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AND  
THE CARIBBEAN

# C E P A L

REVIEW



UNITED NATIONS



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**ECLAC**

ECONOMIC COMMISSION  
FOR LATIN AMERICA AND  
THE CARIBBEAN

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# CEPAL

## REVIEW

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UNITED NATIONS

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*The following symbols are used in tables in the Review:*

(...)	Three dots indicate that data are not available or are not separately reported.
(—)	A dash indicates that the amount is nil or negligible.
	A blank space in a table means that the item in question is not applicable.
(-)	A minus sign indicates a deficit or decrease, unless otherwise specified.
(.)	A point is used to indicate decimals.
(/)	A slash indicates a crop year or fiscal year, e.g., 1970/1971.
(-)	Use of a hyphen between years, e.g., 1971-1973, indicates reference to the complete number of calendar years involved, including the beginning and end years.

References to "tons" mean metric tons, and to "dollars", United States dollars, unless otherwise stated.  
 Unless otherwise stated, references to annual rates of growth or variation signify compound annual rates.  
 Individual figures and percentages in tables do not necessarily add up to the corresponding totals, because of rounding.

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# Health care markets: *their morphology,* behaviour and regulation

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**Jorge M. Katz**  
**Ernesto Miranda R.**

*ECLAC Division of  
Production,  
Productivity and Management.*

*School of Economics,  
University of Chile.*

This article analyses the markets for health care-related goods and services. Particular attention is devoted to three of those markets: medical services, public and private hospital services, and pharmaceuticals. These three markets—which, taken together, account for between 70% and 80% of total health-care operating expenditures—have structures that are characterized by imperfect competition, marked externalities in terms of the consumption of health care, and a high degree of interdependence. As a consequence of the first two of these traits, if these markets are left to their own devices they will not generate optimal solutions in terms of resource allocation or the maximization of well-being. By the same token, their interdependence leads to the transmission of distortions from one health-care market to the next and, in most cases, also tends to magnify those distortions that already exist in any one of these markets. This state of affairs has crucial implications for public policy-making, which, of course, must also take into account the particular economic, social and political conditions existing in each country. The authors therefore identify and analyse a number of regulatory measures which would appear to be advisable for each of these markets and which—if bolstered by the type of institutional, legal and regulatory retooling called for in each case—would diminish, if not eliminate altogether, their incompatibilities with the deregulatory and free-market theories that are now seen as appropriate in other spheres of economic activity.

# I

## Introduction

The members of any given society care for, maintain and regain their health through the use of human resources (doctors, other health-care professionals and other types of personnel), equipment and instruments, public and private hospital services, vaccines and pharmaceuticals, and other health-care and general-purpose inputs. These resources are used in varying proportions and combinations, which are normally determined by health-care professionals, since they are generally the ones who decide which examinations and tests are necessary, assume responsibility for the clinical diagnosis of any pathologies that are detected, and decide what types of treatment are to be given.<sup>1</sup>

Each of these services and inputs has a market of its own made up of a variety of suppliers (public as well as private, national as well as foreign) and users (of final or intermediate, consumer or capital goods and services). These markets all have a going price (or, more accurately, price range) at which the relevant agents—suppliers (i.e., health-care providers) and users (i.e., patients)—have arrived in accordance with certain rules of conduct that are observed within the framework of more or less competitive markets.

□ This article contains a portion of the material prepared by the authors for the ECLAC/PAHO study entitled *Health, social equity and changing production patterns in Latin America and the Caribbean* (document LC/G.1813 (SES.25/18)), which was presented at the twenty-fifth session of ECLAC (Cartagena de Indias, April 1994). The opinions expressed here are those of the authors and do not necessarily reflect the views of the above organizations. The ideas set forth in this article were discussed on various occasions with R. Franco, J. Ramos, F. León and M. Boyer, whom the authors wish to thank for their many contributions, while at the same time emphasizing that they bear no responsibility for the contents of this article.

<sup>1</sup> In a study conducted in the late 1970s, Blumberg estimated that nearly 70% of a community's total expenditure on health services is determined by the decisions taken by medical professionals.

<sup>2</sup> The interdependence of supply and demand which stems from the ability of the former to influence or shape the latter is a hallmark of health-care markets. This influences the behaviour of suppliers of goods and services and, hence, the nature and mode of operation of the regulatory apparatus that needs to be established in order to induce the sort of microeconomic behaviour that will lead to a socially optimal outcome. The final section of this article presents a more detailed discussion of public policy issues relating to the regulation of health care.

For the most part, these are imperfect markets in which supply is to some extent capable of creating its own demand.<sup>2</sup> The variations in the prices of goods and services that are either identical or similar enough to serve as substitutes for one another are generally considerable, since the standards by which quality and therapeutic value should be measured are hazy even for suppliers themselves. Owing to the phenomenon known as "information asymmetry", consumers do not have a clear picture of exactly what is required to meet their needs or of how much better one expenditure option might be than another, and the sovereignty of the consumer can therefore be exercised only in a highly imperfect manner. The random nature of disease, the variability of diagnoses and therapies, and the uncertainty that exists in regard to technological development in the health field and its cost frequently complicate risk management efforts, thereby giving rise to instances of risk selection or risk avoidance.

Three of these markets—the markets for medical services, hospitalization services and pharmaceuticals—absorb between 70% and 80% of the total resources expended by society on the care and restoration of its members' health.<sup>3</sup> Each of these markets raises specific issues in terms of their organization and behaviour; here, we will first look at these issues individually and will then go on to consider the question of their interdependence.

Any analysis of the model used by a given society to organize its health care services must necessarily take the interdependence of the relevant markets into consideration, because of the impact it has on the way in which resources are distributed among the various suppliers of goods and services who interact within this sector. Our argument in this paper is that the way in which the health care system operates is strongly influenced by the changes undergone by that resource distribution over time.

<sup>3</sup> For example, in the United States medical services take up 20% of total expenditures on health care, hospitalization costs account for 40% and medicines for 10% of total expenditure (Feldstein, 1983, pp. 33). In Argentina, however, medical services absorb 28%, hospitalization 22% and medicines 30% of total expenditure (Katz and Muñoz, 1988).



To the extent that each cluster or group of service providers is capable of adjusting the quantity or quality of supply in response to reductions in the relative prices of the goods or services they have to offer, the behaviour of each market and the interdependence among them play a crucial role in accounting for the way in which the system evolves as a whole and for the nature of its predominant traits in

terms of microeconomic effectiveness and efficiency and distributive equity.

The following section (section II) deals with the morphological features and interdependence of health care markets. In section III, we will briefly explore the public-policy implications of the analysis of health sector organization presented here. Concluding remarks and comments are set forth in section IV.

## II

### The morphology and interdependence of health-care markets

The growth of health-care markets is primarily a function of the medical-services market, since medical professionals are the crucial factor in the process of production of health services. Medical practices dictate the nature of the technologies to be used and thus determine the relative proportions of other factors of production to be used. To a large extent, the demand for instruments and equipment, inputs, pharmaceuticals and hospitalization services is a derived demand. Although possibilities of complementarity and product substitution among these factors do exist, the extent to which they are used is none the less determined by doctors and, to a lesser degree, by other health-care professionals.

#### 1. The medical services market

The supply of medical services varies markedly from one Latin American country to the next, as well as from one area to another within each country (see table 1). This fact is reflected in the differences in the index of the number of persons per doctor (see table 2), since this index is similar to the European average in some countries but is only a fraction of that figure in others. Thus, in Argentina, Uruguay and Cuba the average index is roughly one doctor for every 300 persons; in Chile, Colombia and Peru, it is one doctor for every 900 inhabitants; and in a number of other countries, the average figure is just one doctor for over 2 000 persons.<sup>4</sup> This undoubtedly influences the per capita rate of medical consultations, an indicator which likewise exhibits sharp differences between countries and between regions within each country.

Aside from the doctor/population ratio, the behaviour of the medical services market is also influenced by three major sets of variables. The first of these has to do with the growth rate, degree of specialization and breakdown by sex of the supply of new graduates in medicine, dentistry, nursing and other health-care professions, and their geographic location. These variables influence both the shape of the services supply curve and the way it shifts over time, thereby affecting the price (fees charged for medical services), quality and form of organization of medical care. Relevant factors in this regard include the university entrance requirements (entrance examinations or other forms of screening university applicants), the accreditation requirements for practicing medical professions established by the institutional and regulatory organizations operating in each society, the mechanisms for specialization existing in the medical and other health-care professions, and the percentage of female graduates (since young female doctors display a greater propensity than their male counterparts to work part time and to work under someone else).

<sup>4</sup> The average index for the countries of the Organization for Economic Cooperation and Development (OECD) is 2.3 doctors for every 1 000 persons (Schieber and others, 1991). Thus, in countries such as Argentina, Uruguay and Cuba, the medical services market is substantially more saturated than it is, on average, in the industrialized countries, with a heavy concentration of these professionals in urban centres and large metropolitan areas. Montevideo, for example, has one doctor for every 200 inhabitants, and the city of La Plata (capital of the Province of Buenos Aires, Argentina) has the remarkably high rate of one doctor for every 120 people, which is virtually unheard-of anywhere else in the world. Regarding the indexes for Europe, see Schieber and Poullier (1989) and Greenwald (1991).

TABLE I

**Latin America and the Caribbean (29 countries):  
Human resources in the field of health care, around 1990**

Country	Population (thousands)	Doctors	Dentists	Professional nurses	Nursing auxiliaries and other personnel
Argentina	32 700	88 800	21 900	18 000	26 000
Bahamas	259	373	58	682	1 000
Barbados	258	294	33	836	502
Bermuda	61	71	27	27	523
Bolivia	7 300	3 392	333	1 869	4 713
Brazil	151 400	208 966	118 609	57 047	205 110
Colombia	32 800	36 551	19 498	15 251	31 125
Costa Rica	3 100	4 027	1 200	3 021	4 000
Cuba	10 740	46 860	8 057	5 474	68 469
Chile	13 400	15 015	7 000	5 653	28 794
Dominica	72	38	6	233	...
Ecuador	10 800	15 737	4 847	5 045	11 384
El Salvador	5 300	4 525	1 182	2 655	2 439
Guatemala	9 500	7 601	251	3 120	11 281
Guyana	800	138	11	708	83
Haiti	6 600	564	81	728	1 761
Honduras	5 300	3 803	622	1 352	4 936
Virgin Islands	99	21	1	48	27
Jamaica	2 400	338	54	2 130	1 355
Mexico	83 300	149 432	...	80 760	61 540
Montserrat	14.4	5	1	38	18
Nicaragua	3 800	1 723	183	2 200	2 569
Panama	2 500	4 131	957	2 630	3 341
Paraguay	4 400	2 924	1 160	1 375	3 183
Peru	21 900	23 771	6 259	19 612	38 850
Dominican Republic	7 200	11 130	1 898	1 360	4 675
Trinidad and Tobago	1 300	911	109	2 037	1 438
Uruguay	3 100	11 530	3 512	1 710	1 500
Venezuela	19 800	32 616	7 945	15 026	40 324

Source: Population figures: World Bank, *World Development Report, 1993*, Washington D.C., 1993; all other statistics: Pan-American Health Organization (PAHO)/World Health Organization (WHO), *Las condiciones de salud en las Américas 1994* (in the press).

In analysing the educational system, it is important to take into account both quantitative factors—medical-school entrance requirements, enrolment, the amount of time required for the completion of medical school and its cost, the nature of medical residencies, rates of specialization, attrition rates, etc.—and qualitative aspects having to do with the greater or lesser amount of “biologistic” or “social” content in the training imparted to medical students. In discussing the undergraduate educational system, Belmartino and others (1990) have stated that: “The current situation may be described as follows: (a) Special emphasis is given to the type of practice conducted in hospitals devoted to the treatment of rare, acute diseases; (b) Health-care functions corresponding to the most active phases of a disease are stressed, while

such aspects as rehabilitation, re-entry into everyday life, follow-up on chronic diseases, etc., are relegated to a position of secondary importance; (c) The focus is on the curative aspects of health care, while promotion and prevention are neglected; (d) The psychological, social and environmental factors involved in the health/sickness situation are disregarded, and the contributions that could be made by the social sciences, human sciences and epidemiology have not been effectively integrated into the curriculum; (e) Rote learning is emphasized, while not enough attention is paid to reasoning ability and the development of sound clinical judgement in evaluating the condition of the patient”. These authors conclude that: “the educational system lays the intellectual groundwork for the reproduction of the dominant medical model”.

CUADRO 2

**Latin America and the Caribbean (29 countries): Ratio between  
population and human resources in the field of health care, around 1990**

Country	Number of persons per doctor	Number of persons per dentist	Number of persons per nurse	Number of persons per other type of health personnel
Argentina	368	1 493	1 817	1 258
Bahamas	694	4 466	380	259
Barbados	878	7 818	309	514
Bermuda	859	2 259	2 259	117
Bolivia	2 152	21 922	3 906	1 549
Brazil	725	1 276	2 654	738
Colombia	897	1 682	2 151	1 054
Costa Rica	770	2 583	1 026	775
Cuba	229	1 333	1 962	157
Chile	892	1 914	2 370	465
Dominica	1 895	12 000	309	...
Ecuador	686	2 228	2 141	949
El Salvador	1 171	4 484	1 996	2 173
Guatemala	1 250	37 849	3 045	842
Guyana	5 797	72 727	1 130	9 639
Haiti	11 702	81 481	9 066	3 748
Honduras	1 394	8 521	3 920	1 074
Virgin Islands	4 714	99 000	2 063	3 667
Jamaica	7 101	44 444	1 127	1 771
Mexico	557	1 031	1 354	...
Montserrat	2 880	14 400	379	800
Nicaragua	2 205	20 765	1 727	1 479
Panama	605	2 612	951	748
Paraguay	1 505	3 793	3 200	1 382
Peru	921	3 499	1 117	564
Dominican Republic	647	3 793	5 294	1 540
Trinidad and Tobago	1 427	11 927	638	904
Uruguay	269	883	1 813	2 067
Venezuela	607	2 492	1 318	491

Source: Population figures: World Bank, *World Development Report, 1993*, Washington D.C., 1993; all other statistics: Pan-American Health Organization (PAHO)/World Health Organization (WHO), *Las condiciones de salud en las Américas 1994* (in the press).

In other words, in a system where medicine is oriented towards a high degree of complexity, "over-medicalization" and *ex post* reparatory treatment, the training imparted by medical schools—because they need to turn out doctors who will be able to fit in efficiently into the existing system—ends up accentuating those traits by pushing new graduates in the direction of rapid specialization, the use of highly sophisticated technologies, and increasing fragmentation of medical care.

The second set of variables that influences the medical services market is the form of sectoral organization—i.e., wholly public or private—used by the society in question for the financing, management and provision of these services. Thus, in systems where the public sector is responsible for the provision and financing of health care, doctors are salaried officials of the State, whereas in a mixed system—in which the public sector, social security institutions

and the private sector share the task of financing and providing health care—differing forms of market behaviour and types of transfers come into play which are virtually alien to primarily public systems.

In mixed systems, the earnings of members of the medical profession—and of other health-care professions too, although to a lesser degree—do not come only from the salaries paid to them for functions they perform as public servants. Instead, increasingly significant portions of their earnings take the form of professional fees charged in private practice and profits derived from the ownership of instruments, equipment and hospital infrastructure. Through their ownership of such capital goods, medical professionals operate as subcontractors of social security institutions, privately-owned companies that provide health-care services and, on occasion, government bodies.

The way in which this public/private mix gradually shifts towards a greater role for the private sector is closely associated with the development and formalization of health-care markets. As these markets develop, the economic rents afforded by ownership of capital goods and infrastructure come to represent a growing percentage of health-care professionals' total income, and as this process proceeds, these economic rents are increasingly a function of the profits associated with the introduction of highly sophisticated electronic medical equipment (CAT scanners, echograph machines, gammagraphs, etc.).

In such situations, efforts to capture and increase the demand for health-care services move away from competition based on prices and reductions in production costs and instead become focused on product differentiation based on an increasing degree of technological sophistication. This motivates professionals to become more specialized (i.e., to invest in human capital), to acquire instruments and equipment, and to employ diagnostic and therapeutic methods that involve the use of leading-edge technology. Consequently, a growing share of their income will come from investment and technological innovation. In an associated phenomenon, increases and changes are seen in the types of demands faced by the system as regards the training of health-care professionals (combined with increasing restrictions on market entry in the form of specialization requirements) and in the demands that must be met by producers of instruments, equipment and infrastructure. The most dynamic sector will thus be the one that has the greatest concentration of state-of-the-art technology, which is more profitable than traditional technologies.

The third and last set of variables influencing the operation of the medical services market have to do with the payment arrangements used in each organizational model, i.e., flat-rate salaries, payment for each consultation or visit, payment on a per-patient basis, payment for an entire course of treatment, payment on the basis of the results achieved, etc. In mixed public/private models, the practice of making payments for each consultation or visit has been observed to lead to over-numerous visits and treatments and to an increase in costs. It also seems clear that in cases where both private and public health-care systems are in operation, the differential between the salaries paid to health care professionals in the public and private systems will prompt a shift in these human resources towards the private sector, thereby

driving up costs<sup>5</sup> (WHO, 1993; Miranda, 1993b). The available data also indicate that contracts on a per-patient basis, "all-in" fees or "diagnosis groups"—unlike payments per consultation or visit—transfer the risk of rising costs from the financing agencies to the service providers, thereby obliging the latter to manage their resources more carefully. In such cases, incentives are generated for the control of any over-treatment or overbilling through the establishment of technical standards for medical/health-care functions, as well as the use of auditing and other *ex post* systems for monitoring results.

The quality and organization of medical care also appear to be associated with the three sets of variables discussed above. Unless appropriate health-care standards are established and treatment results are properly monitored, per-patient contracts, for example, when used solely as a mechanism for curbing costs, may lead to the under-provision of services and a deterioration in the quality of medical care.<sup>6</sup>

In a system where the public sector has prime responsibility for financing and providing health care, this line of reasoning suggests that whenever budgetary constraints become serious, wages decline and waiting times grow longer, informal markets are likely to emerge within public health-care agencies. In such cases, some members of the community—whether by virtue of their greater economic power or because of their urgent need for health care—will secure attention on a preferential basis in exchange for payments in kind or some sort of under-the-counter payment.<sup>7</sup>

The issues that arise in regard to microeconomic behaviour are of a different nature in mixed models of sectoral organization that are more open and pluralistic than their wholly public counterparts. In mixed models, members of the medical community may be expected to behave in ways that will influence, *inter alia*, the cost of services, the rate at which new technologies are introduced, the quality of medical care, and the way in which it is organized, and their influence may be stronger and more difficult to regulate than in a wholly public system.

<sup>5</sup> Recent studies in Chile have brought to light situations of this sort. See, for example, Oyarzo (1992 and 1993).

<sup>6</sup> This may take the form, for example, of a reduction in the time devoted to each patient or in the number post-operative examinations.

<sup>7</sup> Examples of this type of informal market have been identified in studies on the health-care sector in the former socialist-bloc countries and, more recently, in countries such as Cuba and Costa Rica, to name only a few.

These three sets of variables –the rate of increase in the supply of new graduates and their make-up in terms of sex, location, degree of specialization, etc.; the nature of the health care sector's organizational model; and the payment procedures for medical services– will help to determine the size of the medical community's share in the total resources expended by society on health care. Moreover, they will also promote –or hinder– certain types of reactions on the part of that community.

In summary, the interaction of the above-mentioned variables and types of behaviour will determine what share of total income is received by health-care professionals. These types of behaviour are going to reflect idiosyncratic traits of each society, and each specific case will therefore have to be examined individually when designing and implementing public policy in this field. Thus, each country will need to address these complex issues

when seeking to design an institutional and regulatory framework that will reconcile doctors' and other health-care professionals' legitimate economic rights with the overall interests of society. The microeconomic effectiveness and efficiency of the health-care system will hinge upon the successful completion of this task.

## 2. The public and private hospital-services market

The supply of public and private hospital services also exhibits enormous differences in the various countries of the region (see table 3). In Argentina, Barbados, Cuba and Uruguay, there are about 6 hospital beds per 1 000 persons, while the figure is between 3.5 and 4.3 in Brazil, Chile and Venezuela and between 2 and 3 per 1 000 inhabitants in Honduras, Paraguay, Mexico and Colombia.

TABLE 3

### Latin America and the Caribbean: Hospital beds per thousand persons, 1964-1991

Latin America	1964	1967	1974	1978	1984	1991
<i>Andean area</i>						
Bolivia (1991) <sup>a</sup>	2.1	2.2	1.8	1.8	1.8	1.3
Colombia (1989)	2.7	2.4	1.9	1.7	1.8	1.4
Ecuador (1991)	1.9	2.4	2.1	2	1.9	1.6
Peru (1992) <sup>b</sup>	2.5	2.4	2	2.9	1.7	1.5
Venezuela (1992) <sup>c</sup>	3.3	3.2	2.9	2.7	2.7	2.6
<i>Southern Cone</i>						
Argentina (1992) <sup>d</sup>	6	6.3	5.4	5.4	5.4	4.4
Chile (1991) <sup>e</sup>	4.3	4.4	3.6	3.6	2.9	3.2
Paraguay (1991) <sup>f</sup>	2.2	2	1.5	1.5	1.4	1.2
Uruguay (1991) <sup>g</sup>	6.4	6.4	5.7	5.2	5	4.4
Brazil <sup>h</sup>	3.4	3.8	3.8	3.8	3.6	3.5
<i>Central America and Mexico</i>						
Belize (1989) <sup>i</sup>	4.9	4.9	4.6	3.2	2.5	2.2
Costa Rica (1991)	4.5	3.8	3.8	3.1	2.9	2.2
El Salvador (1992) <sup>j</sup>	2.3	2.2	1.8	1.8	1.3	1.6
Guatemala (1989) <sup>k</sup>	2.6	2.5	2	1.6	1.6	1.6
Honduras (1992)	2	1.7	1.7	1.3	0.9	1.1
Nicaragua (1991)	2.3	2.3	2.2	1.6	1.6	1.2
Panama (1991)	3.2	3.3	3.2	3.9	3.6	2.7
Mexico (1991) <sup>l</sup>	2.2	2	1.2	0.9	0.8	0.8
<i>"Latin" Caribbean</i>						
Cuba (1991)	5.5	4.8	4.2	4	6.1	6
Haiti (1992)	0.7	0.7	0.7	0.8	1	0.8
Dominican Republic (1992) <sup>m</sup>	2.7	2.8	2.8	2	1.2	1.9

TABLE 3 (continued)

Latin America	1964	1967	1974	1978	1984	1991
<i>Rest of Caribbean</i>						
Anguilla (1991)	...	...	...	...	...	2.7
Antigua and Barbuda	7.2	7	5.8	6.3	5.8	...
Netherlands Antilles and Aruba (1992) <sup>n</sup>	...	...	...	...	...	7.6
Bahamas (1991) <sup>o</sup>	5.5	4.9	3.9	4.3	4.1	4
Barbados (1990) <sup>p</sup>	5.8	10.4	8.7	8.7	8	8.1
Dominica (1992) <sup>q</sup>	4.9	4.5	4.3	3	3	3.3
Grenada (1991) <sup>r</sup>	6.9	6.9	7.5	8.6	9	6.6
Guadeloupe	...	...	...	...	...	...
French Guiana	...	...	...	...	...	...
Guyana <sup>s</sup>	5.4	4.6	4.3	4.5	1.5	...
Cayman Islands (1991)	...	...	...	...	...	2.6
Turks and Caicos Islands (1992)	...	...	...	...	...	2.9
U. S. Virgin Islands	...	...	...	...	...	...
British Virgin Islands (1991) <sup>t</sup>	4.3	4.3	3.6	3.5	4.7	3.5
Jamaica (1991) <sup>u</sup>	4	3.7	3.8	2.4	2.6	2.2
Martinique	...	...	...	...	...	...
Montserrat (1990)	5.3	4.9	4.7	5.1	5.7	4.8
St. Kitts and Nevis (1992) <sup>v</sup>	3.4	4	4.3	5.6	5.8	6.6
St. Vincent and the Grenadines (1991) <sup>w</sup>	4.4	4.4	5.4	5.1	4.9	4.4
St. Lucia (1992) <sup>x</sup>	4.7	4.8	5.2	4.4	3.8	3.7
Suriname (1989) <sup>y</sup>	5.2	5.3	5.4	5.8	5.4	3.2
Trinidad and Tobago (1992) <sup>z</sup>	5.3	5.1	4.5	4.1	4.8	3.3

Source: Country reports, Pan-American Health Organization (PAHO)/World Health Organization (WHO), *Health Conditions in the Americas, 1969-1972*, Scientific Publication No. 287, 1974; *Health Conditions in the Americas, 1973-1976*, Scientific Publication No. 364, 1978; *Health Conditions in the Americas, 1977-1980*, Scientific Publication No. 427, 1982; and *Health Conditions in the Americas, 1981-1984*, vols. I and II, Scientific Publication No. 500, 1986, Washington, D.C.

<sup>a</sup> Beds in all facilities (Directorio Nacional de Hospitales de Bolivia). Figures for the Ministry of Health and the Social Security system only (5 096 and 2 591 beds, respectively).

<sup>b</sup> Data for the Ministry of Health and the Social Security system only (26 012 and 6 929 beds, respectively).

<sup>c</sup> Beds in all facilities. Data for the Ministry of Health only (26 867 beds).

<sup>d</sup> Total number of beds according to 1980 census. Data for government subsector only (75 822 available beds, on average) (*Boletín del Programa Nacional de Estadísticas de Salud*, No. 67, 1993).

<sup>e</sup> Beds in all facilities (*Anuario de Atenciones y Recursos*, 1991; *Anuario de Egresos Hospitalarios*, 1991).

<sup>f</sup> Beds in all facilities (*Anuario Estadístico del Paraguay*, 1991).

<sup>g</sup> Beds in all facilities. Figures for short-stay beds in the public sector only.

<sup>h</sup> Beds in all public and private facilities, 1989 (11 530 in public sector and 403 365 in private sector).

<sup>i</sup> Does not include data for two private hospitals.

<sup>j</sup> Beds in all facilities. Use shown for Medical Service.

<sup>k</sup> Beds in all facilities at third level only.

<sup>l</sup> Data for National Health System only.

<sup>m</sup> Beds in all facilities. Data for public sector only (301 beds).

<sup>n</sup> Data for general-purpose beds only. Data for Aruba only (301 beds).

<sup>o</sup> Beds in all hospitals. Data for short-stay hospitals in the public sector only (540 beds).

<sup>p</sup> Beds in all facilities. Data for Queen Elizabeth Hospital only (539 beds).

<sup>q</sup> Beds in all facilities. Data for Princess Margaret Hospital only (195 beds).

<sup>r</sup> Beds in all hospitals. Data for three general hospitals only (349 beds).

<sup>s</sup> Only reports that the country has 24 hospitals.

<sup>t</sup> Data for public and private hospitals. Use shown for public hospital only (50 beds).

<sup>u</sup> Beds in all facilities. Data for government-run hospitals only (5 078 beds).

<sup>v</sup> Beds in all hospitals. Data for J.N. France and Pogson hospitals only (174 and 38 beds, respectively).

<sup>w</sup> Beds in all hospitals. Data for Kingston General Hospital only (207 beds).

<sup>x</sup> Beds in all facilities. Data for Victoria and St. Jude hospitals only (184 and 114 beds, respectively).

<sup>y</sup> Beds in all facilities. Data for the four general hospitals in Paramaribo only (1 213 beds).

<sup>z</sup> Beds in all facilities. Data for public general hospitals only (1 936 beds). Provisional data.

There is no doubt about the fact that most of the available hospital infrastructure in the region is government-owned (see table 4), but private-sector infrastructure is growing the fastest in the majority of the countries. In more than a few cases, in fact, it is the only segment that is growing at all, given the serious financial crisis that has hit both central governments and social security institutions during the past 10 years.<sup>8</sup> The share of total hospital infrastructure owned by the private sector varies sharply from one country to the next, ranging from a negligible proportion in, for example, Costa Rica, the English-speaking Caribbean countries and Cuba all the way up to nearly 75% of the total number of available beds in Brazil. The average is around 24% in Chile, 32% in Argentina, 20% in Peru and 21% of total hospital beds in Venezuela. In Costa Rica, Mexico and, to a lesser extent, Colombia, the social security system administers a significant share of the available hospital capacity.

Even though they offer services which in many ways could be substituted for one another, private and public hospitals exhibit very different organizational models as regards medical attention and health care. In mixed sectoral organization models, there is a tendency towards the consolidation of two largely separate structural frameworks that offer services of different quality and technical complexity. In such cases, public hospitals take care of most of the chronic pathologies (which give little or no profit) while private hospitals tend to specialize in acute pathologies and to use highly complex technologies, such as CAT scanners, gammagraphs, nuclear magnetic resonance imaging, etc.

This gradually gives rise to a dual model of public and private hospital care whereby doctors work in both systems but do so in accordance with two very different codes of conduct. Whereas in public hospitals the main priorities are research, teaching and curricular development, in private hospitals pecuniary considerations are clearly the chief motive. These two spheres of action also interact in some respects, of course. It is not uncommon for patients to consult doctors on a private basis, with the corresponding fees being paid by the social security system or health

<sup>8</sup> During the 1970s and 1980s, the number of hospital beds in government-owned institutions fell from 100 000 to 93 000 in Argentina and from 14 000 to slightly over 8 000 in Uruguay (PAHO, 1993).

TABLE 4

**Latin America and the Caribbean (18 countries):  
Hospital beds in the public and private sectors,  
around 1990**  
(Percentages)

Country	Public sector	Private sector
Argentina	68	32
Bahamas	89	11
Barbados <sup>a</sup>	98	2
Bolivia	84	16
Brazil	25	75
Colombia <sup>a</sup>	80	20
Costa Rica <sup>a</sup>	98	2
Cuba <sup>a</sup>	100	-
Chile	76	24
Ecuador <sup>a</sup>	70.4	29.6
Guatemala	82	18
Honduras <sup>a</sup>	76	24
Jamaica <sup>a</sup>	94	6
Panama <sup>a</sup>	87.2	12.8
Peru <sup>b</sup>	80.4	19.6
Dominican Republic	63	37
Uruguay <sup>c</sup>	72.3	27.7
Venezuela	79.48	20.52

Source: Pan-American Health Organization (PAHO)/World Health Organization (WHO), *Health Conditions in the Americas, 1985-1989*, Washington D.C. and data from lists compiled by health-care systems in Latin America and the Caribbean.

<sup>a</sup> Data for 1991.

<sup>b</sup> Data for 1992.

<sup>c</sup> Data for 1989.

insurance policies or simply coming out of the patient's own pocket, but if those patients need hospitalization, then their treatment and stay in hospital are covered by the public system free of charge. These forms of public-sector subsidization of private health care represent a substantial sum. Chile and Argentina provide clear examples of this phenomenon.

Another example of the interconnections between these dual models is when doctors refer patients in the public system to private health-care institutions. This practice enables medical professionals to expand the demand for their services in the case of patients who can afford to pay for more convenient and efficient care in more comfortable surroundings. The frequency of this practice appears to coincide with the amount of private hospital infrastructure that is owned by medical professionals or with their involvement in other types of commercial arrangements which enable them to share in the income thus generated. In addition to the obvious conflicts of interest existing in such a situation, this

practice also interferes with any cost-recovery measures or redistributive mechanisms implemented in the public sector.

Cost-recovery mechanisms are coming into increasing use in the region's public sectors as a means of obtaining financing directly from users and, in some cases, for redistributive purposes.<sup>9</sup> The medical profession has not always welcomed these types of measures, since they raise greater administrative demands and make it necessary to improve record-keeping and monitoring systems. Indeed, because they do not always afford benefits—pecuniary or otherwise—to the medical professionals involved, the disincentives for such professionals to cooperate with these schemes are so great that they are often difficult to surmount and may ultimately block efforts to implement cost-recovery policies in the public sector.

Payment procedures, which may take any of the forms discussed earlier, have a significant influence on the conduct of health-care providers, just as they do in the case of the medical-services market. In most of the countries' public health care systems, the predominant modes of payment are still based on *ex post* budgetary transfers. Some use has been made, however, of partial transfers based on per-visit payments in Chile (both in public institutions and those that have been transferred over to the municipalities) and in Brazil, where comprehensive tariffs have been employed. It could be argued that the influence exerted by payment procedures in these cases does not differ in any substantial way from what it is in the private sector, although it will be less marked, since production efficiency and the generation of surpluses are generally not prime objectives of the public health care system.

The effect of the contractual payment arrangements made between funding agencies and private health establishments is a more complex question. Obviously, the types of arrangements used will have a strong influence on the cost and quality of health care, on the pace of technological change and on whether or not health-care providers will be inclined to engage in product-differentiating practices and to introduce highly complex medical technologies. These practices and the use of such technologies are the most obviously profitable activities, and this fact

<sup>9</sup> Redistributive aims are served when the percentage of the benefits paid for by the user is determined by the user's income level.

tends to promote the consolidation of an increasingly "medicalized" health-care model which is broken up into many different clinical specialities and sub-specialities.

### 3. The pharmaceutical market

The region's pharmaceutical market exhibits striking variations in terms of both supply—production plus imports of pharmaceuticals—and demand. Let us first consider the question of demand.

At one extreme, there is the case of Argentina, where consumption of medicines amounts to around US\$80 per person annually, based on retail (pharmacy) prices. This is close to the figure registered for countries such as Spain or Portugal and is in marked contrast to the US\$12 or 14 spent in Peru, Mexico or Costa Rica or the US\$7 spent in Guatemala.<sup>10</sup>

Theoretically, the demand for pharmaceuticals is determined by their prices and the regulatory model used by a given society, by the population's epidemiological profile, by the prevailing financing models used in the society in question (i.e., how much of the cost is covered by social security and how much is an out-of-pocket expense), by cultural factors (e.g., the population's attitude towards the use of "self-prescribed" medicines), etc.

Thus, with regard to just one of the above-mentioned variables, recent studies conducted in Europe have shown that the financing mechanisms prevailing in a given society have a significant impact on the level and composition of the demand for pharmaceuticals. In some countries of the European Community, social security covers up to 100% of the cost of medicines that appear on what is known as a "positive list" of items which are reimbursable to the purchaser. In other cases, a "negative list" is used instead, which indicates those items (treatment categories or specific products) for which no reimbursement will be made. There are in fact a great variety of different types of arrangements in use in Europe (see table 5).

<sup>10</sup> These figures should be regarded with some reservations, however, since they are based on very different prices in different countries, even in the case of similar medicines. A more accurate measurement might be the actual number of units sold annually. In Argentina—where the physical volume sold per year totals about 400 million units—the average consumer has access to approximately 15 units per year. Using the same methodology, we find that physical consumption amounts to between seven and nine physical units per year in Chile, Venezuela, Brazil and Colombia.



TABLE 5

**European Community: Financing mechanisms for pharmaceuticals,  
and co-payment percentages**

	Positive list of medicines <sup>a</sup>	Negative list of medicines <sup>b</sup>	Prevailing co-payment system (% of pharmacy price)	Percentage covered by patient	Use of generics encouraged
Germany	No	Yes	Flat charge	25	Strongly
Denmark	Yes	No	25/50/100	33	Yes
France	Yes	No	0/30/60/100	30	Yes <sup>a</sup>
Belgium	Yes	Yes	0/25/50/60	35	Yes <sup>a</sup>
Greece	Yes	No	20	...	Yes
Ireland	No	Yes	Varies by type of patient	...	Yes
Italy	Yes	No	30 or 40	32	Yes <sup>c</sup>
Netherlands	No	Yes	Flat charge	20	Strongly
Portugal	Yes	No	0/20/50	25	Yes
Spain	Yes	Yes	40	25	Yes
United Kingdom	No	Yes	Flat charge	10	Strongly

Source: M. L. Burstall, *Europe after 1992. Implications for pharmaceuticals*, *Health Affairs*, Washington, D.C., Fall 1991, p. 157.

<sup>a</sup> Medicines which are reimbursable.

<sup>b</sup> Medicines which are not reimbursable.

<sup>c</sup> With some reservations.

The existence or absence of officially controlled pharmaceutical prices also influences demand. Until lately, the prices of pharmaceuticals were controlled in many Latin American countries; recently, however, drug prices have been deregulated in Argentina and Mexico, among other countries. In the last few years the prices of pharmaceuticals have risen sharply in real terms in the various countries that have deregulated this market (see table 6), and the amount spent on this item has therefore come to represent a considerably larger share of household expenditure and total health-care expenditure.<sup>11</sup>

Social security institutions' reaction to this trend has been to try to curb the growth in pharmaceutical costs as a percentage of total health-care expenditure by lowering the percentage of such expenses that they will reimburse, reducing their coverage of expenditures on pharmaceuticals, or drawing up special pharmacopoeias or basic lists of generic medicines for which the patient will be reimbursed.

<sup>11</sup> In a recent study of the Mexican pharmaceutical market, Brodosky indicates that the average consumer price was \$0.92 in 1988 and US\$2.60 in 1993, which is a real increase of over 200%. The same thing has occurred in Argentina, where the price jumped from US\$2.50 in 1984 to nearly US\$6 per unit in 1992 (see Brodosky, 1994; Katz and Burachik, 1992).

Turning now to the subject of supply, at least three main types of situations may be identified in the region (see table 7). First, there are countries such as Mexico, Argentina or Brazil, where almost all final pharmaceutical products consumed in the country and between 10% and 40%, approximately, of the main active ingredients or raw materials used by the pharmaceutical industry are manufactured locally. A second group of countries (Chile, Colombia) manufacture a large percentage of the remedies sold on the domestic market but as yet have virtually no local manufacturers of pharmaceutical raw materials, almost all of which must therefore be imported. Finally, the third group is made up of the smaller or less developed countries in which a very considerable portion of final pharmaceutical products are direct imports and raw materials for this industry are not produced locally. These three types of situations obviously raise very different sorts of public-policy issues.

In the first of these three cases, in addition to the question of consumer protection (the prices and quality of the pharmaceuticals sold on the local market), industrial-policy issues must also be addressed, since it has to be determined whether or not it is in the country's interest to develop a local pharmaceutical chemicals industry and, if so, how much support should be given to that industry until it can attain a competitive position in the international market.

TABLE 6

**Latin America (selected countries): Average price per unit<sup>a</sup> of medicine, 1988-1992**  
(US dollars)

	1988	1989	1990	1991	1992
Argentina	2.71	2.26	3.71	4.58	5.34
Dominican Republic	2.41	2.87	2.97	3.79	4.03
Central America	2.98	3.01	2.82	3.00	3.26
Uruguay	1.70	1.73	2.00	2.43	3.04
Peru	0.96	1.24	2.21	2.55	2.89
Chile	1.56	1.75	1.99	2.19	2.51
Mexico	1.39	1.50	1.62	1.94	2.41
Ecuador	0.74	1.00	1.09	1.64	2.27
Brazil	1.22	1.32	1.86	1.46	2.11
Colombia	1.30	1.47	1.57	1.71	2.07
Venezuela	0.62	1.01	1.43	1.63	1.81
Average	1.44	1.51	1.96	2.14	2.73
Increase (%)	9.1	4.9	29.8	9.2	27.6

Source: IMS AG, *PM Reports*, Switzerland, International Medical Statistics, 1993.

<sup>a</sup> Box or other equivalent container.

TABLE 7

**Latin America (12 countries): Structure of the supply of pharmaceuticals, around 1987**  
(In thousands of dollars and percentages)

Country	Total market <sup>a</sup> (thousands of current dollars)	Share <sup>b</sup> (percentages)	
		Local output as a percentage of the total market	Relative share of locally-owned laboratories
Argentina	1 038 878	95.0	56.6
Brazil	1 977 878	83.2	24.5
Colombia	482 000	...	25.0
Costa Rica	51 000	26.0	20.0
Chile	132 000	51.0	43.0
El Salvador	45 000	...	...
Mexico	1 277 000	96.7	24.0
Panama	58 000	25.5	9.5
Paraguay	75 000	85.6	63.4
Peru	179 072	...	27.0
Uruguay	102 000	...	48.4
Venezuela	206 684	95.5	23.0

Source: Pan-American Health Organization (PAHO/WHO), *Informe de la Conferencia latinoamericana sobre aspectos económicos y financieros de los medicamentos esenciales*, Caracas, March 1992.

<sup>a</sup> At wholesale ex-factory prices.

<sup>b</sup> Percentages of total value.

Two crucial factors in determining the viability of any effort to develop such an industry are the type of industrial property legislation which a country decides to adopt – laws that allow or prohibit the patenting of pharmaceutical products, that introduce or preclude the compulsory licensing of newly discovered molecules of pharmaceutical value, that permit or ban the importation of finished products or of the raw materials used to make the corresponding active ingredients, that precisely specify what constitutes “sufficient” use of a patent, etc. – and the issues inherent in the training of the

skilled human resources (biologists, pharmacologists, virologists, etc.) needed in order to develop a local industry to produce active pharmaceutical ingredients.<sup>12</sup>

<sup>12</sup> It is interesting to recall that for many years countries such as Switzerland, Japan and Italy did not allow pharmaceuticals to be patented, in order to protect their national chemical industries. It was not until these industries had become internationally competitive that the above countries signed the 1883 Paris Convention for the Protection of Industrial Property and began to abide by internationally-accepted norms regarding industrial property (Katz, 1972 and 1974).

With the exception of countries such as Argentina and Chile, where locally-owned companies control a substantial portion of the local pharmaceuticals market, transnational corporations dominate the pharmaceutical industry; in fact, they hold nearly 80% of the total market in Brazil, Mexico, Peru and Venezuela.

The combined effect of the decontrol of drug prices, the tariff roll-backs now being implemented and the modifications being made in the laws regarding the patenting of pharmaceuticals is bringing about a radical change in the environment for the pharmaceuticals market in many countries of the region. These countries have once again become extremely attractive to foreign-owned firms which had lost interest in them during the past two decades (Brodosky, 1994; Katz and Burachik, 1992).

Meanwhile, the new institutional and regulatory framework is diminishing the incentives for the independent development of locally-owned pharmaceutical companies; as the situation stands now, it is in their interests to operate as local licensees of large transnational conglomerates while taking advantage of their own firmly-established distribution channels in the markets of the region and their expertise in working with the local medical community. The industry's *modus operandi* is undergoing thorough-going changes and the position of the region's major pharmaceutical laboratories is being redefined under new cooperation agreements with transnational firms.

The situation is somewhat different in the case of the production of pharmaceutical raw materials – a field in which local entrepreneurs in Mexico, Brazil and Argentina had, until recently, made major inroads by swiftly copying newly discovered molecules of pharmaceutical value. They were able to do so because of the existence of weak patent laws that did not protect the patent rights to new products, protective tariffs that made it possible for these entrepreneurs to manufacture active ingredients in small-scale plants, and a system of granting permits for the marketing of new medicines which was strongly biased in their favour.

The core group of locally-owned firms that managed to establish their position during the past three decades thanks to the nature of the prevailing regulatory apparatus now appear to be facing a serious threat to their survival. Given the programmes now being pursued in an effort to open up and liberalize the countries' economies and the new views concern-

ing industrial property that are gaining sway in the region as a result of the strong pressure being brought to bear by developed countries within the framework of GATT (Reichman, 1993), it has become doubtful whether national entrepreneurs will be able to continue developing this industry by quickly producing copies of molecules of pharmaceutical value that have recently been discovered in advanced countries and then manufacturing these substances locally in small, multi-purpose chemical plants.

The very high research and development costs associated with the search for new active ingredients, the possibility of patenting new products, the reduction of tariff barriers which until recently had made it profitable to produce pharmaceutical raw materials locally and, finally, the discontinuation of the privileges that local health authorities often used to grant to local manufacturers (whereby the latter were given preferential access to marketing permits) are now raising some doubts about the future of local pharmaceutical-chemicals industries. Thus, the newly-established institutional and regulatory structure is virtually eliminating the very pillars upon which the development of locally-owned firms was founded in past decades and is thereby bringing about deep-seated changes in the long-term pattern of sectoral behaviour.

Having thus far examined some of the micro-economic characteristics affecting the performance of the markets for the main types of goods and services used in the health-care sector, the next step is to consider the way in which these markets fit in with each other and the implications of that interdependence in terms of the sector's overall performance, its efficiency and effectiveness, and the chances of ensuring equitable access to that sector.

#### 4. Market interdependence

The markets for the goods and services required for the care and restoration of a given population's health exhibit many complex forms of interdependence. For example, childbirth may involve a smaller hospital bill if the patient has received adequate prenatal care on an outpatient basis, or alternatively –if the attending physician decides to perform a cesarean delivery– may occasion a higher level of expenditure for hospitalization and medicines. Such a decision may be taken for therapeutic reasons, but it may also, for example, be adopted because doctors feel that this

procedure will allow them to optimize their use of their workday by avoiding long waiting periods. It may also be taken because the standard fee for a cesarean delivery is higher than for a normal vaginal delivery. Examples of this sort abound, and there is no need to give a long list of such cases here.

The foregoing considerations make it clear that many of the goods and services traded in the health-care sector can be substituted for one another to varying degrees; therefore, the relative price structure works as a powerful mechanism for the redistribution of the available pool of resources among suppliers. Thus, for example, the ratio between doctors' fees and hospital fees as well as between hospital fees and the price of medicines should be viewed as channels for income transfers among the various markets and, within those markets, among the various suppliers. It is therefore not surprising that these issues play a central role in the negotiations conducted among ministries of public health, social security systems, professional associations, business associations representing pharmaceutical laboratories, health schemes, etc.

The structure established by each society for regulating health care must naturally address these questions, because they are of crucial importance in determining the performance of the model used for

the provision of health care services; indeed, they are the main determinants of the system's efficiency, effectiveness and social equity.

There is also another area in which market interdependence is very noteworthy. Recent studies appear to indicate that a given consumer of health-care services will not always behave solely as either a patient under the social security system or a patient under the public sector's health-care system. Instead, patients will tend to mix and match their various options in this regard in order to maximize the level of goods and services they receive from the system (as noted by Lastiri in a personal letter to J. Katz on the subject). For example, people who belong to one of Chile's private health insurance schemes may pay for outpatient care through their private insurance plan but may opt for hospitalization under the public health system (concealing their membership in a private insurance plan) in order to obtain this more complex and costly type of care and the corresponding prescription medicines free of charge.<sup>13</sup> This points up the existence of interdependence and cross-subsidization between the public and private sectors; therefore, in order to gain a full understanding of how the sector functions, we must form an overall picture that takes in both subsectors, rather than treating them as entirely distinct entities.

### III

## Future strategies and regulatory policies

### 1. Active and passive health-care policies

There are two very different approaches to public policy-making in the field of health care today. On the one hand, there is what might be called active policies for altering the public/private financing and service mix. On the other, there are innumerable cases in which the sector has been "passively" restructured as a result of the absence of any explicit public policies regarding the organization and behaviour of suppliers of goods and services in health-care markets.

In the latter case, the restructuring and organization of these markets is an autonomous market response,<sup>14</sup> and these phenomena are bringing about sweeping changes in the workings of the pharmaceu-

tics market, the rate at which medical professionals and other agents are switching from the public to the private sector, growth rates, the private health-care infrastructure's level of complexity, etc.

<sup>13</sup> Interviews conducted in public hospitals in Chile and Argentina indicate that between 20% and 25% of the patients receiving care under the public health-care system (which requires an extremely small co-payment) are covered by private health insurance plans (ISAPRES), in the case of Chile, or by the National Social Security System, in the case of Argentina. These people simply decide not to reveal their membership in such plans in order to obtain free of charge inputs or services not covered by their private or quasi-State health plans. This practice clearly involves a sizeable hidden subsidy for the private sector.

<sup>14</sup> This type of market development has given rise to what the recent literature refers to as new organizational forms (see PAHO/ECLAC, 1994, pp. 39-51).

Since this restructuring of the sector's organizational model is taking place under highly imperfect market conditions, it should come as no surprise that it is creating many new problems in terms of micro-economic efficiency and distributive equity of the type discussed earlier. These problems tend to arise even in countries that have pursued an active sectoral restructuring process, such as Chile (Miranda, 1993a and 1990), so it is even more likely that they will arise in situations where the State adopts a passive attitude. Rising costs, inequitable access, the consolidation of a model that concentrates too much on the individual and curative aspects of health care to the detriment of a community-based, preventive approach, the dualization of the model for the provision of services, etc. are some of the hazards that will almost surely arise in the course of the passive type of sectoral reorganization process that occurs in situations where no appropriate programme is being followed by health-care authorities or the authorities responsible for the overall operation of the economy.

In order to counter these "natural" tendencies, governmental authorities need to pursue an active, consistent health-care policy that is attuned to the particular features of each society and the determinants that arise out of its past evolution. Such an active health-care policy must address the issues posed by the existence of these different markets, as noted in the foregoing discussion. In the following section we will identify some of the main issues that will need to be confronted by health-care policy in the coming years.

## **2. Health-care policy in the area of medical services**

As explained in section 1 of part II, the way in which the medical-services market works is heavily influenced by both supply- and demand-side variables. In relation to supply, one particularly important question is how the market's operation is affected by the rate at which new professionals enter the market and the differing degrees of saturation, in relative terms, exhibited by these markets in the various countries of the region. In turn, the entry of new professionals into the market is determined by the growth rate of university enrolment, the degree of specialization, the location and sex of the human resources involved, and the nature of the educational system in which health-care professionals are trained.

In practice, the educational system plays a fundamental role by determining how many students will enter a formal course of instruction from year to year, the quality of the education provided, and the nature of the attitudes and ideologies regarding medical and other forms of health care which these new graduates bring with them as they embark upon their careers.

On the demand side, the market is becoming populated by a vast and growing array of user institutions, which may be public, private or part of the social security system. This fragmentation and the failure to coordinate services within a unified health-care system are leading to the increasing consolidation of a dual model for the organization of medical and health-care services which is ridden with flaws and glaring disparities between the various occupational categories in terms of quality, microeconomic efficiency and social equity.

This fragmentation and lack of coordination among the public, private and social-security sectors is one of the main issues which health-care policy needs to address. From this standpoint, there is an evident need for some sort of explicit programming of the sector as a whole by the central authority.

Accordingly, in relation to both the supply and the demand for health-care professionals, public policy should address the issues entailed in respect of the rate of entry, qualifications and geographic location of new graduates as well as all the questions that have to do with the conditions under which these professionals enter into the three occupational spheres mentioned above. Thus, university entrance examinations, the nature and duration of medical residencies, and requirements as regards specialization and professional accreditation should all be adapted to conform to projected needs in terms of public, private and social-security health-care infrastructure in each country.

The establishment of regulatory guidelines for health-care services, quality standards and payments procedures based on results rather than the number of consultations should help to reduce the blatant disparities to be observed today in the health-care model in each of the three above-mentioned spheres.

The development of family-centered medical programmes, together with an increase in primary health care in general, could serve as a means of rationalizing access to the health care system in order to make better use of available resources and to alter

the strong trend towards curative (as opposed to preventive) medicine and towards the "medicalization" of services.

### 3. Health-care policy regarding public and private hospital services

The need to counteract the trends observed in this area and their harmful effects, as well as to mitigate and correct the increasing "dualization" of the hospital services provided in the public and private systems, points up the advisability of establishing guidelines for hospitalization in public and private health-care systems and clear-cut procedures for cross-referencing patients in public and private institutions in order to avoid the duplication of expensive equipment and the inefficient use of complex technologies requiring large investments. Existing budgetary mechanisms for financial transfers also need to be evaluated, as do the relative merits of per-visit payment modalities versus results-based payment procedures (e.g., payments per patient, comprehensive tariffs or payment based on "diagnosis groups").<sup>15</sup>

In short, in order to create a true network of public/private hospital services, hospital infrastructure in both sectors needs to be programmed and patient cross-referral procedures need to be set up in order to avoid the unnecessary duplication of sophisticated instruments and equipment, inefficient use of hospital beds, etc.

The administrative decentralization of public health care should be an important component of the programme for linking up existing public and private hospital infrastructure. There also appears to be a need for the wider spread of administrative and management technologies for optimizing the use of that infrastructure.

The anarchic manner in which the incorporation of expensive, highly sophisticated technology has taken place in many countries of the region shows up the need for the establishment of nation-wide mechanisms and standards for controlling the pace at which such equipment is brought into a country,

<sup>15</sup> Data for the United States show that the change in payment procedures has had two main effects: a reduction in the average hospital stay per patient and a decrease in admission rates. The latter is attributable to an increase in outpatient care, for which Medicare continued to pay on a per-visit basis (Pauly, 1987).

achieving its balanced distribution in the public and private systems, ensuring its proper maintenance and regulating its use. It may be instructive to compare the tight controls used by health-care authorities in many developed countries<sup>16</sup> with the random, socially costly nature of this process in many countries of the region.

This situation raises questions as to the true regulatory capacity of the typical Latin American State and the extent to which it is actually capable of performing this task. It is not simply a matter of the State's ability to regulate these activities, but also involves the broader issues posed by an institutional, legal and regulatory overhaul of the entire health-care system. This is an issue that affects each and every country in the region.

### 4. Health-care policy and industrial policy as it relates to pharmaceuticals

What is the "proper" level of pharmaceutical consumption which a society should seek to reach? How much of that demand should be covered by brand-name products and how much by generics? What percentage of that demand can locally-owned companies reasonably be expected to meet, and how much needs to be supplied by transnational corporations? And at what prices? How much financing should be provided by the social security system, the State or private insurance plans as opposed to direct payments out of the patient's own pocket?

These questions have to be answered by the health-care and economic authorities of each of our countries, just as each country is also faced with the task of designing and implementing a national policy on pharmaceuticals which is in keeping with the conditions peculiar to each country's situation.

So far, before a new pharmaceutical drug can be marketed, the company holding the rights to the drug has been required to prove the safety and effectiveness of its active ingredient in order to obtain the necessary permit from the relevant health-care authority. The current advocacy of measures for holding down costs has prompted a number of Governments to speed up the procedures for authorizing

<sup>16</sup> Regarding the situation in seven European countries, see Miranda (1993c).

the sale of generic drugs and to add in the requirement that proof be provided of the active ingredients' cost effectiveness before their sale will be permitted. Australia, for example, recently established a mechanism of this type, and its experience suggests that consideration might be given to the introduction of a similar scheme in the region at some future date.<sup>17</sup>

Expanding the supply of generics is another effective way of holding down costs. To this end, an information campaign aimed at doctors, pharmacists and consumers should be mounted and regulatory provisions should be established that will authorize pharmacists to substitute generics for brand-name products when their prices and the patient's characteristics so permit. Legislation passed in the United States in 1984 represented quite a substantial step in this direction.

The social security system as well as finance and insurance institutions also need to adopt financial protocols that will give priority to and increase reimbursements for the use of generic medicines. The more rapid issue of certificates authorizing the sale of these types of products is another kind of public policy measure which health authorities in a number of developed countries have implemented in recent years with a fair degree of success but which has not yet been used to any significant extent in the region.<sup>18</sup>

The pharmaceuticals market also raises a number of other issues, however, that go beyond the question of the price and quality of the products sold. These include the complicated issues of industrial property and patents, as well as those having to do with the dynamic comparative advantages that may be associated with the development of a sizeable

local pharmaceutical chemicals industry. This area also involves a number of complex questions in the sphere of international relations which are raised by the 1883 Paris Convention's provisions regarding patent protection and the equal treatment of nationals and foreigners, since many countries of the region are signatories of that treaty.

In this respect the countries are faced with a variety of political issues which will not be easy to solve. One of these issues has to do with the pressure which the Department of State and the Department of Commerce of the United States have been bringing to bear on a number of countries in the region (Argentina, Brazil, Chile and Mexico, among others) and in international forums such as UNCTAD and GATT throughout the last ten years in order to convince them to strengthen their patent laws. The objectives here are to enforce international patent provisions relating to pharmaceuticals—which affect the very process of innovation, i.e., the innovative pipeline—and, more generally, to fortify the market position of transnational laboratories, which in the past have faced competition from local companies in the markets for both finished pharmaceutical products and pharmaceutical raw materials.

Countries that now have mature pharmaceutical and pharmaceutical chemicals industries, such as Switzerland, Japan and Italy, chose not to comply with demands for patent enforcement for many decades; it was not until they felt that their local firms had reached a point in their development where they could compete on the international market that they decided to become a party to international treaties on the subject (Penrose, 1951). Today, however, a similar course of action is a very remote possibility indeed, given the contemporary international scene and the conditionality associated with the international financing of many Latin American countries' macro-economic adjustment programmes.

It would therefore appear that the privileges once enjoyed by local pharmaceutical-chemicals and pharmaceutical industries in the region have become untenable. Therefore, the possibility of implementing an industrial policy aimed at generating dynamic comparative advantages in these areas warrants, at the very least, explicit discussion by technical and political experts in each society.

<sup>17</sup> Since January 1993, any application for the authorization of a new drug has to be accompanied not only by the results of clinical pharmacological tests—to prove its safety and effectiveness—but also by an assessment of its economic impact. This assessment must be based on comparisons with alternative treatments and must not only cover the price of the drug itself, but also contain a comparison of its effects with those of other procedures for resolving the same clinical condition, including lengths of hospital stays and other complementary services entailed in the alternative therapies to be evaluated (*Financial Times*, 1994).

<sup>18</sup> See the case of the United States in Olson (1991a).

## IV

### Concluding remarks

Within the overall context of the liberalization and privatization of economic activity that have taken place in the past decade, there would appear to be little question but that the deregulation of health-care markets, the extension of the use of patents to pharmaceuticals and the gradual privatization of the financing and provision of health-care services are the *desideratum* of economic policy in the health-care sector. It is taken for granted that free markets and freedom of choice for consumers will inevitably lead to greater microeconomic efficiency, more effective services and improved access to health care.

In the area of pharmaceuticals, however, empirical evidence indicates that the elimination of price controls has been associated with sharp price increases in recent years. The reduction of tariffs and the establishment of new ground rules regarding patents have prompted many Argentine, Brazilian and Mexican firms to suspend local production—even of products that they had been exporting—and to become local licensees of transnational corporations. This has also led to the abandonment of research and development efforts and of work in the area of process adaptation and improvement.

In the field of medical and hospital services, the deregulation and the gradual formalization and development of these markets have encouraged medical professionals to switch from the public to the private sector, and this shift has been associated with skyrocketing prices. Furthermore, these changes have brought out the potential flaws of health-care markets by setting the stage for forms of behaviour that permit providers to boost the demand for their own services, perform unnecessary health-care services and induce overconsumption. In addition, the expansion

of supply has tended to be concentrated in the sphere of technological innovation and in the most profitable areas of health care, and these phenomena have been accompanied by a move towards product differentiation and price discrimination. The interplay of these trends is heightening the dualism of the health-care model and is leading both to increased costs and to greater social inequity.

All of these effects are, of course, among the unlooked-for consequences and costs of the recent economic liberalization and deregulation policies, and have thus far received very little attention. In view of the various health-care markets' very marked interdependence, it is clear that the effect that these phenomena have had on the system as a whole is far from neutral. Indeed, the pressures at work in each of these markets have spread to and reinforced the pressures affecting the others, thereby gradually undermining the financial position of social security institutions and the State.

The deregulatory and free-market theories that seem appropriate in other fields of economic activity are not necessarily the most suitable ones in this sphere of community life, especially when such principles are applied in an indiscriminate manner without due consideration for the particular features and the institutional and cultural aspects of the health-care sector in each country. This sector, which is fraught with its own very special features, does not appear to lend itself to the application of conventional or universal formulas. Hence the need for the design and implementation of an appropriate regulatory model consonant with the institutional, legal and regulatory retooling called for in the case of each individual country.

(Original: Spanish)

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# Liberalization *or financial* development?

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**Günther Held**

*Coordinator, ECLAC  
Finance Unit.*

The Latin American countries' reorientation towards market economies and their efforts to open their economies up to the international market since the 1970s have given rise to various sorts of financial policies. This article reviews some selected experiences in three areas of the financial sector: i) in the area of banking, eight different cases are examined in which financial liberalization measures led to various problems in terms of bank solvency during the past 20 years; ii) in respect of the capital market, the rapid development of this market in Chile since the start of the 1980s is analysed; and iii) with regard to inflows of private external financial capital, the high rates exhibited by Mexico since the late 1980s are evaluated. Basing his approach on concepts that place financial liberalization within the context of the types of regulatory systems that establish the ground rules in this sector, the author emphasizes the need to develop the institutional structure of the financial system in a carefully planned manner in order to ensure the solvency and efficiency of financial institutions. Thus, a sharp distinction is made between financial deregulation and controlled financial development.

# I

## Introduction

Financial liberalization forms a part of the economic policy reforms being carried forward by a growing number of countries since the mid-1970s in an effort to establish open, market-oriented economies.

This article seeks to demonstrate the decisive role played by the institutional structure –i.e., the system of regulations and standards that establish the “ground rules” for financial institutions– in the attraction and allocation of funds by these institutions in the credit and capital markets. In order to substantiate this assertion, a number of experiences with financial reforms or liberalization in the countries of the region are analysed.

There are at least two other factors that also have a strong influence on the part played by financial markets in the capital-formation process. One is the supply of funds, since the role of financial institutions is to attract funds and allocate them to investment and other socially profitable uses. The second is a macroeconomic environment which sends out correct resource-allocation signals to financial institutions and economic agents, primarily in the form of a real exchange rate and real interest rates that are in line with medium- and long-term conditions. In the following discussion, these factors are regarded as forming part of the overall environment within which financial reforms or liberalization measures are adopted.

# II

## Types of regulations applying to financial institutions

There are basically three types of regulations which, in combination with one another, dictate the ground rules for financial institutions and agents involved in credit and capital markets: financial regulations, regulations governing the way in which the finance “industry” is organized, and prudential regulations designed to safeguard such institutions’ financial stability.

The article first addresses a number of conceptual questions, placing financial liberalization within the context of the types of regulations to which financial institutions are subject (section II) and outlining some alternative systems for the prudential regulation and supervision of the banking sector (section III). Some noteworthy experiences relating to the role of the institutional structure in the credit and capital markets of the countries of the region are then reviewed. The significance of flaws in the system of regulation and supervision of the banking sector is illustrated through an analysis of a sample group of countries in which financial liberalization measures have created problems in terms of institutional solvency during the past 20 years (section IV). The 1981 reform of Chile’s pension system based on the capitalization of pension funds is examined as an outstanding example of an effort to stimulate the capital market’s growth through forced saving and vigorous institution-building (section V). The article also explores the development of Mexico’s capital market since the late 1980s on the basis of domestic financial reforms and the planned introduction of an array of bonds and other securities which, together with strong incentives for foreign portfolio investment, have made Mexico the leading destination for external funds in the region (section VI). Finally, a number of conclusions are presented (section VII).

### 1. Financial regulation

Financial regulations are designed to contribute to macroeconomic stability and secure more efficient resource allocation to production and capital formation through the maintenance of positive (but moderate) real interest rates and a realistic, credible exchange rate.

TABLE 1

## Latin America: Regulation of financial institutions

Type of regulation	Main objectives	Deregulation policies	Policies for reinforcing regulation
Financial	Efficiency in resource allocation Macroeconomic stability	Financial liberalization: broadening of financial markets' role in attracting and allocating funds	The role of financial markets is restricted Intervention may lead to financial repression
Organizational	Financial-institution operating efficiency	Organizational deregulation: the range of financial services which financial institutions may offer is broadened	The range of financial services which financial institutions may offer is reduced
	Financial-market efficiency	Institution-building: new financial instruments and institutions are introduced	Specialized financial institutions are created
Prudential	Solvency of financial institutions	Prudential deregulation: rules governing the solvency of financial institutions are relaxed The absence of prudential regulations leads to the "decontrol" of solvency	Rules governing the solvency of financial institutions are strengthened

Financial regulations influence interest and exchange rates by officially setting them, by establishing bands or ceilings, or by permitting the monetary authority to participate in the money and foreign-exchange markets. Such regulations may also establish restrictions, reserve requirements and taxes on foreign investors' access to domestic financial markets and on national financial institutions' access to third-party funds, whether in local or foreign currency, thereby influencing these key financial prices.

Primarily with a view to enhancing the financial system's efficiency, financial deregulation seeks to broaden the market's range of action in determining interest and exchange rates and to reduce the restrictions on the attraction and allocation of funds, including credit. Seen from this vantage point, financial liberalization is a wide-ranging policy of deregulation which is generally one of the components of broader market-economy reforms. In contrast, the tightening of financial regulations typically involves measures by the authorities to limit the action of the market.<sup>1</sup> When, in taking such measures, the authorities set interest or exchange rates too low or establish high reserve requirements and harsh restrictions on the attraction of funds, a situation of "financial repression" is created.<sup>2</sup>

<sup>1</sup> Regulations are sometimes tightened in order to preserve macroeconomic stability; at other times, such a step is prompted by movements of funds that may cause interest rates or the exchange rate to veer away from their medium- and long-term equilibrium levels.

<sup>2</sup> "Financial repression" reduces the volume and real growth rate of funds and results in a backward type of financial system composed of a handful of oligopolistic banks.

## 2. Organizational regulation

The regulations governing the way in which the finance "industry" is organized are chiefly aimed at increasing the efficiency of financial institutions and of the credit and capital markets.

In order to boost financial institutions' operating efficiency,<sup>3</sup> these types of regulations should allow such firms to make full use of their installed capacity, available economies of scale and the cost advantages afforded by the provision of complementary financial services; at the same time, they should encourage competition by reducing entry barriers to the various segments of the credit and capital markets.

In order for financial markets to be efficient, these regulations should promote full disclosure of the financial standing of participating agents (this subject will be explored further in the discussion on prudential regulations), should avert conflicts of interest among them arising out of zero-sum transactions which increase one agent's assets at the expense of others (through, for example, the use of inside information or information that is not available to the

<sup>3</sup> Operating efficiency is denoted by a minimal spread between the rates on loans and deposits in the case of banks and other financial intermediaries that operate as lending institutions and by minimal commissions in the case of institutions and agents offering financial services.

general public<sup>4</sup>), and should permit the entry of new financial instruments and institutions to an extent commensurate with the amount of funds channeled through the credit and capital markets.

Within this context, the aim of organizational deregulation is to broaden the range of financial services which financial institutions can offer, thus bringing into play the advantages of diversification and the trend towards de-specialization to be observed in today's financial markets. One typical example is that of specialized commercial banks that have expanded their business activities and become full-service banks ("multibanks") or even universal banks offering the entire gamut of financial services. When organizational regulations are tightened, on the other hand, the range of services that financial institutions may offer is restricted as a means of inducing them to specialize (for example, as savings and loan institutions or agricultural banks).

### 3. Prudential regulation

Financial institutions manage a huge volume of other people's funds, assuming varying degrees of risk in the process, or they may put financial investors in contact with companies in the real sector of the economy which issue listed stock in order to obtain medium- and long-term financing. These institutions' ability to perform these functions is founded upon public confidence, and their solvency (i.e., their ability to service their debts and obligations with third parties under pre-arranged terms and conditions) therefore has very substantial macroeconomic externalities.<sup>5</sup> Hence, the prime objective of prudential regulations is to maintain the solvency or financial stability of these institutions.

<sup>4</sup> The following are some examples of conflicts of interest: the granting of high-risk loans by banks to their proprietors ("related-party" loans), the subsequent settlement of which entails a loss of deposits; a bank's expansion of its operations to include the management of third-party funds which it then uses for its own benefit at low interest rates, to the detriment of the parties supplying the funds; and situations where banks are allowed to hold stock in production firms as part of their assets and, by using the inside information contained in the corporate loan and project portfolios to which they have access, are in a position to make an unfair profit in the stock market.

<sup>5</sup> A failure on the part of banks or other financial institutions to pay out deposits or discharge other obligations may trigger a large-scale run on their resources, a loss of confidence in the financial system and a decrease in credit and other financial claims. In contrast, the perceived solvency of financial institutions gives solidity to the payments system, reduces financial institutions' transaction costs and permits the attraction of domestic and external funds that would otherwise not be made available.

To this end (and in order to enhance the efficiency of financial markets), prudential regulations work in two main ways. First, they seek to ensure transparency with regard to the solvency of financial institutions and stock companies by requiring them to provide full, accurate information on a timely basis regarding their exposure, financial performance, assets and other matters that have a bearing on their ability to meet their payments under the agreed terms and conditions on any bonds or other securities they may have issued. This type of disclosure enables financial investors (depositors, savers, etc.) to arrive at informed decisions based on the yield, level of risk and liquidity of the various bonds and other securities offered on financial markets. Second, they seek to maintain financial institutions' stock of assets or capital at adequate levels by requiring the measurement of their exposure, full loss provisioning (through the use of profits to establish the corresponding reserves) and the prompt replenishment of capital in the event of unexpected losses (due to macroeconomic disturbances or other events that generate system-wide risk). This provides incentives for financial institutions to make sure, on their own initiative, that their level of exposure is in keeping with the size of their capital reserves.

In this context, 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 disclosure requirements and of limitations on the level of risk which financial institutions are permitted to assume. The reinforcement of prudential regulations, on the other hand, refines or strengthens provisions designed to maintain the solvency of financial institutions and encourages depositors, savers and financial investors to play an active part in controlling the level of risk that can be assumed by financial institutions and stock companies, in order to prevent the loss of the funds they have put into those firms.

### 4. Supervision

Effective supervision of financial institutions is essential in order to ensure their compliance with the financial, organizational and prudential regulations to which they are subject. Depending on the stage of maturity reached by the relevant credit and capital markets and the policy being used to further their development, such supervision may involve one or more specialized authorities in the public sector.

How well these agencies do their job will be determined primarily by their degree of autonomy, their powers of enforcement and the amount of governmental backing they enjoy, by the extent of their supply of highly skilled personnel (to ensure that regulations and their enforcement are based on sound technical grounds), and by the establishment of clear-cut regulations and carefully calibrated penalties in the event of non-compliance.

### III

## Prudential regulation and supervision of the banking system

In view of the financial fragility of the banking system, the regulatory and supervisory apparatus that safeguards its solvency are of prime importance. This fragility is a result of two of the characteristic features of banks. The first is the highly leveraged nature of their financial structures: their financial liabilities (deposits plus other obligations) or their financial claims (loans and financial investments) are customarily equivalent to more than ten times their capital. Second, banks receive resources from third parties and then loan out those funds in their own name and, in so doing, assume various levels of risk which they cover with their own capital and other assets. Consequently, the loss or decline in value of even a fraction of their loan and investment portfolios may seriously jeopardize their solvency.

#### 1. Regulatory safeguards for the banking system's solvency

A prudential regulatory system for the banking sector includes the following components:

- (a) *Banking-system entry requirements:*
  - (i) The minimum amount of capital necessary for incorporation;
  - (ii) Qualifications required of principal shareholders, directors and chief executive officers.
- (b) *Levels of exposure in keeping with banks' highly leveraged financial structures:*
  - (i) Widely diversified loan and investment portfolios, and restrictions on "related-party lending";

Within this context, the central components of the prudential supervision of financial institutions are the regular monitoring of these institutions to ensure that their portfolios (of loans or financial investments, as the case may be) have been correctly appraised on the basis of their varying degrees of exposure and, on that basis, the publication of simple solvency indicators that are readily understandable by depositors and financial investors.

- (ii) Limits on excessive imbalances between assets and liabilities.
- (c) *Full loss provisioning by banks:*
  - (i) Careful measurement of exposure;
  - (ii) Immediate establishment of reserves to cover all risks.
- (d) *Maintenance of bank capital on a sound footing:*
  - (i) Suspension of interest on high-risk loans;
  - (ii) Prompt replenishment of capital following unprovisioned losses;
  - (iii) Capital requirements in line with asset risk.
- (e) *Transparency in respect of banks' financial status: provision of information (presented in the form of easily-understood indicators) to depositors on a regular basis regarding banks' exposure and assets.*
- (f) *Mechanisms for orderly exiting from the banking system:*
  - (i) Insolvency of a bank and liquidation proceedings;
  - (ii) Establishment of the order in which payments on deposits and other obligations must be made out of the bank's remaining assets.

The effectiveness of these standards and regulations will depend on the effectiveness of their enforcement, the regular publication of indicators of bank solvency, and full awareness by depositors and investors that they may lose their funds in the event of bank financial problems.

If transparency in respect of the banks' financial position is not maintained, depositors and investors will be unable to bring "market discipline" to bear on these institutions by choosing banks on the basis of the interest rates they offer on deposits and the level of risk associated with their assets. At the same time, insufficient transparency will foster the idea among depositors and investors that their funds are covered by some sort of "implicit" government guarantee or, in other words, that the public sector will cover their losses in the event of a bank failure even if no written guarantee to that effect exists. Naturally, if deposits and other obligations are in fact covered by an explicit guarantee or form of insurance, then the extent of depositors' and investors' control over a bank's solvency will be limited in direct relation to the proportion of such funds thus covered.

## 2. Alternative systems of prudential regulation and supervision

The above-mentioned safeguards of bank solvency and insurance or guarantees of deposits are the two main components of an institutional system or mechanism for regulating and supervising banks to ensure their financial soundness. The different possible combinations of these two components yield four types of alternative systems (see table 2): a completely free or unregulated banking system, a banking system controlled by the public sector, a dual-control banking system, and a decontrolled system or one which has no solvency safeguards.

### (a) *Free or unregulated banking systems*

In a free or unregulated banking system, there are no government guarantees or deposit insurance, nor are there regulations to ensure bank solvency, or any other regulations, for that matter. Inasmuch as depositors have to assume a high degree of risk, they will demand full disclosure regarding the banks' financial standing and will take great care in choosing a financial institution or may be willing to make deposits only at very high real interest rates.

### (b) *Banking systems controlled by the public sector*

The existence of explicit or implicit State guarantees or insurance on deposits and other obligations eliminates the need to weight profit/risk considerations against each other, by inducing depositors and investors to make funds available to

banks without taking into account the risk of bank failure. Under these conditions, the primary, if not the only, motivation of depositors and investors is to determine which banks are offering the highest interest rates on deposits. Consequently, the responsibility for ensuring bank solvency rests entirely with the public sector's arrangements for prudential regulation and supervision of the system. Carrying out this task will demand very precise definition of the above-mentioned safeguards and stringent enforcement of them.

### (c) *Dual-control banking systems*

The absence of any explicit guarantees or insurance on deposits and other obligations, when combined with regular reporting on banks' financial standing, encourages depositors and financial investors—especially those dealing in large sums of money—to play an active part in bringing the discipline of the market to bear on the system. They will gauge the level of risk affecting the banks' assets (since this risk also extends to their own funds) and will weigh this against the interest rates being offered on deposits. At the same time, under these systems the authorities enact prudential regulations and supervisory measures will limit bank exposure and will establish requirements in regard to loan-loss reserves and capital. Since in this case both the agents supplying funds and the public authorities are taking steps to ensure bank solvency, the system can be described as being based on a dual-control institutional structure.

### (d) *Decontrolled banking systems or systems having no solvency safeguards*

In this case, broad explicit or implicit government guarantees on deposits and other obligations induce depositors and other bank creditors to make funds available to banks solely on the basis of the interest rates they are offering on deposits, with no consideration being given to their risk of failure. At the same time, prudential regulation and supervision exhibit serious shortcomings or are virtually nonexistent, and banking regulations and supervision are limited to the observance and enforcement of accounting procedures and financial regulations. In these circumstances, neither depositors and other bank creditors nor any government authorities are concerned with the banks' exposure, and safeguards for bank solvency are therefore lacking under this type of institutional arrangement.



TABLE 2

**Systems for regulating and supervising bank solvency**

Guarantees on deposits and other obligations <sup>a</sup>	Solvency regulations	
	Without solvency controls	With solvency controls
Without guarantees on deposits	Free or unregulated banking system: <sup>b</sup> Banks are subject to control by depositors	Dual control of banking system: Banks are subject to control by depositors and government financial regulators
With guarantees on deposits	Decontrolled banking system: Banks are not subject to control by depositors or government financial regulators	Banking system controlled by public sector: Banks are subject to control by government financial regulators

Source: Adapted from Feller (1989).

<sup>a</sup> The table is based on the assumption that, if deposit insurance does exist, premiums are uniform and the insurance therefore has effects similar to those of a partial guarantee on deposits (depositors tend to focus their attention on interest rates and to ignore the level of risk to which their deposits are subject).

<sup>b</sup> Strictly speaking, a "free" banking system would exist only in the absence of any sort of regulation whatsoever, rather than simply a lack of prudential regulations.

## IV

### Problems of insolvency registered in the course of financial liberalization programmes in the region

#### 1. Shortcomings in prudential regulation and supervision as a factor in a banking system's financial instability

Table 3 lists eight financial liberalization programmes which led to problems in regard to bank solvency in the past 20 years. Two factors played an especially important role in this respect. First, the systems' prudential regulation and supervisory apparatus suffered from serious shortcomings due to defects in the system for controlling risks, inadequate regulations concerning reserves and capital, feeble supervision or supervision limited to accounting procedures and financial aspects, and the presence of explicit or implicit government guarantees on deposits and other obligations. Almost all of these problems arose in systems having precisely the type of institutional structure most likely to generate problems of insolvency: i.e., decontrolled banking systems or systems lacking solvency safeguards (see table 2).

Second, in many of these cases the macroeconomic environment generated high levels of systemic risk owing to unstable conditions or the impact of radical adjustments that gave rise to major changes in the levels of economic activity, relative prices, and corporate and personal income. By affecting the "primary" source of loan payments or the value of guarantees (the "secondary" source of payment), these factors themselves reduced the quality of the banks' loan portfolios (see the annex for a summary of these liberalization experiences).

#### 2. Recent reforms in bank regulation

The instances of financial instability seen in the region over the past 20 years (including those listed in table 3) and the spread of financial liberalization and reform policies have led to a generalized tendency to strengthen prudential regulation and supervision of the banking system, particularly since the mid-1980s.

TABLE 3

## Latin America (8 countries): Problems with bank solvency in the past 20 years

TABLE 3

Country	Period	Financial regulation	Macroeconomic conditions	Prudential regulation and supervision	Results	
					Stability of financial system	Financial prices
Argentina	1974-1981	Liberalization of interest rates and credit; early opening of capital account	Fiscal deficit and high inflation; stabilization based on exchange rate (1978-1981)	Serious shortcomings	Financial crisis in banking system	High real interest rates; exchange-rate lags
Chile	1974-1982	Liberalization of interest rates and credit	Structural reforms and financial adjustment of public sector; stabilization based on exchange rate (1978-1982)	Serious shortcomings	Widespread banking crisis	High real interest rates; exchange-rate lags
Uruguay	1974-1982	Liberalization of interest rates and credit; early opening of capital account	Trade deficit; stabilization based on exchange rate (1979-1982)	Serious shortcomings	Financial crisis in banking system	High real interest rates; exchange-rate lags
Colombia	1979-1982	Sectoral credit limits; cautious management of external debt	Relatively stable	Serious shortcomings	Financial crisis in banking system	Fragmented interest rate structure
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 houses	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 shortcomings	Isolated cases of bank failures	Decline in very high levels of real interest rates
Peru	1990-1992	Liberalization of interest rates and credit	Stabilization and structural adjustment following large fiscal deficits and hyperinflation	Flaws in regulations on loan-loss reserves and capital	Problems with bank solvency	Slow decline in very high levels of real interest rates
Venezuela	1989-1994	Liberalization of interest rates and credit	Stabilization and adjustment in the presence of public-sector deficit	Serious shortcomings	Financial crisis in banking system	High real interest rates

The reforms made in these regulatory systems have emphasized solvency safeguards and the role of supervisory authorities, together with the importance of defining and limiting government guarantees or deposit insurance. The first course of action has led to a restriction of portfolio risk, especially in connection with related-party loans, and to the rating of loan portfolios on the basis of the debtors' risk categories, as well as to the establishment of stricter loan-loss reserve requirements and, increasingly, to the practice of setting capital requirements according to the level of risk associated with different categories of assets, in keeping with the recommendations set forth in the Basle Accord.<sup>6</sup> As regards the second course of action, most of the countries have chosen to establish explicit but limited guarantees on deposits, while a few have decided to dispense with this sort of protection.<sup>7</sup>

Little progress has been made, however, in improving the provision of information to depositors and the general public regarding the risk involved in bank investments and credit. This has tended to sustain the belief that there is an implicit governmental guarantee on deposits, even though in fact limits have been placed on such guarantees. Even in Chile, —where, since 1987, relatively simple indicators of these risks and of the financial position of banks have been published and where depositors have been warned of the risk of losing part of their money, since government guarantees are limited to certain

amounts— a considerable percentage of depositors continue to behave as if their funds were actually covered by some sort of implicit guarantee (Valdés and Lomakin, 1988). So long as this belief persists, the responsibility for regulating and supervising the banking system's solvency will continue to be shouldered primarily by the public authorities (see table 2).

The organizational reforms carried out over the past 20 years have often included authorization of the expansion of commercial banks' business activities so that they can become multibanks or even, as occurred in Mexico, universal banks through the establishment of corresponding regulations on financial conglomerates (see section VI). Meanwhile, in those countries of the region which already have fairly well-developed financial systems, there has been a tendency towards the formation of *de facto* financial conglomerates, through the interrelated ownership and management of banks and other financial institutions. This process has raised a number of complex issues in relation to organizational and prudential regulatory systems' effectiveness in achieving the objective of transparency with regard to reporting on the performance and financial status of the relevant institutions and of the conglomerate to which they belong and in forestalling conflicts of interest which may benefit some member firms of the conglomerate at the expense of other economic agents (Morandé and Sánchez, 1992).

## V

### Pension system reform and development of the capital market in Chile

At the end of 1980, the Chilean authorities chose to replace the existing shared-benefit pension system with an individually funded pension scheme. Payments into the system are mandatory for all persons receiving salaries or wages, and these compulsory

payments are made by the employees themselves in the form of a 10% deduction from their earnings (subject to a ceiling, above which the individual may voluntarily make payments in excess of that level). Thus, this new pension system is based on an institutionally-organized form of forced saving.

<sup>6</sup> In order to determine a bank's capital requirements, the Basle Accord assigns a weighting, from 0% to 100%, to various types of assets in the light of the level of credit risk involved. For example, funds on hand carry a weighting of zero while credits are assigned a weighting of 1. In order to bring the capital requirements of banks in different countries in line with one another, the ratio between their capital and the various categories of risk-weighted assets was to amount to 8% by the end of 1992.

<sup>7</sup> National Banking Commission of Mexico, report on the results of a survey on deposit insurance presented at the tenth assembly of the Association of Banking Supervisory Organizations of Latin America and the Caribbean (Santiago, Chile, 1993).

These newly-established pension funds have quickly become the nation's leading institutional investors and have played a pivotal role in the swift development of Chile's capital market.<sup>8</sup> As of late 1992—one decade after they had entered into operation—pension funds had amassed the equivalent of 34.5% of GDP (while insurance companies, mutual funds and foreign investment funds possessed resources equivalent to 9.2%, 2.6% and 3% of GDP, respectively). As of that date, pension funds held approximately 60% of the securities issued by large firms, around 60% of the mortgage bonds in circulation, and over 20% of the shares which they were eligible to purchase. The growing presence of these pension funds is illustrated by the projections which indicate that these funds' resources are expected to equal the country's GDP by 2015-2020 (Iglesias, Acuña and Villagrán, 1988).

### 1. Institution-building in the capital market

Because of the rapid growth of Chile's pension funds, its capital market needs a sturdy institutional structure capable of channeling those resources towards socially profitable uses via an array of financial institutions and instruments that are subject to a prudential regulatory system. Institution-building efforts are felt to have played a decisive role in the achievements of the new pension system to date (regarded as being confined, for our purposes here, to the accumulation of funds and savings) and in its consolidation over time (Arrau, 1993).

Table 4 outlines the institution-building process that has taken place in the securities and insurance market since the end of 1980, when the laws were promulgated which created Chile's new pension system and its basic institutions: pension funds, pension-fund management firms (AFPs) and the superintendency that is in charge of regulating and supervising the latter (the SAFP). The table shows that the country's financial authorities have made an ongoing effort to update and refine the regulations and standards applying to various aspects of the burgeoning capital market (open-ended corporations, securities trading, market transparency, the rating of listed securities, gradual expansion of investment options for pension funds,

redefinition of the role to be played by the Superintendency of Securities and Insurance, etc.).

A bill is currently under consideration by Congress that would make major changes in the regulations applying to the capital market (see table 4) in view of the concentration of pension-fund investments in the stocks of public utilities and the present shortage of financial instruments. Yet new needs for institutional regulation are already in the offing in such areas as overseas investments by pension funds, the further development of the life insurance industry (which pays out pensions in the form of annuities) and the regulation of financial conglomerates as banks expand their activities and move into various segments of the credit and capital markets.

Pension funds and their management firms (AFPs) are subject to extremely stringent prudential regulations and supervision because of the fact that they are made up of workers' forced savings (which will be those workers' main source of income after they retire) (see table 5). The equity capital of the 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. 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.

### 2. Pension reform and national saving

The savings generated by the reform of the pension system have also made a large direct contribution to national savings, although the net effect on the latter is difficult to ascertain due to substitution of or complementarity with other forms of saving. We do know, however, that gross national saving (at current prices) jumped by 11 points from a pre-reform average of 12.5% of GDP in 1976-1979 to an average level of 23.5% in 1990-1992. Pension-based saving directly accounted for slightly more than three points of GDP in that substantial increase.<sup>9</sup>

<sup>8</sup> Their position in this respect is due both to the long payment periods that elapse between the time when an individual enters and withdraws from the workforce (usually between 30 and 40 years) and to the capitalization of those funds throughout that period.

<sup>9</sup> According to data from the national accounts and the Ministry of Finance of Chile.

TABLE 4

**Chile: Development of institutional and regulatory apparatus for pension funds and the stock market<sup>a</sup>**

Nov. 1980	D.L. 3.500	Creates private pension systems which include pension-fund management firms (AFPs) and the Superintendency for Pension-Fund Management Firms (SAFP)
Dec. 1980	D.L. 3.538	Basic Act for the Superintendency of Securities and Insurance (SVS)
Oct. 1981	Act 18.045	Stock Market Act
Oct. 1981	Act 18.046	Companies Act
Dec. 1985	SVS circular 574	Defines "related parties"
Jan. 1986	SVS circular 585	Establishes compulsory disclosure of stock transactions conducted by majority stockholders, directors and executives
March 1986	SVS circular 601	Establishes compulsory disclosure of any event that may significantly affect the business interests of open-end corporations
Oct. 1987	Act 18.660	Requires ongoing rating of stocks on public offer according to their level of risk
July 1989	Act 18.815	Investment Funds Act: permits pension funds to invest in real estate, bearer securities and venture capital
Dec. 1989	Act 18.876	Establishes regulations governing the formation and operation of private securities custodians
May 1992	Rating Commission Agreement	Authorizes AFPs to invest in "greenfield" projects
May 1993	SAFP circular 776	Makes it compulsory to provide standardized information concerning the rate of return on individual accounts according to fund members' income brackets
1993	Bill before Congress	Proposes substantial changes in Stock Market Act: Creates securitization firms Introduces more precise regulations for the rating "industry" Defines responsibilities of bond brokers Creates company development investment funds (FIDES) Strengthens regulations regarding the solvency of insurance companies Introduces greater flexibility with regard to AFP investment ceilings Regulates risk factors for AFPs' overseas investments

Source: Arrau (1993).

<sup>a</sup> Does not include amendments to the laws and regulations governing the activities of banks and financial corporations or of the Superintendency of Banks and Financial Institutions.

The fact that public saving has been positive since 1987 has played a pivotal role in ensuring that the net effect of pension-based saving on national saving has also been a positive one. This indicates that public finances have absorbed the pension-

system deficit that was created when workers' payments were channeled into the new system while the public sector paid the pensions of institutions belonging to the old system (which was plagued with serious financial imbalances of various origins).

TABLE 5

**Chile: Prudential regulations applying to pension funds**

## Contents of regulations

- 
- A. *Pension-fund management firms (AFPs)*
1. The assets of an AFP must be entirely separate from those of the corresponding pension fund
  2. An AFP may manage one fund only
  3. An AFP must ensure a basic minimum rate of return to the fund; in order to do so it shall, if necessary, draw on reserves established by the AFP in question, which are to be held in safe-keeping by the Central Bank.
- B. *Pension-fund investment portfolios*
1. Pension funds may invest only in those securities and financial instruments which are authorized by law
  2. Any security or financial instrument in which a pension fund invests must be rated as an acceptable investment by the Rating Commission
  3. Strict rules govern the diversification of portfolios by type of financial instrument and issuer with the object of maintaining a low-risk profile
  4. As a general rule, all such securities and financial instruments must be traded on a commercial exchange or other established secondary market
  5. An appraisal of such investment portfolios is to be conducted as a routine procedure on a daily basis using prices furnished by the Superintendency for Pension-Fund Management Firms (SAFP). At least 85% of the portfolio must be appraised at market prices
  6. At least 90% of the securities and instruments making up a pension fund's investment portfolio shall be held in the custody of the Central Bank.
- 

Source: Iglesias and Acuña (1991).

## VI

### Development of the financial system and the attraction of private external financial capital in Mexico

Two interrelated factors—out of a number of different domestic and external elements—have played a decisive part in attracting private external financial capital to Mexico since 1989: the institution-building and reforms that have taken place in the domestic financial system, and the strong incentives existing for inflows of financial capital.

#### 1. Institution-building and reform in the domestic financial system

The main financial reforms adopted in Mexico since 1989<sup>10</sup> have included the deregulation of credit and

interest rates, a far-reaching liberalization of the balance-of-payments capital account, and provisions granting foreign investors access to Mexican financial markets and to stock in non-financial corporations (see table 6).

The liberalization of the financial system was undertaken in conjunction with the banking system's return to private ownership and a broad definition of the activities of multibanks; the adoption of regulations on financial conglomerates headed by a holding company and composed of at least three financial institutions (conglomerates may not hold equity investments in production firms);<sup>11</sup> changes in the

<sup>10</sup> The chief elements that set the stage for this financial reform programme were the nationalization of the banking system in 1982 in response to the external debt crisis, and the rules that allowed foreign agents, within certain limits, to acquire stock in Mexican corporations under the terms of the regulations governing the application of the 1973 legislation designed to promote Mexican investment and regulate foreign investment.

<sup>11</sup> A financial conglomerate must include at least three of the following institutions: a multipurpose bank, a leasing company, a factorage agency, a stockbroking firm, a currency broking firm, a general-purpose bonded warehouse, an insurance company, a bonding company or an investment company.

TABLE 6

**Mexico: Reforms implemented in the financial system, 1989-1992**

Type of regulation	Principal measures
Financial liberalization	Deregulation of interest rates Elimination of selective controls on credit Elimination of reserve requirements, although the assets of multipurpose banks must be maintained at a predetermined liquidity coefficient Modifications in the regulations applying to foreign investment aimed at facilitating the entry of external financial capital
Organizational development and deregulation	Privatization of the commercial banking system New law governing lending institutions having as their basis private banks established as multipurpose banks Regulation of financial conglomerates based on a system of holding companies Reforms and/or additions and adjustments to the laws governing insurance, bonding and securities markets
Strengthening of prudential regulation and supervision of banks and financial conglomerates	Rating of loan portfolios based on risk category and reserves to cover the level of exposure in question Capital requirement equivalent to 8% of risk-weighted assets (to be met by 1993) Advances in the regulation and supervision of financial conglomerates Advances in the regulation of the overseas operations of Mexican banks

Source: Martínez (1992); Caro (1994).

structure of the securities and insurance markets with a view to their internationalization; and the adoption of new safeguards to ensure the solvency of banks and financial conglomerates (Martínez, 1992).

Nevertheless, the Nacional Financiera, S.N.C (NAFIN) and the Banco de Comercio Exterior, S.N.C. (BANCOMEXT) have continued to operate as public development finance institutions (DFIs) in which second-tier banking represents a substantial component. One of the main functions of NAFIN is to support investment and small-business financing, while BANCOMEXT supplements the financing of export activities of firms of various sizes.

At the same time, the financial authorities introduced a number of domestic securities designed to attract international portfolio investment and authorized the trading of Mexican securities on international capital markets, creating a special section in national securities listings for that purpose. The options for stock transactions thus made available included the sale of shares in Mexican corporations on the United States market via ADRs;<sup>12</sup> the purchase of freely available (series B) shares –shares conferring

full pecuniary and equity rights– by foreign investors on the domestic stock exchange; the purchase by such investors of shares that had formerly been reserved for Mexican nationals (series A stock) on the condition that they belong to a mutual fund that grants pecuniary rights (through share certificates) but not equity rights, such as the neutral fund administered by NAFIN; and the establishment of “country funds” (such as the Mexico Fund, which is one of the oldest and largest) through which such investors could acquire shares and other securities on local exchanges.

Foreign investors have also been given access to domestic debt paper through the use of short-term treasury bills denominated in pesos (CETES), adjustable bonds (“Ajustabonos”) and other medium-term government securities. Both State and private Mexican firms and banks as well as other public-sector institutions have also been able to secure overseas funds through the sale of bonds, commercial paper and certificates of deposit, primarily in the Euromarket.

## 2. Incentives for financial capital inflows

Three factors have helped to draw capital to Mexico since 1989: (i) a notable decrease in its country risk and in the exposure of Mexican issuers; (ii) high

<sup>12</sup> ADRs (American Depositary Receipts) are stock certificates issued by a United States bank on foreign-company shares or other securities; these certificates can be traded on the stock market in the United States.

domestic interest rates coupled with low exchange risk (thanks to the pre-established and progressively smaller adjustments being made in the nominal exchange rate with a view to price stabilization), contrasting with low interest rates in the United States and other industrialized countries; and (iii) the marked undervaluation of Mexican stocks in the light of the economic prospects opened up by the reforms under way.

A number of economic policy results played a part in reducing the perceived risk of investing in Mexican securities: the completion of the country's external debt renegotiations in 1989, the country's success in putting its public finances back on a sound footing (transforming the consolidated public sector's deficit, which amounted to 6% of GDP in 1989, into a 1.5% surplus by 1992) and the slowing of inflation, which—as measured by the variation in the consumer price index—fell from 30% to 15% during the same period. In 1992, two well-known international rating agencies put Mexico in a country-risk category that brings offerings of Mexican securities on international capital markets very close to "investment-grade" levels. In the case of securities that are negotiable on the local market, one of those agencies gave Mexico's peso-denominated treasury bills (CETES) the highest possible investment rating for short-term debt paper and rated the Mexican long-term public debt as being of investment grade.

The deregulation of domestic interest rates and bank credit (in the midst of the implementation of stabilization and adjustment policies) opened up a large spread between national and international interest rates. In 1989-1992, the average annual rate for domestic deposits hovered at between 11 and 14 points above short-term annual interest rates in the United States (adjusted for exchange-rate variations in Mexico), and the difference was calculated to have been more than 20 points per year in the case of the average domestic lending rate, owing to the wide spread used by local banks. These differentials—together with a low exchange risk (the nominal exchange rate climbed by 4.3% and 1.4% per year in 1991 and 1992 compared with 18.8% and 11.9% increases in the consumer price index for those years, respectively) and the decreasing risk associated with investments in Mexican securities—generated strong incentives for inflows of external capital through the purchase of domestic debt paper (CETES and others) and overseas sales of securities (bonds and other instruments).

The total value of Mexican corporate stock on the exchange was equivalent to only 11% of GDP in 1989. This undervaluation triggered a large inflow of foreign capital to the stock market, contributing to its subsequent boom. The price index for listed shares leaped by 133% in real terms between 1989 and 1992, while the average annual rate of return, in dollars, on investments in the stock market stood at around 60% during this period (due, in part, to the slow rise in the exchange rate). By late 1992, the value of Mexican corporate stock had risen to nearly 50% of GDP.

Table 7 gives a list of floating- and fixed-rate financial instruments traded in the external and local capital markets, together with the capital flows received during the period 1989-1992 and/or the market value of those funds as of the end of 1992.

### 3. Macroeconomic effects and regulation of financial capital inflows

Thanks to the exceptionally attractive conditions which Mexico has been able to offer overseas investment, since the late 1980s the country has quickly become one of the region's foremost destinations for external funds. Between 1989 and 1992 the balance on the nation's capital account soared from 1.5% to 7.9% of GDP. Foreign portfolio investment represented 15.5% of this amount in 1989, but by 1992 its share had skyrocketed to 52% (Caro, 1994).

The massive inflow of external financial capital has had macroeconomic impacts that run counter to other economic-policy objectives. The Mexican peso appreciated by 17.6% in real terms between 1989 and 1992, which handicapped the export strategy launched by the country in the 1980s. External saving at current prices (measured as the balance on current account, of reverse sign) climbed by 3.9 points from 2.6% of GDP in 1989 to about 6.5% in 1992. However, gross domestic investment at current prices for that period only rose from 21.4% to 23.3% of GDP: an increase of 1.9%.<sup>13</sup> Thus, national saving at current prices is estimated to have fallen from 18.8% to around 16.8% of GDP during that period, which sug-

<sup>13</sup> Gross domestic investment at constant prices, however, expanded from 17.3% of GDP in 1989 to 21.7% in 1992—an increase of 4.4% of GDP. The striking difference between the figures for investment at current and constant prices is mainly attributable to the drop in the relative price of capital formation associated with the local currency's steep rise in value and the opening up of the economy to external markets.



TABLE 7

**Mexico: Instruments used to attract external financial capital**  
(In millions of dollars)

Instrument	1989	1990	1991	1992	Gross flows 1989-1992	Value of capital stock at end of 1992
<i>Placements in international market</i>						
Total floating-rate portfolio	-	563	4 404	5 365	10 332	21 773
International share issues (ADRs)	-	-	4 333	5 077	9 410	21 154
Country funds	-	192	71	-	263	619
Total fixed-rate portfolio	697	2 351	4 074	6 052	13 174	...
Bonds	570	2 351	3 444	4 403	10 767	...
Certificates of deposit	-	-	50	1 050	1 100	...
Commercial paper	127	-	580	600	1 307	...
<i>Placements in domestic market</i>						
Total floating-rate portfolio <sup>a</sup>	-	371	-	2 287	2 658	
Series B shares	-	...	-	...	...	5 100
Series A shares (neutral fund)	-	...	-	...	...	1 800
Total fixed-rate portfolio						
Treasury Certificates (CETES)	-	-	...	...	...	} 14 400 <sup>b</sup>
Floating-rate bonds ("Ajustabonos")	-	-	...	...	...	
Other instruments	-	-	...	...	...	

Source: World Bank, statistics on portfolio investment flows, several years; Gurría (1993).

<sup>a</sup> Direct stock purchase.

<sup>b</sup> Estimate.

gests that external saving was being substituted for national saving, to the extent of about half of the 1992 figure. The wealth effect associated with the revaluation of financial assets (and other non-tradable goods) occasioned by the inflow of capital, along with the resulting increase in aggregate consumption at current prices (3.5 points of GDP) during that period, appears to have played an important part in this outcome.

The above-mentioned macroeconomic effects raise the question of whether it would not be advisable to have financial and prudential regulations

designed to curb the inflow of volatile short-term or speculative external financial capital.<sup>14</sup> Advocates of such regulations argue that the incentives for financial capital inflows are excessive and that, in the event of a rapid accumulation of external debt paper, there is a risk that domestic interest rates will be raised in an effort to attract or hold on to these funds. This over-incentive stems from the State guarantee on government securities (CETES and others) and the temporary nature both of low short-term interest rates in the United States (an annual 3.7% in 1992) and of the undervaluation of Mexican stocks.

## VII

### Conclusions

The financial policy initiatives examined in this article demonstrate that the liberalization of financial variables (interest rates, credit, access to external funds, etc.) is only one of the elements involved in applying market-economy principles to the financial system. There are at least two other types of regula-

tions which –along with the necessary supervision and enforcement– also play a part in laying down the ground rules for financial institutions in credit and capital markets: regulations that shape the organiza-

<sup>14</sup> At the start of 1992 the Banco de México put a cap on banks' external borrowing equivalent to 10% of their liabilities.

tional model of the finance "industry" (primarily with a view to increasing the efficiency of financial institutions and markets), and prudential regulations, which are designed to keep financial institutions and stock companies on an even financial keel.

Financial liberalization can bring about a considerable increase in the volume of funds handled by financial institutions and may expose them to varying risks in a more open environment where they are free to take their own decisions. This type of policy, however, does not of itself establish adequate ground rules as regards the solvency and efficiency of such institutions, owing to the problems concerning disclosure, externalities and conflicts of interest that are characteristic of credit and capital markets. Specific types of financial institutions and instruments do not come into being spontaneously, partly because of the highly regulated nature of financial transactions. This makes it all the more important for the financial authorities to make a systematic, deliberate effort to build up such institutions in order to strengthen the sector's prudential regulation and supervision and to promote the creation of new institutions and instruments or the expansion of existing institutions' operational scope.

The financial crises and difficulties experienced by banks in the region (see table 3) support the assertion that programmes which simply deregulate interest rates, credit and other financial variables without effectively reinforcing the prudential regulatory system are actually instances of financial decontrol rather than the practical expression of a policy of financial liberalization. The behaviour of decontrolled banks, or banks that are not subject to adequate prudential controls, has given rise to financial instability. Apart from this, however, portfolio-related difficulties have also arisen in unstable macroeconomic environments or ones that are undergoing drastic adjustments.

The progress made to date in the prudential regulation and supervision of the banking system in the countries of the region has mainly taken the form of the implementation by specialized public-sector authorities of rules and standards designed to maintain that system's solvency. Thus far, however, the flow of information to depositors and the general public regarding asset risk and banks' financial standing has been very meagre indeed. This has helped to perpetuate the idea that deposits and other obligations are covered by an implicit government guaran-

tee, even though explicit guarantees may have been officially withdrawn or limited. Moreover, not even proper, timely disclosure—as in the case of Chile, for example—seems to have altered this impression for many depositors. It is therefore important for the countries to continue their efforts to improve and refine the regulations that limit and control banks' exposure, especially in cases where financial reforms are allowing them to expand the scope of their activities.

Chile's 1981 reform of its pension system constitutes an outstanding example of a controlled process of financial development as opposed to mere financial liberalization. This reform entails forced institutional saving, strict regulations governing the organization of the pension "industry" as such, and close prudential supervision and regulation of pension-fund portfolios. It is this combination of factors, in large measure, which has permitted the build-up of funds and the development of the capital market observed to date. Institution-building—including that of the relevant public regulatory and supervisory agencies—has played an essential role in this regard. Indeed, this type of institutional development is what has made it possible to continue broadening the spectrum of profitable, safe and liquid investment options open to pension funds so that the rapid build-up of resources may be channeled towards real capital formation and other socially profitable uses. Institution-building is regarded as being of pivotal importance in consolidating the new pension system over time since—within a regulatory framework that greatly limits the level of risk associated with the bonds and other securities eligible for inclusion in pension-fund portfolios—the management firms handling these funds compete freely with one another to achieve the best financial performance and to attract members.

The case of Chile's pension-system reform can be highly instructive for financial policy-makers in developing countries because it is based on an approach that offers an alternative to financial liberalization. This reform underscores the importance of having sufficient savings or funds as well as the need for financial authorities to make a deliberate effort to "develop" the financial market and to provide for stringent regulations and close supervision to ensure that financial institutions properly perform their role in capital formation processes; at the same time, it also points up the limitations of policies that are confined to the liberalization of interest rates, credit and other financial variables, since they simply liberalize

what already exists while introducing a high degree of risk as regards the subsequent misuse of funds.

The influx of external capital into Mexico in the form of international portfolio investment since 1989 also provides an excellent example of broad-based institution-building in a domestic financial system. The country's financial reform process has been far-reaching, the financial authorities have introduced a whole array of instruments for overseas investors, and the way has been paved for the sale of Mexican securities on international capital markets. It is also true, however, that this incoming stream of private external capital has occurred in response to excessive incentives for financial capi-

tal (generated mainly by the guarantee provided by the State on government securities, by low short-term interest rates in the United States and by the low domestic level of exchange risk). All these factors soon pushed foreign portfolio investment up to extremely high levels. This has raised the question of the advisability of establishing prudential and financial regulations to stem the inflow of volatile, short-term or speculative external financial capital in order to forestall any adverse macroeconomic impacts on the real exchange rate and national saving and to make more room for medium- and long-term external financial flows.

(Original: Spanish)

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## ANNEX

**Financial liberalization and problems with regard to solvency in Latin America**

In the mid-1970s Argentina, Chile and Uruguay began to liberalize interest rates, credit and other financial variables, as well as adopting policies that provided for a broader definition of the activities that banks could perform or the financial services they could offer. These measures were implemented at a time of highly adverse conditions in terms of the financial institutions' continued solvency. The simultaneous application of ambitious stabilization measures—particularly the adoption, in 1978, of the nominal exchange rate as an anchor to stabilize the currency in these three countries—and of reforms designed to open up trade and the capital account led to 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.

The programmes for the financial liberalization of the banking system in these countries during the 1970s also failed to provide proper safeguards for these institutions' solvency; explicit or implicit government guarantees on deposits and other obligations were prevalent, and both the standards used for limiting risk and reserve requirements suffered from serious shortcomings. In Uruguay, there were no "minimum" rules; in Chile, loan portfolios did not begin to be rated on the basis of their level of risk until the early 1980s, just before many banks' financial problems surfaced; 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 (Banda, 1990; Held and Szalachman, 1989; Salama, 1991). In all three countries, the liberalization of credit and interest rates sparked a sharp rise in high-risk lending at rates from three to five times

higher than the growth rate of GDP. These loans included: credit extended to non-tradable activities (including real estate and speculative operations) which was financed in large part with external debt; widespread rollovers of bad debts, whereby interest was compounded at high real rates (producing income that was never actually paid); and excessive credit to related-party companies or individuals for which very little real collateral was put up. Implicit government guarantees on deposits facilitated the domestic and external borrowing by the banks which sustained this process.

It is difficult to determine how far macroeconomic imbalances or the shortcomings of prudential regulatory and supervisory systems had to do with the far-reaching financial crises that erupted in these countries during the early 1980s. It is clear, however, that the second factor did play a major role. It is significant that in both Argentina and Chile and, in part, in Uruguay as well, the banking system's serious financial problems surfaced before the balance-of-payments and external debt crises of 1982-1983 had brought about sharp downturns in these countries' levels of economic activity.

The crisis that hit Colombian banking in the early 1980s illustrates how a system whose financial standing is not subject to any controls can, within a context of financial liberalization, assume a high level of credit risk and unsustainable portfolio losses even in a fairly stable macroeconomic environment and despite a conservative policy on external borrowing by banks. In 1980-1981, bank loans jumped by over 40% in real terms. Following the widespread intervention in the banking sector that began in 1982, it became clear that high-risk related-party loans to conglomerates—including the use of bank credit to buy stock in firms in the production sector—had

accounted for a substantial part of the abnormal increase in lending activity. Credit limits and standards had been greatly exceeded, and the sector's supervisory authority had lagged far behind in checking the quality of loan portfolios (Zuleta, 1990).

Costa Rica embarked upon a stabilization and economic reform effort in 1983 following a severe balance-of-payments crisis and its declaration in 1981 of a moratorium on external debt payments. Financial reforms broadened the private banking system's role in credit allocation and deregulated interest rates in a three-stage process aimed at achieving positive yet moderate real interest rates in the supervised banking system. Headway was also made in the area of prudential regulation and supervision through the use of a system for rating the level of risk associated with banks' loan portfolios, the establishment of stricter standards for provisions and the introduction of a set of bank performance indicators as a means of furnishing information to depositors and the general public. At the same time, however, the door was left open for "free" or unregulated financial companies. These institutions quickly increased 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 a liquidity crunch in the financial system and to the bankruptcy of all of the unregulated financial companies in existence. Not a single supervised bank failed during this financial disaster, however (De Paula, 1990; Díaz, 1991).

Bolivia and Peru (in 1985 and 1990, respectively) liberalized interest rates and credit in the midst of a situation marked by severe inflationary turbulence and harsh stabilization policies and economic reforms. Real interest rates on loans were extremely high—even after several years had passed, they were still around 40% annually—and both relative prices and the profitability of economic activities fluctuated sharply as the economy was rapidly opened up and steep adjustments were made in aggregate expenditure. These factors were apparently what triggered the banking system's financial troubles in both countries, but flaws in the regulatory and supervisory provisions for safeguarding the system's solvency also played a part. In Bolivia, the closure of four banks in 1987 brought to light the lack of adequate controls on solvency: the limits on exposure were faulty, there was too much related-party lending, supervision was weak and there were implicit government guarantees on deposits. In Peru, the failure of a number of banks

and mutual funds starting in 1991 depleted the deposit insurance fund, and the State had to make up the difference; in March 1993, overdue loans represented 22% of the commercial banks' loan portfolios but their loan-loss provisions totalled only 12%, which pointed up the insufficiency of reserves and the presence of lags in bank recapitalization (Afcha de la Parra, 1990; González Arrieta, 1992).

In Venezuela, the authorities' intervention in a commercial bank in February 1994 marked the start of a financial crisis in the banking system. Midway through the year, eight more banks became subject to government intervention; these banks had received financial assistance in the preceding months and together had about 50 subsidiaries, almost all of which were financial institutions. Serious shortcomings in the regulation and supervision of the financial system appear to have been what set off this crisis. The Superintendency of Banks and the Deposit Guarantee Fund (FOGADE) have been given very little operational autonomy, narrow terms of reference and insufficient regulatory powers to deal with difficult financial situations; their control over financial institutions' solvency has been faulty, and a clear separation between their functions has been lacking. In its rating of loan portfolios, the Superintendency has not given enough weight to the risk represented by projected losses or, in particular, to the consolidated analysis of related-party loans made to companies belonging to the same economic group as the lending bank or of the concentration of loans in groups of firms that act as *de facto* conglomerates in the financial market. For the above reasons, delays arose in the establishment of reserves to cover these risks. In the case of FOGADE, the premiums or contributions which the banks have paid into the Fund have not been differentiated by level of risk, and the Fund's existence appears to have prompted a lack of concern on the part of depositors about their banks' financial standing (Hausmann, Jaramillo and Rigobón, 1992).

The macroeconomic situation also played a role in the Venezuelan banking crisis. The stabilization and adjustment policy introduced in 1989 did not strengthen the public sector's financial status, and indeed, the non-financial public sector's deficit amounted to nearly 6% of GDP in 1992-1993, which, given the country's tight monetary policy, pushed interest rates to high levels. In 1993, real rates on loans were around 30% and themselves led to a deterioration in the quality of bank loan portfolios.



# Fiscal adjustment *and social* spending

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**Rossella Cominetti**

*Consultant, ECLAC  
Economic Development  
Division.*

The external and internal imbalances that appeared in the early 1980s, together with the adjustment and stabilization policies applied throughout that decade in Latin America, juxtaposed the need to reduce the fiscal deficit with the need to make up for the loss of income sustained by the most vulnerable groups of the population as a consequence of the external debt crisis. This article examines patterns of social expenditure in a number of countries in the region, in an effort to determine how these policies affected the level and composition of social spending and, hence, influenced social policy. As a method of analysis, the author reviews patterns of social spending during various episodes of fiscal adjustment and maladjustment in each of these countries and compares them with the trends observed in those countries' public-sector finances. The data suggest that social expenditure was used chiefly as an instrument of fiscal adjustment, which would account for the widespread deterioration seen in this variable during the 1980s. In addition, the impact of this policy was not evenly distributed among the various social sectors but instead had a particularly strong effect on housing and education.

# I

## Introduction

In the course of the 1980s, Latin America underwent a number of costly adjustments in an effort to restore domestic and external equilibria in the wake of the financing crisis which had erupted in the region at the start of that decade. The net result of this process was negative in terms of both growth and social equity. Given the nature of the crisis, the income-supplementation function of social expenditure proved to be at odds with the role it was called on to play in reducing the fiscal deficit.

During the crisis, the groups which were especially at risk within the population expanded, mainly as a result of rising unemployment levels. In addition, inflation and the adjustment programmes implemented during that period eroded the working population's buying power. From a social policy perspective, social spending should have been increased during this process in order to make up for the population's loss of income. The economic adjustment exerted pressure in the opposite direction, however. At the time the crisis hit, the Latin American economies were suffering from large external and internal deficits and had sustained a sudden loss of financing capacity. The chances of eliminating the public sector's growing deficit without cutting government spending were greatly reduced by the impossibility of increasing real receipts at a time when the region's economies were plagued by recession and inflation, as well as by their loss of external borrowing power. As a result, the burden of the fiscal adjustment was shouldered primarily by non-financial government expenditure, one of whose components is social spending.

The 1980s have been analysed extensively in the literature from a macro-fiscal standpoint, and this has taught us some new lessons about the role of fiscal policy in stabilization and adjustment processes.<sup>1</sup> The literature has also devoted a great deal of attention to the social costs of these processes, which have sharply lowered the living standards of much of the

population, as is indicated by the increase in the percentage of the population living in poverty and the deterioration observed in income distribution between 1980 and 1990.<sup>2</sup> Indeed, studies attempting to assess the impact of stabilization and adjustment policies on social programmes generally highlight these policies' effects on the level and composition of social expenditure.<sup>3</sup>

Although it is generally believed that the economic policies applied in the region during the 1980s reduced social spending without doing anything to mitigate the deterioration in the living standards of the most vulnerable groups in the population, no studies have been carried out which focus explicitly on how social expenditure patterns compare with trends in public finances during this period. Those studies that do look at trends in social spending in the 1980s tend to take a piecemeal approach in terms of both the periods and the countries they analyse. Moreover, most of them concentrate on periods during which total public expenditure was reduced. This unnecessarily limits the episodes of fiscal adjustment that are examined; furthermore, reductions in fiscal spending may not necessarily reflect an adjustment of public finances. A more appropriate approach would be to analyse trends in social spending in relation to trends in the non-financial public sector's deficit, while also taking a look at the behaviour of the various levels of government that make up the public sector.

This article seeks to evaluate the role of social expenditure, both at the general and sectoral levels, during the various phases of fiscal adjustment and maladjustment observed in Latin America in the course of the 1980s and to determine the priorities assigned to social spending as a tool of social policy and as a tool for the adjustment of fiscal deficits. This evaluation will be based on an analysis of trends in social spending and in public finances in the region.

<sup>2</sup> See, for example, Altimir (1993), Cornia, Jolly and Stewart (1987), Figueroa (1992), Lustig (1991), Mujica and Larrañaga (1992), Pfeiffermann (1987) and Grosh (1990).

<sup>3</sup> See, for example, Hicks and Kubish (1984), Cornia, Jolly and Stewart (1987), Grosh (1990), Ebel (1991), and Carciofi and Beccaria (1993).

<sup>1</sup> See, for example, Marfán (1986), ECLAC (1989), Frenkel (1990), and Fanelli and Frenkel (1990).



## II

### The fiscal adjustment process in Latin America

As a consequence of the external events associated with the deterioration of the region's terms of trade, the increase in interest rates and the sudden curtailment of its inflows of external resources, most of the Latin American countries' external sectors began to run up large deficits which later spread to their fiscal sectors. These countries were therefore obliged to implement stabilization and adjustment programmes, coupled in some cases with more radical reforms that actually altered the role of the State.

The trends in public finances seen in Latin America in the 1980s were in large measure a reflection of the adjustment process undertaken in the aftermath of the external debt crisis that broke out in 1982. The duration and intensity of the fiscal adjustment process in each country were determined by the initial status of its public finances, external events and the nature of subsequent adjustment policies.

The crisis had an impact on the public finances everywhere in the region, but its effects varied in both intensity and duration from one country to the next; these differing situations, in turn, gave rise to fiscal adjustment processes of varying degrees of intensity and effectiveness. In most cases, the deterioration of public finances took place within an extremely tight domestic and external financing environment and affected both the sources and uses of public funds at the various levels of government. Public-sector revenues shrank, mainly as a result of a slump in domestic economic activity, the nature of exchange policy and the erosion of tax receipts by the inflationary processes that came into play in the early 1980s. In terms of resource use, the main impact of the crisis was an increase in the region's outward transfer of resources owing to the deterioration of its terms of trade and to the rising finance charges associated with the countries' external debt service.

Any reduction in government spending inevitably has an economic and social cost, since, in the short run, it is extremely difficult to offset the impact of a reduction or postponement of government expenditure through an increase in the public sector's efficiency. Furthermore, the existence of obligated funds endows some components of this variable with

a high degree of rigidity, and any reductions that are to be made will therefore be primarily in deferrable items of expenditure. Consequently, capital and social expenditures are usually the first to be cut in the event of a fiscal emergency. In terms of government expenditure, the fiscal policy tools usually employed in Latin America for purposes of fiscal adjustment have been the adjustment of public-sector wages at a below-inflation rate, the suspension or postponement of public investment projects, and the delay of payments owed to the private sector or external agents.

#### 1. The size and causes of the fiscal deficit

The countries of the region varied significantly in terms of their fiscal status at the outset of the 1980s. Some countries which had pursued expansionary fiscal policies—Argentina, Costa Rica and Mexico—had large deficits, while others—such as Chile, Paraguay, Uruguay and Venezuela—had balanced fiscal accounts. These differences largely determined the effectiveness of the adjustment policies implemented by the various countries during the decade.

In order to ascertain the level and source of these fiscal disequilibria, the severity of the fiscal maladjustment, its fluctuations and the main causes of the deterioration seen in the fiscal accounts were analysed for a number of countries (see table 1).

The severity of the fiscal maladjustments was measured as the peak deficit recorded by the non-financial public sector (NFPS) during a period of fiscal disequilibrium. The trend in the public-sector deficit—represented by the variation in the non-financial public sector's financing requirements (NFPSFR)—shows the presence of phases of fiscal maladjustment or adjustment. A phase of fiscal maladjustment is a period in which the NFPSFR is on the rise, while a phase of fiscal adjustment is one in which the NFPSFR is shrinking. The variation in NFPSFR is an indicator of the severity of a fiscal crisis, regardless of the public sector's initial financial position, since it can just as well illustrate the extent of the downturn occurring in a country which has moved from a fiscal surplus to a moderate or small deficit.

TABLE 1

**Latin America (12 countries): Size and origin of fiscal maladjustment**  
(Percentages of GDP)

	Extent of fiscal imbalance <sup>a</sup>	Variation in fiscal imbalance <sup>b</sup>	Variation in SEFR <sup>c</sup>	Variation in GGFR <sup>d</sup>					
				Total	TI	T	PE	GGi	SE
<i>First phase of fiscal imbalance</i>									
Argentina (1980-1982)	10.2	4.7	1.4	3.3	-4.7	-2.3	-4.3	2.9	-2.1
Bolivia (1980-1984)	26.6	18.8	2.8	16.1	-7.1	-5.9	7.4	1.5	-1.0
Brazil (1980-1985)	12.9	9.9	0.9	9.0	-1.9	...	-2.1	9.2	-0.8
Mexico (1980-1982)	15.6	9.0	0.5	8.5	1.3	0.9	6.3	3.5	1.1
Peru (1980-1983)	10.2	6.4	0.9	5.5	-4.8	-5.0	-0.3	1.0	-0.6
Uruguay (1980-1982)	10.4	11.8	3.0	8.8	-0.6	-1.5	7.6	0.7	5.8
Venezuela (1980-1983)	17.2	11.3	6.4	4.9	-1.1	-3.0	3.6	0.2	-0.8
Colombia (1980-1983)	8.2	5.1	3.5	1.7	-1.1	-1.2	0.4	0.2	1.4
Costa Rica (1985-1988)	6.7	5.6	...	...	...	...	...	...	0.2
Ecuador (1980-1982)	6.3	3.1	0.1	3.0	-1.7	-1.3	-1.0	2.4	0.2
Chile (1980-1984)	4.6	10.0	...	9.3	-1.2	0.2	4.8	3.2 <sup>e</sup>	4.2
Paraguay (1980-1984)	5.4	5.8	3.1	2.7	-0.8	-1.7	1.8	0.1	1.7
Regional average <sup>f</sup>	11.2	7.9	2.1	5.9	-2.3	-1.8	1.6	2.1	0.8
<i>Second phase of fiscal imbalance</i>									
Argentina (1987-1988)	8.3	4.8	1.5	3.3	-3.9	-2.9	0.3	-0.9	-0.8
Bolivia (1986-1987)	8.3	5.2	5.1	0.1	-2.5	-2.6	-1.1	-1.2	2.3
Brazil (1988-1990)	24.3	2.1	-2.1	4.2	5.3	...	4.4	5.1	2.2
Mexico (1985-1986)	14.5	7.3	0.9	6.4	-0.4	-0.7	0.4	5.6	-0.1
Peru (1986-1989)	7.5	2.9	6.3	-3.4	-11.7	-8.3	-11.6	-3.4	-0.6
Venezuela (1986-1987)	9.7	7.4	-3.0	10.4	-6.3	-5.9	4.0	0.1	-2.8
Colombia (1987-1989)	3.5	1.9	0.2	1.8	-1.4	-0.9	0.1	0.4	-0.5
Ecuador (1986-1987)	3.3	8.7	8.2	0.5	0.2	-0.1	1.7	-1.0	1.3
Regional average <sup>f</sup>	9.9	5.0	2.1	2.9	-2.6	-3.0	-0.2	0.6	0.1

Source: Cominetti (1994). Data on social expenditure: Vargas de Flood and Harriague (1993), UDAPSO (1993), Macedo and Piola (1993), Chile, Budget Department (1993), Carciofi and Beccaria (1993), IMF (several years), Central Bank of Ecuador (1993), Universidad del Pacífico (1993).

<sup>a</sup> Corresponds to the peak level of the non-financial public sector's finance requirements (NFPSFR) during the fiscal imbalance.

<sup>b</sup> Corresponds to the variation in NFPSFR.

<sup>c</sup> SEFR: State enterprises' finance requirements.

<sup>d</sup> GGFR: General government's finance requirements; TI: total income; T: tax revenues; PE: primary expenditures (total expenditure minus interest payments); GGi: general government interest payments; SE: social expenditure.

<sup>e</sup> Interest payments by State enterprises are included under general government interest payments (GGi).

<sup>f</sup> Simple average.

In order to pinpoint the sectoral origin of an imbalance, table 1 also shows the trends in the financial positions (financial requirements) of State enterprises (SEFR) and the general government (GGFR). Variations in general-government deficits are further disaggregated according to the main sources of public

revenues (tax receipts) and the uses made of those revenues (primary expenditure, social expenditure and interest payments).

The table indicates that many countries suffered from severe domestic disequilibria during the first half of the 1980s. This group includes Argentina,

Bolivia, Brazil, Mexico, Peru, Uruguay and Venezuela, whose fiscal deficits rose to over 10% of GDP. Somewhat smaller fiscal deficits were registered by Colombia, Costa Rica, Ecuador, Paraguay and Chile; in Chile, however, the shift from a surplus equivalent to 5.4% of GDP in 1980 to a deficit amounting to 4.6% of GDP in 1984 none the less signalled the presence of a major fiscal imbalance, since the change was equal to 10% of GDP. The table also shows that most of the countries whose public finances reflected a major imbalance at the outset of the crisis relapsed—following an initial adjustment effort—into a deteriorating trend as regards those finances which was similar in intensity to the first, although somewhat shorter in duration.

In the majority of the countries, the deterioration of their fiscal standing during the various episodes of fiscal disequilibrium was chiefly associated with changes in the financial position of general government. On average, this sector generated around three-quarters of the total downturn in a country's overall financial position, whereas State enterprises were a major factor in the deterioration of the overall public finances only in Venezuela, Colombia and Paraguay during the first episode of fiscal disequilibrium and in Bolivia, Peru and Ecuador during the second.

The general-government fiscal imbalances observed during the decade stemmed primarily from a loss of fiscal revenues (TI) and higher debt service (GGi). The fiscal situation was exacerbated in a few countries by an expansion of primary expenditure (PE); in others, government spending cuts prevented the public sector's financial status from taking an even sharper turn for the worse. This was the case, for example, in Argentina (1980-1982), Brazil (1980-1985 and 1986-1989) and Peru (1986-1989).

The reappearance of fiscal deficits in some countries after the implementation of adjustment and stabilization programmes had less to do with debt servicing than in the initial periods; instead, these deficits were brought on by external factors such as falling oil prices and by factors associated with the implementation of reactivation policies or, in some cases, the outbreak of bouts of hyperinflation.

In short, the fiscal imbalances analysed in this study appear to be linked primarily to the presence of domestic and external macroeconomic disequilibria

caused by the economic crisis rather than being due to deliberately expansionary policies.<sup>4</sup>

## 2. Fiscal adjustment

The fiscal adjustment processes which were implemented varied in intensity and effectiveness, as is suggested by the reappearance of imbalances in a number of countries towards the end of the 1980s.

It has often been argued that during fiscal emergencies, adjustments should be made mainly on the side of demand (use) rather than supply (sources), because the fiscal impact of reforms or changes in the tax system has a long lead time or time lag, and public-sector rates and charges are difficult to correct during economic slumps. Moreover, when spending cuts are made during times of economic crisis, they tend to be concentrated in the capital account rather than current expenditure, due to the unpopularity and higher political cost of reductions in the latter.

Table 2 provides an idea of the scope of the fiscal adjustments made in various countries of the region and of the factors that played a part in balancing the public sector's finances in the course of these countries' fiscal adjustment efforts; as in table 1, the figures are broken down to distinguish between the contributions of State enterprises and those of general government.

In most of the countries studied, fiscal austerity measures were adopted, and both State enterprises and general government made a determined effort to shoulder the weight of the debt burden and to correct overall fiscal imbalances. Table 2 also shows that, except in Brazil, the scope of the adjustment was very considerable in relation to the levels of the original imbalances; Bolivia, in particular, carried out an extraordinary adjustment (23.6% of GDP) within a very short time. It may also be seen that, as in the case of fiscal disequilibria, the input of general government was greater than that of State enterprises.

<sup>4</sup> There are, however, some exceptions, including Bolivia (1980-1984), Mexico (1980-1982), Uruguay (1980-1982) and Chile (1980-1984), where a substantial increase was seen in primary expenditure. In Uruguay and Chile, however, the increase in public-sector expenditure was in large measure a reflection of changes in the social security system rather than of an expansionary fiscal policy.

TABLE 2

**Latin America (12 countries): Size and origin of fiscal adjustment**  
(Percentages of GDP)

	Fiscal adjust- ment <sup>a</sup>	Varia- tion in SEFR <sup>b</sup>	Variation in GGFR <sup>c</sup>					
			Total	TI	T	PE	GGi	SE
<i>First phase of fiscal adjustment</i>								
Argentina (1983-1986)	-6.7	-3.2	-3.5	4.6	2.5	3.6	-2.5	1.4
Bolivia (1985-1986)	-23.6	-	-23.6	14.9	14.3	-11.0	2.3	-3.1
Brazil (1986-1987)	-1.5	-0.4	-1.1	3.4	...	3.5	-1.2	1.2
Mexico (1983-1984)	-8.4	-2.2	-6.2	1.3	2.3	-7.7	2.8	-2.4
Peru (1984-1985)	-7.7	-3.8	-3.9	3.8	2.9	-	-0.1	-0.3
Uruguay (1983-1987)	-9.8	-2.2	-7.6	1.2	1.1	-7.0	0.6	-3.7
Venezuela (1984-1985)	-12.8	-5.3	-7.5	4.6	4.8	-3.6	0.7	0.4
Colombia (1984-1986)	-6.9	-2.8	-4.1	2.3	1.8	-2.1	0.3	-1.1
Costa Rica (1980-1984)	-12.2	-5.9	-6.4	1.1	3.6	-5.2	-0.1	-1.9
Ecuador (1983-1985)	-11.8	-8.1	-3.7	0.4	1.6	-2.7	-0.6	-1.5
Chile (1985-1987)	-4.3	...	-3.0	0.4	-	-3.5	0.9 <sup>d</sup>	-4.6
Paraguay (1985-1987)	-4.6	-1.7	-2.8	0.2	0.5	-3.0	0.3	-1.6
Regional average <sup>e</sup>	-8.2	-3.1	-6.1	3.2	3.2	-3.2	0.2	-1.4
<i>Second phase of fiscal adjustment</i>								
Argentina (1989-1990)	-3.7	-0.2	-3.5	1.1	0.4	-3.1	0.6	-0.2
Bolivia (1988-1989)	-14.4	...	...	...	...	...	...	-0.4
Costa Rica (1989-1990)	-2.6	...	...	...	...	0.5	...	1.2
Mexico (1987-1989)	-9.1	-1.4	-7.7	2.8	1.2	-2.9	-7.1	0.3
Regional average <sup>e</sup>	...	...	...	...	...	...	...	0.3

Source: Cominetti (1994). Data on social expenditure: Vargas de Flood and Harriague (1993), UDAPSO (1993), Macedo and Piola (1993), Chile, Budget Department (1993), Carciofi and Beccaria (1993), IMF (several years), Central Bank of Ecuador (1993), Universidad del Pacífico (1993).

<sup>a</sup> Corresponds to the variation in the non-financial public sector's finance requirements (NFPSFR).

<sup>b</sup> SEFR: State enterprises' finance requirements.

<sup>c</sup> GGFR: General government's finance requirements; TI: total income; T: tax revenues; PE: primary expenditures (total expenditure minus interest payments); GGi: general government interest payments; SE: social expenditure.

<sup>d</sup> Interest payments by State enterprises are included under general government interest payments (GGi).

<sup>e</sup> Simple average.

The main adjustment mechanism used by State enterprises was the reduction of allocations for fixed capital formation.<sup>5</sup> General government, on the other hand, took a number of different steps to boost revenues, such as correcting the prices charged by State enterprises,<sup>6</sup> instituting tax reforms<sup>7</sup> and

raising fuel prices and fuel taxes.<sup>8</sup> At the same time, the easing of inflationary pressures helped to boost tax revenues in some cases, while rebounding petroleum prices helped along the adjustment process in the oil-producing countries.

On the expenditure side, the contribution made by general-government primary expenditure to the fiscal adjustment effort was, on average, just as important as that made by tax revenues (see table 2). Financial expenditure continued to exert some pressure in most of the countries during the fiscal adjustment phase, with an increase being seen,

<sup>5</sup> Devlin and Cominetti (1994) show that the adjustment carried out by State enterprises in Latin America during the 1980s was achieved by reducing investment levels.

<sup>6</sup> This was done, for example, in Costa Rica in 1982 and Mexico in 1983. In many of the countries, however, public-sector rates and charges were also used at one time or another as an anti-inflationary policy tool.

<sup>7</sup> This step was taken in, for example, Colombia (1984), Mexico (1983), Bolivia (1986), Brazil (1986) and Venezuela (1985).

<sup>8</sup> Such measures were implemented in, for example, Argentina, Bolivia and Peru.

overall, in general government interest payments, but general government primary expenditure contributed to the restoration of fiscal equilibrium, with this contribution being quite substantial in such countries as Bolivia, Mexico, Uruguay and Costa Rica. In most cases, the countries' adjustment programmes called for drastic reductions in general government spending, especially in public-sector wages and capital expenditure. These two items exhibit a relative degree of flexibility in fiscal emergency situations, but reductions in these areas may also have serious short-term social implications as well as generating severe growth constraints in the long run.

In summary, the data examined here suggest that, generally speaking, primary expenditure was not a significant factor in the region's bouts of fiscal maladjustment during the 1980s but on the contrary made an important contribution to the restoration of fiscal equilibria. Within this context, it may be instructive to look at social expenditure patterns during phases of disequilibrium and fiscal adjustment and, in particular, to determine whether the trends in social and primary expenditure were similar or whether social spending helped to make up for the loss of income experienced by the population as a result of the debt crisis.

### III

## The role of social expenditure in fiscal adjustment and maladjustment

An analysis of the performance of the Latin American economies in the area of public finances during this period inevitably raises a number of questions about the role of social policy. Did social spending help trigger the fiscal crisis? How did social spending contribute to the fiscal adjustment process? How much did social policy help to make up for the loss of income sustained by the most vulnerable groups in the population?

An attempt will be made to answer these questions on the basis of a simple exercise involving an analysis of social expenditure patterns during periods in which the non-financial public sector's financial standing deteriorated and during periods when adjustments were made to improve its financial status.

#### 1. Social spending and fiscal deficits

The pattern of social spending observed during each episode of fiscal adjustment and maladjustment may be described as being pro-adjustment if social expenditure decreases or pro-maladjustment if it increases. Thus, during episodes of fiscal maladjustment, social spending may have helped to deepen the imbalance by exhibiting a pro-maladjustment pattern or may have helped to mitigate the imbalance and forestall even greater disequilibria, in which case it would have displayed a pro-adjustment pattern. By the same token,

during phases of fiscal adjustment, the pattern of social spending may have followed a pro-adjustment trajectory and thus helped to reduce the imbalance, or may have hindered efforts to reduce that imbalance by displaying a pro-maladjustment trend.<sup>9</sup>

Table 3 provides an overview (in terms of numbers of cases) of the patterns of social spending observed during the period in question by breaking them down into the categories of "pro-adjustment" or "pro-maladjustment" trends during episodes of both fiscal adjustment and maladjustment. It shows that, in terms of frequency, social spending during the 1980s was a strongly pro-adjustment factor in the region during episodes of fiscal adjustment as well as maladjustment. Specifically, out of 21 episodes of fiscal maladjustment, social expenditure was a mitigating factor in 11 cases, while it helped to increase the imbalance in the other 10 cases. Likewise, in 12 of the 16 episodes of fiscal adjustment for which information is available, social expenditure exerted a pro-adjustment influence, working against adjustment efforts in only four cases.

<sup>9</sup> Depending on the definition and unit of measurement (units of GDP) adopted, a pro-adjustment pattern may reflect a situation in which social spending is reduced or one in which social spending increases but does so at a proportionally slower rate than GDP. By the same token, a pro-maladjustment pattern may reflect a situation in which social spending rises or one in which it decreases but does so at a slower pace than GDP.

TABLE 3

**Latin America: The role of social expenditure during episodes of fiscal adjustment and maladjustment**  
(Number of cases)

	Pro- adjustment	Pro- maladjustment
Episodes of fiscal adjustment	12	4
Average variation in social expenditure (as a percentage of GDP)	1.8	1.1
Episodes of fiscal maladjustment	11	10
Average variation in social expenditure (as a percentage of GDP)	1.2	2.0
<b>Total</b>	<b>23</b>	<b>14</b>

Source: Table 2.

In terms of magnitude, it may be seen that although the average increase in social expenditure during times of fiscal maladjustment outweighed the average reduction made in this variable when it was performing a pro-adjustment function, just the opposite was true during episodes of fiscal adjustment. In such situations, not only did the number of pro-adjustment patterns far exceed the number of pro-maladjustment patterns, but the size of the contribution made to fiscal equilibrium was, on average, greater than that observed in those cases where social spending rose.

The cases of Chile (1980-1984) and Uruguay (1980-1982) stand out by virtue of the extent of the change observed in their social expenditure levels during episodes of disequilibrium, inasmuch as in these two countries this factor accounted for nearly 50% of the total imbalance. This was a consequence of special circumstances in both cases (the implementation of a new social security system and of special welfare programmes in Chile, and the reorganization of the social security system in Uruguay). As regards the significance of social spending as a mitigating factor during episodes of maladjustment, it is to be noted that the contribution made by this category of expenditure was quite substantial in percentage terms, considering its relatively small share of the non-financial public sector's total budget.

In addition, trends in social spending during episodes of fiscal adjustment had a pro-adjustment influence in a majority of cases (see table 2); the deep cuts made in social expenditure in Chile during the second half of the 1980s constitute a particularly notable case.

## 2. Social spending and the level of economic activity: pro-cyclical or counter-cyclical?<sup>10</sup>

A social policy intended to play a compensatory role with regard to income levels under recessionary circumstances should call for an increase in social expenditure when the level of economic activity declines; in other words, in the context of such a policy, social expenditure should be counter-cyclical. If, on the other hand, social spending behaves pro-cyclically under such circumstances, then the most vulnerable segments of the population will probably see a further deterioration in their economic position. An analysis of social spending and of the trends observed in the level of economic activity during periods of fiscal adjustment and maladjustment may reveal any of the following types of social expenditure patterns:

(i) Pro-cyclical and pro-adjustment social spending: this social expenditure pattern is observed when the level of activity is moving downward and the level of social spending falls by a greater proportion than GDP, or when GDP is growing and social spending tends to rise, but more slowly than GDP.

(ii) Pro-cyclical and pro-maladjustment social spending: this type of pattern emerges when the level of activity is declining and the reduction made in social spending is smaller than the drop in GDP, or when social spending increases by a proportionately greater amount than GDP at a time when the level of economic activity is on the rise.

(iii) Counter-cyclical and pro-adjustment social spending: this pattern is found when social spending is being reduced while the level of activity is moving upward.

(iv) Counter-cyclical and pro-maladjustment social spending: this pattern is seen when the level of economic activity falls while social expenditure rises.

A pro-cyclical, pro-adjustment pattern reflects a social expenditure policy that places a higher priority on fiscal adjustment than on income supplementation, whereas a counter-cyclical, pro-maladjustment pattern reflects a fiscal policy that places priority on the compensatory role of social spending and thus increases such spending when the population's income levels fall.

<sup>10</sup> The author is grateful for the contributions made by Emanuela Di Gropello to this section.

If, when analysing the situation in the region during phases of fiscal adjustment and maladjustment, a comparison is made between the trends in real social expenditure and in real GDP, then the role of social spending in Latin America is seen to be as shown in table 4. The figures refer to only 25 cases because in another 12 instances the trend in the level of activity was quite irregular. In those cases that did lend themselves to classification, social spending was primarily used as a tool of fiscal adjustment while its income-supplementation role was secondary. This is demonstrated by the predominance of situations in which the pattern of social spending was pro-adjustment and pro-cyclical, inasmuch as there were only three cases in which a counter-cyclical and pro-maladjustment pattern was observed.

Thus far, our analysis of the role of social expenditure suffers from a limitation: it does not tell us anything about changes in the sectoral composition of social expenditure during the period in question, which may have helped to offset short-term decreases in household income. In fact, a number of countries did implement special temporary programmes to aid

TABLE 4

**Latin America: Social expenditure patterns in relation to NFPS fiscal deficit and GDP**

Role of social expenditure	Pro-cyclical	Counter-cyclical
Pro-adjustment	13	5
Pro-maladjustment	4	3

Source: ECLAC, in the press.

the most vulnerable segments of the population. Examples include Chile's employment programme for heads of household (1982-1985), Mexico's National Solidarity Programme, the Emergency Social Welfare Fund created by Bolivia in 1986, Costa Rica's compensatory social programme (1983-1984) and others. In order to detect changes in the inter-sectoral allocation of social funds during the 1980s which may have shielded some sectors at the expense of others, we will now turn to an analysis of the vulnerability of the various social sectors based on a comparison of sectoral expenditure patterns with the changes seen in total real social expenditure.

## IV

### The sectoral dimension of the adjustment

The fiscal adjustment carried out in the 1980s had an uneven impact on the various social sectors; this was, in part, a reflection of each sector's relative ability to reduce or defer expenditures and of the diversion of a portion of the demand for social services from the private to the public sector. In order to determine the extent of the protection given to, or the vulnerability of, these social sectors during the many fiscal adjustment processes pursued in the region, an analysis was made of trends in the sectoral components of social policy during the implementation of the various fiscal adjustment programmes.

Table 5 shows the number of cases in which the percentage variation in sectoral expenditure was greater (>) or less (<) than the variation in total real social expenditure or moved in the opposite direction (c). The figures indicate that the contributions made to the adjustment effort and the benefits obtained during periods of rising social expenditure were not distributed evenly among the various social sectors.

Instead, the most vulnerable sector during periods when adjustments were being made in social spending levels was housing and the second most vulnerable was education, with social expenditure in these sectors falling more steeply than total social expenditure in 14 out of 22 cases and in 10 out of 23 cases, respectively. During these phases of pro-adjustment social spending, the social-security and health sectors contributed less than total social spending did to the fiscal adjustment and actually moved in the opposite direction in a substantial number of cases, i.e., spending levels in these sectors rose, and the brunt of the adjustment was therefore borne by education and housing. Likewise, during times when social spending was on the rise, the most favourably positioned sectors were social security and, in second place, health, while housing and education benefited the least. In a significant number of cases, in fact, spending levels in these latter sectors actually continued to decline even when social expenditure was expanding.

TABLE 5

**Latin America: Real social expenditure patterns, by social sector**  
(Number of cases)

	Education	Health	Social security	Housing
Pro-adjustment social spending <sup>a</sup>				
<i>Episodes of adjustment</i>				
>	5	5	4	6
<	5	2	2	2
c	2	5	2	3
<i>Episodes of maladjustment</i>				
>	5	2	3	8
<	1	2	1	1
c	5	7	5	2
Pro-maladjustment social spending <sup>b</sup>				
<i>Episodes of adjustment</i>				
>	2	3	2	1
<	1	0	1	1
c	1	1	1	2
<i>Episodes of maladjustment</i>				
>	4	4	5	1
<	2	4	3	1
c	4	2	0	6

Source: ECLAC, in the press.

<sup>a</sup> Under the heading of pro-adjustment social expenditure (SE):

> signifies that the percentage decrease in real sectoral SE is greater than the reduction in real aggregate SE;  
< signifies that the percentage decrease in real sectoral SE is less than the reduction in real aggregate SE; and  
"c" signifies that the pattern of real sectoral SE is counter-cyclical with respect to real total SE.

<sup>b</sup> Under the heading of pro-maladjustment social expenditure:

> signifies that the percentage increase in real sectoral SE is greater than the increase in real aggregate SE;  
< signifies that the percentage increase in real sectoral SE is less than the increase in real aggregate SE; and  
"c" signifies that the pattern of real sectoral SE is counter-cyclical with respect to real total SE.

The social security sector consistently contributed to fiscal imbalances whenever social spending exhibited a pro-maladjustment pattern. However, the pro-maladjustment role played by this sector was also a factor with regard to fiscal revenues. The evidence points to a steep drop in the funds of a number of social security institutions in the region as a consequence of a drop in the level of payments made into the social security system during the economic crisis, due to higher unemployment and the inflation registered during that period.

In summary, a review of the various upturns and downturns in social expenditure in Latin America indicates that the housing sector has been highly vulnerable during periods when adjustments were being made in

social spending levels and has also been the sector that has benefited the least during periods when those levels were moving back up. Social security expenditure, on the other hand, has tended to counterbalance downward trends in aggregate social spending during periods of adjustment and has also been the sector that has contributed the most to the expansion of social expenditure during times when it has played a pro-maladjustment role. This pattern demonstrates that even though social policy as a whole has not placed priority on social spending's income-supplementation function, changes in the sectoral allocation of social expenditure have partially offset this low priority, thus reflecting, to some extent, the welfare orientation of social policy in the 1980s.



## V

### Social spending in the 1980s

The strongly pro-adjustment behaviour of social spending during the various periods of fiscal adjustment and maladjustment accounts for much of the fairly widespread deterioration seen in this fiscal budget item in the countries of the region.

Table 6 illustrates the trend in real per capita social expenditure and its relation to GDP and total public expenditure in three different periods: 1980-1981, 1982-1989 and 1990-1991. The object is to assess the relevant expenditure patterns during the pre-crisis period, the crisis and adjustment phase, and the post-crisis stage.<sup>11</sup> Throughout the 1980s, a widespread decline was observed in social expenditure; this is true regardless of which form of measurement is chosen, although, because of the sharp swings in the level of economic activity registered during this period, the downturn appears less striking for some countries when the social expenditure/GDP indicator is used. Nevertheless, in real per capita terms, the trend in the level of social spending was clearly negative. In fact, in 1982-1989, real per capita allocations for social programmes fell in all the countries except Uruguay, and in most cases had still not regained their pre-crisis levels as of the early 1990s.<sup>12</sup> This situation, in the absence of radical institutional changes (with the exception of isolated social reforms in some countries) that might help to make up for the loss of resources through greater efficiency, indicates that there was probably a decrease in the population's access to State-run social services or in the quality of such services.<sup>13</sup> Finally, it should be

noted that in 1982-1989 the share of total public expenditure represented by social spending also shrank on a widespread basis; thus, the decrease in social spending can be said to reflect a fiscal policy that placed priority on non-social sectors.

The unevenness of sectoral trends in social spending shaped a sectoral pattern of expenditure in the 1980s that tended to mirror the various sectors' relative degrees of protection and vulnerability during phases of fiscal adjustment and maladjustment (see table 7). The widespread drop in social spending in the health sector indicates that, despite its relative degree of protection during the decade, the spending cuts made in this sector during downturns in social expenditure outpaced the increases made during upturns. The greater dispersion seen in the case of the housing sector is due to the fact that this sector's share of social expenditure is very small. In the case of education, the general drop in real per capita expenditure is attributable to the vulnerability of this sector, in which wages represent a very large component of social spending (as noted earlier, wages were a widely-used policy tool during the various adjustment and stabilization programmes applied in the region). The sector that suffered the least in 1982-1989 was social security, which is in keeping with the degree of protection afforded this sector during the various phases of fiscal adjustment and maladjustment.

As a result, in the early 1990s the indicators for the social security sector were better than they had been at the start of the 1980s in almost all the countries studied. This finding, which tallies with the results of other studies on social expenditure, may be attributed to differing factors (e.g., the reorganization of the social security system in Uruguay, the increased transfers made in Chile in order to ensure the viability of its new social security system and increases in the welfare component of social security expenditures).

In the health sector, the higher real per capita levels of social expenditure observed in some countries are due to a shift in demand from private health care to free health care services as a result of the crisis. Generally speaking, there are signs of a sharp

<sup>11</sup> This chronological scheme has been chosen for purposes of simplicity; the actual time-frame of the crisis varied from one country to the next. For example, due to circumstances peculiar to that country, Peru did not embark upon an adjustment effort until the late 1980s.

<sup>12</sup> A country-by-country analysis of this variable for the entire period in question indicates that, except in Ecuador and Peru, social spending was moving upward again by the end of the decade, but this ceases to be the case when the analysis is based on averages (ECLAC, in the press).

<sup>13</sup> The available data indicate that in a number of countries in the region, such as Peru and Mexico, the reduction of social expenditure in the education sector primarily affected the quality of instruction.

deterioration in the quality of education provided by the public sector as well as in health care. The fact that the education and housing sectors were in a weaker position in 1990-1991 than at the start of the

crisis gives cause for concern in view of this situation's possible adverse effects in terms of growth potential and the countries' chances of putting an end to poverty and marginality.

TABLE 6

## Latin America: Social expenditure

	Social expenditure/GDP			Real per capita social expenditure (1985 dollars; 1980-1981 = 100)	
	1980-1981	1982-1989	1990-1991	1982-1989	1990-1991
Argentina	16.8	15.1	116.0	82.6	80.4
Bolivia	5.7	4.7	4.5	67.5	61.0
Brazil	9.7	9.4	10.8	98.7	111.1
Chile	17.7	18.7	14.2	96.8	90.0
Colombia	7.8	8.1	7.7	107.1	114.4
Costa Rica	15.2	15.2	15.9	91.9	103.9
Ecuador	10.3	8.9	6.4	82.0	60.2
Mexico	8.6	6.8	7.1	72.5	74.5
Paraguay	3.9	4.2 <sup>a</sup>	<sup>b</sup>	100.0 <sup>c</sup>	<sup>b</sup>
Peru	4.6	3.6	2.0	87.0	35.8
Uruguay	14.9	16.3	17.5	99.7	118.5
Venezuela	11.5	9.5	8.5	72.9	64.4 <sup>a</sup>
Regional average <sup>d</sup>	11.2	10.6	10.2	87.1	83.0

Source: Prepared by the author.

<sup>a</sup> 1990.

<sup>b</sup> These figures are not comparable.

<sup>c</sup> 1980-1987.

<sup>d</sup> Simple average; does not include Paraguay due to a change in institutional coverage dating from 1988.

TABLE 7

Latin America: Patterns of real per capita social expenditure  
(1985 dollars; 1980-1981 = 100)

	Education		Health		Social security		Housing	
	1982-1989	1990-1991	1982-1989	1990-1991	1982-1989	1990-1991	1982-1989	1990-1991
Argentina	86.1	73.0	91.1	90.0	76.8	78.8	133.5	61.9
Bolivia	76.2	59.8	51.3 <sup>a</sup>	71.2 <sup>a</sup>	...	...	37.7	27.3
Brazil	143.3	120.7	116.0	127.4	95.1	119.2	58.9	53.1
Chile	85.2	74.1	90.5	94.5	102.1	102.8	87.2	119.6
Colombia	109.3	103.3	98.6	123.6	107.6	136.9	109.2	50.7
Costa Rica	75.1	85.5	78.4	108.2	153.3	168.0	191.6	43.8
Ecuador	80.0	54.0	90.2	73.3	81.1	63.5	...	...
Mexico	78.4	76.7	75.4 <sup>a</sup>	85.3 <sup>a</sup>	...	...	48.3	35.1
Paraguay	81.7	...	95.4	...	125.6	...	42.3	...
Peru <sup>b</sup>	92.0	77.6	88.1	75.8	...	...	32.6	7.4
Uruguay	88.5	100.5	97.0	129.2	102.0	121.7	117.4	209.1
Venezuela	79.9	58.7 <sup>c</sup>	85.1	79.2 <sup>c</sup>	71.7	83.6 <sup>c</sup>	51.1	44.4 <sup>c</sup>

Source: Prepared by the author.

<sup>a</sup> Includes social security.

<sup>b</sup> Central government budget.

<sup>c</sup> 1990.

## VI

### Summary and conclusions

In the wake of the debt crisis that hit the region in the early 1980s, a conflict of objectives arose in relation to the use of social expenditure as a tool of fiscal policy: on the one hand, there was the aim of offsetting the loss of income experienced during economic downturns; on the other, there was the goal of helping to restore fiscal equilibrium in order to eliminate a major source of macroeconomic instability. An analysis of the available information on a number of Latin American countries reveals that during the 1980s priority was given to social expenditure's role as an instrument of fiscal adjustment. This led to such a sharp and widespread decrease in social spending that as of the early 1990s the great majority of the countries studied had still not managed to bring real social expenditure back up to the levels registered in the early 1980s.

The data indicate that, in general, social spending was not a significant factor in the generation of fiscal deficits but did make a significant contribution to fiscal adjustment processes.

The reductions made in social spending during these adjustment processes were not evenly distributed among the various social sectors. The most favourable treatment appears to have been given to the social security sector, followed by the health sector, but this was to the detriment of the housing and education sectors, which proved to be highly vulnerable. As a rule, the increases made in social spending were largest in the social security sector, which registered quite a widespread rise in real per capita terms during the decade. This growth was partly a reflection

of the increasing welfare orientation of social policy, as opposed to a longer-term approach aimed at furthering equality of opportunity. This latter policy was promoted less vigorously during the period in question, as is demonstrated by the generalized decline in indicators of real per capita social expenditure in the education and health sectors.

While it is true that social spending was not an important factor of fiscal disequilibrium, an important lesson regarding social spending as a component of the fiscal budget is to be learned from Latin America's experiences: a lesson which has to do with the macroeconomic constraints associated with social policy. An expansionary social policy that does not ensure reliable financing for social programmes may jeopardize a country's macroeconomic stability by occasioning the implementation of adjustment plans that may well prove to be very costly in social terms.

At the same time, the high social cost of the mounting poverty and social inequity seen in the 1980s within a context of limited social expenditure underscores the need for the countries to rework their social programmes so that public resources will be used more effectively to improve the status of the most vulnerable groups in the population and to reduce inequalities on a permanent basis. These two considerations—the macroeconomic constraints of social policy and the decline in social equity—demonstrate the importance of shaping a new paradigm that will stress the efficiency, quality and precise targeting of social expenditure.

(Original: Spanish)

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# Women's formal *education:* achievements *and obstacles*

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**Diane Alméras**

*Social Affairs Officer,  
Women and Development  
Unit, ECLAC.*

An examination of women's education in the region leads to apparently contradictory conclusions: on the one hand, genuine progress has been made in terms of coverage and performance, justifying the assertion that the region is making headway towards achieving equal opportunities of access where they do not already exist and that the situation will continue to improve. On the other hand, however, an analysis of the data also brings out less positive factors that warrant continued concern about this issue. In addition to persistent structural problems in most of the region's formal educational systems (which limit the expansion of educational coverage for both men and women), for nearly two decades now various studies and other analyses have been pointing out that the educational process for women is closely linked to the gender discrimination with regard to educational content and professional opportunities that is part of Latin America's cultural ethos. This article seeks to weigh the latest quantitative data on women's access to formal education against the obstacles to genuine equality of opportunity that women encounter in the educational system.

# I

## Introduction

For many years now, studies on formal education in Latin America have underscored the significant advances being made by the countries of the region in their fight against illiteracy and in their drive to boost school enrolment rates at all levels; indeed, the rates for women have been climbing so steadily (ECLAC 1984, 1988 and 1991b) that they have actually moved ahead of male enrolment rates in some countries. Despite this generally bright picture, however, the educational process continues to suffer from serious structural problems; the situation in the different countries varies a great deal and, within those countries, highly stratified socio-educational pyramids have taken shape on the basis of ethnic, regional and socioeconomic differences (Valdés and Gomariz, 1992 and 1993). For the women of the region, all this translates into the continuation of high illiteracy rates among the inhabitants of rural areas, indigenous women and older cohorts.<sup>1</sup>

In the past, the types of gaps or shortcomings existing in the region's educational systems have been due to the global development strategies adopted by the countries and the differing oppor-

tunities open to the various social groups as they seek to find a place in those systems and, having done so, to hold on to that position (ECLAC, 1990). Since, given their traditionally subordinate position in society, women have been excluded from the circles of power that would have enabled them to exert an influence over these development strategies, their integration into the formal educational process has given rise to an array of complex situations created by the interplay of the different variables of gender, age, social class, ethnic identity and geographic area.

Although equality of access to the educational system appears to be a reality for men and women under the age of 25 today, discrimination against women persists in the qualitative aspects of education. In the 1980s people were already denouncing the limitations on women's integration into the educational process, which had led to their concentration (especially at the level of higher education) in spheres that have come to be thought of as "women's areas", such as education, the social sciences, fine arts and certain fields of medicine (ECLAC 1984, 1988 and 1991b). Today, the effects of sexual stereotypes on the content of instruction and the impact of discriminatory bias in vocational counselling on women's lifetime goals have also become recognized subjects for discussion and, increasingly, for analysis. In other words, as the obstacles that once prevented women from obtaining an education are overcome, the issue ceases to be "how many women are in school" and instead becomes one of "what are women studying and how good is the education they are receiving and the academic environment they are receiving it in?" (Bonilla Castro, 1991).

It is therefore necessary to look beyond the quantitative aspects of women's access to the formal educational system in order to examine the nature of the structural problems affecting the male/female enrolment ratio, the socio-cultural elements incorporated into teaching materials, the role played by teachers in constructing and reproducing gender identities, and the impact of the sexual division of labour on job opportunities.

□ The author is grateful for the assistance provided by María-Luisa Jáuregui (UNESCO) in compiling data on illiteracy, pre-school and primary education, intercultural bilingualism and technology. Invaluable comments were also made by Miriam Krawczyk, Irma Arriagada, Molly Pollack, Nieves Rico, Pauline van der Aa and María Rebeca Yañez, colleagues of the author who are closely involved in the work of the ECLAC Women and Development Unit.

<sup>1</sup> Mention should be made here of a widely-recognized problem in the region: the lack of comparability between data drawn from censuses conducted in different years, inasmuch as these data correspond to populations of differing ages and refer to a formal educational structure that divides up grade levels in different ways from one country to the next. In many cases it was necessary to make use of both national household surveys and census data; this limits the usefulness of the tables, since they thus provide no more than an approximate, descriptive context and cannot be used as a tool for "evaluation" in the strict sense of the term. However, even though the data are neither entirely comparable nor completely accurate in a statistical sense, they are none the less representative of the actual situation and afford a better understanding of the direction in which the educational status of women is heading, as well as of the social, political and cultural implications of the situation.

## II

### Exclusionary factors affecting women in the region

Within the above context of notable differences among the countries of the region and shortcomings in the quality of education, and with a view to arriving at a fuller understanding of the significance of the advances made by younger generations of women in gaining greater access to education, we will first consider the factors that work to exclude women in particular while at the same time posing formidable challenges to the educational system as a whole: the isolation of rural areas, the generation gap that exists in terms of education, discrimination based on ethnic identity, and the persistence of illiteracy.

#### 1. The isolation of rural areas

The most recent *Social Panorama of Latin America* published by ECLAC (1993) reports that the educational levels of the rural population remain low and continue to be far below those found in urban areas. Illiteracy rates in rural areas also continue to be notably higher, as do differences between men and women, which are much greater than in urban areas (see table 1). Moreover, unlike the situation in most of the countries' urban areas, women in rural areas tend to share the high repetition and drop-out rates which, at the regional level, are recognized as being a typically male problem (Valdés and Gomariz, 1992 and 1993).

The differences are all the more striking when we take the quality of education into account; the "obligatory primary curriculum is designed in cities and is totally unadapted to rural children, especially those of indigenous origin with little or no knowledge of Spanish" (ECLAC/UNESCO-OREALC, 1992). This situation is compounded by the lack of correspondence between school vacations and the seasonal demand for labour and by the lack of qualified teachers.

Such shortcomings have additional implications for girls, since they are confronted with the discriminatory stereotypes which are incorporated in the instruction provided by teachers who have not been

properly prepared to transmit new educational models. Furthermore, their lifetime goals are also limited by the lack of job opportunities existing in societies such as those of rural Latin America, in which the traditional sexual division of labour is deeply ingrained, and by the shortage of job opportunities in rural areas.

#### 2. The generation gap

The wide generation gap to be observed today in terms of educational levels is the direct result of the growth of school enrolment in the region over the past few decades, which has primarily benefited younger generations. When enrolment figures are broken down and analysed by gender, geographic area and income level, it turns out that the "greatest differences are between age groups" (UNICEF/Chile, MIDEPLAN, 1993).

For women, this situation is the clearest indicator of the amount of progress made in terms of access to formal education. In fact, the differences between the educational status of young women between the ages of 15 and 24 and women aged 50 or over are so great that in describing them it may be appropriate to talk about different "social biographies" (ECLAC, 1994c). For example, the illiteracy rate in Bolivia as of 1988 was 3.5% for women between the ages of 15 and 19 but 66.8% for women over 50, and the latter rate rose to 85.9% in the case of rural areas (Bolivia, Coordinadora de la Mujer, 1990). In Chile, the average level of educational attainment for women over 64 years of age as of 1990 was six years of schooling in urban areas but less than three years in rural zones, while for those in the 15-24 age group, the average was 11 and eight years, respectively (UNICEF/Chile, MIDEPLAN, 1993).

Obviously, the problem is not the existence of such a gap *per se*, but rather the fact that these uneducated older women are living in a society that demands an ever-greater level of efficiency in terms of reading, writing and arithmetic. When their situation

TABLE I

**Latin America (13 countries): Illiteracy rates  
in urban and rural zones, by gender<sup>a</sup>**  
(Percentages)

	Total	Women	Men	Urban zones		Rural zones	
				Women	Men	Women	Men
<b>Bolivia</b>							
1976	36.8	48.6	24.2	23.3	6.2	68.5	37.3
1992	20.0	27.7	11.8	15.5	3.8	49.9	23.1
<b>Brazil</b>							
1980	25.5	26.5	24.4	18.3	14.5	46.9	45.6
1988	18.5	18.6	18.4	13.6	11.5	34.7	37.5
<b>Colombia</b>							
1973	...	19.4	17.4	12.0 <sup>b</sup>	8.6 <sup>b</sup>	34.8 <sup>c</sup>	30.6 <sup>c</sup>
1985	...	12.0	11.5	7.8 <sup>b</sup>	6.2 <sup>b</sup>	23.2 <sup>c</sup>	22.2 <sup>c</sup>
<b>Costa Rica</b>							
1973	10.2	10.3	10.2	5.1	3.7	14.8	14.6
1984	7.3	7.4	7.3	3.8	3.7	11.0	10.9
<b>Cuba</b>							
1981	1.9	...	...	...	...	...	...
<b>Chile</b>							
1982	8.9	9.2	8.5	6.8	5.5	23.2	20.9
1989	5.9	6.1	5.7	4.4	3.6	17.5	16.3
<b>Ecuador</b>							
1982	16.5	19.6	13.2	7.9	4.3	33.4	22.4
1990	11.4	13.5	9.1	6.5	3.6	25.1	15.5
<b>Guatemala</b>							
1981	44.0	50.7	37.2	28.2	16.5	62.5	47.3
1989	40.7	47.8	34.2	27.0	16.5	60.0	45.6
<b>Panama</b>							
1980	13.2	13.7	12.7		5.0 <sup>d</sup>		26.8 <sup>d</sup>
1990	10.7	11.1	10.3		4.1 <sup>d</sup>		23.6 <sup>d</sup>
<b>Paraguay</b>							
1972	19.9	24.5	15.0	14.7	7.4	32.2	19.8
1982 <sup>c</sup>	21.2	23.7	18.6	9.1	13.6	26.4	33.5
<b>Peru</b>							
1981	18.1	26.1	9.9	12.5	3.6	55.8	23.2
1991	10.7	17.4	4.1	6.3	2.2	45.6	10.4
<b>Dominican Republic</b>							
1981	27.7	28.2	27.2	...	...	...	...
1991	17.7	17.9	17.5	10.8	8.7	31.4	29.7
<b>Uruguay</b>							
1975	5.6	5.2	6.1	...	...	...	...
1985	4.6	5.1	4.1	4.1	3.8	10.4	6.2
<b>Venezuela</b>							
1981	14.1	15.3	12.8	11.7	8.6	38.2	34.5
1990	9.3	9.9	8.7		(5.2)		(19.4)

Source: Valdés and Gomariz (1992 and 1993).

<sup>a</sup> Refers to the population aged 15 and over, except in Brazil (10 years and over), Colombia in 1985 (12 and over), Costa Rica in 1973 (10 and over), Cuba (10 to 49 years of age) and Panama (10 and over).

<sup>b</sup> District capitals.

<sup>c</sup> Rest of country.

<sup>d</sup> Men and women.

<sup>e</sup> The general increase in illiteracy shown for this year is attributable to the use of a different recording procedure for the 1982 census. The increase in the rate for men may be due to a higher drop-out rate for boys and shortcomings in the educational system that prompt a large number of male migrants to seek work "on the agricultural frontier or in the construction of hydroelectric plants" (Valdés and Gomariz, 1993).



is compared with that of men, it becomes quite clear that the older generations of women have remained on the sidelines of the drive towards greater equality of opportunity from which younger women are benefiting today. If we look at the cases of Bolivia and Chile once again, we find that, in Bolivia, 40% of men over the age of 50 were illiterate in 1988 as compared to 66.8% of women in that age group; in Chile, as of 1990 men over the age of 65 had, on average, 6.9 years of schooling in urban areas and 3.2 years in rural zones, whereas the averages for women in those same groups were 6.0 and 2.7, respectively (see table 2).

### 3. Ethnic discrimination

#### (a) *The educational situation of indigenous women*

For obvious reasons having to do with communication and co-existence, the difficulties encountered by indigenous women in their daily lives are further exacerbated by language differences. For women,

this situation translates into illiteracy rates that in some cases reach dramatic proportions. In Bolivia as of 1988, for example, 95.6% of the women who spoke only Aymara and 94.7% of those who spoke only Quechua had received no formal education whatsoever; only 4.4% and 5.1% of them, respectively, had had access to primary education.

On the one hand, illiteracy is the major factor in indigenous women's isolation, since it sets them apart from the national culture and helps to keep them in a position of extreme poverty. On the other hand, it is thanks to their relative lack of integration into Latin American society and their absence from the educational system that they have been able to preserve some portion of their traditional culture. The dilemma with which these women are faced is made all the more difficult to resolve by their indigenous tradition itself, according to which the preservation of the culture is a task that falls within the sphere of women's powers and responsibilities (D'Emilio, 1989).

TABLE 2

**Latin America (10 countries): Illiteracy rates among the population aged 15 and over, by age group and gender (Percentages)**

Country	Women			Men		
	Ages 15-19	Ages 20-24	65 and over	Ages 15-19	Ages 20-24	65 and over
Bolivia (1988)	3.5	7.7	66.5	1.5	2.0	43.2
Brazil (1989) <sup>a</sup>	8.0	9.4	50.1	13.2	12.1	40.4
Colombia (1985) <sup>b</sup>	5.5	5.4	34.4	7.8	7.0	26.9
Ecuador (1990)	3.5	5.0	40.6	3.0	3.9	29.3
Guatemala (1989)	29.2	38.9	74.9	16.9	20.3	64.6
Honduras (1988)	18.7	21.8	66.3	23.1	24.0	61.1
Mexico (1990)	4.1	6.2	43.2	3.7	4.4	30.6
Nicaragua (1985)	13.1	11.3	51.1	11.3	15.6	56.0
Panama (1990) <sup>c</sup>	3.9	4.2	26.3	2.7	3.0	25.3
Venezuela (1990) <sup>d</sup>	2.1	...	46.0	3.2	...	35.1

Source: Data from the following censuses: Bolivia, INE (1989), *Encuesta nacional de población y vivienda, 1988. Resultados finales*; Brazil, IBGE (1989), *Anuario estadístico do Brasil*; Colombia, DANE (1986), *Censo 1985*; Ecuador, INEC (1991), *V Censo de población y IV de vivienda, 1990. Resultados definitivos. Resumen nacional*; Guatemala, INE (1989), *Encuesta nacional sociodemográfica*; Honduras, Secretariat of Planning, Coordination and the Budget (1988), *Censo nacional de población, vol. I*; Mexico, INEGI (1990), *Resumen general. XI Censo general de población y vivienda*; Nicaragua, INEC (1989), *ESDENIC 85. Tabulaciones básicas, vol. I. Características generales de la población*; Panama, Department of Statistics and Censuses (1990), *Censos nacionales de población y vivienda. Resultados finales básicos*; Venezuela, Central Statistics and Information Office, Office of the President (1990), *Anuario estadístico*.

<sup>a</sup> The data for the oldest age group refer to persons aged 60 or over.

<sup>b</sup> In the case of Colombia, the age groups used were 12-17, 18-24 and 60 years or over.

<sup>c</sup> These data correspond to the category of "No grade successfully completed" in the 1990 census.

<sup>d</sup> Because other data are unavailable, the figures given for the 15-19 age group actually correspond to the age bracket of 15-24 years.

Although it is still too early to pass judgement on its actual impact, virtually all the countries with a significant percentage of indigenous peoples are in the process of institutionalizing intercultural, bilingual education in an effort to address this issue. There is a greater awareness of the complex and heterogeneous nature of linguistic and cultural realities, of the importance of the mother tongue and culture as tools of educational progress, and of the need to rescue the indigenous population from its current marginalization.

Despite all these efforts, however, because the majority of the indigenous population resides in rural areas, indigenous boys and girls often do not have access to complete schools, do not have teachers who are trained in intercultural bilingual education, lack bilingual textbooks and suffer from a shortage of resources in general. Nor is the integration of girls facilitated by the traditional role of women in rural areas or by the fact that their socialization as part of the labour supply begins very early on; within this environment, their parents resist their regular attendance at school because it distances them from that socialization process and prevents them from "contributing with their labour to the agricultural output and reproductive functions of their mother" (Zúñiga, 1989).

(b) *The educational situation of black women*

Here, a distinction needs to be made between countries having a black majority, such as many Caribbean nations, and those in which black women are a minority group. The position of Caribbean women is notable for the important role they play in their societies—as has been noted in many of the anthropological studies conducted in the Caribbean (Rivera, 1993)—and for the degree of their integration into the formal educational system. In 1990—with the exception of Haiti, where the rate of illiteracy among women (52.6%) was second only to that of Guatemala (52.9%) (see table 3)—the majority of Caribbean countries had female enrolment rates near or above the regional average (see table 4),<sup>2</sup> and in

many cases they exceeded the rates for males at the secondary and higher-education levels (ECLAC, 1991a; United Nations, 1992).

According to reports presented at the first Meeting of Black Latin American and Caribbean Women, which was held in July 1992 in the Dominican Republic and attended by over 300 representatives from 32 countries (León, 1992), in the other countries of the region black women's access to formal education is limited by both ethnic discrimination and their socioeconomic position. The latter factor has this effect because the black population in these countries is concentrated in the poorer sectors that have the least access to services and to the power structure. According to data cited at that conference, the Haitian women living in the sugar mill camps of the Dominican Republic, for example, have no chance of obtaining an education because there are no schools and no funds to pay for any; in Honduras, 48.3% of black women have not finished elementary school; in Uruguay, their level of education is low and 75% of those who work are employed as domestic servants; and in Brazil, only 11% of these women go on to secondary school (León, 1992).

The foregoing corroborates the findings of a study conducted by the Carlos Chagas Foundation on race and educational opportunities in Brazil, which states that the percentage of black and mulatto children who have never had access to the school system is three times as great as the percentage of white children in that position; the study also found that a larger proportion of non-white children enter school late and have to repeat grades or fall behind once they are in school (Hasenbalg and Do Valle Silva, 1990). It is noteworthy that, even under these conditions of glaring inequality, non-white Brazilian women's levels of educational attainment are slightly higher than those of their male counterparts.<sup>3</sup>

<sup>2</sup> In 1988, according to data compiled by UNESCO and CELADE (ECLAC/UNESCO-OREALC, 1992), the net school enrolment rate was 87.6% for the population between 6 and 11 years of age (primary education), 71.6% for young people between the ages of 12 and 17 (secondary education), and 27.2% for those between the ages of 18 and 23 (higher education).

<sup>3</sup> According to data from Brazil's 1982 national household survey, which was the last such survey in which the data are broken down by race and gender, the illiteracy rate among black and mulatto women was 38.3% versus a rate of 39.4% for men; 55.5% of these women had completed elementary school (as compared to 55.2% of the men) and 6.2% had a secondary education (5.4% of the men) (Valdés and Gomariz, 1992).

TABLE 3

**Latin America and the Caribbean (22 countries): Illiteracy rates and number of illiterates, by gender, 1990<sup>a</sup>**  
(Percentages and thousands)

Country	Illiteracy rates (%)			Number of illiterates	
	Total	Women	Men	Thousands (1990)	Variation (%) 1970-1990
Argentina	4.7	4.9	4.5	1 065	-12.6
Bolivia	22.5	29.3	15.3	923	-16.5
Brazil	18.9	20.2	17.5	18 407	6.6
Colombia	13.3	14.1	12.5	2 702	2.5
Costa Rica	7.2	6.9	7.4	139	15.8
Cuba	6.0	7.0	5.0	484	-36.3
Chile	6.6	6.8	6.5	603	-15.3
Ecuador	14.2	16.2	12.2	909	0.3
El Salvador	27.0	30.0	23.8	787	-6.4
Guatemala	44.9	52.9	36.9	2 253	39.3
Guyana	3.6	4.6	2.5	25	-34.7
Haiti	47.0	52.6	40.9	1 858	-9.9
Honduras	26.9	29.4	24.5	766	16.6
Jamaica	1.6	1.4	1.8	26	-31.6
Mexico	12.7	14.9	10.5	7 066	2.2
Panama	11.9	11.8	11.9	187	6.8
Paraguay	9.9	11.9	7.9	252	4.3
Peru	14.9	21.3	8.5	2 025	-8.0
Dominican Republic	16.7	18.2	15.2	744	0.1
Suriname	5.1	5.3	4.9	13	-45.3
Uruguay	3.8	4.1	3.4	88	-43.0
Venezuela	11.9	10.4	13.3	1 450	0.3

Source: UNESCO, *World Education Report 1991*, Paris.

<sup>a</sup> Refers to the population aged 15 or over.

Even in those countries of the region where the proportion of black women and men who have access to the educational system is larger, the women who gathered at the 1992 conference drew attention to the racist content of what is taught (in addition to the already acknowledged gender discrimination incorporated in the instruction given), which denies their ethnic and cultural identity and thus bars their access to an equitable education. This bias is reinforced by the stereotypes used in the media, which associate black women almost exclusively with servile or sexual roles. Thus, like indigenous women, black women are oppressed on the basis of three different attributes—their poverty, their race and their gender—

(León, 1992) and these various forms of oppression influence their educational process.

#### 4. Illiteracy

Despite the substantial progress that has been made in raising literacy rates, sharp differences still exist in the region between countries and, within any given country, among women in different socio-occupational categories (Schiefelbein and Peruzzi, 1991). At the regional level, the rates range all the way from a level of absolute illiteracy among women of 1.4% in Jamaica to 52.9% in Guatemala (see table 3). At the country level, cases may be found

TABLE 4

**Latin America and the Caribbean (24 countries):  
Enrolment rates, by age group and by gender, 1990**

Country	6-11 years			12-17 years			18-23 years		
	Total	Female	Male	Total	Female	Male	Total	Female	Male
Argentina	97.2	97.0	97.3	79.4	82.5	76.4	56.9	61.5	52.3
Barbados	...	...	...	89.4	87.9	90.8	28.4	27.4	28.8
Bolivia	87.9	85.7	90.1	54.2	48.3	60.1	27.8	21.3	34.5
Brazil	77.9	75.8	79.9	74.9	72.6	77.1	22.8	24.9	20.6
Colombia	80.4	81.6	79.2	71.1	71.9	70.3	26.2	24.1	28.3
Costa Rica	87.1	87.6	86.7	47.7	47.7	47.8	20.5	18.4	22.6
Cuba	97.4	97.3	97.6	80.2	80.8	79.7	38.0	40.8	35.3
Chile	90.5	89.5	91.5	91.2	90.8	91.7	29.0	27.7	30.2
Ecuador	92.2	92.8	91.5	75.5	73.9	77.0	48.7	47.6	49.7
El Salvador	70.8	72.0	69.7	53.8	55.0	52.6	21.2	21.8	20.5
Guatemala	56.9	54.3	59.3	43.4	38.9	47.6	15.3	10.3	20.1
Guyana	86.1	85.0	87.2	54.2	55.9	52.4	7.0	7.1	6.9
Haiti	59.7	58.7	60.7	55.0	52.3	57.8	13.7	12.4	14.9
Honduras	82.3	83.7	80.9	55.2	57.2	53.2	21.3	23.4	19.2
Jamaica	100.0	100.0	100.0	82.7	83.3	82.2	7.2	7.0	7.4
Mexico	100.0	100.0	100.0	68.1	66.3	69.9	23.4	20.0	26.8
Nicaragua	72.0	74.2	69.8	51.8	60.8	43.0	27.8	36.7	19.0
Panama	91.6	91.4	91.8	66.3	66.3	66.4	35.4	38.9	32.1
Paraguay	80.1	80.4	79.8	50.2	47.3	53.0	15.3	14.3	16.2
Peru	98.9	97.5	100.0	81.0	78.3	83.6	31.6	25.5	37.6
Suriname	99.4	99.0	99.7	93.9	93.9	93.9	14.2	14.1	14.3
Trinidad and Tobago	100.0	100.0	100.0	63.8	65.2	62.5	5.3	5.1	5.6
Uruguay	94.6	93.7	95.5	80.0	81.9	78.2	61.6	65.6	57.7
Venezuela	91.0	91.3	90.7	64.8	68.6	61.1	26.4	27.6	25.2

Source: UNESCO estimates cited in ECLAC (1994b).

where illiteracy rates among women are twice as high as among men (e.g., the urban areas of Bolivia, Guatemala and Haiti); in other instances, they are nearly double or even higher than that (e.g., in the rural areas, populated mainly by indigenous peoples, of Bolivia, Guatemala, Mexico and Peru) (see table 1). In addition to the above-mentioned effects of the generation gap in terms of illiteracy rates, the situation in these countries lends strength to the conclusion that female illiteracy tends to be greater among the lower strata of the population in both urban and rural areas (Letelier Gálvez, 1993).

Illiteracy has extremely serious consequences in terms of the status of women in society, not only because it prevents them from participating as active citizens in their groups and communities (which greatly restricts their access to development projects and renders women within such projects' target groups less able to take advantage of them) but also because their inability to read the laws and thus know their rights keeps them "trapped in the sexist canons" of the Latin American culture (Braslavsky, 1984).

### III

## The expansion of educational coverage

Despite the structural problems affecting education in Latin America and the Caribbean, women's educational status has improved significantly in recent decades thanks to both an overall improvement in their educational level and an increase in female enrolment in relation to male enrolment. In the 1980s population censuses were already showing up "not only the disappearance of the sharp differences in enrolment rates by gender that were seen in the 1950s, but also a reversal of the situation in half of the countries, where women have gained the advantage in access to primary and secondary education" (Schiefelbein and Peruzzi, 1991). Today, in the majority of the countries of the region, women are on an equal footing with men at the basic and secondary levels, and in a number of countries female enrolment rates in higher education are moving ahead of male enrolment rates (Valdés and Gomariz, 1992 and 1993; United Nations, 1992; ECLAC, 1994b).

#### 1. Preschool education

According to figures compiled by UNESCO (1992b) and FLACSO (Valdés and Gomariz, 1992 and 1993), in the 1980s pre-primary schools were serving a broadly equal number of boys and girls, with variations from one country to the next of one or two percentage points on one side or the other. A study conducted in Chile on the basis of the 1990 household surveys found that "at this level, gender-based differences are not observed, but income-based differences are in evidence, with attendance rising as one moves up the scale from one income quintile to the next" (UNICEF/Chile, MIDEPLAN, 1993). In fact, the private sector has played an important part in the education of those sectors which can afford to pay for preschool instruction, and its contribution in rural zones has therefore been limited. Consequently, the supply of pre-primary education favours the middle- and upper-income segments of the population, although some headway has been made in marginal areas through non-formal programmes.

The proposal put forward by ECLAC and UNESCO for improving the region's educational systems

places emphasis on preschool education as a means of resolving many problems that may arise later on in a child's education (ECLAC/UNESCO-OREALC, 1992). In view of the importance of getting women and men off to an equal start in the formal educational system, it is to be hoped that instruction at this level will be promoted by the Governments and made available to all social sectors once their countries reach the point where they can begin to seek out means of consolidating national educational coverage.

#### 2. Primary education

In respect of the status of women in primary education, data made available by the United Nations Division for the Advancement of Women indicate that in 1990 there were 96 women enrolled for every 100 men in the region; this average is on a par with the figures for the countries of Western and Eastern Europe, which have yet to be surpassed by any world region.<sup>4</sup> At the country level, this average reflects first-grade enrolment rates ranging from 54.3% of women between the ages of 6 and 11 (90 for every 100 men) in Guatemala up to 100% in Jamaica, Mexico and Trinidad and Tobago.

The problems that still stand in the way of efforts to make universal primary education a reality affect girls and boys alike. The main problems identified by UNESCO studies are the difficulty of serving boys and girls who live in the streets or in isolated zones (between 3% and 15% in most of the countries in the region); the absence of intercultural bilingual education programmes at the primary level in areas having large indigenous populations; delayed entry, which is particularly common among students from households at the lower socioeconomic levels; high temporary drop-out rates during harvest-time in rural areas; and the high rates of repetition resulting both from the above problems and from the poor quality of the education provided and the failure to gear the

<sup>4</sup> According to calculations by the Division, based on tables 2.3, 2.4 and 2.5 of the third version of the WISTAT database (indicators and statistics on women) maintained by the United Nations.

curriculum to the students' real-world environment (UNESCO, 1992a).

Although they may exhibit high repetition and drop-out rates in marginal urban and rural areas, women's academic performance is better than men's in all the countries for which figures that are broken down by gender can be obtained (Valdés and Gomariz, 1992 and 1993). The available data's lack of comparability does not permit the calculation of accurate regional rates, however. According to information compiled by ECLAC/UNESCO (1992), the rate of repetition is under 10% in only five countries, and it is only in another three countries that 80% of all students actually complete their primary schooling.

### 3. Secondary education

Women have greatly benefited from the expansion of secondary education in the region: not only have they reached enrolment rates similar to those of men, but they have actually surpassed those rates in 11 Latin American and several Caribbean countries, marking up a regional average of 109 women for every 100 men (see table 4). Although the coverage in rural areas is much lower for both sexes, the ratio between male and female enrolment rates at the secondary level has remained the same (see table 5). In other words, apart from indigenous populations—where the exclusion of women is an even more complex issue—women have held on to the progress they have made in secondary education in relative terms despite the structural problems existing within the educational system in the various countries. There is, however, one exception to this rule: the enrolment of women in technical secondary schools (especially in industrial subject areas) remains low “even in those countries which have opened up this type of instruction to women” (Schieffelbein and Peruzzi, 1991).

Although academic performance—measured in terms of drop-out and repeater rates, postponement of studies and the proportion of over-age students—is lower at the secondary level, women continue to outperform men in all the countries for which the relevant information is broken down by gender, regardless of the socioeconomic level or area of residence involved (Valdés and Gomariz, 1992 and 1993). It should be noted that the main reasons why women drop out of school appear to be economic demands and early pregnancy, but—partly because of the lack of data disaggregated by sex—the number of

young women who have dropped out of the formal school system in Latin America and the Caribbean is unknown. Another factor to be taken into consideration is that the serious deterioration in the social situation in the region has had numerous manifestations, including an increase in the percentage of young people who neither study nor work (ECLAC, 1994a).

### 4. Higher education

Although the expansion of higher education has been more limited than at the lower levels, higher education has also made considerable and quite rapid progress in the region,<sup>5</sup> though the extent to which women have shared in these advances varies sharply from country to country.

Thus, the regional rate calculated by the United Nations of 106 women for every 100 men enrolled in institutions of higher learning as of 1990—the highest proportion in the world—masks widely differing rates, ranging from 50 women for every 100 men in Guatemala to 200 women or more per 100 men in some of the small Caribbean countries (United Nations, 1992; ECLAC, 1994b). The differences are all the more striking when they are cross-classified with the differences found from one country to the next in the level of post-secondary studies attained by the population and the differences between urban and rural zones in a given country (see table 6).

When we look at students' selections of their main subject or area of specialization, we find that the percentage of women choosing to specialize in what have traditionally been thought of as “masculine” fields has increased, especially in countries suffering from severe educational shortcomings (Valdés and Gomariz, 1992 and 1993). This shift has still not been extensive enough to do away with the segmentation of women's career choices, however. The real problem here is a form of sex-based discrimination, and the situation is quite similar to what occurs in industrialized countries, where a large percentage of women are concentrated in courses of study leading to careers that have more flexible working hours or that are more compatible with a greater commitment to domestic tasks, and in which

<sup>5</sup> Gross enrolment rates at the tertiary level (higher education) climbed from an average of 3% in 1960 to 19% in 1990.

TABLE 5

**Latin America (12 countries): Levels of schooling  
of rural population, by gender**

Country	None or less than 1 year		Primary level		Secondary level		Higher education	
	Women	Men	Women	Men	Women	Men	Women	Men
Bolivia (1992)	40.0	18.1	44.7	61.4	5.4	12.2	0.3	0.8
Brazil (1988)	32.6	37.7	55.0	52.6	9.7	7.1	2.5	2.5
Colombia (1985)	21.3	21.1	62.8	64.1	11.9	10.7	0.4	0.5
Costa Rica (1992)	7.9	8.2	66.4	67.3	21.7	20.2	3.5	3.5
Cuba (1981)	5.9	5.1	67.5	61.2	25.9	32.8	0.7	1.0
Chile (1989)	0.6	0.8	63.5	66.6	17.0	14.8	0.9	1.1
Ecuador (1990)	24.0	16.2	51.2	56.2	15.0	17.2	2.9	3.6
Paraguay (1982)	18.7	11.4	71.7	76.7	6.4	9.3	1.0	0.8
Peru (1991-1992)	21.8	8.3	60.9	64.5	14.4	23.3	2.4	3.2
Dominican Republic (1991)	29.8	29.4	57.4	56.4	10.7	11.9	1.5	2.1
Uruguay (1985)	7.6	9.0	70.6	72.5	19.6	16.2	0.9	1.0
Venezuela (1981)	37.9	25.2	54.4	67.9	7.5	6.5	0.3	0.4

Source: Valdés and Gomariz (1992 and 1993).

TABLE 6

**Latin America (12 countries): Level of schooling of  
population in urban (U) and rural (R) zones of each country <sup>a</sup>**

Country	None or less than 1 year		Primary level		Secondary level		Higher education	
	U	R	U	R	U	R	U	R
Bolivia	17.4	29.0	43.4	53.1	24.6	8.9	6.7	0.5
Brazil	12.3	35.1	66.9	53.7	13.3	8.5	7.4	2.5
Colombia	7.2	21.2	42.5	63.5	41.2	11.3	7.6	0.4
Costa Rica	5.8	8.1	55.0	66.8	29.1	20.9	9.3	3.5
Cuba	3.5	5.6	43.3	64.0	47.6	29.6	5.6	0.8
Chile	0.5	0.7	41.8	65.2	41.6	15.8	7.9	1.1
Ecuador	5.3	20.0	31.5	53.7	41.3	16.1	17.7	3.2
Paraguay	10.6	14.9	63.5	74.3	18.2	7.9	5.6	0.9
Peru	6.8	15.0	42.8	62.7	33.3	18.9	16.7	2.8
Dominican Republic	17.5	29.6	49.5	57.0	22.9	11.3	10.0	2.1
Uruguay	5.0	8.5	51.9	71.8	37.3	17.5	5.0	1.0
Venezuela	15.1	31.1	56.8	61.6	23.4	7.0	4.7	0.3

Source: Valdés and Gomariz (1992 and 1993).

<sup>a</sup> Brazil: the urban population corresponds to the south-eastern region, while the rural population corresponds to the north-eastern region; Bolivia, Chile, Costa Rica, Paraguay, Peru, Dominican Republic, Uruguay and Venezuela: total urban population.

there is less risk of sex-based wage discrimination (ECLAC/UNESCO-OREALC, 1992). Thus, the source of discrimination is not so much an effort on the part of the educational system to make distinctions as a means of openly putting women at a disadvantage,

but rather the fact that this system is part of a larger society, and the opportunities it offers are therefore used differently by women and men in accordance with the dominant values and beliefs of that society (Varela, 1991).

## IV

### Socio-cultural obstacles faced by women in the educational system

These sexist traits are connected with the tendency in Western thinking to divide up and classify people, capacities and activities by gender, as part of an attitude that “diminishes, excludes, under-represents and stereotypes people on the basis of their sex” (Abu Nasr, Lorfing and Mikati, 1983, cited by Michel, 1989). This is the source of the overvaluation of “masculine” views and outlooks and of the silencing of the “feminine” perspective in academia, and it is subsequently reproduced in the stereotypical content of instruction, in the failure to pay an equal amount of attention to girl students in the classroom, and in fewer job opportunities for women. In the following section we will see how sexual stereotypes, teachers’ attitudes and gender segregation in labour-market orientation may help to distort girls’ individual opportunities and to oblige them to internalize their subordinate position in society (Subirats, 1990).

#### 1. Sexual stereotypes in education

A careful examination of the studies that have been carried out in the region on the content of teaching materials –textbooks, illustrations, films– used at the elementary and secondary levels of instruction in the vast majority of the Latin American and Caribbean countries confirms the existence of gender discrimination. The point of departure for a study focusing on this type of discrimination may be such indicators of sexism as the frequency of the presence of females and males, their participation in work-related activities and in domestic and household activities, the descriptive adjectives used to refer to one or the other sex, and leadership situations (Chile, National Women’s Service (SERNAM), 1992). According to an analysis of school textbooks in Belize (Laaksonen, 1991), Chile (Chile, National Women’s Service, 1992), Costa Rica (Costa Rica, Ministry of Culture, Youth and Sports/Ministry of Public Education, 1991), El Salvador, Guatemala and Panama (Caldera, 1990), Peru (Valdés and Gomariz, 1993) and Uruguay (Piotti Núñez, 1990; Valdés and Gomariz,

1992), the texts and other books that were examined referred to women in fewer than 30% of the leadership situations mentioned and depicted them as occupying socially inferior, weak or subordinate positions (Caldera, 1990). In Venezuela, a study of sexual stereotypes in school textbooks used at the preschool and basic levels classified such stereotypes as belonging to one of three categories: the exaggeration of behavioural traits, household or professional roles, and group relationships. Thus, a glaring mismatch was observed between Venezuelan society as it actually is and the models presented in the texts, which were constructs corresponding to “social situations of the past” (Montero, 1993).

This discrepancy between reality and models is precisely what stereotypes are –i.e., “rigid, anonymous models which serve as the basis for the reproduction, in a mechanical manner, of images and forms of behaviour” (Dunningan, cited by Michel, 1989). This may be expressed openly, as in the case of school curricula that guide boys and girls towards typically “masculine” or “feminine” disciplines, or in a veiled manner, as in the omission of certain qualities or roles from among the options presented to girls and boys (Michel, 1989). For example, the textbooks used in the various countries of the region primarily depict women as idealized versions of mothers and housewives (Piotti Núñez, 1990; Torres, 1993) and lead the reader to believe that men play the important roles in both the public and private spheres of life. When women are presented as taking public action, they are usually shown to be engaging in activities that have traditionally been regarded as feminine. Dynamic forms of action that demand effectiveness and productivity or that have to do with guidance or leadership are attributed almost exclusively to men (Valdés and Gomariz, 1992). These stereotypes do harm to girls’ self-image and identity, and perpetuate the beliefs underlying gender discrimination (Rico, 1994).

In the wake of these studies on the content of teaching materials in the above-mentioned countries,



a number of Governments have begun to modify the textbooks now in use and to present models of women in the region that are more in line with reality. As a result, the types of images of women that are being presented are somewhat more numerous, although they are still in a minority. Greater flexibility is also beginning to be introduced in the characterization of traditional roles, and women may now be depicted as being more active in the public sphere, while men may be shown as participating in household chores and child-rearing. However, school curricula have yet to be reformulated in such a way as to acknowledge the value of the contributions made by each of the sexes and to present a balanced picture of both.

The problems involved in designing teaching materials that reflect what are as yet incomplete socio-cultural changes are certainly formidable, and it should therefore come as no surprise that educational authorities have difficulty in producing textbooks that are in keeping with the times. At present, this has led to the use of ambiguous materials in which contradictory models overlap one another and which do not help students to arrive at a clear idea of what direction they wish to take in life. In the place of the old stereotypes, there is an accumulation of "models, modes of behaviour and attitudes that do not necessarily provide a broader range of options or new horizons, since the assignment of priority to reproductive roles within the family still appears to be inevitable. At the same time, men's models are changing more slowly, and this means that the context for any innovations that arise will be an unbalanced process of change in gender images" (Rico, 1994).

One approach to the problem that has sparked a great deal of interest in the region is the integration of women's issues and the gender perspective into the teaching of history at all levels of the formal educational system. The incorporation of women's history into academic culture would reaffirm women's leadership roles in society and thereby help young girls to develop an identity and a feeling of self-worth. By promoting a more complex and modern view of history, it would also help to democratize the educational system and introduce the study of the black and indigenous cultures (León, 1992). In order to accomplish this, historical research will have to be undertaken and the cooperation of both educational authorities and academic institutions will be required. The challenge being confronted here is

how to go about shaping a common societal agenda in which all citizens –both women and men– can participate and which makes room for diversity and different identities.

## 2. The role of teachers

Another fundamental factor in the democratization of the formal educational system is the role played by teachers; this is because a student and his or her teacher form a power relationship involving pedagogic elements, social aspects, communication and the transmission of skills and knowledge, and this relationship constitutes the most decisive element in the learning process within the school (Labourdette, 1989). For these same reasons, teachers "may play a very important role either in the perpetuation of sexist stereotypes and prejudices or in their refutation and elimination" (Rico, 1994).

Thanks to the contributions made by a number of studies on the presence of gender discrimination in the educational system, there is a growing awareness in the region of just how important the teacher-student relationship is in the transmission of sexual stereotypes. Second only to the family, the classroom is where young girls and boys experience the hierarchization of the social roles and models which society is going to impose upon them in the form of attitudes and modes of behaviour. The way in which teachers support, encourage or ignore the demands for attention made upon them by the girls and boys in class sends implicit messages to those children about the norms of the society that surrounds them and prepares them to adapt to those norms. For example, a study conducted in Chile has demonstrated that both male and female teachers pay more attention to boys in class in terms of going over their homework, asking them questions and disciplining them. Because girls tend to be better students and to observe institutional rules more readily, their teachers perceive them as being less creative and less capable of acting as leaders than boys (Rossetti, 1988 and 1992). Another study on teachers of both sexes in Ecuador found that 72% of them felt that women had less of an aptitude for technology-related subjects and three out of ten of these teachers felt it was their obligation to guide students towards careers that were "appropriate for their sex" (Robalino, Villanueva and Isch, cited in Rico, 1994).

Training teachers –both men and women– in such a way as to sensitize them to the consequences

of their conduct and encourage them to transform their classrooms into a place where students can learn about the cultural changes occurring in the outside world is all the more important in view of the fact that the majority of the teachers in the educational systems of the region are women. According to figures gathered by FLACSO throughout the region for its statistical compendium *Mujeres latinoamericanas en cifras* (Valdés and Gomariz, 1992 and 1993), in the vast majority of the countries in the region, almost all the teachers at the preschool level, three-quarters of those at the elementary level and half of the teachers in secondary schools are women. Women are in the minority, however, in higher education.<sup>6</sup> Teacher training colleges are the only exception, where women are in the majority in both the faculty and the student body. Women are not a major presence in senior executive or administrative posts either, and little effort has been made to train teachers to adopt a proper gender perspective; this situation tends to perpetuate a vicious circle between their own situation and the reproduction of a gender-based discriminatory bias within the educational process.

The implications of this state of affairs were discussed by women teachers in Paraguay in July 1991 when the Public Educators' Network organized a campaign "for non-sexist education". At seminars attended by teachers from both public and private schools, these educators stated quite clearly that "they felt they were not held in high regard and were not considered to be direct agents of educational reform" (ECLAC, 1992).

### 3. Gender segregation in vocational guidance

In order to do away with gender-based discrimination in the formal educational system, it is important not only to take action within the educational process as such but also to look at that system from the standpoint of labour and of the demands generated by production processes. Steps need to be taken to rectify the inequality of educational opportunities for women that stems from the role they are assigned in

the social development process, where they are regarded as factors of reproduction rather than social actors in full possession of their rights (Dasso and Montañó, cited in ECLAC, 1991b).

Given the ways in which production patterns are now changing in the region and the new types of demands that this process is generating in the labour market, women's participation in scientific and technological progress and in the production of knowledge in general needs to be significantly increased; this will, in turn, influence the definition of production, the sexual division of labour and the cultural values of society; in addition, a determined effort to increase the level of activity in the area of technical education is needed in all the countries. Furthermore, at a time when the region is beginning to address the urgent need to update the way in which management principles are being taught and adapt them to the requirements of modern-day enterprise, it is also important for women to be initiated into new forms of leadership, management and decision-making.

In many countries of the region, the advances made by women in the field of education in the past three decades have enabled the women in the economically active population (EAP) to attain a higher level of education than their male counterparts (see table 7). It has also been estimated that in most of the countries in the region, women who hold skilled jobs have an average of two more years of formal training than men who hold equivalent jobs (ECLAC, 1991b; Psacharopoulos and Tzannatos, 1992). Even though women make up about 50% of the student body in secondary schools and institutions of higher learning, however, "a clear difference exists in terms of the type of training selected by men and women, with a number of cases where the percentage of women is smaller in vocational schools than in normal schools" (Parada, 1991).

The resulting segmentation as between men and women affects the development potential of society as a whole as well as of women themselves. For example, at the close of the 1980s, fewer than 35% of engineering graduates were women in four countries in which the development of the production sector is a key factor of economic and social progress.<sup>7</sup> This

<sup>6</sup> 22.6% in Colombia, 34.2% in Costa Rica, 45.0% in Cuba, 17.8% in Ecuador, 19.0% in Guatemala, 33.9% in Panama, 15.2% in Paraguay, 21.7% in Peru, 34.0% in Uruguay and 37.4% in Venezuela.

<sup>7</sup> Brazil: 15.2% in 1988; Colombia: 27.1% in 1986; Cuba: 34.8% in 1989; Venezuela: 34.6% in 1988 (Valdés and Gomariz, 1992 and 1993).

TABLE 7

**Latin America (12 countries): Economically active population,  
by gender and by years of schooling**

Country	None or less than 1 year		Primary school		Secondary school		Higher education	
	Women	Men	Women	Men	Women	Men	Women	Men
<b>Brazil</b>								
1988	14.1	18.8	56.5	61.3	29.1	19.7	...	...
<b>Colombia</b>								
1985	10.4	12.0	44.9	51.4	33.9	27.8	7.7	8.8
1989	2.8	1.8	32.8	32.4	49.2	46.9	15.1	18.9
<b>Costa Rica</b>								
1990	3.1	5.4	43.3	57.3	34.5	26.6	18.0	9.7
<b>Cuba<sup>a</sup></b>								
1980	...	...	35.9	51.0	47.8	36.7	16.3	12.3
1986	...	...	18.6	26.5	57.1	55.4	24.3	18.1
<b>Chile</b>								
1989	0.3	0.4	35.7	45.9	45.3	38.1	13.2	9.1
<b>Ecuador</b>								
1982	13.8	15.1	35.2	53.1	28.6	16.7	14.1	7.1
1990	10.4	9.8	32.2	45.9	31.9	27.5	20.6	11.9
<b>Panama</b>								
1991	2.4	6.6	23.1	41.8	46.5	36.5	28.0	15.1
<b>Paraguay</b>								
1982	6.1	7.7	56.1	68.7	29.6	18.7	6.3	3.1
<b>Peru</b>								
1981	20.8	10.5	34.5	49.1	24.5	28.2	16.8	10.2
1987 <sup>b</sup>	3.3	0.8	25.9	19.7	51.8	55.4	19.0	24.1
<b>Dominican Republic</b>								
1991	10.5	16.9	42.9	48.4	25.5	19.3	18.1	9.6
<b>Uruguay</b>								
1985	1.9	3.3	40.5	52.9	47.7	37.5	9.0	5.9
<b>Venezuela</b>								
1987	6.4	10.9	34.8	46.7	44.7	33.4	14.1	8.8

Source: Valdés and Gomariz (1992 and 1993).

<sup>a</sup> Civilians in State sector.

<sup>b</sup> Population of the Lima metropolitan area.

state of affairs is even more ominous over the long term because the most conspicuous feature of the current occupational cycle is not a decline in the number of jobs, but rather the fact that the swift pace of technological innovation is rapidly outmoding certain skills and areas of expertise (ECLAC, 1994a), as a result of which women are being left further and further behind.

According to studies sponsored by the World Bank in 15 Latin American and Caribbean countries concerning the relationship between women's participation in the labour force and their level of education and pay rates, career choice is also a very influential factor in wage discrimination against women. These studies have found that women's participation in the labour market rises sharply as their number of years

of formal schooling increases, especially at the levels of technical secondary and post-secondary training, and that education is a factor of overriding importance in determining the income levels of women as well as men. Nevertheless, education's "rate of return" in terms of income has remained lower for women in all 15 of these countries. According to the authors of these studies, this fact cannot be accounted for by shortcomings in human resources development but is instead due primarily to discrimination in the labour market and to occupational choice (Psacharopoulos and Tzannatos, 1992).

Thus, career choice is not only a crucial element in terms of an individual's development; it also has a strong influence on people's opportunities for participating in society and, by determining their income level, on the quality of their living conditions. Taking these findings into consideration, an analysis of the segmentation characterizing women's enrolment in secondary and higher education indicates that women's increased presence at these levels does not necessarily mean that "a change is taking place in the social status of each sex, although there may be some redefinition of occupational roles together with a qualitative change which as yet is difficult to evaluate" (Rico, 1994).

Whether at the level of secondary-school vocational training or higher education, a large majority of women choose to study subjects that are an extension of their traditional roles and that "do not alter the sexual division of labour from a symbolic standpoint or have any real influence on inter-gender hierarchies" (Rico, 1994). For example, in such disparate countries as Cuba and Paraguay, in secondary vocational and technical schools, women are in the majority in those courses of study having to do with public health, economics and art; they are on a par with men in subjects dealing with the chemical and food industries; they are in the minority in traditionally masculine fields such as metallurgy, construction and agriculture; and they are entirely absent from others, such as mechanics, carpentry and graphic arts (Valdés and Gomariz, 1992 and 1993).

Research has also confirmed that in higher education, despite the changes that have taken place and the increasing redistribution of women students among a broader range of career possibilities, women tend to congregate in the fields of education, the humanities, the arts, social science and certain disci-

plines in the health sciences, such as nursing, obstetrics, nutrition and dentistry. There are promising signs that women may soon be on an equal footing with men in the fields of management, economics, architecture, urban planning, law and chemistry, which have until now been regarded as prestigious, traditionally masculine careers.<sup>8</sup> Meanwhile, engineering and the natural and exact sciences continue to be a male preserve; this state of affairs, which is particularly notable when the percentages of women students in these fields are disaggregated by discipline,<sup>9</sup> leads to the exclusion of women from activities involving technological innovation and the generation of knowledge.

The enrolment figures for vocational schools reveal a close correlation between the proportion of women students and the types of specializations offered, with the percentage of women falling to negligible levels in occupational fields traditionally associated with men. In view of these factors, a recent study on women's contributions to economic growth in Latin America and the Caribbean concluded that training in this field has not opened up new vistas or income-earning opportunities for women but has instead guided them towards traditional, low-income occupations, thereby perpetuating the differences in the opportunities open to men and women in the production sector (Buvinic and Lycette, 1994).

<sup>8</sup> Recent studies suggest, however, that these careers are beginning to be thought of as "options for women" (Varela, 1991), which would seem to be leading to "a steady decline in their status based on impressions of what is going on in the labour market" (Rico, 1994).

<sup>9</sup> If, for example, the figures on the women students specializing in these fields in the public and private universities of Peru are broken down by area of study, the situation was as follows in 1986: chemistry: 23.9%; fisheries: 22.8%; industrial engineering: 17.1%; civil engineering: 11.2%; geology: 4.4%; electronics: 2.8%; mining: 2.2%; and mechanical engineering: 0.9%. If the same sort of disaggregation is performed for the natural and exact sciences, the results indicate that there are clear-cut differences underlying the nearly equal proportions of men and women in these fields and that those differences correlate with the status of the various disciplines. Thus, in Peru, as of 1986 the percentages of female enrolment in each area of study were as follows: 53.1% in chemistry, 43.8% in biology, 31.4% in zoology, 15.6% in agronomy, and 8.8% in physics (Valdés and Gomariz, 1992 and 1993).

## V

### Some final thoughts

Just as the educational system permits the reproduction of traditional models, this system's structure can also spur the development of new models. In order for this to happen, however, a country must have the political will to question the cultural content of education and must be able to elicit the participation of all the social agents positioned within the system's structure: national and educational authorities; educators; textbook authors, illustrators and publishers; employers; society at large; and women's organizations. Along these same lines, in their proposal for upgrading the educational systems of Latin America and the Caribbean, ECLAC and UNESCO emphasize that a multi-faceted effort will be needed in order to change the pattern of education in the region (ECLAC/UNESCO-OREALC, 1992).

In practical terms, the aim is to modify a socialization process—which begins in the home, continues in the schools and is reaffirmed by the social environment—which currently defines gender identities that stress differences and breed subordination and asymmetrical power relationships. The objective is to overhaul these inter-gender referential and relational patterns with a view to fostering a different kind of

environment in which roles will be more flexible and both men and women can develop their potential as individuals and citizens. As applied to the design of a proposed curriculum, this would involve rectifying the androcentric biases underlying the theory and praxis of education and identifying their repercussions in terms of the living conditions, growth, personal development, integration into the workforce and social participation of students of both sexes.

In sum, public policies aimed at increasing the benefits of formal education for women should, first and foremost, be directed towards assisting women in all social sectors of the region to become fully-fledged citizens of modern society who enjoy equal opportunities in both education and the labour market. The strategies to be proposed should also lead to the elimination of sexual stereotypes from the educational process, improvement of the status of girls and women at all levels of formal and non-formal education, and the furtherance of research on the reciprocal relationships existing between culture and education, inasmuch as culture is both the matrix and the outcome of the educational process.

(Original: Spanish)

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# Labour market *flexibility:* what does it *really mean?*

**Ricardo A. Lagos**

*Consultant to the  
International Labour  
Office and Coordinator  
of the ILO/UNFPA  
Regional Project on  
Population, Poverty and  
the Labour Market in  
Latin America.*

The 1980s witnessed the emergence of the concept “labour market flexibility” (LMF) in industrialized countries as well as in some developing countries. As a consequence of poor economic performance in the early 1980s, the view that the way in which labour markets operated constituted a significant obstacle to economic growth gained support at the level of policy makers, employers in general and, not least, in part of the academic establishment. The problems with the labour market were blamed on its “rigidity” in terms of the price of labour, conditions of employment and the quantity and quality of manpower, and this rigidity was blamed in turn on institutional constraints, social policies, legislation and collective agreements, centralized bargaining, trade union action and/or governmental guidelines. The focus, then, was on eliminating a variety of rules and regulations which were felt to make the labour market rigid and thus prevent it on the one hand from absorbing the labour supply, and on the other from adapting to the requirements imposed by technological change and external competition. This paper therefore reviews the meaning of the concept “labour market flexibility” and identifies the various forms which it may assume and their rationale, noting that labour markets in Latin America have undergone substantial flexibilization but there have not been any substantial changes on the institutional side.

# I

## Introduction

The 1980s witnessed the emergence of the concept "labour market flexibility" (LMF), in industrialized countries as well as in some developing countries, together with the accompanying debate. As a consequence of poor economic performance in the early 1980s—marked by stagnation of growth, rising levels of unemployment and inflation—the view that the way in which labour markets operated constituted a significant obstacle to economic growth gained support among policy makers, employers in general and, not least, part of the academic establishment. The perception that traditional means of controlling unemployment and resuming economic growth had failed (i.e., the breakdown of the Keynesian consensus), the contrast between the economic performance of the United States and Japan in terms of employment creation and the mediocre showing of Western Europe in that respect, and the pressure of external competition both from other developed countries and from the newly-industrialized Asian countries (NICs), led to the belief that the problems lay at least partly in the functioning of the labour market: specifically, in its "rigidity" in terms of the price of labour, conditions of employment and the quantity and quality of manpower.

This rigidity or lack of flexibility was seen as a consequence of institutional constraints, social policies, legislation and collective agreements, centralized bargaining, trade union action and/or governmental guidelines. The focus, then, was on eliminating a variety of rules and regulations which made the labour market rigid, on the grounds that

such rules prevented the labour market from, on the one hand, absorbing the labour supply, and, on the other, adapting to the requirements imposed by technological change and adjusting to external competition. From this viewpoint, labour markets not only became part of the diagnosis of the economic difficulties but also of the remedies for overcoming them.

Starting from this basic and simple diagnosis that there was a need for less rigid employment relations, the conceptualization of what is understood by LMF has led to various and more complex forms of flexibility—forms which reflect the different types of flexibility demanded or required in certain economies and the different approaches or views on flexibility itself.

The purpose of this paper, then, is to review the meaning of the concept "labour market flexibility" and to identify the various forms it can assume and their rationale. In order to do this, section II discusses the concept of flexibility. Section II goes on to analyse the different forms of LMF, while section IV deals with the issue of LMF in Latin America, noting that labour markets have undergone substantial flexibilization but there have not been any substantial changes on the institutional side. Finally, section V presents some concluding remarks. It must be pointed out that this article does not discuss whether (greater) flexibility is desirable or whether it is a welcome contribution to labour economics. Though the interest of these latter topics cannot be denied, the scope of this paper is much narrower (and, certainly, less exciting).

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## II

### The concept of flexibility

As often happens with widely and extensively used terms, LMF has proved to be difficult to define. Economists have traditionally applied the word flexibility to the "capacity of [nominal] wages to rise and fall with the state of the labour market" (Piore, 1986, p. 146). However, as the debate on LMF has progressed, the concept of flexibility has been extended to the point that nowadays it implies the idea of a capacity for adaptation.

In fact, nowadays it is this latter aspect which has become more relevant when referring to the issue of LMF. For example, according to the Organization for Economic Cooperation and Development (OECD), flexibility refers to "...the ability of individuals and institutions to abandon established ways and adapt to new circumstances..." (OECD, 1986a and 1986b, p. 7). For Michon, "flexibility becomes imperative in a context of rapid change: it signifies an aptitude for change" (Michon, 1987, p. 154). Atkinson maintains that flexibility alludes to "...changes to institutional, cultural and other social or economic regulations and practices which permanently increase the capacity to respond to change..." (Atkinson, 1987, p. 88). Standing argues that at an abstract level "flexibility... means responsiveness to pressure" and that "to be flexible is to be responsive to pressures and incentives and to be able to adapt to them" (Standing, 1986a, p. 6). For Boyer, flexibility refers to "the ability of a system or subsystem to react to various disturbances" (Boyer, 1987, p. 113).

The above definitions have the characteristic of being uncommitted with regard to the actual content of LMF, for they do not specify the means through which the adaptation to the new circumstances should be made –which is precisely *the* contested issue concerning LMF. Besides, this neutrality not only does not prejudice on the means but also leaves the door open to the possibility that "the same need to adapt may be satisfied by very different forms of flexibility" (Meulders and Wilkin, 1987, p. 5).

Nevertheless, the discussion on LMF rarely takes place on the basis of these general concepts. In more specific and narrow terms LMF expresses the notion that employment practices should be adaptable to

changes in the economic cycle and technological change. For instance, the International Labour Office (ILO) views LMF as "the capacity of the labour market to be adapted to economic, social and technological circumstances" (ILO, 1986a, pp. 4-7). The OECD understands LMF as an adjustment of all real costs of labour to variations in economic conditions (OECD, 1986a). For the International Organisation of Employers, LMF means the capacity to adapt relative labour costs between enterprises and occupations or adaptation of the costs of factors of production to market conditions (International Organisation of Employers, 1985). Lastly, for American businessmen flexibility is associated with "efforts to convert the traditional highly integrated, hierarchical corporate structure into a more supple organizational form capable of responding quickly to shifting market conditions and product demand" (Piore, 1986, p. 146).

It is at this more specific and narrow level that the concept of flexibility becomes both more diverse and more loaded, since the definitions tend to concentrate on the specific means for achieving the adaptability of employment practices to particular conditions.

The diversity is seen in different emphasis. For instance, despite the common emphasis in both the United States and Europe on seeking less rigid employment relations, the concept of LMF has progressively taken on different meanings as a consequence of the different systems of industrial relations prevailing in each country, and thus different employer's needs. Thus, in the United States the flexibility debate has been mainly related to the freedom to deploy labour within the enterprise, whereas in European countries the main concern in the first half of the 1980s was with the freedom of employers to lay off and discharge workers in response to economic conditions, while by the second half of the decade the debate also centered on making flexibility more compatible with employment security. Moreover, the flexibility issue has also been present in some developing countries, where emphasis has been on the reform of labour laws which affect job security and lower indirect labour costs (Tokman, 1989, p. 39).

Moreover, on looking more closely at the different views on LMF one notices that the concept has become loaded or biased in certain directions. One view maintains that flexibility is merely the rational response, at the labour market level, to changes in the economic environment. Flexibility, it is held, consists of adjustments of the labour force and hours of work and/or the wage structure to unstable and fluctuating economic conditions. It is argued that adjustment to changes is slow and insufficient due to institutional rigidities—a circumstance that calls for the introduction of more flexible employment relationships (OECD, 1986b).

Another view maintains that flexibility is a euphemism for changing power relationships in the production process and for growing labour insecurity: it is only a fashionable catchword disguising attempts to reverse the gains made by workers during the post-war years.<sup>1</sup> Flexibility conceals the employers' desire to become more competitive by making conditions of employment less secure rather than by introducing advanced technology or promoting a

better-trained workforce. It is argued that flexibility has the hidden purpose of depressing real wages, ending the protection of workers, and speeding up the pace of work (European Trade Union Institute, 1985).

Without entering into the above discussion, suffice it to say that both views stress meaningful aspects of the debate. On the one hand, the need to introduce changes in labour institutions does seem to be necessary as a consequence of changes in economic conditions, expressed in greater trade liberalization and the globalization of markets, technological change, changes in the organization of production, and new patterns of international labour flows. On the other hand, the introduction of greater flexibility has been associated with negative effects for workers: income inequality, loss of jobs, and the various ways in which workers' conditions became more precarious (Harrison and Bluestone, 1987; De Bandt, 1991). These two aspects require the construction of formal mechanisms (i.e., new regulations) which reduce the costs of flexibility and at the same time promote changes in labour institutions.

### III

## Different forms of labour market flexibility

As mentioned above, the conceptualization of LMF assumes different forms, depending on the particular aspects which are emphasized as ways of achieving greater degrees of flexibility. In the following pages, an attempt is made to identify these forms and explain their rationale. With this in mind, three different types of flexibility are reviewed: labour cost flexibility, numerical flexibility and functional flexibility.

#### 1. Labour cost flexibility

Of the many forms of rigidities likely to impede the smooth working of labour markets, rigidity of labour costs is the most debated. "Labour cost flexibility" is understood to mean the degree of responsiveness of nominal wage and non-wage costs to changes in economic conditions in general (e.g., inflation, productivity, terms of trade, demand) and/or the performance of individual firms. Labour cost flexibility, therefore, involves two elements: wage and non-wage costs. The first refers to the gross remuneration paid to the wage earners. Non-wage or indirect costs refer to mandatory costs and charges paid by the employer (e.g., fringe benefits, payroll taxes, workers' compensation insurance, etc.).

The claim made by advocates of this form of flexibility is that an important element—though not the only one—behind high levels of unemployment is

<sup>1</sup> It is argued that the expression "labour flexibility" is in itself a loaded term. The term "flexibility" bears a positive connotation, the ability to adapt to circumstances, whereas its opposites "inflexibility" or "rigidity" have clear pejorative connotations. In this context, if labour or labour markets are becoming more flexible, then that must be socially and economically desirable (Standing, 1986a, p. 2).

the downward rigidity of wage costs.<sup>2</sup> In fact, a widely disseminated view argues that the absence of this type of flexibility explains to a large extent the different employment performance of the United States and Europe after the two oil shocks. It is argued that in many European countries, unlike the United States, real labour cost inertia caused the main adjustment to the oil shock and the productivity slowdown to take the form of quantity adjustments (i.e., declines in employment) rather than price adjustments (i.e., wage adjustments) (OECD, 1986b, pp. 9-10; Sachs, 1983).

Moreover, non-wage costs –which have increased faster than wages themselves– also bear some responsibility for the high levels of unemployment. Since their contribution to total labour costs is significant, they provide an incentive to replace labour by capital (Sarfati and Kobrin, 1988, p. 8).<sup>3</sup>

In this analysis, one way of reducing unemployment and introducing wage flexibility is to remove or relax the various barriers that prevent wages from adapting. The most frequently cited barriers include wage-indexing, guaranteed minimum wages, high levels of unemployment benefits, and high non-wage costs. It is maintained that the type of flexibility thus obtained constitutes a source of job creation and reduces unemployment. The rationale is that the drop in wage cost should increase profits and stimulate investments, resulting in more jobs. Moreover, as the cost of labour falls relative to the cost of other factors of production the capital/labour substitution ratio should be modified in favour of labour.

The view favouring the removal or relaxation of minimum wages relates to two aspects. Firstly, to the extent that wages reflect individual productivity more accurately (due to the reduction or removal of minimum statutory wages), some potential low-wage jobs may be generated and thus employment opportunities will increase for those priced out of the labour market by high and rigid wages.

<sup>2</sup> Freeman finds, for a given output performance, a significant real wage/employment trade-off across OECD countries and across industries within countries (Freeman, 1988, p. 77).

<sup>3</sup> These authors also noted that high non-wage costs “discourage the recruitment of certain categories of workers in respect of which they are relatively high (young workers in particular)”.

Secondly, by abolishing or relaxing statutory minimum wage requirements it is believed that unemployment of young people could be reduced (Clarke, 1985). It is argued that in general young workers have few skills directly of value to an employer; that they are unused to work discipline; and that they have little firm commitment to a particular occupation or industry, thus giving rise to high turnover rates. Under these circumstances, young workers present higher recruitment, screening and training costs for employers and, it is argued, their wages should reflect these differences in costs and productive value in relation to those of adult workers. If not, employers will prefer to hire adults.

The above reasoning has been questioned on several grounds. Firstly, it is often disputed that greater degrees of wage flexibility will lead to lower levels of unemployment. Some studies indicate that a sharp general fall in wages would do little to reduce unemployment (Boyer, 1988, pp. 237-239).

Secondly, it is pointed out that the theoretical framework underlying the call for greater wage flexibility (i.e., the neoclassical analysis of labour demand) is open to question (Rosenberg, 1989b, p. 396). Rosenberg refers to a study by Bowles and Boyer where a macroeconomic model is developed “that takes account of the influence of the wage on both aggregate demand and the endogenous determination of output per labour hour, and finds that the level of employment may respond either positively or negatively to particular changes in the real wage rate”.<sup>4</sup> Moreover, Rosenberg states that empirical work on the behaviour of real wages over the business cycle also does not support the neoclassical theory of labour demand. Research by Michon on “...cyclical movements in real wages over 1950-1982 for the United States, Canada, Japan, France, the [former] Federal Republic of Germany and the United Kingdom... demonstrates that there is no necessary cyclical wage behaviour common to these six countries”.<sup>5</sup>

Thirdly, it has been pointed out that, in some cases, in spite of the introduction of greater flexibility wages may not fall according to supply and demand, and different wage levels may prevail for what appears to be the same occupational category. What

<sup>4</sup> Rosenberg (1989b), p. 396, based on Bowles and Boyer (1988).

<sup>5</sup> Rosenberg (1989b), p. 396, based on Michon (1987).

may be seen as a distortion of the labour market may be considered perfectly rational by those involved in employment relationships, however. This is the case, for example, when employers incur labour costs in hiring, testing and training workers and wish to retain the trained workers so that they can recover their investment in them, for which purpose they are prepared to pay the workers higher wages that they could obtain elsewhere. The greater the extent of firm-specific skills, the more difficult it is to expand employment through reduction of wages (ILO, 1989, pp. 7-8). In this case it is in the employers' own interest to pay wages above the market clearing level.

There are two other cases where labour market distortions may prove beneficial for employers. Since relatively higher wages may very likely increase the choice of applicants for jobs the quality of the workforce is improved. Besides, higher wages provide an incentive for higher productivity from the existing workforce, thus lowering unit labour costs (ILO, 1989, pp. 7-8).

Fourthly, it has been argued that the removal of minimum wage mechanisms would impede technical progress by reducing pressure to modernize factory machinery. This could contribute to reduced competitiveness, the closure of firms, and thus more unemployment (Standing, 1986b, p. 14).

Fifthly, the claim that unemployment benefits in some countries are a factor in preventing wages from falling sufficiently to generate additional employment is not conclusive. Research on the effects of unemployment benefits on unemployment shows that cross-country differences in unemployment compensation cannot explain the "large rise in unemployment duration in Europe, or the enormous rise of unemployment levels in the United Kingdom, France, and the [former] Federal Republic of Germany compared with those in Sweden and the United States".<sup>6</sup>

Though the discussion on wage flexibility is far from settled, some trends towards finding ways to overcome wage rigidity can be detected. One such trend is the bypassing of minimum wage regulations and other statutory wage agreements, either through legislative reform, non-implementation of laws or through the use of work arrangements that escape their jurisdictions (e.g., home work and subcontracting) (Standing, 1986a, p. 31).

<sup>6</sup> Burtless (1987), p. 155. Quoted by Rosenberg (1989b).

The tendency towards wage control is also seen in the efforts of several countries to secure agreements providing for wage moderation and deindexation.<sup>7</sup> The main goal of these efforts is that wage increases must depend on productivity gains.

There seems to be a strengthening of trends towards "two-tier" or "multiple-tier" wages structures. In Australia a two-tier wage fixing system was introduced in 1987 in which wage increases up to a ceiling of 4% could be gained if industry productivity and efficiency are enhanced (Rimmer and Zappala, 1988). Various forms of two-tier pay structures have emerged in Canada and the United States in which new employees are taken on at lower wages or benefits than established employees doing the same work (Walker, 1987).

Furthermore, experimental forms of "participation wages" are becoming more popular. They include schemes of payments by results, shifts towards the use of bonus systems instead of part of the money wage, or conversion of part of the total remuneration into a flexible component linked to the performance and characteristics of firms.<sup>8</sup>

In some cases the payment system has become more flexible through wage reductions or freezes (nominal wage reductions), in return for some increase in employment security ("concession bargaining"). In this regard, it is noteworthy that according to a European survey by the European Community a significant share (51%) of workers were willing to accept a temporary wage cut if their firm were in difficulties – provided that, once the firm recovers, the workers receive a corresponding share of the profits (Commission of the European Communities, 1985, pp. 1-6).

## 2. Numerical flexibility

Numerical flexibility refers to two aspects: adjustment of the workforce and adjustment of working hours. The first aspect is known as "external numerical flexibility" and means the ability of firms to increase or decrease the numbers of workers in

<sup>7</sup> Evidence of trends in deindexation policies for Australia, Belgium, Denmark, Italy and Spain is given by Sarfati and Kobrin (1988).

<sup>8</sup> This approach reflects the ideas put forward by Weitzmann (1984) whereby wage increases are linked not only to individual productivity but also to the overall performance of the enterprise and its workforce.

response to variations in demand and/or technological changes. The second aspect is referred to as "internal numerical flexibility" and relates to the freedom that firms have for modifying the number of working hours without changing the number of employees.

a) *External numerical flexibility*

The arguments for increased external numerical flexibility (or employment flexibility) are closely related to that for wage flexibility. It is maintained that the regulations for protecting employment are too restrictive and thus impede the adaptation of manpower resources to market conditions. This view is also greatly influenced by the observation of the performance of employment and unemployment between the United States and European countries. It is argued that the relatively low unemployment levels in the United States are, to an important extent, a consequence of American employers' freedom to lay off or discharge workers in response to economic changes.

It is held that enhanced employment flexibility will lead to increased employment and a lowering of unemployment. The rationale behind the call for greater employment flexibility stresses that laws which protect employment by making dismissals difficult and expensive prevent firms from recruiting extra workers as needed, because firms know that they will not be able to dismiss them easily if circumstances change (International Organisation of Employers, 1985; OECD, 1986a; ILO, 1986b). Furthermore, firms face difficulties in establishing more flexible and diversified forms of contractual relationships (so-called "atypical forms of employment").<sup>9</sup> These circumstances encourage the substitution of capital for labour. It is therefore considered that measures which diminish rigidities regarding dismissal (i.e., measures to make dismissals cheaper and easier) will lower labour costs, with two effects: first, they will encourage substitution of labour for capital, thereby fostering employment growth, and second, easier and less costly arrangements for dismissals should incentivate employers to hire extra workers in periods of growth (Rosenberg, 1989a, p. 11). Moreover, if firms are allowed to rely more on atypical forms of employment, they would be able to offer more jobs.

<sup>9</sup> There is a call for more intensive use of fixed-term contracts, part-time work and temporary work.

The way to enhance employment flexibility is mainly through the relaxation of dismissal laws or industrial relations agreements which regulate them, and, to a lesser extent, through the extension of fixed-term contracts, temporary work and part-time work. In fact, a good deal of the discussion is centered on regulations governing dismissals – advance notice, amounts of compensation, pre-eminence of the seniority rule, prior agreements of various bodies, etc.

Criticisms concerning this type of flexibility have questioned its allegedly positive effect on unemployment. Although studies are not conclusive, there is evidence which suggests that the effects of "labour flexibility measures in terms of jobs are...meagre and the most thorough analysis of numerical flexibility even reveals an increase rather than a decrease in unemployment" (Meulders and Wilkin, 1987, p. 15).<sup>10</sup>

Moreover, the widely disseminated view about Europe's stricter regulations concerning dismissals has also been questioned. First, the correlation between high unemployment rates and rigid labour markets does not apply to all cases. The Nordic countries and Austria have kept low levels of unemployment in spite of having "rigid" labour markets. Second, it has been argued that the degree of flexibility available to employers in Europe has been understated, while that available in the United States has been exaggerated.<sup>11</sup> Although American employers are free to cause employment levels to vary with market requirements, they are required to respect rules and procedures<sup>12</sup> which make dismissals very expensive, and thus inhibit new hires. In the case of European regulations governing job security, although there is significant variation among countries these rules are considerably less rigid than is claimed, their main effects being to delay employment adjustment and make it more costly.

Furthermore, it has been argued that the relaxation of rules governing dismissals encourages a shift of employment patterns from full-time, long-term workers towards more part-time, temporary and

<sup>10</sup> Other studies which refute the positive effects of external numerical flexibility on employment are those by Boyer (1987) and Michon (1987).

<sup>11</sup> See Piore (1986), p. 155; Flanagan (1987), p. 164 (reference taken from Rosenberg (1989b), p. 396); Emmerson (1988), p. 777; and Rosenberg (1989a), p. 10, note 10.

<sup>12</sup> On such matters as employees' seniority, allocation of work in the enterprise, and the distribution of tasks.

fixed-term workers, not covered by employment protection legislation.<sup>13</sup> This may lead to the creation of a category of workers whose conditions of employment are generally inferior to those enjoyed by full-time workers.<sup>14</sup> In turn, it is argued that this would lead to the institutionalization of a dual labour market comprising on one side poorly paid and unstable jobs and on the other side stable and well-paid occupations (Clarke, 1985; Piore, 1986; Standing, 1986b; Meulders and Wilkin, 1987, and ILO, 1989).

b) *Internal numerical flexibility*

Increased flexibility of working time arrangements (i.e., reduction and restructuring of working time) is considered as a possible alternative to wage or employment adjustments in the face of changing economic conditions. The variety of aspects covered by this form of flexibility is wide: fixing of normal or maximum weekly (monthly, yearly) hours of work, various forms of staggered work, organization of overtime and compensatory leave, work outside authorized hours (weekend work), and entry into or retirement from the labour force (Meulders and Wilkin, 1987, p. 9; ILO, 1989, p. 18; OECD, 1989, p. 15; Rosenberg, 1989a, p. 9).

The discussion on internal numerical flexibility (or flexibility of working time) is less contested than that on wage and employment flexibility. In principle, this form of flexibility is seen as an area of potential mutual benefit for workers and employers and one which may help to reconcile part of their conflicting interests (Meulders and Wilkin, 1987, p. 9; ILO, 1989, p. 18).

Reduction of working hours has been the form of flexibility which has had the greatest acceptance. For trade unions, it "fits the idea of solidarity between workers in the fight against unemployment and with a certain fairness in the sharing of employment" (Sarfati and Kobrin, 1988, p. 26). Besides,

internal numerical flexibility fits in with the changing attitudes towards work and leisure, where workers seek more freedom to organize their private lives.<sup>15</sup>

Employers are particularly interested in the extension of operating hours beyond the normal working day. Because of the high cost of new equipment, employers seek to operate it as long as possible,<sup>16</sup> and thus want to introduce up to three or even four working shifts (OECD, 1989, p. 15). In addition, it is argued that increased internal numerical flexibility could help to achieve more efficient use of working time by allowing closer adaptation of working time to fluctuations in demand.<sup>17</sup>

With regard to the employment effects of this form of flexibility, it is maintained that these "depend on the political and social objectives within which it is set" (Meulders and Wilkin, 1987, p. 9) and thus on the nature of the working time flexibility being discussed. For example, the shortening of the working week may create jobs or at least maintain jobs that would otherwise disappear, by sharing the available jobs among a greater number of workers. Reduction of the retirement age, in contrast, substitutes younger workers for older ones and may lower unemployment by shrinking the labour force rather than by creating jobs (Rosenberg, 1989a, p. 12).

In spite of the positive mood concerning flexible hours of work, some criticisms have been made. It is argued that there is a danger of marginalizing various categories of workers and that conflicts may arise between new styles of work and the traditional rhythm of family, social and school life, or between working time and leisure time (Gaudier, Greve, Grootings and Hethy, 1986, and OECD, 1986a). Trade unions have objected that social security and retirement schemes still operate on the basis of full-time employment for fixed hours and are incompatible with flexible hours of work (European Trade Union Institute, 1985).

<sup>13</sup> According to some studies, the development of these employment patterns gives grounds for maintaining that these forms of LMF should be seen as a cause of unemployment rather than a solution to it. This assertion is based on the observation that chronically high and rising unemployment has coincided with these growing forms of LMF (casual and temporary forms of work, shift from collective bargaining to individual settlements, etc) (Standing, 1986a, and Rodgers and Rodgers, 1989).

<sup>14</sup> Workers whose hours of work or incomes do not reach certain thresholds may be excluded from many of the basic provisions of protective legislation or benefits (ILO, 1989, p. 19).

<sup>15</sup> This support is partly reflected in the results of a survey among employees carried out by the European Community. Most of the workers covered by the survey would accept hours of work fixed monthly (39%) or even annually (16%), and one in three would be willing to work evenings and Saturdays in exchange for reduced annual hours of work (Commission of the European Communities, 1985, pp. 1-6).

<sup>16</sup> In this way fixed capital costs can be distributed over a greater number of hours and units of output.

<sup>17</sup> Business intensity may vary during the hours of the day or on certain days of the week or the month, as in the case of retail stores, or over longer seasonal periods, as is frequent in manufacturing (ILO, 1989, p. 18).



### 3. Functional flexibility

Functional flexibility concerns the ability of a firm to use its workforce more effectively by varying the work performed in response to changing workloads and the possibilities offered by new technologies. This form of flexibility relates to the mobility of workers within the firm; it involves the capacity of firms to reorganize jobs, which requires access to a workforce capable of carrying out different tasks of the production process; it calls for operatives able to adapt to a variety of tasks of varying levels of complexity and involves such aspects as multiskilling, job rotation, work units, changes in the functional division of labour, retraining and upgrading (Meulders and Wilkin, 1987, p. 8). To sum up, functional flexibility "appeals to the know-how and skills of workers and... to their ability to master various segments of the same productive process" (Boyer, 1987, p. 109).

From the workers' viewpoint, functional flexibility is preferable to wage and/or employment flexibility, since it is not based on wage reductions or restrictions on workers' rights. This type of flexibility enables them to make better use of their know-how and skills, get more involved with the production process, and eventually, play a more active role in the management of firms. It is seen as one of the ways of responding to workers' aspirations and at the same time as one of the tools enabling the labour market to respond to the reorganization of productive systems (OECD, 1990, p. 24).

The stimulus for seeking increased functional flexibility has been mainly the introduction of new technology. Since new equipment tends to reduce job boundaries, firms are forced to seek multi-skilled workers who can adapt to different functions within the labour process. In some cases, however, the stimulus emanates from the need to cut costs: significant cost savings may result from reorganizing the existing production process and making the corresponding changes in the way labour is used (ILO, 1989, p. 19).

Moreover, functional flexibility is put forward as a way to handle an increasingly uncertain business environment (Rosenberg, 1989a, p. 12). As in certain sectors demand has become more variable, due to the emergence of more diversified and specialized patterns of consumption, and firms are forced to respond to market signals in shorter periods of time, resources must be able to be shifted to new uses. This is made possible by the existence of both modern and more

flexible technology and a polyvalent multi-skilled workforce. These elements enhance employers' capacity "to handle bottlenecks or slackness in production by moving labour rather than hiring and firing" (Rimmer and Zappala, 1988, p. 568).

A central element concerning functional flexibility, then, is the presence of workers with several skills which allow them to switch from one activity or job to another. This is the reason why training programmes are increasingly incorporated into the formal relationships of employers and trade unions. While advances have been made in the way training is perceived by both employers and workers, problems remain. For example, not all workers benefit equally from new training programmes. Some employers may be reluctant to "invest resources on training older workers, on the grounds that there is a shorter expected pay-back period or that it is more expensive and consequently may prefer recruiting young workers" (ILO, 1989, p. 21).

Another problem that has been highlighted refers to the lack of policies concerning anti-poaching regulations (i.e., preventing other enterprises from attracting newly-trained workers without bearing the costs of training)—a circumstance that may reduce employers' interest in providing training (ILO, 1989, p. 21).

Functional flexibility depends heavily on the reduction of job demarcation barriers. However, explicit or implicit rules about manning requirements and the types of work that different occupational classifications can undertake are common and thus hinder the development of this type of flexibility. This is especially so in the United States, where it constitutes the main concern among American employers. In the United States, management is relatively free to vary the level of employment but not the allocation of work within the enterprise, and American employers maintain that in respect of this form of LMF, European labour markets are more flexible than their own and that this circumstance goes a long way towards explaining why labour productivity in the United States is stagnating (Piore, 1986, p. 149).

Yet trade unions are often suspicious of management's attempts to reduce demarcation barriers. The reorganization of production and the introduction of new technologies may serve to intensify the pace of work and increase managerial control over the production process. Unions also fear that the flexible deployment of labour will increase internal labour market segmentation between a skilled "core" workforce and an unskilled "peripheral" workforce.

# IV

## The Latin American labour market and LMF

As pointed out at the beginning of this article, during the 1980s substantial support arose for the view that the introduction of greater flexibility into the labour market through deregulation would facilitate the adaptation of that market to the new requirements imposed by structural adjustment. In the industrialized countries this view has led to a process of deregulation concerned with the elimination of institutional obstacles which prevent the labour market from adapting to new conditions of production and international competitiveness. In less developed regions, however, the labour market is not so extensively regulated, and where such regulations do exist, institutions are often unable to enforce them. Where this is the case, it is likely that the flexibility required for the purposes of structural adjustment will not necessarily entail a process of deregulation. It is argued here that to an important extent Latin America is no exception to this phenomenon. In fact, it is possible to sustain that the labour market in the region has displayed substantial flexibility but this has not been accompanied, nor much less promoted, by major institutional reforms. It has been a process of flexibility without deregulation. In these circumstances, the recipe for securing greater flexibility through deregulation is not at all clear. In the following paragraphs, reference is made both to the process of de facto or "underground" flexibilization and the institutional lag.<sup>18</sup>

### 1. Underground flexibilization

A global analysis of developments in the Latin American labour market in the 1980s indicates that the major trends point in the direction of greater flexibility. This is consistent with the conclusions drawn

by PREALC (1990) to the effect that between 1980 and 1989 the Latin American labour market was characterized by lower job security, the replacement of full-time employment by part-time employment, and growing recourse to subcontracting.

One indicator of this process is the high annual growth rate of the informal sector (6.7%, or more than double the 3.0% growth rate of the formal sector), which caused the proportion of the population engaged in informal activities to rise from 16% of the non-agricultural EAP in 1980 to 22% in 1989.

A second indicator of the increase in flexibility is the extraordinary expansion of employment in small enterprises (those with fewer than ten employees), which are concentrated in services and industry. Within the formal sector, the rate of growth of employment in small enterprises was 7.5%, as compared with only 0.5% in medium and large enterprises. Fully 40% of all jobs created in urban areas between 1980 and 1989 resulted from the dynamism of small enterprises, whose share of the economically active population (EAP) rose from 15% in 1980 to 21% in 1989.<sup>19</sup>

A third indicator is the trend – also noted by PREALC – for large enterprises to subcontract the production of certain basic components of their own productive processes, as well as certain essential services (such as transport, cleaning, maintenance and security), to small enterprises or even to some of the more modern units in the informal sector (PREALC, 1990).

A fourth indicator of the greater flexibility of the labour market is the drop in the level or growth rate of public sector employment. This phenomenon is relevant, since this is a sector which is characterized by considerable rigidity. For the 1980-1989 period as

<sup>18</sup> The remainder of this section is partly based on an earlier work (mimeo), co-authored with Eugenio Tironi, which was entitled *Flexibilisation and regulation of the labour market* and was written for the Employment and Development Department, International Labour Office (EMPLOI/ILO), Geneva.

<sup>19</sup> The rate of growth of small enterprises must be viewed with circumspection, however, inasmuch as the total calculated by PREALC (1990) for the region as a whole is strongly influenced by estimates of great expansion in Brazil.

a whole, the reduction of public sector employment is not really substantial, since it only went down from 15% to 14% of the EAP (PREALC, 1990). If one considers the annual growth rate of public sector employment in recent decades, however, it is evident that there has been a drastic deceleration. Thus, its annual rate of growth, which averaged 4.5% in the period 1950-1980, fell to 3.7% between 1980 and 1989. This deceleration is even more striking when it is considered that between 1980 and 1983 public employment was still growing at the high rate of 4.7% per year, but slowed to an annual rate of only 2% in the period 1986-1989.

The trend towards lower absorption of labour by the State has taken place at different rates in different countries. Nevertheless, virtually all countries in the region have adopted programmes to reduce public employment. It is too early to tell what the outcome of these programmes will be, but it is likely that they will reduce some of the rigidities in the labour market.

A fifth indicator which highlights the extent of the LMF which has taken place in the region relates to labour-cost flexibility. Both legal minimum wages and real average wages have deteriorated in the 1980s, showing substantial downward flexibility. In the early 1990s average minimum wages in Latin America fell by around 35%.<sup>20</sup> In the case of real wages, when the average actual real wages in different regional sectors of activity (agriculture, construction, industry) are considered as a whole, it is noticeable that in 1992 all of them were lower than at the beginning of the 1980s (PREALC, 1993).

There are other important indicators of the process of flexibilization which is taking place in Latin America. For example, there is evidence in nearly all countries of a shift towards piece-rates and away from time-based wages, as well as an increase in home work as a substitute for the concentration of workers in factories or enterprises. This coincides with the growing integration of women into the labour market, which was the most significant development in the supply of labour in the 1980s (PREALC, 1993).

The inescapable conclusion is that many of the changes which characterize flexibilization of the labour market have indeed taken place in Latin America and the Caribbean in the 1980s. As this phenomenon has not been accompanied, nor much less promoted, by major institutional reforms, in most cases (with some notable exceptions) it is an "underground" process, stimulated by the internal dynamics of the labour market in response to certain macro-economic factors (liberalization of foreign trade, the reduction of State subsidies, privatization), but without the State's active leadership. In other words, this trend towards flexibility is a *de facto* phenomenon which has often taken place in spite of, rather than through, existing institutions. This helps to explain its frequently unorganized nature, its partial and uneven scope, and the high costs associated with it, especially as regards unemployment.

## 2. The institutional lag

There have been virtually no changes in the past decade in the standards and institutions which govern the labour market in Latin American countries.<sup>21</sup> Thus, even though the institutional arrangements in force have neither stimulated nor channelled the process of flexibilization, they do not appear to have raised any obstacles to it. This can be explained either by the fact that these arrangements were already rather lax, so that there was consequently no practical need for deregulation, or because general standards for the protection of workers which entail certain rigidities were usually overwhelmed by the labour market's own dynamics. This second situation seems to fit the context of Latin America, and is responsible for this underground flexibilization.

The labour market in Latin America is regulated by the State, and there have been virtually no modifications in this situation. The protection of workers is based on labour legislation of universal application, rather than on enterprise or branch-level collective agreements or individual employment contracts (Bronstein, 1990). For example, as regards dismissal (a crucial area of flexibility), the legislation establishes many conditions or requirements: in some

<sup>20</sup> Exceptions to this trend were Colombia, Costa Rica and Paraguay, where real urban minimum wages were higher in 1992 than in 1980 (PREALC, 1993).

<sup>21</sup> There are exceptions. Chile, Colombia, Panama and Venezuela, for example, have amended their labour codes, and other countries (such as Argentina) are currently discussing reforms.

cases, a worker may not be dismissed without a prior inquiry into the facts on which the dismissal is based; in others, dismissals must be authorized by the administrative authority or the dismissal must be notified to a tripartite committee which rules whether the dismissal is fair or unfair. Some legislations establish that for workers whose length of service exceeds ten years, the dismissal must be approved by a labour court. Whenever dismissals are attributed to financial reasons, many countries require that the dismissal be approved by the administrative authority, or by conciliation and arbitration committees or tripartite commissions.

In every country throughout the region the employer bears the burden of proof for showing that there are valid reasons for dismissal. In some countries, if the employer cannot furnish this proof, the dismissal is automatically annulled; in others, the employer is required to pay an indemnity. There is also a third group of countries in which the employer may unilaterally terminate an employment contract without having to show just cause, but he is none the less required to pay an indemnity which may vary according to the cause for dismissal.

The most exceptional situations are those of Chile and Brazil. In Chile, following certain labour reforms enacted in the early 1980s, there are no restrictions on dismissal other than the cost which it entails for the employer, which was increased by labour reforms enacted in late 1990 and early 1991. In Brazil, workers are protected by a "Length of Service Guarantee Fund" (FGTS), which is financed by the employer. This fund, set up in 1966, protects workers in the event of dismissal, but gives the employer flexibility as regards the workforce. Recently, however, legislation has been passed which, though it does not prohibit dismissal, renders it substantially more expensive for the employer.

Recent changes introduced in some countries, as well as planned reforms under consideration in others, seek indirectly to facilitate dismissal. They do so, for example, by introducing various possibilities for temporary contracts, thus giving greater flexibility for signing and terminating employment contracts. Similarly, enterprises are increasingly resorting to temporary employment agencies or temporary service enterprises, for which legal provisions have only recently been introduced in some countries or are envisaged in the reforms under consideration in others. Both mechanisms facilitate temporary or

fixed-term contracts which fall outside the scope of job security standards. Recent legislative reforms also seek to facilitate collective dismissals based on economic or technological reasons or *force majeure*. With the exception of Chile, however, there have been no direct reforms or changes in legislation concerning job security.

Thus, from a formal standpoint the Latin American labour market seems to be highly regulated. In addition to establishing stringent requirements for dismissal, the legislation limits temporary employment, restricts performance-based pay systems, and discourages labour subcontracting. With the exception of a few countries, the region has not undertaken a systematic reform of labour market institutions in the direction of deregulation. Nevertheless, the pre-existing institutional framework has been unable to prevent the process of flexibilization which, as noted above, has unfolded as an underground phenomenon.

### 3. Re-regulation of the labour market

Inevitably, the underground flexibilization mentioned above, which has not been guided by the State or channelled institutionally, and which has often skirted legislation and responded to direct stimuli from economic restructuring, has assumed certain features that may give rise to concern. The most serious of these, without a doubt, is its partial nature, for while certain segments of the labour market have been subjected to a violent increase in flexibility, others have managed to "protect" themselves fairly effectively from this tendency. This is the case, for example, of large enterprises which, in addition to the protective regulations of universally applicable legislation (although, as noted, these have proved weak), also enjoy the safety inherent in collective agreements. In contrast, greater flexibility has invaded all other segments, where the ineffectiveness of labour institutions has left allegedly "protected" workers exposed to the most unrestrained forms of flexibility.

The shortcomings of Latin American labour market institutions in respect of the dynamics which have arisen as a result of structural adjustment and new requirements for competitiveness and the organization of production, have certain serious implications. For one thing, these shortcomings have stimulated a growing dualization of the labour market throughout the region, and they must be

overcome in order to stem this trend, both in order to address the problems posed by segments of the labour market where corporative rigidities persist and present obstacles to increased productivity, as well as to regulate the flexibility which has developed in other segments and left workers unprotected.

Overcoming the flaws in labour market institutions in Latin America does not necessarily mean endorsing deregulation theories. Such an approach is meaningful only where existing regulations are truly an obstacle to flexibility, and it is by no means clear

that this is the case in Latin America. Thus, the challenge faced by the region is quite different: the *re-regulation of the labour market*, in other words, an overhaul of labour institutions which, in addition to extending flexibility to all segments of the labour market, will also guarantee to all segments a basic level of protection. Essentially, this entails ensuring conditions to boost productivity while at the same time maintaining certain minimum levels of protection which will establish acceptable social limits for economic reform.

## V

### Concluding remarks

The different forms of flexibility examined above reflect the different approaches or views towards the issue of labour market flexibility. In fact, the debate has revolved around two different views. One view, referred to as defensive or passive, places emphasis mainly on lowering wage and non-wage costs (labour cost flexibility) and making it easier to adjust the workforce to fluctuations in market conditions and technical change (external numerical flexibility). As a reaction to this approach to flexibility, the idea of offensive or active flexibility has progressively gained ground. This offensive or active approach, while not dismissing the need to introduce higher degrees of flexibility into the labour market, questions many of the "rigidity"-based assumptions and stresses the need to provide the workforce with training and new skills in order to facilitate their adaptability to changes in the production process.

The defensive approach is based on the view that labour markets are excessively regulated, and therefore distorted, so that there is a need to deregulate them. The offensive or active approach recognises the need to introduce more flexibility into labour relations, but without reducing employment security and with emphasis on forms of flexibility which the social partners identify as less conflictive or non-conflictive (internal numerical flexibility and functional flexibility).

It is interesting to note, however, that as the debate has progressed the distinction between defensive and offensive flexibility has been substantially overcome as some consensus has been reached on certain

issues. Thus, the approaches to flexibility have tended to move from very reactive and short-term views towards longer-term (and less conflictive) solutions. There is a perception that the structural problems which, among other things, caused high levels of unemployment cannot be overcome by relying on measures that alleviate adjustment in a merely temporary way (e.g., wage flexibility, external numerical flexibility). Two quotations from the OECD—an enthusiastic supporter of defensive forms of flexibility during the mid-1980s—illustrate this point:

"The greater the flexibility of the labour market, the lower the economic costs of adjustment: there will be less unemployment and less loss of output. Standard micro-economic theory postulates that, in a perfectly free labour market, wages and unemployment adjust to rectify imbalances between supply and demand. In the real world, however, there are obstacles to adjustment. These make relevant policies that not only assist those most affected but promote the flexibility of salary structures and the adjustment of manpower" (OECD, 1984, p. 29).

"The new policy framework developed by the OECD requires a shift from a concentration on short-term problems to one on the structural requirement that labour markets should be able to react efficiently to economic and social change...Efficient labour markets are to be fostered through improving the quality of the labour force [and] reducing inequalities in access to jobs and training... Promoting the efficient functioning of the market does not mean simply letting loose market forces by indiscriminate

deregulation or a narrow focus on wage flexibility" (OECD, 1992, p. 12).

Finally, it seems appropriate to point out that the issue of LMF is also relevant in developing countries. In an international context, the scope and nature of the introduction of labour market flexibility will differ from country to country according to the structure of the economy, the prevailing institutional arrangements for industrial relations and the degree of dialogue between social partners. Since the debate surrounding LMF has taken place almost exclusively in and about industrialized countries, it is probable that some (if not many) of its analyses and prescriptions may not adequately take into account or reflect

developing countries' structural differences: especially such aspects as weak trade unions, low rates of unionization, the existence of a large proportion of the labour force involved in informal activities and thus located outside the institutional umbrella, high rates of underemployment, and labour markets poorly regulated relative to those of industrialized countries. The examination made of the Latin American situation partly suggests this. In this context, then, the idea of stressing deregulation of labour markets as a way of securing greater labour flexibility, along the lines of the approach taken in industrialized countries, is open to doubt.

(Original: English)

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# The modernization *of bank* supervision

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**Christian Larraín P.**

*Adviser, Superintendency of  
Banks and Financial  
Institutions of Chile.*

This article analyses the main challenges involved in modernizing bank supervision in the light of recent banking crises and the changes currently taking place in the financial system at the international level. Within a highly dynamic environment –rapid technological development in the field of informatics, stiff competition within the capital market as a result of liberalization, the increasingly prominent roles being assumed by financial conglomerates in an effort to achieve economies of scope, and the high degree of volatility of the main economic variables, which sharply increases the level of financial risk– the supervision of the banking system needs to be flexible in order to permit financial institutions to take advantage of opportunities for increasing their profitability and efficiency. At the same time, however, it must be geared to the achievement of its strategic objectives, which are to give the system stability, ensure its transparency and safeguard the government guarantees that have been extended. Within this context, the major issues involved in the supervision of banks in Latin America are the following: capital solvency standards and their role in supervision; mechanisms for appraising the book or market value of a bank's economic capital; supervisory methods for improving the coverage of financial risk; means of incorporating the regulation of financial conglomerates, and the importance of taking an integral approach to supervision of the banking system, with emphasis on the quality of management.

# I

## Introduction

In the specialized financial literature, it is argued that, because of the special features of banks, government regulation and supervision of their activities are necessary. The regulation of banks is directed towards the strategic objective of ensuring the banking system's transparency and stability within a framework of efficient allocation of financial resources. The regulation of this sector should be based on a dynamic approach and should constantly be adapting to any changes that occur in the way the system functions, in order to ensure the achievement of these strategic objectives.

The financial crises that erupted in various Latin American countries during the 1980s prompted major changes in the supervisory approaches employed by bank regulators (Held and Szalachman, 1992). Nevertheless, new challenges are still emerging now in the mid-1990s as a result of the banking system's highly dynamic mode of operation at the international level and the experience gained from recent

banking crises, such as those involving the Banco Español de Crédito (BANESTO) and Banco Latino. Factors such as the fierce competition between banking and non-banking institutions in the capital market, the swift pace of progress in the field of information technology and the globalization process are opening up business opportunities and possible avenues for improving the efficiency and profitability of financial institutions, but they also mean that bank supervision must be ready to deal with the sector's increasing complexity.

This article will seek to identify the different policy options available to bank regulators for meeting today's challenges and to outline the main components of each. On many issues, it is not possible to take definitive positions, and the following discussion will therefore be aimed at identifying the terms of the debate and providing a number of policy guidelines rather than making an exhaustive analysis or setting forth definite proposals.

# II

## The work of supervisory bodies

Because many of the claims on banks are liquid at par, any disturbance in a bank that shakes the confidence of its depositors may lead to massive withdrawal of funds. Because of the special features exhibited by banks, the risks associated with specifically banking activities may jeopardize the position not only of the banks' own stockholders but also of the rest of the system and, indeed, the whole of society (system-wide risk). When a banking institution's financial standing becomes shaky, the public perceives its difficulties as potentially affecting other institutions, even though the latter may be economically sound. This may spark runs on banks that hurt the economy as a whole, thereby generating what economic theoreticians refer to as a negative externality. This is all the more serious in the case of large

banks, whose failure could have disastrous consequences for the rest of the system.<sup>1</sup>

It is because of the need to uphold the public's faith in the banking system, to shore up confidence and to avert runs on banks that (explicit and implicit) deposit insurance is provided.

The most serious problem associated with this sort of insurance is what is known as "moral hazard", i.e., the fact that the existence of such insurance increases the incentive to take risks, which in turn increases the chances that the insurance will have to be used. Since depositors covered by such insurance

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<sup>1</sup> In other words, they are too big to be allowed to fail.

know they will not lose their money if the bank fails, they will neither keep a careful watch on its activities nor discipline it by withdrawing their deposits or demanding a higher risk premium if the institution runs too many risks (Mishkin, 1992). Consequently, banks that have deposit insurance can assume more risks than they otherwise would (unless the premium for such insurance is differentiated as a function of risk).

Another problem with deposit insurance is the perverse selection effect it has in terms of the type of entrepreneurs who are attracted by the possibility of investing in the banking sector.<sup>2</sup> For a bank, the benefit of deposit insurance will increase along with the level of risk it assumes, since usually the cost of such insurance is not adjusted for changes in that level, and this type of benefit is therefore more valuable to risk-takers than to more conservative investors. Since insured depositors have little reason to impose any sort of discipline on the banks, this means that entrepreneurs who are willing to run risks will be attracted to the banking industry.

The role played by information is another important aspect of the banking market. For example, small savers cannot afford to analyse (or the sums they handle are too small to justify the cost of analysing) the large volume of information required for a thorough evaluation of the entire array of available institutions. Unless there is some entity that can guarantee the reliability of the system, or that can at least furnish information in a somewhat more highly processed form so that it will be readily understandable, these depositors will not participate in this market but will instead put their resources to other uses which, in all likelihood, will not be the best ones for the country. A proper form of regulation that promotes transparency will give these depositors confidence and forestall the need to resort to the extreme measure of providing State backing.

Thus, because the supply of information is very uneven within the capital market, proper regulation and supervision of activity in this sector are needed to prevent the misuse of information and conflicts

of interest within the financial system. In addition to being unfair, these types of behaviour may undermine the public's faith in these markets and thereby create disturbances that will impair their efficiency and stability.

In summary, the special characteristics of the way in which the banking system works generate certain types of flaws or imperfections, such as externalities or asymmetries in the supply of information, that point up the need for government regulation and supervision in order to minimize their potential impacts on deposit insurance arrangements and avoid the conflicts of interest associated with such asymmetries.

This should be done within a framework of efficient financial-resource allocation, which requires that competition within the capital market be conducted fairly and not be distorted by cross-subsidization. In the case of banks, care must be taken to ensure that the prerogatives they enjoy by virtue of their access to the "safety net"<sup>3</sup> will not be extended to subsidiaries or affiliates involved in areas of activity other than banking.

In a dynamic environment, the above represents a formidable challenge for public policy-makers in the area of banking regulation because it not only calls for State intervention but also requires the optimization of that intervention. The regulation of banking activity and the application of prohibitions have explicit and implicit costs associated both with the use of the resources needed for their implementation and with the opportunity cost of diverting resources to inefficient activities. If those costs rise beyond the level required to ensure the banking system's stability and to minimize the impact on deposit insurance, unfair competition may take place in connection with other, non-banking institutions, thereby engendering a process of "artificial" disintermediation (Federal Reserve Bank of Cleveland, 1993).

In order to achieve an optimum regulatory system, new approaches and policies that complement conventional methods of regulation will be needed.

<sup>2</sup> A perverse selection effect is also generated in respect of clients, as a result of asymmetries in the supply of information in the banking system.

<sup>3</sup> The English-language financial literature defines "safety net" as the set of regulatory mechanisms which give financial institutions access to the Central Bank as a lender of last resort and to the backing provided by government deposit insurance.

### III

## The international experience

At the international level, there are four main trends that are affecting the banking system: the disintermediation process engendered by technological developments, increased competition in response to liberalization measures, the more prominent role being played by financial conglomerates, and the upward trend in levels of financial risk.

Thanks to advances in the field of telecommunications, transactions are becoming less expensive, easier to carry out and broader in scope as new markets are opened up at the international level. Computers make it possible to store and process huge volumes of information which make the rewards and risks of the various sorts of investments more immediate, while the progress being made in the area of communications helps to keep market agents well informed. This process has given rise to an efficient form of non-bank intermediation based on reductions in information processing costs and, consequently, to a marked shift away from bank intermediation (Moody's Investors Service, 1992).

In addition, there are many liberalization measures that form part of the move towards a system of universal banking; non-bank financial institutions have been allowed to engage in activities that had traditionally been performed by banks, and banks have been permitted to enter into non-traditional financial activities such as stockbroking, financial consulting services, portfolio management, the management of mutual funds, life insurance and others (Corbo, Donoso, Hernández, Rosende and Valdés, 1993). This, too, has helped to heighten competition in the capital market.

Technological changes and liberalization processes have set the stage for financial conglomerates to move to the forefront of the capital market as they strive to take advantage of economies of scale and of scope.<sup>4</sup> Although the world market is moving in the

direction of a broadened spectrum of banking activities, there is no consensus as to the new types of activities that should be undertaken nor the types of institutional arrangements upon which such a move should be based. From an organizational standpoint, the predominant scheme has involved the use of financial holding companies, with new activities being launched through affiliates or subsidiaries rather than through authorization for banks to set up their own in-house divisions to conduct such activities.

Another phenomenon of the 1980s was the increasing importance of managing what has come to be known as "financial risk", owing to the greater volatility exhibited by exchange rates, interest rates and inflation. In the marketplace, this trend prompted the appearance of a broad array of derivatives that can be used to hedge against such risks (O'Connor, 1993).

In addition to the foregoing, some of the aspects of recent bank crises also need to be taken into consideration in the design of a more modern system of supervision because they shed light on various gaps in risk coverage to which regulators should devote more attention.

In the case of the Banco Latino in Venezuela, although firm data are not available, the preliminary figures indicate that the losses may amount to as much as US\$3 billion, and the rush by depositors to withdraw their funds threatened nine other banks as well. In order to stave off a domino effect, the Central Bank of Venezuela had to soften its anti-inflationary monetary policy. Not only did it lower the reserve requirement from 15% to 12% but, in conjunction with the Deposit Guarantee Fund, it also had to inject some US\$3.5 billion into the banking system in order to cover the liabilities of the Banco Latino itself and to bail out the other banks that were in trouble. The problems encountered by this bank underscore the extent to which financial risk and the concentration of lending operations influence a bank's financial performance, as well as the definite presence of flaws in the internal controls and limits needed to keep such institutions on a solid footing, particularly with regard to their external operations.

<sup>4</sup> Supply-side economies of scope arise when the cost of joint production efforts is lower than individual production costs. Demand-side economies of scope occur when joint consumption generates a higher level of well-being for the consumer than consumption on an individual basis would.

In the case of the Banco Español de Crédito (BANESTO), preliminary reports from the Banco de España indicate that the bailout will cost about US\$3.5 billion. The source of the trouble was the excessive expansion of operations, accompanied by

the lack of appropriate hedging policies and the presence of serious defects in the bank's information systems and internal controls. The information brought to light thus far points to shortcomings in terms of the quality of management in both banks.

## IV

### The modernization of supervision: the current debate

The trends associated with the dynamics of the financial system—principally the intensification of competition, technological development, the increase in financial risk and the more prominent role of financial conglomerates—are what are generally called “heavy” or structural trends. These trends are opening up a world of opportunities, and under such circumstances regulatory provisions need to be flexible so that financial institutions will be able to take advantage of the higher returns, on both the internal and external fronts, afforded by new lines of business; of the economies of scope made possible by the combined supply and consumption of financial services; of new, efficiency-boosting technologies; and of the hedging possibilities provided by the use of derivatives. Rather than opposing these trends, regulatory and supervisory systems should adapt to these realities in order to ensure the achievement of their strategic objectives of stability, transparency and the protection of deposit insurance.

It may be added that competition and the expansion of the banks' range of business activities confer significant social benefits by contributing to the provision of more and better financial services at lower cost and permitting the utilization of the financial system's potential economies of scale and of scope.

The guiding principle for the regulation of the banking system should be one of prudential supervision aimed at nipping problems in the bud, before they actually surface and lead to a possible run on the banks that could jeopardize the stability of the entire system and the government guarantees underlying deposit insurance arrangements, whether implicit or explicit.

#### 1. The requirements of prudential supervision

The way in which faltering financial institutions are handled when they are on the verge of failure has major implications for the long-term soundness and viability of deposit insurance and for the stability of the banking system as such.

As banks approach the point of insolvency, they have less and less to lose if they adopt an aggressive strategy involving high-risk investments as a means of hopefully putting themselves back on a profitable footing. Thus, supervision is a powerful tool for controlling the perverse incentives that influence undercapitalized banks.

Generally speaking, a supervisory body's ability to take early and effective corrective action will depend on three factors (United States Department of the Treasury, 1991). First, it must be able to identify potential problems before they result in a loss that must be covered by deposit insurance. Second, once the problem has been identified, the supervisory body must have the authority to enforce corrective measures or to prevent the situation from deteriorating further. Third, once it has identified the problem and has the necessary regulatory powers, it must not hesitate to use its authority as appropriate.

As a rule, the supervisory process makes it possible for regulators to identify banks that could incur deposit-insurance losses. However, in some cases such problems—in the level of capital reserves or ratings—are not fully detected. In addition, banks, for their part, may “err” when setting their level of loan-loss provisions, through either excessive optimism or deliberate misrepresentation.

There are three reasons why the auditing process may not always determine a bank's true financial

status. First, some types of problems may arise suddenly. Second, some banks may not have been audited often enough. If a bank has initially been classified simply as a "troubled" or "problem" bank<sup>5</sup> and then fails within six months, it may be that it was not audited with sufficient frequency. Third, audits may simply fail to bring to light the full magnitude of the problem.

Unless the problems that exist are properly identified, the possibilities of taking early action to apply corrective measures to undercapitalized banks are very limited indeed.

Furthermore, supervisory bodies' problem-identification capabilities are of limited usefulness unless they also have sufficient authority to enforce corrective measures. Usually, when a bank's financial standing begins to deteriorate, supervisory agencies have a range of options to choose from in order to remedy the problem. For example, following each inspection, a bank's examiners may meet with management, including the board of directors, to discuss the bank's operations. These informal discussions are often enough to rectify the less serious sorts of problems.

In more serious cases, regulators may have recourse to recapitalization plans, or they may block outward transfers of funds, limit the bank's exposure in certain types of operations, restrict the payment of dividends, limit growth, make staff changes at management levels or impose a freeze on bank operations.

It is important to note that supervisory agencies are often given formal authority to take corrective measures in respect of faltering banks but the administrative requirements regarding the evidence they must gather in order to do so are so exacting that it is extremely difficult for them to compel a bank that is operating within the law and making a profit to increase its capital reserves or apply more prudent policies in specific areas.

The third requirement for prudential supervision is the determination of supervisory agencies to use their authority. It is often argued that these agencies have the proper tools for controlling a bank's

exposure but lack sufficient incentives to use those tools appropriately. Various reasons for this have been cited.

One factor is that regulators tend to be co-opted by the industry they regulate. In other words, the regulators are under pressure to serve and promote the industry they oversee. The prospect of obtaining a future post in the industry may also be a factor in the sometimes permissive attitude adopted by regulators (Mishkin, 1992).

A second factor that may make regulators unwilling to take action is the strong political pressure that may be brought to bear in some situations in order to protect certain social groups whose interests might be hurt if a crisis were to erupt in a given bank; this may stop regulatory agencies from taking appropriate action.

A third factor is that supervisory bodies may be reluctant to step in quickly when a bank is in difficulties because bank failures and the resulting deposit insurance pay-outs may hurt the supervisory agency's image by making it seem that it has not been doing its job. According to this line of reasoning, bank supervisors would prefer not to admit how serious the problems really are and thus put off a definitive solution. This is the hypothesis advanced by *The Economist* (1994) regarding the Banco Latino.

In order to counter the effect of the incentives that exist for supervisors to adopt a permissive stance regarding the need to take corrective action in the case of troubled banks, and in view of the high cost which the deferral of such action may have, some circles have proposed that supervisory action should be governed by clear-cut, mandatory rules and that regulatory discretionality should be eliminated.

There are two arguments against this approach (Stiglitz, 1993). With regard to the "rules versus discretionality" debate, the first is that it is impossible to formulate rules that will fit the particular circumstances in every case. The second is that the use of any set of rules increases the likelihood of making two types of mistakes: closing down banks that should be left open, and failing to close banks that should be put out of action. Changing the standards in one direction or the other would probably increase the frequency of one of those types of errors while reducing that of the other.

One possible solution would be a system in which, in the normal course of events, undercapitalized banks would be subject to a series of presumptions that would trigger the implementation of

<sup>5</sup> In the United States, the Office of the Comptroller of the Currency (OCC) uses an internal classification system whereby banks are rated on a scale from 1 to 5. Troubled banks are given a rating of 3. Although this category does denote a faulty performance, it does not mean that the financial institution in question may be expected to fail in the near future.

corrective measures by the relevant supervisory agency, in accordance with the severity of the problem. Departures from this pattern would be made at that agency's discretion but would be limited in extent by regulatory provisions.

## 2. Strengthening the role of capital in institutional incentives

The financial standing of banking institutions is determined by a set of factors which are summed up by the traditional model known as CAMEL<sup>6</sup> (Larraín, 1993). It can be argued, however, that a sufficient supply of capital is, virtually by definition, the single most decisive factor in bank solvency. The connection between an insufficient supply of capital and insolvency is obvious, since a bank is acknowledged to be insolvent only when its capital reserves become dangerously small or disappear altogether.

The benefits of a sufficient supply of capital may be summarized as follows:<sup>7</sup>

(i) *A lower probability of insolvency.* The more capital a bank has, the better it will be able to cope with unexpected losses without fear of insolvency, thus giving regulators time to take prudential measures.

(ii) *Fewer incentives for risk-taking.* Stockholders whose capital commitments are small have more incentives to take risks ("if the business deal is a success, I stand to gain a lot; if it fails, then the bank will be the loser"). The closer a bank's capital commitments bring it to insolvency, the more perverse the incentives will be.

(iii) *A reduction in deposit-insurance exposure.* When a bank fails, each dollar of the losses that can be covered by its capital is one dollar less that must be covered with public assets.

Despite the above considerations, however, capital requirements should not be raised so high that they would protect a bank from any sort of system-wide shock whatsoever, because this would make the banking business unviable. Furthermore, the role of prudential supervision is precisely to prevent such catastrophic events from occurring in the first place. Thus, the solution is more complicated than simply raising capital standards across the board.

<sup>6</sup> The elements taken into account in this model are Capital, Assets, Management, Earnings and Liquidity; hence the acronym CAMEL.

<sup>7</sup> See United States Department of the Treasury (1991).

Strengthening the supervisory role of capital involves the following:

(i) Adapting capital standards so that, rather than being measured as a function of a fixed debt ratio, capital requirements will be flexible and based on risk-weighted assets, along the lines of the Basle Accord (Larraín and Zurita, 1993; Bank for International Settlements, 1988). The purpose of a scheme of this sort is to make capital costs sensitive to the level of risk associated with financial institutions' assets. The empirical evidence (Avery and Berger, 1990) shows that a system of capital standards based on asset risk is more effective than a scheme based on fixed requirements in preventing bank failures.

(ii) Establishing differentiated levels of supervision based on the amount of capital backing. The idea is for the level of supervision to increase as a bank's backing declines. The aim of such a procedure—as with the application of capital "zones" in the United States—is to make the extent to which a bank's capital position has weakened the factor that triggers the implementation of the battery of regulatory tools available to bank supervisors (Federal Reserve Bank of Cleveland, 1993).

(iii) Raising capital requirements when types of business operations are embarked upon which fall outside the sphere of traditional banking activities. The idea here is to raise capital standards only when an institution moves into new territory.

There are two main grounds for this proposal. First, risk is generated by an institution's relative lack of expertise regarding new operations and by a lack of experience with their supervision. The clearest example of this is provided by overseas subsidiaries. Most of the Latin American countries have no tradition of overseas banking, and this creates a higher level of risk, which must be taken into account. Accordingly, any move to embark upon international activities should be based on very solid banking institutions that are better able to deal with the level of risk involved in such operations.

It is also unlikely that the region's supervisory agencies can provide effective support for such operations, because they lack experience with this type of activity (unlike the case of operations involving the European Community or the United States). This, too, increases the risk associated with an internationalization process, which can be reduced by restricting these operations to more heavily capitalized banks.

Second, there is the risk generated by an increase in system-wide risk. Systemic risk arises when the failure of a few large debtors puts the entire system in jeopardy. When banks broaden their range of action by opening up subsidiaries, it is possible that: (i) the level of system-wide risk will rise because the failure of any bank will involve a larger number of business activities, and (ii) the social cost of maintaining the system's stability in the face of disruptive shocks will increase.

Even in cases where the coverage of explicit forms of government insurance is confined to a bank's parent company, a subsidiary's difficulties may spread to that company too. If the market perceives the existence of a link between a bank and its subsidiaries—and especially if there are few limitations on the pooling of intangible and tangible assets—then, clearly, if one of these subsidiaries is in trouble, a bank will be motivated to bail it out. This increases the exposure of the underlying government guarantees and extends the scope of the "safety net".

The main arguments against the idea of raising capital requirements when banks move into new areas of business refer to their potential impact on the banks' international competitiveness. However, even though higher capital requirements may hurt a bank's competitive position in the short run, the experience of developed countries indicates quite clearly that, in the long run, a bank's solvency has a strong positive correlation with its profitability and the value of its stock.

Thus, studies of international banks that are rated by the IBCA demonstrate that a positive statistical correlation exists between the Cook Index and profitability and between that index and stock prices (Kredietbank, 1993). These same studies also show that the way this effect operates is to reduce the cost of the funds to which the strongest banks have access. This is because investors assess each bank's exposure/earnings ratio and demand a smaller risk premium from the banks whose financial standing is the most solid.

The study presenting the Treasury Department's proposal to the United States Congress regarding the modernization of the U.S. banking system arrives at the same conclusion. This study underscores the fact that the United States banks that are most successful in the international marketplace are also the ones that are the most solvent. Accordingly, the proposal calls for the creation of a category to be called "Zone 1"

for the most heavily capitalized banks, which would enjoy greater regulatory latitude.

### 3. Book or market value?

An approach that is based on prudential supervision and places emphasis on the role of capital should ensure that the relevant authority will step in before a bank's net worth falls to zero or less in order to forestall losses that would ultimately be charged against government deposit insurance. If this is to be done, it is essential that a bank's economic value or capital should be measured accurately (Stiglitz, 1993).

There is some controversy about the measurement of bank assets and liabilities. According to generally accepted accounting principles, capital requirements are calculated on the basis of historical costs. Appraisals based on book values (or historical costs) generate a systematic bias, since assets which are appraised at below-market value may be sold off at a profit, while overvalued assets may be kept on the books in order to avoid recording a loss (Mishkin, 1992).

An across-the-board appraisal at market prices would enable regulators to determine very rapidly when a bank's capital reserves are falling below the required levels; this, in turn, would allow them to take corrective measures before the bank's net worth falls to zero. This would reduce the losses that have to be covered by deposit insurance, and there would be less incentive for a bank to adopt a high-risk strategy when its financial status is deteriorating.

Despite the superiority of this approach on the theoretical plane, however, across-the-board appraisals at market prices pose serious problems from a practical standpoint. Since there are no secondary markets for many of banking institutions' assets and liabilities, their market values would have to be estimated on the basis of some sort of discounted cash flow (DCF) analysis. The subjectivity inherent in such procedures would lessen the comparability of estimates prepared by different agencies, thereby hampering the supervisory process. These types of problems would, furthermore, open up possibilities for increased manipulation, which would in turn spark greater uncertainty about the true financial status of such institutions, whose viability hinges upon public confidence (United States Department of the Treasury, 1991).



Furthermore, the actual cost of developing and implementing a comprehensive system for appraising assets at their market value could be quite high, and this would hurt smaller institutions.

For the above reasons, conducting across-the-board market-value appraisals would be a complex proposition at the present time, but this approach should nevertheless be given increasing weight. On the one hand, measuring variations in market prices brought about by rate changes would not pose any major difficulty. On the other hand, however, when such variations are the result of the assets' credit risk, the situation is more complicated, and in this case a scheme of provisions based on estimates of the projected decrease in the value of those assets would have to be used. This system would permit regulators to make a proper assessment of a bank's economic value without running up costs that would far exceed the benefits of such an appraisal. In addition, it would be feasible to increase the frequency of supervisory activities so that a picture of each bank's status could be put together and then updated on an ongoing basis.

Finally, it is important for regulators to be mindful of the imperfections involved in measurements of a bank's net worth when the time comes to establish regulatory standards. If a bank's level of economic capital cannot be determined with a high degree of accuracy, then capital requirements should be stringent enough to leave a safety margin so that prudential action may be taken even in cases where measurements are not exact (Stiglitz, 1993).

#### 4. The management of financial risk

As a consequence of the mounting volatility of international rates, since the mid-1970s losses caused by unexpected changes in interest or exchange rates have come to be an increasingly serious problem for financial institutions.

These kinds of losses are sustained, for example, when an unexpected rise in interest rates causes the market value of assets to decrease more than the market value of liabilities. This differential change in market values occurs when an institution's assets are less sensitive than its liabilities (Kaufman, 1984). In the final analysis, any variation in rates can have an impact on a bank's net earnings and profitability depending upon its exposure, which, in turn, is a reflection of how efficiently it has managed its assets and liabilities.

The problems associated with financial risk are quite well known, but it is no easy task to measure levels of risk accurately, and without such measurements risk management is impossible. This underscores the importance of having suitable methodologies for covering risk.

Along these same lines, international regulators working within the framework of the Basle Accord are considering the possibility of adding a financial-risk component to existing capital standards (Bank for International Settlements, 1993). This marks a departure from the current approach, which deals with financial risk primarily through the establishment of caps. In the proposal which is now being formulated, the idea is to require a progressively higher level of capital as financial risk increases (the reader will recall that international capital standards are currently set on the basis of credit risk rather than financial risk.)

Capital requirements give banks greater incentives to hedge their risk than limits do, while at the same time ensuring that they have a "cushion" of capital to absorb unexpected losses. Although there are difficulties involved in their practical implementation, advances in the application of models that permit more precise measurements of financial risk would clearly bring advantages, since these practical problems could be surmounted by applying simplified versions of existing methodologies for the measurement of such risk. It may prove necessary to use a combination of capital requirements and limits in order to establish absolute ceilings on bank exposure while at the same time reinforcing internal controls.

#### 5. The regulation of financial conglomerates

At the international level, banking activities are tending to expand into areas that fall outside the industry's traditional sphere of action. The main purpose for offering comprehensive financial services is to take advantage of economies of scope.

The expansion of a bank's line of business does, however, involve significant potential costs: i) a potential increase in system-wide risk; ii) an intensification of conflicts of interest; and iii) the possibility of unfair competition through cross-subsidization (Herring and Santomero, 1990).

The subject of system-wide risk was discussed in some detail in an earlier section and will therefore not be dealt with here.

Conflicts of interest are a problem that does not originate in the provision of State backing for some bank deposits but is instead common to the capital market as a whole and to many other markets as well (Valdés, 1989). The broader the spectrum of financial services that a firm offers, the greater the likelihood that conflicts of interest will arise (Herring and Santomero, 1990), and since conglomerates are involved in a broader range of transactions, they also have a broader information base.

Conflicts of interest may emerge when banks engage in business transactions which, by definition, involve making investments on behalf of third parties (Morandé and Sánchez, 1992). In such cases, banks—which also invest on their own behalf—could reserve the best deals for themselves and use the rest for third-party investments. They could also use third-party funds to make transactions in advance on their own, as a means of influencing market prices.

Concern about the possibility of unfair competition arises out of the fear that a financial conglomerate might make use (implicitly or explicitly) of its access to the Central Bank as its lender of last resort, or of the lower cost of its funds due to its coverage by government deposit insurance, to subsidize other lines of business. This may distort competition with other firms that do not have similar sorts of backing.

Since comprehensive financial services are provided chiefly by conglomerates (Valdés, 1989), the banking system's institutional structure becomes a fundamental factor in reinforcing the social benefits of the process and in minimizing the associated costs. In such cases, regulation is essential in order to obtain optimum results.

The central aim of bank regulation should be to protect banks so as: i) to ensure that the safety net—which includes access to the Central Bank as a source of liquidity and government deposit insurance—is not extended to include activities in which banking expertise is irrelevant; ii) to limit cross-subsidization (whether implicit or explicit) by the bank of its subsidiaries or affiliates; and iii) to forestall conflicts of interest and prevent insider trading (United States Department of the Treasury, 1991). This does not mean that all of a bank's non-traditional activities need to be completely separate; this will depend on the nature of each activity (i.e., on how much it complements traditional banking activities, on possible opportunities for

the use of economies of scope, on the potential conflicts of interest involved, and on the cost of regulation and supervision).

A bank may undertake new activities either directly (through a department of the bank) or through a subsidiary or an affiliate that belongs to the same holding company. These various forms of organization generate differing degrees of legal, economic and marketing distance between the bank and these new activities (United States Department of the Treasury, 1991).

The various possible blends of legal and operational separateness can be translated into three basic organizational models for financial conglomerates.<sup>8</sup>

#### *Model 1*

The completely integrated model—also known as the German multibank model—enables a conglomerate's executives to direct all of its activities within a single entity; thus, with this structure, any combination whatsoever of financial products can be provided at the lowest possible cost. The greater operational efficiency of this option must, however, be weighed against its costs.

The problems posed by oligopolistic practices, conflicts of interest and disruptive shocks may be exacerbated in a multibank scheme. Moreover, there would potentially be a great deal of room for the bank to provide implicit subsidies to its other lines of business.

It is also more difficult to regulate this type of structure than when a bank confines itself to traditional banking activities.<sup>9</sup> In the absence of any operational or legal separation, the combination of a wide range of financial activities presents regulators with the challenge of grasping the implications of the prudential supervision of a large number of different financial products. As a result, the regulation of this type of organization may be both costly and imprecise.

<sup>8</sup> Apart from these pure theoretical models, others can be formed from the various possible combinations of them.

<sup>9</sup> In his analysis of the German banking model, Kregel (1992) concludes that the most significant factor in this model is not the lack of regulation, but rather a different regulatory approach.

*Model 2*

In this second basic type of structure, banking activities are conducted by the parent bank while non-banking functions are performed by separate corporate subsidiaries. This structure, which corresponds to the British model, is the basis for the scheme currently being implemented in Chile.

Legal separation has some costs in terms of efficiency, however, and the cost of producing a given mix of financial services may therefore be somewhat higher than in the preceding case, but this model also has two countervailing advantages. First, the separation of banking activities from non-banking ones facilitates equitable supervision of both bank-related enterprises and independent concerns in the same line of business, which also reduces the cost of supervision.

Second, in theory, this model shields the bank if other activities undertaken by the conglomerate turn out badly, yet allows it to benefit from positive outcomes. Because they have limited liability, non-bank subsidiaries can augment but not diminish the value of the bank.

This may prove to be an empty advantage, however, if the bank feels that its reputation and the cost of its funds could be adversely affected by a subsidiary's bankruptcy; in such cases, the bank will have incentives to prop up this subsidiary even when doing so requires a sum greater than its capital investment. If the market reinforces this perception, the cost of the conglomerate's funds will be reduced, but competition with the activities of firms not linked to a financial conglomerate will be distorted.

In order to reduce this risk, regulatory authorities may seek to establish operational separation in order to back up the existing legal separation of activities. The cost of such a course of action in terms of efficiency is clear, but its contribution to the reinforcement of market discipline for the subsidiary is less certain.

*Model 3*

A third type of structure is the holding-company model, which is customary in the United States. Here the parent company owns both the bank and its non-bank counterparts. Since the legal separation is greater here than in the preceding model, the cost of providing a given combination of financial products is probably somewhat higher with this option. This model does, however, capture some of the social

benefits of economies of scope in the marketing and distribution of financial products and presents less of a threat to the safety net, since the extension of that net beyond the bank is limited. Nevertheless, since operational efficiency may be hindered by these "firebreaks", there may be some loss of efficiency.

From a regulatory standpoint, this model has the same advantages over model No. 1 as model No. 2, since it facilitates equitable supervision and safeguards the bank. The main advantage of model No. 3 over model No. 2 is that the bank may have fewer incentives to shore up a non-banking unit if it is an affiliate than if it is a subsidiary of the bank. In the United States, regulators have tried to deepen this separation by requiring a number of what are known as firebreaks: the affiliate must have a different name from that of the bank, separate staff, separate offices and separate distribution networks. The aim of these measures is to soften the adverse impact which the bankruptcy of an affiliate may have on a bank's reputation.

Obviously, the particular conditions in each country will determine which of the models is the most suitable choice. It is essential to take the supervisory capabilities and the autonomy of the regulatory agency into account in this connection. The nature of the links existing among the various groups in the banking and non-banking industries is also an important consideration, as is the possible existence of government guarantees in each case.

## 6. The implementation of an integrated supervisory approach

Given the increasing complexity of the financial system's mode of operation, progress must be made towards the implementation of an integrated form of supervision. In order to apply a scheme of prudential oversight, supervisory agencies need to make an ongoing, systematic analysis of the main determinants of a bank's status. To do so, the supervisory schemes currently being used in the Latin American countries—which are primarily based on an examination of financial institutions' assets and provisions—will need to be augmented, with more emphasis on such elements as ensuring adequate capitalization and assessing the institution's management. Ultimately, this means that the countries will need to move towards the implementation of a CAMEL-type supervisory scheme.

It is important to point out that the application of such an approach demands a great deal of coordination and information exchange within supervisory agencies regarding the various aspects of the banks. Although for purposes of analysis it may be possible to differentiate between capital, assets, management, etc., in practice all these aspects are closely interrelated: for example, bad management may lead to problems in terms of the quality of assets or an insufficient level of capital.

One of the weakest areas of banking supervision in Latin America is the evaluation of management, despite the fact that this is one of the most crucial considerations in projecting banking institutions' future status, above and beyond the X-ray provided by quantitative financial indicators.

In the United States, in contrast, the relevant supervisory body—the Office of the Comptroller of the Currency (OCC)—regards the quality of management as a pivotal consideration. The premise underlying every aspect of the OCC's work is that a bank's management and board of directors are ultimately responsible for how the institution functions. In order to gain a better understanding of the relative degrees to which external economic conditions and internal management-related factors influence a bank's performance, the OCC conducted a study on the subject (OCC, 1988).

This study showed that although adverse economic conditions make it more difficult for a bank to continue to make a profit, the policies and procedures established by a bank's management and board of directors play a more influential role in determining whether the institution will succeed or fail. In other words, poor management and other internal problems are the common denominator shared by insolvent or faltering banks.

## V

### Conclusions

The increasing complexity of the banking system's current mode of operation offers financial institutions a wide range of opportunities for increasing their efficiency and profitability, but it also confronts bank regulators with a series of challenges as they strive to ensure the achievement of the supervisory system's strategic objectives.

The quality of management appears to have played a significant role in the downward path of 90% of the insolvent or troubled banks that were evaluated by the OCC. Many of the difficulties experienced by these banks had to do with faulty lending policies, problems in credit identification systems, or a failure to enforce in-house policies and banking regulations. In other cases, imprudent action on the part of a bank's directors or management led to the granting of high-risk loans and overlending. Self-enrichment and fraud were also a significant factor in more than one-third of the banks that failed or that were in trouble.

The economic slump added to the difficulties of many of the banks that were covered by the study; in fact, the economy was a significant factor in one-third of the cases. Yet economic factors were rarely the only cause of the problem; only 7% of the banks that failed or that were on shaky ground were free of serious internal management problems.

In sum, the study shows that a bank's management and board of directors are, in the final analysis, responsible for its success or failure. If a financial institution sets up well-designed policies, controls and systems when the economic situation is favourable, it will increase its chances of continuing to make a profit when economic conditions take a turn for the worse.

In a prudential supervisory system, when defects in a bank's management are detected they serve as the basis for the application of corrective measures designed to solve the problems it is experiencing. This points up the need for bank supervisors in the Latin American countries to examine management issues in greater depth.

This is demonstrated by the analysis of recent bank crises—such as those of the Banco Latino and BANESTO—which was undertaken with a view to averting or minimizing further crises of this sort.

In order for a prudential form of supervision to be implemented, supervisory bodies must have the capacity to identify problems accurately, must have

the authority to take corrective action before the problems make their effects felt, and must be willing to take such action.

The following are the main issues in the current debate regarding the modernization of the supervisory system in the banking sector. First, there is the question of a stronger role for capital. If the role of capital is to be reinforced, then capital standards based on the weighting of asset risk must be adopted, levels of supervision will have to be differentiated on the basis of the level of capital backing available, and reserve requirements for the opening of new lines of business will have to be raised. Second, valuation mechanisms need to be refined, along with a gradual

shift in emphasis away from book values and towards market prices. Third, financial risk needs to be factored into capital standards. Fourth, regulatory systems need to take the presence of financial conglomerates into account so that the industry can take advantage of the benefits of economies of scope while minimizing the potential costs of system-wide risk, conflicts of interest and cross-subsidization. The fifth and final issue is the consolidation of a comprehensive supervisory system based on the CAMEL model which would look at all the various aspects that influence the status of a financial institution, with special emphasis on management quality.

(Original: Spanish)

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# Central American *integration:* its costs and benefits

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**Luis René Cáceres**

*Principal Officer,  
Department of Strategic  
Planning and Operational  
Policy, Inter-American  
Development Bank.*

This article sums up the benefits and costs of Central American economic integration. Increased economic growth, industrialization based on intra-industry trade, and greater competition in a broader subregional market represent significant benefits for the Central American countries, although for the most part these benefits are concentrated in the more developed countries. The costs of integration stem from the inter-country monetary flows occasioned by currency arbitrage, currency substitution, and the high transaction costs associated with inconvertibility. The elimination of these costs would have other costs, however, in the form of the reduction of national autonomy with regard to macroeconomic policy as a consequence of multilateral coordination and monitoring. The article closes with a call for the establishment of coordination schemes that reach beyond the realm of macroeconomic policy; such schemes would encompass a subregional agenda for structural change and would direct the subregion's efforts towards policy alignment as a means of doing away with disparities and making the Central American countries better able to integrate with one another and with the international economy.

# I

## Introduction

In the last three years, the Central American integration process has made considerable headway, thus putting an end to the stagnation of this process seen during the 1980s. Trade within Central America has been steadily on the rise since 1986, and in 1992 it totalled US\$892 million, which was close to the 1980 record high. The upturn can be accounted for by the economic growth of the Central American countries, an improvement in their external liquidity, and the major advances made in the elimination of trade barriers.<sup>1</sup> Progress has also been significant on the institutional front. Major accomplishments in this respect include the entry into operation of the secretariat of the Central American Integration System (SICA); Nicaragua's accession as a member of the Central American Parliament; the conclusion of trade and investment agreements between the subregion and Mexico, Venezuela and Colombia; advances in the coordination of economic policy; and the approval by the Central American presidents of the Protocol to the General Treaty on Central American Economic Integration. These events are a promising sign that Central American integration is entering into what may well prove to be a new era of great accomplishments.

Nevertheless, there is still a great deal to be done before full integration is achieved, for exports

between Guatemala and El Salvador still represent a full 59% of total intra-subregional trade. Moreover, in 1992 extra-subregional trade was below 1980 levels for all the countries except Costa Rica. Yet another factor is that the level of investment in physical infrastructure which is needed is considerable, as are the shortcomings existing in the social sectors of some countries.

In view of the progress made in the past few years, the ongoing process of economic globalization and the entry into force of the North American Free Trade Agreement (NAFTA) between Mexico, the United States and Canada, at this point in time it would be a good idea to analyse the contributions that integration could make to the Central American economies. The following article will therefore review the benefits that the Central American economies could derive from integration (section II), identify some of the obstacles that have prevented these potential benefits from becoming a reality (section III), discuss the possible costs of integration –and of failing to integrate– and propose certain policy-coordination and alignment schemes that might keep those costs to a minimum (section IV) and, finally, present a number of conclusions (section V).

# II

## What benefits would integration bring?

### 1. Domestic saving

One potential benefit is an increase in domestic saving as a result of the expansion of intra-subregional exports, given the causal relationship between

exports and saving in developing countries (J.K. Lee, 1971; Laumas, 1982). Based on annual data for the period 1971-1988, equations were estimated for domestic saving ( $S$ ) as a function of exports directed outside Central America ( $X_o$ ) and to Central America ( $X_{CA}$ ) and for gross domestic income minus total exports ( $Y-X$ ). The results are given in table 1.

It may be seen from this table that the chief determinant of national saving is extra-subregional exports. The coefficient for exports going to Central America is negative and statistically significant in Guatemala and Costa Rica and is positive but not

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<sup>1</sup> For a recent assessment of the Central American integration process, see ECLAC (1993).



TABLE 1

Central America: Saving and exports<sup>a</sup>

	Equation	R <sup>2</sup>	DW
Guatemala	55.5801 + 0.0389 (Y-X) + 0.0732 X <sub>O</sub> - 0.3454 X <sub>CA</sub> (1.97) (4.15) (12.57) (3.43)	0.98	1.53
El Salvador	99.5437 - 0.1915 (Y-X) + 0.8159 X <sub>O</sub> + 0.5554 X <sub>CA</sub> (1.99) (5.65) (6.01) (1.69)	0.87	2.16
Honduras	-17.8749 - 0.0285 (Y-X) + 0.5649 X <sub>O</sub> + 0.5715 X <sub>CA</sub> (0.57) (0.94) (6.23) (6.12)	0.91	1.33
Costa Rica	-101.4822 + 0.0192 (Y-X) + 1.00 X <sub>O</sub> - 0.9359 X <sub>CA</sub> (2.61) (0.64) (11.77) (2.97)	0.96	2.02

Source: Permanent Secretariat of the General Treaty on Central American Economic Integration (SIECA), *Estadísticas macroeconómicas de Centroamérica*, Guatemala City, several issues. The series for Nicaragua was incomplete.

<sup>a</sup> The statistical values of "t" are shown below the corresponding coefficients; R and DW stand for the coefficient of determination and the Durbin-Watson coefficient, respectively.

significant in the case of El Salvador. This indicates that extra-subregional exports do not stimulate saving, except in Honduras. This may be due to the fact that a large part of intra-subregional trade is made up of consumer goods whose production requires the importation of intermediate goods (Cáceres and Quintanilla, 1990).

2. Trade creation

Another possible advantage of integration is that trade creation could outweigh trade diversion in intra-subregional trade. Trade creation occurs when domestic production is displaced by less expensive imports from other member countries. Trade diversion takes place when goods produced at relatively low cost by a country not belonging to the integration scheme are replaced by more expensive products from a member country. Measurements of trade creation and diversion are based on the assumption that, in the absence of integration, the income elasticity of total imports would remain constant. When their income elasticity rises following integration, it is deduced that trade creation has occurred.

In order to identify the presence of this phenomenon, an equation was formulated for Honduras for the period 1950-1969 that expresses total imports (M) as a function of gross national product (Y), a dummy variable (W) to show up the change in the income coefficient during the post-integration period (1962-1969), and time (T):

$$\text{Log } M = -6.6249 + 1.8393 \text{Log } Y - 0.0157 W - 0.0251 T \quad R^2 = 0.97$$

(3.18) (5.37) (0.53) (2.88) DW = 1.68

The fact that the variable W is not statistically significant indicates that the income elasticity of imports did not change. Therefore, in Honduras there was no trade creation or diversion. A similar result was obtained when an equation was estimated for the period 1970-1991 and an attempt was made to detect a change in income elasticity during the period 1986-1991 using the variable W<sup>1</sup>:

$$\text{Log } M = -6.5357 + 2.1244 \text{Log } Y + 0.0071 W^1 - 0.1327 T \quad R^2 = 0.96$$

(3.34) (5.39) (0.53) (2.88) DW = 1.76

In the equations for the other countries during the period 1962-1991 (see table 2), W1 and W2 show the change in the Log Y coefficient during the 1970s and 1980s, respectively. It may be seen from these equations that, with the exception of El Salvador, the dummy variables are not significant.

The foregoing indicates that integration did not lead to a change in resource allocation during the pre- or post-integration periods except in El Salvador, where this phenomenon may be attributable to the fact that intra-subregional trade does represent a large percentage of El Salvador's total exports, which -according to Balassa (1967)- is one of the conditions for the occurrence of trade creation.

TABLE 2

**Central America (three countries): Changes in the  
marginal propensity to import**

	Equation	R <sup>2</sup>	DW
Guatemala	-3.7466 + 1.2996 Log Y - 0.0241 T + 0.0171 W1 - 0.0205 W2 (3.88) (9.08) (1.24) (1.27) (0.93)	0.99	1.48
El Salvador	-1.1246 + 0.9896 Log Y - 0.0152 T + 0.0489 W1 + 0.0331 W2 (1.77) (11.17) (1.30) (5.44) (2.35)	0.99	1.56
Costa Rica	-0.6180 + 0.9211 Log Y + 0.0361 T - 0.0032 W1 - 0.0201 W2 (0.78) (9.12) (2.02) (0.38) (1.50)	0.99	1.49

Source: International Monetary Fund (IMF), *International Financial Statistics Yearbook, 1993*, vol. XLVI, Washington, D. C., 1993.

### 3. Increased economic growth

Integration generates spillover effects that propel economic growth in the member countries via the trade flows among them. Studies have shown that these forces are quite powerful, but in Central America they vary a great deal from country to country (Nugent, 1974; Cáceres, 1981; Cáceres and Seninger, 1980). A quantification of this effect can be obtained using the following model:

<i>Country No. 1</i>	<i>Country No. 2</i>
$C_{p1} = (1 - s_1)Y_1$	$C_{p2} = (1 - s_2)Y_2$
$I_1 = b_1 Y_1$	$I_2 = b_2 Y_2$
$V_1 = m_1 Y_1$	$V_2 = m_2 Y_2$
$M_1 = z_1 Y_1$	$M_2 = z_2 Y_2$

$$Y_1 = C_{p1} + I_1 + E_{o1} + (V_2 - V_1) - M_1 + C_{g1}$$

$$Y_2 = C_{p2} + I_2 + E_{o2} + (V_1 - V_2) - M_2 + C_{g2}$$

where:

Y	=	gross national product
C <sub>p</sub>	=	private consumption
C <sub>g</sub>	=	(exogenous) public consumption
I	=	gross domestic investment
M	=	extra-subregional imports
V	=	intra-subregional imports
E <sub>o</sub>	=	(exogenous) extra-subregional exports

The above equations can be represented in the form of a matrix, as follows:

$$\begin{bmatrix} Y_1 \\ Y_2 \end{bmatrix} = \begin{bmatrix} s_1 - b_1 + z_1 + m_1 & -m_2 \\ -m_1 & s_2 - b_2 + z_2 + m_2 \end{bmatrix}^{-1} \begin{bmatrix} C_{g1} + E_{o1} \\ C_{g2} + E_{o2} \end{bmatrix}$$

from which the following can be worked out using the income vector:

$$\begin{bmatrix} Y_1 \\ Y_2 \end{bmatrix} = \begin{bmatrix} s_1 - b_1 + z_1 + m_1 & -m_2 \\ -m_1 & s_2 - b_2 + z_2 + m_2 \end{bmatrix}^{-1} \begin{bmatrix} C_{g1} + E_{o1} \\ C_{g2} + E_{o2} \end{bmatrix}$$

For the five Central American countries, the model's parameters were calculated using average values from 1990-1992. The following matrix of multipliers was obtained:

$$\begin{bmatrix} Y_G \\ Y_{ES} \\ Y_H \\ Y_N \\ Y_{CR} \end{bmatrix} = \begin{bmatrix} 4.19235 & 0.49716 & 0.31855 & 0.48916 & 0.10548 \\ 0.21391 & 4.08816 & 0.12822 & 0.16093 & 0.06074 \\ 0.01681 & 0.03901 & 3.61925 & 0.02242 & 0.00218 \\ 0.01711 & 0.03289 & 0.03796 & 2.40346 & 0.01061 \\ 0.04455 & 0.05203 & 0.04302 & 0.17542 & 1.62662 \end{bmatrix} \begin{bmatrix} C_{gO} + E_{oO} \\ C_{gES} + E_{oES} \\ C_{gH} + E_{oH} \\ C_{gN} + E_{oN} \\ C_{gCR} + E_{oCR} \end{bmatrix}$$

This matrix of multipliers indicates that if, for example, El Salvador's extra-subregional exports were to rise by US\$100, then the country's GDP would grow by US\$409, while the GDPs of Guatemala, Honduras, Nicaragua and Costa Rica would increase by US\$50, US\$4, US\$3 and US\$5, respectively.

The multiplier effects are greater for Guatemala and El Salvador than they are for the other countries. This fits in with the findings of several studies which indicate that these two countries have received the lion's share of the benefits of integration (Cline, 1978).

Table 3 shows the multiplier effect on each country of a simultaneous US\$1 increase in exogenous expenditure (public consumption or exportation to the rest of the world) on the part of the other countries. It also gives the multiplier effect on the other countries of a US\$1 increase in the exogenous expenditure of each country.

TABLE 3  
**Central America: Multiplier effects across the economies of the subregion**

	Multiplier effect of rest of Central America on each country	Multiplier effect of each country on rest of Central America
Guatemala	1.4102	0.2818
El Salvador	0.5612	0.6210
Honduras	0.0794	0.5710
Nicaragua	0.0990	0.8470
Costa Rica	0.3140	0.1788

As may be seen, Guatemala receives the greatest multiplier effect from the rest of the region (1.4102), followed by El Salvador (0.5612) and Costa Rica (0.3140), and the situation was the same in the 1960s and the 1970s (Cáceres, 1981). The countries having the greatest multiplier effect on the rest of Central America, on the other hand, are Nicaragua (0.8470), followed by El Salvador and then Honduras. Costa Rica has the smallest multiplier effect.

It is interesting to note that the size of the multipliers decreases with distance. In particular, the multiplier effects generated and received by Costa Rica—which is located at the far end of the subregion—are the smallest of all. This is a reflection of just how influential transport costs are in terms of the benefits of integration (see figures 1, 2 and 3).

The above indicates that the benefits of integration—in terms of the spread of economic growth—may, in part, be determined by the friction caused by distance. Hence the strategic importance of the road system and transport costs in the subregion.

FIGURE 1  
**Central America: Multiplier effects received by El Salvador**

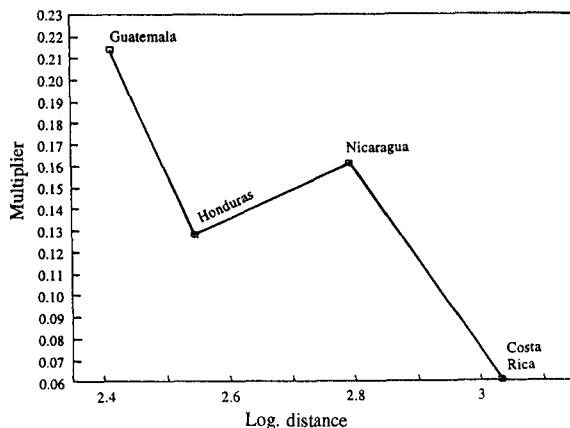


FIGURE 2  
**Central America: Multiplier effects received by Honduras**

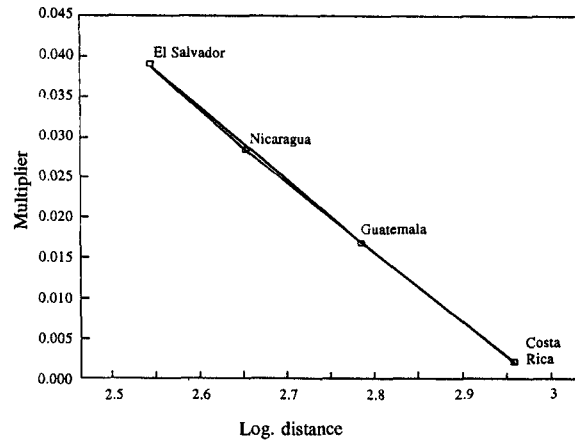
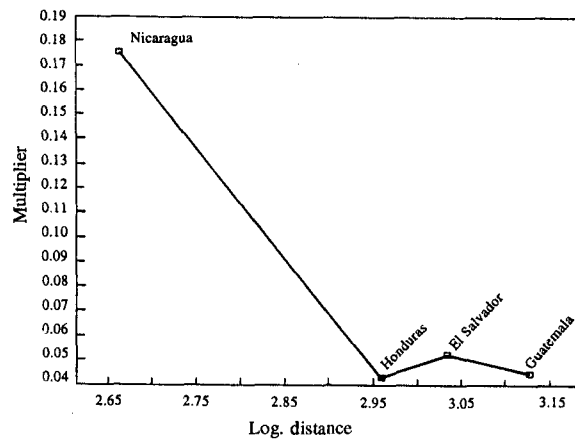


FIGURE 3  
**Central America: Multiplier effects received by Costa Rica**



4. The stabilization of economic growth

The stabilizing effect that would arise as growth spreads to the different countries depends upon there being no synchronous fluctuations in these countries' economies. One of the main determinants of economic growth in the Central American countries is the trend in their terms of trade. However, since the correlation among these countries' terms of trade is positive (see table 4), intra-subregional trade could not be expected to have a stabilizing effect even if trade flows were to increase.

Given the synchronous nature of the trends in the exogenous variables that affect the Central American countries' economies, it should come as no surprise that fluctuations in extra- and intra-subregional trade exhibit a close correlation (see figures 4 and 5).

TABLE 4

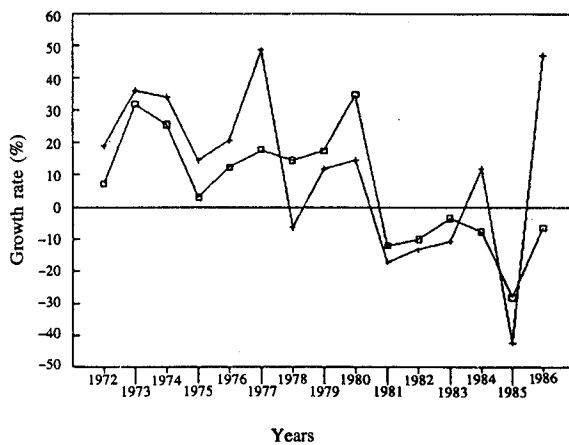
**Central America: Terms-of-trade correlation coefficients,  
1981-1992**

	Guatemala	El Salvador	Honduras	Nicaragua	Costa Rica
Guatemala	1	0.69	0.52	0.74	0.81
El Salvador		1	0.05	0.37	0.95
Honduras			1	0.30	0.08
Nicaragua				1	0.59
Costa Rica					1

Source: Calculated on the basis of data from the International Monetary Fund (IMF), *International Financial Statistics*, IMF, Washington, D.C., several issues.

FIGURE 4

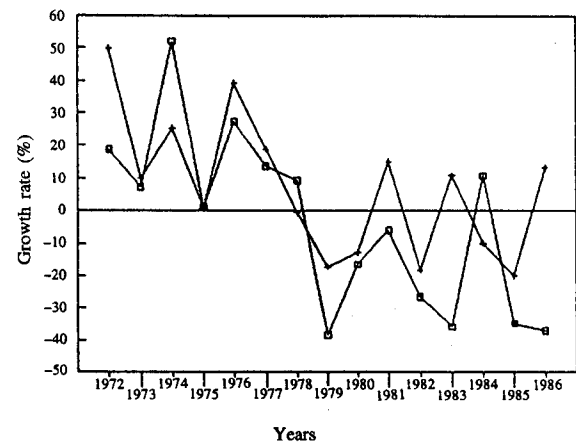
**Guatemala: Growth rates for exports  
inside and outside the subregion**



□ Exports to Central America    + Exports to rest of world

FIGURE 5

**Nicaragua: Growth rates for exports  
inside and outside the subregion**



□ Exports to Central America    + Exports to rest of world

## 5. Intra-industry trade

One of the potential benefits of integration is the stimulus it can give to industrialization based on intra-industry trade. A number of studies have observed that the similarity of consumer preferences in countries at the same level of development allows each country to specialize in the production of nearly identical goods which are then differentiated on the basis of marketing, packaging, appearance, etc. This two-way trade in similar products paves the way for industrialization because a country can thus focus its efforts on the efficient manufacture of a given product, regardless of the relative comparative advantages involved, thanks to the economies of scale that become possible in the broader market created by

integration.<sup>2</sup> In order to calculate how much of foreign trade is made up of intra-industry trade, exports and imports must be broken down into standardized product categories. This can be measured by the Grubel-Lloyd index (1975), defined as:

$$B = \frac{\sum (X_i + M_i) - \sum |X_i - M_i|}{\sum (X_i + M_i)}$$

where  $X_i$  and  $M_i$  represent exports and imports of product "i", respectively. Based on the data for 1987 shown in table 5, the values of B were estimated for intra-industry trade (see table 6).

<sup>2</sup> See Greenaway and Milner (1990) for a summary of the literature on intra-industry trade.

TABLE 5

## Central American trade, 1987

	Intra-subregional trade					Extra-subregional trade						
	ISIC <sup>a</sup> division	Exports Xi	Imports Mi	Diff- erence Xi-Mi	Total Xi+Mi	(Xi-Mi) (Xi+Mi)	ISIC <sup>a</sup> division	Exports Xi	Imports Mi	Diff- erence Xi-Mi	Total Xi+Mi	(Xi-Mi) (Xi+Mi)
<b>EL SALVADOR</b>												
Food, beverages and tobacco	31	9.80	27.80	-18.00	37.60	0.48	31	43.80	66.40	-22.60	110.20	0.21
Textiles, leather and footwear	32	24.60	13.80	10.80	38.40	0.28	32	36.10	30.10	6.00	66.20	0.09
Wood and furniture	33	0.40	9.10	-8.70	9.50	0.92	33	0.80	1.70	-0.90	2.50	0.36
Paper, printing and publishing	34	19.90	6.30	13.60	26.20	0.52	34	2.20	41.40	-39.20	43.60	0.90
Chemical products derived from petroleum, rubber and plastic products	35	35.90	60.90	-25.00	96.80	0.26	35	16.50	288.60	-272.10	305.10	0.89
Non-metallic mineral products	36	0.60	9.50	-8.90	10.10	0.88	36	0.10	10.40	-10.30	10.50	0.98
Basic metals industries	37	13.40	18.10	-4.70	31.50	0.15	37	1.20	54.50	-53.30	55.70	0.96
Metal products, machinery and equipment	38	12.10	13.60	-1.50	25.70	0.06	38	2.20	273.10	-270.90	275.30	0.98
Other manufactures	39	2.30	1.40	0.90	3.70	0.24	39	0.60	4.50	-3.90	5.10	0.76
			92.10	279.50	0.67				679.20	874.20	0.22	
<b>GUATEMALA</b>												
Food, beverages and tobacco	31	40.60	22.30	18.30	62.90	0.29	31	127.30	97.90	29.40	225.20	0.13
Textiles, leather and footwear	32	28.40	22.20	6.20	50.60	0.12	32	14.80	54.50	-39.70	69.30	0.57
Wood and furniture	33	5.10	2.50	2.60	7.60	0.34	33	5.00	3.60	1.40	8.60	0.16
Paper, printing and publishing	34	6.70	14.00	-7.30	20.70	0.35	34	0.40	56.80	-56.40	57.20	0.99
Chemical products derived from petroleum, rubber and plastic products	35	85.60	42.70	42.90	128.30	0.33	35	45.10	543.20	-498.10	588.30	0.85
Non-metallic mineral products	36	10.20	1.30	8.90	11.50	0.77	36	4.80	19.50	-14.70	24.30	0.60
Basic metals industries	37	12.00	14.60	-2.60	26.60	0.10	37	1.80	79.60	-77.80	81.40	0.96
Metal products, machinery and equipment	38	10.50	12.90	-2.40	23.40	0.10	38	2.00	409.20	-407.20	411.20	0.99
Other manufactures	39	2.10	1.50	0.60	3.60	0.17	39	0.40	13.10	-12.70	13.50	0.94
			91.80	335.20	0.73				1 137.40	1 479.00	0.23	
<b>COSTA RICA</b>												
Food, beverages and tobacco	31	14.40	17.30	-2.90	31.70	0.09	31	133.00	48.10	84.90	181.10	0.47
Textiles, leather and footwear	32	11.60	27.40	-15.80	39.00	0.41	32	63.20	58.50	4.70	121.70	0.04
Wood and furniture	33	2.40	0.80	1.60	3.20	0.50	33	11.10	1.80	9.30	12.90	0.72
Paper, printing and publishing	34	4.30	8.30	-4.00	12.60	0.32	34	6.20	94.60	-88.40	100.80	0.88
Chemical products derived from petroleum, rubber and plastic products	35	36.60	36.90	-0.30	73.50	-	35	64.00	440.20	-376.20	504.20	0.75
Non-metallic mineral products	36	6.40	2.60	3.80	9.00	0.42	36	6.80	19.30	-12.50	26.10	0.48
Basic metals industries	37	13.40	6.00	7.40	19.40	0.38	37	5.90	93.20	-87.30	99.10	0.88
Metal products, machinery and equipment	38	14.20	6.00	8.20	20.20	0.41	38	25.40	421.60	-396.20	447.00	0.89
Other manufactures	39	3.70	2.20	1.50	5.90	0.25	39	21.70	30.30	-8.60	52.00	0.17
			45.50	214.50	0.79				1 068.10	1 544.90	0.31	
<b>NICARAGUA</b>												
Food, beverages and tobacco	31	1.50	3.00	-1.50	4.50	0.33	31	52.50	36.40	16.10	88.90	0.18
Textiles, leather and footwear	32	1.00	8.80	-7.80	9.80	0.80	32	1.90	49.30	-47.40	51.20	0.93
Wood and furniture	33	0.70	0.10	0.60	0.80	0.75	33	1.30	6.50	-5.20	7.80	0.67
Paper, printing and publishing	34	1.10	1.20	-0.10	2.30	0.04	34	0.10	21.50	-21.40	21.60	0.99
Chemical products derived from petroleum, rubber and plastic products	35	4.50	19.0	-14.50	23.50	0.62	35	1.40	338.80	-337.40	340.20	0.99
Non-metallic mineral products	36	0.30	0.50	-0.20	0.80	0.25	36		9.60	-9.60	9.60	1.00
Basic metals industries	37	3.40	1.80	1.60	5.20	0.31	37	1.10	40.70	-39.60	41.80	0.95
Metal products, machinery and equipment	38	2.00	5.70	-3.70	7.70	0.48	38	0.50	248.60	-248.10	249.10	1.00
Other manufactures	39	0.10	0.60	-0.50	0.70	0.71	39	3.60	7.40	-3.80	11.00	0.35
			30.50	55.30	0.45				728.60	821.20	0.11	
<b>HONDURAS</b>												
Food, beverages and tobacco	31	4.00	6.40	-2.40	10.40	0.23	31	110.20	63.40	46.80	173.60	0.27
Textiles, leather and footwear	32	3.70	2.20	1.50	5.90	0.25	32	1.90	29.50	-27.60	31.40	0.88
Wood and furniture	33	3.80	-	3.80	3.80	1.00	33	40.20	0.80	39.40	41.00	0.96
Paper, printing and publishing	34	0.40	4.80	-4.40	5.20	0.85	34	2.60	38.50	-35.90	41.10	0.87
Chemical products derived from petroleum, rubber and plastic products	35	4.60	3.50	1.10	8.10	0.14	35	4.20	329.20	-325.00	333.40	0.97
Non-metallic mineral products	36	0.30	4.60	-4.30	4.90	0.88	36	2.60	14.20	-11.60	16.80	0.69
Basic metals industries	37	1.50	6.30	-4.80	7.80	0.62	37	0.20	40.90	-40.70	41.10	0.99
Metal products, machinery and equipment	38	1.40	1.30	0.10	2.70	0.04	38	0.10	247.90	-247.80	248.00	1.00
Other manufactures	39	0.50	0.20	0.30	0.70	0.43	39	0.80	18.90	-18.10	19.70	0.42
			22.70	49.50	0.46				792.90	946.10	0.16	

Source: Data taken from Bulmer-Thomas (1992a).

<sup>a</sup> The titles of the divisions of the International Standard Industrial Classification (ISIC) have been shortened.

TABLE 6

**Central America: Grubel-Lloyd index of intra-industry trade**

	Intra-subregional trade	Extra-subregional trade
Guatemala	0.73	0.23
El Salvador	0.67	0.22
Honduras	0.46	0.16
Nicaragua	0.45	0.11
Costa Rica	0.79	0.31

The figures show that in Central America a direct relationship exists between a country's level of development, as represented by per capita income, and the Grubel-Lloyd index in both intra- and extra-subregional trade. The highest values are for Costa Rica, followed by those for Guatemala, El Salvador, Honduras and Nicaragua. Indeed, 79% of Costa Rica's subregional commerce takes the form of intra-industry trade: a proportion similar to the figures for developed countries. The above indicates that integration enables the Central American countries to produce and export goods which otherwise would probably not be part of their foreign trade.

Costa Rica also has the highest value –0.31– for extra-subregional trade, followed by Guatemala (0.23), El Salvador (0.22), Honduras (0.16) and Nicaragua (0.11). In 1974, for the subregion as a whole, the indexes of intra-industry trade within Central America and outside the subregion were 0.505 and 0.025 (Laird, 1981).

The intra-industry trade indicators proposed by Balassa (1966) were also calculated for individual industrial branches. They are defined as:

$$\frac{|X_i - M_i|}{X_i + M_i}$$

This index goes from zero, when all trade is intra-industrial ( $X_i = M_i$ ) to 1, when there is no two-way flow of such trade. Table 5 demonstrates that intra-industry trade is an important component of all the Central American countries' trade flows in the following industries: basic metals, metal products, machinery and equipment, and other manufactures. It is also an important factor in the textile and chemical industries. This might indicate a lack of specialization at the country level, which would mean that all the countries would have the same comparative advantages.

In trade flows directed outside the region –primarily to the United States, Japan and Germany– the intra-industry trade indexes for Honduras and Nicaragua are not significant for any branch of industry except food, beverages and tobacco. This industry has higher indexes in all the countries, which fits in with the postulates regarding comparative advantages.

The above results tally with those of a number of other studies in that they indicate that intra-industry trade is greatest among countries with similar income levels (Gray, 1988). Specifically, Balassa and Bauwens (1987) found that the intra-subregional trade flows occurring within the framework of the Latin American Free Trade Association (LAFTA) were chiefly of an intra-industrial nature, and Greenaway (1987) obtained a similar result for the EEC.

Thus, the prevalence of intra-industry trade in the Central American integration process facilitates these countries' industrialization, because this process allows similar yet differentiated products to find a broader market, thus paving the way for larger production series with consequent economies of scale (Balassa, 1979).<sup>3</sup>

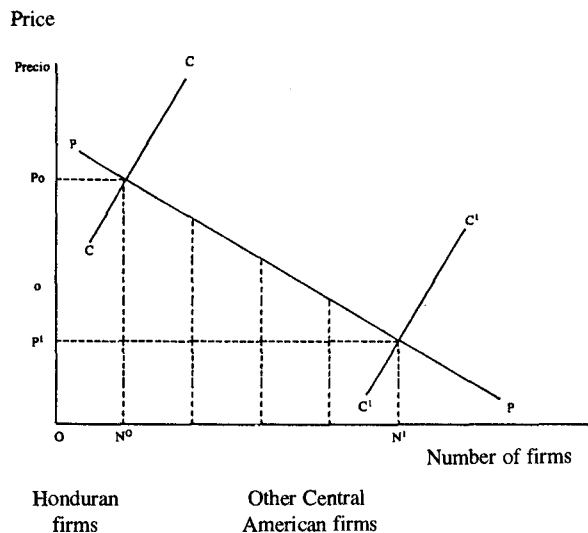
## 6. Broadening the market

Traditionally, analyses of the benefits of economic integration have been based on an assumption of perfect competition, which does not always occur in developing countries where there is a heavy concentration of industrial enterprises (N. Lee, 1984 and 1992). This is the case in Central America (Rapoport, 1978). Accordingly, for these countries, the imperfect competition model may be more useful in illustrating the benefits of integration. This model assumes the existence of a monopolistic form of competition in the internal market. Consequently, prices are determined by the average costs of the firms in the relevant industry rather than by their marginal costs. As the number of firms in the industry rises, so do average costs, since the market for each individual firm shrinks (Helpman and Krugman, 1986).

<sup>3</sup> Bulmer-Thomas (1992a) has noted that the food, beverage and tobacco industry accounts for 50% of the subregion's manufacturing output but represents only 15% of its intra-subregional exports. This author states that the expansion of trade in the products of this industry through the elimination of existing non-tariff barriers would provide a strong stimulus for trade within Central America, especially in the cases of Honduras and Nicaragua. The indexes point to the desirability of expanding trade in these products so that the countries can take advantage of the economies of scale inherent in intra-industry trade.

In figure 6, taking the case of a single country (Honduras, for example), CC represents the direct relationship between the number of companies in the relevant industry and their average costs. As the number of firms rises, the competition among them increases and their prices decline. Thus, PP denotes the inverse relationship between the number of firms and the going price in that industry. The point of equilibrium is at the intersection of CC and PP, where the price ( $P_0$ ) is equal to the average cost level that will not prompt firms to either enter or leave the sector, and thus determines the number of national companies ( $N^0$ ). When integration takes place, the increase in monopolistic competition that will result from the participation of firms in the other countries will cause prices to go down. At the same time, the firms' average costs will now be influenced by the broader market and larger number of companies. The expansion of the market tends to push down the average cost, but the increase in the number of firms tends to raise it. As a result, CC shifts outward ( $C'C'$ ), which implies lower average costs and a larger number of firms. The equilibrium solution involves having fewer companies than the total number of firms existing prior to integration, and a price below its pre-integration level as a result of larger sales volumes per firm and more competition. Figure 6 shows the new equilibrium price ( $P^1$ ) and the new number of firms ( $N^1$ ) which are the outcome of monopolistic competition on a subregional scale.

FIGURE 6  
Honduras: Market expansion and monopolistic competition



The above shows that integration gives each Central American country access to the markets of the other countries in the area. This does not occur in the case of a general unilateral liberalization of trade, which does not guarantee the initiating country access to any other market in exchange. In this case, the going price in the domestic industry would be the international price.

Rodrik (1988 and 1990) has shown that, once the assumption of perfect competition in the national market is discarded, trade reform manifests itself in three different ways, each of which has a positive impact when the situation unfolds as follows: (i) an expansion of imports of goods which had previously been protected and a contraction of the corresponding domestic sectors; (ii) an increase in the output of oligopolistic firms; and (iii) the growth of firms that take advantage of economies of scale. The first effect could run counter to the other two, since protected sectors are generally of an oligopolistic nature and enjoy economies of scale.<sup>4</sup> In other words, in a more general analysis of the various implications of trade reform, the contraction of protected industries leads to an increase in well-being, but this effect might be cancelled out if these industries have an oligopolistic structure and if the technological efficiency provided by economies of scale is lost. In such a case, the net result could be ambiguous.

Rodrik (1988) says that this conflict could be resolved by an increase in the exports of formerly protected sectors. It should be emphasized that integration provides an opportunity to expand the exports of these and other sectors, which would ensure that the benefits associated with a unilateral liberalization of trade would actually be received. Hence, integration and liberalization can be complementary. It may also be seen that the assumption of perfect competition may be unsuitable for analysing the effects of liberalization and integration.

<sup>4</sup> Cline (1978) has quantified the economies of scale in Central American industry. The heavy industrial concentration observed in the Central American countries has been highlighted by Rapoport (1978), who states that, at a subregional level, industrial concentration lessens in relation to the degree of national concentration, thus becoming similar to the level of concentration existing in the United States. In short, says the author, these measures exhibit an extremely high level of industrial concentration for each Central American country when considered individually but a significantly lower overall concentration—comparable to that existing in the United States—when the subregion is regarded as a single unit. He adds that the Central American Common Market probably played a substantial role in reducing monopolistic and oligopolistic power in Central America (p. 670).

Along these same lines, using a model of imperfect competition, Smith and Venables (1988) found that the integration of markets within the EEC has led to an increase in extra-regional exports, because of the price reductions occasioned by the economies of scale made possible by the European market. Other studies have found that, at the level of industries and firms, industrial concentration is inversely related to the expansion of exports (Glejser, Jacquemin and

Petit, 1980) and that such concentration diminishes with the size of the market (Meller, 1978).

It has also been observed that Costa Rica's increased sales of non-traditional exports to countries outside the subregion were preceded by a period in which it gained experience in exporting the same products to the Central American market. These findings have been interpreted as proof that integration offers exporters the opportunity to "learn by doing" (Webb and Fackler, 1993).

### III

## Obstacles to enjoyment of the benefits of integration

The preceding section showed that integration has benefited the Central American countries in terms of economic growth, industrialization driven by intra-industry trade and increased competition in a broader market. It has also been noted, however, that these benefits have been concentrated in the more developed countries of the subregion. The data also indicate that these benefits have been related to the size of a member country's share of trade within the subregion. We may then ask ourselves what types of factors determine the nature of the various countries' intra-subregional export performance. The argument has also been made that the larger size of the more developed countries' economies has facilitated the industrialization process based on economies of scale and better physical infrastructure (Cáceres, 1981). In other words, a higher level of activity in the export of commodities laid the groundwork for a greater industrial capacity when the integration programme began in the 1960s. Be this as it may, an examination of the variables that have been seen to influence exports within the subregion is a matter of special interest.

#### 1. Transport costs

The high transport and insurance costs associated with the exports of Central American countries have gone relatively unnoticed. According to the International Monetary Fund (IMF), this cost can be calculated as the difference between one country's exports to another region or country and its imports from that same region or country. When the transport

costs involved in trade with developing countries—which, in this case, would essentially correspond to intra-subregional trade—are estimated on this basis, we find that they are particularly high for Honduras and Nicaragua (see table 7).

TABLE 7

**Central America: Estimated transport and insurance costs, 1992**  
(Percentages of exports)

Guatemala	6.2
El Salvador	0.8
Honduras	52.8
Nicaragua	14.1
Costa Rica	2.41

Source: Calculated on the basis of figures from the International Monetary Fund (IMF), *Direction of Trade Statistics Yearbook, 1993*, Washington, D.C., 1993.

#### 2. Low levels of human capital

Among the factors of production influencing a country's export capacity, the supply of human capital is of particular importance. The crucial role played by this type of capital in the creation of comparative advantages has been quantified for the EEC countries by Neven and Roller (1991). In addition, in a study on determinants of bilateral trade that made use of a sample composed of 18 developed and 20 developing countries, Balassa and Bauwens (1988) found that one of the variables influencing exports between trading partners was the ratio between the



TABLE 8

Central America: Human capital indicators, 1990

	Enrolment rate		Index	Exports to rest of Central America, 1992 (millions of dollars)
	Secondary level	Post-secondary level		
Honduras	32	9	77	34.3
Guatemala	21	...	...	353.0
El Salvador	29	17	114	207.1
Nicaragua	43	8	83	51.9
Costa Rica	41	24	161	224.5

Source: Calculated on the basis of data from the World Bank, *World Development Report, 1991*, Washington, D.C., 1991.

exporting country's and the importing country's supplies of human capital. According to these authors, if this ratio rose by 1%, exports would expand by between 0.123% and 0.233%, depending on whether the trade flow was between developing or developed countries.

The indicator for human capital used in the above-mentioned studies is the secondary-school enrolment rate plus five times the level of the post-secondary enrolment rate. This index has been calculated for the Central American countries as of 1990 (see table 8).

The importance of the role played by the size of a country's pool of human capital as a determinant of trade flows within Central America is illustrated by the use of an equation which expresses the exports of country "i" to country "j" ( $E_{ij}$ ) as a function of the human capital indexes of the exporting ( $H_i$ ) and importing ( $H_j$ ) countries and the distance (in kilometres) between the two ( $D_{ij}$ ). The results of this estimate –based on a sample of the intraregional trade of El Salvador, Honduras, Nicaragua and Costa Rica in 1992 and using the human capital indexes shown in table 8– are as follows:<sup>5</sup>

$$\begin{aligned} \text{Log } (E_{ij}) = & -4.8536 - 0.8027 \text{ Log } (D_{ij}) + 2.9216 \text{ Log } (H_i) \\ & (0.90) \quad (1.48) \quad (3.45) \\ & -0.1408 \text{ Log } (H_j) \quad R^2 = 0.54 \\ & (0.19) \quad \text{DW} = 1.62 \end{aligned}$$

This demonstrates that the determinant of trade within Central America is the exporting country's level of human capital.

A similar result was obtained using data from 1965 on the five Central American countries and incorporating GDP variables for the exporting ( $Y_i$ ) and importing ( $Y_j$ ) countries:

$$\begin{aligned} \text{Log } (E_{ij}) = & -7.8331 + 1.3591 \text{ Log } (Y_i) + 0.7179 \text{ Log } (Y_j) \\ & (1.93) \quad (4.01) \quad (2.12) \\ & -1.1416 \text{ Log } (D_{ij}) + 0.6901 \text{ Log } (H_i) \\ & (4.40) \quad (2.40) \\ & + 0.2749 \text{ Log } (H_j) \quad R^2 = 0.71 \\ & (0.95) \quad \text{DW} = 1.94 \end{aligned}$$

The exporting country's human capital index is significant, but less so than in 1990. This would appear to indicate that the role of human resources in intra-subregional trade has been gaining in importance as time has passed. Hence, the Central American countries' efforts to promote integration and economic modernization may be in vain unless they can raise their levels of human capital substantially.

An examination of the trends in human capital indexes for the period 1960-1990 (see table 9) reveals that Costa Rica displays higher values than the other countries, while Guatemala exhibits a slower rate of improvement. Furthermore, these indicators declined during the second half of the 1980s, except in El Salvador, which by 1990 had greatly improved upon the levels it had recorded in the early 1980s.

<sup>5</sup> The data on trade within Central America are taken from ECLAC (1993).

TABLE 9

## Central America: Human capital indicators

	Years					
	1960	1975	1978	1983	1985	1990
Guatemala	17	33	40	51	56	...
El Salvador	16	58	63	84	97	114
Honduras	13	43	48	83	81	77
Nicaragua	12	51	81	108	93	83
Costa Rica	46	128	141	174	171	161

Source: Calculated on the basis of data from the World Bank, *World Development Report*, Washington, D.C., several issues.

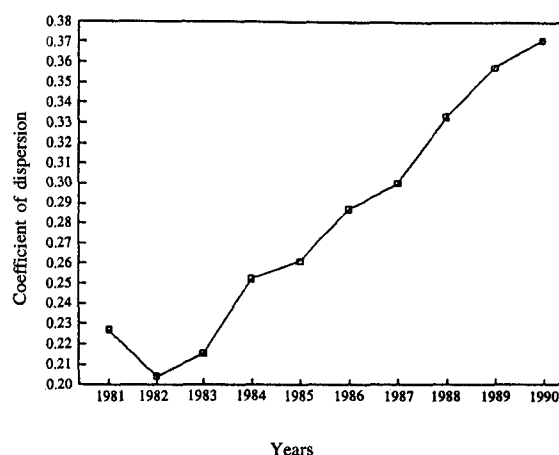
In view of the disparities existing among the countries' levels of development in terms of human capital, one appropriate subregional policy option might be to institute unrestricted mobility for the labour force. Such a step might well be more effective over time than an effort to achieve a rapid increase in the stock of human capital in the countries that have lagged furthest behind in this respect, although such an increase is at all events urgently needed. Indeed, according to the analyses carried out by De Franco (1993), the economic benefits of labour mobility are considerable.

### 3. The absence of measures to promote equity

Despite the differences observed in the various countries' abilities to take advantage of the benefits of integration, no policy has been formulated in Central America to promote equity in this regard or to provide the less developed countries with any sort of compensation. Furthermore, the economic disparities among the countries of the subregion deepened during the 1980s, and the coefficient of per capita income dispersion –i.e., the standard deviation divided by the average value– has tended to move upward (see figure 7). This could be interpreted as an indication that the Central American countries are becoming more heterogeneous. In the case of the European Union, the Maastricht Treaty sets forth the principle of cohesion –defined as the reduction of regional disparities– as the most basic

FIGURE 7

### Central America: Dispersion of per capita income levels



canon of European integration<sup>6</sup> (Begg and Mayes, 1993). It would therefore appear important to devise measures to promote equity within the context of Central American integration in order to maximize the benefits to be derived from the integration process.

<sup>6</sup> In the countries belonging to the Organization for Economic Cooperation and Development (OECD), the index of per capita income dispersion fell from 0.45 in 1950 to 0.28 in 1985 (Dowrick and Nguyen, 1989).

## IV

### The costs of integration

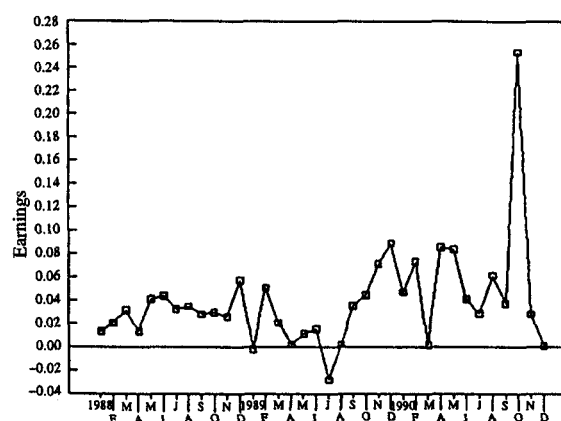
In considering the costs of integration, a number of recent studies have computed the cost to the Central American countries of refraining from engaging in integration, with this "non-integration" option being defined as the suspension of intra-subregional trade. In particular, Gallardo (1992) has stated that this cost could be significant for all the countries except Honduras. The validity of these studies notwithstanding, there are other types of costs—which may prove to be quite substantial—that have received relatively little attention. These costs stem from a failure to coordinate the policies that have a bearing on integration efforts; in other words, even in areas where integration is already a reality, the lack of policy coordination could generate significant costs. These costs will be analysed below.

#### 1. Currency arbitrage

One phenomenon that underscores the need for coordination is currency arbitrage, i.e., the practice of buying and selling a good (currency) that has different prices in two different markets in order to make a profit. By way of example, a person could travel from Guatemala to El Salvador and exchange his quetzales for colones at an exchange rate of  $C/Q$  and then buy dollars at an exchange rate of  $C/D$ . This individual could then return to Guatemala, exchange the dollars for quetzales at an exchange rate of  $Q/D$  and turn a profit. If the going exchange rate for converting colones to quetzales is higher than the cross-currency exchange rate (colón-dollar/quetzal-dollar), then a profit-making opportunity exists. In other words, if  $C/Q > C/D/Q/D$ , then the conditions exist for the initiation of a flow of quetzales to El Salvador, and the demand for colones and dollars will therefore rise.

Figure 8 gives the earnings from the above operation  $C/Q - C/D/Q/D$ , in colones per quetzal traded, for the period 1988-1990. In most cases, the result is positive, which means that El Salvador is a source of supply of dollars for Guatemala. It also means that, given this ongoing inflow of quetzales to El Salvador, Guatemala's monetary planners should seek to determine what portion of that country's money

FIGURE 8  
Guatemala and El Salvador: Earnings  
from arbitrage  
(Colones per quetzal traded)



supply is flowing into El Salvador. By the same token, El Salvador should try to ascertain how much of the money supply in that country is made up of quetzales. Thus, it is clear that at least two currencies are in circulation in these economies. This is an especially important factor in determining the degree of precision attained by financial planning and in the design of adjustment programmes, and calls for an effort on the part of the Central American countries to coordinate their exchange policies.

#### 2. Currency substitution

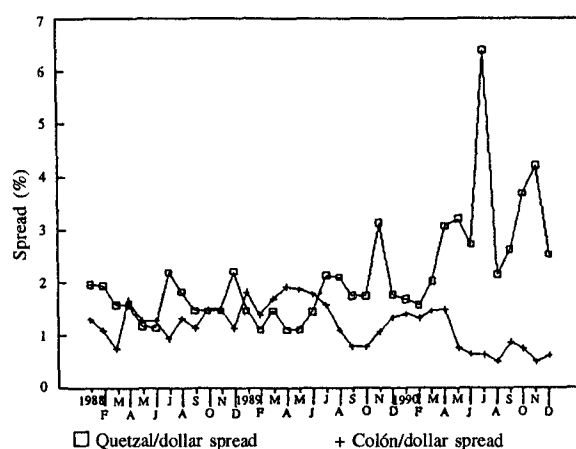
In connection with the subject of the preceding section, it may be noted that some studies have found that in El Salvador and Guatemala the respective demands for those countries' currencies are interdependent, inasmuch as the demand for colones in El Salvador is partially determined by the supply of quetzales in Guatemala (Cáceres and Suay, 1988a). The question then arises as to which monetary aggregate would be the most effective tool for monetary planners to use in each country. There is also empirical evidence that the principal determinant of the inflation rate in El Salvador is a variable composed of the aggregation of the money supplies of Guatemala

and Costa Rica (Cáceres and Suay, 1988b). The same type of interdependence has also been found in the case of the exchange rates of these countries. In fact, the Granger test of causality shows that Guatemala's exchange rate determines the rate for El Salvador (Cáceres and Núñez-Sandoval, 1992). Since these countries' exchange rates are determined by their money supply, the expansion of one country's money supply has repercussions on the exchange rate of the other. Consequently, exchange stability—which is of particular importance for trade within Central America—would appear to depend in part on variables outside the country in question. This points to the need for an operational framework for the coordination of monetary policy, since the costs of not having such a system may be quite high.

### 3. Exchange-rate spreads

Another phenomenon that shows up the need for coordination is the spread existing between the buying and selling rates for the dollar in Guatemala and El Salvador, which represents a significant transaction cost. The spread is wider in Guatemala than in El Salvador because the volume of currency traded is greater in the latter (see figure 9).

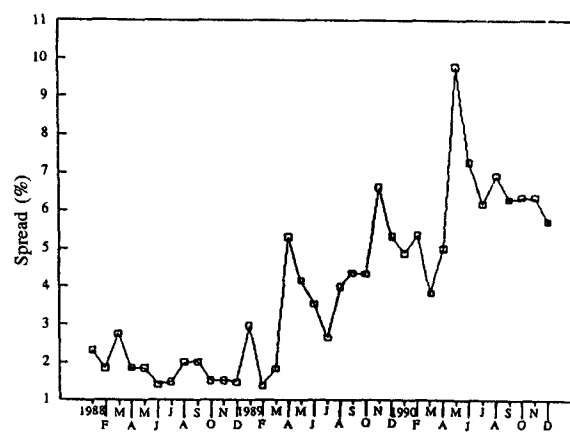
FIGURE 9  
El Salvador and Guatemala: Exchange-rate spread in dollar markets  
(Selling price-buying price/average price)



Moreover, the two spreads exhibit opposite trends, i.e., when the volume of exchange operations is low in one country, it is high in the other and vice versa. The spread in the exchange rate for the quetzal against the colón (see figure 10) is much higher than for the other two currencies due to the smaller volume of such transactions.

The above examples represent a genuine form of "monetary integration"; such *de facto* integration takes place due to the forces of supply and demand for these currencies, which, in turn, reflect the monetary and fiscal policies of these countries. The examples also make it clear that, without proper coordination, this sort of integration may be costly, thus highlighting the need to set up mechanisms for the convergence and multilateral oversight of these policies.<sup>7</sup> If they are to eliminate the costs of integration, the countries will have to pay the "cost" of reducing the autonomy of their monetary and fiscal policies. In other words, the countries would not be able to establish their own monetary and fiscal programmes independently but would instead have to do so on a consensual basis whereby such policies would be subject to the needs of the entire subregion.

FIGURE 10  
Colón/Quetzal exchange-rate spread



<sup>7</sup> For an excellent overview of policy coordination in Central America, see López (1994).

# V

## The need to coordinate integration efforts

The preceding section stressed the need for a policy coordination system which would enable the countries to eliminate the costs of a *de facto* form of integration. Indeed, in order to take full advantage of the benefits of integration, the Central American countries should adopt a broader policy-coordination system with a view to the harmonization of their structural reform efforts.

### 1. Structural reform

Taking a subregional approach to the structural reform process would—in addition to permitting all the countries to advance at a more even pace while still allowing each to follow its own timetable and base its actions on its individual capabilities for implementing such reforms—permit the identification in each country of needs that could be met and opportunities that could be seized more effectively through joint efforts. It would also ensure that the results of the process in each country would be in keeping with those of the other countries in the subregion, particularly with regard to economic and sectoral policies. In the following paragraphs we will see just how a subregional approach could help to further the three components of the structural reform process: stabilization, adjustment and reform as such.

#### (a) *The subregional macroeconomic framework*

The first component of the structural reform process is stabilization. To that end, a coordinated agenda for the macroeconomic management of the five countries could play a particularly important role. Such an agenda should include a system for the coordination of macroeconomic policies<sup>8</sup>—which need not be identical but should be consistent with one another—and should be structured so as to keep certain macroeconomic variables in each country within a pre-established range. It would also lend greater credibility to the countries' economic reform efforts, since each of the national reform programmes would be perceived as forming part of a subregional commitment.

#### (b) *The framework for structural adjustment*

The subregional alignment of adjustment programmes for specific sectors (the second component) would create a harmonious framework within which the countries could pursue their sectoral policies, thus

contributing to a more balanced form of development that would not exacerbate existing disparities. Such an approach would be of particular importance in the transport sector, especially with regard to policies on competition; in the energy sector, where privatization and leasing arrangements would be advantageous for investors in the subregion; and in agriculture, because of the effects it would have on trade in agricultural products. What is more, if the reform of the State were to be carried out on a subregional basis, it would ensure a better articulation of the countries' public sectors and would pave the way for greater consistency in regard to labour codes, the civil service, occupational and other health standards, investment laws, etc.

Industrial retooling would be an extremely important item on this subregional agenda for structural adjustment. The countries need assistance in providing suitable business services of specific types, especially in the areas of human resources development, quality-control systems, marketing, storage and market information (Willmore and Máttar, 1991). Strategies for optimizing these services would be more effective within the framework of a subregional approach because they would then allow the countries to draw upon the lessons learned by the other countries and to build on the experience already gained in Central America. Training is a highly important factor in this regard.<sup>8</sup>

The subsectors in which industrial retooling should be undertaken would have to be selected from a subregional vantage point in order to enhance those subsectors' complementarity and vertical integration. Within this framework, each country would have access to a whole range of experiences and opportunities, and firms would find it easier to work together to win new markets and negotiate the use of relevant technologies.

<sup>8</sup> A study conducted by Willmore and Máttar (1991) on the need for industrial retooling in Central America concluded that the steps that would contribute the most to an increase in plant efficiency were not the modernization of equipment or huge investments but rather the implementation of mechanisms for improving the quality of business administration, making the fullest possible use of raw materials, improving planning and control of incentives, and improving marketing techniques, all of which involves quite a low level of costs and investments.

(c) *Subregional structural change*

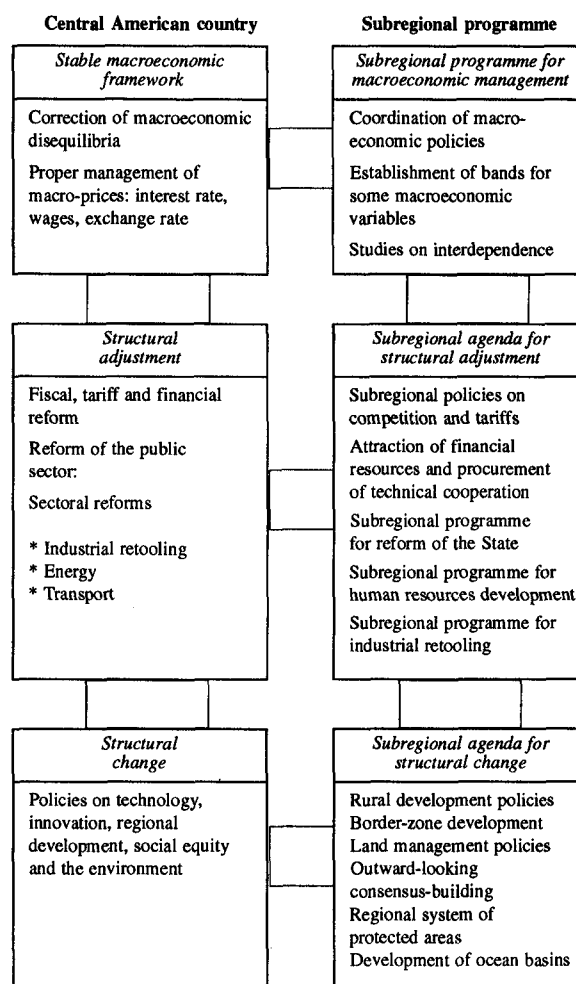
The third component of the reform process is structural change. Whatever programmes of this nature the countries might decide to implement on a joint basis – policies on technology, the promotion of innovation, the development of the poorest zones (especially in border areas) and the diversification of international economic relations – would be strengthened by the adoption of a subregional approach, especially through the increased access to financial resources and technical cooperation and the greater degree of policy convergence that would come with integration. A subregional approach would also be a valuable aid for governments in their efforts to remedy social imbalances, as well as having an important demonstration effect. A subregional agenda for social reform should therefore be drawn up that could serve as a basis for programming the steps needed to bring about the convergence of the social development process in the subregion, particularly with regard to basic education, primary health care and sanitation. Figure 11 provides an example of how a subregional agenda for structural reform might be formulated on the basis of national programmes.

An appropriate mechanism for framing such an agenda would be the Central American Cabinet of Ministers, which meets periodically to analyse issues of subregional scope. The meetings of this body would provide an opportunity to identify the various aspects to be covered in a given sector while differentiating between issues of national concern and those having implications for the entire subregion. The analysis of the latter types of questions would be directed towards ensuring that the countries are truly prepared for integration by making sure that they constitute congruent components of a Central Ameri-

can production matrix. This approach would also allow for the harmonization of the elements needed in order to permit the integration of the subregion, as a bloc, with the rest of the world.

FIGURE 11

**Subregional agenda for structural change**



## VI

### Conclusions

Economic integration has benefits to offer the Central American countries because it can stimulate economic growth, promote industrialization (through intra-industry trade) and help boost the efficiency of the production apparatus (as a result of increased monopolistic competition at the subregional level

and, in particular, by guaranteeing access to other markets). These benefits lay a more solid foundation from which to cope with the competition from other parts of the world that will emerge as these economies become more open. The countries' ability to take advantage of the opportunities offered by inte-

gration will, however, hinge upon the measures they take to strengthen their stock of human capital.

Integration also has its costs, however, due to the unforeseen repercussions that one country's monetary and fiscal policies may have on the others (especially as a result of currency substitution), which may make it more difficult for the countries to fine-tune their monetary policies. The cost associated with de facto monetary integration could be cancelled out by the lesser "cost" of establishing a coordination scheme that might diminish national authorities' autonomy in the area of macroeconomic policy management.

The Central American countries should take a subregional approach to the structural reform process, especially as it relates to social issues and in-

dustrial retooling. In order to ensure that such reforms facilitate and encourage subregional integration and are in keeping with that process, they need to be guided by common objectives and proceed according to a set timetable, although that timetable may be different for each country. A subregional agenda for structural change should therefore be formulated that will promote the advancement of all the countries and carry forward the integration process with greater institutional and sectoral consistency and harmony. The implementation of such an agenda would permit the identification of opportunities for greater economic complementarity and cross-sectoral integration, as well as promoting a harmonious form of integration with other regions.

(Original: Spanish)

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# Some lessons *of the Argentine* privatization process

**Daniel Azpiazu**  
**Adolfo Vispo**

*Member of the Scientific  
Researcher Course of  
CONICET and Principal  
Researcher of the  
FLACSO Argentine  
Programme.*

*External Consultant of the  
ECLAC Buenos Aires Office  
and Visiting Researcher  
of the FLACSO  
Argentine Programme.*

The reduction of the role of the State in the Latin American economies has become one of the central topics in the debate on the process of the economic and social restructuring of the region. Because of the magnitude and rapidity of its achievements, the programme carried out in Argentina in the early 1990s is seen as a paradigm which gives rise to reflection and offers a broad range of lessons for those countries seeking to maximize the social benefits that could be obtained from the privatization of public enterprises. From this point of view, the present article highlights some of the main macroeconomic repercussions of the privatization process (in the fiscal sphere, the external sector, the structure of relative prices, and investment), together with its effects on market formation and the strategies of the main business conglomerates of the country, the forms of public regulation of the privatized areas, and the limitations and shortcomings observed. It is concluded that the short-term emphasis of the process probably militated against the achievement of many of the proposed objectives and departed from the criteria that could be deduced from the incipient international experience in this field. The failure of the authorities to pay much attention to certain fundamental issues (the transparency of the process, the need to take measures to put the enterprises to be privatized on a sound footing before offering them for sale, the maximization of transfer prices, the exercise of regulatory powers, the competitiveness of markets and of the economy as a whole, the consolidation of reserves in oligopolistic markets, etc.) resulted in the process making only a marginal –if not a frankly negative– contribution to social equity in Argentina.

# I

## Introduction

In line with various efforts being made at the time in other countries, a new item was placed on the agenda of Argentine society in the 1980s: the "denationalization" of public enterprises.

Since the late 1970s, the international economy has witnessed a growing tendency to question many of the forms assumed by State regulation, especially as regards the public ownership of service enterprises, and above all such ownership of goods-producing entities.

Argentina has not been unaffected by this phenomenon. As early as the democratic government that was in office from 1983 to 1989, the first tentative efforts<sup>1</sup> were made to privatize some of the main public enterprises. These projects were blocked by the members of the main opposition party, who questioned the essence and form of the proposed privatization operations.<sup>2</sup>

Shortly after the present government took office in mid-1989, however, that same party won legislative approval—almost without opposition—for an ambitious privatization programme which was much wider and faster than the programme it had rejected a little earlier. From then on, with the enactment of Act No. 23696 on Reform of the State (August 1989), the role of the public sector in Argentina entered on a new phase, with the emergence of new markets for private activity and privileged areas with extraordinary quasi-rents and reserved market sectors.<sup>3</sup> With the adoption of this Act, practically all the enterprises producing

goods and services which belonged wholly or partially to the State became eligible for privatization.

Generally speaking, the first steps in this broad privatization programme suffered from various kinds of problems<sup>4</sup> which, in many cases, substantially altered the planned conditions and the ambitious original timetables. If there is one feature that distinguishes the Argentine process from the efforts being carried out in other countries at more or less the same time, however, it is the rapidity and extent of its achievements. Thus, between 1990 and 1991 the privatization process covered the national telecommunications and air transport companies, the State's share holdings in the petrochemical industry, the central and secondary areas of the petroleum industry, over a third of the national highway system, over 5 000 kilometres of railroads, etc. In 1992 and 1993 the privatization process continued, extending to important new sectors (especially in the field of energy) and consolidating its progress in others. Suffice it to note that the process covered the transport and distribution of natural gas, electric power (generation, transport and distribution), the National Water and Sanitation Company, various elevators in different ports, and the two integrated steelworks (SOMISA and Altos Hornos Zapla). At the same time, privatization was continued and intensified in the central and secondary areas of the petroleum industry (spreading to the refineries, oil pipelines, tanker fleet and other assets of Yacimientos Petrolíferos Fiscales (YPF)), while YPF itself was partially privatized, as also were railroad and subway lines, the road system and means of access to the capital, stock holdings in petrochemical industries, enterprises in the area of Defence, and other assets such as the main racetrack, the Liniers commodity market, over 800 units of real estate, etc.

Up to the end of 1993, this rapid and wide-ranging privatization programme brought in resources

□ This study was executed, with the cooperation of Dr. Klaus Esser of the German Development Institute, as a contribution to the Project on the Transition of Economic Systems which is being carried out under FLACSO's Argentine Programme, sponsored by the Volkswagenwerk Foundation.

<sup>1</sup> These were the abortive efforts to privatize the State airline (Aerolíneas Argentinas) and the State telecommunications company (ENTEL).

<sup>2</sup> The Government's intentions covered various public enterprises. In reality, however, the privatization operations carried out during this period were limited to the sale of the State's share holdings in two petrochemical firms and the ex-SIAM welded pipe plant.

<sup>3</sup> This happened during the 1980s, in a sporadic manner, through the State's acceptance of responsibility for private external debt, industrial promotion, public-sector purchases of goods and services, etc.

<sup>4</sup> In addition to macroeconomic problems (high levels of inflation, severe fiscal imbalances, widespread uncertainty) there were also the problems of the deficient regulatory conditions, the need to fit in with the parallel negotiations on the external debt, and, in general, the natural inconsistencies due to the priority given to speed in the privatization process.

totalling over US\$15 billion, over one-third of which corresponded to the market value of the external and domestic debt paper capitalized in the various processes.

This structure of the income from the privatization process displays marked differences between two clearly-defined stages in the execution of the programme, both in terms of the methods and modalities used in each case and in respect of their functionality *vis-à-vis* the other public policies. Thus, in the first of these stages, extending up to the inception of the Convertibility Plan (April 1991), the repurchase of external debt paper accounted for more than 85% of fiscal income, whereas in the privatization operations carried out between April 1991 and December 1993 the capitalization of external debt paper did not even represent 30% of total income.<sup>5</sup>

Whereas in the first stage priority was given to global transfers, with hardly any attention being given

to the formulation of regulatory frameworks—a situation largely explained by the urgent political needs of the Administration—,<sup>6</sup> in the second stage the authorities also resorted, among other things, to the segmentation of enterprises that were to be privatized and the public sale of shares, while at the same time slowly progressing towards the regulation of some of the public services which had been privatized.

The functionality of the privatization process *vis-à-vis* the stabilization programme also took on a different dimension in this latter period. The leading features of this new functionality were the absorption by the Ministry of the Economy of the mission and functions of the former Ministry of Public Works and Services (which was responsible for most of the public enterprises subject to privatization), the improvement in the short-term fiscal situation, the maintenance of a fixed exchange rate, and the moderate recovery in investment.

## II

### The main macroeconomic effects

The implementation of the privatization programme undertaken in Argentina has undergone many changes of different kinds, thus giving rise to reflection about its fiscal impact and its effects on, *inter alia*, the external sector, the structure of relative prices, capital formation, and the regulation of oligopolies in the absence of anti-monopoly legislation.

#### 1. Fiscal aspects

The application of the privatization programme has had a substantial once-only fiscal impact in the form of the cash income received by the State for the transfer of enterprises or share holdings. At the same time, it has also introduced a new item in the form of the future tax income that will be generated by the payment of taxes—essentially profits tax—by the consortia which purchased the privatized firms.<sup>7</sup>

On the other hand, the State has ceased to receive various specifically assigned internal taxes—such as that corresponding to social security—which were included in the prices of certain public services. In

most cases, these “surcharges” were absorbed by the adjustments in scales of charges which accompanied the privatization operations and were thus ultimately transferred to the purchasers as part of their new scales of charges.

From the point of view of fiscal outlays, the State has benefited from the elimination of the operating deficits registered by many of the privatized public enterprises, as well as from the elimination of the service costs in respect of the external debt capitalized in the privatization operations. On the other hand, since in most cases the State assumed responsibility for the debts of the privatized enterprises,<sup>8</sup> this involved subsequent fiscal outlays in respect of payments of principal and interest (table 1).

<sup>6</sup> According to Gerchunoff (1992), “the changes had to be made one way or another; whether it liked it or not, the Government had to privatize”.

<sup>7</sup> With few exceptions, the privatized public enterprises either did not pay such taxes or did not make profits subject to profits tax.

<sup>8</sup> Although in practice the Treasury ultimately took over the debts contracted by public enterprises, the corresponding service costs and almost all the commercial debts were generally assumed by the enterprises themselves. In other words, instead of the previous unstable and heterogeneous situation the State simply absorbed those debts.

<sup>5</sup> The privatization operations in the area of the petroleum industry mostly fell within the second stage and in all cases consisted of transfers and concessions paid for in cash.

TABLE I

**Argentina: Indebtedness of privatized public enterprises assumed by the National Treasury**  
(Millions of pesos)

Privatized enterprises	External debt	Domestic debt	Total
Yacimientos Petrolíferos Fiscales (Y.P.F.)	8 786.6	7.2	8 793.8
Ferrocarriles	1 971.8	585.8	2 557.6
Gas del Estado	1 892.8	387.3	2 280.1
Hidronor	1 485.3	2.9	1 488.2
Somisa	612.7	825.1	1 437.8
Agua y Energía Eléctrica	328.3	729.8	1 058.1
Segba	817.8	83.9	901.7
E.L.M.A.	406.3	329.9	736.2
Caja Nacional de Ahorro y Seguros	-	600.0	600.0
Aerolíneas Argentinas	421.3	6.4	427.7
ENTEL	269.6	26.4	296.0
Obras Sanitarias de la Nación	86.8	42.6	129.4
Encotesa	2.6	110.6	113.2
<i>Total</i>	<i>17 081.9</i>	<i>3 737.9</i>	<i>20 819.8</i>

Source: Prepared on the basis of the 1994 National Budget.

It may be inferred from the above considerations that, although certain approximations may be made in some concrete cases,<sup>9</sup> it is difficult to make a precise estimate of the overall fiscal impact of the privatization process. At the aggregate level, it may be said that in the short term the generalized privatization process had a positive effect on the fiscal accounts. After the exhaustion of this first impact, due essentially to the cash inflows and the elimination of the service costs of the capitalized debt, however, the public accounts have been increasingly eroded by the effect of certain items—such as the service costs on the debts absorbed by the State—which tend to outweigh this first positive impact in the medium and long term.

Beyond the fiscal effect in terms of income and outlay flows, mention should be made of other aspects directly or indirectly related to that impact. One of these is the increased value of the activities transferred to the private sector, in which generally speaking the current value of the future rents has proved to be significantly higher than the respective transfer

<sup>9</sup> See, for example, the estimates given by Gerchunoff (1992) regarding ENTEL, high-traffic highways, and the petroleum reserves. These estimates, however, do not take account, for example, of the fiscal effect due to the State's absorption of the liabilities of the privatized enterprises or areas.

prices of the enterprises. In this respect, the undervaluation of the public assets which were privatized<sup>10</sup> was due to the speed of the processes and the lack of attention by the authorities to the restructuring of the enterprises to be privatized and to the need to put them on a sounder basis in technical, production, economic and financial respects.

At all events, leaving aside the question of the generalized undervaluation of State assets, the income from the privatization process was a key element in changing the financial situation of the public sector.<sup>11</sup> Indeed, the resources from the privatization process have played a leading role in the reordering of the fiscal accounts, especially in the early months of the Convertibility Plan, when they proved to be the main foundation for the necessary fiscal balance. Thus, in the last nine months of 1991, the income from privatization operations was nearly 80% of the total: a proportion which went down significantly in the following two years to 42.3% in 1992 and 20.9% in 1993 (table 2).

This smaller relative contribution by the privatization process to fiscal balance does not indicate a structural improvement which makes the fiscal sector less dependent on windfall resources, however. On the contrary, the trends in the public accounts display imbalances and shortfalls which raise serious doubts as to what will happen when the privatization programme comes to an end. Thus, as from the fourth quarter of 1992 and during the whole of 1993 there has been a deficit in the operating results of the Treasury, due to the relative stagnation of current income and the growing incidence of total expenditure, especially that in respect of payments for goods and services. The positive overall result has therefore been due to non-tax income: i.e., to windfall resources.

<sup>10</sup> In the case of ENTEL, for example, the imprecise valuations of the enterprise ranged from US\$1.9 billion (the price at which the company was transferred) to US\$3.5 billion, while many marginal oilfields (fields with a high gas/petroleum ratio) were transferred without placing any value whatsoever on their gas content.

<sup>11</sup> Although Decree No. 575/90 laid down that the resources from the privatization operations would be used for social expenditure, successive exceptions to this rule resulted, in practice, in the inoperancy of this provision. The Argentine case is a very typical example of the problem described by Devlin (1993), who, while stressing the importance of assigning the windfall resources from privatization to social expenditure, nevertheless notes that "... it may be difficult to make specific allocations in situations of generalized fiscal urgency".

TABLE 2

**Argentina: National Treasury. Income and outlays during the application of the Convertibility Plan, second quarter of 1991 to fourth quarter of 1993**  
(Millions of pesos at February 1994 prices)

	Total income	Current income	Other income	Total outlays	Operating result <sup>a</sup>	Total result <sup>b</sup>	Privatization operations	Percentage of total result corresponding to privatization operations
1991								
2nd quarter	3 094	2 508	586	2 547	-39	547	630	115.2
3rd quarter	3 866	2 579	1 287	3 497	-918	369	134	36.3
4th quarter	3 469	2 868	601	2 865	3	604	430	71.2
Last 9 months	10 429	7 955	2 474	8 909	-954	1 520	1 194	78.6
1992								
1st quarter	3 806	2 896	910	2 830	66	976	666	68.2
2nd quarter	3 277	3 025	252	2 769	256	508	152	29.9
3rd quarter	3 453	3 126	327	2 752	374	701	114	16.3
4th quarter	3 876	2 705	1 171	3 367	-662	509	208	40.9
Total	14 412	11 752	2 660	11 718	34	2 694	1 140	42.3
1993								
1st quarter	3 224	2 488	736	3 038	-550	186	4	2.2
2nd quarter	4 015	2 991	1 024	3 253	-262	762	226	29.7
3rd quarter	4 315	3 312	1 003	3 395	-83	920	155	16.8
4th quarter	4 116	3 131	985	3 160	-29	956	204	21.3
Total	15 670	11 922	3 748	12 846	-924	2 824	589	20.9

Source: Prepared by the authors on the basis of information from the Ministry of Finance.

<sup>a</sup> Current income less operating costs.

<sup>b</sup> Total income less total costs.

If these windfall resources are not matched by changes involving a reliable long-term improvement in the fiscal accounts, their effective impact will tend to be diluted by the persistence of structural imbalances and even by the implicit costs of the privatization programme itself.<sup>12</sup>

## 2. Effects on the external sector

In the short term, the capital income derived from the funds which the State receives in cash for the sale of its enterprises has a positive impact on the balance of payments. In the case of Argentina, this income was

of decisive assistance<sup>13</sup> in reversing a trend that had existed for over two decades: the permanent net transfers of capital to the exterior. Thus, in the three-year period 1990-1992, for the first time in many years, there was a net inflow of foreign exchange of the order of US\$15 billion (Argentina, Ministry of the Economy and Public Works and Services, 1993) which was a decisive factor in sustaining the exchange rate parity and offsetting the trade deficits registered in that period.

In this respect, information on the balance of payments capital account shows that the income associated with the privatization programme increased considerably during the period 1990-1992: according to official projections, this income will tend to

<sup>12</sup> This is reflected, in an as yet incipient manner, in the evolution and conformation of the pattern of expenditure of the National Treasury. Thus, for example, expenditure on goods and services doubled in only two years (1991-1993), so that its incidence in the total rose from 9.0% to 15.2%, accounting for nearly 80% of the growth in total expenditure.

<sup>13</sup> Another substantial proportion of the inflow of external resources was due to short-term movements associated with the existence of domestic dollar interest rates higher than those prevailing at the international level.

stabilize at around US\$4.7 billion in the two-year period 1993-1994, after which it will begin to decline rapidly as from 1995.

The main positive effect of the privatization process –the inflow of capital– is registered exclusively during the process of “denationalization” of public enterprises. As these are transferred to the private sector, however, another effect is generated on the balance of payments which is permanent and opposite to the above-named effect. This is the remittance of profits and dividends abroad by the consortia which purchased the privatized enterprises. From a medium-term standpoint, this has grown steadily since 1990, in line with the consolidation of the operations of the privatized firms (table 3).

This behaviour of remittances of profits and dividends tends to cancel out the initial positive effect of the privatization process on the balance of payments. As it is expanding in a domestic macro-economic and international financial context which is unfavourable to the remittance of profits abroad,<sup>14</sup> its most negative effects will only be registered in the

medium term, if there is a change in one or more of the factors in that context.

Another important effect of the privatization process on the balance of payments is due to the elimination of the service costs in respect of the external debt paper which was capitalized as part of the payment for the enterprises transferred to the private sector. Thus, up to the end of 1993, the total value of the State-owned enterprises privatized came to US\$23.16 billion if the repurchase of domestic and external debt bonds is calculated at their nominal value, but only a little less than US\$15.5 billion if they are calculated at their effective value (i.e., 66.9% of the first figure). The nominal value of the public debt paper repurchased under the programme came to US\$13.4 billion (i.e., 58.0% of the total income), while its effective value was US\$5.76 billion, equivalent to 42.9% of the nominal value (table 4).

The repurchase of external debt bonds had a significant initial impact on the cumulative debt (it is expected to exceed US\$20 billion by the end of the programme). The debt reduction due to the sale of public assets (a little over US\$11 billion) was equivalent to 19% of the total external debt as at 1989. However, this reduction was more than offset by the fresh indebtedness incurred during the period, so that there was a net increase of some US\$2.7 billion in the external debt between 1989 and 1992.<sup>15</sup> In other words, in spite of Argentina’s incorporation into the Brady Plan, the evolution of the country’s external indebtedness shows that the effect of the sale of public enterprises has been wiped out (table 5).

Underlying this net increase in external indebtedness is another phenomenon which will probably become even more noticeable in the future. This is the change in the structure of indebtedness which marks the beginning of a new cycle led by the private sector in general and the business groups which bought the privatized enterprises in particular. By way of example, the value of the negotiable obligations issued by private firms up to late 1993 came to US\$3 457 million, which represents an increase of US\$2 701 million during the year; at the same time, negotiable obligations authorized but not yet issued came to US\$705 million, while obligations requested but not yet authorized amounted to US\$1 700 million (table 6).

TABLE 3

**Argentina: Balance of Payments. Trends in foreign direct investment,<sup>a</sup> privatization operations and remittances of profits and dividends, 1988-1995**  
(Millions of dollars)

Year	Income		Outlays
	Foreign direct investment	Privatization operations	(Profits and dividends)
1988	1 147		-660
1989	1 028		-664
1990	333	1 703	-716
1991	465	1 974	-805
1992	2 852	1 841	-850
1993 <sup>b</sup>		4 647	-945
1994 <sup>b</sup>		4 718	-1 407
1995 <sup>b</sup>		3 896	-2 057

Source: Prepared by the authors on the basis of information from the Central Bank of the Argentine Republic and the 1994 National Budget.

<sup>a</sup> The capitalization of external debt paper in the various privatization processes is included under “Foreign direct investment”, while income from cash payments is included under “Privatization operations”.

<sup>b</sup> Official projections.

<sup>14</sup> Between 1990 and 1992 the 180-day LIBOR rate fell by 57% (from 9.22% to 3.95%).

<sup>15</sup> What is more, the public external debt, which is directly affected by the privatization operations, grew by US\$900 million.

TABLE 4

**Argentina: Financial results of the privatization programme, 1990-1993**  
(Millions of dollars)

	Cash	Debt paper		Liabilities transferred	Totals	
		Nominal value	Effective value		A <sup>a</sup>	B <sup>b</sup>
Telephones	2 279.0	5 029.0	1 257.0	-	7 308.0	3 536.0
Airlines	190.1	1 313.8	394.1	-	1 503.9	584.2
Electricity	1 283.1	2 543.5	1 836.0	460.7	3 826.6	3 579.8
Ports	13.3	-	-	-	13.3	13.3
Radio and TV	13.9	-	-	-	13.9	13.9
Petroleum	4 846.8	1 271.1	1 080.4	-	6 117.9	5 927.2
Gas	658.0	3 082.1	1 120.3	1 110.0	3 740.1	2 888.3
Petrochemicals	53.3	132.0	46.0	-	185.3	99.3
Shipyards	59.8	-	-	-	59.8	59.8
Steelworks	143.3	41.8	22.5	-	185.1	165.8
Real estate	130.9	-	-	-	130.9	130.9
Other	65.2	12.0	2.0	-	77.2	67.2
<b>Totals</b>	<b>9 736.7</b>	<b>13 425.3</b>	<b>5 758.3</b>	<b>1 570.7</b>	<b>23 162.0</b>	<b>15 495.0</b>

Source: Prepared by the authors on the basis of information from the Ministry of the Economy and Public Works and Services.

<sup>a</sup> Result of adding the nominal value of the capitalized debt paper to the cash receipts and the liabilities transferred.

<sup>b</sup> Result of adding the effective value of the capitalized debt paper to the cash receipts and the liabilities transferred.

TABLE 5

**Argentina: Trends in the external debt and interest payments, 1986-1992**  
(Billions of dollars)

Year	External debt			Interest paid
	Total	Public	Private	
1986	51.4	44.7	6.7	4.4
1987	58.3	51.8	6.5	4.5
1988	58.5	53.5	5.0	5.1
1989	63.3	58.4	4.9	6.4
1990	61.0	...	...	6.1
1991	63.7	...	...	5.6
1992 <sup>a</sup>	66.0	59.3	6.7	4.6

Source: Prepared by the authors on the basis of information from the ECLAC Office in Buenos Aires.

<sup>a</sup> Provisional estimate.

An analysis of the enterprises which have issued or are arranging to issue negotiable obligations makes it possible to estimate the degree of connection between this type of indebtedness and the privatization process. Thus, the consortia which purchased

privatized enterprises (Telefónica or Telecom, for example) and the firms which directly participate in some of them (Astra or Pérez Companc) account for the majority of the obligations issued (72%). The same is true of the negotiable obligations authorized but not yet issued, in the case of which the firms in question account for 71% of the total amount, and even more so in the case of obligations not yet authorized (91%) (Basualdo, 1994).

### 3. Effects on the structure of relative prices

The evolution of the real prices of the public services transferred to the private sector has given rise to substantial changes in the structure of relative prices of the economy. These trends have been further strengthened by their convergence with the policies of deregulation of markets and opening-up of the economy: the extent to which goods and services are tradeable abroad goes a long way towards explaining the behaviour of their respective prices.

TABLE 6

**Argentina: Negotiable obligations of the private sector at the end of 1993**  
(Millions of dollars)

Companies	Negotiable obligations			Total
	Issued	Authorized	Requested	
<i>In connection with privatization operations:</i>				
TELECOM	750		500	1 250
Pérez Companc	600			600
Banco Galicia	600			600
EDESUR		300		300
Astra			300	300
Acindar		200		200
Telefónica	150		500	650
Comercial del Plata			150	150
Siderca			100	100
Loma Negra	85			85
Bridas	85			85
IMPSA	60			60
TECPETROL	60			60
Others	86			86
Subtotal	2 486	500	1 550	4 536
Others	971	205	150	1 326
Total	3 457	705	1 700	5 862

Source: Prepared by the authors on the basis of information from the National Securities Commission.

There are a number of cases of adjustments which easily exceed the growth rate of most of the other prices in the economy.<sup>16</sup> Furthermore, especially in the energy area, there has been a growing dispersion of price structures, with considerable differences in the real evolution of the prices of the various services.<sup>17</sup>

The establishment of a new structure of relative prices which tends to favour the private areas supplying services at the expense of the sectors producing non-protected tradeable goods is reflected in the patterns of behaviour of the various economic activities. In this respect, a study by the Argentine Industrial Union (Coloma, 1993) reveals that both in terms of the evolution of their sales and, above all, the respective profit margins, the enterprises with the best performance indicators are those which have been privatized, while the producers of non-protected tradeable goods are those which display the highest

levels of relative deterioration, whatever the variable considered (the enterprises producing naturally or legally protected goods are in an intermediate situation).

It should be noted that in all the areas where the consortia which purchased the privatized enterprises have decisive power in the fixing and updating of prices, the State not only transferred the respective assets but also the capacity to influence the structure of relative prices of the economy. In other words, there was a shift in the market mechanisms<sup>18</sup> and, at the same time, in the official side's attitude to the possibility of applying public policies to regulate or induce certain private activities. The transfer of a normal economic policy instrument also implies the transfer to certain segments of the private sector (which enjoy naturally or legally protected oligopolistic or monopolistic positions through the existence of reserved markets) of much of the regulatory power

<sup>16</sup> In some cases (such as ENTEL or Aerolíneas Argentinas) the adjustment in scales of charges took place before the transfer to the private sector, as a way of attracting potential buyers, and there were even contractual guarantees in respect of real prices, while in others (electricity, gas) the biggest relative increases took place after the service enterprises in question came under private management.

<sup>17</sup> Generally speaking (especially in the energy field), the increases in prices for big users have tended to be well below the average levels and even further below the rates for household users.

<sup>18</sup> For example, although in a few cases (gas, electricity) "cross-subsidies" are explicitly prohibited, the absence of regulatory mechanisms or at least of minimum criteria in this respect rules out all possibility of restrictive action. Indeed, the possibility of signing specific contracts between the supplier enterprise and the users of the services makes it perfectly feasible, when both firms belong to the same conglomerate, to resort to transfer prices.



over markets which play a leading role in determining the competitiveness of the economy as a whole.

#### 4. Effects on investment

According to the objectives of the privatization programme, the stimulation of capital formation is at once one of its main foundations and one of the basic results expected, in view of the disinvestment observed in most of the enterprises eligible for privatization.

There are two main components which should be identified here: on the one hand the capital formation that the purchasing consortia would effect (partly under formal undertakings), and on the other hand the potential multiplier effect of this capital formation.

With regard to the first of these, the estimates which have been made reveal that the effect on aggregate investment has been only modest. Considering the capital formation deriving from a broad group of privatized areas (gas, telephones, electricity, railways, subways, roads, ports, and water supply and sewerage), the resulting aggregate investment is estimated at a little over 2% of GDP up to the mid-1990s, stabilizing thereafter at around 1.5% until the end of the decade (FIEL, 1992). At the same time, according to official estimates, the investment commitments in public enterprises which were privatized or granted as concessions would be around 1.0% of GDP in 1994, going down in 1995 to only 0.8% of GDP (Argentina, Poder Ejecutivo Nacional, 1993). According to official projections, these amounts of investments would amount to an annual average of close on US\$2.6 billion in the three-year period 1993-1995: a figure equivalent to only two-thirds of the average annual capital formation of the public enterprises during the three-year period 1980-1982 and only 54.6% of that corresponding to the three-year period 1986-1988 (FIEL, 1992).

Although investment in the privatized areas was below the average levels of most of the 1980s, however, it was slightly higher than the low levels registered in the years immediately before the process. This is explained, on the one hand, by the acute and generalized disinvestment of the public enterprises in the latter period and, on the other, by the need to rehabilitate and maintain the privatized services.

In this sense, in the short term there is a positive impact on aggregate investment, but its local multiplier effects are reduced by the high proportion of equipment purchased abroad (as for example in the case of telecommunications) and are restricted to a limited number of sectors of activity.

Finally, since the most dynamic activities in terms of sales and profitability are those protected from external competition and the recently privatized service enterprises, capital formation tends to reproduce and consolidate this same configuration. In this context, there is little incentive to invest in most of the goods-producing sectors in view of the options offered by the privatization of public enterprises, much of the services sector, and, in general, activities associated with goods and services not tradeable abroad. Consequently, as far as the international competitiveness of the Argentine economy is concerned, it can only be hoped that in the course of time the improvements in the productivity of the privatized enterprises will be transferred, through reductions in costs, to the rest of the economy and especially to the sectors producing exportable goods.

#### 5. Effects on the oligopolization and conglomeration of the economy

Another salient feature of the privatization programme is its role in promoting the concentration and centralization of capital. In most of the privatization operations carried out in the country, the form of the invitation to make bids itself favoured the presence of only a few bidders, and this was further strengthened in most cases by the coordination and lobbying of business groups in respect of their own offers. This led, on the one hand, to marked concentration of the ownership of the "denationalized" enterprises and areas in the hands of a small number of big economic agents,<sup>19</sup> and, on the other, to the survival and strengthening of legal monopolies and oligopolies, with the consequent consolidation of protected markets, on conditions which ensured little or no business risk, and with broad freedom to fix prices. In this respect, compared with the experience of other countries, it may be noted that there was little concern by the authorities to promote the spread of property through the capital market.<sup>20</sup>

<sup>19</sup> These were mostly the same conglomerates of national and foreign capital which, in previous years, had internalized the transfers in those areas sporadically favoured by public policies (industrial promotion, assumption of external indebtedness by the State, State purchases, etc.).

<sup>20</sup> On the contrary, in most cases very high minimum levels of net worth were fixed for receiving authorization to participate in the bidding, or else similarly high levels were one of the main requirements for pre-qualification or purchase. In other words, the net worth of the potential buyers became the main barrier governing entry into the market for the privatization of public enterprises.

This heightening of the process of concentration of capital associated with the privatization of public enterprises also reflects the consolidation of a trend which goes back to the mid-1970s: association of big local economic groups with foreign-owned companies. Such associations generally include the following elements: big Argentine-owned conglomerates which provide management and domestic lobbying capacity; foreign or local banks and public contractors which have capitalized external or domestic debt paper, and certain transnational corporations which generally provide technological and management capacity and experience.

In other words, the forms assumed by the various privatization processes – net worth requirements, technical requirements, rapidity, importance of lobbying power, etc. – have facilitated and even caused the adoption by the main local conglomerates of strategies which fit in with the growing polarization of economic power. In this respect, a by no means exclusive list could be made of the corporate strategies adopted for the acquisition of most public sector assets:

i) There were economic groups which, through one of their subsidiaries, acquired public enterprises or State share holdings in firms operating in the same sector of activity as themselves (concentration). This is so, for example, in the case of the Indupa group and its purchase of shares in Petropol S.A. and Induclor S.A.; the Garovaglio and Zorraquín groups' participation in Polisor S.A., or the Techint conglomerate's purchase of the majority of the shares in SOMISA. The same thing occurred in the privatization of areas of petroleum activity, most of which came into the hands of the main firms in this sector.

ii) There were business conglomerates which acquired public enterprises or services, or obtained concessions in respect of them, in order to achieve directly or indirectly a greater degree of vertical or horizontal integration. There are many examples of this: the Techint and Acindar steel companies, which integrated the production and distribution of electricity and gas (fundamental inputs for their production activities); the main edible oil companies (Bunge y Born, Cía. Continental, La Plata Cereal, La Necochea Quequén, etc.), which did the same in respect of railways and port facilities; the cement oligarchies, in respect of railways; the former suppliers of ENTEL, when that company was privatized (the Pérez Companc group (PECOM-NEC) and the Techint group

(Telettra and Italtel)); the oil companies, which came into control of refineries, distilleries, oil pipelines, port facilities, tanker fleets, etc.

iii) There were economic groups which were actively and extensively present in the various privatization processes (diversification and conglomeration). Typical examples are the Pérez Companc group (electricity generation and distribution, transport and distribution of gas, activities in the petroleum sector, refineries and distilleries, railways, telecommunications, etc.) or the Cía. General de Combustibles group (electricity generation, petroleum and distillery activities, railways, telecommunications, water supply and sewerage, etc.). Table 7 gives a summary of the consortia in which some of the main conglomerates operating in the country are active participants.

This list of corporate strategies adopted in response to the privatization programme clearly shows that the growing oligopolization and conglomeration of the Argentine economy and the consolidation and preservation of reserved markets with oligopolistic quasi-rents are among the main effects of the implementation of that programme.<sup>21</sup>

Above and beyond its macroeconomic and social connotations, the above phenomenon introduces additional rigidities and limitations into the sphere of the privatized areas or markets, such as: i) increased risk of capture or cooptation of the regulatory bodies; ii) serious distortion of socially efficient resource allocation through the incorporation of market flaws which are reflected, for example, in price-fixing policies (use of transfer prices between suppliers and consumers belonging to the same business group); iii) the generation of new barriers to entry into the privatization market, in addition to those due in most cases to the inherent nature or regulatory frameworks of the privatized activities or areas; and iv) erosion of already low levels of competition.

In short, the lack of official concern for broadening the ownership of privatized enterprises has resulted in additional effects of capital concentration which at the same time militate against the competitive evolution of the markets affected by the privatization processes.

<sup>21</sup> This programme tends to consolidate certain patterns of corporate behaviour which are increasingly at variance with risk investments, the incorporation of technical progress, innovation, improvement of management standards, etc.

TABLE 7

**Argentina: Presence of the main economic groups in the privatization programme, by sectors of activity**  
(Millions of dollars)

Economic groups	Electricity	Natural gas	Petroleum	Railways	Telephone services	Manufacturing	Others
Pérez Companc	<ul style="list-style-type: none"> <li>• Central Costanera (generation) 90.1 million</li> <li>• TRANSENER (high-tension transmission) 234.1 million</li> <li>• EDESUR (distribution) 511.0 million</li> </ul>	<ul style="list-style-type: none"> <li>• Transportadora Gas del Sur (transport) 356.2 million</li> <li>• Distribuidora de Gas Metropolitana (distribution) 300 million</li> </ul>	<ul style="list-style-type: none"> <li>• Central Areas: Puesto Hernández (240.8 million) Santa Cruz II (141.6 million)</li> <li>• Secondary Areas: 11 areas (70.2 million)</li> <li>• Campo Durán refinery (64.1 million)</li> <li>• San Lorenzo distillery (12.2 million)</li> <li>• Patagónicas marine terminal (10.1 million)</li> <li>• Oleoducto del Valle (oil pipeline) (77.0 million)</li> </ul>	<ul style="list-style-type: none"> <li>• Ferroexpreso Pampeano (concession of 5.287 km)</li> </ul>	<ul style="list-style-type: none"> <li>• TELECOM Argentina 677 million</li> <li>• Telefónica Argentina 794 million</li> </ul>		
TECHINT	<ul style="list-style-type: none"> <li>• EDELAP (distribution) 139.0 million</li> </ul>	<ul style="list-style-type: none"> <li>• Transportadora Gas del Norte (transport) 210.2 million</li> </ul>	<ul style="list-style-type: none"> <li>• Central Areas: Tordillo (100.9 million) Aguargue (143.7 million)</li> <li>• Secondary Areas: 10 areas (39.5 million)</li> <li>• Patagónicas marine terminal (10.1 million)</li> <li>• Oleoducto del Valle (oil pipeline) (77.0 million)</li> </ul>	<ul style="list-style-type: none"> <li>• Ferroexpreso Pampeano (concession of 5.287 km)</li> </ul>	<ul style="list-style-type: none"> <li>• Telefónica Argentina 794 million</li> </ul>	<ul style="list-style-type: none"> <li>• SOMISA (integrated steelworks) 147.2 million</li> </ul>	<ul style="list-style-type: none"> <li>• Various national highways (concession)</li> <li>• Ingeniero White port grain elevator (concession)</li> </ul>
ASTRA	<ul style="list-style-type: none"> <li>• EDENOR (distribution) 427.9 million</li> </ul>	<ul style="list-style-type: none"> <li>• Distribuidora de Gas Metropolitana (distribution) 300 million</li> </ul>	<ul style="list-style-type: none"> <li>• Central Areas: Vizcacheras (174.0 million) Santa Cruz II (141.6 million)</li> <li>• Secondary Areas: 6 areas (24.9 million)</li> <li>• Oil tanker fleet (41.8 million)</li> <li>• Campo Durán refinery (64.1 million)</li> <li>• Patagónicas marine terminal (10.1 million)</li> <li>• Oleoducto del Valle (oil pipeline) (77.0 million)</li> </ul>				
Compañía General de Combustibles (Soldati Group)	<ul style="list-style-type: none"> <li>• Central Guemes (generation) 86.2 million</li> </ul>	<ul style="list-style-type: none"> <li>• Transportadora Gas del Norte (transport) 210.2 million</li> <li>• Distribuidora de Gas Metropolitana (distribution) 300 million</li> </ul>	<ul style="list-style-type: none"> <li>• Central Areas: Palmar Largo (36.0 million) Santa Cruz I (55.0 million) Aguargue N.O. (143.7 million)</li> <li>• Secondary Areas: 3 areas (1.3 million)</li> <li>• Interpetrol (marketing company) 8.7 million</li> </ul>	<ul style="list-style-type: none"> <li>• Ferroexpreso Pampeano (concession of 5.287 km)</li> <li>• Delta - Borges branch line (concession)</li> </ul>	<ul style="list-style-type: none"> <li>• Telefónica Argentina 794 million</li> </ul>	<ul style="list-style-type: none"> <li>• Dock Sur distillery 11.7 million</li> <li>• San Lorenzo distillery 12.2 million</li> </ul>	<ul style="list-style-type: none"> <li>• Ingeniero White port grain elevator (concession)</li> <li>• National drinking water supply and sanitation services (concession)</li> <li>• Channel 11 TV (concession) 8.2 million</li> </ul>
SOCMA (Macri Group)		<ul style="list-style-type: none"> <li>• Distribuidora Gas del Centro (distribution) 138 million</li> <li>• Distribuidora Gas Cuyana (distribution) 122 million</li> </ul>	<ul style="list-style-type: none"> <li>• Central Areas: Palmar Largo (36.0 million)</li> <li>• Secondary Areas: 9 areas (18.5 million)</li> <li>• Campo Durán refinery (64.1 million)</li> </ul>				<ul style="list-style-type: none"> <li>• Various national highways (concession)</li> <li>• Northern access system (concession)</li> </ul>

### III

## Rationality in the privatization and regulation of public services

This section will deal with two closely associated matters. On the one hand, some issues connected with the economic rationality of the privatization programme will be analysed; on the other, an assessment will be made of the characteristic features of the exercise of regulatory powers over privatized public services.

#### 1. The "limited" rationality of privatization operations

Generally speaking, the arguments used to justify a privatization policy are based on the conviction that free competition is an efficient mechanism for resource allocation in and for markets. In the case of naturally monopolistic markets, such as the majority of public services, it is assumed that a suitable system of regulations and/or subsidies will give rise to efficient microeconomic behaviour under a system of private ownership and management.

In reality, however, the assessment of the efficiency of any organization will depend essentially on the definition of the goals and restrictions governing its operations. Replacement of the goal of "social welfare" with the objective of the private maximization of profits will bring complications, since the final results are not independent of the process of interaction of the economic agents involved (see Coloma, 1992; a more comprehensive model may be found in Piffano, 1991).

Thus, for example, it is possible that in a public enterprise where decision-making power is concentrated in the hands of government agents seeking to maximize the surplus for consumers, the level of prices will tend to be below that of another enterprise where the managers "associate" with external suppliers or syndicated authorities.

From the microeconomic standpoint, it is expected that the decisions of professional managers who are encouraged to maximize the profits of private shareholders should result in reduction of the degree of inefficiency. In fact, however, efforts to

improve the productivity of organizations supplying services usually begin with staff cuts, changes in the profile of qualifications of the staff who are kept on, and the introduction of a more competitive and "client-oriented" culture. Only afterwards are investments made in fixed production assets. These changes, however, only ensure a relative improvement on the previous levels of service. In order to come closer to the standards of "best international practice", two other conditions are required: effective regulatory bodies, and investors who are willing to take the risks involved.

The macroeconomic rationality of privatization operations is undoubtedly very closely linked with their effects on economic growth and income distribution (Canovesi and Rozenwurcell, 1991). Generally speaking, the privatization of public enterprises will only raise the growth rate of the product if the global investment rate is raised too. In the case of Argentina, however, the necessary investments were financed mainly from the windfall profits generated by the fixing of prices higher than those compatible with ordinary levels of profitability. As a function of the social pattern of consumption of public services, improvements in the growth rate would thus be due, in the final analysis, to regressive changes in income distribution.

It is also generally assumed that public investment is less efficient than its private counterpart, since it is frequently distorted by extra-economic pressures. There is no proof, however, that in the Argentine economy the propensity to reinvest behaves in accordance with the theoretical model (Azpiazu, Vispo and Fuchs, 1993): the income from the frequent systems of cross-subsidization has not generated the same proportion of domestic saving and, in the final analysis, has not resulted in equivalent increases in the stock of productive capital.

At the same time, in view of the economic and social structure of the country, the far from Schumpeterian attitude of its business class (Nochteff, 1993) and the special features of the Argentine privatization

process, the first consequence of a scheme of this type would be greater concentration of economic power. The functionality of this centralizing process has not been demonstrated by the authorities, which therefore run the risk of suffering some loss of credibility and social support for the process of change.<sup>22</sup>

## 2. Some features of the regulation of natural monopolies

Just as economic theory recognizes the existence of market flaws and problems of public intervention, so it also identifies the risks associated with the regulation of privatized public services. Out of the various factors mentioned in such theory, we will analyse only two which display a certain mutually-reinforcing relationship.

### a) *Non-symmetrical access to information*

These problems of non-symmetrical access to information belong to the type of problems tackled by the theory of the principal-agent dilemma, and arise when the critical data are difficult to obtain. The supervising agent—in this case, the regulator—must design systems of incentives which ensure, at the lowest possible follow-up cost, that the information supplied is reliable and that decisions are in line with the agreed objectives. Generally speaking, the regulators too will suffer from some degree of non-symmetrical access to information on the profitability of investments, the effects of the incorporation of new technologies, efforts aimed at minimizing costs, the calculation of subsidies which will guarantee a certain amount of socially optimum services, and other aspects.<sup>23</sup>

<sup>22</sup> A policy of atomization of ownership, such as that used in Great Britain, reduces the validity of these doubts founded on principles of long-term efficiency and social equity. If, on the other hand, a concentrative strategy is adopted, this reduces the transparency of markets and encourages diversification and oligopolization.

<sup>23</sup> In the case of Argentina, the regulatory bodies' capacity for follow-up and negotiation was severely restricted during the privatization processes themselves. In this period there were cases of interruption, disconnection, and on many occasions "privatization" and dismantling of important historical records containing basic information in such areas as energy, transport and ports.

Although the prime responsibility of regulatory bodies is usually concentrated on following-up the prices and quality of the agreed services, in the case of natural monopolies (telecommunications, drinking water, gas, etc.) big capital investments are often needed, and these too must be supervised.<sup>24</sup> Many of these investments will constitute an "entry barrier" to new bidders. The State must ensure both the satisfaction of future demand and a reasonable degree of technological updating.<sup>25</sup>

In order to monitor the execution of investments it is also necessary to have the appropriate information at hand. Every scheme has its own special features: if a certain level of profitability is allowed in regulating the supply of services, this will encourage over-capitalization in order to increase profits, but on the other hand, if an adjustment formula is used based on the price index less a correction factor, this will result in lower service quality and under-investment.

The problem is even more complex when multiple products are involved or price frameworks are established for the future, since the regulator cannot observe many of the variables directly. In these cases, it is hard to avoid the emergence of situations of discrimination and possibly of cross-subsidies.

Finally, while economic theory only takes account of "non-symmetrical access in good faith" due to the technical complexity of the activities dealt with, the Argentine case involves a broader phenomenon which could be termed non-symmetrical access to information due to the "renunciation" of the State.<sup>26</sup>

<sup>24</sup> It should be recalled that one of the central justifications for the privatization process was the insufficiency of public investment in service systems. These systems displayed serious deterioration due to inadequate maintenance, and in some cases they were near the end of their useful life (certain drinking water mains) or needed to make the transition to a new generation of technology (digital telephone exchanges).

<sup>25</sup> The question arises, for example, of the long-term consequences of fixing electricity prices (that is to say, the prices charged by the least efficient thermal generator) on the basis of marginal cost estimates which do not guarantee the big investments needed in order to cover the growth of demand beyond the year 2000.

<sup>26</sup> As, for example, the inability to monitor the fulfilment of the current regime for the motor industry or the possession by private agents of the urban real estate registers for the Federal Capital, with details of the zoning that governs the possibility of commercial exploitation (the master copy of these registers "disappeared" in a fire).

b) *Co-optation of the regulatory agent*

Another critical point in a regulatory system is the nature of the relationship between the regulatory agents and business. In these cases, frequent interaction between the two sides may make the regulator more permeable to the interests of business firms. The official's term of office, his salary level, the prospects of obtaining a high position in the sector subject to regulation and other aspects decisively affect the degree of independence of the regulator and, ultimately, the effectiveness of the regulatory system.

Likewise, the officials of regulatory bodies may be sensitive to pressures from high political circles of the government which appoints them. In this respect, and especially in view of the hastiness and makeshift nature of some of the privatization operations carried out in the country, the regulators' authority has been weakened by prior decisions aimed at satisfying government political objectives.

In general terms, it seems desirable that regulatory mechanisms should maintain the highest possible credibility and that the discretionary leeway allowed to the regulatory agents should be limited by a legal framework which provides for adequate means of inspection and penalties. Since the regulation of privatized public services raises complex problems in both conceptual and practical terms, it is essential to have clear legislation and a suitable technical team empowered to collect the necessary basic information in order to act in an independent manner. If the condition of the independence of the regulators from both business interests and government officials is not met, then the system will continue to depend on decisions associated with particular political projects and yet another of the requirements for a "rational" privatization programme will be ruled out.<sup>27</sup>

In short, in the light of the conditions identified by Devlin (1993), it may be concluded that the Argentine privatization process has not been notable for its transparency. Thus, no mechanisms have been introduced which reduce the non-symmetrical nature of the regulators' access to the information they need.

<sup>27</sup> There are many instances of this two-sided co-optation: for example, the attempt to make use of the fund for the stabilization of the spot price of electricity in order to apply these resources to infrastructural works in a province intervened by the federal government was approved by the Electricity Regulation Board (ENRE).

Nor has the republican principle of giving full publicity to government actions been respected, since access to the concession contracts and the official decisions of the various bodies (documentation which is of great importance in view of its potential for "interpreting" the framework legislation) continues to be restricted for the public and even often for the representatives of various government bodies.<sup>28</sup>

**3. Bodies responsible for supervising privatized public services**

The regulatory functions of the State are defined as the set of attributions and instruments needed for the follow-up and supervision of compliance with rules imposed for the good of the community (environmental control, road safety, etc.), including monitoring of the provision of public services transferred to the private sector. These regulatory functions cannot be delegated, since they are designed to safeguard the common good.

In Argentina, regulation was often implicitly delegated to the firms and bodies responsible for the provision of the services in question, thus giving rise to a rather unclear system of responsibilities. It was only with the privatization of public services that the explicit institution of regulatory bodies, designed to protect the rights of the consumer and, where possible, promote competition, appeared on the Argentine economic institutional scene.<sup>29</sup>

a) *The regulatory bodies*

To date, the bodies responsible for the regulation of privatized public services constitute a collection of unconnected experiences at different stages of progress. A preliminary listing of the processes in terms of their degree of maturity and the level of effectiveness attained is as follows:

<sup>28</sup> An example of this is the effort made by the Ministry of the Economy to prevent the General Accounting Office from supervising the newly privatized firms.

<sup>29</sup> In reality, the regulatory system has various components: the framework legislation, specific legislation for the most important services, the corresponding regulations for the application of this legislation, the concession contracts (practically inaccessible to the public), and finally, the bodies set up to implement the State's supervisory powers. For reasons of brevity, the contents of the various laws will not be analysed in this paper, which will confine its attention to the current capacities and effective limitations of these bodies.

i) *Bodies with formal regulatory capacity.* These bodies are the National Telecommunications Commission (CNT), the Electricity Regulation Board (ENRE), the National Gas Regulation Board (ENARGAS), and the Tripartite Sanitation Works and Services Board (ETOSS).<sup>30</sup> The CNT was set up in 1990 and has the biggest operating resources (a budget of 44 million pesos (dollars) and a staff of nearly 100). It corresponds to the first stage of the privatization process, which was characterized by improvisation and efforts by the government to gain political credibility.<sup>31</sup> It was only after two years, during which the Commission remained officially intervened and without a definitive structure, that the regulations for the basic telephone service were approved (these regulations seek to check some common practices of the companies holding the concessions, such as billing for services that were never provided). The establishment of ENRE and ENARGAS has suffered serious delays, and right from the start heavy political pressures have limited the autonomy declared in their respective terms of reference. Their boards of directors and technical management staff were only completed more than a year after the respective concessions began to operate, and as at the end of 1993 their effective monitoring capacity was still dubious. Both of them have had to intervene in conflicts with social repercussions (such as the massive disconnection of illegal consumers in low-income areas), but some of their decisions were reversed by the Executive. Furthermore, as a result of investigations into the quality of the services provided, these bodies have imposed fines on private distributors (although these fines were very small and were only paid under protest) and have ordered the return to consumers of payments due to over-billing.

ii) *Bodies without effective regulatory capacity.* These are bodies which were legally established but do not have an adequate structure or do not enjoy autonomy because they come under the administrative authorities originally entrusted with the privatization process.

<sup>30</sup> In this latter case, it was only early in 1994 that steps were taken to fill the necessary technical posts.

<sup>31</sup> It may be noted that none of the markets corresponding to the other privatization operations of this first stage (highway toll concessions, sale of petroleum areas and air transport) has a specific regulatory framework.

This group includes the National Postal and Telegraph Commission, which is responsible for an enterprise which has not yet been privatized; the National Rail Transport Commission, which is to supervise the concessions granted in that area; the National Railway Regulation Commission, which is empowered to act in conflicts among users, the State and the railway operators; the Commission on Highway Concessions, which comes under the former Department of Roads and Highways, and the National Motor Transport Commission, which comes under the Ministry of Transport.

iii) *Areas without regulatory bodies.* To a large extent, conflicts of interest have prevented the establishment of regulatory bodies in the fields of air transport, the petroleum refining and marketing and gas distribution sector, multimodal transport in Greater Buenos Aires, ports and navigable waterways, and other areas.

In general terms, both the legal structure of the regulatory frameworks and the formal attributions of the respective bodies seem to have incorporated the recommendations derived from international experience (calls for fair and reasonable scales of charges; defence of users' rights, free competition and efficiency, etc.). Furthermore, the organizational structures of the bodies have been designed by international-level consultancy firms, salary scales are in line with the functions discharged, management and technical posts must be filled through public competition, and reasonable rules on incompatibility have been applied.

However, all these conditions make little sense in practice when they are not backed up by the detailed conditions of the contracts, and it is in this aspect that there are still serious doubts. The ultimate effectiveness of regulatory bodies depends largely on their independence of the concession-holders and political officials, their credibility in the eyes of society, and the supervisory measures adopted.

#### 4. The lessons of the first years of operation<sup>32</sup>

In Argentina, regulatory bodies have been organized for each privatized service or enterprise,

<sup>32</sup> For details of international and Latin American experience, see OECD (1993) and Rausch (1993).

but independently of each other and subsequent to the granting of the concessions and the consequent transfer of assets. This strategy has had various consequences:<sup>33</sup>

i) *Policy inconsistency*. An example of this is that the regulatory bodies for gas and electricity are completely dissociated from one another, thus complicating the tasks of medium- and long-term investment planning, design of policies for energy substitution and rational use of energy, etc. Moreover, such an important source of income as petroleum has no specific regulatory body or regulatory framework.<sup>34</sup> The same kind of problems may emerge in time in connection with the various forms of land transport.<sup>35</sup>

ii) *Deficient coordination of information*. Another of the negative consequences of the successive and disconnected establishment of the regulatory bodies is that the State loses the possibility of maintaining a centralized and readily accessible store of information. This problem is further compounded by the varied jurisdictional nature of the regulatory functions.

iii) *Professional suitability of the new techno-structure*. The nominations and appointments to management posts in the regulatory bodies have not been the result of clear competition. Sometimes this means that those appointed are not the most suitable candidates, but rather representatives of various power groups or agents.

iv) *Equivocal legal status*. As many of the concession contracts antedated the detailed regulatory legislation, any change could be considered as an alteration of the rules of the game, thus depriving the government authorities of bargaining power. This can give rise to eminently technical arguments between the regulatory bodies and the concession-holders, and frequently to verdicts based on political considerations at the various levels of the Executive. When this happens, the autonomy of the regulatory bodies is weakened and the process of co-optation of the regulators is facilitated.

v) *Little evidence of defence of users' rights*. An example of this was the attempt to present condominiums with a single global bill for drinking water supply, which would have significantly reduced the administrative costs of the water companies (by presenting only one bill instead of many), as well as solving problems of arrears of payment, since if the water were cut off, this would affect all the users in the building, and the cost of collecting or paying off the amounts owed by debtors would be paid by the neighbours. The political authorities finally intervened by postponing the implementation of this practice, thereby committing a *de facto* and *de jure* violation of the terms of the concession, which did in fact authorize this practice. It may be noted that the clause in question came from the regulations of the former National Water Supply and Sanitation Service, although it had not been applied in the past.

Generally speaking, suitable conditions for clear and effective regulation do not appear to exist, since the regulatory bodies were not established before the privatization operations were effected, a new independent technical structure has not been established, the system is not clear and easily understandable to users, and penalties are not applied automatically, but rather on a "consensual" basis.

In short, the rationality of the Argentine privatization programme has been significantly limited in at least two respects. Firstly, because certain critical assumptions on microeconomic behaviour (the propensity of the agents favoured by the programme to make reproductive investments from their profits) are not being fulfilled, and secondly, because the non-market mechanisms needed to get closer to optimum solutions under conditions of the monopolistic supply of services are not yet operating.

<sup>33</sup> Although these problems were in a sense to be expected, in view of the context which preceded the privatization operations and the haste and broad scope of the process, the possibilities of correcting the shortcomings will be significantly reduced after the expiry, in the middle of the next period of government, of the possibility of initiating legal actions that alter the present system. From then on, there is a serious risk that the regulatory style of co-optation on two fronts will become consolidated.

<sup>34</sup> Indeed, the central government has not been able to prevent increases in the local prices of fuels. The only tool available for checking these oligopolistic practices would appear to be the precarious Act on the Defence of Competition.

<sup>35</sup> This problem could be avoided by, for example, the establishment of a centralized "superbody" which would obviate over-specialization by the regulating official and reduce the possibilities of co-optation. In an economy in which the main business conglomerates also dominate the privatized public services sector, and in the absence of strict anti-monopoly laws, such a structure would in fact be essential.



## IV

### Summary and conclusions

In terms of economic, political and social relations, the privatization programme carried out in Argentina up to the end of 1993 has brought changes of a structural nature and provided many lessons on the successes and errors, the social costs and benefits, and the advantages and disadvantages of undertaking such a broad and rapid programme.

Quite apart from the differences that may be seen between the privatization operations carried out up to 1991 and those effected in the two-year period 1992-1993, the Argentine denationalization programme has distinctive features which differentiate it from other international experiences of the same period.

In this respect, the speed at which the operations were carried out is undoubtedly the most salient feature. In little more than three years, the authorities transferred to the private sector almost all the public enterprises producing goods and services, which together generated nearly 8% of GDP and around 20% of total investment in the country.

This great speed, and the emphasis on a short-term approach, initially made it possible to turn around the public sector's critical financial situation. Furthermore, the capitalization of a large amount of external debt paper improved both Argentina's position in the various areas of external debt renegotiation and the institutional relations with local economic groups.

By giving priority to speed, however,<sup>36</sup> this approach militated against the achievement of some of the objectives originally declared, and it also went against many of the recommendations that were beginning to emerge from the incipient international practice in this field. Thus, a number of objectives were not attained, and sometimes the achievements were less than those that could have been reached with a better-organized and more gradual privatization programme.

<sup>36</sup> In the words of Gerchunoff (1992), "the urge to improve the Government's image in the eyes of the business community" impelled and hastened "its privatization activities". In reality, as has become clear in recent years, this attitude of the government, and hence also of the top business circles, has played a leading role in seeking the necessary political, institutional and corporative support in order to facilitate (or even shore up) the present government's economic and social policy.

In the following paragraphs, some of the declared objectives are compared with the real results obtained:

i) *Stimulation of investment in the privatized enterprises, with its consequent multiplier effects*: the contractually committed investments are minimal and, in view of the shortcomings and limitations of the regulatory framework, difficult to monitor; where there is no effective commitment, capital formation has reached only insignificant levels, and even then these scanty investments have mostly been spent on the purchase of imported equipment.

ii) *Definitive solution of fiscal imbalances*: in most cases, the initial positive effect will be wiped out in the medium and long term; the generalized undervaluation of the assets transferred has reduced the income received by the government; the tax exemptions and benefits granted to some of the consortia which purchased the privatized enterprises reduce fiscal income; the absorption of almost all the liabilities of the privatized enterprises means that there will be future fiscal outlays in respect of principal and interest payments, etc.

iii) *Significant reduction in external indebtedness*: beyond the short term, the effect of the capitalization of external debt paper has been more than offset by new external indebtedness both by the purchasers of the privatized enterprises and by the public sector itself.

iv) *Incorporation of modern management techniques, with improvement of business efficiency and of the quality of the goods and services supplied to the community*: for the moment, the relative improvements in the performance of many of the privatized enterprises are only due to the serious deterioration suffered by those enterprises before they were transferred to the private sector.

v) *Global changes in the rules of the game*: there has been a further strengthening of the power of the same economic agents who grew in the past thanks to such measures as industrial promotion, assumption by the State of the private external debt, and public-sector purchases of goods and services, and there has been an increase in their lobbying power and their

influence on relative prices and the distribution of wealth. Thus, rather than helping to give rise to a new business class with more enterprising features, public policies in general—and the privatization policies in particular—have helped to consolidate the market power of a few business conglomerates, mainly located in sectors producing non-tradeable goods and services.

Furthermore, there has been a flagrant failure to take account of some issues of crucial importance for achieving the social benefits which could theoretically result from a selective and gradual policy of privatization of public enterprises. Examples of this are the lack of concern for putting the enterprises to be privatized on a sound footing before their sale; the scant attention paid to the need to regulate certain privatized areas; the transfer and further consolidation of oligopolistic or monopolistic reserved markets; the establishment of conditions ensuring low or non-existent business risks; freedom to fix the prices and scales of charges of various public services; the transfer to a handful of economic agents of power to regulate markets; abrupt changes in the relative prices of the economy, to the detriment of consumers and of the sectors producing internationally tradeable goods; the scant interest shown in organizing competitive bidding with a considerable number of bidders and the fixing of “entry barriers” based on the wealth of the potential bidders; and the further heightening of the process of the concentration and centralization of capital.

There have also been shortcomings as regards public regulation, especially in the case of “natural monopolies” and areas and sectors where a highly oligopolistic structure has become consolidated. Among these shortcomings, special mention may be made of: i) the formulation of regulatory frameworks and the establishment of the respective regulatory bodies *after* the transfer of public enterprises to the private sector; ii) the adoption of provisions tending to preserve the monopolistic or oligopolistic nature of the enterprises privatized. Even though there may be clauses limiting the duration of these rights, the relative bargaining power of the parties when the contracts come to an end will not be such as to favour the State, as long as the weakness of the regulatory bodies and their co-optation by the economic agents they are supposed to regulate persists; iii) the frequent reformulation of rules laid down before the privatization process, which adversely affects the

public credibility of the regulatory system and may run counter to prior rights whose renegotiation would almost certainly be to the disadvantage of the State; iv) the scant protection afforded to consumers in the face of the oligopolistic practices of the consortia which purchased the privatized enterprises;<sup>37</sup> v) the establishment of formal anti-monopoly requirements which, however, in practice can be easily evaded without risking any penalty,<sup>38</sup> and vi) the absence of rules guaranteeing the independence of the regulatory bodies with respect to private companies which acquire privatized firms or areas.

The Argentine experience also raises some queries about the heavy concentration of ownership of the privatized enterprises in a few big economic groups;<sup>39</sup> within this context, the growing bargaining power of the conglomerates weakens the State in its role of promoting better links and relations within society as a whole.

Finally, what has been done in Argentina in the field of the privatization and regulation of public services is virtually in contravention of the best practices in this respect.<sup>40</sup> Thus, most of the other experiences of privatization point to the conclusion that once the political decision to privatize all or some public enterprises has been taken, it is necessary to apply a gradual approach, with criteria in terms of the time sequence which make it possible to harmonize and optimize multiple short- and long-term objectives, the recognition right from the start of the need to restructure the enterprises to be privatized and put them on a sound business footing so as to maximize the value of their assets, and the prior formulation of regulatory frameworks which guarantee the greatest possible social benefits.

(Original: Spanish)

<sup>37</sup> An example of this is the behaviour of the YPF S.A. company, whose predatory and anti-competitive practices have proved to be impossible for the Government to check with the instruments at its disposal.

<sup>38</sup> The most flagrant example of this is the acquisition by Acindar of part of the equity of the former Somisa, thus infringing the condition laid down in the privatization process that two local steelmaking firms could not form part of the same consortium.

<sup>39</sup> It has even happened that, after being favoured by the “entry barrier” represented by the fixing of minimum levels of corporate wealth for eligibility to participate in the bidding, some big firms forming part of the purchasing consortia have subsequently transferred their share holdings, thus obtaining huge financial benefits in a very short space of time.

<sup>40</sup> See, *inter alia*, OECD (1993), Devlin (1993) and World Bank (1988).

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# Extraordinary *comparative advantage* and long-run growth: *the case of Ecuador*

**André A. Hofman**  
**Rudolf M. Buitelaar**

*The authors are Economic Affairs Officers of the ECLAC Economic Development Division, stationed in Santiago, Chile and the ECLAC Subregional Headquarters in Mexico, respectively.*

The objective of this article is to describe how the transformation of the trade and industrialization regime is taking place in Ecuador and what are the systemic factors which condition the realization of this transformation. A long-run perspective of economic policy and growth in Ecuador (considering the whole of the twentieth century) reveals that growth has been relatively fast compared to other countries in the region, with exports as the driving force of that growth. The disturbing fact is that these exports have been dominated by a few booming export products at different points in time, and that growth has therefore shown a distinct stop-go nature. Corporate behaviour would seem to be characterized by rent-seeking, as natural economic rents have been present at several moments in history. This study develops the hypothesis that one of the above-mentioned systemic factors is the country's unstable growth, which can partly be attributed to the existence of extraordinary comparative advantages, and the effects of export booms and busts under different policy regimes are highlighted in this connection. The overall conclusion is that the import-substitution policy created a manufacturing industry that was hardly competitive, mainly because it replaced the economic rents from windfall profits with policy-induced economic rents. In the concluding section the outlines of a policy approach that could minimize the existence of such rents are discussed.

# I

## Introduction

Ecuador, like most Latin American countries, experienced one of the severest economic crises in the 1980s, with mounting inflation and negative per capita growth, and this crisis led to a major shift in economic policies. Likewise, in Ecuador, just as in most of the other countries of the region, there is a growing conviction that the import-substitution industrialization strategy must be dismantled and that there must be a reorientation toward a more outward-looking development strategy. This change of policy orientation is clear when one looks at the programmes of the two former administrations and the present government, but the programmes adopted, whether of a more orthodox or heterodox nature, have failed because of natural disasters or systemic political and economic factors. The objective of this article is to describe how this transformation of the trade and industrialization regime is taking place in Ecuador and what are the systemic factors which condition its realization. This study develops the hypothesis that one of these systemic factors is the country's unstable growth, which can partly be attributed to the existence of extraordinary comparative advantages, and the effects of export booms and busts under different policy regimes are shown.

Policy approaches in Ecuador aimed at diversifying the export base and hence improving the stability of economic growth have a long-standing tradition but show frustratingly few successes. Only, perhaps, during the heyday of the oil boom, in the mid-1970s, can any noteworthy upsurge in non-traditional exports be observed. This –perhaps surprisingly– makes the 1973-1978 period, together with the years of the Second World War, the only moments when the well-known “Dutch Disease” effects are least visible in the performance of other tradeables. But this development was also related to rent-seeking behaviour, as different policy instruments were developed to channel oil rents to the manufacturing industry. The collapse in the early 1980s proved this export drive based on oil rents to be unsustainable.

A long-run perspective of economic policy and growth in Ecuador (considering the whole of the twentieth century) reveals that growth has been relatively fast compared with other countries in the re-

gion, with exports as the driving force of that growth. The disturbing fact is that export performance has been dominated by a few booming export products at different points in time, so that growth has therefore shown a distinct stop-go nature. Corporate behaviour would seem to be characterized by rent-seeking, as natural economic rents have been present at several moments in history.

The various approaches seem to be closing a circle: the essentially “laissez-faire” regime of the beginning of the century was abandoned during the Great Depression of the thirties, and the subsequent interventionist import-substitution strategy began to be dismantled during the debt crisis of the eighties. The debate is now about whether the unrestricted working of market forces will lead the country to a better performance, or if a different policy approach should be designed and what this should entail.

It is not clear why the dismantling of interventionist policies would achieve by itself high and stable growth. The country continues to depend on exports based on significant natural advantages, which renders long-run growth unstable and leads to what has been called “ultra-biased” growth. There are strong reasons to support the dismantling of most import-substitution policies, as there are also strong reasons to suggest that a different type of intervention in the market mechanisms is called for. The lessons to be drawn from the Ecuadorian policy approaches may shed light on the contours of a new strategy, a main feature of which should be how to avoid rent-seeking behaviour among manufacturing enterprises.

This article develops the argument in a descriptive, chronological way. In section II the problem of unstable growth is shown through time-series permitting an international comparison covering most of the twentieth century. Section III puts forward the hypothesis that this problem can be attributed to the presence of extraordinary comparative advantages that lead to “Dutch Disease” effects.

Section IV refers to long-run time series on exports and real effective exchange rates to show the effects of export booms and busts under different policy regimes. Three observations are crucial for the

argument: one is that an export boom under a *laissez-faire* regime in effect hinders the development of other tradeables; the second is that an export bust leads to changes in the policy regime; and the third is that the import-substitution policy designed to alter the effects of the export boom succeeded in stimulating the upsurge of other tradeables, but failed to provide a sustainable base for the diversification of exports and the stabilization of growth.

Mainly in order to explain the third observation, section V analyses in some detail the policy ap-

proaches adopted, while section VI deals with the behaviour of firms in different stages of the boom-and-bust cycle. The overall conclusion is that the import-substitution policy created a manufacturing industry that was hardly competitive, mainly because it replaced the economic rents from windfall profits with policy-induced economic rents. In the concluding section (section VII) the outlines of a policy approach that minimizes the existence of such rents are discussed and the final conclusions of the study are presented.

## II

### The basic problem: Instability of long-run economic growth and productivity

The 1900-1989 period has been subdivided, as shown in tables 1 and 2, in order to permit international comparisons (Maddison, 1986 and 1991; Hofman, 1993a). In the case of a specific country these benchmarks obviously function as a straitjacket, and we will therefore give the appropriate phases for the Ecuadorian case, when appropriate. However, it should be noted that our phases do in fact fit in rather well with Ecuador's economic development (Benalcazar, 1989 and Hofman, 1994).

The first years of the twentieth century show fast growth in Ecuador, propelled mainly by cocoa exports (especially between 1908 and 1914) (Moncada, 1991 and Salgado, 1989). In the phase from 1914 until 1924 growth was relatively slow, due, among other things, to the First World War and the decrease in cocoa exports. In the second half of the 1920s growth rates improved following institutional reform (creation of the Central Bank) and policies aimed at development and export promotion (Drake, 1984; Rodríguez, 1987, and Marchán Romero (ed.), 1987).

The "Great Depression" finished off this promising phase and led Ecuador, together with Latin America and the rest of the world, into a period of recession. We have divided this period into two subperiods -1929-1938 and 1938-1950- as these two subperiods show quite different results on a world scale. The first subperiod, 1929-1938, showed worldwide deceleration of per capita growth. This panorama changed drastically during the 1938-1950

period, however, when the world experienced the disaster of the Second World War but Latin America remained relatively untouched, increased its exports and initiated an import-substitution industrialization process also induced by the unavailability of imports, thus increasing economic growth (Blomström and Meller, 1990; Abril-Ojeda, 1990).

The 1950-1989 per capita growth rates (table 1) indicate that growth accelerated in Ecuador and Latin America during the 1950-1980 period but suffered an extreme slowdown, even with negative per capita growth, in the 1980s. The picture is different for the Asian and advanced countries, which show much higher growth acceleration in 1950-1973, after which, however, the Asian countries increased growth a little further in 1973-1980 and again in 1980-1989, whereas growth in the advanced countries slackened abruptly in 1973-1980, speeding up again slightly in the 1980s.

Table 2 presents a comparison of the levels of per capita GDP with those of the United States for the 1900-1989 period.

It is thus clear that, comparatively speaking, Ecuador's growth record looks quite satisfactory. A closer scrutiny, however, reveals some important drawbacks. Figure 1 gives the annual per capita GDP growth data in constant dollars from 1940 to 1990. It can immediately be seen that the growth record is rather unstable. The average growth for the whole 50-year period amounts to 2.5% per year, but the standard deviation is 4.7%. In the 1940s, 1970s and

TABLE 1

**Per capita gross domestic product, 1900-1989**  
(Annual average growth rates)

Country or region	1900-1913	1913-1929	1929-1950	1950-1973	1973-1980	1980-1989	1900-1989
Ecuador	2.5	1.6	2.0	2.9	3.3	-0.7	2.2
Latin America	1.9	1.6	1.7	2.5	2.3	-0.6	1.7
Asian countries	0.5	1.0	-0.6	4.8	5.4	5.9	2.3
Spain and Portugal	1.1	0.7	0.4	5.3	1.4	1.9	2.1
Industrialized countries	1.2	1.5	0.5	4.7	1.8	2.1	2.1
United States	2.0	1.7	1.5	2.2	1.0	2.2	1.8

Source: A. A. Hofman, 1993b.

TABLE 2

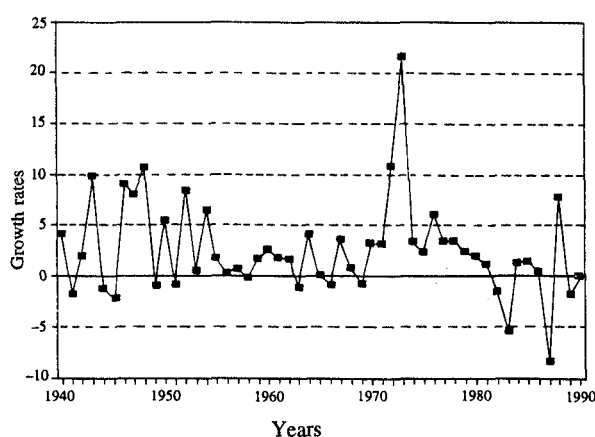
**Per capita gross domestic product, 1900-1989**  
(United States = 100)

Country or region	1900	1913	1929	1950	1973	1980	1989
Ecuador	12	13	13	16	19	22	17
Latin America (average)	29	29	28	28	29	32	24
Asian countries	18	15	14	9	16	22	26
Spain and Portugal	34	31	28	21	41	42	40
Industrialized countries	60	54	51	43	68	71	70
United States	100	100	100	100	100	100	100

Source: A. A. Hofman, 1993b.

FIGURE 1

**Ecuador: Per capita GDP growth rates, 1940-1990**



1980s growth rates are either between 8% and 10% a year, or else are negative.

This unstable growth can be related to the country's export performance, as we will argue at a more theoretical level below. Total per capita exports in constant dollars over the same 50-year period show an average growth rate of over 7% a year, but with a standard deviation of 26%. In other words, growth rates per year were as high as 80% or even more, but they also fell to -20% or less.

Other flaws in Ecuador's rather favourable long-run growth performance relate to productivity growth, and specifically to the capital-intensity of that growth and the quality of labour. In a paper by Hofman (1993b), in which figures on labour productivity in Ecuador and other Latin American countries are presented, it is shown that Ecuador systematically registered significantly higher growth rates (except in 1929-1938) than the other countries of the region. In capital productivity the overall picture is somewhat different, as Ecuador had lower capital productivity growth over the 1950-1989 period than the average for Latin American countries. With respect to total factor productivity, Ecuador turned in a good performance, having the highest growth, together with Colombia. As regards labour inputs, however, the figures show that the growth rate of labour quality is far below the standards of other developing economies.

In sum, Ecuador's growth record in this century has been favourable in comparative terms, but shows problems of high instability. This seems to be due to the very unstable, but nevertheless dynamic, overall export performance. Other problems with Ecuador's growth performance are the capital-intensity of growth and the slow improvement in the quality of labour.



### III

## The hypothesis: "Dutch Disease" leads to unstable growth

Since *The Economist* coined the term "Dutch Disease", referring to the problems which arose in the Dutch economy as a consequence of the natural gas price hike following the first oil shock, it has mostly been associated with the situation in oil-exporting countries. Conceptually, though, it can be (and has been) applied to all kinds of major windfall profits accruing to an economy. In Bianchi and Nohara (1988), the concept of extraordinary comparative advantage is used as a substitute for the Dutch Disease and is applied to the historical development experience of Latin America, which it fits quite well. We will here follow their line of reasoning in order to identify the effects we will trace throughout the Ecuadorian development experience.

The main hypothesis is that the unbridled exploitation of economic rents creates distortions that favour both those sectors with extraordinary competitive advantages and the non-tradeable sectors, while precluding the production of other tradeables. This hypothesis is based on a static and a dynamic argument. The static argument is that an export boom brings about a change in relative prices in favour of a booming tradeable, with an impact similar to an across-the-board tax on other tradeables. This works as follows: the massive inflow of foreign exchange leads to a sharp increase in internal demand, which exerts inflationary pressure on non-tradeables, assuming that output growth in non-tradeable sectors will not be able to match the growth in demand. Strong public investment in non-tradeables (infrastructure, public services) exacerbates these inflationary pressures in the short run, as a significant time lag is involved before output increases. The prices of tradeables are held in check through increasing imports. Exchange rates will increase less than the domestic rate of inflation, and the real effective exchange rate appreciates. A loss of competitiveness results, precluding the growth of other tradeables and eroding the comparative advantage of the booming tradeable. The movement of the real effective ex-

change rate is thus pivotal in these mechanisms, and although they do not tell the whole story, the index of the real effective exchange rate will be used in the next chapter to show the incidence of the Dutch Disease effects.

The dynamic argument is that the exploitation of these rents leads to permanent distortions in product, capital and labour markets, in the nature of rent-seeking. Both arguments combined lead to the phenomenon of ultra-biased growth, characterized by virtually complete specialization in tradeables with extraordinary competitive advantage and in non-tradeables.

If export booms were permanent and the economy had no distortions, this specialization would scarcely matter for long-run growth. As it turns out, however, export booms are by nature transitory phenomena (although there can be a number of successive export booms), and their exploitation creates a number of distortions, for example on the capital market, where the private rate of discount will contain a rent-element. Since rent-seeking does not increase value-added (output), growth of production will show a downward trend over time, as capital formation is precluded. If we assume imperfections in the labour and land markets, then the process of the erosion of the export boom will be further accelerated, as a search for supra-competitive wages comes about, as well as a search for rents through the concentration of ownership rights. If we furthermore introduce into the argument the existence of international competition, which makes the exporting economy a price-taker on international markets, it becomes clear that economic rents dissipate and export-booms are, by their very nature, transitory phenomena. In theory, an optimal rate of domestic savings and asset accumulation would suffice to keep long-run growth up to potential, but in view of the above-mentioned imperfections it can be argued that capital accumulation will be restricted to the booming activity and will, in general terms, fall short of the rate required for optimal long-run growth. Thus, the resulting ultra-biased

growth is lower than long-run potential growth, and furthermore it is of a "stop-go" nature.

To be sure, policy intervention can alter the effect of temporary booms, but the question is whether there are arguments to make the case that policy interventions would lead to welfare improvement. It is theoretically possible, if we assume that economies

of scale, technological learning effects and the like externalities are greater in other tradeables than in the booming tradeables, that a policy-induced distortion of relative prices in favour of other tradeables can lead to higher long-run growth and welfare gains. It depends, however, on the type of instruments used and the way of implementing them.

## IV

### Export booms and busts

Long-run series in constant 1980 dollars have been constructed for exports, the real effective exchange rate<sup>1</sup>, and GDP (Buitelaar and Hofman, 1993).<sup>2</sup> In the following paragraphs we will analyse three cycles of booms and busts. The first is the cocoa cycle, with a boom at the beginning of the twentieth century, followed by its collapse and diversification of exports during the 1920s. The Great Depression and the years of the Second World War cannot be seen as part of a particular Ecuadorian boom and bust cycle, and are therefore discussed in the cocoa section up to the end of the depression (1937), and in the next cycle from that year onward. This second cycle really started with the banana boom in the early 1950s and lasted until the beginning of the oil boom in the 1970s. The third (oil and debt) cycle continues until the present. In each of these subperiods we will analyse the results with respect to the product enjoying a boom and other exports which do not enjoy extraordinary comparative advantages.

#### 1. The cocoa cycle

At the beginning of the twentieth century Ecuador experienced a period of rapid economic growth in which exports of cocoa were the dominant element. The boom before the First World War was further

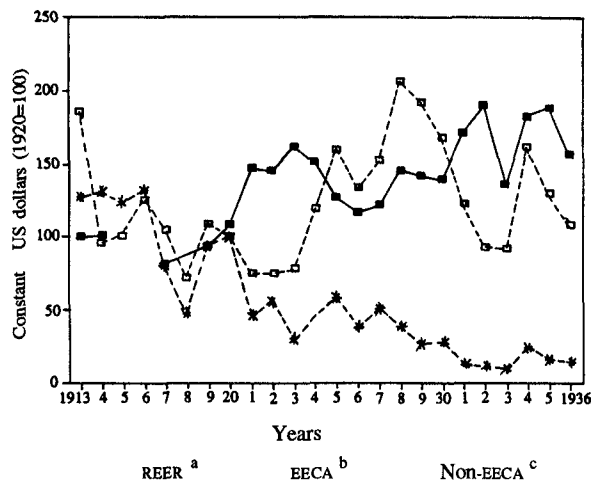
stimulated by the opening of the Panama Canal in 1914. At this time, Ecuador was the main exporter of cocoa in the world, with 20% of the market. The boom reached its historical peak between 1908 and 1914, with exports amounting to some US\$77 million (in constant 1980 dollars) in the years 1914 and 1916. A downturn occurred in 1918, but exports recovered to some US\$60 million in 1919-1920. The movement of the real effective exchange rate was as expected, with the national currency appreciating up to 1914 and depreciating strongly after 1918. This would suggest a Dutch Disease problem in the second decade (see figure 2). Non-cocoa exports, consisting mainly of coffee, tagua, rubber and wood, fell steadily from almost US\$37 million in 1912 to an all-time low of less than US\$11 million in 1921-1922. The Dutch Disease hypothesis is thus confirmed, showing a sharp fall in other exports during the cocoa boom. The economic policy regime in these years is usually characterized as being a "laissez-faire" regime. Nevertheless, it is interesting to note that even so the policymakers reacted to the economic circumstances. A fundamentally self-sufficient agricultural economy was in these years transformed in an agro-export economy, and the major source of tax receipts changed from the taxes levied on landowners in the Sierra to import taxes, and later an export tax on cocoa. This economic evolution brought about a political rupture in 1895, when the so-called Liberal Revolution transferred power from the pre-capitalist Sierra landowners to the emerging capitalist agro-exporters: i.e., the rising financial and commercial class of the coastal areas.

There were also other typical signs of the Dutch Disease, such as heavy public spending, basically on infrastructure. The single most important public works

<sup>1</sup> The real effective exchange rate was calculated only with the nominal exchange rate and the consumer price indexes of the United States and Ecuador. A more sophisticated approach would need to consider the impact of industrial and commercial policy instruments (see, for example, the work of Schydrowski, S. Levy, R. Parot, M. Rodríguez, S. Hunt and I. Mezzera at the Center for Latin American Development Studies of the University of Boston).

<sup>2</sup> These series can be obtained upon request from the authors.

FIGURE 2  
Ecuador: Exports and exchange rates, 1913-1936



<sup>a</sup> Real effective exchange rate

<sup>b</sup> Exports with extraordinary comparative advantages

<sup>c</sup> Exports without extraordinary comparative advantages

project carried out in these years was the railroad between Quito and Guayaquil, for which the Government obtained a foreign loan. This railroad, which was opened in 1908, significantly increased contacts between the two main cities. It was constructed under the second government of General Eloy Alfaro: a period which was also marked by important sanitation works and public lighting projects carried out in Quito and Guayaquil through foreign enterprises, as well as important institutional changes (education law, separation of Church and State, etc) (ECLAC, 1953).

In the latter years of this cycle (1926-1930) the export structure diversified with the inclusion of coffee (a rather spontaneous phenomenon, brought about by favourable prices) and rice exports, bringing the share of cocoa exports to less than 50% of overall exports. Non-cocoa exports rose in the 1920's following the depreciation of the currency, with a time lag of several years. Total non-cocoa exports combined climbed from US\$18 million in 1922 to US\$49 million in 1928, reducing the share of cocoa exports in the total to less than a third. It could therefore clearly be concluded that the collapse in cocoa exports impelled policy reforms which, together with currency depreciation and the private-sector efforts to increase other exports, seem to have had the desired effects.

The Great Depression of the early 1930s brought this modest recuperation to an abrupt end, and overall export revenue sank to an all-time low of less than US\$30 million in 1933. Once again, devaluations,

foreign exchange controls and tariff hikes were necessary in order to adjust to an extraordinarily low level of import capacity. Even so, the gold and foreign exchange reserves were depleted, making it necessary to maintain a very high real exchange rate until 1940.

## 2. The banana cycle (with a prelude covering the Second World War years)

All exports recovered from 1937 onward. Up to 1948, they were quite diversified, as may be seen from the remarkable upsurge in exports of Panama hats, which were the main export product in 1945, accounting for just over 25% of the total (26 out of 103 million constant 1958 dollars). The bulk of the exports in the Second World War years consisted of rice and coffee, the latter being usually considered as the fourth export product of Ecuador. There is, however, no reason to distinguish a separate coffee boom with possible Dutch Disease effects, as coffee exports were never the main foreign-exchange earner and thus cannot be supposed to have altered significantly the internal price structure.

The restrictions on imports because of lack of supply provided an opportunity for "spontaneous" import substitution, despite the strong appreciation of the currency. Important industries that were established during the 1930s include the oil refinery and a cement plant, as well as other industries basically funded by foreign investors. A typical example of this phenomenon is the pharmaceutical industry, created by an Italian immigrant in 1940. This plant reportedly grew to employ as many as 700 persons in the 1940s, and exported to most countries in South America.

Exactly how "spontaneous" this import substitution was might be a matter of debate, since import tariffs were quite high: ECLAC reports tariffs for raw materials between 25% and 30%, for intermediate inputs between 30% and 90%, and up to 265% for finished products. The term "spontaneous" refers not so much to the absence of trade policy as to the absence of a rationale in terms of economic theory (a rationale that was later formulated by ECLAC, around 1950). In any case, the war years provided a stimulus for industrial growth, and the industrial production index went up from 50 in 1939 to 100 in 1948. The recovery observed during the war years must be viewed, however, in the perspective of the extremely poor country Ecuador still was.

A second moment of windfall profits for the Ecuadorian economy occurred in the early 1950s, with the banana boom. The main reason for the rise in the country's banana exports did not lie in a strong price increase, but in the fact that the Central American countries, until then the major producers, suffered from a pest (the Panama disease) that destroyed a large part of their crops. Thus, Ecuadorian banana exports rose from US\$10 million in 1948 to US\$113 million in 1955.

There was never a significant collapse in the banana cycle, as occurred with the other two important product booms. Exports did fall to US\$96 million in 1958, but recovered gradually to US\$184 million in 1964. In the mid-1960s a structural change occurred in the Ecuadorian market position, as a disease-resistant new variety was introduced in Central America. Ecuadorian planters reacted immediately by changing varieties, but the country lost its leading position on world markets to the countries in Central America. Political turmoil in the latter region from the end of the 1970s onward, however, restored Ecuador's market position, and favourable prices on world markets towards the end of the 1980s led to an all-time high in banana export receipts of US\$433 million (in constant 1980 dollars) in 1990. This second banana boom came to an end in 1992.

If we define banana and cocoa exports as being based on extraordinary comparative advantages and analyse the performance of all other exports, we see an unstable and rather sluggish period in which the total value of the latter exports fluctuated between US\$120 million (1952, 1957) and US\$87 million (1959, 1961). In these years, coffee exports accounted for the bulk of such other exports.

The Dutch Disease effect of the banana boom can thus be expressed by the downturn in the 6-year average of all other exports: from slightly above US\$115 million in the 1952-1957 period to slightly more than US\$100 million in the 1958-1963 period. If this is a Dutch Disease effect at all, it is definitely milder than the reaction following the cocoa bust. In 1965 a significant increase in other exports was registered, bringing the figure close to US\$150 million, around which level it remained until 1971.

Growth slackened from 1955 onward, investments hardly increased and construction stagnated. An atmosphere of national crisis was felt in 1959, when some revolts took place, inflation accelerated, and a devaluation was necessary in 1961. Neverthe-

less, it is difficult to speak of a collapse of banana exports, as in 1971 such exports surpassed historical records. It was the period of institution-building necessary to implement the by then widely accepted import-substitution strategy. The National Economic Planning and Coordination Board was set up in 1954, and the first Industrial Development Act was adopted in 1957. It provided for total exemption from import duties on capital goods and substantial reductions in other import duties, and it also allowed tax exemptions on reinvested profits. The National Finance Corporation was created in 1963, and the Industrial Development Centre, which provides technical assistance, was established in 1962.

Towards 1970 the legal and institutional framework of the import substitution industrialization strategy was completed: the changes in the import tariff structure of 1971 consolidated high and dispersed effective rates of protection, mainly for consumer goods; the interest rate was legally fixed in 1970 at 12%, which meant negative rates in real terms, and a complex system of tax benefits and tariff exemptions for industries, as well as import prohibitions and licenses, had been consolidated through the periodic revisions of the Industrial Development Act. The limited scale of the domestic market was a known problem, and the solution adopted consisted of ambitious regional cooperation projects in the context of the Andean Pact market. The only missing elements in this strategy were resources to invest and import.

From 1955 to 1972 domestic-market industries (in a broad definition) became the most dynamic element in the economy. These comprised the non-tradeable public utilities (water, electricity and sanitation, which grew at 15% annually in the 1950s) and the services sector, which grew faster than the rest of the economy. Manufacturing industry in factories grew by 10% or more annually in these years, spurred by Government incentives and cheap credit, but overall manufacturing growth was less (5% per year) because of the stagnation of small enterprises and handicrafts.

Within the manufacturing sector, the traditional food and textile sectors continued to be those which contributed most to growth, together with the chemical sector, which received a strong impulse from banana production because of the latter sector's intensive use of pesticides and of plastics as protection for the fruit. Most other industries, including

metal products and other advanced industries, also have their (modest) origin in this period, however. A special case is sugar production, which more than trebled after Ecuador was granted a quota for the US market in 1960.

### 3. The oil and debt cycle

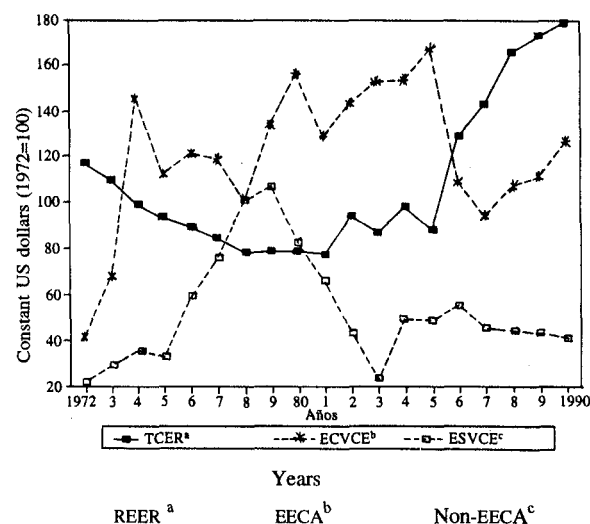
#### a) *Export performance and economic policy*

Investment in oil exploration led to the discovery of oil in the Amazon region in 1967 and to a considerable increase in production capacity in the early 1970s. The international oil price hike in 1973 provided the country with an affluence of foreign exchange that helped to overcome two of the basic problems that were structural in the years before: the low levels of domestic savings and demand, and the low capacity to import. Oil revenue rose from virtually nothing in 1971 to US\$1160 million in 1974, accounting for almost two-thirds of total export earnings that year. A new high was reached in 1980, and an all-time peak of US\$1400 million (in constant 1980 dollars) was registered in 1985. Public investment grew rapidly in the 1970s, channelled for example through the National Development Fund (FONADE), which effectively limited the danger of overexpanding Government consumption expenditure. Inflation was held in check by deliberately keeping the wages of civil servants low. Most sectoral policies were consumer-oriented, in the sense that the basic goal was to provide wage goods at low prices.

Exports of products other than those with extraordinary comparative advantages (i.e., total exports minus exports of cocoa, bananas and oil: non-EECA exports, for short) multiplied by a factor of almost seven between 1969 and 1979, reaching an all-time high of US\$950 million at the end of the first oil boom. This result is certainly not in line with the Dutch Disease argument, and calls for an explanation both in terms of economic policy and in terms of linkage effects. Two-thirds of these non-EECA exports came from two sources related to EECA exports: oil derivatives and cocoa derivatives. The exports of chocolate were not due solely to linkage effects, but were forcefully stimulated by the military government of the time, which obliged cocoa producers to build up chocolate production capacity. A significant number of other products also registered steep increases.

FIGURE 3

Ecuador: Exports and exchange rates, 1972-1990



<sup>a</sup> Real effective exchange rate

<sup>b</sup> Exports with extraordinary comparative advantages

<sup>c</sup> Exports without extraordinary comparative advantages

The boom in domestic demand and the possibility of importing capital goods provided fertile ground for a rapid increase in manufacturing output, together with the tax benefits provided by the Industrial Development Act, from which half of all the firms benefitted (a total of 800 enterprises claimed benefits under this Act).

Further benefits were the extremely low energy and gas prices. Schematically, we can speak of a channelling of oil rents to manufacturing industry through a series of mechanisms:

- low energy and gas prices
- subsidized interest rates, negative in real terms
- tax exemptions for capital goods imports
- tax benefits for new industries
- wage repression made viable through the policy of price controls on basic consumer goods
- a slowly appreciating domestic currency, making capital goods imports cheaper
- strong protection of domestic industry through high tariffs (basically on finished products), import licenses, prior deposit requirements, etc.

The outcome in the 1970s was a rapid increase in manufacturing output (almost 10% a year during that period), through the establishment of a host of small firms in a great number of activities. The resulting manufacturing sector was allegedly over-

dimensioned and intensive in the use of energy and capital, but not in the use of labour, as rigid labour laws dissuaded entrepreneurs from granting long-term contracts to employees. Furthermore, the industrial sector ran heavy balance-of-trade deficits and performed poorly in terms of developing linkages both within the sector and with the rest of the economy. Agriculture benefitted least of all from these mechanisms channelling oil rents to the economy, and the growth of agricultural output was the lowest of all the productive sectors (Vos, 1984).

While public expenditure increased, public income slackened as it relied excessively on petroleum revenue. Oil exports remained more or less stable during the 1975-1982 period, and this, combined with a fixed exchange rate and a marked anti-export bias, led to fiscal deficits and balance-of-payments problems in the latter years of the 1970s. It was possible to put off the necessary adjustments, as international banks were more than willing to increase lending and the international debt soared. The long-postponed adjustments finally became unavoidable, however, as international interest rates went up and capital transfers stopped after the Mexican debt-servicing failure of September 1982 (Acosta, 1990).

The expected Dutch Disease effect of declining exports on other products can be seen in the subsequent period, between 1979 and 1983. By this time, a new product with extraordinary comparative advantages had developed: shrimps. Exports of this product rose from US\$30 million to US\$300 million constant dollars between 1978 and 1990. Consequently, we have also subtracted shrimp exports from the total. All other exports plummeted back to US\$207 million in 1983, recovering to US\$490 million in 1986 but suffering a steady decline afterwards.

In the early 1980s the oil boom, rapid economic growth and significant social improvements came to an end. In 1980 oil production fell, and in 1981 economic growth per capita was very low. The boom of the 1970s had left Ecuador quite unprepared for the 1980s. The competitiveness of its agricultural sector was weakened, while the subsidized manufacturing sector had grown a great deal without becoming internationally competitive. The public sector had grown rapidly, accounting for 23% of GDP in 1973 but over 30% in 1982. However, this public sector expansion was financed almost exclusively with oil revenues and foreign debt.

The debt crisis broke out in 1982 and brought a reversal in capital transfers and consequent balance-of-payments problems. However, exports of oil did not decline further (after the 1980-1981 drop) until the collapse in oil prices in 1986 and the earthquake that destroyed the oil pipeline in 1987. Cocoa exports had a low point in 1983, bananas in 1984, shrimps in 1985 and oil in 1987. Overall, we see periods of declining exports between 1980 and 1983, a slight recovery in 1984-85, a collapse in 1986-87 and a very modest recovery afterwards. The debt crisis ended the possibilities for debt-led growth and the government of President Hurtado was forced, for the first time since 1970, to devalue the sucre and introduce a package of stabilization policies. The package included reduction of the fiscal deficit from 7% of GDP in 1982 to a small surplus in 1984, and import restrictions were introduced to improve the trade balance. However, the reduction of the deficit was financed in great part by money creation, causing an increase in inflation and a fall in per capita GDP in 1982 and 1983.

It was the newly-elected administration of President Febres Cordero which initiated in 1984 a major stabilization programme also aiming at modernizing the economy through a series of measures contained in a neo-liberal (or neo-conservative) programme. The direct role of the State in the economy was to be reduced, along with the web of regulations. The programme also included the elimination of price controls and subsidies (e.g. on energy) and the freeing of trade and the exchange rate, and it involved a shift from import substitution to the promotion of manufactured exports. Foreign direct investment was promoted through this programme, and full debt servicing was designed to improve Ecuador's image. This programme had similarities with the programmes initiated earlier in Chile, Argentina and Uruguay, but with great differences in the economic and political context (Ramos, 1986).

The initial results of the programme were relatively positive, as GDP grew over 4% in 1984 and 1985, helped in particular by the recovery of the agricultural sector after the floods of 1983. However, social unrest mounted in the country as the social costs of the restrictive monetary and fiscal policy affected a great part of the population through the removal of price controls, devaluation, falling employment, declining government subsidies and sinking real wages. The loss of political support,

worsened by the fall in oil prices in 1986, led to the relaxation of fiscal austerity and the initiation of a public works programme, with resulting budget deficits and a rise in the rate of inflation in 1986 and 1987. The 1987 earthquake which destroyed the pipeline transporting oil from the Amazon region to the coast, and the additional fall in oil prices in 1988, caused disastrous economic results at the end of the Febres Cordero administration.

The expected upsurge in other exports after the oil collapse in 1986 is not yet clearly visible, but perhaps we should bear in mind that historically non-EECA exports have lagged several years in reacting to the existence of a high real effective exchange rate. Total exports other than oil, cocoa, shrimps and bananas declined from US\$490 million at constant 1980 prices to US\$322 million in 1990. This tendency was

heavily influenced, however, by coffee, oil derivatives and chocolate. Some minor exports seem to be picking up, without reaching a scale that affects the overall picture.

The Borja administration took office in 1988 and managed to restore the international reserves but did not advance very much in the modernization of the Ecuadorian economy. On a per capita basis the performance was rather meagre, with zero per capita growth over the whole 1988-1992 period, although GDP growth did pick up somewhat at the end of the Borja administration. Inflation was persistently high, around 50%, during the whole period. One of the causes of this persistent inflation was that the administration was not able to combine monetary and fiscal policy efficiently, for while monetary policy was rather restrictive, this was not the case on the fiscal side.

## V

### Economic policy

Poor manufacturing export performance and production inefficiency characterize the Ecuadorian industrial sector<sup>3</sup>, and this situation was made worse by the economic policies applied. Special attention will be given in this section to trade policy, exchange rate policy, and policy regarding foreign direct investment.

#### 1. Trade policy

Ecuador has a long tradition of the application of export regulations which has further increased the bias against exports, including export permits, export prohibitions and regulations on foreign exchange proceeds. Domestic protection, with its effect of decreasing the relative prices of exportables compared to import substitutes and non-tradeables, consisted of a very complicated system including four separate tariff lists which, until 1985, each had different exchange rates, a system of tax exemptions which were largely firm-specific, prior authorization for selected imports, import prohibitions and foreign exchange

authorizations. During the 1980s protection through tariffs and surcharges was raised and lowered on several occasions. In 1983 new surcharges were added which increased the rate of protection. In 1986 a new tariff structure was introduced that lowered rates and reduced their dispersion, but in 1989 new import taxes were introduced. At the end of 1992 Ecuador dropped its previous objections to the Andean Pact Free Trade Area, and imports from Colombia and Bolivia have entered duty free since September 1992, and those from Venezuela since February 1993. In November 1992 Ecuador further reduced tariff rates by adopting a 5% to 20% tariff schedule for imports other than from the Andean Pact countries. Advances have also been made in the simplification of import and export procedures.

#### 2. Exchange rate management

Up to March 1983 the country had a fixed exchange rate system which was relatively stable. Between 1950 and 1983 the exchange rate was only changed four times, rising from 15 sucres per dollar in 1950 to 33 sucres per dollar in 1983. Until the mid-1980s exchange rate policies discriminated against tradeable goods. The main instrument for exchange rate

<sup>3</sup> For a more general description of economic policy and the political process, see Hurtado (1988), De Janvry, Sadoulet and Fareix (1991), and Thoumi (1990).

management has been direct intervention in the supply of foreign exchange, fostered by oil exports and foreign indebtedness. These policies encouraged capital-intensive production and thus imports of capital goods. In 1983, after a macrodevaluation, a crawling peg system was introduced which lasted almost two years, after which the government introduced a dual exchange system. In 1986 a free market exchange rate system was introduced, with only official imports and oil exports remaining in the official market, but macroeconomic instability caused the free market to collapse in 1988. After a short experiment with a fixed exchange rate, a new crawling peg system was introduced which remained in place until September 1992. Since then the government has moved towards a free market exchange system, with Central Bank intervention to stabilize the exchange rate (a dirty float).

### 3. Foreign direct investment

Recent years have seen a liberalization of the foreign investment regime. In 1991 new regulations included equal treatment for national and foreign firms in

terms of taxes, tariffs and other fiscal incentives, eliminated limits on the repatriation of net profits (doing away with the previous ceiling equivalent to 40% of the company's capital base), and allowed foreign investment in sectors which had previously been classified as strategic, such as utilities, the mass media, advertising and domestic transportation. At the beginning of 1993 the recently installed new government further liberalized foreign investment regulations, eliminating the remaining restrictions on foreign investment in commercial banking and extending to foreign firms the promotional mechanisms available to Ecuadorian firms. The new rules allow foreign investors and firms to become local investors without registering or meeting specific qualifications and eliminates prior authorization for the transfer of equity shares. Regulations on technology transfer have also been eased.

A new investment code was adopted in mid-1991 which gives equal treatment for national and foreign corporations in terms of fiscal incentives, does away with restrictions on the repatriation of profits and permits foreign investment in several previously restricted sectors.

## VI

### Business behaviour

Typically, industries catering for domestic demand in Ecuador can be classified in four subgroups which have different characteristics as regards the type of firms involved (ownership, size), and as regards the type of government intervention applied. It may also therefore be assumed that they are different as regards the strategies of the firms in response to changes in the policy environment:

- Basic-needs-oriented companies, with price controls and oligopolistic market structures.
- Enterprises producing traditional consumer goods, sometimes with a distinct indigenous background and usually operating in rather competitive markets, despite the frequently high tariff protection.
- Companies producing durable consumer goods, with private quasi-monopolies in strongly regulated markets.

- Enterprises producing industrial and agricultural inputs, usually linked to firms dominating the field of traditional export products.

The policy-induced distortions are greatest in the first and third groups of industries, and thus the changes in company behaviour in response to changes in the policy environment are likely to be stronger in these groups.

#### 1. Industries catering for basic needs<sup>4</sup>

Industries which may be classified in this group include those producing sugar, rice, oils and fats, pharmaceuticals, and cement. Policies regarding this type

<sup>4</sup> The descriptions of specific industries are partly based on Spurrier Baquerizo (ed.), various issues.



of industries generally obeyed the basic objective of keeping the consumer prices low, in order to diminish social unrest stemming from low wages. This poses the problem of how to guarantee an acceptable profit rate and usually requires the establishment of price controls throughout the production chain. Exports have to be prohibited, because otherwise foreign consumers would benefit from the subsidized consumer prices. As the profit rate thus depends on Government decisions regarding price levels, incentives to invest in expanding production capacity or in modernization efforts designed to improve efficiency are very low. Production will eventually fall short of domestic (subsidized) consumption, and imports become necessary. These imports have to be subsidized, making this another form of rent channeling to producers. Some examples may clarify these points.

In the *sugar industry*, cane is processed in three main mills or "ingenios", one of which is State-owned (by the CFN). The quota granted to Ecuador on the United States market makes sugar exports a highly profitable operation. The quota is distributed among the ingenios by the State retailing company, the National Commodity Storage and Marketing Company (ENAC), but in exchange the ingenios are obliged to sell all sugar for domestic consumption to ENAC. Price controls operate at all points in the chain: from the price between cane producers and ingenios, to the price for sugar in the shops. Since sugar production usually falls short of domestic demand, permits are given for the importation of sugar both to complement supply on the home market and for re-export to the United States. It may naturally be assumed that the effect on company behaviour is that there is no incentive to invest in more production capacity or to improve productivity, neither on the farms nor in the plants.

A similar situation is found in the *rice sector*. This is still an important product, as a significant number of small farmers engage in rice production. Price controls are used, but cannot be enforced as easily as in the case of sugar. The grain mills are obliged to sell their output to ENAC. When prices are raised, production readily increases and has to be exported, which causes deficits for ENAC, as home producer prices are higher than the (allegedly heavily subsidized) world market prices. Such market saturation leads the Government to lower prices, leading to less rice cultivation and the need to import rice. In

this case, too, ENAC still suffers losses, as consumer prices need to be subsidized. The endless political struggle about rice prices is an explosive issue which has occasioned the dismissal of several Ministers of Agriculture.

Four plants dominate *cement production*, one of which is State-owned. Price control was practiced until very recently, by fixing the profit rate in the industry. Output used to be at maximum potential, yet a shortage of cement in the market was the rule. Black market prices were alarmingly high, and cement smuggling to Colombia was reported. However, the price controls hindered investments to expand production capacity. The Borja Government raised cement prices and abolished import controls, and the black market disappeared as demand dropped. The Andean Development Corporation proposed a major investment project for increasing production capacity.

The *pharmaceutical industry* also has an important share in the consumption basket of the population. It is perhaps surprising that this sector had a good performance from as early as the 1940s, and frequently exported its products, although these were based on imported active principles, which account for around half the production costs. Most of the transnational pharmaceutical enterprises set up shop in Ecuador, and by 1987 more than 100 laboratories were registered, of which the largest 26 accounted for 80% of production. Only two of these 26 are of Ecuadorian capital. Stiff price policies were meant to keep consumer prices low, and this was perfectly possible during the 1970s because imports were cheap in sucre terms. The devaluations from 1982 onward brought profit levels down, however, and enterprises reported losses, in response to which the Government decided to grant a subsidy based on the amount of imports. The laboratories always protested against these subsidies, which implied a fiscal sacrifice of close to US\$50 million in 1990, arguing that the best solution was the abolition of price controls. Obviously, exports had to be prohibited and massive smuggling was reported (up to 30% of total production). Finally, in September 1991 the Government announced the elimination of the subsidy and its replacement by a direct subsidy to low income groups. To the dissatisfaction of the laboratories, however, price controls were not eliminated. The entrepreneurs stress the competitiveness of the sector in the Andean market, and they are confident that the transnational companies might prefer Ecuador as a

production base for the regional market. This will depend on the elimination of the export prohibition and the incidence of other trade and foreign investment policies.

These examples clearly illustrate the negative side-effects of price controls designed to keep consumer prices low.

## 2. Durable consumer goods

Perhaps the best-known example of the effects of Ecuadorian industrial policies is the establishment of industries producing durable consumer goods. The policy approach was to guarantee a high rate of return for new establishments by subsidizing investments and guaranteeing a market. Investment subsidies took the form of credits at negative interest rates and tariff exemptions on imports of capital goods. The markets were secured through high tariff protection and regional agreements within the Andean Pact integration scheme. The result was that the price-quality relation did not really matter as far as making profits was concerned. Most industries did not develop a genuine capacity to compete in open markets, and they virtually disappeared after the change in economic policy. One exception is the automobile industry, where policy changes were slow to be implemented, and the competitiveness of the industry in open markets is therefore yet to be tested.

The history of the automobile industry in Ecuador is strongly linked to the common industrialization efforts of the Andean Pact countries. Before the Andean Pact there was only one assembly firm, linked to General Motors, and few suppliers of auto parts. The automobile policy of the Andean countries did not have all the desired effects, but nevertheless two more firms entered the market. In 1983 a more protectionist policy was installed, and Volkswagen set up shop in Ecuador. The main policy instrument was the authorization to import Completely Knocked Down (CKD) kits, with complete prohibition of other automobile imports. This complete prohibition was relaxed for a short time between 1985 and 1987, but extremely high import tariffs were maintained. The CKD import authorizations were distributed among firms by a coordinating agency, CORDINAUTO. In the latter half of the 1980s these authorizations were used to implement a programme known as the Economic Automobile. Under this programme, 40% of all

CKD imports should be of inexpensive automobiles, and it caused local assembly operations to flourish. In 1991 the programme was stopped, and imports of CKD kits were freed from restrictions. The Andean Pact automobile production scheme was eliminated, and free imports from member countries were stimulated. The Ecuadorian automobile industry does not seem to fear the competition from Colombia, Peru or Venezuela. Most firms are owned by mother companies which also own firms in other Andean Pact countries. Consequently, a specialization strategy among daughter firms in the countries is taking shape, with Ecuadorian firms exporting cheap cars to Peru and Colombia, while importing the more luxurious models from those countries, and especially from Venezuela. The prospects of the industry in a scenario of liberalization towards third countries (a prospect that might become a reality after 1993) are not so clear, however.

Among the other industries which benefitted to some extent from the impulse of the Andean Pact industrialization policies was the refrigerator industry: a branch that registered at the end of the 1970s exports to member countries as high as US\$80 million, but the end of the Andean Pact industrialization strategy brought this export drive to a complete stop. The same is true of the woodworking industries. All four enterprises in this branch collapsed after the breakdown of the common policy. Likewise, of the 15 enterprises that entered the metalworking industry under the Andean Pact policies, all but four have stopped producing. The remaining four, producing electrical systems, sewing machines, vacuum cleaners and hydraulic systems, exported together US\$8 million in 1989. In the chemical sector at least two enterprises (both of them in the pharmaceutical industry) survived the closing down of the Andean Pact industrialization policies. The country's experience with the industrialization scheme in the context of Andean integration has not given Ecuador any important lasting capacity in any branch, with some firm-specific exceptions. Most firms simply could not survive without protection.

To prove this last point, Ecuador's share in the imports of the OECD countries has been calculated for the years 1963, 1971, 1980 and 1990, at the three-digit SITC level. Only the items with a market share of at least 0.01% of OECD imports have been taken into account. The oil boom was the period of strongest export performance, also in items other than the

traditional products. A decline in competitiveness was observed in the 1979-1983 period, in line with the Dutch Disease argument, while there was a very

modest recovery of competitive positions in the 1983-1989 period, basically in EECA exports other than oil.

## VII

### Summary and conclusions

Ecuador is on the road to a new development strategy which, as in many other Latin American countries, includes a reorientation towards a more outward-looking strategy. The transformation of the trade and industrialization regime should take into consideration one of the basic features of Ecuadorian growth, namely its instability as a result of the existence of extraordinary comparative advantages.

Ecuador has grown quite fast during the twentieth century: the overall 1900-1989 annual per capita GDP growth rate was 2.2%, compared to 1.7% for Latin America as a whole and 2.3% for the Asian developing countries. Since 1950 Ecuador's per capita GDP growth has been significantly faster than the Latin American average, although the Asian countries have grown more than twice as fast as Ecuador.

In this article we have analysed the different booms and busts that have occurred in Ecuador in the twentieth century: the cocoa boom at the beginning of the century, followed by its bust in the 1920s and the Great Depression of the 1930s, the banana boom of the 1950s and its decline in the 1960s, and finally the oil boom during the 1970s and the debt crisis in the "Lost Decade" of the 1980s. Ecuador experienced a clear-cut Dutch Disease problem during the cocoa boom at the beginning of the century. Growth in non-tradeables—such as the very necessary public services—, inflation and weakened competitiveness of other exports were the signs of this. It was already clear in 1921 that export diversification was called for, and a number of policy instruments were created to achieve that: import tariffs, foreign exchange controls, credit allocation and tax benefits for other industries. Some results were achieved in the latter half of the 1920s, but then the Great Depression brought the exports to a halt. The recovery after 1937, spontaneous import substitution and diversification of exports were an abnormal phenomenon due to the disarray of the developed countries. Banana exports in the 1950s, while not constituting a boom of the

magnitude of the cocoa and oil periods, allowed the strengthening of the Administration and financial institutions, and public investment rose quickly. An institutional system oriented towards an import-substitution strategy was built at this time. A hint of Dutch Disease problems can be seen in the sluggish performance of non-EECA exports between 1955 and 1965, but domestic manufacturing industries were born and grew at a considerable pace.

Oil revenues provided the financial resources needed to complement the institutional set-up for the import substitution industrialization strategy. Rents were channelled to manufacturing industry through a large number of direct and indirect mechanisms, enough to offset the Dutch Disease effects. All exports grew, and the export structure diversified up to 1978. The inflow of foreign exchange through the accumulation of debt exacerbated the Dutch Disease problems, however, and the export data clearly show the weakening of competitiveness in the 1978-1982/3 period. A gradual adjustment strategy was followed from 1982 to 1984, and a change in development strategy was essayed after 1984, with the abolition in practice of special credits and fiscal benefits. The change in development strategy was consolidated after 1988 as tariff reductions and deregulation proceeded, and a deepening of the liberalization strategy can be expected in the near future. The deliberate import-substitution strategy, which lasted roughly 30 years, from 1955 to 1985, altered the Dutch Disease effects significantly and allowed the build-up of some manufacturing capacity and the diversification of exports, basically through the oil-rent-based subsidization of producers. However, it did not create a competitive manufacturing sector that can compete without subsidies, with perhaps some firm-specific exceptions.

But the return to a development strategy based exclusively on the mechanisms of free trade is not likely to produce stable export-led growth, as the Ecuadorian economy is still characterized by the

presence of extraordinary natural competitive advantages, and distortions on the internal markets abound. It is not unimaginable that Ecuador will experience a second oil boom, just as it experienced a second banana boom between 1987 and 1991. Or perhaps a new product will significantly alter the export structure, just as the surprising boom in the shrimp industry did in the 1980s. Will tropical hardwood be the next product that brings significant rents to Ecuador, transforming the rain-forest just as cocoa and bananas transformed the coastal area?

The question remains how to make best use of these windfall profits in order to create competitive advantages in other areas and diversify (and hence stabilize) exports and, as a final goal, growth. Undistorted free trade will not do the trick unless one assumes an economy without distortions. In the past, the free trade regime did not achieve sustainable growth, and the distribution of rents to entrepreneurs while maintaining real wages low, as in the import substitution industrialization period, has severe drawbacks as shown by the reduced responsiveness and increased vulnerability of the production apparatus, not to mention the macroeconomic flaws of excess public spending and inflation.

A free trade regime and the presence of extraordinary competitive advantages distorts price signals and market mechanisms in the domestic economy, through rent-seeking behaviour. A conscious intervention strategy should be followed so as to stabilize, but not immobilize, the relative price structure over time. This could involve measures to protect or stimulate other tradeables during a boom. But the specific measures taken in the 1955-1985 period were misdirected, if we evaluate them with the crite-

tion of long-term growth. In a period of export booms, instead of subsidizing producers, measures should be taken to subsidize consumers, especially of the lower-income strata, through direct support, e.g. in the guise of scholarships for basic education and training. To slow down spending and stimulate saving, however, a high real interest rate would be necessary, instead of the negative interest rates that prevailed during ISI. Social insurance mechanisms are of the utmost importance for capturing savings and providing long-term resources to the financial system. At the same time, booming internal demand would be a great stimulus for local industries, and they should therefore not be (permanently) protected from international competition, but should instead be made familiar with international standards and practices. Apart from the drawback that protection from international competition hinders technological learning, imports are necessary to contain inflationary pressures and moderate oligopolistic behaviour.

In sum, Ecuadorian development will require public intervention in the market forces in order to attain optimum long-run growth. Such intervention will require other mechanisms, other institutions and better implementation than the type of intervention used in the past, however. To some extent, it will be a form of intervention to create and improve the functioning of the market forces in the domestic economy, instead of suppressing them. The task of changing the economic policy regime started with the debt crisis, but the shape of the new model is not yet entirely clear. It will probably take well into the next century to achieve a reasonably articulated and integrated set of institutions and mechanisms.

(Original: English)

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# The cultural industry *and new codes* of modernity

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**Martín Hopenhayn**

*Social Development  
Division, ECLAC.*

Within the context of the globalization of the economy, communication and culture and the transition towards societies based on information and knowledge, the sustained development of the cultural industry stands out as a priority means for the articulation of society. For at least the last three decades, culture has been increasingly linked with the growth of the social communication media. Indeed, the cultural industry is becoming a strategic sector for competitiveness, employment, consensus-building, the style of politics and the circulation of information and knowledge. This growing weight of the cultural industry is closely linked with its own diversification. Technological innovations have given rise to great leaps forward in the cultural industry which make it necessary to redefine its limits year by year. A market for messages which forms part of the circuit of global interchange and constant acceleration in terms of time is transforming the limits of "heavy" and "light" culture, highbrow and lowbrow culture, sophisticated cultural products and those appealing to a popular audience, and national and foreign cultural manifestations. In the following pages, an analysis will be made of the changes which these developments have brought about in the image of modernity and modernization in Latin America. The coexistence of various past times in a single present and the current tension between the high levels of symbolic integration through the cultural industry and the low levels of social integration form the central concerns of this article in its efforts to set forth the potential and risks of the cultural industry in the region.

# I

## Preliminary considerations

The concept of culture has two very different connotations. The first of these associates culture with the past, with the fine arts and letters; it is the sphere of the "great works" of the spirit, of the highest intellectual, scientific and artistic achievements of a society, and of its architectural and archaeological heritage. The second connotation is broader, and sees culture as the way of life of a people, its systems of values, language and codes of communication, and the various forms of popular thought and creation.

In the following pages, this second connotation will be used, for two reasons. Firstly, because the close relation between the dynamics of culture and those of development becomes more evident when using a broader concept of culture, and secondly, because the assessments of the recent impacts of the cultural industry on society are of such varied scope that they make it essential to work on the basis of a global view of culture.

Likewise, the concept of the cultural industry should itself have a sufficiently broad scope to allow it to be related with the broad universe of culture. The division which José Joaquín Brunner proposes between the "light" and "heavy" cultural industries is very interesting in this respect. The first of these refers to "television, popularization, rapid reading, snapshots, dictionaries of quotations, ready-made products in general, hack writing, occasional art, therapeutic religions...", whereas the heavy cultural industry is "that of long-lasting ideologies: age-old religions, classics, formal education, taboos and a sense of guilt, authority, beauty, methodology, accumulated knowledge" (Brunner, 1988, p. 27). Although this classification may seem rather vague for defining the cultural industry, it does illustrate the leading role that industry could play both in the superficial and fortuitous exchange of messages and in the construction of ideologies and bodies of knowledge which form an underlying presence and develop by slow accumulation.

The rapid cultural de-territorialization due to the globalization of communications and the telematics revolution<sup>1</sup> makes it difficult to maintain

watertight views and categories in this field: "The de-localization of enterprises, the worldwide simultaneity of information, the adaptation of certain international knowledge and images to the knowledge and habits of each people (...), the de-localization of symbolic products by electronics and telematics, the use of satellites and computers in the spreading of culture, also prevent us from continuing to see the conflicts of peripheral countries as frontal combats with geographically defined nations (...). The reorganization of cultural scenarios and the constant crossing of identities mean that we must look elsewhere for the orders which systematize the material and symbolic relations between groups" (García Canclini, 1990, pp. 288-289). It is even argued that national societies are merely segments of global markets and that this is particularly true in the field of the cultural industry and the consumption of culture. The differences, it is claimed, lie in the local reception codes, within "the unceasing movement of transmission circuits which extend all the way from publicity to pedagogy" (Brunner, 1988, p. 218). If this approach is accepted, then the cultural universe opened up by the combined impact of telematics and the cultural industry may be defined as an era of decentralized culture in which cultural heterogeneity does not refer to the diversity of local and national expressions but to "segmented and differential participation in an international market for messages which 'penetrates' the local cultural framework on all sides and in the most unexpected ways" (Brunner, 1988, p. 218).

There is tension between the concentration prevailing in the classroom and the dispersive force of the multimedia of social communication. Hybridization goes beyond the ethnic level and becomes an everyday event that affects everyone: there is no identity that can remain in the pure state for more than a few hours in the face of the extremely strong stimuli received from all corners of the earth. The aesthetics of collage and pastiche which is so dear to post-modern sensibility is not a chance phenomenon but is a metaphor for this state of continual recombination of cultural sensibilities and messages. Such

<sup>1</sup> Telematics is taken to mean the combined effect of new technologies in telecommunications and informatics.



terms as “hybridism”, “syncretism”, “intercultural tissues” or “decomposition and recomposition of signs” are increasingly common in analyses of the cultural processes of today. In this sense, there is no clear limit for the cultural industry or well-defined frontier for delimiting cultural identities. It is within this dynamic of blurring of frontiers that we must place ourselves in order to understand both cultural processes and their close links with the cultural industry complex.

It must also be remembered that during the last five years the world has undergone dizzying political changes and a considerable proportion of the world’s population have witnessed the recomposition of the international political scene from their own homes. The Gulf War, the conflicts in the former Yugoslavia, the fall of the Berlin Wall and the rise of the new democracies, with all their airs of renewal and their more sinister aspects, have been witnessed in detail and without a moment’s delay in all latitudes of the world. Not only is instantaneous and exhaustive in-

formation now available, but there is also a growing diversity of readings in this planetary-scale diffusion of events. The incorporation of telematics into the cultural industry has meant that the whole world is now affected by the rest of the world. Muslim fundamentalism, Serbian nationalism or the violent acts of groups of young neo-Nazis in Germany serve as a mirror or appeal to the conscience of other cultures or groups in other parts of the world which are under the stress of this new modernity open to the world at large.

In this context of rapid change and intensive dissemination, culture tends to become a kind of ongoing dialogue among the citizens of the world. The cultural industry may be defined, partly as a metaphor and partly literally, as a play of mirrors which makes it possible at every moment to recompose our identities through dynamic relations with all the other identities which we see in action through the mass media, information networks, comments heard in the street and at work, and telephone consultations.

## II

### Cross-temporal cultural consumption

The school, the city and the television are the pillars on which, over the last four decades, a mass culture has been built which is in many respects a mixture of heterogeneous cultures and times. This diachrony has been particularly marked in the case of the leap forward in education: access of the middle class to higher education was promoted when half the population over 15 in the region was still illiterate.<sup>2</sup> Through rapid urbanization and the modernization of employment, the masses are now rapidly forced to participate in a type of social life which demands that they be able to handle codes which were previously

totally unknown to them: bureaucratic rationality, technical rationality and abstract mental processes. With regard to the impact of the mass media, it has often been said that this phenomenon causes cosmopolitanism to exist side by side with localism, especially in view of the speed and extent to which the various components of the conventional cultural industry have spread in Latin America and the Caribbean.<sup>3</sup> In terms of access to information, this means that the local spaces, including those which previously suffered from chronic isolation, now have a window through which they can see what is going on in the world.

<sup>2</sup> Only four decades ago, around 1950, Latin America was a totally different continent in terms of its cultural makeup: 61% of the population lived in rural areas, the illiteracy rate among those over 15 was nearly 50%, and gross enrolment at the secondary level was barely 7%. Today, however, gross enrolment rates are 100% in primary education and over 50% at the secondary level. In a number of countries, the proportion of the population over 25 with a post-secondary level of education is between 5% and 7%, which is comparable to the levels in Austria, Hungary and Italy (Brunner, 1990, pp. 11 and 31).

<sup>3</sup> In this region, “the number of radio receivers increased to nearly 140 million by 1987: that is to say, 332 per 1 000 inhabitants – a proportion more than double that of the average for all developing countries. Likewise, the number of television transmitters, which was only 250 in 1965, rose to 1 590 by 1987, while the number of television receivers, which was only 8 million in 1965, amounted to 60 million by 1987, representing an increase from 32 to 147 per 1 000 inhabitants, compared with 1987 figures of 49 per 1 000 in Asia and 14 per 1 000 in Africa” (Brunner, 1990, p. 32).

The effect may be even more profound, however, in the case of symbolic consumption, where a whole range of new codes, sensibilities, dramas of human passion, human conflicts and scales of values are set forth in television films or soap operas and now reach publics which lived for centuries on the basis of reciprocal relationships, immemorial forms of religious syncretism, rituals connected with the agricultural cycles and precarious forms of survival. Not only do different time-scales exist in the contrast between the messages and the cultural environment in which they are decoded, but the programming of the media itself contains at one and the same time forms of logic and sensibility which belong to different cultural "moments": a Mexican soap opera and a Flash Gordon serial follow each other without a break in the weekday afternoon programmes shown in La Paz or Guatemala.

In point of fact, modernity in the region is a new time which contains many other times. This means that it is difficult to project to our region the assumption of the linearity of historical time, based on the idea of the "relief" of one culture by another culture which succeeds it, which forms part of the classical idea of modernity in the countries of the North. In Latin America and the Caribbean, cultures reflect this syndrome of tardy modernity which consists of rapid incorporation into exogenous symbolic markets and which inevitably results in some degree of cultural hybridism.

At the same time, there is no scale which allows the recipients of the messages from the media to be grouped according to their degree of modernity of cultural consumption. What criterion can we use to determine whether a person watching the CNN television news is more modern than one watching a Brazilian soap opera, or whether the reader of a political journal is more modern than someone reading a sports magazine? In the light of experience, in hyper-communicational modernity the modern aspects are increasingly connected with the logic of the mass media. The degree of modernity is no longer defined by an order of categories, but by the incorporation of technology and intellectual added value in the production of messages. Thus, a light entertainment programme on the television is more modern than a cultural report if it is capable of simultaneously integrating with presenters and programmes of other countries. On the other hand, a cultural report may be more modern than a soap opera if it is capable of

introducing greater contrasts, a greater variety of levels of discourse, better definition of views or greater dynamism in dealing with a subject.

With the most recent effects of the globalization of communication and technological diversification on the cultural industry complexes, the idea of modern culture is shifting from a scale of contents to a scale of fertility of communication. This phenomenon, further heightened by the tremendous increase in the supply of products of the cultural industry (videos, cable television, video games and computing, telematics and fax networks, satellite antennas), is redefining the conventional contrast between traditional and modern culture.

The new scenario into which new and flexible branches of the cultural industry are being incorporated is not just a more highly developed version of the heterogeneity of times and cultural patterns already referred to. As far back as a couple of decades ago, the spread of television led to the oft-quoted assertion that "the medium is the message". In more recent years, however, the change has gone even deeper. Because of the greater competition and internationalization of television and the proliferation of new production and consumption options in the field of the cultural industry, a substantial change is taking place in the concept of what is modern in the area of cultural production and consumption.<sup>4</sup>

In the cultural market, the level of modernity is increasingly defined by the form of production rather than the content, by the technological packaging rather than by the message, by the rate of innovation rather than the "class" of the product. This change is bringing new signs into the cultural imagination. While on the one hand it undermines the conventional categories of values of culture, it also undermines cultural identities. It destabilizes views of the world and heightens cultural hybridism to undreamed-of degrees: hybridism is no longer just a syncretism or crossing of two cultural codes, but a creative game or new invention for the cultural market – a totally new combination which makes it possible to continue innovating in the field of recreation.

<sup>4</sup> For example, in the field of cultural consumption a new-generation Nintendo game about monsters is more modern than a conventional television series set in New York. A laser digital recording of Beethoven's Ninth Symphony is more modern than Ravel's Bolero recorded on a conventional cassette. No matter how boringly domestic its subject may be, a home video film is more modern than a 1960s superproduction.

The same flexibility of images, codes, languages and rules which forms part of the technology of video games, computer games or virtual reality gives rise to a state of continual metamorphosis of images, symbols and traditions. The different combinations are limitless. The world can be recreated for ever in a diskette or video tape. There is not even any shortage of space for this, because the spaces can be reduced almost infinitely in the microchips where so many worlds circulate. Instead of needing a football field (or the street, to go out and play with the neighbours), there are thousands of games right there inside the monitor. A Nintendo is an infinite version of the whole universe of games: it takes up hardly any space, never gets tired, is always new, and yet at the same time unceasingly neutralizes the whole intensity of that novelty.

Culture is passing from a hybrid state to one marked by the unbridled repetition of the act of "hybridization": every day, as part of the race engaged in by the image industry itself, a new version is produced of the encounter between Hernán Cortés and Malinche. It is not clear what impact these new cultural technologies are having on the view of the world held by children who are just beginning to tune in to the new waves of the cultural industry. What happens to the view of the world held by a second-generation literacy student who still maintains certain

vernacular traditions and values in his order of symbols when he enters the vortex of the constant entry into and exit from new worlds every time he sits down in front of a video screen or a computer? What influence is exerted on the selective capacity, the image of the world and of the specific place each person occupies in that world, and the storage of information in the mind by the relatively recent habit of coming home in the evening and beginning to jump from one to another of twenty or more possible television channels coming from ten or more different countries?

It is not our intention to draw an apocalyptic picture suggesting that the globalized impact of the cultural industry will wipe out all the social links, customs and values which have been built up in the course of centuries of conflictive history in Latin America and the Caribbean. The new forms of the cultural industry are not necessarily negative: it is not so much the negative or positive nature as the extent of the impacts of the cultural industry in recent years that need to be taken into account. It is no longer possible to speak solely of the incorporation of the masses into modern forms of language, modern ideas and modern occupations: what is now involved is their incorporation into the ongoing changes in forms of language, images, ideas and occupations.

### III

## Active and passive participation in the area of the cultural industry

The new branches of the cultural industry make possible a fuller mutual relation between the producers and consumers of culture. The operational flexibility and smaller size of the components and the cost of the equipment have made it possible for some years now to expand the field of the producers and establish more horizontal links among the actors in the cultural market.

Paradoxically, the new cultural industry complex combines greater professionalization with a more mass-oriented focus among the issuers of messages. The professionalization of the cultural field increases as competition among television stations becomes

more intense and more internationalized. Operators and transmitters become more highly technified, while two different fronts made up of producers and consumers are maintained. Nevertheless, the progressive diversification of the supply of television programmes forces viewers to develop greater selectivity and to play a more important role as consumers. We are in the presence of "the creative work of millions of viewer/consumers who, individually and sometimes collectively, process, interpret, appropriate and experience in their own way this mass of signs which are produced and transmitted" (Brunner, 1990, p. 36). The apocalyptic view which was taken

a few years ago, warning of the growing passivity of consumers with regard to what the media put before them, has been replaced by the idea of an active, decodifying, selective consumer who processes the information supplied to him. The welter of options and the competition reigning among the media providing them force the consumer to develop into a productive consumer.

In the new products which the cultural industry is disseminating among our societies, at great speed and at ever-lower prices, the division between producers and consumers is becoming more tenuous. Neither heavy resources nor much technical knowledge are required in order to make home videos, operate video games or computer games, play an active part in the circulation of messages through telematics networks or teleconferencing, or –what is most novel and surprising– to change one's life and persona for five minutes by putting a few coins in the slot in order to enter the limitless world of virtual reality.<sup>5</sup>

The capacity to take an active part in the new technologies may be facilitated by learning the rudiments of computing in primary school. The shift from professionalism to everyday use by the masses is evident when we see how, in the industrialized countries, millions of children are operating computers with a mastery and ease which only seemed to be within the reach of engineers and advanced technicians just a few years ago. This familiarity with computers and integrated information/communication systems is indeed a new form of literacy. It is most impressive that many children are already capable of reprogramming a game on the computer and that nowadays they show greater aptitude than many adults for the assumption of interactive roles in new branches of the cultural industry.

In Latin America and the Caribbean, however, these "computer-literate" children are a minority. Whether because they go to elite schools or because they come from families where the computer is part of family life, they have a considerable advantage over the many schoolchildren who are lucky if they have one computer monitor for a whole classroom. In a new and disturbing manner, this redefines the dividing line between those who are "in" and those who are "out". We are, of course, still very far from a

situation where every Latin American home has a computer, but the new strength gained by the cultural industry with the incorporation of this new range of goods brings into social interaction the image of a computer within the reach of everyone. In the case of these new "literate" the relation with work, study and leisure necessarily involves radical changes in the uses of communication and information.

In our region, this new spurt in the cultural industry also brings the risk of further increasing the gap between those who are integrated in the new system and those who are not. "Integrate or die" would be a crude but very apt image of this new pattern. The danger that this gap may be consolidated from the earliest years of schooling means that in the future there may be a substantial majority of people who are computer illiterates and do not know how to cope with the logic of computer languages. In Brazil, which is the leading country in the region in terms of the television and informatics industries, the promises of individual development could extend, with luck, to a third of the total population, who are moving ahead with giant steps. In the case of the other two-thirds, the low income levels and scanty access to the benefits of modernity represent an insurmountable barrier to their expectations of personal development.<sup>6</sup>

<sup>5</sup> It is no longer a question, as in Gabriel García Márquez's famous novel *Cien años de soledad*, of an experience like that of Colonel Aureliano Buendía, when his father took him as a child to a gipsy's tent to get to know ice: virtual reality now allows us to enter ice, move about inside it, look out of it from the inside, and so forth.

<sup>6</sup> The following contrasts in Brazil give food for thought: whereas that country has the fourth biggest television network in the world (O Globo), in 1990 the members of 43% of the country's households had an average of between 0 and 3 years' schooling. Likewise, in 1990 the country had 213 television sets per 1,000 inhabitants, which suggests that most Brazilian households had a window on the world through this medium, yet at the same time the national illiteracy rate was close to 20%, the incidence of child malnutrition was around 13%, and 55% of the economically active population were classed as "poor" (World Bank, 1993; UNESCO, 1992).

## IV

### Blurring of limits in the cultural industry

The distinction between the "heavy" and "light" cultural industry is increasingly difficult to maintain as the systemic integration of the means of information and communication advances. Can we really assert, nowadays, that a religious upbringing makes a deeper impression on a child's mind than his contact through television with the war in Iraq or the last world football championship, or that the subjects he had to study for a history examination are etched more deeply in a child's memory than a cultural report that he watched on television for half an hour or so while browsing through the various channels? Who can really swear that an adolescent develops a greater capacity for logical thinking through a course of syntax or mathematics at his secondary school than through the games he plays on his computer when he gets home in the afternoon?

The field of cultural consumption is becoming so diverse that it is now very difficult to draw the line where the cultural industry ends. The logic of computer software moves from the monitor screen to the street and becomes a new form of processing of culture. Cultural consumption takes on a new form which serves as a kind of packaging for very varied contents: a form like that of software, which each user starts, stops and interchanges according to the relevant preferences, situations and objectives. The software model as it applies to culture also enters into training activities, through workshops with audiovisual support, weekend retreats and videos or computer programmes on new forms of management.

In this software-type cultural consumption, too, the cultural industry is blurring the frontiers between producers and consumers. When learning processes become light and varied, little training is needed in order to progress from student to teacher or from consumer to producer. Training to become a professor of meditation in a Himalayan monastery is a very different thing from receiving training in a personal development module in a business firm; being a literature professor in a university is very different from being a literature teacher in a neighbourhood group. As cultural consumption takes on the form of software, it also becomes a simpler matter to enter the

cultural industry as a supplier of goods or services. Protagonism exists side by side with "provisionalism" in the new cultures integrated into the recent waves of modernity.

In our region, this combination of protagonism and provisionalism in integrated culture becomes exclusion and precariousness in the case of the poor. Here, the lightness is connected more with the precariousness of survival than with flexibility in the consumption of cultural goods. The uncertainty about the future is due more to fear than to the wealth of options available for shaping one's life; more to insecurity than to dynamism. The lightness becomes deprivation; diversification becomes fragmentation. The software metaphor also penetrates here, but it is mingled with the survival-oriented culture of the big cities, where the activities for each new day are re-programmed in the light of the need to generate a minimum income: the software is a strategy based on the culture of precariousness, not "provisionalism".

In the Latin American setting, the integrated and the excluded are on the one hand united by television culture, and on the other hand restratified in the new cultural markets. In the case of television, as the definition of the supply of all types of programmes improves, the limits between highbrow and lowbrow culture become increasingly blurred. But although cultures may intersect in television, the socio-cultural gap reappears in new forms in other fields of the cultural industry. As we already noted, society is divided up into those who are integrated into the rapid circulation of information and new languages and those who are excluded from this.

It is true that rapid obsolescence and growing competition quickly reduce the cost of computers, video cameras and recorders, cable television services and other new cultural goods, which means that the middle strata can join the ranks of those who are integrated into the new ways, albeit with some delay in the rate of renewal. A very large section of the population, made up of the low and lower-middle income strata, however, remain on the sidelines of these new patterns of cultural consumption and symbolic integration. The result of this is that forms of

general symbolic integration (through the television, generalized basic education, opening up of channels of political participation thanks to democracy) coexist with forms of segmentation as regards the consumption of the vast range of goods that now make up the cultural industry.

In short, the blurring of limits in the cultural field is a development which is both strongly marked and recent. The frontiers between light and heavy in the channels of internalization of culture are disappearing; the personal "menu" as regards the use of goods and services connected with the cultural industry is becoming much more diversified; the patterns of integration and discrimination in the field of symbolic consumption are being reshaped as a result of the rapid changes in the cultural industry, and the limits are also disappearing between producers and consumers or between active and passive participants in the field of the supply and consumption of culture.

This blurring or disappearance of limits due to the changes in the cultural industry must not be taken lightly. It tends to have such a profound impact on the culture of our societies that it even alters the perception of everyday life in various senses. Firstly, it is no longer so easy to associate everyday matters with continuity. Whether through provisionalism or precariousness, everyday matters are becoming more random and dispersed. Secondly, the reiterative dimension of everyday matters is becoming less marked, through employment insecurity, the speeding up of technical change, the growing volatility of traditional roles, or the sensation of a "time tunnel" experienced as a result of the explosive increase in the offerings of the information and communications industry. Finally, the short-term horizon is tending to take the place of any long-term project in daily life, through the effect of precariousness in some cases, through provisionalism in others, and through the much faster rate of change in all areas of everyday activities.

## V

### **The need for new efforts to promote cultural integration in societies with low levels of social integration**

In societies with low levels of social integration, like a large proportion of the Latin American and Caribbean countries, the potential contribution of the cultural industry to development may be under-utilized. In our region, the segmented access to the new goods in the fields of information and communication means that a large part of society is kept in a situation of relative backwardness, with the risk that the gaps in terms of levels of productivity, access to new markets and development of intellectual faculties may be further widened. On the one hand, the lowering of the cost of the new goods offered by the cultural industry and their greater ability to penetrate to different socio-cultural sectors holds out the promise of greater integration, but on the other hand, the new forms of illiteracy represent a new threat for the great masses of the region's population who have no access to any form of information-based progress.

The tensions between cultural identity and modernity, which could be resolved with synergic effects through the new potential of the cultural industry, may also take on more conflictive features due to the high levels of social disintegration. Uncertainty about the future is generated by the impact of globalization on endogenous cultures and on their relation with the universalist culture which prevails in global exchanges. It is hard to know, in our region, whether this globalization of communications will make it possible to reduce the levels of social disintegration, offset economic and social disintegration with higher levels of cultural and political integration, or else set off a kind of societal schizophrenia, with a great deal of integration in cultural consumption but profound heterogeneity in levels of productivity and material well-being.

In order to reconcile the special socio-cultural features of our societies with the universalist impulse that modernity is now channelling through its new cultural industry complexes, an order of modern citizens is required. Modern citizenship means the existence of social actors who have the capacity to decide for themselves, to represent their interests and demands, and to exercise their legally recognized individual and collective rights. As long as this modern citizenship is only the privilege of minority sectors of society, the symbolic integration made possible by the cultural industry complex will have the dual effect already referred to: integration in some fields, but greater discrimination in others.

The impact of the cultural industry complex on societies with low levels of social integration is thus rather ambiguous. As an inertial trend, it may be expected that new relations of exclusion will be formed. Thus, for example, the division between formal and informal-sector workers in the field of labour may shift to a gap between those who have

access to information-based progress and those who have not; the segmentation between the modern and the traditional may shift in the cultural field to a new division between active and passive participants, and the gap between literates and illiterates will give rise to a division between achievements of high quality and those of low quality.

Finally, the cross-temporal aspects which have given culture in the region its hybrid identity will be bound to intersect even more as the cultural industry expands, without however dissolving the ways of life and views of the world maintained by Andean or Caribbean communities, jungle tribes and Afro-Brazilians. This exacerbation of different times within a broader single time need not necessarily have a negative effect: they can also be a reflection of a cultural fabric of great complexity, richness and beauty. They may even be seen as an asset for the future, in view of the increasingly heterogeneous nature of symbolic exchanges in the new versions of the cultural industry complex.

## VI

### The cultural industry as a new vehicle for social integration and participative culture

The link between culture and endogenous development depends to a large extent on the adaptation of the potential offered by the cultural industry. Objectively, its structure of growing versatility and diminishing costs is a feature of the new cultural industry complex which can be used to promote greater social integration and cultural development. The possibilities for action and for playing important roles opened up to ethnic groups and socio-cultural actors who have been deprived of access to the benefits and codes of modernity can be considerably increased if the resources of the cultural industry are properly mobilized. This synergic mobilization of information, communication and interaction resources can do a great deal to reverse the attitudes of resignation, pessimism and fatalism which spread over Latin America and the Caribbean during the 1970s and 1980s with regard to the viability of endogenous development and of the full deployment of national cultures.

In the field of the cultural industry, costs are going down and there are increasingly flexible technical possibilities for incorporating socio-cultural actors so far little integrated into the public exchange of messages. This should make possible intensive use of the niches of the cultural industry complex to carry out small-scale actions designed to promote and defend autochthonous cultures which have only precarious access to the benefits of modernization. "Over the last four decades, the real cost of "hardware" has been going down steadily by an average of 20% per year. The most sophisticated technologies of the recent past are increasingly accessible (if not for all, at least for many more people every year). One metre of fibre optic cable, which cost US\$3.50 in 1977, now costs 25 US cents, and this decline in cost has been accompanied by a marked improvement in quality" (Annis, 1991, p. 94). And in the words of ECLAC: "The dissemination of telematics (a combination of

telecommunications and information technologies) opens up a good many possibilities (...). Increasing affordability, miniaturization and user-friendliness and the ease with which these technologies can be put to many different uses make them ideal for purposes of coordination among very diverse or dispersed agents" (ECLAC, 1992a, p. 243).

As the price of components goes down, communications can be more and more horizontally linked. Integrated systems –telephones which link up with telexes, computers, databases, fax machines– have so many entry points that their access can also benefit low-income socio-cultural actors.<sup>7</sup> At the same time, increasingly light and portable components mean that information is physically more accessible to remote areas, which are precisely where autochthonous cultural identities are most often preserved, albeit in isolation.

The region needs to consolidate a second generation in the development of the communications industry and to ensure progress towards a third generation which will strengthen endogenous development and socio-cultural protagonism (Annis, 1991). The first generation oriented the use of television and radio towards the sale of commercial products. The second generation, which is currently beginning to show positive effects, adapts publicity techniques to "social marketing", which includes educational campaigns on the environment, the prevention of epidemics, political information and other matters which help to build modern citizenship. A culture of citizen concern and action promoted by the communications media helps to break down social barriers and to involve society at large in common problems. The third generation, which is still very incipient, moves from the phase of active reception to that of horizontal interchanges among the communication agents. Systems of teleconferences, informatics networks and integrated connections (telephone-fax machine-computer-photocopier) can

<sup>7</sup> The following is a good example of what the telephone holds out for the future: "Nippon Telegraph and Telephone, the Japanese communications giant which employs 3,000 scientists on technological research and design, hopes to develop and spread throughout the world a portable telephone device, the size of a calculator or digital clock, which will be very cheap to buy and use and will serve to communicate with anywhere in the world and also see the person receiving the call, in what it calls "intelligent visual personal communication services". Moreover, the calls will be free from interference and can make use of simultaneous interpretation services if language is a problem in communication" (*El Mercurio*, 1993).

serve to give voice to those who have not previously had the possibility of making their views known in public spaces. These new systems, when also integrated with the mass media, offer a very valuable potential for expanding public communication spaces. By this means, a wide range of social demands coming from dispersed or subordinated actors could begin to find their place in the public circulation of messages.

Thus, the strategies for the development of the cultural industry in the region are faced with an enormous challenge. The assertion of an endogenous form of development requires a participative culture, a body of citizens with the will to play a leading role, and socio-cultural actors who are incorporated into modernity in the horizontal interchange of symbols and messages. For this purpose, the consolidation of the second and third generations of the communications and information markets can become a vital element.

The tendency to decentralize the issue of messages in the cultural industry can contribute to the democratization of the region's societies. As we have already attained political democracy in the great majority of our countries, the further heightening of democracy on the basis of more prominent roles for a broad range of social actors could be boosted by the spread of the new forms of the cultural industry in the area of communication. There are now interesting cases in various countries of the region where the use of new goods produced by this industry has made possible horizontal links among various groups which previously suffered from socio-cultural segregation. These cases could serve to promote new initiatives in this field, such as the establishment of systems for the incorporation of the demands of dispersed sectors, greater links among the indigenous ethnic groups of the countries of the region, the production of programmes for the spread of autochthonous cultures, organized by the indigenous sectors themselves, etc.<sup>8</sup>

<sup>8</sup> Thus, for example, in Guatemala indigenous peasants fax messages about human rights violations to international non-governmental organizations, even though they do not know how to use a typewriter. In Amazonia, in Brazil, illiterate Indians exchange video cassettes in order to spread their native customs. Mexican neighbourhood organizations increase their pressure in public spaces with the aid of computers, their own data bases, and inter-neighbourhood information networks. In Chiapas, associations of small coffee producers communicate with similar groups in Central America and the Caribbean in order to share information on transport, markets, international prices, production techniques and international negotiations (Annis, 1991).



Because of their decreasing costs and flexible capacity for systemic combination and linkages, the possibilities opened up by the new cultural industry complex present society with a challenge in terms of creativeness and intelligence. It is necessary to develop a capacity for inventiveness and adaptation, both in State cultural policy and among the various economic actors in the cultural industry, in order to take advantage of the potential for social and cultural integration offered by the new cultural industry com-

plex. The virtuous circles which can be sparked off in connection with this complex through the innumerable possible combinations of uses and linkages of the available components also depend on the flexibility and intelligence in terms of such combinations developed by governments for this purpose. This also means flexibility and intelligence of combination in terms of the ways in which State policies link up with the private economic agents working in the field of the cultural industry.

## VII

### The cultural industry and the spread of codes of modernity

In order to link up education, knowledge and productive development in the region it is necessary that there should be universal access to the codes of modernity (ECLAC/OREALC, 1992, pp. 157-169). Thus: "the entire population should be trained to handle the basic cultural codes of modern society or, in other words, should possess the knowledge and skills required in order to participate in public life and play a productive role in modern society" (ECLAC/OREALC, 1992, p. 149). It is also specified, in the same text, that these capabilities include those required for the execution of basic arithmetical calculations; reading and understanding a written text; communication in writing; the observation, description and critical analysis of the surrounding world; the reception and interpretation of the messages of modern communication media, and participation in the design and execution of group tasks.

Universal access to the codes of modernity, as defined in the preceding paragraph, calls for an intensive effort by the countries of the region to achieve universal coverage of basic education, to improve its quality, and to modernize it, as well as the strengthening and adaptation of programmes of education and training for adults. Education must not only transmit useful items of knowledge but must also, as suggested above, teach students how to obtain and analyse information. This requirement would appear to be of prime importance if the aim is to give the new generations better opportunities to gain access to the benefits of an information-based society and respond more effectively to its challenges.

In the same proposal presented by ECLAC and UNESCO to the governments of the region, emphasis is placed on the need for a systemic approach, involving the mobilization of the various different agents and instruments, in order to secure the equitable dissemination of knowledge on how to gain access to the items needed in order to meet the new demands of the modern world in the fields of production and communication. The following lengthy quotation may serve as an illustration: "In modern society, there are many different sources of knowledge (libraries, data banks, manuals, newspapers and magazines, the mass media, experts, etc.), and an individual can gain access to that knowledge only if he or she has learned to make use of those sources. Education should plot out "access routes" to knowledge by incorporating all these sources as different types of reference materials (...) The use of modern communications media such as radio, television and, increasingly, computers is especially important; indeed, the use of such media in the region has spread so rapidly –and continues to do so– that their inclusion in any future educational strategy is clearly called for" (ECLAC/OREALC, 1992, p. 155).<sup>9</sup>

<sup>9</sup> In ECLAC (1992b) emphasis is laid on the seriousness of the pattern of exclusion in the field of telecommunications, because of the multiplier effect this can have on well-being and social cohesion. This document notes that in the countries of the region which have a low density of telephone service, the installation of public and rural telephones, with preferential charges for distant areas, becomes a part of social equity policy. This can be equally or even more decisive in the light of the integration into the telephone system of other "communications goods" such as fax services, the radio, and various information services.

Efforts to spread the capacity to gain access to the new cultural codes of modernity, which facilitate improved performance in the fields of both production and communications in a knowledge-based society, must necessarily encompass two elements (ECLAC/OREALC, 1992, p. 162):

i) The use of the communications media to develop more or less formal channels for distance learning by children and adults which will give access to the cultural codes of modern society to dispersed population groups with few resources and little training.

ii) The utilization of the content and techniques of modern communications media to put out educational programmes, by means of their integration into learning processes and their use as a means of opening up the schools to the community. This also requires complementary action by the schools to teach television viewers to receive and interpret the messages sent out over the mass media in a critical and selective manner.<sup>10</sup>

The cultural industry complex is both the agent and the product of the new dynamics of dissemination and use of the cultural codes of modernity. On the one hand, it is an agent because the policy-makers, entrepreneurs and operators of the cultural industry must make use of a wide range of options, which can be combined in a very flexible manner, in order to jointly optimize access to those codes. On the other hand, it is a product because cultural codes of modernity are also required in order to optimize the use of the cultural industry, not only in consumption but also in its management and in the exchange of messages in that field.

This brings us to a new paradox. On the one hand, the cultural industry favours the dissemination of codes of modernity to society as a whole and thus has a favourable impact on social integration. On the other hand, however, insofar as cultural codes of

modernity are needed in order for its products to be consumed in a productive manner, it generates greater segregation among possible users. Those who have more training in the handling and selection of information, in language skills and mathematics, and in flexible systems of management and organization will always be in a better position to take advantage of the products of the cultural industry complex.

Consequently, an integrated strategy in the field of the cultural industry must deal with both sides of this question: mobilizing the cultural industry to democratize the knowledge required by modern life, and at the same time employing it to teach how to use the new cultural goods, especially on the threshold of the third generation referred to earlier, which opens up the possibility of creating more horizontal and interactive links in such use. To this end, the region must not only take advantage of the successful experience built up over the last decade in the various countries but must also take into account the experience in the field of the dissemination of the codes of modernity which has given good results outside the region.

Finally, the capacity for discernment and production of symbols is not only functional to the performance of individuals in a modern habitat, but also has an important ethical and political dimension, since in knowledge-based societies the exercise of citizenship and the development of persons requires this capacity for discernment. "Thus, increasing the capacity to obtain and prepare cultural information (...) means that there cannot be a single or total solution for any of the great dilemmas of human existence (...) and therefore socially establishes the right to trial and error" (Bravo, 1991, p. 16).

Today, cultural democracy necessarily involves democracy of communications, i.e., "the possibility that the various social and cultural agents of the country can express their presence in the collective imagination: in the way we conceive and represent ourselves" (Subercaseaux, 1992, p. 27). The region must advance in the areas of cultural pluralism and the democratization of culture. Both the processes of political democratization experienced in the 1980s and the progressive impact of the opening-up of the communications and information markets and the consequent increase in cultural exchanges are having far-reaching effects in our region. In Latin America and the Caribbean, they impart special importance to the links between innovations

<sup>10</sup> Some isolated experiments have been made in the region in this respect, such as the "Telesecundaria" programme organized in Mexico in the late 1970s to provide educational services in isolated and thinly-populated areas where the cost of setting up and maintaining traditional-type schools was prohibitive. Various initiatives have also been taken in Chile in the last ten years, such as the television series "Sentencia", where a dramatic format was used to show legal problems affecting the low-income urban population; "Teleduc", which is a pilot system of television classes, and the mass communication campaign undertaken in support of the educational effort on breast-feeding carried out by the National Food and Nutrition Council.

in the cultural industry complex, on the one hand, and the democratization of our societies and of access to culture in them, on the other. The promotion within society of initiatives that will make it possible to take advantage of this "ecstasy of communication" for the benefit of more horizontal cultural exchanges

is still only at an incipient stage, but such horizontality—whether in terms of the mutual penetration of points of view or the dance of symbols—can become a renewed version of the utopia of hybridism in Latin America and the Caribbean.

(Original: Spanish)

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## Recent ECLAC publications

**Reformas tributarias en América Latina. Análisis de experiencias durante la década de los años ochenta** (Tax reform in Latin America. An analysis of the experiences of the 1980s), *Ricardo Carciofi, Guillermo Barris and Oscar Cetrángolo*, ECLAC/Netherlands Government Regional Project on Public Policy Reform, May 1994, Santiago, Chile, 356 pages.

During the 1980s, a number of Latin American countries carried out substantial reforms of their tax systems. In most cases, these reforms were a policy response to the macroeconomic and fiscal imbalances being experienced by the countries of the region at that time. In other cases, the reforms were applied with the aim of modifying the tax structure through changes in the way various taxes operated, but they were not designed to increase the real tax burden. This study analyses the experiences of six countries—Argentina, Bolivia, Chile, Colombia, Costa Rica and Mexico—as regards the tax reforms they implemented in the 1980s. In view of the characteristics of the period in question, the study not only analyses the specific content of the tax policies applied but also seeks to place the reforms in the macroeconomic context in which they were undertaken, with particular attention to the fiscal and institutional aspects forming the framework for tax policy. It thus emphasizes the relation between the macroeconomic, fiscal and institutional context and the specific features of the tax measures adopted in each case.

The first part of the study deals with the six national cases, while the second part compares the tax policies applied, noting the effects of the respective reforms on the design of the main taxes and the influence exerted by the macroeconomic and institutional context.

Two observations of a general nature may be made with respect to the first part of the study (chapters I to VI). The first of these refers to the scheme of contents followed in the case studies. The index, which is applied in all the cases, has three main headings. The first of these refers to the most salient aspects of the macroeconomic trends observed during the decade, with more or less explicit emphasis (depending on the countries) on the interaction between the external and fiscal deficits, indicating the periods involved and the policies used to deal with these two deficits. The second heading covers the evolution of the public finances, bringing out the institutional dimensions of the public sector which are relevant for understanding its economic performance. The third heading concentrates on tax matters proper: it describes the tax system and its main structural features and analyses the tax reform policies. In order to facilitate consideration of the national cases, preference has been given to the use of data sources of common scope.

The second general observation concerns the nature and depth of analysis of the case studies. A by no means inconsiderable part of the overall research effort was devoted to the collection and identification of the facts involved, especially those of particular significance for tax aspects and tax reform. Although from the analytical point of view this may seem to be a minor problem, in

practice it was by no means easy to collect the relevant information on the evolution of the tax system and, in particular, to obtain data making it possible to understand the objectives behind the various reform efforts and the specific contents of the measures adopted. This difficulty was not encountered, of course, in the case of the macroeconomic evolution of the countries, regarding which there are many more information sources and studies than in the case of tax matters proper.

The second part of the study (chapters VII to X) deals exclusively with comparative aspects and explores three basic ideas. Firstly, it looks for common issues given priority in the reforms, even though these issues may have arisen in connection with situations which are very different from each other in macroeconomic and fiscal terms. The result is very noteworthy, not only because there were indeed changes which, time and again, mainly affected similar types of taxes, but also because the thrust of these changes was similar in many cases. These tax issues, which crop up repeatedly in the various national cases, are analysed in the second part of chapter VII, following a summary of the main reforms applied. Chapter VIII makes a comparative analysis of certain features (mainly quantitative) of the tax systems studied. Using data from the early part of the decade, a comparison is made of aspects of the level and composition of the tax burden, and the situation of the six countries studied is contrasted with a broader sample of 86 developing countries. An analysis is then made of the evolution of the tax burden in the course of the decade, using information which makes it possible to identify the main differences between the tax systems of the six countries. This analysis brings out economic and institutional features which result in tax systems, within the group of countries studied, whose soundness in terms of tax levels and structures is very varied: there are countries whose tax system is much better fitted to absorb macroeconomic shocks.

Chapter IX brings out the influence of macroeconomic variables on the behaviour of tax systems and indicates in what way and to what extent the reforms studied represent a suitable answer to the prevailing conditions, as well as noting their similarities and differences. An important distinction which is made is that some countries carried out tax reforms whose contents and general thrust were in line with conventional thinking on the matter, while others applied policies whose main objective was to completely renew their tax systems. The last section in the chapter deals with the political and institutional factors conditioning the reform processes.

Finally, chapter X presents some conclusions, recapitulating the leading topics dealt with in the second part of the study and highlighting certain issues which the authors feel should be included on a future agenda for the reform of the tax systems of the region.

**Industrialización y desarrollo tecnológico** (Industrialization and technological development), Report No. 15, Economic Commission for Latin America and the Caribbean, LC/G.1791, Santiago, Chile, December 1993, 72 pages.

This issue in the series "Industrialización y Desarrollo Tecnológico" presents a summary of the results of four studies on industry in Bolivia.

The first study, by Luis Baudoin Olea, analyses the potential dynamism of Bolivian manufacturing, with special reference to the textile and jewellery industries.

The second study, by Freddy Bascopé and Enrique Arana, deals specifically with the textile industry and the manufacture of goods made from cotton fabrics, angora and fine camelhair.

The last two studies, by Heinz Meder and Daniel Pozo, respectively, make an in-depth analysis of the production of jewelry from gold, silver and semi-precious stones.

The studies propose policies whose application could help to raise the levels of competitiveness of the sectors of Bolivian industry studied, which are particularly noteworthy because of the important role played in them by small-scale enterprises and craft-type microenterprises.



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