and chemical industries in Colombia, and the textile, metal products, electrical machinery and automotive industries in Mexico.<sup>36</sup>

34 For a definition of export supply functions see Mogueillansky and Titelman (1993).

35 In this context a short-term response is defined as one which takes place within the same period (quarter or year) as the policy variation.

36 A study conducted by Cohen (1989) on industrial subsectors in Mexico, disaggregated to four digits, also shows that price elasticities are positive and significant for 23 of the 28 sectors studied. This is consistent with the results obtained for the aggregate manufacturing sector by Mendoza (1993), but contrasts with the lack of sensitivity of aggregate non-petroleum exports, as estimated by Peñaloza Webb (1988).

Table IV.2  
TOTAL EXPORT SUPPLY ELASTICITIES IN RELATION TO THE REAL  
EXCHANGE RATE IN SELECTED LATIN AMERICAN COUNTRIES

Country	Short-term elasticity	Long-term elasticity	Period estimated
Argentina	0.39 (1 lag)	n.s	1970-1992 <sup>a</sup>
Brazil	0.38	0.91	1970-1986 <sup>b</sup>
Bolivia	0.39	0.81	1980-1990 <sup>a</sup>
Colombia <sup>c</sup>	0.51	0.93	1967-1991 <sup>a</sup>
Costa Rica <sup>d</sup>	0.30	0.54	1970-1990 <sup>b</sup>
Chile <sup>e</sup>	0.32	1.26	1963-1990 <sup>a</sup>
Mexico <sup>f</sup>	0.12	n.e	1982-1987 <sup>b</sup>

Source: For Argentina: F. Navajas, "Una estimación de la función agregada de exportaciones. Argentina: 1970-1992", Buenos Aires, Argentina, ECLAC office in Buenos Aires, August 1993, unpublished; for Brazil: A. Zini, "Funções de exportação e de importação para o Brasil", *Pesquisa e planejamento econômico*, vol. 18, No. 3, Rio de Janeiro, December 1988; for Bolivia: R. Ferrufino, "El tipo de cambio real y la balanza comercial en Bolivia durante el periodo de post-estabilización", *Análisis económico*, vol. 6, La Paz, Economic Policy Analysis Unit (UDAPE), July 1993; for Colombia: L. Villar Gómez, "Política cambiaria y estrategia exportadora", document presented at the Thirteenth Symposium on the Capital Market, Santa Fe de Bogotá, Asociación Bancaria de Colombia, October 1992, unpublished; for Costa Rica: E. Gaba and R. Araya, "Determinantes de las exportaciones globales de Costa Rica", *Comentarios sobre asuntos económicos*, Central Bank of Costa Rica, June 1993; for Chile: G. Mognillansky and D. Titelman, "Análisis empírico del comportamiento de las exportaciones no cobre en Chile: 1963-1990", *Working Paper series*, No. 17, Santiago, Chile, ECLAC, May 1993; for Ecuador: ILPES/CONADE (Latin American and Caribbean Institute for Economic and Social Planning/National Development Council) (1989), "Modelo macroeconómico de Ecuador", Quito, CONADE, July 1989; for Mexico: R. Peñaloza Webb, "Elasticidad de la demanda de las exportaciones: la experiencia mexicana", *Comercio exterior*, vol. 38, No. 5, Federal District, May 1988.

Notes: 1. A dash (-) indicates zero or insignificant quantity.

2. n.e. = not estimated.

<sup>a</sup> Annual. <sup>b</sup> Quarterly. <sup>c</sup> Includes all exports except coffee, petroleum, ferronickel and gold. <sup>d</sup> Non-traditional exports. <sup>e</sup> Total non-copper exports. <sup>f</sup> Non-petroleum exports.

In the case of Chile, fresh fruit and agricultural exports are slow to react to short-term changes in the exchange rate; in that sector, the effects of such changes and the velocity of adjustment are considerably less significant than in the manufacturing sector. This is to be expected, given the nature of investment in fruit growing and the number of years before output is ready to harvest. This means that if an attempt is made to use exchange rate policy to stimulate this sector in a temporary crisis situation, there will be no visible results in the short term. In the manufacturing sector, however, the exchange rate stimulus elicits a greater response.

The results of the study of Brazilian industry show that while changes in the exchange rate have a delayed impact on manufactured products, their impact on semi-manufactures is instantaneous.

Long-term elasticity also differs; it is greater than one for manufactures, whereas exports of semi-manufactures do not show any significant positive long-term correlation to the real exchange rate. This is because of the characteristics of these industrial commodities and the timing of the maturation of large investments made in the mid-1970s. In this case, foreign sales had more to do with the need to cover investment costs in a context of domestic recession than with relative prices between the domestic and foreign markets.

This analysis shows that the sensitivity of exports to real exchange rate fluctuations varies according to the sector or kind of product and that the repercussions are mixed. Estimates show that elasticity increases in direct proportion to the value added to production. It can also be seen that

Table IV.3  
ELASTICITIES AND ADJUSTMENT VELOCITY IN RELATION TO REAL  
EXCHANGE RATES IN SECTORAL EXPORT FUNCTIONS

Country and product	Short-term elasticity	Long-term elasticity	Average lag	Period
<b>Brazil</b>				
Industrial products	0.58	1.39	1.72 <sup>a</sup>	1970-1986 <sup>a</sup>
Manufactures	0.47	1.16	2.10 <sup>a</sup>	1980-1991 <sup>a</sup>
	(1 lag)			
Semi-manufactures	0.81	-	-	1980-1991 <sup>a</sup>
<b>Colombia</b>				
Agricultural products	0.86	3.7	2.00 <sup>b</sup>	1970-1992 <sup>b</sup>
Manufactures	0.80	1.1	2.00 <sup>b</sup>	1970-1992 <sup>b</sup>
- Foodstuffs	1.17	n.e.	n.e.	
- Textiles	2.20	n.e.	n.e.	
- Chemicals	2.40	n.e.	n.e.	
<b>Chile</b>				
Fresh fruit	0.18	1.80	10 <sup>b</sup>	1963-1990 <sup>b</sup>
	(1 lag)			
Other agricultural products	0.33	0.58	1.78 <sup>b</sup>	
	(3 lags)			
Manufactures	0.65	1.93	0.52 <sup>b</sup>	
<b>Mexico</b>				
Manufactures <sup>c</sup>				
Textiles	1.64	n.e.	n.e.	1982-1988 <sup>a</sup>
Petrochemicals	0.48	n.e.	n.e.	
Metal products	1.53	n.e.	n.e.	
Electrical machinery	1.54	n.e.	n.e.	
Automobiles	2.54	n.e.	n.e.	
<b>Peru</b>				
Manufactures	2.34	n.e.	n.e.	1970-1988 <sup>b</sup>

Source: For Brazil: G. Mognillansky, "Factores determinantes de las exportaciones industriales brasileñas durante la década de 1980", *Working Paper series*, No. 22, Santiago, Chile, ECLAC, 1993; A. Zini, "Funções de exportação e de importação para o Brasil", *Pesquisa e planejamento econômico*, vol. 18, No. 3, December 1988; for Colombia: G. Alonso, "Determinantes de la oferta de exportaciones menores colombianas", Santa Fe de Bogotá, Banco de la República, May 1993, unpublished; for Chile: G. Mognillansky and D. Titelman, "Análisis empírico del comportamiento de las exportaciones no cobre en Chile: 1963-1990", *Working Paper series*, No. 17, Santiago, Chile, ECLAC, May 1993; for Mexico: A. Cohen, "Trade policy in Mexico: an analysis of structural change", Berkeley, University of California, Ph.D. dissertation, 1989, unpublished; for Peru: C. Paredes, "Trade policy, industrialization and productivity growth: the case of Peru", *Brookings Discussion Papers in International Economics*, No. 94, Washington, D.C., The Brookings Institution, 1992.

Notes: 1. A dash (-) indicates zero or insignificant quantity.

2. n.e. = not estimated.

<sup>a</sup> Quarterly. <sup>b</sup> Annual. <sup>c</sup> Certain industrial subsectors were chosen to illustrate the range of variation in intersectoral elasticities.

exports from countries whose industrial development and diversification are more advanced permit stronger and more immediate responses to changes in exchange rate policy.

Lastly, since the measurement of the real exchange rate for exports should be corrected by a weighted average of external prices, a basket of currencies of the country's main trading partners is taken as a benchmark. This is important, since the countries of the region have frequently been guided only by variations in the United States dollar in designing their exchange rate policies.

Table IV.4 shows the contribution of real exchange rate variations to export growth in Brazil, Chile and Colombia during the period 1980-1991, taking into account estimated long-term elasticities. In Brazil's case, manufactures exports could have grown by a further 18% if the real exchange rate had not been revalued by 15% between 1980 and 1991. As some studies show (Bonelli, 1992; Baumann, 1994 and Mognillansky, 1993), especially during the second half of the 1980s, manufacturers in Brazil turned to the export market because of the recession in the domestic market, external demand (in some cases ensured by the links between transnational export firms and their parent company or subsidiaries located in other countries) and enhanced competitiveness, rather than because of the profits to be made during that period.

In Chile, on the other hand, the 94% depreciation in the real exchange rate for non-copper exports accounts for 80% of their growth over the past 11 years, and the same is true in Colombia: more than a third of the enormous growth in non-traditional exports is attributable to a 91% depreciation in the real exchange rate during the period.

#### 4. Exchange rate policy, competitiveness and trade policy

Greater competitiveness reduces the costs of exports in relation to the corresponding international costs. This relationship depends on wages, tariffs and other domestic costs as compared with external costs, the exchange rate and especially the productivity of local industry, which in turn depends on innovations, organizational improvements and technological development.<sup>37</sup> Under the systemic approach to international competitiveness outlined by ECLAC –which entails simultaneous, integrated advances in a number of variables– it is nonetheless worth investigating whether any of these variables has had more impact than others on the competitiveness of the export sector.

This question has been researched at least in Brazil and Mexico. For Brazil, Bonelli (1992) indicates that the competitiveness of industrial exports rose significantly in the first half of the 1980s, owing both to productivity gains and to exchange rate and wage fluctuations. During the second half of the decade, however, a deteriorating exchange rate/wage ratio clearly contributed to the fact that the gains in competitiveness of manufactures exports –although still positive– increased far less than in the previous period.

Casar's study of Mexican industry (1993) shows that in most of the subsectors that increased their competitiveness in the period 1980-1989, the determining factor was a rise in labour productivity. In the more backward subsectors, on the other hand, competitiveness was associated with low wages and the real exchange rate.

Few estimates have been made in Latin America of the impact of competitiveness (i.e., the ratio between the relative cost of a product and its international market price) on export

<sup>37</sup> ECLAC emphasized these points in its proposal on changing production patterns with social equity (ECLAC, 1990a and 1992a), according to which competitiveness is sustainable in the long term if it is genuine, i.e., if it is not overly dependant on the favourable evolution of the exchange rate/wage ratio.

Table IV.4  
CONTRIBUTION OF REAL EXCHANGE RATE  
VARIATIONS TO EXPORT GROWTH, 1980-1991

Cumulative effect during the period	Export growth (volume)	Real exchange rate variation (total variation during the period)	Long-term elasticity	Impact of real exchange rate on exports	Contribution of real exchange rate to export growth
	(A) %	(B) %	(C)	(B) · (C) %	(B)(C) / (A) %
<b>Brazil</b>					
Manufactures exports	155	-15	1.16	-18	-12
<b>Chile</b>					
Non-copper exports	119	94	1.26	118	80
<b>Colombia</b>					
Non-traditional exports	239	91	0.93	85	36

Source: For Brazil: G. Mognillansky, "Factores determinantes de las exportaciones industriales brasileñas durante la década de 1980", *Working Paper* series, No. 22, Santiago, Chile, ECLAC, 1993; for Chile: G. Mognillansky and D. Titelman, "Análisis empírico del comportamiento de las exportaciones no cobre en Chile: 1963-1990", *Working Paper* series, No. 17, Santiago, Chile, ECLAC, 1993; for Colombia: L. Villar Gómez, "Política cambiaria y estrategia exportadora", document presented at the Thirteenth Symposium on the Capital Market, Santa Fe de Bogotá, Asociación Bancaria de Colombia, October 1992, unpublished.

development. Econometric estimates of demand functions for industrial exports in Brazil (historically the most developed in the region) show strong short-term elasticity, much higher than the impact of profitability on exportable supply of both manufactured and semi-manufactured products. In order to maintain competitiveness when an exchange rate revaluation is unavoidable and fiscal or financial incentives are lacking, the alternatives are to increase productivity or accept lower profit margins. This is what apparently took place in Brazil in the second half of the 1980s, when the fiscal crisis made it impossible to continue to finance the same level of incentives as before.

Trade reforms have greatly reduced costs, especially when the export sector

previously had no tax exemptions on imported inputs. Trade liberalization also made it possible to import a greater variety and higher quality of inputs, which in turn often led to higher profitability and helped stimulate export supply. In other instances, liberalization or tariff exemptions partially offset the decline in profitability brought about by the appreciation of the real exchange rate that resulted from stabilization policies or inflows of external financing.

With respect to this last point, figures IV.1 to IV.4 show the evolution of the real exchange rate and an index of tariffs on imported inputs and incentives for four countries.<sup>38</sup> Figure IV.1, for Argentina, shows that while export drawbacks on manufactures remained steady, the real

38 As in measurements of the real exchange rate, indexes of tariffs and incentives are not homogeneous among countries. In the case of tariffs, they are nominal averages. With regard to incentives, they include subsidies, drawbacks, tax exemptions, etc. Export incentives in Brazil and Colombia represent the potential total share, i.e., what would happen if all exporters benefited from all the incentives.

Figure IV.1

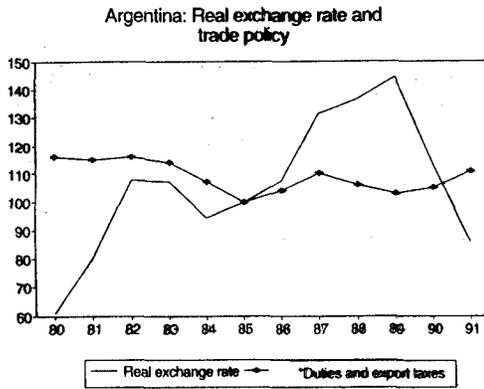


Figure IV.2

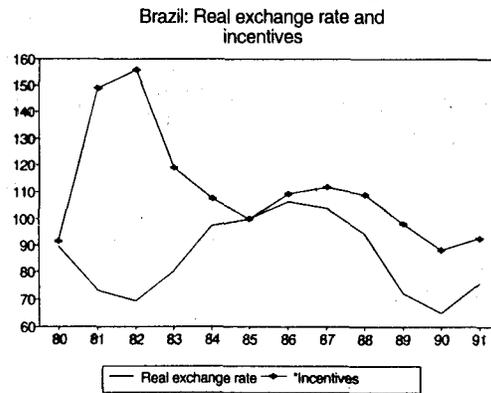


Figure IV.3

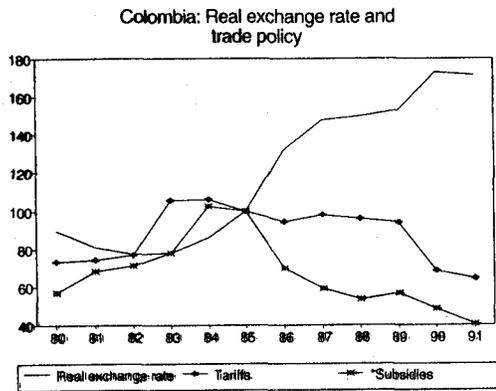
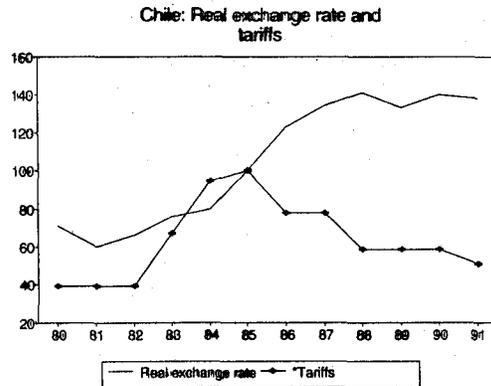


Figure IV.4



Source: ECLAC, on the basis of official figures.

exchange rate appreciated sharply from 1989 onwards, without there being any compensation between the two policies.

In Brazil, export benefits and subsidies moved in the same direction as exchange rate policy from 1985 onwards, so that during the revaluation period the export sector received no compensatory incentives. However, producers have benefited from the trade reform implemented gradually from 1987 onwards, which shortened the list of prohibited imports, simplified red tape

and lowered tariffs: the average duty on imports was reduced from 51% in 1987 to 14% by the end of 1993.

Figure IV.3, on Colombia, shows a sharp drop in subsidies for non-traditional exports, but this was offset by a depreciation in the real exchange rate and by the gradual reduction of tariffs. A similar evolution in exchange rate policy took place in Chile from 1985 onwards, accompanied by a gradual reduction of the average tariff level, which had risen in 1982 in response to the external debt crisis.

### 5. Exchange rate uncertainty and export growth

Uncertainty about exchange rate policies and their instability has an impact on production for the export market. If entrepreneurs are unsure about the future real exchange rate or its possible range of variation (which in turn determines expectations of profitability), they are hardly likely to invest in the export sector. Exchange rate instability is also often associated with trade policies that are ephemeral and have little credibility, and this neutralizes the intended incentives to economic agents.

Since exchange rate policy does not exist in a vacuum from other economic policies, such as monetary and fiscal policies, it is bound to be subject to some instability. For example, a devaluation in a highly unbalanced fiscal situation, which forces an unprogrammed increase in the money supply, quickly triggers an inflationary situation that neutralizes the authorities' attempt to devalue or maintain the real exchange rate; this uncertainty about exchange rate trends affects export performance.

One way of empirically measuring the impact of exchange rate volatility is by an indicator of real exchange rate variability.<sup>39</sup> Table IV.5 gives the results obtained for some countries.

We can see that the elasticities observed in different studies are high and negative in the short term. This is because an increase in instability raises costs without allowing them to be transferred to export prices, and this acts as a disincentive to selling in foreign markets.

As mentioned above, long-term instability influences investment and reduces exportable supply. The strong

estimated impact in Peru (-4.7) is consistent with the degree of instability measured by the coefficient of real exchange rate variation during the period 1960-1985.<sup>40</sup> On the other hand, as a result of the reduction seen in the instability of the exchange rate in Colombia since the reforms of 1967, this variable has had no statistically significant impact on exports. In the case of Chile, the lower short-term elasticity found in Paredes' study (1989) for the period 1963-1983 coincides with greater exchange rate stability throughout the 1960s, while the study by Caballero and Corbo (1989) concentrates more on years of high instability (1970-1985).

These results, together with those mentioned in the previous section, confirm the need to ensure stable exchange rate policies in order to maintain long-term growth in the export sector.

### 6. Other factors influencing exports

Along with exchange rate policy, tariff reforms and direct benefits that affect the profitability of the export sector, other factors have intervened in the growth of merchandise sales in foreign markets. These include pressures from domestic demand on available supply, the role of regional integration processes and trends in external demand.

The purpose of some econometric studies is to find out to what extent pressure from domestic demand determines export-oriented production. The indicator of short-term pressure from domestic demand that is used is the rate of utilization of productive capacity, which measures the gap between actual and potential output.

39 Empirical studies carried out since the mid-1970s show a significant negative relationship between real exchange rate volatility and exports: see Díaz-Alejandro (1976) for Colombia and Coes (1979) for Brazil. The most important studies of the 1980s are those by Paredes (1987), Caballero and Corbo (1989) and Alonso (1993).

40 See Paredes (1989) and Alonso (1993). The coefficient of variation was taken to be the average annual standard deviation divided by the mean, calculated on the basis of monthly data.

Table IV.5  
ELASTICITY OF EXPORTS IN RELATION TO REAL  
EXCHANGE RATE VOLATILITY

	Short-term elasticity	Long-term elasticity	Period
Chile	- 1.9	-	1963-1983
Peru <sup>a</sup>	- 4.3	-	
Colombia	n.s.	-	1970-1985
Chile	- 5.4	-	
Peru	- 1.1	- 4.7	
Colombia			1970-1992
Agriculture	- 0.3	- 0.6	
Industry	- 0.2	- 0.2	

Source: For Colombia: G. Alonso, "Determinantes de la oferta de exportaciones menores colombianas", Santa Fe de Bogotá, Banco de la República, May 1993, unpublished; for Chile: R. J. Caballero and V. Corbo, "The effect of real exchange rate uncertainty on exports: empirical evidence", *The World Bank Economic Review*, vol. 3, No. 3, May 1989; for Peru: C. Paredes, "Exchange rates regimes, the real exchange rate and export performance in Latin America", *Brookings Discussion Papers in International Economics*, No. 77, Washington, D.C., The Brookings Institution, August 1989.

Note: A dash (-) indicates zero or insignificant quantity.

<sup>a</sup> Paredes, in fact, found high elasticities (-1.5 for the short term and -3.6 for the long term) also for Brazil, but his results are distorted by the period of analysis. Compare, for example, with the data compiled by Nogués (1990) who, in analysing eight Latin American countries in the period 1978-1987, observed that Brazil was the country whose real exchange rate had varied the least. Like the present study, Nogués believes that stabilizing the real exchange rate is more important than providing export incentives.

Of the studies that exist, only those on Brazil confirm the impact of fluctuations in domestic demand on exportable supply.

Historically, there has been a significant negative correlation in Brazil between the rate of utilization of productive capacity and industrial exports, with very high elasticities.<sup>41</sup> This implies that entrepreneurs have turned to export markets more as a defence mechanism against domestic recession than as a conscious effort to develop their export activity. This is confirmed by the results of surveys of the industrial export sector (Baumann, 1994).

Moreover, the estimated long-term elasticities of capacity utilization were

higher than those obtained for potential output, suggesting that manufactures exports will be limited, in a context of economic growth, by the need to meet domestic demand, unless investments are made which increase productive capacity.

The magnitude of the impact of external demand on exports differs according to the type of product. Traditionally, the income elasticity of commodity exports has been low when measured against the level of activity of the industrialized countries, while the income elasticity of industrial products depends on the kind of goods exported.

The "small country assumption" has been used in estimating export functions for manufactures. This means that

41 See the summary of results drawn up by Zini (1988) and those obtained by Moguillansky (1993).

exporters can sell to the external market as much as they are able to produce. Consequently, export prices are not affected by the quantity exported, since they are determined by the international market.

However, this assumption has been found to be invalid for some countries. In the case of Brazil's manufactures exports, for example, the best adjustments were obtained on the basis of an estimate of simultaneous models of export supply and demand. The demand equations show high, significant coefficients for income elasticity,<sup>42</sup> indicating that industrial exports are affected by trends in the external market.

In Villar's (1992) estimates for Colombia, elasticity with respect to an index of real GDP of the countries to which Colombia exports is high in the short term. He also suggests that the underestimation of non-traditional exports generated by the econometric model for 1991 can be partially explained by the rapid process of trade integration between Colombia and Venezuela, which caused exports to Venezuela to increase by 152% that year and helped maintain that rise in 1992. Similar effects occurred in trade between Argentina and Brazil, Bolivia and Ecuador, Chile and Argentina and Peru.

This requires looking at another factor that has influenced recent export performance, namely, regional integration processes.

Data for different countries of the region show that positive performance in intraregional exports and exports to third countries are in fact complementary. There is a significant positive, correlation between the coefficient of intraregional industrial exports and the proportion of domestic demand met by imports from other regions. This shows that the ready availability of quality inputs at competitive costs is a decisive factor for

productivity in producing non-traditional exports. Moreover, empirical evidence shows that exporting to markets in the same region can offer learning opportunities for entering extraregional markets.<sup>43</sup>

## 7. Conclusions

The above points can be summarized in the following general conclusions. First, a look at the impact of changes in the real exchange rate on aggregate exports, except for certain countries, shows a long-term elasticity close to or somewhat above one. Thus, exchange policy can be seen to have a significant effect. Nevertheless, there is an implicit need to also use other stimuli to ensure rapid development of the export sector. Gradual elimination of anti-export biases and deficiencies in infrastructure, technology, financing, human resources and external promotion should gradually increase the response of exports to the exchange rate. This is evident even in the short-term elasticity of exports in relation to the exchange rate in the Asian economies.

Second, both the real exchange rate and other stimuli should be stable. Uncertainty about exchange rate policy discourages investment in the export sector, while unstable incentives appear unreliable and economic agents ignore them.

Third, a disaggregation of the export sector by type of product shows that the effects of exchange rate policy are mixed, and that also the greater the diversification and installed capacity in industry, the more sensitive the response to exchange rate policy: exports from more industrially diversified and developed countries respond more strongly and more immediately to exchange rate policy.

The elasticity of the manufacturing sector is in all cases higher than that of

42 The GDP of the main importing countries or an index of those countries' imports was used as an indicator of external demand.

43 For more on this point, see chapter III and ECLAC (1994a).

aggregate exports, in both the short and the long term, and this sector also responds more quickly, especially in countries which historically have achieved greater industrial diversification and have developed greater productive capacity. Exchange rate policy elicits little short-term response from agricultural activities; any attempt to stimulate this sector in a temporary crisis will therefore be ineffective if exchange rate policy is the only instrument used.

An evaluation of policy at the level of industrial subsectors shows high elasticities in both the short and the long term in certain cases, indicating that some export activities can be seriously hurt by a revaluation of the real exchange rate.

Fourth, in the countries studied, tariff reforms have been beneficial for export development, but once they are implemented, they cease to be determining factors in further export development.

Fifth, domestic demand has an important impact on branches of industry not specifically geared to the export market. To maintain exportable supply in these cases, new investment resources must be allocated, or investment incentives provided, for these activities.

Lastly, trends in external demand are crucial to the performance of commodities, but are also significant for some countries' industrial exports.

## Chapter V

# TRADE POLICY

### 1. Recent trade liberalization processes

After more than half a century of protectionism, the mid-1980s saw the emergence of a clearly-defined school of thought that called for a radical change in development strategy and in its associated policies. As shown in table V.1, reforms aimed at liberalizing trade have been quite widespread in the region in recent years. Of the nine countries listed in the table, the great majority have implemented reforms that can properly be described as both drastic and sudden, with import trade being liberalized in as little as two or three years.

These reform processes are not easy to pigeonhole, but two broad categories can be distinguished. The first comprises the attempts observed in some countries—such as Chile since 1974, Argentina in 1976-1981 and again in 1988, and Bolivia since the mid-1980s—to liberalize both their trade and capital accounts at the same time as part of a larger process of economic liberalization. The second category consists of experiences—particularly in Brazil, Colombia and, initially, Mexico—where high levels of protection for import-substitution activities were kept in place for several decades, with these protection mechanisms' adverse effects on other production activities being largely offset by strong export incentives.

These trends in the region's trade policies have been complemented by a concomitant wave of bilateral trade liberalization agreements, some of which entail the adoption of common tariff structures (ECLAC, 1994a). In some countries, such as those of Central America (e.g., Costa Rica and Guatemala), the combination of subregional integration agreements and structural adjustment programmes have strongly influenced national tariff-reduction processes, especially since the mid-1980s.

To a great extent, all of these reforms have provided for the elimination of most quantitative restrictions and substantial tariff reductions. Thus, in general, they have represented an appreciable change from pre-reform tariff protection levels (see table V.1) and have dramatically diminished the spread in rates of effective protection. No country has yet adopted a zero tariff rate, however, and only Chile has a uniform tariff (currently 11%).

#### *a) Experiences in comprehensive liberalization*

Until recently, one of the common features of the countries of the region was the practice of imposing sizeable, highly dispersed tariffs and of adding on surcharges and specific duties during certain periods, along with various types of non-tariff barriers. For manufactures, the resulting levels of effective protection

Table V.1  
LATIN AMERICA (SELECTED COUNTRIES): OVERVIEW  
OF TRADE LIBERALIZATION PROCESSES

Country	Programme starting date	Maximum tariff		Number of tariff rates		Average tariff		Non-tariff barriers	Variation in real exchange rate <sup>a</sup>
		Initial	Year-end 1993	Initial	Year-end 1993	Initial	Year-end 1993		
Argentina <sup>b</sup>	1989	65	30		3	39 <sup>c</sup>	15 <sup>c</sup>	In 1988 the value of industrial output subject to restrictions was reduced from 62% to 18%. In 1989-1991 non-tariff barriers, additional temporary duties and specific duties were eliminated.	-49
Bolivia	1985	150	10		2	12 <sup>d</sup>	7 <sup>d</sup>	With few exceptions, all import bans and licence requirements were discontinued.	92
Brazil	1988	105	35	29	7	51 <sup>e</sup>	14 <sup>e</sup>	In 1990 the list of banned imports and prior-licensing requirements were eliminated. However, national-content requirements for intermediate and capital goods will be maintained.	44
Colombia <sup>b</sup>	1990	100	20	14	4	44 <sup>d</sup>	12 <sup>d</sup>	Nearly all prior-licensing restrictions were lifted in late 1990.	-4
Costa Rica	1986	100	20		4	27 <sup>e</sup>	14 <sup>e</sup>	Import permits and other restrictions were phased out in 1990-1993.	10
Chile <sup>f</sup>	1973	220	10	57	1	94 <sup>e</sup>	10 <sup>e</sup>	In the 1970s, quantitative limits on imports were eliminated.	-10
	1985	35	11	1	1	35 <sup>e</sup>	11 <sup>e</sup>	Price bands were re-introduced and an anti-dumping system was established.	32
Mexico	1985	100	20	10	3	24 <sup>c</sup>	12 <sup>c</sup>	The coverage of import permits was reduced from 92% in June 1985 to 18% by December 1990, and official import prices were eliminated.	-15
Peru <sup>b</sup>	1990	108	25	56	2	66 <sup>e</sup>	18 <sup>e</sup>	Import licences, quotas and bans were discontinued in September 1990.	-28
Venezuela	1989	135	20	41	4	35 <sup>d</sup>	10 <sup>d</sup>	The number of categories subject to restrictions was reduced from 2,200 in 1988 to 200. Specific duties, which in some cases had raised the tariff ceiling to 940% prior to the liberalization programme, were eliminated.	15

Source: ECLAC, on the basis of national figures.

<sup>a</sup> Between the year prior to the initiation of the liberalization programme and 1993; the exchange rate for exports has been used. <sup>b</sup> Tariffs include surcharges. <sup>c</sup> Weighted by domestic production. <sup>d</sup> Weighted by imports.

<sup>e</sup> Simple average of tariff items. <sup>f</sup> Chile's first trade liberalization programme was completed in 1979. The 10% uniform tariff remained in force until 1982. Therefore, the information given in the first row corresponds to that period (1973-1982). The second row contains information on the reduction of import duties, which, after being raised to 35% in 1984, were reduced to 20% in 1985, to 15% in 1988 and to 11% in 1991.

were in most cases notably higher than nominal levels.

Often, however, the impact of these measures was partly offset by equally broad systems of various kinds of exceptions (especially as part of regional and sectoral promotional schemes); this resulted in considerably lower or even negative levels of effective protection for many producers of industrial inputs or capital goods.

Exchange rate policy –which often provides for fixed nominal exchange rates or controlled devaluations– often accentuates the biases of trade policy. This effect is compounded by changes in the rules concerning the capital account of the balance-of-payments, whose net results are fluctuations in the real exchange rate, a lack of production incentives for exportables and –in addition to other factors– macroeconomic instability, whose best-known manifestation in Latin America has been high inflation.

Some countries have tried to turn this situation around by adopting packages of what are conventionally described as fiscal and structural reforms of the price system (in particular, trade liberalization and the deregulation of the treatment accorded to foreign capital). In several of the cases considered, such reforms constituted the backbone of policy packages designed to stabilize prices and revive production.

Chile's trade liberalization scheme is the oldest and longest continuously-applied programme in the region. In late 1973, before the reforms were introduced, nominal tariffs averaged 94% and ranged from 0 to 750%; in addition, countless non-tariff restrictions and a complicated multi-rate exchange system were in force (Ffrench-Davis, Leiva and Madrid, 1991; Meller, 1993) (see box V.1).

The more pragmatic approach to trade policy that began to emerge in Chile in 1982-1983 has been extended to include exchange-rate policy and the capital account of the balance of payments. Since

the late 1980s, Chile has had to cope with a renewed inflow of foreign capital. During the first trade liberalization programme (1974-1981), the authorities allowed the currency to appreciate for an extended period of time; this decision was associated with an increasingly liberal policy on private capital inflows. In contrast, since 1989 they have tried to curb the currency's appreciation in order to safeguard the forward momentum of the production of tradables. Specific measures have included the application of reserve requirements and the levying of taxes on foreign financial loans. These policies have proved to be successful in slowing the upward trend in the currency's real value which began in 1988 and intensified in 1991-1992.

Some of the conclusions drawn from an analysis of the Chilean experience suggest that the second trade reform (1985-1991) has yielded more positive results than the first. The steep tariff reductions and the elimination of quantitative limits carried out as part of the first trade liberalization programme gave exports a bigger boost than did the modest tariff reductions implemented during the second programme, since the first trade reform took place in a situation that left a great deal of room for cutting costs by substituting imported inputs for domestic ones, as well as providing ample opportunity for bringing about changes in relative rates of profitability. However, given the recessionary environment in which the reforms were implemented, the abrupt nature of their introduction and the behaviour of exchange and interest rates, this expansion of exports was achieved at an extremely high cost, and the export sector's buoyancy did not carry over into the rest of the economy; thus, per capita GDP (between the maximum levels for 1974 and 1981) rose by less than 1% per year, investment stood far below its historical levels and an intensive de-industrialization process took place<sup>44</sup> (see box V.1 and table V.2).

44 For a more detailed discussion of the subject, see Ffrench-Davis, Leiva and Madrid (1991).

## Box V.1

**CHILE: THE DIFFERENCES BETWEEN TWO TRADE REFORM PROGRAMMES**

Thanks to the fact that Chile has a long history of trade reform, more reliable lessons regarding such reforms' effects can be drawn from its experiences. To this end, it is important to bear in mind that Chile actually implemented two different trade reform programmes: a radical scheme in 1974-1979 and a more moderate one in 1985-1991. Although the policies of refraining from the use of non-tariff barriers and of establishing a uniform tariff have not changed since 1979, tariffs had returned to relatively high levels by 1984 and were accompanied by measures designed to guard against unfair competition and by price bands for some agricultural products. Indeed, the tariff rate averaged 20% in 1984-1989, which was twice what it had been in 1979-1982. But the essential difference between the two programmes is that, during the first liberalization exercise—within an environment marked by an redoubled effort to curb inflation and an increasingly abundant supply of external finance—the currency appreciated steadily, following an initial depreciation. By contrast, in the 1980s the reduction of tariffs from a maximum rate of 35% in September 1984 to the current level of 11% in June 1991 was accompanied by a sharp real devaluation (associated with the debt crisis), which sent positive signals to exporters and, at the same time, more than offset the slightly negative impact of the tariff reduction on the production of goods that compete with imports. For this reason, during the second programme non-traditional exports grew more steadily and the production of import substitutes made a strong recovery, primarily between 1984 and the

end of the 1980s. In evaluating Chile's two trade reforms, it is interesting to note the performance of capital formation and of the industrial sector. Although gross fixed capital formation and capital efficiency increased once the crisis of the early 1980s was over, the coefficient of fixed investment was far below what it had been in the 1960s; in fact, it was not until 1993 that this coefficient finally surpassed its average level for that decade. The economy's inability to raise its investment rates above that level prevented it from attaining significant growth between 1974 and the end of the 1980s, during which time its cumulative rate of growth averaged less than 3% per year.

During the first trade liberalization programme, the economy fell victim to a significant degree of de-industrialization, and this was reflected in a decrease of five percentage points in the share of manufactures in GDP. Many potentially strong manufacturing firms went bankrupt as a result of the particular mix of trade and exchange policies in force at that time.

Despite the successes of the second programme, the de-industrialization process which was spurred on by the first reform has not been reversed. Exports remain concentrated in natural resource-intensive product lines. Nevertheless, items involving a higher level of value added have been gaining ground, investment has continued to rise, and the creation of new production capacity has begun—although not until the 1990s—to expand at a sustainable rate that is substantially higher than the rate recorded in the 1960s.

Source: R. French-Davis, P. Leiva and R. Madrid, *Trade Liberalization in Chile: Experiences and Prospects*, Trade Policy series, No. 1 (UNCTAD/ITP/68), New York, United Nations Conference on Trade and Development (UNCTAD), 1991. United Nations publication, Sales No. E.91.II.D.18; M. Agosin and R. French-Davis, "Trade liberalization in Latin America", CEPAL Review, No. 50 (LC/G.1767-P), Santiago, Chile, August 1993.

Starting in 1984, the economy first made a recovery and then embarked upon a sustained growth path based on an expansion of the exportable supply being produced by non-traditional sectors. The chief cause of the buoyancy of non-traditional exports has not been lower tariffs, however, since the reductions were quite moderate and exporters have drawback mechanisms at their disposal.

During the second programme, the depreciation of the currency was the main reason for the success of Chilean exports; in fact, the real exchange rate more than doubled between 1981 and 1988. In addition, foreign direct investment (FDI) has played a vital role in the country's export activity. As a result of the changes being made in the Chilean economy, exports have come to represent a

substantially larger share of GDP –more than 30% in recent years (see table V.2).

Chile's perseverance in carrying forward this reform process has brought about changes in the country's production patterns that have entailed a reorganization of its sectoral structure. The unique features of Chile's experience in this regard would make it very difficult to reproduce under other circumstances, however, particularly in view of the amount of time it has required and its initially high economic and social costs.

Two other cases in which trade and capital movements have been liberalized at the same time are those of Argentina in 1976-1981 and Bolivia since 1985.

In 1976, the Argentine Government launched a trade reform programme to which it soon added an all-out financial liberalization drive and, immediately thereafter, an anti-inflation policy based mainly on the control of the exchange rate. At that point in time, the Argentine programme bore some similarities to Chile's programme of the 1970s. In 1976-1978, the authorities started out by dismantling non-tariff barriers and slashing tariffs (from 94% to 44%, on average). At the same time, a compensatory devaluation was put into effect.

As in Chile, the objective of making a structural adjustment in the economy to further the internationalization of the production system was gradually supplanted by the goal of lowering inflation through exchange rate lags; this was facilitated by financial liberalization measures and abundant liquidity in international financial markets. In 1979 and 1980, a policy was implemented to create a lag in the real exchange rate through nominal devaluations below the rate of inflation. As a result, a decrease in the average tariff from 44% to 35% was accompanied by a real appreciation of the exchange rate of over 30%. As in the case of Chile –although here it occurred one year before the external debt crisis spread throughout the region– when the supply

of external credit needed to finance the growing current-account imbalance evaporated, the authorities were forced to discontinue the programme.

In recent years, Argentina has carried out a second liberalization experiment. Beginning in October 1988, a notable trend towards trade liberalization emerged with the elimination of a surcharge and the introduction of a new tariff regime. In the period between the adoption of those measures and the reforms of April 1991, tariffs were revised downward on 11 different occasions. The trade and financial liberalization process culminated in the adoption of a package of measures that included a convertibility act, a total opening of the capital account and a consolidation of trade reforms.

The programme has been highly successful in terms of drastically reducing the country's spiralling inflation, giving a strong boost to production and generating more optimistic expectations. The introduction of a fixed nominal exchange rate has translated into a real appreciation of the peso, which has been validated by a large inflow of foreign capital. Protection for producers of tradables has declined considerably, owing both to the tariff reductions and the dismantling of non-tariff barriers as well as to the extraordinarily strong appreciation of the peso. Industry has suffered a decrease in profitability rates in both domestic and foreign markets. As long as favourable business expectations are reflected in higher investment and gains in efficiency and productivity, however, these effects may progressively offset the decrease in the profitability of tradable sectors caused by the appreciation of the currency. In fact, GDP is showing a vigorous recovery that has already lasted four years. On the other hand, however, the country's trade and current-account deficits have been widening considerably.

In 1985, Bolivia also launched an ambitious trade liberalization programme which is still in effect as part of the country's plan to stabilize and reorganize its economy in order to stem the country's

Table V.2  
**CHILE: SELECTED GROWTH INDICATORS, 1961-1993<sup>a</sup>**  
 (Percentages)

	1961-1971	1971-1974	1974-1981	1981-1989	1989-1993
Growth rates/GDP	4.7	0.3	2.8	2.5	6.2
Real exports <sup>b</sup>					
Total	3.4	9.1	7.1	8.5	9.1
Non-copper	4.7	8.5	12.8	11.5	10.6
	1961-1970	1971-1973	1974-1981	1982-1989	1990-1993
<b>Average shares</b>					
Gross fixed investment/GDP	20.2	15.9	15.7	15.1	19.9
Manufactures/GDP	25.4	27.2	22.2	20.7	20.9
Exports <sup>c</sup> /GDP	12.0	9.9	21.4	27.0	33.2

**Source:** For the period 1961-1980, calculations have been based on figures from the Central Bank of Chile and R. French-Davis and O. Muñoz, "Desarrollo económico, inestabilidad y desequilibrios políticos en Chile: 1950-1989", *Colección Estudios CIEPLAN*, No. 28, Santiago, Chile, Economic Research Corporation for Latin America (CIEPLAN), June 1990. For the period 1980-1993, they are based on figures from the Central Bank of Chile, *Cuentas nacionales de Chile, 1974-1985*, and the chaining of 1985 data with official national accounts for 1986-1992; growth rates (computed in pesos at 1986 prices) for 1993 were obtained from the Central Bank of Chile, *Cuentas nacionales trimestralizadas, 1986-1993*, Santiago, Chile, 1994.

<sup>a</sup> At 1977 prices. <sup>b</sup> Exports of goods. <sup>c</sup> Exports of goods and services.

hyperinflation and restore growth (Morales, 1992).

Prior to the introduction of the liberalization programme, tariffs were highly dispersed, with a maximum level of 150%. Import bans and licensing requirements were also in force. The authorities began by establishing a single exchange rate, returning to total convertibility, scrapping quantitative restrictions and cutting tariffs. They also opened up the capital account almost completely. Since then, the real effective exchange rate has undergone significant devaluations (see table V.1).

Bolivia simplified its tariff system in 1986 by establishing a uniform tariff of 20%. In 1990 the tariff rate was reduced to 5% for capital goods and 10% for other goods; thus far, these levels have been maintained. Bolivia now has one of the most open economies in Latin America and, indeed, in the world.

This reform effort has achieved its objectives in terms of stabilization, but the

expected recovery of economic performance has been slow in coming; since hyperinflation was quelled in 1986, the Bolivian economy's growth rates have been modest, especially in comparison to those of the 1970s, and investment, measured as a percentage of GDP, remained low for many years following the reforms.

In addition to the drastic reduction of inflation, another positive change has been the diversification of exports, although they remain concentrated in mineral and agricultural products and the total still falls short of the levels reached in the early 1980s.

In the last two years, however, exports have expanded considerably and are now approaching their 1980 level. This substantial increase has also entailed a greater degree of diversification. In addition, during this biennium GDP has grown at the reasonable pace of over 4% per year and investment has picked up.

Bolivia's experience suggests that, in an economy marked by low levels of diversification and productivity, a reform that alters market signals in order to align national prices with international ones, though necessary, is not enough in and of itself to fuel a rapid process of growth-oriented structural change.

*b) Experiences with high countervailing trade incentives prior to liberalization*

The experiences of other countries of the region have differed from those described above. In these economies, high levels of protection have been maintained for long periods, but at times their distortive effects on relative prices have been offset, at least partly, through the adoption of various export incentives (such as drawbacks, special import regimes, tax exemptions and preferential financing for exporters).

Certain limitations, both in the domestic sphere (especially fiscal constraints) and on the external front (reactions on the part of trading partners), have reduced the authorities' maneuvering room in terms of the use of export incentives, however. At the same time, a recognition of the potential benefits associated with an ability on the part of local firms to stand up to foreign competition and the successful experiences of some developing countries have prompted a proliferation of trade liberalization processes since the end of the 1980s. In fact, in recent years a shift in the direction of liberalization has been observed even in countries that have traditionally preferred to keep import barriers in place while neutralizing their effects on the export sector.

From the 1960s until the time when the reform process began to be stepped up in 1988, Brazil's trade and exchange regime exhibited three main features: a highly restrictive import policy based on import licences and bans, which were an essential component of the country's industrial policies; an active export promotion effort which included the use of fiscal incentives,

various lines of financing and drawbacks on imported inputs (Baumann and Moreira, 1987); and a crawling peg which, except for brief periods, succeeded in preventing the overvaluation and excessive fluctuations of the real exchange rate that have plagued other countries in the region (Fritsch and Franco, 1993). This last factor paved the way for a strong export performance despite the Brazilian economy's high levels of inflation.

Trade policy was closely linked to sectoral industrial policies, which were administered by a variety of agencies, including the business associations in each sector. Another salient feature of the Brazilian trade system was the neutralization of the widespread anti-export bias of protectionist policies through hefty subsidies for the exports of selected industries. In addition to these fiscal incentives, some exporters of manufactures enjoyed access to inputs and capital goods imported under special programmes, in exchange for a commitment to export and to maintain a positive balance in the use of foreign exchange. In point of fact, of all the countries of the region, Brazil's trade policies are some of the most similar to the policies implemented by the Republic of Korea and the Chinese Province of Taiwan.

In 1985 the country began to reform some aspects of its trade policy. Tariffs were reduced a number of times from 1988 on, and in 1990 a programme to further the liberalization of trade was launched. This was followed by the dismantling of quantitative controls and, later, the reform of the external trade regime and the streamlining of its administration.

In 1991 Brazil announced a new timetable for tariff reductions – which had brought tariffs down to an average of 14% by mid-1993 – and the elimination of various export incentives. Another important change made in 1990 was the addition of a "dirty" float applying to current international transactions to complement the crawling peg already in existence.

Until the early 1990s, Colombia's trade policy called for a combination of import substitution (based on fairly high, differentiated tariffs and import licensing) and the promotion of non-traditional exports through subsidies and drawbacks aimed at mitigating the anti-export bias of import policies. Tariffs were accompanied by a complex system of prior licensing, although there were also special regimes for certain sectors which lowered the amount of duty actually paid. The various attempts to liberalize external trade in recent decades have not altered the essential features of the prevailing regime (Ocampo and Villar, 1992a).

In the 1960s, Colombia became the second country (Chile was the first) to adopt a crawling-peg regime based on strict exchange controls. Trade reforms were launched in 1990, after Colombia's currency had undergone a number of sharp devaluations in real terms starting in 1985 which prompted a considerable increase in exports other than coffee. The first phase of the reform programme called for the removal of quantitative restrictions, although their protectionist effects were replaced by higher tariffs and devaluations. Tariffs were subsequently lowered.

The trade liberalization process was completed in Colombia in early 1992. The average nominal level of protection had decreased to 12%, compared to 44% in early 1990, and effective protection of domestically-produced goods had fallen from 91% to 29%. The degree of tariff dispersion had also been drastically reduced (Ocampo, 1993, p. 17).

In the financial sphere, a series of steps were taken to halt the appreciation of the currency (Cárdenas and Barrera, 1993); these measures included the application of reserve requirements to financial flows. In practice, the system still provides for a significant degree of regulation by the Banco de la República.

In 1985, Mexico implemented a programme to liberalize imports and phase out the traditional instruments of industrial policy. It should be noted that the liberalization process in this country was preceded and followed by sharp real depreciations (in 1982-1983 and 1986-1987) which gave the industrial sector a thick buffer that helped it make the necessary adjustment (Ten Kate, 1992). These steep devaluations were necessary in order for the country to be able to cope with the fiscal and balance-of-payments crises touched off by the suspension of foreign credit (in 1982) and the drop in oil prices (in 1986-1987).<sup>45</sup>

Before it embarked upon its trade liberalization programme, Mexico used a wide variety of instruments to control imports, stimulate industrial production and orient the manufacturing sector towards external markets. Local production was protected not only by a highly dispersed tariff structure with a ceiling of 100%, but also by the requirement of import permits for 92% of all foreign purchases and the use of officially appraised values that were higher than actual purchase prices in the case of 19% of total imports.

Exporters of non-traditional goods enjoyed tax breaks, which partially offset the anti-export bias of trade policy. In addition, for many years Mexico successfully used industrial promotion programmes to boost import substitution in sectors considered to be of strategic importance, sometimes in conjunction with export promotion programmes (Ros, 1993).

The country's trade liberalization programme began in 1985 with the removal of quantitative restrictions on a large number of tariff items. Liberalization measures focused on intermediate and capital goods, but also applied, although on a more selective basis, to some consumer goods. At first, tariffs were

45 It should be recalled that in Mexico, as in Chile, devaluations contribute to fiscal equilibrium, since earnings from the country's main export product are an important source of fiscal revenue and make the public sector a net supplier of foreign exchange.

raised to compensate for the elimination of direct controls. In 1987, the authorities carried the trade reform process further by eliminating the requirement of advance permits for imports of many consumer goods, discontinuing the use of officially appraised values in the remaining cases, and simplifying the tariff structure by reducing it to five rates ranging from 0 to 20%, with the average rate –weighted by output– being 12% (6% if the weighting is based on imports).

Trade reforms were then extended to include exports. Permit requirements have been eliminated in many cases, and the remaining quantitative restrictions on exports are those called for by the existence of price controls (for some agricultural products) or by the provisions of bilateral or international agreements. Traditional export subsidization mechanisms have been eliminated, partly as a consequence of Mexico's accession to GATT and its bilateral negotiations with the United States.

The use of industrial incentive policies has also been significantly reduced. The remaining programmes, which still include quantitative restrictions on imports, are concentrated in a few specific sectors, such as the motor vehicle and microcomputer industries.

The sharp real devaluations of 1986 and 1987 made it possible for the Government to launch the Economic Solidarity Pact, under which the exchange rate was frozen, the trade liberalization process was intensified and a policy of wage restraint was instituted in an attempt to lower annual inflation to single-digit levels; this goal was achieved in 1993.

Mexico's exports of manufactures are growing rapidly, and the industrial sector's share of GDP has risen slightly. However, Mexico's post-reform growth rates for the economy as a whole have been modest (see table V.3), and the deficit on current account has been climbing sharply (the projected figure for 1994 was over US\$ 28 billion).

c) *Experiences involving subregional agreements and structural adjustment programmes*

Trade liberalization programmes create special sets of circumstances when they coincide with subregional integration processes, particularly if they entail the adoption of a common tariff. The case of Costa Rica and Guatemala is one example of just such a situation.

These two countries effected a gradual, three-stage reduction in their levels of protection between 1986 and 1993. In both countries, trade liberalization was combined with sizeable real devaluations and with an increase in industrial output which was linked to the expansion of intra-Central American trade. This cushioned them somewhat from the potentially negative impact of trade liberalization with respect to third countries.

Although the two countries embarked upon the liberalization process at the same time –as part of a reform of Central America's common external tariff carried out in 1986– their paths subsequently diverged as a result of prior multilateral commitments made by Costa Rica with respect to structural adjustment and trade liberalization. None the less, by 1993 the two countries' tariff rates had converged towards equivalent levels.

Prior to 1986, Costa Rica and Guatemala had average (unweighted) nominal protection levels of about 50%, with higher rates of up to 100% for consumer goods and lower rates or exemptions for inputs and capital goods. In general, both countries' markets had been more open –as measured in terms of imports as a proportion of GDP or the level of effective protection– than those of other countries in the region (Rapoport, 1978), and non-tariff barriers had not –except for brief periods, such as 1982-1984 in Guatemala– been very significant in either country.

The first tariff reform to be carried out simultaneously by the two countries, in

Table V.3  
MEXICO: SELECTED GROWTH INDICATORS, 1980-1993 <sup>a</sup>

Years	Growth rate of GDP (percentages)	Gross fixed investment/GDP (percentages)	Manufactures/GDP (percentages)	Non-oil exports (billions of dollars)		
				Goods <sup>b</sup>	Maquila services	Percentage of total exports <sup>c</sup>
1970-1979	6.5	23.4	22.8	-	-	85.9
1980	9.2	24.8	22.1	6.0	0.8	40.0
1985	2.6	17.9	21.4	6.9	1.3	35.6
1986	-3.8	16.4	21.0	9.7	1.3	63.6
1987	1.9	16.1	21.3	12.0	1.6	61.8
1988	1.2	16.8	21.7	14.1	2.3	71.3
1989	3.3	17.3	22.5	15.0	3.1	69.9
1990	4.4	18.7	22.8	16.9	3.6	67.4
1991	3.6	19.6	22.9	18.7	4.1	73.6
1992	2.8	21.1	22.8	19.2	4.7	74.2
1993	0.6	20.7	22.5	22.6	5.4	79.1

Source: ECLAC, *Preliminary overview of the economy of Latin America and the Caribbean, 1994* (LC/G.1846), Santiago, Chile, December 1994; *Statistical Yearbook for Latin America and the Caribbean, 1993 Edition* (LC/G.1786-P), Santiago, Chile, February 1994. United Nations publication, Sales No. E/S.94.II.G.1; J. Ros, "La reforma del régimen comercial en México durante los años ochenta: sus efectos económicos y dimensiones políticas", *Reformas de política pública*, series, No. 4 (LC/L.743), Santiago, Chile, ECLAC, April 1993; and Banco de México, *Informe anual*, various issues.

<sup>a</sup> At 1980 prices. <sup>b</sup> Does not include exports from maquiladoras. <sup>c</sup> Share of total merchandise exports plus maquila services represented by non-oil merchandise exports plus maquila services.

1986, was primarily aimed at rationalizing their systems of protection. As part of this reform, the countries eliminated exemptions which, when applied to imports of inputs and capital goods, had substantially raised their levels of effective protection. They also did away with the surcharges which had been agreed upon by all the Central American countries, and lowered their highest tariffs. These measures brought average nominal tariff protection down from 50% to about 25% in both countries, as well as narrowing their tariff spreads.

These reforms do not seem to have had any significantly adverse effects on production activities. First of all, there was "water" in these tariffs; i.e., they were so high that, given the existence of competition from regional firms, it was not in producers' interest to make full use of them. Second, devaluations took place in

both countries: in 1986, Guatemala's real exchange rate<sup>46</sup> depreciated by some 42%, while Costa Rica's did so by 7% that year and by another 10% the following year.

Levels of tariff protection in Costa Rica and Guatemala began to diverge in 1987, when Costa Rica initiated a second tariff-reduction programme in accordance with the commitments it had made as part of a structural adjustment programme agreed upon with the World Bank; this was, in part, reinforced by the concessions made by Costa Rica in connection with its accession to GATT in 1990. The country agreed to cut its tariffs to an average level of 20% by 1990, while it continued to narrow its tariff spread and eliminated a national surcharge which it had justified as being an instrument for defending its balance-of-payments position. This tariff reduction process was accompanied by a gradual depreciation of the real exchange

46 The exchange rate weighted by the relative prices of the relevant country's main trading partners.

rate between 1987 and 1990 as a result of the adoption of a crawling-peg regime.

In 1990 Guatemala carried out a reduction of its nominal level of tariff protection (which, although later in coming, was also sharper), reducing its average level to 19%; in this case, too, these measures were linked to forthcoming agreements regarding structural adjustment and entry into GATT, which took place in 1991. However, the effect of the greater reduction of protection against importables was neutralized by a sharp devaluation (17%) of the real exchange rate in 1990.

In general, the steep devaluations of 1986, 1987 and 1990 in Guatemala, as well as the more gradual depreciation seen in Costa Rica, created favourable conditions for the production of tradable goods and services. This mitigated the negative effects of the third phase of tariff reduction undertaken by the two countries in 1992 and 1993, despite the very sharp appreciation of the real exchange rate in Guatemala in 1991 and the more moderate rise recorded in Costa Rica in 1992 and 1993. Moreover, capital inflows and the appreciation of the two countries' currencies, together with the economic recovery observed in both 1992 and 1993, helped to boost intra-Central American trade, thus enabling the industrial sector to carry out an expansionary adjustment despite the reduction of its levels of protection.

The end result of the third round of tariff reductions was equivalent tariffs in Costa Rica and Guatemala, with a maximum of 20% for finished goods and a minimum of 5% for inputs and capital goods. Guatemala's entry into GATT, which occurred later than Costa Rica's, involved stiffer tariff concessions, inasmuch as the former's tariffs were consolidated at 45%, whereas the latter's were consolidated at 60%. The tariff reductions made by other Central American countries under similar structural adjustment agreements facilitated the conclusion of an agreement on a new common external tariff in 1993 having these same rates of 20% and 5%.

Two lessons can be drawn from a comparative analysis of the experiences of Costa Rica and Guatemala, which serve as an illustration of the situation surrounding the conclusion of integration agreements between two or more countries. First, such an analysis confirms the desirability of reducing protection gradually, with a clear sense of direction, and of combining it with a gradual depreciation of the local currency in real terms. The case of Costa Rica demonstrates that this can be achieved through the use of a crawling peg, while Guatemala's experience indicates that, although devaluations can offset the impact of a decrease in protection, the exchange rate can become extremely volatile in the absence of a policy based on either a crawling peg or clearly defined parities. The combination of a gradual approach, on the one hand, and a clear sense of direction, on the other, is probably the main reason why Costa Rica has one of the highest investment coefficients and best export performances in Latin America and has recorded the highest GDP growth rate of the entire subregion for the 1980s and 1990s (ECLAC, 1994d).

Second, both countries' experiences illustrate the complex relationship that exists between international and subregional trade liberalization agreements. In particular, the international commitments made under structural adjustment programmes can play a decisive role both in fostering the abandonment of a common external tariff (CET) agreed upon at the subregional level and in promoting a convergence of levels conducive to the conclusion of an agreement on a new CET. In turn, a CET may lend greater credibility to national trade liberalization initiatives, since it can help to consolidate or "lock in" tariff reductions through the joint commitment of a number of countries (ECLAC, 1994a).

## 2. Export promotion policies

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This section will present a comparative study of the different mechanisms used during the past two decades to promote

exports in nine countries of the region (Argentina, Brazil, Chile, Colombia, Costa Rica, Guatemala, Mexico, Paraguay and Uruguay). The aim of this analysis will be to describe the practices adopted in those countries, observe the trends that have emerged over time and, insofar as possible, compare these two elements with their counterparts in other regions.

A review of the export-incentive profiles of these nine countries from the standpoint of the process of changing production patterns suggests that, in general, the region suffers from several weaknesses in this area.

The most frequently used incentives are those that furnish access to imported inputs and tax exemptions on domestic value added. Export policies are generally defined in strictly commercial terms, and few countries provide incentives for upgrading the supply of exportables and access to foreign markets through promotion, marketing, quality and brand differentiation activities, or the creation of export trading companies (characteristic of the aggressive trade strategy of the Asian countries) or the celebration of export contracts, with incentives being differentiated according to the types of commitments made with regard to the value of exports (another prominent feature of the approach taken by Asian countries). Much the same is true of the promotion of overseas investments in marketing activities and participation in wholesale distribution chains, all of which are important factors in promoting the internationalization of production.

#### *a) Fiscal incentives*

A comparative analysis of fiscal incentives in these nine countries of the region leads to the following conclusions (see table V.4):

i) The most frequently used instruments for stimulating exports are fiscal incentives (tax exemptions or drawbacks) rather than financial

mechanisms. Argentina, Brazil and Colombia have employed various sorts of incentives since the 1960s; other countries, such as Guatemala, have not adopted such measures until more recently.

ii) Since the second half of the 1980s, and concurrently with import liberalization processes, the use of a number of these instruments has been discontinued, including profits-tax exemptions and export performance-based incentives (in Argentina and Brazil), and exemptions from indirect taxes other than the value-added tax (VAT) (in Mexico).

The reasons for these changes vary. In some cases, it has simply been that the structure of incentives had to be adapted to conform to the conditions agreed to within the framework of GATT; in others, as in the case of Mexico, plans to sign a bilateral trade agreement required the elimination of certain mechanisms. In still other cases, such steps were taken for fiscal reasons and for reasons of efficiency in terms of an effective means of stimulating the export sector, or simply because of the more general desire to reduce the role played by public policy.

iii) The most commonly used instruments have to do with the provision of preferential access to imported inputs (drawbacks) and exemptions from domestic value-added taxes. These types of measures afford a minimum level of export promotion, i.e., they eliminate barriers to the importation of inputs and taxes on exportable products.

iv) The differences observed among the various countries are linked to the nature of their respective domestic fiscal structures (e.g., the existence or absence of indirect taxes)<sup>47</sup> and the composition of their exports: only two of the nine countries grant incentives to export marketing firms.

v) Export performance-based incentives—which are traditional in Colombia and have been introduced more recently in Mexico—have been eliminated

<sup>47</sup> Or the absence of an income tax, as in Uruguay.

Table V.4  
LATIN AMERICA (SELECTED COUNTRIES): SUMMARY OF FISCAL EXPORT INCENTIVES (1992)

Incentives	Argentina	Brazil	Chile	Colombia	Costa Rica	Guatemala	Mexico	Paraguay	Uruguay
Rebates	Leves similar to tariffs (new manufactures)	No	Levels similar to tariffs	No	Yes	Yes	Includes indirect exporters	No	No
Tax credit certificates	No	No	No	Excludes traditional products	Up to 30% of exported value	No	No	No	No
Drawbacks	Refund of import duties and charges (1960)	Refund of import duties and charges (1964)	Refund of import duties and charges (1988)	<sup>a</sup>	Refund of import duties and charges (1972)	Refund of import duties and charges (1983)	Refund of import duties and charges (1972)	Mechanism planned but not operative	Refund of import duties and charges
Exemption from value-added tax	Includes credit for pre-export stages	Includes credit for pre-export stages (1964)	Since 1975	<sup>b</sup>	No	Yes	Includes credit for pre-export stages	Includes credit for pre-export stages	Includes credit for pre-export stages
Exemption from other indirect taxes	Includes indirect exporters	Benefits industrialized products	No	Excludes some products	No	No	Until 1985	Yes	Up to 10% of exported value
Exemption from tax on profits	In effect from 1985 to 1989	No	No	No	Non-traditional products	Non-traditional products	No	Yes	No
Export performance-based incentives	In effect from 1986 to 1993 <sup>c</sup>	In effect from 1972 to 1990	No	Since 1959	Since 1972 <sup>d</sup>	No	Since 1986	No	No
Incentives for export trading companies	Since 1985 (not operative)	Since 1972 <sup>e</sup>	No	No	No	No	Since 1986	No	No

Source: ECLAC, on the basis of official figures.

<sup>a</sup> The facilities provided for in the Vallejo Plan are classified as export performance-based incentives.

<sup>b</sup> The CERT exemption is classified as a tax credit certificate.

<sup>c</sup> Reintroduced for the motor vehicle industry other exporters.

<sup>d</sup> Not subject to export contracts; incentive proportional to the amount exported.

<sup>e</sup> The same incentives as are given to

in recent years in Argentina,<sup>48</sup> Brazil<sup>49</sup> and Costa Rica as part of these countries' economic reform programmes.

*b) Financial mechanisms*

International conditions have a decisive influence on export financing policies owing to the industrialized countries' efforts to impose a certain discipline on competition among lenders regarding the finance terms they offer and the reduction of the degree of subsidization implicit in those terms. The countries of the Organization for Economic Cooperation and Development (OECD) follow explicit guidelines in this connection,<sup>50</sup> thereby defining parameters on which other countries base their decisions. The use of a number of new types of private-sector credit instruments<sup>51</sup> is also on the rise, making the utilization of export credits increasingly common<sup>52</sup> in countries whose financial and insurance markets run fairly smoothly.

In Latin America, export financing has played a crucial role in expanding and diversifying external sales of non-traditional items. Empirical evidence shows a strong positive correlation between the availability of export financing and an increase in the share of total exports represented by sales of non-traditional products (especially manufactures) (Rhee, 1989).

The export financing mechanisms employed in the countries of the region

have traditionally involved the direct or indirect use of public resources: i) financing by government agencies; ii) rediscounting of notes purchased from exporters; iii) refinancing, at preferential rates, of private-sector credits granted to exporters; iv) coverage of the spread between market interest rates and fixed rates set at a lower level in order to promote exports; and v) provision of insurance and credits, especially in the case of financing extended to foreign buyers.

In the case of virtually all of these mechanisms, commercial banks play a key role in export financing in most countries of the region. Given the absence of any parallel insurance policy, especially with regard to pre-shipment credits, only those exporters who are in a position to offer guarantees actually have access to credit; this works to the detriment of most small and medium-sized enterprises.

A second consequence is that, in most countries, the bulk of such financing goes to final exporters. Few mechanisms exist for the domestic suppliers of inputs to the export sector. Third –owing to the shortcomings of the countries' capital markets, especially as regards long-term credit– the short-term lending in which commercial banks engage has the effect of limiting the financing of fixed capital investment for export activities as well as the post-shipment financing of capital goods and other products, thereby hindering efforts to achieve export diversification.<sup>53</sup>

48 This type of incentive has been reintroduced for the motor vehicle industry.

49 Such incentives are available only in the case of some contracts signed before 1990.

50 Since 1978, the OECD countries have observed the provisions of the Arrangement on Guidelines for Officially Supported Export Credits.

51 One example of such an instrument is the mechanism known as "forfeiting" (a private-sector mode of lending to buyers that enables exporters to obtain post-shipment financing and to discount medium-term promissory notes). Another is "securitization" (a mechanism enabling groups of small enterprises to form a pool in order to obtain pre-shipment credit by reducing their individual risk).

52 In some industrialized countries, official support for exports is limited to the provision of insurance and guarantees.

53 Some exceptions are financing that has an impact on supply, such as lines of credit for exports of consultancy and engineering services and of capital goods, and financing for enterprises with export potential and programmes for the development of exportable supply.

This suggests that an appropriate export finance policy should include: i) channels providing access to credit; ii) insurance systems to enable firms having fewer guarantees to offer for pre-shipment financing to obtain credit; iii) mechanisms for providing long-term lines of credit; and iv) the necessary insurance structure to cover post-shipment risks.

Table V.5 summarizes some of the financial incentives provided for exports in the nine countries studied.

The most marked differences among the various financial incentive structures relate to lines of credit to supplement supplier credits and financing for the production of exportable goods. For example, not all the countries have lines of credit specifically intended to serve the purpose of trade promotion or for investments by exporters in fixed assets, nor do they have mechanisms that facilitate access to financing for agents involved in the various stages of the production process. These are areas in which –because of the high level of risk entailed in export activities and the lengthy periods of time they involve– inputs of government resources or lines of financing from international bodies are generally required. Even so, this does not eliminate the bias against small and medium-sized enterprises or the difficulty of channeling benefits to indirect exporters.

The lower section of table V.5 illustrates the magnitude of the shortcomings that exist with regard to export credit insurance. In all the countries –except Mexico since 1987– insurance for pre-shipment financing is furnished by private companies, as is the insurance needed to cover commercial risks in post-shipment stages. Mechanisms for covering exchange risk are not highly developed, and often no coverage is available for extraordinary risks. Given the existing limitations on access to major

financial markets, it is often difficult to obtain the reinsurance that insurers need in order to diversify their securities portfolios.

For purposes of comparison, tables V.4 and V.5 present only those incentives that are similar in a number of different countries. However, a descriptive analysis should at least make mention of other existing mechanisms, some of which have had clearly positive effects on the export sector, as well as still others which have been adopted more recently and have been welcomed by the various agents. These include: i) the stimuli generated by a more efficient use of trade promotion services in diplomatic missions and by the provision of greater access to information and more streamlined processing procedures through integrated computerized systems for foreign trade (SISCOMEX<sup>54</sup> in Brazil) and “random customs selections” (Mexico); ii) incentives granted in exchange for certain commitments in terms of the value or volume of exports (Commission for the Extension of Fiscal Benefits to Special Export Programmes (BEFIE) in Brazil, the Vallejo Plan in Colombia, and the Programme for Consensus-Building with Major Export Enterprises (ALTEX) in Mexico); iii) mechanisms such as the “export card” (Mexico), which gives the various agents involved in production and export activities easy access to domestic credit; iv) lines of credit not included in table V.5, such as those used to finance services exports, the export of turnkey production plants, the acquisition of storage facilities abroad, the preparation of market surveys, and the shipment of commercial samples (Argentina, Brazil, Colombia); and v) other types of incentives, such as temporary clearances, administrative facilities and differentiated customs treatment for warehoused exportables, and initiatives such as the Chile Foundation, a semi-public organization that conducts projects aimed

54 SISCOMEX has considerably simplified administrative procedures relating to exports and imports by taking the place of a number of documents and has made possible a computerized integration of the activities of the main agencies involved in foreign trade.

Table V.5  
LATIN AMERICA (SELECTED COUNTRIES): SUMMARY OF FINANCIAL EXPORT INCENTIVES (1992)

Incentives	Argentina	Brazil	Chile	Colombia	Costa Rica	Guatemala	Mexico	Paraguay	Uruguay
<b>Pre-shipment credit</b>									
a. Public resources	Existed from 1963 to 1991	No	For some products	Since 1967	Since 1983	For some products	Since 1985		Since 1985
b. Private resources	Market conditions		Market conditions	Market conditions	Market conditions	Market conditions	Market conditions	Market conditions	Market conditions
<b>Post-shipment credit</b>									
a. Public resources	Existed from 1965 to 1991	For some products	For some products	For some products	Since 1983	For some products	For some products		
b. Private resources	Market conditions	Market conditions	Market conditions	Market conditions	Market conditions	Market conditions	Market conditions	Market conditions	Market conditions
<b>Trade promotion</b>	Only for small and medium-sized enterprises (FOPEX resources)	No	Sercotec-CORFO line of credit	Since 1967	No	No	Since 1985	No	No
<b>Fixed asset financing for exporters</b>	No	No	No	% varies according to export/sales ratio	Since 1983	Yes	Since 1985	No	No
<b>Financing for development of exportable products</b>	No	No	Sercotec-CORFO line of credit	Since 1967	Yes	No	Since 1985	No	No
<b>Letter of credit for exports</b>	No	No	No	No	No	No	Since 1985	No	No
<b>INSURANCE: Pre-shipment financing</b>	Private insurers	No	Private insurers	Private insurers	No	No	BANCOMEXT guarantee since 1987	No	No
<b>Post-shipment financing:</b>									
a. Commercial risk	Private insurers	Private insurers	Private insurers	Private insurers	No	No	BANCOMEXT guarantee	Private insurers	Private insurers
b. Extraordinary risk	Treasury resources	Treasury resources		Existed until 1986	No	No	BANCOMEXT guarantee	No	No
c. Exchange rate risk	No	No	No	No	No	No	No	No	No

Source: ECLAC, on the basis of official figures.

at developing new exportable products, after which –once such products' economic viability has been demonstrated– it auctions them off to the private sector (see box V.2).

c) *Non-price-based promotion mechanisms*

i) The institutional structure for export policy. Policies providing institutional support for exports vary as to the decision-making levels involved in the different countries of Latin America. In some countries (Mexico, Guatemala, Colombia, Paraguay, Brazil between 1965 and 1990), general guidelines are defined by ministerial councils that are specifically responsible for matters of foreign trade,<sup>55</sup> while in others, foreign trade is the province of one (Argentina) or more (Brazil) secretariats or departments of ministries in charge of economic affairs. There are also differences as to the kinds of agencies that administer foreign trade policy: Mexico and Colombia have foreign trade banks with powers relating to policies on export credit insurance and financing, while in other countries these functions are performed by non-bank agencies whose job is essentially one of administering budgetary resources (Brazil); in still other cases, there simply is no centralized trade policy but instead an agency charged with the development and promotion of exports (Chile).

Other differences have to do with the degree to which private agents are involved in the formulation of foreign trade policy. In some countries (Mexico, Colombia, Brazil until 1990), private agents take part in this activity on a routine, formalized basis via the representation of producers' organizations on ministerial councils for foreign trade and other special-purpose commissions. In other cases, the private sector

participates indirectly via sectoral agencies (such as the sectoral chambers in operation in Brazil since 1990) or consultative bodies, such as the Foreign Trade Council which has been in existence in Chile since 1990.

For the most part, the agencies responsible for backstopping Latin American exports have concentrated primarily on promoting trade rather than on influencing supply conditions. Initiatives aimed at fostering the creation of export trading companies, making intensive use of the facilities of diplomatic missions for commercial purposes or establishing trade representatives' offices, either in the countries' major markets or in their potential markets, have been few and far between. Some of the reasons for this may be found in the lack of trade promotion incentives, while others are linked to the absence of a tradition of involving private agents in foreign trade policy-making.

ii) Quality control policy. As an export-promotion mechanism, this type of policy represents a new and increasingly important issue in the region, since quality is becoming a key aspect of competitiveness in international markets.

Including this policy among the array of incentives used by a country to improve its exportable supply can facilitate gains in productivity and the adaptation of supply to conform to stricter standards of international demand (see box V.3).

This type of adaptation is quite a high priority as regards environmental and phytosanitary standards, particularly in order to obtain access to the EEC market, which demands official certification for its imports of horticultural and fruit products.

From a more general vantage point, encouraging firms to set up quality control systems permits them to modernize their management techniques and, particularly in the case of small and medium-sized

55 In some countries (such as Costa Rica since 1986), there are specific ministries for foreign trade, while in others –the majority– such matters are handled by agencies linked to Ministries of Finance, Industry, Trade or Agriculture.

## Box V-2

## THE CHILE FOUNDATION

The origins of the Chile Foundation go back to the nationalization of the *Compañía de Teléfonos de Chile*, a subsidiary of ITT, during the administration of Salvador Allende. During the following administration, the Chile Foundation was created as part of a compensation agreement: under the terms of that agreement, each of the two parties was to invest US\$ 25 million of seed capital in this joint venture. The idea was for the Foundation to gradually become self-supporting by providing services to the private sector and establishing lucrative production companies that would employ new technologies.

The Foundation's first projects were directed mainly at improving the quality of processed fruit and vegetables and providing technical assistance to the edible oils industry, including advisory services regarding methods for refining fish oil and using other by-products.

Few of these early projects got beyond the pilot stage. In view of this problem, the Foundation decided it needed to gain more experience by launching business projects of its own.

The idea was to determine which activities might benefit from new technologies, and then to acquire and adapt these technologies. Once a technology was assimilated, the Foundation would take charge of commercial production and marketing through a subsidiary. When the

subsidiary became profitable, it would be sold, thereby completing the technology-transfer process. Using this procedure, the Foundation has set up more than 20 subsidiaries, primarily in the agricultural and fisheries sectors.

Salmon farming is one example of a very successful initiative. In 1981, the Foundation decided to carry out a pilot project using a cage-based technique of freshwater salmon farming. In the course of the project, a number of problems were solved in relation to the feeding of the fish, disease control, changes in currents and water temperature, techniques for the handling of eggs and fry, the selection of species and the behaviour of the fish in the cages.

Commercial production began in the period 1986-1987, and output doubled in the following period. The project began to turn a profit in 1988, and the technology-transfer cycle was completed that same year when the Foundation sold the project to a Japanese fish and shellfish company.

The Foundation's salmon-farming project gave a definite boost to overall salmon output in Chile, which increased from 94 tons in 1983 to over 4,000 tons in 1988. The technological capacity developed within the Foundation was so great that the organization was able to provide technical assistance to more than half of the new projects undertaken in this area.

Source: T. Huss, "Transfer of technology: the case of the Chile Foundation", *CEPAL Review*, No. 43 (LC/G.1654-P), Santiago, Chile, April 1991.

enterprises, to rationalize costs and make better use of available incentives, which often go unused due to a lack of knowledge of their existence or to poor business management. Promoting the creation of private firms specializing in quality certification also encourages competition in the sector and motivates the public sector to concentrate on regulation and supervision. By the same token, this type of competition also gives the public sector more options when the

time comes to designate testing laboratories.

### 3. Export processing zones (EPZs)

Some Latin American and Caribbean countries have accorded differential treatment to export processing units on quite a large scale as a way of boosting their external sales and, in addition, of heightening labour absorption and the internationalization of technical progress.

## Box V-3

## CHILE: EXPORT QUALITY

The Government has submitted a bill to the legislature proposing the establishment of a national quality control system to promote the standardization of export products and the creation of certification mechanisms for those products. The idea is to move towards a system of export quality certification that would be sufficiently flexible so as not to hinder export activity but that would also provide the necessary incentives to bring about genuine improvements in the quality of exported items.

This is the concept that was behind the creation of the National Quality Programme, whose operations initially focused on the areas of technical standardization, sectoral authorities, metrology and quality certification. The proposal now being advanced under this Programme calls for the establishment of a National Quality System under which sectoral quality-control authorities would be responsible for accrediting the certifying agencies of the corresponding ministries, and a technical service agency would be in charge of standardization, metrology and the monitoring of accredited agencies. The system would be coordinated by a National Quality Secretariat, which would in turn be the executive arm of a National Quality Council composed of representatives of the public and private sectors.

Preliminary studies have revealed the existence of a wide range of functions relating to quality, safety and health that are scattered among a number of different ministries, the use of relatively obsolete technical standards and an overlapping of regulations with, in many cases, others that have not been formally repealed or whose legal status is unclear.

CORFO (the Production Development Corporation) recently created a technical assistance fund for quality control and technology transfer whose aim is to support such functions in small and medium-sized enterprises. The fund operates on the basis of five modules: baseline analysis, training regarding the concept of quality, planning, administration and production processes in quality-control and product-design systems. In each of these modules, firms can apply for a subsidy equivalent to 75% of the cost of the consultants they hire, up to a limit of nearly US\$ 2,000. The modules are cumulative in order to encourage business enterprises to set up integrated quality control systems. The initial funding for the programme amounts to US\$ 232,000.

A national quality award has been created and is presented to outstanding firms in this area each October, which has been designated national "quality month".

At the sectoral level, the difficulties encountered by Chilean fruit exporters in gaining entry into the EEC market in 1993 prompted an active national debate on quality control for fruit exports. This led to a plan for regulating the fruit industry which was drawn up by the Association of Exporters, the Federation of Fruit Growers and the National Agricultural Society. The plan envisages a compulsory quality-certification system based on predetermined standards, verification of the condition of the fruit upon arrival at its destination, and a shipment scheduling system that would avert situations of oversupply and would organize the timing of the fruit's arrival in the main export markets.

Source: Science, Technology and Quality Control Programme of the Ministry of Economic Affairs, Development and Reconstruction of Chile

Any analysis of this policy instrument must make some sort of comparison between the incentives granted to these units and the benefits received by other producers/exporters; this topic goes beyond the bounds of this chapter, however. Our purpose here is simply to discuss some of the factors that provide an indication of just how important the

maquiladora industry has become in the region and to draw some conclusions based on specific country experiences.

a) *Export processing zones*

Export processing zones (EPZs) are physical and economic enclaves where free-trade and export-promotion policies

can be applied without altering the trade regime or the structure of protection in use in the rest of the country.<sup>56</sup> These zones are delineated areas that are placed outside the jurisdiction of the country's customs authority. Although most of the firms operating in these zones tend to be subsidiaries of transnational corporations, there are also many joint ventures and national firms that are serving as subcontractors of companies which operate in importing countries. Generally speaking, EPZs produce labour-intensive goods such as light manufactures (wearing apparel, electronics, processed foods, etc.) whose transport costs are low.

There are more than 200 EPZs in developing economies, the first of which were set up in southern and eastern Asia. Their creation is not linked to the size of the domestic market, but rather to the existence of a supply of relatively cheap labour, the availability of services and infrastructure, and the absence of trade, exchange and administrative barriers. For example, in Latin America and the Caribbean, EPZs exist in Costa Rica, Colombia, Dominican Republic, El Salvador, Guatemala, Grenada, Haiti, Honduras, Jamaica, Mexico, Saint Lucia and other countries. Table V.6 shows the relative significance of EPZs in terms of the total exports of some countries of the region.

The most commonly used incentive in these zones is an exemption from duty on imports of foreign merchandise, both consumer goods and industrial goods for use in the zone itself. Nearly all the EPZs also offer exemptions from indirect taxes on such operations and from income taxes, and some also permit a limited percentage of output to be sold on the domestic market subject to the payment of the corresponding import duties. Another hallmark of EPZs is that they offer a free exchange market, in that foreign exchange earnings from exports are not subject to

restrictions. In general, these incentives are granted for a fairly long period of time (usually about 20 years).

The most successful EPZs exhibit a high degree of operational efficiency. In addition to quality infrastructure and communications capabilities, the success of the main types of promotion policies depends less on the existence of generous tax and financial incentives than it does on the streamlining of such procedural matters as port and customs formalities, among others, and the minimization of red tape.

One of the EPZs' chief drawing cards is that they permit the consolidation of commercial and administrative transactions into a single service (or "window") which centralizes all formalities, intercedes with other government offices, takes decisions and solves administrative problems. This streamlining of processes and decision-making allows the investor to spend less time on procedural matters, thereby reducing the investor's administrative costs and improving the competitive environment.

EPZs may, of course, entail both benefits and costs. In those cases where developing countries have fostered the creation of EPZs, they have done so to promote a net inflow of foreign exchange, increase productive employment and attract foreign direct investment and technology; to open up opportunities for upgrading labour and management skills; and to further the establishment of linkages between firms located in the EPZs which are in closer contact with the international competition and more sensitive to technological innovations and domestic firms.

The benefits of EPZs should be assessed in the light of their potentially changeable nature. One possible scenario is that these zones may generate rising levels of value added and foreign exchange, along with increasingly stringent requirements in

56 The definition of EPZs as physical enclaves is not entirely accurate in all cases. In a number of countries, some export-processing plants enjoy differential treatment in respect of fiscal and exchange matters even though they are located in various parts of the country.

Table V.6  
 IMPACT OF MAQUILADORAS/EXPORT PROCESSING ZONES ON  
 TRADE IN SELECTED COUNTRIES, 1980-1992

	1980	1985	1990	1992
<b>Mexico<sup>a</sup></b>				
Total exports (A)	15.5	26.8	40.7	46.2
Maquiladora-EPZ exports (B)	2.5	5.1	14.1	18.9
Exports of manufactures (C) <sup>b</sup>	3.0	5.0	13.9	16.7
B/A (%)	16.1	19.0	34.6	40.9
B/(B+C) (%)	45.5	50.5	50.4	53.1
<b>Jamaica<sup>d</sup></b>				
Total exports (A)	963	610	1,323	1,275
Maquiladora-EPZ exports (B)	-	70	289	384
B/A (%)	-	11.5	21.8	30.1
<b>Dominican Republic<sup>d</sup></b>				
Total exports (A)	1,079	954	1,574	1,757
Maquiladora-EPZ exports (B)	117	215	839	1,191
B/A (%)	10.8	22.5	53.3	67.8
<b>Saint Lucia<sup>d</sup></b>				
Total exports (A)	46	83 <sup>e</sup>	127	-
Maquiladora-EPZ exports (B)	-	7.5 <sup>e</sup>	19.1	-
B/A (%)	-	9.0 <sup>e</sup>	15.0	-
<b>Costa Rica<sup>d</sup></b>				
Total exports (A)	1,003	1,090	1,668	2,171
Maquiladora exports (B)	4	149	307	453
B/A (%)	0.4	13.7	18.4	20.9

**Source:** Banco de México, *México: Indicadores económicos*, Mexico, City, various issues, and *The Mexican Economy-1993*, Mexico City; Larry Willmore, "Export processing in the Dominican Republic, Jamaica and Saint Lucia: ownership, linkages and transfer of technology", *Working Paper series*, No. 25, Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), 1995; Economic Commission for Latin America and the Caribbean/External Trade Data Bank for Latin America and the Caribbean (ECLAC/BADECEL); International Monetary Fund (IMF), *International Financial Statistics*, various issues.

<sup>a</sup> Billions of dollars. Totals include gross value of exports by maquiladoras. <sup>b</sup> Excluding manufactures produced in maquiladora plants. <sup>c</sup> Estimated relative weight of maquiladoras in total exports of manufactures. <sup>d</sup> Millions of dollars. <sup>e</sup> 1986.

terms of skilled labour, and may constantly update their management techniques in line with the best international practices. Alternatively, however, these zones may stagnate or diminish in importance if they become less attractive than EPZs in other countries due to the presence of a less competitive workforce, inadequate infrastructure or political instability. It may be useful to determine exactly which types of circumstances encourage a strong performance on the part of EPZs,

as well as looking at the possibility of a transition towards the formation of an "export processing country or territory", as has occurred in Singapore and Hong Kong.

Various aspects of these zones need to be examined. The level of net exports from EPZs is considerably lower than their gross exports owing to their high content of imported inputs. The infrastructure required for the establishment and operation of EPZs entails a direct cost that may considerably raise the cost of the jobs

they create. In addition, there are implicit subsidies in the prices of the land, industrial sites, public services and other business services.<sup>57</sup> Finally, the concessions and incentives granted to firms located in EPZs have in some cases crowded out local producers whose facilities were originally located outside this special zone.

The creation of EPZs may serve as an initial stage in a process of export-oriented industrialization in developing countries or in given areas of such countries. In fact, special zones are often found in remote areas in which there are few alternative means of labour absorption.<sup>58</sup>

It is also possible that the development of production activities in EPZs may remain confined to assembly operations. This may have two possible consequences. First, the absence of linkages can limit the impact of EPZ exports on the income and productivity of the rest of the economy, although the importance of this factor will depend on the relevant country's type of production base, its level of competitiveness and the presence of policies that encourage or discourage the formation of such linkages. Second, a lack of systemic competitiveness – particularly in the form of a dependence on low wages and preferential access to external markets – raises the possibility of disinvestment or of the sudden curtailment of new investments in these zones.<sup>59</sup>

It should be noted that, in order to promote linkages between firms located within EPZs and domestic firms, the economy needs to have effective mechanisms for the provision of financing, technological support and human resources training so that it can take

advantage of the stimuli generated by EPZ activities.

*b) Export processing in the Caribbean*

i) Effects on employment and labour markets. Together with the tourist industry, export processing plants have been a major source of jobs in several countries of the Caribbean. Employment in the export processing plants of the Dominican Republic's EPZs climbed from 20,000 workers (23% of total employment in the manufacturing sector) in 1981 to 141,000 workers (63% of total employment in manufacturing) in 1992. EPZs accounted for 1.3% of all jobs in 1980 but for 6.6% in 1991. In Saint Lucia, the largest of the seven members of the Organization of Eastern Caribbean States (OECS), it is estimated that export processing firms employ more than 2,800 persons in 17 plants, which is one half of all the jobs in manufacturing and 6% of the total number of jobs in the economy. Finally, the Jamaican economy employs more than 900,000 persons, of whom 31,000 (mainly young women) work in export processing plants. Export processing accounts for 3% of all jobs in the economy, and 30% of employment in the manufacturing sector.

Wages, benefits and working conditions tend to be better in the EPZs than in the rest of the country. Employers in the EPZs are subject to the same labour laws as employers elsewhere. However, although labour unions in the Caribbean countries are by law guaranteed the freedom to operate, there is little union activity in any of the EPZs. In the Dominican Republic a minimum level of fringe benefits is required by law (mainly social security,

57 It should be noted that private EPZs also exist (e.g., in Costa Rica and the Dominican Republic) which do not receive subsidies.

58 The absence of adequate infrastructure may curtail the development of this type of EPZ, however; it is therefore advisable to limit the number of the EPZ's objectives in order to increase the probability of attaining them.

59 This is a danger which, as repeatedly pointed out in the Caribbean and Central America, may result from the signing of the North American Free Trade Agreement if it leads to an erosion of the preferential access to the United States market enjoyed by the countries participating in the Caribbean Basin Initiative.

paid sick leave and holidays, and a Christmas bonus equal to one month's pay). Most of the firms in Caribbean EPZs provide more benefits than the minimum, however, as well as numerous bonuses for punctuality and productivity. In Saint Lucia, incentive pay actually exceeds the regular wage in some cases. In Jamaica, fringe benefits are even more generous; in fact, this is so much the case that only about half of local expenditure goes to wages, with the remainder being for water, electricity, local transport, rent, imports from territory under the jurisdiction of the Jamaican customs authority, and the like.

ii) Linkages and technology transfer. Overseas assembly is universally recognized as a means of employing large numbers of relatively unskilled workers, but its usefulness as a vehicle for the transfer of technology is frequently overlooked. The importance, for a given economy, of introducing workers to the rigours of an industrial environment and to the concepts of punctuality, quality control and deadlines should not be underestimated. In addition, different policies may represent incentives or obstacles to technology transfer, as is demonstrated by the experiences of the Dominican Republic and Jamaica as compared to that of Saint Lucia.

In the Dominican Republic, export processing and tourism have been the only buoyant sectors of the economy during the past decade. During the period 1982-1991, GDP grew by an average of only 1.2% per year, merchandise exports from the territory under the jurisdiction of the customs authority fell in both volume and value, and manufacturing production outside the EPZs diminished. Over this same period, expenditure by tourists rose at an average rate of 14% per year to US\$ 877 million, exports from the EPZs climbed by 23% per year to more than US\$ 1 billion, and foreign exchange earnings of the customs-free zones increased by an average of 17% per year to US\$ 249 million.

The range of products produced in the EPZs of the Dominican Republic has expanded a great deal over the years, yet the degree to which output is concentrated in the textile industry has actually risen slightly, with the result that more than two thirds of the companies and employees working in the EPZs are now engaged in the manufacture of textile products. Assembly of electronic and electrical equipment has grown rapidly, but still accounts for less than 5% of EPZ employment. Data processing is another new area of export activity, and this export service is now being marketed in such fields as airline reservations and the processing of health insurance claims for foreign clients (see box V.4).

EPZ exports from Jamaica grew steeply until 1989, but have since stagnated. By the same token, local expenditures by EPZ firms also rose steadily until 1989 but thereafter began to decline. The United States is the main source of investment and the largest market for export processing firms in the EPZs of these Caribbean countries.

Seventy of the 79 locally-owned companies in the Dominican Republic are in the textile and garment industry, and most of the remainder are in "low-tech" industries producing footwear, leather articles, ceramics and furniture. In the case of the apparel and footwear industries, the local companies are subcontractors that assemble products for overseas firms.

Firms in the Dominican customs-free zone are well managed, use the best conventional production practices and are able to meet stringent quality standards and short deadlines. Quality and manpower qualification levels are high. In contrast, the technically backward producers for the domestic market have not benefited from the presence of exporters in the EPZs owing to the weak linkages existing between the two kinds of producers. Firms producing for the domestic market operate at low levels of efficiency and use antiquated quality-control systems.

## Box V-4

## DATA PROCESSING: A NEW TYPE OF MAQUILA IN SELECTED CARIBBEAN COUNTRIES

In 1989 the island of *Grenada* managed to attract a United States-owned company that employs 150 data entry operators and has another 30 people in training. One reason for the success of this venture is that the investors installed a satellite dish in Grenada so that could send and receive images of documents on their own equipment rather than having to use the mails or pay high fees to the local telephone company. Last year, the parent company acquired a corporation in *Dominica* which had previously been owned by the local telephone company. The number of jobs provided by the firm grew from 85 to 115, and a satellite dish was installed. Poor communications restrict *Saint Lucia's* data processing activities to articles for medical or legal journals and the like, which do not require fast turn-around times, whereas firms in Grenada and *Dominica* are able to serve clients such as Federal Express, Bank of America, Xerox and Blue Cross of California.

Ten years ago, there were only five data processing firms in *Jamaica* and, for the most part, they served the domestic market. The industry began to grow rapidly, however, when the Government offered incentives to firms that were willing to specialize in export markets and to refrain from maintaining any domestic clients. These exporters of services now employ more than 2,500 workers. In 1985 the Government changed this policy, ruling that in the case of data entry services -unlike manufactures-, tax exemptions and duty-free import privileges would be restricted to companies located in the customs-free zones.

*Jamaica's* shortage of skilled labour hinders its data processing industry, which prefers to hire high school graduates who know how to type. Owners and managers of firms in this sector complain that they have difficulty recruiting data entry operators and that the people who they do hire have such a poor level of general knowledge that they require a minimum of from three to four months of training. During the training period they must be paid the legal minimum wage even though their productivity is close to zero. Once trained,

operators often switch over to another employer, as there is fierce competition for the limited pool of trained data entry operators due to the fact that -unlike manufacturing firms in the garment industry- data processing companies do not have a policy of cooperating with one another in the labour market. This provides a classic example of externalities: a company that incurs the expense of training a worker is not able to recoup its investment, and all of the firms in this industry therefore invest very little in training new workers. It would be better to conduct basic training activities outside the firm, with all firms in the industry sharing the costs. Moreover, if this were done most of the cost would be borne by the trainee, as he or she need not be paid a minimum wage while undergoing training. The data processing firms in the Kingston area have, in fact, begun a programme of this type for high school graduates in cooperation with Human Employment and Resources Training, a government-run vocational training programme.

The growth prospects of the data processing industry in *Jamaica* are quite good because it is supply-constrained rather than demand-constrained. Managers of firms in this industry claim that they could employ many more operators if they were available. The qualifications required for these positions are the ability to read, write and type; candidates who start off with a basic commercial education can easily learn to use the data-entry and word-processing programmes involved. This is a highly competitive industry, however, in which *Jamaicans* must compete with firms throughout the world, so wages are low despite the severe shortage of personnel.

Data processing firms must keep abreast of technological advances in both software and hardware if they are to remain competitive, and they appear to be doing this successfully in *Jamaica*. Many of the companies are now incorporating image scanners in their operations, since these devices greatly increase productivity for some types of data entry.

Source: Larry Willmore, "Export processing in the Caribbean: The Jamaican experience", *CEPAL Review*, No. 52 (LC/G. 1824-P), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), April 1994.

Backward linkages between EPZs and the customs territory of the Dominican Republic are almost non-existent. Bureaucratic requirements (e.g., export licenses) hamper sales by firms under the jurisdiction of the customs authority to companies in the custom-free zones. Although there has been a law on the books since 1979 that provides for the temporary import of goods that are to be incorporated into exports (Export Incentives Act No. 69), this has never worked in practice as it was intended. Nor is there any drawback mechanism that would allow an exporter to recover the duty paid on imported raw materials and intermediate inputs, quite apart from the costs occasioned by delays in their clearance through customs. This makes the products of firms located within the customs territory uncompetitive on the open market, including that of the custom-free zones. The high costs and enormous difficulties involved in meeting quality standards and delivery deadlines constitute a formidable obstacle to the formation of such linkages (see box V.5).

In Jamaica, EPZ companies are almost never allowed to sell their goods on the domestic market. Firms operating outside the EPZs under the provisions of the Export Industry Development Act encounter formidable obstacles if they attempt to produce for the local or subregional market; consequently, all of these firms have chosen to export the whole of their output to markets outside the Caribbean Community (CARICOM). The only way they could legally supply the local market would be to maintain a physical separation in the factory between goods processed for export and goods destined for the local and CARICOM markets. The small size of the local market makes this option an unattractive one.

As a result of this regulatory environment Jamaica's garment industry is segmented. One segment is modern, operates on a large scale, is efficient and highly productive, and produces exclusively for the export market. The

other segment operates on a small scale and, for the most part, is unspecialized; its productivity is low and it produces for the domestic and, to a very limited extent, CARICOM markets. There is virtually no contact between the two segments; neither workers nor managers move from one segment to the other.

For Saint Lucia, on the other hand, export processing may represent a useful first step along the path of industrialization. Much of the work performed by the country's export processing companies cannot be described as simple assembly. In the garment industry, nearly 75% of the employees work in factories that are engaged in cutting, making up and trimming garments rather than sewing pre-cut pieces. The largest electronics firm on the island produces wire-wound resistors to exacting specifications using sophisticated equipment; it then coats and labels them. Another company uses plastic injectors to produce a variety of novelty items—including souvenir coasters and key chains for Euro-Disney—from PVC pellets and waste plastic. Considerable technology transfer also takes place at the managerial and supervisory levels of export processing companies, where all the supervisors and most of the managers are citizens of Saint Lucia.

Saint Lucia's export processing companies have been able to develop backward linkages for several reasons: i) local businesses can sell goods and services to enclave and free-zone factories without first obtaining an export license; ii) backward linkages from the banana industry (the production of plastic bags and cardboard boxes) indicate that intermediate goods are produced on a large enough scale for costs not to be excessive; iii) producers of intermediate goods pay no tax other than a 3% customs service charge on the raw materials they import, and sales to exporters are automatically exempt from the excise tax that is charged on goods destined for the local market. In sum, Saint Lucia's policies are conducive to the formation of backward linkages, in

## Box V-5

## GARMENTS: TRADITIONAL EXPORT PROCESSING

In *Saint Lucia* the garment industry now provides 72% of total employment in export processing companies, up from 65% in 1989. This industry also accounts for more than 80% of all imports and exports of goods by export processing plants in the period 1986-1990.

Because of its small size, *Saint Lucia* is not subject to mandatory quotas in the United States, its main export market. Perhaps for this reason, six of the nine factories and three quarters of the workers cut, sew and trim cloth imported from Asia rather than assembling cut pieces imported from the United States under item 807 of the United States customs schedule even though the former face full customs duties in the United States.

The garment industry also accounts for a majority of export processing activity in *Jamaica* (74 of the 109 firms and nearly 90% of employment). Data processing is the next largest export activity, but these firms are quite small compared to the manufacturing plants.

Employment in *Jamaica's* garment industry has increased from approximately 6,000 persons in 1983 to 28,000 today; this means that the average rate of growth between 1983 and 1992 was 19% per annum, but the industry's expansion actually proceeded at a much faster pace through the end of 1987 than in later years. All the growth in employment has occurred in companies that export their products exclusively to non-CARICOM countries. These exports rose steadily from US\$ 11 million in 1983 to US\$ 384 million in 1992, with the steepest increase occurring in the earlier years (1983 to

1987). More than half the exports are garments made up from pieces cut in the United States in order to take advantage of item 807 of the United States customs schedule (renamed HS 9802.00.80), under which duty has to be paid only on the value added in *Jamaica*. Less than half the value of exports is of the "cut, make and trim" variety, which creates more jobs in *Jamaica* per dollar's worth of exports even though all the cloth used is imported.

Increasingly, the cloth utilized in foreign assembly plants under the provisions of item 807 is made and cut in the United States so that the manufacturer will be eligible for the Caribbean Basin Initiative's Special Access Program (807A/9802A), under which the United States has granted generous quotas to *Jamaica*. In 1992, *Jamaica* was the largest supplier of "807" women's hosiery and underwear to the United States market.

Although the *Dominican Republic* has been a beneficiary of the terms provided by the European Economic Community under the Lomé Convention since 1989, the United States and its possessions continue to receive nearly 95% of the exports from the customs-free zones. Since the United States is the largest buyer of its exports, the *Dominican Republic* is understandably concerned about the effect that the formation of a free trade area under the North American Free Trade Agreement (NAFTA) may have on those sales, inasmuch as clothing, along with most textiles, leather products, footwear and gloves, are specifically excluded from the Caribbean Basin Economic Recovery Act.

Source: Larry Willmore, "Export processing in the Caribbean: The Jamaican experience", *CEPAL Review*, No. 52 (LC/G. 1824-P), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), April 1994

contrast to the policies in effect in *Jamaica* or the *Dominican Republic*.

c) *The maquiladora industry in Mexico*

i) Employment and foreign exchange. Maquiladoras have been in operation in

*Mexico* since 1965.<sup>60</sup> Imported materials and components enter the country duty-free and are exported primarily to neighbouring countries after having been partially processed or assembled in a registered plant. These firms are

<sup>60</sup> It is important to note that in *Mexico* the term "maquiladora" is applied to firms which are subject to a certain legal regime. Although in some cases it is also used to refer to assembly operations involving a low content of locally-produced parts and components, not all activities of this type can be classified as maquiladoras from a legal standpoint.

authorized to sell up to 20% of their output on the domestic market, and import duties on the foreign components and inputs contained in such products is applied to these sales.

In the second half of the 1980s and the early 1990s, the maquiladora industry in Mexico boomed. Between 1980 and 1993 the number of plants jumped from 620 to 2,142 in 29 of the 32 federal states of Mexico; the number of jobs they created rose from 124,000 to 532,000; and the value added (net exports) by this industry soared from US\$ 772 million to US\$ 5.9 billion. Since the late 1980s, the maquiladora industry has become the country's second-largest source of foreign exchange and its fastest-growing employer, with the maquiladoras creating about 17% of the jobs in the manufacturing sector (SECOFI, 1992a).

At the beginning of the 1990s, slightly over 50% of the maquiladora plants set up in Mexico were either wholly-owned by United States investors or such investors held a majority interest in them; about 40% were totally or primarily Mexican-owned; and the rest were controlled by Japanese, German or Spanish investors. Data for 1992 show that the main production activities of the maquiladora industry in terms of local value added were the following: transport equipment (28%), electric and electronic materials and accessories (25%), electric and electronic machinery and appliances (11%), other manufactures (10%) and textiles (7%). In terms of value, 80% of the total output of the maquiladora industry comes from the area along Mexico's border with the United States, while only 20% comes from plants located in the country's heartland (see table V.7).

ii) Linkages and technology transfer. The maquiladoras have not significantly increased their use of Mexican-produced materials, parts and components; only 4%

of the inputs used since the programme was launched in 1965 have been of domestic origin. This negligible degree of integration with other industries located in Mexico is a consequence of the concentration of potential domestic suppliers in areas far from the northern border (e.g., in the Mexico City metropolitan area); an inadequate communications infrastructure (until recently) between the border area and the rest of the country; and still unresolved problems with domestic vendors in regard to price levels, quality and delivery dates. Above and beyond these factors, one of the chief reasons for the isolation of the maquiladoras from the rest of Mexican industry has been the government policies that were applied during the long period when the maquila was regarded as an activity of little value (see box V.6 and Grunwald, 1989).

Although maquiladoras have some of the same features as enclave enterprises, they have played a highly positive role in upgrading the skills of the labour force at various levels (manual workers, supervisors, technicians and administrative personnel).<sup>61</sup> The very reason that maquiladoras were set up in the first place (labour cost savings) leads these firms to use the smallest possible number of foreign workers (both manual and non-manual). With the exception of top management positions –and in some cases even this exception is not necessary– the staff of the maquiladoras are Mexican nationals.

The situation with regard to technology transfer in the maquiladora industry is determined by its very nature as an export activity. Available data show that maquiladoras are no longer devoted to unskilled labour-intensive assembly activities as they were in the late 1960s and early 1970s, but have instead moved into manufacturing and assembly activities

61 It is often said that the workers in maquiladoras carry out technically unspecialized tasks. This may be true if these tasks are compared with the work being done in maquiladoras and similar industries in the United States; however, the technical training required by Mexican maquiladoras is on a par with the requirements of other Mexican industries (Sklair, 1989).

Table V.7  
**STRUCTURE OF THE VALUE OF OUTPUT IN THE  
 MEXICAN MAQUILADORA INDUSTRY, 1993**  
 (Percentages)

	National total	Border states <sup>a</sup>	Non-border states	State of Mexico and Federal District <sup>b</sup>
Wages and benefits	13.3	12.9	17.5	23.5
Domestic raw materials, containers and packaging	1.4	0.9	6.8	14.5
Miscellaneous expenditures in Mexico <sup>c</sup>	6.1	5.6	11.5	17.5
Profits and other	3.2	2.8	7.2	7.5
<b>Subtotal</b> (value added in Mexico)	24.0	22.2	43.0	63.1
Imported raw materials, containers and packaging	76.0	77.8	57.0	36.9
Gross value of output	100.0	100.0	100.0	100.0
Regional structure of value added in Mexico	100.0	84.4	15.6	0.9

Source: National Institute of Statistics, Geography and Informatics (INEGI), *Avance de información económica: industria maquiladora de exportación*, Mexico City, May 1993 and August 1994.

<sup>a</sup> Baja California, Coahuila, Chihuahua, Sonora and Tamaulipas. <sup>b</sup> These figures cover the period up to April 1993.

<sup>c</sup> Includes rental of machinery, equipment, buildings and sites, electric power, telephone, telegraph and telex; customs formalities, freight and transport; maintenance of buildings and equipment; and other expenses.

#### Box V.6

#### THE MEXICAN MAQUILA INDUSTRY AND ITS INTEGRATION WITH OTHER DOMESTIC INDUSTRIES

A detailed analysis of the cost structure of the Mexican maquiladora industry shows that the percentage of local value added and of physical and service components of domestic origin is much higher in plants located in the interior of the country than in those along the border (see table V.7). Although they represent only a small percentage of the maquiladora industry (0.3% of the total), the plants operating in Mexico's most industrialized zone (the Federal District and the state of Mexico) exhibit higher percentages of domestic integration. Precisely because the

northern part of Mexico is a very attractive area for maquiladoras due to its proximity to the United States, it is not economically feasible to increase this activity's integration with an industrial structure that is concentrated in the central region of the country. The northward shift of a portion of the national industrial structure, as has occurred in a number of sectors, may somewhat reduce the problems involved in increasing the integration of the maquiladora plants located in the north with the domestic production structure, but it is not likely to eliminate those difficulties altogether.

Source: W. Peres, 'From Globalization to Regionalization: The Mexican Case', *Technical Papers* series, No. 24, Paris, OECD Development Centre, 1990.

involving a fairly intensive use of skilled labour. This shift is due to the change in the industry's sectoral composition as its main focus has switched from sewing garments to the production of electronics, electrical equipment and components, and motor vehicle parts.

There is also evidence of a widespread application of modern management techniques in the maquiladoras belonging to these new industrial sectors (Carrillo, 1989). Just-in-time inventories, statistical process control, zero-defect techniques and team-based work patterns are now in common use; these practices have led to increased training efforts and to a reduction in the high personnel turnover rates prevalent in this activity (8%-15% per month).

To sum up, subcontracting arrangements have both advantages and

disadvantages for developing countries. Those countries that have not been able to move beyond the EPZ stage suffer from all the well-documented problems of low wages, long workdays, high staff turnover and job insecurity. On the other hand, subcontracting has played a decisive role in helping the newly industrializing Asian economies to move up in the production hierarchy and to become successful industrial exporters. The difference between these two types of cases is attributable to many factors. These factors, which are discussed in another section of this study, include investment in human capital, technological innovation and government support in creating a propitious environment that will help firms upgrade their performance.

## Chapter VI

# TOWARDS COMPREHENSIVE TRADE REFORM

Import liberalization or rationalization is only one of the ingredients of a comprehensive trade reform effort. As noted in earlier chapters, most of the countries of the region have carried out extensive tariff reforms. Trade policy includes many other dimensions besides tariff policies as such, however. It also covers export promotion instruments such as exemptions and drawbacks. The changes now taking place in international trade norms are exerting a strong influence on the Latin American and Caribbean countries in terms of the amount of leeway those countries have in designing their export promotion policies. Past policies tended to focus on exports of manufactures while often neglecting products based on natural resources and thus failing to take full advantage of existing production potential. A comprehensive approach should consider the entire production system, as well as taking into account the fact that, for most of the region, a majority of exports will continue to be based on natural resources for a long time to come; furthermore, there are ample opportunities for developing comparative advantages in non-traditional exports based on natural resources.

### 1. Some general rules for trade policy

One essential rule for trade policy is that it should be highly selective. The main

problem with import substitution policies was not their selectivity but rather the fact that they ended up being quite general in nature, thus leading to a lack of clarity and transparency as to exactly what was being promoted or what purpose was being served by intervention. In addition, the fact that the State is subject to major constraints in terms of information and management needs to be recognized. This means that government action must focus on a few strategic, carefully selected areas.

Since most industrial activities are subject to dynamic externalities of a more or less diffuse nature, it can be argued (Rodrik, 1992) that it is usually best to benefit broad categories of manufacturing activities rather than getting embroiled in trying to "pick winners". It is also true that, since competitiveness can be acquired, a flat tariff no longer makes sense. Some graduation of tariffs (as in other policy instruments) has become desirable. In fact, as noted earlier, most of the countries of the region have opted for a non-uniform tariff. The degree of differentiation –which is now considerably less– and the average level of the tariff will depend on a series of factors, including a country's stage of development, the chances of contraband trade occurring and the size of the economy in absolute terms. None the less, for reasons of administrative efficiency

and transparency as well as in order to avoid corruption and unproductive activities, it is best to limit the number of tariff brackets.

Two other general observations are in order. First, the higher tariffs (or incentives for specific activities) should be strictly temporary, with a pre-announced timetable for lowering those tariff rates (or reducing the subsidies). Second, the tariff structure should be similar to the structure of export incentives in order to block the anti-export bias generated by the tariff.

On the assumption that it is better to promote certain categories of economic activities than to focus on specific product lines, "automatic graduation" policies could be applied to a large number of sectors and then suspended once those policies' objectives have been reached. Automatic graduation affords an appreciable advantage, given the weaknesses of Latin American States and the difficulties they have in dissuading entrepreneurs from seeking easy profits. In addition, when such a mechanism is applied to a range of activities rather than to specific products, the market then has a great deal of latitude in choosing which activities are to be promoted.

A particularly fruitful area for applying selective policies is that of incentives for non-traditional exports that are equipped with a "self-destruct" mechanism, i.e., incentives that automatically cease to apply once a certain target has been reached.

## 2. Export promotion policies

Although the anti-export bias has been greatly reduced in the region as a result of trade reforms, it continues to exist, to a greater or lesser extent, in all the economies of the region. This is why it is important to promote exports, particularly those that are knowledge-intensive or involve a high level of value added. If such promotion efforts are not pursued, then the volume of exports, as well as the number of exporting firms and

products, will be smaller than desirable, and export activity may tend to be concentrated in a limited number of firms and in products for which the demand on world markets is more sluggish and vulnerable.

In such cases, the level and quality of exports will be sub-optimal owing to the strong externalities that are characteristic of this activity. Firms that begin to sell new types of exports generate more benefits than they can assimilate (e.g., in terms of knowledge and prestige); thus, they generate externalities that accrue to other firms and to the economy as a whole as export activity becomes an established area of endeavour and the reputation of the country's new export products grows. These externalities justify government support for pioneering export firms.

The shortcomings of capital markets are another good reason for backstopping export activity. If the region's banking institutions are reluctant to provide long-term and venture capital for investments in their own countries, for example, then their reticence will be even greater when it comes to export credits. If the Government does not act, the level of financing made available for exports will be sub-optimal.

There are a number of considerations that reinforce and complement the well-known argument in respect of economies of scale within a context of economic globalization. Exporting makes it easier for firms to gain know-how and is conducive to increased competitiveness, thus enabling them to stay in closer touch with changes in demand, to read market signals and obtain information on new products and to keep abreast of the latest technological and organizational changes.

Generally speaking, export promotion efforts need to be buttressed by a sustainable macroeconomic framework, a high, stable exchange rate and clear-cut, reliable rules regarding the operation of the economy. The promotion of non-traditional exports, however, calls for a certain degree of selectivity. In designing mechanisms for the promotion of non-traditional exports, care must be taken to

ensure that they will be moderate in nature; it is also important to establish pre-announced time limits and provisions for periodic evaluation to correct their course and to make sure that firms have ample access to incentives. These measures should therefore be selected in close coordination with private-sector bodies in order to ensure a systematic form of cooperation between the public and private sectors in conducting export promotion activities. Otherwise, there is a danger that these programmes will lose touch with the chief concerns of the business world and thus become less effective.

In any sustained effort to promote non-traditional exports, there are three priority areas: access to inputs at competitive prices, the promotion of exports of new products or to new markets, and institutional support.

*a) Access to inputs at competitive prices*

A basic condition for enhancing export firms' competitiveness is to make sure they have access to inputs on competitive terms. The experiences of the majority of countries that have become successful exporters indicate that this factor is of crucial importance. Firms that want to import inputs for the purpose of producing exports should have access to these inputs on an automatic basis once they have fulfilled certain basic requirements. A number of countries in the region have mechanisms that allow for the temporary importation of inputs for the production of export goods. It has been observed that these types of measures function more smoothly and have a greater impact in terms of the level of exports when they operate on an automatic rather than discretionary basis. In contrast, the impact on export levels is less notable in countries where firms are required to submit new applications each time they want to import inputs and must then wait for discretionary approval.

Mechanisms that provide tariff exemptions for the importation of inputs

that are to be used to produce export goods are preferable to drawback mechanisms for reimbursing firms after the fact. This is because the former are simpler to administer and entail lower financial costs for the firm in question (the latter consideration is a decisive factor in high-inflation economies).

The temporary importation of inputs for use in producing export goods should be accompanied by training programmes for customs personnel and by informational campaigns, since in some countries, temporary import mechanisms have proved to be inefficient because customs officials actually hinder the process or because there is a lack of information about how these mechanisms work. Ways should also be sought to include indirect exporters (domestic producers of inputs for exporters) in the system.

*b) Incentives for developing new export products and markets*

The public sector usually cannot afford to run a large-scale drawback programme. At times, the success of such programmes has actually forced Governments to discontinue them because of their high fiscal cost. One efficient response to this type of situation would be to provide incentives only for new export products or for the penetration of new markets. Chile's simplified drawback for non-traditional exports is one example; in order to be eligible for this incentive, the exports of a given product must not have exceeded a pre-determined value during a certain period. This mechanism has three advantages: i) it encourages exports of new products; ii) it automatically ceases to apply once it has met its objectives, and thus has a limited fiscal cost; and iii) it requires exporters to complete only one short and simple formality.

In all cases, export incentives should have simple application procedures; they should be moderate, i.e., designed to help place competitive or nearly competitive products on external markets; they should

have specific time limits; and they should be required to produce definite results in terms of new products, sums or markets.

The new GATT agreement on subsidies allows the developing countries much less leeway than was available to the newly industrializing economies (NIEs) of Asia. It is also true, however, that importing countries are less likely to impose countervailing duties if subsidies are moderate, expressly temporary (especially those that are automatically graduated) and used by countries whose share in the world market for the subsidized products is small. The Latin American and Caribbean countries will have to examine this agreement carefully in order to determine how they can promote new activities for international markets.

*c) Institutional support for export activity*

Since promotion efforts are more effective when they are coordinated, it is advisable to consolidate a country's export promotion agencies –i.e., those in charge of information on exports, export finance and insurance, participation in international trade fairs, development of exportable supply, etc.– into a single institution. In a number of countries of the region, export promotion agencies are widely scattered, were established at different times under differing types of legal provisions and are not always well-coordinated with one another.

An entity that provides comprehensive support for non-traditional exports should have stable financing, a qualified professional staff and close ties with the private sector, all of which will enhance its impact on policy decisions affecting exports.

*d) Other aspects of export promotion policies*

In addition to the aspects mentioned above, a number of other areas exist in

which government action can play a decisive role in helping to improve export performance.

i) *Information.* One of the first problems facing firms that are attempting to export their products is a lack of information. Strong externalities exist in this area, and the help of the public sector is crucial. This is why it is so important to create or establish information centres covering a wide range of variables, such as tariff levels abroad, potential export markets, prices, product specifications, export contacts and forthcoming international trade fairs.

ii) *Export finance and insurance.* In a number of countries of the region, financial support for exports is virtually non-existent and is therefore available to only a very few firms. Without financing to provide working capital and credit for foreign customers, firms are at a competitive disadvantage with respect to other countries where firms receive such support. In fact, there is evidence that the competitiveness of the exports of some countries of the region is, in part, attributable to their firms' access to credit for foreign customers. It is also often the case that competitive firms may even lose markets because they are unable to offer credit to buyers.

In addition, firms need to have full access to export insurance, both against commercial risks to their customers and against political risks in target markets. The cost of information –often one of the most expensive components of the total cost of export insurance– could be cut by using regional information networks.

iii) *Management training.* One of the areas in which an export promotion agency should be active is management training. The attitude of entrepreneurs towards exporting and their knowledge about potential business opportunities in foreign markets and about mechanisms for promoting non-traditional exports are pivotal factors in their decision as to whether or not to invest in the production of exportables. Often, entrepreneurs have little interest in exporting because they are

accustomed to producing for a protected domestic market, and this attitude may be reinforced by a lack of knowledge about export-related variables.

iv) *Overseas promotion efforts.* The promotion of a country's exportable supply in other parts of the world is an area involving strong externalities which a number of Governments in the region are currently addressing. In most countries, however, public-sector support in this connection is insufficient. In some cases, this is due to a lack of financial resources. Export-promotion agencies need to have enough resources to fund the participation of firms in international trade fairs, and the expertise of trade advisers serving in diplomatic missions abroad should be used more effectively. It is also important for export promotion agencies to work in close cooperation with private-sector organizations such as exporters' associations and business groups in order to marshal their efforts while avoiding duplications of work and a dispersion of energy. In a number of countries, the organization of exporters' associations is weak, and this is reflected in the scant amount of technical and financial resources devoted by export promotion associations to the design of private marketing strategies for regional (markets) and sectoral (products) export drives. This lessens the chances of achieving an improved form of coordination between the public and private sectors in the areas of overseas promotion and marketing, quality control, and standardization. An effort might be made to encourage entrepreneurs to organize and coordinate their export efforts, which would enhance technical interchanges between exporters and Governments.

v) *Development of exportable supply.* The promotion of a country's exportable supply abroad also requires a more active form of support on the domestic front in order to develop that supply and gear it to the demands of external markets. Promotion efforts should not be limited to existing products, but should also help to

adapt the exportable supply to respond swiftly to signals of international demand. The timely dissemination of up-to-date information on demand in export markets in terms of quality, standardization, deadlines and volumes would make this task easier and could encourage new firms to enter the export business.

One way of gradually adapting exportable supply to the requirements of foreign markets, while at the same time fostering ties between domestic firms and international buyers, is to select specific sectors in which the country has export potential and then, in conjunction with the private sector, to endeavour to create an exportable supply in those sectors while promoting contacts with marketing firms and importers in target markets. In addition to laying the groundwork for strategic export alliances between domestic and foreign firms, this would encourage a systematic improvement in quality and stimulate the development of new products as a flexible response to commercial opportunities. The programme for the development of exportable supply being carried out by the Banco Nacional de Comercio Exterior of Mexico (BANCOMEXT) is a good example of such an initiative.

### 3. Prospecting and development of natural mining and agricultural resources

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It is usually assumed that exports of natural resource-based products reflect the presence of static comparative advantages. Actually, there are opportunities for acquiring and strengthening dynamic comparative advantages in this field as well. The systematization and intensification of national efforts to determine the quality and volume of a country's natural resources (including climate and seasonality) can make a very valuable contribution to the development of new lines of production. In point of fact, a number of countries in the region have

managed to achieve a considerable diversification of their exports of products based on non-traditional natural resources.

The search for new natural resources is closely associated with the major scientific advances of this century. Technical progress has not only led to the substitution of these resources and a reduction of their share in the consumption levels of many industries; it has also helped to cut the costs of exploration and of evaluating resource quality.

In the case of mining, the rapid expansion of exploration activity is linked to the depletion of the deposits that are now being mined and the need to lower the costs of further exploitation. In the agricultural sector, new technologies have made it possible to inventory existing resources more accurately; this has led to better resource management, which is, in turn, conducive to improved forms of environmental protection. It has also facilitated the compilation of official land registers in which land is classified according to its use capacity and current use. These registers have helped determine patterns of land division and characteristics of the agricultural land tenure system for purposes of development and, in some cases, tax assessment.

Mining exploration methods have also changed, and today it is possible to cover vast areas and concentrate on specific sites with a minimum of physical contact, which was very difficult to do using direct methods that required the movement of materials, sampling and measurements in the field. Today's prospectors spend more time in their offices than in the field. They concentrate on studying the geological features observable in satellite images and, with the help of computers, manipulate a vast number of variables in order to arrive at a more precise evaluation and determination of size. Technical progress has made more accurate information available more rapidly at a relatively low

cost, considering the large volume of data that can be processed.

All this has been made possible by the great technological leap represented by remote sensing via satellite, which has revolutionized the exploration of natural resource potentials and become a mainstay for practical applications of the geosciences.

These images are obtained from remote sensors positioned on space platforms and even spaceships and have revolutionized the study of soils, vegetation, freshwater resources, river basins, the dynamics of marine and land-based ecosystems and the status of all the components of the natural environment in general. This information makes it easier to perform a number of tasks: prospecting for natural resources; preparing land inventories that include soil characteristics; drawing up land registers or current inventories that are highly appropriate tools for assessing forestry resources, permanent or long-cycle plantations and livestock populations; detecting problems of deforestation and desertification; improving land-use planning; observing the movement of tectonic plates and volcanic activity; controlling plant diseases and pests; and upgrading urban development planning.

In addition, satellites provide mining prospectors with large-scale magnetic-band photographs, which help define geological and geophysical features of the land that are invisible to the naked eye. Geophysical techniques can be used to obtain information about areas that are covered by soil, vegetation or transported material, thus facilitating the selection of sites that warrant closer examination.

Geochemistry, using highly sophisticated analytical methods and equipment, facilitates the study of the occurrence and dispersion of the elements that are found on earth and has perfected techniques for identifying minerals through the sampling and analysis of the various means of dispersion, such as soils, sediments, stream flows and rock.

These technological changes have been fostered by the development of computer technology, which enables scientists to process and analyse a large number of variables. Thus, for example, there is software available today that makes it possible to obtain models of the future development of deposits; specify the clearing radius of mines and simulate the mining operation; study geological features and ore content; project flows to dressing plants; and calculate the volume of barren material that must be moved during the mining operation. On the basis of this data, operating costs and all sorts of financial calculations can be determined with a greater degree of precision. In addition, large stretches of farmland can be surveyed for the purpose of compiling registers of production units and scheduling planting in accordance with the best agro-ecological options. This information is also very useful for tax administration purposes, since it makes it easier to identify potential taxpayers as well as allowing for the design of land-based taxation alternatives.

These data are of considerable interest to economic decision makers in the relevant markets and have helped countries to acquire comparative advantages in non-traditional export products.

#### 4. Promoting efficient import substitution

There has been a notable increase in the number of export firms in the countries of the region in recent years. These include many firms that were formerly engaged in import-substitution activities. As a country strives to promote its exports, it is equally important to encourage

competition among firms within the country itself.<sup>62</sup>

Many manufacturing firms in the region are undergoing a process of change and are making efforts, to a greater or lesser extent, to become more competitive. However, many potentially competitive firms will cease to exist if programmes to support their efforts are not implemented.<sup>63</sup> These firms need help in order to improve their competitive position, especially in the following areas: gaining access to skilled labour and long-term financing at a reasonable cost; acquiring inputs at competitive prices and quality in international markets; designing products that are geared to market trends; organizing their production processes; revamping their quality control systems; and ensuring distortion-free conditions in which to compete.

One of the constraints faced by firms in their efforts to restructure and export is a financial one. To become more competitive, they must invest heavily in improving various aspects of the production process. However, they must make these investments precisely at a time when anti-inflationary policies have driven up interest rates sharply. The fact that trade liberalization processes and stabilization programmes are being carried out simultaneously has caused interest rates to soar in a number of countries of the region. Access to credit at non-subsidized but internationally competitive interest rates is an important component of current efforts to restructure and enhance business enterprises' competitive positions. Without sources of financing for working capital and export credits, manufacturing firms find it difficult to compete with firms in other countries where such financing is available.

62 In a study conducted in a number of Latin American countries, most of the entrepreneurs who were interviewed said that their first priority was to become competitive in the domestic market, after which they would attempt to export their products (Guerguil, Macario and Peres, 1993).

63 In the case of firms that are in great distress but nevertheless do have competitive potential, retooling programmes should be developed to upgrade their competitive position (see chapter VIII, section 4).

It is also important to rectify the shortcomings of the countries' weak, segmented capital markets. Measures that merit consideration include the promotion and development of a long-term capital market and lines of credit for the purchase and lease of capital goods, especially for small and medium-sized enterprises.

### 5. Quasi-tariff measures and unfair competition

There are a series of trade policy measures that are frequently employed in industrial countries but which, with the exception of quantitative restrictions, have been used very little in Latin America and the Caribbean. These quasi-tariff and non-tariff barriers have been exhaustively debated in the Uruguay Round, and the countries of the region would do well to examine them carefully. They consist of anti-dumping measures, countervailing duties to correct the distortions produced by subsidies, and safeguard clauses for dealing with unexpected increases in imports. Each of these types of measures fulfils a different function and is governed by different rules at the international level.

Anti-dumping and countervailing duties seek to correct the distortionary effects of unfair competition. Anti-dumping measures are used when a distortion is generated by the actions of a foreign firm which is using price discrimination to crowd domestic producers out of the market so that, once it is in a monopolistic position, it can then raise prices, thereby hurting the consumer. Countervailing duties are intended to counteract the distortionary effect of government export subsidies. The need to resort to these duties will probably decline as, thanks to the export subsidy agreement concluded under GATT, the use of such subsidies becomes less frequent in the international marketplace. The safeguard clause included in the General Agreement grants the right of self-protection against imports in specific cases for domestic reasons unrelated to unfair competition.

Until now, anti-dumping measures have mainly been used by industrial countries. The agreement contained in the Final Act provides for a more rigorous approach as regards the price comparison used to ascertain whether or not dumping is taking place, the determination of the extent of harm done to national producers and the decision as to how long the measures taken by the affected country shall remain in effect. It also stipulates that consumers of the product in question must be consulted prior to the imposition of anti-dumping duties. Lastly, the agreement includes a *de minimis* clause to protect small exporters. From the standpoint of Latin American countries as users, the anti-dumping agreement will allow them to protect themselves from unfair trade practices stemming from the actions of business enterprises; such practices tend to increase during economic slumps in the countries that supply their imports.

Much remains to be done in the region in this respect. Most of the countries lack regulations in this crucial field, and in those countries which do have them, such regulations suffer from many flaws as instruments of protection against unfair competition.

The Latin American and Caribbean economies –especially now, after their recent import liberalization programmes– may find themselves faced with problems in regard to dumping practices that could seriously impair the operations of firms having far less economic power than the transnational corporations which usually supply imports to the region. A distinction must be drawn between the type of competition that normally takes place in any market economy and predatory price policies that seek to eliminate competitors. The optimal solution would therefore be to address this issue within the context of policies on competition, which suffer from serious defects in most of the economies of the region. As a partial solution, it is recommended that an attempt be made to introduce anti-dumping mechanisms that are in keeping with the way the

international norms in this area have changed following the conclusion of the Uruguay Round. The public agencies administering these mechanisms will need to possess a high degree of technical expertise so that they can measure up to exacting professional standards and hence ensure that they and their decisions have credibility and are held in high regard. If these agencies have highly qualified officials who are committed to the principle of competition, the danger of encouraging protectionist practices within the country can be avoided.

The safeguard clause has rarely been invoked because most of the developed countries regard it as a very restrictive provision. Article XIX of GATT authorizes the contracting parties to withdraw tariff concessions which they have granted to the other parties when a sudden increase in imports, for reasons unrelated to unfair trade practices, is doing serious harm to that country's producers. The increase in tariffs must be temporary and must apply equally to all the relevant imports regardless of their country of origin; in addition, a country that decides to take this step must be willing to compensate the exporting nations which are adversely affected by the measure. Modification of the safeguard clause and the elimination of grey-area measures that may be used in its place (e.g., "voluntary export restraints") were intensely debated in the Uruguay Round. There is an urgent need to adopt regulations on this topic in Latin America and the Caribbean, especially in relation to regional integration.

The Final Act of GATT prohibits all voluntary export restraints and other grey-area measures which industrial countries have used rather than resorting to the safeguard clause of the General Agreement. Each trading partner may retain only one measure of this type until the end of 1999. Although the use of quantitative restrictions as a safeguard—even, in exceptional cases, against individual countries—is still permitted, the agreement establishes a limit of four years

for their application, which may be extended up to a maximum of eight years in exceptional cases, and 10 years for developing countries. Any measure imposed for a period of more than one year must be gradually relaxed during the period of its application. Safeguards against exports from developing countries having a market share of less than 3% are prohibited, unless the combined share of all developing countries exceeds 9%.

If, under the agreement on safeguards, the industrial countries replace the restrictive practices they have applied until now with temporary safeguard measures subject to international monitoring, then developing countries will definitely benefit in a way that will, to some extent, make up for their having been obliged to accept the imposition of quantitative safeguards on a *de jure* basis.

The safeguard clause of GATT must also be assessed from the point of view of the developing countries as importers. This clause, which has almost never been invoked by the Latin American and Caribbean countries, is one more type of protectionist mechanism, and as such is important to domestic producers when they must face a sudden increase in competition from imports.

The dismantling of non-tariff barriers and sharp reductions in tariff levels and spreads in most of the countries of the region have left domestic producers very vulnerable to competition from imports. While it is true that greater competition will help boost efficiency, it is equally true that the economies of the region are highly vulnerable to short-term external shocks, which makes the exchange rate very volatile. As a result of the recent liberalization of trade, the vulnerability of producers of tradables will become more apparent. It is therefore essential that the above-mentioned regulatory mechanisms, which have been used very little until now, be given a much more important place than before in the region's trade regimes.

## 6. Conclusions

Those cases in which trade liberalization programmes have been complemented by export promotion policies suggest that the various characteristics and status of each economy at the time of liberalization should be taken into account in any analysis. Factors such as the initial level of the exchange rate, export performance, investment rate and macroeconomic situation will play a very influential role in determining the ultimate effects of trade reforms. An analysis of experiences outside Latin America, such as that of East Asia (see box VI.1), supports this conclusion.

In short, the basic lessons to be learned from these experiences are:

i) There is no "blueprint" for liberalization; the results vary according to the structural features of each country. The existing economic situation and the policy mix used are what will determine the outcome of the process and its evolution over time. In every case, however—setting aside the debate as to which methods of liberalization are the best—the intensification of linkages with the international economy is the path that most of the region's economies are choosing to take. Aside from the gains in terms of efficiency, entrepreneurial spirit and macroeconomic discipline that this option affords, the main point is how to take advantage of the progress that has been made in order to ensure that these liberalization processes serve to promote exports. Part of the answer obviously lies in exchange policy, but there must also be a commitment to export activity which is reflected in the creation of incentives and institutions.

ii) Tariff reductions should be accompanied (if not preceded) by a compensatory adjustment of the real exchange rate, and this rate should then be maintained during the period that follows. An increased access to imports in conjunction with an appreciation of the currency (as well as the use of exchange policy for anti-inflationary purposes) is a

dangerous combination in terms of the equilibrium of the balance of payments and the development of production.

iii) Most of the countries that liberalized imports during the 1980s were pressured by the international economic environment to depreciate their currencies in real terms. This contributed to a more efficient adjustment in countries such as Costa Rica, Chile (in the second stage) and Mexico. In contrast, under the conditions prevailing since the early 1990s, as international capital markets have begun to regard the Latin American countries in a positive light, liberalization of the capital account has led to significant currency appreciations (see Calvo, Leiderman and Reinhart, 1993) at a time when trade reforms are making a depreciation imperative. The challenge facing economic policy makers is to find a way to carry on with trade liberalization while bringing about a depreciation of the currency in a situation marked by sizeable capital inflows. This means that they must regulate those inflows and boost domestic saving in order to maintain the real exchange rate at a competitive level in keeping with its medium-term determinants. Thus, aggregate expenditure and aggregate output need to be brought into line with one another, and incentives should be provided for increasing investment and the production of tradables.

iv) During the transitional phase of trade reform processes, misleading short-term signals may be sent out (e.g., a temporary increase in exports resulting from a recession at the outset of the process, or a temporary rise in imports, which do not react immediately to liberalization measures). Experience has shown that imports, like exports, take some time to gather momentum in cases where there were no pre-existing marketing channels, where consumers have not yet become aware of the existence of new products and have thus not yet changed their preferences, and where producers have not yet restructured their production systems to adapt them to new

## Box VI-1

## TRADE REFORMS AND EXPORT PROMOTION IN THE ECONOMICALLY DYNAMIC COUNTRIES OF ASIA

Despite their marked diversity, the Asian countries that export manufactures have certain characteristics in common. Their varied experiences offer useful lessons that are relevant for Latin America and the Caribbean, the most important of which are the following:

- 1) All these countries have provided a favourable climate for growth through the implementation of stable, export-oriented policies. They all had low inflation rates, a balanced fiscal situation and high rates of saving and investment.
- 2) In all cases, the aim was to carry forward an export-oriented form of industrialization rather than simply to mount an export drive. Incentives were stronger and broader in scope in the early stages of the export promotion effort and coincided with upswings in world trade; as the countries' industrial structures became more complex, incentives tended to become more general in nature. After 25 years of expanding production and export growth, economic liberalization and deregulation programmes were launched and limits were placed on direct action by the State.
- 3) The economies' export orientation shaped the impact of subsidies and controls on economic efficiency by imposing the discipline of international competition. Even when support measures deviated from market prices, they tended to be applied for limited periods of time and were conditional upon the achievement of specified export targets.
- 4) Investment in the expansion of production capacity for exports was facilitated by public policies that lowered the relative prices of investment goods and by the considerable degree of efficiency exhibited in channelling savings towards productive investment. Investment subsidies took the form of both preferential interest rates or the direct allocation of credit to specific sectors and direct subsidies.
- 5) Private entrepreneurs played a key role in modernizing production, but were invariably subject either to a severe competition-generated form of discipline or to government regulation.
- 6) Labour markets tended to be uncompetitive, either because trade union activity was repressed or because unions were co-opted.
- 7) High priority was given to infrastructure, education and technology. In some cases, the emphasis in public investment was on the transport sector; in others, the focus was on housing or industrial zones. In all cases, education was a priority.
- 8) The foregoing was coupled with financial and exchange policies aimed at preventing any major appreciation or sharp fluctuations in the exchange rate, in contrast with what has occurred in Latin America.

Source: P. Petri, "The NICs: Pragmatic policymakers", *International Economic Insights*, Washington, D.C., Institute for International Economics, March-April 1993; O. Rosales, "Desempeño reciente de los NICs asiáticos: políticas e instrumentos de fomento competitivo", Santiago, Chile, ECLAC, 1994, unpublished; L.E. Westphal, "Industrial policy in an export-propelled economy: Lessons from South Korea's experience", *Journal of Economic Perspectives*, vol. 4, No. 3, 1990.

inputs. Once marketing agents, consumers and producers have adjusted their behaviour, then a protracted and rapid process of import growth tends to emerge, whereas the expansion of exports will obviously be slower, since it involves investment shifts whose completion takes

a longer period of time. It is, of course, important to avoid an excessive restructuring involving a bias towards importables and to send out clear signals as to the advisability of expanding export capacity. Here, too, a well-balanced management of the exchange rate, a

gradual reduction in overall protection levels and the various export promotion mechanisms will all play a crucial role.

v) The experiences studied suggest that opening up the economy to imports and devaluing the real exchange rate are not enough in and of themselves to achieve high export and output growth rates. The results achieved by these means tend to be very slow in coming and entail needlessly high costs during the transitional phase. Complementary measures, geared directly to these objectives, are clearly needed. This may be illustrated by citing various examples: the Asian economies, for instance, have used integrated packages of instruments and have taken care to proceed gradually (see box VI.1); the results of Chile's programme took quite some time –despite its successful export performance– to engender a rapid expansion of production capacity; and Bolivia had difficulty in bringing about a sharp rise in its exports.

vi) Experience has shown that gradual reform processes based on decisions reached by common accord with private agents are less traumatic because they make it possible to adjust to the new conditions at the micro-economic and sectoral levels. If trade liberalization is accompanied by coherent macroeconomic policy and credibility in government action, there will be a better chance that the relevant agents can work together to reduce the costs of the adjustment. Furthermore, in order for liberalization to result in substantial increases in exports and output, import liberalization must be accompanied by explicit export incentives.

vii) The need to expand non-traditional and particularly pioneer exports justifies the maintenance of a higher effective exchange rate than the rate applying to import substitutes, since today's infant industries are the ones that are geared towards winning a place in external markets. Moreover, even if tariffs are low and a neutral approach is adopted, exports have to be compensated proportionately with direct or indirect

drawbacks or lower tax rates, since the tariff amounts to a tax on exports. International competition also makes it necessary to provide financing for non-traditional exports at international interest rates. Cases of successful export drives outside the region have involved the granting of incentives for pioneering firms' efforts to open up foreign markets and a marked emphasis on external marketing activities, including overseas investment in wholesale distribution chains and the establishment of import houses in target markets that deal in the relevant country's products.

viii) On this basis, once the most obvious anti-export biases have been eliminated, the challenge will be to adapt incentives and the institutional framework to the behaviour of the global economy. To this end, the links between trade policy and policies on technology, production and human resources should be strengthened with a view to refining product designs, standards and quality along with trade and business management techniques and technical assistance and training in research and development (R&D), all of which are key factors in increasing productivity and competitiveness. The current process of rapid economic globalization also demands new types of export promotion instruments. For example, investment in overseas production activities and in marketing chains is becoming an increasingly important factor in penetrating markets, diversifying risk, reducing protectionist barriers and reaping the benefits of economies of scale, while the systematization and intensification of national-level efforts to assess the quality and quantity of available natural resources may contribute to the development of new export products.

ix) As trade policies and import regimes have been liberalized, economies have become more vulnerable to unfair trading practices. Trade reform policies must therefore be accompanied by the adoption or improvement of

anti-dumping regulations, countervailing measures and safeguard clauses.

x) The adoption of the new regulations negotiated in the Uruguay Round could make it more difficult to implement an aggressive trade policy. These regulations do, however, provide for favourable treatment of developing countries in certain types of special situations, and the countries of the region should take

advantage of these provisions in order to promote their exports without infringing upon the multilaterally negotiated rules on such matters; in addition, the countries of the region should seek to take an active part in setting up the World Trade Organization (WTO) and should explore the potential benefits of that participation in terms of dispute settlement procedures and other such mechanisms.

**Part Two**

**PRODUCTIVE DEVELOPMENT POLICIES**

## Chapter VII

# BASES OF A PRODUCTIVE DEVELOPMENT POLICY

### 1. The productivity gap and its implications

Policies that affect production systems are a factor in improving linkages between the economies of Latin America and the Caribbean and the international economy. This subject has been dealt with systematically in previous documents (ECLAC, 1990a and 1992a), which discuss the interaction between a coherent, stable macroeconomic policy, on the one hand, and micro-economic and meso-economic policies<sup>1</sup> and institutional reforms, on the other. Those documents focused on describing how technical progress can be applied to the production process with a view to raising productivity.

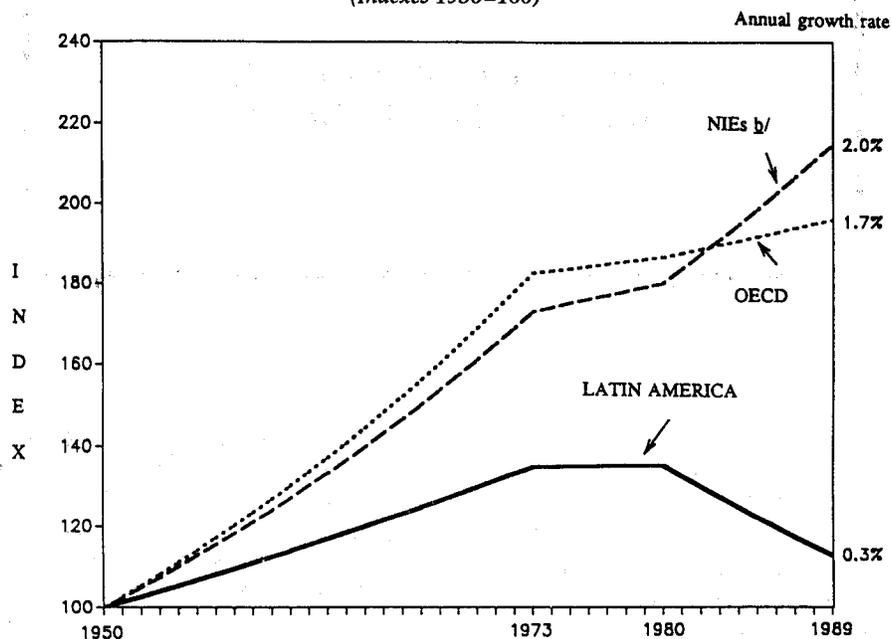
There are four general features of productivity in Latin America and the Caribbean which must be mentioned:

*First*, there is a gap on the order of 2.5 to 1 between Latin America and the developed countries (Hofman, 1993) with regard to total factor productivity (TFP).<sup>2</sup> This gap is apparent both in the use of outdated equipment and obsolete production methods and in a deficient organization of labour, vertical and sometimes confrontational industrial relations, failure to improve quality, excessive inventories, unsystemic and unsophisticated marketing techniques, outdated after-sales services, etc. In fact, it shows an obvious failure to use internationally available "hard" and "soft" technologies.

*Second*, this gap grew markedly wider during the post-war era (see figure VII.1). In the period 1950-1989, the increase in TFP in the region was equivalent to one seventh of that of the Asian newly industrializing economies (NIEs) and at

- 1 In this text, macroeconomic policies are not only those which maintain the basic macroeconomic balances, but also those which establish the key prices of the economy. The term "micro-economic policies" refers to those which directly affect the operation of the firm, especially the use of the best "hard" and "soft" technology. Meso-economic policies are those which affect the firm's "habitat" and environment, i.e., they are the "horizontal" policies which influence the systemic competitiveness within which the firm operates (infrastructure, linkages with the scientific and technological system, training, finance and promotion of new exports or new markets).
- 2 Total factor productivity is the production component which is not the result of either the quantitative or the qualitative accumulation of the factors of production, capital and labour. It may be considered an approximate measure of the effect of disembodied technical progress on long-term growth (Hofman, 1993, pp. 128-129).

Figure VII.1  
 LATIN AMERICA, OECD<sup>a</sup> AND ASIAN COUNTRIES:  
 TOTAL FACTOR PRODUCTIVITY, 1950-1989  
 (Indexes 1950=100)



Source: A. Hofman, "Capital accumulation in Latin America: a six country comparison for 1950-1989", *Review of Income and Wealth*, vol. 38, No. 4, December 1992.

<sup>a</sup> Organisation for Economic Cooperation and Development.

<sup>b</sup> Newly industrializing economies.

least a fifth of that of the developed countries. Moreover, even during the time of greatest economic expansion in the region (1950-1973), TFP growth reached little more than half that of the Asian NIEs, it then stagnated between 1973 and 1980 and subsequently fell, owing to the macroeconomic imbalances produced by the debt crisis of the 1980s.

*Third*, these productivity gaps between the region and the developed countries occur at both the global and the sectoral levels. The available data suggest

that the differences in total factor productivity among different countries are due not so much to concentration in low-productivity sectors as to the fact that almost all industrial subsectors, even those of intermediate and capital goods, are working far below the level of the best international practices. For example, data provided by the United Nations Industrial Development Organization (UNIDO)<sup>3</sup> show that, while in some subsectors—such as petroleum refineries and related products—the region's productivity is very

3 These data were taken from UNIDO (1992) but refer to the value added per worker—a concept distinct from that of total factor productivity. It is obvious that sectoral productivity shows important country-to-country differences in the region. It should be borne in mind that this traditional "value added per worker" measurement tends to overestimate effective differences in productivity, chiefly because it does not take into account differences in the capital stock held by countries of varying levels of development. Nevertheless, even if the various sectors of each country are treated separately, the sectoral productivity differences among the countries of the region—even the most advanced—and the developed countries continue to be very significant.

similar to that of the United States, and in non-ferrous metals it is 64% and in rubber products and iron and steel it is around 50% of that of the United States, in the 24 remaining industrial subsectors (which represent nearly 75% of industrial value added), the region's productivity is less than 35% of that of the corresponding subsectors in the United States, the average being 30%.

*Fourth*, such sectoral averages of course hide enormous productivity differences within the same category deriving from the tremendous structural heterogeneity of the region. On the one hand, there are marked productivity differences depending on the size of the firm. For example, in the case of Mexico, data for 1980 show that whereas small enterprises in the manufacturing sector had a productivity equivalent to only 69% of the sectoral average, in large private domestic firms productivity was 20% higher than the average, and in transnational corporations it was 78% higher. Moreover, just as there is an incomplete process of technological dissemination at the international level, so too the domestic dissemination process is slow, giving rise to considerable differences in productivity among same-sized firms in the same sector.<sup>4</sup> Actually, in the great majority of subsectors there are some firms whose practices are very similar to the best international practices. This means that the average for the remaining firms would be substantially below the sectoral average, reflecting the tremendous structural heterogeneity of the many economic activities carried on in the countries of the region. If the process of

disseminating the best practices within a country is also slow, the average productivity of the sector will be less.

## 2. Policy implications

The situation described above has five important implications for defining a productive development policy.

*First*, while the productivity gap is a reflection of a relatively lower level of development, it is also the factor that would enable countries to initiate a rapid growth process if they were able to use internationally available technologies, thereby skipping intermediate stages. In fact, late development makes it possible to take full advantage of these technologies, and the lower the point of departure, the faster the growth. That is why, sometimes, the further a country is from the technology frontier, the more quickly it will grow.<sup>5</sup> At present, China is expanding at a faster rate than the Asian NIEs (8% to 10% as compared with 6% per capita per year), just as the latter grew more quickly than Japan and the Nordic countries (whose take-off was in the late nineteenth century), the last-mentioned countries grew more rapidly than Germany and France (which took off around 1840 and grew more quickly than the United States which took off in 1800), and the slowest growth was recorded in the country where the Industrial Revolution began (England) (see figure VII.2).

*Second*, in the past it was customary to attribute this wide gap to the fact that production was concentrated in low-productivity sectors, especially agriculture. This was an argument in

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- 4 Although part of that difference can be explained by the kind of sector in which each type of firm is concentrated, there are also important elements deriving from the capacity to use economies of scale. For a more detailed analysis, see Casar and others (1990).
- 5 Nevertheless, it is not the degree of backwardness alone that determines the speed of growth. On the contrary, current data suggest that there is not always a leap forward in growth. To achieve it, other conditions are required; only after crossing a certain threshold (not of per capita income but of stability, market consolidation, managerial capacity and general know-how, and a development "ethos") can an economy take off towards a steady growth period in which the rate is proportional to the initial degree of backwardness.

favour of industrialization, but it did not stop there; instead, it extended to the types of industries to be promoted. There was therefore a tendency to identify a productive or industrial development policy with the establishment of new sectors which were not included on the input-output table and whose effective or potential productivity was greater than that of most of the "traditional" sectors of finished goods. This largely explains the emphasis placed, in the second stage of import-substitution strategy, on the sectors producing intermediate inputs and capital goods and the mechanical engineering industry.

Nevertheless, the notable differences in sectoral productivity between the countries of the region and the developed countries suggest that this sectoral or "vertical" policy approach, characteristic of the past, has serious defects. It is not so much a matter of establishing new sectors which do not at present appear on the input-output table (as if all productivity came automatically out of them, which is not usually the case), as of improving total factor productivity in existing sectors.

*Third*, the enormous heterogeneity existing among firms in the same sector suggests that the main challenge to a productive development policy is for the great mass of enterprises that work with obsolete equipment and outdated methods to rapidly adopt, adapt and disseminate the technologies at present available internationally. This is more important than the high targets for investment in research and development (R&D), which are of interest only to a small number of domestic firms that are already working near the frontier of the best international practices.<sup>6</sup> The essence of a

productive development policy—at least at the present stage of development so far below the international technological frontier—is to expedite the process of disseminating better practices.

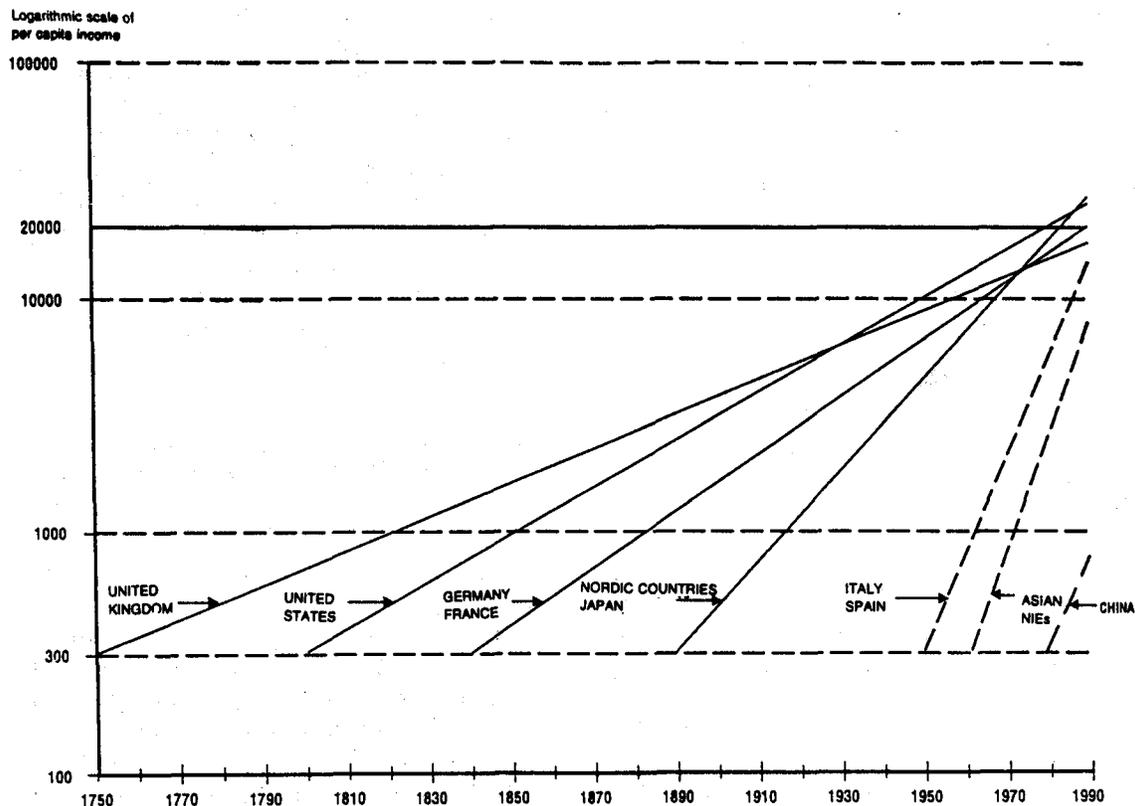
*Fourth*, since the great majority of sectors are working with a total factor productivity that is far below the international technological frontier, the concept of comparative advantage is relatively difficult to predefine, except in obvious cases such as that of rents derived from natural resources. Actually, with such wide differences in productivity among sectors, those which can more quickly close the productivity gaps which separate them from the developed countries will ultimately have a comparative advantage. This may be acquired by one sector, provided it is capable of bridging the productivity gap with the more developed countries more rapidly than the other sectors of the same economy.

*Fifth*, the decline in productivity in the 1980s shows the importance, in designing a productive development policy, of keeping basic macroeconomic equilibria within tolerable margins. Actually, the instability produced by the external debt crisis and exacerbated, in general, by badly designed or implemented stabilization and adjustment policies, led to severe drops in output, which had a negative effect on the use of installed capacity, investment, engineering and design equipment, and efforts at innovation. The serious setbacks caused by these macroeconomic imbalances could not be offset by better efficiency at the corporate level, with the result that total productivity collapsed almost throughout the region during the 1980s. This shows

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6 This certainly does not negate the importance of a minimum scientific and technological infrastructure, because without it firms will be unable to identify more appropriate technologies or to acquire, transfer or adjust them quickly and conveniently. What it does indicate is that, at the current stage of development of the countries of the region, the main point is to identify the international practices most suitable for the various national economies, adapt them to the reality of each country and rapidly disseminate them. Research and development proper are more important at a later development stage, when imitation and dissemination have advanced and firms are approaching the frontier of the best world practices.

Figure VII.2  
**LATE GROWTH AND DEVELOPMENT: SCHEMATIC HISTORICAL EXPERIENCE**  
 (Logarithmic scale of per capita income)



Source: ECLAC, on the basis of official figures.

that the achievement of greater competitiveness requires both micro-economic efficiency and macroeconomic stability.

### 3. Obstacles to overcoming the productivity gap

On the basis of the foregoing considerations, it may be wondered why Latin America and the Caribbean have not been able to use their advantage as late developers to skip stages, make use of the

available technology and grow at much faster rates. The three standard responses to this question are, in theory, complementary rather than mutually exclusive.

#### a) Economic policy failures

Under this approach, the macroeconomic instability which has characterized the region, the distortion of key prices, particularly that derived from the strategy of industrialization through import substitution, and the weight and

preponderant intervention of the public sector in managing the economy explain the comparatively poor performance of the region during the period in question. As a result, this orthodox approach argues for macroeconomic stability, trade opening and privatization, while restoring the private sector to its prime role in the economy.

*b) Problems at the level of firms*

This second approach focuses the analysis at the opposite extreme: in firms. On the one hand, it claims that the region has suffered "capitalism without capitalists", i.e., it has lacked a forceful entrepreneurial class. This explains the existence of such large differences in total factor productivity between Latin America and the developed world. Moreover, it was this absence of innovative entrepreneurship that prompted so many governments to intervene increasingly in the economy to offset the lack of entrepreneurial drive. On the other hand, it emphasizes the difficulty (cost) for each individual enterprise to identify, and subsequently internalize, the technology, processes and most suitable production methods available at the international level and the most appropriate market niches for producing competitively. There is a notable underinvestment in this area, therefore, with the great majority of enterprises waiting for others to act first, so as to imitate them. Since the identification and dissemination of hard and soft technologies is a "public good", there would be ample room for adopting macroeconomic policies designed to promote the "socialization" of costs and the rapid dissemination of such technologies among firms.

*c) Market failures, externalities, public goods and problems of industrial organization*

This third approach refers to the advantages of emphasizing policies which improve the functioning of factor markets

(meso-economic or "horizontal" policies), rather than policies designed to develop the markets for specific products. The need to focus State action on the most critical bottlenecks explains the desirability of emphasizing the correction of the more serious failures of factor markets, which affect all sectors. Likewise, there will always be room for policies aimed at internalizing significant externalities, providing public goods, and regulating oligopolistic markets for non-tradable goods (especially, in the last case, most infrastructure: telecommunications, ports, irrigation, electricity, etc.) which seriously affect the systemic competitiveness of tradables.

#### **4. Theoretical justification of an active productive development policy**

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Nowadays in Latin America and the Caribbean, there is broad consensus concerning some general parameters which facilitate the implementation of measures for modifying the supply of exportable goods. These include the maintenance of basic macroeconomic equilibria and trade opening aimed at utilizing economies of scale and incentives for healthy competition. The debate tends to centre on how to define these policies more precisely, determine the pace and intensity of their application and, in particular, decide whether they by themselves are sufficient incentive for promoting a change in production patterns.

ECLAC has maintained that, in order to overcome the productivity gap referred to above, macroeconomic and trade policy ought to be complemented by a mix of active policies which make use of the technological and organizational advances of the more developed countries in order to skip stages, as generally happened in the successful late developing countries. More specifically, it considers that productive development requires, in addition to sound

macroeconomic and liberalization policies, two groups of complementary actions: "meso-economic" or horizontal policies focused on improving markets and filling the existing gaps therein, and micro-economic policies which help to internalize externalities related to the identification, adjustment and dissemination of the best internationally available technologies and practices. Without such micro-economic and meso-economic policies, and without suitably pragmatic forms of macroeconomic management and international integration, the restructuring necessary for initiating accelerated growth will be unnecessarily slow and inefficient.

Indeed, liberalization and restructuring will either benefit or clearly hurt some firms and activities in both the short and the long term. Nevertheless, the effect of these processes on other firms and activities may be very ambiguous: first, because it is not clear whether the key prices prevailing at the time the measures are taken will remain unchanged over the long term, and second, because many potentially competitive enterprises and activities may be adversely affected in the short term until they are able to identify, introduce and assimilate the changes necessary for acquiring competitiveness in the domestic market and even abroad. This may be the case both for enterprises and activities that are potentially competitive in efficient import substitution and for potential producers of non-traditional exports. The speed of their restructuring and, in some cases, their very survival will depend on the information and human and financial resources at their disposal. Hence it is important that key markets –those for technology, capital assets, human resources and foreign currencies– operate at optimal levels. Otherwise, the more imperfect these markets and the greater

the uncertainty with regard to the seriousness of the adjustment and liberalization process and the permanency of the key prices in force, the more likely it is that potentially competitive firms will be unable, for lack of time and resources, to neither carry out the restructuring necessary to compete at the national level or to penetrate external market niches in which they could acquire a competitive advantage. This situation may be aggravated if there is a recession and abnormally high interest rates.

On the basis of the foregoing, it may be concluded that the restructuring process that followed the outbreak of the debt crisis was very costly at the beginning and slower in the recovery phase, because macroeconomic and trade policy was virtually unaccompanied by productive development policies (micro-economic or meso-economic). Moreover, when liberalization was complemented by a sound updated industrial policy, it contributed to a number of the region's most notable export successes, including those in the sectors producing automobiles and parts, wood, paper and pulp. Nevertheless, these cases were exceptional. Generally speaking, with liberalization almost all the industrial policy of the past was eliminated,<sup>7</sup> most of the time without being replaced, instead of being adapted to the new requirements; for example, it would have been possible to adopt policies linking incentives to export performance or to productivity improvements and promoting non-traditional exports, the development of human resources, technological dissemination and efficient sources of financing.

The main theoretical and empirical arguments in favour of a productive development policy more in line with the requirements of the 1990s are presented below.

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7 This was a reasonable decision, because the policy tended to have no time-limits, often led to the production of items with scant possibilities of developing comparative advantages and was basically oriented towards the domestic market, which for many activities, except in Brazil and Mexico, was too small to permit the minimum scales required for an efficient output.

a) *Market failures*

i) *The technology market.* Modern versions of development theory emphasize the concept of endogenous technological change in firms, generated by their investment both in acquiring and transferring technology and in research and development. This approach refers both to "hard" technology, i.e., that incorporated into machinery and equipment, the day-to-day efforts being made in the field of engineering to improve productivity or product design, and to "soft" technology, which includes improved management techniques, quality control, industrial relations, "just-in-time" production, and other elements.

This is a field in which market forces on their own tend to behave suboptimally. First of all, there is an intrinsic asymmetry with regard to information between the technology supplier (who knows what it is really worth) and the buyer (who is ignorant of the real value of the new technology since he is unfamiliar with it, and depreciates it when he learns more about it because he can then try to reproduce it), and this makes it difficult for the market to arrive at a correct valuation. Secondly, whereas in an ideal world the optimal decision would be to develop or acquire, all at once, all the technical know-how available and to ensure that the other economic agents had access to it immediately, in the real world all agents would prefer that the others absorb the costs of developing a new technology or of identifying the technology most suitable for introduction into a developing country, so that they could then imitate it at a marginal cost. Thirdly, even where there is a private interest in developing a new technology, this technology may be so specific to the firm in question that the

latter is not afraid that the technology will be imitated and disseminated but the firm's scale of production may be insufficient to justify making significant research and development efforts, with the result that there will tend to be underinvestment both in the acquisition and in the development of new technologies.

Indeed, technical know-how and information are goods, whose benefits cannot be completely appropriated by those who create them; moreover, they are non-exclusive goods which may be used simultaneously by several users (Romer, 1990).<sup>8</sup> This results in underinvestment by the private sector in the introduction of a new technology into a country or in the development by that country of its own technology. This underinvestment can be offset –partially and inadequately– by direct or indirect State investment in research on and the development of new scientific and technical know-how and by the establishment of institutions as mechanisms for protecting patents and trademarks.

Similarly, a country's capacity to adapt international technology to its own conditions, make better use of available natural resources, climate (in the case of agriculture and tourism) and the size of its markets, and deal with the relative shortage of factors depends on the quantity and quality of its researchers and on the interrelationship between scientific and technological research centres and the production system. The opportunities of acquiring and retaining competitive advantages will ultimately depend on the quality of the scientific and technological infrastructure and its links with enterprises in the production system.

ii) *The human capital market.* A strong demand for technology requires a

8 Exclusion from the use of these goods is not always feasible, even when there is an appropriate institutional and regulatory framework for industrial property matters. Exclusion is much more complex if such an institutional framework does not exist, or if the courts only pay it lip-service. The prevailing market structure in each industrial branch is influenced by the appropriability of, or exclusion from, the fruits of technological change, and this raises problems which the competitive model cannot solve. Government regulation and coordination then come to the forefront.

dynamic supply of skilled manpower that is capable of absorbing new know-how and productive innovations. Although public investment in human resources is adequate, private investment in such resources tends, intrinsically, to be insufficient.

For one thing, firms are unwilling to finance general training services which benefit only the worker; in other words, a firm will tend to concentrate its investment in training in its area of specialization so that it can derive the full benefit, while its investment in general training will tend to be suboptimal. Although general training raises labour productivity in many enterprises, it usually benefits the worker more than the enterprise itself. The result is that firms tend to limit training, at this level, to the minimum needed to teach workers how to use new equipment or procedures properly. For the same reason, small firms will tend to offer little formal training, because virtually all they could provide would be general education and that could be used by the worker in numerous other firms. Therefore, training in small enterprises tends to be limited to learning by doing, and the worker pays indirectly for this type of implicit training since he receives a lower wage than that paid in bigger firms.

Investment by the potential beneficiaries –the workers– is also inadequate because they cannot offer the necessary financial guarantees in order to borrow money to pay for training for themselves or their family members, and this hinders the development of a private lending market for human resources training (ECLAC/UNESCO, 1992). As a result, private investment in human resources is insufficient; the fact that it is limited to the family's capacity to finance itself is a serious obstacle, since in order to obtain training a family must pay both the direct

cost of the courses and the opportunity cost (income not received) of the time devoted to study.

iii) *The long-term financial market.* National financial markets are inadequate and embryonic, even in countries without large macroeconomic imbalances and with a significant amount of institutional investment. First of all, in practice, there is no long-term financial market except for the few enterprises with access to stock exchanges. The problem is not limited to small and medium-sized enterprises (SMEs) but affects the bulk of a country's firms. Secondly, both the domestic and international financial markets are asymmetrical (see Part Three of this document): there is access to finance in times of boom, but such access tends to disappear when resources are needed to deal with restructuring in difficult situations. Third, access to the financial market is very segmented, because it depends more on guarantees (the result of past performance) than on projections of future profitability. Thus, the bulk of investments by firms are self-financed, a situation which causes productive inertia instead of restructuring in favour of enterprises with better prospects.<sup>9</sup> Fourth, there are serious obstacles to the financing of new enterprises and to technological innovation in the area of either products or processes.

One of the main factors that explains the above-mentioned bias in the financial system is the conflict between the obligation on this system to correctly gauge the creditworthiness of potential borrowers and the difficulties it faces in obtaining the information it needs to perform this task effectively; the seriousness of the problem increases in activities which require long financing terms. If the information available to the financial agent to evaluate the future cash flows of a project is insufficient or if access

9 For a discussion of a series of proposals for creating markets or filling the large gaps in the region's financial markets, see chapter VII of ECLAC (1992a). In the case of small and medium-sized enterprises, specific proposals such as leasing, factorization, risk capital funds, secondary stock-exchange markets and credit cards for small businessmen are included.

to such information raises the transaction costs, the agent is likely to make use of the guarantees brought by the borrower as a critical indicator of his creditworthiness. Thus, in the case of new, short- or long-term projects, the requirement of guarantees may be increased, and this consolidates the bias. This procedure may hinder the implementation of profitable projects and lead to underinvestment and a lower rate of effective growth.

The above situation may be aggravated when financial deepening coincides with the presence of financial conglomerates. Together with presenting new challenges of regulation associated with systemic risk, conflicts of interest, cross subsidies or implicit endorsement, the action of these conglomerates can increase the above-mentioned biases.

Finally, the development of long-term financial markets is discouraged, on the one hand, by macroeconomic instability and, on the other, by a lack of institutional investors, such as pension funds and insurance companies, with an interest in assuming long-term commitments, and a shortage of specialized bodies capable of evaluating longer-term instruments, projects and investments.

iv) *The foreign exchange market.* There is also underinvestment in the generation of new exports and in the opening of new markets abroad, since such activities entail high costs in terms of time and resources for producers, while the first producers to open a new market or introduce a new export cannot reap the full benefits of such activities; obviously, these costs are proportionately higher for SMEs. Likewise, the absence of a medium-term futures market for foreign exchange increases uncertainty as regards the permanency of the key prices in force, particularly the real exchange rate. This necessitates an exchange rate policy which serves to signal to exporters foreseeable medium-term macroeconomic trends. As stated above, exchange rate uncertainty tends to have a greater negative effect on non-traditional exports and on domestic and less diversified firms.

b) *Problems of industrial regulation and organization*

The aforesaid problems are particularly serious in the case of small and medium-sized enterprises. Actually, there is very little incentive to invest time or resources in penetrating new markets or in studying how to acquire new and better technologies, because such costs are not justified at the level of a single small firm, although investment would be very appropriate for the firms in that sector as a whole. This would justify programmes to encourage the relevant association or chamber of commerce to carry out surveys of external markets and look for more efficient technologies for subsequent dissemination via extension programmes.

Conversely, these problems do not greatly affect transnational corporations or those belonging to economic groups. Although enterprises that form part of national economic groups or conglomerates solve the problem of access to finance by grouping together, this privileged access may prompt them to increase their economic power by buying up very diverse enterprises with good prospects but little capital, so that they receive monopoly rents rather than generating wealth. The activities of conglomerates therefore require a regulatory framework that ensures or increases competitiveness.

In the case of transnational corporations, there is no problem with penetrating external markets, since one of their attributes is that they have access to these markets; in general, they also have no problems of access to capital markets or to modern technologies. The difficulty in such cases is that the corporate strategy of globalization may not coincide with that of the countries in which they are established. Reconciling these interests is a fundamental objective of a national economic policy aimed at attracting a great number of transnational corporations, of diverse origins and well-adapted to the country, to the sectors which are deemed to have priority and the activities which offer the best

learning and dissemination opportunities (ECLAC/UNCTAD, 1993c).

c) *Increasing returns and strategic complementarities*

A firm's competitiveness depends not only on its own productivity but also on that of its environment, because the latter determines systemic productivity. Thus, no matter how efficient a firm may be, its competitiveness depends on the productivity of its suppliers (in terms both of quality and of prices and timely delivery); the overall level of education and, consequently, the efficiency and speed with which its workers can be trained; the extent to which the financial system to which it has access meets its needs; domestic transport costs and the efficiency of the country's port system (as regards the cost both of imported inputs and of shipments abroad); the costs and efficiency of the electric power generation system and of other public utilities which affect its costs; and the telecommunications system, in terms of charges, speed and efficiency.

All these factors, although external to the firm and hence beyond its control, may be just as important as its productivity in determining its international competitiveness. Indeed, these factors are in a sense public goods because, since they generate externalities and are not subject to the firm's full control, it is not in the firm's interest to take unilateral action with regard to them. These are functions which require collective action, whether by trade unions or by the regional or national government.

Increasing returns to scale at the level of the firm generate external financial economies at the aggregate level, and hence produce strategic complementarities which make it possible to justify coordinating the activities of private agents with the economic authority. The presence of economies of scale and of strategic complementarities produces externalities and coordination costs which decentralized market signals cannot take fully into account. No doubt these

anomalies vary considerably from one industry to another, and, as Krugman (1986) states, "if there are important rents in certain sectors, trade policy can raise national income by securing for a country a larger share of the rent-yielding industries". The same could be said for actions aimed at productive development.

The presence of increasing returns at the level of the firm precludes working with competitive models. Therefore, the consideration of alternative scenarios (such as imperfect competition or oligopoly) is a distinctive feature of modern theories of growth and international trade. The State's role, which is regulatory as well as coordinating, has again become of vital importance in terms of, for example, topics related to industrial property, anti-trust legislation and anti-dumping regulations.

##### 5. Practical reasons for a policy of productive development

In the first place, in most latecomers to development, the State has played an active, efficient role in perfecting or improving markets, providing substitutes for them and creating an environment conducive to investment and innovation. In the past, Germany and France, for example, took measures to promote a close relationship between the banking and industrial sectors. Japan also, at the end of the nineteenth century and again following the Second World War, promoted imitation or licensing of technology with the support of the Ministry of International Trade and Industry in order to concentrate resources on priority sectors. Similar actions were taken more recently in the Republic of Korea and, to a lesser extent, in the Chinese Province of Taiwan and in Singapore, where high export performance incentives were established.

Secondly, these successes are not automatic, nor are they always assured. However, they may function in the latecomers to development precisely

because the road to be followed is fairly clear. Although the technological frontier continues to advance in unexpected directions, since these countries are so far behind, they do not have to make efforts to be at the forefront of technology; rather, it is more a matter of mastering modern, mature technologies on which future technological advances will be based.

Third, the public sector also has its defects: it does not have unlimited or privileged knowledge. Its efforts should therefore extend only so far as its real capacities allow. Consequently, determining how much State intervention is warranted is an empirical matter, not a theoretical one, and depends on the real capacities of the public sector and the scope of market failures. Experience suggests that State intervention will be more effective when it is i) "market friendly" and does not try to supplant the market, and ii) selective and transparent, because of the State's limitations and because there is a need to prevent an avalanche of private demands which seek to control easy rent-seeking activities instead of creating wealth.

Fourth, experience also indicates that there is a wide variety of alternatives regarding State intervention, including: i) development led by conglomerates (Republic of Korea) or by small and medium-sized enterprises (Chinese Province of Taiwan); ii) growth led by domestic firms (Republic of Korea, Chinese Province of Taiwan and Japan) or by direct investment by public enterprises and transnational corporations (Singapore) which must comply with certain performance requirements; iii) promotion of comparative advantages which stress the importance of both supplying mass markets and concentrating on niches or specialized segments; iv) development

propelled by exploitation and processing of natural resources with the later establishment of backward or forward linkages, or even sideways linkages<sup>10</sup> (Denmark, Sweden and Finland, among others in the past; Thailand, Malaysia and Indonesia at present), or an initial development of manufacturing when significant natural resources are not available (Japan, Republic of Korea and Chinese Province of Taiwan); v) exporting since the beginning of the industrialization process or import substitution at an early stage, subject to increasing external competition, in order to export subsequently; vi) an initial opening based on promoting exports while liberalizing imports of inputs and capital goods, followed only later by a wider trade opening (in the case of most of the Asian NIEs) or a free market almost from the start (Hong Kong and Singapore).

Fifth, although a large part of the import substitution strategy lacked economic rationality (frequently "each sector was given the protection it needed" without linking it with the social benefit), it permitted important advances in the region's industrial development. In fact, there are sectors—even technologically sophisticated ones—which show that a dynamic advantage can be acquired in a reasonable amount of time. The Mexican and Brazilian automobile industries are good illustrations of this. Also, there are many "traditional" labour-intensive sectors (food processing, apparel, footwear and textiles, and production of durable goods such as appliances, inputs and even capital goods, especially if they are custom-made) which have become internationally competitive, either in the domestic market, through efficient import substitution, or in the international market, through exports.

10 Sideways linkages are movements towards the production of i) complementary products (e.g., from garments to footwear because they have similar distribution channels); ii) different products which use a similar technological base (e.g., from bovine insulin to porcine insulin and then to human insulin, or from specialized machinery for separating and selecting different grades of coffee beans to electronically selecting all kinds of beans by colour, texture or size); and iii) close substitutes (e.g., from single- to multi-flavoured juice or from regular to "light" beer).

Sixth, experience suggests that competitive advantages can be acquired through productive development policies which strengthen market forces rather than supplanting them, provided that several requirements are met, including the following:

i) That the incentives are transitory, for only when the obligation to compete internationally is established is it feasible to persuade entrepreneurs to adopt a favourable attitude towards productive activities and not towards those that are merely rent-seeking.

ii) That the scale of production is sufficiently large, i.e., that there is a large domestic market (e.g., traditional firms in most countries or the automobile assembly industry in Brazil and Mexico), that exports have been taken into account from the start (automobile engine plants installed in Mexico since the end of the 1970s, or other product lines aimed at foreign markets as a result of export-promotion policies, as in Brazil and Colombia) or that an industrial commodity is produced which is easily exportable if there is insufficient domestic demand (a considerable part of the production of intermediate inputs in Argentina and Brazil).

iii) That, generally speaking, the use of obsolete or rapidly evolving technologies is avoided. In the case of the former, this is because the comparative advantage would be based only on maintaining low labour costs and could be quickly lost as the technology changed. Likewise, sectors where technology is making giant leaps forward should generally be avoided because, by the time this technology has been mastered, the best international practice will have already moved forward significantly; this would appear to be the case in the field of information sciences in Brazil, the pharmaceutical industry in other countries, or the production of spare parts or capital goods for producers of intermediate inputs, where few plants of this last category exist and where investment in them is sporadic.

Experience therefore points to the importance of adopting a relatively advanced but already proven, mature technology, as in the case of automobile engine manufacturing in Mexico, so that the technology can be mastered and even adapted before it is replaced by a very different one. Technology should therefore be relatively advanced and proven and should allow a country, within a reasonable period of time, to start producing according to the standards of the best world practice and to remain on the international technological frontier.

## 6. Summary

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The traditional industrial promotion instruments used in the region, such as high or non-time-limited tariffs, import quotas, local subsidies and the provision of goods and services by State corporations at subsidized prices (for example, electricity, petroleum, steel) are no longer valid. The loss of importance of these instruments was due to several factors: i) the lack of economic rationality in their levels and periods of application; ii) the abuses to which they gave rise during part of the period when the industrialization strategy based on import substitution was in force; iii) the tight financial constraint on the public sector during the adjustments of the 1980s; and iv) the fact that most of the policies which involved the use of these instruments came into conflict with the policies that began to apply in the mid-1980s (trade and financial liberalization, privatization and deregulation).

As for alternatives, an analysis of several experiences and policies designed to increase the competitiveness of the production system indicates that future policies in the region will need to have a high degree of flexibility and pragmatism, combine elements of different scope (segments, sectors and neutral policies) and give priority to solving specific market-related and institutional

problems. An appropriate mix of private and public efforts is, of course, a precondition for effectively implementing and correctly designing these policies. The productive development policy proposals formulated within and outside the region

in recent years, as discussed in the following chapter, make it possible to identify a series of elements which should be taken into account in elaborating and implementing future competitiveness policies (Peres, 1993).

## Chapter VIII

### PRODUCTIVE DEVELOPMENT POLICY OPTIONS FOR THE 1990s

There is a wide range of instruments for achieving faster and more effective production restructuring. In particular, there are some instruments which fulfil the three conditions of avoiding the excesses of the past, complying with the consensual principles referred to in the preceding chapter, and having been successfully tested, above all in the Asian NIEs.

What is required in order to promote competitiveness and close the productivity gap with the developed countries is not only sound macroeconomic and trade liberalization policies but also an active productive development policy which includes:

i) *"Horizontal" or meso-economic policies*, that is, policies which support the systemic competitiveness of the environment in which the enterprise operates, especially those focused on filling the gaps and overcoming the most critical bottlenecks in the factor markets, such as policies for innovation and the dissemination of technology, training, export promotion, financing and infrastructure development.

ii) *Micro-economic policies* which directly support the operations of enterprises and, in particular, the use of the best technologies. Learning and restructuring in the areas of technology, organization, quality control and

marketing all require a heavy investment of time and physical and human capital. The essential role of a modern industrial or productive development policy is to facilitate this learning and restructuring, reinforcing rather than replacing the market forces.

In order to apply this set of policies it is necessary to get away from the idea that when it comes to meeting the challenge of competitiveness there are only two kinds of firms: those which are prepared to restructure and transform themselves into competitive enterprises, as many are already doing, and those which will disappear because of the difficulties they encounter in adapting to new circumstances or because of their lack of motivation to do so. Although the attitude that giving the market forces free rein is sufficient of itself to ensure that inefficient enterprises will disappear and competitive enterprises will survive is not always explicit, the lack of support policies which would help enterprises to become competitive shows that this attitude still prevails in practice. Nevertheless, reality shows that a large proportion of the region's enterprises belong to a third group: those which have the potential to be competitive, but which need support in order to improve their product design, reorganize their production processes and acquire the capacity to respond quickly to

changes in demand: in short, to strengthen their competitiveness. These are the enterprises on which policies to promote competitiveness should concentrate.

### 1. Policies to further innovation and the dissemination of technology

#### a) *The situation of enterprises at the beginning of the 1990s*

Entrepreneurial performance in the region is tending to display increasing dualism. In order to overcome the challenges and take full advantage of the opportunities referred to earlier, Latin America and the Caribbean must considerably increase their efforts in the area of technology.

On the one hand, there are large private national groups, subsidiaries of transnational corporations and many small and medium-sized enterprises (which often act as subcontractors for the first two types of companies) which are engaged in an intensive process of modernization reflected in the growing competitiveness of such activities as the automotive industry in Mexico, the aluminium industry in Argentina, the paper and pulp industry in Brazil or the domestic appliances industry in Chile. Even in traditional sectors, many companies have shown a great capacity for modernization, as in the cases of the ceramic products and leather industries in Uruguay, the footwear industry in Chile, textiles and clothing in Colombia, and textile and canned food in Central America. Even in situations of acute and prolonged macroeconomic crisis combined with trade liberalization, as in the case of Brazil at the beginning of the 1990s, substantial restructuring processes

and increases in competitiveness are to be observed (see box VIII.1).

In contrast to this relatively promising picture, however, it is clear that in a number of countries and sectors the competitiveness of regional manufacturing is still only incipient and that innovation is the rule only in a very limited number of enterprises.<sup>11</sup> In particular, for the three largest economies of the region, the change in their trade structure points to a relative loss of international competitiveness in the 1980s in production sectors that are know-how and capital goods-intensive, in spite of the considerable advances achieved in sectors producing natural resource-based goods or in the motor industry (Gurrieri, 1993; Katz, 1993).

At the enterprise level, the slowness with which many firms in some important production sectors have responded to the new pressures of the more competitive environment created by the increasing trade liberalization of the region's economies is cause for concern. This is especially true in the case of enterprises which do not carry on export activities, either because of problems of internal competitiveness or for systemic reasons. An example of this situation, even in a modern activity producing goods based on abundant natural resources, is the Venezuelan chemical and petrochemical industry. Out of a total of 113 enterprises highly representative of the production and employment generated in this industry in 1988 and 1992, about 40% lacked basic information on technological, commercial, organizational and even accounting problems, and one-fifth did not even attach importance to this fact or showed no awareness of the need for such information (Pirela, 1993).<sup>12</sup>

11 Some recent data point to growing private participation in the costs of research and development; in the case of Mexico, for example, data for 1992 indicate participation of 22%, which, although still far below desirable levels, marks a clear advance compared with the figures below 10% registered in the 1980s.

12 Although this description could also be applied to some enterprises in developed countries, the situation is particularly serious in a context –like that of the region– marked by increasing international competition and a tendency towards an appreciation of the currency (see chapter XI).

## Box VIII.1

**ADJUSTING FOR SURVIVAL IN AN ENVIRONMENT OF SEVERE MACROECONOMIC  
IMBALANCES AND ECONOMIC STAGNATION: THE PROGRESS OF BRAZILIAN  
ENTERPRISES TOWARDS GREATER COMPETITIVENESS**

During 1993, ECLAC cooperated with the Government of Brazil in a broad study carried out by Brazilian specialists on the competitiveness of the manufacturing sector. The study showed that big domestic and foreign firms had an extraordinary capacity for achieving substantial increases in productivity and quality in order to cope with the economic turbulence of recessions, four-digit inflation and trade liberalization experienced over the past six years.

The study confirmed the trends suggested in the last two years by a series of isolated indicators, all of which pointed to important improvements during that period in the competitiveness of the manufacturing sector. For example, not only has there been a sharp increase in the activity of technological consulting enterprises but also, according to the data provided by the Brazilian Geographical and Statistical Institute (IBGE), during the period 1991-1993 productivity increased by more than 25%, in contrast with the stagnation of labour productivity during the previous five years. This study has contributed enormously to an understanding of the process, as it provides a detailed examination of its internal operation.

The macroeconomic disequilibria are limiting progress by restricting investment in fixed capital. Moreover, there has not been much progress in certain areas which are critical for long-term competitiveness, such as training and technological research, although improvements are foreseen in the near future in most of the enterprises included in the study.

Nevertheless, the data given by the study indicate substantial progress in a series of basic determinants of competitiveness. Considerable rationalization of costs is being achieved through: i) contracting of support services

outside the enterprise; ii) specialization in fewer product lines, but at the same time incorporating more models and more rapid changes within them in areas where the firms have comparative advantages; iii) de-verticalization; iv) elimination of bottlenecks; v) more efficient use of inputs and consequent reduction in waste; and vi) reduction in levels of authority (from 6 to 5). Moreover, enterprises have placed great emphasis on measures to ensure and control quality, including greater technological refinement, better adjustment to technical specifications, better use of consultants, and a radical change of attitude towards suppliers. Lastly, production has begun to concentrate much more on the customer, as is demonstrated by greater durability of products, shorter delivery times and quicker preparation and introduction of new products.

Given the stagnation of demand, it is natural that these efforts should have been concentrated on certain areas which require little new investment in fixed capital. Nevertheless, the benefits of the current adjustment should not be underestimated, as it has spread throughout the manufacturing sector and has advanced very rapidly since 1990. Moreover, it has helped to avoid a serious collapse of the sector by increasing the capacity of Brazilian enterprises to cope with trade liberalization, in an unfavourable international environment and a difficult macroeconomic situation, by achieving substantial increases in competitiveness. Furthermore, although it has not contributed to significant technological progress—for example, there are few examples of flexible automation—it represents a good beginning which will ensure the introduction of technological progress in the future, once investment increases and enterprises begin to invest in the so-called third industrial revolution and reap its benefits to the full.

**Source:** R. Bielschowsky, "Adjusting for survival: domestic and foreign manufacturing firms in Brazil in the early 1990s", *Two Studies on Transnational Corporations in the Brazilian Manufacturing Sector: The 1980s and Early 1990s*, Desarrollo productivo series, No. 18 (LC/G.1842), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), December 1994; R. Baumann, "Exporting and the Saga for Competitiveness of Brazilian Industry, 1992", Documento de trabajo series, No. 27, Santiago, Chile, ECLAC, 1994.

Moreover, nearly two-thirds of the enterprises exhibited characteristics, both before and after the structural changes initiated in 1989, which justified describing them as "passive" or "isolated from the sources of technological dynamism" (see table VIII.1).<sup>13</sup> In addition, out of a subgroup of enterprises (54) which formed part of the sample in both 1988 and 1992, only a little more than one-third made positive changes and tended to become more active, while the rest regressed, in that their learning capacity diminished or they did not see the need to change their behaviour.

Other studies with similar goals show that in very important sectors there has still not been sufficient adaptation of the prevailing business culture to the new reality of international competition to enable production units to perceive that there is a clear and direct relationship between their technological behaviour and their economic performance.<sup>14</sup> Although there may well still be some uncertainty about the wisdom of seeking to adapt to a new environment which may be reversible, it would seem that the main reason for the relative passivity observed is inertia, the correction of which will require policy measures that recognize the structural dualism evident from the examples given.

The perception by enterprises that they are confronting an increasingly competitive environment plays an important role in their technological modernization decisions. Thus, in the garment production sector in Chile, Mexico and Venezuela in the early 1990s, we can observe growing concern by firms

to acquire modern machinery and equipment. This is due to the combination of trade liberalization, exchange rates with a tendency towards revaluation, sales pressure from international enterprises facing recession or slow growth in their main markets, and the progressive development of marketing channels that make it possible to take greater advantage of international prices. All these factors reduce the trading opportunities of the customary suppliers of the domestic market. The increased competitive pressure is reflected in efforts to reduce costs, and in doing this there is naturally a tendency to concentrate on those cost factors which can be reduced by introducing modern machinery.

Accordingly, as economies stabilize, wage costs rise and there is less room for increasing competitiveness through significant exchange rate devaluations, enterprises in these sectors confront the need to adapt their technologies. This process of reaction by enterprises would naturally be easier in a climate of economic growth, with access to financial resources at reasonable cost.

The above analysis indicates that an appropriate system of incentives is a necessary but not a sufficient condition for stimulating technological innovation, and must be supplemented with the development of a special set of institutions.

#### *b) Institutional experience*

Although a number of problems still persist in the technological culture and behaviour of the region's enterprises, there is a wealth of institutional experience in the

13 "Passive" enterprises are those which show considerable technological backwardness and do not carry out internal technological activities or develop external linkages which would enable them to overcome that backwardness, while "isolated" firms are those which make technological efforts but do not link them up with sources outside the enterprise that would make it possible to give them a boost. The latter firms, which have an interesting record of technological learning in the past, seem to be over-adapted to an economic environment which is becoming less and less relevant to their activities, while they have been unable to establish linkages with outside sources of technology (as enterprises which are "technologically dependent on the outside world" have done) or to transform themselves into "active" enterprises (i.e., enterprises well adapted to the present environment and with close links with national research centres).

14 See, for example, Prochnik (1989) in the case of the Brazilian textile and garment industry and Guerguil, Macario and Peres (1993) in respect of the garment industry in Chile, Mexico and Venezuela.

Table VIII.1  
**VENEZUELA: TECHNOLOGICAL DYNAMISM OF CHEMICAL AND  
 PETROCHEMICAL ENTERPRISES, 1988 AND 1992**

Type	Number in 1988	Number in 1992	Technological characteristics	Comments
Active	28	20	Some capacity for design and technological experience. Main competitive strength is customer service	Large enterprises suffer from shortage of qualified staff. Maintain links with universities
Technologically dependent on the exterior	22	32	New products are the key to their competitiveness. Greater weight of competitive markets	Produce mass-consumption goods. Many foreign enterprises or joint enterprises with foreign control
Passive	19	18	Technological lag of 5 to 15 years. Competition based on prices	Concentrate on producing one line of goods with mature technology
Isolated or non-differentiated	44	43	Adaptation to the environment based on customer service. The "professional challenge" still exists	Good technological level, but are isolated
<b>Total</b>	<b>113</b>	<b>113</b>		

Source: A. Pirela, "De la taxonomía empresarial a la política industrial: los efectos del ajuste estructural en la cultura tecnológica de las empresas", paper presented at the international seminar on "Entrepreneurial conduct and technological culture in Latin America: the chemical and petrochemical industry", Caracas, ASOQUIM/Centro de Estudios del Desarrollo, 1993.

development of national science and technology systems, technology management, linkages between universities and industry, "enterprise incubators", technology parks and local systems of innovation and international cooperation, and these initiatives deserve special attention as successful and intra-regionally transferable policy instruments (Peres, 1993; Dini and Peres, 1994). The following conclusions can be drawn from this experience:

i) The development of direct action at the enterprise level is the key to promoting organizational change and the absorption of new technologies. What most restricts the introduction of new technologies is the

insufficient demand by firms for them, and this is particularly true for important industrial sectors in the region which utilize mature technologies, readily available in the international market, but lack adequate information on the available international supply and its potential impact on their profitability. The problem therefore is how to fill this gap and stimulate demand by firms. There are two successful examples in the region of institutions directed towards this end: Costa Rica's experience with "technology management nuclei" shows that these can be an efficient and transferable instrument,<sup>15</sup> while Chile's experience

15 This initiative, carried out by the Centre for Technology Management and Industrial Information Systems (CEGESTI), is based on teams of experts in technology and management who work directly with the senior management of enterprises to improve their competitiveness by means of increased productivity, organizational changes and technology management in general.

with the establishment of "pilot" enterprises shows that they can stimulate new private investment in areas which have been insufficiently developed because of the inadequate information available in that sector and thereby create a demand for technology transfer and adaptation services.<sup>16</sup>

ii) Technology-based enterprises originating from major public research and development centres have proved to be an efficient instrument for spreading technological capacity; in some cases it has been observed that the development of "enterprise incubators" or technology parks has helped such enterprises to mature. The science and technology bodies of some countries of the region and their associated funds have contributed financing for such efforts on the basis of shared benefits and risks.<sup>17</sup>

iii) National science and technology bodies have tended to establish closer links with the production sector, although much remains to be done before their activities can have a significant impact on productive activity as a whole. These bodies have concentrated their attention on policy instruments connected with the financing of training and research and development at the enterprise level, particularly in small-scale and micro-enterprises. The conditions of this financing (interest rates and guarantee requirements), although better than those prevailing in the market, in many cases still do not fully incorporate the risk factor and the externalities present in technological activity.

iv) The management of cultural variables is decisive in efforts to link production firms with top research centres. The most important factors involved are the development in such centres of an environment more conducive to interaction with enterprises and the consolidation of broad, long-term policies and institutional support to regulate that relationship.

v) The most important role of international cooperation in the technological field is to act as a catalyst for promoting joint technological efforts between centres of excellence, between centres and enterprises, and between enterprises located in different countries.<sup>18</sup>

vi) The development of local systems of innovation in countries of the region, despite the successes achieved, has run into major problems: first, neither businessmen nor policy makers fully recognize the role that cooperative efforts can play in the effective implementation of policies for promoting such systems, particularly those made up of small firms; second, the weakness of local economic and social structures, combined with the limited capacity for implementing State policies, promotes a tendency on the part of enterprises to take advantage of the collective effort without contributing to it ("free riders"); third, the public institutions responsible for promoting innovation have centralized management structures which are not efficient for identifying the needs of enterprises in unstable and dynamic contexts; and

16 A well-known example of "pilot" enterprises is provided by the Chile Foundation, whose initiatives in the creation of enterprises have demonstrated the potential profitability of activities which the country's business class did not perceive as profitable (see box V.2 and Huss, 1991).

17 Two examples of the promotion of enterprise incubators are the Incubator Programme for Technology-Based Enterprises (PIEBT) of the National Council for Science and Technology (CONACYT) of Mexico, and the Technological Enterprises Programme of the National Council for Scientific and Technological Research (CONICIT) of Venezuela.

18 Two important experiments in this field are the Bolívar Programme for Regional Technological Integration, Innovation and Industrial Competitiveness, and the Iberoeka Programme being carried out within the framework of the Science and Technology for Development (CYTED) Programme of the Spanish external cooperation system.

fourth, there is a conspicuous lack of coordination between promotion policies and the specialization and complementation needs of the firms participating in efficient local systems of innovation.

*c) Policy lines*

A review of technological behaviour and institutional experience in the region leads to the conclusion that the strategies outlined by ECLAC in 1992 for developing the capacity for the assimilation, adaptation and development of technology remain valid, especially as regards: i) strengthening social capacity for the absorption of knowledge by increasing the integration between technological and human resources development systems; ii) promoting firms' own research and development activities; iii) promoting cooperative research among firms and supporting the establishment of research and development consortia; and iv) encouraging stronger links between industry and research institutions.

Recent developments also suggest that these strategies must be supplemented by four additional elements: i) preventing technological lag due to the adjustment policies, since loss of local engineering capacity can give rise to permanent technological backwardness; ii) introducing policies on domestic competition which go beyond the liberalization of trade, since the small size of the market in most countries of the region would allow the few producers in the domestic market to prevent the entry of new suppliers or suppliers of substitutes, even for internationally tradeable products; iii) supporting the development of strategic alliances between large national firms and international technological leaders, as this is a key mechanism both for rapid technology transfer and for increased international linkages; and iv) acting in a way which takes account of the impact of current regional and subregional integration processes,

especially as regards the coordination of technological policies and policies on intellectual property rights which reduce the scope for disseminating potential technology "spill-overs", a situation which could have serious repercussions on some production sectors.

Finally, three factors should be taken into account: i) the problems of technological policy in the region (like those of production development policy in general) are due much more to the failure to implement policies than to the absence of instruments to propose or policies to support; ii) the instruments applied and the institutions established have reflected a low level of commitment to technological change, leading to the development of institutions which have a positive effect on only a few enterprises and which channel only marginal resources; and iii) there are many businessmen in the region who do not even know that policies of technological modernization are in effect or who, if they do know this, very often write them off as inaccessible without first carrying out an in-depth evaluation.

Three sets of proposals are made below which emphasize the enterprise dimension and are particularly important for taking advantage of the technological know-how currently available and thereby closing more rapidly the great gap in factor productivity between the countries of the region and the developed countries.

The first proposal, which would permit a qualitative leap forward in this area, requires the initiation of programmes to speed up and generalize the dissemination of "best practice" technologies.

As was done during the reconstruction of Europe through the Marshall Plan technical assistance programme, it would be very useful to establish programmes for co-financing medium-length visits (between 6 and 8 weeks) to "best practice" plants abroad by businessmen, engineers, foremen and trade union leaders from the various local

production sectors, who would later pass on what they had learnt to enterprises in their own countries.<sup>19</sup> In the case of Europe, increases in productivity of between 25% and 50% were achieved at very low cost (some US\$ 20 million per country at 1993 values to send between 20 and 40 people from each of 50 selected sectors) and with very little additional investment.<sup>20</sup> It should be noted that the gap between the total factor productivity of the developed countries and of Latin America (of the order of 2.5 to 1) is much greater than that existing between the United States and Europe in the late 1940s.

Because it would cost little and would lead to big productivity gains, such a programme could have a high cost/benefit ratio. Moreover, with the same multiplier as the Marshall Plan,<sup>21</sup> it would serve to disseminate experience to between 5,000 and 10,000 firms in each of the participating countries, making it possible for the region to take advantage of its late development and skip intermediate stages, thus moving more rapidly towards the global technological frontier.

This proposal has two additional advantages: i) it would increase national awareness of the importance of productivity, making productivity a national effort and not just the responsibility of firms or certain trade associations,<sup>22</sup> so that productivity would become a unifying issue by being presented as a national challenge and as the principal source of solid and lasting improvements in the standard of living of the entire population; and ii) it would be open to all sectors wishing to participate,

or at least to the first ones each year which submit a programme for their sector and are prepared to participate in its co-financing.

In addition, this programme could be supplemented with another one successfully tried in Singapore, based on granting incentives to the first companies to introduce significantly new technologies in a particular category (both technologies that reduce costs and those that improve quality), since, in the last analysis, the first company to acquire a new and appropriate technology in its country is a "Schumpeterian innovator" that generates an externality: other companies can profit by its experience without incurring costs or risks of equal magnitude.

The second group of measures includes proposals which, taken individually, would not have a significant immediate impact but which, taken together, would have such an effect in the long run because they reinforce each other and have a cumulative effect:

i) Continuation of efforts to improve technological and management information systems and networks. Efficient systems with low-cost access for their users are an essential complement to efforts to modernize and heighten the awareness of enterprises. Moreover, it is essential to make progress in the development of an information infrastructure which makes possible the execution of ongoing sectoral studies to monitor the changes taking place on the international technological frontier. Permanent contact by regional producers

19 This idea is taken from a proposal by Carl Dahlman, a World Bank staff member, for the restructuring of the productive sector of the former Soviet Union on the basis of a report prepared for that institution (Silberman and Weiss, 1992).

20 Co-financing might mean, for example, that enterprises would continue to pay the salaries of those of their workers who participate in the visits and prepare the corresponding reports, while the government contribution would finance the travel, subsistence and administrative costs of the programme.

21 In the case of the Marshall Plan, each member of the mission transferred his experience to an average of between 5 and 10 plants in his country of origin.

22 Indeed, this was done in Europe during reconstruction, through the establishment of national productivity committees made up of heads of firms, trade unionists, technicians and public officials.

with the available international information complements efforts to inform them of the experience of companies employing the "best practice".

ii) Improvement of the financing conditions for technological efforts. In most countries of the region, the funds handled by the institutions that are trying to promote technological development are insignificant compared with the total requirements of production modernization. Nevertheless, they can demonstrate to private banks the potential profitability of financing technological investment, and they can serve as a mechanism for learning and teaching how to evaluate technological risk. Conditions of financing should be revised to reflect support for the external economies deriving from technological development. To that end, in spite of the difficulties involved, efforts should be made to evaluate the trade-offs between granting preferential interest rates and assuming all or part of the technological risk, as well as to move towards reducing the margin of intermediation for technological credit, the high level of which reduces demand from companies. It is likewise necessary to develop insurance for such credits and to strengthen the traditional mechanisms for financing prototypes and pilot plants, thus easing the firms' transition from pre-competitive research to the installation and start-up of production plants, with special attention to the needs and limitations of small and medium-sized enterprises.

iii) Dissemination of regional experience in the operation of institutions for supporting companies' technological activities. There is considerable experience in this field, but although it is well known to experts on technological questions it has not yet filtered through to decision-making bodies, particularly in small and medium-sized countries. Moreover, in spite of the positive experience accumulated in connection with technological centres at the level of industrial branches, incubators and technology parks, linkages between universities and enterprises and alternative

financing mechanisms, the feasibility of expanding them to the whole economy has not yet been properly evaluated, yet without such expansion they will have only a marginal impact on productivity.

iv) Promotion of alliances among companies by simplifying procedures, providing information and granting fiscal incentives. The first two mechanisms are clearly called for if the aim is to promote a strategy of developing company alliances. Although there is no consensus on the third, it would undoubtedly serve to send a signal that this is a priority strategy for modernization and that, in view of its importance, there is a readiness to accept the necessary trade-offs in terms of public expenditure.

v) Support for the efforts of enterprises to modernize their associations. Many of the region's industrial business associations were established at a time when their basic function was to guarantee their members high levels of protection and good access to policy-makers and those responsible for public contracts. In the eyes of those they represented, the fundamental criterion used to measure the success of industry representatives was their efficiency in lobbying. In a new competitive environment characterized by trade liberalization and greater competition, however, such functions have declined in importance, and in some cases this has deprived some organizations of their very *raison d'être*. For that reason, the region's more modern business associations have sought to transform themselves into providers of services for their members, especially in areas related to the provision of information, the consolidation of efforts in the areas of trade and transport, and business and economic analysis. These efforts entail important externalities and should be supported as a mechanism which makes for higher levels of efficiency in the region. In particular, a mechanism which has shown itself to be especially useful for achieving such purposes is the facilitation of exchanges of

modernization experiences among business leaders so that they can weigh alternatives and have access to the relevant advice.<sup>23</sup>

The third set of measures relates more specifically to the region's agriculture, as the special characteristics of this sector require that special attention be paid to the forces which can promote technological change in it. Thus, the small average size of farms, producers' difficulties in organizing themselves to carry out and internalize technological efforts, the need to adapt even basic techniques to specific soil and climate conditions, and the difficulty of protecting intellectual property rights in this field call for a special effort by the public sector.

In order to achieve more dynamic growth in which the agricultural sector plays an important part, it is necessary to restore and promote public programmes of technological research and dissemination. With the crisis of the 1980s and the consequent reduction in public expenditure, agricultural research and extension systems suffered contraction and dismantling which resulted in significant deterioration in the capacity to generate and disseminate agricultural technologies, precisely in a sector in which such linkages had been most successful. The full impact of these cutbacks has yet to be felt, given the long delay between theoretical research, its experimental development and its subsequent dissemination and full maturity.

Resuming the unfinished research and restoring research teams will require a long and considerable effort, but this is all

the more necessary because the region needs the expansion, diversification and development of "non-traditional" crops (ECLAC, 1993d). This is particularly important because perfecting a new variety requires a decade or more of research and adaptation: a period of time which increases considerably in the case of the genetic improvement of animals. In an environment of highly dynamic markets, in which agricultural and agroindustrial products appear and are replaced with great rapidity, research and dissemination in the field of agricultural technological innovation is a decisive factor for ensuring a supply capable of adapting to the quality and timing requirements of such markets. This is even more evident in the case of products or crops that are new to a country, in which case the adaptation process and the introduction of quality standards must be carried out in the shortest possible time.

Some countries of the region have become aware of this situation and its requirements and have taken action in recent years to restructure their national systems of scientific and technological research. The importance of these measures should be emphasized, as recent studies on the social profitability of agricultural research and extension have shown highly favourable results. Indeed, one of them, which aggregated the findings of 114 specific studies on the subject in developed and developing countries, concluded that the rate of social profitability of investments in this area was above 50% in 45% of the cases, between 30% and 50% in 42% of the cases, and below 20% in only the remaining 13% (Evenson, 1992).<sup>24</sup>

23 A successful example of such exchanges in the region is the modernization effort made by the Chamber of Industry of the State of Carabobo (CIEC) and the Venezuelan Plastic Industries Association (AVIPLA). For an analysis of these efforts, see León (1993).

24 Similar results were obtained with regard to investments in agricultural extension systems. In this connection, it should be emphasized that, even when extension services are not very efficient, the externalities generated are considerable and directly benefit the rural community in areas such as adult education and training and improvement of communications. Moreover, the results obtained were not significantly different for developed and developing countries. This makes it clear that there are very good reasons for investing in national systems of agricultural technology generation and dissemination.

Lastly, mention must be made of the considerable impact that proper linkages between producers and agroindustries can have on the modernization of the agricultural system, especially in the case of small and medium-scale producers. The fact that agroindustrial enterprises need inputs of a given

quality, at a given time and with high yields (to offset high transport costs) leads them to provide technical and financial assistance to agricultural producers, and this is an effective means of transferring technological advances and improvements (see box VIII.2).

#### Box VIII.2

#### LINKAGES BETWEEN AGRICULTURAL UNITS AND AGROINDUSTRY

Research carried out by the Agricultural Development Unit of ECLAC and by country institutions has made clear the effect of agroindustrial processes on agricultural productivity and product quality. In certain circumstances, agroindustry constitutes a powerful means for modernizing agriculture, particularly in the case of small and medium-scale producers. This phenomenon is particularly important in some agroindustrial chains usually, although not exclusively, connected with foreign markets. The need to ensure good quality and an adequate supply of raw materials leads many agroindustrial enterprises to sign contracts involving the provision of technical and financial assistance to farmers, who, in turn, must meet pre-established standards and deliver their products on schedule. For some products such as vegetables, where quality depends to a large extent on careful handling, agroindustries prefer to establish relations with family farms, usually small-scale ones. In many of these cases, the technology transferred has more general applications and can be used for other crops too.

There is much evidence that an environment of stable, long-term contractual relations has led to increases in productivity and that in the course of time productivity levels even out between the various scales of producers. Examples of this are to be found in activities such as milk and sugar beet production and tobacco growing. Moreover, the share of contract agriculture covers a significant portion of the total. Research carried out by ECLAC in Paraguay shows that of a total of 307,000 producers, nearly 200,000 have some form of contractual

relationship with agroindustry. Of these, nearly 130,000 are small farmers with less than 10 hectares of land. In most cases, these contracts provide for advance payments in cash and in kind. These arrangements by agroindustries for financing agricultural producers are additional to those provided by Paraguay's National Development Bank, which covers almost 30% of the land under cultivation.

In Chile, of a total of 200,000 production units, about 80,000 producers have linked themselves with agroindustry. Of these, more than 60,000 are small farmers and, in most cases, are dependent on the corresponding agroindustrial chain and receive technical and financial assistance. In industrial crops such as tobacco, sugar beet and tomatoes for paste and concentrates, this assistance may cover 100% of producers. Similar rates of coverage are also found in the case of new export products such as berries. This phenomenon is not limited to exports, however. In the dairy products chain, which is basically geared to the domestic market, technical and financial assistance for producers is also widely prevalent as a means of raising productivity and the quality of the raw material.

Another study, carried out by the Bank of Guatemala in 1990, shows that about 80% of agricultural producers specializing in fruit and vegetables for export are linked to agroindustrial enterprises by various contractual agreements under which nearly 75% of them normally receive technical assistance. This has made it possible to increase and standardize productivity for a large number of export crops.

Source: ECLAC, on the basis of case studies for various countries.

## 2. Training policies

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Education and training are basic determinants of the competitiveness of countries. There is no doubt that the basic requirement for securing a lasting, long-term improvement in the productive competitiveness of the region and the standard of living of its population is educational reform focused on quality. Nevertheless, in the short term, training is the activity most closely related to the competitiveness of the production sector and the main instrument for equipping the workforce to cope with labour-related changes in the enterprise. This is all the more necessary now that rapid changes in technology, the organization of work and demand make it essential for the workforce to be able to learn on an ongoing basis.

### a) *The problem, the potential and the challenge*

The few studies available on the training activities of enterprises in the region show that they are of rather modest proportions, with no more than 10% of employees receiving any form of training. This contrasts with the evidence that training costs have a high rate of social profitability (25% on average, and always more than 10%), as indicated by evaluations of vocational training programmes which include apprenticeship, initiation and supplementary training courses (ECLAC/UNESCO, 1992). Moreover, the average worker in the region currently receives barely a month of training throughout his working life, which

contrasts with the 5-10 months of training he would receive if 1% of the payroll were devoted to this purpose, in line with the internationally suggested minimum and the legislation of various countries of the region.<sup>25</sup>

Not only is there little training, but the management of human resources in the region is frequently not of a professional nature and does not follow integrated programmes, being dictated instead by short-term considerations. In this context, training is seen as a mass of dispersed efforts, in response to specific requests or problems, without reference to the overall production process. Businessmen generally regard training as a cost rather than an investment, and therefore naturally tend to minimize it. They frequently regard it as a social benefit granted to employees and rarely connect it with the firm's modernization strategy. This is in line with their perception that external factors (especially exchange rate policy, foreign trade legislation and tax policy) are much more important for their competitiveness than factors internal to the enterprise (ECLAC, 1988a and 1993e; Guerguil, Macario and Peres, 1993).

A clear and very up-to-the-moment example of the secondary role which many enterprises assign to training is the way in which computerized equipment has been introduced: despite its importance, it has been accompanied by only a minimum of training, and this has, of course, reduced the possibility of improving the productive efficiency of firms. On the one hand, there is no question that computerized machines are more productive, facilitate quality control and

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25 Part of the reason for the minimal training given to workers, even where programmes with significant financing exist, is that generally such training is directed towards only a few workers and enterprises, and many of those who do receive it belong to middle or senior-level management. External training (outside the enterprise) in fact usually concentrates on administrative or management subjects, instead of those directly related to production. In Chile, for example, almost half the staff trained in 1992 belonged to the management and administrative categories (SENCE, 1993). In contrast, the training of production staff is usually carried out in the enterprise; such courses are usually narrow in scope, covering only initial training (for a specific job) or training related to the introduction of new machinery; the former is usually provided by supervisors and the latter by suppliers.

are generally easier to use, as a result of which they require less initial training.<sup>26</sup> On the other hand, such equipment requires sophisticated maintenance services which are usually contracted outside the firm, generally from the supplier himself. The lack of training of the firm's maintenance staff prevents them from coping adequately with the tasks of basic maintenance, the adjustment of machines or the detection of malfunctions. In countries where the external supply of maintenance services is not very efficient, down-time is lengthened and there may even be reluctance to introduce new machinery because entrepreneurs see it as involving greater risks of interrupting the production process.

Moreover, many of the enterprises which have introduced computerized machines fail to take advantage of their versatility, because of the scant training they give its operators, who are then unable to control the efficiency of the process or the quality of the product, necessitating a greater number of final checks, and unable to adapt themselves quickly to changes in product specifications. By contrast, enterprises which have made greater training efforts achieve higher product quality and, in general, greater productive efficiency.<sup>27</sup>

The contrast between the minimal training provided and its high social profitability naturally raises the question as to why this discrepancy between possibility and reality exists. Basically, the answer would be that entrepreneurs see general training as benefiting the worker, not the enterprise, because worker productivity is increased not only in the enterprise in question but overall, which means that the enterprise cannot fully appropriate this greater productivity and thus cannot recover the cost of such training.

On the other hand, the main beneficiary of the potential training –the worker– usually lacks the resources needed to finance it (both the direct and the opportunity costs).

In the light of these factors, three complementary approaches seem possible: i) to recognize the primary interest of the worker in his own training and generate instruments in the capital market which will make it possible to use new forms of financing for people who wish to receive advanced training, using, for example, their pension fund or social security accounts as a guarantee; ii) to develop training activities with the help of State resources: an approach which is fully justified because such activities are a public asset and generate considerable externalities; and iii) to seek to change entrepreneurs' perceptions about training, promoting a broader and longer-term outlook. As the first point has been analysed in detail in ECLAC (1992a), proposals will be developed in this document which go more extensively into the other two.

#### *b) Proposed measures*

Three kinds of measures are proposed for reducing the gap between the potential and actual productivity of the workforce as quickly as possible.

##### *i) Measures to stimulate and channel the demand by enterprises for training services through the provision of training for heads of enterprises and differentiated incentives*

*a. Direct or indirect incentives for training.* In some countries of the region, there are financial incentives for training, either positive (tax exemption) or negative (deduction of the cost of activities carried out in enterprises themselves from the compulsory contribution to vocational

26 This technology transfers part of the workers' skills in production programming to the machine's computerized memory, which can then perform very complex routines without interruption.

27 In a survey of firms in the garment industry, a clear inverse relationship emerged between the length of initial training and the rate of final defects (Guerguil, Macario and Peres, 1993).

training institutions).<sup>28</sup> These mechanisms do not seem to have attracted new resources quickly and massively to training, as only a few enterprises (especially the large ones, which usually train their personnel in any case) take advantage of them;<sup>29</sup> these incentives have nevertheless had other positive effects, such as promoting expansion of the private supply of training services, providing more information on these services and furthering greater market transparency. Moreover, they may have positive side-effects if they are accompanied by promotion and information efforts on the part of the authorities.<sup>30</sup> It would therefore be useful to introduce mechanisms of this kind in appropriate countries.

The possibility of reducing, at least partially, the compulsory contribution by enterprises to vocational training institutes, on the basis of the training activities carried out by the enterprise itself, is a particularly efficient mechanism for simultaneously promoting both the supply of and the demand for training. One possible form of action would be to establish a training fund which would grant subsidies on the basis of the amount which firms spent on training; in this case, the burden of financing could be shared between the public and private sectors, with public funds acting as the counterpart of the private contribution or providing the necessary seed capital,

which would then be replaced by private resources.

It would also be advisable for public subsidies to be differentiated on the basis of the expected social effectiveness of training activities. For example, more general training (rather than the specific training that the enterprise would in any case carry out) and the training of staff with a lower educational level should be subsidized more heavily. Other programmes which should be given greater incentives are those which envisage training that is passed on down to lower levels, including the training of staff to act as "potential instructors" who will then be responsible for passing on within the enterprise or plant the knowledge they have acquired. In addition, in order to reinforce the impact of financial incentives and subsidies, in special cases direct incentives might be considered, such as the creation of an ad hoc committee to promote training in enterprises, which would be responsible for identifying firms where there is room for improvement in this field and helping them to establish and implement internal training programmes.

b. *Promotional, information and awareness-building measures.* In order to speed up the dissemination among employers of more efficient practices in the fields of labour organization and human resources management, it is proposed that dissemination and information activities on these issues be

28 Most countries in Latin America and the Caribbean have introduced a compulsory tax, equivalent to 1%-2% of the firm's payroll, for financing public or semi-public vocational training institutions. Some countries (Brazil and Venezuela, for example) authorize firms that carry out their own training activities to deduct all or part of the cost from that tax payment, while some other countries (Chile is the most obvious case in the region, but Argentina and Brazil have similar, albeit less extensive schemes) allow firms to deduct training costs from the taxes due on their profits (Ducci, 1990).

29 In Chile, for example, in 1992 only 6% of the total number of firms made use of the tax exemption for training; although enterprises with more than 200 workers accounted for only 17% of these firms, they received almost 80% of the value of the subsidies granted (SENCE, 1993). Similarly, in Brazil, only 7% of enterprises opted in 1987 to reduce their compulsory contribution on the grounds of their direct training activities (ECLAC/OREALC, 1992; Ducci, 1990).

30 In Chile, for example, a growing number of enterprises have been making use of the system of tax exemption for training activities; the increase in the share of small enterprises in this total is particularly important: from 24% in 1978 to 58% in 1992 (SENCE, 1993).

carried out with a view to changing prevailing attitudes. Consideration might be given, for example, to the establishment of an "open school" for businessmen, with seminars in various cities, lectures by specialists, case illustrations, plant visits, etc.<sup>31</sup> Moreover, encouragement could be given to the establishment of centres which provide information and advice on the availability of courses, teaching materials, training techniques, etc. Since lack of training is not usually the only impediment to a firm's competitiveness, such centres might offer complementary services such as technological information, market studies, management techniques, and industrial extension services in general, in order to increase their attractiveness to the business world.

Conflictive labour relations limit both the desire of enterprises to train their employees and the desire of workers to take part in the corresponding programmes. An environment of mistrust and conflict leads the owner of an enterprise to limit training to what is strictly necessary to ensure the operation of the equipment, since he is afraid that better training for the workers will translate immediately into pressures for wage increases. The workers, for their part—since they do not feel involved in the fortunes of the enterprise—tend to see training simply as a means for the owner to increase productivity without giving them anything in return. It is common, in such cases, for the attitude of workers to training courses to be one of apathy.

Finding ways of promoting better labour relations within the firm is therefore a necessary step for encouraging a favourable attitude towards training on the part of both the trade unions and businessmen. The holding of seminars on this subject directed jointly at businessmen and trade union leaders, the dissemination of experiences in which good labour relations have played an important part in improving the

productive performance of specific firms, and increasing support for better training on the part of trade union leaders are measures which can help to promote relations directed towards cooperation rather than conflict within an enterprise. This would create a more propitious climate for increased training efforts and greater benefits from them.

ii) *Expanding the supply of training services and improving their quality*

The regional supply of training services is limited and comes, for the most part, from public or semi-public institutions financed by firms' compulsory contributions. At present, much of the activity of these institutions is geared to the initial training of young people for traditional occupations or to social fields such as rural training, assistance to small businesses, and training of traditionally neglected groups such as marginal urban workers and the self-employed. Moreover, with some exceptions, these institutions have proved to have only limited capacity for adapting to the demands of the modern production sector and their programmes have gradually become obsolescent; consequently, the services they offer attract little interest from enterprises. Public expenditure on such institutions accounted for somewhat less than 0.5% of GDP during the 1970s, but it decreased in the 1980s as public resources became more scarce and enrolment declined: in 1987, enrolment was estimated at only 2% of the region's labour force (ECLAC/UNESCO, 1992; Ducci, 1990).

The private supply of training services is even smaller and comes basically from suppliers of machinery. In addition, there are a number of consulting institutions which provide training services generally directed at administrators and managers, the supply of which has increased significantly in recent years. Lastly, there are a few training centres belonging to large enterprises or groups of enterprises

31 As we saw in the section on technological policies, among the measures which might be considered are visits to foreign plants using the best international practice.

which use them for the initial training and later upgrading of their employees.<sup>32</sup> The main feature of the training market in the region is therefore its lack of development and its distribution between relatively obsolete public institutions and a handful of private institutions. It is up to the authorities to design policies which will make it possible both to broaden the scope and improve the quality of this supply, to which end four lines of action are needed:

a. *Institutional development.* The promotion of such development involves abandoning the traditional methods, which give priority to the supply of these services by the public sector, in favour of another approach which seeks to concentrate public action in the areas where it is most needed (especially the training of traditionally neglected sectors such as own-account workers or workers in the informal urban sector), while at the same time encouraging private supply, which is more flexible and more closely linked to the needs of enterprises. This change of focus requires the establishment of new norms for the provision of training services and the regulation of the market. Some countries, for example, establish public monopolies for the supply of some services of this kind; others restrict or even prohibit apprenticeship contracts. These restrictions should be eliminated in line with the new requirements of entrepreneurial, production and labour sectors. As a complementary measure, adequate channels for the dissemination of information should be created, such as centres or networks for exchanges between enterprises, so that firms can share information on such services and their evaluation. As the training market develops, support can be given to the establishment of mechanisms for certifying the training given. For such certification to make an effective contribution to increased competitiveness

without hindering the flexibility needed to meet the changing needs of the productive environment, it is necessary to have the active participation of business and trade union associations.

b. *Improving the quality of the supply of public training services.* Although there are examples of public institutions in the region which carry out training tasks, in many cases it is essential to make their operations more flexible so as to bring them closer to enterprises and make them better able to meet the latter's needs. Some of these public institutions, for example, have already replaced long-term formal education by short in-plant courses; others have signed agreements with enterprises to provide training services better adapted to the enterprise's needs. In general, it would be desirable for these public institutions to develop two-pronged training procedures which would increase their links with enterprises and facilitate their graduates' subsequent access to the labour market. Encouragement should also be given to the provision of such services by other educational institutions, such as technical institutes and universities, which would then be able to improve their curriculum by gaining a better understanding of the problems of enterprises and supplementing the training they give with in-service training of their students in production plants.

c. *Making full use of training sources outside the enterprise,* such as suppliers of machinery and equipment, professional journals, visits to plants or the services of expatriates from the region who are performing highly skilled jobs in developed countries and can transfer their expertise during brief visits to their countries of origin.

d. *Promoting the development of purely private training facilities.* Three kinds of measures might be particularly useful for this purpose:

32 In Chile, the country in which the private supply is relatively most developed because of the impact of the existing tax incentives, there are no more than 520 of these institutions in the entire country (one for every 900 enterprises).

- i. In addition to the financial incentives to demand already referred to, incentives can be offered to encourage enterprises which have their own training centres to share them with other enterprises in the same sector, particularly their suppliers or subcontractors. This would give smaller enterprises access to training and strengthen coordination linkages between enterprises by making use of subcontracting networks as collective education mechanisms.
  - ii. Public training programmes, such as those directed towards marginal or neglected sectors, should consider inviting competitive bids for the provision of at least some of the services they offer.
  - iii. Consideration could be given to public support for the retraining of instructors and the modernization of the equipment of private training institutions, as there is often a significant gap in terms of modernity between their equipment and that of enterprises; this reduces the relevance of the training given and leads to concentration within the overall supply of training on administrative and sales areas, where the investment in equipment is much lower. To achieve this goal, tax legislation could be revised to encourage contributions from firms in the form of loans of equipment and materials and in-service training of instructors. An additional option would be to include private training institutes in public programmes of technological support.
  - iii) *The main prerequisite: improving the general educational level of the present and future labour force*
- It must be emphasized, once again, that any significant and lasting

improvement in the competitiveness and standard of living of the region is dependent on reform of the educational system aimed at improving its quality. A joint ECLAC/UNESCO document prepared in 1992 (see box VIII.3, which summarizes the document) notes that although the educational, training and science and technology systems of most countries of the region have expanded considerably in recent decades, they have obvious deficiencies as regards the quality of their results and the possibility of equal access to them by all levels of society.

Successful as they may be, educational reforms will only begin to have an effect on the labour force 15 or 20 years from now and will not solve the immediate problem of the inadequate basic education of almost half the present workforce of the region (see box VIII.4 on the educational level of the region's labour force). The fact that these workers do not have the minimum reading, writing and arithmetical skills needed in order to respond efficiently to the requirements of a modern production system that is increasingly integrated into the international economy reduces labour productivity and, ultimately, business competitiveness and increases the amount which firms must spend on initial training.

The above assertion is corroborated by the real situation of enterprises, according to the results of a survey of firms in the garment industry carried out in 1993 in some countries of the region. These results show that Mexican firms require an average of six weeks to train a newly hired machinist, as compared with only two weeks for Chilean firms; in other words, in order to make up for the lower average educational level of the population (six years in Mexico as compared with nine years in Chile), Mexican firms must spend three times more than Chilean firms on initial training, quite apart from the impact of the other factors that affect the amount that must be spent on initial training, such as the rate of staff

## Box VIII.3

**THE JOINT ECLAC/UNESCO PROPOSAL FOR REFORMING HUMAN RESOURCES  
TRAINING SYSTEMS IN THE REGION**

This proposal, made in 1992, notes that a quality educational system requires institutional reforms which will transform it into a participatory, flexible, open system integrated into its environment and helping to encourage the relevance and mutual enrichment of educational, training and research and development systems and of the production and social systems. The strategy proposes the adoption of new standards of equity, emphasizing real equality of opportunity and giving priority to the effectiveness and quality of educational practices and their results, allocating the best resources to the places of greatest need, and getting away from the traditional emphasis on quantitative indicators.

On this basis, policy measures in seven areas are identified. The first concerns institutional reform of the system of production and dissemination of knowledge, along two basic lines: i) a decentralized form of organization designed to increase the autonomy of educational establishments and thereby their flexibility in adapting to the changing needs of the environment in which they operate; and ii) a flexible regulatory framework that ensures the integration and coherence of the system, equitable access and certain minimum levels of efficiency by strengthening the governing bodies and establishing systems of accreditation and certification.

The next two areas relate to the results sought by this institutional liberalization. First, emphasis is placed on the importance of ensuring universal access by the population to the set of skills and knowledge which they need

in order to participate in public life and function productively in modern society. Such skills are the necessary basis for future learning in or out of school. One essential requisite for achieving universal access to them is to guarantee universal basic educational coverage, but it is just as vital, or even more so, to improve the *quality* of education. Second, international experience has shown that competitiveness is positively related to policies which promote innovation and dissemination of scientific and technological progress. In this respect, actions are proposed to increase the supply of technology, the demand for it from the production system and the linkages between the two.

The last four policy areas are of an instrumental nature. The best way to ensure the internal and external efficiency of a decentralized system is to establish an effective system of information and evaluation, since this enables users to demand higher quality, helps schools to improve their performance, and makes it easier for the authorities to concentrate their action where results are poorest and the equity of the system most needs strengthening. Emphasis is also placed on the urgent need to raise the professional level of teaching, through reform of the processes of recruitment, training and remuneration of teachers. Financing policies are then outlined to help bring together various sources of public and private funding, with selective mechanisms for allocating public resources in line with the objectives of increasing competitiveness and equity. Lastly, various areas of potential international and regional cooperation are identified.

Source: ECLAC/UNESCO Regional Education Office for Latin America and the Caribbean (OREALC), *Education and Knowledge: Basic Pillars of Changing Production Patterns with Social Equity* (LC/G.1702/Rev.2-P), Santiago, Chile, 1992. United Nations publication, Sales No. E.92.II.G.6.

turnover and wage levels (Guerguil, Macario and Peres, 1993).

In order to ensure that this large number of workers with incomplete primary education ceases to be a short-term obstacle to the productive modernization of the region, it is necessary to:

a. Increase general education opportunities for the adult population and make their access to such services more flexible. This calls for efforts to promote an awareness that such educational efforts are of benefit to both the enterprise and the worker and, where necessary, the amendment of labour legislation to

## Box VIII.4

## EDUCATIONAL LEVEL OF THE REGION'S LABOUR FORCE

Because of the considerable expansion of educational systems in the last 30 years, Latin America's economically active population now has an average of six years of schooling, but the impact of these quantitative advances has been sharply reduced by the low efficiency and high rates of repetition prevailing in basic education. The decrease in the proportion of the population without any education has probably been accompanied by an increase in the proportion whose primary education is incomplete, with a much smaller increase in the proportion with post-primary education. It is estimated that, at the beginning of the 1990s, at least 70 million people (40% of the economically active population of the region) have not completed their primary education and could be considered absolutely or functionally illiterate, while only 30% (slightly more than 50 million) have had some post-primary education.

The above data do not bear comparison with newly industrializing economies (NIEs) such as the Republic of Korea, where even in 1980 only 16% of the EAP had an educational level below that of primary schooling. Moreover, the present figure for Latin America is higher than

that for the South-East Asian countries as a whole (including relatively poor nations like the Philippines and Thailand), where the figure for workers without full primary education was 37% almost a decade and a half ago (1980).

It is estimated that the working-age population (WAP) of the region will exceed 350 million by the year 2000. Since the population now of school age will only represent a little more than a quarter of that total, even a rapid and spectacular increase in the coverage and quality of primary education in the current decade will have only a modest influence on the educational level of the WAP as a whole. For example, an increase of two years in the average educational level of the population leaving school during the 1990s would only result in an increase of 0.5 years in the average educational level of the WAP. Improvement of the *quality* of basic education would have a more visible, though still modest, effect: thus, if 80% of each age group completed primary education (as compared with only 60% at present), the proportion of the WAP without education or with incomplete primary education would still be over one-third of the total in the year 2000.

Source: ECLAC/UNESCO Regional Office for Education for Latin America and the Caribbean (OREALC), *Education and Knowledge: Basic Pillars of Changing Production Patterns with Social Equity* (LC/G.1702/Rev.2-P), Santiago, Chile, April 1992. United Nations publication, Sales No. E.92.II.G.6.

authorize the granting of unpaid leave for this purpose.

b. Incorporate basic education subjects, such as mathematics or writing skills, into the training activities of firms or suppliers of machinery. Although some firms have already found it necessary to carry out such activities, it is very unlikely that the practice will become widespread, because of the likelihood that the trained worker will leave the firm. To overcome this reluctance, it is suggested that tax incentives be offered to firms which incorporate general educational subjects into their training programmes. The authorities should also promote the

design of teaching materials and their dissemination in business circles.

It must nevertheless be clearly understood that training is not a panacea for problems of low labour productivity. Even with the efforts suggested, investment in training cannot compensate completely for deficiencies in the basic education of the workforce. Moreover, in order to make training more fruitful and make investing in it attractive, it is necessary to introduce substantial changes in the management styles prevailing in many firms in the region, where centralized management leaving little room for workers to contribute actively to

an increase in productive efficiency still predominates.<sup>33</sup> In these circumstances, it is understandable that owners of firms may fail to see training as a fundamental tool for increasing productivity.

Breaking this vicious circle, in which deficient management of the firm and mutual distrust between the workers and their employers act as disincentives to training and ultimately undermine labour relations, is the primary goal of the proposals made in this section.

### 3. Infrastructure development policies

It has been repeatedly stressed throughout this document that competition in foreign markets is not something that takes place simply among isolated companies. When companies compete, they are supported by an infrastructure in which the functioning of the energy supply, telecommunications, transport networks, ports and customs plays a prime role. The legal and institutional framework, the efficiency of the banking system and the prevailing business culture are also basic infrastructural elements. The concept of systemic competitiveness assumes special importance when it is understood how important it is for firms to be able to rely on an infrastructure that is equal to the challenges they have to face.

A survey based on interviews with businessmen in several countries of the region showed that manufacturing firms which export from countries where such support systems function reasonably well have a substantial competitive edge (Guerguil, Macario and Peres, 1993). On the other hand, there are countries where the difficulties encountered by firms when they try to send their merchandise abroad and therefore have to go through customs

are so serious that they are one of the main reasons why companies do not even try to export. Complicated customs procedures, corruption and the risk of theft are such formidable obstacles that beginners in the export business finally give up trying to overcome them. In other countries, deficient telecommunications and energy supply systems raise costs considerably because firms are forced to establish their own facilities for such services.

These differences are serious enough to alter the competitive conditions of businesses with otherwise similar productivity characteristics. Thus, for example, in two countries of the region of very different sizes, a survey was made of two companies which were similar as regards their products, size and quality levels and which had both made significant efforts to improve their internal organization and raise their productivity. However, the products of the company in the larger country faced competition in their own market from the products of the company in the smaller one. This difference in competitiveness did not originate in the companies themselves, but in the environment in which they operated. While the company in the smaller country operated within an environment which was relatively efficient for its needs, that in the larger country had to contend with arbitrary import and export formalities and absorb the costs of an inefficient transport system, customs delays and the large number of permits needed in order to operate. All this resulted in higher production costs which eventually cancelled out the initial similarities in physical productivity.

#### *a) Energy supply*

In some countries of the region, a stable energy supply is a priority target for

33 Firms that are successful at the global level usually have management styles which, by various means, stimulate active participation by workers in decisions relating to production processes. When they assume greater responsibilities, workers increase their commitment to the goals of the firm, and this is reflected in suggestions for innovations which can have positive effects on production and organizational procedures. In these enterprises, improving the skills of the workforce becomes a highly profitable investment.

enhancing companies' competitiveness. One of the prior conditions that must be met if a manufacturing firm is to be able to produce efficiently and if its products are to be competitive in international markets is that it should have an adequate, steady energy supply at reasonable cost. The long period of time needed for the installation and start-up of an adequate energy generation and distribution system clearly shows the systemic nature and public utility of such a system, as well as the various externalities it generates along the production chain.

In countries with an inadequate energy supply, a common complaint from businessmen is that the introduction of relatively sophisticated equipment results in energy shortages for the rest of their company's production processes. Moreover, energy supply restrictions are also an obstacle to plant modernization and the use of new technologies, as well as presenting a challenge to regional integration efforts (see box VIII.5).

#### *b) Telecommunications*

Properly functioning telecommunications are important for any productive activity, but they are absolutely crucial when a company is trying to penetrate export markets.

When companies have problems in communicating with their customers abroad or in receiving their orders, this often results in loss of markets even for products which are competitive at the international level or for companies which exploit rich, high-grade natural resources. Such problems usually force companies to spend large sums of money on acquiring a telecommunications system which operates properly. For example, Venezuelan businessmen have expressed their dissatisfaction with the inefficiency prevailing in telecommunication services there, despite rate increases in recent years which they would not mind paying if the services were satisfactory.

A detailed survey conducted in several countries, inside and outside Latin

America, showed a positive correlation between increases in telephone density and average investments in telecommunications, on the one hand, and indicators of competitiveness on the other (ECLAC, 1992a). According to the survey, telephone density is much lower in the countries of the region than in some countries in other areas where GDP has grown faster. This is especially true for the Republic of Korea, which at the end of the 1980s had a much higher telephone density indicator than the Latin American countries, although it had begun the decade with similar indicators. The survey in question concludes that it is imperative to establish an adequate telecommunications infrastructure and to encourage the broadest possible dissemination of information technologies in order to stimulate productivity increases in individual companies. Once again, the fact that these services are in the nature of a public good providing strong externalities clearly stands out, and that is precisely why the formulation of an adequate regulatory framework is needed when such services are privatized.

Likewise, it is essential to improve the telecommunications systems that support computer use, and especially electronic data exchange, at both the national and international levels. The strong shift in the region towards export-led growth makes it increasingly necessary to modernize these support systems for business management, which involves not only timely, informed decision-making but also new management techniques such as "just in time" delivery of materials and global sourcing, both of which depend on a continuous flow of "real time" data.

#### *c) Cargo transportation*

In recent years, cargo transport needs have grown sharply in the region, in terms both of frequency and of the average volume of shipments. At the same time, there have been changes in methods of transportation all over the world, and a growing proportion of cargo is being

## Box VIII.5

**MODERNIZATION AND RATIONALIZATION OF ELECTRIC POWER SERVICES  
IN CENTRAL AMERICA AND THE CARIBBEAN**

In the Dominican Republic, the Dominican Electricity Corporation (CDE) held a monopoly over electric power generation until 1990. While the company had a total installed generating capacity of 1,140 MW in that year, plant obsolescence and lack of maintenance, as well as inadequate price-fixing and revenue collection policies, prevented it from generating more than 590 MW. Because of these problems, the electric power supply was sometimes interrupted for more than 12 hours a day.

Electric power supply difficulties were a major problem for Dominican manufacturing companies, which were often compelled to install their own generating plants at an extremely high cost, both for individual companies and for the economy as a whole. In 1988, for example, the cost of power cuts in terms of loss of production was estimated at US\$ 180 million, the

equivalent of 3.3% of that year's GDP. CDE is currently engaged in a process of administrative restructuring and is making new investments with the support of the World Bank, in order to correct these problems and regularize energy supply.

The State electric power companies of all the Central American countries and Panama are currently looking into ways of linking up their national electric power systems. Such linkages would enable these countries to obtain electricity from a neighbouring country in the event of failure of their own supply, as has happened in the case of Argentina, Brazil and Paraguay, which share the hydroelectric power grid based on the Itaipu Dam. The project for Central America would cost US\$ 500 million and would be financed by the Inter-American Development Bank and the Governments of Spain and China.

Source: M. Peña, *Privatización de la Compañía Dominicana de Electricidad (CDE)*, Santo Domingo, 1991, and World Bank, *Dominican Republic: Issues and Options in the Energy Sector*, Report No. 8234-DO, Washington, D.C., 1991.

containerized. All these changes require large-scale port and road infrastructures, which likewise assume the character of public goods producing important externalities.

In most countries, the cargo transport infrastructure takes the form of links between major cities and the sources that supply domestic markets. Patterns developed in colonial times, when roads were built between ports and mining or agricultural areas, also persist. These ports, in turn, were designed chiefly for exporting traditional commodities and their installations are not always suitable for handling some of the new products which are emerging as a result of the diversification of the region's economies.

In Venezuela, for example, a survey of 40 companies which together represent about 43% of non-traditional exports revealed that low competitiveness was due mainly to transport problems

(Clemente, 1993). Similar observations are often made about Mexico's inefficient road transport system, which accounts for 75% of cargo traffic. Likewise, 45% of the companies surveyed in a study on the competitiveness of Brazilian industry were of the opinion that it was necessary to modernize the transport infrastructure, including roads, railways and port operations (MCT/FINEP/PADCT, 1993).

The inadequacy of the highway infrastructure of certain countries of the region results in traffic congestion problems, particularly in cities and near ports. Roads also deteriorate because they were designed years ago for trucks and buses that were smaller and lighter than those used today, and this deterioration is further accelerated by truck overloading made possible by inadequate or non-existent provisions for regulation and inspection.

As in other infrastructural areas, the region is still recovering from the drop in tax revenues earmarked for transport infrastructure in the 1980s. This reduction resulted in a lack of new investments, but its repercussions were even greater on the existing infrastructure, which suffered severe deterioration as a result of lack of maintenance. The resulting deficiencies continue to prevent the transport system from adequately meeting the demands made on it. In order to reverse this situation and ensure the rehabilitation and proper maintenance of the road system, several countries are awarding concessions to the private sector, where this is economically viable, in order to lighten the burden of this branch of the infrastructure on the public budget.

The discrepancies existing between countries or groups of countries with respect to the standards regulating truck weight and size represent an additional problem for international transport. In rail transport, there are gauge (track width) incompatibility problems at border crossings where the rail systems of Brazil and Uruguay, Guatemala and Mexico, and Brazil and Argentina meet, thus limiting the contribution that this means of transport could make to efficient international trade.

Some efforts can be made at the enterprise level, however, to use the existing transport infrastructure more efficiently. One option is to promote the consolidation of cargo among groups of companies in order to reduce transportation costs. In more general terms, it is essential to establish the legal and institutional frameworks needed to reap the considerable benefits of multimodal transport. These transport systems must not be geared only to the domestic market or to the export of traditional commodities, but must encourage competitiveness throughout the foreign trade sector.

Lastly, in addition to increasing investments in infrastructure, priority must be given to its efficient management. This involves implementing adequate toll

policies, which are a prerequisite not only for achieving greater efficiency but also for ensuring the sustainability of infrastructural investments over the long term (Winston, 1991).

#### *d) Ports*

Port management, port charges and loading and unloading facilities affect the final cost of exported goods and also compliance with delivery dates, all of which are clearly important for maintaining positions won in foreign markets.

Efficient port management requires reforms which involve the modification of labour, institutional and physical infrastructure variables. Labour reform means putting an end to the monopoly of cargo handling by dockers' unions as well as union workrolls which favour their own members. Institutional reform requires the establishment of a legislative framework which identifies and defines the rules for private sector participation in loading and unloading ships and in financing port investments. It is interesting to note that the market is already headed in this direction with the vertical integration of big national groups which are extending their operations from natural resources to transportation and finally also to port infrastructure, as is clearly seen in the production and marketing of soybeans and sunflower products in Argentina.

An example of the achievements which such changes can bring about is the case of Chile, where the 1981 port reforms enabled operations to increase from one and a half shifts approximately 300 days a year to three shifts 365 days of the year. This made possible not only the reduction of port operating costs, but also the postponement for ten years of fixed investment in port expansion which would otherwise have been necessary. In the case of fruit exports, it reduced the unit handling cost per crate from US\$ 0.54 to US\$ 0.26 and the turnaround time for ships from 129 to 40 hours. It has been estimated that these port reforms

permitted savings of US\$ 75 million a year (ECLAC, 1990a).

One case which is all too typical in the region is the situation in Mexican ports, where the problem has been so severe that companies located in Monterrey have often opted to send their exports to third countries via Houston because of the additional delays they would incur by sending them through the ports of Tampico or Altamira (*Latin American Regional Reports*, 1993). At the same time, a large proportion of imports from Asia are unloaded in United States ports and then transported to Mexico City overland rather than entering directly via the port of Manzanillo, because using Manzanillo would almost double both the cost and the time needed to receive the merchandise.

While Mexican customs administration has been simplified, thereby significantly reducing the time spent on the corresponding formalities, companies still experience difficulties in dispatching their exports through national ports because of obsolete port facilities. The decision to turn over the administration of several ports to the private sector and the outright privatization of some port facilities reflect the Mexican Government's determination to increase port management efficiency. It is also planned to make substantial investments for improving multimodal transport, so as to be able to combine container transport by truck, rail and ship.

The modernization prospects for Latin American port systems are generally encouraging. While modernization has been relatively slow because of the vast number of new rules which must be designed and implemented, some of the current changes aim to improve even on the conditions under which some ports operate in developed countries, especially with respect to collective bargaining, levels of decentralization, and customs procedures (Sgut, 1993).

#### e) Customs

Transit of goods through customs can be a serious hurdle for manufacturing

firms in some countries of the region, both for importing inputs and for exporting their products. These difficulties are particularly significant for small and medium-sized companies, and this in practice limits the benefits of trade liberalization.

Most customs authorities in the region follow procedures designed for a highly complex system of tariff and para-tariff protection designed to meet trade protection needs, and adapting these practices to a context of trade liberalization and internationalization has not been an easy task. The trade liberalization processes initiated in several countries have led to the modification of some customs procedures, but much remains to be done in order to bring customs operations in line with the new orientation of the region's economies. Indeed, there are some countries which have liberalized their trade but have not experienced any significant increase in their foreign trade. One of the reasons advanced for this is that serious impediments still exist in practice, since customs authorities still wield a good deal of discretionary power and their officials have too much leeway in the interpretation of existing regulations. In addition, the weakening of the public sector has prevented the necessary investments in infrastructure and in the training of customs officials, thus compounding the difficulties of enforcing the new regulations.

Modern customs authorities (such as those of the European Common Market) have changed their mode of operation so that there are now very few physical checks on traffic but there is more investigation of the tax, financial and accounting aspects of export and import operations. The most notable result of this trend has been the uninterrupted physical flow of goods, yet greater efficacy in curbing fraud. The almost complete elimination of direct contacts between customs officials and users has had the effect of inhibiting arbitrary actions and corruption.

f) *Conclusions*

It can be seen from the above that the disparity in the infrastructures available to companies in different countries of the region leads to differences in their levels of competitiveness. These differences affect companies' readiness to attempt to export their products, and sometimes they are even discouraged from importing inputs that would enable them to be competitive in the domestic market; these impediments are particularly severe for companies wishing to export manufactures, in which the region usually has less of a competitive edge than in products based on natural resources.

Some notable features of infrastructure as a determinant of company competitiveness may be identified:

i) Infrastructure supply is obviously a public asset because it generates strong externalities for productive activities as a whole. Because of the indivisible nature of the big investments it entails, this supply is characterized by conditions of increasing returns and monopolistic or heavily oligopolistic structures of ownership and control. This makes it imperative to formulate adequate regulatory frameworks that establish standards for disseminating the systemic effects deriving from tariff policy and infrastructure modernization.

ii) The need for increased investment in infrastructure, both to compensate for the sharp drop of the 1980s and to narrow the gap in per capita availability of services as compared with the developed countries and some newly industrialized countries, offers great opportunities for stimulating the domestic and intraregional supply of related engineering services. This would have a major spillover effect on the industries that produce inputs and capital goods for construction and heavy engineering.

#### 4. Industrial restructuring policies

The growth of a country's varied economic activities is never a homogeneous process; while some sectors are innovative and increase their efficiency, others exhibit less

dynamism or fall clearly behind. The term "restructuring" applies here only to situations where specific products or sectors have fallen behind. When the whole economy, or the whole industrial sector, has lost its competitiveness, it is likely that the problems are due to flaws in macroeconomic management (exchange-rate lag, high interest rates) or structural defects (insufficiently skilled labour, lack of complementary infrastructure), both of which require the adoption of global measures.

When a subsector of the economy falls behind or ceases to be competitive, this may be the result, among other factors, of sudden sharp reductions in the level of the subsector's relative effective protection; changes in key prices in the economy which erode the competitiveness of low-profitability subsectors; technological advances that render obsolete the production processes used or generate good substitutes for existing goods; the emergence of new competitor countries with comparative advantages in the sector (lower wages, cheaper raw materials); or the exhaustion of a natural resource on which a particular activity is based. The problems arising from these situations can be aggravated when companies react to them too late out of inertia or because they do not know what to do.

a) *Bases for a restructuring policy*

If markets functioned perfectly and factors were fully mobile, nothing would need to be done in this respect. Declining competitiveness would be simply an indication that, in the new situation, the old allocation of factors in the economy had ceased to be efficient and must therefore be modified. Since factors could move freely and instantaneously, there would be no adjustment cost.

In reality, however, there are many barriers to factor mobility, while the functioning of markets exhibits imperfections that justify State action in that field (Atiyas and others, 1992). These distortions include the many flaws in

factor markets, as well as the externalities already mentioned; the specific characteristics of the equipment and plant installed and the human resource capital acquired, which limit the free movement of factors; lack of coordination by companies in adjusting to the new requirements of the different sectors; the multiplicity of often conflicting interests involved in the restructuring process –of owners, managers, workers, consumers and even government– as a result of which the pressures of individual agents can seriously impede the adoption of what would be the most opportune measures from the social point of view.

Some of these distortions thwart the adoption of restructuring policies by companies, seriously reduce their chances of success or increase the costs of a sharp contraction of the sector. Consequently, unless measures are taken to confront these distortions, they may lead to a waste of important productive potential and to high social costs.<sup>34</sup>

b) *Elements for an industrial restructuring policy*

Aside from the trade and productive development policies examined, a subsectoral restructuring policy comprises two kinds of actions: i) measures to create an environment that would stimulate and facilitate the early adoption by firms of action to overcome their lagging competitiveness; and ii) targeted restructuring programmes.

i) *Creation of an environment conducive to restructuring.* In order to maintain and

increase the competitiveness of companies, it is necessary first of all to instil an attitude of foresight. To this end, it is of paramount importance, on the one hand, to send out clear signals that the authorities will not reward delays in making adjustments by adopting protectionist measures or awarding public subsidies and, on the other hand, to facilitate the necessary readaptation processes by taking steps to eliminate the above-mentioned obstacles and distortions that impede companies' restructuring efforts.

The first area of action is the dissemination of information on market behaviour, technological trends and, in general, the competitiveness of domestic producers. It must be reiterated that information is an asset which is subject to externalities and economies of scale, and it is therefore reasonable that the State should encourage its dissemination or provide this service directly. A technical unit could be created for this purpose to make periodic evaluations of the situation in the different branches of activity and of the global economic trends affecting them. The detection of problems or anomalies in an area should then be followed up quickly by detailed studies to identify the proper course of action. Such a unit would have to have the assistance of the private sector both for guiding its activities and helping to finance it.<sup>35</sup>

A second area of action involves elements that facilitate factor mobility, especially that of labour, given its obvious impact on social equity. This involves strong support for training, outside as well

34 The possibility that the lack of an appropriate restructuring policy may have high social costs is also a pragmatic argument in favour of government action to aid an efficient industrial restructuring process: when confronted with a sharp sectoral contraction, there is always the risk that the authorities may be subjected to such pressure that they have to resort to a "rescue" operation to keep a specific activity artificially afloat. This would result in a waste of resources that would postpone or put an end to firms' decisions to restructure, with the further drawback that it would create unjustified incentives for companies.

35 Another option is for the State to support the creation of private institutions which provide these services or the establishment of technical units based on business organizations. However, such options can leave smaller companies at a disadvantage and should therefore be considered as complementary, rather than as alternatives to a government service.

as inside the company, in order to sustain a process of continuous adaptation of the labour force to the changes which companies must make, as well as measures in the direction of the introduction of unemployment insurance schemes linked to manpower retraining programmes and the creation of institutions that provide timely information on employment supply and demand. Attention should also be given to management training, especially in areas related to aspects of the production process, such as inventory management, organizational change and quality control systems.

A third key element of restructuring is the need for flexible instruments, rapidly accessible to their beneficiaries, enabling companies to obtain qualified advisory services or to strengthen their own research and development units.

ii) *Targeted restructuring programmes.* In spite of the above measures, it is possible that the resources available through programmes to support competitiveness will be insufficient to resolve severe, concentrated crisis situations. The most dramatic cases, which for that very reason deserve special intervention, are those in which the activity is highly concentrated in geographical terms and directly or indirectly generates a large share of the jobs in a region. There is then a need to implement targeted restructuring programmes, but only as an exception and selectively, since otherwise there would be a danger of delaying the necessary adjustment and making it even more costly.

These programmes should give firms a chance to regain competitiveness in their subsector or to specialize in other areas of the same sector,<sup>36</sup> but should not be

confused with "rescue" programmes or serve to disguise indiscriminate transfers of public resources to the private sector. The existence of the necessary technical and supervisory capacity on the part of the public sector is consequently an essential condition for the implementation of such programmes, in order to ensure strict supervision to determine whether steps are being taken in the right direction. Without this capacity, the risk of failure is very high and it is very likely that the programme will have a higher social cost than not intervening at all.

The exact design of the programme should be based on a diagnostic study of the situation and of the problems of the sector concerned (see box VIII.6). Such a study must be a shared effort by the parties involved –the government, employers and workers– in order to avoid working at cross-purposes. The generation of a degree of consensus among workers and employers is essential in order to ensure the success of the initiatives undertaken.

Decisions concerning the action to be taken should come from the firms themselves, but can be facilitated by the measures contemplated in the restructuring programme. In this respect, the heart of the programme should be the concentrated application at the sectoral level of the development instruments already available (including training incentives, support for technological innovation, and the provision of market information), which can be adapted to meet more effectively the specific needs of the sector concerned.

Nevertheless, there may be two problem areas which require special measures. The first arises when it is

36 The irreversible loss of competitiveness of certain subsectors when they are the economic mainstay of a city or region is a separate case, of course. The management of such crises may require both the retraining of the workforce and its movement to other activities and regions, as well as transitory incentives for the installation of enterprises of other kinds in the region. The economic justification for such subsidies would be that they avoid the cost of creating additional infrastructure in other areas of the country, while taking advantage of the existing physical and human infrastructure in the area, the opportunity cost of which would be very low or nil.

## Box VIII.6

## SPAIN'S EXPERIENCE WITH INDUSTRIAL RESTRUCTURING

In 1981, Spain adopted an Industrial Restructuring Act in order to provide a framework for dealing with problems of excess production capacity and lack of international competitiveness in a number of industrial sectors in Spain.

The Act was inspired by two basic principles. First, the initiative and responsibility for restructuring rested with the private sector, and government intervention must be kept to the minimum. Second, the Government was not supporting individual firms but the restructuring programme as a whole. The Act also emphasized the need for a concerted effort by the Government, employers and trade unions.

The specific purposes of the programme were to reduce excess installed capacity and overmanning, put firms' finances on a sounder basis, and contribute to the implementation of an investment programme which would make it possible to modernize the sectors involved.

In addition, complementary measures were adopted to minimize the social costs of restructuring, especially those created by lay-offs. One of the most important initiatives was the establishment of emergency reindustrialization zones in the areas most

affected by restructuring processes. A series of incentives was created (tax reductions, subsidies and investment credits) in order to encourage firms to stay in those areas or move to them, and the Government provided funds to stimulate early retirement programmes and compensate those who had lost their employment. In the latter case, the unemployed workers were offered the opportunity to participate in a programme of retraining and assistance in finding new employment. Less than half the workers chose that option, however: the majority preferred to receive substantial severance payments.

An evaluation of the programme carried out in 1988 (López-Claros, 1988) showed that 77% of the 84,000 superfluous jobs had been eliminated and that 66% of the planned investments had been made. Mergers and specialization agreements had also been achieved in various sectors, supported by subsidized credits from the Government. Although the State had contributed a considerable amount of resources, improvements in the financial position of firms and faster growth of productivity were also evident. The weakest point of the programme was the unwillingness of redundant workers to look for new jobs, because of the generous benefits to which they were entitled.

Source: I. Atiyas and others, "Fundamental Issues and Policy Approaches to Industrial Restructuring", *Industry Series Paper*, No. 56, Washington, D.C., World Bank, April 1992.

necessary to adjust installed sectoral capacity. It is very difficult for an efficient adjustment of this nature to be made independently, because each firm hopes that it will be others that abandon the market or decrease their production. Outside intervention to encourage the merging of firms or the closure of less efficient companies would provide a better outcome than the market solution. Experience shows, however, that if some firms remain outside the agreement reached and there is no effective system of

incentives and penalties, the desired result may not be achieved.

The other problem area is access to financing for firms that are in the process of restructuring. If a given sector has problems of profitability, it is unlikely that financial institutions will be able to distinguish between firms with good prospects and those with little chance of success, since this would require very specialized technical capacity and the supervisory work required would be very costly. Instead of providing funds directly,

the State might help to reduce the costs involved for credit institutions by promoting the establishment of specialized consulting firms to provide evaluation services to banks or, if there was a general feeling that this would be effective, directly subsidizing the financial institutions dealing with these cases. This would facilitate access to credit without generating the traditional problems of supervision or implicit guarantees normally involved in the provision of public funds.

#### **5. Macroeconomic preconditions for a policy of productive development**

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High inflation causes firms to take a very short-term view, so that restructuring considerations are subordinated to more immediate needs, which—in the case of high inflation—often go no further than how to survive the next 30 days. It is no accident that in such circumstances the strategic decisions and investments required to achieve international competitiveness are postponed, no matter how favourable the relative prices for carrying out such restructuring may be. Moreover, given the uncertainty and instability characteristic of situations of high inflation, the response of firms to the micro and meso-economic policies that are implemented, as well as to current relative prices, becomes inelastic. However, this problem has been solved in most of the countries thanks to their successful stabilization efforts. Consequently, other macroeconomic factors take on greater importance.

In the external accounts, macro-economic imbalances are also associated with big fluctuations in the terms of trade, international interest rates or capital inflows, which give rise to sudden and unstable adjustments in aggregate demand and rates of exchange. This hinders exports and the efficient production of import substitutes (whose expansion is more sensitive to long-term

signals), while stimulating imports. Consequently, the greater the instability of trade accounts, current account balances or capital accounts, the lesser the credibility of the incentives in effect at a given moment and the greater, therefore, the incentives needed to achieve the desired response from economic agents, while there is a even bigger danger of falling into the trap of a costly “over-adjustment” such as occurred, for these reasons, in almost the whole of the region during the 1980s.

Macroeconomic instability is also reflected in an imbalance between aggregate demand and productive capacity. Such instability obviously leads to a sub-optimum rate of average use of that productive capacity, and its consequences are an actual productivity level lower than the potential level, as well as lower rates of profitability, which consequently discourage capital formation. In addition, the instability of aggregate demand and relative prices tends to discourage firms from making innovations that could increase their productivity.

The micro-economic consequences of macroeconomic imbalances are the reduction or postponement of investments designed to modernize equipment and processes, as well as of innovation efforts. Thus, for example, when they have a large part of their installed capacity idle and shorten their planning cycles, firms tend to give priority to activities with very short-term returns, to the serious detriment of expenditures on investment and development. One very damaging effect of reductions in these expenditures is the frequent dismantling of entire engineering departments or the loss of critical masses of work on innovation, adaptation, design and development, with the consequent loss of know-how and technological capacity acquired at such a high cost during the substitution industrialization stage. Moreover, this attention to the short term even affects efforts to find new methods and processes, above all if these

involve expensive visits abroad. Finally, as Brazil's recent experience shows (see box VIII.1), although macroeconomic instability does not completely delay all innovation efforts, the shortage of resources and the uncertainty which necessarily accompany it lead to an emphasis on "soft technologies", whose

full potential can only be realized by complementary investments in modern equipment, processes and plants ("hard technologies").

The subject of macroeconomic policies, particularly as they relate to capital movements and the stability of key prices such as exchange rates, is taken up in part three.

**Part Three**

**MACROECONOMIC STABILITY AND  
INTERNATIONAL FINANCIAL FLOWS**

## Chapter IX

# INTERNATIONAL FINANCIAL FLOWS IN LATIN AMERICA AND THE CARIBBEAN

### 1. Background

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Since the beginning of the 1990s, the countries of Latin America and the Caribbean have received large net amounts of external capital. During the period 1992-1993, the flow of capital towards the region reached an annual average of US\$ 63 billion. Inflows were also substantial in 1994, until the extremely sharp devaluation put into effect in Mexico in December of that year (see table IX.1).

This extremely heavy capital flow represents an abrupt turnaround from the equally noteworthy restriction in the matter of external finance which the region had to face during practically the whole of the 1980s as a result of the external debt crisis. This turnaround was of dramatic scale: between 1983 and 1989 the net entry of capital, on average, was only US\$ 8 billion a year (see table IX.1). The recovery, too, was of a surprising magnitude: the net entry of capital in 1992-1994 was 50% higher than the previous peak, recorded in 1981 –the last year before the debt crisis

exploded, with the consequent collapse of financial flows. As a proportion of the GDP of Latin America and the Caribbean, the net entry of capital represented 5.2% in 1992-1993,<sup>1</sup> as compared with a coefficient of 4.5% in 1977-1981 (see table IX.2) and of only 1.2% in 1983-1989.

Because of this abundant flow of capital, combined with lower interest payments on the external debt, the region registered a net positive transfer of resources for the first time since the beginning of the crisis. Thus, in 1991 the transfer became positive again, with a value of US\$ 7 billion, while for 1992-1993 it rose to an average of US\$ 31 billion. In terms of regional GDP, the positive transfer in these last two years amounted to 2.6%, compared with an average negative figure of 3.7% of the regional product in 1983-1989 (see table IX.3).

Nearly all the Latin American and the Caribbean countries benefited in the 1990s from this spectacular expansion of capital inflows. However, in some of them the turnaround was especially marked. The most noteworthy case was that of Mexico: while it generated a quarter of the output

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1 The coefficient for 1992-1993 was calculated, for purposes of converting each country's GDP into dollars, on the basis of the real exchange rate for 1990-1991, as shown in table IX.2. The coefficient for 1992-1993 turns out to be 4.9% if calculations are based on the nominal exchange rate corresponding to the real average rate for 1990-1994.

Table IX.1  
**LATIN AMERICA AND THE CARIBBEAN: NET CAPITAL MOVEMENTS<sup>a</sup>**  
*(Millions of dollars per year)*

	1950- 1965	1966- 1973	1974- 1976	1977- 1981	(1981)	1982	1983- 1989	1990	1991	1992	1993	1994 <sup>b</sup>
<b>Latin America and the Caribbean (19)</b>	<b>814</b>	<b>4,042</b>	<b>14,956</b>	<b>28,861</b>	<b>39,804</b>	<b>20,133</b>	<b>8,154</b>	<b>17,975</b>	<b>37,211</b>	<b>61,682</b>	<b>65,088</b>	<b>56,65</b>
<b>Oil-exporting countries (6)</b>	<b>274</b>	<b>1,601</b>	<b>5,449</b>	<b>12,297</b>	<b>17,632</b>	<b>3,835</b>	<b>533</b>	<b>7,965</b>	<b>25,833</b>	<b>33,171</b>	<b>37,991</b>	<b>25,420</b>
Bolivia	26	23	72	253	493	230	378	355	444	780	823	575
Colombia	34	289	338	956	1,941	2,182	879	53	-527	167	2,213	3,075
Ecuador	11	105	165	705	653	863	503	549	741	1,325	962	800
Mexico	192	924	3,425	8,154	17,393	2,806	-662	10,716	21,882	26,664	29,531	19,500
Peru	61	149	1,054	778	1,200	1,692	1,046	1,653	2,837	2,711	2,662	5,975
Venezuela	-51	110	394	1,451	-4,048	-3,938	-1,612	-5,361	456	2,717	1,800	-4,505
<b>Non-oil-exporting countries</b>	<b>539</b>	<b>2,442</b>	<b>9,507</b>	<b>16,564</b>	<b>22,172</b>	<b>16,298</b>	<b>7,622</b>	<b>10,010</b>	<b>11,378</b>	<b>28,511</b>	<b>27,097</b>	<b>31,145</b>
<b>South America (5)</b>	<b>438</b>	<b>2,025</b>	<b>7,828</b>	<b>14,664</b>	<b>19,757</b>	<b>13,974</b>	<b>5,308</b>	<b>7,513</b>	<b>7,362</b>	<b>24,259</b>	<b>23,322</b>	<b>28,335</b>
Argentina	108	92	142	1,895	1,519	1,684	1,757	-1,173	3,301	11,213	10,047	10,500
Brazil	210	1,727	7,244	9,329	12,382	11,113	1,991	5,054	1,640	8,802	9,041	13,060
Chile	87	169	207	2,627	4,942	1,033	1,260	3,075	1,404	3,487	2,838	3,145
Paraguay	7	29	106	339	420	316	198	438	873	519	774	1,040
Uruguay	24	8	129	473	494	-172	103	119	144	238	622	590
<b>Central America and Hispaniola (8)</b>	<b>102</b>	<b>417</b>	<b>1,322</b>	<b>1,900</b>	<b>2,415</b>	<b>2,324</b>	<b>2,313</b>	<b>2,497</b>	<b>4,016</b>	<b>4,252</b>	<b>3,775</b>	<b>2 810</b>
Costa Rica	17	83	232	455	360	398	437	364	515	587	518	295
El Salvador	3	19	114	68	224	210	297	535	299	482	495	450
Guatemala	21	44	186	184	273	361	361	205	740	738	879	510
Haiti	8	15	106	111	185	141	172	179	154	76	35	85
Honduras	8	35	146	219	250	174	303	307	400	371	335	350
Nicaragua	10	57	175	225	735	593	755	467	935	1,096	771	900
Panama	31	71	206	235	-50	136	-285	369	516	398	250	300
Dominican Republic	4	91	157	402	438	311	275	72	457	504	522	-80
<b>English-speaking Caribbean</b>	<b>68</b>	<b>292</b>	<b>357</b>	<b>576</b>	<b>710</b>	<b>974</b>	<b>270</b>	<b>200</b>	<b>50</b>	<b>...</b>	<b>...</b>	<b>...</b>
Barbados	4	36	49	66	134	44	1	-13	-9	...	...	...
Guyana	3	22	60	76	148	139	54	...	...	...	...	...
Jamaica	25	139	174	79	122	302	323	550	192	...	...	...
Suriname	17	28	58	83	136	111	-30	10	...	...	...	...
Trinidad and Tobago	18	66	15	271	171	379	-78	-347	-133	...	...	...

Source: ECLAC, on the basis of official figures.

<sup>a</sup> Includes long- and short-term capital, unrequited official transfers, and errors and omissions. <sup>b</sup> Preliminary figures, projected on data covering the period up to October, approximately.

Table IX.2  
**LATIN AMERICA AND THE CARIBBEAN: NET CAPITAL MOVEMENTS  
 AS A SHARE OF GDP<sup>a</sup>**  
*(Percentages of gross domestic product)*

	1950- 1965	1966- 1973	1974- 1976	1977- 1981	(1981)	1982	1983- 1989	1990- 1991	1992- 1993
<b>Latin America and the Caribbean (19)</b>	<b>1.2</b>	<b>2.8</b>	<b>4.2</b>	<b>4.5</b>	<b>4.6</b>	<b>2.8</b>	<b>1.2</b>	<b>2.5</b>	<b>5.2</b>
<b>Oil-exporting countries</b>	<b>1.0</b>	<b>2.5</b>	<b>3.7</b>	<b>4.6</b>	<b>4.3</b>	<b>1.2</b>	<b>0.2</b>	<b>4.0</b>	<b>7.7</b>
Bolivia	3.9	2.4	2.9	7.1	13.1	8.8	6.0	8.5	15.2
Colombia	0.8	4.0	2.4	3.4	5.4	5.4	2.3	0.1	2.4
Ecuador	1.3	6.1	3.6	7.3	4.9	6.8	4.7	6.0	4.5
Mexico	1.7	2.6	4.2	5.1	6.5	1.7	-0.4	6.1	9.6
Peru	2.4	2.1	7.6	4.5	4.9	6.7	4.2	5.8	6.5
Venezuela	-0.8	0.9	1.0	2.9	-6.1	-5.8	-3.0	-5.0	3.7
<b>Non-oil-exporting countries</b>	<b>1.3</b>	<b>3.0</b>	<b>4.6</b>	<b>4.5</b>	<b>4.8</b>	<b>4.0</b>	<b>1.9</b>	<b>1.6</b>	<b>3.6</b>
<b>South America</b>	<b>1.0</b>	<b>2.5</b>	<b>4.1</b>	<b>4.1</b>	<b>4.4</b>	<b>3.5</b>	<b>1.4</b>	<b>1.2</b>	<b>3.4</b>
Argentina	0.7	0.4	0.4	2.0	1.3	2.5	2.5	0.6	5.2
Brazil	1.0	3.6	5.5	4.1	4.4	3.8	0.7	0.8	2.0
Chile	2.0	2.0	2.3	12.7	16.2	4.3	6.5	7.2	8.2
Paraguay	2.7	4.5	6.8	10.2	8.5	6.2	5.4	10.2	9.2
Uruguay	2.1	0.4	3.6	6.2	4.3	-1.6	1.7	1.4	4.0
<b>Central America and Hispaniola</b>	<b>4.8</b>	<b>8.7</b>	<b>10.5</b>	<b>9.2</b>	<b>10.3</b>	<b>10.6</b>	<b>7.6</b>	<b>6.6</b>	<b>7.2</b>
Costa Rica	4.0	9.0	11.8	12.7	13.3	16.1	10.3	7.6	8.2
El Salvador	0.5	1.8	6.4	2.1	6.5	5.8	6.2	7.3	7.1
Guatemala	2.2	2.4	4.7	2.7	3.2	4.1	4.6	5.2	8.0
Haiti	...	4.4	21.6	13.5	20.3	15.0	14.1	10.1	3.6
Honduras	2.3	5.1	12.3	9.7	8.8	6.0	8.1	12.0	10.4
Nicaragua	5.8	7.2	11.3	11.0	29.7	21.2	34.4	7.0	9.0
Panama	7.7	6.9	11.4	8.0	-1.3	3.2	-6.0	8.2	5.0
Dominican Republic	0.6	6.0	4.8	7.8	7.7	5.7	5.3	3.0	5.1

Source: ECLAC, on the basis of official figures.

<sup>a</sup> Estimates of GDP in current dollars for the period 1950-1990 were calculated on the basis of GDP data expressed in local currencies and the exchange rate for exports of goods and services which is implicit in the balance-of-payment series published by the International Monetary Fund (IMF); estimates for the period 1990-1993 were calculated using a nominal exchange rate based on the assumption of a constant real exchange rate for the 1990-1991 biennium.

Table IX.3  
**LATIN AMERICA AND THE CARIBBEAN: NET RESOURCE TRANSFERS<sup>a</sup>**  
*(Percentages of gross domestic product)<sup>b</sup>*

	1950- 1965	1966- 1973	1974- 1976	1977- 1981	(1981)	1982	1983- 1989	1990- 1991	1992- 1993
<b>Latin America and the Caribbean (18)</b>	<b>-0.6</b>	<b>0.7</b>	<b>2.4</b>	<b>1.9</b>	<b>1.1</b>	<b>-2.5</b>	<b>-3.7</b>	<b>-0.4</b>	<b>2.6</b>
<b>Oil-exporting countries</b>	<b>-2.2</b>	<b>-0.1</b>	<b>1.8</b>	<b>1.9</b>	<b>1.1</b>	<b>-4.3</b>	<b>-4.7</b>	<b>0.9</b>	<b>4.3</b>
Bolivia	3.7	0.3	2.0	1.8	3.5	-7.0	0.9	3.3	11.5
Colombia	-0.2	0.8	0.0	1.6	4.0	3.0	-2.2	-5.5	-1.3
Ecuador	-0.9	3.4	0.5	3.2	-0.2	0.3	-4.1	-3.4	-2.1
Mexico	0.2	0.9	2.0	1.6	2.4	-5.9	-5.6	3.2	6.0
Peru	0.7	0.1	5.7	-0.0	0.7	2.6	-0.4	3.2	4.2
Venezuela	-9.5	-4.5	0.6	3.3	-5.2	-8.0	-6.7	-6.3	0.8
<b>Non-oil-exporting countries</b>	<b>0.4</b>	<b>1.3</b>	<b>2.8</b>	<b>1.9</b>	<b>1.2</b>	<b>-1.2</b>	<b>-3.0</b>	<b>-1.2</b>	<b>1.5</b>
<b>South America</b>	<b>0.4</b>	<b>1.2</b>	<b>2.6</b>	<b>1.7</b>	<b>1.0</b>	<b>-1.6</b>	<b>-3.5</b>	<b>-1.5</b>	<b>1.3</b>
Argentina	0.4	-0.7	-0.6	0.4	-1.9	-4.4	-5.1	-2.1	3.6
Brazil	0.2	2.5	4.0	1.4	0.7	-0.8	-3.3	-1.7	-0.0
Chile	0.3	-0.1	-0.9	8.9	11.4	-3.7	-3.3	1.5	3.8
Paraguay	2.2	2.9	5.0	9.0	8.1	6.7	2.8	9.5	7.8
Uruguay	1.5	-0.7	1.9	5.2	3.6	-3.4	-3.5	-1.6	2.5
<b>Central America and Hispaniola</b>	<b>0.8</b>	<b>2.6</b>	<b>5.0</b>	<b>4.0</b>	<b>5.2</b>	<b>3.8</b>	<b>4.3</b>	<b>3.5</b>	<b>4.3</b>
Costa Rica	1.9	6.8	9.0	7.9	2.0	1.1	2.8	3.9	5.3
El Salvador	-0.1	0.8	4.7	-0.0	3.5	3.1	3.7	5.1	5.4
Guatemala	1.9	0.5	3.3	2.0	2.0	2.7	2.3	3.3	6.6
Haiti	...	0.8	5.7	13.5	23.9	22.6	12.4	8.5	3.0
Honduras	0.3	1.8	9.6	4.7	3.4	-1.0	2.4	2.7	1.0
Nicaragua	2.8	3.7	7.6	5.8	22.5	14.6	24.2	4.1	4.5
Dominican Republic	-1.2	3.9	1.8	4.0	2.8	1.0	0.3	0.9	2.8

Source: ECLAC, "Postwar Transfer of Resources Abroad by Latin America", Cuadernos de la CEPAL, series No. 67 (LC/G.1657-P), Santiago, Chile, 1992. United Nations publication, Sales No. E.91.II.G.9.

<sup>a</sup> Net resource transfers are equivalent to net capital inflows (unrequited official transfers, short- and long-term capital, and errors and omissions) less net profits and interest, which includes both interest payments actually made and interest due but not paid. Negative figures indicate a transfer of resources out of the region. <sup>b</sup> Estimates of GDP in current dollars for the period 1950-1990 were calculated on the basis of GDP data expressed in local currencies and the exchange rate for exports of goods and services which is implicit in the balance-of-payment series published by the International Monetary Fund (IMF); estimates for the period 1990-1993 were calculated using a nominal exchange rate based on the assumption of a constant real exchange rate for the 1990-1991 biennium.

of Latin America and the Caribbean, it absorbed one half of the capital movements directed towards the region in 1991-1993. As a result, the annual average flow of capital into Mexico rose from a negative balance of US\$ 700 million between 1983 and 1989 to a positive inflow of US\$ 26 billion in 1991-1993. The flow ebbed somewhat in 1994, dropping off to one third of the region's capital inflows for that year. Even so, when expressed as a percentage of GDP, the annual flow jumped from a negative balance of 0.4% to a positive level of over 9% between 1983-1989 and 1992-1993. Argentina has also been a very important recipient of capital: between the two periods, its average flow as a proportion of GDP increased from 2.5% to 5.2%. Brazil, Chile, Costa Rica, Peru, Guatemala and Venezuela have also received exceptionally large capital inflows in the 1990s (see tables IX.1 and IX.2).<sup>2</sup>

## 2. The new capital movements in historical perspective

### a) *The tight financial situation of the 1950s*

In the first decade after the war, Latin America faced persistent financial constraints. In fact, between 1950 and 1965 the annual average inflows of external resources received by the region barely represented 1% of its GDP: not enough to compensate for the outflows in the form of profits and interest on external capital. As a result the net transfer of resources to the

region was negative in this period (see table IX.3).<sup>3</sup> It is interesting to note, however, that in this time of moderate financial constraints, the countries of the region attained fairly acceptable rates of growth of GDP, of the order of 5.5% a year.<sup>4</sup>

This financial situation was due largely to external factors. Among these it is noteworthy that in the 1950s the capital markets of the northern hemisphere were oriented mainly towards domestic financing (Hayes, 1977), due partly to the fact that investors recalled the non-compliance with many international obligations during the period between the two wars, some of it attributable to Latin America (ECLAC, 1964). Moreover, controls had been established over the movement of capital by the industrialized countries, which were still in the process of economic reconstruction. At that time, most of the external financing came from foreign direct investment (FDI) (equivalent to 60% of the total net flow of capital) and from medium- and long-term loans awarded initially by suppliers or their Governments and, from the 1960s onwards, by multilateral financial agencies. Private financing was generally limited to the short term and to specific projects with State guarantees.

### b) *An expansionary financial cycle: from the mid-1960s to the early 1980s*

In the mid-1960s the capital accounts of the Latin American and

- 2 The countries of Central America and the Caribbean showed the most modest growth in average capital flows between 1983-1989 and 1990-1992 (table IX.1). This was partly because this subregion was not faced in the 1980s with such a sharp contraction in the flow as that observed in most Latin American countries; in its turn, this reflects the fact that the economies of Central America and the Caribbean have relatively greater access to official loans and donations, which usually represent a relatively stable source of external financing. This subregion also benefits from quasi-capital flows in the form of transfers by nationals working abroad, primarily in the United States.
- 3 During this period Venezuela recorded large net outflows of capital and profits. Excluding Venezuela, the entry of capital and transfer of resources from the countries of the region were equivalent to 1.4% and 0.4% of GDP, respectively.
- 4 For a more detailed analysis of this period, see Ffrench-Davis, Muñoz and Palma (1994).

Caribbean economies began to be more dynamic owing, to a large extent, to new events in the international economy. Thus, there now began a broad, expansionary phase of external financing, within an equally expansionary international financial cycle, which was to extend up to the debt crisis of 1982. The increase in the external financial flows received by the economies of the region was as significant as it was widespread: already in the early 1970s the capital flows represented, on average, 3% of regional GDP. This expansion was further intensified in the second half of the 1970s and the early 1980s, when flows reached 4% to 5% of GDP (see table IX.2).

This large increase in capital inflows was due mainly to external factors. In fact, the very development of the industrialized countries' banking sector exerted a decisive influence. Firstly, we must mention the general change that occurred in banking circles in the 1950s: a period in which a "new" banker appeared, less marked by the financial crises of the 1930s. This, together with the excess liquidity in the financial markets of the industrialized countries and the decline in the participation of the banks in those markets, meant that banking executives were more and more ready to apply an expansionary strategy to place their available funds (Hayes, 1977). Initially, their field of action was limited to domestic markets, but during the 1970s this expansionary strategy began to be extended to the international level.

During the major part of the 1960s the banks concentrated their expansionary forces on the markets of the OECD countries which enjoyed greater solvency; however, the intense

competition in those markets and the resulting reduction in the margins of intermediation, together with the marked recessionary trend which affected the OECD economies in 1969-1970, induced the bankers to explore new markets in the developing countries.<sup>5</sup>

While in the period 1966-1981 the private international banks were undoubtedly the main driving force behind the dynamic supply of external financing to the region, there were other factors which also helped to feed this huge flow of external capital. The oil crises of 1973-1974 and 1979-1980 gave a strong impetus to this capital movement. On the one hand, a strong demand arose in connection with the current-account financing of the oil-importing countries; on the other, there was an increase in the apparent creditworthiness of the oil-exporting countries, which became a preferred objective in the internationalization strategy of the private banks. Similarly, the great influx of "petrodollar" deposits into the international banking system accelerated the expansion of their loans. The governmental policies of the OECD countries also helped to swell the flow of resources, given the existence of negative real domestic interest rates<sup>6</sup> and the bank regulations in force, which became more lax in the early 1970s. The Latin American countries, for their part, displayed passive receptiveness in the face of an aggressive supply.<sup>7</sup>

It is worth recalling that there was a great deal of optimism about the boom in bank loans. Bankers, international organizations and many analysts applauded without reservations the abundant flows from the banks, and many countries thought that they had

5 For a more detailed analysis of the factors which contributed to the banks' expansion, see Devlin (1989).

6 The negative real interest rates led many analysts, including certain international bodies, to think that external indebtedness was "good business" for the developing countries.

7 The only exception was Colombia, which distinguished itself by the caution with which it managed the supply of loans from the international financial markets (Junguito and Perry, 1983).

finally been freed from the paternalism of official financing.<sup>8</sup>

The expansionary phase of the credit cycle continued almost without interruption between 1966 and 1981. However, there was a brief crisis in mid-1974, which illustrated the fragility of the financial systems and showed how international financial cycles can have a life of their own. At this time a small German bank, Herrstatt, failed after incurring losses through speculation on the European exchange markets. Although this failure was in no way linked to Latin America, it had important consequences for the region, for as a result of the panic set off in banking circles, towards the end of 1974 the flow of loans to Latin America was paralysed, their cost went up drastically, and repayment terms were notably reduced, all of which made the servicing of the debt and the macroeconomic management of the countries of the region more difficult. The market settled down again in the second quarter of 1975, bringing with it a renewed flow of bank loans to the region.<sup>9</sup>

Another result of the expansion of bank lending was the heavy accumulation of liabilities with variable interest rates. At the beginning of the 1980s Latin America's external debt already exceeded US\$ 300 billion, of which over three-quarters corresponded to private bank loans. At that date, the total value of the regional debt exceeded the critical level of solvency of 200% of export earnings, and its servicing absorbed one-third of exports, while interest payments on the external public debt represented between 10% and 25% of tax revenue (Altimir and Devlin, 1994). Furthermore, the banks' enthusiasm for issuing loans led them to take excessive risks: thus, at the beginning of the 1980s the nine biggest United States

banks had accumulated loan exposure in Latin America equivalent to nearly 200% of their capital (ECLAC, 1990b). In short, the permissiveness then reigning in the unregulated international capital market and the adoption of frankly pro-cyclical public policies with respect to taking advantage of the great capital supply placed the region in a position of vulnerability which created favourable conditions for a crisis.

### c) *The financial constraints of the 1980s*

As is well known, the debt crisis began in August 1982 when Mexico declared that it could not continue to service its bank debt, the second biggest in the developing world. In the months following Mexico's failure to pay, the negative externalities that usually occur in the midst of a financial crisis were exacerbated by the banks' panic, which led them to almost completely cut off new loans to the Latin American countries, including countries like Colombia that had been very cautious in the management of their capital inflows. As loans were not renewed, this meant that the countries of the region, except Colombia, found themselves in a situation of *de facto* non-compliance with their debt service commitments to the banks. *De jure* non-compliance was avoided only thanks to a rescue operation agreed by the creditors, which enabled the countries to formally meet their obligations (ECLAC, 1984a).

While this rescue operation avoided formal non-compliance, it had an enormous social cost for the region, because an integral part of the rescue was the requirement that the countries should adjust their economies, generally within the framework of a programme

8 So great was the faith in market criteria that some even thought that the International Monetary Fund had become redundant as far as regulation of the macroeconomic policies of the developing countries was concerned (Morgan Guaranty Trust, 1976).

9 Portfolio investment, for its part, continued to represent only a small fraction of the total external resources available, while the share of foreign direct investment shrank to less than one-fifth of total net financing.

agreed with the IMF, the objective being to generate a trade surplus large enough to enable them to service the bulk of the interest due on the commercial bank debt.

In this context, the negative transfer of resources from Latin America (i.e., from the region to the rest of the world) reached a level without precedent. Between 1982 and 1986, it was equal to 4% of the region's GDP: an even bigger proportion than Germany had had to pay after the First World War as reparations to the Allies (ECLAC, 1991b). Because of the size of this transfer and the very short term over which it had to be paid, it was clear that it could only be achieved at the cost of a spectacular reduction in imports (40%) and a sharp economic recession in the region (see ECLAC, 1984a and chapter XI).

The heavy capital flight by residents of Latin America and the Caribbean also fuelled the crisis and aggravated the problem of the transfer of resources abroad. This phenomenon was reflected, in part, in the negative balances recorded under the entries "Errors and omissions" and "Short-term capital" in the capital accounts of the region during the first half of the 1980s. Using a fairly common methodology, the World Bank (1993b) has determined that capital flight reached a very significant order of magnitude in 1980-1983: about US\$ 90 billion.<sup>10</sup>

It must also be remembered that, at this time, there were high rates of interest on deposits in international markets, a fact which gave even more impetus to the flight. Before the crisis broke out, capital flight was concentrated in Mexico, Trinidad and Tobago, Argentina and some Central American countries. This reflects the fact that in these countries national agents anticipated the beginning of the crisis.<sup>11</sup> After 1982, however, the flight

became widespread and was related to the existence of uncertainty and to the recessionary adjustment that the debtor countries had to make, under strong pressure from their creditors. As indicated below, although the capital of domestic agents was the first to flee, it was apparently also among the first to come back in the 1990s.

The high cost of Latin America's debt crisis may have been partly the result of the type of capital received by the region from the 1970s onward, for the artificial rescue of the value of the loans, through reprogramming of payments of principal and the granting of new "involuntary" loans by the banks in the 1980s, was not subject to any direct market valuation,<sup>12</sup> so that it was easier for the banks to insist that the nominal value of the debt must be respected. Unlike the portfolio investors of the 1930s, the banks could isolate themselves from market forces, which probably would have forced the bank creditors to accept immediate and substantial losses on their loans.

Indebtedness with the banks had two other characteristics which heightened the impact of the crisis in Latin America. Firstly, by contrast with the atomized market of bondholders of the 1930s, the banks operated in an oligopolistic market which enabled private creditors to create a quasi-cartel in order to exert effective pressure on the debtor countries. Secondly, the capital flows were owed, to a disproportionate extent, to a single type of investor (the banks) and the resulting concentration of credit was so excessive that it became a systemic risk for the international financial markets. As a result, the governments of the OECD countries decided to intervene actively to overcome the crisis, but unfortunately their action was not at all even-handed,

10 We stress "order of magnitude" because there is no consensus on what constitutes "capital flight" nor on how to calculate it. See Lessard and Williamson (1987) for an analysis of the problems involved in estimating capital flight and a presentation of the various estimates.

11 In Central America political uncertainty also exerted an influence.

12 See ECLAC (1984a) for a study of the rescue techniques.

since it helped to transfer most of the cost of the crisis to the debtors.<sup>13</sup>

During the second half of the 1980s there were some novel changes in capital movements. As the debt crisis persisted, a secondary market for the external debt paper began to arise, and the heavy discounts at which this paper was traded revealed publicly what was already suspected: the real value of the debt was much lower than its nominal value. The development of the secondary market had two other important positive effects. Firstly, from 1985 onwards, the countries used the big discounts in the secondary market to initiate involving the swapping of debt for equity in programmes of national enterprises, thus facilitating the financing of privatization operations, and the subsidy implicit in these operations served to stimulate foreign investment flows through these channels, especially from 1987 onwards (Fuentes, 1992 and Calderón, 1994) (see table IX.4).<sup>14</sup>

Secondly, the development of the secondary market and the growing discounts undermined the credibility of the official crisis-management strategy, in which it was not envisaged that the banks should register any losses. As regards external debt service, which was a heavy burden for the debtors, from 1987 onwards growing arrears of interest payments built up (see table IX.5). For Latin America, these arrears represented substantial forced inflows of capital. At the beginning of the 1990s, the accumulated arrears amounted to more than US\$ 25 billion (of which US\$ 21 billion were for bank credits), a sum equal to about 30% of the net capital inflows registered between 1983 and 1990. Although the accumulated arrears served as a safety-valve to counter the debt pressures, however, they are in fact a relatively inefficient form of external financing. Fortunately, together with the decline in international interest rates seen up to 1993 and the increase in capital

flows, a trend towards the regularization of payments was observed, inasmuch as the region's interest arrears had decreased substantially by the end of 1992.

### 3. The resurgence of capital movements in 1990-1994

As we have seen, over the last 20 years, the region has been affected by abrupt capital movements that have often perturbed macroeconomic management. Moreover, the fluctuations of financing were often determined by external factors. Thus, as the financial rationing of the 1980s clearly gave rise to costly adjustments, the return of capital flows in the 1990s obviously had initial positive effects, since it put an end to the external constraints which had affected the region since the financial crisis of 1982. Indeed, the economic recovery and the greater price stability in recent years were directly linked to the greater external leeway permitted by the entry of capital. This, in turn, confirmed the perception that external financing was an important ingredient missing from the official adjustment programmes of the previous decade (ECLAC, 1990a). However, the favourable impact of capital flows over the medium term will depend on their stability and cost over time, as well as on the efficiency with which economic policy channels those capital flows to meet the needs of macroeconomic stability, changing production patterns, international competitiveness and social equity. A summary analysis of the volume and nature of the different capital flows in the 1990s is given below.

#### a) Types of flows

Besides the increase in the volume of external resources mobilized, the recovery of capital flows in the 1990s has been characterized by a significant

13 For an analysis of the biased nature of the official handling of the debt, see ECLAC (1990b).

14 For a detailed analysis of these programmes, see Bouzas and Ffrench-Davis (1990), Islam and Hilton (1993) and ECLAC (1990b).

Table IX.4  
**LATIN AMERICA (SELECTED COUNTRIES): FOREIGN DIRECT INVESTMENT FLOWS (FDI),  
 BY CATEGORY, 1988-1993**  
*(Millions of dollars)*

Country / Category	1988	1989	1990	1991	1992	1993 <sup>c</sup>	1988-1993
<b>Argentina</b>	<b>1,147</b>	<b>1,028</b>	<b>1,836</b>	<b>2,439</b>	<b>4,179</b>	<b>6,305</b>	<b>16,934</b>
Normal FDI flows	807	869	-80	1,586	2,112	587	5,881
Debt swaps	340	159	815	-	-	-	1,314
Privatizations <sup>a</sup>	0	0	1,101	853	2,067	5,718	9,739
<b>Brazil</b>	<b>2,969</b>	<b>1,267</b>	<b>901</b>	<b>972</b>	<b>1,454</b>	<b>802</b>	<b>8,365</b>
Normal FDI flows	882	321	618	850	1,359	752	4,782
Debt swaps	2,087	946	283	68	95	50	3,529
Privatizations	0	0	0	54	0	0	54
<b>Chile</b>	<b>933</b>	<b>1,289</b>	<b>590</b>	<b>523</b>	<b>699</b>	<b>841</b>	<b>4,875</b>
Normal FDI flows	-15	67	235	563	731	891	2,472
Debt swaps	809	1,107	355	-40	-32	-50	2,149
Privatizations	139	115	0	0	0	0	254
<b>Colombia</b>	<b>203</b>	<b>576</b>	<b>500</b>	<b>457</b>	<b>790</b>	<b>850</b>	<b>3,376</b>
Normal FDI flows	203	576	500	405	790	850	3,324
Debt swaps	0	0	0	0	0	0	0
Privatizations	0	0	0	52	0	0	52
<b>Mexico</b>	<b>2,594</b>	<b>3,037</b>	<b>2,632</b>	<b>4,762</b>	<b>4,393</b>	<b>4,901</b>	<b>22,319</b>
Normal FDI flows	1,671	2,648	2,432	3,956	4,302	4,901	19,910
Debt swaps	868	389	85	19	0	0	1,361
Privatizations	55	0	115	787	91	0	1,048
<b>Peru</b>	<b>26</b>	<b>59</b>	<b>41</b>	<b>-7</b>	<b>127</b>	<b>349</b>	<b>595</b>
Normal FDI flows	26	59	41	-7	-13	60	166
Debt swaps	0	0	0	0	0	0	0
Privatizations	0	0	0	0	140	289	429
<b>Venezuela</b>	<b>89</b>	<b>213</b>	<b>451</b>	<b>1,916</b>	<b>629</b>	<b>372</b>	<b>3,670</b>
Normal FDI flows	39	30	148	159	545	347	1,268
Debt swaps	50	183	303	258	70	25	889
Privatizations	0	0	0	1,499	14	0	1,513
<b>Total<sup>b</sup></b>	<b>7,961</b>	<b>7,469</b>	<b>6,951</b>	<b>11,062</b>	<b>12,271</b>	<b>14,420</b>	<b>60,134</b>
Normal FDI flows	3,613	4,570	3,894	7,512	9,826	8,388	37,803
Debt swaps	4,154	2,784	1,841	305	133	25	9,242
Privatizations	194	115	1,216	3,245	2,312	6,007	13,089

Source: Alvaro Calderón, "Transformación productiva y empresas transnacionales", Santiago, Chile, ECLAC, 1993, unpublished, and additional official information.

<sup>a</sup> All of Argentina's inflows during 1991-1993 from external debt-equity swaps formed part of the country's privatization programme. <sup>b</sup> This total includes Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela only. Debt-equity swaps carried out as part of privatization operations are included in the figure given for the latter.

<sup>c</sup> Preliminary estimates.

Table IX.5  
**LATIN AMERICA AND THE CARIBBEAN: EXTERNAL DEBT INTEREST ARREARS<sup>a</sup>**  
 (Millions of dollars)

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
<b>Total</b>	<b>129</b>	<b>247</b>	<b>916</b>	<b>1,893</b>	<b>-489</b>	<b>791</b>	<b>4,861</b>	<b>327</b>	<b>8,167</b>	<b>8,978</b>	<b>1,779</b>	<b>-6,179</b>
<b>Oil-exporting countries</b>	<b>12</b>	<b>47</b>	<b>114</b>	<b>419</b>	<b>536</b>	<b>713</b>	<b>1,280</b>	<b>668</b>	<b>766</b>	<b>887</b>	<b>-784</b>	<b>-380</b>
Bolivia	12	39	26	95	137	56	48	-306	-58	-44	9	-4
Colombia	0	0	0	0	5	-5	2	-1	2	25	-5	-12
Ecuador	0	0	0	0	9	4	446	341	271	451	370	153
Mexico	0	0	0	0	0	0	0	0	0	0	0	0
Peru	0	8	88	324	384	657	782	635	548	460	-1,157	-661
Venezuela	0	0	0	0	1	1	2	-1	3	-6	0	144
<b>Non-oil-exporting countries</b>	<b>117</b>	<b>200</b>	<b>802</b>	<b>1,474</b>	<b>-1,025</b>	<b>78</b>	<b>3 581</b>	<b>-341</b>	<b>7,401</b>	<b>8,091</b>	<b>2,563</b>	<b>-5,798</b>
<b>South America</b>	<b>28</b>	<b>29</b>	<b>919</b>	<b>1,270</b>	<b>-1,118</b>	<b>-212</b>	<b>2,912</b>	<b>-1,034</b>	<b>6,552</b>	<b>7,445</b>	<b>3,031</b>	<b>-5,953</b>
Argentina	0	0	837	1,237	-1,297	-291	-135	1,777	3,405	1,921	1,063	451
Brazil	28	29	74	27	166	54	3,033	-2,838	3,162	5,485	1,948	-6,314
Chile	0	0	0	0	0	0	0	0	0	0	0	0
Paraguay	0	0	8	6	13	25	14	27	-15	39	20	-90
Uruguay	0	0	0	0	0	0	0	0	0	0	0	0
<b>Central America and Hispaniola</b>	<b>89</b>	<b>171</b>	<b>-117</b>	<b>204</b>	<b>93</b>	<b>290</b>	<b>669</b>	<b>693</b>	<b>849</b>	<b>646</b>	<b>-468</b>	<b>155</b>
Costa Rica	84	145	-214	51	-53	67	140	60	105	-304	-12	-41
El Salvador	0	0	0	0	2	2	1	4	14	-17	0	8
Guatemala	0	0	0	10	30	19	24	13	21	81	-7	5
Haiti	0	0	0	9	2	-1	1	5	-1	-2	10	7
Honduras	2	2	7	19	14	19	44	28	29	-83	-14	-21
Nicaragua	0	18	85	55	139	158	354	229	304	348	-416	134
Panamá	0	0	1	0	0	-1	16	295	302	355	181	6
Dominican Republic	3	6	4	60	-41	27	89	59	75	268	-210	57

Source: O. Altimir and R. Devlin, "An overview of debt moratoria in Latin America", *Development Policy Review*, vol. 11, No. 4, December 1993.

<sup>a</sup> Net annual cumulative figures.

diversification of financing sources. Thus, the banks have been largely displaced by other important flows, especially foreign direct investment and portfolio investment (see table IX.7).

*i) Financing with indebtedness*

*Commercial banks.* It is estimated that the contribution of the banks to the external financing of the region amounted to US\$ 11 billion in 1992. This is about 18%

of total flows: a small fraction of its share in the 1970s. Although the net financing provided by the banks was a good deal greater than that supplied in 1991, it was mostly short-term. This reflects their attitude to Latin America, which has been restrictive since the crisis. In 1992, Argentina, Brazil and Chile were very active borrowers in this segment of the market. In 1993, the level of net loans made

Table IX.6  
**LATIN AMERICA: SOME SOURCES OF EXTERNAL FINANCING**  
 (Millions of dollars)

	1989	1990	1991	1992	1993 <sup>a</sup>
<b>A. Debt</b>					
Bonds <sup>b</sup>	833	2,760	7,242	12,577	27,397
Banks <sup>c</sup>	-6,497	8,559	6,800	10,900	5,200
Commercial paper	127	-	1,212	840	315
Certificates of deposit	-	-	670	1,100	65
<b>B. Investment</b>					
Direct <sup>d</sup>	8,118	7,733	12,064	13,420	14,675
ADRs/GDRs <sup>e</sup>	-	98	4 120	4,063	5,725
External funds <sup>f</sup>	416	575	727	293	10

Source: ECLAC, on the basis of official figures from the International Monetary Fund, World Bank and Bank for International Settlements.

<sup>a</sup> Preliminary figures. <sup>b</sup> Gross value. <sup>c</sup> Net, short- and medium-term. <sup>d</sup> Includes profit reinvestment in some countries. <sup>e</sup> ADR = American Depository Receipts; GDR = Global Depository Receipts. Includes only sales of new stock issues. <sup>f</sup> Includes only closed-end funds; starting capital.

Table IX.7  
**LATIN AMERICA AND THE CARIBBEAN: INTERNATIONAL BOND ISSUES<sup>a</sup>**  
 (Millions of dollars)

	1989	1990	1991	1992	1993
<b>Total</b>	<b>833</b>	<b>2,760</b>	<b>7,242</b>	<b>12,577</b>	<b>27,397</b>
Argentina	-	21	795	1,570	6,233
Brazil	-	-	1,837	3,655	6,679
Chile	-	-	200	120	433
Colombia	-	-	-	-	566
Guatemala	-	-	-	-	60
Mexico	570	2,477	3,782	6,100	10,783
Panama	-	-	50	-	-
Peru	-	-	-	-	30
Trinidad and Tobago	-	-	-	100	125
Uruguay	-	-	-	100	140
Venezuela	263	262	578	932	2,348
Average term (years)	...	4.9	4.0	3.9	4.5

Source: International Monetary Fund, *Private Market Financing for Developing Countries*, Washington, D.C., December 1993 (data covering period up to 1992 and information obtained directly (1993)).

<sup>a</sup> Gross financing.

to the region was more modest. Brazil, Chile and Mexico featured prominently in this, especially in the contracting of short-term trade credits.

Bonds. From 1989 onwards, the Latin American and Caribbean countries obtained extensive access to the international bond market: a source of financing to which the region had had only limited recourse since the Great Depression. In fact, its entry into this market has been on a noteworthy scale: in 1993 the countries of the region issued US\$ 27 billion in bonds, –double the total registered during the whole previous year (see table IX.7). In 1992, bond issues were equivalent to 21% of the region's financing, and in 1993 they rose to 43% (see tables IX.1 and IX.7).

The countries most active in the bond market have been Mexico, Brazil, Argentina and Venezuela. They have been joined by a growing number of other countries, however, Chile and Colombia entered the market in 1991;

Trinidad and Tobago and Uruguay began to issue bonds in 1992, while in 1993 a Central American country (Guatemala) participated for the first time (see table IX.7).

Apart from the growth in the number of transactions and participants, there are other signs of growing receptiveness in this segment of the market. For example, the size of new bond issues is increasing; in March 1993 a private Mexican firm and in June a United States subsidiary of the Venezuelan State Petroleum Enterprise made "jumbo" bond issues of US\$ 1 billion each.

Furthermore, financing through bond issues continues to be relatively expensive. In relation to the LIBOR rate, the bond margins have often been higher, especially in Argentina and Brazil, as compared with Chile, Mexico and Colombia. The initial yields offered on bonds are around 8% to 10% for terms of three to five years, and there has also been some lengthening of the terms (up to 7 years) (see table IX.8).<sup>15</sup>

Table IX.8  
LATIN AMERICA AND THE CARIBBEAN: INDICATORS OF TERMS AND  
CONDITIONS FOR INTERNATIONAL BOND ISSUES<sup>a</sup>

	1990		1991		1992		1993 <sup>b</sup>	
	Yield <sup>c</sup>	Term <sup>d</sup>	Yield <sup>c</sup>	Term <sup>d</sup>	Yield <sup>c</sup>	Term <sup>d</sup>	Yield <sup>d</sup>	Term <sup>d</sup>
Argentina	-	-	10.6	3.2	9.3	...	8.7	3.4
Brazil	-	-	12.2	2.7	10.6	2.8	9.7	3.9
Chile	-	-	...	...	...	...	7.4	7.5
Colombia	-	-	...	...	-	-	7.5	3.1
Mexico	13.1	3.7	10.7	5.6	9.8	4.9	8.3	5.3
Trinidad and Tobago	-	-	-	-	11.8	5.0	...	...
Uruguay	-	-	-	-	8.6	3.0	...	...
Venezuela	14.0	5.0	10.4	4.3	9.6	5.0	8.8	4.0

Source: ECLAC, on the basis of figures provided by the West Merchant Bank.

<sup>a</sup> Weighted averages for a large sample of bond offerings. <sup>b</sup> January-October. <sup>c</sup> Initial yields in annual percentages. <sup>d</sup> Terms in years.

15 It should also be noted that the initial costs of incorporation in a new financing market are typically high. In time, it is hoped that competition between lenders will help to reduce bond charges.

ii) *Foreign investment*<sup>16</sup>

Foreign investments of risk capital have assumed considerable importance in the region. In 1993, identifiable flows of foreign capital totalled US\$ 21 billion (see table IX.6).

Foreign direct investment (FDI). It is estimated that in 1993 the flow of FDI to the region was close to a record level of US\$ 15 billion. Moreover, the share of total capital flows represented by FDI rose to 25% in the three-year period of 1991-1993, compared to 17% in 1977-1981 (see tables IX.1 and IX.9).

In the 1990s, FDI flows have increased substantially, especially in Mexico, Brazil, Argentina, Chile, Costa Rica and the Dominican Republic.

In Mexico, the FDI inflow was three times the annual average for the period before the crisis (see table IX.9). This boom in direct investment is linked to a large extent to the announcement and subsequent ratification of the North American Free Trade Agreement (NAFTA) and the profound economic reforms carried out in Mexico.

Chile has also received a strong flow of direct investment. The average annual inflow of US\$ 700 million in 1991-1993 was notably higher than the US\$ 300 million received during the crisis years (more than half of which was in the form of external debt paper) and the US\$ 200 million received annually between 1977 and 1981. In 1991-1993, the investment was made without the benefit of the big subsidies offered between 1985 and 1989, when foreign investment benefited from the

national debt/equity conversion programme (see table IX.4).<sup>17</sup>

In the case of Argentina, the average FDI flow of US\$ 5.2 billion in 1992-1993 was more than double the amounts recorded in 1991 and 1990. Three-fourths of these investments were attracted by the ambitious programme for privatizing public enterprises (Calderón, 1994).

The FDI flow to Venezuela declined from US\$ 1.9 billion in 1991 to US\$ 500 million in 1992-1993, largely because of the paralyzation of the privatization programme. As for the increased flow of FDI to Costa Rica, this was due in part to the efficiency of the official incentives programme (in respect of assembly industries, for example) for foreign investors (Rodríguez, 1993).

It is difficult to specify the yield required by FDI, because of serious problems of measurement. However, a rough indicator may be the estimate made by the United States Department of Commerce regarding the rate of return on FDI from the United States in Latin America. This statistical base suggests that in recent years FDI has usually been gaining relatively high annual yields of the order of 15%-20% (see table IX.10).

*American Depository Receipts (ADRs)*.<sup>18</sup> While these instruments came into being in 1927 and there are now more than 700 ADR and GDR programmes, only in the last few years has there been active participation by developing countries in this market. In 1993, a number of Latin American enterprises issued US\$ 5.7 billion in stock that was then converted into ADRs and GDRs—equal to 9% of the total

16 The word "foreign" is not totally appropriate; as will be seen below, Latin American residents are repatriating capital through financial instruments which have traditionally been associated with foreigners.

17 In this sense, the Chilean programme was a pioneering one. For an analysis of the subsidies offered, see Ffrench-Davis (1990).

18 ADRs are negotiable certificates issued by United States banks. They represent a share package in foreign companies. ADRs are quoted on the United States stock exchanges and give the holder the same rights as any other shareholder of the State in which they are issued. There is also a variant of ADRs (Global Depository Receipts—GDRs), which are certificates circulating simultaneously on various stock exchanges of the world. The figures appearing in the text refer to initial sales of new shares (primary ADRs/GDRs).

Table IX.9  
**LATIN AMERICA AND THE CARIBBEAN: NET INFLOWS  
 OF FOREIGN DIRECT INVESTMENT<sup>a</sup>**  
 (Millions of dollars)

	1977- 1981	(1981)	1982	1983- 1989	1990	1991	1992	1993
<b>Latin America and the Caribbean (24)</b>	<b>5,317</b>	<b>8,177</b>	<b>6,536</b>	<b>5,881</b>	<b>7,733</b>	<b>12,064</b>	<b>13,430</b>	<b>14,675<sup>b</sup></b>
<b>Oil-exporting countries</b>	<b>1,948</b>	<b>3,788</b>	<b>2,643</b>	<b>3,130</b>	<b>3,735</b>	<b>7,265</b>	<b>6,127</b>	<b>5,737</b>
Bolivia	34	76	31	5	27	52	93	...
Colombia	144	265	366	571	500	457	790	...
Ecuador	55	60	40	67	82	85	95	115
Mexico	1,576	3,078	1,901	2,401	2,634	4,762	4,393	4,901
Peru	60	125	48	13	41	-7	127	349
Venezuela	78	184	257	73	451	1,916	629	372
<b>Non-oil-exporting countries</b>	<b>3,370</b>	<b>4,390</b>	<b>3,892</b>	<b>2,752</b>	<b>3,997</b>	<b>4,799</b>	<b>7,303</b>	<b>8,938</b>
<b>South America</b>	<b>2,951</b>	<b>3,821</b>	<b>3,575</b>	<b>2,381</b>	<b>3,403</b>	<b>4,018</b>	<b>6,468</b>	<b>8,174</b>
Argentina	423	837	227	587	1,836	2,439	4,179	6,305
Brazil	2,138	2,520	2,910	1,470	901	972	1,454	802
Chile	208	383	401	300	590	523	699	841
Paraguay	32	32	37	5	76	84	136	150
Uruguay	150	49	...	19	...	...	...	76
<b>Central America and the Caribbean</b>	<b>419</b>	<b>569</b>	<b>318</b>	<b>371</b>	<b>594</b>	<b>782</b>	<b>834</b>	<b>765</b>
Barbados	6	8	5	6	11	7	14	...
Costa Rica	55	70	29	79	163	178	220	280
El Salvador	6	-6	-1	18	2	25	15	16
Guatemala	116	127	77	110	48	91	94	149
Guyana	0	-2	4	2	...	...	...	...
Haiti	10	8	7	7	8	14	...	...
Honduras	11	-4	14	34	44	45	60	...
Jamaica	-9	-12	-16	11	138	127	87	139
Nicaragua	4	...	...	0	...	...	15	39
Panama	3	6	3	17	-18	-30	2	-41
Dominican Republic	65	80	-1	73	133	145	180	183
Suriname	2	35	-6	-50	-43	10	-30	...
Trinidad and Tobago	150	258	204	66	109	169	178	...

Source: ECLAC, on the basis of figures provided by the International Monetary Fund and national agencies.

<sup>a</sup> Includes debt swaps and privatizations. <sup>b</sup> Covers only 16 countries, which accounted for 88% of total net inflows in 1983-1989.

Table IX.10  
**RATE OF RETURN ON FOREIGN DIRECT INVESTMENT OF UNITED STATES ORIGIN<sup>a</sup>**  
*(Annual average percentages)*

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
All countries	18.2	14.7	9.9	9.9	10.1	12.8	12.6	13.4	15.5	15.0	14.3	11.5	10.7
Developing countries	23.5	23.1	16.9	12.1	15.2	13.8	12.0	13.1	16.4	18.0	17.0	16.0	17.5
Latin America <sup>b</sup>	14.2	12.2	3.2	-0.3	6.6	7.6	8.8	10.9	17.0	18.8	14.2	13.6	18.6
Argentina	29.9	3.9	16.8	12.5	2.2	4.7	13.3	11.6	13.8	1.8	17.2	19.4	17.3
Brazil	6.6	6.3	8.7	1.5	5.9	6.1	9.2	12.8	19.9	26.3	10.0	6.5	17.8
Chile	1.7	23.3	-12.4	21.5	42.6	93.3	53.8	40.8	44.3	29.1	20.4	16.8	17.0
Colombia	7.2	5.4	13.3	7.6	9.5	12.6	7.1	3.2	6.1	4.2	20.6	18.3	18.1
Ecuador	0.0	17.4	14.5	11.3	19.9	25.4	21.2	6.6	1.1	7.1	9.7	10.1	15.8
Mexico	22.1	21.0	-18.7	-6.2	7.7	13.7	4.4	14.4	23.6	20.3	19.9	20.3	19.6
Peru	0.0	22.6	13.3	6.0	5.7	-2.0	-0.3	-4.0	-10.8	-14.6	-17.3	-3.8	1.6
Venezuela	5.3	14.3	12.4	-30.8	8.8	3.9	13.5	7.5	13.7	7.8	15.0	22.1	30.8

Source: ECLAC, on the basis of data published in *Survey of Current Business*, United States Department of Commerce, Washington, D.C., various issues.

<sup>a</sup> This rate of return was calculated as the income from foreign direct United States investment (reinvested profits plus distributed profits) divided by the average stock of these investments between the beginning and end of each year at current prices. However, the main limitation in using current prices for this purpose is that they give rates of return which may differ from the returns on other similar investments made at different times and at different prices.

<sup>b</sup> Including Argentina, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Paraguay, Peru, Suriname, Uruguay and Venezuela. The Caribbean island countries were not included, nor was Panama, since most of the foreign direct investment from the United States is concentrated in the financial sector.

flow of net external financing received by the region. This amount compares with US\$ 4.1 billion in 1991 and 1992 and US\$ 100 million in 1990, the first year in which an enterprise from the region issued certificates of this type (see tables IX.6 and IX.11).

The country which has made most use of ADRs and GDRs is Mexico. In 1992, 10 new programmes were launched for obtaining fresh capital of US\$ 3.1 billion, i.e., 75% of the resources mobilized by regional enterprises through this instrument. While the number of Mexican issues continued to be high in 1993, their volume declined to US\$ 2.5 billion (see table IX.11).

In 1992 two Argentine firms mobilized some US\$ 370 million through ADR and GDR issues, while in 1993, Argentine companies obtained US\$ 2.8 billion –48% of the total value of ADRs and GDRs issued—mainly through an issue made by the privatized firm Yacimientos Petrolíferos Fiscales (YPF). Chile was the pioneer in the

use of ADRs, since in 1990 its privatized telephone company issued the first certificates from the region for an amount close to US\$ 100 million. During 1992, two programmes totalling US\$ 130 million were launched, while in 1993 four new operations totalling US\$ 270 million were registered (Ffrench-Davis, Agosin and Uthoff, 1995). In the biennium 1992-1993 companies from Bolivia, Brazil, Colombia, Panama, Peru and Venezuela joined the ADR market.

Offshore investment funds. This financial mechanism was added to the market in the 1980s with the aim of facilitating foreign investment in the new emerging stock markets of developing countries. The administrators of a fund ask the authorities of a developing country for the right to buy and manage a portfolio of shares to be traded on the local stock exchange; the fund is subscribed in dollars and is quoted on foreign stock exchanges. The funds may be "open", i.e., with the

Table IX.11  
**LATIN AMERICA: INTERNATIONAL SHARE OFFERINGS<sup>a</sup>**  
*(Millions of dollars)*

	1990	1991	1992	1993
<b>Total</b>	<b>98</b>	<b>4,120</b>	<b>4,063</b>	<b>5,725</b>
Argentina	-	356	372	2,793
Bolivia	-	-	-	10
Brazil	-	-	133	-
Chile	98	-	129	271
Colombia	-	-	-	91
Mexico	-	3,764	3,058	2,493
Panama	-	-	88	-
Peru	-	-	-	25
Venezuela	-	-	283	42

Source: International Monetary Fund, *Private Market Financing for Developing Countries*, Washington, D.C., December 1993 (data covering period up to 1992 and information obtained directly (1993)).

<sup>a</sup> ADRs and GDRs offered on United States exchanges for purposes of capital widening.

right to increase the initial capital, or "closed", with only one capital offering when the fund is established. It is estimated that at the end of 1993 there were more than 40 offshore funds operating with regional portfolios and more than 20 funds specializing in individual countries.

In 1992 the establishment of new closed offshore funds—which represent only a part of the investment funds' activity—generated capital flows on the order of US\$ 300 million (see table IX.12).<sup>19</sup>

As regards the yield offered by these investment funds, a sample of some of the funds with the best performance covering Chile, Brazil and Mexico suggests that there is a fair amount of variability, associated with the big fluctuations in stock-market quotations. Thus, in March 1993 the best yield was that of Mexico (an average of 7%), while in the case of Chile there was a loss of 6%. In September 1993, the highest return was the 5% rate attained in Brazil, while a loss of 5% was recorded in Mexico (World Bank, 1993a). Even so,

cumulative rates of return for investors have generally been very high. For example, US\$ 490 million in investments made in Chile between 1989 and 1993 were worth US\$ 1.73 billion by the end of 1993 (see Ffrench-Davis, Agosin and Uthoff, 1994).

### *iii) Other flows*

While the amount of data available for 1993 is still quite meagre, it is known that other capital flows into the region came to about US\$ 16 billion. Most of these were short-term credits and other flows. In 1992 the region also obtained US\$ 1.1 billion through the issue of certificates of deposit and US\$ 840 million through the sale of commercial paper (see table IX.6). As regards the terms of indebtedness, certificates of deposit carry terms of two to three years, and in 1992 their spread over LIBOR varied from 2.3% for Mexico to 2.8%-4.7% for Argentina and Brazil. In the case of commercial paper, their term of repayment is less than a year, with spreads over LIBOR of between 2.8% and 3.8% for Argentina in 1992 (Goldstein and

<sup>19</sup> These figures may underestimate the total flow generated by the funds.

Table IX.12  
**LATIN AMERICA: NEW CLOSED OFFSHORE INVESTMENT FUNDS <sup>a</sup>**  
*(Initial capital, in millions of dollars)*

	1989	1990	1991	1992	1993
<b>Total</b>	<b>608</b>	<b>383</b>	<b>771</b>	<b>293</b>	<b>10</b>
Argentina	-	-	56	-	-
Brazil	-	-	43	112	-
Chile	230	180	-	-	-
Mexico	192	-	71	-	-
Venezuela	-	-	100	-	-
Regional	186	203	501	181	10

Source: S. Gooptu, *Portfolio Investment Flows to Emerging Markets*, Policy Research Working Papers, No. 1117, Washington, D.C., World Bank, 1993, and ECLAC, Economic Development Division.

<sup>a</sup> Including Global Depository Receipts (GDRs).

Folkerts-Landau, 1993). It is also known that substantial foreign resources have entered Mexico through the purchase of treasury bills (treasury certificates or readjustable bonds) expressed in pesos. It is estimated that capital inflows by this mechanism amounted to US\$ 9 billion in 1992 and US\$ 7 billion in 1993.

It is difficult to break down the remaining resources. However, it may be assumed that the bulk of them were acquired by the region's banking systems as interest-bearing short-term deposits or took the form of increases in enterprises' working capital or investments on the stock exchange or in real estate. In particular, direct portfolio investment in the stock market may have been highly significant. In Mexico, for example, it is estimated that 19% of the capital increase on the Mexican stock exchange was coming from foreign investment by 1992, while in Argentina, the proportion was over 25% (Gooptu, 1993). This has given rise to a close interconnection among the stock exchanges in different countries as well as to the transmission of changes in expectations, a phenomenon that poses the risk of fostering a high degree of volatility.

*b) Factors behind the resumption of capital flows*

There are a varied range of factors, both national and international, that explain the inflow of capital into Latin America during the 1990s.

The external and internal factors underlying the capital movements of the region are varied and it is hard to determine their relative importance. However, we know that the structural reforms of the Latin American economies and the high domestic interest rates are not completely new: they have been present to a greater or lesser extent since the mid-1980s. In contrast, the abrupt changes in two determinants of financial profitability in the countries of the northern hemisphere (low interest rates and slower economic growth) are recent events which more or less coincide with the renewed external capital flows. Indeed, this is the conclusion of Calvo, Leiderman and Reinhart (1993). In their econometric study of 10 Latin American countries during the period 1988-1991, they conclude that external factors, particularly the fall in United States interest rates, have exerted considerable influence on the development of the Latin American capital account, and in at least

five countries have been the most influential factor. Clearly, both factors—low interest rates and slow economic growth rates—are impermanent in nature and could undergo an abrupt turnaround.

i) The fall in international dollar yields. The recession in the United States and the sharp fall in international dollar interest rates, especially short-term ones, seem to have acted as strong external stimuli from 1990 onwards. The LIBOR short-term dollar rate registered an annual average of 11% in 1979-1988 and 9% in 1989, but from 1992 onwards it fell to less than 4%, the lowest level in 30 years. In real terms, its fall was even more marked: from annual averages of 4.4% in 1979-1988 and 4.6% in 1989, it declined to less than 1% in 1992-1993 (see table IX.13). Long-term dollar interest rates also declined, although to a lesser extent. For example, the yield on long-term United States Government bonds fell from an annual average of almost 11% in 1979-1988 and 8.5% in 1989 to 7% in 1992 and to less than 6% during 1993.

The reduction in international interest rates was originally a phenomenon that occurred primarily in the "dollar zone"; in fact, the rates in Europe and Japan went up at the beginning of the 1990s, but they too showed a downward trend as from 1992 and 1993, respectively (see table IX.13).

After a decade of high yields on dollar loans, the sharp fall in the international interest rate in dollars obviously led investors to reassign part of their dollar portfolio. This movement, together with the drop in real estate yields and in the profits of United States enterprises (Calvo, Leiderman and Reinhart, 1993) made it even more attractive to invest in Latin America, a region which continued to offer very high yields on short- and medium-term capital. Moreover, the risk premium applied by investors to these yields was probably lowered to the extent that the creditworthiness of countries

indebted in dollars improved as a result of the drop in international interest rates and the bigger supply of funds, which reduced the risk of exchange-rate devaluation.

ii) The persistence of high yields on capital in Latin America. As already noted a large volume of short-term external capital has entered the Latin America banking systems. During the 1990s, the *ex post* difference between international interest rates in dollars and those prevailing on the capital markets of Latin America (in dollar equivalents) was often extraordinarily high in favour of the latter region.<sup>20</sup> The differences in yield have varied sharply from one year to another. In 1991, the biggest differences were recorded in Brazil, Peru and Guatemala, while in 1993, the most striking differentials were seen in Brazil, Colombia, Ecuador, El Salvador, Mexico, and Venezuela (see table IX.14).

Although it is difficult to make a precise calculation, it is known that a large part the external capital has seized the spectacular opportunities for profits offered by the region's stock markets. Figure IX.1 shows that the behaviour of these profits as a whole between 1990 and 1993 was extremely dynamic, for in the 1990s the share price index in dollars increased more on the Latin American stock exchanges than on those of Asia, the United States, the United Kingdom and Japan, with the stock exchanges of Chile, Argentina, Mexico and Colombia being particularly active.

Privatization operations were another incentive that helped channel capital towards the region. Between 1990 and 1992, Latin American public enterprises worth some US\$ 40 billion were privatized, the process being particularly intense in Mexico, Argentina, Chile, Venezuela and Peru (see table IX.15). Investments in most of the big privatized undertakings, especially those in the public service sectors, have been attractive

20 The reasons for the high interest rates in the region differ according to the situation. In some countries they reflected restrictive monetary policies, motivated by efforts to control aggregate demand and domestic prices. In other cases, they were linked to the shortage of capital and exchange instability.

Table IX.13  
INTERNATIONAL INTEREST RATES  
(Percentages)

	1972- 1978	1979- 1988	1989	1990	1991	1992	1993
<b>Dollars</b>							
A. LIBOR (180 days)							
Nominal	7.9	10.9	9.3	8.3	6.1	3.9	3.4
Real	-0.8	4.4	4.6	3.2	1.7	0.9	0.7
<b>B. United States</b>							
Government bonds							
Nominal	7.4	10.7	8.5	8.6	7.9	7.0	5.8
Real	-1.2	4.3	3.8	3.4	3.4	3.9	3.0
<b>Marks</b>							
A. LIBOR (180 days)							
Nominal	...	6.6	7.2	8.8	9.4	9.4	7.0
Real	...	0.4	2.6	3.6	4.9	6.2	4.2
<b>B. Long-term German</b>							
Government bonds							
Nominal	8.0	7.6	7.1	8.9	8.6	8.0	6.3
Real	-0.7	1.4	2.5	3.7	4.2	4.8	3.5
<b>Yen</b>							
A. LIBOR (180 days)							
Nominal	...	6.6	5.5	7.9	7.2	4.4	3.0
Real	...	0.4	1.0	2.7	2.7	1.3	0.3
<b>B. Long-term Japanese</b>							
Government bonds							
Nominal	7.8	6.8	5.1	7.4	6.5	4.9	3.7
Real	-0.8	0.6	0.5	2.2	2.1	1.9	0.9

Source: ECLAC, on the basis of figures supplied by the International Monetary Fund (IMF).

because of the potentially high yields offered by captive markets and, in a number of cases, the modest prices asked.<sup>21</sup> This was reflected in active participation by foreign companies in the direct purchase of public enterprises, which also led to new investments designed to expand and improve the goods and services produced by the newly privatized companies; this phenomenon was particularly marked in Argentina and Venezuela (see table IX.4).

Furthermore, governments also sold shares in privatized enterprises to the general public on local stock exchanges, thus influencing the behaviour of the latter, as well as to investors with foreign capital, either directly, through ADR and GDR programmes and offshore investment funds, or indirectly, through deposits made in Latin American banking systems from the exterior. Where the share package on sale was big compared with the size of the domestic market,

21 There are quite a few indications of a notable under-valuation of the sale prices of public enterprises. For an analysis of this phenomenon and other aspects of the privatization programmes in the region, see Devlin and Cominetti (1994).

Table IX.14  
**LATIN AMERICA: DIFFERENCES BETWEEN NATIONAL AND  
 INTERNATIONAL INTEREST RATES<sup>a b</sup>**

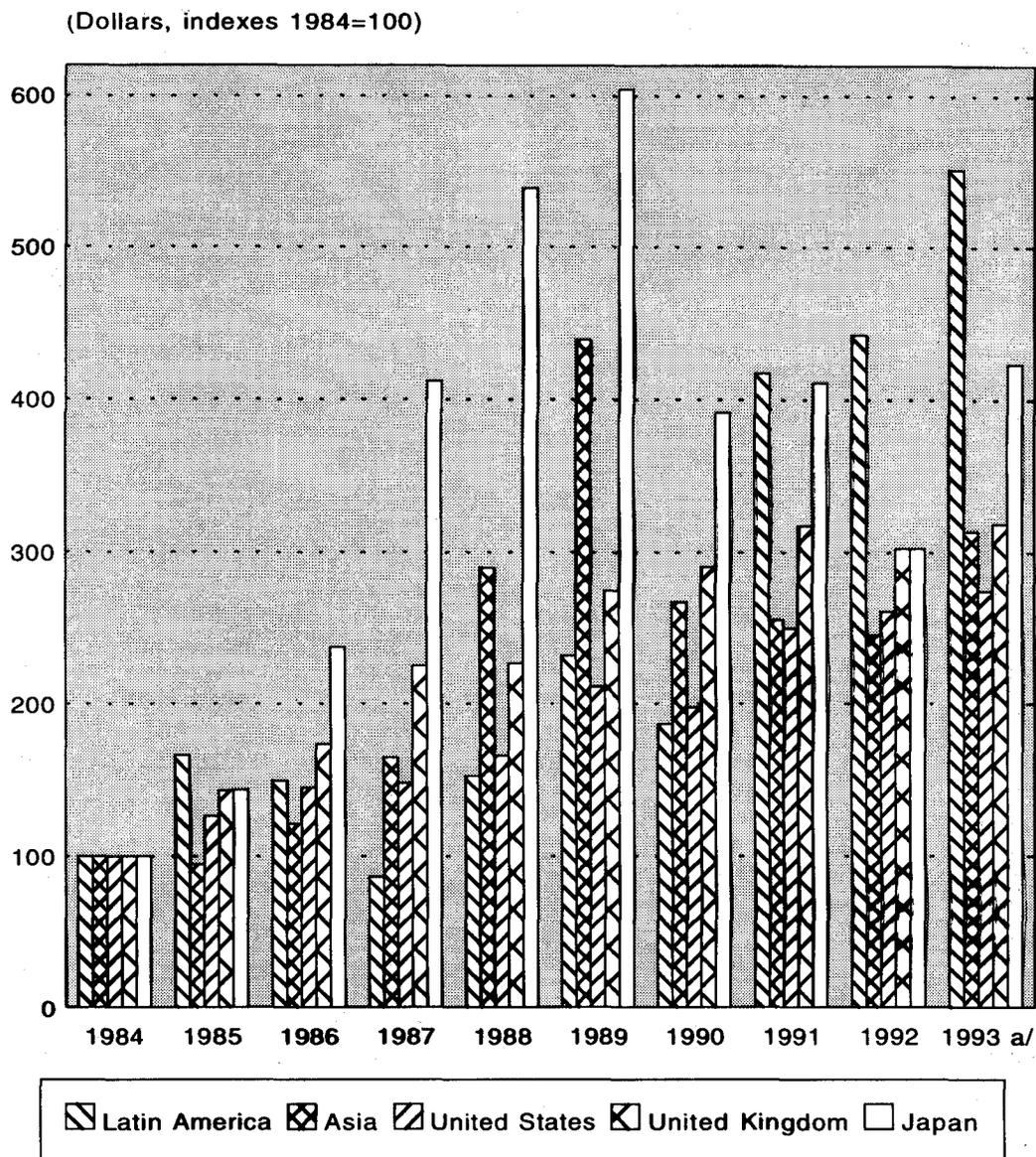
	1989	1990	1991	1992	1993
<b>Argentina</b>					
Short-term	26.4	127.7	-12.6	9.2	5.8
Long-term	27.2	127.5	-14.4	6.1	3.4
<b>Bolivia</b>					
Short-term	-6.4	0.0	6.2	8.5	8.7
Long-term	-5.7	-0.2	4.4	5.4	6.3
<b>Brazil</b>					
Short-term	98.8	-2.0	24.1	38.7	32.1
Long-term	99.6	-2.2	22.3	35.6	29.7
<b>Chile</b>					
Short-term	-3.3	15.7	4.1	11.2	2.1
Long-term	-2.5	15.5	2.3	8.1	-0.3
<b>Colombia</b>					
Short-term	-9.3	-8.4	3.7	-8.3	17.3
Long-term	-8.5	-8.6	1.9	-11.4	14.1
<b>Costa Rica</b>					
Short-term	-0.1	-8.8	-8.8	9.9	3.0
Long-term	0.7	-9.0	-10.6	6.8	0.6
<b>Ecuador</b>					
Short-term	-13.8	-3.7	-7.9	-2.6	21.1
Long-term	-13.1	-3.9	-9.7	-5.7	18.7
<b>El Salvador</b>					
Short-term	7.0	-19.7	9.4	-5.2	18.5
Long-term	7.8	-19.9	7.6	-8.3	16.1
<b>Guatemala</b>					
Short-term	-14.7	-10.0	16.6	2.0	-1.9
Long-term	-13.9	-10.2	14.8	-1.1	-4.3
<b>Honduras</b>					
Short-term	-0.7	-58.5	2.5	0.1	-13.8
Long-term	0.1	-58.7	0.7	-3.0	-16.2
<b>Mexico</b>					
Short-term	9.0	8.9	6.1	10.1	12.4
Long-term	9.7	8.7	4.3	7.0	10.0
<b>Peru</b>					
Short-term	75.8	-42.2	76.9	-6.0	5.3
Long-term	76.5	-42.4	75.1	-9.1	2.9
<b>Uruguay</b>					
Short-term	-4.6	-7.9	4.8	5.6	6.7
Long-term	-3.8	-8.1	3.0	2.5	4.3
<b>Venezuela</b>					
Short-term	-29.6	3.2	2.8	0.8	27.2
Long-term	-28.8	3.0	1.0	-2.3	24.8

Source: ECLAC, on the basis of official data and statistics of the International Monetary Fund (IMF).

<sup>a</sup>National deposit rates, equivalent in dollars, less international dollar interest rates.

<sup>b</sup> Short-term rates correspond to national rates, less LIBOR, while long-term rates correspond to national rates, less the yields of United States Government bonds.

Figure IX.1  
REGIONAL INDEXES OF SHARE PRICES  
ON STOCK EXCHANGES



Source: International Finance Corporation (IFC).

<sup>a</sup> Average January-September.

Table IX.15  
LATIN AMERICA: INCOME FROM PRIVATIZATIONS

	Number of sales		Gross public income <sup>a</sup> (millions of dollars)				Total
	1989-1992	1989	1990	1991	1992	1993	1989-1993
Argentina	43	-	2,105	2,592	6,094	4,565	15,356
Brazil	17	-	-	1,658	2,340	2,697	6,695
Colombia	16	52	72	670	82	5	881
Mexico	130	730	3,205	10,831	7,007	1,403	23,176
Peru	14	-	-	3	264	318	585
Venezuela	13	-	9	2,290	20	33	2,352
<b>Total</b>	<b>233</b>	<b>782</b>	<b>5,391</b>	<b>18,044</b>	<b>15,807</b>	<b>9,021</b>	<b>49,045</b>

Source: ECLAC, on the basis of official figures, and *Latin Finance*, March 1994.

<sup>a</sup> In cases where the privatization was financed with external debt paper, this was valued at secondary market prices.

selling stock abroad sometimes constituted a good way of reducing the possibility of saturating the local market with shares and thus causing a fall in prices. For example, when 160 million shares of Yacimientos Petrolíferos Fiscales (YPF) of Argentina were placed on sale, with a value of more than US\$ 3 billion, 75% of them were bought by investors living in the United States and Europe.

The difference between capital yields in Latin America and the industrialized countries also partly explains the region's capacity to sell bonds abroad. The yield of the Latin American bonds, with fairly short terms, was higher than that of United States Government bonds with terms that were four to six times longer (see tables IX.8 and IX.13).

As the capital supply was stimulated by the relatively high yields promised by investments in the region, the demand for their financing tended to be directed at external markets, attracted by the lower costs of new capital. Interest rates on loans obtained in Latin American capital markets have generally been very high because of a combination of high real interest rates in local currency and exchange revaluations which make the cost of domestic credit even dearer,

compared with external credit. For example, in 1993 the dollar equivalent cost of such loans was almost 50% in Peru, 41% in Bolivia, 18% in Costa Rica, 11% in Chile, 18% in Argentina, -2% in Honduras, 12% in Guatemala and 40% in Ecuador (see table IX.16). Indeed, the rates on loans in Latin American markets became so high that, in many cases, the available capital was confined to very short terms or was rationed by some lenders. In this context, it is only logical that many enterprises in the region decided to seek working capital and medium-term financing abroad.

iii) The economic policies of the Latin American countries. The economic policies of the countries of the region have undoubtedly also influenced the boom in capital flows. Many countries, to varying degrees have carried out profound structural reforms whose effects have included the following: they have stabilized the expectations of private agents and increased the productivity and profitability of private investments; they have offered foreign investors equal or better conditions than local investors; and through the policy of liberalization, especially of the capital account, they have reduced the transaction costs and the risks involved in the movement of capital

Table IX.16  
 LATIN AMERICA: DOLLAR EQUIVALENT RATES FOR LOANS TAKEN OUT  
 ON DOMESTIC CAPITAL MARKETS <sup>a</sup>

	1988	1989	1990	1991	1992	1993
Argentina	40.6	1,087.5	138.0	-8.8	18.4	21.5
Bolivia	...	14.2	24.1	28.0	32.7	41.1
Chile	16.9	12.8	31.6	15.8	20.6	10.9
Colombia	1.1	11.0	10.7	18.3	20.5	30.6
Costa Rica	11.4	22.0	9.0	6.2	26.2	18.3
Ecuador	-25.3	-11.6	0.2	1.8	7.9	36.9
El Salvador	17.0	18.5	-8.9	19.0	2.6	26.3
Guatemala	7.1	-2.9	2.4	32.2	14.6	12.5
Honduras	15.4	15.4	-46.3	18.8	12.7	-2.0
Peru	...	131.6	29.5	504.9	49.9	48.9
Uruguay	31.0	28.8	39.5	60.0	54.3	27.1 <sup>b</sup>
Venezuela	8.5	-25.3	11.9	7.8	3.5	37.6 <sup>c</sup>

Source: ECLAC, on the basis of official figures and IMF data.

<sup>a</sup> Average quarterly values. <sup>b</sup> From 1993 on, figures refer to the prime lending rate. <sup>c</sup> From 1993 on, figures refer to effective rates.

between the national and international markets. The reforms have been recognized by the market as is clear from the investment risk ratings assigned by Moody's Investors Service and Standard and Poor (S&P) of the United States.

Capital flows have also been stimulated by the "neutral" economic policies of a large number of governments. In cases where the sterilization of capital inflows was not very marked, they were reflected in exchange rate appreciation, an increase in the trade deficit, and greater demand for financing. The relative permissiveness shown by many governments in their systems of regulation of external liabilities has also contributed to the increase in these flows.

iv) Institutional changes in international markets. Apart from their interest in taking advantage of the relatively high yields offered in Latin America, it has been observed that many portfolio investors abroad are gradually modifying their investment strategy. The "emerging markets" of the developing countries are not very highly integrated with international capital markets, and some experts have therefore concluded that this lower interdependence between the two, together with the higher growth

prospects of the developing countries, offer additional benefits to investors who diversify their portfolio in order to participate in the new markets. Moreover, since their investments in emerging markets represent only a very small fraction of their total portfolio, their exposure to exchange risks does not necessarily outweigh the favourable effects of such diversification. Moreover, emerging markets typically offer only limited information to the public, so that investors ready to spend money on the generation of information have a better chance of identifying undervalued shares with appreciation potential. Finally, the emerging markets are now being discovered by investors who traditionally concentrated their attention on the industrialized countries.

External investors also apparently see Latin American bonds as a relatively secure instrument. Firstly, during the crisis of the 1980s, the countries of the region continued to service the bonds they had previously issued in a normal manner, and some experts have concluded from this that the bonds have *de facto* priority with regard to the availability of foreign exchange. Secondly, it is often maintained that bonds are less subject to non-payment

than commercial loans, as it is a good deal easier for bondholders to initiate legal action (Gooptu, 1993).<sup>22</sup>

There were also regulatory factors at the international level which facilitated the entry of capital. One of the most important of these was probably rule 144A adopted in April 1990 by the Securities and Exchange Commission in the United States. This rule allowed institutional investors registered in the United States to buy and sell securities not registered with the Commission. This strengthened the "private market" for securities not registered in the United States, thus making it possible for Latin American enterprises to organize sales of ADRs without having to adhere to the conditions imposed on the "public market" of registered securities (for example, the adoption of the United States system of book keeping).

Financial "engineering" has become the fashion in international markets and has given Latin America greater access to those markets. Enterprises with a low market profile have been able to obtain financing thanks to the imaginative mechanism of offering special guarantees in cash; for example, some Mexican enterprises were able to issue bonds by using the backing of blocked funds, financed against future earnings of foreign exchange. Another technique used has been to offer bonds with option certificates or warrants; the Mexican firm *Nacional Financiera S.N.C.* recently made a US\$ 100 million bond issue which gave investors the option, after the third year, to convert their bonds into shares in a State enterprise.

The popularity acquired by financial instruments such as ADRs also facilitated the flow of capital into the region, because they created a more favourable environment for external investors. On the one hand, dividends are received directly

in dollars; on the other, the ADRs may be purchased with the cheaper credit available in the United States. A sizeable sub-group of ADRs (known as secondary ADRs) have done more to boost stock prices than to increase business firms' capital, however, and have heightened stock quotations' sensitivity to cyclical fluctuations. From a macroeconomic standpoint, in a number of countries investments in the stock market have entailed inflows of foreign exchange that have put strong upward pressure on the currency. Thus, they have come to represent a source of future instability.

c) *Sources and uses of the new external capital flows*

As already noted, one of the main features of the recent boom in capital flows has been the relative marginalization of the commercial banks and the emergence of more diversified sources of financing than those of the 1970s. In particular, a more important role has been played by foreign direct investment (FDI) and portfolio investments (shares, bonds and other securities).

Naturally, the flows of FDI originate in decisions taken by transnational corporations, most of which are located in the industrialized countries, especially the United States, which has traditionally been the primary source of FDI (Calderón, 1994). Although the industrialized countries are the main generators of these flows, however, intra-Latin American investments are showing increasing dynamism (Calderón, 1993b). During the two or three last years, for example, Chilean enterprises have become important foreign direct investors in Argentina.

Unfortunately, investments in securities, which are now one of the most important sources of financing, represent

22 This confidence appears to contradict historical experience, for in the 1930s prolonged cases of non-payment of the external debt occurred mainly in the case of bonds, which were then the main debt instruments (ECLAC, 1964). In the 1980s, in contrast, bonds represented only a minimal proportion of the total debt.

to a large extent anonymous transactions in which it is not easy to identify the investors.<sup>23</sup> Nevertheless, there is relatively general agreement that, in the beginning, the predominant source of portfolio finance was the repatriation of assets held by Latin American residents abroad (Gooptu, 1993). An estimate based on a methodology contained in a recent report of the World Bank (1993b), as cited earlier, suggests that between 1988 and 1992 the return of flight capital was a very significant source of external financing, even taking into account substantial errors of overestimation.

As already noted, there are various reasons which explain such repatriation. Firstly, residents are perhaps the best informed about developments in their own country, so that when problems arise they may be the first to "escape", and when the situation improves, the first to return. Clearly, the structural reforms and liberalization which have been carried out have increased the opportunities for obtaining profits and reduced the transaction costs of moving domestic financial resources into and out of the region. Another motive for repatriation has been the relatively high cost of domestic credit, together with the low profitability of external assets. The purchase of Latin American bonds (which are seen as having government support), of shares in specific country investment funds and of American Depositary Receipts (ADRs) have also given local residents a feeling of security against political risks and risks involved in the transfer of resources.

Although part of this repatriation is permanent, perhaps the prime motivation is speculative – to obtain high profitability over the short term (Gooptu, 1993). To the extent that this is true, this means that a large part of the region's external financing is highly volatile.

Other sources of financing are foreign individuals and enterprises who seek

high-risk high-return investments. The main channels for this type of investment have been the managed funds specializing in the securities of emerging markets (bonds and shares) and in the retail purchase of international bonds and ADRs.

The most stable sources of portfolio financing are the big institutional investors, like insurance companies and pension funds. The institutional investors with the largest foreign portfolios are to be found in the United Kingdom, followed by Japan and the United States. However, their investments in emerging markets constitute a relatively marginal part of their portfolios, amounting to less than 5% of their total investments abroad. Even so, institutional investors seem to have been much more active in Latin America in 1992-1993, and certain information provided by market operators suggests that those organizations might continue to considerably increase their participation in the years to come (Gooptu, 1993). Finally, as regards the geographical origin of the portfolio flows towards Latin America, they appear to come largely from the United States, followed by Europe (especially the United Kingdom) (Howell, 1993).

As regards the use made of the new external financing, relatively little information is available. It is clear, however, that the Latin American private sector mobilizes the bulk of the portfolio investment. Naturally, most of the investment in capital stock is mobilized by private enterprises. But the private sector has also predominated in bond issues: in 1992 and 1993 private bodies accounted for 70% and 55%, respectively, of the total value of new bonds (World Bank, 1993a).

#### 4. The quality and future prospects of the new financing flows

One of the problems in evaluating the current increase in the flow of capital is the relatively limited nature of the

23 For example, bonds are usually payable "to bearer", while, investments in equity are also hard to trace unless there is an official requirement to register them.

information available. There is no single complete source of data on the different components of capital flows. The large quantity of local deposits in United States dollars (see table IX.17) and local-currency government securities acquired with dollars (such as the Treasury Certificates (CETES) issued in Mexico) represent potential foreign-currency obligations which do not appear in the external debt figures. Meanwhile the most general estimates of flows and obligations are full of chronological anomalies, while the various public and private efforts to collect information do not necessarily generate compatible estimates. A similar situation prevailed in the 1970s with regard to bank loans to the developing countries, and this lack of information on the part of creditors may have contributed to the excessive granting of loans, the overindebtedness and crisis (Ffrench-Davis and Devlin, 1994).<sup>24</sup>

In spite of these limitations, a brief assessment of the new capital flows is given below.

#### a) *Terms and costs*

A relatively large proportion of the new flows of external financing seem to be on relatively burdensome terms, with a significant proportion of short-term maturities. Aside from short-term loans and bank deposits, portfolio investment has quite short maturities or can be liquidated (albeit perhaps at a loss) quite rapidly.

Bonds—considered as one of the most rapidly growing of the new financial flows—have formally had a medium-term maturities, but in the 1990s this means three to five years. This limited horizon compels borrowers to have frequent recourse to difficult and uncertain refinancing exercises. The present

situation contrasts with the past century when developing countries could attract capital by issuing bonds with terms of up to 99 years (Hughes, 1979). Even the commercial banks offered average terms of seven to 10 years in the 1970s. If Latin America can maintain access to these bond markets, and if more institutional investors participate, the terms might be extended. Stock exchange investment, for its part, carries no commitments as regards terms and can be withdrawn without prior notice.<sup>25</sup> FDI, however, which made up less than a fourth of net flows in 1992 and 1993, is a long-term commitment.

All the new sources of finance are relatively burdensome. Such is the case of bonds and FDI; but it is also true in general of financing based on stock issues (Williamson, 1993a). This is one of the reasons why stock exchange investment in new shares is not usually an important source of new capital.<sup>26</sup> Naturally, the high cost is not in itself a problem if the resources are used in activities with even higher profitability and if the global economy can generate enough foreign exchange to service the external capital. Unfortunately, there is little microeconomic information on the manner in which external financing is used; however, at the macroeconomic level it is possible to examine the association between changes in external financing and domestic use of the resources for consumption or investment. This question is addressed in chapter XI.

#### b) *Volatility*

As already stated, an important source of capital has been the repatriation of funds by residents and the entry of foreign capital for short-term speculation in Latin America. The profits from such

24 Indeed, creditors only became aware of the growing debt problem at quite a late stage.

25 Naturally, there must be a domestic buyer. This question will be examined later.

26 In the United States, stock exchange investment is only 7% of new gross investment, and in the developing countries it is much lower (Welch, 1993). Traditionally, the main role of stock markets has not been to encourage new investments, but rather to offer liquidity to investors.

Table IX.17  
**LATIN AMERICA: FOREIGN CURRENCY DEPOSITS**  
*(Millions of dollars)*

	1990	1993	Share of external flows <sup>a</sup> (In percentages)
Argentina	3,442	17,126	55.7
Mexico	10,765	17,027	8.0
Paraguay	242	632	18.0
Peru	1,031	4,120	37.6
Uruguay	4,427	5,584	115.2
<b>Total (5)</b>	<b>19,907</b>	<b>44,489</b>	<b>21.6</b>

Source: ECLAC, on the basis of official figures.

<sup>a</sup> Increase in the sum of foreign-currency deposits between 1990 and 1993, expressed as a percentage of the increase in the stock of external liabilities (measured by approximation as the sum of net capital flows during the three-year period 1991-1993 as given in table IX.1).

speculation are currently quite high, partly because of the international recession and the low international real interest rates in the North. Naturally, any substantial variation in short-term profitability in Latin America compared with the rest of the world may reverse the direction of the capital flow, with negative consequences for the balance of payments and external adjustment. The speculative nature of these flows makes them potentially unstable.

Another perspective from which to judge volatility is to examine the standard deviation of the flows in the capital account broken down by types of transactions. This is the procedure used in table IX.18 for Latin America as a whole and six relatively large countries of the region. From this table we can see that the short-term financial flows (i.e., those with terms of less than one year) have traditionally been highly volatile in the last 40 years.<sup>27</sup>

In contrast with short-term capital, in general long-term flows have shown much less volatility over the last 40 years.

This category includes some portfolio flows, such as bonds. Up to the 1990s, however, the magnitude of this type of financing was so small that evaluations of its historical volatility are of no great significance. Also, with the exception of the early 1980s, the "loans" category has shown a relatively low degree of volatility over the period since the war. However, in the 1990s this type of flow has not been very dynamic, partly because of the variability of the international strategies of the commercial banks.

Another long-term flow is foreign direct investment (FDI). This balance of payments category also has relatively low volatility. FDI is usually touted as a very attractive source of external financing, which is claimed not only to be relatively permanent but also to incorporate technology and know-how. Supposedly, it also follows an anticyclical trend in the sense that profits are sensitive to the ups and downs of domestic economic activity.

However, an examination of FDI trends in Latin America suggests that a few warnings are in order regarding the

27 This is clear from the very high standard deviations for the category "short-term" flows of the balance of payments for the period 1950-1992. These standard deviations are comparable, since they were standardized by the average for each sub-period.

Table IX.18  
**LATIN AMERICA: VOLATILITY OF EXTERNAL CAPITAL FLOWS**  
*(Coefficient of volatility)<sup>a</sup>*

Net capital movements	1950-1959	1960-1969	1970-1979	1980-1989	1990-1992	1980-1992
<b>Latin America</b>						
Long term	0.63	0.45	0.62	0.88	1.92	0.87
-Loans	0.69	0.42	0.63	1.25	3.12	1.90
-Foreign direct investment	0.77	0.58	0.61	0.34	0.36	0.40
Short term	3.40	2.20	1.76	3.63	2.61	16.20
Grants and donations	0.70	0.16	0.44	0.43	1.73	0.72
Errors and omissions	1.39	1.80	4.10	1.45	5.98	1.80
<b>Argentina</b>						
Long term	1.50	3.10	1.60	0.80	0.69	0.78
-Loans	2.60	22.10	1.60	1.10	1.80	1.70
-Foreign direct investment	1.50	1.60	1.50	0.68	0.95	0.98
Short term	3.70	2.90	39.70	2.10	2.30	2.70
Grants and donations	2.50	2.60	2.90	-	-	-
Errors and omissions	19.60	3.60	2.70	2.20	3.10	2.70
<b>Brazil</b>						
Long term	0.67	0.48	0.50	1.10	2.20	1.28
-Loans	1.39	0.80	0.60	1.50	3.70	1.70
-Foreign direct investment	0.50	0.30	0.50	0.52	1.40	0.60
Short term	6.70	2.30	1.30	4.80	2.10	3.30
Grants and donations	0.50	0.40	1.50	5.20	-	3.70
Errors and omissions	3.30	1.60	3.00	1.00	0.70	0.80
<b>Chile</b>						
Long term	1.00	0.52	1.80	0.80	0.38	0.72
-Loans	1.60	0.39	1.40	1.40	0.47	1.30
-Foreign direct investment	1.30	2.40	9.20	0.65	0.41	0.70
Short term	15.40	1.60	1.16	4.20	1.00	2.40
Grants and donations	1.20	1.20	0.62	0.56	0.43	0.92
Errors and omissions	3.80	3.00	2.00	5.00	43.60	7.90
<b>Colombia</b>						
Long term	1.20	0.76	0.69	0.53	0.38	0.73
-Loans	1.30	0.80	0.75	0.68	0.18	1.00
-Foreign direct investment	2.50	0.76	0.63	0.64	0.07	0.58
Short term	13.20	3.20	27.60	3.70	1.10	2.57
Grants and donations	0.93	0.82	0.54	11.20	0.20	2.97
Errors and omissions	2.00	7.80	0.86	2.20	0.75	5.16
<b>Mexico</b>						
Long term	0.40	0.57	0.62	1.12	0.56	0.98
-Loans	1.02	0.74	0.67	2.28	1.20	1.53
-Foreign direct investment	0.29	0.58	0.51	0.58	0.50	0.72
Short term	2.20	4.49	7.49	2.53	0.43	10.80
Grants and donations	1.35	1.39	0.42	1.13	1.14	1.36
Errors and omissions	3.20	8.70	2.60	2.29	3.70	2.40
<b>Venezuela</b>						
Long term	1.58	5.58	1.59	25.70	0.81	4.60
-Loans	2.45	7.00	1.41	2.56	1.80	2.90
-Foreign direct investment	1.55	6.00	3.60	1.08	0.76	1.24
Short term	12.40	2.88	19.30	1.46	2.30	1.55
Grants and donations	0.46	1.25	0.84	0.16	0.26	0.25
Errors and omissions	1.20	2.00	1.56	3.30	0.62	2.10

Source: ECLAC, on the basis of official information.

<sup>a</sup> Standard deviation, weighted by the average for the relevant sub-period.

anticyclical nature of this type of flow. According to preliminary statistical analyses, the correlation coefficients tend to suggest that net transfers of FDI have been positively associated with the direction of the global external transfer of resources and with the behaviour of the export sector and the levels of reserves. Hence, it could be worth going more deeply into the hypothesis that the financial behaviour of FDI is procyclical in the face of balance-of-payments trends. If this is so, then its financial effects on the external sector may not be all that favourable.

As regards external capital on the Latin American stock exchanges, it should be noted that it cannot be withdrawn unilaterally: in order to sell part of it, there must be a buyer to act as a counterpart. Hence, massive withdrawal from these markets can only be achieved at the cost of a steep price drop. For this reason, some maintain that it is improbable that external capital trends on the stock exchanges could be suddenly reversed. However, the financial influence of investors and externalities on the stock exchanges is so great that it could prove to be a serious mistake to underestimate the risks of possible stampedes by foreign investors and systemic crises, for events on the stock or foreign exchange markets may induce a massive liquidation movement in an attempt to cut losses sustained as a result of additional price declines.<sup>28</sup>

### c) *Future access*

In speculating as to whether Latin America will further extend and develop its present advantageous position on

international capital markets, there are reasons to be optimistic: for example, there are certain indications that in the 1990s portfolio investors "discovered" emerging markets in the developing countries (Howell, 1993). If the only thing motivating them are high profitability, this might simply be a passing interest, but apparently there has been a growing interest in gaining the supposed benefits derived from the diversification of portfolios towards financial markets whose behaviour is not closely correlated with that of markets in the industrialized countries. This latter motive is more structural and permanent. Moreover, the external portfolio of the investors is enormous. For example, at the end of 1992 international investors held US\$ 900 billion in foreign securities (Howell, 1993), and only a tiny fraction of this sum is currently assigned to the emerging markets. Consequently, even a small diversification towards those markets could bring a huge flood of resources to the developing areas, and to Latin America in particular.<sup>29</sup>

Another factor that must be borne in mind on the supply side is that the capital holdings maintained abroad by Latin American residents are apparently very considerable. Kuczynski (1992), for example, estimates that Latin Americans have some US\$ 300 billion deposited abroad.<sup>30</sup> Nor can we discount the possibility that the favourable demonstration effects generated by the profits obtained by foreign investors may renew the interest of banks in extending medium-term loans to developing areas. At the same time, economic growth, added

28 Hence the importance of internal regulation, which is dealt with in chapter XII.

29 The pension funds of the United Kingdom have increased their investments in foreign securities, which represented 18% of their assets as of 1990; this is by far the highest coefficient among developed countries. If 5% of these investments were placed in emerging markets, this would still represent only 1% of these funds' total assets. The percentage of foreign securities held by German pension funds was 1%, while for United States pension funds the figure was 4% (Griffith-Jones, 1994, table 12). In contrast, at the beginning of the century, portfolio investors held up to 50% of their investments in emerging markets (Howell, 1993).

30 Naturally, not all these funds would be available for repatriation, for they may include significant amounts of semi-permanent investments abroad.

to transparent and attractive investment rules, should continue to attract foreign direct investment.

But as pointed out by Williamson (1993a), in the Latin American economy we should not equate access to external financing with success, for on quite a few occasions the region has had access to abundant external financing –the last episode was in the 1970s– only to end up in crisis. Clearly, continued presence in these markets will depend not only on good incentives for investors but also, in more general terms, on prudent economic management, including the extent to which the volume, type and use of external financing are compatible with macroeconomic stability, international

competitiveness and a strong domestic process of saving and investment. The external capital markets are usually less disciplined than the textbooks and market operators like to make out, and they are clearly prone to adopt prevailing cyclical trends and to make adjustments which create unsustainable financial booms. Moreover, the volume of resources available at a given moment may be enormous, compared with any developing country's capacity for efficient absorption and production. Consequently, in times of abundance borrowers need to maintain far-sighted policies and special discipline rather than trusting exclusively in the "judgement of the market" or of the creditors.

## Chapter X

# CAPITAL MOVEMENTS AND DEVELOPMENT: THE ANALYTICAL FRAMEWORK

From both the theoretical and the practical standpoint, external financial inflows can be a valuable complement to domestic efforts to initiate and sustain development processes. This chapter examines the relationship between inflows of external capital and macroeconomic stability and development.

Section 1 discusses a number of theoretical arguments, both traditional and relatively new, which analyse the role played by external capital mobility in development processes. Section 2 presents a brief description of the ongoing debate on the dynamics of capital account liberalization. What is attempted here is not to make a detailed study of the literature on these topics,<sup>31</sup> but rather to review the development of some of the main ideas and policies on capital mobility. This will provide useful background information which, together with the discussion of the composition and volume of capital flows in the previous chapter, will make it easier to analyse the relevant public policies in the region.

### 1. The role of external capital mobility in development

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External capital flows have long been assigned an important role in

development. Moreover, in recent years increasing attention has been given to the issue of capital mobility and its impact on development. Here, six central roles for capital mobility are identified: a) improved macroeconomic resource allocation; b) mobilization of foreign savings; c) smoothing out of expenditure over time; d) risk diversification; e) micro-productive efficiency and f) enhanced credibility of the monetary authorities. Each of these roles is backed up by powerful theoretical arguments. However, it also will be shown that the real second-best world in which we live can run counter to many of the textbook appreciations of capital flows. This has given rise to certain caveats about the role of capital mobility in the development processes, the most important of which are also outlined in this section.

#### *a) Efficient resource allocation*

At the aggregate level, capital movements are supposed to improve the efficiency of world resource allocation (Mathieson and Rojas-Suárez, 1993), for real returns on marginal investment in capital-rich countries are typically lower than those in capital-scarce countries. With capital mobility, savers in the

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31 For a good recent study, see Hanson (1992).

capital-rich country may be expected to give up their lower-yielding investments at home for higher-yielding investments in the poorer country. Thus, savers in the rich country earn a higher rate of return on their capital, while domestic investment and national income of the capital-poor country increase. The improved world resource allocation is also gradually reflected in smaller differentials in yields on investment between the two countries.

Like many theoretical arguments, the predicted outcomes depend on compliance with some strict conditions. Among these is the condition that financial markets, which intermediate most international movements of capital, must have what Tobin (1984) terms fundamental valuation efficiency: i.e., market valuations must accurately reflect the updated value of the dividends that the assets in question can reasonably be expected to generate over time. Accurate pricing is extremely important because prices are the main signal for the market's reallocation of capital. Unfortunately, price movements in financial markets often do not reflect fundamentals (Tobin, 1984; Stiglitz, 1993; Kenen, 1993). Thus, those investments which attract cross-border capital flows owing to their higher expected private returns may not necessarily be the investments with the highest social rate of return.

Thus, empirical studies (summarized in Tobin, 1984; Akyüz, 1993; Lessard, 1991) as well as historical analyses (Kindleberger, 1978) suggest that serious inefficiencies can arise from the allocative mechanisms of capital markets. Indeed, under conditions of capital market imperfections, together with non-economic factors, almost anything can happen regarding the conjunctural flow of capital.

In the long run, the process of trial and error allows market agents to get a better idea of the prevailing distortions and imperfections, so that, over time,

unencumbered international financial markets can systematically allocate capital more efficiently.<sup>32</sup> However, in the short term the imperfections in question can cause financial markets to allocate too much or too little capital (*vis-à-vis* the underlying returns) to some recipients at a given moment. The risk of such misallocation rises in proportion as flows are directed to purely financial operations rather than to productive investment and trade. When the short-term misallocation is very large or systemic, it can induce a crisis and have devastating consequences for firms, economic sectors and nations. Moreover, these short-term disturbances in finance, which seriously disrupt output and distort returns to capital, can obviously impart arbitrary advantages and disadvantages to different economic agents, which in themselves can become determinants of returns and thus of international resource allocation trends.

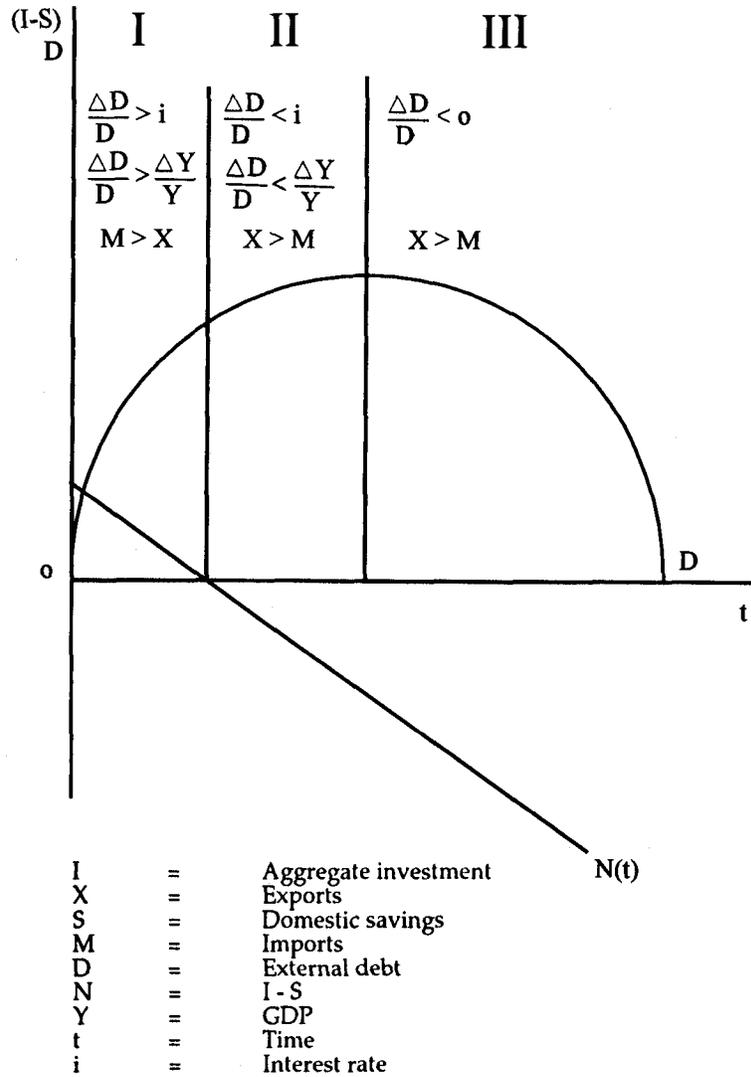
#### b) *Mobilization of external savings*

This has been perhaps the most traditional, and certainly the strongest, argument in favour of international capital mobility and flows to developing countries, for in developing countries capital is usually the scarcest factor of production, while relatively low incomes and domestic savings hinder rapid capital accumulation and growth. Therefore, external savings in the form of net capital inflows can supplement domestic savings, raise investment levels and boost growth. In turn, expansion of aggregate income can further raise domestic savings and investment, thereby creating the basis for sustained economic expansion.

The "virtuous cycle" is usually seen in terms of the favourable long-term external resource cycle shown in figure X.1. During period I, foreign capital (for the sake of simplicity represented exclusively in the form of debt) finances the shortfall in savings. External saving has its

32 Indeed, Bloomfield (1968) concluded that free international mobility of capital in the 19th century resulted in capital migrating to the places with the highest rates of return.

Figure X.1  
A VIRTUOUS DEBT CYCLE



counterpart in a deficit on the country's trade account. In this initial period foreign debt grows faster than GDP because new loans must not only cover the savings gap but must also refinance the debt service falling due. However, economic growth progressively raises the proportion of targeted investment that can be financed from domestic savings, until a point is reached at the end of period I, where the country's savings level is high enough to

finance all its investment and trade balance is reached. Interest payments are still, however, covered with new debt.

In period II, continued economic growth generates a surplus of domestic savings with respect to targeted investment levels and this manifests itself in the emergence of a trade surplus, which permits the country to voluntarily begin to reduce the flow of resources from abroad by paying progressively greater

proportions of the interest on its foreign debt. Consequently, the rate of growth of the debt gradually declines until it ceases growing altogether at the end of period II, when the savings (and trade) surplus rises to a level large enough to cover all interest on foreign liabilities. In period III, economic growth and the continued expansion of the domestic savings surplus permit the country not only to cover all its interest commitments, but also to begin paying off the foreign debt until it falls to zero. After this, the country's virtuous credit cycle culminates in its graduation to the club of net capital exporters.

While obviously highly stylized, this traditional parable has some powerful messages. First, external capital flows should consistently go to augment aggregate investment, and not be diverted to consumption. Second, an aggressive domestic savings effort is called for: from the outset of the cycle, the marginal savings rate must be kept at a level which is much higher than the country's average savings rate and also considerably greater than the investment rate, thus eventually permitting a savings surplus to emerge. Third, the investment must be efficient. Fourth, the country must invest heavily in tradables, exports and import substitutes, in order to be able to create a trade surplus large enough to transform domestic savings into convertible currency, so as to service the debt in stage II and pay it off completely in stage III.<sup>33</sup> Fifth, it requires well-informed, and patient, creditors who are willing to provide stable and predictable flows of finance on reasonable terms, especially in the delicate stage of period I, when creditors must roll over the total sum of debt service as well as financing a positive transfer of resources over a considerable number of years.

These strict stylized conditions may not all be complied with in practice, of course: countries may experience an ongoing substitution of domestic savings

by foreign savings; investments may not always be efficient or channeled sufficiently into tradable goods, and creditor behaviour may be perverse. Indeed, convincing though the traditional argument for the transfer of international savings to relatively poorer countries may be, the above problems have often caused this valuable developmental mechanism to operate only feebly. It may be recalled, for example, that between the Great Depression and 1965, relatively little capital flowed to developing regions. Moreover, when flows were renewed in the 1970s, many countries experienced a glut of finance which was one of the causes of the crisis. Notwithstanding these serious difficulties, however, foreign savings have historically played a significant role in the development of many countries, with some, like the United States, emerging as industrialized nations and subsequently evolving into major capital exporters.

Latin American countries have long used foreign savings to promote development and growth. Latin America's history as regards external financial flows has been chequered, however, as countries have repeatedly entered into defaults and crisis either due to imprudent deployment of foreign resources, destabilizing creditor behaviour or adverse external shocks (ECLAC, 1964; Stallings, 1987). The most recent crisis was of course the devastating debt problem of the 1980s.

Table X.1 shows the importance of external savings in aggregate investment flows in the region since 1970. As may be seen, even if the crisis years are excluded, for the region as a whole external savings have financed only about 15% of aggregate investment. It should be noted that this average masks the much greater significance for foreign savings for Central America and the Caribbean, where their contribution to investment is a third or more. This relatively high participation of

33 If the government is the main debtor, a fiscal surplus must also be generated, implying some combination of increased taxes and lower expenditure. For an analytical framework, see Eyzaguirre (1989).

Table X.1  
**LATIN AMERICA AND THE CARIBBEAN: EXTERNAL SAVINGS AS A  
 PERCENTAGE OF TOTAL INVESTMENT<sup>a</sup>**  
 (Percentages)

	1970- 1975	1976- 1982	1983- 1989	1990- 1991	1992- 1993
Latin America and the Caribbean	13.5	17.3	6.1	7.0	20.0
Petroleum exporters	9.7	14.3	1.5	8.2	31.2
Non-petroleum exporters	16.2	19.9	9.6	5.9	10.0
South America Central America and the Caribbean	30.9	35.0	38.9	41.5	47.0

Source: ECLAC, on the basis of official data.

<sup>a</sup> External saving is equal to capital income less the variation in reserves as shown on the balance of payments. Investment is equal to gross capital formation. Data are expressed in 1980 dollars.

foreign savings, which confirms the special situation of that subregion, is due in part to the importance of official donations, which unlike most foreign savings do not involve a direct servicing burden.

At all events, it is clear that domestic savings is by far the principal source of financing for the bulk of investment, even in Central America and the Caribbean. Clearly, without a sustained effort on this front, the level of investment will fall short of what is needed for sustained growth. Thus, foreign savings only complement this domestic effort. This conclusion is all the more evident in the case of the "success stories" of East Asia (see table I.2).

*c) Smoothing-out of expenditure over time*

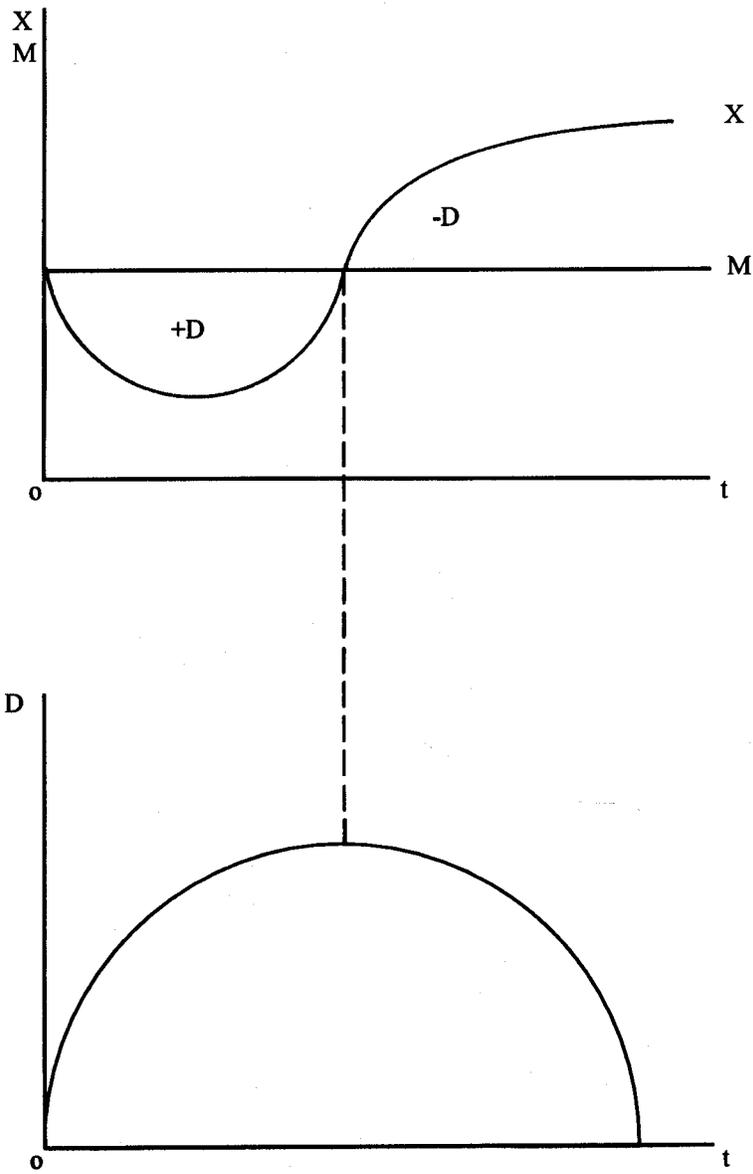
There are some possible scenarios where external capital inflows can reduce the costs of intertemporal differences between production (or income) and expenditure. Whereas the previous arguments focused on long-standing movements of capital, this one is more oriented towards conjunctural trends.

The simplest example of this role of external capital is shown in figure X.2, where a country experiences in the first half of every year a sharp and predictable seasonal drop in the output of its principal export commodity. Even if it had no reserves to draw upon, it could sustain a constant capacity to import by compensating the period of low export earnings through external borrowing and then repaying the loans in the period when earnings rise to their seasonal peak, thus leaving the country with no net debt. In this way, at the cost of the interest payments on the debt, the country avoids the social disruption of adjusting its domestic expenditure to the fluctuations in the output of its principal export.

Developing countries may also confront very protracted shocks and loss of income. In this case external financing can smooth the inevitable adjustment process and even allow the country to keep up its domestic expenditure (and import capacity) while resources are reallocated to new productive activities.

For instance, a world-wide technological change may suddenly

Figure X.2  
COMPENSATORY INDEBTEDNESS



- X = Exports
- M = Imports
- D = External debt
- Y = GDP
- E = Aggregate expenditure
- t = Time

adversely affect external demand and production in a major exporting sector, causing exports, output and income to fall. Obviously, the country must adjust and reallocate its now idle domestic resources to new productive export activities if it is to regain its pre-crisis level of output and restore balance in the external accounts. The start-up of production and exports by new activities is inevitably a lengthy process.

Thanks to capital flows the growth of domestic expenditure can be maintained at or near the old levels during the adjustment period with a concomitant external deficit and rise in foreign debt. While this policy does not eliminate all the costs of adjustment, it does minimize the under-utilization of productive resources and the social disruption caused, by allowing the inevitable costs to be spread out over time, although when the fruits of adjustment produce new exports and there is a recovery in the growth of output, the rate of expansion of aggregate expenditure must be restrained so that a domestic surplus (i.e., negative foreign savings) emerges to repay the foreign debt.

If the shock were basically transitory (for example, a temporary rise in international interest rates or a conjunctural worsening of the terms of trade), the country could borrow foreign resources to sustain expenditure. In this case, no structural adjustment would be necessary, but here too there is a cost similar to the above: in order to service the debt and repay it in the future, aggregate expenditure must be kept below aggregate output for a certain period of time.

While capital mobility can theoretically help to spread out over time the costs of intertemporal differences between output and expenditure, the process may not always evolve smoothly in practice. If the transitory swings in external variables –like the volume of exports, the terms of trade, or interest rates– are entirely predictable, free capital markets could conceivably provide the desired finance without much difficulty.

But in developing countries it is not always easy to ascertain whether a downturn in the external sector is transitory or not, and this uncertainty, coupled with imperfections in international capital markets (especially their shortsightedness or relatively narrow time horizons), the relatively large impact that even small external shocks can have on poor developing economies, and the less than perfect policy responses that can emerge, all represent obstacles to the arrival of adequate amounts of external finance. Moreover, in the face of a protracted shock, where creditworthiness depends on the ability and uncertain willingness of the country to adjust, the mobilization of adequate non-compensatory finance may be very problematical indeed. In these circumstances official compensatory finance –e.g., from the IMF– could fill the financing gaps that might emerge. However, here the record shows that in this respect there are serious imperfections owing to the mechanical limits on the availability of multilateral funds to each borrower and the only modest overall financial capacity of official lenders (O'Connell, 1993).

When this valuable role of international capital mobility is played only imperfectly, the costs of adjustment for developing countries can be enormous. That is because in the face of a negative external shock (and limited domestic international reserves), any shortfalls in capital inflows will require immediate cutbacks in domestic expenditure to restore the external balance. Moreover, while in theory output need not necessarily fall during this adjustment of expenditure, it almost certainly will in practice because of the natural rigidities standing in the way of resource reallocation, while there also tends to be a disproportionate cutback in investment. Latin America's external adjustment in the 1980s illustrates this point very well: much higher interest costs on the foreign debt and deterioration in the terms of trade, coupled with a severe shortage of financing, forced a massive adjustment of

domestic expenditure. At the same time, resource rigidities and serious contractions in the supply of imported inputs and investment contributed to unprecedented losses of output (ECLAC, 1984a; Ramos, 1985; Ground, 1986; Feinberg and French-Davis, 1988).

d) *Diversification of risks*

If finance is treated analogously to goods, social benefits could be perceived in a two-way international trade in financial assets, since capital mobility would allow individuals to satisfy their risk preferences more fully through greater diversification of their asset holdings. As Hanson (1992) emphasizes, this social benefit arises even if capital mobility has no effect whatsoever on the savings and investment process.

Following the analogy of trade in goods, this relatively recent idea concerning the benefits of capital mobility leads logically to the recommendation of free trade in financial assets (Mathieson and Rojas-Suárez, 1993). Indeed, this is one of the most widely-used arguments for justifying international across-the-board capital mobility. The conclusions are based on the notion of an integrated world economy where total well-being is the sum of the well-being of individual investors.

The strength of the general argument is weakened, however, when one breaks with the analytical tradition of the representative agent and the unit of analysis used is the country, some of them net debtors and others net creditors. In the first place, it is an individual's desire for diversification through capital outflows that initiates the trade in financial assets, and in the final analysis the main benefits from free trade in financial assets will go

to those countries which are net capital exporters rather than those which are net importers of capital, as is usually the case in developing regions (Williamson, 1983). In the second place, during the process of equalization of interest rates, an unregulated situation could degenerate into big imbalances owing to the excessive proliferation of investors with speculative instincts, who, it is well known, can lead to a weakening of the savings-investment process, which is of course of central importance to a developing country. High-risk transactions are known to be inherently more unstable, and when their volume is substantial they can cause the economy to adjust to prices which will not prevail in the medium term. These phenomena could weaken the solvency of financial systems, raise the interest cost to borrowers, deter investment in tradables, and develop into speculative bubbles which end in a crisis.<sup>34</sup>

In fact, the analogy between trade in goods and trade in financial assets may be mistaken. Trading in international financial assets is not identical to, for example, cross-border trades of wheat for textiles (Díaz-Alejandro, 1985; Devlin, 1989). The latter transaction is complete and instantaneous, whereas trade in financial instruments is inherently incomplete and of uncertain value, since it is based on a promise to pay in the future. In a world of uncertainty, incomplete insurance markets, informational costs and other distortions, *ex ante* and *ex post* valuations of financial assets may be radically different. Moreover, the separation in time between a financial transaction and payment for it, coupled with informational barriers, generates externalities in market transactions that can magnify and multiply errors in

34 Indeed, significant speculative bubbles arose in Argentina, Chile and Uruguay in the 1970s and early 1980s. Domestic interest rates and the value of domestic financial assets grew considerably faster than output and income, and remained above the levels observed in international financial markets. Financial bubbles were basically the result of four factors: i) relatively fast, radical liberalization of domestic financial markets; ii) a permissive or non-existent domestic regulatory system; iii) heavy capital inflows, mainly resulting from the liberalization of the capital account and the big interest rate spread; and iv) the corresponding exchange rate lag caused by these flows.

subjective valuations to the point where finally the market corrections are very abrupt and destabilizing. It is precisely because of this that well-being may decline with deregulation of trade in financial assets and rise with a certain amount of increased public intervention (Stiglitz, 1993). Thus, public control of trade in certain financial assets might reduce some individuals' well-being, but at the same time it would increase national or aggregate well-being through the enhancement of macroeconomic stability and better investment performance.

Finally, the separation in time between a financial transaction and the payment for it, with the consequent risk of default, also leads to efficiency criteria which are different from those found in the markets for goods and services, which clear themselves naturally through prices. In contrast, many financial markets do not clear exclusively through prices, as informational, monitoring and enforcement problems related to the borrower's behaviour cause efficient creditors to ration the volume of finance in practice.<sup>35</sup>

#### e) *Microefficiency of production*

International capital mobility is also supposed to improve productive efficiency at the micro-economic level. For the financial system this would imply lower intermediation spreads between lender and borrower (Akyüz, 1993). Generally, productive efficiency also entails lower interest costs; this increases the average quality, or creditworthiness, of applicants for funds in the capital market (Stiglitz, 1993). Lower interest rates also raise the capital value of

non-financial firms and stimulate their investment processes.

Since inflows of external funds compete with domestic capital, it may be expected that capital mobility will lower domestic interest rates. In addition, it can raise the number of effective intermediaries working in the market –including foreigners– which encourages financial innovations and puts downward pressure on intermediation spreads. The lower financial costs and the more intensive monitoring of borrowers (assuming that international investors are initially more sophisticated than their counterparts in a developing country) could also be conducive to greater efficiency in non-financial enterprises.

If the increased external capital is not allocated properly, or promotes greater volatility of asset prices, however, the mean result could be persistently high real domestic interest rates and spreads even in the face of massive capital inflows. High interest costs deteriorate loan portfolios and erode the capital value of firms as well as their savings/investment processes (Akyüz, 1993). Indeed, all these problems were present during the upward credit cycle in Latin America in the 1970s, particularly in those countries that indiscriminately encouraged unrestricted flows of external loans (Ramos, 1986).

Some regulation of competition may therefore be desirable, especially if financial market stability and predictable, stable access to finance help to reduce the perceived risks of long-term investment. This is one reason why many industrialized countries have been willing to sacrifice some degree of competition for the sake of tight regulation and stability in financial markets.<sup>36</sup>

35 This rationing occurs due to fears of "adverse selection", i.e., at some point a higher interest rate will attract only the market's riskiest borrowers, causing an overall deterioration in the expected value of the creditors' loan portfolio. Thus an efficient creditor will not necessarily offer loans to the highest bidder, as would occur in fragmented goods markets. For more on this see Jaffee and Russell (1976) and Stiglitz and Weiss (1981).

36 European countries (except the United Kingdom) tend to follow this pattern (*The Economist*, 1993a). In contrast, the United States has probably one of the most competitive financial markets, but it also has one of the highest rates of failure of financial institutions (Stiglitz, 1993).

f) *Credibility of the monetary authorities*

Some authors view capital mobility as a key ingredient in policies designed to give credibility to the monetary authorities, especially when that credibility has been lost owing to serious outbreaks of inflation. In its most conventional form, this analytical framework (often termed the monetary approach to the balance of payments) assumes open and internationally integrated trade and capital accounts, in conjunction with a fixed nominal exchange rate. The important thing, however, is that in the context of this overall scheme the economic agents should perceive that the existence of full convertibility and capital mobility takes away the ability of the country's authorities to manage the money supply: in other words, the money supply becomes just another endogenous variable of the economy. Consequently, the economic agents will anticipate that inflation will converge to international levels. On the one hand, the announcement of a fixed exchange rate favourably affects inflationary expectations, because it signals a commitment to an anti-inflationary policy, while on the other hand, arbitrage of goods and financial assets may be expected to push domestic prices down towards international levels.<sup>37</sup>

In this approach, the monetary authorities' credibility supposedly rises not because of what they can do but rather of what they cannot do. In effect, they attempt to overcome a reputation for monetary indiscipline (and inflation) by renouncing monetary policy altogether: owing to the existence of capital mobility, their actions cannot affect the level of the money supply, which will adjust "automatically" to the real demand for money through changes in balance-

of-payments transactions which alter the amount of the international reserves.<sup>38</sup>

This theoretical approach has been controversial and has generated much debate (Ardito Barletta, Blejer and Landau, 1983). On the one hand, its theoretical conclusions are weakened when international arbitrage suffers from serious imperfections, as is usually the case in developing countries. Even with radical trade liberalization, goods arbitrage can be hindered by market segmentation and product differentiation, monopolistic distribution systems, and high transport and distribution costs. Moreover, the opening up of trade will not stabilize all prices, as non-tradable goods can (at least for some time) find their price level with some degree of independence, and wages can also rise. Meanwhile, an open capital account in and of itself will not convert risk-averse investors into risk-neutral investors, so that domestic and foreign assets will not necessarily be perfect substitutes for each other (Kenen, 1993; Dornbusch, 1983). The result is that the monetary authorities will still have some impact on the money supply, and the "single price law" will be imposed only slowly. As a consequence, there can be real exchange rate appreciation and financial crisis. Indeed, all these problems emerged in the Latin American countries which tried to use the monetary approach to stabilize prices in the late 1970s (Ramos, 1986).

Whatever its theoretical merits, the monetary approach has important detractors; as Peter Kenen (1993) has remarked, it is clearly a "high-risk strategy" because "no sensible sailor throws out an anchor before the boat stops moving". Indeed, instead of trying to attack inflation indirectly through the complex channels of an exchange rate commitment, many experts are of the

37 For a more detailed overview of the monetary approach, see Blejer (1983).

38 This approach focuses basically on the changes in reserves rather than on the internal components of the current account of the balance of payments. This is because if the fiscal accounts are in balance, movements in the reserves are assumed to reflect private agents' demand for money.

opinion that it is more efficient to use direct fiscal, monetary and institutional reforms for that task.<sup>39</sup>

## 2. Liberalization of the capital account: policy evolution since the war

### a) Recent trends in developed countries

For the most part, liberalization processes have been cautious and very gradual in the developed economies of the world. A global trend towards open capital accounts started in the industrialized countries and was formalized in the 1961 OECD Codes of Liberalization. The Codes emerged as a collective plan for liberalizing restrictions on foreign exchange transactions and avoiding the costs caused to member countries by unilateral actions. Their objective was to make a transaction between non-residents as easy as one between residents of a country. The original Codes focused mainly on medium-term capital movements, but in 1989 they were modified to include short-term capital flows. The Codes are meant to guide the liberalization process in the industrialized countries; indeed, they subject member countries to regular reviews, in which they must justify their reservations regarding implementation of any aspect of the Code as well as any temporary backsliding they may have

experienced with respect to previous liberalization measures (Ley, 1989).

In the 1950s all the OECD countries had some type of major restriction, in line with the prevailing orientation of public policy at that time and the notion of national autonomy. In particular, controls helped to give more autonomy to monetary policy in the context of fixed exchange rates of the Bretton Woods system.

The countries that first began to liberalize restrictions were Canada, the United States, Switzerland and Germany, which had eliminated practically all their controls by the end of the 1950s. However, the last three countries periodically reintroduced controls in the 1960s and 1970s to deal with conjunctural problems involving exchange rates and/or the balance of payments. Indeed, controls continued to play an important role in most OECD economies during this period (OECD, 1993).

A more marked liberalization trend began in the 1980s. This pattern can be seen in table X.2, which describes the situation for a representative group of OECD countries.<sup>40</sup> As may be seen, a few countries like Germany, Canada, and the United States started out the decade with no restrictions on the movement of foreign exchange, while some countries radically eliminated all their restrictions at once: this is clearly seen from the table in the case of the United Kingdom, but it is also true of New Zealand and Australia (not shown

39 It has also been argued that capital mobility can increase the credibility of the fiscal authorities. In effect, when an economy is closed, it is easier for governments to arbitrarily tax its citizens, either directly or via inflation. Potential taxes also cause foreign investors to raise their risk premiums. Since many taxes, but especially the inflation tax, are considered distortionary, it has been argued that well-being could be increased by permitting greater capital mobility; in this way, citizens could escape the taxes at low cost and society would benefit (Hanson 1992). Moreover, the authorities would be bound in the future to keep the tax burden at internationally acceptable levels. Capital mobility can certainly erode governments' ability to tax, especially today when there are few countries with bilateral tax treaties, and it is common practice to exempt non-residents' deposits from tax liabilities. However, it would be taking things to an extreme to conclude *a priori* that capital flight is welfare-enhancing; it would first be necessary to determine how tax revenue is spent and how much weight upper-income groups have in society's welfare function.

40 The table uses a homogeneous source of data: IMF information on foreign exchange restrictions on the trade and capital accounts. The data only indicate whether the restrictions exist or not, not their intensity or scope.

in table X.2).<sup>41</sup> Most countries, however, took a gradual approach, with the poorer Southern European countries being the most gradual of all. At the beginning of the 1990s, France and several other OECD countries still maintained some substantial restrictions on capital movements.

It is clear, then, that most industrialized countries have generally been cautious in managing foreign exchange movements and the opening of their capital account.<sup>42</sup> It is also clear that the Codes of Liberalization have undoubtedly served to drastically reduce foreign exchange restrictions in the OECD area. Even so, it seems that the consensus on the need for an inflexible commitment to an open capital account has been weakened by recent speculative attacks on OECD currencies and the doubts that many have about the degree to which movements of funds are motivated by long-term considerations (fundamentals).<sup>43</sup> Thus, the use of temporary controls on short-term capital has recently been mooted, and indeed Spain, Portugal and Ireland reintroduced certain restrictions in the autumn of 1992 in order to deal with serious currency instability.<sup>44</sup> However, by the end of the year the situation had calmed down enough to allow the countries to relax the restrictions once more (OECD, 1993).

#### b) *Recent trends in developing countries*

There is a broad consensus that international capital mobility is a necessary component of the development

process. Moreover, it may be recalled that external capital has many and diverse potential roles. However, most of these arguments analyse capital-as-a-whole and take no account of important real world conditions such as informational shortcomings, the institutional peculiarities of investors, the structure of the market within which investors operate, the volume and timing of financing, its costs and volatility, public regulation and incentive structures, and the recipient country's political and economic matrices. These and other factors do not always mix in ways which permit countries to tap the full potential benefits of external capital movements. Indeed, systemic market failure can and does occur. Frequent reminders of this problem are the major financial crises, accompanied by macroeconomic collapse, that have appeared in economic history, including the recent crisis in Latin America.

Since the real world can condition the merits of even the most attractive theoretical arguments, it is not surprising that lively debates have arisen over the functioning of international financial markets, capital mobility and open capital accounts. The debate has been further fuelled by the fact that many of the most important benefits attributed to capital mobility –e.g., the use of external savings to supplement domestic saving for financing development– do not necessarily require an open capital account *per se* (Williamson, 1983), for while liberalization allows more *individuals* to interact with foreign capital markets,

41 The countries which carried out such radical liberalization tended to experience some serious economic problems, at least to begin with. For a good case study of New Zealand, see Chapple (1991).

42 For instance, Japan and Denmark took 16 and 15 years, respectively, to carry out this process (OECD, 1993).

43 As *The Economist* (1993b) pointed out, "The market...could not care less about these fundamentals. Once investors believe that governments are unable to defend their currencies with high interest rates, the game is up. With some US\$ 1 trillion a day traded on foreign-exchange markets, no amount of intervention is likely to defeat the speculators".

44 Economists Eichengreen and Wyplosz (1993) have argued that speculative attacks can and should be discouraged. Their preferred response is temporary margin requirements, with zero interest, on short-term capital inflows.

Table X.2  
INDUSTRIALIZED COUNTRIES: EVOLUTION OF EXCHANGE RESTRICTIONS <sup>a</sup>

	Germany <sup>b</sup>					Canada					United States				
	1970	1975	1980	1984	1991	1970	1975	1980	1984	1991	1970	1975	1980	1984	1991
<b>A. Exchange rate</b>															
1. More than one exchange rate for capital transactions	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2. More than one exchange rate for imports and/or exports	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
<b>B. Quantitative restrictions on foreign exchange payments</b>															
1. On current account transactions	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2. On capital account transactions	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
<b>C. Surcharges</b>															
1. Advance import deposits	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2. Requirements for surrender of export proceeds	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
	France					Japan					United Kingdom				
<b>A. Exchange rate</b>															
1. More than one exchange rate for capital transactions	X	-	-	-	-	-	-	-	-	-	X	X	-	-	-
2. More than one exchange rate for imports and/or exports	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
<b>B. Quantitative restrictions on foreign exchange payments</b>															
1. On current account transactions	X	-	-	-	-	-	-	-	-	-	X	-	-	-	-
2. On capital account transactions	X	X	X	X	X	X	X	X	-	-	X	X	-	-	-
<b>C. Surcharges</b>															
1. Advance import deposits	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2. Requirements for surrender of export proceeds	X	X	X	X	X	X	-	X	-	-	X	X	-	-	-
	Spain					Greece					Italy				
<b>A. Exchange rate</b>															
1. More than one exchange rate for capital transactions	-	-	-	-	-	-	-	-	-	-	-	X	X	-	-
2. More than one exchange rate for imports and/or exports	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
<b>B. Quantitative restrictions on foreign exchange payments</b>															
1. On current account transactions	X	X	-	-	-	X	X	X	X	X	-	X	X	-	-
2. On capital account transactions	X	X	X	X	X	X	X	X	X	X	X	X	X	-	X
<b>C. Surcharges</b>															
1. Advance import deposits	X	-	-	-	-	X	X	X	-	-	-	-	-	-	-
2. Requirements for surrender of export proceeds	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
	Portugal					Sweden					Finland				
<b>A. Exchange rate</b>															
1. More than one exchange rate for capital transactions	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2. More than one exchange rate for imports and/or exports	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
<b>B. Quantitative restrictions on foreign exchange payments</b>															
1. On current account transactions	X	X	X	X	-	-	-	-	-	-	X	-	-	-	-
2. On capital account transactions	X	X	X	X	X	X	X	X	X	X	X	X	X	X	-
<b>C. Surcharges</b>															
1. Advance import deposits	-	-	-	-	-	-	-	-	-	-	-	X	-	-	-
2. Requirements for surrender of export proceeds	X	X	X	X	X	-	-	-	-	-	X	X	-	-	-

Source: ECLAC, on the basis of International Monetary Fund, *Exchange Arrangements and Exchange Restrictions*, Washington, D.C., various issues.

<sup>a</sup> X indicates the existence of one or more restrictions. <sup>b</sup> Data refer to the Federal Republic of Germany.

similar volumes of capital flows could in principle be realized through a relatively limited number of capital-account channels.

The evolution of positions on the question of open capital accounts has been very interesting. On the one hand, the number of proponents of open capital accounts in developing countries has steadily grown over the years, to the point where many consider that an open capital account should be a major objective of economic policy. Indeed, during the 1980s developing countries were under heavy pressure to open their capital accounts. However, there is a growing trend towards more pragmatic thinking regarding capital account opening; this view counsels caution and gradualism, to the point of severely questioning the urgency of a perfectly open capital account, at least over a time horizon relevant to economic policy determination. More recently, there has been some sympathy for the idea of permanent monitoring of short-term capital flows, with controls being used for its regulation if necessary. A brief review of these trends is given below.

i) From closed to open economies. During the 1950s and 1960s, development thinking predominantly focused on real economic activity rather than questions of money and financial markets, at the same time, government investment planning and major State intervention in the savings/investment processes were generally considered an acceptable, if not necessary, practice for successful development.<sup>45</sup> Moreover, the analysis of foreign savings flows concentrated on a very limited number of channels of capital inflow, basically government-to-government bilateral foreign aid, multilateral lending and foreign direct investment.

The above situation had its roots in concrete historical circumstances. Thus, since the Great Depression of the 1930s,

the activity of private markets, and international finance in particular, had been partially in recess, with a slow revival beginning only after the Korean War. As a consequence of market failures, government economic intervention in developed and developing country markets had become routine. Most countries had comprehensive controls on capital movements. Therefore, given the restrictions on private markets, governments of developing countries were often the only borrowers able to mobilize large amounts of medium- and long-term foreign credit.

State intervention in the economies enjoyed a degree of legitimization thanks to relatively successful, albeit not always efficient, economic growth performances. This policy orientation did not have a monopoly of ideas, however: indeed it was confronted by energetic competing paradigms, particularly variants of classical *laissez faire* economics (see Killick, 1989). These latter arguments focused on the gross inefficiencies and rent-seeking typical of government intervention and the need to improve resource allocation through deregulation of markets and the consequent emergence of "correct" market-based prices. Moreover, these ideas enjoyed a growing international following towards the end of the 1960s, due partly to the increasing difficulties that governments were encountering in bringing their regulation in line with the realities of the recovery of domestic and international market activity in the period since the war. Highly symbolic of the new trend was the decision in 1971 to abandon the Bretton Woods agreement, which had been the cornerstone of government regulation of the international monetary system.

The new trends also contributed to a decisive change in the direction of development policy. Major studies emerged which focused on the need to reduce government intervention and to

45 This was symbolized in popular development theories such as the "big push", "balanced development" and "linkages".

liberalize markets, with special emphasis on domestic financial markets.<sup>46</sup> The main argument was that financial markets are the nerve center of the savings/investment process and their performance was typically being "repressed" by government intervention, with negative consequences for growth. Such so called financial repression has many dimensions, but the existence of low or negative real interest rates is at the heart of the argument. The principal prescription of these studies was therefore domestic financial deregulation and the freeing of interest rates. This was expected to raise domestic savings, stimulate more and better-quality investment, improve social equity, reduce dependence on foreign aid, and raise growth rates.<sup>47</sup>

It was also held that an open capital account was needed as a way to raise domestic saving, deepen domestic financial markets, reduce the costs of financial intermediation through enhanced competition, satisfy individuals' demand for risk diversification and optimize country and world resource allocation: in short, most of the benefits of capital mobility outlined above were invoked. This prescription, while mainly stressing the importance of relaxing the repression of financial activity, also led logically to the need for reforms and liberalization in other areas.

ii) Opening up and sequencing. While those attracted to this approach were in broad agreement on the diagnosis and general policy prescription, there were big differences of opinion regarding implementation. On the one hand, there was the position that basic reforms were part of a "seamless web" and should ideally be undertaken simultaneously in a type of "big bang" (Shaw, 1973). On the other, there were those who favoured the

sequencing of reforms, with the capital account being opened up only after consolidation of the other liberalization measures, with domestic financial reform and trade liberalization being given the highest priority (McKinnon, 1973). The capital account was deemed an especially sensitive area because, if it were opened up in conjunction with other reforms, that could induce a surge of capital inflows which could bring premature exchange rate appreciation, with negative consequences for the trade liberalization and resource allocation programme. According to this view, a competitive exchange rate was crucial to trade reform; hence, maintenance of capital controls could be justified as a way to temporarily reduce pressures for exchange rate appreciation.

The different policy focuses began to have real implications for Latin America in the mid-1970s when three Southern Cone countries –Argentina, Chile and Uruguay– underwent radical economic liberalization processes, inspired partly by the financial repression hypothesis. All three countries removed price controls, freed interest rates, sought to make fiscal reforms and opened up their trade and capital accounts.<sup>48</sup>

There was an additional incentive for encouraging capital account opening. Many analysts viewed the 1970s world-wide boom in international bank lending as an inherently benign event for development. On the supply side, private financial markets –and especially the unregulated Eurocurrency market– were considered to be highly efficient and capable of imposing "market discipline" on borrowers, in contrast to the allegedly inefficient and permissive lending of official agencies (Friedman, 1977). Furthermore, it was

46 The pioneering studies were by Shaw (1973) and McKinnon (1973).

47 An underlying assumption was that personal savings are very interest-sensitive. In contrast, Stiglitz (1993) argues that savings and investment can actually be enhanced with a reasonable amount of financial repression. At all events, studies in Latin America have shown that there is no strong relation between high real interest rates and national saving (Held and Szalachman, 1990).

48 For a detailed analysis see Foxley (1983), Frenkel (1983), Ramos (1986) and Corbo and de Melo (1987).

felt that portfolio and direct investment decisions were based on the long-term key variables – “fundamentals” – of the countries concerned, and were therefore inherently favourable to greater order and discipline. On the demand side, there was also a popular notion that if, moreover, the borrowers were from the private sector – in contrast to public agencies – the resources would be deployed efficiently (Robichek, 1981). This latter consideration was especially relevant in the Southern Cone, where the private sector was a very active borrower, especially in Chile.

As already noted, the Southern Cone experiment ended in failure as the economies collapsed because of the impact of price disequilibria and speculative bubbles on asset prices, low domestic savings and investment, the huge external debt accumulated by the countries and rampant insolvency. Some attributed the failure to unexpected external shocks; others to a flawed basic concept; and still others to poor macroeconomic management. But most of the debate has focused on the failure of international financial markets and/or flawed sequencing of the liberalization reforms.

As far as market failure is concerned, it was concluded that the so-called discipline of the private financial market had simply not materialized, for instead of facing an upward supply curve for funds, with credit rationing, as would be assumed for a market with efficient lenders, many developing countries in the 1970s apparently faced a horizontal supply curve, which gave inherently perverse price signals for the savings/investment process.<sup>49</sup>

As for the reasons for the horizontal supply curve and market failure, some

have laid stress on the presence of direct or indirect public guarantees for lenders and borrowers (McKinnon, 1984 and 1991), while others have stressed flaws in the structure of international banking markets and lending practices, as well as permissiveness in national and international regulatory frameworks (Devlin, 1989). The optimism about the inherent prudence of private borrowers also proved to be excessive, to judge by the overly-leveraged firms and banks in the Southern Cone.

As far as sequencing is concerned, there is now some consensus that the capital account opening was premature in the Southern Cone and should have been postponed until other major reforms had been consolidated and equilibrium prices established. The lesson is that during adjustment, open capital accounts (especially in periods of elastic supply of international finance) can induce surges of capital inflows with destabilizing macroeconomic and sectoral effects. In the first place, if domestic financial markets are still shallow and uncompetitive, they will not be able to efficiently intermediate a surge in capital flows, thereby threatening the sustainability of the flows.

Secondly, without a solid tax base and flexible fiscal instruments, authorities must rely on monetary policy to regulate the domestic economy, and it should be remembered that unless countries are willing to abandon exchange rate management, even partial opening up of the capital account can erode the effectiveness of monetary policy (Reisen, 1993a).

Lastly, since part of the capital flows are inevitably spent on non-tradables, the relative price of the latter tends to rise, with consequent real exchange rate

49 In properly functioning private credit markets, borrowers face an upward supply curve for finance; this is because the more that is borrowed, the riskier the loan is at the margin, thus resulting in appropriate price signals to borrowers. With a horizontal curve, however, the marginal price of credit does not rise; this gives incentives for external indebtedness to substitute domestic savings effort (Harberger, 1981; McKinnon, 1991). In the 1970s the situation was further complicated by the fact that the supply curve was actually slanting down, meaning that increased loan volumes were accompanied by falling interest rates and shrinking commissions.

appreciation. This in turn is reflected in widening of the current account deficit due to the fall in the production of tradables, coupled with a rise in domestic demand for them. The real appreciation of the exchange rate can obviously distort the resource allocation and investment, seriously debilitating a country's medium-term structural objective of penetrating external markets with new exports.<sup>50</sup> Real appreciation also tends to bring unnecessary social costs, as domestic resources most probably will have to be switched back to production of more tradable goods, through later real depreciation of the exchange rate (Edwards, 1984; Park and Park, 1993; Jiménez, 1995). This is because the counterpart of the current account deficit is an accumulation of external liabilities, which must eventually be serviced in foreign exchange.

A considerable body of expert opinion has thus emerged which urges that capital account opening should only take place after the consolidation of other major liberalization programmes, especially in the areas of trade and domestic finance; indeed, according to McKinnon (1991, p. 117), "during liberalization, stringent controls on suddenly increased inflows (or outflows) of short-term capital are warranted".

Where there has been perhaps most divergence of opinion is with respect to the speed of capital account opening once the decision is taken: some have advocated rapid and ambitious opening-up, while others counsel a gradual approach. The first-named position is favoured by those who distrust government intervention in foreign exchange and capital markets and/or fear that vested interests will paralyse liberalization programmes. The second approach stems from the belief that macroeconomic stability also requires a

certain sequence in capital account opening. At a more general level, a clear distinction is drawn between inflows and outflows, and it is suggested that countries should liberalize the former before the latter, partly because the benefits that can be derived from outflows are more evident for a country that has accumulated substantial net foreign assets (Williamson, 1991 and 1993b). There could also be sequencing within the components of inflows and outflows: for instance, long-term inflows could be liberalized before short-term transactions, while in the case of outflows, priority might be given to direct export-oriented investments and trade credit.

While there is no consensus on radical versus gradual opening, the gradualist approach seems to be gaining ground; moreover, it is more consistent with the helpful insights gained from the international discussion on the sequencing of reforms. Thus, even though developing countries may have made radical reforms, it may take a long time before conditions emerge – i.e., a deep and institutionally diversified domestic financial market, a broad, consolidated tax base, a diversified, internationally competitive export sector, and a wide range of available macroeconomic policy instruments – which will allow their economies to absorb unregulated movements of external capital in ways that are consistent with sustained growth and social equity.<sup>51</sup>

The proponents of sequencing only question the order and timing of liberalization, not the ultimate objective of an open capital account. However, the overriding importance of macroeconomic stability, coupled with the overwhelming size of international capital markets compared with the much smaller Latin American economies and the serious

50 As noted in the first chapters of this document, the countries which have successfully devoted themselves to export activities have typically needed a prolonged period of balanced and stable exchange rates.

51 Of course, as long as there are serious imperfections in capital markets, unrestricted capital flows will never be fully compatible with macroeconomic stability. This point will be discussed later.

imperfections existing in such markets, makes an inflexible commitment to an open capital account undesirable. Indeed, the increasing volatility of international capital flows, and the enormous amounts of foreign exchange traded every day, which are out of all proportions to real economic activity, have already given rise to renewed discussion in the industrialized countries on the potentially destabilizing behaviour of capital markets and the possible need for the temporary use of capital controls.<sup>52</sup> If the industrialized countries, which have the most mature markets and the most powerful battery of indirect macroeconomic policy instruments, are debating the need for more direct management of some types of flows of external capital, it would certainly be reasonable for developing countries to be doing the same.

There are a number of ways to manage capital flows. The more pressing the need for regulation, and the more underdeveloped fiscal and monetary

policy is, the more likely it is that the use of direct controls on certain types of external capital will be warranted, even if only temporarily. Of course, any sort of control is often branded as inefficient and always capable of being circumvented by ever more sophisticated capital market operations. But as Williamson (1991, p. 139) points out, "assertions about the ineffectiveness of capital controls are vastly exaggerated." As mentioned earlier, there are obviously costs involved in the use of these instruments. However, these must be measured against the global social benefits in terms of macroeconomic stability, investment and growth as well as against the feasibility and reliability of possible alternative ways to achieve the same goal.<sup>53</sup> As Zahler (1992) argues, the possible micro-economic costs of regulating capital movements may be more than offset by the benefits resulting from greater macroeconomic stability. Naturally, the net result will depend on the economic climate and the quality of the regulatory policies applied.

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52 For example, in September 1992 the United States Government called for the Group of Ten countries to study new forms of international cooperation to deal with the size and complexity of the world's money markets (Graham, 1992). Meanwhile, in September 1993 Jacques Delors, President of the Council of the European Community, discussed the possible use of capital controls to manage short-term speculative flows (*Financial Times*, 1993a).

53 Korea's recent financial liberalization and capital account opening has been very gradual and Korea frequently resorts to direct controls for management of domestic liquidity. This is because the authorities find sterilization to be too expensive and they view the direct controls as powerful instruments that give predictable results (Kang, 1993).

## Chapter XI

# CAPITAL INFLOWS: THEIR DOMESTIC EFFECTS AND MACROECONOMIC POLICY APPROACHES

### 1. Macroeconomic impact of capital flows

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Chapters IX and X examined in detail the resumption of private capital flows to Latin America and the Caribbean in the 1990s, after their virtual absence throughout the 1980s. This chapter examines the issue from the standpoint of the impact of these resources on the region's economies.

Both a shortage and an abundance of external funds pose challenges to economic policy. Specifically, this chapter analyses how to increase an economy's capacity to absorb external savings so that those savings can help strengthen productive development, generate sustainable growth trends in the trade balance and the balance of payments, and foster macroeconomic policies which encourage investment and increased productivity. Policies adopted by different countries of the region are examined, bearing in mind the effect that the interrelationship between the financial and macroeconomic dimensions has on two of the basic pillars of changing production patterns with social equity: the generation of savings and the intermediation of these funds in a way that will enhance the region's systemic competitiveness.

As discussed in the preceding chapter, one of the main arguments –from the perspective of a developing country– for promoting a linkage with external capital is that it opens up an opportunity for mobilizing external savings to strengthen national savings and investment. It is important for external capital to supplement –rather than replace– a country's domestic savings effort, since domestic saving plays a decisive role in generating the investment required in order to change production patterns with social equity (ECLAC, 1990a; 1992a).

Large-scale capital inflows into a country's economy may have two possible effects. The first is Keynesian in nature and is reflected in greater effective demand within a context marked by an underutilization of production capacity. It also results in a reduction of the external constraints under which the country is operating, with a consequent upturn in the growth rate of output. If the capital inflow is only temporary, then the Keynesian effect will be transitory as well. If demand is financed from external sources (external savings), it is important to note that the increase in aggregate expenditure will outpace the growth of output. The danger inherent in this situation is that, since the increase in spending has been financed by external borrowing, a reversal of these

flows can cause output and investment to drop. If, in addition, the terms of trade are unfavourable –as in the case of Latin America during the preceding decade–the adverse effects on the level and growth of national income could be even greater.

In the first phase of a sharp upward trend in capital inflows, there is generally a tendency for the real exchange rate to appreciate, since the entry of capital exerts pressure for a revaluation of the currency in the foreign exchange market. This in turn intensifies the entry of capital and heightens the trend towards an appreciation of the currency. The major appreciations in the real exchange rate observed in 1976-1981 and in 1990-1994 were also associated with the use of the exchange rate as a tool for combating inflation in several countries of the region.

The second effect of capital inflows, as distinct from the first, is that they influence a country's production capacity. In this case, it is important to determine what proportion of these external flows is being channeled into investment in the recipient country, how productive this investment is, and what percentage of it is being used –directly or indirectly– to produce tradables. If a large proportion of this investment is being used in a way that increases production efficiently (and is, to a great extent, being converted into tradable goods and services), then it is more likely that the economy will be able to cope with future changes in the terms and conditions applying to external debt servicing or in the volume of external flows.

As was discussed in chapter IX and is shown in table XI.1 and figure XI.1,<sup>54</sup> the region's experience during the 1976-1981 boom in capital inflows demonstrates that, as macroeconomic disequilibria intensified, it failed to create the necessary conditions to ensure the sustainability of

those capital flows. Instead, the subsequent adjustment led to a deep recession as the countries strove to contend with deteriorating conditions in international financial and commercial markets (French-Davis and Devlin, 1993).

The excess expenditure—amounting to about 4 percentage points of GDP—observed during 1976-1981 was accompanied by large speculative “bubbles” in the financial markets of some countries of the region, particularly Argentina, Chile and Uruguay.<sup>55</sup> The value of domestic financial and real estate assets grew at significantly higher rates than output and income, and domestic interest rates remained above the levels observed in international financial markets. These financial bubbles were attributable chiefly to two factors: i) large inflows of capital (stimulated by large interest-rate spreads); and ii) the widening exchange-rate lag sustained by these flows. The severe problems faced by domestic financial systems during the debt crisis demonstrate that these factors were not sustainable over time (Ramos, 1986; Corbo, de Melo and Tybout, 1985).

As indicated earlier, in the 1990s many countries of the region have re-entered international financial markets, which has enabled them to reactivate their production systems. However, prevailing circumstances in international markets for goods and services have not generated conditions conducive to a full recovery on the part of the region's economies. The terms of trade have continued to have seriously adverse effects (see table XI.1), with the resulting loss of resources swelling by 80% between 1983-1989 and 1991-1993. At the same time, the relative burden of external debt servicing has diminished thanks to the decline in international interest rates witnessed up to 1993, although its relative level remains high.

54 Except where otherwise indicated, the figures in the text and the tables are expressed in 1980 dollars.

55 These countries were pioneers in the liberalization of domestic financial markets in the region. Chapter XII analyses the various experiences of the countries of the region in supervising and regulating the commercial banking system.

Table XI.1  
LATIN AMERICA: MACROECONOMIC INDICATORS

	Billions of 1980 dollars							Percentage of GDP			
	1976- 1981	1983- 1989	1990- 1993	1990	1991	1992	1993	1976- 1981	1983- 1989	1990- 1991	1992- 1993
1. Net capital inflow	32.7	7.9	38.6	15.8	32.3	51.8	54.7	4.9	1.0	2.8	5.9
2. Variation in reserves	6.6	-0.3	16.7	12.1	16.0	21.9	16.8	1.0	-0.0	1.7	2.2
3. External saving (1-2)	26.1	8.1	22.0	3.7	16.2	29.9	37.9	3.8	1.0	1.2	3.8
4. Deficit on current account (5+6+7-8)	26.1	8.1	22.0	3.7	16.2	29.9	37.9	3.8	1.0	1.2	3.8
5. Trade deficit	4.3	-53.8	-51.6	-62.9	-54.7	-43.8	-45.0	0.6	-6.9	-7.0	-4.9
6. Effect of deterioration in terms of trade <sup>a</sup>	5.5	28.7	51.1	41.9	48.6	53.9	60.2	0.8	3.7	5.4	6.3
7. Factor service	16.9	35.1	28.7	29.6	28.8	27.3	28.9	2.5	4.5	3.5	3.1
8. Unrequited transfers <sup>b</sup>	0.6	1.9	6.2	4.9	6.5	7.4	6.2	0.1	0.2	0.7	0.8
9. GDP	671.3	778.6	781.2	829.2	858.5	884.3	912.9	100.0	100.0	100.0	100.0
10. National income (Y=9-6-7+8)	648.4	712.9	785.2	752.9	774.6	795.7	817.6	96.8	92.1	91.8	91.3
11. Consumption	513.5	594.4	672.3	637.1	664.1	893.9	704.0	76.5	76.3	77.1	77.2
12. Gross domestic investment	162.2	130.5	147.3	129.2	139.6	156.6	163.9	24.2	16.8	15.9	17.8
13. Expenditure in excess of GDP (11+12-9)=5	4.3	-53.8	-51.6	-62.9	-54.7	-43.8	-45.0	0.6	-6.9	-7.0	-4.9
14. Expenditure in excess of income (11+12-10)=4	26.1	8.1	22.0	3.7	16.2	29.9	37.9	3.8	1.0	1.2	3.8
15. Per capita GDP (US\$ 1,980)	2,044	2,017	2,023	1,982	2,013	2,034	2,061				
16. Per capita Y (US\$ 1,980)	1,978	1,857	1,852	1,823	1,847	1,864	1,873				
17. Growth rate of GDP	4.6	1.8	2.5	0.2	3.5	3.0	3.2				
18. Growth rate of exports (goods)	6.5	5.5	6.5	6.4	4.9	8.1	6.4				
19. Growth rate of imports (goods)	5.4	1.4	13.6	10.2	16.1	19.8	8.7				
20. Exports of goods	81.8	120.6	162.7	148.2	155.5	168.1	178.9	12.2	15.5	18.0	19.3
21. Imports of goods	79.5	70.3	113.6	89.8	104.2	124.8	135.8	11.8	9.0	11.5	14.5

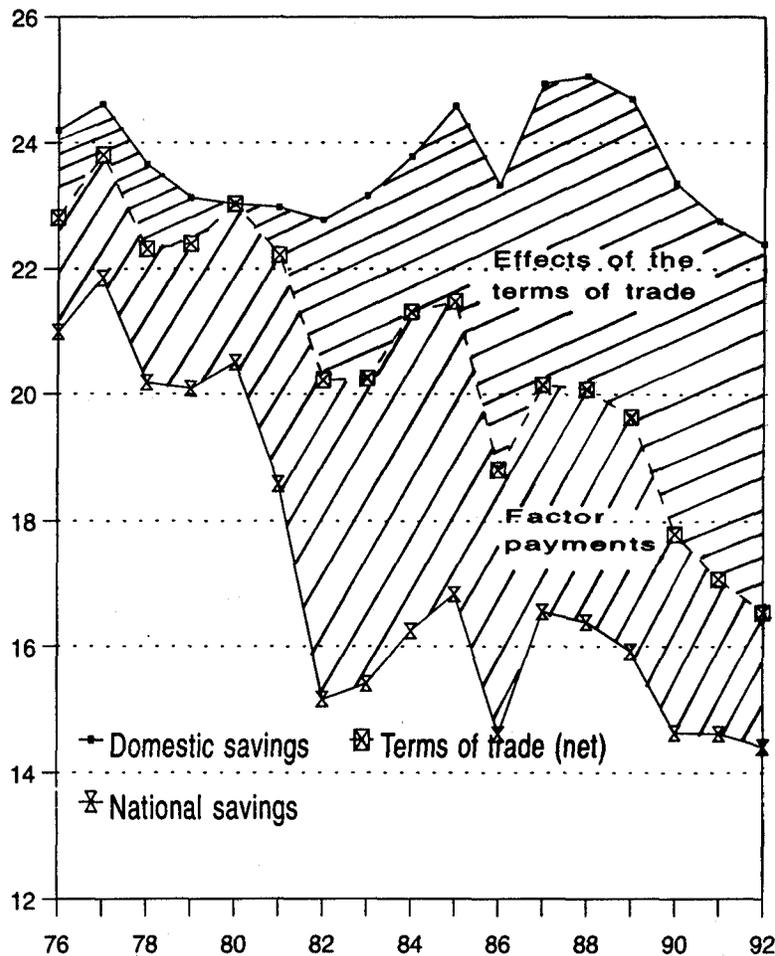
Source: ECLAC, on the basis of figures from the balance of payments and national accounts of the countries concerned.

<sup>a</sup> Resources necessary to cover the loss resulting from the increased price of imported goods as compared with goods exported by the region, measured at 1980 prices. <sup>b</sup> Corresponds to net private flows in the form of grants and donations and other non-official operations.

In 1992-1993, net capital inflows reached an annual average of US\$ 53 billion (in 1980 dollars). About one third of this amount went to build up the Latin American and Caribbean countries'

inadequate international reserves, with the rest being used to cover the current account deficit (4% of GDP). This figure was four times as much as the external savings received during the 1980s and exceeded

Figure XI.1  
**LATIN AMERICA: DOMESTIC SAVINGS AND NATIONAL SAVINGS**  
*(Percentages of GDP)*



Source: ECLAC, on the basis of official figures.

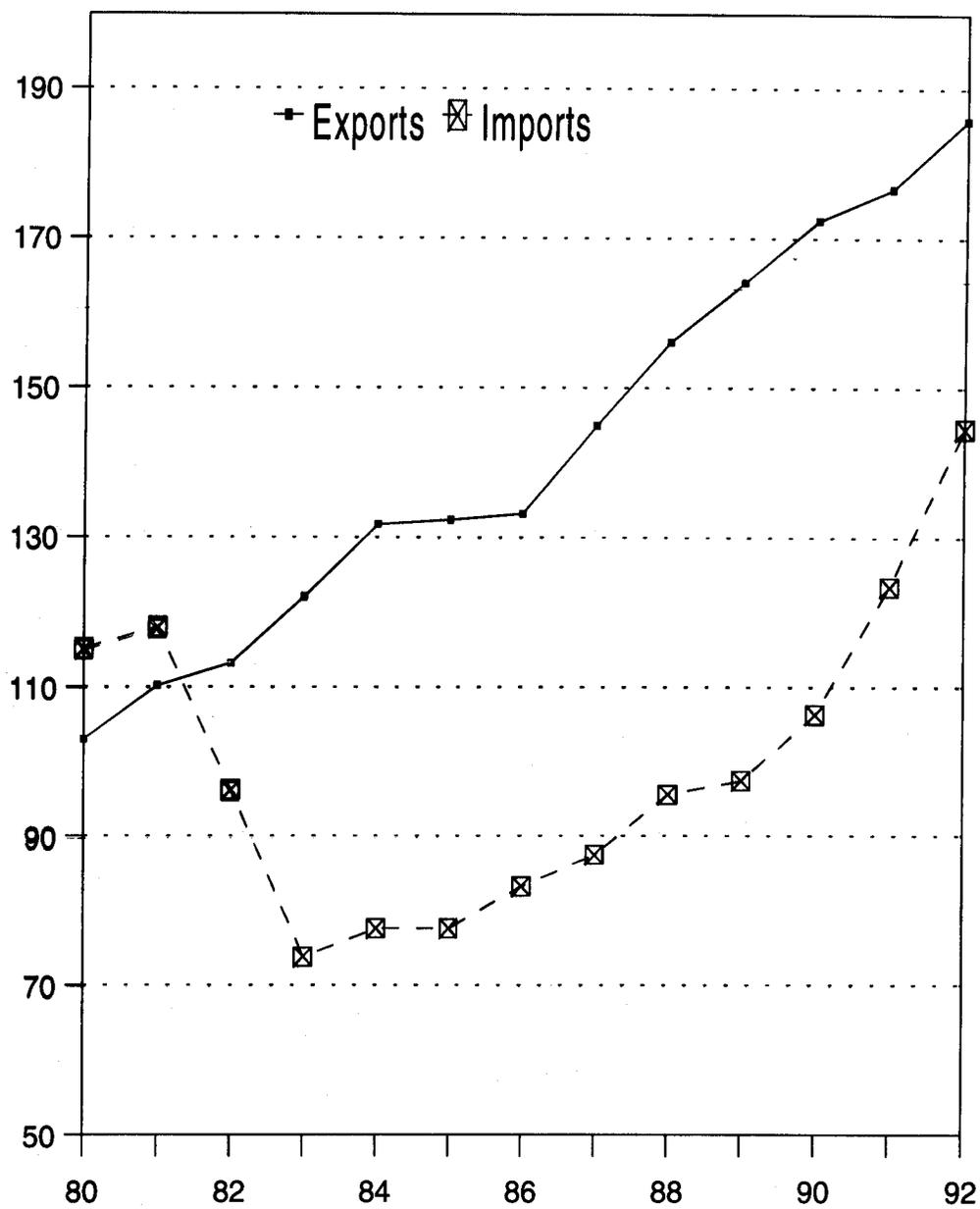
<sup>a</sup> Domestic savings less the negative terms-of-trade effect.

factor payments for the first time since 1981. Due to the adverse effect of the terms of trade, however, domestic expenditure remained below GDP. The investment rate, for its part, was only one point above the average for 1983-1989. Thus, the rate of capital formation remains very low.

The experience of the region in the past decade and a half provides us with valuable lessons about the way in which—at a point in time when countries are in the process of re-entering international

financial markets—the short-term macroeconomic situation influences the design of economic policy. A relative abundance of capital flows leads to currency appreciations which may be incompatible with medium- and long-term objectives. The authorities must base their decisions on four major objectives: i) to maintain stable capital inflows; ii) to sustain a competitive exchange rate; iii) to ensure the stability of aggregate demand and prices; and iv) to

Figure XI.2  
LATIN AMERICA: BALANCE OF TRADE IN GOODS AND SERVICES  
(Billions of 1980 dollars)



Source: ECLAC, on the basis of official figures.

promote capital formation and savings for the production of tradables while channelling these funds primarily towards investment in sectors that will increase the economy's productivity.

## 2. Use of external capital and questions of economic policy

The countries' return to international financial markets and the lessons of the past two decades point to the need to design an economic policy that fulfils three conditions: i) the impact of external funds must not adversely affect the efficiency of the economy's allocation of resources, which should be oriented towards a sustained form of growth for which international competitiveness is the driving force; ii) the absorption of external savings must not act as a disincentive for national saving if the economy is to achieve the level of investment required for long-term growth; and iii) measures for managing the balance of payments (exchange rate policy and regulation of short-term movements) must not needlessly discourage the entry of long-term capital (Calvo, Leiderman and Reinhart, 1993; Reisen, 1993b).

An *initial level of intervention* is in the foreign exchange market. In this instance, the purpose of intervention is to moderate any tendency towards an excessive appreciation of the real exchange rate, since this rate is one of the main instruments of export promotion.<sup>56</sup> This function has become more important as the countries have pursued trade liberalization programmes and regained access to the international capital market.

Variations in reserves reflect official sales and purchases of foreign exchange and indicate the extent to which the central bank has intervened in the foreign exchange market. This form of intervention is meant to lend stability and credibility to a type of exchange policy that

will send out signals conducive to on-going, sustainable growth. This point was stressed by the President of the Central Bank of Chile (Zahler, 1992, p. 161) when he said: "From a macroeconomic standpoint, the impact of an 'excessive' inflow of [external] capital on the level of the real exchange rate may be even greater than that of increased exchange-rate volatility. If the exchange rate remains below equilibrium for too long, it will have at least two kinds of undesirable effects. First, the tradables sector of the economy may be hurt. It is a well-known fact that many of the economies that have been successful in recent years (especially the small ones) have based their development on the growth of the export sector ... Second, ... sooner or later the value of the currency will have to return to its long-term equilibrium level (or even rise above it for a time), and this will put pressure on prices, thereby jeopardizing the goal of curbing inflation."

At the first level of intervention, two very different situations may arise, depending on how central banks respond to increases in capital inflows. One response is not to intervene at this first level (not to accumulate reserves). In this case, capital flows would not bring about any changes in the international assets held by the central bank, and the full weight of the increase in these flows would be brought to bear on the exchange market, where it would exert pressure for a revaluation. This sets the scene for a net increase in imports of goods and services.

The other situation occurs when the monetary authority intervenes at this first level by building up reserves. In this approach, the effects of that increase on the foreign exchange market can be sterilized, but it also has implications for the money market. Under these circumstances, the authorities must decide whether or not to sterilize the monetary effects of the build-up in reserves –which, in fact, influences the degree of liquidity of the

<sup>56</sup> This has not always been the approach taken. As will be seen later, the exchange rate, in a context of increasing capital inflows, has served anti-inflationary purposes in a number of cases.

economy—by increasing the money supply. At this *second level*, intervention involves choosing between an active or passive approach to monetary policy (in terms of managing aggregate demand) and its relationship with stabilization. In the most extreme case, if monetary authorities were to intervene actively and buy up all the foreign exchange brought in by capital inflows, then the increase in the capital account balance would be equal to the increase in official reserves. In this case, sterilization of these resources means that, at least in the short term, the central bank is preventing them from being used to finance the current account deficit and, hence, is stopping them from being channelled towards the domestic market through the use of external savings. Moreover, there is no change in the differential between national savings and investment, or in the net external wealth of the economy. It may, however, require a great effort on the part of the central bank to sterilize the monetary effects of exchange operations in order to maintain the level of the real exchange rate (Calvo, Leidermann and Reinhart, 1993; Reisen, 1993b).

Finally, countries can always modify the way in which they choose to open up their capital account in order to regulate the composition of inflows and bring them more closely into line with national development objectives. Thus, there is a *third level* at which intervention can occur. Most countries have chosen to open up their economies to capital inflows. A number of countries have also, however, set up intervention mechanisms designed to block the entry of short-term, speculative capital which does not contribute to the investment process (Ffrench-Davis and Griffith-Jones, 1995; World Bank, 1993d).

To sum up, policy options are available at three levels: i) intervention in the currency market through a build-up of reserves compatible with the various aspects of exchange policy; ii) sterilization by the central bank of the monetary effect of the increase in reserves with a view to influencing the level and composition of aggregate demand; and iii) regulation of capital movements for the purpose of controlling their level and shifting their composition in favour of long-term flows.

Since economic authorities have reacted in different ways to capital inflows, depending on the status of their countries' economies at the relevant point in time, a wide variety of policy measures have been adopted in the region. These measures will be discussed below.

a) *Capital inflows and their macroeconomic effect*

Capital inflows have brought to light an important policy issue. On the one hand, they have provided the financing needed to carry out, in a more socially efficient way, the structural adjustment programmes initiated by a number of countries in the 1980s. On the other, they have posed challenges for policy makers to design safeguards that will prevent those inflows from setting off financial crises, while at the same time ensuring the stability and sustainability of macroeconomic equilibria and promoting investment. Concern about these challenges has re-emerged as a key policy-making element as the countries re-enter international financial markets.<sup>57</sup>

For the region as a whole, the inflow of capital has had a positive effect, since it has made it possible to achieve a higher use rate for existing production capacity and,

57 ECLAC documents have drawn attention to two aspects related to the availability of external financing: i) the need for countries, once structural adjustment processes have been initiated, to have access to external financing to facilitate each of the different stages (ECLAC, 1990a, pp. 49-59); and ii) as shown by the events of the 1970s—when financial “bubbles” and crises were observed in a number of countries of the Southern Cone—liberalization and the opening of financial markets must take place in an appropriate macroeconomic and regulatory framework (Corbo, de Melo and Tybout, 1985; Ffrench-Davis, 1983; and chapter XII of this document).

as a result, to bring about a reactivation of production, income levels and employment.<sup>58</sup> As can be seen from table XI.2, along with the processes of external liberalization initiated as part of adjustment programmes, the region's success in overcoming existing external constraints in the early 1990s has enabled it to resume its economic growth, whose average annual rate increased from 1.8% for 1983-1989 to 3.4% in 1991-1994 without any significant increase in investment. This upturn is largely attributable to the fact that the greater availability of external financing has made it possible to finance more imports of inputs, thus boosting the use rate of existing production capacity, and this, via its effect on output and income, is spurring forward aggregate demand.

One special concern of the countries' economic authorities should be to ensure that the aggregate expenditure of the economy is not channelled solely towards consumption but that a large portion of that expenditure goes towards investment in sectors that produce competitive tradables. This largely depends on the incentives offered by the economy, including the strategic variable of the exchange rate.

Together with this reactivation, the speed with which capital inflows have closed the external gap and generated a surplus of external funds has been reflected in a tendency for the currency to appreciate,<sup>59</sup> a rapid reduction in trade surpluses and a widening of the current-account deficit (i.e., an increase in the use of external savings). Initially, these trends may have reflected a return to "normal" levels of aggregate demand, imports and the real exchange rate, all of

which had been dampened by the external constraints present during the period 1983-1989. The continuing abundance of capital is sustaining these trends over time and, in doing so, is causing an overadjustment of these variables. This brings economic authorities face to face with an issue of crucial importance in determining future stability, since, if the inflow of capital were to be reversed, the levels of aggregate spending, imports and the exchange rate would not be sustainable in the medium and long terms. When at their equilibrium values, these variables ought to serve as a reflection of the internal status of the merchandise and money markets, as well as the sustainable supply of external savings, which depends on whether capital flows are permanent or temporary, on their volume and on how they are used.

Table XI.2 shows that in the four-year period of 1990-1993: i) a larger proportion of capital inflows was used to build up reserves than in the past, thereby moderating the impact of these flows on the region's economies (the increase amounted to 7.7% of the region's GDP during those four years); ii) even so, the share of imports in terms of GDP climbed to levels above those registered prior to the debt crisis (14.5% in 1992-1993 and 12.3% in 1980-1981); iii) domestic expenditure rose faster than output and income, while the surplus on the total and non-financial current accounts shrank –which is tantamount to an increase in the use of external savings; and iv) national savings were displaced by external savings, as evidenced by the fact that the increase in total investment was less than the increase

58 The external constraints under which the region's economies were operating did not allow them to make use of their production capacity. Once –thanks to a reactivation– the short-term production frontier has been reached, the prospects for continued growth will then be determined by the intensity of savings and investment efforts and by gains in productivity (Fanelli and Frenkel, 1994; Devlin, French-Davis and Griffith-Jones, 1995).

59 In recent years, the countries of the region have tended to modify their exchange policies, without necessarily avoiding an appreciation of their exchange rates. Table XI.3 shows that most of the countries have an active exchange policy involving first-level interventions. Figure XI.3 illustrates the changes observed in the real exchange rate in 18 countries of the region, 13 of which have seen their currencies appreciate since 1990. These 13 countries account for over 97% of the region's GDP.

Table XI.2  
**LATIN AMERICA: SELECTED INDICATORS**  
 (Percentages of GDP based on figures expressed in 1980 dollars)

	1976- 1979	1980- 1981	1982	1983- 1989	1990	1991	1992	1993
Net capital inflows	5.0	4.7	2.6	1.0	1.9	3.8	5.9	6.0
Variation in reserves	1.6	-0.1	-2.7	-0.0	1.5	1.9	2.5	1.8
External saving	3.3	4.8	5.3	1.0	0.4	1.9	3.4	4.2
<b>Effect on reactivation</b>								
GDP growth rate (%)	5.4	3.1	-1.1	1.8	0.2	3.5	3.0	3.2
Imports (goods)	11.6	12.3	10.2	9.0	10.8	12.1	14.1	14.9
Gross domestic investment	24.1	24.3	20.5	16.8	15.6	16.3	17.7	18.0
Per capita GDP (1980 dollars)	1,994	2,144	2,057	1,726	1,982	2,013	2,034	2,061
<b>Medium-term effect</b>								
Domestic saving	23.9	22.9	22.6	23.6	23.2	22.6	22.7	22.9
National saving	20.8	19.5	15.2	15.7	15.1	14.4	14.3	13.8
Exports (goods)	12.0	12.5	13.2	15.5	17.9	18.1	19.0	19.6
<b>Non-financial current account</b>								
Trade balance (goods and services) plus term-of-trade effect	-1.3	-1.7	-0.2	3.3	2.5	0.7	-1.1	-1.7

Source: ECLAC, on the basis of official figures.

in external savings. It is noteworthy that the coefficient of capital formation has remained very low thus far in the 1990s.<sup>60</sup>

The effects of these new inflows of capital have differed from country to country, as have their access to such resources and the use which the region's economies have made of international financial markets. The capacity to absorb these flows, as well as the policies pursued by the various countries, has been affected

by each country's timing (in terms of initial conditions) of the economic adjustment process. Thus, the region's return to international financial markets has caught the various countries at different stages in their adjustment programmes.<sup>61</sup>

#### b) Policy approaches

The countries of the region have used a variety of policy instruments to tackle the conflicts described above. In general,

60 Something similar occurred during the period when the debt crisis was brewing. In that case, however, the reduction in national savings was due to a marked expansion of consumption, whereas now the drop in income brought about by the deterioration of the terms of trade is a more significant factor. In 1991-1993, the loss of income represented 5% of GDP (in 1980 dollars) as compared to the period 1976-1981.

61 Some countries found themselves in a situation where they needed to establish or reinforce *macroeconomic stability*; others, which were further along in the process of stabilizing their economies but had idle production capacity, were at a point where they needed to stimulate the *reactivation of the production apparatus*; lastly, a few (which had inflation under control and were seeing signs of a reactivation of their production apparatus) were seeking to strengthen their *savings and investment capacity* so that they could attract the financial resources they needed in order to expand their production capacity and achieve *sustainable economic growth*. While this description serves to illustrate the components of an adjustment programme, these stages do not necessarily occur in the above order.

Table XI.3  
LATIN AMERICA AND THE CARIBBEAN: EXCHANGE RATE SYSTEMS  
IN OPERATION AS OF MID-1993

Fixed dollar	Float based on currency band	Float involving intervention <sup>f</sup>	
1. Argentina	1. Chile <sup>b</sup>	1. Bolivia	7. Haiti
2. Panama	2. Colombia <sup>c</sup>	2. Brazil	8. Honduras
	3. Mexico <sup>d</sup>	3. Costa Rica	9. Jamaica
	4. Uruguay <sup>e</sup>	4. El Salvador	10. Paraguay
<b>Crawling PEG</b>		5. Ecuador	11. Peru
1. Nicaragua <sup>a</sup>		6. Guatemala	12. Trinidad and Tobago
			13. Venezuela

Source: ECLAC, on the basis of reports from the countries concerned.

<sup>a</sup> A system involving small daily devaluations since 1992. <sup>b</sup> A dirty float within a band which fluctuates around a benchmark exchange rate, which is determined on the basis of a basket of the currencies of the country's main trading partners. <sup>c</sup> A benchmark exchange rate determined by the resale value of an exchange certificate. <sup>d</sup> No intervention is involved, but fixed nominal floor and ceiling rates are used based on a sliding parity that changes at the rate of 0.40 thousands of a new peso per day. <sup>e</sup> The floor of the band is set daily, with the quotation for the dollar being corrected on the basis of the annual monetary programme. The width of the band is 7% above the minimum. <sup>f</sup> Floating exchange-rate regimes involving intervention by the central bank. Among the countries using this system, the central banks of Bolivia, El Salvador and Guatemala use auction mechanisms on a daily or weekly basis. In Honduras (for official transactions) and the Dominican Republic, the monetary authority adopts a benchmark quotation which follows trends on the free market. In Brazil, Costa Rica, Ecuador, Paraguay, Peru, Honduras (for private transactions) and Venezuela, foreign-currency quotations are determined by the foreign exchange market, usually of the banking system.

within a context of financial liberalization, the instruments adopted have been applied primarily at the first and second levels of intervention. Depending on the importance attached to the need to mitigate trends towards currency appreciation, the authorities have engaged in different forms of intervention in the foreign exchange market; in addition, depending on whether they have chosen to pursue an active or passive monetary policy, they have undertaken different degrees of intervention for the purpose of regulating aggregate demand. Some countries have also regulated capital inflows in order to influence their level and composition and to align them more closely with their development objectives.

The possible combinations of first- and second-level forms of intervention yield different mixes of exchange rate policy and monetary policy which can be identified with one of two major intervention options. The first, favoured by countries which have chosen to maintain a passive monetary policy, is known as *non-sterilized intervention*. This option involves building up substantial international reserves, since the central bank buys up the foreign currency entering the country in the form of capital flows and exchanges it for local currency, without sterilizing the monetary effect of these operations, under a controlled exchange rate system.<sup>62</sup> This averts an appreciation of the nominal exchange rate

62 The usual forms range from fixed nominal exchange rates and crawling pegs to dirty floats within pre-established bands. See, for example, Helpman, Leiderman and Bufman (1993).

but, if an adjustment via an increase in imports does not occur quickly enough, this alternative can expand the monetary base beyond desirable limits. This usually generates inflationary pressures which push up the real exchange rate and set the scene for excesses and changes in the composition of expenditure.

The second option, which is used by countries that, in addition to defending their exchange rate, have chosen to pursue active monetary policies, is known as *sterilized intervention*. As in the case of non-sterilized intervention, it involves accumulating reserves, but it also systematically approaches the second level of intervention in that it also involves sterilizing the monetary effects of these operations. The purpose here is to isolate the money stock from fluctuations stemming from the mobility of foreign capital. This type of sterilization, if effective, prevents real domestic interest rates from falling. In economies that are making full use of their production capacity, this approach has the advantage of helping to control aggregate spending and forestalling any further appreciation of the real exchange rate. However, with this option, if interest rate differentials persist, capital inflows will continue to be stimulated, thereby creating a need for further sterilization operations. This may be a source of quasi-fiscal deficits, since the central bank is called upon to place commercial paper on the domestic market at higher interest rates than those it obtains on its international reserves.

The sterilized-intervention option is not problem-free. Conflicts arise mainly when the tax system is not flexible enough for national economic authorities to use this policy to offset domestic or external shocks. What happens in these cases is that the executive branch is deprived of yet another policy tool and hence cannot use fiscal instruments when it wants to curb aggregate spending or stimulate the economy, but must instead rely solely on

monetary and exchange instruments. A more flexible tax system permits a better policy mix and more stable interest and exchange rates.

In the absence of a flexible fiscal policy, the problems associated with sterilized intervention arise out of the dilemma confronting economic authorities when they try to control, simultaneously, the real interest rate (as an instrument of monetary policy for implementing stabilization policies) and the real exchange rate (as an instrument of trade policy for boosting the production of tradables). If the interest rate needed to pursue the objective of stemming inflation (through the sterilization of the monetary effects of a build-up in reserves) is higher than the international rate once the latter has been adjusted for expectations of devaluation, then the tendency will be for capital inflows to continue to exert upward pressure on the real exchange rate, thereby jeopardizing the objective of protecting the tradables sector of the economy. If, on the other hand, the domestic interest rate is allowed to fall, then both objectives may be thwarted, since the higher level of expenditure prompted by lower interest rates will put pressure on prices as well as pushing up the real exchange rate (Zahler, 1992).

It is for this reason that, in practice, the sterilized-intervention option has been used in combination with other policy measures in an effort to take action at: i) the first level of intervention, to influence the exchange market; ii) the second level of intervention, to regulate aggregate demand; and iii) the third level of intervention, to modify the level and composition of capital flows –either directly, through restrictions and levies aimed particularly at short-term capital, or indirectly, by generating exchange-rate uncertainty. Some of the possible measures are the following:<sup>63</sup>

63 Table XI.4 presents examples of these measures as applied in Argentina, Colombia, Costa Rica, Chile and Mexico in 1991 and 1992.

At the first level of intervention, measures designed to influence the foreign exchange market include: i) increasing the demand for foreign currency by creating incentives for the outflow of capital during periods when there is a surplus of funds; this can be done by relaxing the rules governing investment by nationals abroad and the repatriation of foreign direct investment, by authorizing institutional investors to invest overseas and by permitting various categories of debtors to make overseas payments in advance; ii) applying foreign trade measures designed to gear the level of imports, the current account deficit and the build-up of reserves to the country's exchange-rate target; and iii) promoting the introduction of mechanisms which encourage productivity growth in keeping with the level of exchange rate appreciation.<sup>64</sup>

At the second level of intervention, whose purpose is to control the impact on aggregate demand, possible measures include: i) introducing mechanisms for regulating the financial system in order to avoid distortions in the sector and remedy shortcomings in the prudential and financial regulation of the banking system (see chapter XII); ii) imposing fiscal discipline in an effort to ease the additional pressures on demand; and iii) supplementing exchange policy with social contracts regarding prices and wages.

At the third level of intervention, measures designed to alter the composition of capital inflows may include: i) applying indirect types of exchange measures aimed at reducing the inflow of short-term financial capital by introducing an element of uncertainty as to the trend of the exchange rate; this could be accomplished by having the central

bank play a part in determining that rate over the short term; ii) adopting direct measures to regulate capital inflows; such measures may take the form of adjustments in the reserve requirements (often without interest) applying to bank deposits or other external credits and various kinds of quantitative controls (along with requirements as to minimum maturity periods, minimum volumes for bond issues, caps on interest rates on foreign capital and regulations regarding the participation of foreign capital in the stock market).

### 3. National experiences with intervention

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#### a) *Non-sterilized intervention*

This option has often been adopted by countries which focus on price stability as a priority objective of economic policy. It is a strategy which acts directly on inflation and indirectly on the real exchange rate. In setting up this mechanism, the expectation is that national interest and inflation rates will rapidly converge with international rates. Much of the success of this strategy ultimately depends on the confidence of economic agents in the monetary authority's ability to maintain the nominal exchange rate. This situation, in the final analysis, requires the central bank to maintain a large stock of international reserves, which affects its mix of assets and liabilities.

The success of this strategy also depends on the relationship between the nominal exchange rate and inflation. If there are substantial lags<sup>65</sup> in the inflationary dynamic, using the nominal

64 If the production sector registers strong gains in productivity on a par with the currency appreciation being led by the financial sector, then it can be expected that the macroeconomic equilibrium will be maintained. It has usually been the case, however, that during periods marked by a great abundance of external finance, financial appreciation far outweighs productivity growth. This generates an imbalance that often proves to be unsustainable in the long run.

65 This refers to the inertial component which tends to impede the reduction of the inflation rate. This element is a function of the economy's degree of formal and informal indexation and should be considered when designing an exchange policy for purposes of stabilization.

exchange rate as an anchor to stabilize prices can cause marked currency appreciations, along with the consequent effects on other relative prices, resource allocation and macroeconomic equilibria (Fanelli and Frenkel, 1993). Ultimately, if this trend persists and domestic inflation consistently exceeds the external rate, the authorities must be prepared to make adjustments in the level and composition of economic activity in cases where the real exchange rate deviates sharply from its long-term value.

While, in practice, countries can be seen to have used different policy mixes, Argentina is one of the countries that, starting from high levels of inflation, have come closest to using a pure form of this option.

In recent years, Argentina has adopted a series of measures whose general purpose has been to deregulate the various markets, including those related to capital movements. With regard to the operation of the foreign exchange market, the Convertibility Act promulgated in March 1991 (which set the nominal exchange rate for the peso at one-to-one with the dollar and established the legality of contracts denominated in different hard currencies) has permitted an extensive deregulation of this market's operations. The explicit aim of this Act was to curb inflation and ensure the stability of the nominal exchange rate (Argentina, Ministry of Economic Affairs and Public Works and Services, 1993; Fanelli and Machinea, 1995).

These changes in exchange parities have been coupled with monetary and fiscal reforms.<sup>66</sup> In September 1992, the Central Bank's charter was amended.

Some of the main amendments provided for the independence of the Central Bank, the prohibition of monetary financing of the public deficit and the elimination of State guarantees on deposits. These changes are intended to increase the credibility of the programme for maintaining monetary stability over time and of the convertibility of the currency (Fanelli and Machinea, 1995; Argentina, Ministry of Economic Affairs and Public Works and Services, 1993). At the same time, policies designed to deregulate and open up the capital account have been applied in order to step up the trade liberalization process. This move towards deregulation, under a system of fixed exchange rates, has helped to control the prices of internationally traded goods and thus to back up efforts to curb inflation.

The increase in international reserves,<sup>67</sup> in the absence of mechanisms for sterilizing the effects of exchange operations, has brought about a considerable monetization of the economy (starting from the low levels observed after the country's bout of hyperinflation of 1989); this situation, combined with the increased use of external savings and the expansion of domestic credit, has sharply boosted aggregate demand and economic activity during the four years from 1991 to 1994.

The policies instituted in the 1990s have drastically reduced the inflation rate. Measured in terms of the consumer price index (CPI), this rate was 1,344% in 1990, 7% in 1993 and 4% in 1994. The slackening of inflation was accompanied by a strong appreciation of the real exchange rate (following a steep devaluation in 1990

66 Other measures adopted in order to stimulate capital movements have been the Economic Emergency Act (August 1989), which established equal treatment for foreign and national capital invested in production sectors; the Tax Amnesty Act (April 1992); the deregulation of the financial and securities markets; and, lastly, public-sector reforms. The latter have had a major effect on capital movements and have included, in particular, the State Reform Act, which paved the way for the privatization of public enterprises and debt-equity swaps.

67 Measured in months' worth of imports, reserves amounted to about 4.5 months in 1989, but in 1990 they jumped to the equivalent of 15 months' worth. In 1993, reserves were equivalent to 10 months of imports.

which enabled the country to mark up a large trade surplus); this process slowed, however, as the domestic inflation rate drew closer to the international rate. At the same time, the authorities have promoted the creation of incentives for productivity growth.

According to ECLAC figures expressed in 1980 dollars, GDP growth rates in Argentina have been high –averaging 7.4% between 1991 and 1993– and have been coupled with a widening deficit on the current account, which went from 0.9 points of GDP in 1991 to 4.4 in 1993.<sup>68</sup> Domestic and national savings exhibited a downturn, with this trend being more pronounced in the case of domestic savings, which fell from 27 points of GDP in 1990 to 23 points in 1993. Investment recovered, reaching 19.8% of GDP in 1993, although this figure was still far below the average for 1976-1981. The trade surplus (measured in constant 1980 dollars) was reduced from 13 points of GDP in 1990 to 7 points in 1993, reflecting the fact that the growth of imports outpaced that of exports as a result of the reactivation of the economy, the appreciation of the currency and the liberalization of trade. In nominal terms, the merchandise trade balance flip-flopped from a surplus of US\$ 8.6 billion in 1990 to a deficit of US\$ 2.5 billion in 1993 and of US\$ 4.2 billion in 1994, while the current account balance plunged from a surplus of US\$ 1.9 billion to a deficit of US\$ 10.5 billion in 1994.

To sum up, the Argentine option –based on a fixed nominal exchange rate, the adoption of a monetary regime which does not provide for the sterilization of the effects of capital flows on the money supply, and the implementation of a structural reform package–has made considerable headway in terms of stabilization and the reactivation of production; these advances have been accompanied by a strong appreciation of the real exchange rate which has influenced the composition of demand and the allocation of investment

resources, along with a growing deficit on current account.

#### b) *Sterilized intervention*

This alternative has been preferred by countries that have pursued an active monetary policy while at the same time maintaining a more cautious position with regard to the make-up of capital flows. It is an approach that arises out of a concern for the continued development of the tradables sector, the generation of national income and the channelling of that income towards savings and investment in that sector.

Among the countries which have opted for active intervention, Chile has done so most consistently, but others –such as Colombia, Costa Rica and Mexico– have also taken this approach. Some of the instruments used by these countries at the three levels of intervention are reviewed below (see table XI.4).

*The case of Chile.* In 1991, the authorities began to take steps to regulate capital inflows and sterilize the monetary effects of the build-up of reserves by intervening in the foreign exchange and money markets. Chile has primarily used three instruments for these purposes: an exchange policy based on a “dirty” float of the exchange rate using a benchmark value determined on the basis of a basket of currencies; sterilization of the monetary effects of the accumulation of reserves through open market operations; and the application of levies and reserve requirements to regulate the entry of capital and discourage excessive inflows, mainly of short-term capital (Ffrench-Davis, Agosin and Uthoff, 1995).

The Chilean authorities opted for intervention with a view to influencing the real exchange rate in the short term; this approach was based on two assumptions: i) the monetary authority has a clearer picture of probable future trends in the

68 The available figures in 1980 dollars generally cover the period up to 1993 only. Figures expressed in current dollars for 1994 are preliminary in nature and have been taken from ECLAC (1994a).

Table XI.4  
LATIN AMERICA AND CENTRAL AMERICA (SELECTED COUNTRIES): SUMMARY OF  
CAPITAL-INFLOW INTERVENTION MEASURES

	Argentina	Colombia	Costa Rica	Chile	Mexico
<b>First Level</b> (Moderation of the impact of capital inflows on currency appreciation/build-up of reserves)	March 1991: Convertibility Act fixes the nominal exchange rate and deregulates the foreign exchange market. Liberalization and opening up of trade.	June 1991: introduction of floating band ( <i>certicambios</i> ). January 1992: exporters allowed to hold a portion of their earnings abroad, and residents allowed to hold up to US\$ 500,000 in assets abroad without prior permission. February 1992: reduction of the minimum maturity period for external loans to be used for working capital or fixed investment. Liberalization of trade.	Early 1992: introduction of float coupled with intervention measures	1991: small revaluations followed by gradual devaluations that heighten the inflow of short-term capital. March 1992: "dirty" float initiated within the currency band. July 1992: criterion used for setting exchange rate is changed; rate pegged to a basket of currencies 1991: increase in percentage of foreign currency deposits which banks can use for foreign trade. Rules for overseas investment by nationals made more operations flexible.	Introduction of floating band with fixed floor. November 1991: band ceiling devalued by 20 centavos per day. October 1992: daily devaluation increased to 40 centavos.
<b>Second level</b> (Sterilization of the monetary effect of exchange operations)	Strengthening of public finances and introduction of a passive monetary policy.	Strengthening of public finances. January-October 1991: active monetary policy. October 1991: interest-rate controls lifted and sterilization policy abandoned.	Strengthening of public finances. Open market operations and reserve requirements on deposits in foreign and local currency.	Strengthening of public finances. Active monetary policy based on open market operations.	Strengthening of public finances. Moderate sterilization.
<b>Third level</b> (Moderation of capital inflows)		June 1991: 3% tax on foreign-exchange transactions generated by personal services rendered abroad. February 1992: increase in commission on purchases of foreign exchange from Central Bank from 1.5% to 5%. June 1992: regulation of the entry of foreign exchange as payment for services.		June 1991: reserve requirement of 20% (without interest) on external credits. January 1992: reserve requirement raised to 30% and extended to apply to foreign-currency deposits.	The amount of liabilities which the banking system may hold in foreign currency is limited to 10% of its total liabilities.

Source: ECLAC, on the basis of various authors cited in the text.

balance of payments and how they may affect the economy; and ii) it has a longer planning horizon than do agents operating in short-term markets (Zahler, 1992).

Chile's exchange policy has undergone important changes in recent years. In 1983, once the freeze placed on the nominal exchange rate in 1979 had been lifted, the country returned to a crawling peg system which involved setting a benchmark price for the dollar. This was devalued daily by the Central Bank on the basis of domestic and external inflation differentials. In order to give the market some role to play in this respect, the price for the purchase and sale of foreign exchange was allowed to float within a certain range on either side of the benchmark value for the dollar. As of mid-1989, this band was fixed at 5% of that value.

Due to the intensification of capital inflows from 1990 on, the official exchange rate repeatedly settled near the floor of the band, forcing the Central Bank to step in. As a result, the Central Bank had to buy up US\$ 1.5 billion in 1990 and US\$ 3 billion in 1991, as well as engaging in a large volume of open market operations in order to sterilize the monetary effect of exchange operations. As will be seen later on, these measures were supplemented with reserve requirements on external credits, taxes which mainly affected short-term operations, and the gradual liberalization of capital outflows, although this last measure failed to have the desired effect.

In addition to this large inflow of capital, Chile also witnessed an improvement in its non-financial services account thanks to a strong expansion of exports of services and of non-traditional goods and to reductions in the external debt service. The authorities felt that some of the factors that were contributing to the positive trends in the current and capital accounts were of a fairly permanent nature and therefore proceeded to adapt the economic environment to these trends by means of two additional measures: i) a 2% revaluation in June 1991 coupled with a reduction in customs tariffs from 15% to 11%; ii) a further revaluation, of 5%, in

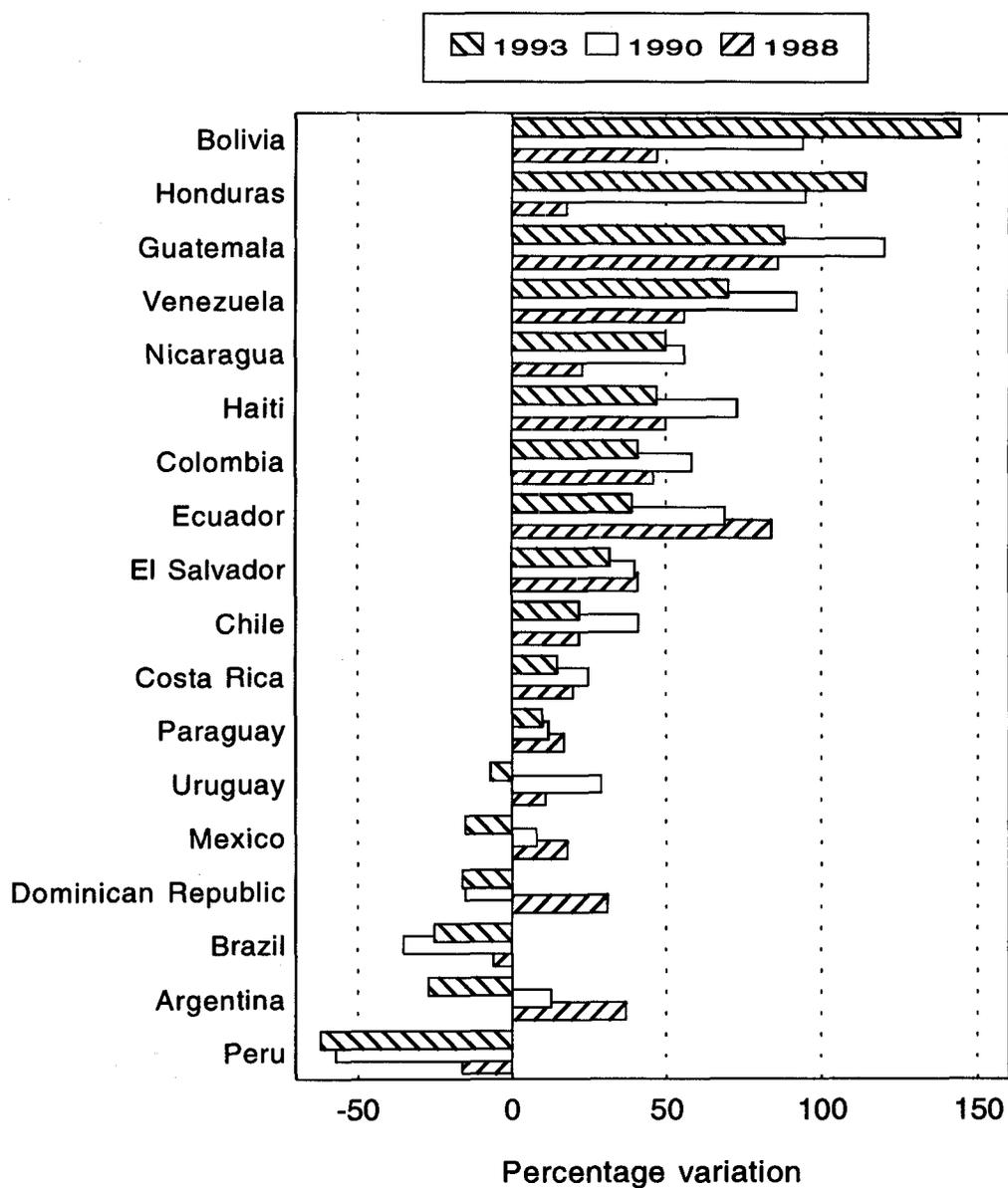
January 1992. Nevertheless, the foreign exchange market persisted in bringing pressure to bear for a significantly larger appreciation. In response to this situation, the Chilean monetary authorities, who were convinced that they were dealing largely with transitory factors, took a series of steps that enabled them to blunt these upward pressures.

Some of the main such measures were: i) in 1991, a 20% reserve requirement and a 1.2% tax on short-term external credits were established; ii) in 1992, the currency band was widened from 5% to 10% of the dollar's benchmark value in order to introduce more uncertainty into the formation of short-term expectations; iii) this measure was supplemented in March 1992 by the Central Bank's decision to intervene on a discretionary basis within the limits of the band (a "dirty" float); iv) in May 1992, the reserve requirement was raised to 30% and its application was extended to include foreign-currency deposits; and v) in July 1992, exchange regulations were amended with a view to reducing the linkage of Chile's monetary policy with that of the United States and tying it more closely to the policies of Chile's other main trading partners. To this end, the benchmark exchange rate was pegged to a currency basket made up of the United States dollar (50%), the German mark (30%) and the Japanese yen (20%), with these weightings reflecting the importance of the different currency areas in terms of Chile's foreign trade (Ffrench-Davis, Agosin and Uthoff, 1995).

To sum up, in order to discourage inflows of short-term capital—stimulated, in particular, by differences between domestic and international interest rates—the Chilean authorities have looked for ways of raising the cost of foreign-currency borrowing from overseas sources through the use of reserve requirements (and taxes) designed to equalize it with the cost of domestic credit (adjusted for the exchange risk assumed by agents wishing to operate in Chile). In addition, by instituting a dirty float and pegging the exchange rate to a currency

Figure XI.3  
 LATIN AMERICA AND THE CARIBBEAN: INDEXES OF THE REAL EFFECTIVE  
 EXCHANGE RATE <sup>a</sup>

(Percentage variations in relation to the 1985-1989 average)



Source: ECLAC, *Preliminary Overview of the Economy of Latin America and the Caribbean, 1994* (LC/G.1846), Santiago, Chile, December 1994.

<sup>a</sup> The consumer price index was used for all the countries.

basket, the authorities have increased the uncertainty and costs of agents dealing in short-term speculative capital.<sup>69</sup> These measures discourage capital inflows, thereby easing upward pressure on the currency and helping to restore control over the domestic interest rate and aggregate demand.

Another important characteristic of the Chilean experience has been the Central Bank's ability to gain access to the domestic financial market in order to counter the liquidity created by the build-up of reserves, which trebled between 1989 and 1993.<sup>70</sup> The national financial market received a strong boost, *inter alia*, from the reform of the country's pension system. In fact, the rate at which pension funds have been accumulating resources has outstripped the increase in the supply of authorized financial assets, and they now hold a majority share in the market for some instruments. This development of the capital market has allowed the Central Bank to place a very large volume of notes on that market, mainly for the purpose of sterilizing the increased liquidity resulting from its purchases of foreign exchange.

In terms of combating inflation, the policies implemented in Chile demonstrate that if a country places

priority on curbing the trend towards an appreciation of its currency, it may find it necessary to set less stringent inflation targets in the short run, but these targets may not necessarily be unsatisfactory by Latin American standards or compared with the country's (in this case, Chile's) historical averages. Chile's annual rate of inflation, as measured by the CPI, dropped from over 30% at the start of 1990 to 13% in 1992 and 9% in 1994. The measure of inertia displayed by the inflation rate in recent years is a consequence of the fact that the anti-inflation effort is being made in the context of a heavily indexed economy.<sup>71</sup>

*The case of Mexico.* Mexico's return to international financial markets began in the second half of 1989 and has resulted in large surpluses on the capital account of its balance of payments. This has enabled the country to cope with growing deficits on its current account while at the same time building up its international reserves.

Since 1983, Mexico's economic strategy has been based on two courses of action: i) macroeconomic adjustment and stabilization of price levels; and ii) structural reforms.<sup>72</sup> In this context, and given the possibility that, by expanding aggregate demand, new capital inflows might prevent the economic authority

69 Chile has also adopted a number of important measures to encourage selective, gradual capital outflows. In 1991, the authorities raised the percentage of foreign-currency deposits which commercial banks could use for financing external trade, loosened regulations applying to overseas investment by national enterprises, shortened the time period allowed for the remittance of capital brought into the country through debt conversions, and authorized pension-fund management boards (AFPs) to invest part of their portfolios in low-risk instruments on overseas markets. In general, the effects of these measures have been very limited because returns on investment have continued to be higher in Chile. The only significant developments have been overseas investments involving the purchase of business firms as part of privatization operations and the purchase of shares in bullish stock markets, since in both cases investors look forward to large capital gains.

70 As early as 1991, these reserves were equivalent to one year's worth of imports.

71 Other issues, such as the policy governing international reserves, the 6% average growth rate of GDP in the 1990s coupled with a record level of investment in 1993, and the quasi-fiscal cost of sterilizing the increase in reserves (in that the interest rates which the Central Bank must pay on its notes are much higher than those it obtains from its foreign-currency holdings), are examined in French-Davis, Agosin and Uthoff (1995).

72 Structural changes have been based, *inter alia*, on: i) trade liberalization; ii) modifications in the regulatory framework for foreign investment; iii) privatization of public enterprises; iv) deregulation on the domestic front (commercial, industrial, financial sectors); and v) strengthening of public finances.

from attaining its inflation targets, a number of measures aimed at reducing the impact of such flows on the economy have been adopted: i) the sterilization of the effect of foreign exchange operations; ii) a relaxation of exchange policy; and iii) the imposition of limits on external borrowing by commercial banks (Banco de México, 1993; Gurría, 1995).

The primary objective of monetary policy has been to combat inflation and exchange policy has been used to help achieve that goal (Banco de México, 1993).

Mexico's exchange policy allows the exchange rate to fluctuate within a band whose maximum point of intervention is lowered daily by a pre-announced amount, while the lower level of the band remains constant.<sup>73</sup>

For purposes of monetary policy, this exchange system (i.e., controlled movement of the nominal exchange rate) entails an endogenous money supply determined by variations in domestic credit and by the balance of payments. Thus, the main instrument of monetary policy available to the authorities is to control domestic credit, giving the interest rate full freedom to adjust to the target exchange rate (Banco de México, 1993).

The authorities have been cautious in their use of open market operations to sterilize the impact of capital flows. It is estimated that the cost of sterilization amounted to 0.25 points of GDP during 1990-1992 (Gurría, 1995).

Together with these sterilization operations and a relaxation of exchange policy, in 1992 Mexico placed a limit on the amount of liabilities which commercial

banks could hold in foreign currency: the current limit is 10% of total liabilities. The coefficient of liquidity was maintained at 15%, which must be placed in low-risk instruments.

With regard to the objectives of stabilization, the results have been positive. The annual rate of inflation (measured by the CPI) declined from 30% in 1990 to 8% in 1993 and 7% in 1994. The exchange rate has shown a persistent trend towards real appreciation, however, and in 1993 reached levels similar to those of 1980 (see figure XI.4). In 1980 dollars, the current account deficit rose from 4.4% of GDP in 1990 to 9.5% in 1993; total investment increased from 19% of GDP in 1991 to 21% in 1993.<sup>74</sup> Domestic and national savings have been declining, with the former slipping from 24% of GDP in 1990 to 22% in 1993 (see table XI.5), and the growth rate of output has been edging upward quite hesitantly in some years, averaging 3% since 1990.

*The case of Colombia.* During the period 1990-1992, the Banco de la República of Colombia built up its stock of international reserves to the point where it practically doubled its original balance.<sup>75</sup> There is now some degree of consensus among analysts that the bulk of the build-up in reserves was the result of capital movements and not, as on previous occasions, of export-related movements (Carrasquilla, 1993).

During the first three quarters of 1991, capital inflows were accompanied by an active policy effort to sterilize the monetary effects of the build-up in reserves through open market operations

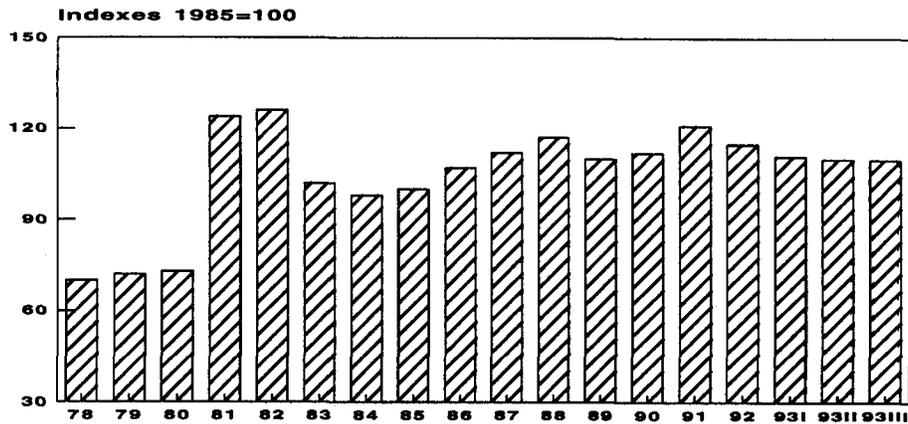
73 In November 1991, together with the elimination of exchange controls, Mexico widened its currency band, allowing a devaluation of the band's ceiling of 20 centavos per day. In October 1992, it increased the devaluation to 0.40 thousandths of a new peso per day (equivalent to an annual rate of devaluation of 4.5%). By the end of 1993 the difference between the minimum and maximum levels amounted to 9%. The purpose of this measure was to give the exchange rate greater flexibility in adapting to the increased supply of capital and, by widening the band, to increase the level of exchange risk in order to deter short-term capital inflows.

74 In nominal terms, the current account deficit rose from US\$ 8 billion in 1990 to US\$ 25 billion in 1992 and US\$ 29 billion in 1994. Exports of goods amounted to around 19% of GDP in 1993.

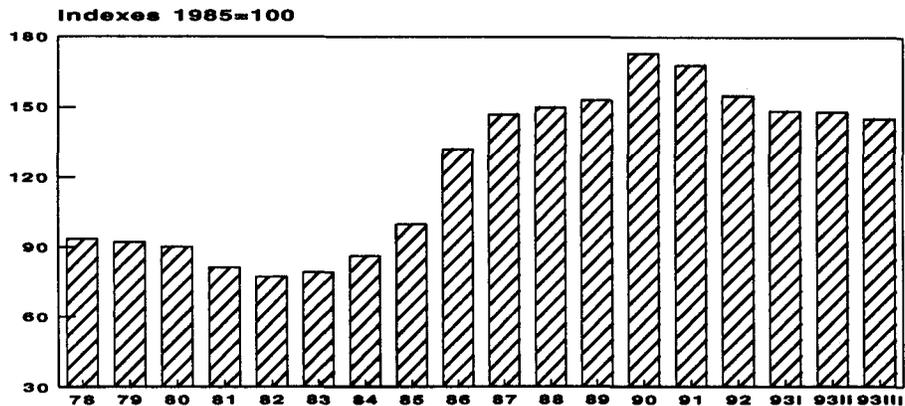
75 In 1990, reserves were equivalent to 10 months' worth of imports; in 1991 they jumped to 16 months' worth, but fell back to the equivalent of 10 months in 1993.

Figure XI.4  
**INDEXES OF THE REAL EXCHANGE RATE FOR  
 EXPORTS IN SELECTED COUNTRIES**  
 (1990 = 100)

**COSTA RICA**



**COLOMBIA**



**ARGENTINA**

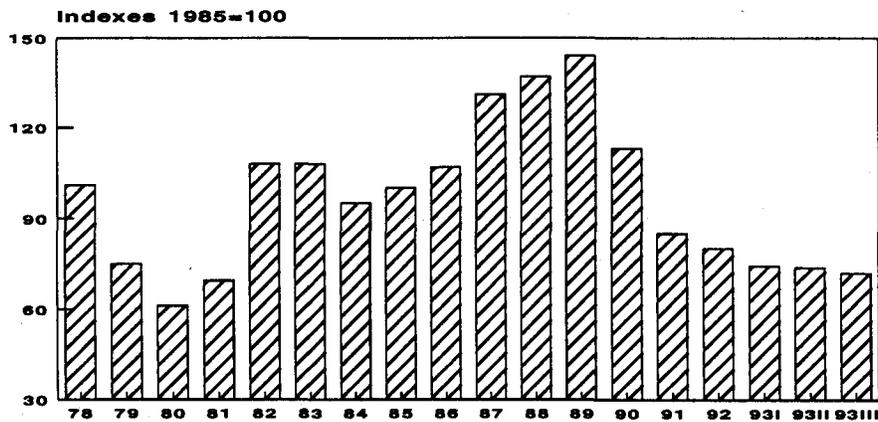
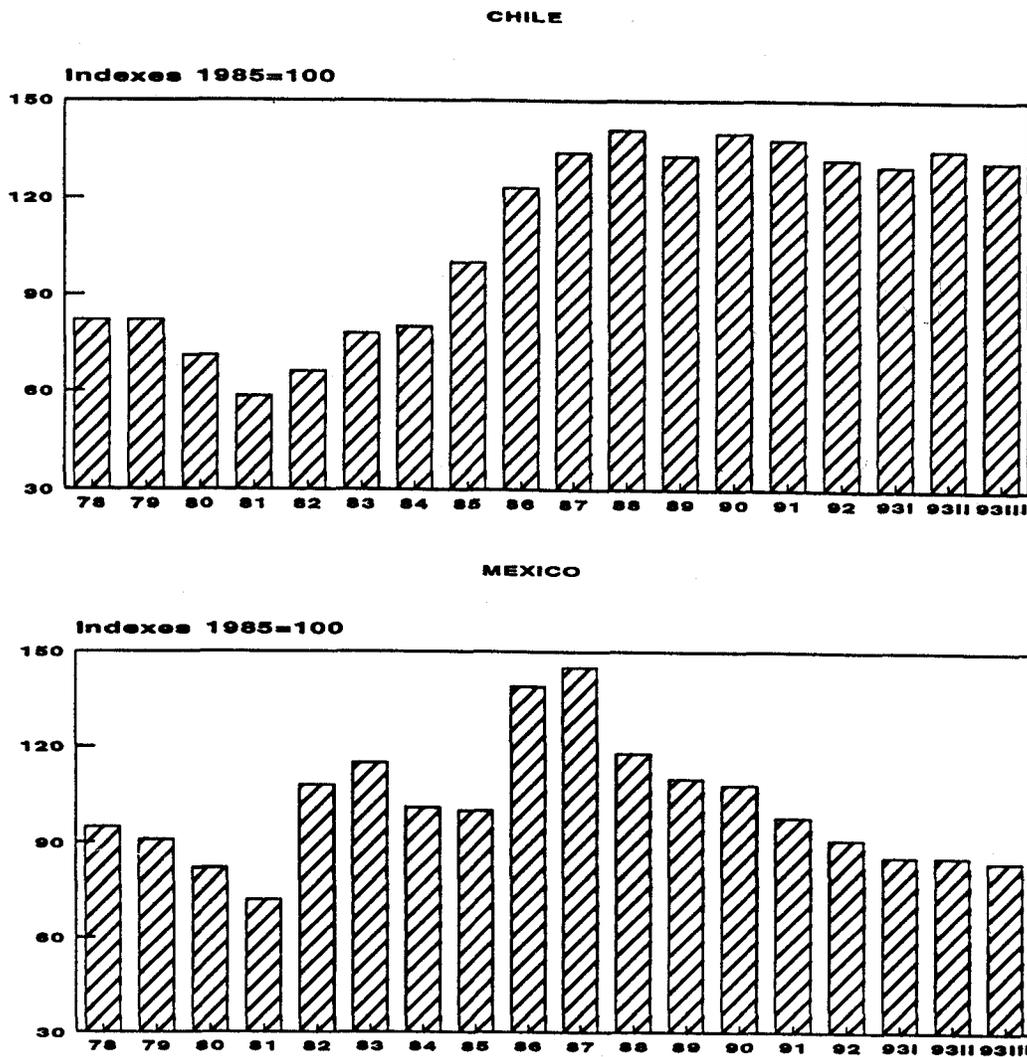


Figure XI.4 (concluded)



Source: ECLAC, *Preliminary Overview of the Economy of Latin America and the Caribbean, 1994* (LC/G.1846), Santiago, December 1994, table A-8.

<sup>a</sup> Values for 1994 correspond to the average for the period from January to September.

and by a change in exchange policy, in June of that year, designed to backstop those sterilization efforts.<sup>76</sup>

As a result of this change, the Central Bank would no longer pay cash for foreign exchange but would instead pay with

76 Other measures aimed at reducing capital inflows included the application, in June 1991, of a 3% tax on transactions in foreign currency generated by personal services rendered abroad and on other types of transfers. In February 1992, the Banco de la República raised the commission on foreign exchange purchases from 1.5% to 5% (IMF, 1993).

Table XI.5  
**LATIN AMERICA (SELECTED COUNTRIES): INDICATORS OF  
 RESERVES AND PRICES**

	1989	1990	1991	1992	1993
<b>Argentina</b>					
Reserves (months' worth of imports)	4.5	14.8	10.7	9.9	9.9
Real exchange rate (1985=100)	151.1	105.6	88.0	81.8	78.6
Interest rate spread					
Short term	26.4	127.7	-12.6	9.2	5.8
Long term	27.2	127.5	-14.4	6.1	3.4
Inflation according to CPI	4 923	1 344	84.0	17.6	7.7
<b>Chile</b>					
Reserves (months' worth of imports)	6.7	10.3	11.5	12.5	11.3
Real exchange rate (1985=100)	135.4	140.4	138.9	133.1	135.0
Interest rate spread					
Short term	-3.3	15.7	4.1	11.2	2.1
Long term	-2.5	15.5	2.3	8.1	-0.3
Inflation according to CPI	21.4	27.3	18.7	12.7	12.2
<b>Colombia</b>					
Reserves (months' worth of imports)	9.5	9.9	15.9	14.2	10.1
Real exchange rate (1985=100)	149.0	167.8	169.5	150.2	139.8
Interest rate spread					
Short term	-9.3	-8.4	3.7	-8.3	17.3
Long term	-8.5	-8.6	1.9	-11.4	14.9
Inflation according to CPI	26.1	32.4	26.8	25.2	22.6
<b>Costa Rica</b>					
Reserves (months' worth of imports)	5.7	3.5	6.6	5.8	4.6
Real exchange rate (1985=100)	109.0	111.2	120.5	114.7	111.9
Interest rate spread					
Short term	-0.1	-8.8	-8.8	9.9	3.0
Long term	0.7	-9.0	-10.6	6.8	0.6
Inflation according to CPI	10.0	27.3	25.3	17.0	9.0
<b>Mexico</b>					
Reserves (months' worth of imports)	3.2	3.8	5.6	4.9	6.1
Real exchange rate (1985=100)	108.4	105.0	95.7	88.0	82.8
Interest rate spread					
Short term	9.0	8.9	6.1	10.1	12.4
Long term	9.7	8.7	4.3	7.0	10.0
Inflation according to CPI	19.7	29.9	18.9	11.9	8.0

Source: ECLAC, on the basis of official figures provided by the countries and the International Monetary Fund; ECLAC, *Preliminary Overview of the Economy of Latin America and the Caribbean, 1994* (LC/G.1846), Santiago, Chile, December, 1994.

exchange certificates called "*certicambios*", which were dollar-denominated non-interest-bearing bonds having a maturity period of one year. These bonds' redemption price in pesos (referred to as the official exchange rate) was fixed daily by the Central Bank. At the time of their issue, *certicambios* could be sold on the secondary market at a discount that fluctuated within a band of from 5.5% to 12.5%. The price of these certificates on the secondary market was equivalent to the price of the dollar.

If the discount moved above 12.5%, the authorities would intervene by buying *certicambios*; thus, whenever the demand for these certificates expanded, their discount shrank (Cárdenas, 1993). This system was discontinued in 1994, and in April of that year a reserve requirement on external credits was instituted.

Although this exchange strategy permitted the monetary effects of the build-up in reserves to be spread out over a period of time, the monetary sterilization operations carried out during this period were intense, and it is estimated that in 1991, its impact on the quasi-fiscal deficit was equivalent to between 0.5% and 1% of GDP (Cárdenas, 1993; IMF, 1993).

In October 1991, an effort began to be made to bring down interest rates in the domestic financial system. Colombia thus abandoned the active sterilization policy it had pursued during the first nine months of 1991, and the emphasis of monetary policy began to shift more and more towards a gradual elimination of the spread between domestic and external interest rates in order to discourage inflows of speculative capital, even at the cost of allowing a sharper expansion than before in the means of payment. Despite this increase, the inflation

rate slowed in 1992 and 1993 (Carrasquilla, 1993; Garay, 1993). At the same time, however, the balance on current account took a notable turn for the worse.

In order to backstop the implementation of a monetary policy that did not provide for sterilization, the tax reform approved in June 1992 included a measure for regulating inflows of foreign-exchange earnings from services as a means of influencing capital inflows; at the same time, the rules governing capital outflows were relaxed.<sup>77</sup>

The rate of inflation, as measured by the CPI, fell from 32% in 1990 to 23% in 1993 and 1994, and the appreciation of the real exchange rate has tended to pick up speed since 1992 (see figure XI.4). In 1980 dollars, the current account yielded a surplus amounting to 1.2% of GDP in 1991, but showed a deficit of 5.4% in 1993. The domestic savings rate and the investment rate climbed swiftly between 1990 and 1993, but the growth rate of the economy has been moderate, averaging 4% for 1990-1994.

Historically, the pattern of capital movements in the countries of *Central America* and *the Caribbean* has differed from that of the other countries in the region. As mentioned in earlier sections, in those countries the trend in net capital movements has been relatively less unstable during the past three decades.<sup>78</sup>

One particularly notable feature of the composition of these flows is the importance of official and private unrequited transfers (with remittances from emigrants making up the bulk of the latter). On average, each of these two headings accounted for one-third of the capital movements recorded in 1990-1992, representing a sharp increase over the period 1980-1989.

77 In January 1992, all exporters were authorized to hold a portion of their foreign-exchange earnings abroad; formerly, only State-run exporters of oil and minerals and coffee exporters had been permitted to do this. In addition, residents were allowed to hold up to US\$ 500,000 in assets abroad without having to seek prior permission. In February 1992, Colombia reduced the minimum maturity period for external loans to one year (it had been five years with a two-year grace period). These loans are permitted only if they are to be used for working capital or to finance fixed investment (IMF, 1993).

78 On average, net capital inflows totalled 9% of GDP in 1977-1981, 8% in 1983-1989 and 7% in 1990-1993.

Costa Rica's involvement in international financial markets has also exhibited the above-mentioned features, although the proportion of unrequited transfers in total capital flows has been below the average for the subregion. Official unrequited transfers accounted for an average of 21% of capital movements in 1990-1992, while private transfers hovered around 13%. Compared with the other countries in the subregion, Costa Rica has used more macroeconomic instruments for the management of capital flows, the build-up of reserves has been significant and the composition and volume of new flows has been different.

In 1982, Costa Rica embarked upon a gradual process of economic reform whose main thrust was to liberalize the country's foreign trade, financial system and exchange policy.<sup>79</sup>

Since the mid-1980s, Costa Rica has sought to encourage private participation in the financial market, most of which had previously been in the hands of the State. In March 1992, the Government authorized commercial banks to accept deposits in foreign currencies (prior to that time they had done so only on behalf of the Central Bank), to engage in securities trading and to make foreign-currency loans. In late 1989, banks began setting interest rates on their own (traditionally, interest rates had been regulated by the economic authorities), and in 1991 restrictions on the banks' credit-allocation functions were lifted (Rodríguez and Rodríguez, 1993).

Within this context, the main tools used by the Central Bank to implement the country's monetary policy have been open market operations and the establishment of minimum reserve requirements on checking accounts and time deposits in local and foreign currencies.

As regards exchange policy, after using a crawling peg system for a time, in early 1992 Costa Rica allowed its currency to float;<sup>80</sup> banks and other institutions were allowed to buy and sell foreign exchange freely, and exchange restrictions on capital movements were eliminated.

The country's currency exhibited a tendency to rise in value, appreciating by 7.5% between the time of the float's introduction at the start of 1992 and June of the same year. After that, the Central Bank began to intervene actively in an effort, first, to reverse this trend and, second, to maintain a fairly stable real exchange rate in 1993 and 1994 (see figure XI.4).

Output expanded at a relatively rapid pace between 1991 and 1994, with its annual growth rate averaging 5% (see table XI.6). Inflation (as measured by the CPI) fell from 25% in 1991 to 9% in 1993, but rebounded to 17% in 1994 (ECLAC, 1994d).

Measured in constant 1980 dollars, after dropping to 5 points of GDP in 1991, the current account deficit swelled to 12% in 1993. National savings rose by 4 points of GDP between 1990 and 1993, while total investment was up by 2 points (see table XI.6).

#### 4. Reflections on the countries' experiences

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From the various experiences outlined above it can be seen that, in general, the renewal of capital inflows to the region in the 1990s has led to a reactivation of the countries' economic growth. In addition, this has taken place within relatively more stable macroeconomic environments than in earlier decades, and this fact has been

79 Costa Rica has also applied other reforms, such as price decontrol, the elimination of subsidies, fiscal adjustments and special regimes for promoting foreign investment.

80 The Central Bank of Costa Rica has continued to engage in some degree of intervention through the direct sale and purchase of foreign exchange, and this has been reflected in a gradual accumulation of international reserves. In terms of months' worth of imports, reserves totalled 3.5 months in 1990 and 5.8 in 1992. It should be noted that Costa Rica has an import coefficient of around 50% of GDP.

reflected in a considerable downturn in the inflation rate.

Both in the countries discussed here and in the region as a whole, a significant trend towards currency appreciation is to be observed, as well as towards widening current-account and trade deficits.

Countries which have opted for a moderate degree of sterilization or which have chosen not to engage in sterilization tend to exhibit a marked appreciation of their exchange rates, larger increases in their current-account and trade deficits, reductions or moderate increases in national saving and success in combating inflation.

Countries which have adopted active intervention policies display increases in their national saving rates, less of a trend towards currency appreciation, and smaller current-account deficits. The reductions registered in their rates of inflation have also been less notable than in the above cases.

The region's experiences, particularly during the last decade and a half, teach us that one of the main factors in ensuring that external capital inflows will contribute to medium- and long-term growth is the countries' ability to maintain a stable macroeconomic environment which will bolster their efforts to change their production patterns and increase their international competitiveness. Accordingly, these experiences suggest that an economic policy's success should be measured in terms of a country's ability to –simultaneously– ensure the continuity of capital inflows over time, maintain a degree of control over its exchange and monetary policies, and increase national savings and investment –elements which should serve to support the production base –for tradables and non-tradables– so that the country will be able to compete in the international marketplace.

A carefully-conducted form of sterilization and regulation of short-term capital inflows is usually needed in order to accomplish this. Generally speaking, intervention schemes have been applied at three levels: i) intervention in the

foreign exchange market by floating the currency within predetermined bands; ii) sterilization of the monetary effects of the increased supply of foreign exchange; and iii) regulation of short-term speculative capital movements through reserve requirements, quotas and commissions.

The experiences analysed here illustrate the importance of having instruments that can be adapted rapidly and flexibly to the economic situation. The object is for such instruments to permit the establishment of regulations to: i) isolate the money and foreign-exchange markets from short-term speculative international capital movements; ii) permit the management of monetary policy when capital inflows bring about changes in the monetary base which generate excess demand; iii) discourage capital outflows during periods when the economy is subject to external constraints by neutralizing the effect of cyclical factors that are not in keeping with medium- and long-term trends; and iv) bring the cost of gaining access to external capital into line with the cost of domestic credit in order to forestall overborrowing by the private and/or public sectors as well as the emergence of destabilizing bubbles.

Intervention also has its risks, however. Excessive restrictions must be avoided because: i) an overabundance of regulations creates uncertainty, which generally discourages productive innovation; ii) regulations which consistently run counter to medium-term market forces end up being violated or reversed; iii) overly restrictive regulations also limit the range of risk, liquidity and maturities available to creditors and borrowers; and iv) they could limit economic growth by cutting the country off from other opportunities for obtaining funds to finance such growth and for cushioning the economy from short-term, transitory shocks. Hence regulations, although essential, need to be designed very carefully. A comparative analysis of different experiences in this regard sheds a great deal of light on the subject.

Table XI.6  
**LATIN AMERICA: INDICATORS FOR SELECTED COUNTRIES**  
*(Percentages of GDP based on figures in 1980 dollars)*

	1981	1976- 1981	1980- 1982	1989	1983- 1990	1991	1992	1993
<b>Argentina</b>								
Net inflow of capital	41.7	1.6	1.6	1.3	-0.1	2.5	6.7	5.8
Variation in reserves	2.8	-2.5	-0.6	-0.1	2.4	1.6	2.5	1.4
External saving	-1.1	4.2	2.2	-1.3	-2.5	0.9	4.2	4.4
<b>Effect on reactivation</b>								
GDP growth rate	3.9	-1.4	-3.1	0.0	-0.1	8.9	8.7	6.0
Imports of goods	5.2	7.9	4.8	3.8	3.0	5.0	8.2	9.1
Investment	25.2	23.7	19.2	16.5	13.3	15.3	18.5	19.8
Per capita GDP (1980 dollars)	3,932	3,978	3,655	3,553	3,255	3,500	3,757	3,936
<b>Medium-term effect</b>								
Domestic saving (GDP-C)	28.6	22.3	24.3	24.4	26.7	24.0	22.4	22.7
National saving (Y-C)	26.3	19.5	17.0	15.3	16.5	14.9	14.7	15.7
Exports of goods	8.3	7.8	8.0	10.3	15.0	13.2	12.2	12.1
<b>Non-financial current account<sup>a</sup></b>	3.4	-1.7	2.5	3.2	5.9	2.0	-2.0	-2.6
<b>Chile</b>								
Net inflow of capital	6.1	15.6	4.5	5.4	7.8	3.5	7.7	6.0
Variation in reserves	2.0	2.8	-5.6	0.9	5.8	3.0	5.5	0.9
External saving	4.2	12.8	10.1	4.5	2.0	0.5	2.2	5.2
<b>Effect on reactivation</b>								
GDP growth rate	8.2	6.6	-12.6	4.5	2.8	5.7	9.8	5.6
Imports of goods	17.6	22.6	16.1	16.3	19.2	19.3	21.7	23.2
Investment	14.1	19.8	12.6	15.6	18.8	17.4	19.5	20.8
Per capita GDP (1980 dollars)	1,998	2,362	2,070	2,247	2,570	2,673	2,890	3004
<b>Medium-term effect</b>								
Domestic saving (GDP-C)	14.2	12.8	15.2	22.9	28.3	29.3	32.0	31.1
National saving (Y-C)	9.9	7.2	2.7	11.3	16.9	17.0	17.5	15.7
Exports of goods	18.9	17.2	19.9	22.8	26.4	26.6	29.5	28.8
<b>Non-financial current account<sup>a</sup></b>	0.1	-7.9	-1.6	2.5	2.6	3.9	1.9	-1.9
<b>Colombia</b>								
Net inflow of capital	2.5	5.1	6.5	3.6	2.0	2.1	3.3	5.4
Variation in reserves	3.9	1.4	-2.4	0.1	1.1	3.3	1.9	-0.0
External saving	-1.4	3.7	8.9	3.5	0.9	-1.2	-1.4	5.4
<b>Effect on reactivation</b>								
GDP growth rate	5.7	3.3	1.0	4.2	4.0	1.8	3.6	4.9
Imports of goods	11.0	13.4	15.1	10.9	10.2	8.7	11.0	16.0
Investment	18.3	20.1	22.0	17.3	14.9	13.3	17.9	21.7
Per capita GDP (1980 dollars)	1,138	1,225	1,213	1,326	1,444	1,445	1,472	1,518
<b>Medium-term effect</b>								
Domestic saving (GDP-C)	19.4	18.2	17.0	19.1	21.6	22.2	25.5	25.1
National saving (Y-C)	19.7	17.0	13.6	15.3	15.9	17.5	19.4	18.1
Exports of goods	11.9	11.5	10.1	12.6	15.9	17.2	17.9	18.3
<b>Non-financial current account<sup>a</sup></b>	1.1	-2.7	-6.3	0.7	3.3	4.9	2.0	-2.7

Table XI.6 (concluded)

	1976- 1981	1980- 1981	1982	1983- 1989	1990	1991	1992	1993
<b>Costa Rica</b>								
Net inflow of capital	14.8	16.2	12.7	12.5	9.5	12.5	13.8	11.7
Variation in reserves	1.1	0.6	3.7	1.3	-4.5	7.7	2.9	-0.4
External saving	13.7	15.6	9.0	11.2	14.0	4.8	10.9	12.1
<b>Effect on reactivation</b>								
GDP growth rate	6.5	-0.9	-7.3	4.1	3.4	2.1	7.3	6.1
Imports of goods	41.5	34.5	24.7	36.5	46.1	42.6	51.9	58.0
Investment	24.3	21.8	13.6	21.2	22.4	19.2	23.6	24.1
Per capita GDP (1980 dollars)	1,526	1,512	1,325	1,399	1,462	1,455	1,523	1,577
<b>Medium-term effect</b>								
Domestic saving (GDP-C)	11.9	16.7	23.8	22.0	20.6	24.7	23.4	22.0
National saving (Y-C)	10.7	6.9	5.5	11.1	9.7	15.5	14.4	13.7
Exports of goods	31.5	29.1	29.3	31.4	34.2	41.5	46.4	49.0
<b>Non-financial current account</b> <sup>a</sup>	-12.4	-8.3	2.2	-2.5	-8.3	-0.5	-6.6	-8.1
<b>Mexico</b>								
Net inflow of capital	3.2	7.7	1.5	0.6	5.3	9.9	11.0	11.7
Variation in reserves	0.1	0.5	-1.8	0.2	1.0	3.1	0.7	2.2
External saving	3.1	7.1	3.3	0.4	4.4	6.8	10.4	9.5
<b>Effect on reactivation</b>								
GDP growth rate	7.3	9.0	-0.6	1.1	4.4	3.6	2.8	0.6
Imports of goods	6.9	11.3	7.4	8.8	14.2	15.9	19.3	18.7
Investment	23.0	27.9	21.8	17.2	18.9	19.6	21.8	21.0
Per capita GDP (1980 dollars)	2,275	2,705	2,704	2,463	2,455	2,490	2,506	2,470
<b>Medium-term effect</b>								
Domestic saving (GDP-C)	24.6	25.0	27.4	26.6	23.6	22.9	21.3	21.8
National saving (Y-C)	19.9	20.9	18.7	17.2	15.4	13.8	12.5	12.4
Exports of goods	6.8	9.3	12.5	16.4	17.4	18.1	18.1	18.5
<b>Non-financial current account</b> <sup>a</sup>	1.6	-2.7	2.9	3.8	-1.2	-3.5	-6.8	-5.6

Source: ECLAC, on the basis of official figures.

<sup>a</sup> Balance for goods and services plus the terms-of-trade effect.

## Chapter XII

# REGULATION, SUPERVISION AND STABILITY OF FINANCIAL INSTITUTIONS AND CAPITAL MARKETS

The liberalization of the capital account of the balance of payments, as described in previous chapters, is generally carried out as part of a broader process of financial—and indeed economic—deregulation designed to give priority to market forces in the determination of key prices within the economy. Whatever the pace and content of a financial liberalization effort, however, a regulatory and supervisory apparatus must be in place in order for it to be successful, given the importance of upholding the credibility and solvency of financial institutions and capital markets.

Because of the dominant position which banks occupy in domestic financial systems, the deregulation of credit, of interest rates and of the instruments used by banks to attract funds plays a prominent role in these policies. Since the mid-1980s, a number of Latin American countries have extended the scope of financial reforms to cover securities markets as well. In some cases, institutional investors have played an important part in the development of

securities markets and in capital formation. Since the start of the 1990s, the inflow of international funds to these countries in the form of portfolio investments has also given a boost to emerging securities markets.<sup>81</sup>

This chapter will analyse the significance and role of one of the main determinants of the performance of financial institutions and capital markets: the regulations and standards which establish the “ground rules”, or institutional framework for the relevant agents, governing the attraction, intermediation and allocation of funds, together with the enforcement of those regulations.<sup>82</sup> The analysis focuses on regulatory and supervisory systems designed to ensure financial solvency. These types of regulations play a particularly important role in programmes aimed at bringing about the financial liberalization of the domestic market and opening up the capital account. The deregulation of interest rates, credit, access to external funds and other

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81 A more detailed analysis of policy proposals concerning the regulation, supervision and stability of financial institutions and capital markets in Latin America and the Caribbean may be found in a number of ECLAC reports, particularly Held (1994).

82 The solvency and efficiency of banks and financial institutions also hinge upon the following factors: macroeconomic conditions and policies, incentives for saving and capital formation, and the manner in which those institutions manage their portfolios.

financial variables gives banks and financial institutions greater decision-making latitude as regards the allocation and attraction of funds, as well as exposing them to various forms of risk.

### 1. Regulation and supervision of financial institutions and capital markets

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#### a) *Financial regulation*

At the macroeconomic level, the main objective of financial regulations is the control of monetary aggregates, or of aggregate expenditure, with a view to stabilizing price levels and achieving a high rate of economic activity. Macroeconomic policies having these same aims were one of the central themes of chapter XI. These types of regulations can influence the two key financial prices: interest rates and the exchange rate. As discussed in the preceding chapter, such regulations may be used to establish price bands for these variables or rules that govern their behaviour, or simply to fix one or both of these key prices. These prices may also be influenced indirectly through the use of rules that affect the availability or cost of funds by imposing restrictions on access, establishing reserve requirements or levying taxes. Rules governing the inflow and outflow of foreign or domestic capital are another type of financial regulation.

Financial deregulation seeks to extend the scope of the market's role in determining interest rates, the exchange rate, and the attraction and allocation of funds at the microeconomic level. In this context, financial liberalization constitutes a broad-ranging deregulation policy which customarily forms part of market-oriented reforms.

#### b) *Prudential regulation*

Prudential regulation is aimed mainly at ensuring the solvency of banks, financial funds, insurance companies and

other agents which manage funds or assume risk for third parties on a large scale. The performance of these functions strongly influences public confidence, and the solvency or stability of financial institutions therefore generates important macroeconomic externalities.

Prudential regulations have two distinct aims. The first is to give transparency to the financial standing of institutions and other agents that float bonds and issue securities that can be traded on the stock exchange. The fulfilment of this objective requires the provision of a sufficient amount of accurate, up-to-date information about such institutions' assets and performance as well as other evidence of their ability and intention to comply, under the agreed conditions, with the payment obligations stipulated in the securities and share certificates they issue. The second aim is to control the amount of risk which financial institutions can assume. The attainment of this objective calls for a precise definition of the financial services such institutions may provide, the restrictions and prohibitions applying to their activities, and the pertinent capital requirements. A clear identification of the levels of risk, assets and yields associated with the provision of different financial services is essential in order to maintain transparency and avoid conflicts of interest whenever the range of activities in which financial institutions may engage is broadened.

Prudential deregulation involves the relaxation of controls designed to safeguard financial institutions' solvency. If this process is carried too far, it results in "decontrol", i.e., a conspicuous lack of rules governing risk and information management. Prudential regulation, in contrast, strengthens controls aimed at maintaining financial institutions' solvency and encourages agents that supply funds to such institutions to play an active part in controlling the level of risk which they can assume. Prudential regulation has been growing in importance at the international level,

especially as the world's economies have become more liberalized.

*c) Supervision*

Effective supervision is crucial in ensuring that banks, financial institutions and other agents operating in credit and capital markets observe the financial and prudential rules governing transactions and the provision of services. Depending upon the level of sophistication and development policies of these markets, such supervision will involve one or more specialized authorities of the public sector.

One of the central components of the prudential supervision of financial institutions is regular monitoring of these institutions to ensure that their portfolios of financial assets (loans or financial investments, as the case may be) have been correctly appraised in accordance with their varying degrees of exposure and, on that basis, the publication of simple solvency indicators that are readily understandable to depositors, savers and financial investors.

The rather limited development of credit and capital markets in many Latin American and Caribbean countries indicates that the role of regulatory agencies in the financial system must not be confined to the enforcement of existing rules. One of the main tasks of these regulatory authorities is to introduce or modernize solvency standards for new institutions and financial instruments in order to meet the demand created by the attraction, intermediation and allocation of a growing volume of funds.

## **2. Prudential regulation and supervision of the banking system**

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In view of the financial fragility of the banking system, the prudential regulation and supervision of that system are highly important. The system's fragility is attributable to two of its distinctive characteristics. The first is the highly leveraged nature of banks' financial

structures, in that their ratio of financial liabilities (deposits and other obligations) or financial assets (loans and investments) to equity is very often 10 or more to one. The second is that, since banks take in funds from third parties by issuing certificates of deposit and other obligations and then use these funds to extend loans and make financial investments in their own name, they are putting up their own equity and other assets against various types of risk. Consequently, the loss or devaluation of even a fraction of their loan and investment portfolios can severely jeopardize their solvency.

*a) Solvency-oriented regulations and supervision*

Table XII.1 shows how important it is for banks to maintain types and levels of exposure compatible with their highly leveraged structures. Since corporate and personal loans are a bank's main types of lending activity, credit risk or default risk (i.e., of failure to make payment in accordance with the conditions stipulated when the loan was granted) is a distinctive type of risk assumed by banks. The table also refers to the following types of risk: exchange risk, which becomes a factor when loans or investments are made in a currency other than that in which the underlying deposits are expressed; interest-rate and liquidity risk, which arise when a bank makes loans or investments that have longer repayment or maturity periods than those of the deposits used to finance them; and the risk associated with the concentration of loans or financial investments in certain agents, sectors of activity or geographical areas due to an insufficient diversification of bank portfolios.

If the condition of transparency with regard to bank solvency is not fulfilled, depositors will not be able to exert market control. A lack of transparency may also give depositors and other bank creditors the impression that deposits and other obligations are covered by some sort of "implicit" government guarantee, i.e., that

Table XII.1  
PRUDENTIAL BANKING REGULATIONS

Objective of regulation	Content of regulation
Stringent entry requirements	<ul style="list-style-type: none"> <li>- High minimum level of capital required for entry</li> <li>- Eligibility requirements for principal shareholders, directors and CEO</li> </ul>
Risk associated with excessive leverage	<ul style="list-style-type: none"> <li>- Broad diversification of loan and financial investment portfolios (to avoid concentrating risk in certain agents, economic sectors or financial instruments)</li> <li>- Written rules governing the extension of loans and the constitution of guarantees (to control the credit risk of personal loans, especially "related-party" loans granted to shareholders, directors and bank agents)</li> <li>- Limits on maturity-period differentials between assets and liabilities (to control interest-rate risk)</li> <li>- Limits on asset/liability currency differences (to control exchange risk)</li> <li>- Limits on investment in fixed assets or immovables and requirements regarding holdings of liquid financial instruments (to control liquidity risk)</li> <li>- Control of other types of bank exposure.<sup>a</sup></li> </ul>
Full loss provisioning	<ul style="list-style-type: none"> <li>- Careful measurement of all portfolio risk</li> <li>- Setting aside of reserves to fully cover bank exposure</li> <li>- Suspension of interest on high-risk loans</li> </ul>
Maintenance of bank capital on a solid footing	<ul style="list-style-type: none"> <li>- Prompt replenishment of capital following expected losses</li> <li>- Minimum capital requirements commensurate with the risk associated with different types of assets</li> </ul>
Transparency in respect of banks' financial status	<ul style="list-style-type: none"> <li>- Provision, on a regular basis, of information –presented in the form of simple indicators of exposure, reserves, and equity or net worth– to depositors and the general public regarding banks' financial standing</li> </ul>
Orderly withdrawal from the banking system	<ul style="list-style-type: none"> <li>- Orderly liquidation of insolvent banks</li> <li>- Rules governing the order in which payments on certain types of deposits and other obligations (such as checking accounts, savings deposits, Central Bank credits, etc.) are to be made</li> </ul>

Source: ECLAC, on the basis of case studies of the Joint ECLAC/UNDP Regional Project on Financial Policies for Development.

<sup>a</sup> Refers mainly to risk that is "off the balance sheet", or risk that is not located in the loan and investment portfolio.

the public sector will cover their losses in the event of a bank failure, even if no written guarantee to that effect exists.

*b) Banking systems without solvency controls*

Solvency-oriented regulations (see table XII.1) and loan guarantees or insurance on deposits and other obligations constitute the two main components of any regulatory and supervisory system whose purpose is to ensure the financial soundness of the banking system.

Hence, when the presence of some system (whether explicit or implicit) of government guarantees coincides with serious shortcomings in the prudential regulatory framework, neither depositors nor any public-sector agency will be concerned with the banks' financial stability.

A banking system whose financial status is not subject to controls has incentives to make high-risk loans, often at high real interest rates. The presence of an explicit or implicit State guarantee on deposits and other obligations facilitates this process. At the same time, the perception of security and the existence of attractive interest rates on deposits generates an excessive stimulus for investors of domestic and foreign funds.

Consequently, when financial liberalization is pursued within the context of a decontrolled banking system, it may give rise to overborrowing by production firms, a high proportion of loans which are difficult to collect, and losses that severely undermine the banks' equity position.

### **3. Regulation, supervision and financial instability in countries of the region**

*a) Shortcomings in prudential regulation and supervision as a factor of financial instability*

Table XII.2 presents a sample group of countries in the region in which various types of policies have led to financial problems in the banking system during

the past two decades. These problems have been due, in particular, to two factors. The first has to do with serious flaws in the prudential regulatory and supervisory system arising from weaknesses in terms of risk management, inadequate regulations concerning banks' capital and reserves, insufficient supervision or supervision narrowly focused on accounting and financial aspects, and the existence of explicit or implicit State guarantees on deposits and other obligations. Almost all of these problems arose in systems having the type of institutional structure most likely to generate problems of insolvency, i.e., decontrolled banking systems or systems lacking solvency safeguards. Second, these problems arose out of macroeconomic environments that were unstable or subject to severe misadjustments that entailed major changes in the levels of economic activity, relative prices, and corporate and personal income which, by affecting the "first" source of loan payments or the value of guarantees (the "second" source of payment), reduced the quality of the banks' loan portfolios.

In the mid-1970s Argentina, Chile and Uruguay began to liberalize interest rates, credit and other financial variables; these policies also provided for a broader definition of the activities in which banks could engage, and they did so under highly adverse conditions in terms of the banks' solvency and stability. The simultaneous application of ambitious stabilization measures—particularly the adoption of the nominal exchange rate as an anchor to stabilize the currency in these three countries from 1978 onward—and of structural reforms focusing on foreign trade and the liberalization of the capital account generated inconsistencies in economic policy and macroeconomic instability. Overly low exchange rates, high real interest rates and major shifts in the profitability of various economic activities undermined the quality of the banks' loan portfolios (ECLAC, 1984b; Corbo, de Melo and Tybout, 1985; Ramos, 1986).

Table XII.2  
**PROBLEMS RELATING TO BANK SOLVENCY IN LATIN AMERICAN AND CARIBBEAN  
 COUNTRIES OVER THE PAST TWO DECADES**

Country	Period	Financial regulation	Macroeconomic conditions	Prudential regulation and supervision	Stability of financial system	Financial prices
Argentina	1974-1981	Liberalization of interest rates and credit. Opening of capital account.	Fiscal deficit and high inflation. Stabilization based on exchange rate (1978-1981).	Serious flaws.	Financial crisis in banking system.	High real interest rates. Exchange-rate lag.
Chile	1974-1982	Liberalization of interest rates and credit.	Structural reforms and financial adjustment of public sector. Stabilization based on exchange rate (1978-1982). Heavy external indebtedness.	Serious flaws.	Widespread banking crisis.	High real interest rates. Exchange-rate lag.
Uruguay	1974-1982	Liberalization of interest rates and credit. Opening of capital account.	Misadjustment of trade balance. Stabilization based on exchange rate (1979-1982).	Serious flaws	Financial crisis in banking system.	High real interest rates. Exchange-rate lag.
Colombia	1979-1982	Sectoral credit limits. Cautious management of external borrowing.	Relatively stable macroeconomic conditions.	Serious flaws.	Financial crisis in banking system.	Fragmented interest-rate structure.
El Salvador	1980-1989	Sectoral credit allocation. Fixed interest rates.	Substantial fiscal deficit. Inflationary pressures.	Serious flaws.	Financial crisis in banking system.	Financial repression in banking system.
Dominican Republic	1982-1990	Sectoral credit limits and fixed interest rates.	Fiscal imbalance. Rising inflation.	Serious flaws.	Financial crisis in unregulated financial sector.	Financial repression in regulated banks. High interest rates in unregulated sector.
Costa Rica	1983-1987	Gradual liberalization of interest rates and credit.	Stabilization and adjustment of balance of payments.	Substantial improvements in prudential regulation and supervision.	Financial crisis in unregulated finance companies.	High real interest rates in unregulated financial sector.
Bolivia	1985-1990	Liberalization of interest rates and credit.	Stabilization and structural adjustment following large fiscal deficits and hyperinflation.	Serious flaws.	Isolated bank failures.	Decline in very high real interest rates.
Peru	1990-1992	Liberalization of interest rates and credit.	Stabilization and structural adjustment following large fiscal deficits and hyperinflation.	Defects in regulations governing capital and reserves.	Problems relating to solvency within the banking system.	Slow decline in very high real interest rates.

Source: ECLAC, Regulación, supervisión y estabilidad de las instituciones financieras y los mercados de capital en América Latina y el Caribe (LC/R.1358), Santiago, Chile, December 1993.

Furthermore, these liberalization processes were pursued within banking systems that lacked proper solvency controls. In all three countries there was an explicit or implicit State guarantee on deposits and other obligations and serious shortcomings in the rules controlling exposure and reserve requirements. In Uruguay there were no minimum requirements (Banda, 1990); in Chile, loan portfolios did not begin to be rated on the basis of their level of risk until shortly before many banks' financial problems emerged in the early 1980s (Held and Szalachman, 1989); in Argentina, the banking system operated with virtually no supervision, and the rating of bank portfolios was not initiated until after the Government stepped in during the early 1980s (Salama, 1991).

In the Southern Cone countries, the banking systems' loan portfolios swelled at an abnormally rapid pace in relation to the increase in GDP and other aggregate indicators of economic activity. Five years after these countries had launched their financial liberalization programmes, credit continued to expand at rates from five to six times higher than the growth rate of GDP. This process was associated with a rapid rate of high-risk lending activity, i.e., loans to non-tradable activities (including real estate and speculative operations) financed largely with foreign debt, widespread rollovers of loans for which interest was compounded at high real rates (accruing interest that was never actually paid), and related-party loans for which very little real collateral was put up.

Although it is difficult to evaluate the relative importance of macroeconomic instability versus shortcomings in solvency-oriented regulation and supervision, in the widespread financial crises that hit the Southern Cone countries in the early 1980s, there is no doubt that the latter factor played a major role. Significantly, in both Argentina and Chile,

and, in part, in Uruguay as well, the banking systems' severe financial problems surfaced before the external debt crisis had brought about sharp downturns in these three countries' levels of economic activity.<sup>83</sup>

The banking crisis that erupted in Colombia in the early 1980s illustrates how a banking system which is not subject to solvency controls can assume a high level of credit risk and suffer unsustainable capital losses even in a fairly stable macroeconomic environment and despite a conservative policy on external borrowing by banks. Bank loans exhibited a "bubble" in 1980-1981, when they shot up by over 40% in real terms. The widespread intervention in the banking system that began in 1982 demonstrated the undesirability of granting high-risk, related-party loans to conglomerates—for, among other purposes, buying stock in non-financial enterprises—and the part it played in this abnormal expansion. Credit limits and standards had been greatly exceeded, and the supervisory authority had lagged far behind in monitoring the quality of loan portfolios (Zuleta, 1990).

The nationalization of the banks in El Salvador in 1980 and the Government's hefty deficit led to financial repression of the banking system during the 1980s. The allocation of credit was subject to sectoral directives and politically-influenced guidelines. Regulation and supervision focused on compliance with financial norms regarding interest rates, reserve requirements and mandatory bank investments. Since there was an implicit government guarantee covering bank deposits, the absence of concern about portfolio risk and insufficient levels of loan-loss provisioning and capital reserves placed this experience within the context of a banking system lacking in solvency safeguards. When the poor quality of bank portfolios was brought to light in 1989, it was found that losses equivalent to more than three times the

83 The severe contraction in economic activity and the substantial devaluations brought on by the crisis also eroded the quality of the banks' loan portfolios.

banks' capital had been sustained (Belloso, 1992).

Financial repression became a significant factor in the Dominican Republic during the 1980s at a time when lax regulation and supervision had sparked the emergence of a flourishing unregulated financial sector. In fact, by 1987 approximately 650 unregulated financial agents (investment houses and financial groups, building societies, leasing firms, credit card companies, etc.) were handling one-fourth as much credit and one-third as many deposits as the regulated banking system. The eruption of a financial crisis in 1989 pushed dozens of unregulated financial agents into bankruptcy and led to the failure of some regulated banks. Flaws in the system of prudential regulation and supervision were identified as being the main obstacle to the modernization of the Dominican Republic's financial system at the close of the 1980s (Guilliani and Aristy, 1991).

Costa Rica adopted stabilization policies and economic reforms in 1983 in response to a severe balance-of-payments crisis and the declaration of a moratorium on the country's external debt payments in 1981. The financial reform programme expanded the scope of the banks' involvement in credit allocation and deregulated interest rates in a three-step process designed to achieve positive yet moderate real interest rates within the supervised banking system. Progress was made in strengthening the prudential regulatory and supervisory system through the introduction of a rating system for bank loan portfolios, stricter rules on provisioning, and a set of performance indicators for banks which had to be disclosed to depositors and the general public. As part of these financial reforms, the establishment of "free", or unregulated, financial associations was also authorized. These associations soon grew in number and began to operate in higher-risk segments of the market at high real interest rates. The adoption of a tight monetary policy in late 1987 led to problems of illiquidity in the financial

system that triggered the failure of all the unregulated financial associations. Not a single supervised bank failed as a result of this financial debacle, however (De Paula, 1990; Díaz, 1991).

Bolivia (1985) and Peru (1990) liberalized interest rates and credit in a context of considerable macroeconomic turbulence and severe stabilization and structural adjustment policies involving rapid price decontrol, an opening of the economy to external trade, and drastic fiscal adjustments. Uncertainty regarding the behaviour of prices sparked a sharp increase in interest rates. In Bolivia, real annual interest rates on bank loans amounted to about 100% in 1985, 40% in 1987 and 20% in 1989-1990 (Afcha de la Parra, 1990), while in Peru the initial increase in interest rates was greater and their decline slower; in the first halves of 1991, 1992 and 1993, real annual interest rates on bank loans were around 170%, 50% and 35% respectively (Central Reserve Bank of Peru, 1993a).

Interest rate trends and fluctuations in relative prices and in the profitability of economic activities caused by stabilization and macroeconomic adjustment policies appear to have been the main factors behind solvency-related problems in the banking systems of Bolivia and Peru. Flaws in solvency-oriented regulatory and supervisory systems have also contributed to such problems, however.

The closure of four banks in Bolivia in 1987 revealed the system's lack of proper solvency safeguards; specific shortcomings included insufficient limitations on exposure, excessive related-party lending, weak supervision and the existence of an implicit State guarantee on deposits.

In Peru, prudential regulation has been considerably improved by the institution of a rating system for bank credit and the explicit limitation of State guarantees on deposits (1991) through the introduction of an insurance scheme affording limited coverage that is financed with premiums paid by the banks, along with the provision of information to the public regarding the quality of bank

portfolios (González Arrieta, 1992). The failure of a number of banks and mutual funds starting in 1991 depleted the insurance fund, and the State therefore had to cover the deficit. In March 1993, unpaid commercial bank loans represented 22% of such banks' credit portfolios, but their reserves amounted to only 12% (Central Reserve Bank of Peru, 1993b). This situation clearly indicates an insufficient level of reserves. Another factor in the emerging problems with regard to solvency may have been a decline in the qualifications of the supervisory authority's technical staff due to deep cuts in public expenditure.

*b) Recent reforms in bank regulation and supervision*

The above-mentioned cases of financial instability and the financial reform and liberalization policies being applied in many countries of the region have helped to strengthen their bank regulation and supervision systems, especially since the mid-1980s.

Reforms in the area of prudential regulation and supervision have emphasized both the application of solvency controls by the supervisory authority and the importance of explicitly defining and limiting State guarantees and deposit insurance. The first course of action has led to the limitation of portfolio risk, especially the exposure associated with related-party credits; the rating of loan portfolios; the adoption of stricter rules on reserves in combination, in some cases, with the establishment of minimum capital requirements based on the level of risk associated with different categories of assets (such as those provided for in the Basel Accord); and the strengthening of

the executive and technical capabilities of the supervisory agency.<sup>84</sup> As for the second course of action, six of the nine countries included in the sample group covered in table XII.2 have opted for limited deposit guarantees, while another two have decided not to maintain any system of protection whatsoever (Comisión Nacional Bancaria de México, 1993).

These advances notwithstanding, in only a few countries have the reforms included the provision of public information on the banks' exposure and actual financial standing to depositors and other bank creditors. This raises some question as to the continued existence of an implicit State guarantee on deposits and other obligations.

#### **4. Prudential regulation and supervision of pension funds in Chile**

Towards the end of 1980, the Chilean authorities opted to replace the country's existing pay-as-you-go pension plans with an individual funded pension system. By the end of 1992, the pension funds' resources were equivalent to 34% of GDP and their portfolios included nearly 60% of the bonds issued by large companies and of mortgage bonds then in circulation and more than 20% of the total number of corporate shares which they were eligible to purchase.

The rapid growth of these funds poses a formidable challenge; that challenge consists of finding a way to establish a sturdy institutional structure for the country's capital market so that those resources can be channelled to socially profitable uses via an array of financial institutions and instruments subject to strict prudential regulation and supervision.

<sup>84</sup> The Basel Accord is based on the assumption that a bank's sturdiness and safety depends mainly on the size of its capital base. The Accord assigns a weighted risk to each category of asset, as well as to items that do not figure in a bank's balance sheet; this risk weighting ranges from zero to 100%, depending on the relative level of credit risk, and is used for the purpose of setting capital standards. With a view to arriving at common minimum capital standards for a number of different countries, the Accord provided that the ratio between capital and off-balance-sheet items (converted into credit equivalents), weighted by their relative level of risk, was to be 8% by the end of 1992 (Cornford, 1993).

These regulations reflect the fact that the system calls for forced worker savings which will become those workers' chief source of income during their retirement years. The statutes governing the funds' portfolios stipulate that all bonds and securities must meet rigorous risk-evaluation standards and must carry high ratings; these portfolios must also be widely diversified in terms of both financial instruments and issuers, and the bonds and other securities they contain are subject to an ongoing appraisal at market prices and must be held in safe-keeping by the Central Bank. The equity capital of the pension-fund management boards (AFPs) is completely separate from that of the pension funds; an AFP may administer only one fund at a time and must guarantee a minimum return on the assets it manages.

A bill is currently under consideration which would make major changes in the regulations applying to the capital market in response to the concentration of pension-fund investments in the stock of public utilities and the present shortage of financial instruments. Yet new types of institutional demands are already in the offing in such areas as the prudential regulation and supervision of financial conglomerates and overseas pension-fund investments (Arrau, 1994).

The Chilean experiment with an individual funded pension system has awakened interest in other countries of the region. Peru introduced a similar system in 1992, and Argentina, Bolivia and Colombia are quite far along in the formulation of proposed reforms which also envisage funded systems as an option. In Brazil, El Salvador, Paraguay, Venezuela and other countries, studies are being carried out with a view to reforming the existing pension schemes. As in Chile, the results achieved by these new pension systems will hinge upon the institutional development of the relevant national capital markets, including effective measures of prudential regulation and supervision.

## 5. Regulation of international portfolio investments

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Since the beginning of the 1990s, a number of countries in the region have gained a significant degree of access to foreign capital through international portfolio investment (see chapter IX). This has made more foreign exchange and external savings available to the recipient countries, thus paving the way for higher levels of economic activity, investment and growth. International portfolio investment also entails various forms of risk for the recipient country, however, with the nature of that risk being determined by the exposure of the foreign investors concerned.

### a) *International portfolio investment risk*

When investors purchase securities on international capital markets that have been issued by entities in other countries, they are exposed to the country risk of those issuers.

Country risk involves a complex evaluation that takes the following factors into consideration: foreign-exchange risk, or the chance that foreign investors will not have access to foreign exchange for the remittance abroad of commitments in respect of capital, interest and profits; exchange risk, or the chance that the necessary hard currency will only be available at a substantially less favourable real rate of exchange than the going rate at the time the funds entered the country; price risk, or the chance that there will be an appreciable fall in the market value of the securities in which funds have been invested; and liquidity risk, or the chance of having to trade securities from local issuers at a very early date, thus incurring a sizeable loss of capital.

These types of risk are assessed chiefly in terms of the relevant country's political and economic stability, the soundness of its economic and social policies, its growth prospects and the solvency of its financial system.

International rating agencies have recognized the progress made by the countries of the region in recent years in the areas of stabilization, trade liberalization and the development of national capital markets. Chile was given an investment-grade rating in 1992, while Mexico and Venezuela were assigned speculative-grade ratings, just one rung below an investment-grade classification<sup>85</sup> (Harper, 1992).

*b) International portfolio investment risk for the recipient country*

The benefits of an inflow of financial capital for the recipient country will depend mainly upon the volume and term of those flows and the extent to which they support the country's levels of economic activity and capital formation. Medium- and long-term financial capital inflows will contribute to these objectives so long as they are in keeping with the capability of the recipient country's financial system to channel funds to socially profitable uses. Heavy inflows of primarily short-term and/or speculative capital, on the other hand, can jeopardize a country's macroeconomic stability and prospects for growth.

The macroeconomic hazards associated with heavy inflows of financial capital can translate into the following principal impacts: i) currency appreciation which weakens a country's export effort (see chapter XI); ii) a wealth effect stemming from steeply rising prices for financial paper which boosts consumption and diminishes national saving; iii) external borrowing through the purchase of securities, which increases the level of country risk (and/or the credit risk of national issuers of securities), thus making it necessary to raise interest rates in order to keep external financial capital in the country and/or attract fresh flows of portfolio investment.

In economies that have emerging securities markets and are making headway in improving their country-risk ratings, a number of factors can generate high profit expectations for international portfolio investment and may even overstimulate financial capital flows. One such factor is the existence of government guarantees on public debt paper, since they reduce and/or eliminate the issuer's credit risk. A second is the significant cost advantages of borrowing via the purchase of international securities, given existing differentials between national and international interest rates, such as those shown in table IX.14 for the countries of the region for the period 1989-1993. In these cases, as indicated in table IX.13, extraordinarily low short-term international interest rates (the 180-day LIBOR for dollar loans was only 3.9% in 1992 and 3.4% in 1993) acted as an additional, if temporary, incentive for international portfolio investment. A third factor is the substantial undervaluation of share capital in the countries of the region and the consequently strong potential for realizing capital gains, as evidenced by the regional index of stock quotations in 1990-1993 (see figure IX.1).

As of late 1993, international capital markets had not perceived any risk of excessive holdings of securities issued by the countries of the region. Table IX.8 shows that the yield on bonds floated by these countries declined in 1990-1993. However, the short terms of these securities and the volatility of short-term capital flows (see table IX.18) indicate that events which lead to a deterioration in the country risk of the region's economies can lead to a turnaround in these yields (or interest rates).

The equity capital of the countries in the region with emerging securities markets (Argentina, Brazil, Chile, Mexico and Venezuela) soared by 320% in

<sup>85</sup> Low country-risk ratings are usually given to developed nations and securities markets, since such ratings reflect the simultaneous achievement of favourable conditions with regard to all the above-mentioned risk factors and the likelihood that no adverse changes will occur that would hurt foreign investors.

1986-1992 and by 170% in 1991 alone (measured in current dollars). In fact, the jump in these markets' capitalization in Mexico, Argentina and Chile bordered on the spectacular, with increases of 2,245% and 209%, 1,131% and 460%, and 660% and 104% during these two periods, respectively. And it was precisely in 1991 – a year in which net inflows of foreign capital quadrupled in relation to the 1983-1990 average – that stock indexes skyrocketed, as shown in figure XI.1.

The wealth effect associated with these price rises appears to be one of the reasons for the trends seen in consumption and saving in the region.<sup>86</sup> As shown in table XI.1, consumption climbed by 0.8 points of GDP between 1983-1990 and 1991-1993 (from an average of 76.1% to 76.9%) while national saving fell by 1.3 points of GDP between those same periods (from 15.8% to 14.5%).

c) *Prudential regulations oriented towards international portfolio investment*

The arguments presented above underscore the importance of guarding against the following hazards when countries with emerging stock markets open their capital account up for international portfolio investment:

i) An appreciation of the currency which would push the real exchange rate out of alignment with medium- and long-term conditions;

ii) A stock-market bubble and wealth effect which could lead to a decrease in national saving; the subsequent drop in stock indexes could, in its turn, spur an outflow of financial capital as well as exerting downward pressure on the exchange rate (Akyüz, 1993); and

iii) An external debt overhang in stocks which might in some ways be similar to the external debt overhang in bank loans witnessed in the late 1970s and early 1980s in various countries of the region.

The prudential regulation of international portfolio investment can contribute to the policy approaches described in chapter XI by promoting an orderly, stable inflow of medium- and long-term external financial capital. The contents of a policy package having this objective are outlined in table XII.3.

## 6. Conclusions and policy recommendations

a) The experiences which the countries of the region have had over the past two decades with various types of financial policies demonstrate just how strongly prudential regulation and supervision influence the performance of financial institutions and capital markets.

The regulation and supervision of banks, pension funds and other financial institutions and of access to external funds (including international portfolio investment) are important regardless of what type of financial policy is being implemented. The role of regulation and supervision is distinct and especially critical, however, in the context of financial liberalization policies (extensive deregulation of interest rates, the exchange rate and conditions for access to funds in the national and international markets).

b) The severe financial troubles experienced by banks and credit institutions in a representative sample of countries in the region since the end of the 1970s have in all cases stemmed from flaws in the system of prudential regulation and supervision. Simply deregulating financial variables within such a framework constitutes a policy of financial "decontrol" rather than one of financial liberalization. It is significant that cases can be identified in which banking systems not subject to solvency safeguards have generated or contributed to the

<sup>86</sup> The increased availability and lower prices of consumer goods resulting from trade liberalization measures are also a factor, as is the expansion of credit which typically occurs when financial liberalization programmes are implemented within the banking system.

Table XII.3  
REGULATION OF INTERNATIONAL PORTFOLIO INVESTMENTS

Objective of regulations	Content of regulations
To counteract any incentive to incur an external debt overhang through the issue of securities	<ul style="list-style-type: none"> <li>- Explicit elimination of State guarantees on bond sales conducted on international securities markets by private companies</li> <li>- Explicit definition and delimitation of State guarantees on bond sales on international securities markets conducted by firms in which the public sector has an interest</li> <li>- Requirement of express authorization by financial authorities for the sale of bonds and other debt paper by public institutions and firms to international portfolio investors</li> </ul>
To orient external equity debt towards medium- and long-term securities	<ul style="list-style-type: none"> <li>- Facilitation of the sale of medium- and long-term bonds on international markets by local companies, subject to the aforementioned conditions regarding guarantees.</li> <li>- Restrictions on short-term capital inflows being channelled towards stock and other securities markets and on speculative capital inflows (reserve requirements, taxes or bans)</li> </ul>
To avert the formation of stock market "bubbles"	<ul style="list-style-type: none"> <li>- Authorization of the sale of shares on international stock markets (via ADRs or the registration of issuers) only to local companies which meet exacting requirements of transparency and solvency</li> <li>- Granting of access to the domestic stock market to foreign investment funds or country funds only on a gradual basis</li> </ul>

Source: ECLAC, Regulación, supervisión y estabilidad de las instituciones financieras y los mercados de capital en América Latina y el Caribe (LC/R.1358), Santiago, Chile, December 1993.

outbreak of financial crises in economies pursuing a financial liberalization programme as well as in situations marked by financial repression and freely-operating financial institutions. Be that as it may, it has also frequently been the case that unstable macroeconomic environments and high real interest rates have themselves been the cause of solvency-related problems.

c) The strengthening of the prudential regulation and supervision of the banking system in some countries of the region, primarily from the mid-1980s onwards, appears to be one of the main contributing factors to the financial stability exhibited by those banks and credit institutions since that time.

Rating systems, reserve requirements and capital standards are the areas in which the greatest inroads have been made. Thus far, however, little information has been provided to depositors and the general public regarding the exposure and financial standing of banks and credit institutions. This has helped to perpetuate the idea that deposits and other obligations are covered by an implicit government guarantee in spite of the withdrawal or limitation of explicit guarantees. This highlights the importance of continuing to refine regulations that limit and control the exposure of financial institutions.

d) The mobilization of contractual savings, mainly through individual

funded pension systems and insurance schemes covering specific types of risk (unemployment, disability, survivorship, etc.), constitutes an effective option for furthering the development of national securities markets. The speed with which pension schemes and other institutional investors are able to accumulate funds poses formidable challenges for the system of prudential regulation and supervision in terms of the introduction of an array of securities that will bolster real capital formation.

e) Inflows of international portfolio investment capital presuppose the existence of a fairly well developed domestic securities market and of clear rules regarding access to the foreign exchange market. These capital inflows can contribute to the development of local securities markets and real capital formation provided they are motivated primarily by medium- and long-term factors. However, government guarantees on public debt paper, an interest rate spread that tilts the balance in favour of external

borrowing and an undervaluation of equity capital in countries issuing securities that can be traded on international capital markets may overstimulate inflows of external financial capital and thus have adverse macroeconomic impacts (a sharp appreciation of the currency, a wealth effect and the substitution of national saving, and the risk of incurring an external debt overhang in securities). This constitutes grounds for the implementation of prudential regulations governing international portfolio investment as part of a broader policy designed to achieve stable inflows of medium- and long-term capital.

f) Generally speaking, the more intensive a financial deregulation programme is, the greater the need to strengthen the prudential regulation and supervision of the system. This reinforcement is a part of the institution-building process in credit and capital markets and as such calls for a determined effort on the part of public authorities in the financial sector.

## Chapter XIII

### CAPITAL INFLOWS AND POLICY IMPLICATIONS: RECAPITULATION

The region's return to international financial markets provides it with an opportunity to supplement domestic saving in order to meet the demands involved in changing production patterns with social equity. It is especially important for the region to promote investments that will enhance the competitiveness of its economies and the well-being of its population.

International capital markets have grown dramatically since the mid-1960s. This expansion is, in part, reflected in the fact that the movement of funds in international foreign exchange markets currently averages nearly US\$ 1 trillion per day. Thus, in a single day, total transactions exceed the annual GDP of many industrialized countries and amount to the equivalent of over one quarter of the annual value of world trade.<sup>87</sup>

International capital movements are partly a reflection of growing economies, expanding world trade and the globalization of production; however, to a very large and increasing degree, they also are a manifestation of purely financial factors. In the 1960s, the growing presence of lightly-regulated offshore financial centres stimulated capital movements by enabling creditors and debtors alike to

evade national financial regulations, capital controls and taxes. Then, in the 1970s and 1980s, many countries began to deregulate their domestic financial sectors and to relax or eliminate regulations applying to foreign exchange transactions. This, combined with revolutionary technological advances in information management and telecommunications and the emergence of increasingly sophisticated techniques of financial engineering, has contributed to a spectacular increase in both national and international financial flows.

It may be premature to speak of integrated financial markets, since international capital mobility is clearly far from perfect. Yet there is no doubt that the international circulation of capital and global financial integration are steadily on the rise. These developments have sparked controversy. At one extreme, there are those who see increasing integration as a sign of greater efficiency; according to their interpretation of events, markets are in the process of overcoming the financial repression characteristic of inefficient governments. At the other extreme, there are those who see the boom in capital flows as no more than a high-risk form of speculation that threatens national sovereignty. Of course, between these two

<sup>87</sup> Global exports totalled US\$ 3.7 trillion in 1993 (IMF, 1994).

extremes there are various intermediate positions which recognize the significant potential advantages of greater international capital mobility, but are also concerned about issues such as the composition and terms of capital flows and the need to ensure that they are compatible with macroeconomic stability, investment, growth, social equity and national autonomy. Whether the achievement of all of these objectives will be facilitated or hindered by financial liberalization depends on how it is carried out. This, then, is an area in which the design of active economic policies has a central role to play.

Recently, this controversy has assumed greater importance for Latin America and the Caribbean. It is true that, in the 1980s, the region's links with international capital markets were largely severed as a consequence of the massive debt crisis brought about by international commercial banks' permissive lending policies during the preceding decade. However, the region has witnessed a strong resurgence of capital inflows during the early 1990s. In fact, in 1992 and 1993, average net capital inflows reached a record level of over US\$ 63 billion a year (ECLAC, 1994d). One of the main benefits of these inflows has been a reduction of the severe external constraints that not only contributed to inflation and low investment levels but also brought on a severe economic recession in the region. Increased external saving –so long as it supplements national saving rather than taking its place– makes it possible to achieve a higher rate of investment and growth. Nevertheless, these inflows have also had an unwelcome effect on exchange rates, the degree of control over the money supply and aggregate demand, the price stability of financial assets, external liabilities and the region's vulnerability to further external shocks in the future.

Financial markets play a number of important roles in development. For the countries of the region, active participation in international financial markets affords them the advantage of

providing their economies with a means of attracting capital to activities that offer high rates of return in international terms. For investors, it offers a means of diversifying risk. Unfortunately, international financial markets are also the most imperfect markets in the economy. They have a long history of phases of burgeoning growth followed by contractions of varying severity (Kindleberger, 1978), and there are no compelling reasons to believe that these markets will not continue to exhibit this volatility in the future.

Perhaps one of the best illustrations of the serious flaws affecting the operation of these markets is the virtual stagnation of international capital flows between the time of the Great Depression and the early 1960s. Even when foreign capital inflows are maintained, an excessive percentage of that capital may be channeled towards short-term transactions. Moreover, adjustments in the volume and prices of flows can be sudden and unpredictable.

From a public policy perspective, the ideal solution would be to separate the permanent components of capital inflows from the temporary ones. If the inflow of capital is of a permanent nature, then such related phenomena as an appreciation of the real exchange rate, a widening of the deficit on current account and increased consumption could be interpreted as stabilizing adjustments and, hence, as economically sound developments. If, on the other hand, capital flows were temporary, the aforesaid movements in key variables would be distortionary, since they would create economic imbalances that would greatly increase the likelihood of disruptive adjustments in the future involving high social costs. This distinction is, of course, very difficult to make in practice. There are, however, certain types of economic policy measures which can have a differentiated impact on short- and long-term flows or on flows of productive as opposed to purely financial investment.

The externalities and other serious imperfections of international capital

markets give rise, among other things, to frequent cycles of alternating abundance and shortages of resources and to systemic crises; consequently, even potentially permanent flows can evaporate overnight (Guttentag and Herring, 1984). Accordingly, it is always advisable for Governments to exercise caution where capital inflows are concerned if they are to succeed in fostering a situation where the aggregate amount and main components of such flows are in keeping with macroeconomic stability, investment, and growth based on international competitiveness. If the size and composition of capital flows are incompatible with these parameters, sooner or later their sustainability could be threatened, making it necessary to resort to compulsory, potentially destabilizing and socially costly national adjustments. In addition to this problem of domestic absorptive capacity, consideration must also be given to the inherent risks of any short-term external shock in international financial markets.

Since capital flows can affect, and are affected by, national economic variables, Governments should exercise caution on two fronts. First, they need to forestall any situation in which capital inflows would create atypical values or major distortions in key national economic indicators, such as real exchange rates, domestic interest rates, sectoral and national indebtedness, inflation (including asset prices), consumption, investment and the production of tradables.

Second, Governments should guard against using external capital flows as the mainstay for efforts to achieve a rigid or extreme target for a single domestic economic variable (e.g., inflation), especially over a prolonged period of time. By doing so, they would run the risk of achieving their objective at the cost of throwing other important variables out of balance, thereby impairing the very instrument they tried to use in the first place, namely, external capital inflows.

Capital flows are not always compatible with the objectives of

macroeconomic stability in a broad sense, sustained economic growth or social equity. A degree of direct or indirect public "management" aimed at influencing the volume and composition of these flows is therefore justified. There have been numerous cases in which such an approach has been taken—successfully and unsuccessfully—in the past. The extent to which the capital account should be opened may vary over time, depending on short-term domestic and international conditions and the stage and demands of the development process.

In order to maintain a stable real exchange rate, the speed at which the capital account is opened should be tailored to fit the economy's capacity to absorb and efficiently allocate external resources. For instance, a distinction might be drawn between capital inflows and outflows (Williamson, 1992). It may be desirable to liberalize long-term capital inflows first, before facilitating short-term financial transactions. In the case of capital outflows, it may be advisable to give priority to credits for export promotion and to direct overseas investments by national firms, which would also be another way of improving such firms' export platform.

The liberalization of the capital account in industrialized countries has been a fairly slow and gradual process whose pace has accelerated only in the past 10 years as the globalization of capital markets has proceeded. However, it is interesting to note that Spain, Portugal and Ireland introduced certain restrictions on capital movements in 1992 in an effort to combat exchange rate instability. Once their objectives in this regard were achieved, the restrictions were lifted. This highlights the importance of having flexible instruments which, when circumstances so warrant, allow temporary constraints to be imposed on capital movements in order to support efforts to promote macroeconomic stability.

In times of scarcity, there may be sound reasons for seeking out both

specific and more general ways of attracting capital inflows and for using some means of screening capital outflows. Just the opposite would be true in cases where there is clearly an abundance of capital in a country's markets; it would then be a question of restricting certain types of inflows while promoting channels for capital outflows.

Using special instruments to regulate capital flows obviously entails some costs. However, experience has shown that always allowing the market to determine the volume and composition of such flows may also have major costs.<sup>88</sup> No single instrument, or set of instruments, works perfectly or with complete efficiency; in an imperfect world, instruments must be judged by their overall results. Thus, pragmatic use must be made of the policy instruments that offer the greatest *net* benefits in terms of macroeconomic stability and growth, while minimizing their costs.

The inflow of capital has done away with the external constraints on growth and offers an opportunity to obtain financing both for reactivating the region's economies and for making the investments necessary for sustained and sustainable growth. In order to seize this opportunity, action must be taken in regard to two aspects of financial policy: i) its interaction with macroeconomic policy, with a view to engendering a stable economic environment that offers suitable incentives for economic agents; and ii) its interaction with domestic capital markets, with a view to supplementing national saving efforts and matching them up with investment needs.

Promoting a strategy of changing production patterns with social equity necessarily entails, at a strictly macroeconomic level, an effort to manage aggregate demand and its composition. The instruments available for this purpose are fiscal, income, monetary and exchange policies. In the absence of active fiscal and

income policies, the only means of achieving this objective is through the simultaneous control of the real interest rate (as a monetary policy tool for purposes of stabilization and the control of aggregate domestic expenditure) and the real exchange rate (as a trade policy tool for purposes of promoting the growth of tradables production and influencing the composition of aggregate expenditure).

A conflict arises, however, when the level of the domestic interest rate that is in keeping with the objective of curbing inflation and stabilizing economic activity (by sterilizing the monetary effects of the build-up in reserves) is higher than the international rate (once the latter has been adjusted for expectations of devaluation), since this spurs the inflow of capital and heightens the appreciation of the currency, thereby jeopardizing the objective of protecting the tradables sector of the economy. If, on the other hand, real domestic interest rates are allowed to fall, then both objectives may be thwarted, since the higher expenditure prompted by lower interest rates will put pressure on prices and rapidly widen the current account deficit, thus posing the danger of an unsustainable macroeconomic imbalance. The way to resolve this conflict is to take direct or indirect action on capital flows, as some Latin American and Caribbean countries have been doing in the 1990s.

When the authorities are faced with an unexpected abundance of external finance which they consider to be partly of a temporary nature or which is flowing too fast for the economy to absorb, they can intervene at three decision-making levels. At the first level, they can act to moderate the inflow's impact on the exchange rate by having the Central Bank buy up foreign exchange (which will push up the level of reserves). At the second level, they can adopt sterilization policies to mitigate the monetary impact of the increase in reserves caused by intervention at the first

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88 During the 1970s, most Latin American countries let the market determine the volume and terms of external credit; the adverse consequences of this course of action are well known by all.

level. At the third level, they can use incentives, surcharges or quantitative controls to influence the composition and volume of capital inflows; the aim here would be to encourage a volume of flow that is compatible with the economy's domestic absorptive capacity and to channel those funds into productive investment projects while discouraging the entry of short-term speculative capital.

Some Governments have chosen an approach referred to as non-sterilized intervention, meaning that they intervene at the first level by having the Central Bank buy up foreign exchange, but refrain from sterilizing the resulting monetary effect. If this option is combined with the liberalization of capital movements in a situation where the Government is committed to holding the nominal exchange rate to a predetermined rate of variation, then the authorities may lose control over monetary aggregates. Another option, known as sterilized intervention, broadens the scope of action of the first alternative by offsetting the monetary impact of the accumulation of reserves by means of active measures to regulate the money supply. This is intended to keep the real exchange rate within a desirable range in terms of medium- and long-term objectives.

Most countries in the region have at some point opted for sterilized intervention and have had to deal with serious conflicts between their exchange and monetary policies. In order to ease those conflicts, they have used supplementary measures, such as providing for a degree of flexibility in fiscal policy in order to regulate aggregate demand; establishing stabilization funds for their main export products to cushion shocks in their price cycles (as in the case of Chilean copper and Colombian coffee); and using income policies to adjust relative factor prices to changes in productivity.

As mentioned earlier, when fiscal policy makers do not have sufficiently flexible instruments at their command, then monetary policy (interest rates) and

exchange policy (exchange rates) are the only means of controlling aggregate demand. To resolve the conflicts that may arise in terms of the simultaneous management of these two variables, the authorities have the option of intervening at the third level by adopting measures intended to change the volume and composition of capital flows; the aim here would be to give priority to long-term flows through the use of incentives (reserve requirements or taxes, and exchange rate measures that generate greater uncertainty for short-term capital flows) or quantitative controls.

Direct quantitative controls include such measures as compulsory minimum maturity periods; minimum volumes for bond issues; and regulations regarding the involvement of foreign capital in the stock market.

In the area of exchange management, the aim is not only to dampen the tendency towards a real appreciation of the currency but also to discourage international interest-rate arbitrage, particularly by raising the level of uncertainty surrounding short-term price trends for hard currencies through the use of mechanisms which permit a greater degree of intervention. For example, one option is to implement a "dirty" float within a pre-established band using a benchmark value for the dollar based on market conditions in the relevant country's trading partners.

Under the current circumstances of an abundant supply of external funds and what are still comparatively low international interest rates, third-level intervention policies –as well as sterilized intervention– act on monetary aggregates to prevent overspending on the part of the private or public sector by forestalling artificial, temporary increases in domestic expenditure which could cause steep decreases in national saving and excessive increases in external liabilities unmatched by a corresponding increase in the production capacity for tradables.

The extent to which foreign capital flows can further the aims of a strategy for

changing production patterns with social equity largely depends on the characteristics of the relevant domestic financial markets. This observation is based on the experience of the external debt crisis, which was caused by heavy inflows of foreign bank credit.

The reorganization of a country's financial system (including the liberalization of capital movements) should give priority to channelling resources into savings and investment, and should do so in close coordination with the development of production capacity. Closer attention needs to be paid to the relationship between the financial system and national saving and investment processes, and between the financial system and external financial markets. The present situation is clearly unsatisfactory, since too small a percentage of the increase in capital inflows has been used to bolster the region's productive investment levels in recent years.

Where the relationship between financial markets and capital formation for development is concerned, an institutional framework is needed that will complete or refine those markets on the basis of three criteria. The first is that a segment of the dynamic, long-term financial market must be included in order to provide financing for production projects. This means that speculative segments must be discouraged and that attention should be concentrated on long-term international capital, together with access to technology and export markets. Capital inflows that take the form of foreign direct investment in the region are an important factor in this regard when the nature of that investment makes a genuine contribution to the creation of additional production capacity.

The second criterion is that the institutional framework must promote access to financing for small and medium-sized firms that are suffering from the effects of the capital market's segmentation. To that end, this market must operate on the basis of a number of

selective criteria that reflect the needs of small production firms in the areas of training, development promotion and modernization. Credit institutions and guarantee mechanisms are needed to accomplish what the region's capital markets have failed to do spontaneously. The aim is not to subsidize the cost of credit, but to promote access to financing at normal interest rates, as well as access to technology, inputs and services, marketing channels, long-term financing and infrastructure that will enhance the production capacity of these sectors of the population.

The third criterion is based on a recognition of the fact that when a country with an emerging market pursues a financial liberalization programme that opens up the capital account to international portfolio investment, it runs the risk of overborrowing from external sources and excessive fluctuations in the stock market and the exchange rate. Large-scale inflows of foreign capital to domestic markets can trigger stock-market bubbles and a decrease in the exchange rate at one and the same time. The subsequent decline in stock market quotations can, in turn, prompt capital outflows and push up the exchange rate. Hence the need to regulate and supervise financial institutions operating in such capital markets in order to ensure their stability.

Concern about such financial-market risks as the generation of speculative bubbles, perverse selection and moral hazard has underscored the need to introduce regulatory and supervisory mechanisms to ensure the stability of the financial institutions operating in capital markets. Such mechanisms are particularly necessary in open, free-market economies. By contrast with what took place during the debt crisis, when the prudential and financial regulatory apparatus was weakened, the reinforcement of that apparatus can counter the above risks and help make the attraction of overseas portfolio investments a more orderly and stable process.

In short, the region's economies can take better advantage of the opportunity afforded by access to international financial markets if their domestic economic policies manage to achieve the following three objectives:

i) To ensure stable access to foreign capital flows while making sure that such flows do not contribute to distortions in key economic variables such as the exchange rate and interest rates. The exchange rate should be maintained at a level that will stimulate the international competitiveness of the production apparatus, while real interest rates should be kept relatively low –but not so low as to generate an excessive level of aggregate demand– in order to encourage private national investment, reduce the risk of insolvency in the financial system and forestall macroeconomic distortions. A number of countries in the region have opted for simultaneous intervention in the foreign exchange and money markets in conjunction with such measures as the establishment of reserve requirements and taxes and other disincentives for short-term capital movements.

ii) To seek to ensure that a large proportion of funds are channelled into efficient investments which will enhance the international competitiveness of the region's economies. In order to make this possible, the absorption of those resources should take place within the framework of an export promotion policy which is based on a realistic, stable exchange rate in keeping with medium-term economic conditions and which is bolstered by a sufficient pace of technological and human resources development. This will enable the economy to generate sufficient external resources to stave off any future debt crises. To this end, the region would be well advised to strengthen its financial markets by further developing their long-term segment and reducing their segmentation so that these markets' allocation of resources will truly be based on a cost-benefit analysis of such investment projects.

iii) To step up the supervision and regulation of financial institutions (particularly of a prudential nature) to ensure that the increase in assets and liabilities generated by external flows does not endanger their future solvency.

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