

# CEPAL

## REVIEW



UNITED NATIONS

# 38

# CEPAL

## Review

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#### Notes and explanation of symbols

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

Three dots (...) indicate that data are not available or are not separately reported.

A dash (—) indicates that the amount is nil or negligible.

A blank space in a table means that the item in question is not applicable.

A minus sign (-) indicates a deficit or decrease, unless otherwise specified.

A point (.) is used to indicate decimals.

A slash (/) indicates a crop year or fiscal year, e.g., 1970/1971.

Use of a hyphen (-) between years, e.g., 1971-1973, indicates reference to the complete number of calendar years involved, including the beginning and end years.

Reference to "tons" mean metric tons, and to "dollars", United States dollars, unless otherwise stated.

Unless otherwise stated, references to annual rates of growth or variation signify compound annual rates.

Individual figures and percentages in tables do not necessarily add up to corresponding totals, because of rounding.

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## Neo-Keynesian macroeconomics as seen from the South

*Joseph Ramos\**

The central problem in macroeconomics is to determine to what extent variations in aggregate demand will fall exclusively on prices, or whether they will also have an impact on output. The Phillips curve was one answer to this question, but when this attempt at synthesis failed, the issue was reopened.

The crisis in macroeconomics gave rise to two schools in the "North" —the new classical and the neo-Keynesian. Both attempt to base macroeconomics on solid microeconomic foundations— rational expectations and maximization. The neo-Keynesians, however, question the new classicists' basic postulate that markets are in continual equilibrium. On the contrary, they argue that there are specific rigidities in the various markets which lead to adjustments in output not only in prices.

In this article the author traces the development of macroeconomics upon the demise of the Phillips curve. He recognizes the contribution of the new classicists, especially as regards expectations, but emphasizes the advances of the neo-Keynesians, since he believes that the rigidities which they identify and the imbalances that may arise from them are more relevant to understanding the problems of the South (LDCs). Lastly, he examines why, despite the huge macroeconomic costs such rigidities entail, the market fails to generate incentives sufficient to overcome these rigidities and thus why the latter need to be dealt with directly by macroeconomic policy.

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## Introduction

Macroeconomics fell into crisis 20 years ago and a new synthesis is still far from complete. Owing to this crisis, however, macroeconomics has become one of the most fertile areas of economics. Moreover, the absence of a new consensus does not signify a great loss for Latin America, since the previous one (the neoclassical synthesis) was largely irrelevant to our countries' problems. Indeed, the models and approaches that have proliferated with the crisis in macroeconomics are much more useful to the South than those of the past. Although it is true that they are not integrated, polished models, they are much more easily adapted to the heterogeneity of the developing countries' typical problems than are the traditional ones.

For the new classicists, the crisis originated in the fact that traditional macroeconomics (seen as the neoclassical synthesis expressed in the IS and LM curves) was but a loose combination of empirical relationships among aggregate variables, bereft of theory. This gave rise to the categorical dichotomy between microeconomics and macroeconomics. In the former, the agents responded to incentives to optimize; in turn, the *ad hoc* assumptions of the latter made possible the existence of "equilibria" with unemployment, although they failed to explain the causes of the rigidities and why optimizing agents failed to respond to incentives to overcome them.

For the Keynesians, however, the lack of rigour and theoretical elegance of traditional macroeconomics was offset by its relevance and, in particular, by its capacity to offer an explanation for the phenomenon of involuntary unemployment. What good was the theoretical elegance of microeconomics if it basically denied the possibility of involuntary unemployment, treating it as an apparent or at most frictional phenomenon, i.e., one of short duration?

The clash between the two disciplines managed to continue without major variations as long as the main macroeconomic problems were still unemployment without inflation, or inflation without recession. Moreover, thanks to the Phillips curve approach, the coexistence of inflation and unemployment could be adequately

dealt with for a while. Nevertheless, even this latter approach proved to be unsatisfactory in the mid-1970s, when its weak theoretical basis was joined by policy failures, especially in the countries affected by persistent inflation.

Since then, macroeconomics has been in crisis. Some would prefer to rebuild it on the basis of an extension of price theory. This is the choice of the new classicists, with rational expectations and its assumption of markets in continual equilibrium. Others (the neo-Keynesians) are trying to develop the microeconomic foundations of macroeconomic relations.

In this paper the author reviews the debate and subsequent macroeconomic advances, especially those achieved by the neo-Keynesians. He undertakes this task from a Southern perspective, i.e., giving particular attention to the advances of greatest interest to the developing countries,<sup>1</sup> especially with regard to anti-inflationary programmes.<sup>2</sup>

The first three sections describe the crisis in macroeconomics from the fall into disrepute of the Phillips curve to the subsequent reconstruction based on the incorporation of rational expectations. Two different approaches have emerged. The first is that of the new classicists, who add the assumption of continual equilibrium to that of rational expectations. The assumption of continual equilibrium is particularly unappealing in the South, given the sizeable disequilibria these countries often endure. The second approach is that of the neo-Keynesians, who incorporate rational expectations but do not assume continual equilibrium.

Rather, they emphasize the existence of important rigidities which show movements towards equilibrium, even with rational expectations. Moreover, they identify specific rigidities and do not, as in the past, limit themselves to assuming their existence. Not only is this approach more rigorous, but it has important policy implications, for rigidities can be taken advantage of (in the North) to reduce unemployment or overcome (in the South) to slow inflation without recession.

In their efforts to identify these rigidities, they go beyond those more traditionally associated with the labour market. They detect rigidities in other markets as well (the credit market and, in particular, the goods market itself). Thus the bulk of this article —section IV— is centred on identifying these rigidities, which form the microeconomic bases of neo-Keynesian macroeconomics.

Section V analyses why, if these rigidities are so important in the generation of serious macroeconomic imbalances, the market does not automatically produce incentives to eliminate them. The conclusion is that, despite its high macroeconomic cost, the private cost of each rigidity for the enterprise is usually quite low. The rigidity therefore tends to persist, unless it is dealt with by macroeconomic policy directly and deliberately.

Section VI concludes by presenting some critical issues and promising topics using this approach, such as credibility, multiple equilibria, automatic adjustment, the "corridor" of credibility and institutions.

<sup>1</sup>It should be clarified that this is not a review of the macroeconomic advances made in the South or of studies on the South (for example, Taylor, 1983). Rather, it is a review of the neo-Keynesian advances in the North, which favour points that are more relevant to the South. Recent interpretations that take the

same approach are, *inter alia*, those of Arida (1985) and Corden (1986). The most complete review is found in Cortázar (1986).

<sup>2</sup>Thus the article refers only tangentially to problems of external disequilibria, which are dealt with, for example, in Arellano (1986) and Meller (1987).

## I

## Macroeconomics in crisis: the demise of the Phillips curve

The main issue in current macroeconomic theory and policy is to determine whether variations in aggregate demand will cause prices alone, or both prices and output, to vary. Although it is clear, for example, that a reduction in inflation will ordinarily require a deceleration in the growth of nominal aggregate demand, often such a deceleration reduces not only inflation but also output. Determining why the adjustment to decelerations in nominal aggregate demand sometimes falls exclusively on prices, while at other times it also hurts output, is the main problem still facing macroeconomic theory.

The Quantity Identity tells us that nominal output equals the price level ( $P$ ) times the volume of output ( $Y$ ), which by definition equals the quantity of money ( $M$ ) times its velocity of circulation ( $V$ ). In its dynamic version (where lower-case letters mean growth rates):

$$(l)m + v = p + y$$

Or, the variations in aggregate demand will affect both prices and output (unless the monetary expansion is completely absorbed by compensatory movements in  $v$ ).

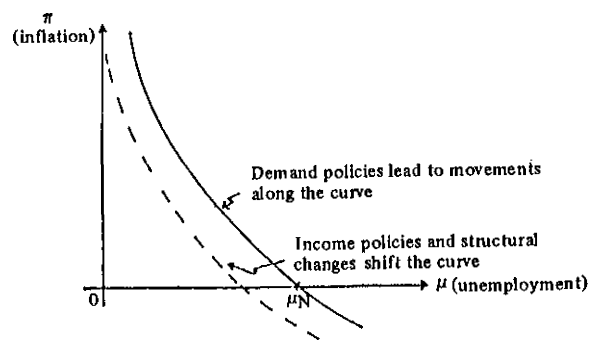
Since the traditional classical approach assumes full employment ( $y=0$ ), any variation in demand affects prices, hence the classical theory is one of inflation without unemployment. The Keynesian approach, on the other hand, assumes price rigidity, and consequently any variation in demand affects only output and employment; in other words, it is a theory of employment without inflation. As long as the economy was clearly characterized by either of these two limited states (full employment, during the Second World War, or acute depression during the Great Depression), such a dichotomy of approaches was tolerable. However, for less critical situations an approach was needed that would permit the coexistence of inflation and unemployment (above the "natural" rate).

The Phillips curve came along to fill this vacuum. It was the "missing equation" which

tried to elucidate how reductions in nominal aggregate demand broke down into lower prices (or less inflation) and slowdowns in output (or recession). In its original version (Phillips, 1958; Lipsey, 1960), this curve suggested the existence of an inverse empirical relationship between inflation (nominal wages) and non-frictional unemployment (or unused capacity). Its explanation appeared obvious: as full employment was approached and unused capacity reduced, increases in aggregate demand would have an increasing impact on prices, since, in such circumstances, it would be difficult for output to rise without pushing up wages and costs.

This possible trade-off between inflation and unemployment left ample scope for macroeconomic policy. Structural and supply side policies served to push the Phillips curve back to the origin, while demand policies (monetary and fiscal) permitted policymakers to move along the curve to reach the preferred combination of unemployment and inflation (figure 1). Unfortunately, the empirical relationship did not prove to be stable. Moreover, the underlying theoretical base turned out to be shaky, especially in contexts of persistent inflation (as has been the case for the industrialized countries since the mid-1970s and for Latin America for much

Figure 1  
ORIGINAL PHILLIPS CURVE



longer), as it related a dynamic variable (the inflation rate) with static variables (unemployment and unused capacity).

In its more modern formulation (Friedman, 1968; Phelps, 1970) the Phillips curve was modified to take into account inflationary expectations. According to this new version, variations in excess demand (the difference between the natural and effective unemployment rates) are associated not with an inflation rate but with the difference between effective and expected inflation ( $P - bP^e = a(U_N - U)$ ).<sup>3</sup>

The more aggregate demand expands, the higher effective inflation will rise above the expected rate and the greater will be the reduction in unemployment. However, if future inflation is correctly predicted, there will be no excess demand, and consequently neither output nor employment will increase.

The trade-off between (unexpected) inflation and unemployment will therefore persist only as long as expected inflation differs from effective inflation. To what can we attribute this lag (or rigidity) in expectations? One suggestion — "adaptive" expectations — is to assume that expectations are adjusted only on the basis of past inflation. In such a case, since accelerations in nominal aggregate demand (consistent with a higher inflation than in the past) are unexpected, output increases, for, by assumption, prices accelerate more slowly than aggregate demand (being determined largely by past inflation).

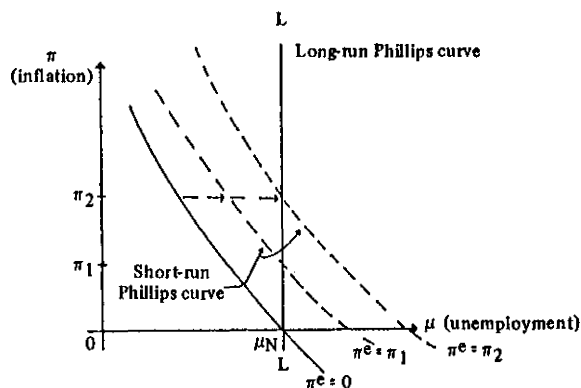
<sup>3</sup>P is effective inflation;  $P^e$  is expected inflation;  $U_N$ , the "natural" unemployment or full employment rate (given the "imperfections" prevailing in the economy);  $U$ , the effective unemployment rate;  $a$ , a coefficient of output response to excess demand; and  $b$ , a coefficient which reflects the degree to which effective inflation adjusts to expected inflation.  $b=0$  is the original Phillips curve, uncorrected for inflationary expectations, that is, distorted by monetary illusion.  $b=1$  implies that no matter how slowly expectations are adjusted, they eventually converge with effective inflation, especially if inflation lasts a long time. In effect,  $b=1$  means that inflationary expectations do not suffer from systematic under- or over-estimation, since there is no permanent monetary illusion. It is typically associated with mechanisms of "perfect" indexation. There was a certain amount of empirical controversy about the value of  $b$ , as to whether it was 1 (the natural rate hypothesis of Friedman and Phelps) or less than 1, resulting in permanent trade-offs between unemployment and higher inflation. Empirical studies increasingly showed a  $b=1$ ;  $b$  could be less than 1 for a time, for institutional reasons (e.g., wages are negotiated for long periods), but eventually  $b$  tended to 1. For a detailed description of this point see Gordon (1981) and ILPES (1977).

The existence of adaptive expectations on the part of the public enables the government to reduce cyclical unemployment, but at the cost of ever more rapid accelerations in aggregate demand, and in the long run, of greater inflation. Moreover, for this policy to be successful, the public must continue to underestimate coming inflation, ignoring the fact that the authorities are systematically accelerating aggregate demand. In point of fact, sooner or later the public is bound to discover what the authorities are up to and will no doubt modify its formation of expectations to take into account not only past inflation but also the probable policy of the authorities in dealing with it.

This second type of expectations — known as "rational" (Lucas, 1972; Sargent and Wallace, 1975; McCallum, 1980) — does not postulate that the public's expectations will be confirmed; what it does assume is that there will be no systematic error in either direction. Indeed, as long as learning is taking place and agents "rationally" adjust their expectations (looking to the future, not just the past), expected inflation will tend to equal effective inflation, and hence excess demand will gradually disappear through greater inflation, while output and employment will return to their original levels.

Thus will exist a trade-off between unemployment and higher inflation in the short run as long as expectations have not fully adjusted to effective inflation (figure 2). On the other hand, once inflationary expectations have fully

Figure 2  
EXPECTATIONS-AUGMENTED PHILLIPS CURVE



adjusted, the short-term Phillips curve will shift (upward for unexpected accelerations in demand and downward for decelerations). Consequently, in the long run, the Phillips curve is vertical, and thus the permanent trade-off between lower unemployment and higher inflation disappears, and full employment is compatible with any inflation rate.

The consequences of this reformulation for macroeconomic policy are enormous in scope: the systematic reduction of unemployment can be achieved only by continued accelerations in inflation; indeed, rigorously speaking, these accelerations need be unexpected, since agents will be formulating their expectations of future inflation not only adaptively, on the basis of its past evolution, but also taking into account all the available information with regard to the

future (rational expectations), including, to be sure, economic policy goals (*inter alia*, the reduction of cyclical unemployment by growing accelerations in the inflation rate).

Macroeconomic policy affects the employment level only if economic agents are incapable of predicting it or if its instrumentation is so complex and innovative that agents cannot "decipher it" in time to neutralize its effects. The adoption of unexpected measures allows for activism then, but at the cost of accentuating rather than tempering economic cycles. This is why the proponents of rational expectations advocate the use of rules to prevent or minimize discretionary decisions (for example, fixed expansion, rather than anticyclical increases, in money supply) and prefer to forego attempts at "fine turning" macroeconomic policy.<sup>4</sup>

## II

### The view from the South

Before dealing with the outcome of the debate in the North, it is worth examining those issues to which a policymaker from the South should be especially sensitive. In the first place, what is being questioned in the North is "upward activism", that is, just how useful is it to attempt to reduce cyclical unemployment through variations in aggregate demand.<sup>5</sup> However, the macroeconomic policy of the South is today more interested in "downward activism", which

attempts to reduce inflation at a minimum cost in output. The original Phillips curve analysis or the expectations-augmented curve suggested that in order to reduce inflation there would have to be a recessive cost. On the other hand, if expectations are rational, decreasing inflation may not require a recession, as long as the inflationary goal set by the economic policy earns the public's confidence.

Hence, whereas adaptive expectations make upward activism possible, they make downward activism costly (recessive). On the other hand, if expectations are rational, the Phillips curve becomes vertical, and consequently anticyclical upward activism is of little use. The counterpart of the theorem of the uselessness of upward activism is the effectiveness (and low recessive cost) which downward activism *may* have (Sargent, 1982), as long as the anti-inflationary programme has credibility.

That stabilization policies do not necessarily have to be recessive is undoubtedly good news for the South, to the extent that the rational expectations approach is correct. However, this conclusion is less certain than it appears. For

<sup>4</sup>To draw this conclusion requires further assumptions. Obviously, if the economy is stable and regulates itself automatically, there will be no need for intervention, however intelligent and well-intentioned the government may be. The matter becomes more complicated when, as in real life, the economy is not very stable and the government is not very competent or is motivated by short-term political needs (see Blinder, 1987).

<sup>5</sup>What is in doubt is the usefulness of fine tuning and not of a macroeconomic policy to free the country (or accelerate its escape) from a deep, non-cyclical recession. What might be inappropriate is an economic policy that varies systematically with the cycle. On the other hand, an economic policy which is contingent upon a non-foreseeable state (e.g., recession resulting from external shock) will probably bring about real effects, since it comes as a surprise to the agents. Such shocks may be positive or negative, and thus the private agent would be unable to foresee them and take into account the reaction of the policy.

there is an important asymmetry in the informative assumptions of the two types of activism. Upward activism is a predictable change in established macroeconomic policy —and hence presumably can be anticipated by the public; on the contrary, an anti-inflationary policy represents not a modification of the policy in the cycle, but a change of régime (or rule), whose goal no longer consists of stabilizing employment, but prices. This change in policy rules, however, will not necessarily be recognized or believed by agents. This is why it is not enough merely to announce a new policy goal (to reduce inflation to a certain level) for the public to adjust its expectations immediately and completely. Nor is it irrational that the consistency between the goal and its implementation, or the permanency of this new goal, will be called into question. In the South, therefore, the problem of credibility is of crucial importance.

Second, as its name suggests, macroeconomic management by fine tuning refers to marginal or small changes, commonly within the same economic strategy or policy. The desire to smooth the cycle may give rise to systematic policies which lead, for example, to an expansion of the money stock each time the economy grows at less than its trend rate. Adjustments in the South, on the other hand, are wider in scope and therefore difficult to anticipate. Thus, lowering inflation does not constitute a systematic goal; it implies rather a modification of the rule or the goal of the previous economic policy (which was more tolerant in this matter). The changes in rules erode credibility, since it is difficult to discern or anticipate them, apart from the fact that there is no guarantee that they will be permanent,<sup>6</sup> and until price stability becomes credible, prices will be sticky, subject to rigidities analogous to those arising from adaptive expectations.

Third, the use of rules rather than discretionary policies probably helps to avoid dynamic inconsistencies (Kydland and Prescott, 1977). For the public knows that the government may achieve a short-run benefit if it abandons the

announced policy (e.g., raising demand above the targeted inflation in order to increase employment) and so is distrustful of mere promises of stability in policy. To achieve credibility, it may be necessary to follow rules which prevent the adoption of discretionary measures. Thus, it could be advisable to make a rule, for example, that the Central Bank's financing of the Treasury must not exceed a given percentage of the gross domestic product.

Moreover, the stability of past policy itself generates credibility. It is no surprise, then, that the cost of discretionality is higher wherever credibility represents an important asset (in the North). Owing to the same instability characteristic of economic policy in the South, policy announcements have little credibility. This fact predisposes its economic authorities to abandon the announced policy and adapt to the public's expectations while encouraging their counterparts in the North to follow the announced policy, because this is what the public expects. Consequently, where credibility exists, it will be easier (less recessive) to lower inflation than where credibility is scarce (in the South). This also explains why each failed attempt at stabilization raises the probable recessive cost of the following attempt.<sup>7</sup> It also explains why other instruments must be used to make up for the lack of credibility, at the risk of a serious recession.

Fourth, intervention may be effective in increasing employment, as long as expectations are adaptive or there are other rigidities which slow the adjustment of prices. On the other hand, these same rigidities, which facilitate an active upward policy (the usual goal in the North), will hamper (make recessive) an anti-inflationary policy (a typical goal of the South). Thus, effective economic policy in the South requires the identification of such rigidities in order to overcome them and offset their effects.

Fifth, macroeconomic models of the North typically assume the existence of well-developed, if not perfect, capital markets. The reality of most Latin American countries is certainly oth-

<sup>6</sup>It is not so much that the future is unknown as that the rules for intervention depend on contingent states, since these states constitute radical departures from the equilibrium situation.

<sup>7</sup>It is noteworthy in this context that successive attempts at price freezing and stabilization in Argentina, based on the Plan Austral in June 1985, were of increasingly shorter duration and the inflationary surges increasingly higher.

erwise. Domestic capitals markets are incipient and incapable of absorbing more than a fraction of the financing needs of the public or private sector. Moreover there is an insufficient and asymmetrical integration with external capital markets, so that, there is far more capital mobility outward than inward. These differences can be noted in different areas:

i) The distinction between monetary and fiscal policy —so important in the North— is less relevant in the South, since in the latter case the possibilities for fiscal financing through indebtedness (external or internal) are very limited. The South's monetary policy is basically determined by the fiscal deficit. Thus, a restrictive monetary policy largely involves a reduction of the fiscal deficit, while a growing fiscal deficit implies an expansive monetary policy. In other words, the margin for autonomy in both policies is very small.

ii) To restore external balance, monetary policy in the North may resort to measures to attract or induce capital movements. In the South, an expansive monetary policy may lead to

capital flight, but a restrictive policy will not necessarily attract new capital (apart from slowing down outflows), owing to its asymmetrical integration into the international markets. Thus, in the South a restrictive monetary policy will largely affect internal equilibrium (it may slow down an inflationary process). External equilibrium will be achieved via commercial more than capital flows, thus suggesting the greater effectiveness of devaluations and fiscal policies rather than interest rate policies.

iii) The most relevant analytical models for the South are those of open economies with restricted capital movements. Thus, when the domestic real interest rate is lower than the international rate, there is capital flight; but even if the domestic interest rate, adjusted by devaluation risk, is higher than the international rate, there may be no inflow of capital. In other words, external capital seems to be rationed more by quantity than by price. The domestic interest rate will therefore always remain above the international rate adjusted for risk of devaluation.

### III

## The post-rational-expectations split in macroeconomics

Whatever the economic school to which one subscribes —classical, monetarist or Keynesian— the rational expectations revolution is here to stay. *Ad hoc* assumptions, such as those behind adaptive expectations, have been rejected; on the contrary, the aim is to base macroeconomics on solid microeconomic foundations, in particular, the principle of maximization. It cannot be assumed that agents will continue to repeat the same mistakes regardless of losses. Rather, the risk of incurring such losses will induce them to seek out and anticipate the use of any policy which might try to exploit passive and inert behaviour on their part. Hence because learning is possible, it cannot be assumed that, when confronted by changes in the goals or orientation of economic policy,

agents will persist in their past behaviour. This puts in doubt the validity of most estimates of the parameters included in the macroeconomic models (and the supposition that they will remain stable) and of the proposed policies based on them (Lucas, 1976).

Similarly, one must reject simplistic schemes of interaction which suppose that policymakers act on a private sector whose optimal decisions are already given and known. On the contrary, individuals know that the authorities may feel tempted to break their word and therefore they take into account this possibility. Thus, unless the authority limits the possibilities of its own in compliance, suboptimal choices may be made, as a result of conflictive interaction, rather than optimal ones on the basis of co-operation. All



this has led to a reassessment of norms and institutions, and not just of economic policy, for the sake of greater stability and the development of a more co-operative interaction between the public and private sectors.

The adoption of national expectations by all reflects a convergence of approaches; thereafter, the different schools of thought diverge. The "new classicists" take rational expectations as their point of departure and add the assumption that the markets are in continual equilibrium. Unemployment thus becomes voluntary: faced with slight decreases in the relative price of labour, attributable to technological shocks, individuals —assuming a strong substitution between leisure and work— choose to work less now and more in the future.<sup>8</sup> Consequently, systematic monetary policy has no real effects; and, according to the "neo-Ricardian theorem" (Barro, 1974), fiscal policy does not affect aggregate spending either, since a greater public deficit will be offset automatically by greater private savings. In the South, these same assumptions suggest, in their "strong" version, that stabilization policies will affect only prices, and not employment; and in a more moderate version, that the effects on employment are

transitory, lasting only, as long as there persist difficulties in distinguishing relative from overall changes in the price level (Lucas, 1972, 1973).

Except for such issues arising from problems of information and credibility, the new classical thought seems to have little direct relevance for the South.<sup>9</sup> A more promising vein of thought is offered by the neo-Keynesians, who accept rational expectations, but reject the assumption that markets are in continual equilibrium, convinced as they are that involuntary unemployment is an all too obvious and habitual result of stabilization policies. Instead, they emphasize the existence of rigidities which, even in the presence of rational expectations, slow movements towards equilibrium. Unlike the past, neo-Keynesians now try to identify (and not simply assume) rigidities, whether in prices, wages or both. Thus, economic policy recovers its important role: rigidities are used in the North to raise or smooth cyclical fluctuations, in order to augment employment; whereas in the South, once identified, such rigidities need to be offset or overcome, so as to eliminate the negative effects of anti-inflationary policies on output.

## IV

### The microeconomic foundations of neo-Keynesian macroeconomics

The crux of the neo-Keynesian approach is to identify those rigidities which slow the full and rapid adjustment of prices to variations in aggregate demand. To the extent that this adjustment is incomplete, fluctuations in aggregate demand will give rise to changes in output (desirable increases, in the case of upward activism, and undesirable decreases, in the case of downward activism). The neo-Keynesian research strategy has sought to explore the rigidities associated with each market, either to exploit them (upwardly) or offset them (downwardly).<sup>10</sup>

#### 1. *Rigidities in the labour market*

Labour contracts with backward-looking indexation imply that reductions in nominal aggregate demand will reduce inflation less than the amount desired, so inducing a recession (Dornbusch and Simonsen, 1983; Williamson, 1985). Nevertheless, when such rigidities are identified

<sup>9</sup>As for the neo-Ricardian theorem —except for the case of capital flight—, its implications contradict the importance which both orthodox and neo-Keynesians in the South attach to fiscal deficit reduction.

<sup>10</sup>The studies by Mankiw (1987) and Rotemberg (1987) are quite useful as an introduction to this topic.

<sup>8</sup>On the real theory of cycles, see Prescott (1986).

in time and enough political support is available, they may be counteracted. In the case of anti-inflationary programmes, it is necessary to introduce wage adjustment laws and "forward" indexation, which take into account expected rather than past inflation, entailing the modification of a wide range of contractual norms. Thus, the Plan Cruzado put into effect by the Brazilian authorities in 1986 adjusted the rate of inflation implicit in all wage contracts to the targeted rate. The adjustment to which each contract was entitled was calculated according to the number of months it had been in force.

A more serious situation is where labour productivity depends not only on the absolute wage level but also on the relative wage, as postulated by efficiency wage theories (Summers, 1988; Katz, 1986; Stiglitz, 1986).<sup>11</sup> Indeed, to the extent that labour effort varies positively with the relative wage, enterprises will be less inclined to lower wages when their demand falls, since they will fear that effort, and thus productivity, will decline and their costs will therefore not be lowered (or will be lowered less than proportionately). Productivity could fall with relative wages to the extent that a lower relative wage encourages carelessness, discourages initiative, reduces the average quality of new applicants or leads to greater labour turnover.

To the extent that most firms want to pay a higher than average wage in order to reap the benefits of greater effort and higher productivity, equilibrium is reached with a wage greater than that which would prevail with full employment; since all firms cannot pay more than the average, equilibrium is thus achieved via unemployment. Enterprises do not hire labour willing to work for less, since they fear that this would lower the productivity of the rest of their employees. Unemployment is therefore involuntary, since the unemployed exhibit the same characteristics as the employed and are willing to work with the same productivity as the

employed, and at the same wage. Yet, this is an equilibrium unemployment, since there is no incentive for enterprises to lower wages to hire the unemployed.

These models involve an additional attraction for the South, since they serve to explain the market segmentation so frequently observed in these countries. Efficiency wage theories have greater validity in the more modern or formal segments of the economy, where technology is more complex and a possible oversight consequently entails greater risks; where it is more difficult to control the efficiency of the work force; where the costs of hiring and layoffs are higher, and where specific training within the firm is of great importance. For these reasons, formal sector firms pay higher wages than in the informal sector and hire a substantial amount of workers, forcing the less privileged majority to eke out an existence in marginally productive jobs in the informal segment of the economy (Cortázar, 1986).

In such a model, cyclical unemployment (or higher underemployment) arises as a consequence of perceptual errors about the behaviour of relative wages. Thus firms may slow wages less than aggregate demand at the onset of a stabilization programme. In this way, they might hope to avoid slumps in productivity resulting from workers' mistaken belief that the drop in demand is only a local one and means a deterioration in their relative wage, and not of the general wage level. So long as firms feel that their workers are not yet fully aware that the slowdown in wages is a generalized phenomenon, they will not slow the growth in wages, since they fear that doing so will erode productivity, and so, their profits. It is enough for a few companies to exhibit such behaviour for the rest to imitate them (even though they know what is going on), since they do not want to appear to be paying a relatively lower wage. In such circumstances, then, adjustments to possible decelerations in demand will be made by cutting jobs and production, and not simply by slowing wages. Thus although wage-setting power basically be in the hands of the company, the fact that the worker has the capacity to adjust his effort (efficiency) to not only the absolute but also the relative wage may generate unemployment to the extent that the company avoids wage cuts to

<sup>11</sup>The efficiency wage theory states that power over the labour market lies principally in the hands of enterprises, not in the labour force, a situation which is more in keeping with Latin American reality and which is therefore more useful in our analysis. Hence, we will not examine theories which are based on workers' power in the labour market, such as insider-outsider type theories. See Lindbeck and Snower (1985).

maintain its productivity. This characteristic makes these models quite important for the South.

This approach certainly coincides with Keynes' explanation of why workers are more willing to accept lower real wages when these fall because of higher inflation rates—which hurt everyone, but do not affect their relative wages—than a direct lowering of nominal wages, for the latter would seem to mean a decrease in their relative, as well as in their absolute, wages. In effect, to the extent that relative wages affect productivity, a problem of "co-ordination" arises, which slows the movement from one equilibrium to another. Few firms will wish to lower their wages—so long as others are not also lowering theirs—fearing they will lose through a decline in productivity more than they will gain by cutting its workers' wages. And the fewer the companies that decide to cut wages, the greater the cost to the company (in terms of productivity) of lowering its own. Worse yet, there are perverse incentives for the worker to resist a cut in his wages. The less widespread he believes the fall in demand to be, the greater his absolute wage need be (to put off a fall in his productivity) and so the lower the incentive for him to find out what is really going on. In fact, what educates him as to the state of aggregate demand is not a wage reduction (which is put off), but unemployment (or adjustment in quantity), and this is quite a costly way of providing information. Involuntary unemployment is thus a failure in the price system, and especially of its crucial co-ordinating role. Such a failure could, in principle, justify government intervention to restore equilibrium, either through an expansion in demand (upward activism in the North) or a restrictive wage policy (downward activism in the South).

Were such wage rigidity to exist, declines in output and employment would tend to be accompanied by increases in real wages (when inflation unexpectedly decelerated). In this sense, it would be a form of "neoclassical" unemployment. But recession and unemployment are often accompanied by marked reductions in real wages. To explain the concurrence of these phenomena (neo-Keynesian unemployment) we have to look outside the labour market, to the goods market.

## 2. Rigidities in the goods market

Recessions occur when prices do not adjust instantaneously to decelerations in demand. The aforementioned explanations attribute the lag in prices to the slowness with which (labour) costs adjust. If the latter were flexible, prices would presumably also adapt instantly.

This section, however, deals with lags which do not originate in the labour market. It thus explains why prices might adjust even more slowly than wages and so why some recessions are accompanied by declines (not rises) in real wages. In other words, this type of recession would develop not because of unduly high labour costs, but because of the contraction in sales owing to the overblown prices of goods.

Similarly, to the extent that price adjustments were slow, devaluations (revaluations) would make sense. For by directly and instantaneously modifying the price of tradeables to non-tradeables, a nominal devaluation could speed the move towards equilibrium, thus maintaining the stability of the real effective exchange rate and the external account balance (Dornbusch, 1988; Solimano, 1986).

This approach emphasizes the role of price rigidity in the goods market. Hence it abandons the postulate of perfect competition and recognizes that the firm has some margin of manoeuvre to set its prices. In fact, a little imperfect competition will suffice, this being—at least in the short run—much more widespread than it would appear at first glance. For in disequilibrium—such as during a recession or in any situation where the current price differs from the expected price—all firms, even normally competitive ones, have some scope to set prices (Arrow, 1959) and behave like firms in imperfect competition; this, as we shall see, produces a negative macroeconomic impact of great importance.

The assumption that companies have a certain margin to set their prices clearly relates to the tradition of the South, in which prices are typically modeled as a fixed margin over variable costs (mark-up pricing).<sup>12</sup> Moreover, the

<sup>12</sup>See, for example, Frenkel (1984) for Argentina; Lara Resende and Lopes (1981), Modiano (1983) and Monteiro (1981) for Brazil; Chica (1983) for Colombia; Corbo (1982) and Jadresic (1985) for Chile; and Aceituno and others (1984) for Mexico.

assumption of imperfect competition makes it possible to incorporate into macroeconomics important recent advances in industrial organization (Stiglitz, 1984), many of which are also useful in explaining recessions:

i) Under perfect competition, a price that is too high entails enormous losses to the firm (at worst, bankruptcy); on the other hand, a lower (correct) price raises sales and profits considerably. Consequently, the incentives for a speedy adjustment are strong, far in excess of those which exist in imperfect competition, where sales are not so sensitive to prices, since whatever is lost in sales volume because of too high a price is gained back, at least in part, precisely through this higher price. To the extent that the speed of adjustment is a function of possible profits, the speed of adjustment will be lower under imperfect competition than under perfect competition.

ii) In imperfect competition, prices adjust slowly, and hence changes in demand also give rise to fluctuations in the quantity produced. A positive turnabout in demand, therefore, will raise output without exerting pressure on prices, since the output generated previously with imperfect competition was suboptimal from the social point of view (the original price exceeded the marginal cost). Imperfect competition thus attracts upward activism. The converse is not true, however, for reductions in demand increase imperfect competition (the raising price in relation to marginal costs), thereby slowing price adjustment. There is thus an important asymmetry under imperfect competition: rises in aggregate demand will result in an increase in output, with little effect on prices, the system thus approaching perfect competition, whereas restrictive policies will make competition even more imperfect, thereby slowing price decelerations and so reducing output.

iii) Slow price adjustments by firms leads to externalities depressing aggregate demand. The inflexibility of one company's prices rigidifies the average level of prices in the economy, so that decelerations in demand erode real income and hence real aggregate demand. In fact, an overblown price will lower own sales (according to the price-elasticity of demand), as well as overall national income, thus reducing the demand for all enterprises according to the

income-elasticity of demand. As the latter (or income effect) depends only marginally on its own behaviour, however, each firm will completely ignore this externality and will concentrate on the former (price) effect alone (that is, to what extent its overblown price hurts profits). Indeed, the best thing for each company would be for all other sectors to lower their prices quickly, since this would allow for the aggregate demand of the economy to rise and consequently the demand of its sector; and for its sector to be the last one to adjust. To the extent that this reasoning is valid for all and no sector wants to be the first to adjust, all will tend to wait for the rest to lower their prices, thus worsening the negative macroeconomic impact.

It is difficult to exaggerate the importance of this insight for the South, even before its formalization in the North. Indeed, many authors in the South have drawn attention to the formation of prices in conditions of imperfect competition to explain the slow adjustment of prices during stabilization programmes, and hence why these tended to be recessive.<sup>13</sup>

Moreover, the scope for price setting by firms under imperfect competition helps explain the failure of domestic and international prices to converge, as suggested by the "law of one price", even after trade openings such as those in the Southern Cone at the end of the 1970s,<sup>14</sup> and consequently why the use of

<sup>13</sup>See, among others, Ramos (1977), Frenkel (1979) and Foxley (1983).

<sup>14</sup>For example, at the beginning of the liberalization process many importers, especially small-scale ones, set the price of the imported product at the level of the domestic price rather than at cost (international price plus transport costs and customs duties). Thus, the "law of one price" worked upwards (towards the domestic price), but not downwards (towards the international price). In a second phase, importation was concentrated on differentiated products not previously available in the domestic market (e.g., whisky), which although they took market share away from the closest domestic substitute (e.g., local *aguardiente*), they did not affect its price to any great extent, since they were very imperfect substitutes. Finally, a great deal of importation was organized by the producers of the same domestic product with which it was competing. If competition in importation and distribution was insufficient — a typical situation, except in the case of relatively standardized and high-turnover products, such as televisions and tape recorders — it was possible for prices to remain above the international price plus customs duties. Certainly, in the long run, and as a competition increased, prices would tend to converge. However, the point is that this adjustment process may be quite slow.

exchange policy to curb inflation frequently leads to lagged exchange rates (ECLAC, 1984; Dornbusch, 1987).

In the spirit of neo-Keynesianism, imperfect competition is not simply assumed, but an attempt is made to describe what factors might give rise to it. Among others, the following hypotheses stand out from the theory of industrial organization.

a) *Asymmetries in demand due to information costs*

If a firm faces a demand curve that is only partly elastic, it will set its optimal price according to the price of its competitors and the quality of its product. It will thus establish its niche in the market, earning a certain reputation and regular customers. If the firm later raises its price, its regular customers will find out about it immediately, and will also realize that there has been no improvement whatever in the quality. A reduction in demand will then occur, in accordance with the price-elasticity of the respective demand curve. If, on the other hand, the firm lowers its price, the demand for the product will increase less elastically. Its own clientele's demand will rise, but the number of customers will not expand immediately. In the first place, the general public (i.e., the company's potential but not regular customers) will take some time to find out about the drop in price; and, secondly, since the occasional customers may think that the price decrease results at least in part from a deterioration in quality, their demand will rise even less elastically. As long as the news that the price drop does not involve poorer quality does not become widespread, the company will continue to face a broken demand curve, which is elastic to price increases, but less elastic to price declines.

Owing to this asymmetry in information costs, there will be fewer incentives for the company to lower its prices, since it will adjust them on the basis of its short-run demand curve, which is (and is perceived as being) less elastic. Stabilization programmes will thus tend to be recessive, since prices will decelerate less rapidly (lag) than nominal aggregate demand (Stiglitz, 1984).

b) *Oligopolistic markets in recession*

It is well known that on entering a monopolistic or oligopolistic market probable profits need to be calculated not on the basis of those of the current oligopoly, but on the basis of the much lower gains which the two firms would make if they had to divide up the market between them. Indeed, to discourage the entry of new competitors, the oligopolistic firm will charge a suboptimal price as well as maintain unused installed capacity. However, during a recession (or faced with the danger that one will develop, typical of any stabilization programme) there is less need to maintain a price much lower than the monopolistic one, since sales fall and the sector's unused capacity rises. It is thus likely that, when faced with decreases in nominal aggregate demand, the oligopolistic firm will react by increasing its margins, thus bringing its price closer to its monopolistic price, and so slowing the overall adjustment of prices in the economy.

Moreover, the existence of collusive price agreements (whether formal or informal) between oligopolistic companies tends to check the price adjustments required by reductions in aggregate demand. Because of differences in the costs, markets, quality and specificity of products, negotiations to reach such agreements are difficult. Hence, once they have been established, there is a strong incentive to maintain them, since their violation or repudiation entails the risk of a price war, in which all producers will lose. To avoid renegotiating agreements, decreases in demand tend to be dealt with initially by reducing sales rather than lowering prices, thus rigidifying adjustments in the goods market.

c) *Staggered price setting*

As it is costly to set prices every day, a company maintains prices for a given (though possibly variable) interval. During this period, it is possible that its costs will change; as certainly will its real income, dependent as it is on the prevailing rate of inflation. Consequently, the price the company sets is not the one which balances supply and demand today, but the one which will balance them throughout the period during which it remains in effect. An unexpected

slowdown in aggregate demand during this period will necessarily be incompatible with the expected inflation at the time when prices were set. Thus, if the prices are not changed, sales will drop. However, this situation will persist only until the next price change, when (if the restrictive policy is foreseen to be permanent) prices will drop in accordance with the decrease in demand, and the recession will be avoided.

However, if various companies set and reset their prices at different moments, the overall adjustment will be much slower.<sup>15</sup> For in its decision to change its prices, the company may adopt as a referent not only the equilibrium price that is compatible with the new aggregate demand, but also its competitors' prices. In so doing, it will not change its own price completely, unless all its competitors have reset their prices simultaneously. The degree of its adjustment will thus depend on the percentage of competitors which have changed their prices. When it is the other companies' turn, they too will not adjust fully to the change in aggregate demand, since many will not yet have reset their prices, and the others will have done so only in part. If firms do not want to change their own price in relation to the average sectoral price, their adjustment to drops in aggregate demand will thus be insufficient and slow. This lack of price synchronization will create an inertia in prices, even without problems of credibility, which will aggravate fluctuations in aggregate demand.<sup>16</sup> This is the type of problem, among others, that the so-called "desagio" table—the daily, scheduled devaluation of the old currency in relation to the new currency—sought to correct in the Austral and Cruzado Plans in Argentina and Brazil, and in this way eliminate the high inflation any expectation implicit in financial and rental contracts, so as to harmonize prices with the new targeted inflation.

<sup>15</sup>For further discussion of this topic, see Taylor (1980) and Blanchard (1983 and 1986).

<sup>16</sup>If the lack of synchronization is so costly, why do firms not synchronize their actions? One of the explanations offered is that each company faces idiosyncratic shocks or different price-setting costs, and this results in different intervals (Ball and Romer, 1987). Another interpretation (Okun, 1981) underlines each company's desire to obtain information about the behaviour of its competitors (either the price they are charging or the wage they are paying). Everyone's desire to be the last to set prices is what hinders synchronization.

Likewise, in high or sharply fluctuating inflationary contexts, the cost of maintaining a fixed price-setting interval rises; hence, the interval will be shortened. Prices not quantities, become the increasingly more important adjustment mechanism (thus approaching the instantaneous adjustment referred to in textbooks). Hence the higher or less stable the inflation rate, the less the trade-off between expected inflation and output (Ball, Mankiw and Romer, 1988). In other words, although there is general agreement with Lucas (1973) that the trade-off between inflation and output decreases as the variation in demand increases,<sup>17</sup> it has likewise been observed that, unlike what Lucas postulates, this trade-off diminishes the higher the rate of inflation. This undoubtedly helps explain why it is less costly (there is less recessive risk) to end hyperinflation (as in Bolivia in 1985) than high and persistent, but not yet explosive, inflation (like the kinds of inflation which have afflicted the region in the past 15 years).

#### d) *Asymmetry in perception and strategic interdependence*

Lastly, errors in perception about the average price level may give rise to lags in the adjustment of prices (Phillips, 1958; Lucas, 1972). It is reasonable to assume that own prices are known more quickly than the average price level. Sudden variations in aggregate demand will give the impression, then, that there has been a drop in relative prices themselves: one's prices are seen to fall, whereas the overall price level is not yet observed as falling. If there is resistance to relative price adjustments, stabilization policies may bring on a recession.

Thus far we have an explanation based on an *ad hoc* assumption. Typically, however, the goals of an anti-inflationary programme are known; what is less certain is whether they will be achieved. If there is symmetrical uncertainty about the achievement of the goal, as in the case of upward activism,<sup>18</sup> i.e., if it is equally probable

<sup>17</sup>According to Lucas, this lesser trade-off stems from information problems; for the neo-Keynesians, greater variations in demand result in reductions in price-setting intervals.

<sup>18</sup>In the case of upward activism, there is no foreknowledge of the precise unemployment reduction target, nor of the nominal increase in aggregate demand and how long it will last. It must be assumed, then, that there is a symmetrical distribution of expectations about the real unemployment reduction target being pursued.

that effective inflation will be 10 points higher or lower than the target, there will be no systematic errors or resultant systematic reductions in output and employment. In the case of downward activism, however, it seems reasonable to assume that the uncertainty will point in only one direction, i.e., failures will occur only in the direction of an inflation which is higher than the projected rate. Accordingly, each company will tend to assume that the others will readjust their prices at an equal or greater rate than the target, making it virtually certain that overall inflation will exceed the target, thus bringing on a recession. This approach has been studied in depth in the South (Simonsen, 1988) in an attempt to explain price inertia caused by the strategic interdependence between economic agents and the consequent recessive tendency of anti-inflationary programmes.

The problem may be illustrated by an analysis of the dependency of a company's pricing policy on the assumed behaviour of its suppliers. Each firm must decide whether to adjust its price at the same rate as the government's target inflation, or at a higher rate. Its decision will largely depend on what it believes its suppliers will do, since its gains or losses will vary depending on its price relative to that of its suppliers. There will be four possibilities, then, as illustrated in figure 3. If both the firm and its suppliers adjust

their prices at a higher rate than the targeted inflation, the firm will retain its market share, although it will experience some losses (since there will be some recessive effect, on account of the generally overblown price level). It will come out ahead if it adjusts prices above the targeted inflation, while its suppliers remain within this limit. If it adjusts its prices according to the targeted inflation, it will neither gain nor lose so long as its suppliers do the same, but it will lose a great deal if the latter raise their prices above target inflation. Thus the firm will both minimize losses as well as maximize gains if it raises its prices above targeted inflation.

Moreover, since all other firms are apt to reason along the same lines, they too can be expected to set prices above targeted inflation, whereby we may conclude that this is the optimal price policy for the firm. Unfortunately, such asymmetry in expectations implies that all firms will set prices above the targeted inflation, bringing on a recession, since the error of each generates an externality on aggregate demand (a negative income effect, owing to the generally overblown level of prices). The challenge, then, is to create incentives so that each firm will adopt the socially optimal solution ( $P = \text{target}$ ,  $P$ ), for unless each firm can be reasonably certain that all others will also adhere to target inflation (especially its suppliers, including its labour force), it would be reckless for the company to set its prices according to the targeted inflation of the stabilization programme.

These are four hypotheses (among others) concerning rigidities in the goods market which help explain why companies tend to adjust to equilibrium from "above" (that is with prices above those compatible with the macroeconomic programme), and consequently why anti-inflationary programmes tend to be recessive.

To the extent that these explanations of price rigidity are valid, they suggest the usefulness of temporary intervention in the goods market during stabilization programmes in order to avoid a recession. The idea would be to maintain relative prices, but at lower absolute levels. For firms are able to keep their relative prices constant but run into difficulties if they need do so at the lower absolute price level compatible with aggregate demand. The co-ordination of price setting among firms

Figure 3

TABLE OF GAINS AND LOSSES OF A TYPICAL FIRM  
(According to prices set by the firm and its suppliers)

		Firms supplying inputs	
		$P = \text{target } p$	$P > \text{target } p$
Firms producing final goods	$P = \text{target } p$	0	-
	$P > \text{target } p$	+	0

would justify policy intervention and require the use of an additional instrument (price controls) as long as the problem lasts.<sup>19</sup>

The purpose of price guidelines or controls would not be to repress inflation but to speed the adjustment of prices to a level compatible with aggregate demand policy. The essential objective would be to assure each economic agent, as far as possible, that its decision to adjust its price in accordance with the targeted inflation would not lead to a systematic relative loss, since all other economic agents would likewise be adjusting their prices according to the same target. This would mean co-ordinating expectations with each other and harmonizing them with the targeted inflation implicit in the monetary and fiscal policy.<sup>20</sup> The price and incomes policy is therefore not a substitute for, but a complement to, an aggregate demand policy aimed at lowering inflation without generating a recession.

### 3. Rigidities in the credit market

The basic assumption is that economic cycles are due to investment fluctuations; and the latter are associated not so much with the ups and downs of the real interest rate—which fluctuates relatively little, at least in developed countries—as with changes in the availability of credit.<sup>21</sup>

It is suggested that the main defect—intrinsic to capital markets—, arises from the asymmetry of information between lenders and borrowers concerning the feasibility or profita-

bility of the investment project in question. This creates two types of problems, which prevent rationing exclusively on the basis of interest rates; for a rise in this rate leads to an adverse selection of borrowers, since the more responsible potential debtors withdraw from the market, thereby increasing the probability that an unreliable borrower will be selected. Moreover, a perverse incentive (moral hazard) is created, since a higher interest rate leads to a preference for projects with greater variance, although their average profitability might even be less, since if they fail the loss to the debtors is the same, but if they succeed there is more to be gained.

Since a higher interest rate is likely to lower the quality of the average loan, the rationing of credit solely through interest rate becomes inefficient. Indeed, above a certain level, the effective profitability of a higher interest rate (taking into account the greater risk of the loan) may begin to decline. Accordingly, around this level, the supply of credit will tend to be relatively insensitive to the interest rate and credit will have to be rationed, no longer just by price, but by quantity as well. Variations in the demand for credit around this point will be met by greater or lesser rationing of this resource, whereas the interest rate will fluctuate but mildly.

Although the supply of credit will not be very sensitive to the interest rate, it will respond to the degree of uncertainty (or exogenous shocks). The presence of greater uncertainty will lead banks to contract the availability of credit. This is why recessions—which raise the risk of bankruptcy—are characterized by considerable reductions in credit, rather than interest rate increments. Conversely, in prosperous economies, where there is less uncertainty, credit availability will be greater at each level of interest rate.

The demand for credit will move inversely. Recessions (or prosperity) will diminish (or augment) the availability of funds, thus increasing (or reducing) the need for credit. During a recession, then, the demand and supply of credit will move in opposite directions, generating a shortage of this resource, or "credit crunch". Credit thus has a procyclical character, which cannot be offset by contrary movements in interest rates.

<sup>19</sup>The literature on this subject clearly suggests the existence of a price rigidity and co-ordination problem. Price controls may then turn out to be justifiable, although against this potential benefit should be weighed the administrative difficulties these entail and the abuses to which bureaucratic discretion lends itself. Their use should therefore be reserved for especially serious situations, in accordance with appropriate aggregate demand policies, and for brief periods.

<sup>20</sup>This co-ordination problem is automatically resolved in a context of hyperinflation, since indexation and price-setting in such an economic setting are increasingly based on the free exchange rate, the only parameter whose value varies continually, is quickly and automatically known and has a wide-ranging impact on costs. Consequently, if the (free) exchange rate can be stabilized, all the other prices will fall into line automatically and synchronically, and thus—during hyperinflation—additional price controls will become redundant. For an analysis of this phenomenon in the Bolivian case, see Morales (1988).

<sup>21</sup>For a summary of the bibliography on this type of rigidity, see Gertler (1987) and Greenwald, Weiss and Stiglitz (1984).



The uncertainty attributable to asymmetry in information may be minimized through credit guarantees. However, this expedient also raises problems. In times of crisis, the value of the guarantees declines, bringing on a credit squeeze, even though the profitability of the projects may not have deteriorated. This favours established firms over newer or smaller firms.

The literature on this subject emphasizes the role of financial crises as well as monetary factors in explaining the depth and persistence of the Great Depression of the 1930s (Bernanke, 1983). Its relevance to the external debt crisis in the early 1980s in Latin America is obvious: variations in the risk of lending to the various countries was reflected not in differences in interest rates charged (on the contrary, these were fairly uniform among countries) but in a rationing of the amounts of credit provided. Thus, the crisis arose not so much from increases in international interest rates (1980-1981) as from the collapse of the flow of new credits (1982-1983).

Such an approach, however, requires considerable adaptation before it can be used to explain the recent crisis in domestic financial markets.<sup>22</sup> For one thing, contrary to hypothesis, domestic interest rates did not remain stable. Nevertheless, even though interest rates did vary enormously, credit was rationed by other means as well: to wit, by discriminating between firms with and without adequate guarantees. The latter had limited access to credit i.e., it was rationed by quantity, while in the privileged segment, credit was rationed almost exclusively through the interest rate (with the exception of firms belonging to the same economic group as the banking system).

On the other hand, owing to the substantial availability of external credits and to high debt/equity ratios, firms found it more attractive to obtain loans than to worry about using them efficiently. Potential earnings were greater the more one borrowed, whereas losses were limited to one's own equity (much lower). Moreover, borrowing at high interest rates was not consi-

dered unduly risky, since interest rates were soon expected to decline. Similarly, owing to the low capitalization of most banks and the likely government guarantee on deposits which most felt existed should the need arise, few banks felt the need to operate cautiously, since they were essentially risking only outside funds. This explains the inability of the real interest rate, no matter how high, to contract (ration) the demand for credit.

The persistence of these rates, which were much higher than both the growth rate of the economy and firms' capacity to repay, forced the banking system to renew its loans, at any interest rate, to keep borrowers from going bankrupt. Once the crisis erupted, since banks could no longer ration by quantity and were forced to supply all the credit demanded by their borrowers, the banks' own solvency became increasingly determined by the deteriorating quality of their borrowers' investments. Instead of fulfilling a rationing function, high interest rates came to reflect serious imbalances in the overall economy (exchange lag, external overindebtedness), which led to an artificially high demand for credit. Thus the accrued interest rate would be extremely high (although it would never actually be paid).

These models also serve to explain the phenomenon of financial bubbles, arising from generalized optimistic expectations, fed and sustained through credit. When credit is procyclical, the positive expectations feed on themselves, giving rise to even more favourable expectations. The bubble swells on the basis of expectations and procyclical credit—even in the absence of real economic factors—, until it bursts as a result of some exogenous shock. What happened in the Argentine and Chilean stock markets (among others) up to 1980 is a case in point.<sup>23</sup> An unsophisticated, unregulated or poorly regulated financial system permitted the unfounded optimism of many to be transformed into collective euphoria, as long as this optimism could be fed by enormous flows of external credit.

<sup>22</sup>Massad and Zahler (1987) examine the analytical consequences brought on by overindebtedness and the crisis in the domestic financial systems of the region since 1981. Massad and Zahler (1988) offer case studies for Argentina, Brazil, Colombia, Chile and Peru.

<sup>23</sup>The real average value of a share on the Argentine stock market quadrupled between 1978 and 1980; and on the Chilean market, it increased by 16 times between 1975 and 1980. In both cases, these movements far exceeded the prospects of the real economy (Ramos, 1986).

## V

## The private and social cost of rigidities

Why don't such socially costly rigidities automatically set in motion strong incentives so that economic agents overcome them on their own initiative? The reply, in essence, is that while the social (macroeconomic) costs of such microeconomic rigidities are severe, of the highest order of magnitude, the private costs to enterprises (or the benefits derived from correcting their errors) are low, or second order (Mankiw, 1985; Akerlof and Yellen, 1985; Blanchard and Kiyotaki, 1987). This is because the macroeconomic costs of maintaining an overblown price are directly proportionate to the difference between the price charged and the correct or equilibrium price (since the total product will fall in the same proportion). On the other hand, the microeconomic incentive to correct any price error is

equivalent to the profit foregone by charging an incorrect price. For a competitive firm, this foregone income would be enormous (even infinite); in a context of imperfect competition, however, which is closer to the real world, the fall in profits is much less marked. This is why the assumption of imperfect competition is so important in these models.

This point can be easily and rigorously demonstrated. Profits ( $U$ ) are a function of both sales ( $Q$ ) and price ( $P$ ). Although the volume of sales falls when the price is too high, the decline in earnings, which is what most interests the firm, is much less, for sales are made at high prices.

In more technical terms,  $U = f(P, Q)$ . A Taylor's expansion around the optimal price,  $P^*$ , permits us to conclude:

$$U(P) = U(P^*) + \frac{dU(P^*) (P-P^*)}{dP} + \frac{1}{2} \frac{d^2U(P^*) (P-P^*)^2}{dP^2} + \dots$$

$$U(P) - U(P^*) = \frac{dU(P^*) (P-P^*)}{dP} + \frac{1}{2} \frac{d^2U(P^*)}{dP^2} (P-P^*)^2 + \dots$$

Around the optimal price, the variation in profits attributable to a change in price approximates zero, so that the first term disappears. Thus,

$$U(P) - U(P^*) = \frac{1}{2} \frac{d^2U(P^*) (P-P^*)^2}{dP^2} + \dots$$

In other words, profits lost by setting an excessively high price are proportional not to the error in price ( $P-P^*$ ), but to the square of the error in the price. Thus, if the price is set at a level 10% higher than equilibrium, the reduction in profits will be on the order of  $(10\%)^2$ , or 1%. The incentives to each firm to introduce the relevant correction are, therefore, of the second order  $(P-P^*)^2$ . However, the cost to the economy is of the first order, since the drop in total production (and aggregate demand) will be directly proportional to the difference between the price

charged and the equilibrium price ( $P-P^*$ ). Hence, although the macroeconomic cost of price (or wage) inertia or rigidity is high, the private cost to the firm *seems* low.

It is not that recession does not entail serious costs to the firm. The problem is that correcting its "error" in prices will improve its profits only marginally, for the expansion of demand for the firm's products depends not only on the correction of its price (an improvement of the second order) but on the simultaneous correction of their prices by all other firms (an improvement of the first order). This eventuality does not depend on the company's own behaviour (an externality in aggregate demand). To be sure, the firm will tend to correct its own prices, but since its incentive is weak, it will do so slowly.

Furthermore, it is intuitively obvious and can be shown (Akerlof and Yellen, 1985) that the greater the number of firms which maximize

(as above) slowly or incompletely (the probable situation in the South), the less costly this process will be for each of them, since they will lose little to their competitors, and thus the less severe the "penalty" they pay for being "inefficient". In other words, the fact that some firms are prepared to tolerate rigidities—for these

have but second order effects on their profits—is enough to bring about serious and prolonged macroeconomic effects, without this being sufficient to automatically speed up correction. Price inertia can coexist with economic rationality, then, without violating the principles of maximization, at least to a first approximation.

## VI

### By way of conclusion

#### 1. *Convergences*

At this point there is no doubt that expectations are a basic, determining factor in the behaviour of economic agents and produce consequences of the first order for macroeconomics. Likewise it seems best to assume maximizing behaviour, on the part of all agents, both for reasons of consistency as well as to allow for some learning to take place. Although this involves modelling expectations in "rational" terms, it does not mean that all information is readily and immediately available to agents nor that these are free of perceptual errors. Nor does it mean, in the absence of sufficiently developed future markets, that the agent will be able to predict with ease the permanence of a policy, or how its competitors' expectations will be formed. Difficulties in this area may give rise to false or incomplete transactions; errors of co-ordination; or simply imbalances similar to those produced by adaptive expectations and *ad hoc* rigidities. What is new is the need to describe the error or rigidity causing the imbalance, and not just to postulate a presumed error arbitrarily or groundlessly.

The need to identify and specify the error and reconcile it with the agent's maximizing behaviour has led theoreticians to give priority to the necessity of building macroeconomics on solid microeconomic foundations. For this reason they have attached so much importance to game theory and advances in the field of industrial organization to explain, respectively, non-co-operative interactions among groups and the behaviour of firms in imperfect competition. This move towards establishing the microeco-

mic foundations of macroeconomics has shifted interest away from disequilibrium theories. Recent efforts have turned to the identification of the origin of disequilibria, rather than the explanation of its consequences, so well provided by disequilibrium theories.

#### 2. *Critical and promising topics*

Similarly, major progress can be expected in four additional areas of crucial importance for both the South and the North.

##### a) *Credibility*

With credibility, even bad policies may yield good results for a time; without it, however, even the best policies will be very costly. This is why credibility is such an important asset, not to be squandered. What can be done if it is absent? This is the South's typical problem when a new stabilization programme is initiated. A prerequisite for gaining credibility is that the programme should be consistent and appropriately implemented. However, this is not enough. How can the public be convinced that the programme will last, and that it will not be set aside at the first sign of an obstacle? Since nothing and no one can guarantee that the programme will be maintained, uncertainty arises about its implementation, although in only one direction: that inflation will be higher, never lower, than the target. For this reason, expectations tend to adjust slowly, and "from above", to the targeted inflation, thus bringing on a recession.

Moreover, even if an agent is convinced of the good design, consistency and permanence of the stabilization programme, he is entitled to ask whether other economic agents, especially his competitors and suppliers, will adjust their prices instantaneously and completely according to the targeted inflation, or only partially and "from above", until they see the results (Di Tata, 1982). A vicious circle is thus created, in which the very expectations that the programme will be only partially successful lead to its failure; inflation comes down too slowly, and recessive trends are generated. The government is faced with the dilemma of either pursuing its inflationary target —at the risk of provoking a recession— or slackening in its pursuit ratifying the public's expectations (skepticism) and thereby further weakening its own credibility.

Thus, at least as regards changes of policy régime, the public's expectations may well be adaptive (i.e., the public is skeptical). Systematic modifications of policy within a given régime (e.g., management of anticyclical fine tuning) can be anticipated; but not changes in policy régimes. For the government's commitment to maintaining the new policy régime (i.e., the anti-inflationary programme) cannot readily be known nor ascertained.

Once the change of régime gains credibility, however, decelerations in aggregate demand will fall on prices alone. On the other hand, as long as there is no such firm conviction, the public's skepticism will slow price adjustments, making the stabilization programme recessive.

The challenge, then, is to convince the public that the new régime (low inflation) will be maintained, so as to avoid a severe and protracted recession. The reasoning behind the price and wage policies of the recent heterodox stabilization programmes in Argentina, Brazil, Mexico, Peru and Israel point in this direction. These policies may be interpreted as attempts not to repress inflation but to guide and harmonize the inflationary expectations of agents among themselves and with the targeted inflation implicit in economic policy, so as to avoid a recession while public uncertainty persists about the general credibility and permanence of the new policy. Obviously, if the rest of the economic programme —in particular, fiscal policy— is

inconsistent with the targeted inflation, the programme will be doomed to failure, as was the case in Argentina, Brazil and Peru (Ocampo, 1987).

#### b) *Multiple equilibria*

A common feature of the above-mentioned rigidities is that they admit the existence of more than one equilibrium for a given stabilization policy; one, at a lower inflation with full employment (an absolute optimum); another, of recession with excessive inflation (a local maximum, but an absolute suboptimum). This is especially likely to occur when it is believed that the first reaction of producers to a contraction of demand is to maintain their prices so that a period of quantitative restrictions on sales can be foreseen. In other words, the expectation that adjustments will be in quantity rather than in prices will tend to induce firms to behave in accordance with this assumption. Thus, at least for a time, expectations will become self-fulfilling prophecies, giving rise to various local equilibria, each of which is consistent with a different set of expectations: optimism generates prosperity; pessimism, recession; and expectations of stagnation, more stagnation.

None of these equilibria can be discarded as irrational. Moreover, since the incentive for each agent to act depends on how it believes others will act, a suboptimum could become a point of equilibrium. One justification for intervention on the part of the economic authorities could thus be to move the economy from such a suboptimal equilibrium to an optimal one.<sup>24</sup>

In fact, a good part of the logic of intervention —especially of heterodox stabilization programmes— against "inertial inflation" may be understood as an attempt to move the economy from a high inflation equilibrium to one with low inflation, for a given "inflation tax". The latter is nothing else than the product of the inflation rate times the monetary base. Since the real monetary base contracts as inflation increases, beyond a certain point the reduction in the base exceeds the rise in the inflation rate, and

<sup>24</sup>In order to determine whether this provides enough justification, it would be necessary to assess the possible costs of each intervention.

thus it may happen that, with two substantially different rates, the same inflation tax is paid. Lowering inflation from a high equilibrium rate to a low equilibrium rate would then require a co-ordinated move of prices (a price and incomes policy) rather than a reduction of the deficit.<sup>25</sup>

Just as important as admitting that rigidities may make the system come to rest at a local but suboptimal maximum is the recognition that the possible equilibria are not indifferent to the path chosen to reach them. In other words, the economic system is not necessarily reversible; what represented an optimal equilibrium before a recession might no longer be viable after the recession, especially after a prolonged one. Brief downturns (with respect to trends) in employment and investment levels may well be recoverable in the expansive phase of the cycle, and the system would then return to its optimal equilibrium. The same is not true, however, for shocks of longer duration (Arida, 1985). Long-run growth may return to its historical rate, but the availability of capital and therefore the *level* of production will be lower, since the optimal level of equilibrium is sensitive to the transition process and its duration (*hysteresis*).

The long-run Phillips curve will in any event be vertical, although at two different levels of "full employment". In this context, monetary and fiscal policies will be important not so much to restore cyclical deviations from one of the full employment equilibria, but more basically to ensure that the long-run equilibrium consistent with a more productive full employment is reached.

c) *Automatic adjustments and the "corridor" of credibility*

If various possible equilibria exist—depending on the state of expectations—, to which of them will the market spontaneously lead? Since the free interplay of supply and demand is a good adjustment mechanism for small variations (marginalism) around equilibrium in a given market, presumably marginal deviations from equilibrium will be corrected automatically by market forces inducing a con-

vergence to optimal equilibrium. But when the deviations are large, when they affect more than one factor and, especially, when they require considerable co-ordination between agents and markets, the spontaneous operation of the market will probably be seriously flawed. This is what led Leijonhufvud (1981) to formulate the hypothesis that within a certain corridor (moderate deviations), market forces are stabilizing. Outside this corridor, the trends toward convergence are considerably weakened, since co-ordination difficulties are exacerbated and ultimately give rise to false and incomplete transactions and an overall failure of market signals.

There are two situations in which this hypothesis is especially important for the South. One is the case of a severe and prolonged recession, in which the market's co-ordinating role (which leads to optimal equilibrium) has broken down. For example, a decline in wages will minimize unemployment due to imbalances in the labour market alone. However, such a decline could be counterproductive if unemployment originates in a disequilibrium in the goods market due, for example, to the prevalence of inflated prices which make it impossible to sell all that can be produced. In this case, according to disequilibrium models, and contrary to the spontaneous reaction of the market, it is prices which must fall, and at a greater rate than wages, in order to recover normal levels of sales, production and employment. In other words, as long as price and wage adjustments in the goods and labour markets are not synchronized and co-ordinated, the recession will go on.

The second situation occurs when policy régimes change. It is what happens at the inception of a strong anti-inflationary programme, whose target cannot be fully anticipated or believed by the market, and in which it is likely that the agents will approach equilibrium asymmetrically, "from above", with prices rising at a rate higher than targeted inflation. Both situations—which are clearly located outside the corridor in which the market is truly efficient—will give rise to a recession or the persistence of one, if there is no clear and definite intervention by the authorities to co-ordinate expectations and harmonize the behaviour of agents with the targeted inflation implicit in macroeconomic policy.

<sup>25</sup>To be sure, lowering inflation to zero would require reducing the deficit, since the inflation tax at zero inflation also falls to zero.

d) *Institutions*

If many macroeconomic problems stem from insufficient information about the behaviour of other economic agents, and, especially, if different sets of expectations can give rise to very different equilibria, questions may be raised about the feasibility of reducing information needs or of anchoring expectations in order to attenuate the degree of uncertainty with respect to equilibrium.

The answer to both questions may be to establish behavioural norms that could be agreed on beforehand, although defining these is no easy matter.<sup>26</sup>

From this point of view, many economic institutions (contracts, indexation schemes, bankruptcy laws, guarantees on deposits, labour legislation) are aimed at lessening uncertainty about others' behaviour, especially when this involves trading off a future promise for a current commitment. Far from being imperfections, these are mechanisms that try to reduce the degree of instability and risk stemming from a situation in which any agent may do anything. By narrowing (by agreement) the range of unpredictability, these institutions generate a more stable and less risky behaviour. Moreover, by lowering the cost of transactions between future and present commitments, they facilitate trade and help raise the standard of living.

On the other hand, however, in analogy with the debate on rules and discretionality, such norms and institutions limit the flexibility and speed of response to unexpected situations. Although rules are modifiable, it is very costly to change them. Thus, unless the changes are well grounded and are intended to be long-lasting, the choice will probably be to extend the current norms and institutions, although they may no

longer be very appropriate to the new circumstances. For example, the rules for wage indexing are suitable for persistent inflation, since they reduce the likelihood of random redistributions in income; however, they may become disadvantageous if the aim is to lower inflation, since they tend to slow price adjustments, thereby bringing on recession. The most appropriate institutionality will depend, then, on the probable economic context: in this case, indexing if there is persistent inflation; no indexing if there is little or no inflation.

On the other hand, unforeseen economic circumstances, especially those which exceed expectations, require vigorous compensatory action, which must certainly include the immediate modification of norms and institutions, all the more so if these are inducing behaviour which is unsuitable in the new circumstances.

To be sure it is always possible to renegotiate the rules individually. However, unless the costs of not renegotiating are very high for both parties (or a repetition of the "game" is expected, where winners and losers might trade places), the obstacles will probably prevent such a renegotiation, despite its high net social benefits. This divergence between social and private benefits is an argument in favour of government intervention. Arguments against it include, on the one hand, the risk of the wrong kind of intervention and, on the other, the cost of the greater uncertainty arising from the very changing of the rules. This provides just one more argument in favour of limiting changes in institutions and norms to cases of abnormally wide deviations, i.e., for especially acute and prolonged recessions or very high inflation rates: in other words, within the normal cycle, stable rules (whether or not contingent); outside this corridor, activism.

<sup>26</sup>For example, some feel that norms should be defined with respect to instruments managed by the authorities (such as the monetary base), which would maximize simplicity and control; others, however, prefer norms with respect to results (such as price stability), especially when the relationship between the instrument and the results is slow, uncertain or equivocal. Likewise, rules may be devised for different contingencies (e.g., depending on whether

there is higher or lower inflation, unemployment or external imbalance). Unfortunately, the greater the number of contingencies, the less predictable and more discretionary their application. A rule may be defined, on the contrary, that is to be followed regardless of contingencies (e.g., a fixed expansion in the money supply), but although this expedient is simpler, it entails the risk of disaster if unforeseen economic situations occur (Blinder, 1987).

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## Saving and investment under external and fiscal constraints

*Nicolás Eyzaguirre\**

In this article the author examines recent trends in the coefficient of domestic saving—or the unconsumed portion of the product—in the region. He shows how it has stagnated in relation to the saving prevalent before the external debt crisis, despite the sharp decline in per capita consumption. In other words, consumption and the product have fallen in a parallel fashion. Thus austerity has been useless in raising the coefficient of saving, which would have kept the turnaround produced by the net transfer of resources abroad—which must be financed with domestic saving—from in turn resulting in a total loss of available financing for investment.

The stagnation of the saving coefficient is a consequence of the fall in investment demand, caused by crisis-induced macroeconomic imbalances. An aggregate model is constructed which illustrates the constraints that operate in three basic imbalances or gaps: the saving-investment balance, the fiscal budget and the balance of payments. The author then shows how the fiscal and external gaps can act as dominant constraints, by reducing the investment rate to below what would be feasible with potential capacity for saving. Finally, some policy conclusions are drawn that highlight the different impacts of the various instruments available—exchange-rate, monetary and fiscal—depending on which gap or gaps are more restrictive.

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## Introduction\*

The magnitude of the negative impact of the external debt crisis on the Latin American economy is already reaching alarming proportions. Per capita gross domestic product dropped more than six percentage points between 1981 and 1988. Given the prevailing trends, the average inhabitant of the region will be worse off by the end of this decade than at the beginning.

Moreover, there are indications that economic problems have tended to worsen. There is no relief in sight from the burden of the external debt, despite efforts to pay interest and principal. In fact, in 1988 the external debt/gross domestic product ratio for Latin America as a whole reached 55%, in comparison with an annual average of 56% in the period 1982-1987 (ECLAC, 1988b).

For its part, the rate of investment—key to future growth—continued to decline in most Latin American countries. In a sample of six countries, the investment coefficient in 1985-1987 was lower than before the crisis, and also lower than the 1982-1984 rate, with the exception of Chile and Brazil (table 1).

Lastly, inflation has risen steadily since 1986 for the region as a whole, reaching an all-time high of close to 500 points in 1988. Such an imbalance is partly due to the serious fiscal problems faced by most Latin American countries.

In this context, it is absolutely essential to formulate a policy package capable of reversing the situation, in order to recover production and investment levels. To this end, research must be done on the relationships between the external debt burden and fiscal constraints, inflationary pressures and the decline in the investment rate.

The cessation of capital flows to the region and the rise in international interest rates from 1982 onwards produced a turnaround in the net financial transfer of resources from abroad (net

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Table 1

LATIN AMERICA (SIX COUNTRIES) TOTAL  
GROSS DOMESTIC INVESTMENT  
AS A PERCENTAGE OF GROSS  
DOMESTIC PRODUCT

(1980 dollars)

Country	Periods <sup>a</sup>		
	1975-1981	1982-1984	1985-1987
Argentina	21.1	14.1	11.5
Brazil	23.3	16.1	16.9
Chile	16.2	10.4	13.7
Ecuador	25.0	19.0	16.8
Mexico	24.3	18.6	16.7
Peru	24.6	22.6	19.7

Source: ECLAC, Statistics and Quantitative Analysis Division, National Accounts Section.

<sup>a</sup>Simple arithmetic mean for the years indicated.

capital inflow minus interest payments). This transfer (on average, 2.6% of GDP in the period 1973-1981) reached almost -4% in the period 1982-1987. Since the coefficient of investment is approximately equal to the coefficient of saving plus the quotient of the net financial transfer of resources, this upset dealt a hard blow to investment financing.

Recovering the coefficient of investment presupposes decreasing the net flow of resources abroad or increasing the coefficient of domestic saving. The first alternative necessarily involves trying to renegotiate the external debt and bring about lower international interest rates. This article deals with the second alternative, recovering the coefficient of domestic saving.

In most of the countries in the sample—once again Chile is different—the coefficient of domestic saving, or the unconsumed part of the product, remains practically at a standstill in relation to the level before the outbreak of the crisis (table 2). Brazil and Mexico are having some success at raising it, but by a lower proportion than the loss they have sustained in the transfer of resources. It is certainly paradoxical that the coefficient of saving remains static while average Latin American per capita consumption in 1988 was around 7% less than in 1980. Furthermore, no one can say that there has been a lack of austerity since the crisis. The drop

Table 2

LATIN AMERICA (SIX COUNTRIES) TOTAL  
GROSS DOMESTIC SAVING AS A  
PERCENTAGE OF GROSS  
DOMESTIC PRODUCT

(1980 dollars)

Country	Periods <sup>a</sup>		
	1975-1981	1982-1985	1985-1987
Argentina	23.2	22.5	20.5
Brazil	19.4	20.1	21.6
Chile	14.4	16.6	24.9
Ecuador	27.4	25.7	27.9
Mexico	24.3	28.0	27.2
Peru	24.5	25.5	22.0

Source: ECLAC, Statistics and Quantitative Analysis Division, National Accounts Section.

<sup>a</sup>Simple arithmetic mean for the years indicated.

in real wages, the rise in unemployment rates, the deterioration of State aid to the neediest groups are, among others, eloquent indicators of how much adjustment there has been. However, efforts at austerity have not led to an increase in saving; that is to say, the crisis has meant a parallel decline in the product and in per capita consumption, with the consequent adverse effect on living conditions, but without an increase in the coefficient of saving. Thus the turnaround in the transfer of external resources has equalled the decline in the coefficient of investment, while the fall in consumption has not led to higher levels of domestic saving, to mitigate the decline in net external financing.

The question then is how to moderate consumption and increase the product, pushing saving up, instead of lowering the product and consumption—a formula that brings saving to a halt and penalizes investment (given the turnaround in the transfer of resources). In the search for an expansionary policy for promoting saving, it is essential to introduce the distinction between *ex ante* saving and *ex post* saving. If we try to moderate consumption in order to absorb, without detriment to investment, the turnaround in the transfer of resources, the result will be an expansion of *ex ante* saving. However, if the adjustment effort leads to a decline in investment, *ex post* saving may remain

unchanged—in other words, the austerity will be useless. On the other hand, if the initial moderation of consumption is accompanied by a stable level of investment, *ex post* saving will rise.

Adjustment policies, then, condition investment decisions by action or omission. Empirical evidence shows that in the desire to promote domestic adjustment through austerity, measures to promote saving often end up depressing it by inhibiting investment. For that reason, in this article, we add two channels of interaction between the external financing crisis and the investment possibilities. The turnaround in the transfer of resources affects investment behaviour not only by decreasing available saving (domestic saving plus the transfer of resources) but also by influencing the balance of payments and the fiscal budget.

The effect of the external crisis on the balance of payments is direct. The decrease in the net external flow of capital and the increase in interest payments on the debt erode the availability of foreign currency. The consequent shortage restricts the capacity to import finished consumer goods, intermediate inputs for production and capital goods for investment. Then, to avoid declines in production and investment, foreign currency must be saved by consuming fewer imports, and imported intermediate inputs and capital goods must be replaced by domestic products. However, given the inflexibility of the domestic structure of production in substituting for imported goods and the impossibility of discriminating in the reduction of consumption—so that only imported consumer goods or domestically produced exportables are affected—adjustments in consumption depress effective demand, production and investment.<sup>1</sup> Thus part of the increase in *ex ante* saving produced by the drop in consumption is frustrated by the decline in investment, and *ex post* saving adjusts to a lower level as production and investment fall.

The effect of the external financing crisis on the public budget has also been negative. The

cutoff of the flow of capital has limited the public sector's capacity for indebtedness abroad, while the rise in the international interest rate has increased the burden of servicing the external public debt. In many countries in the region, governments have guaranteed part of the external private debt; at times the corresponding private-sector domestic debt has been liquidated, and in other cases, the State has subsidized private debtors and the domestic financial system, in order to prevent it from collapsing. All of this has put pressure on public finances. At the same time, the recessive adjustment has deteriorated fiscal income because of the lower level of domestic activity and consequent reduction in tax receipts, and because of the drop in imports and resultant decline in customs duties. Finally, the effort to adjust external accounts has brought on real devaluations of the national currency, provoking an increase in the deficit in real terms in countries whose public sectors lacked foreign currency.

By recurring to domestic borrowing and issuing more currency, the authorities initially tried to prevent the worsening fiscal position from slowing down government consumption

Table 3

LATIN AMERICA (SIX COUNTRIES) GROSS  
FIXED PUBLIC INVESTMENT AS A  
PERCENTAGE OF GROSS  
DOMESTIC PRODUCT

(1980 dollars)

Country	Periods <sup>a</sup>		
	1975- 1981	1982- 1984	1985- 1987
Argentina	...	...	...
Brazil	...	...	...
Chile <sup>c</sup>	5.5 <sup>d</sup>	5.1	9.2
Ecuador	6.2	4.9	5.0
Mexico	9.6	7.6	5.8
Peru	5.6	6.4	4.3

Source: ECLAC, Statistics and Quantitative Analysis Division, National Accounts Section.

<sup>a</sup>Simple arithmetic mean for the years indicated.

<sup>b</sup>Official unavailable figures.

<sup>c</sup>Unofficial estimates (Larrañaga, 1989).

<sup>d</sup>For 1978-1981.

<sup>1</sup>A scarcity of foreign currency has repercussions on investment through recessive adjustments, required by the disequilibrium of the balance of payments, instability due to fluctuations in external financing, and an interest rate kept high by the authorities to avoid capital flight.

and investment. At the saturation point of domestic borrowing, and faced with an inflationary spiral,<sup>2</sup> governments were obliged to reduce their current expenditures and investment.<sup>3</sup> This decline in fiscal investment depressed private investment, limiting *ex post* saving (table 3).

In short, the external debt crisis has placed direct and indirect constraints on investment capacity. Applying austerity policies to consumption (promoting *ex ante* saving) will be inefficient and recessive to the extent that these policies do not influence the investment factors which are also affected by the crisis, namely, the

process of generating foreign currency and the fiscal budget for public investment.

In this article, we build a macroeconomic model that shows the above interrelationships. It tries to show that the formation of *ex post* saving, or saving effectively materialized, differs according to whether the balance of payments and the fiscal budget act as restrictive variables or not. The presence of two possible gaps, external and fiscal, means that there are four potential situations, according to whether each one, both, or neither exerts a restrictive pressure. In each case, the most suitable policies for promoting domestic saving are indicated.

## I

### The model

To deal with the external debt crisis, Latin American economies have been forced to put into effect economic policies that have moved them away from full employment. Unemployment and idle installed capacity suggest the adoption of a Keynesian analytical model, according to which the product is determined by the effective demand side.

Thus we assume that the economy produces a generic good in quantity "Y", which is offered at price "p"; the effective product is determined by the quantity demanded of the product at price p,  $D(p)=Y$ .

The domestic product is offered on both the internal and external markets. In the latter, the domestic good faces a negatively sloped demand<sup>4</sup> at the relative price between the domestic good and a generic good produced abroad at price  $p^*$ . Since both prices —p and  $p^*$ — are denominated in different currencies, the number of units of

the local currency per unit of foreign currency being e, the relative price between them is  $ep^*/p$ , which we will call the real rate of exchange (TR).

For the sake of simplicity, we set  $p^*=1$  as the unit value of the exchange rate of the model, making  $TR=e/p$ . We will describe below the equations that regulate the different components of effective demand.

#### 1. The public sector

Government consumption is considered exogenous or, to be more exact, as one of the instruments of fiscal policy.

Thus,

$$(1) \quad CG = \overline{CG},$$

where CG represents government consumption in units of the domestic good.

Tax receipts originate, on the one hand, in direct taxes on residents' income, and on the other hand, in indirect taxes on both the domestic good and the imported good.

$$(2) \quad T = t Y + B TR M,$$

where t is the average tax rate (direct and indirect) per unit of the domestic good produced,

<sup>2</sup>Furthermore, inflationary adjustment deteriorates tax receipts (Tanzi, Blejer and Teijeiro, 1987).

<sup>3</sup>Table 3 shows that the trends in public investment, total investment and domestic saving differ in Chile from those in the rest of the region. For an analysis of the Chilean case, see Eyzaguirre (1989).

<sup>4</sup>The offer of the domestic product is infinitely elastic, so that if its external demand were also, the level of the product would remain undetermined.

while  $B$  represents the combined rate of average customs duties and indirect taxes paid on the imports ( $M$ ). These latter are measured in units of the imported good.

$$(3) \quad YDG = T - DPENC - TR DPEFC \\ - r BGP - TR r^* BGX$$

We call the difference between tax receipts and a group of financial entries that will be spelled out below disposable government income ( $DGY$ ). The deficit of public enterprises in national currency and foreign currency is represented by  $DPENC$  and  $DPEFC$ , respectively (if there were a surplus, the sign before the entry would be changed).<sup>5</sup> Bonds issued by the government and sold to the general public ( $BGP$ ) pay a fixed nominal interest. Assuming that the public keeps the real volume of these bonds at least constant, the servicing of the government's domestic debt is given by  $r BGP$ , where  $r$  is the real interest rate. Lastly,  $BGX$  represents public-debt securities issued in foreign currency at the international interest rate,  $r_i$ .

Disposable government income ( $DGY$ ) equals the volume of government expenditure capable of being financed without having to resort to increasing the volume of the real domestic public debt, the monetary base or the external indebtedness of the public sector.

Let us now introduce the concept of fiscal constraints. We will speak of dominant fiscal constraints if the government cannot acquire more real domestic debt,<sup>6</sup> if it is inadmissible or impossible to increase inflation tax receipts and if its capacity to increase external indebtedness is exogenously determined.<sup>7</sup>

The public-sector deficit is given by:

$$(4) \quad PSD = DBGP + DBGX TR + \pi m,$$

<sup>5</sup>The formulation assumes that public enterprises do not issue their own debt securities.

<sup>6</sup>We adopted an extreme presupposition to make the model simpler. Assuming that, within a certain range, the government can acquire more domestic debt if it offers a higher interest rate. However, this range will probably be narrow if the public's perception is that the government cannot possibly service its debt in the future. In this latter case, the government would be incapable of financing its deficit by issuing domestic debt.

<sup>7</sup>This is the situation that in practice has been in effect since the crisis of 1982.

where  $DBGP$  is the increase in the real volume of public-sector domestic indebtedness,  $DBGX$  is the increase in public sector external indebtedness in units of foreign currency,<sup>8</sup>

$\pi$  is the rate of inflation,

$m$  is the real money supply,<sup>9</sup>

$\pi m$  is the real receipts of inflation tax.<sup>10</sup>

Thus the dominant fiscal constraints are the equivalent of  $DBGP=0$ ,  $DBGX=F$  and  $\pi m=k$ , where  $F$  is the net exogenous flow of capital from abroad and  $k$  a constant.

Finally, government investment is given by:

$$(5) \quad GI = DGI = DGY - CG + PSD$$

if the fiscal constraints are not dominant (NDFC).<sup>11</sup>

Note that if the government can finance  $PSD$ , public investment is a policy variable ( $\bar{GI}$ ) determined on the basis of medium-term considerations; in this case the adjustment variable is  $PSD$ . On the contrary, if fiscal constraints are dominant (DFC), the  $PSD$  is fixed and the variable that is adjusted is government investment.

$$(6) \quad GI = DGY - CG + k + TR F$$

if fiscal constraints are dominant.

## 2. The private sector

Private sector consumption, measured in units of the domestic good, is given by:

$$(7) \quad CP = C_0 + C_1 (Y - t Y + r BGP \\ - TR BPX r^* - \pi m) - C_2 TR - C_3 r,$$

<sup>8</sup>Note that, given  $p^* = 1$ , units of foreign currency is the equivalent of units of the foreign good.

<sup>9</sup>For the sake of simplicity, we assume that the real demand for money  $m$  is constant. The other possibility would be to introduce a demand function for money that would relate the demand to income and the interest rate. Such a formulation would make it possible to include changes in seigniorage.

<sup>10</sup>In this formulation we take the case of the economic authority who avoids financing the public debt through a money issue that accelerates the rise in prices. Thus inflation is not caused by excess demand, but is merely inertial, and the government collects the consequent inflation tax.

<sup>11</sup>Note that the option is to model public investment as an adjustment variable and government consumption as a policy variable. The purpose is to show that government consumption is relatively less flexible.

where BPX represents private-sector external indebtedness in units of foreign currency.

The term in parentheses approximates the disposable income of the private sector. The real exchange rate exerts a negative influence on private consumption, under the implicit assumption that the real exchange rate correlates inversely with real wages and that workers' propensity to consume is higher than that of capitalists. Finally, the real interest rate is postulated to be a variable that negatively affects private-sector consumption, by acting as a relative price between present and future consumption.<sup>12</sup>

In turn, private-sector investment is explained as a function of the product, government investment and the real interest rate.

$$(8) \quad PI = I_0 + I_1 Y + I_2 GI - I_3 r$$

Implicit in this formulation is that public investment is complementary to private investment.<sup>13</sup> Thus a larger public investment (for example, in infrastructure) improves the profitability of private projects and pushes up private investment. For its part, the real interest rate approximates the cost of capital.

### 3. The external sector

The equations that describe foreign trade correspond to the behaviour of imports and exports, as well as to the movement of international reserves.

$$(9) \quad M = M_0 + M_1 Y + M_2 (PI + GI) - M_3 (1 + B) TR$$

<sup>12</sup>Consumption could have been modeled on the basis of wealth, approximating it by (disposable income/ $r$ ). The practical impossibility of lending and borrowing at the  $r$  rate, without constraints of time and quantity, makes it recommendable to model income and the interest rate as separate arguments. It should be noted, on the other hand, that, all else being equal, private saving is directly linked to the interest rate. However, on the general equilibrium level, the correlation between saving and the interest rate may be inverse, as we will see further on.

<sup>13</sup>Note that the complementarity of public investment and private investment takes on a technical character in (8), in the sense that private investment requires public investment to provide infrastructure, services, etc. The so-called "crowding-out effect", by virtue of which public investment would displace private investment by competing for financing, comes from the indirect impact via interest rates. This is also included in the model.

It is assumed that the number of units of the foreign good demanded by the residents is positively correlated with the product and with total investment. On the other hand, a relative price rise between the foreign good and the domestic good  $\{(1+B) TR\}$  will discourage demand for the imported good.

$$(10) \quad X = X_0 + X_1 TR$$

The number of units of the domestic good sold abroad ( $X$ ) is determined by the external demand for the domestic product. The cheaper the domestic good compared to the foreign good, that is, the higher the real exchange rate, the greater the demand. By construction, in this model an improvement in the terms of trade is approximated by a rise in  $X_0$ , for a given real exchange rate.<sup>14</sup>

$$(11) \quad \Delta R = F - r^* (BGX + BPX) + (X/TR) - M$$

Finally, the result of the balance of payments, expressed in units of foreign currency, is given by the difference between the net transfer of resources from abroad  $\{F - r^* (BGX + BPX)\}$  and the result of the trade balance  $\{(X/TR) - M\}$ . We speak of the dominant external constraints (DEC) if the economic authority, faced with an unsustainable loss of international reserves, imposes an equilibrium on the balance of payments,  $\Delta R = 0$ .

### 4. The closures of the model

The existence of two possible fiscal régimes (dominant and non-dominant fiscal constraints) and of two possible situations of foreign trade (dominant and non-dominant external constraints) comprise four conceivable closures for the model.

#### a) Both sets of non-dominant constraints (case I)

In this case, the economy in question has a financially solvent public sector, with the capacity to face its current expenditures and invest-

<sup>14</sup>In more rigorous terms, it is a question of a positive displacement of foreign demand for the domestic good.

ment costs, either through current income or through the sale of public debt. Its external position is also solid and financing the balance of payments presents no problems.

The model is closed with the equation for determining the product on the side of effective demand.

$$(12) \quad Y = CP + CG + PI + GI + X - TR \quad M$$

Given the above, equations (3), (4), (6) and (11) are inactive, i.e., they do not contribute to determining the endogenous variables. The domestic interest rate is defined by the monetary policy, while the tax rate, government consumption and investment respond to fiscal policy. The exchange rate, finally, is also a policy variable.

Reducing the model to its basics, case I could be described by four equations:

$$Y - PI - CP + TR \quad M = CG + GI + X_0 + X_1 \quad TR$$

$$I_1 \quad Y - PI = -I_0 + I_3 \quad r - I_2 \quad GI$$

$$C_1 (1 - t)Y - CP = -C_0 + C_1 \quad \pi m + TR \\ (C_1 \quad r^* \quad BPX + C_2) + r (C_3 - C_1 \quad BGP)$$

$$M_1 \quad Y + M_2 \quad PI - M = -M_2 \quad GI - M_0 + \\ M_3(1 + B) \quad TR$$

b) *Dominant fiscal constraints and favourable external conditions* (case II)

In this case, the critical macroeconomic variable is the domestic transfer of resources from the private to the public sector, i.e., the inability of the State to finance its plans for current expenditure and investment. This economy will typically face problems in financing the public deficit, but it may well have favourable external accounts.<sup>15</sup>

In this situation, changes in available public-sector financing (motivated, for example, if  $BGX > 0$ , by a rise in the international cost of credit or by a decline in the refinancing of outstanding interest) will require that an adjustment be made in the amounts of public investment. Given the complementary nature of public and private investment, an adjustment of the former will affect the amount of the latter and, *ex post facto*, the economy's level of aggregate domestic saving.

The model that describes case II can be seen in the following five equations:

$$Y - GI - PI - CP + TR \quad M = CG + X_0 + X_1 \quad TR$$

$$t \quad Y - GI + B \quad TR \quad M = DPENC + CG - k \\ + TR(DPEFC + r^* \quad BGX - F) + r \quad BGP$$

$$I_1 \quad Y + I_2 \quad GI - PI = -I_0 + I_3 \quad r$$

$$C_1 (1 - t) - CP = -C_0 + C_1 \quad k \\ + TR (C_1 \quad r^* \quad BPX + C_2) + r (C_3 - C_1 \quad BGP)$$

$$M_1 \quad Y + M_2 \quad GI + M_2 \quad PI - M = -M_0 \\ + M_3 (1 + B)TR$$

c) *Dominant external constraints and favourable fiscal conditions* (case III)

This case symbolizes the problem of an economy that faces serious problems in financing its balance of payments but not its fiscal accounts. Here the problem is one of an external, not domestic, transfer of resources. The government can finance its plans for consumption and investment, either directly through taxation or by selling domestic debt (bonds or money). However, the overall economy is confronted with an imbalance in international payments, and neither the public nor the private sector can sell abroad the amount of bonds needed to finance this imbalance.

We make the dominant external gap operational by means of  $\Delta R = 0$ . The subsystem (9)-(11) indicates that, given a certain level of investment, the level of product is determined by the external imbalance; or, more precisely, there is a level of maximum domestic product compatible with the external accounts. When that level of production is less than full-employment production, we speak of a dominant external gap.

There is no guarantee, however, that the level of product that satisfies equation (12) is the same as the level implicit in the subsystem (9)-(11). This is an important point; if effective demand (equation (12)) determines a level of production higher than the one compatible with the external gap, the economy will begin to lose international reserves. The economic authorities will then be forced to contract effective demand; to do so they could reduce public expenditures, modify the exchange rate and/or regulate the real interest rate through the monetary policy. However, since government consumption and

<sup>15</sup>This was clearly the case of Brazil in 1988.



investment are usually variables, with little flexibility and determined by considerations other than that of regulating effective demand, we will assume that the adjustment will be made through the monetary policy.<sup>16</sup> In other words, in conditions of a dominant external gap, the monetary policy will adjust the interest rate to make effective demand compatible with the external constraints.<sup>17</sup>

In case III, since we are assuming the existence of favourable fiscal conditions, equation (5) once again replaces equations (3) and (6), while equation (11) is also activated. Unlike the previous cases, the interest rate becomes an endogenous variable. The case can be described by the following five equations:

$$Y - PI - CP + TR M = CG + GI + X_0 + X_1 TR$$

$$I_1 Y - PI - I_3 r = -I_0 - I_2 GI$$

$$C_1 (1 - t)Y - CP - (C_3 - C_1 BGP) r = -C_0 + C_1 \pi m + TR (C_1 r^* BPX + C_2)$$

$$M_1 Y + M_2 PI - M = -M_2 GI - M_0 + M_3(1 + B)TR$$

$$TR M = TR \{F - r^* (BGX + BPX)\} + X_0 + X_1 TR$$

d) *Dominant fiscal and external constraints (case IV)*

Let us examine the last case, which is the most complicated situation. The economy faces problems of financing the public sector and the balance of payments, i.e., it suffers from problems of both domestic and external transfers. As we pointed out above, it is not a question of mere academic speculation; rather, since external shocks —such as the 1982 crisis— may affect both equilibria, this is currently the most common economic-policy problem in many countries of the region.

<sup>16</sup>The adjustment can also be made through the exchange rate. However, that entails modifying the real rate of exchange, which presupposes changing real wages (at least in the short term); and, on the other hand, the effect of the real exchange rate on demand is less precise (Krugman and Taylor, 1978).

<sup>17</sup>If reserves are being lost, the monetary policy can raise the interest rate to reduce effective demand. However, the contrary is not necessarily true. If external conditions were favourable, the interest rate could not fall below the minimum level necessary to avoid capital flight. When the real exchange rate is fixed, that minimum level is approximately equal to the international interest rate, less external inflation, plus the country risk.

The model that synthesizes case IV once again activates equations (3) and (6) instead of (5). The external constraints (equation (11)) remain operative and, for that very reason, the interest rate is an endogenous variable. The case can be described by the following six basic equations:

$$Y - GI - PI + TR M = CG + X_0 + X_1 TR$$

$$t Y - GI + B TR M - r BGP = DPENC + CG - k + TR(DPEFC + r^* BGX - F)$$

$$I_1 Y + I_2 GI - PI - I_3 r = -I_0$$

$$C_1 (1 - t)Y - CP - (C_3 - C_1 BGP) r = -C_0 + C_1 k + TR (C_1 r^* BPX + C_2)$$

$$M_1 Y + M_2 GI + M_2 PI - M = -M_0 + M_3(1 + B)TR$$

$$TR M = TR \{F - r^* (BGX + BPX)\} + X_0 + X_1 TR$$

5. *The factors that determine saving*

Having laid out the model in its separate phases, we can now explicate the underlying theory regarding the determination of the domestic interest rate in the economy. When we introduced the model, we spoke of idle installed capacity and of determining the product through effective demand. With respect to the process of saving and investment, this is equivalent to introducing the fundamental distinction between *ex ante* saving and *ex post* saving, i.e., to considering saving as a derivative amount basically resulting from effectively implemented investment programmes.

The national accounts establish that,

$$(13) \quad DS = Y - CG - CP,$$

where DS is domestic saving, measured in units of the domestic good.

Using (12) we have

$$(14) \quad DS = PI + GI + X - TR M$$

And if external constraints are dominant,

$$(15) \quad DS = PI + GI - TR \{F - r_i (BGX + BPX)\}$$

What is fundamental here is the direction of the causality: it goes from investment to saving and not vice versa. The level of investment, both public and private, is an endogenous variable,

whose value is the result of all the variables that operate in the model. Furthermore, the factors that determine investment—and by extension, saving—vary, depending on whether the fiscal and external constraints are operative or not. We thus arrive at the main argument of this article, namely that the economy's aggregate saving, and therefore, the policy measures to affect it, are determined by the prevailing fiscal and external macroeconomic constraints.

The above analysis is valid wherever the external debt crisis in the Latin American countries has generated macroeconomic situations characterized by high unemployment, huge fiscal deficits—with consequent inflationary pressures—and disequilibria in the balance of payments. For a different economic situation, for example, one in which there is an abundant flow of voluntary credit and full employment, the above model would have to be reformulated.

## II

### The results

The economy's level of domestic saving and investment, as we saw above, depends on the system of dominant gaps. In this section, we study the effect produced by a range of policies and shocks in exogenous variables on the reduced function of domestic saving and total investment.

We are particularly interested in isolating the effect of some selected variables. First, we will investigate the impact of monetary policy through changes in the real interest rate.<sup>18</sup> We should stress that we can do so only if the external constraints are not dominant, because when they are, monetary policy becomes endogenous.

We will then analyse the impact of a group of fiscal policy variables, namely, government consumption, the tax rate<sup>19</sup> and the deficit (surplus), in both national and foreign currency, of public enterprises.

Finally, we will examine the effect of the changes originating in the external sector of the economy. Changes in the real rate of exchange belong in this category.<sup>20</sup> We also consider

changes in the terms of trade (estimated through changes in  $X_0$ ), in the international interest rate and in the flow of capital from abroad.

To establish the impact of various policies and shocks on the exogenous variables, we will calculate the slopes of saving and investment with respect to the elements in question.<sup>21</sup> However, given the structure of the model, the signs of the different elements of the slopes cannot be determined *a priori*; to further understand the effects we need make some assumptions about the basic data and the elasticities of the structural model.<sup>22</sup>

#### 1. Basic assumptions about variables and parameters

In formulating these assumptions, we have attempted to keep some variables free—particularly the debt levels of the various agents, the deficit of public enterprises and the flow of capital—for the purpose of achieving general results.<sup>23</sup> The “free” variables were

<sup>18</sup>This effect, although in the framework of another kind of model, has received a good deal of attention in the literature. Studies on this question are found in Fry (1980), Giovannini (1983), Blinder (1975) and Boskin (1978).

<sup>19</sup>For the purposes of this model, a change in the degree of tax evasion has similar repercussions.

<sup>20</sup>The effect of real devaluations on the product has been widely studied. Classical references on the subject, in the context of developing countries, are Cooper (1971), Diamand (1978) and Krugman and Taylor (1978). The impact of devaluations on saving derives in part from repercussions on the product.

<sup>21</sup>The analytical solution of the endogenous variables in the four cases described presented enormous difficulties of algebraic resolution. We were able to overcome these obstacles thanks to the recently developed, computer programme “Maple”, which was capable of handling the equations. Even so, the algebraic structure of the gradient of saving is, in the four cases, very extensive. It is set out in detail in Eyzaguirre (1989).

<sup>22</sup>Since we do not have an econometric estimate of the model at this stage.

<sup>23</sup>We could have also assigned values to each of the variables and parameters and simulated the model. However, this alternative is generally valid only as an example.

selected precisely to make more flexible the factors that are most essential in differentiating among macroeconomic structures, namely, the levels of domestic and external debt and the foreign currency position of the public-sector flow.

The basic assumptions are as follows:

i) Ratios to the product: exports (0.25), imports (0.20), public investment (0.1), private investment (0.05), government consumption (0.2) and private consumption (0.6).

ii) Elasticities: all the product elasticities (imports, private investment and private consumption) are equal to unity. The price elasticities of imports and exports are both set at 0.5 (thus ensuring that they will remain within the limits of the Marshall-Lerner condition).

The elasticities of private investment and consumption, in relation to the real interest rate, are fixed at 0.5 and 0.05. The effect of the real exchange rate on private consumption, in terms of elasticity, is set at 0.12.

iii) Tax rate, 20%; taxes on imports, 30%; inflation tax, equal to 3% of the product.

Two exercises are performed on the basis of these data. The first is to find the sign of the influence of the various factors that determine saving and investment, allowing the free variables to fluctuate within reasonable ranges.<sup>24</sup> Expressed in percentage points of GDP, these are as follows:

BGX	: between 10 and 80
BPX	: between 0 and 40
BGP	: between 0 and 60
DPENC	: between 0 and 6
DPEFC	: between -10 and 0
F	: between 2 and 8

A run of the free variables yields an interval for each element of the saving and investment slopes. The effect of the different variables will be considered positive if the interval does not represent negative values, and vice versa. If the

<sup>24</sup>The ranges come from data taken from Latin American countries. For example, according to data provided by ECLAC, the coefficient of the external debt (1982-1987 average) fluctuates between 25% for Colombia and 110% for Costa Rica. In the case of government domestic debt, the case of Mexico can be cited: in 1986, the respective coefficient reached 62.8%, although it was projected to drop to 50.6 in 1987, according to data supplied by the Office of Financial Planning.

possible interval contains both negative and positive values, the corresponding variable will be considered to have an ambiguous effect.

The second exercise consists of choosing a value within each interval, in order to calculate the elasticities of saving and investment in relation to each of their determinant factors. For this purpose, the average value of the above-mentioned intervals was adopted in each case.

## 2. *The impact of the interest rate*

Before analysing the effect of the real interest rate on saving and investment, we might do well to note the way in which the rate is determined, according to this model. The monetary authorities, by buying and selling Central Bank bonds that pay a certain real interest,<sup>25</sup> regulate the interest rate of the economy. When there are external constraints, the interest rate is fixed at a level that makes overall demand compatible with these constraints. In other words, if the Central Bank begins to lose international reserves, it can "brake" the speed of domestic activity by raising interest rates and vice versa.

When the external constraints are non-dominant, the interest rate ceases to be an endogenous variable and can be freely changed by the economic authorities. This happens in case I, in which both constraints are non-dominant, and in case II, in which the economy faces a fiscal problem.<sup>26</sup>

Given the parameters assumed above, the impact of a rise in the interest rate on investment is negative in case I (the model without constraints). With fiscal constraints (case II), the impact is even more negative, since in addition to the direct impact of the higher interest rate on private investment, there is also a reduction of public investment, owing to the increased burden of servicing the domestic public debt.

<sup>25</sup>Or via the discount rate.

<sup>26</sup>A high fiscal deficit can lead to a strong expansion of money through credit to the public sector. Nevertheless, even in these conditions, the monetary authorities can affect aggregate demand by buying and selling Central Bank bonds, changing the discount rate or providing credit to the private sector. That is to say, fiscal constraints do not imply that the monetary authorities lose control over the interest rate and aggregate demand. (I am grateful to Roberto Zahler for a discussion on this point, although any remaining misunderstandings are my own responsibility.)

Table 4

## ELASTICITIES OF DOMESTIC SAVING (S) AND INVESTMENT (I)

Variable	System	Case I (NDFC-NDEC)	Case II (DFC-NDEC)	Case III (NDFC-DEC)	Case IV (DFC-DEC)
Interest rate	S	-0.13	-0.46	a	a
	I	-0.36	-1.20	a	a

<sup>a</sup>In these cases the interest rate is endogenous.

The effect of the rise in the interest rate on saving is also negative in both cases, since the impact is greater when there are fiscal constraints. The drop in saving is due to the fact that the decline in investment leads to a bigger reduction in the product than in consumption.

It may be concluded, then, that it is possible to increase saving by lowering the rate of interest; the efficiency of the measure will depend on how favourable external conditions are, and on the amount of idle capacity. Table 4 presents the elasticities obtained in each case.

### 3. The impact of fiscal-policy variables on the level of domestic saving and investment

#### a) Government consumption

In the model with no constraints, the impact of government consumption on the economy's level of investment is positive. The reason is found in the traditional Keynesian argument concerning the multiplier effect of fiscal policy on the product and the consequent increase in investment induced by expanded demand. However, with external constraints (case III), the so-called "crowding-out effect" is found. This is a partial encroachment of public expenditure on investment. The increase in effective demand derived from higher government consumption encourages imports, and consequently the balance of payments deteriorates; the economic authorities are then obliged to intervene by raising the interest rate, which discourages private investment. If the economy also has fiscal problems (case IV), the displacement effect is even greater, in so far as government consumption is expanded at the expense of public investment. Finally, the negative impact of government con-

sumption reaches its highest value when there are only fiscal constraints (case II). With fiscal constraints, public consumption completely overrides public investment, and the lower level of public investment discourages private investment, generally resulting in a contraction of effective demand and a fall in the product. Nevertheless, in this case the recessive component can be avoided by lowering the interest rate.

The above can be better explained with the aid of a diagram (figure 1). In the space  $(y,r)$ , the equilibrium of the goods market (BB) has a negative curve, due to the negative effect of a rise in the interest rate on private consumption and investment. The external equilibrium (XX) is inelastic, in so far as the balance of payments is not directly affected by the domestic interest rate (throughout the model we have assumed that the external flow of capital  $F$  is an exogenous variable). Finally, the fiscal equilibrium (FF) shows a positive curve, in so far as the rise in the interest rate increases the burden of servicing the domestic public debt and an expansion of the product increases tax receipts.

Figure 1

#### THE EFFECTS OF EXPANDED GOVERNMENT CONSUMPTION

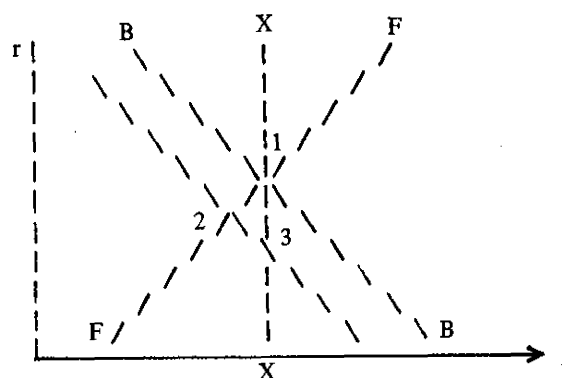


Table 5

## ELASTICITIES OF DOMESTIC SAVING (S) AND INVESTMENT (I)

Variable	System	Case I (NDFC-NDEC)	Case II (DFC-NDEC)	Case III (NDFC-DEC)	Case IV (DFC-DEC)
Government consumption	S	-0.18	-0.94	-0.43	-0.51
	I	0.11	-1.84	-0.57	-0.67
Taxes	S	0.09	0.46	0.24	0.35
	I	-0.05	1.51	0.32	0.47
Deficit of public enterprises in national currency	S	-	-0.19	-	<sup>a</sup>
	I	-	-0.48	-	<sup>a</sup>
Deficit of public enterprises in foreign currency	S	-	-0.31	-	<sup>a</sup>
	I	-	-0.80	-	<sup>a</sup>

<sup>a</sup>The effect is ambiguous.

In the presence of fiscal constraints, since expanded government consumption completely replaces public investment and depresses private investment, the equilibrium BB moves down. In case II, the economy remains at point 2; and in case IV—the case in which the level of total investment is highest—the economy is at point 3.

The effect of expanded government consumption on domestic saving is also generally negative.<sup>27</sup> The reasoning is very similar to that concerning investment. For cases III and IV, the effect on saving is the same as the effect on investment. With external constraints, since the change in government consumption cannot affect the trade balance—which is determined by the net transfer of resources from abroad—saving and investment move together.<sup>28</sup> In case I, the economy without constraints, the increase in government consumption promotes domestic saving, through the multiplier effect. Finally, in case II, the negative impact of government consumption on domestic saving is at its greatest, given the recessive effect commented on above.

<sup>27</sup>The type of relationship established in this model between public saving and private saving is generally contradictory to the equivalency hypothesis of Ricardo (Barro, 1974).

<sup>28</sup>National accounts show that investment is equal to saving plus the amount of the trade balance.

Table 5 shows the positive or negative effect of government consumption on investment and saving in the different cases, as well as estimates of the elasticities involved.<sup>29</sup>

#### b) *The impact of taxes*

The effect that a change in the tax rate (and/or the degree of tax evasion) has on investment and saving also shows important differences according to the dominant system of gaps.

In the model without constraints, an increased tax burden will contract investment. The increase in taxes reduces disposable personal income and private consumption, thereby depressing the product and investment. However, if the external gap is dominant (case III), the reduced consumption generates favourable external conditions, allowing for a reduction of the interest rate and an increase in investment. If there are also fiscal constraints (case IV), the positive effect on investment is even greater in so far as the higher fiscal receipts make it possible to expand public investment and encourage private investment. If there are only fiscal constraints, the impact is highest, since the recovery of public and private investment allows for an

<sup>29</sup>Note that the value of the elasticities is influenced by the assumptions about some of the parameters of the structural model.

Table 6

## ELASTICITIES OF DOMESTIC SAVING (S) AND INVESTMENT (I)

Variable	System	Case I (NDFC-NDEC)	Case II (DFC-NDEC)	Case III (NDFC-DEC)	Case IV (DFC-DEC)
External demand	S	0.51	0.82	0.94	0.99
	I	0.07	0.83	1.25	1.33
Real exchange rate	S	0.44	0.43	<i>a</i>	0.24
	I	<i>a</i>	<i>a</i>	<i>a</i>	<i>a</i>
External flow of capital	S	-	0.31	0.23	0.28
	I	-	0.80	0.65	0.70
External interest rate	S	-	-0.30	-0.69	-0.30
	I	-	-0.80	-0.90	-0.87

<sup>a</sup>The effect is ambiguous.

expansion of both aggregate demand and the product, which in turn induces further investment.

The behaviour of saving in relation to taxation differs slightly from that of investment. In the model without constraints domestic saving, unlike investment, expands in reaction to an increased tax burden. This is due to the fact that consumption is reduced more than the product; the trade balance improves, since investment decreases; and domestic saving rises, resulting in a more favourable balance of payments. In all the other cases, the effect of higher taxes on saving is positive and the impact even greater. The elasticity of saving in relation to taxes is particularly sensitive to the tightness of the fiscal budget (table 5).

c) *The deficit of public enterprises*

Variations in the results of public-sector enterprises have little influence on saving and investment if the State has a margin of indebtedness or a favourable fiscal situation. However, when fiscal constraints exist, an improvement in the public-enterprise balance makes it possible to recover public investment and hence private investment and saving (this latter item rises in case II, since when public investment first recovers, the product grows more than consumption).

If external constraints also exist (case IV), the impact on saving and investment is ambiguous. The increase of public investment, which would allow for improving the financial situa-

tion of the State enterprises, exerts pressure on aggregate demand and the balance of payments. With external constraints, the economic authorities have to slow down the rate of activity by raising interest rates.

4. *The impact of the external sector*

a) *Increase in external demand*

In the framework of this model, an increase in external demand for the domestic product (and/or an improvement in the terms of trade) has a positive effect on the formation of saving and the level of investment in all the cases. But the magnitude of the impact grows the more the economy is constrained.

Let us first look at the effect on investment. In the model without constraints, a growth in exports leads to an expansion of the product and investment, through the multiplier effect. With fiscal constraints and an increase in exports and the product, there is an expansion in tax revenues and thus in public and private investment. In turn, the inflow of foreign currency increases, making possible a financed expansion of domestic demand when external constraints are dominant.

The effect on domestic saving is similar. In the model with no constraints, the product grows more than consumption, causing saving to rise and the trade balance to improve. Saving expands in all the other cases and the elasticity reaches its highest value in case IV (table 6).

b) *Exchange policy*

The effects of a real currency devaluation on the formation of saving and the level of investment are generally ambiguous. Devaluations trigger a variety of effects, whose relative importance varies according to the prevailing dominant gaps.

A real devaluation encourages exports while inhibiting the demand for imports, and makes each unit of the imported good more expensive in real terms. The net impact of the previous changes on the trade balance is studied in the so-called Marshall-Lerner condition. On the other hand, a real devaluation has an impact on real wages and on private external debt servicing, resulting in lower private consumption.

In choosing the parameters, the sum of the price elasticities of exports and imports was posited to be equal to one; nevertheless, as the export coefficient is greater than the import coefficient, the net impact of the real devaluation on the trade balance is slightly positive. Since the devaluation contracts private consumption in the model without constraints, the total impact on aggregate demand is ambiguous. Also in case I, the effect on saving is positive, in so far as private consumption declines.

Another effect is added when there are fiscal constraints: the devaluation affects the fiscal budget, favourably or unfavourably, according to the sign of the fiscal position in foreign currency ( $F - r^* BGX - DPEFC$ ). Countries with a high external fiscal debt and low direct public income in foreign currency (i.e., DPEFC slightly negative or close to zero) will be unfavourably affected, and vice versa. For this reason, the impact of the devaluation on the product and on investment remains ambiguous. The effect on saving is positive, while private consumption decreases.

If external constraints are present, the product grows if they are weakened by the devaluation. This depends on the Marshall-Lerner condition, which was assumed to be zero in this case; therefore, the effect on investment remains ambiguous, as in case IV.

In short, the devaluation will tend to favour investment in so far as the price elasticity of imports and exports is greater, and to favour government income in foreign currency to the extent that private indebtedness abroad is lower and the propensity of capitalists to consume is more on a par with that of workers. These last two factors have an inverse effect on saving.

c) *The net flow of capital and the interest rate*

The effect of these two variables —which together with the volume of domestic debt determine the net transfer of external resources (NTER)— is very important if the economy is faced with some type of constraint. An increase in the net flow of capital and/or a reduction in the international cost of credit —which is equivalent to an increase in NTER— makes it possible to relax external and fiscal constraints simultaneously. Saving rises in all the cases with constraints (II, III, IV), and so does investment.

The increase in NTER makes it possible to recover fiscal and private investment in cases II and IV; in case III, where there are only external constraints, the initial favourable situation of foreign currency allows for a more expansionary economic policy. If this leads to lower interest rates, private investment recovers as a consequence of both the lower cost of credit and the expansion of domestic demand.

The corresponding elasticities are given in table 6. We should point out that in the economy without constraints (case I), the impact of NTER is nil in the context of this model. This is because it is assumed that economic policy regulates the changes in NTER via the volume of international reserves (and monetary effects are nullified, since there is no change in  $r$ ). It is possible —and this in fact happened in Latin America towards the end of the 1970s— for the effect of a rise in NTER to be negative for saving in case I, if the new resources are allocated to finance plans for private or government consumption. In this situation, external financing replaces domestic saving.

### III

## Conclusions

The empirical evidence on recent trends in consumption, domestic and external saving and the rate of investment in Latin American countries raises some basic questions about the causes of these trends. The spectacular fall in external financing brought on by the debt crisis has dealt a hard blow to available investment funds; per capita consumption, in turn, has also plummeted during the adjustment process. However, the reduction in consumption has not led to a greater availability of domestic saving, which would have prevented the decline in external financing from being adjusted, as it was, through an equivalent deterioration in the investment rate. On the contrary, consumption and the per capita product declined in parallel fashion, the rate of domestic saving remained unchanged and investment dropped by the same amount as net external financing or the financial transfer of resources. This is what we have called useless austerity.

The basic assumption on which we have based this article is that the reduction of external financing has given rise to severe constraints in the foreign currency budget (external gap) and public-sector budget (fiscal gap), besides undermining the capacity for saving. This seems to have produced a change in the nature of macroeconomic functioning. We have particularly highlighted the way in which such gaps contract investment and thereby frustrate efforts to increase private saving. The reasoning adopts a clearly Keynesian approach: the scarcity of investment produces a recessive adjustment, and the potential excess of saving disappears as income drops.

It is certainly paradoxical that a crisis provoked by a decline in saving (in this case, external saving) should lead to a situation characterized by an excess of saving. This needs to be explained. The reduction or cessation of external financing produces a contraction of public saving, and ultimately, of public investment, an effect that may be likened to a lack of saving. Nevertheless, in the private sector, the decline in public investment and the recession

brought on by the adjustment to the external gap discourage investment. Here is where the potential additional saving dries up.

The analysis of macroeconomic functioning under the different systems of gaps—external, fiscal, both or none—helps in identifying the policies capable of increasing investment and domestic saving. The analysis also studies the impact of changes in variables beyond the control of economic policy on saving and investment.

An increase in government consumption and/or tax relief tend to be expansionary in an economy without serious budgetary constraints, be they fiscal or from the balance of payments. Both policies favour investment, although tax relief discourages domestic saving somewhat (see the elasticities in table 2). However, with fiscal and/or external constraints, government consumption crowds out investment and discourages the formation of saving, while taxation encourages saving and investment.<sup>30</sup> If there are external constraints, and the level of the product therefore remains subordinate to the equilibrium of the balance of payments, fiscal austerity makes it possible to recover investment; if fiscal constraints exist, the substitution is indirect. This is the case of useful austerity.

The effect of a rise in the interest rate tends to be negative for the formation of saving and the level of investment, even in the case of an *ex ante* reduction in consumption. The adverse impact of the real interest rate is much stronger where there are fiscal constraints.

The effect of the exchange policy also depends on the kinds of gaps present. Without fiscal and external constraints, the impact of a devaluation will depend on the price elasticities of exports and imports and on the level of private external debt, as well as on the effect of that devaluation on real wages, and of this latter on

<sup>30</sup>Taxation is generic in this model. Obviously, a breakdown of taxes would make it possible to draw more precise conclusions; it cannot be supposed, for example, that taxes on profits have the same effect as indirect taxes.



private consumption. However, with fiscal constraints, the devaluation will also have repercussions on public investment, in the sense that it will depend on the foreign currency flow position of the public sector. This last effect will tend to be positive the higher the direct income of the State in foreign currency (when export activities are in the hands of the State) and the lower the effective servicing ( $r^* \times BGX - F$ ) of the public debt. External constraints slightly change the conditions for an expansionary devaluation of the model without constraints; what is important in this last-mentioned case is the effect on the trade balance, in national currency, while in the case of fiscal constraints, what is key is the impact on the trade balance in foreign currency, which is more restrictive.

A positive shock in external demand is in all cases favourable to saving and investment, but its impact is much greater when there are constraints on the economy. Such a shock improves the balance of payments and the fiscal budget, the impact on the latter being greater if the shock takes place in exports controlled by the State.

Finally, external financing appears clearly complementary to domestic saving and investment when the economy suffers constraints. Consequently, the present emphasis on improv-

ing the net transfer of resources points in the right direction. We should emphasize that the effect of external financing on saving and investment is not clear—it can even be negative—if the economy is free of constraints.

In short, since the external debt crisis has resulted in external and fiscal problems in most of the countries of the region, we can draw some relatively general policy conclusions. First, limiting the negative transfer abroad of resources clearly favours the recovery of domestic saving and investment. Second, moderating government consumption and raising taxes—by increasing tax rates or improving collection methods in order to minimize evasion—are unavoidable policies for recovering growth in the future. Otherwise, fiscal investment will make the adjustment, while discouraging private investment in the process. Finally, exchange policy must be handled with enormous caution, attending to the specificities of each case. If the State carries out significant share of export activities and its effective payments for external indebtedness do not produce a deficit in the public budget in foreign currency, a real devaluation—on the assumption that exports and imports fulfill the appropriate elasticities—will point in the right direction. Otherwise, a devaluation by itself could be counterproductive.

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## Export promotion and import substitution in Central American industry

*Larry Willmore\**

The countries of Central America are often described as open economies because the ratio of trade to gross domestic product (GDP) is high. During the 1980s, the ratio of exports to gross regional product in Central America has averaged 23% and the ratio of imports to gross regional product (29%) is even higher. A large (but declining) portion of this trade consists of the exchange of manufactures among countries of the region. Still, there can be no doubt that the economies are very open by this measure.

In the manufacturing sector of Central America, the economies are even more open in terms of import ratios, but from the perspective of export ratios they are relatively closed. Extra-regional imports supply approximately a third of the apparent consumption of manufactures, yet less than 10% of the region's output of manufactures is exported to third countries, and there is no tendency for this ratio to rise. Excluding processed food, the dichotomy is even greater: extra-regional imports supply more than 40% of the region's demand for manufactures, while less than 5% of the production is exported to other countries.

The author provides a detailed study of this poor performance in export promotion and import substitution. He reviews trends in economic growth and trade, estimates the contribution of import substitution and export promotion to manufacturing growth, examines changing patterns of trade, and undertakes a preliminary analysis of the relationship between international trade and tariff protection.

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## I

### Economic growth and trade in manufactures\*

The 1960s were golden years for Central America. Spurred by import substitution in a protected common market, manufacturing output grew at an annual rate of 8.4%, well above the 5.7% per annum growth of gross regional product (table 1). As a result, the contribution of manufacturing to gross regional product increased from 12% at the beginning of the decade to more than 16% in 1970 (table 2).

In the first half of the 1970s, GDP growth fell to 5.3% per annum, and manufacturing growth plunged to 6%. Only Costa Rica and Honduras managed to continue with high rates of manufacturing growth into the 1970s, but that cannot be ascribed to regional integration. This is most obvious in the case of Honduras, which left the Central American Common Market at the end of 1970, re-establishing trade barriers to protect its industries from intra-regional import competition. The low growth rate of GDP for Honduras in the 1970-1975 period is due to Hurricane Fifi, which destroyed much of Honduran agriculture in September 1974. Costa Rica continued to participate in the Central American Common Market, but it is import substitution and extra-regional exports, not intra-regional trade, that account for the 1970-1975 growth in manufacturing output.

In the second half of the 1970s, GDP growth fell to 3.5% and manufacturing growth to 4.4%. This worsening performance was due solely to internal problems in El Salvador and Nicaragua, for despite the "oil shock" of 1979 the terms of trade improved for each of the five Central American countries in the 1975-1980 period. If one looks only at Costa Rica, Guatemala and Honduras, their combined growth rates in 1975-1980 were 6.9% and 5.8% for manufacturing and GDP, respectively, which compare favourably to the rates of 6.2% and 5.3% registered in the 1970-1975 period.

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Table 1

**CENTRAL AMERICA: GROWTH OF GROSS DOMESTIC PRODUCT AND  
ITS MANUFACTURING COMPONENT**

(Average annual rates at constant prices)

	1960- 1970	1970- 1975	1975- 1980	1980- 1986	1986	1987
<b>Total</b>						
<b>Manufacturing</b>	8.4	6.0	4.4	-0.8	2.3	2.7
<b>GDP</b>	5.7	5.3	3.5	-0.6	1.3	2.8
<b>Costa Rica</b>						
<b>Manufacturing</b>	9.2	8.9	6.0	0.4	7.1	5.5
<b>GDP</b>	6.1	5.8	5.1	0.2	4.6	3.8
<b>El Salvador</b>						
<b>Manufacturing</b>	8.1	5.7	0.3	-2.9	2.5	3.0
<b>GDP</b>	5.6	5.4	0.8	-2.0	0.6	2.6
<b>Guatemala</b>						
<b>Manufacturing</b>	7.6	4.7	7.7	-2.1	0.7	1.5
<b>GDP</b>	5.5	5.6	5.8	-1.2	0.2	2.5
<b>Honduras</b>						
<b>Manufacturing</b>	7.0	6.8	6.2	1.0	0.5	3.9
<b>GDP</b>	5.0	3.7	7.2	0.6	2.4	4.4
<b>Nicaragua</b>						
<b>Manufacturing</b>	11.1	5.9	-0.9	0.9	1.9	1.0
<b>GDP</b>	6.9	5.1	-4.2	0.6	-0.6	1.7

Source: 1960-1970: *Statistical Yearbook for Latin America, 1979*. 1970-1985: *Statistical Yearbook for Latin America and the Caribbean, 1987*. 1986-1987: Preliminary estimates by ECLAC based on official data.

In summary, economic growth in Central America slowed in the 1970s, but manufacturing was less affected than other components of GDP. As a result, the ratio of manufacturing output to GDP continued to climb in all five countries, reaching 17.7% for the region as a whole in 1980 (table 2). Moreover, the slowdown in economic growth is due largely to the poor performance of El Salvador and Nicaragua; the growth rates of the other three countries in the 1970s compare favourably with their growth rates in the 1960s.

After 1980 economic recession affected all five countries, particularly severely in El Salvador and Guatemala, where manufacturing output and GDP fell in the 1980-1985 period. These declines, combined with stagnation in the other three countries, resulted in a decline in manufacturing and total output for the region as a whole (table 1). The recession, caused primarily by deterioration of the terms of trade in the five countries, has been aggravated by an absolute decline in the value of goods traded among the

Central American countries. The years 1986 and 1987 registered positive growth rates; yet, with the partial exception of Costa Rica, the recovery has been extremely weak. Central America's real per capita output of manufactures is now lower

Table 2

**CENTRAL AMERICA: RATIO OF  
MANUFACTURING OUTPUT TO GROSS  
DOMESTIC PRODUCT**

(Percentages)

	1960	1970	1975	1980	1985
<b>Total</b>	12.1	16.4	17.0	17.7	17.5
Costa Rica	11.1	15.5	17.9	18.6	18.8
El Salvador	13.8	15.2	15.4	15.0	14.6
Guatemala	11.7	16.7	16.1	17.6	16.8
Honduras	11.4	12.7	14.7	14.0	14.3
Nicaragua	12.6	20.9	21.7	25.6	25.9

Source: 1960: *Statistical Yearbook for Latin America, 1979*. Other years: *Statistical Yearbook for Latin America and the Caribbean, 1987*.

than that of 1975 and its gross regional product per capita is lower than that registered in 1970.

Intra-regional trade contracted sharply in the 1980s, but its deterioration began in the early 1970s. In 1970 intra-regional trade accounted for 11.5% of apparent consumption and 16% of the gross value of Central America's production of manufactures.<sup>1</sup> If processed food is deleted, these proportions rise to 12.7% and 21.7% respectively. Between 1970 and 1975 there was a relative contraction of trade between countries in the region, and intra-regional shipments fell to 9.5% of consumption and 12.6% of output. In other words, intra-regional trade failed to keep pace with the growth in regional demand or production (table 2).<sup>2</sup>

It is interesting to note that in 1970 the ratios of intra-regional imports to consumption vary little by country: from 9.5% for Costa Rica to 13.6% for Honduras; in contrast, the ratios of the intra-regional exports to output vary widely. Honduras in 1970 exported only 6.6% of its manufacturing output to neighbouring countries, whereas Guatemala exported more than a fifth (22.7%) of its production to countries of the region. Throughout the 1970s and into the 1980s, Guatemalan industry continued to be highly dependent on exports to countries in the area (table 3).

Between 1975 and 1980 there was a sharp and unsustainable expansion of intra-regional trade owing largely to exports from Costa Rica and Guatemala in 1980 to war-torn El Salvador and Nicaragua. Despite this expansion, intra-regional trade ratios for Central America as a whole were lower in 1980 than they had been in 1970. By 1985, trade had contracted to such an extent that intra-regional trade ratios on average were little more than half those of 1970.

The ratio of extra-regional imports to regional consumption of manufactures rose from 32.8% in 1970 to 35.4% in 1975, declining

slightly to 34.4% in 1985. This relative stability between 1970 and 1985 masks considerable inter-country differences: in Costa Rica and Honduras, the ratio fell after an initial rise; in Guatemala and Nicaragua the ratio rose; and in El Salvador it was extremely volatile, but only slightly higher in 1985 than in 1970 (table 3). El Salvador thus remains the Central American country that is least dependent on overseas sources for its supply of manufactures.

The ratio of extra-regional exports of manufactures to the gross value of output rose sharply in 1975 owing largely to increased exports of sugar, but it fell back in 1980 to its 1970 level (9% of output). In 1985 only 8% of Central America's output of manufactures was exported to extra-regional markets, with the ratio varying from 12.0% in Honduras to 3.1% in Nicaragua. If processed food, which includes such traditional exports as chilled beef, sugar and frozen shrimp, is deleted, the extra-regional export ratios fall to 4.7% for Central America as a whole, and to 6.2% and 1.2% for Honduras and Nicaragua, respectively. These ratios are somewhat underestimated, for extra-regional exports are valued at competitive world prices, while production for home markets and intra-regional exports are valued at the higher prices made possible by a protective tariff.<sup>3</sup>

As might have been expected, some of the decline in intra-regional imports was substituted by local production and some by imports from third countries. Between 1970 and 1985, the proportion of apparent consumption of manufactures supplied by local plants increased 3.5 percentage points to 59.2%, and the proportion supplied by plants in third countries increased 1.6 percentage points to 34.4% (tables 4 and 5). Central America as a region became more "open" to imports, while individual countries became more closed at the expense of intra-regional trade.

By 1985, local production satisfied more than half of the consumption in 13 of the 18 categories of manufactures listed in table 4. The exceptions were chemicals (28.8%), basic metals and metal products (32.1%), machinery (17.7%), transport equipment (12.7%) and

<sup>1</sup>Apparent consumption is defined as national production plus imports less exports. In the remainder of the paper, the word "consumption" is used interchangeably with "apparent consumption".

<sup>2</sup>Throughout this document Panama is included in intra-regional trade figures, since it has bilateral treaties of preferential trade with Central America, it is as much as part of regional integration as Honduras is. Panamanian production and consumption are excluded from the regional totals only because of a lack of comparable data.

<sup>3</sup>See section IV. The same reasoning applies, of course, to extra-regional import ratios.

Table 3

## CENTRAL AMERICA: TRADE RATIOS, 1970-1985

	Intra-regional imports (apparent consumption)				Intra-regional exports (production)				Extra-regional imports (apparent consumption)				Extra-regional exports (production)			
	1970	1975	1980	1985	1970	1975	1980	1985	1970	1975	1980	1985	1970	1975	1980	1985
<b>Total manufacturing</b>	11.5	9.5	10.3	6.4	16.0	12.6	14.3	9.0	32.8	35.4	34.6	34.4	9.1	14.1	9.0	8.0
Costa Rica	9.5	7.4	7.7	3.6	11.9	10.1	12.8	7.6	34.6	34.9	35.2	30.2	7.3	10.0	8.3	8.3
El Salvador	11.5	12.4	15.5	11.4	17.8	13.9	12.0	6.9	27.5	33.4	23.6	28.2	4.7	14.5	5.3	6.8
Guatemala	10.7	7.9	6.0	5.5	22.7	18.1	25.1	20.0	36.2	41.1	46.6	42.8	8.0	16.3	9.7	8.8
Honduras	13.6	7.2	5.9	5.7	6.6	5.9	6.3	2.6	37.3	37.9	40.4	34.0	15.2	18.7	14.9	12.0
Nicaragua	11.0	10.5	16.5	3.7	11.8	9.7	5.8	1.4	28.0	29.6	21.8	39.2	13.1	13.2	7.8	3.1
<b>Total manufacturing less food</b>	12.7	10.3	11.4	7.3	21.7	17.1	18.7	12.0	41.1	42.6	41.3	42.1	3.2	4.7	3.5	4.7
Costa Rica	10.2	7.5	8.3	3.9	15.6	12.8	16.4	10.1	43.4	42.4	42.9	38.8	0.9	2.8	2.9	5.6
El Salvador	13.5	13.4	18.9	13.8	26.4	19.6	18.0	10.8	35.9	39.2	28.9	36.2	1.1	3.6	3.1	5.4
Guatemala	11.9	8.2	6.1	5.9	28.4	24.0	29.9	24.5	43.1	47.1	52.4	49.0	2.1	2.6	3.5	4.0
Honduras	13.4	7.6	6.3	6.5	8.3	7.8	8.4	3.3	44.0	45.1	47.6	40.2	13.1	16.7	7.7	6.2
Nicaragua	13.3	12.8	19.7	4.6	15.7	13.2	8.0	1.6	37.5	38.8	25.8	46.6	2.1	3.0	1.1	1.2

*Source:* Estimates of the author based on official data.

*Note:* Intra-regional trade includes Panama.

Table 4  
CENTRAL AMERICA: SOURCES OF CONSUMER SUPPLY

(Percentages)<sup>a</sup>

Industry	Local factories		Intra-regional imports <sup>b</sup>		Extra-regional imports	
	1970	1985	1970	1985	1970	1985
Total	55.7	59.2	11.5	6.4	32.8	34.4
Food	86.4	85.5	7.5	3.7	6.1	10.8
Beverages	94.8	96.1	1.0	0.5	4.2	3.4
Tobacco	95.0	99.2	4.7	0.7	0.3	0.1
Textiles	44.5	51.7	28.0	15.8	27.5	32.5
Garment/shoe	81.8	86.4	14.1	8.7	4.1	4.9
Leather	72.0	88.1	19.3	6.3	8.7	5.6
Wood	85.8	90.4	10.6	6.8	3.6	2.8
Furniture	87.1	97.0	9.8	2.1	3.1	0.9
Paper	41.4	53.9	9.5	8.0	49.1	38.1
Printing	78.2	76.5	8.1	3.5	13.7	20.0
Chemicals	30.2	28.8	20.3	12.7	49.5	58.5
Petroleum derivatives	70.7	61.2	4.1	3.8	25.2	35.0
Rubber	50.8	62.6	22.9	11.8	26.3	25.6
Non-metallic minerals	66.2	72.7	10.0	7.3	23.8	20.0
Metals & products	26.1	32.1	13.5	8.4	60.4	59.4
Machinery	11.6	17.7	7.9	4.5	80.5	77.8
Transp. equipment	15.7	12.7	1.2	2.0	83.1	85.3
Other	47.3	38.6	8.2	6.9	44.5	54.5

Source: Estimates of the author based on official data.

<sup>a</sup>Distribution of percentages of apparent consumption in each category of manufactures.

<sup>b</sup>Includes imports from Panama.

other manufactures (38.6%). The increased dependence of the Central American consumer on local plants was fairly generalized among industry subsectors, but not among countries. The shift from imported to local manufactures is the result of sharp increases in the share of demand satisfied by local producers in Costa Rica and Honduras. In El Salvador, Guatemala and Nicaragua, despite the existence of widespread excess capacity, the proportion of consumption of manufactures supplied by local plants fell between 1970 and 1985. Only in El Salvador did the intra-regional import/consumption ratio remain constant between 1970 and 1985; in the other countries it declined sharply (table 3).

As a result of the contraction of intra-regional trade, consumers in Costa Rica and Honduras have become more dependent on local producers, but local producers in all countries of the region, especially El Salvador and Nicaragua, have become more dependent on their home market. The proportion of total output of manu-

factures sold in home markets in Central America increased from 75% in 1970 to 83% in 1985 (table 5). In both years, well over half of the sales of each of the eighteen subsectors listed in table 5 were destined for home markets. The share of output marketed locally in 1985 varies from 65.8% (chemicals) to 99.4% (beverages).

With depressed demand and barriers to intra-regional trade, one might expect to see a surge of extra-regional exports. Surprisingly, the proportion of output exported to extra-regional markets in 1985 was only 8%, lower than the 9.1% recorded in 1970. This result stems from a decline in the export ratio for processed food from 19% of total production in 1970 to 14% in 1985. In all other industries, except for petroleum derivatives, extra-regional export ratios rose. The increase in the export ratio is especially notable for textiles (from 1.3% to 11%) and furniture (from 0.4% to 9%). Moreover, studying the detailed statistics available to the author of this paper, only in Honduras and Nica-



Table 5  
CENTRAL AMERICA: DESTINATION OF MANUFACTURING OUTPUT

(Percentages)<sup>a</sup>

Industry	National markets		Intra-regional exports <sup>b</sup>		Extra-regional exports	
	1970	1985	1970	1985	1970	1985
Total	74.9	83.0	16.0	9.0	9.1	8.0
Food	74.6	82.5	6.4	3.5	19.0	14.0
Beverages	99.0	99.4	1.0	0.5	0.0	0.1
Tobacco	94.3	95.2	4.6	0.6	1.1	4.2
Textiles	60.4	68.3	38.1	20.7	1.3	11.0
Garment/shoe	84.6	85.9	14.6	8.7	0.8	5.4
Leather	78.4	89.4	21.1	6.4	0.5	4.2
Wood	63.5	65.6	7.7	4.9	28.8	29.5
Furniture	89.5	89.0	10.1	2.0	0.4	9.0
Paper	81.3	86.0	18.6	12.8	0.1	1.2
Printing	90.3	94.8	9.5	4.4	0.2	0.8
Chemicals	57.0	65.8	39.5	28.4	3.5	5.8
Petroleum derivatives	87.8	91.5	5.0	5.8	7.2	2.7
Rubber	68.5	81.2	30.8	15.4	0.7	3.4
Non-metallic minerals	72.3	89.0	27.5	8.9	0.2	2.1
Metals & products	64.1	75.5	32.8	19.4	3.1	5.1
Machinery	58.5	77.2	39.8	19.4	1.7	3.4
Transp. equipment	92.7	84.0	7.1	13.8	0.2	2.2
Other	84.2	81.9	14.6	14.7	1.2	3.4

Source: Estimates of the author based on official data.

<sup>a</sup>Percentage distribution of gross value of output.

<sup>b</sup>Includes exports to Panama.

ragua is there evidence of widespread falls in extra-regional export ratios between 1970 and 1985. In each of these countries, the domestic currency was increasingly overvalued with the result that exports were not encouraged.

Although extra-regional export performance has shown some improvement, by 1985 10% or more of the region's output was

exported to third countries in only three industries: food, textiles and wood. Costa Rica registered ratios greater than 10% in five industries: food, textiles, leather, metals and metal products, and other manufactures; El Salvador only in textiles; Guatemala in food, garments and wood; Honduras in food, wood and furniture; and Nicaragua in none.

## II

### Sources of manufacturing growth

In this section the exports/output and imports/consumption ratios discussed earlier are employed to decompose manufacturing growth into a) that part "expected" from the growth of final demand, i.e., with all trade ratios constant, b) that attributable to import substitution, and

c) that attributable to export promotion. The calculations are inspired by H.B. Chenery's classic paper "Patterns of Industrial Growth".<sup>4</sup>

<sup>4</sup>*American Economic Review* 50:4, September 1960, pp. 624-654.

Chenery, and the researchers that followed him,<sup>5</sup> measured import substitution as a fall in the ratio of external purchases to total supply. Since exports are a part of total supply, this measure has the disadvantage that it is affected both by changes in imports and by changes in exports. Any increase in exports is interpreted as "import substitution" because it decreases the ratio of imports to total supply.

In the calculations reported in this section, the effects of export promotion on manufacturing growth are separated from those of import substitution. Any fall in the ratio of imports to consumption is indicative of import substitution. Similarly, a rise in the proportion of the output that is exported is considered to be evidence of export promotion. (See the appendix for details.)

This decomposition of industrial growth rests, of course, on arbitrary assumptions that may be questioned. Output growth is probably not independent of the level of exports, so in focusing solely on changes in the ratio of exports to output we miss part of the positive effect of exports on industrial growth. Similarly, one might argue that import substitution results in less consumer choice, hence lower demand, so that the equation overstates the contribution of import substitution to growth. Unfortunately, to take into account these interrelationships requires an enormous amount of information that is not available to us. Such criticisms are valid, but this decomposition provides a useful description, and the exercise is intended to be a *description*, not an *explanation*, of reality.

This decomposition of industrial growth was carried out for each of 18 industrial subsectors and each of the Central American countries. Table 6 reports the results of these calculations treating Central America as a single unit. Trade between the five countries of the region is included with local shipments, but trade with Panama is treated as exports and imports because Panamanian output is excluded from Central American production. All data are in

current Central American pesos, a unit of account equal to the United States dollar, so the calculations measure price inflation as well as real growth in output and consumption.

Manufacturing output in Central America grew by more than 2 000 million pesos between 1970 and 1975, and extra-regional export promotion accounted for nearly a tenth of this growth. Export promotion was concentrated in the food and, to a lesser extent, the textile and chemical industries. Our measure of import substitution reveals a negative effect on industrial growth in this period, but significant import substitution does appear to have taken place in textiles. Trade with Panama had little effect on overall growth, but the 7 million pesos of import substitution reflects largely a big fall in imports of chemicals, while the negative 2 million peso figure for export promotion is due to reduced sales of petroleum derivatives.

Between the years 1975 and 1980, nominal manufacturing output grew by 3 600 million pesos, but real growth was undoubtedly much lower because of the inflation in this period. In sharp contrast with the previous period, promotion of extra-regional exports did not contribute to industrial growth. On the contrary, the changes in extra-regional exports had a negative effect on growth, notably for food, wood and petroleum derivatives, reflected in declines in the proportion of output exported to third countries. Export promotion of textiles continued, but its contribution to growth was only 3.8 million pesos, much smaller than in 1970-1975. Extra-regional import ratios continued to rise at a faster pace, with the notable exception of the metal-working industries, which recorded substantial import substitution.

The nominal value of industrial production fell by more than 500 million pesos between 1980 and 1985. Nearly 40% of this fall can be attributed to increases in extra-regional import ratios and decreases in extra-regional export ratios, a reflection of supply disruptions caused by armed conflicts and increasingly over-valued exchange rates in the region. It is of interest to note, however, that although the lack of import substitution was widespread, export promotion continued in textiles and began, stimulated no doubt by decreased regional demand, in garments and footwear.

<sup>5</sup>See, for example, Padma Desai, "Alternative Measures of Import Substitution", *Oxford Economic Papers*, November 1969, pp. 312-324, and Salvatore Schiavo-Campo, "Sustitución de Importaciones en Centroamérica", *La integración económica centroamericana*, ed., Eduardo Lizano (Fondo de Cultura Económica, Mexico, 1975), vol. 1, pp. 135-163.

Table 6  
**CENTRAL AMERICA: SOURCES OF INDUSTRIAL GROWTH BY INDUSTRY, 1970-1985**  
 (Millions of Central American pesos)<sup>a</sup>

	Actual growth	Expected growth <sup>a</sup>	Sources of growth			
			Panama trade		Extra-regional	
			Import substitution	Export promotion	Import substitution	Export promotion
<b>1970-1975</b>						
Total	2 332.6	2 137.5	7.0	-2.0	-18.8	208.8
Total less food	1 502.8	1 470.0	8.4	-2.1	-6.3	32.9
Food	829.7	667.6	-1.4	0.1	-12.4	175.9
Beverages	142.9	145.4	0.5	-	-3.1	-
Tobacco	39.3	35.9	0.2	-	0.1	3.1
Textiles	134.9	110.2	-0.3	0.1	14.1	10.8
Garment/shoe	79.1	73.9	-	0.1	1.2	4.0
Leather	20.2	17.4	-	-	1.4	1.4
Wood	70.9	68.5	-0.1	-0.2	-4.6	7.5
Furniture	20.0	18.7	0.1	-	0.7	0.5
Paper	57.0	47.1	-0.1	-	7.3	2.7
Printing	31.6	32.9	0.5	-0.2	-2.1	0.4
Chemicals	291.3	294.8	8.0	-0.4	-25.0	14.0
Petroleum derivatives	256.3	266.0	-0.7	-3.6	9.3	-14.8
Rubber	61.8	57.8	-0.2	0.1	4.1	-
Non-metallic minerals	101.1	91.5	0.1	2.0	5.4	2.1
Metals & products	96.0	90.5	1.0	-0.5	6.3	-1.2
Machinery	58.6	71.8	-0.3	0.7	-15.6	2.0
Transp. equipment	26.2	26.1	0.1	-	-0.1	0.1
Other	15.5	21.5	-0.2	-0.2	-5.7	0.2
<b>1975-1980</b>						
Total	3 622.5	4 117.1	-30.0	10.0	-165.9	-309.0
Total less food	2 517.6	2 660.8	-21.9	8.2	-99.0	-30.5
Food	1 104.9	1 456.3	-8.1	2.1	-67.0	-278.5
Beverages	324.9	319.7	-2.2	0.1	7.1	-
Tobacco	93.8	95.2	-	-	-	-1.5
Textiles	112.2	115.2	-0.7	2.0	-8.0	3.8
Garment/shoe	186.1	197.4	-0.6	1.9	-8.4	-4.2
Leather	31.8	29.7	-0.1	-	-	2.3
Wood	63.7	81.7	0.2	-	8.8	-27.1
Furniture	59.1	54.9	-	-0.1	-0.5	4.8
Paper	82.1	98.4	-7.5	0.3	-7.9	-1.2
Printing	72.6	79.8	-0.1	0.1	-6.5	-0.7
Chemicals	265.8	319.5	-7.9	9.3	-47.3	-7.8
Petroleum derivatives	557.3	668.9	1.3	-5.7	-91.1	-16.2
Rubber	160.9	150.4	0.2	-0.2	6.0	4.4
Non-metallic minerals	157.8	154.4	-	-2.5	5.8	-
Metals & products	141.8	147.6	-1.4	1.2	-11.5	5.9
Machinery	129.1	80.6	-1.8	0.8	44.2	5.2
Transp. equipment	57.4	33.6	-0.3	0.1	23.4	0.6
Other	21.2	33.7	-1.1	0.9	-13.2	1.0
<b>1980-1985</b>						
Total	-574.1	-352.6	-3.7	7.7	-131.6	-93.9
Total less food	-516.6	-461.0	-7.9	4.7	-112.2	59.7
Food	-57.5	108.4	4.1	2.9	-19.5	-153.5
Beverages	3.7	-2.1	1.7	-0.5	4.5	0.1
Tobacco	1.6	0.5	-	-	0.1	1.0
Textiles	-85.3	-70.7	-0.5	0.5	-30.5	16.0
Garment/shoe	-76.0	-87.2	-1.1	-1.2	2.1	11.4
Leather	-3.4	-0.7	-	-	0.4	-2.3
Wood	-44.4	-57.5	-	-0.6	0.1	13.5
Furniture	-13.5	-17.0	-	0.1	1.0	2.5
Paper	26.1	-12.4	6.9	-0.2	33.5	-1.7
Printing	-18.6	-20.1	0.5	0.5	-0.1	0.6
Chemicals	-29.5	8.4	6.1	2.6	-48.5	1.9
Petroleum derivatives	-120.0	57.1	-21.8	3.2	-57.7	13.4
Rubber	4.9	16.4	-0.7	0.4	-14.3	3.1
Non-metallic minerals	-31.9	-32.8	-0.4	0.2	-0.7	1.8
Metals & products	-45.4	-55.8	1.0	0.9	6.2	2.3
Machinery	-33.7	-40.3	1.7	-0.3	10.0	-4.8
Transp. equipment	-58.1	-32.3	-2.4	-	-24.0	0.6
Other	6.9	-0.4	1.2	-0.7	6.6	0.3

Source: Estimates of the author based on official data.

<sup>a</sup>Expected growth is estimated with constant trade ratios.

In summary, in each of the three five-year periods, nearly all industrial growth can be attributed to that which would be expected with constant trade ratios (table 6). In other words, neither import substitution nor export promotion was of great importance as a source of growth in those periods. Nonetheless, it is interesting to note that there was a generalized absence of extra-regional import substitution during those 15 years, whereas some export promotion was evident in 1970-1975 and, to a lesser extent, in 1980-1985.

The decline of the Central American Common Market (CACM) began in the early 1970s. Costa Rica, Guatemala and Honduras show considerable substitution of intra-regional imports in the 1970-1975 period, and all five countries registered falls in intra-regional export promotion. The 1975-1980 period was one of recovery of intra-regional trade owing to exports from Costa Rica and Guatemala to El Salvador and Nicaragua as well as to increased trade with Panama. In 1980-1985, however, integration declined rapidly, as a consequence of restrictions on intra-regional imports and export restrictions due to problems with the intra-CACM payments system. Guatemalan industries, which gained most from the 1975-1980 expansion of intra-regional trade, were most affected by its subsequent contraction.

Regarding extra-regional imports, the 1970-1975 period shows a varied experience by country: Costa Rica reveals considerable import substitution, while Guatemala shows strong import expansion and the other three countries are in intermediate positions. The strong expansion of external purchases in Central America in the 1975-1980 period was due entirely to imports of Guatemala and Honduras, for the other three countries record positive import substitution in this period; in the 1980-1985 period, however, the import expansion is attributable to Nicaragua and, to a lesser extent, El Salvador, a reflection of supply disruptions, hence increased need for imports, in those war-torn countries (table 7).

Extra-regional export promotion contributed significantly to the growth of manufacturing output in all countries except Nicaragua in the 1970-1975 period. In 1975-1980 the contribution of extra-regional exports was negative in all five countries, and in 1980-1985 it was negative in all countries save El Salvador (table 7). Nevertheless, if food products are deleted there is evidence of export promotion in Costa Rica and El Salvador in the 1980-1985 period. (Detailed calculations are not shown here, but are available from the author upon request.)

### III

## Intra-regional and extra-regional trade patterns

A well-known feature of the Central American Common Market is the surprising uniformity of intra-regional exports between the five countries. They all tend to produce and export similar products, and it is difficult to identify a country which dominates output in any given industry.<sup>6</sup>

<sup>6</sup>See L. Willmore, "Free Trade in Manufactures among Developing Countries", *Economic Development and Cultural Change* 20:4, July 1972, pp. 659-670, and "El Patrón de Comercio y Especialización en el Mercado Común Centroamericano", in *La Integración Económica Centroamericana*, ed., Eduardo Lizano (Fondo de Cultura Económica, Mexico, 1975), vol. 1, pp. 214-231.

The weakening of economic integration in the 1970s and 1980s had only a small effect on this uniformity of trade patterns. As can be seen from the statistics reported in table 8, rank correlation coefficients calculated from data for 80 four-digit ISIC industries fell only slightly for pairs of countries, and in all cases remained positive and highly significant. The rank correlation between Panama's exports and those of each of the five countries increased substantially over the 1970-1985 period along with the increasing trade of Panama with Central Amer-

Table 7  
CENTRAL AMERICA: SOURCES OF INDUSTRIAL GROWTH BY COUNTRY,  
1970-1985

(Millions of Central American pesos)<sup>a</sup>

	Actual growth	Expected growth <sup>b</sup>	Sources of growth			
			Intra-regional <sup>a</sup>		Extra-regional	
			Import substitution	Export promotion	Import substitution	Export promotion
<b>1970-1975</b>						
Total	2 332.6	2 137.5	7.0	-2.0	-18.8	208.8
Costa Rica	613.9	562.6	28.1	-30.4	20.1	33.6
El Salvador	447.5	407.8	-1.8	-35.0	-8.2	84.8
Guatemala	541.9	485.7	30.0	-30.9	-21.3	78.5
Honduras	267.3	218.6	46.2	-8.2	-9.2	19.9
Nicaragua	461.9	467.1	2.8	-17.9	6.3	3.5
<b>Percentages<sup>c</sup></b>						
Total	100	92	-	-	-1	9
Costa Rica	100	92	5	-5	3	5
El Salvador	100	91	-	-8	-2	19
Guatemala	100	90	6	-6	-4	14
Honduras	100	82	17	-3	-3	7
Nicaragua	100	101	1	-4	1	1
<b>1975-1980</b>						
Total	3 622.5	4 117.1	-30.0	10.3	-165.9	-309.0
Costa Rica	1 145.8	1 134.9	-25.1	70.4	3.4	-37.8
El Salvador	513.3	659.8	-67.2	-6.3	53.0	-126.0
Guatemala	831.1	925.0	23.7	118.3	-170.6	-65.4
Honduras	729.8	768.2	26.6	5.2	-38.6	-31.6
Nicaragua	407.2	559.5	-104.7	-30.3	21.5	-38.9
<b>Percentages<sup>c</sup></b>						
Total	100	114	-1	-	-5	-9
Costa Rica	100	99	-2	6	-	-3
El Salvador	100	129	-13	-1	10	-25
Guatemala	100	111	3	14	-21	-8
Honduras	100	105	4	1	-5	-4
Nicaragua	100	137	-26	-7	5	-10
<b>1980-1985</b>						
Total	-574.1	-352.6	-3.7	7.7	-131.6	-93.9
Costa Rica	-13.8	-61.6	122.5	-111.7	39.3	-2.3
El Salvador	-11.5	16.5	73.7	-47.3	-72.5	18.1
Guatemala	-445.5	-373.9	17.6	-92.6	28.0	-24.7
Honduras	20.7	43.9	1.3	-38.0	40.8	-27.3
Nicaragua	-124.0	-15.2	238.5	-48.5	-248.9	-49.9
<b>Percentages<sup>c</sup></b>						
Total						
Costa Rica						
El Salvador						
Guatemala						
Honduras	100	212	6	-184	198	-132
Nicaragua						

Source: Estimates of the author based on official data.

<sup>a</sup>Intra-regional trade includes Panama and for Central America it is only trade with Panama.

<sup>b</sup>Expected growth is estimated with constant trade ratios.

<sup>c</sup>Percentages are not shown for negative growth.

Table 8

CENTRAL AMERICAN ISTHMUS: COEFFICIENTS OF RANK CORRELATION  
FOR INTRA-REGIONAL EXPORTS OF MANUFACTURES

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua	Panama
Costa Rica						
1970	...	0.724	0.755	0.654	0.676	0.340
1985	...	0.558	0.783	0.511	0.466	0.571
El Salvador						
1970	0.724	...	0.652	0.685	0.629	0.402
1985	0.558	...	0.588	0.646	0.591	0.546
Guatemala						
1970	0.755	0.652	...	0.697	0.612	0.277
1985	0.783	0.588	...	0.591	0.469	0.566
Honduras						
1970	0.654	0.685	0.697	...	0.652	0.264
1985	0.511	0.646	0.591	...	0.608	0.456
Nicaragua						
1970	0.676	0.629	0.612	0.652	...	0.289
1985	0.466	0.591	0.469	0.608	...	0.349
Panama						
1970	0.340	0.402	0.277	0.264	0.289	...
1985	0.571	0.546	0.566	0.456	0.349	...

*Source:* Calculations of the author based on official statistics.

*Note:* Spearman rank correlation coefficients, data for 80 ISIC industries ranked by the value of intra-regional exports. All coefficients are statistically significant at the .02 level, and coefficients larger than 0.277 are statistically significant at the .01 level.

Table 9

CENTRAL AMERICA: COEFFICIENTS OF RANK CORRELATION FOR  
EXTRA-REGIONAL EXPORTS OF MANUFACTURES

	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
Costa Rica					
1970	...	0.073	0.360	0.300	0.341
1985	...	0.384	0.532	0.472	0.265
El Salvador					
1970	0.073	...	0.487	0.104	0.333
1985	0.384	...	0.541	0.496	0.301
Guatemala					
1970	0.360	0.487	...	0.405	0.475
1985	0.532	0.541	...	0.478	0.420
Honduras					
1970	0.300	0.104	0.405	...	0.420
1985	0.472	0.496	0.478	...	0.310
Nicaragua					
1970	0.341	0.333	0.475	0.420	...
1985	0.265	0.301	0.420	0.310	...

*Source:* Calculations of the author based on official statistics.

*Note:* Spearman rank correlation coefficients, data for 70 industries (1970) and 73 industries (1985) ranked by the value of extra-regional exports. For 1970, all coefficients are statistically significant at the .01 level except those for El Salvador-Costa Rica and El Salvador-Honduras. For 1985, all coefficients except Costa Rica-Nicaragua are statistically significant at the .01 level. Panama is not included owing to lack of comparable data.

Table 10

**CENTRAL AMERICA: COEFFICIENTS OF RANK  
CORRELATION BETWEEN INTRA- AND  
EXTRA-REGIONAL EXPORTS**

	1970	1985
Costa Rica	0.489	0.545
El Salvador	0.435	0.672
Guatemala	0.502	0.542
Honduras	0.400	0.517
Nicaragua	0.507	0.539

*Source:* Calculations of the author based on official statistics.

*Note:* Spearman rank correlation coefficients, data for 80 ISIC industries ranked by the value of intra-regional and extra-regional exports. Exports to Panama are regarded as intra-regional. All coefficients are statistically significant at the .01 level.

ica. The calculations in table 8 refer only to manufactures, but this category of goods accounts for more than 90% of total intra-regional trade.

Since 1970, manufactures have typically accounted for 20% to 25% of Central America's extra-regional exports, so it is interesting to see whether the countries display the same uniformity in extra-regional exports that they do in intra-regional exports. The rank correlations were therefore calculated with figures for some 70 industries which registered extra-regional exports (table 9). When these statistics are compared with those of table 8, it is apparent that the pattern of extra-regional exports is less uniform among countries than the pattern of intra-regional exports. Nevertheless, the correlations show a marked increase over time for all pairs of countries except those paired with Nicaragua, and almost all the coefficients in 1985 are highly significant in a statistical sense. These results can be summarized by stating that the unweighted average of the rank correlations for extra-regional exports increased from 0.33 in 1970 to 0.42 in 1985. For intra-regional exports, the unweighted average for the same pairs of countries, excluding Panama, fell from 0.67 in 1970 to 0.58 in 1985.

The Central American countries resemble each other in both intra- and extra-regional exports because each country exports to extra-regional markets manufactures that are similar to those it exports to the regional market. The correlation coefficients between intra- and

extra-regional exports for each of the countries was in the 0.40 to 0.51 range in 1970 and increased to the 0.51 to 0.67 range in 1985 (table 10).

Another way to demonstrate the similarity of intra-regional exports is to calculate, for each of the 80 industries, the amount of "trade overlap", i.e., the exports and imports of a particular trade category that offset each other, and to express this as a percentage of trade turnover. Suppose, for example, that an industry in a country registers 35 000 pesos of intra-regional exports and 5 000 pesos of intra-regional imports. The trade overlap would then amount to 10 000 pesos which, expressed as a percentage of the 40 000 peso trade turnover, is 25%. This is an index of what has come to be known as "intra-industry trade", the simultaneous export and import of goods classified in the same industry or commodity category.<sup>7</sup>

The estimates for intra-regional trade indicate that intra-industry trade, as a percentage of trade turnover, fell in every country other than Panama between 1970 and 1985. For Central America and Panama as a whole, intra-industry trade fell more than 10 percentage points, to 43% in 1985. Only 37.7% of Panama's trade in manufactures with Central America was intra-industry in 1970, but in 1985 Panama's index was 47%, second only to Costa Rica's 53% (table 11).

The indices of intra-industry trade are much lower for trade with third countries than they are for trade within the preferential trading area of Central America and Panama. The indices also remain far below those of the newly industrialized countries (NICs) of Latin America and Asia,<sup>8</sup> even though they rose markedly in Costa Rica and El Salvador between 1970 and 1985. Because of the increased intra-industry trade, of these two countries, the weighted average index for extra-regional trade in Central America rose from 6% in 1970 to 10% in 1985.

<sup>7</sup>The term "trade overlap" is due to J.M. Finger, "Trade Overlap and Intra-Industry Trade", *Economic Inquiry* 13, 1975, pp. 581-589, and this index of intra-industry trade was suggested by H.G. Grubel and P.J. Lloyd in *Intra-Industry Trade*, Macmillan, London, 1975, p. 21.

<sup>8</sup>See G.G. Manrique, "Intra-Industry Trade between Developed and Developing Countries: the United States and the NICs", *Journal of Developing Areas* 21:4, July 1987, pp. 481-494.

Table 11

**CENTRAL AMERICAN ISTHMUS:  
INTRA-INDUSTRY TRADE IN MANUFACTURES**

(Percentages)

	1970	1975	1980	1985
<b>Intra-regional trade</b>				
<b>Central American</b>				
<b>Isthmus</b>	53.6	54.3	47.7	43.3
Costa Rica	60.9	61.2	65.0	53.0
El Salvador	56.2	61.0	53.4	43.6
Guatemala	59.8	55.6	41.4	42.7
Honduras	38.1	39.5	42.9	35.1
Nicaragua	45.8	42.5	28.3	21.6
Panama	37.7	51.9	47.8	47.2
<b>Extra-regional trade</b>				
<b>Central America</b>				
<b>Central America</b>	6.2	7.8	8.6	10.3
Costa Rica	2.5	6.6	7.5	13.5
El Salvador	4.8	10.0	12.3	14.7
Guatemala	10.2	7.3	10.2	10.6
Honduras	8.7	10.2	5.8	6.3
Nicaragua	4.8	5.7	8.0	5.9

*Source:* Calculations of the author based on official statistics.

*Note:* Extra-regional export data were not available for Panama.

In Central America, as in any small economy, exports are much less diversified than imports of manufactures. The increase in intra-industry trade with outside countries thus reflects increasing diversification of exports, so that exports of manufactures are coming to resemble imports of manufactures. In 1970 Central American countries registered extra-regional exports in 41 industries, on average; in 1985 all countries sold outside the region goods from 54 industries on average. As a result of this diversification, exports are much less concentrated in a few industries.

In 1970 three industries accounted for proportions of extra-regional exports of manufactures ranging from 71% in Guatemala to 90% in Costa Rica. Especially important were "manufactures" such as chilled beef and frozen shrimp. By 1985, the concentration of exports was substantially lower for all five countries. Costa Rica and El Salvador—the two countries with the greatest increase in intra-industry trade ratios—also show the greatest fall in the con-

Table 12

**CENTRAL AMERICA: LEADING THREE INDUSTRIES IN  
EXTRA-REGIONAL EXPORTS OF MANUFACTURES**

(Percentages)<sup>a</sup>

ISIC	Description	Costa Rica	El Salvador	Guatemala	Honduras	Nicaragua
1970						
	<b>Total leading three</b>	<b>90.8</b>	<b>76.5</b>	<b>71.1</b>	<b>78.6</b>	<b>88.4</b>
3111	Meat	55.0	...	35.6	25.7	54.9
3114	Seafood	4.2	27.6	...	...	12.3
3115	Vegetable oil	...	10.1	...	...	...
3118	Sugar	31.6	38.8	27.3	...	21.2
3311	Wood	...	...	...	39.8	...
3529	Other chemicals	...	...	8.2	...	...
3530	Petroleum refining	...	...	...	13.1	...
1985						
	<b>Total leading three</b>	<b>48.0</b>	<b>54.7</b>	<b>66.6</b>	<b>65.6</b>	<b>71.7</b>
3111	Meat	29.6	...	14.1	...	35.3
3114	Seafood	10.9	25.5	8.3	29.2	...
3118	Sugar	7.5	15.6	44.2	15.6	23.8
3121	Other food products	...	...	...	...	12.6
3211	Textiles	...	13.6	...	...	...
3311	Wood	...	...	...	20.8	...

*Source:* Calculations of the author based on official statistics.

*Note:* The absence of an entry does not indicate the absence of exports, but rather that the industry does not rank among the leading three exporters. Extra-regional exports exclude exports to Panama.

<sup>a</sup>Percentages of total extra-regional exports.



centration of their exports. The share of the leading three industries in Costa Rica's exports fell from 90% to 48%, and in El Salvador's from 76% to 55% (table 12).

In summary, the intra-regional exports of the Central American countries have always been diversified and similar in pattern from one

country to another. They are now beginning to diversify their exports of manufactures to countries outside the region, and in each country the pattern is beginning to resemble somewhat that of extra-regional imports and, to a much greater extent, the pattern of the extra-regional exports of other Central American countries.

## IV

### Protection and trade

The intent of the common external tariff agreed among the Central American countries in the 1960s was undoubtedly to protect their manufacturing industries against competition from imports from countries outside the region. "Centroamérica, al construir el Mercado Común, enunció desde el principio una política de industrialización y desarrollo, 'hacia adentro', y como parte de ésta se concibieron distintos instrumentos, de los cuales el más importante fue un arancel de clara orientación proteccionista, unido al régimen de libre comercio."<sup>9</sup> Nevertheless, students of Central American integration believe that much of this protection has never been utilized. They suspect that Central American producers sell their goods at prices considerably lower than the CIF import price plus tariff. To the extent that this is true, the tariffs may contain considerable "water" and could be reduced with no effect on domestic output, imports or consumption.

Central American producers may fail to price up to the tariff for a number of reasons. First, they may price their products lower than the tariff-inclusive international price because of real or perceived quality differences between their products and those of foreign producers. Second, they may maintain low prices as a hedge against a future fall in import prices. Third, they may find themselves competing with contraband that does not pass through the customs house. Fourth, they may face competition from duty-free imports authorized by governments,

especially if they are producing capital goods or intermediate goods. Fifth, competition among the region's producers may force prices of Central American products down, so that imported goods are no longer attractive to the consumer. Only this last case is a true example of tariff redundancy, of water in the tariff. In the first two cases, any reduction in tariff rates would allow importers to gain market share at the expense of the region's producers, while the second two cases are examples of erosion of the legal tariff resulting from duty exemptions or smuggling activity.

Owing to a dearth of price comparisons between Central American products and imports (or potential imports), no study has yet been undertaken of the structure of actually utilized protection, although there are a number of studies of the structure of legal protection. Such a study done recently for Costa Rica<sup>10</sup> is exceptionally careful and detailed and has the advantage of calculating not only the legal rate of protection, but also what the author calls a "real" rate of protection when tariff exemptions are taken into account.

It is not clear which tariff—legal or real in the Costa Rica study—is most relevant for our purposes. The legal tariff on textiles (ISIC category 3211), for example, was 46% in 1982, but importers were exempted from payment of well over half the duties in that year, so the duties collected as a proportion of the value of extra-regional imports was only 19%.

<sup>9</sup>SIECA, *El desarrollo integrado de Centroamérica en la presente década* (BID/INTAL, Buenos Aires, 1974), vol. 4, p. 38.

<sup>10</sup>Marvin Taylor D., *Estructura de la protección al sector industrial en Costa Rica* (DISEGRAF, Fernández Arce), San José, Costa Rica, 1984.

This 19% rate is regarded as the "real" tariff in the Costa Rica study, but no one actually paid it. Manufacturers of clothing enjoyed a zero rate of duty because imports for further processing were generally exempt. Stores purchasing cloth for direct sale to the consumer paid the full legal tariff, i.e., 46%. The 19% "real" rate is thus an average applicable to two very different types of consumer. Perhaps both rates should be used: the low one in calculating effective rates of protection of the clothing industry and the higher one in calculating nominal and effective protection of the textiles sold to final users. This possibility was not considered by the author of the Costa Rica study, so the "real" rate (19% in the case of textiles) is used, even though this underestimates the tariff protection.

The way in which the average tariff for each industry was estimated in the Costa Rica study also underestimates the real protection rate. In the absence of detailed data for consumption or production of individual products, imports were used as weights to obtain average rates of protection in each four-digit ISIC industry. Import weights are generally suspect for this purpose because imports are affected by tariff protection: high tariffs, which do a good job keeping out imports, receive low weights; but what is more, prohibitive tariffs receive zero weights. Nevertheless, it is quite possible that the author used *total* imports rather than *extra-regional* imports as weights. In this case, there would be no systematic tendency to underestimate protection, for high tariffs result in a diversion of trade from extra-regional to regional suppliers.<sup>11</sup>

Taking the estimates of the "real" rate of protection of each Costa Rican industry in 1980 and 1982 as data, table 13 reports the results of weighting each rate by five different variables: production, intra-regional imports, intra-regional exports, extra-regional imports and extra-regional exports. Tariff rates were generally lower in 1982 than in 1980 because the Costa Rican government removed a number of import surcharges and import deposit requirements following a sharp devaluation of the national currency.

<sup>11</sup>If total imports were used as weights, this could explain the lack of any significant correlation between nominal protection and imports within each four-digit industry. See Marvin Taylor, *op. cit.*, pp. 37-42.

Table 13  
COSTA RICA: NOMINAL AND EFFECTIVE  
RATES OF PROTECTION  
(Weighted averages)

Weight	Nominal protection		Effective protection	
	1980	1982	1980	1982
Production	38.0	31.5	186.6	183.3
Intra-regional				
Imports	32.1	24.3	135.0	120.0
Exports	31.0	26.0	136.9	111.5
Extra-regional				
Imports	24.8	20.2	126.3	104.1
Exports	33.3	29.9	153.7	270.3

*Source:* Calculations of the author based on official trade and production statistics and estimates of nominal and effective protection (Corden method) in Marvin Taylor Dormond, *Estructura de la protección al sector industrial en Costa Rica* (DISEGRAF Fernández Arce, San José, 1984).

*Note:* In an attempt to weight tariffs by trade and output at free trade prices, intra-regional trade and output destined for domestic or regional markets was deflated using the nominal tariff of the corresponding 4-digit ISIC category. Intra-regional trade is trade with other Central American countries and Panama.

Raw materials and inputs for industry tend to have very low tariffs or to be exempted from payment of tariffs. Thus the effective rate of protection, i.e., protection of industrial value-added, shown in table 13, tends to be much higher than the nominal rate of protection. Furthermore, average protection—both nominal and effective—is lower when weighted by intra-regional trade than when weighted by production. This indicates that the manufactures traded within the region tend to receive somewhat less protection than those destined for home markets. Weighting each industry's rate by extra-regional imports reduces average protection, because high tariffs discourage imports. Surprisingly, average protection when weighted by extra-regional exports is nearly as high as when weighted by production. In one case—effective protection in 1982—the extra-regional export-weighted average rate actually exceeds the production-weighted rate by a considerable margin. If tariff protection is a disincentive to export, one would expect extra-regional exports, in the absence of subsidies to be concentrated in industries with low rates of protection.

Table 14  
**COSTA RICA, EL SALVADOR, GUATEMALA AND NICARAGUA:  
 NOMINAL AND EFFECTIVE RATES OF PROTECTION**

(Weighted averages)

	Costa Rica		El Salvador		Guatemala		Nicaragua	
	Nominal	Effective	Nominal	Effective	Nominal	Effective	Nominal	Effective
Production	42.1	90.9	...	...	39.4	86.6	...	...
Intra-regional								
Imports	38.3	86.1	37.9	82.0	35.9	76.8	35.9	73.6
Exports	35.6	74.4	38.9	85.0	35.9	78.4	32.6	67.9
Extra-regional								
Imports	31.4	60.3	31.7	64.6	30.8	61.2	30.1	58.6
Exports	41.8	100.1	46.3	93.2	39.9	89.1	40.6	106.9

*Source:* Calculations of the author based on data from SIECA and each country.

*Note:* Output and trade data are for the year 1985, but the new external tariff was not implemented until 1986. In an attempt to weight tariffs by trade and output at free trade prices, intra-regional trade and output destined for domestic or regional markets was deflated using the nominal tariff of the corresponding 4-digit ISIC category. Disaggregate production data were not available for El Salvador or Nicaragua. Intra-regional trade is trade with other Central American countries and Panama.

In 1985 the four members of the Central American Common Market agreed on a new Common External Tariff that was implemented in three countries in 1986 and in the fourth (Nicaragua) in 1987. SIECA has made some rough estimates of nominal and effective protection for four-digit ISIC industries, so it is possible to repeat the same exercise of alternative weighting schemes for each of the four countries. It is important to emphasize that these calculations, reported in table 14, are not comparable with those of table 13 for two reasons: first, and most important, the SIECA calculations start from an unweighted average tariff of all final goods and of all inputs, unlike the import-weighted procedure used in the Costa Rica study; secondly, the Common External Tariff does not cover all industries, and those industries that are subject to national discretion are excluded from the calculations.

The results using estimated rates of the new Common External Tariff coincide with the findings for Costa Rica in 1980 and 1982. Average rates of protection weighted by intra-regional trade are lower than those weighted by production. Protective rates weighted by extra-regional imports are even lower, but those weighted by extra-regional exports are highest of all.

That extra-regional export-weights should produce the highest estimate of protection would appear to be counter-intuitive. Nonetheless, there are three possible explanations for

this result, and they are not mutually exclusive. First, it may be evidence of considerable "water" in the external tariff: producers in export industries are competitive and have no need for the high protection accorded their activities. Second, producers may price discriminate between regional and extra-regional markets, charging local consumers for the fixed cost of production and employing lower, marginal cost prices in competitive export markets. Third, and most important, the four-digit ISIC industries are very heterogeneous, so exports and imports (or potential imports) are often very distinct products. Consider, for example, ISIC 3114 "Canning, Preserving and Processing of Fish, Crustacea and Similar Foods". This industry enjoys extremely high rates of protection, yet also registers high levels of extra-regional exports. The exports, however, consist largely of frozen shrimp, whereas imports cover a wide range of goods from salted cod to smoked oysters and caviar. Those who freeze and export shrimp need no protection at all, whereas factories processing tuna and sardines for the local market may require considerable protection in order to compete with imports.<sup>12</sup>

<sup>12</sup>The effective rates of protection for the seafood industry were infinite in 1980 and 1982, implying negative value-added when inputs and outputs are measured at free-trade prices. In this case—and all other cases of extremely high protection—I arbitrarily used a protective rate of 500% in the calculations reported in table 13.

## V

## Summary and conclusions

In the 1960s Central American manufacturing grew rapidly by producing locally goods that were previously imported from outside the region. By the end of that decade, possibilities of import substitution were generally considered to be exhausted and the ratio of extra-regional imports to apparent consumption of manufactures ceased to fall in the 1970s and 1980s.

Most of the industries producing simple consumer goods such as beverages, tobacco, clothing, shoes, wood and furniture now have extremely low ratios of extra-regional supply, so further import substitution will have to come from capital and intermediate goods. Textiles is an exception in that it is one light industry where there is room for import substitution. Extra-regional imports supply nearly a third of the textiles consumed in Central America even though there is considerable excess capacity in this industry. This meagre import substitution in textiles compared with other simple manufactures did not occur by accident: textiles are inputs for the clothing industry, and the governments of Central America have followed a policy of tariff exemptions for the importation of inputs. Nonetheless, the new Common External Tariff has eliminated the practice of granting this type of tariff exemption, and this should encourage greater substitution for imports of textiles.

In the 1970s manufacturing grew at a slower pace than it had in the previous decade, but it continued to grow more rapidly than other sectors of the Central American economy. Nonetheless, it was internal demand and not import substitution that fueled the growth of manufacturing. The ratio of extra-regional imports to consumption of manufactures actually rose in this period, and there was little promotion of exports of manufactures to markets outside the region. The model of industrialization based on the substitution of imports in an expanded market began to falter, and this became most evident in the crisis of the 1980s.

During the decade of 1970-1979 intra-regional trade began to contract in relative terms and the contraction accelerated after 1980. With

the loss of markets in neighbouring countries, and given the absence of incentives to export to countries outside the region, the industrialists of Central America turned to their home markets. In 1970, they sold 75% of their production to local consumers. In 1985 this proportion increased to 83%.

Although the Central American Common Market has not been transformed into a platform for exporting manufactures to the rest of the world, there have been some gains in the last two decades. All five countries now export a much wider range of manufactures than they did a few years ago. In intra-regional trade the structure of exports in each country has always been similar to that of their imports. This similarity is now becoming a feature of extra-regional trade in manufactures as well. Moreover, exports of manufactures to third countries are very similar to exports to countries of the region. This suggests the possibility that producers have learned to export in the protected Central American market and, with some incentives, could turn to extra-regional markets.

Lack of success in promoting extra-regional exports of manufactures is usually attributed to a high level of tariff protection. Tariffs allow the Central American manufacturer to sell high cost, low-quality products at high prices and make exports to competitive overseas markets unattractive. If this is true, one would expect the average protection for those manufactures that are exported to be much lower than protection for goods sold in the regional market.

Surprisingly, the available data appear to indicate that extra-regional exports of manufactures receive, on average, higher rates of protection than intra-regional exports. This might be interpreted as evidence of a lot of "water" in the external tariff: Central American industrialists produce at low cost and have no need for such high rates of tariff protection. It is also very likely that this result is due, at least in part, to statistical shortcomings. At the available level of disaggregation (four-digit ISIC) industries are

very heterogenous, so that very dissimilar products are included. The seafood industry (ISIC 3114), for example, has a high rate of protection but is also a big exporter. A detailed analysis of this industry shows that exports are mainly of frozen shrimp, while imports include more highly processed products, especially canned goods. Although it is true that shrimp exports do

not need protection, canned tuna and sardines may require high protection if they are to survive. The rates of protection employed for the present study, are averages for entire industries. Further research is needed with desagregated data and, preferably, comparisons of Central American prices with international prices, and not just legal tariffs.

## Appendix

### *Sources of manufacturing growth*

Consider the following accounting identity:

$$(1) Q = D + X - M,$$

where  $Q$  is the output or production of an industry,  $D$  is home demand or apparent consumption,  $X$  represents exports and  $M$  is imports. Let the absence of import substitution be represented by a constant ratio  $m$  of imports to apparent consumption:

$$(2) m = M/D = M / (Q - X + M).$$

Similarly, let us assume that the absence of export promotion requires constancy of the ratio of exports to local production:

$$(3) x = X / Q.$$

Once we have values for apparent consumption and output in a base year and a terminal year, observed changes in imports and exports ( $\Delta M$  and  $\Delta X$ ) can be divided in to changes attributable to growth in demand or production ( $\Delta D$  or  $\Delta Q$ ) and changes attributable to changes in the ratios  $m$  and  $x$ . It is easily shown that a change in imports is identically equal to the sum of two terms:

$$(4) \Delta M = m_0 \Delta D + (m_1 - m_0) D_1.$$

The first term on the right is the import ratio in the base year ( $m_0$ ) multiplied by the change in demand, whereas the second term is the change in the import ratio multiplied by consumption in the terminal year ( $D_1$ ). The first term is thus the "expected" growth of imports given growth of domestic demand, whereas the second is a measure of import substitution, i.e., the deviation of imports from their expected level. Similarly, the observed change in exports is equal to expected export growth plus a measure of export promotion:

$$(5) \Delta X = x_0 \Delta Q + (x_1 - x_0) Q_1.$$

Expected exports equal the base period export ratio times the change in output, whereas export promotion is the change in the export ratio times the output of the terminal year.

Equation (1) can also be written in deviation or change form,

$$(6) \Delta Q = \Delta D + \Delta X - \Delta M,$$

where  $\Delta Q = Q_1 - Q_0$ ,  $\Delta D = D_1 - D_0$ ,  $\Delta X = X_1 - X_0$ , and  $\Delta M = M_1 - M_0$ .

Substituting the expressions of equations (4) and (5) for  $\Delta M$  and  $\Delta X$ ,

$$(7) \Delta Q = (1 - m_0) \Delta D + x_0 \Delta Q - (m_1 - m_0) D_1 + (x_1 - x_0) Q_1.$$

The first two terms on the right-hand-side (R.H.S.) of equation (7) represent the change in output attributable to "expected" growth of consumption and exports; their sum is the change in output consistent with constant trade ratios. The third term is a measure of import substitution and carries a negative sign, since a decrease in the import ratio has a positive effect on local production. The last term measures the contribution of export promotion (an increase in the export ratio) to overall growth.



## The specificity of the Latin American State

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The events of the last few years in Latin America have made it necessary to resume the discussion on the role of the State in the development of the region.

With a view to contributing to this debate, the author presents in five sections a synthesis of the ideas put forward on the subject of the authors consulted. The first section deals with the influence of external links on the character of the Latin American State, the special features of that influence being closely related to the past and present links between the economies of the region and the international economic system. The relationship between the State and the national economy is the central theme of the second section. In it, the State's role in the formation of a national form of capitalism is pointed out, and this entails considering the relationship between State administration and management in private enterprise, the intervention of the State in social conflict, the problems to be faced in making the economic logic of the private sector compatible with the political and economic logic of the State, and the question of planning in mixed economies. The third section refers to the State and the system of social relations. It emphasizes the processes of social articulation and disarticulation that affect the countries of the region and the role the State plays, against this background, in establishing a social order. The central point in this analysis is the relationship between the State and civil society, taking into account the greater complexity of the latter in today's world. The fourth section deals with the State and the political system. It discusses the thesis of the ungovernability of democracy and proposes as an alternative greater democratization and receptiveness to social demands on the part of the State. The section also contains an analysis of the system of political institutions and of the expectations about the relationship between modernization and democracy. Finally, in the fifth section the State apparatus proper is analysed, with emphasis on its historical character and the elements that influence the orientations of the bureaucracy, especially the pressures exerted by society on the State.

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## Introducción

The economic, social and political problems affecting Latin America have made it necessary to return to the question of the role of the State in development. Indeed, this is a matter of growing urgency in the context of world and local change in which these problems arise.

Given the persistent ideological debates of the last few years, the magnitude of the coming changes is obvious. Deeper consideration therefore needs to be given to the virtues or vices of State administration and, even more importantly, certain judgements of reality that condition the purely ideological options need to be taken into account in the proposals that may be made.

There is a relatively extensive literature in Latin America dealing directly or indirectly with the concrete forms of State action in the countries of the region. This article is a first attempt to put some order into the subject. It is not exhaustive, however, either with respect to bibliographical sources (a number of important works were not included) or to the questions that could be treated.

The article limits itself to what the consulted authors have to say, although without quoting them directly, so that much of the text is a synthesis of what has been said by the authors that appear in the bibliography.

It is worth repeating that this essay aims only to be a preliminary contribution to the discussion in question.

## I

### The State and the external relations of Latin America

The State always reflects the complex set of economic, social and, especially, power relations that are found in a society. Neither the history of the State nor its present form can be understood by considering only the forms in which the economic relations between classes and social groups are organized. Considering the State as a



superstructure which reflects a given economic relation does not come anywhere near exhausting the different possibilities of analysis and interpretation. Neither is the State a phenomenon that takes place outside the bounds of social relationships.

With respect to its specific characteristics, the particular nature of the State in the Latin American countries is linked in large measure with the way in which capitalism, as an economic and social formation, is established in each country. This means taking into account both the way in which it was implanted as a "mode of production" and also the type of social relations it gives rise to in society as a whole. The manner of implantation of capitalism, especially in the case of Latin America, however, cannot ignore the relations established with international capitalism, which must be considered hegemonic.

Latin American authors frequently point to a flagrant contradiction in the formation and development of the States of the region—a contradiction characterized by the coexistence of a modern State, possessing a constitutional, juridical and institutional order, side by side with a mode of social relations readily characterized as traditional because of its oligarchical character. This contradiction, it is held, derived from a dual reality: on the one hand, the need to be linked with the "modern" world of international capitalism, and on the other, the need to ensure a form of internal control based on social relations that are not capitalist in the strict sense of the term. That duality involved alliances between social strata whose interests were different because their power bases were capitalist to different degrees, leading to the "contradictory" character of the State.

Thus, for these different sectors with diverse interests and linkages, the political problem was not simply to acquire control of the State apparatus, but to be able to define the State and, through it, a mode of relations. However, just as the forms of internal relations between the different groups characterized the State, the external relations and the ways of establishing them became another almost essential dimension of building the State in Latin America.

The dependent character of the Latin American countries' insertion into the world market has led to backwardness. The centre-periphery relationship that arose faced the "peripheral" countries with the challenge of securing a form of development that implied setting national objectives, the achievement of which, in one way or another, was considered to be the task of the State. The peripheral status of these countries was compounded by their dependence and late development—a situation in which the State found itself practically obliged to carry out the greater part of the development effort.

The particular situation in which the centre-periphery dependent relationship places the Latin American countries also influences the role that the State has to play. Because of the ongoing process of evolution of world capitalism, the latter is subject to reorganizations which very often lead to crises in the Latin American countries. This is because—as many analysts have pointed out—the economic transformation of a dependent country generally lacks an internal driving force, so that the reorganization of the central economies means drastic adjustments in the way peripheral and dependent countries are inserted in the world economy. In almost all circumstances, the State has had to play an important role in overcoming this kind of crisis and in reinserting the country into the world economy.

In the context of the external relationship already referred to, the State plays an important role in regulating the pace and volume as well as the orientation of economic activity. In many cases, the State has adopted policies designed to regulate the quantity of exportable goods, specially minerals and agricultural products, in order to gain better conditions of access to the world market. More often than not, the cost of these operations is covered by the State.

In late-developing countries, the State plays a key role in the accumulation of public or private capital, and in dependent economies, it often organizes accumulation "administratively", generally using mechanisms for regulating foreign trade, the whole range of mechanisms for transferring income from one sector to another, and the control of exchange rates.

In short, the State fulfills a prime function with regard to relations with the economic centre, but also through legislation, it establishes the way foreign producers incorporated in local production must operate and, in this sense, acts as a mediator.

It is important to emphasize that the above gives the State the power to intervene, especially through the State bureaucracy, which, as will be seen later on, can use this power to its own benefit.

Even though the State in dependent countries must fulfill the important tasks mentioned, this does not necessarily mean that it is a strong State. In the majority of cases it faces these challenges from a position of weakness, due to the peculiar relation between political and economic matters which exists in those countries.

In contemporary capitalist societies the economic sphere is undoubtedly shaped by the world market, and in that context the dependent countries are "subordinate". They generally have relatively little power to take certain basic economic decisions, especially those concerning the production and marketing of goods. On the other hand, the "political sphere" still has the nation-State as its principal referent. This does not mean that "international politics" does not exist, but rather that it is carried out as a function of the nation-State. The result is that while the economic logic imposed by the power of the world market can in some cases agree with political logic, it can also frequently oppose it.

In the "central countries", in contrast, there tends to be a greater correspondence between the political logic —purposes, objectives and orientations of the nation-State— and the economic logic linked to the world market. This is simply due to the power those countries have in that market.

The logic of the world market tends to weaken the nation-State when it is imposed in the dependent countries. The State apparatus can nevertheless grow in spite of that, even if it has less power. This apparent contradiction is due to the fact that the "State apparatus" ensures the form of dependence.

When the peripheral countries' economic forces are compared with those of the central countries, the contrast between the weakness of

the local socioeconomic agents and the power of their foreign counterparts becomes immediately apparent. The awareness of this weakness of the local agents has led in various circumstances to attempts to use the State apparatus to favour the development of the national private sector.

In addition to policies designed to create ways of associating with foreign capital through the State suitable conditions for strengthening the local economic agents, have frequently been sought. Most of the "developmentalist" policies have been aimed at consolidating and favouring a national bourgeoisie, with the supposed goal of contributing to national political autonomy. Those sectors, however, frequently prefer to seek a formula of association with international capitalist development rather than being independent. In that sense, a contradiction is produced in the very heart of the State between policies that favour the development of the bourgeoisie and the intention to promote national political autonomy.

On the other hand, it is always interesting to observe how foreign capital, when it has participated in the national market, has taken advantage of the same protectionist measures designed to promote the development of national capital.

Students of present trends in the world economy point out that the State —which in spite of its difficulties is still a key factor in defining external economic relations— now has much less room for action in this sphere because of the transnationalization of the international economy. When they consider the relation between the State and the international economy, many authors characterize the present phase of capitalism as post-national capitalism, a term intended to emphasize the degree of inoperativeness of the State in the local economy. This phenomenon has been observed even in the central economies, and it is asserted that the policies of large corporations are often in contradiction with governmental orientations. These authors stress the fact that national economic policies are no longer fully effective. This obviously affects the foundations of political systems, such as autonomy and sovereignty.

The history of the ways in which transnationalization has influenced the State in Latin America is relatively well-known. In many coun-

tries, the decisive presence of transnational enterprises in key sectors of the economy has meant that even the dynamics of domestic development are highly influenced by the policies of those enterprises, and that the importance of the State's action in those dynamics has diminished. In fact, in many cases the State has had no option but to go along with the dynamics imposed by the transnationals. In order to tackle the phenomenon of transnationalization, some Latin American States have sought to apply policies based on the new situations this has been generating.

The development of transnationalization meant that distinct poles were formed in the world capitalist system. The most important are the economies of Japan and West Germany; but also important—in addition to other economies—are the European Economic Community as a whole and some countries belonging to other regions, which allows for a wider gamut.

Some Latin American States have attempted to develop a policy of avoiding dependence on U.S. capital. To that end they have sought to create competition between foreign investments, with a view to giving national capital different ways of participating and also allowing for distinct forms of regulation and technological relations, for example, by breaking down "technological packages", developing intermediate technologies, and other options.

Looking back on the overall situation, the analysts agree that policies of associating with foreign capital have not succeeded to the degree that was hoped for. For this reason, the thesis is once again being put forward that the creation of development opportunities for local capital, be it private or of the State, still depends in large part on the existence of some protectionist guidelines, determined public policies and State support.

Finally, let us turn to one of the most interesting facts of the present moment. It is well known that for part of the 1970s the expansion of national economies (public or private) in Latin America was principally due to additional financing from international banks. In many cases, through such credit, foreign enterprises participated in areas usually reserved for the State. The most common instruments for

securing this participation were co-production contracts, technological services, marketing services and the provision of machinery and inputs. That kind of foreign participation naturally affected the autonomy of the economic activities undertaken.

In this connection, it should be emphasized that not only does a certain manner of functioning of transnationalized capitalism endanger or diminish the autonomy and power of the State, thus increasing dependency, but also that some domestic groups, especially those that promote export strategies to the extreme, reinforce this tendency by opposing what they consider to be harmful State intervention. The most serious areas of intervention for these groups are: first, those that refer to international trade, since in their view, intervention leads to restrictions that tend to isolate the national economy from the rest of the world; second, internal price and wage fixing, because they consider that these produce rigidities in factor and product markets and lead to a general disorganization of relative prices, the result being high inflation, maintained in turn by incoherent fiscal, monetary and wage policies; and lastly, direct production by State enterprises, which they consider harmful because they claim that State production is inefficient and subsidized, with artificially low prices that will necessarily produce a budget deficit. In general, their opinion is that State intervention is inefficient and detrimental to "true development". The strategy proposed by these groups stresses the need for the State to withdraw from the market, to do away with restrictions on foreign trade and eliminate the so-called internal "rigidities", to use policy instruments (both general and indirect) to curb inflation, and to promote an export-oriented outlook. The application of this strategy naturally also implies, a "State policy", so that the real problem is who determines the actions and omissions of the State and how these are determined. The question, then, is not that of taking it for granted on the analytical level that the State should withdraw from the arena, but rather of determining who should orient the State and through which policies.

Thus, for example, the present form of relation with the exterior has led to strong

pressures that have obliged some States to implement a policy of recessionary adjustments, combining restrictions on demand and reorientations of growth strategies, in order to promote domestic savings and investments and expand investments. In fact, restrictions have been placed on net international reserves, the maximum deficit on current account, exchange and tariff policies, the maximum deficit of the

non-financial public sector, the scales of charges of public enterprises, and maximum inflation rates, while wage increases have been controlled by making wages non-adjustable. This list of conditions for external negotiations, which is applicable to a considerable number of countries, shows the degree of dependence to which State policies can be reduced.

## II

### The State and the national economy

The present discussion about the State's role in the economy centres on aspects different from those around which the debate of the first half of the 1980s revolved. This is due to the clearer perception of the current world changes brought on by the inevitable technological transformations and by the reordering of overall national and international economic relations. Furthermore, the region also appears to be changing politically in the direction of democratization, which above and beyond its positive aspects, also presents difficulties and conflicts inherent in that kind of process.

The crisis of the 1980s and the greater awareness of the challenges faced seems to have given rise now to a certain consensus that governments should promote policies to renew the accumulation process and restore growth capacity in order to attain real development.

The central topic of the debate is the magnitude of the efforts needed to accomplish those objectives and less explicitly the question of who, or what social force, is capable of accomplishing them.

Furthermore, in the light of the process of democratization referred to above, the goal of development which is being pursued must also involve dimensions of equity, so that issues such as income distribution and the consumption levels of the popular sectors continue to be relevant. Moreover, equity is not only a requirement for the goal of democratization but also a key element for the performance of the economy itself, since the social cohesion that

equity makes possible is a crucial factor in economic development.

The level of consensus referred to is nonetheless not without areas of disagreement and even conflict regarding the way to accomplish these objectives. There is considerable external and internal pressure regarding fundamental points related to the possibilities of accomplishing the goals with the discussion centering particularly on the level and composition of public expenditure, the size of the fiscal deficit, and the type and possibilities of indebtedness.

However, because of the experience acquired in the last few years, it is now once again agreed that a necessary function of the State is to modify some of the negative results (both economic and social) springing from a market economy, taking into account the real conditions in which that economy is now operating.

Indeed, given the challenges of the crisis and imminent technological and economic change, it is almost inevitable that the State should participate in the formulation of criteria for allocating resources. For a democratic system to function, the demands of the different sectors have to be heeded and furthermore the performance of governments must be periodically sanctioned by means of political votes. This obliges the State to explicitly formulate a development policy that takes into account the interests of the different social groups and develops a real capacity to satisfy them, and in addition, especially under present

conditions, governments will have to reformulate the question of income distribution and specify the kind of policies they propose to achieve it.

Despite this obvious need for State action, however, criteria are constantly put forward which stress the desirability of the predominance of the market laws. As a counterpart, it should be pointed out that decisive State action presupposes accepting that it is the State's responsibility to formulate the criteria for the allocation of resources, and moreover, if it is really intended to take care of the demands of less favoured sectors, policies expressly designed to improve income distribution must be put into effect.

It must be emphasized that the functioning of the market reproduces the dominant form of social power, and therefore, if the allocation of resources is left to the market, these will flow to the sectors with power or to the activities that they are interested in. It is a fact that the market, as a social relation, constantly reproduces social differentiation, so that, without deliberate action to, for example, redistribute income through direct or indirect mechanisms, the situation of the less favoured sectors cannot be positively expressed in the market.

A policy of State action presupposes, then, an intentional policy of both economic and social development, which implies, according to the terminology in vogue, an "image-objective" of society. It consequently presupposes or calls for a type of economic action whose rationale seeks to adapt the means — policies in the broad sense in this case — to achieve the desired ends.

The opposite point of view holds that the most efficient allocation of resources is achieved through the functioning of the market itself, and that society as a whole can benefit from this.

Along with the "rationality of the market" (which, it should be remembered, is only rational in theory) the supporters of this approach also tend to affirm that the leading agent of economic dynamism is the entrepreneur, who, moreover, is often seen in his typical, ideal Schumpeterian form.

This theoretical position advocates a model of high-productivity, more dynamic enterprises. The option put forward is to attempt to come as close as possible to a rationality based on the

economic calculation of those enterprises. It should be noted, however, that there are no serious studies identifying what the "economic calculation" of that type of enterprise in Latin America really is; and perhaps if such studies were carried out they would produce a number of surprises.

In the formula outlined, the State's primary task is to ensure the functioning of the market, although it is not clear if it should do so in the light of the power structure that the real market signifies or if it should seek to adapt that power structure to the conditions that the theory presupposes.

The less extreme positions about who should have pre-eminence in determining economic orientations have tried to seek a balance between the public and the private sectors, that is, between the role of the State and that of the market. This position is based on the assumption or perhaps more the underlying intention that it may be possible to take advantage of the positive aspects of both of them. If this were done, the theory holds, this would facilitate the complementarity of the two sectors and, even more, avoid the negative consequences that might be supposed to come from an excessive predominance of either of them.

This proposed reconciliation would seem to be eminently sensible and rational, but it is very difficult in practice to reconcile the power of the *market* with the *power* of the *State*, or rather the social relations that take place in the marketplace and those that relate to the State. The concrete fact is that the conflictive relations between these two forms of power have always been more important than proposals of a strictly technical, neutral character.

From a socio-political viewpoint, what is paradoxical in Latin America is that often the proposals stressing the need for State action were based on the idea that the State could contribute to the development of a "national capitalism" and, consequently, to a vigorous private-enterprise group.

The challenges that arose involved making social relations fully capitalist. In general, the following were considered key problems for development policies: a) the transformation of external relations to make possible a more

autonomous form of development; b) the transformation of internal relations and especially of the agrarian structure; it is not by chance that this structure is constantly branded as feudal, semifeudal, precapitalist, or something similar; and c) it was taken for granted that the State should promote the transformations that had been brought about in other places by the capitalist bourgeoisie, but at the same time it should try to form a sector of "local capitalist entrepreneurs".

The apparent consensus nevertheless began to break down when it was hinted that it was necessary to establish the "set of capitalist relations" characteristic of modern societies, that is to say, when it was recommended that the capacity to form trade unions should be strengthened and that a system of non-traditional —neither authoritarian nor paternalistic— labour relations and other features of modern society should be put into effect. Promoting such transformations presupposes conflicts, and frequently the demands of the new sectors are contradictory to the objectives and interests of the would-be "capitalist entrepreneurs".

The State-versus-market controversy may tend to obscure the undeniable fact that the State, independently of the degree to which society is capitalist or "free-enterprise", always has the function of establishing the institutional framework in which capitalism operates. The concrete fact is that in a capitalist society the State legitimates social relations. It can certainly make reforms and corrections, but basically its purpose is to ensure the functioning of the system.

To a certain extent the State has had the function of "installing capitalism", and this has interesting implications. The fact that the State proposed a capitalist society meant that the whole of society had to be capitalist, and this called for an explicit development plan. Consequently, what was involved was a capitalist society which nevertheless incorporated the idea of a planning State. The State used mainly monetary and fiscal instruments, exchange rates and tariffs to accomplish this task.

However, the main presupposition —and a logical one if it was aimed to construct a capitalist society— was that the direct execution

of economic activity should remain preferably and principally in private hands. In the original proposals as already pointed out, State activity was complementary and applicable only when strictly necessary.

The problem continues to be, however, how to make the "general objectives" (that is to say, those that are valid for the whole of society) coincide with the particular objectives of the entrepreneurs. The exact coincidence between general interest and particular interest can only be affirmed in theory, since at that level the correspondence between the two is formulated on a highly abstract level, far removed from the day-to-day clash of immediate interests.

A review of Latin American history shows that generally speaking every transformation promoted by the State has created situations of conflict. The goal of converting Latin American society into a modern industrial society necessarily implied transforming the traditional structure, and consequently a struggle with the interests connected with the latter was almost inevitable. The very idea of preparing a plan valid for the whole of society naturally presupposed —above and beyond the difficult task of reconciling opposing interests— the redistribution of economic and social power: a change that could hardly be peacefully accepted.

The development tasks proposed involved efforts in such areas as capital accumulation, the protection and promotion of industrialization, reduction of external vulnerability, creation of infrastructure, and the stimulation and guidance of technological change. None of these options was or is socially neutral, and the form these processes take has a strong impact on the established economic and social powers, and, hence on the social situation itself.

In short, the economic action of the State —to the extent that it intends to introduce structural change— necessarily involves the need to solve or intervene in the conflicts that such change provokes. The important point is that since the State, is itself the agent of change, it must resolve within itself the conflicts of interest produced in society.

Looking back at recent history, it is very noteworthy that problems have got worse in proportion as the process of development and economic growth has gathered momentum. The

problem no longer consisted only in confronting "traditional" society and the interests it represented. Instead, given the prevailing development style in Latin America, what came to the fore were the well-known tendencies towards social and regional concentration of power, wealth and income, with their corollary of the exclusion of vast social groups from the benefits of growth. It was no surprise, therefore, that in these circumstances a few factors were sufficient to exacerbate social conflicts. Doubts always arise in such a situation about the possibilities of planning and arriving at economic and social pacts in a context like that.

In short, in a capitalist system like that prevailing in Latin America, which seeks to operate in a democratic context, the State's capacity for economic action is closely linked to its political capacity, understood fundamentally as its capacity to achieve some kind of agreement and social support which will make it possible to reach collective economic goals.

The special features of the economic and social structure of Latin America and the context in which it is situated render it difficult to make social relations harmonious. The State has often tried to counteract what can be considered as the individually-oriented attitude of the private sector: an attitude which—in view of the present conditions— can be resolved in favour of the general interest only with great difficulty. The mechanisms promoted by the State with this aim have often been direct investment in production, public finance mechanisms, and some degree of control over the private financial system.

In this sense, economic policy instruments are of key importance for giving the overall economy, through State action, an orientation serving the general interest. There are also other functions of the State, however—particularly social policies—which contribute to the running of the economic system. Satisfying the demands of middle- and working-class, rural and urban groups, apart from the immediate benefit involved, helps to maintain a certain degree of social harmony while at the same time legitimizing the State and the economic and social system as a whole. Social policies clearly do more than just legitimize the system: many of them, for example, help to increase the productivity of labour. It could even be argued

that many projects and services connected with social policies actually give the capitalist sector the possibility of lowering the costs of reproducing the labour force.

Nevertheless, State action in the economic sphere in Latin America takes on different forms in each country. The mode of production is common, that is, it is the capitalist mode, but it has diversified into different and particular forms of development which constitute specific capitalist situations. Historically distinct patterns of formation of the productive system, different models of accumulation and different structures of dominant classes and organization of power can therefore be noted. Consequently, this diversity leads to different forms of constitution of the State, different forms of the State's economic role, and differing kinds of articulations of the State with the class structure and society.

The fact that the economic activity of the State is carried on in a capitalist system does not preclude taking account of the differences between the private and the State economies. If we adhere strictly to theory, the market economy should satisfy the demands of individuals, although in fact actions of different kinds of "groups" which superimpose themselves on the "individual" are by no means unknown in this type of economy. On the other hand, the market also expresses a system of social relations of production, and particularly important among these is the relation that is established between the owners and the non-owners of the means of production. In theory, too, the demands in the State economy are not from individuals; they are social demands. Moreover, the relationship between those who participate in the State economy is not supposedly a relationship between owners and non-owners of the means of production, since, at least theoretically, the property is socialized through the State. In short, different forms of social and power relations are constituted both through the market and through the State, each one with its own modalities and specificities. The problem in Latin America—and in any mixed economy—is to make these forms of power compatible and establish relations among them.

State enterprises in Latin America have often expanded to the point of having their own accumulation base. That meant more economic

power for the State, and, consequently, for the bureaucracy, which in extreme situations began to manage the public sector in its own self-interest.

Some attempts would seem to have been made to overcome the above-mentioned difficulty of rendering different forms of power compatible—at least recently in some countries—by running State enterprises according to criteria very similar to those of private enterprise.

The private-enterprise sector, for its part, maintains an ongoing interest in the economic action of the State. During slumps it frequently attempts to pass on investment costs—reproductive or otherwise—to the State. Also during slumps this sector tries to ensure that State investment is maintained in a form which is as favourable as possible to it, and it therefore tries to define investment “priorities”. It likewise exerts pressure on the State to shoulder the social cost of the contraction and to formulate policies that will keep the social costs low. At times of expansion, as is to be expected, capitalist interest in investment flares up once again, and the biggest concern of the private sector is that the State “should not invade its areas of investment”.

Examples like those above—and many more could be added—prove that there is a relation between the private sector and the State, but the principal problem remains—in spite of everything—how to make the interests of the two sectors compatible. This is why it is important that the State should establish a formal framework within which economic activities are to be carried on. It is a question of achieving an agreement that cannot be merely political, in the parliamentary sense of the word. If it were a purely “parliamentary” agreement, then it would be decisively influenced by competition between political parties, the electoral calendar, regional criteria and many other things. Nor would it be unusual for specific interests and short-term views to tend to predominate in this type of agreement.

One solution sometimes proposed for making interests compatible is to try to combine parliamentary representation with corporatist representation. As many authors point out, however, corporatist representation in Latin

America has little or no transparency, and often takes the form of direct lobbying of the appropriate ministry.

By way of clarification, it should be pointed out that an important feature of the Latin American State is that, unlike the “pure capitalist State” (as an “ideal type”), it possesses its own productive sector. When the basis for accumulation is solely private, the State is dependant on that basis, since it obtains its resources through taxes or some other similar method. When that happens, those who exercise the State power are basically interested in promoting more favourable conditions for private accumulation, on which a good part of the State power depends, and in such a case, the analysts point out, State action aimed at expanding private accumulation does not necessarily derive directly from control that the capitalist class exercises on the State apparatus.

Mixed economies—which cover the majority of those in Latin America—are characterized by the existence of two logics. One of these, which is of a strictly economic nature, applies within the context of the market and is the expression of the private sector; the other is a political logic which applies within the context of the State. In the first context, the conduct of the actors will be guided by the profit motive; in the second (that of the State), it will be the political objective which predominates.

One of the attempts to articulate these two logics has taken the form of planning. Planning, over and above the “written Plan”, should have been a context where economic conflicts could be resolved and economic considerations could be made compatible with political objectives. However, for planning to work it was important—among other requisites—for the bureaucratic structure to be changed and especially for the technocracy to be reoriented. However, the bureaucracy was often not even integrated with the technocracy. The form of lobbying practiced by the corporatist organizations (a phenomenon already alluded to) also contributed to the inefficiency of planning. Another factor was the political system, and especially the predominant structure of the political parties, which failed to overcome their characteristic favour-granting, caudillismo and other vices, thus making it very difficult to reach



political agreement and attain the framework of relative stability which every planning exercise requires. In the Latin American experience, even on the level of "government", a logic based on the needs of the moment predominated, with the result that the logic of planning acquired different and changing contents according to the situation.

These considerations support the view of specialists that the problem of the "economic action of the State" is not only a problem of technical and bureaucratic efficiency but also involves intricate power relations. In these circumstances, the analysts, consider that the challenges of today mean that a) backing forms of growth different from the present one entails changes in social relations and decisive action on the part of the State to promote these new forms and make them possible; b) the tendency towards concentration and marginalization observed in Latin America excludes a whole group of people from the "market", thus giving rise to the division of labour into "formal" and "informal" categories, so that the political and economic problem of the State is not only to

ensure the functioning of the "formal market", but also to resolve the conflicts between the two forms of the social division of labour, with all their consequences; c) a key problem where there is a mixed economy is that of defining the form that the State economy should take, which involves the definition by society of the kind of social relation that should correspond to the "State mode of production" raising the question of whether this is similar to the mode of production of capitalist enterprises, or whether it is different, and, if so, how?; d) if the State economy is considered as the socialized sector of the economy, should it be assumed that the institution which expresses this is the plan, just as, in the private economy, the corresponding institution is the enterprise, and the fundamental element is the management decisions of the entrepreneur. The following questions arise at this point: how is the plan drawn up in the socialized sector?; how does it function?; how is it managed?, and what forms of participation are there in defining goals or in managing it?

### III

## The State and the system of social relations

It is not easy to make a case for attributing the driving force of social relations, and hence of social change, exclusively to the system of economic relations. No one disputes, for example, the importance assumed in many countries of the region by systems of differentiation based on ethnic background, by levels and types of culture, and by the conflicts that arise between the people incorporated into the predominant socioeconomic system and those marginalized from it. In addition, as many authors point out, the driving force of economic change is usually of an external rather than an internal nature because of the dependent character of the Latin American economy.

According to some analysts, this situation has led to a certain kind of "social disarticulation". This expression means that the

problems linked to the relations of production are different from those that stem from the maintenance and change of the social order.

If a non-dependent capitalist system is taken as a point of comparison, it will be noted that in such a system the State intervenes in order to ensure the social order, that is to say, the reproduction of society as such. This is closely connected with the relations of production, which, in the case of the capitalist system, are essentially "private". In Latin America, on the other hand, the State intervenes in both spheres: in the economic sphere, since it acts to adjust the internal situation to the dynamics of change which, it may be recalled, is principally external and in the "social" sphere, since that is the one that legitimates and regulates the socio-political order. Consequently, a large bureaucracy has

developed, as well as something which is simultaneously image and ideology but which also has concrete dimensions of reality —something which one author called the "function of the State". This expression is an apt one because most often the State or people connected with the State are the ones who carry out the great processes of change.

This does not mean there is no relation between the State and the dominant classes or groups. According to some analysts, in Latin America the action of the State "covers" the action of these classes or groups and thus appears in fact as the historical agent of social change.

In these circumstances, analysing the importance of the role of the State for the whole set of social relations means getting away from the oversimplified view that the State is the mere instrument for executing the policy of a given power coalition. According to studies made in Latin America, the State is often itself another social actor. It has often been stressed that the State has a fundamental role in maintaining the social order, but it also plays a fundamental part in the transition from one type of growth and development to another, even in the framework of the capitalist system.

Some authors hold that in Latin America the State and its bureaucracy play a very special role in managing the economy as well as in the accumulation process which could be characterized, with perhaps some degree of exaggeration, as acting as a substitute for a dominant class. This role derives from the nature of the very process of economic development in the region, where there is a constant need to adapt to the evolution and current situation of the capitalist centre. As has been pointed out, this fact affects the processes of both growth and differentiation of the domestic productive system. This sensitivity of the economy to the external relation and the urgent need to accommodate to it give rise to rapid disorganization and reorganization of the economic structure of the periphery. The analysts therefore hold that this situation hinders the dominant classes from settling into "bourgeoisies" and consequently makes it even more difficult for those classes to work out a long-range plan for society. The options left to

the State are to express that same instability in its action and character, or, as indicated at the beginning, to make up for the lack of "social" efficacy of a true bourgeois class.

Once the importance assumed by the State in Latin America is clear, then its predominance over civil society can be presumed. The State is not only the political expression of society and of the power that exists in it, but it also organizes the whole of society. Any observer of Latin America can see the constant presence of the State in the complex of social relations; at the same time, however, it would not be correct to affirm that the development of the State in the region has taken place entirely at the expense of civil society. A brief look at contemporary Latin American history is enough to show that the action of the State has been almost decisive in the formation of the urban-industrial system, which has resulted in a more developed and complex civil society. In turn, as a consequence of that evolution, entrepreneurial, industrial, commercial, financial and other types of groups have sprung up, and middle-class sectors and groups of workers and urban lower-class elements have developed and diversified. It is interesting to note that in many cases the State has had an important role even in promoting the capacity for organization.

It is inappropriate, then, to speak of an absence of civil society, although this does not imply that this is a social structure without problems. The relation between the State and society is very complex in Latin America because of the above-mentioned complex process of disarticulation and rearticulation of social relations and because of the presence in the national economic system of foreign groups which often control a very substantial part of it. In many countries of the region, these groups have a decisive influence and have consolidated their position in both the productive system and in the conditions which decisively influence the accumulation process. The economic power of these groups has a political correlation, but it takes on a different concrete form from that of the national actors.

The so-called middle classes have played an extraordinarily important role in recent history in forming the State apparatus in most of the countries of the region. These groups have been

highly conscious of the crisis of the system of oligarchical domination, as well as the economic and social consequences of that way of relating to the exterior. These sectors not only contributed to the formation of the State apparatus established after the oligarchical crisis, but were also decisive in the creation of the political parties that were the mainstays of the State. They also played an important part in the organization of the civil society's claims and demands on the State, particularly those of the middle sectors themselves and to a certain extent the popular sectors also, especially in the cities. Nevertheless, it can be held that in many cases, owing to the ever-growing complexity of civil society (which meant more powerful and highly developed entrepreneurial groups) the presence of transnational enterprises, and the stronger capacity for organization and demands of the popular sectors, all of which have led to a transformation of the character and meaning of social conflicts, the middle sectors as they were traditionally known have lost some of their importance. In contrast a leading place has now been occupied by technocratic—at times even military—group that appears to be more closely connected with the new economic power structure and which, in many circumstances, has displaced the old bureaucratic middle sectors and redefined the character of the main political parties.

It is worth emphasizing the extraordinary complexity of the relation between the State and civil society in Latin America. On the economic plane, the State is also a producer State, as pointed out above, so that it penetrates very directly into society. On the other hand, the struggles and conflicts that take place in society are expressed within the State, and it cannot be conceived of as alien to from this type of struggle. There can be no pretended "neutrality" of the State, but neither is the State the expression of only one segment of society. The real political struggles of society make themselves felt within the State itself.

Because of all this, social conflict needs to be analysed in order to understand to the full the character of the State in Latin America. There can be no denying the importance of the conflicts that take place between the different sectors of the economically dominant groups, as for

example between exporters and importers, productive and financial sectors, entrepreneurial sectors and wage earners, and a series of others that can be easily identified and observed. The analysts point out, however, that over and above these there are other types of conflicts that divide society in different ways and directly influence the particular character of the relation between the State and civil society in the region. In the majority of those countries, the various sectors of society have very diverse possibilities of gaining access to what are considered basic services (housing, health care, education). These differences are due to the unequal distribution of income among the different social strata, but they are also to be perceived within each stratum. According to the analysts, the question of whether or not a group has access to these services leads to radically different modes of existence which can produce serious conflicts, since access to the services becomes a privilege that some try to defend while the others either try to acquire it or, what is worse, combat it.

Such lack of access is particularly marked among the popular sectors, which, especially when they live in urban areas, may experience a feeling—which is certainly more than purely psychological—of being totally bereft of the values that are considered basic in the rest of the community.

In addition to this division, there is another one affecting groups whose social category is closely related to the place they occupy in the social division of labour established by the economic system as well as other social categories—such as women, young people or others—whose demands have a certain specificity distinct from—and even occasionally contradictory to—that of the above categories.

There are also antagonisms between demands that affect the whole of society—for example, human rights, political democratization, the fight against inflation and many others—and demands that are absolutely particular. It is always difficult to reconcile general interests with particular interests. The State normally tends to satisfy the demands of people incorporated in the formal organization of the economic process: that is to say, those who participate in the formal social division of labour. The demands of these groups are clearly

defined and particularized. It could be said that they are not only more easily articulated with the State, but also to a certain extent form part of the "logic of the functioning of the State". In contrast, the other groups mentioned tend rather to form movements that exert social pressure and constantly enter into conflict with the State, and these groups tend to remain excluded.

All this leads to the conclusion that while the conflicts mentioned take place on a societal level, they are closely related to the possibility of being able to develop or not some kind of link to the State, which plays a key role in social relations.

The important point is that in Latin America the presupposition implicit in the promotion of the growth was that such growth made social incorporation possible and that in that process the State had a primordial role to play. In practice, however, the prevailing type of development has led to very clear forms of exclusion. This simple observation supports the assertion that what is in crisis in Latin America is a form of social relation associated with a particular type of growth.

An immediate consequence of this is the need to reformulate the problem of participation in Latin America. For many analysts, it would be a question of the State restoring power to civil society. This attitude is very much linked to the Anglo-Saxon tradition in which the "citizenry" negotiate with the "sovereign", whose powers they limit. The problem is different, however, when the State is constituted as an agent of

"socialization"; in that case the question is of participation in the power of the State.

In the relation between the State and society in Latin America, the challenge which the State apparently faces —given the level of disarticulation and disaggregation of society— is how to expand citizen participation. To do so, social interests must be channelled and integrated. In practice they are structured on different levels and frequently contradict one another; therefore they must be organized in broader and more complex groups. According to specialists in this question, what is involved is a process of democratic selection of demands and a permanent mechanism for arriving at agreements between different forces, in order to achieve increasingly general interests on an increasingly consensual basis.

The traditional mechanisms of representation and participation are primarily those of a political nature. In these the citizen expresses himself through his vote or also by means of other forms of expressing his political rights, especially the right to participate and form political parties. These mechanisms serve to formulate policies.

Another form of participation takes place through intermediate groups and organizations, but for these to be successful, institutional channels are needed that give access to opportunities for discussion within the State apparatus. The key point for efficacious representation is that the State must recognize the political and social forces and their organizations as legitimate.

## IV

### The State and the political system

In analysing the relation between the State and the political system, it is a good idea to begin by trying to clear up a controversial question which is apparently still raised today —the widespread thesis regarding the ungovernability of democracy.

The main assumption of the most common version of this thesis is that the biggest problem faced by democratic States arises from an excess

of demands. This happens because a democratic system gives rise to forms of increasing participation on the part of citizens and indeed itself encourages these processes. As broader participation becomes possible, both social groups and individuals constantly increase their demands on the government. Those who hold this thesis point out that in present conditions the demands are of such a magnitude, diversity

and complexity that they cannot be processed, and much less satisfied, by the public sector. In these circumstances, society runs the certain risk of becoming ungovernable.

Reflections of this type have often been present in one form or another in analyses of Latin American political processes. "Populism" is often the term used, even though, paradoxically, populist régimes have in many cases been far from democratic, at least formally.

The hasty conclusion that could be drawn from the observation of this hypothesis would be that only a non-participative, authoritarian régime could ensure governability. Closely associated with this kind of statement is the insistence on applying—even at the risk of falling into drastic forms of action—the longed-for social discipline. The argument clearly associates the increase in demands with the notion of "disorder".

Exaggerations apart, the forecast of conflict could be accepted as valid. But to guide the analysis it is helpful to ask if the solution should not rather be a search for more democracy and a greater receptivity on the part of the State, rather than hasty resort to authoritarianism. In that case, it would not so much be a question of restraining demands, but rather of increasing the capacity to meet them. Difficulties would be perceived as stemming not so much from the "uncontrollable upsurge of demands"—without denying that this could exist—as from the rigidity of the instruments designed to deal with them.

A fact mentioned time and again is that the structures of Latin American societies are constantly being built up and then dismantled again. One consequence of this is that changes and social transformations take place rapidly in the region. In spite of the reality of these rapid structural changes, political institutions are generally designed to handle changes slowly. An example of this is the time taken up by the institutional formalities and procedures that have to be observed in order to discuss approve and implement a law. Furthermore, in many Latin American countries the institutional systems provide for slow change of political power through systems that seek to ensure that one renovation of institutions is widely separated from another, so that the old

correlation of forces remains as a damper in the new circumstances. Because of the slow way it works, the institutional system is often overwhelmed by new demands.

Imbalances in domestic power also produce problems for the institutional order of the State. It should not be forgotten that the current development model in Latin America tends towards a concentration of economic and social power. When power is unevenly distributed, democratization is usually presented as a way of correcting these imbalances, and that often leads to an extremely conflictive political struggle.

In a situation of rapid change, constant unstructuring and restructuring, and great inequalities of economic and social power, it is very difficult for the overall system to be considered "legitimate" on the basis of a positive perception springing from the social relations themselves. It may happen that in other societies, where the different groups and organizations (business organizations, trade unions, etc.) have sufficient force—which means that civil society as a whole is organized—the "social pact" sees the State merely as a means of expression. In that case, it could be said that this is a form of "legitimacy" that passes from civil society to the State. In Latin America, however, the "legitimacy" (in its Weberian sense) derives in many cases from the capacity of the State to organize different interests and direct society. Socio-political legitimacy, in particular, is achieved by the capacity of the State to propose and put into effect social policies that take care, at least partially, of the aspirations of the masses.

In spite of this, which would seem to be evident, it is well known that the ideologies in Latin America that emphasize the significance of the State are in crisis. Ideologies that see the State as a mediator of the general interest are questioned. Populist ideas that conceive of the State as the "benefactor of the people" are also in crisis. Faced with this situation, Latin American thought faces the challenge of elaborating a new ideology regarding the State.

The idea of the "social State"—which is close to but not necessarily identical with the idea of the "welfare State"—refers to the need for the juridical ordering of the State to be such that it can make its presence felt in the

organization of society as a whole. In Latin America, this was a question of expanding the concept of the citizenry, although with the added ingredient that rights must be equal not only formally but also materially. The basic postulate was that the relation in society should be a relation between citizens endowed with equal rights. In practice, however, the notion of citizenship is undergoing an important change, leaving behind to a certain extent the notion of the individual citizen and coming to see citizenship as being exercised through belonging to organizations. In a sense, it becomes a "citizenship of organizations". It is the organizations that give expression to social demands and supposedly contribute to the elaboration of policies. In that sense it can be said, then, that the State, rather than being a State of "citizens", is a State of "organizations".

This is an important point for Latin America because it has several implications for the functioning of the political/institutional system. As already noted, one of the characteristics of the structure of that system is that a large part of the population remains outside of the formal organization of the social division of labour. The immediate result of this is that by not being organized, their possibility of exercising their rights as citizens is considerably reduced.

In the "formal sector", in contrast, the growth of the organization and its increased power tend to constitute a corporatist order. The corporatist power or order often enters into contradiction with the political order of the classical democratic régimes. In these, the representative and decision-making mechanisms, such as parliaments, legislative assemblies, municipal councils and others, do not incorporate corporatist representation easily, and in these circumstances the corporatist system tries to represent itself directly to the Executive or to pressure it. On the other hand, in practice in Latin America the executive often recognizes corporatist representation and excludes those who are not connected with it. The role of the corporations in the political system can be said in many cases to consist of an authoritarian centralization of the institutional workings.

The degree of social disarticulation is a point that needs to be emphasized in relation to the question of the State and the political system in Latin America. It may be noted first of all that the State can hardly be only the expression of an order constituted by "an economically dominant class", since in most of the countries the formal economic system (capitalist) does not structure the whole of society. This social disarticulation is one of the most typical elements of the character of the State in Latin America.

In a disarticulated society characterized by strong external dependence, inequality in rural/urban, capital/non-capital relations, etc., it is easy to understand the difficulty that exists for one group to set up in a definitive and stable way an economic, social and political hegemonic centre which is truly national. In fact, because of all the factors mentioned earlier (corporatism, exclusion, absence of hegemony, social disarticulation) it would appear that there are situations in which a system of reciprocal vetoes prevails. In these circumstances, a necessary condition for the success of the project of some of the socio-political actors is often the passivity of most of the actors: a condition which is certainly difficult to attain.

The unstructured character of society is also seen in the system of political parties. According to F.H. Cardoso —not only an author but also a political actor— "the political parties function with patchwork styles —partly American, partly caudillo, partly ideological— and with a mixture of forms of political parties from Europe, the United States and Latin America itself".

Another effect worth pointing out is the unclear separation between the State and society. Not only is the State permeated by class conflicts and conflicts arising from change, but also the State in its own sphere becomes the political arena in which the interests, orientations and options of the different social actors are expressed and compete with each other.

In short, the challenge faced by the State in Latin America on the political plane is that of profoundly changing its régime, due to the fact that it has to face the problem of implanting and exercising democracy in a society which is at present corporatist, disarticulated and without a clear system of hegemony.

## V

## The State apparatus, its general functions and democracy

It is necessary to recall some features of the historical background in order to gain an understanding of the institutional system which shapes the State in Latin America. In its general lines this system arose from attempts to respond to the challenges presented on the one hand by the organization of the nation—a problem that the majority of the countries faced especially in the nineteenth century—and on the other hand, by economic development, especially in the twentieth century.

The expansion of the State and its degrees and forms of institutional differentiation and specialization are the result of the various efforts that have been made to solve the problems involved in developing society: a phenomenon which, as often noted, tends to acquire very contradictory traits. Likewise, the formation of the State bureaucracy is seen as a form of institutional crystallization of the various political projects that have existed in the region.

The orientation of the State bureaucracy stems from various sources, which can be distinguished as follows: a) holders of posts closely linked with the government in power, who try to put the policy guidelines and orientations emanating from the government into a normative framework applicable to the administration of different bureaucratic organizations; b) the "clientèles", who can be public, private or international, and who express specific interests and are linked or seek to be linked to the different bodies involved in the application of policy measures; and c) the "bureaucratic" organizations themselves, which carry out measures, programmes and policies.

It is worth bearing in mind that these different sources of orientation, since they generally differ among themselves, generate strong tensions within the State apparatus. Particularly important are the distinct orientations of the "clientèles" who, in addition to struggling with each other within the State apparatus, carry on their conflicts on the societal level too.

Since these tensions can only be resolved with difficulty, they often lead to a certain disorganization of the State apparatus, and this disorganization is frequently further increased because the State has to alleviate social conflict, which gives rise to *ad hoc* measures. The attenuation of social conflict has been a traditional function of the State, especially in democratic régimes and this explains why it is usually difficult to normalize and rationalize the State, for if the State has to try to solve social conflicts, it is logical that even in its structure—and especially in its actual functioning—it will respond more to political considerations than to a strictly administrative rationality. This is why analysts distinguish different forms of articulation within the State apparatus. One of these corresponds to the distribution of the different kinds of policies, that is, specific spaces that reflect the "social division of labour" within the State apparatus; another refers to the hierarchical structure and corresponds to the organizational chart; and a third form reflects an "invisible stratification" and is closely linked to the role the different "clientèles" play in the diverse State organizations. The special features of these forms of articulation naturally depend on the nature of the prevailing régime. The "invisible stratification" is in some ways a reflection of the prevailing social structure and power structure in a given situation.

A realistic analytical criterion for the functioning of the bureaucracy is the type of relation it establishes with the so-called "clientèles". These clientèles, which are sometimes united by very specific interests, exert pressure to orient the State agencies to which they are linked as a function of their own interests. When the "clientèle's" pressure is successful—and this is often the case—the satisfaction of their demands becomes the real and true object of that State agency.

Another important element for understanding the type of orientation and functioning of the public administration consists of the

organizational models used as a reference for its norms of conduct. At the present time, there is a widespread idea that the great historical referent should be "private enterprise". It is often a question of reproducing in the public sector this model's objectives, basic strategies, organizational technology and in general its whole style. When the public sector is criticized for alleged inefficiency, it is argued that this inefficiency stems from behaving differently from private enterprise. The remedy that is proposed in some circles is to adopt a "private-enterprise" form of functioning, for which purpose it would be useful to transfer the technology of functioning of the private sector to the public one. It has even been asserted that a guarantee of efficiency for public agencies would be to put them into the hands of successful private-sector managers. This opinion has actually been put into effect in some cases, and even after some enterprises have been nationalized, not only have some of the middle-level personnel continued to work in them, but even also some of the top executives from the previous private ownership.

The concrete fact is that the application of the "private" management model to public enterprises means that the routines of functioning, the commercial strategies and the norms of internal organization, such as, for example, accounting systems, management-evaluation mechanisms, information systems, etc., are the ones usual in private enterprise. The problem that arises is whether these norms are really appropriate to the objectives, goals and functions of the public enterprise. The problem deepens when the objective pursued by public enterprises is the virtual transfer of resources to social sectors and is thus very different from the objectives of a private enterprise. The adaptation of the procedures and the criteria for evaluating efficiency are fundamentally different in these cases.

It should be mentioned that on many occasions the military has influenced the definition of the norms for State action. This fact is responsible, for example, for the high relative importance—in comparison with other sectors—given to defence and security agencies in fiscal expenditures. Moreover, the military at times claim control over certain areas of

production or inputs which they consider to be strategic, such as for example steel, petrochemicals, atomic energy, air transport and other areas. Active or retired personnel of the armed forces frequently have participated, or still participate, in various sectors of State administration. Without entering into a discussion of the appropriateness of such measures, it is undoubtedly true that a "military style" has imprinted certain characteristics on the "bureaucratic culture" which are reflected in administrative matters as well as in control methods, procedures, rules, etc.

It should also be borne in mind that many Latin American countries have experienced authoritarian régimes, and this too has influenced the formation of bureaucratic conduct. According to those who have studied the phenomenon, in authoritarian States the bureaucracy is characterized by a strong predominance of hierarchical functioning, with extremely vertical command structures and a tendency to concentrate State decision-making mechanisms in a few hands. With regard to procedures, there is tremendous differentiation in practice between the top-level administrators who are responsible for taking decisions and those who have to carry them out. This marked separation of functions influences the transparency of the process and often makes it difficult to determine political responsibilities for the actions of the bureaucracy. According to those who know this reality, in these cases responsibility can normally always be passed higher up so that it reaches people "who are above public scrutiny".

In many authoritarian régimes there is a whole set of hurdles standing in the way of the full expression or representation of certain types of social interests. This means in effect that the authorities are ignorant of a large part of the citizen's demands because these have no channels of access to it. This also gives rise to a tendency to consider as real the "demands" that the technocracy or bureaucracy itself establishes as such, and which are the only ones recognized. Authoritarian régimes generate a kind of bureaucracy that tends to function in a "closed" way, thus increasing the lack of transparency already mentioned. In such situations it is almost impossible to know who has participated in



decisions, or what road the decision-making process has followed. Secretiveness predominates in the formulation of policies, and since there is in fact no prior public debate, these policies are only known at the moment they are promulgated. The tendency of the bureaucracy is not to render accounts to the citizens but only to the top authorities. As already noted, bureaucratic responsibility is, in the best of cases, only procedural. In these circumstances the functioning of the State apparatus acquires eminently technocratic characteristics, and this technocratic attitude takes on the features of an ideology when it is asserted that problems are treated exclusively with "scientific, neutral and objective" criteria. Moreover, the management style is clearly oriented towards alleged "efficiency".

Because of the influences mentioned and the different kinds of prevailing orientations and patterns of conduct, it is common in Latin America to find substantial disparities between certain presuppositions about the characteristics of the State apparatus and the actual reality. The danger is that often proposed policies are based on the assumed "existence" of these presuppositions and are designed as if they were real. Thus, for example, policies are frequently based on a presupposition of the unity and internal coherence of the different economic agents that make up the State and on the assumption that these agents really respond to the orientations and directives emanating from government leaders. The reality is quite the opposite, however. As we have tried to demonstrate, the State apparatus is a highly complex structure, which has to face tasks that daily grow more difficult, and in which multiple actors or "clientèles" try to impose their own interests using different power resources.

There is also a tendency in policy formulation to presuppose that the State apparatus has sufficient technical and administrative capacity to carry out the proposals efficiently. However, even though the management itself may be efficient, the definition of efficiency and the parameters governing it —the private-enterprise model, military-influenced features, etc.— often do not necessarily correspond to what might be understood as "efficiency of the public sector".

It is worth dwelling a little on the problem of the autonomy of the State apparatus with respect to the external agents. The assumption is that this autonomy makes it possible to overcome partial viewpoints and avoid the dominance of excessively personal interests. The presupposition is that the autonomy of the State apparatus —when properly applied— would make possible an overall view allowing for the expression of general interests of the nation as a whole. In reality, however, the State administration is often a result of complex decision-making processes involving the intervention of many powers, both State and private. The real "rationale" of the decision is sometimes a confused mixture of technical, bureaucratic and political rationales.

If these facts of reality —which cannot be bypassed by mere administrative voluntarism— are taken into account, the permanent problem is how to achieve greater congruence between the political project and the way the institutional apparatus really functions. The solution would call for redefining attributions, changing structures of authority, and reallocating resources.

Although this might seem paradoxical, the problem often arises of how the government can gain control over the bureaucracy. The bureaucracy frequently justifies itself by saying that technical and administrative efficiency is necessary and inevitable. Although this is an acceptable objective, however, it cannot be imposed in absolute fashion over all the other objectives that should orient the action of the State apparatus. To a certain extent, it is important that administrative efficiency should be co-ordinated with —or even at times subordinated to— the "social efficiency" which is decisive for achieving coherence between State management and the objectives and economic and social policies that should govern it.

Social efficiency also presupposes a certain sensitivity towards social demands. These are expressed through the various ways society is organized, but also through the general and specific orientations that the government gives to the action of the State apparatus. In a democratic system, the basic legitimacy of the government programme —which the bureaucracy must put into practice— derives

from the election results, but that legitimacy is reinforced by the concrete policies formulated by the State apparatus and directed by the government.

Finally, it is normal to demand more and better articulation of the State apparatus. Often the organizational relations between the central and the decentralized administration are extraordinarily precarious at basic levels of action. In the majority of cases, regional and municipal bodies have few links with each other and only a weak connection with the central apparatus. These problems should be faced not only formally but also in practice. The important

thing is that there should be the necessary mechanisms of substantive articulation.

Specialists in public administration point out, with reference to the State apparatus, that the basic question is to redesign its action using new qualitative criteria. This would mean planning new patterns of resource allocation, mobilizing present human and material capacity, and using economies of scale. All of this is closely related to the dimensions and scale of operation attained by the State apparatus. But what is fundamental—they emphasize—is that the public administration or the State apparatus be really efficient for the exercise of democracy.

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# The ecopolitics of development in Brazil

*Roberto P. Guimarães\**

How a collectivity deals with nature discloses as much about its internal social relations as the other way around. The present inquiry is a prologue to more detailed study of ecopolitics, to the study of the political philosophy of relations between human beings and nature, exploring the feasibility of integrating the knowledge of the social and of the natural sciences on the interchange between human activities and the cycles of nature. It is also an introduction to the study of a specific type of public policies, those that address issues of resource use and conservation, and the quality of life, especially in the so-called developing countries.

Analysis of the Brazilian case provides a particularly helpful focus for Third World studies. Because Brazil has been one of the fastest-growing economies in the world, the study of its ecopolitics sheds light on the crucial dimensions of the debate over development and the environment, with important implications for politicians, policy-makers and social scientists. The historical analysis of environmental management in the context of Brazil's political development unveils the social and political conditions that allowed for, and conditioned, the creation of a specialized environmental agency, the Special Secretariat for the Environment (SEMA). Detailed study of the bureaucratic politics of public policies concerning the environment reveals also how "environment" is conceptualized in development planning, and how environmental management reflects the main features of the political system and of the social formation of Brazil.

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*Why not? We have a lot left to  
pollute. They don't.*

J. P. dos Reis Velloso, Planning  
Minister (1969-1974), on  
Japanese investments in Brazil.

*When the Gods wish to punish us,  
they answer our prayers.*

Oscar Wilde

## Introduction\*

The history of humankind is the history of its relations with nature. More than pure rhetoric, this statement acknowledges a reality whose multiple facets have not been fully understood so far. Living in an era of automobiles, non-returnables and computers, we have been led to believe that we can get everything we want in the supermarket, in the drugstore, or through telephone orders. Yet we forget that all our basic needs have a source on the land or in the sea. It has been all too easy to forget, for instance, that if it were not for the sudden disappearance of dinosaurs, human beings, like any other mammals, would not have had much chance to mature as a species. It is only when great famines occur, or when countries wage war in part to secure access to natural resources, that we stop suffering such lapses, that we realize that "We have for a long time been breaking the little laws, and the big laws are beginning to catch up with us".<sup>1</sup> But then, again, there is the conquest of the Moon, the advent of robotics, or a new breakthrough in the cure of cancer, and we retreat into our delusions of power.

The emergence of this new, ecological dimension in the political debate poses hitherto unforeseen challenges to the social sciences. Among other things, we need to identify and analyse what elements of the natural environment contribute to the flourishing, maintenance, and eventual demise of human societies; and how social conditions affect natural systems, disturbing or reinforcing their life-support cycles.

\*Based on a presentation at the XIV World Congress of the International Political Science Association, Washington, D.C., 1988.

<sup>1</sup>A. S. Coventry, quoted in G. Tyler Miller, Jr. (1979): *Living in the environment*, 2nd ed., Belmont (California), Wadsworth Publishing Company, p. 32.

Consequently, to understand adequately the inner workings of an ecosocial system —how natural and human systems interact, reinforce, maintain, and transform one another— it is crucial to explore the political dimension of these relations.<sup>2</sup> In effect, it is time to recognize that the ecological outcomes of the way people use the earth's resources are ultimately related to the modes of relationships amongst people themselves.

Ecopolitics is thus a short word for ecological politics. It emerges from the recognition that to overcome the current ecological and environmental crisis, decisions will have to be made, thereby favouring some interests over others, both within as well as between nations. However, this sort of ecopolitical understanding can come only after one acquires a historical perspective on how economic interests, social classes and the political and institutional structure have

evolved in the recent past of a particular nation. Consequently, we must turn our attention to studying the process of social formation that makes more transparent the prevailing patterns of relationship between humans and nature in a particular national setting; in this case, that of Brazil.

Yet, meaningful knowledge cannot become relevant to the everyday concerns of citizens and policy-makers without careful scrutiny of the evidence immediately above the ground. Ecopolitics must, in this sense, come closer to ecopolitics. The study of the creation of a specialized agency for environmental matters in Brazil is thus a logical result of what will be developed in the first three sections of this article. It is also a necessary prelude to a deeper analysis of environmental politics, for a closer focus on how decisions are made may shed light on more general processes.

## I

### Some preliminaries about the Brazilian social formation

#### 1. *The Brazilian "dilemma": patrimonialism and bureaucratic power*

Brazilian society is a typical example of "parallax view" at work. The parallax effect, a concept borrowed from astronomy to help unfold social reality in Brazil, indicates the apparent change in the position of an object resulting from the change in the position from which it is observed. This may indeed be the best way to describe Brazil. In a penetrating analysis of what he calls "the Brazilian dilemma", anthropologist Roberto da Matta has managed to reveal, with an insight unparalleled by any other study of the Brazilian character so far, that authority, hier-

rarchy, violence and oppression pertain to this society as much as democracy, egalitarianism and compromise. He writes:

We have in Brazil carnivals and hierarchies, equality and compromise, with the cordiality of an encounter full of smiles giving place, shortly after, to the terrible violence of the repulsive "do you know to whom you are talking?" And we also have *samba* [a Brazilian dance of African origin], *cachaça* [liquor distilled from fermented sugar cane], beach and soccer, but mingled with "relative democracy" and "Brazilian-style capitalism", a system where only the workers assume the risks, while, as it is known, they do not realize any profit... And all of this, above anything else, in the name of our undeniable "democratic vocation".<sup>3</sup>

<sup>2</sup>A comprehensive analysis of the ecological foundations of politics is William Ophuls, *Ecology and the politics of scarcity: Prologue to a political theory of the steady state* (1977): San Francisco: W. H. Freeman. A most lucid and provocative essay on scarcity and political power is J. Barnett (1981): *The lean years: Politics in the age of scarcity*, New York: Simon and Schuster.

<sup>3</sup>Roberto da Matta (1980): *Carnavais, malandros e heróis: Para uma sociologia do dilema brasileiro*, 3rd ed., Rio de Janeiro: Zahar Editores, p. 14.

Despite the apparent difficulty of characterizing the Brazilian social formation, its basic elements are quite straightforward: hierarchy, paternalism, repression and authoritarianism, alone or combined in different ways. For example, although paternalistic, Brazil is also an extremely formalistic society, where rules and regulations are much more important than facts. Also, in a society at once paternalistic and repressive, there is always a "Big Father" to be revered, often the personification of the State through a demagogic leader, in contraposition to the depersonalized masses. Above and beyond these elements, however, the most dominant structural facet of the political development of Brazil has been the presence of patrimonialism, a bureaucratic order that encompasses both public and private dimensions.<sup>4</sup>

The patrimonial order is usually described in terms of its concrete political practices of social control, such as clientelism, patronage, or co-optation, which combine elements of paternalism, repression, hierarchy and the authority to rule and stand above social classes. The bureaucracy, administrative apparatus and general staff of the patrimonial order should not be confused with the "State" bureaucracy, the "élite", or the "dominant classes". The bureaucracy does not constitute a class in and of itself, although more often than not it acts as a surrogate of the élite. It may stand above dominant classes, but it does not enjoy autonomy over society. Conversely, even if the composition of the élite changes, the patrimonial order persists.

As Faoro explains, this bureaucratic "caste" develops a pendular movement that often misleads the observer. It turns against the landowner in favour of the middle classes; alternatively, it turns for or against the proletariat. Also, the bureaucratic apparatus may be

modernizing or conservative. It may favour the pluralistic aspects of democracy or it may enhance patronage and co-optation. These apparent behaviours are actually optical illusions suggested by the projection of modern ideologies and realities upon a past that is historically consistent within the fluidity of its mechanisms. Therefore, for the estate patrimonial structure, social formations are mobile points of support.

The process of formation of the Brazilian State also compounds the difficulties of understanding reality in that country. Whereas in the vast majority of countries the State follows the pre-existence of a more or less organized society, in Brazil it happened the other way around. The first Governor General of Brazil, Tomé de Souza, arrived in the country in 1549 already with a government structure, laws, rules and regulations, and even with a constitution, the *Regimento de Almeirim* prepared in Portugal one year earlier. These had all been derived from the institutional and political system prevailing in Portugal, and they were to be implemented in a Brazil as yet without Brazilians. The Indians, as still today, have never been considered citizens. The Brazilian State was, so to speak, part of Tomé de Souza's luggage. This situation prevailed at least until the 1930s, when, despite some profound changes in the society, the same institutional framework remained in force.

This explains most of the elements of the social formation described above. The patrimonial, bureaucratic character of the State has imposed, and will probably continue to impose, its own limits on the constitution of society, giving it the distinctive features of formalism, bureaucratism and authoritarianism. There has been such a concentration of power in the hands of the State that civil society has had very little room to organize itself, to form strong channels for articulation of interests. The little it may have had has often been co-opted or simply suppressed. On the other hand, political society itself (the Legislature, party system and electoral processes) has not been able to represent the plurality of interests existing in Brazilian society. In short, to the formation of society and of the State in Brazil corresponds a power structure that is concentrated and exclusionary; an organization of decision-making processes that responds to the particular interests of the best

<sup>4</sup>According to Raymundo Faoro (1977): *Os donos do poder: Formação do patronato político brasileiro*, 2 vols., 4th ed., Porto Alegre: Editora Globo, p. 28, "Side by side with the property of the Crown there is private property, recognized and guaranteed by Princes. Above these properties, the King's or private, there is an overproperty, identified with the territory and including the command, but barely separated from the dominion, over things and persons, over all things and all persons". See also, for the same subject, James Lang (1979): *Portuguese Brazil: The King's plantation*, New York: Academic Press; and Fernando Uricoechea (1980): *The patrimonial foundations of the Brazilian bureaucracy*, Berkeley, University of California Press.

organized groups of society; and, finally, a strong technocratic, hierarchical and formalistic pattern of conflict resolution.

## 2. *Ecopolitical implications of the Brazilian social formation*

Insofar as ecopolitics is concerned, the obstacles posed by this particular process of social formation seem to be rather obvious. First of all, we should note the legalistic tradition of Brazilian politics. The compulsion to have every minuscule aspect of life foreseen, regulated and enshrined in the law is such in Brazil that someone suggested the most effective solution to all of the country's problems would be one single law making all previous ones mandatory.<sup>5</sup> This means also that reality, to be accepted as such, must be first imagined by the legislator. For example, up to the presidencies of Getúlio Vargas (1930-1945, 1951-1954) the mobilization of the working classes was considered to be mostly a "police problem". Their unions became legitimized only when the State bestowed its recognition upon them. Similarly, in a patrimonial order where nothing has value in and of itself, environmental issues assume relevance in the eyes of the State as their functionality to its corporatist policies also increases. Until that happens, this particular reality simply does not exist. Society, which is used to seeing through the eyes of the State, may not recognize it. Even after its sanctification through the law, there is not any guarantee that it will be adequately addressed, as Brazilian workers discovered long ago.

A second aspect, in fact a corollary of the legalistic tradition, is the quasi-worship of everything that is public. This manifests itself in several ways. The most common way was summarized by Raymundo Faoro as follows:

<sup>5</sup>It is worth mentioning one example of the legalistic tradition of Brazilians, which, at the same time, illustrates their disrespect for the law. In 1595 King Felipe II issued a law forbidding the enslavement of Indians in Brazil. Only 11 years later, there got under way one of the largest and longest operations to hunt down and enslave Indians in Brazil. These operations were called *Bandeiras* [pathfinders]; they lasted for two centuries, and often enjoyed governmental support.

A Brazilian who excels is bound to have lent his collaboration to the State apparatus, not to private enterprise, to business success, or to cultural contributions, in a Confucian ethics of the good servant with an administrative career and a curriculum vitae approved from the top down.<sup>6</sup>

But because Brazilians are proud to be "the largest Catholic country in the world", while church attendance must be among the lowest, and while *candomblé*, *umbanda* and other Afro-Brazilian rituals claim increasing numbers of followers, so their worship of the State is also blended with a certain dose of iconoclasm.

None of this should be allowed to add more confusion. The State is the source of much of what concerns the individual, in private or public life, and the results are too well known to deserve further comment here: a tightly controlled society, corruption and the distribution of privileges. Still, it should be underlined that corruption may assume a multitude of forms; for example, direct payment in exchange for a favour, or a specific way of making life easier without necessarily being illegal. It may not even be considered corruption. This should not alarm anyone, since in many instances the (in)famous *jeitinho brasileiro* [the Brazilian fix, sometimes euphemistically referred to as "creative imagination"] may well be a powerful weapon against the discretionary powers of the State.

For ecopolitical purposes, the most important manifestation of corruption is the "structural" variety. Because to survive and remain in State favour one should not cause too many problems, it is no surprise that government agencies and State enterprises in Brazil are generally the worst environmental offenders. The State sector is the first to claim environmental awareness, but it is also the first one to shove problems under the rug.

<sup>6</sup>Faoro, *Os donos do poder*, p. 743. Joaquim Nabuco, a leading abolitionist and an influential politician during the Empire, referred to public service, in his *Abolicionismo* (1949): São Paulo: Instituto Progresso Editorial, as "a noble profession, and the vocation of all. Take, at random, twenty or thirty Brazilians in any place where educated society meets: all of them either had been, are or will be public employees; if not they, their children will be" (p. 158).

## II

## Ecopolitics in Brazil from colonial times up until the military régime

Even without firm ecological periodization, three important periods stand out in the ecopolitical history of Brazil. The first encompasses the initial 300 years of colonization, when the roots of agriculture were laid. The second is the time between the second half of the nineteenth century and the first decades of the twentieth, when agriculture paved the way for industrialization. The final period, from the 1950s to the late 1970s, witnessed the rapid modernization of the country. Actually, if speculation could run wild—of the kind that Karl Popper once said “makes science possible”—one could assert with a good degree of confidence that the most important ecopolitical phase is yet to come, most probably in the next decade. Ecopolitical historians of the twenty-first century will probably classify the 1990s as “Brazil’s time of reckoning.”

### 1. *Colonial Brazil (1500-1822)*

The ecopolitics of colonial Brazil can be described through one of the most salient environmental dimensions of the patrimonial order: “extractivism” (vegetal, mineral and agricultural). From the discovery of Brazil in 1500 until the turn of the eighteenth century, colonization was based on successive cycles of extraction that more or less coincided with the tendencies and fluctuations on the international scene, but that also varied with the ecological cycles in terms of exhaustion of resources. At first, Brazil wood and the red dye it produced was the only thing that mattered to Portugal. Brazil wood was followed by other extractive cycles, especially Brazil nuts, cocoa and rubber. Rubber had more significance than the other two, lasting until the first decades of the twentieth century. Sugar production also had cyclical fluctuations, alternating with cotton, tobacco and coffee. Livestock activities emerged basically as a response to the needs of the agrarian economy for food and beasts of burden, but it also played a crucial role in the extractive cycle for minerals. Mining started with the discovery of gold in 1695 and of dia-

monds a little later, and lasted until the end of the 1700s.

The most profound environmental feature of colonial times, one that has left the deepest and most distinctive impression on today’s agricultural practices, was the way in which the land, then the most precious natural resource, was appropriated and utilized. The existence of large rural properties can be attributed to the abundance of land combined with the patrimonial order. In any event, this type of land concentration usually spells disaster. Socially, it locks peasants and rural workers into a cycle of poverty, with low wages, indebtedness and servitude. Ecologically, it perpetuates the irrational use of the land, through shift cultivation, and through slash-and-burn techniques that lead to the abandonment of the land after two or three years of cultivation. With land concentration came monoculture, which violated all principles of ecological wisdom, contributing to soil deterioration and to desertification. Monoculturalism, in its broadest sense, meaning not only a form of agriculture but also economic overspecialization (in mining, in extractive activities and in manufacturing) is always harmful. It has always been detrimental to the country, economically, politically and environmentally. Sure enough, as early as 1877 the Northeast suffered its first major drought, which lasted for two years. As late as 1986 the South entered this cycle. Since the very first moments of Brazil’s existence, Brazilians have boasted about the immensity of their territory and the quality of its soil, as attested by the jingoism of Pero Vaz de Caminha, the official registrar of the discovery; but the “big laws” of ecology started to catch up with them, and the ecopolitics of colonial Brazil took its toll.

### 2. *The Brazilian Empire (1822-1889)*

With independence and the advent of the Brazilian Empire in 1822, the basic character of the economy did not change. Its secular orientation toward external markets helped to maintain and



reinforce the binomial relationship between land concentration and monoculture. The political changes that ensued, however, deepened the ideology of "tear down and move on" that still squanders the country's resource base without much concern for the future. State power was consolidated in the hands of the proprietor classes, i.e., the sugar producers in the Northeast and coffee planters in the Southeast. In addition to strengthening the power of the landed oligarchy, several important alterations of the ecopolitical landscape resulted from independence.

Foremost among them, a truly Brazilian bureaucracy was born, to fill the many posts in the governmental structure that had been created to look after the interests of the Portuguese Crown when the court was in Rio. The process of independence itself added to the growth and expansion of an already enlarged metropolitan bureaucracy that was clearly disproportionate to the country's economy and population. Paramount also was the creation of the National Guard in 1831, which soon was able to mobilize 200 000 men, in contrast to the 5 000-man professional army of the first years of the Empire. The *coronel*, power-broker par excellence, represented the very personification of the patrimonial order and of regionalism as well. His title, still used for political bosses in the rural areas, derives historically from the rank given to the head of the local regiment of the National Guard, who was the main intermediary between state and federal governments on one side, and local interests on the other.

Another major change of the nineteenth century was the abolition of slavery in 1888, a process that started with the traffic in slaves being brought to a halt in 1850. In 1871 freedom was granted to children born to slaves, and in 1885 to slaves over sixty years of age. This was partially brought about by international pressure, especially from Britain, but it also had internal causes. The development of the economy in that period shows that, except for slave-owners themselves, everyone else gained from abolition. The increasing costs of slave labour, especially after 1850, its inefficiency, the larger internal market needed by an incipient industrial bourgeoisie, all these elements combined to produce the downfall of slavery in Brazil. As a result

of this process one finds European immigration and the beginnings of manufacturing. Between 1884 and 1903, over 1.7 million immigrants arrived in Brazil. Most came as substitutes for slave labour in the coffee plantations of São Paulo, but many established themselves in the capital, thereby contributing to the expansion of industrial activities.

Most "environmental" concerns during the Empire could be subsumed more readily under public-health issues. It was an epidemic, for example, that led to the organization in 1857 of the first sewage service in Rio de Janeiro. When one examines the many regulations issued during that period, especially the *Regimento dos Municípios* (1828), which organized public life in the municipalities, it is also impressive to note the extent to which the State was authorized to interfere with private businesses. The minute detail on how public officials were to prevent the occurrence of "anything that may alter or harm the salubrity of the atmosphere" would amaze, and of course enrage, most antiregulation crusaders of today.

Finally, basically as a result of the efforts of André Rebouças, albeit not very successful, there appeared an incipient conservationist movement. Deeply impressed by the creation in 1872 of the first modern national park in the world (Yellowstone in the United States), Rebouças four years later proposed the creation of two national parks in Brazil: one in Ilha do Bananal (in the Central Region) and another in Sete Quedas (in the South). For reasons that are not entirely clear, these pioneering proposals had to wait 60 years to be finally implemented. And for reasons that are well known to all—the construction of the Itaipú Dam in the 1980s—it took less than that time to undo Rebouças's dream. Sete Quedas no longer exists.

### 3. *The Old Republic (1889-1930)*

The Empire was brought down by the convergence of two forces, which inaugurated the Brazilian Republic in 1889. These were the disaffection of the dominant classes with respect to slavery and the growing influence of the military, particularly after the war against Paraguay. Hence, a new era began in Brazilian politics and economics. Its characteristics were the domi-

nance of the national bourgeoisie, first agrarian and later industrial, although most of the time it was associated with export-oriented commercial interests and the presence of the military in politics. At the other extreme stood the majority of the population, mostly rural workers—some of slave origin, others descended from Portuguese immigrants or from the miscegenation process—and recent Italian, German and Japanese immigrants. Also in the lower strata there was already an urban proletariat, mostly of Italian and Spanish origin.

The heavy presence of foreign capital also shaped the formation of the ecopolitical arena in this period ending in 1930: of the 201 corporations authorized to operate between 1899 and 1919, 160 were foreign. Finally, the process of transformation that was taking place in the economy and society of Brazil entailed at least one major ecological change, the growth of the cities. One of the consequences of urbanization was the proliferation at the turn of the century of tenements and multi-family dwellings, the forebears of the modern *favelas* (squatters' settlements), where are found today three-fifths to two-thirds of the population of a metropolitan region. Another consequence of urbanization was the deterioration of sanitary conditions in the cities. During the Empire, as noted above, the great drought of 1877-1879 signaled the beginning of the environmental crisis in the rural areas. Likewise, its earliest urban manifestation was the epidemic of yellow fever and bubonic plague in Rio de Janeiro in 1903. The political overtones of environmental problems or, according to the perspective adopted here, the ecological foundations of politics are clearly demonstrated in the bitter dispute that followed Oswaldo Cruz's attempts to solve the problem and establish a sanitation policy for Rio de Janeiro.<sup>7</sup>

<sup>7</sup>See in this respect, Nancy Stepan (1976): *Beginning of Brazilian science: Oswaldo Cruz, medical research and policy, 1890-1920*, New York: Science History Publications, pp. 84-91. For a comprehensive analysis of public-health issues during this period, refer to Luiz A. de Castro Santos (1980): "Estado e saúde pública no Brasil, 1889-1930", *Dados* 23, May-August, pp. 237-50, and "O pensamento sanitário na Primeira República: Uma ideologia de construção da nacionalidade" (1985): *Dados* 28, May-August, pp. 193-210.

#### 4. From Getúlio Vargas to the military (1930-1964)

The three decades from the closing of the "Old Republic" (1889-1930) and the advent of the military régime (1964) represent one of the most interesting periods of Brazilian history. Politically, the installation of the Getúlio Vargas régime from 1930 up until 1945 represents the downfall of an oligarchy that comprised large landowners, coffee producers and export-oriented commercial interests, and its replacement by a new, populist alliance. Forgers of the populist pact were the rising industrial bourgeoisie, the agrarian élites whose production activities were oriented toward the internal market, the corporatively organized urban workers, and the "new" middle classes emerging from the growth of the bureaucracy as well as from State-induced industrialization. These middle classes distinguished themselves from the old, "parasitic" middle classes through their increasing relationship with the country's production structure.

This period also witnessed the strengthening of the industrialists, who after 1964 became the dominant class. Also of importance were the early stages of a strong technocracy, based on the multiplication and expansion of both public and private organizations in the decades before 1964. The technocrats were the most articulate members of the "new" middle classes, encompassing lawyers, administrators, managers, health workers, educators and other occupational groups. Together they have formed what F. H. Cardoso calls the "bureaucratic rings" that link the interests of foreign and domestic capitalists with those of these specialized, highly trained technicians. These rings, which operate through the management levels of State enterprises, private corporations and the government bureaucracy, played a leading role in the presidency of Juscelino Kubitschek (1955-1961) and especially thereafter, creating new channels for articulation of interests beyond political-party structures, as well as new forms of clientelism.

In economic terms, these three decades saw dramatic alterations in the country's production structure. During the years 1940-1961, the gross national product increased 232%, the per capita product rose 86%, and industrial production

climbed 683%. This was also a period in which major efforts were made to integrate the national territory, especially through construction of highways. Between 1928 and 1955, railways increased only 10% to 37 000 km, whereas highways more than tripled, reaching a total of 460 000 km. Especially after 1955, industrial expansion centered on the automotive industry, with the production of cars reaching 35 000 (a fifteenfold increase) in 1962, while trucks and buses totalled 30 000 (a rise of 150%). The presence of the State in the economy, if not yet as spectacular as during the military régime, was already considerable. State participation in total expenditures rose from 17.1% in 1947 to 23.9% in 1960. The public sector was responsible for 28.2% of the total investment, or the country's gross capital formation in 1956, a proportion that jumped to 48.3% in 1960 and to 60% in 1964.

This last characteristic of the period, State interventionism, had a twofold impact on ecopolitics in Brazil. Natural resources became an important government priority, and there was a persistent move toward nationalization. Heavy exploitation also began, resulting in depletion of the resource base. Several public organizations, either agencies or enterprises, came to oversee or promote, under State monopolies, the exploration of natural resources. Similarly, important initiatives were taking place in legislation, such as the promulgation of several codes: the Waters, Mining and Forestry Codes, all in 1934; the Fishing Code in 1938; and the Hunting Code in 1943. Governmental structure also became an object of change. For example, in the early 1960s the municipal governments of Santo André, São

Bernardo do Campo and São Caetano do Sul, in the so-called ABC Paulista—the heart of the automotive industry in São Paulo—founded the Intermunicipal Commission for Water and Air Pollution Control. This became the embryo of today's State Company of Environmental Sanitation Technology (CETESB), which is considered to be the largest and best-equipped environmental control agency in Latin America. In Rio de Janeiro, the Sanitation Engineering Institute (IES) was created in 1962, later becoming the State Foundation of Environmental Engineering (FEEMA).

Insofar as conservation is concerned, the First Brazilian Conference for the Protection of Nature, which took place in 1934 in Rio de Janeiro, marks a new era of awareness. Of the 38 national parks and biological reserves that exist today, half were established between 1937 and 1961, comprising over one million hectares of protected land, flora and fauna. Some 11 of the 69 state parks and biological reserves were also created before 1964, with close to 900 000 hectares. This brings the total of officially protected area in this period to close to a quarter of 1% of Brazil's total area, which is still one of the lowest indices of any nation in the world.<sup>8</sup> Finally, community organizations also developed around environmental issues. Among the most active organizations in the 1930-1964 period were the Associação Rio Grandense de Proteção aos Animais (ARPA, 1951, protection of fauna), the Associação de Defesa do Meio Ambiente (ADEMA, 1955, environmental protection and conservation) and the Fundação Brasileira para Conservação da Natureza (FBCN, 1958, environmental protection and conservation).

<sup>8</sup>Since then, this figure has been multiplied by six, amounting to 1.5% of Brazil's territory, still a very low figure. Japan, for example, with roughly the same population as Brazil and with less than one-twentieth of the Brazil's territory, has 13.5% of its area permanently protected. The United States, slightly larger than Brazil but with a population almost twice as large, has 17%. And in

Sweden, about the size of Japan but much less densely populated, the total protected area is 60% of its territory. Roberto P. Guimarães (1986): "Ecopolitics in the Third World: An institutional analysis of environmental management in Brazil", doctoral thesis submitted to the University of Connecticut, pp. 192, 328-329.

### III

## Developmentalism and megalomania: Brazil under military rule

The crisis of the political system in 1964 represents the culmination of a process through which successive attempts had been made to solve the crisis of oligarchic domination that went back to the collapse of the Old Republic in 1930. Neither populism (Vargas 1930-1945) nor developmentalism (Kubitschek, 1956-1961), much less reformism (Goulart, 1961-1964), seemed to have worked. Faced with the choice of deepening the incorporation of new social groups into the general process of economic growth, or accelerating the modernization of the most dynamic sectors of the economy, the Brazilian élite opted for the latter. That would, of course, intensify the associated and dependent character of Brazil's incorporation into the international economic order. But the transformation of Brazil into a "world power", according to the ideology of the military régime, was well worth its social costs. The same applied to the political costs of marginalizing from public life the popular sectors of society, depriving an entire generation of its political citizenship. The costs would also prove to be great for the environment.

#### 1. *The ecopolitical alliance of the military régime*

The civilian-military régime installed in Brazil after 1964, can be described in very simple terms. It represented the alliance of the financial and industrial bourgeoisie with multinational interests. The agrarian and commercial elements of the bourgeoisie now occupied the back seats. The working classes were, of course, excluded. What made this alliance possible was the existence of a well-trained, specialized and willing technocracy, both civilian and military.

The period 1964-1982 may go into history as a time of stirring up the "sleeping giant" mentioned in the national anthem. Brazilians have a tendency to favour grandiose schemes; they have the biggest football stadium in the world, the largest (urban) tunnel in the world, the largest

(intercity) bridge in the world and a series of "wonders" that are called the biggest even when they are not. Such grandiose self-perceptions do not, of course, automatically need the bureaucratic-authoritarian pact for them to be wasteful, but they characterize a culture where waste was almost inevitable.

#### 2. *Some examples of the military's "world power" project*

These works cannot be dismissed as a mere "tendency to exaggerate or imagine things big", as is the definition of megalomania. They are instead quite real and, above all, ecologically and financially costly. The first manifestation of this emerging "world-power" complex was undoubtedly the Trans-Amazon Highway, which was supposed to run for 4 300 kilometers and consolidate the integration of the national territory. It drew worldwide attention as it accelerated the assault on one of the few tropical forests left on earth, and it led to what became known as "the genocidal policies" against Indian populations. Located at the eastern border of the forest, in the states of Pará and Maranhão, is the largest mineral deposit in the world (here we go again!) in an area of 780 000 km<sup>2</sup> or the equivalent of Texas and New England combined. There one finds the régime's latest and most ambitious venture, the Carajás Project. Over US\$60 billion is expected to be invested and, if all goes well, the project will generate around US\$18 billion in exports by the 1990s (especially of iron ore, bauxite, manganese and nickel). To meet the energy needs of Carajás there stands the environmentally controversial Tucuruí hydrostation, with a price-tag of US\$6 billion to generate 8 000 megawatts of electricity.

Near the southern border with Paraguay Itaipú, the largest hydroelectric project in the world, was built at a time when Brazil was already approaching surplus production of electricity. When Itaipú is fully operational it will

have cost US\$16 billion to produce 12 600 megawatts, or 20% more electricity than the projected capacity of the Grand Coulee Dam in the United States, the largest in the world today. In the meantime, Itaipú has destroyed the Sete Quedas Falls, inundated farmland and natural sanctuaries, and evicted thousands of families.

The energy orgy was completed with the Brazil/West Germany Nuclear Treaty of 1975, which called for the construction of eight power plants, at a cost of over US\$30 billion. A Westinghouse-built nuclear plant, contracted before the German deal, was to come on line in 1977, but it had managed only trial runs by 1983. Incidentally, this plant was built on one of the worst-proven ecological sites, whose Indian name (Itaorna) means "rotten rock". In addition to that, the plant stands in the middle of a string of world-famous beaches between Rio and São Paulo, barely 134 and 240 km from the two most populous concentrations of Brazilians. In short, it has already cost several times more than originally anticipated, due to a fact known for centuries to the Indians; it may hurt tourism; and it poses a serious threat to over 25 million persons, as it does to the flora and fauna of the region. On top of everything else, it was also built in the South, which helps to make Itaipú's contribution of energy even more surplus. As a matter of fact, the Angra dos Reis nuclear power plant has had so many problems, with short periods of operation followed by longer shutdowns, that people call it "firefly", evidencing the Brazilians' sense of humour amidst a planning tragedy that must also be one of the largest in the world.

Another indication of technocratic rationality at its most questionable is the Pro-Alcohol Programme, designed to find a domestic substitute for imported oil. Many consider it to be a success, for its yearly production of over 10 billion litres allows a 20% mixture of alcohol with gasoline. Furthermore, over a third of the country's car fleet runs exclusively on alcohol. On the other hand, Brazilian environmentalists cogently ask whether the alcohol programme is worth the ecological costs. It is undoubtedly true that Pro-Alcohol represents a sounder strategy for energy problems in general, i.e., the development of renewable sources. However, only 6 to 8% of Brazilians own an automobile, and creating a renewable energy source for them comes at

the cost of displacing essential food crops for all citizens through extensive plantations of sugar cane. Similarly, the 10 billion litres of alcohol produced each year represent 100 to 120 billion litres of *vinhoto*, a waste product. In these quantities this effluent has a toxicity equivalent to the sewage of 280 to 340 million persons in terms of biochemical oxygen demand, a commonly used measure of water pollution. In other words the yearly production of alcohol is equivalent to the pollution generated annually by the untreated sewage of two to three times the entire population of Brazil.

The list could grow longer, but the point is not simply the grandiosity of Itaipú and other projects. There can be no doubt that it is much better to spend money in this fashion, on an infrastructure that will be put to use in the future, than to put it in Swiss bank accounts, as was done elsewhere.<sup>9</sup> Above all else, however, what must be noted in the case of Brazil is that all of this took place in less than 10 years. There is simply no other example, in the history of capitalism, of one country's developing so many and such diversified projects all at once. But this also means that a massive debt, developed in less than one generation, will have to be paid back by several generations to come.

### 3. *The ecopolitical underside of megalomania*

Many of these projects make sense in purely economic terms. It is undoubtedly cleverer to spend cruzados every time a car stops at the "gas" pump than to spend hard-earned dollars. But do these projects make genuine sense in a country that has the highest concentration of income among 32 major capitalist countries? Or do they make sense in a country that has the highest rates of infant mortality, malnutrition and parasitic diseases among nations with a comparable level of per capita income? Notwithstanding the severe "social" costs of megalomania, "costs" that are in fact a euphemism

<sup>9</sup>According to a monthly bulletin of the Morgan Trust Company, 13% of the Brazilian external debt can be attributed to capital flight. Still according to the Morgan estimates, Brazil would be the country that has best invested resources borrowed from abroad. Cited by "Boletim falava da evasão de divisas" (1986): *Jornal do Brasil*, 23 May, p. 15.

for misery and starvation, ecological and environmental costs must also be brought into the picture. There has been extensive destruction of nature, with irreparable loss of fauna and flora and increasing levels of pollution. Even more important, the impact of all these projects on the squandering of natural resources has yet to be reckoned up. The process of desertification of the Amazon is but one manifestation of this type of reckoning, and probably not the worst. The monoculturalism of Pro-Alcohol, the lake formed by Itaipú, the exploitation of mineral reserves at Carajás—all represent a direct toll on Brazil's natural resource base. The financial resources needed for their development must be paid back, which in turn creates a need to earn dollars, which means more exports, which means intensified exploitation of already over-exploited resources.

As this process continues on and on, one can fully appreciate the extent of Brazil's social and environmental mortgage. It was a nationalistic Olavo Bilac who asserted: *Não verás país como este!* [*You will not see a country such as this one!*]. Every Brazilian child is taught to appreciate Bilac's description of the country's riches, which has helped to fuel Brazilian jingoism for over a century. In years to come we may see the day when his exhortation is replaced by the title of a recent novel: *Não verás país nenhum!* [*You will see no country at all!*].<sup>10</sup> Finally, insofar as ecopolitics goes, it should be pointed out that in none of the projects mentioned so far have Brazilian citizens as a whole been called upon to decide these issues.

Brazil's social and political dilemmas are environmentally compounded, in short, by what has been recently emphasized: too much, on too many fronts, in too little time. It may indeed be said that one of Brazil's major ecopolitical problems derives precisely from what may be called the "superimposition of history", i.e., the fact that Brazilian economic growth and social differentiation find no parallel in the historical development of the now industrialized societies. This superimposition of history may be interpreted in a positive way, when we consider that in its process of rapid economic growth Brazil has

never had to face environmental conditions as harsh as those of Great Britain during the nineteenth century. This applies even to the most depressed areas on the periphery of the urban centres. On the other hand, if Brazil has not had a "situational" Liverpool, it has had a "structural" Cubatão in the industrial heart of São Paulo. Conversely, Brazil has not yet solved basic sanitation and public-health problems, and already the country has extreme cases of environmental degradation.

Consequently, when one looks at the 1960s and 1970s, the official ideology clarifies the relationship between ecology and development in Brazil. After all, most of the institutional structure to deal with resource management and environmental protection was set in motion in this period. This was also the period in which the bulk of Brazilian environmental legislation was enacted. In any event, even the most committed environmentalist must agree that Brazil's environmental problems cannot be blamed on the lack of legal statutes. Developmentalist ideology has been so effectively ingrained in Brazilian politics that even those who were supposedly on the other side of the fence have fallen prey to it. Seldom if ever would environmental protection agencies adopt an adversary stance in public policy. The most complete expression of their naiveté was their widely proclaimed slogan of "development with low ecological cost". This euphemism is so powerful that many bureaucrats who claim to be environmentally conscious do not even perceive the ideological overtones of the message.

Lest anyone miss the point, it should be made crystal clear that there is no suggestion here either that, in order to exploit natural resources rationally or to protect the environment, one must be anti-development. We must recognize the conflictive—yet, not necessarily antagonistic—relationship between environment and development. To expect that entrepreneurs will take environmental "costs" into account is as naive and Pollyanna-ish as to expect that they will protect the interests of labour. Again, labour unions are the last to take a stand against development, for in fact they share the interests of businessmen in economic growth. But, if labour had advocated "development with low human cost" or "labour impact assessment"

<sup>10</sup>Ignácio de Loyola Brandão, *Não verás país nenhum* (1981): São Paulo: Global Editora.

it would be now in a worse situation than it actually is.

Several important ecopolitical implications derive from these experiences. Some of these will no doubt strongly influence the prospects for democracy in the near future, such as the emerging industrial-military complex<sup>11</sup> and the polarization of social differences between classes and groups. The combination also of some of the elements of the "new" authoritarianism (demobilization of society, internationalization of the economy and technocratism), all shaped ecopolitics in Brazil. Policies came to be formulated and implemented in an autocratic way. The disproportionate importance given to pollution control over the management of natural resources constitutes just one of several examples. But their synergistic effect also poses serious questions for ecopolitics in the future. With the return to civilian rule and the expected reorganization of society, there is absolutely no guarantee that a new brand of corporatism will not emerge.

If so, environmental problems could still be treated separately, on an emergency basis, and according to the narrowly defined interests of each social class or economic group.

Garrett Hardin and William Ophuls, for example, appear to believe that the current rationality guiding the use of common resources could lead to authoritarian societal organizations, and that this might be the only way to enhance our chances of overcoming the environmental crisis and surviving the ecological transition.<sup>12</sup> I believe, however, that the danger lies in the other direction, and Brazil may unfortunately provide the best illustration in years to come. It is precisely the corporatist organization of this society, with the heavy burden of its patrimonial and authoritarian heritage, as well as its inherent inability to conciliate the interests of each sector into a genuine "national" programme, that may truly underscore the "tragedy" of the commons.

## IV

### The creation of the special secretariat for the environment

It has become almost axiomatic to repeat Engels's assertion that people themselves make their history, only they do so within a determined environment that conditions it, based upon real relations that are already in place.<sup>13</sup> Bearing Engels in mind, we turn to a little known, almost unnoticed fact of Brazilian ecopolitical history, that is, the very situation, almost fortuitous, that allowed SEMA to come into being.

In the late 1960s Congress was suggesting the need for a national environmental policy. The year 1967 opened with the establishment of a National Sanitation Policy. In that same year the National Council for Environmental Pollution Control was created in the Health Ministry. All Brazilian states had at least one agency closely concerned with pollution abatement. General João Baptista Figueiredo, Secretary-General of the National Security Council, and

<sup>11</sup>Comprehensive analyses of this phenomena are still lacking. For a recent attempt to identify the many implications of the industrial-military complex, see Clóvis Brigagão (1985): *A militarização da sociedade*, Rio de Janeiro, Jorge Zahar Editor. See also René A. Dreifuss and Otávio S. Dulci (1983): "As forças armadas e a política", in *Sociedade e política no Brasil Pós-64*, ed. Bernardo Sorj and Maria H. T. de Almeida, São Paulo: Editora Brasiliense, pp. 87-117.

<sup>12</sup>See Garrett Hardin, "The tragedy of the commons" (1968): *Science* 162, 13 December, pp. 1243-48, reprinted in Hardin (1972): *Exploring new ethics for survival: The voyage of the spaceship Beagle*, New York: The Viking Press, pp. 250-264, and Ophuls, *op. cit.*

<sup>13</sup>Friedrich C. Engels (1894): "Letter to Starkenburg", in *Karl Marx and Friedrich Engels: Selected correspondence. 1846-1895*, London: M. Lawrence, pp. 516-519.

later President of Brazil, called attention in 1971 to the need for a national pollution control policy to be formulated by the Federal Government.<sup>14</sup> The Declaration of the United Nations Conference on the Human Environment, held in Stockholm in 1972, also called for the creation of a specialized agency. In short, the time was ripe for SEMA. But, although over a year had gone by since Stockholm, the government did not seem to be in any hurry.

The opportunity came in a very peculiar form. The operation of a wood-pulp plant near Porto Alegre, the capital of the southern state of Rio Grande do Sul, was causing severe inconvenience for the general population. Every time the wind blew the wrong way, a new wave of nausea, vomiting and sickness affected an increasingly vocal population. After contact was made with the Interior Ministry, which was supposed to have a say in urban planning and zoning, this matter was brought to the attention of the Gabinete Civil through a decree that was tailor-made for the situation. Its backers were ready with the necessary *Exposição de Motivos* [a document that usually accompanies a piece of legislation, containing the justification for a particular policy] and everything else that the patrimonial order would call for on such occasions. This decree provided for a specific agency to be charged with solving specific problems such as the one in question. Being a very popular figure in Rio Grande do Sul and also an authority on legal matters, Professor João Leitão de Abreu, the Chief of Staff, immediately seized the opportunity.

With the enactment of Decree 73.030 by President Garrastazú Médici in October 1973, Brazil gained a new agency, the Secretaria Especial do Meio Ambiente (SEMA), under the

co-ordination of the Interior Minister (in 1986 SEMA was transferred to the new Ministry of Urban Development).

### 1. *The organizational culture of SEMA and ecopolitics*

This experience reveals more about Brazil than it appears to do. The way in which an organization comes into being exerts strong influence on the perceived missions of its bureaucrats.<sup>15</sup> An agency that has resulted, for example, from an emergency situation is likely to respond in its day-to-day operations in a spasmodic, emergency-like pattern. Another agency created to placate special interests is unlikely to address broader issues that may enlarge its clientele, thereby jeopardizing the original interests. Therefore, because we have analysed the ecopolitical foundations of SEMA in the Brazilian social formation, it seemed appropriate to reveal the most intimate moments of SEMA's birth. SEMA was created in response to an instance of environmental pollution, and this fact would later have a lasting effect both on its members' sense of purpose, its organizational "culture", and on its effectiveness in implementing environmental policies as well. Ecopolitics in Third World countries deals more with managing the natural resource base than with abating pollution. Brazil was one of the leading speakers for this viewpoint at Stockholm; yet, up to now the dominant environmental perception in Brazil relates to the pollution of air, water and soil rather than to natural resources management.

A second element of SEMA's creation that also reflects the ruling alliance installed after 1964 is the technocratic orientation instilled at the moment of its inception. First of all, the *Exposição de Motivos* that accompanies the decree establishing SEMA justifies it on the grounds that Brazil already had a multitude of agencies working on specific areas, citing 18 agencies distributed among nine ministries. Despite that, the proposed "solution" was to create yet another organization. Worse, an agency that worked according to the dominant

<sup>14</sup>Figueiredo made this recommendation in the context of the NSC review of the Itamaraty (Brazilian Ministry of Foreign Relations) position paper regarding environmental matters, a document that was to be used as the basis for the Brazilian participation in the United Nations Conference on the Human Environment, held at Stockholm, in June 1972. For more detail see: Brasil, Presidência da República, Conselho de Segurança Nacional, *Exposição de Motivos No. 100/71, sobre a posição a ser adotada pelo governo brasileiro no que diz respeito aos problemas ligados ao meio ambiente* (Brasília, 22 December 1971). See also: Brasil, Ministério das Relações Exteriores (Itamaraty), *Conferência das Nações Unidas sobre o meio ambiente: O Brasil e a preparação da conferência de Estocolmo* (Brasília, 1972).

<sup>15</sup>See, in this respect, the penetrating analysis of Anthony Downs (1967): *Inside bureaucracy*, Boston: Little, Brown and Company.



precepts of technobureaucratic behaviour could not possibly be expected to get other agencies to co-operate. Being a second-class secretariat of an ordinary ministry, it could not have any political clout, even in the strictest bureaucratic sense, that would help formulate and implement a national environmental policy. Furthermore, the actual way in which SEMA was set up and staffed points to the predominance of a particular professional perspective, that of the natural sciences broadly defined: chemistry, biology, pharmacology and others. As a result, the Brazilian government was able to depoliticize environmental issues, reducing them to a question of technical, or technobureaucratic, expertise.

Necessarily, these are some of the ecopoliti-

cal implications of the alliance forged after 1964. They all refer to structural characteristics of Brazilian society that cannot be done away by a change of régime, not even by the "redemocratization" of the 1980s. Therefore, observers must be temperate in their criticism of SEMA's role in managing the environment. To be sure, current practices reinforce the dominant ideology, and SEMA is liable for most of them. Nevertheless, the most important characteristics of ecopolitics in Brazil go beyond specific administrations; they have been unfolding through a much longer process. The advent of the military régime, it should be stated once more, simply enhanced already latent values, beliefs and practices of the leadership cadres in Brazil.

## V

### Development plans and the environment: a summary review

Most countries of Latin America started to pay closer attention to planning activities immediately after, and in part because of, the 1929 crisis. In the case of Brazil, planning began to be taken seriously during the Getúlio Vargas era.<sup>16</sup> The growth of State functions called for the existence of well-trained, professional bureaucrats. As part of the efforts to reform the administrative apparatus of the State, Vargas formed the Administrative Department of the Public Service (DASP) in 1938. One year later there appeared the Special Plan of Public Works and Equipment of National Defense, whose main objectives were to foster the creation of basic industries and improve the transport infrastructure.

<sup>16</sup>One of the best studies of the attempts to institutionalize national planning in Brazil, from Getúlio Vargas until the military coup of 1964, is Benedicto Silva (1964): *Uma teoria geral de planejamento*, Rio de Janeiro, Fundação Getúlio Vargas. Octavio Ianni has approached the subject as a way to unveil the patterns of relationships between the State and the economy. The result was his insightful (1977): *Estado e planejamento econômico no Brasil (1930-1970)*, 2nd ed., Rio de Janeiro, Editora Civilização Brasileira. See also Robert T. Daland (1967), *Brazilian planning: development, politics and administration*, Chapel Hill: University of North Carolina Press.

This is the period in which key planning institutions, such as the National Bank for Economic Development (BNDE), came into being. This was also the time when attention began to focus on the country's natural resources, with the establishment of a multitude of public organizations to control, promote or otherwise regulate their exploitation. The National Department of Mineral Production (DNPM), the Vale do Rio Doce Company (CVRD) and the Brazilian Oil Company (PETROBRAS) are just a few examples of the dozens of State enterprises or agencies that appeared during the 1940s and 1950s.

The military régime installed in 1964 was to inaugurate a period of profound changes, and the institutional aspects of national planning received more attention than ever. In 1967 the Extraordinary Ministry for Planning created by Goulart became the (permanent) Ministry of Planning and General Co-ordination —what today is the Planning Secretariat of the Presidency of the Republic. Since then those who have occupied this post have been traditionally the most powerful members of the cabinet, enjoying political clout equivalent to that of a prime minister in parliamentary régimes. The obligation to

carry out planning activities for social and economic development became enshrined at the highest institutional level: in the Constitution of Brazil.

It is not the purpose here to analyse the results of the multitude of development plans. Nevertheless, just as Brazil's environmental problems cannot be blamed on a lack of legislation, so they cannot be blamed on a lack of planning either. What seems to be missing is relevance, planning that is detailed and "appropriate". Since the emphasis must be placed on the culture of bureaucracies as perceived by the actors involved, rather than on a culture derived from some arbitrary order imposed by the observer, we should turn our attention to the perceptions of environmental officials. The overriding conclusion that comes out of various interviews at the highest levels of environmental decision-making is one of frustration with the job that SEMA has been able to perform in this area.

Insofar as the planning process is concerned, one generalized perception is that the culture of development planning in Brazil was, and still is, largely dominated by macroeconomic criteria. Development plans at the national as well as at the regional level consistently fail to incorporate any environmental dimension, much less one that might be deemed more or less appropriate. This is believed to be the case not only because of lack of understanding or sensitiveness to environmental issues on the part of economists who hold power positions in the planning structure; there also seems to be consensus that so long as development plans are prepared according to the concepts and techniques of economics, no one should expect better results. The dominant technobureaucratic ideology of "privatization" of national resources only compounds the difficulties.

The institutional structure for planning is also held to be an obstacle to the incorporation of the environmental dimension into development plans. Located in one sectoral ministry, and having to compete for the allocation of resources on a sectoral basis, SEMA has repeatedly failed to influence the planning cultures of other ministries, and particularly that of the Planning

Secretariat itself. Government officials often mentioned that every major public enterprise or project in Brazil already had an environmental unit. Yet these units have played a minor, almost cosmetic role. Never have major revisions been promoted or projected because of their work. The environmental legislation requires that an impact assessment of large-scale projects be undertaken. The potential incentive for internal compliance is high, for the government is supposed to withhold the disbursement of resources until this requirement is met. Again, the law is uniformly ignored, and yet nobody has been punished so far.

Finally, plans themselves are cited as indicators of SEMA's disappointing performance. Most assessments of SEMA's contribution to the several national and regional plans underline the fact that it has never exerted any influence whatsoever. Some officials add that SEMA could not have done so, even if it had been "granted" the opportunity, since it lacks the necessary human and material resources to tackle the task of harmonizing sectoral programmes and environmental criteria.

In short, no matter how one looks at it, the conclusion seems to be the same. The ecological and environmental realities of Brazil have not yet made their way into planning. As the opening quotation to this paper indicates, Brazil's leaders have defined the situation as one where destiny "imposes" development, tearing down, moving on. The country is seen as big enough to heal itself, and this makes business as usual possible. Ironically, at Stockholm the Brazilian government passionately advocated that environment and development be tightly connected. But more than a decade after Stockholm, Brazil's government authorities have still decided not to realize in their own country what they preached to the world. The situation described here assumes bleak overtones once additional elements are considered. The context of environmental problems, or the "agenda" of public policies in this area, adds to the complexity of policy formation and implementation. The multitude of actors involved in policy-making also renders environmental problems almost intractable in Brazil.



## Social policies in Costa Rica

*Ana Sojo\**

Costa Rica's significant achievements in social development have been closely linked to the democratic government and its economic and social policies based on effective consensus. Until the late 1970s, these policies notably included wage increases and, despite the increasingly regressive tax structure, social spending with a redistributive effect.

In this article, the author discusses the social implications of the crisis and economic policy, especially changes made in the Welfare State, and suggests possible social development options for the coming years.

Although social inequalities have become more marked, the State has tried to find some solutions to the crisis that would benefit the majority; meanwhile, the earlier dynamics of social development provided a cushion for the most serious effects of the crisis. Despite the deterioration of social policy, there was no overall dismantling of Welfare State institutions, and their redistributive effect persisted. The financial stability recommended in order to cover the deficit in welfare and social security institutions was achieved mainly by rationalizing spending, with preference being given to administrative reform, revenue enhancement and the restructuring of services. These measures, together with the partial recovery of wages, reflect the policy's consensus-based orientation, which contributed to economic stabilization.

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## Introduction\*

The significant social achievements in Costa Rica since the 1950s have been closely linked to the democratic government and some of the basic orientations of its economic and social policies. The State, acting as an underpinning of private accumulation, has proven to be an effective promoter of compromises among different and often opposing interest groups, such as entrepreneurs and low-income sectors.

The considerable expansion of the domestic market has been consistent with a policy of increased wages. From the 1950s to 1972, real wages rose, and in the 1970s as a whole, although wages declined in the years of greatest inflation, there was an overall rise.

Also of major importance, in view of the increasingly regressive tax structure, has been the redistributive effect of social spending through social welfare institutions. Some of these, which provided social benefits, arose out of the turbulence of the 1940s; they later expanded considerably and diversified, even in the 1970s when problems of economic growth were already beginning to arise.

The recent crisis and economic policy have had an impact on employment and on the level and distribution of income, and have brought about some changes in the Welfare State, certain aspects of which will be discussed further on. Some possible social development options for the coming years will also be suggested. The conclusion reached is that, although there has been a deterioration in social policy, there has been no overall dismantling of Welfare State institutions, whose considerable redistributive effect persists. Financial stabilization, which has been advocated to help close the gap in social welfare institutions, has been achieved basically by rationalizing spending, giving preference to administrative reform, revenue enhancement and the restructuring of services (Rivera and Gendell, 1988a, pp. 18 and 19).

\*Article based on an advisory report prepared by ECLAC and presented at the Seminar on Social Development Options for the 1990s, organized by ECLAC, FLACSO and ILPES in commemoration of the 40th anniversary of ECLAC, and held in San José, Costa Rica, in November 1988.

These developments show the consensus-based orientation of policy, one of the important collateral effects of which was its contribution to economic stability during President Monge's term of office. Future prospects will depend, *inter alia*, on the positive or negative results of

structural adjustment and the renegotiated terms of payment of the external debt. These factors, and the implementation of other economic and social policy options instead of the current ones, will determine the possible scenarios for the coming decades.

## I

### Standard of living and economic policy

Economic and social policies are part and parcel of development, and their mutual integration in the promotion of investment, employment, and distribution is the cornerstone of democracy (ECLAC, 1986, p. 6). Thus, social policy is not the only policy responsible for equity, which is achieved not through social services alone but through all areas of economic and social policy and includes both short-term and long-term perspectives. Social problems and their solutions can neither be isolated from nor subordinated to the goal of economic growth (ECLAC, 1987, p. 7).

There is a relationship in Costa Rica between the behaviour of macroeconomic variables and that of income; however, changes in the magnitude of poverty do not automatically correspond to changes in macroeconomic indicators. Taking into account income, consumption, employment and infant mortality in discussing the standard of living of the past two decades, we can clearly distinguish three periods (Trejos and others, 1988, pp. 54-61), as follows:

a) *Rise in the standard of living (1970-1979)*: improvement in income indicators, especially wages. The upper-income levels appear to have benefited the most, but some indicators, such as infant mortality, fell considerably indicating an improvement in the living conditions of low-income groups. There was a slight drop or stagnation in 1974 and especially in 1975, related to the oil crisis.

According to comprehensive estimates, 25% of families and 30% of individuals were living in poverty. The phenomenon of poverty is mainly rural; and it has increased in intensity, as

can be seen in the resurgence of extreme poverty and the greater amount of resources needed to eradicate it. As for extreme poverty, there is disagreement about whether it has been overestimated.

b) *Marked reduction in standard of living (1980-1983)*: within three or four years, the standard of living indicators retrogressed by at least a decade. Wage-based income fell more rapidly than family income, and the latter dropped faster than consumption. The impact of the change, with individual variations, was felt throughout the population. At first, open unemployment rose more than underemployment, but later the two evened out. The systematic reduction of the infant mortality rate came to a halt, stagnating at around 20%.

During this period, the proliferation of poor groups mostly represented a rise in basic poverty, while extreme poverty showed a slight drop. Generally speaking, the increase in poverty appears to be concentrated in groups situated slightly above the poverty threshold, primarily in urban areas; this is why these groups are highly vulnerable in critical periods. In 1983, 40% of poor families and 38% of poor individuals lived in urban areas.

Income concentration, according to the Gini coefficient, was approximately 0.47 in 1983, as against 0.44 in 1971, a moderate degree of concentration when compared to other Latin American countries. The poorest 10% of families received less than 2% of total income, while the richest 10% of families received 37%. Over half of total family income was concentrated in 20% of the highest-income families, and approximately 70% of families

were located below the medium family income, which rose to 14 066 colones per month (Trejos and Elizalde, 1986, p. 90).

According to a tentative general comparison of income distribution between 1971 and 1983 (*ibid.*, pp. 100-101), in both years the concentration was higher in the urban areas, a phenomenon which became more marked in 1983. It declined in the poorest sectors (the lowest 20%) and medium-income sectors (the middle 60%), while it rose in the highest 20%, especially in the Metropolitan Area. Within the highest income bracket, a separation or differentiation occurred between the ninth and tenth decile in favour of the latter, especially in the cities. Thus, the increase of approximately 18% in income recorded at the national level, especially in rural areas, did not signify any progress in income redistribution (*ibid.*, pp. 102-103).

c) *Recovery of the standard of living 1984-1986* (without full restoration of pre-crisis levels). Except for infant mortality, which remained steady, the trend towards a deterioration in the various indicators was reversed, although most of them did not reach 1977 levels. Income recovered to a greater extent than consumption.

During this period there was a reduction in the absolute magnitude, incidence and intensity of poverty, both by strata and by areas. The greatest decrease occurred in basic urban poverty. The 50% reduction of intensity was sharper than that of incidence, which fell by only 26%. It should be noted that the coefficients of poverty in 1986 were more favourable than in 1971, 1973 and 1977.

In 1987 and 1988, with worsening inflation and setbacks in the recovery of income, the standard of living again declined, thus delineating a fourth period, although one that has not yet been systematized.

The behaviour of these indicators is partly related to the social implications of economic policy. In this relationship, three phases can be distinguished. The first corresponds to the government of President Carazo, whose policies, aimed at contracting demand, failed to take into account how they would affect the structure of relative prices and incomes. This orthodox approach, together with the liberalization of

interest rates and the exchange market, led to stagflation and a distributive clash which in turn exacerbated the destabilization and social uncertainty (Rivera, 1987). The second phase, that of the government of President Monge, marked the success of a heterodox stabilization policy, whose social effects were conditioned by such elements as compensatory measures in the most vulnerable social sectors, gradual transformation of the economic structure and enormous increases in the cost of public services. The wage policy was very restrictive at first. A basic basket was defined, composed of 16 commodities and subject to price control. Wage increases were determined every six months, solely in accordance with the price rises for this basket. The real minimum wage fell by 10% in 1981, and by 5% in 1982 (Castillo, 1986, p. 2000). The real wages of the lower-income strata were readjusted disproportionately, and their purchasing power was thus protected. This was in contrast to the behaviour of the lowest predominant real wages in Latin America, which fell more than the average (Tokman and others, 1988). After 1984 there was a general recovery of wages.

In the third phase, during the government of President Arias, attention has been focused on structural adjustment. In this context, the fundamental social conflict centres on the problem of the peasantry and the so-called "new agriculture". Changes are expected to take place in employment, related to tariff modifications and industrial reconversion. With regard to the external debt, despite a strong flow of resources from AID and other sources since the term of office of President Monge and their effects on adjustment (Rosenthal, 1986), the impossibility of compliance has led the government to pay the service in accordance with the country's capacity to pay. A growing discrepancy can be seen between contractual and effective payments: according to data provided by the Central Bank, only 35% of the interest was paid in the first half of 1988 as compared to 95% in 1985.

Naturally, this adjustment strategy attenuated the effects on the economy and well-being of the population since it was oriented towards growth.

It is important to consider the State's role in terms of employment. No mass lay-offs were

decreed with the aim of rationalizing government institutions. During the 1980s, Costa Rica's open unemployment rates have stayed relatively low (table 1). However, the labour market has continued to discriminate against women, as can be seen in their lack of access to jobs and in the employment and income rates, even where women have educational advantages. A look at average wages by sex indicates that, in 1980, female wages were 90%

of male wages; in 1982 they were only 84%, and in 1985, 87%. This behaviour was characteristic of the private sector (Moritz, 1986, p. 90) and shows a wage bias which has accentuated sex discrimination.

Fiscal policy has become increasingly regressive over the decade, in the framework of an indiscriminate promotion of exports to third markets.

Table 1  
COSTA RICA: UNEMPLOYMENT RATES, PUBLIC AND PRIVATE SECTORS, 1980-1986

	1980	1981	1982	1983	1984	1985	1986
Country							
Private sector	5.2	8.5	8.3	8.0	6.8	6.2	5.8
Public sector	2.2	2.8	4.3	3.2	2.9	3.0	2.5
Central government	2.5	3.1	5.2	3.5	3.4	3.1	2.6
Autonomous inst.	2.0	2.6	3.5	2.9	2.4	2.8	2.2
Non-metropolitan Central Valley							
Private sector	5.9	8.7	9.1	8.9	6.7	5.8	5.5
Public sector	2.7	2.5	3.5	2.8	3.5	2.4	2.3
Central government	2.7	2.3	4.0	3.2	4.8	3.9	2.5
Autonomous inst.	2.7	2.7	2.6	2.3	2.1	1.3	2.2
Metropolitan Area							
Private sector	5.0	8.1	10.7	7.3	7.4	7.0	6.2
Public sector	1.7	3.4	5.7	3.1	2.3	3.2	1.6
Central government	2.4	4.5	6.7	3.9	2.3	2.9	2.2
Autonomous inst.	1.3	2.7	5.0	2.4	2.4	3.4	1.2
Rest of country							
Private sector	4.6	8.7	5.3	7.7	6.5	5.9	5.7
Public sector	2.5	2.5	3.4	3.7	2.5	3.4	3.8
Central government	2.2	2.6	4.1	3.4	2.2	2.8	3.8
Autonomous inst.	2.7	2.3	2.8	3.9	2.8	3.9	3.8

Source: Argüello and Labell (1988).

## II

### Social policy in a context of economic crisis

#### 1. Redistributive effect of State social policy

Studies on public subsidies of social programmes (Trejos and others, 1988, pp. 175-196) estimate the total subsidy at 19 512 million colones for 1983, or 16% of the gross domestic product for that year. Of this subsidy, 39% was devoted to education, 38% to health, 9% to water supply

services and water purification, 7% to housing, 5% to food and nutrition and 2% to social security. One third of the subsidy benefited poor families; of these, 53% were at the basic poverty level and 47% at the extreme poverty level (*ibid.*, p. 180).

Poor families received more than one fourth of the education funds. However, access to education clearly varies according to social

stratum: those who received a secondary education are concentrated in the middle-income sectors; 42% of those who receive higher education come from the two highest-income deciles of families, and for primary education the situation is the reverse (*ibid.*).

In health, 37% of spending went to poor families. Within this population, the average health subsidy per poor family was 50% greater than that of non-poor families (*ibid.*).

In food and nutrition, as well as social security, subsidies were given mainly to low-income families; two thirds of this spending benefited poor families (*ibid.*). On the contrary, in housing, water, and water purification, the non-poor sectors were the primary beneficiaries. Poor families received only 11% of the housing subsidy and 20% of the water and water purification subsidy. For families living in extreme poverty, there was no housing subsidy, and they received only 9% of the water subsidy (*ibid.*, p. 182).

The redistributive effect of these programmes is noteworthy. In both relative and absolute terms, the poor were the most favoured group. Taking into account the entire country, the subsidy raised total monthly family income by more than one fourth. The family income of the poor rose by 4 187 colones, representing 86% of their family income, and 18% of the income of non-poor families (*ibid.*, p. 184). In the case of extreme poverty, income more than doubled. Regionally, the monthly subsidy to urban families (an average of 4 166 colones) was higher than that of rural families (2 993 colones), although the poor received greater benefits than the non-poor in rural areas. Thus it may be concluded that "if the subsidy is included in the calculation, the overall proportion of poor families dropped from 26% to only 10%. The sharpest reduction, to only 3%, took place in the extreme poverty sector. As a result, the composition of overall poverty changed, in that 70% of it represented basic poverty (compared to 53% prior to the subsidy) and the rest represented extreme poverty" (*ibid.*, p. 188).

Taking into account the subsidy, total national income and total urban income increased by one fourth, and rural income by 30%. Except for urban families living in basic poverty, the subsidy resulted in higher median

levels for all (*ibid.*, p. 190). As a result of the subsidy, the total poverty gap per family declined from 3 332 colones to 2 732 colones and, as a per capita figure, from 498 to 382 colones; the total gap was reduced from 439 to 137 million colones, representing a drop of almost two thirds (*ibid.*, p. 192).

These data are based on a household survey conducted in 1983. In describing the situation from then on, the effect of a certain amount of real contraction in public spending for these subsidies must be taken into account, as will be seen below.

## 2. Real reduction in social-sector spending

The fiscal situation in the 1980s—characterized by high debt service, dependence on external financing from institutions which have recommended ways of improving public finances and precariousness of economic growth—limited the resources available to the institutions responsible for social welfare.

During the period 1975-1985, there was a significant real decrease in public spending for social policies, especially beginning in 1981. The 1980 levels were exceeded only in the labour and social security sectors in 1985 (tables 2 and 3).

The various sectors were affected in different ways. From 1975 to 1981, the proportion of resources allocated to all the social sectors remained relatively stable, but beginning in 1981 there was a sharp reduction. The sector most affected was health, which received only 17% in 1985 compared with 26.4% in 1979. The housing sector was severely hurt in 1982, with its share of total public spending dropping to a mere 1.5%; it later recovered and rose above the 1975 percentage in 1985, with 2.4% of total available resources (MIDEPLAN, 1987a, p. 31).

In relationship to the total population of Costa Rica—not to direct beneficiaries alone—spending showed a considerable decrease in the social sectors, mainly those of education and health. All sectors showed a real reduction in 1985 compared to their 1975 level, except housing, which recorded a rise of 9.5%. The health sector was affected the most, declining 29% over the 10-year period (*ibid.*, p. 34).

However, taking total spending as a proportion of GDP, the reduction is less marked:



the share of total spending actually rose to 42.1% in 1985 compared to 41% in 1978 and 35.6% in 1975 (*ibid.*, p. 35) (table 4). As measured by productive capacity and the real decrease in social spending, there appears to have been no overall dismantling of the Welfare State, even with severe fiscal constraints. On the other hand, the efforts to reduce spending and rationalize employment in the public sector, together with the effects of the wage policy, in particular have been clearly evident: central

government spending for salaries and wages in the social services was reduced from 29.7% in 1975 to 14.3% in 1985 (*ibid.*, p. 53).

Naturally the spending cut had an impact on the provision of services. In the education and human resources sector, a government study recently noted the considerable cut in budgetary resources and its adverse effects on the hiring of staff, the efficiency of services and the meeting of infrastructure needs (Executive Office, 1987).

Table 2  
COSTA RICA: PUBLIC SPENDING IN CERTAIN SOCIAL SECTORS, 1975-1985

(Thousands of colones at current prices)

Year	Total	Education	Health	Labour and Soc. Sec.	Housing	Other <sup>a</sup>
1975	6 028 291.2	932 475.4	1 476 327.3	608 142.9	126 328.7	2 908 598.6
1976	7 667 182.3	1 243 005.3	1 701 257.9	690 422.1	188 678.4	3 843 818.6
1977	10 348 253.1	1 550 052.4	2 095 511.8	774 165.7	234 403.7	5 694 119.5
1978	12 407 851.6	1 916 476.7	2 901 224.2	1 054 479.6	264 413.3	6 261 257.8
1979	14 870 749.4	2 307 532.5	3 930 052.0	1 455 936.1	359 948.9	6 817 279.9
1980	18 662 560.6	2 876 174.5	4 673 548.5	1 483 347.2	637 475.0	8 992 015.4
1981	22 137 024.1	3 443 934.0	4 533 741.8	1 473 480.7	408 882.0	12 278 985.6
1982	34 876 762.0	4 826 198.9	6 146 936.1	2 487 934.1	513 834.4	20 901 858.5
1983	53 606 103.9	6 709 286.9	9 154 956.7	3 287 932.1	1 230 641.8	33 223 286.4
1984	68 680 246.8	8 551 652.3	11 591 452.3	5 279 275.8	1 654 086.0	39 583 780.4
1985	78 459 058.8	10 209 509.7	13 402 978.6	6 994 025.4	1 766 145.2	46 086 399.9

Source: Prepared by MIDEPLAN on the basis of official data.

<sup>a</sup>Includes other social and non-social sectors.

Table 3  
COSTA RICA: PUBLIC SPENDING IN COLONES AT CONSTANT PRICES<sup>a</sup>  
IN CERTAIN SOCIAL SECTORS, 1975-1985

Year	Total	Education	Health	Labour and Soc. Sec.	Housing	Other <sup>b</sup>
1975	2 273 430.9	350 291.3	554 593.3	228 453.4	47 456.3	1 092 636.6
1976	2 401 999.5	389 412.7	532 975.5	216 297.7	59 109.8	1 204 203.8
1977	2 770 616.5	415 007.3	561 047.3	207 273.3	62 758.7	1 524 529.9
1978	2 854 951.4	441 584.5	668 484.3	241 271.8	60 924.7	1 442 686.1
1979	2 996 926.5	465 040.8	792 029.8	293 417.2	72 541.1	1 373 897.6
1980	3 157 276.3	486 580.0	790 652.8	250 963.8	107 845.5	1 521 234.2
1981	2 967 827.4	461 715.2	607 821.7	197 544.1	54 549.1	1 646 197.3
1982	2 885 477.0	399 288.4	508 557.6	205 835.5	42 511.3	1 729 284.2
1983	3 128 456.6	391 554.5	534 284.0	191 884.0	71 820.4	1 938 913.7
1984	3 151 039.8	404 237.9	547 929.7	249 552.1	78 188.9	1 971 131.2
1985	3 011 054.3	391 814.5	514 371.5	268 411.8	67 780.1	1 768 676.4

Source: Prepared by MIDEPLAN on the basis of official data.

<sup>a</sup>Deflated by the implicit price index of final general government consumption spending; taken from *Cuentas Nacionales de Costa Rica*.

<sup>b</sup>Includes other social and non-social sectors.

Table 4  
 COSTA RICA: PUBLIC SPENDING IN CERTAIN SOCIAL SECTORS,  
 AS A PROPORTION OF GROSS DOMESTIC PRODUCT, 1975-1985

(Colones at current prices)

Year	Total	Education	Health	Labour and Soc. Sec.	Housing	Other
1975	35.6	5.5	8.7	3.4	0.7	17.3
1976	37.0	6.0	8.2	3.3	0.9	18.6
1977	39.1	5.8	7.9	2.9	0.9	21.6
1978	41.0	6.3	9.6	3.5	0.9	20.7
1979	48.0	6.6	11.4	4.2	1.1	19.7
1980	45.1	6.9	11.3	3.6	1.6	21.7
1981	38.7	6.0	7.9	2.6	0.7	21.5
1982	35.8	4.9	6.3	2.6	0.5	21.5
1983	41.2	5.1	7.0	2.5	1.0	25.6
1984	42.0	5.4	7.3	3.3	1.0	25.0
1985	42.1	5.4	7.2	3.8	0.9	24.8

Source: Prepared by MIDEPLAN on the basis of official data and figures provided by the Central Bank of Costa Rica in *Cuentas Nacionales de Costa Rica*.

### 3. Rationalization of social policy and State centralization

The sizeable social spending cuts required by the unavoidable need to change the social policy did not break up the Welfare State, largely because of the inertia of institutions, the government's political will to continue promoting a redistributive material base through the State as a form of social integration and co-operation, and the institutionalized presence of low-income sectors in the State and society at large (Sojo, 1986, p. 43). This is why the State was effective in "confiscating" social conflicts, which was not easy in a era of transition to a new economic model and redefinition of the State.

The strong pressures from international financial institutions to rationalize public spending have naturally had an impact on social policies. One example was the law concerning the financial stability of the public sector, whose terms were negotiated with the World Bank's Structural Adjustment Facility (SAF) II. At the same time, deficiencies in government institutions have resulted in wide-ranging proposals for reorganizing and redirecting them; thus the rationalization process is not being viewed from one side only, nor are

institutions being seen as subject to external controls.

Gradualism in the transformation of the economic structure is also reflected in social policy. During the past two governments, the financial stabilization which had been recommended in order to deal with the deficit of welfare and social security institutions, was achieved basically through the rationalization of spending. This was focused on administrative reform, revenue enhancement and the restructuring of services (Rivera and Gendell, 1988, pp. 18 and 19).

The trend towards modifying the Welfare State has been reflected in the growing participation of the Executive Power in decision-making, and a relative weakening of the influence of the Legislative Assembly (*ibid.*, p. 21). By direct intervention in institutions, the Executive has promoted administrative reforms in the production and provision of public services. These institutions have included the People's Bank, the Administrative Board for the Development of the Atlantic Slope (JAPDEVA), the Costa Rican Water Supply and Sanitation Institute (ICAA), the National Housing and Urbanism Institute (INVU), the Agrarian Development Institute (IDA), Costa Rican

Railways, S.A. (FECOSA) and Costa Rican Publishing, some of which were directly involved in very disparate social policies, ranging from credit to water supply, housing and agrarian development.

Unlike the Costa Rican Social Security Fund, which autonomously adopted a strategy for restructuring, as we will see, these institutions were unable to do so. Common intervention procedures included the establishment of commissions of "experts", appointed on an *ad hoc* basis by the Executive; a review of the strategies, methods and procedures used by the institutions; the development of an administrative restructuring plan; the creation of administrative mechanisms and controls, and technical bodies to implement the new guidelines (*ibid.*, para. 3.2.1). The reasons given for intervention include deficiencies in the provision of services; user discontent; alleged administrative irregularities; financial deficiencies; need for restructuring organizational procedures; and charges of corruption (*ibid.*).

The centralization of decision-making in the State is not a new process. Decentralization, which began in 1948 with the rise of autonomous and quasi-autonomous institutions, lasted through the 1960s, but the situation took a different turn in the following decade (Sojo, 1984). In the 1980s, centralization has basically meant that decision-making concerning public spending primarily lies with the budgetary authorities, through the use of a single tax fund. In special cases, the Executive has proposed budgetary changes which have been approved by the Legislative Assembly, such as the creation of the Housing Subsidy Fund through Act No. 7052, which earmarked 33% of social development funds and family allowances for this purpose. For institutions related to social sector spending, this centralization changed the way the interests of the low-income sectors were represented, and the way their demands were channelled (Sojo, *ibid.*, p. 157).

#### 4. *New relations with the user and privatization*

Up to the beginning of this decade, social sector spending was carried out almost monopolistically through public institutions.

Recently, changes in the provision of services have made participation by the community and people's organizations, such as co-operatives and joint associations, more important (Rivera and Gendell, para. 3.2.1).

In this framework, it has been proposed to transfer some services to small enterprises, a suggestion that has until now had only a minimal effect (e.g., telephone services). Some studies reveal skepticism about the potential economic benefit and service resulting from privatization, especially if the private entrepreneurial capacity is uncertain, and they bring out a crucial point which deserves further thought: if the potential entrepreneurs do not have the required capacity, the privatization policy may lead to a crisis in services (Sanguinety, p. 205).

In the case of housing, the members of the groups that have been formed to demand better housing have been encouraged to participate, and a political agreement has been reached with them based on new housing programmes. It is estimated that more than 300 organized groups are currently participating in housing projects. Of the total loans granted by the Home Mortgage Bank (BANHVI), the leading institution in the sector, nearly 40% were channelled through co-operatives (Ministry of Housing, 1988). There has also been an effort to promote the establishment of health co-operatives, which would be subcontracted by the Costa Rican Social Security Fund (CCSS) to administer clinics and hospitals (Rivera and Gendell, *op. cit.*).

Another proposal has been to encourage community self-management, for example in administering school lunchrooms (*ibid.*). This proposal, in order to be efficient, would require an estimate of community entrepreneurial capacity.

#### 5. *Focusing of efforts and the tendency towards social conflict*

In the 1970s, a universalistic concept of social policy prevailed, and several initiatives aimed mainly at low-income sectors were undertaken, such as the Joint Social Assistance Institute. Following the outbreak of the crisis, the government of President Monge created the Social Compensation Plan, which included some

aspects of employment, housing and nutrition, and strengthened the regular activities of the public institutions which had dealt with these sectors previously.

Some studies show the need to direct the public policy subsidy to the poorest sectors. It has recently been estimated that it would be feasible to eradicate poverty by transferring 3% of total family income. This implies that income redistribution, not the availability of resources, is the key to the problem (Trejos and others, 1988, p. 198). It is recommended that social programmes be redefined to improve their overall redistributive efficiency; that assistance and emergency programmes be created; and that a more efficient use be made of the available resources (*ibid.*, p. 211). The direct distributive efficiency of social programmes is estimated at around one-third, and in the rural areas at 45%. In all areas, two-fifths of this amount are considered to be an excessive subsidy; it would be enough to redistribute two-thirds of this excess to eliminate poverty totally (*ibid.*, p. 209). If the emphasis is placed on absolute poverty, efforts should be directed towards target groups in the rural areas; if it is placed on relative poverty, the emphasis should be equal in both rural and urban areas, or even greater in the cities, specially in the Metropolitan Area (*ibid.*, p. 40).

The crisis pointed up certain needs that were not being met. In the case of housing, as noted above, the State had not provided many benefits to the lower-income sectors, who did not have the required capacity to pay (Valverde, 1986). Towards the end of the 1970s, this situation led to the formation of groups demanding better housing. The government of President Oscar Arias has reached an agreement with them and set up a new housing programme, and these groups have stopped using land takeovers as a conventional form of struggle.

The government's main innovation in social policy has undoubtedly been to give priority to the problem of housing. According to official figures, the potential housing demand, classified according to capacity to pay, can be broken down as follows: 21% of families have no capacity to pay, 40% of families have the capacity to pay, if offered special arrangements for minimal dwellings, and 22% of families have the capacity to pay for public or low-cost housing. In other

words, financing is required in order to make housing available to 61% of the population (Ministry of Housing, 1988b). The emphasis placed on this type of solution shows the priority given to the problem of housing; this is the most outstanding innovative feature of the current social policy, whose special features will be discussed below.

#### 6. *Specific sectoral policies for coping with the fiscal crisis*

We have reviewed the general trends towards a reduction in spending, together with continued redistribution despite constraints. The various sectors and public institutions involved have dealt with this situation by using specific policies, two of which stand out especially: health policy, because this is the social sector which has received the most resources until recently; and housing policy, because it is the least developed sector and has a more restricted redistributive effect. The most radical reorganization process is currently taking place in this latter sector.

##### a) *Health policy*

The cut in health spending has been significant. In 1981 and 1982, per capita spending on health, in relation to GDP, declined respectively by 28.8% and 35.5%; although it then recovered slightly, it never reached its previous levels (Sanguinety, 1988, p. 53). Correlations of the indexes of annual variations of GDP and health spending show that the latter systematically fluctuated more widely than GDP; when the product increased, health spending increased at a greater rate, while in periods of contraction the reduction in health spending was also more pronounced.

The Costa Rican Social Security Fund (CCSS) faced a considerable operational deficit at the beginning of the decade in connection with the universalization of its services, under way since 1973; the transfer of hospitals and clinics, which had been administered by the Social Protection Board until 1979; and the debt contracted by the State in its capacity as employer, which continued to accumulate until it reached 2 027 million colones in 1983 (Gendell, 1988).

The impact of decreased spending on services has not been studied as a separate item, although the College of Physicians and Surgeons, has pointed out some of the deficiencies (*ibid.*). It notes that there is currently a "virtual deterioration in the quality of health services", which is very evident in respect of primary health care (rural and community health care, dental care, food and nutrition) and in the morbidity of the population, in view of the incidence of disease, which has been increasing considerably (MIDEPLAN, 1988, pp. 46-47).

It would be inadequate, however, to evaluate available services only on the basis of spending, whose contraction does not necessarily indicate an effective total reduction of available resources. CCSS, whose spending is concentrated primarily on the health sector, took strict measures in the midst of the crisis to increase its internal efficiency by reducing hospital and out patient costs. From 1980 to 1982 the real decline in CCSS spending was 50% while that of the Ministry of Health was 49%. In 1985, total CCSS spending was 24% less than its spending in 1979. Meanwhile, the recovery of expenditure which had been initiated by CCSS in 1983 was achieved by considerably increasing taxes; the share paid by employers rose from 6.75% to 9.25% of wages that year (Sanguinety, p. 49); this is an indication of the consensus-based orientation of policy during a period of economic contraction.

A distinction should be drawn with regard to budgetary constraints in the health sector. The Ministry of Health and other institutions dependent on the State budget suffered sharp cuts. CCSS, owing to its autonomous financing, was able to consolidate its financial base. This explains why sickness and maternity insurance revenues showed a steady increase from 1983 on. From 1983 to 1986, annual growth rates were approximately 35%, 18%, 14% and 6%, respectively. The spending policy produced a surplus: of the 11 090 million colones collected in 1985, 9 206 million were spent on services; in 1986, revenues reached 12 840 million, and outlays, 10 955 million. As a result, CCSS made an increasing number of transfers to the Ministry of Health (*ibid.*, pp. 49 and 79). State debt has not yet been paid; it reached 4 100 million colones in 1986 (Gendell, 1988). Certain

measures set forth in the Act on Financial Stability which had tended to slow down employment were made more flexible after protests had resulted in the intervention of the Legislative Assembly (*ibid.*).

The current situation of CCSS is also related to the predominant political trends. During the government of President Carazo, an attempt by physicians to privatize health, through the free choice of physicians and hospitals, resulted in failure. From the government of President Monge onward, the prevailing mode was not favourable to indiscriminate privatization either, but to measures for rationalizing spending and the provision of services (*ibid.*), in conjunction with the transfer of services to co-operatives.

#### b) *Innovations in housing policy*

During the government of President Carazo, a proposal was made for restructuring the housing sector in order to give preference to providing minimal, basic dwellings for low-income sectors. This proposal was not put into practice because of disagreements within the government itself. Furthermore, in the midst of the fiscal crisis, a large amount of resources originally intended for the housing sector were used for other purposes (Valverde, 1986). Spending constraints had a huge effect on the provision of basic dwellings, which recorded the lowest indexes in the last 30 years. Thus, compared to the 1 989 minimal units completed by INVU in 1978, only 52 were completed in 1982. This latter figure is comparable only to the first year of INVU's operation; the number rose to 255 in 1983. All the public institutions which finance housing suffered a radical credit contraction from 1980 onward (*ibid.*, para. 2.3).

If the accumulation of the housing deficit is taken into account the social impact of this sectoral contraction is even more striking. According to official figures, this deficit affected 270 000 families in 1983, or 61.7% of the total population (*ibid.*, p. 98). This situation is closely related to the traditional profile of the nation's housing policy in respect of its scope and redistributive effect. In 1982, the total subsidy for the housing sector amounted to only 1.05% of GDP; of this percentage, 96.2% corresponded to credits and 3.8% to direct subsidies. The distribution of the latter was very progressive,

while that of credit was regressive; 10% of the poorest families in the country were completely excluded, and the subsidy was concentrated in the urban areas (Rodríguez, 1986, pp. 76-78).

Since the end of the 1970s, the housing deficit and the regressive nature of housing policies have resulted in a wide-scale social movement to demand housing. Reforms in this area introduced during the government of President Oscar Arias have made it possible to reach an agreement with these movements, and they demonstrate the government's growing sensitivity to a largely unmet demand. In view of the fiscal situation and the advancement of proposals at other levels to reduce subsidies and limit the role of the State, these measures are highly innovative and constitute a clear counter trend (Vargas, p. 2). In point of fact, the housing problem began to be perceived as a national problem of high priority, subject to "a political rationale" which forced the government to "achieve almost spectacular short-term results" (*ibid.*).

It was not simply a question of increasing resources for housing, but of designing and implementing a radical restructuring of the sector. At the end of 1986, the National Home Financing System was established, under the management of the Home Mortgage Bank (BANHVI). Two special funds were also created: the National Housing Fund (FONAVI) whose purpose was to generate continuing resources at the lowest possible cost, and the Housing Subsidy Fund (FOSUVI), for low-income families. The purpose of the latter was more complex: "... what is needed is to establish and operate an efficient system of housing subsidies, one that is capable of achieving the goal of gradually eliminating the serious housing problem, that will not distort the normal functioning of the home financing market, and that will provide adequate attention to truly needy groups" (*ibid.*, p. 3).

The financing established by law for FOSUVI represents a considerable reallocation of public funds, partly from the Social Development and Family Allowances Fund (which will earmark 33% of its annual resources to FOSUVI), plus 3% from the national budget of the Republic, extrabudgetary resources and donations. FOSUVI was conceived of not as an emergency or contingency fund, but as a permanent fund. The

family housing credit is an individual, long-term loan designed to enhance the family's creditworthiness. Families with incomes equal to or below an amount four times the minimum wage of a skilled construction worker are eligible for this credit (*ibid.*, p. 2).

The crux of the sectoral restructuring is a new national financial system to administer the resources, headed by a co-ordinating or centralizing body. At the same time, the State will no longer be involved in the construction sector (Rivera and Gendell, 1988, p. 23).

From May 1986 to September 1988, a total of 46 462 dwellings were built in Costa Rica (Ministry of Housing, 1988a). During the second half of 1987, construction, in terms of square metres, increased by 35.35% compared to 1986; the growth was 84% for construction of so-called "social interest", or minimal housing, units of less than 70 square metres (Ministry of Housing, 1988, p. 43). In May 1988, FOSUVI granted 4 935 family credits (*ibid.*, p. 16), from May 1986 to April 1988, BANHVI financed 21% of a total of 26 460 housing operations the medium income of the beneficiaries of these dwellings was 12 845 colones, which is an indication of the social nature of the programme (*ibid.*, pp. 17 and 18).

### 7. Private social policy

In contrast to the weakening of the trade union movement over the decade, the movement towards solidarity (in which workers' associations were strengthened by employer support) reached a peak; this was conceived of as an improvement upon the labour law relating to benefit funds. These associations provide very diverse services, such as wholesale purchasing, scholarships and individual and home loans. Through this movement of solidarity and their own private policy, entrepreneurs are promoting measures to consolidate an agreement with workers. In view of its potential repercussions, this may be compared to a wage agreement, in that the worker becomes involved in the system on the basis of his relationships within the enterprise itself. It thus differs from the agreements reached on the basis of social policies promoted by the State (Sojo, 1986, pp. 45 and 46).

### III

## Future options for economic and social development

Although social inequalities have become more marked in the past few years, the State has made some attempt to find solutions to the crisis that would also help the majority. The dynamics of social development prior to the outbreak of the crisis acted as a considerable cushion for the most serious effects of the crisis. It should also be recognized that the government's experience in designing and managing social programmes has made it possible to take some effective steps to deal with the worsening social situation (Pinto de la Piedra, p. 3).

Future socioeconomic options may include three potential areas of effort. Although there may be crucial economic constraints, such as the external debt problem, the direction of future development will also depend to a large extent on the efforts and political will that may operate in favour of one solution or another: a) on the one hand, through radical changes, a conservative end to the crisis may be brought about; b) the solutions tried thus far may stagnate or lead to even worse crises, if the vulnerable areas are not dealt with on the medium and long term; or c) economic development may be recovered with equity, if these problems are overcome and innovative proposals are made.

The conservative option is basically derived from an analysis of the economic crisis which advocates the reestablishment of the capacity for international competition on the basis of the comparative advantages that would result from the full liberalization of the economy in various areas (trade, exchange, finances and tariffs). This would occur in the framework of an essentially static model, in terms of both the allocation of resources within the domestic productive structure and of comparative advantages in international trade (Garnier and others, 1985; Herrero and Rodríguez, 1987a). Its impact on social policy is clear: adequate remuneration of the factors, which would eliminate subsidies and taxes on capital or labour; and the political forces would be perceived as possible sources of distortion of price formation.

The adoption of this conservative option would need to be accompanied by fundamental changes in the Costa Rican political system. It would mean a radical turnabout in the representation of the various social interests in the government and in the society at large, in favour of an entrepreneurial corporativism. Its viability would be linked to a substantial weakening in the political forces, which have thus far been characterized by a consensus-based treatment of economic and social issues.

At the same time, the focus of efforts until now presents certain aspects which make it vulnerable if changes are not introduced in order to lay the foundations for a form of economic development based on the productivity of national resources and on social equity.

#### 1. *Economic options*

At the economic level, the indiscriminate nature of export promotion needs to be pointed out. This is symptomatic of the absence of basic criteria that would enable the socioeconomic development strategy to overcome current stumbling blocks. These criteria should include the selection of the type of exports in accordance with their sectoral insertion, their vertical and horizontal links with other domestic activities and their potential ability to enhance productivity (Garnier, 1984). Moreover, the predominant mode has been one of excessive experimentation, which may entail high social and economic costs. Information is scattered, and there is a lack of knowledge in a great number of areas and a lack of experience in production and marketing, all of which portend problems of government policy and entrepreneurial capacity (Herrero and Salazar, 1987, p. 18).

Reference has already been made to the increasingly regressive nature of the tax structure; this feature has been considerably aggravated by the promotion of non-traditional exports, which entails a high fiscal cost. At the same time, no effort is being made to formulate a

deliberate policy of structural change aimed at integral development; such a policy would include the sustained reactivation of domestic demand combined with a selective expansion of import substitution and a rehabilitation of the productive apparatus for non-traditional exports (Garnier and others, 1985, p. 6).

There is also a need to take vigorous steps to strengthen the Central American Common Market, although the emphasis on exporting may be outside the area. There have been no proposals for "an adjustment that is not only compatible with integration but preferably one that would be facilitated by the encouragement of mutually beneficial interdependence" (Fuentes, 1988, p. 5).

The results of structural adjustment can scarcely be conjectured, and the present period can clearly be called a transition towards an opening to the international market. In order to improve the country's productivity and achieve social development with equity, a series of efforts are needed to deal with vulnerable aspects such as those mentioned. Failure to deal with them may aggravate the trade balance problems, bring on bankruptcies and a deterioration of the standard of living of small-scale producers, without there being any way for them to be reincorporated into the labour force, and may generally lead to unemployment unless there is a clear reorientation of resources. One option which would be detrimental to equity would be to base comparative advantages on the cheapening of labour.

## *2. Social policy options*

The challenges in the field of social policy are enormous. It is obvious that there are limits to how far social spending can be reduced in order to enhance economic stability. No short-term changes are foreseen in State revenue unless a radical turnabout occurs in the external debt, or there is a change in the increasingly regressive character of the fiscal structure. The restructuring of welfare institutions to promote an optimal yield of services is an urgent need, because it is impossible to reduce spending without affecting the offer of services, and because of the political difficulties that would arise from such fiscal modifications.

The transition to the new economic model and the opening of the market will inevitably bring about changes in employment, which will lead to severe short-term pressure on the State, if there exists a will to protect the weakest sectors in order to achieve equity during this transition process (for example, by providing emergency employment programmes). A cutback on spending (at the same time that services are expanding because of other events during the period) will result in additional tensions.

The transfer of services and their provision by non-governmental bodies may be appropriate and may even contribute to democratization, as long as the quality and costs of the service are in accordance with the goal of social equity. If these changes occur, the public sector will have to continue playing a role as regulator, supervisor, evaluator and provider of resources (Bustelo, p. 24).

There will continue to be tension between the universality of the social policy and attempts to focus it. If emphasis is placed on the latter aspect alone, a number of past social gains may be lost; grave political consequences may ensue, affecting social sectors such as the middle classes, whose standard of living has been adversely affected and whose resources have been considerably reduced.

In the face of financial constraints and at the same time a quest for equity, it is essential to give priority attention to the production and ownership of resources (Herrero and Salazar, 1987, p. 5), with the goal of economic democracy. The experience with co-operatives in Costa Rica (for example, in coffee production) has yielded positive results which should be more thoroughly studied and expanded. This will undoubtedly require a sizeable political effort, in view of certain reticences in Costa Rican society, which can be seen, for example, in the failure to promote the Labour Economy Sector. In this sense, the sale of the Costa Rican Development Corporation (CODESA), the Tempisque Sugar Plant, S.A. (CATSA) (a sale already in progress), Pacific Cements and Central American Fertilizers, S.A. (FERTICA) may signify some progress, in terms of helping to democratize ownership. The strategy of transforming the economy should contain



proposals for efficient associative schemes in order to strengthen economic democracy and fairly apportion the benefits of adjustment.

External indebtedness, the sword of Damocles in this case, requires an urgent

solution that will deal with all these challenges: more than ever, there is a need to use national resources for domestic consumption and investment, in this small country so vulnerable to reverses in foreign trade.

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# Poverty in Ecuador

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Ecuador is one of those developed countries which has experienced the greatest economic changes and at the same time the highest rates of infant mortality, malnutrition, illiteracy, morbidity and overcrowding.

In this article consideration is given to the performance of various macroeconomic variables including investment, the international prices of raw materials, external indebtedness, income distribution and real wages and to the development of urbanization and the impact of various natural disasters on the national economy. Consideration is also given to the social policies followed in recent decades and to social development plans and programmes, the sectoral approaches taken and the institutional framework of those policies.

A new social policy should be based on the great structural heterogeneity observed in the country and should provide for the application of far-reaching agrarian planning measures which, without inhibiting agricultural development, may prevent the migration of the poor rural sector of the population to the city. A new style of industrialization is also suggested as being the most efficient way of decreasing unemployment and underemployment. The importance of promoting the development of artistic and utilitarian craftsmanship is also suggested. Finally, attention is drawn to some basic elements in the proposal for a new social policy, such as the proposal to increase the degree of social awareness, mobilization and organization.

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## Introduction

During the 1980s, Ecuador and Latin America in general have been experiencing one of the most far-reaching crises of the century. In ECLAC's view, it has, strictly speaking, been a lost decade. The crisis has been complicated by stabilization policies of a markedly recessive nature, which have been responsible for negative growth rates of gross domestic product, a worsening of the age-old problem of the concentration of wealth and income and a resurgence of open unemployment and underemployment. These effects have, in combination, raised the levels of absolute poverty in the country and in the region.

Thus, for example, the levels of absolute and critical poverty, which in Ecuador have been among the highest in Latin America, fell slightly as a result of the so-called banana and petroleum booms, in particular during the period between the 1950s and the 1970s (table 1). However, in 1982 a reversal begins to be noted from the point of view of levels of concentration of wealth and income, the growth rate of the social product and employment statistics. In 1988 critical poverty measured on the basis of these and other indicators would stand at a level similar to that recorded in 1970, which would indicate that present-day Ecuador has, in terms of absolute and critical poverty, moved back to the point at which it stood nearly two decades ago. It would thus appear that we are up against a case of true social regression. Unfortunately, statistical series in the social field are very far behind, and in periods of crisis, when they are most urgent and necessary, it may almost be said that they are notable for their absence. In spite of these limitations, some more or less trustworthy references do exist on the basis of which it may be assumed that the living conditions of the poorer sector of the population deteriorated considerably as a result of the crisis. This is borne out by the drop in real wages which have been cut in half during the decade of the 1980s so far. It may be assumed that this deterioration has been even more pronounced among non-wage earners in poor groups, in particular in the peasant and the urban informal sectors. Historical events which have aggravated this situation include the weakening of the indicative

planning system, the failure to establish long-term strategies, the pre-eminence given to the short-term approach and the paralyzation of processes of social change, such as agrarian reform, which in the case of Ecuador, has to all intents and purposes been shelved. An obsession with pragmatic, short-term methods, especially those of a monetarist, neoliberal nature, has meant that a long-term perspective is no longer taken.

The so-called "lost decade" is the most telling proof that the direction and scope of

development in Latin America and in Ecuador in particular are no longer the same, with the result that absolute poverty has grown substantially. This increase in absolute poverty works against social stability and—even more serious—against political stability in the context of the re-establishment of democracy, the most noble objective of Latin American society. In the case of Ecuador, democracy is affected by the fact that half the country's population suffers from segregation, discrimination and marginalization, due to the problems of existence generated by absolute poverty, including the non-satisfaction of basic needs. Ecuador's tragedy is not due primarily to slow growth of its social product as may be seen from the frequent cocoa, banana, shrimp and oil booms but rather to the drain on the country's resources caused by social disconnectedness and heterogeneity which are reflected in a high concentration of wealth and income. It may properly be said that the challenge of existence in Ecuador is more of a social challenge than an economic one. There are few places in the world where the struggle against absolute poverty is waged on a broader front than in Ecuador, which, in spite of being one of those countries of the developing world and Latin America which has changed the most in the post-War period, is still beset by an extraordinarily high incidence of infant mortality, malnutrition, illiteracy, semi-literacy, premature school leaving, morbidity, overcrowding and slum housing conditions.

Table 1  
LATIN AMERICA: PERCENTAGE OF  
HOUSEHOLDS BELOW THE LINE  
OF POVERTY  
(Percentages)

	Around 1970	1981	1987
Argentina	8	8	
Brazil	49	46	
Colombia	45	43	
Costa Rica	24	23	
Chile	17	17	
Ecuador	55	53	55
Honduras	65	64	
Mexico	34	32	
Peru	50	50	
Venezuela	25	25	
Latin America	39	37	

Source: *De crisis a crecimiento equitativo*, edited by Rob Vos.

## I

### Absolute poverty and the behaviour of gross domestic product

It may be inferred from the experience of Ecuador over the years that the relationship between the growth rate of gross domestic product and levels of absolute poverty is not very close since, in spite of the repeated booms experienced within the agro-exports model (cocoa, rice, coffee and bananas) and the more recent oil bonanza, absolute poverty has remained at levels which are among the highest

in Latin America. Although it is true that Ecuador was one of those countries which showed the highest levels of economic transformation in the post-War period, its experience in terms of social transformation has not been equivalent; and although it is still not the most backward country in the region since it has surpassed the levels of advancement of Haiti, Honduras, Bolivia and Paraguay and can

Table 2  
 ECUADOR: GROWTH RATES  
 (At 1975 prices)

	1975	1979	1980	1981	1982	1983	1984	1985	1986 <sup>a</sup>	1987 <sup>b</sup>
Total GDP (at buyers' prices)	5.60	5.30	4.90	3.90	1.20	-2.80	4.20	4.30	3.20	-5.20
Total consumption	11.80	6.10	7.60	4.40	1.50	-3.10	1.60	2.30	0.50	1.80
Final household consumption	10.40	6.40	7.20	4.80	1.80	-2.40	2.70	3.60	0.70	2.50
Final government consumption	18.70	5.10	9.00	2.40	0.50	-6.20	-3.60	-4.20	-0.40	-2.00
Gross capital formation	17.20	-2.80	8.80	-13.40	12.60	-31.20	-1.40	8.00	1.90	0.70
Total fixed gross capital formation	23.30	-0.30	6.10	-7.20	0.70	-26.10	-4.50	6.90	2.90	6.90
Fixed gross capital formation (government)	0.70	-9.00	27.20	6.60	-12.90	-19.50	-3.40	17.80	9.60	-7.60
Fixed gross capital formation (other)	33.50	2.10	0.80	-11.60	5.90	-28.30	-4.90	3.00	0.20	13.40
Exports	-8.40	5.00	-2.40	4.70	-5.00	2.40	12.50	12.00	9.50	-17.10
Imports	16.70	-0.10	10.10	-9.30	6.90	-24.60	-2.40	7.30	-0.80	11.40
Total GDP (at producer prices)	5.10	5.80	4.50	5.10	1.40	-1.70	4.10	4.20	3.30	-5.40

Source: Banco Central de Ecuador, *Cuentas Nacionales del Ecuador*, Nos. 7 and 11.

<sup>a</sup>Semi-final calculations.

<sup>b</sup>Provisional figures.

almost be classified among those countries of Latin America which are at medium levels of development, the extremely high level of poverty from which its population suffers keeps it at the threshold of development, poverty constituting the clearest demonstration that a development model is not functioning adequately, especially where equity is concerned.

As for the present decade, the recessive adjustment and the stabilization policies (table 2) caused the gross domestic product to show negative growth in 1983 whereas the negative growth recorded in 1987 was due to the earthquake of 5 March, and mild recoveries were experienced in 1984, 1985 and 1986, the latter being the year when petroleum prices plummeted. Positive rates were recorded in 1980, 1981 and 1982, when in spite of the moderate growth shown, the national economy showed the negative effects of the conflict on the

border with Peru and the cessation of private loan flows which brought the problem of the external debt to the fore.

In short, present-day Ecuador is caught in the grip of external debt, which is putting a strangle hold on its economy, and internal debt, which is forcing it to tighten its belt until it hurts. These are the fruits of the recessive adjustment which contracts demand in an attempt to stabilize the economy and cuts social expenditure (on health and education) with profound consequences in terms of income redistribution. At the same time, the nearsightedness of the free market has allowed two basic indicators—the exchange rate and the interest rate—to float, sacrificing investment and encouraging speculation whose only effect is to make the rich richer. Thus, the monetarist neoliberal model is giving rise to a kind of social regression which promotes the growth of absolute poverty.

## II

### The investment coefficient

The weakening of investment (table 3) is undoubtedly one of the most severe consequences of the crisis and the adjustment policy. It has had profound effects, including the paralysis, regression or slackening of capital accumulation; a decline in the growth rate of the productive sectors and a drop in both public and private investment. This has resulted in a considerable increase in open unemployment, which has doubled in the course of the present decade, and, what is even worse, it has fostered the development of complex linkages and of reciprocal dependency between the formal and informal sectors of the economy. The weakening of the formal sector has had serious repercussions on the informal sector, whose rapid growth has contributed to its inefficiency. Thus, absolute poverty is on the rise again in this sector, affecting over 90% of its active population.

Table 3

#### ECUADOR: INVESTMENT COEFFICIENTS

	Gross internal investment/GDP	
	Gross internal investment/GDP	Gross fixed investment/GDP
1980	26.6	23.7
1981	22.1	20.9
1982	24.6	21.0
1983	17.4	16.0
1984	16.5	14.7
1985	16.7	15.0
1986 <sup>a</sup>	16.5	15.0
1987 <sup>b</sup>	16.0	14.0

Source: Banco Central del Ecuador, *Cuentas Nacionales del Ecuador*, Nos. 8 and 9.

<sup>a</sup> Preliminary estimates showed that the investment coefficient for 1986 was 11.7, a figure which was later readjusted by the Central Bank.

<sup>b</sup> Estimated figures.

## III

### Income distribution

The crisis and the stabilization policies corresponding to it have set off a process in which wealth and income are becoming markedly concentrated as can be seen from the share of wage-earners in gross domestic product (table 4). In other words the crisis has made the traditional model even more apt to result in concentration since strictly speaking, the lion's share of the burden imposed by the crisis is absorbed by the poorer sectors of the population, which are increasing in size and in their relative share in the total population. The situation has grown still worse as a result of the shrinkage of social expenditure, especially expenditure on education and health, the major impact of which has tended to be income redistribution.

Table 4

#### ECUADOR: DISTRIBUTION OF GDP BY EMPLOYEE REMUNERATION AND GROSS OPERATING SURPLUS 1980-1986 (Millions of sucres)

Year	Employee remuneration		Gross operating surplus	
	Sucres	Percentage	Sucres	Percentage
1980	93 662	31.9	175 187	59.8
1981	105 275	30.2	210 755	60.4
1982	120 017	28.9	259 967	62.5
1983	135 761	24.2	377 847	67.4
1984	179 524	22.0	565 415	69.0
1985	231 506	20.0	737 674	66.0
1986 <sup>a</sup>	291 218	21.0	924 528	67.0

Source: Banco Central del Ecuador, *Cuentas Nacionales del Ecuador*, No. 9.

<sup>a</sup> Preliminary estimates showed that employee remuneration in 1986 amounted to 16% of GDP, a figure which was adjusted to 21% later on.

## IV

### Real wages

One of the most tragic consequences of the adjustment policies which have characterized the 1980s in Latin America has been the drop in real wages. This drop has been particularly notable in Ecuador, where the wage index has fallen from 100% in 1980 to an index estimated by ECLAC to be 61.8% in 1986 (general minimum living wage, 1986, January-October average) (table 5). Estimates for 1987 and 1988 are for an even greater loss due to the acceleration of inflation. The drop in the level of remunerations has meant a decrease in demand,

which has been reflected in a greater contraction in the already limited domestic market, and this, in turn, has helped to deepen the recession.

Table 5

#### ECUADOR: URBAN MINIMUM WAGES

1980	1981	1982	1983	1984	1985	1986 <sup>a</sup>
100	86.2	75.9	63.6	62.8	60.8	61.8

Source: ECLAC, on the basis of official information.

<sup>a</sup>Preliminary figures.

## V

### Urban growth

One of the most important phenomena in the history of Ecuador is the accelerated rate of urban growth (table 6), which is among the highest in Latin America. This growth has given the country a certain amount of inter-urban and urban-rural balance and harmony, of a kind which may also be observed in Colombia. Ecuador is a country with many medium-sized and small towns and two large development poles —Guayaquil and Quito— as well as Cuenca, a smaller pole. In spite of this comparative harmony, however, the country has increasingly tended towards macrocephaly,

particularly in the case of Guayaquil, whose slums are mushrooming, a phenomenon which in the last analysis, constitutes the very best indicator of absolute poverty. It should be noted then that the process of urban growth has been characterized by the ever-present conflict between modernity and the increasing severity of social clashes and manifestations of social violence and by the alarming proliferation of crime, especially in Guayaquil and Quito.

A rise in urbanization over the past 15 years has not helped to eliminate absolute poverty, which has in fact persisted and even increased as

Table 6

#### ECUADOR: DEMOGRAPHIC INDICATORS

	1975	1979	1980	1981	1982	1983	1984	1985	1986	1987
Total population (thousands of people)	7 035	7 893	8 123	8 361	8 606	8 857	9 115	9 378	9 647	9 922
Urban	2 940	3 629	3 825	4 021	4 226	4 444	4 677	4 881	5 094	5 310
Rural	4 095	4 264	4 298	4 340	4 380	4 413	4 438	4 497	4 553	4 612
Density (inhabitants, per km <sup>2</sup> )	26	29.2	30	30.9	31.8	32.7	33.7	34.7	35.6	36.7

Source: CONADE INEC-CELADE, *Ecuador: estimaciones y proyecciones de población 1950-2000*, Quito, December 1984; INEC CONADE, *Proyecciones de población ecuatoriana 1982-1995*, November 1985. Provisional data.



a result of the crisis (tables 1 and 6). Such poverty has, however, moved from the urban sectors to the metropolitan areas. In this respect, it is a matter of concern that violence as expressed socially in urban guerrilla activity has on occasion cropped up in Ecuador as, for instance, in the "Alfaro Vive" incident, which is all the more worrying when viewed in the light of the fact that for several decades the country

was known as an oasis of peace in Latin America. All of this is cause to ponder the strategical importance of combating absolute poverty as the incubator of social violence. Repressive measures are inadequate when viewed in the positive light of development policies providing for social justice, which tend to eliminate social violence, one of those evils which cast a long shadow over democracy in our region.

## VI

### Natural disasters

The 1980s has been characterized not only by the persistent structural crisis affecting the economy but also by sizeable and serious natural disasters, including the floods of 1983 and the earthquake of 5 March 1987. The floods destroyed much of the road infrastructure on the coast, which seriously jeopardized the harvest of basic food commodities and made agricultural commodities in general scarce. Because they were scarce, inflation reached a level higher than 50%, an

unusual occurrence in a country accustomed to financial and monetary stability. As for the earthquake, it destroyed the trans-Ecuadorian pipeline, left over 70 000 victims in the eastern part of the country and affected the colonial quarter of Quito, regarded as part of the cultural heritage of mankind. These disasters contributed to the resurgence of absolute poverty, especially among peasants.

## VII

### International prices of raw materials

Since Ecuador's economy is one whose growth is directed outward, one of the factors which has contributed most spectacularly to the crisis has been the deterioration in the terms of trade (table 7). This deterioration occurred primarily because of the tremendous drop in petroleum prices in 1986 and also because of the persistent rise in the prices of imports. Another contributing factor was speculation due to the floating of the exchange rate in the context of an international scenario in which "monetary chaos" prevailed and which was characterized by an irresponsible, unco-ordinated floating of

their exchange rates by the leading industrialized countries of OECD. The external bottleneck has been the factor most responsible for the acceleration of the crisis.

Table 7

#### ECUADOR: TERMS OF TRADE

1981	1982	1983	1984	1985	1986 <sup>a</sup>
85.6	68	52.5	47.3	35.3	19.9

Source: Banco Central del Ecuador.

<sup>a</sup>Provisional figures.

## VIII

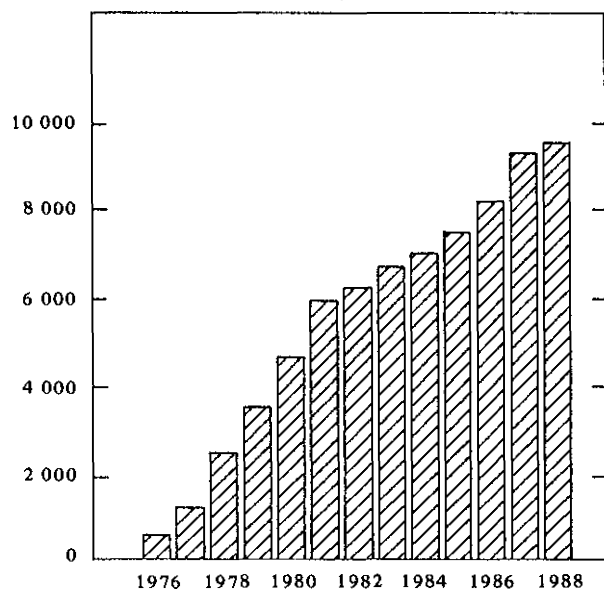
### The external debt

The most negative aspect of the economic and social development of Ecuador during the present decade so far has undoubtedly been the country's inherited "aggressive" external debt, which rose from just US\$693 million in 1976 to an average of approximately US\$11 billion in 1988. In only 10 years —between 1976 and 1986—, the external debt increased twelvefold

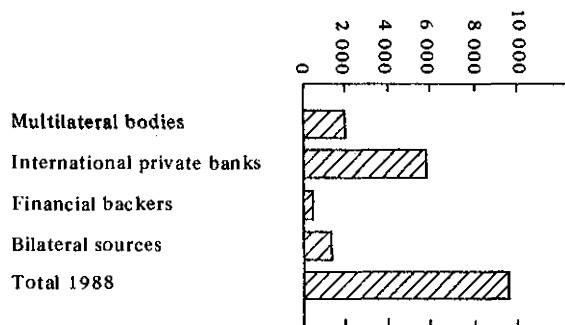
(figure). This has been one of the reasons why external debt servicing has become the crucial problem in terms of the crisis and development. Not only does debt servicing lessen any possibilities for economic growth and make it necessary to maintain recessive stabilization policies (which are imposed from outside (IMF) and inhibits effective demand and the consumption of the middle and poor strata in particular, it also has a very bad effect on both public and private investment, and its human and social cost is high.

In other words, the external debt has become the most dangerous symptom of dependence and is one of the root causes of the social regression observed in Latin America and in Ecuador in particular.

Figure  
EXTERNAL DEBT  
(Millions of US dollars)



COMPOSITION OF THE EXTERNAL DEBT IN 1988  
(Millions of US dollars)



Source: Banco Central del Ecuador.  
Note: 1987 and 1988, provisional data.

## IX

### Social policies in recent decades

As has usually been the same in Latin America, social analysis was brought into focus late in Ecuador, problems were viewed from a sectoral perspective, and little progress has been made in global analysis. Some recent indicators have made it possible to affirm that this trend is changing in favour of the multi- and

interdisciplinary approaches which are beginning to be seen in the social sciences. These are, however, only in their early stages and an enormous task remains to be done in order to identify the structural characteristics of and the areas of interrelationship between the economic, social, political and cultural topics covered in

planning and in development strategies; consideration should be given, for example, to the interaction between economic structure and levels of organization, consciousness-raising, mobilization and social participation.

A certain amount of progress has been made in the study of the processes of capital accumulation, while the study of wealth and income has proceeded more slowly and in less depth, and the study of the capacity for resource development, especially human resource development has been still slower and even less progress has been made. In contrast with the importance attached to these economic variables scant attention has been paid to the role which has been played, particularly in the Andean countries, by the slow and sometimes heart breaking process of crossbreeding. The challenges presented in this connection range from inter-ethnic exploitation to marketing, and all of them affect the age-old patterns of concentration and distribution of wealth and income and the cultural models for social integration. They also affect the assimilation and creation of science and technology, an area in which the country lags enormously behind the industrialized countries. This structural heterogeneity, especially in the social and cultural fields, has not been fully explored and reflects a cultural identity crisis. It goes hand in glove with the systems of dependence in which Latin America and Ecuador, in particular, have developed, and its resolution or persistence of the identity crisis is the very best yardstick for measuring the economic and social development potential of the region for the most profound obstacles to its development.

In addition, the advances made by the science of economics and the comparative lag in sociological, political and, in particular, cultural interpretation are the reflection of a very

unequal process of development which makes it difficult to perceive development, in the sense of human development, in an integral and integrated manner. This lag must be eliminated in order to come to a better understanding of the dynamics of development.

Another problem is that both absolute and critical poverty have been viewed of relatively marginal issues and only recently have they been examined from the perspective of basic needs, an approach which has contributed much to the study of poverty. The studies on marginality carried out by the National Council on Economic Planning and Co-ordination at the end of the 1960s provide an objective insight into the severity of the poverty problem which at that time affected over 50% of the economically active population of Ecuador. The national population and housing censuses carried out since the 1950s and also the agricultural censuses have unquestionably provided quantitative information concerning the country's demographic structure and outmoded systems of landholding and land use. The latter are reflected most tellingly in the persistence of large holdings and the proliferation of small holdings, the two structural obstacles most responsible for the high poverty levels in Ecuador.

It must be noted that planning has been practised in Ecuador for over three decades. The National Council of Economic Planning and Co-ordination (JUNAPLA, now CONADE), an institution which has made a notable contribution to the re-creation of the social diagnostic, was established in 1954. According to that diagnostic, the most important obstacle to the development of Ecuador is the country's alarmingly high index of absolute poverty, which, since the crisis, has climbed back to where it stood in 1969, i.e., at over 50% of the country's population.

## X

### Social development plans and programmes

Social development plans and programmes have been incorporated in the general plans and the development strategies applied ever since the 1960s. These global plans and strategies place emphasis on the urgent need to introduce structural changes for purposes, in particular, of replacing outmoded systems of landholding and land use and other systems which contribute to the process of wealth and income concentration. However, a gap may be observed between what should be and what is; although knowledge of the country's social problems has led to the establishment of objectives and goals (of a utopian nature), achievements in the realm of structural change have in fact been few and far between. For example, the Agrarian Reform and Settlement Act of 1964 in conjunction with Decree No. 1001 abolished dubious systems of landholding and land use and main capitalist relations universal throughout the countryside, but the basic problem of the existence of large holdings and, even more so, of small holdings was not overcome and is still present.

In this connection it is important to point out that the unusually high rate of horizontal

mobility of the population in internal migrations in Ecuador, where such mobility is as intensive as it is anywhere in the developing world, has done more than structural change to strengthen social integration and transformation. Thus, it may be said that the dynamic process of settlement along the coast and, more recently, in the eastern part of the country has been the most active contributing factor where social integration and articulation are concerned. The expansion of the agricultural frontier and rapid urban growth, together with the harmony which exists at the rural-urban and inter-urban levels, have been more the result of people moving from place to place than of conscious efforts to bring about structural change. Ecuador, like Colombia, has a rich and well articulated demographic mix but it is not as well articulated as it might be because of the persistence of absolute poverty and the absence of structural change, which represent increasingly urgent problems now that the possibilities for expanding the agricultural frontier and for land settlement within the country are in the process of waning.

## XI

### The sectoral approach to social problems

In Latin America as in Ecuador, a sectoral approach is often applied in the design of social policy, which is viewed in particular in terms of health, education, food and housing and of problems relating to employment. This approach corresponds to the existential challenge of improving the systems of biological and social reproduction, which has been responsible for the importance attached to the satisfaction of basic needs without ignoring the great achievements made in the sectors mentioned. However, it has still not been possible to identify the basic causes of absolute

poverty, which are not the causes of the malfunctioning of the development model but rather its symptoms. Although it may seem paradoxical, the fact that the negative indicators of absolute poverty have been regarded as elements in and of themselves and have not been looked at within the context of the global functionality of the system has been responsible for the stubborn persistence of the alarming negative indicators of social development. These include a high general mortality rate and a particularly high infant mortality rate; the expansion of the so-called "geography of

hunger", which embraces the indigenous population of the Ecuadorian sierra in particular; the prevalence of high rates of illiteracy and semi-illiteracy; an alarmingly high number of school dropouts and the proliferation of slums in Guayaquil and of shanty towns in Quito which constitute the broadest negation of

all low-income housing solutions. All these negative indicators constitute dramatic proof that a sectoral, assistance-oriented approach is not the solution to the social tragedy and point to the strategic importance of working towards a global approach based on the elimination of the causes of absolute poverty through social change.

## XII

### The framework of social institutions

It was not until the end of the 1970s and hence rather late in the game that the finishing touches began to be put to the framework of institutions intended to give an overall perspective to the social policy of Ecuador. This initiative was concretized in the establishment of the Ministry of Social Welfare, an institutional and organizational entity in the public sector responsible for systematically formulating, directing and executing social policy in the fields of social security, protection of miners, the co-operative movement, the promotion of popular participation

and social welfare. No mention is made of the struggle to eliminate absolute poverty, and that omission may not be entirely accidental. Moreover, in spite of the efforts made and the results achieved, the institutional framework, in addition to having been slow in coming, still suffers from serious structural defects due to the low level of inter-agency co-operation and to the nearly total failure to co-ordinate relations between the public and the private sectors, although the private sector has played an important role from the point of view of assistance.

## XIII

### Towards the design of a new social policy

There can be no doubt that in various phases of its history and in particular during the time of the cocoa, rice, banana and petroleum booms, Ecuador has experienced sustained and at times even very high rates of economic growth. This growth is not, however, consonant with the country's heterogenous social development. The social contradictions, which are shown most forcibly in the extreme poverty which affects over 55% of the population and is particularly prevalent among the peasant population, is indicative of the lack of co-ordination between economic development in terms of growth on the one hand and social development on the other. Social development may be viewed as a process in which equal opportunities for the

whole society of Ecuador are generated in freedom. There can be no doubt that the alarmingly high indexes of absolute poverty reflect incidents of social discrimination which must be vanquished.

It must be noted that at the social level and within the context of underdevelopment, Ecuador is a classic example of structural heterogeneity. Few countries in the world show more signs of social contrast. In this respect it may be recalled that in an article on the marginated population of the Ecuadorian sierra, Emilio Bonifaz told of having asked a natural history professor from the Max Plank Institute in Germany who had visited Bolivia, Peru and Ecuador to say a few words concerning his

impressions of Ecuador. The professor had replied that in Ecuador one can drive out of the city and along a highway for an hour and cover 100 kilometres in space while going back three centuries in time.

"Actually", the professor continued, "People drive along without noticing that they have dropped back from the twentieth to the eighteenth century. We are so used to poverty that we pass through it without seeing it". This state of affairs has produced a sociological setting in Latin America which is full of contradictions, where it seems almost natural for modernity to coexist with absolute poverty in such a way that a country like Ecuador is all but divided into two parallel countries, one of which is replete with opportunities while the other remains virtually immobile.

Referring to Guayasamín, Regis Debray wrote that "no Indians of the Andes had ever ridden behind a Zapata or, even for a week, sat like the euphoric Pancho Villa, boots and all, in the velvet armchair of a President. They have been a defeated nation from first to last, with never a victory to celebrate and no consolations. They have no glorious history to look back on; their language is the language of despair; and when they speak they speak in pain and sorrow. The black-and-white cloth they weave has all the banality of tears; their faces, all the anonymity of babies put to death at birth".

Brought face to face with the tragedy of the Ecuadorian people as reflected in a depressing index of absolute poverty, from which over half the population suffers, one wonders why no revolutionary upheaval occurs to interrupt the traditional pattern of social injustice. An answer was thought to lie in the tremendous rural exodus from the sierra to the coast which stemmed from the industrial revolution and the country's incorporation in the international market as a supplier of raw materials. The country is undergoing a process of continual transformation as the result of a quick succession of internal migrations. At the beginning of the industrial revolution, scarcely 10% of the population lived on the coast; now the population of the coast and that of the sierra are equal, and, as indicated above, more people are settling in the eastern part of the country. Although this extraordinary horizontal mobility

which may be seen in several locations where the external trade sector is highly dynamic is not accompanied by a similar degree of vertical mobility, it constitutes the best reason for the evaporation of social tension before it could result in social rebellion as a means of achieving national integration and development as happened in Mexico with the agrarian revolution and also in Bolivia.

The expansion of the agricultural frontier and the settlement of the hinterland are, however, processes which are gradually nearing their saturation point making it essential to proceed without delay towards a new development strategy, which must be based on a process of social change in which agrarian, urban and fiscal reforms constitute the most important instruments for overcoming the obstacles to development. The agrarian reform must be accompanied by a guarantee of the holding and use of efficiently formed land. How can this apparent contradiction be resolved? By implementing a profound agrarian reform in the land developed by large projects for the regulation and distribution of water, such as the Daule-Peripa project, which especially since its extension to the Santa Elena peninsula, can benefit over 200 000 families provided the areas incorporated are made subject to reform. This huge infrastructure work, which has been financed primarily out of the surplus funds generated by petroleum, would then benefit over one million Ecuadorians. The same approach could be adopted in respect of other irrigation projects embarked upon in the future. Consequently, there is no truth in the argument that agrarian reform is incompatible with agricultural development and with the guaranteed protection of livestock raising and production for export or domestic consumption in predetermined priority zones. Agrarian planning has no other alternative than to pose the key challenge of a strategic agrarian reform project used in the service of agricultural development in order to combat absolute poverty and the permanent exodus of rural migrants to the city, which is swelling the urban informal sector, especially in the slums of Guayaquil and the shanty towns of Quito. No form of assistance can solve the problems of absolute poverty unless the structural changes

implicit in the country's history and character are brought about.

The design of a new social policy also involves another strategical structural change, which consists in progressing towards a new style of industrialization based on the factors of production present in Ecuador. In other words, the type of industry sought is that which gives preference to labour, the factor in which the country is richest, over capital, the factor which is scarcest. This calls for structural changes within the institutional framework of industry, including changes in the laws governing the promotion of industry and in the system providing financial support. Such changes would make industry an important element in the solving of the agonizing problem of open unemployment and underemployment. It is equally important to promote the development of arts and crafts, forming a small handicrafts industry if at all possible. At the same time, impetus should be given to the development of export-oriented industrial development, with priority placed on agro-industry, in order to give greater value added to those raw materials which are exported. To this end, recourse might well be had to the Andean Group's Joint System of Planning and to ALADI's list of items to which concessions are granted. Another challenge for the strategy is the rationalization of the imports substitution process, which is in an intermediate stage of development.

To make it possible to effect these structural changes, an imaginative and audacious effort must be made to spur on a more fluid transfer of technology and the implementation of the basic science and technology project. First, however, it is indispensable to introduce profound changes

at all levels of the educational system and its contents and of course to eliminate illiteracy.

The proposed new social policy is based on the following action:

- *Social consciousness-raising.* In Ecuador full awareness at national level of the problem of poverty still does not exist; what does exist is a poverty culture, which views the problem fatalistically as being one of the idiosyncracies inherent in the country and in the traditional economic and social development models. A new culture must be created with rejection of poverty at the international and the domestic levels at its nerve centre. Absolute poverty results from dependence, centre-periphery relationships and an internal model whose very dynamics depend on concentration of wealth and income.
- *Social mobilization.* The Ecuadorian society is faced with the challenge of mobilizing the population of the country in a veritable crusade against absolute poverty with the political parties playing a strategic role.
- *Social organization.* No national development project will have positive results unless society is organized in such a way that it is enabled to overcome backwardness and underdevelopment and the worst scourge of all — absolute poverty. Democracy will be fully viable in Ecuador only if it is based on a system of social justice set in an atmosphere of freedom, which is a requirement for the creation of democratic socialism.

# Natural disasters and their economic and social impact

*J. Roberto Jovel\**

This paper identifies the effects of natural disasters on economic development and living conditions in the Latin American and Caribbean region. On the basis of quantitative analyses and undertaken to assess the damage caused by the main natural disasters which have occurred in the region during the past 16 years, the author justifies the undertaking of preventive, planning and preparedness measures to reduce the impact of disasters.

\*Director of the Division of Operations, ECLAC's focal point for work on natural disasters. The author gratefully acknowledges the comments and suggestions made by Messrs. Robert T. Brown, Fernando Galofré and Ian Thomson.

## Introduction

### 1. General

Disasters have negatively affected mankind since the dawn of civilization. They can be caused by natural phenomena or by the action of man, but it is natural disasters which are the subject of this paper.

A distinction is to be made between a natural phenomenon and its consequences. The first-named is "a natural event which threatens both life and property; a disaster is the realization of such a threat".<sup>1</sup> The severity of the damage suffered by the population in any given disaster depends on the intensity of the natural phenomenon, the proximity of human settlements to the location or path followed by the phenomenon, and the prevention measures taken and degree of preparedness achieved by the human group involved.

Mankind has no control over the location—in time and space—and the intensity of natural phenomena which may cause disasters. Short of relocating entire human settlements to safer areas, the only practical option—at a bearable cost—open to man to reduce the effects of disasters is to adopt the prevention and preparedness measures which are within his reach.

Given their high costs—in social and economic terms—and the frequency with which they occur throughout the world,<sup>2</sup> natural disasters should be recognized as development problems rather than as isolated events. Disaster prevention and planning and preparedness measures should be included in long-term development plans.

<sup>1</sup>See John Whittow, *Disasters: The Anatomy of Environmental Hazards*. Penguin Books Ltd., Harmondsworth, Middlesex (England), 1980.

<sup>2</sup>For a summarized, overall picture of the time and space distribution of disasters in the world and their direct consequences, see R. Jovel, *Natural disasters and their impact on the social and economic development of Central America and the Caribbean*, International Congress on Urban Emergencies, Cancún (Mexico), 1982.



## 2. *Origin and characteristics of natural disasters*

Natural phenomena of meteorological and geological origin frequently cause disasters of varying intensity in the countries of Latin America and the Caribbean. On the one hand, tropical storms traverse the Caribbean every year and directly or indirectly affect the countries of that subregion; similar events affect —albeit less directly— the countries located in the tropical belt of the Pacific Ocean coast. Major modifications in the atmospheric circulation over the Pacific bring about changes in the sea-water characteristics off South America and floods and drought on the Pacific slope of the continent.<sup>3</sup> Furthermore, the annual North-South displacement of the Inter-Tropical Convergence Zone over the continent causes frequent flooding in Central America and the northern part of South America. On the other hand, the presence of the "ring of fire" along the Pacific Coast of the continent, together with other lines of contact between tectonic plates, causes frequent and intense earthquakes and volcanic eruptions in the region.

The above-mentioned natural phenomena result in disasters of different intensity in the region. They cause loss of life and injury among the population, damage and disruption to essential services and to social and economic infrastructure, as well as losses of stocks and production. Furthermore, these direct and indirect losses have secondary effects on macroeconomic variables which hinder governments' efforts to achieve sustained growth.

Available information in regard to the major natural disasters which have occurred in the world from 1846 through 1978 indicates that 34 such events occurred in Latin America and the Caribbean and that they caused the death of around 1.2 million persons.<sup>4</sup> More detailed information is available on major disasters in the region from 1972 to date.

<sup>3</sup>This event is called the El Niño Southern Oscillation (ENSO) phenomenon, and normally occurs once every three to 12 years.

<sup>4</sup>*Natural disasters and their impact...* *op. cit.*

While the mass media have provided extensive live coverage of the human suffering and destruction brought about by recent disasters, no accurate quantitative estimates of losses caused by disasters are available for the region on a systematic basis.

An attempt is made in this paper to present a preliminary estimate of the social and economic effects of natural disasters in Latin America and the Caribbean, with a view to justifying the undertaking of disaster prevention and planning activities in the region. This estimate is based on information collected in recent years by the United Nations Economic Commission for Latin America and the Caribbean (ECLAC).

## 3. *ECLAC's work on natural disasters*

During the past 18 years ECLAC has accumulated detailed quantitative information on the social and economic impact of selected natural and man-made disasters in the region, as part of its work programme on damage assessment and rehabilitation/reconstruction planning following disasters. Upon the request of a government affected by a disaster, ECLAC sends a special field mission to undertake an independent assessment of the direct and indirect damage, to estimate its effect on national economic development and its impact on social conditions, and to identify rehabilitation and reconstruction projects.

To undertake such work ECLAC has devised a methodology for the assessment of sectoral damage and for evaluating its impact on overall economic performance and on living conditions. The field mission is normally composed of specialists in damage assessment available at ECLAC; specialized agencies of the United Nations designate sectoral experts in their field of competence to participate in the mission.

This work assists the affected government in defining its post-disaster action priorities and in seeking the required international co-operation. The international donor community —individual governments and multilateral organizations— utilizes these assessments to orient their co-operation with the affected country.

## I

## Analysis of recent major natural disasters in Latin America and the Caribbean

### 1. Definitions

The effects of natural disasters must be viewed not only in humanitarian terms, but also —and primarily— in economic and social terms. These effects can be divided into the following main categories:<sup>5</sup>

- the direct effects on the property of the population affected by the disaster;
- the indirect effects which result from the decline in production and in the provision of services; and
- the secondary effects which may appear some time after the disaster: decreases in economic growth and development; increased inflation; balance-of-payments problems; increases in fiscal expenditures and deficits; decreases in monetary reserves, etc.

Direct effects include losses of capital stock and inventories and —in some cases— of production. Indirect effects include diminished production in the area affected, increased expenditures to provide services or to maintain a given standard of living conditions, etc. In a way, indirect effects can be considered as "losses in the pipeline" of the economic system.

### 2. Case studies

Following the above-described definition of losses and using a damage-assessment methodology developed by ECLAC, detailed analyses have been made to determine the social and economic effects of selected major disasters which have occurred in Latin America and the Caribbean during the period 1972-1988.

Damage assessments were undertaken for a number of natural disasters of both geological

and meteorological origin. Earthquakes and volcanic eruptions are geologically originated disasters, whereas floods, winds and drought are caused by meteorological phenomena.

Analyses were made of detailed information concerning the Managua, Nicaragua (1972), Guatemala (1976), Mexico (1985), San Salvador (1986) and Ecuador (1987) earthquakes, and the eruption and ensuing mudflow of the Nevado del Ruiz volcano in Colombia (1985). Similar analyses were conducted for the cases of hurricane Fifi in Honduras (1974), hurricanes David and Frederick in the Dominican Republic (1979), the floods and drought caused by the El Niño phenomenon in Bolivia, Ecuador and Peru (1982-1983), and the damage done by Hurricane Joan in Nicaragua (1988).

Tables 1 and 2 present summaries of the economic losses caused by each event. To facilitate comparisons between results of the different disasters, damage figures were adjusted, in order to take account of inflation, to 1987 values.<sup>6</sup>

a) *The 1972 Managua earthquake.*<sup>7</sup> An earthquake which originated in shallow, localized tectonic faults destroyed most of downtown Managua in late 1972. The quake demolished or damaged most commercial and public administration buildings as well as housing and other social infrastructure. In addition, the industrial capacity was heavily affected.

The main social effects included 6 000 deaths, or about 1.4% of Managua's population at the time, while more than 20 000 people were injured and 300 000 were left without shelter (70% of the total city population). In addition, some 58 500 persons were rendered temporarily unemployed or subemployed due to destruction or damage to their places of work.

<sup>6</sup>The damage figures for the case of Hurricane Joan are given in 1988 U.S. dollars.

<sup>7</sup>See ECLAC, *Assessment of damages and repercussions of the Managua earthquake on the Nicaraguan economy* (E/CN.12/A-C.64/2/Rev.1), Santiago, Chile, 1973.

<sup>5</sup>See Office of the United Nations Disaster Relief Co-ordinator (UNDRO), *Disaster prevention and mitigation: vol. 7, economic aspects*, United Nations, New York, 1979.

Direct losses were estimated at US\$1 580 million (at 1987 prices). They included the destruction or damage to the social infrastructure (housing, health and education facilities) and losses in stock of the commercial and industrial sectors. Indirect losses were estimated at US\$387 million, including increased costs for the provision of essential services and production losses (mainly in the industrial sector). Total losses caused by this disaster were thus estimated at US\$1 967 million (see table 1).

Secondary effects in the years following the disaster included an increase of US\$687 million in the public sector deficit, due to the need to invest in reconstruction and to the reduction of tax revenues, and an increase of US\$186 million

in the balance-of-payments deficit, caused by the need to import equipment and materials for reconstruction purposes. Further secondary effects included the reduction in growth of the gross national product (GNP) and of per capita income in 1973. In addition, consumer prices increased and monetary reserves diminished.

b) *Hurricane Fifi*. In 1974, Hurricane Fifi swept mainland Central America. Its high winds and ensuing floods caused destruction or damage to housing and other social infrastructure in marginal urban areas; to transport and other physical infrastructure; to permanent plantations and annual crop production; and to the natural resources and environment.

Table 1

ECONOMIC LOSSES CAUSED BY RECENT NATURAL DISASTERS OF GEOLOGICAL ORIGIN IN LATIN AMERICA AND THE CARIBBEAN

(In millions of 1987 US dollars)<sup>a</sup>

Losses and effects	Earthquakes:					Volcanic eruption
	Managua 1972	Guatemala 1976	Mexico City 1985 <sup>b</sup>	San Salvador 1986 <sup>c</sup>	Ecuador 1987 <sup>d</sup>	Nevado del Ruiz 1985
<b>Total losses</b>	1 967	1 437	4 337	937	1 001	224
<b>Direct losses</b>	1 580	1 402	3 793	710	186	154
Capital stock	1 412	1 381	3 777	694	184	150
Inventories	168	21	16	16	2	4
<b>Indirect losses</b>	387	35	544	227	815	70
Production	...	35	154	71	704	17
Services <sup>e</sup>	387	...	390	156	111	53
<b>Secondary effects</b>						
Public sector finances	687	368	1 899	935	397	...
Increased expenditures	673	368	2 025	974	55	
Decrease in revenues	14	-	(126)	(39)	342	
<b>External sector</b>	186	419	8 579	350	781	...
Reduction of exports	-	-	1 650	-	635	
Increase in imports	186	419	9 075	447	155	
Disaster-related income	...	...	(2 146)	(97)	(9)	

Source: ECLAC.

<sup>a</sup>All figures adjusted for inflation through 1987 to enhance comparability.

<sup>b</sup>Secondary effects estimated for 1985 to 1987, and projected thereafter through 1990.

<sup>c</sup>Secondary effects estimated for 1986 and 1987, and projected thereafter through 1991.

<sup>d</sup>Includes damages caused by ensuing floods and mudflows which represent a very high percentage of the total.

<sup>e</sup>Losses of income due to reduction or disruption of services, and/or higher expenditures for the provision of services.

<sup>f</sup>From emergency relief aid and reinsurance payments from abroad.

Table 2

**ECONOMIC LOSSES CAUSED BY RECENT NATURAL DISASTERS OF METEOROLOGICAL  
ORIGIN IN LATIN AMERICA AND THE CARIBBEAN**

*(In millions of US dollars)<sup>a</sup>*

Losses and effects	Hurricanes:			El Niño floods and droughts 1982-1983 <sup>c</sup>
	Fifi 1974 <sup>b</sup>	David and Frederick 1979 <sup>c</sup>	Joan 1988 <sup>d</sup>	
<b>Total losses</b>	<b>588</b>	<b>1 057</b>	<b>840</b>	<b>3 970</b>
<b>Direct losses</b>	<b>388</b>	<b>842</b>	<b>745</b>	<b>1 311</b>
Capital stock	329	506	668	1 060
Inventories	14	230	18	251
Production	45	106	59	-
<b>Indirect losses</b>	<b>200</b>	<b>215</b>	<b>95</b>	<b>2 659</b>
Production	175	185	15	1 284
Services <sup>f</sup>	25	30	80	1 375
<b>Secondary effects</b>				
Public sector finances	224	303	605	... <sup>g</sup>
Increased expenditures	214	264	605	
Decrease in revenues	10	39	-	
<b>External sector</b>	<b>362</b>	<b>464</b>	<b>241</b>	<b>621</b>
Reduction of exports	48	167	27	547
Increase in imports	314	296	223	74
Disaster-related income <sup>h</sup>	...	...	(9)	...

Source: ECLAC.

<sup>a</sup>All figures adjusted for inflation through 1987 in order to enhance comparability.

<sup>b</sup>Damages refer to Honduras only, even though other countries were affected as well.

<sup>c</sup>Damages refer to the Dominican Republic only, even though other countries were affected as well.

<sup>d</sup>These figures are in 1988 US dollars. Secondary effects have been projected through 1993.

<sup>e</sup>Damages refer to Bolivia, Ecuador and Peru, although other countries were affected as well.

<sup>f</sup>Losses of income due to reduction or disruption of services, and/or higher expenditures for the provision of services.

<sup>g</sup>Sizeable increases in the fiscal deficit occurred, but no accurate estimates are available.

<sup>h</sup>From emergency relief aid and reinsurance payments from abroad.

In Honduras alone<sup>g</sup> (other countries such as Nicaragua, El Salvador, Guatemala and Belize were also affected) 7 000 persons were killed. Nearly 15 000 more were rendered homeless, and although this figure represents only a small proportion of the population in the affected area, some small villages were entirely wiped out. Insufficient information prevented the estimation of the number of injuries and of the effects on employment.

Direct losses amounted to US\$388 million and included destruction or damage to housing,

health and education services; bridges, ports and roads; and the loss of some permanent plantations and arable lands which were eroded by the winds. This figure also included damage to domestic and commercial inventories. Indirect losses were estimated at US\$200 million and included losses in banana and annual crop production and higher costs of public sector utilities. The total losses caused by the hurricane in Honduras alone thus amounted to US\$588 million (see table 2).

Secondary effects included a US\$362 million worsening of the balance-of-payments situation, caused by reductions of agricultural exports and by imports of reconstruction equipment and materials. Public-sector finances suffered a nega-

<sup>g</sup>See ECLAC, *Informe sobre los daños y repercusiones del huracán Fifi en la economía hondureña* (E/CEPAL/A-C.67/2/Rev.1), Santiago, Chile, 1974.

tive impact of US\$224 million due to the need to invest in rehabilitation and reconstruction and to a reduction of export tax revenues (see table 2).

A further secondary effect was the drop in GNP growth in subsequent years, which contrasts notably with the vigorous (5%) rate of growth in preceding years.

c) *The Guatemala earthquake of 1976.*<sup>9</sup> A severe quake caused by the displacement of the Caribbean, Cocos and North American tectonic plates, with epicentres located along a major geologic fault which traverses the country, caused extensive damage in many small villages and medium-sized towns in the interior and in Guatemala City.

It was estimated that 22 800 lives were lost, which makes this earthquake—together with the Nevado del Ruiz eruption in 1985—the most damaging to human life in the recent history of the region. Furthermore, 76 000 persons were injured, and over one million people—or nearly 19% of the country's population—were made homeless.

Direct losses were estimated at US\$1 400 million. They included the destruction to housing and other social infrastructure, transport infrastructure, and domestic and commercial inventories. Indirect losses of over US\$35 million were incurred due to the reduction of commercial and agricultural production and to brief interruptions of the water supply and electricity services. Total losses thus amounted to 1 437 million dollars (see table 1).

Secondary effects on the economy were estimated at US\$787 million. The fiscal budget was burdened by the need to increase expenditures to finance rehabilitation and reconstruction projects, and the balance-of-payments situation deteriorated due to the need to import materials and equipment for relief, rehabilitation and reconstruction activities (see table 1).

d) *Hurricanes David and Frederick.* In 1979 Hurricane David traversed the Dominican Republic; several days later, tropical storm Frederick—later to become a full hurricane—also

struck the island. Dominica, Haiti and Cuba were also affected.

The combination of very high winds and subsequent flooding resulted in widespread destruction or damage to housing, agricultural infrastructure and production, electricity and water supply services, physical infrastructure in general and the environment.

The main social effects included the death of a number of persons (only 2 100, thanks to the existence of a warning system and evacuation plan), while over 600 000 people, or 10% of the country's population, were left without a home. No complete figures were collected concerning injuries and unemployment.<sup>10</sup>

Direct losses were estimated at US\$842 million. They include losses of US\$506 million in the capital stock of (in decreasing order of magnitude) the agriculture and livestock sectors, housing, energy and water-supply systems, and transport infrastructure; US\$230 million worth of cattle stock, commercial and household inventories; and US\$106 million of banana and other crop production. Indirect losses amounted to US\$215 million and refer to decreased agricultural production and commercial output in subsequent years (US\$185 million), and to increased costs and diminished revenues in the services sectors. Total losses were thus calculated at US\$1 057 million (see table 2).

Secondary impacts on the economy included negative effects in the amount of US\$464 million on the balance of payments, caused by increased imports to attend disaster needs and by reductions in the exports of bananas and other crops, and a negative impact of US\$303 million on public-sector finances originated by increased spending to attend relief, rehabilitation and reconstruction and by the reduction in export tax revenues (see table 2).

The gross national product actually grew faster during the years after the disaster: a fact which was due, at least in part, to the economic recession of previous years caused by the rising oil prices. Only scant information is available

<sup>9</sup>See ECLAC, *Daños causados por el terremoto de Guatemala y sus repercusiones sobre el desarrollo económico y social del país* (CEPAL/MEX/76/Guat.1), Mexico City, 1976.

<sup>10</sup>See ECLAC, *República Dominicana: repercusiones de los huracanes David y Federico sobre la economía y las condiciones sociales; nota de la Secretaría* (E/CEPAL/G.1098/Rev.1), Santiago, Chile, 1979.

regarding inflationary pressures and monetary reserve fluctuations after the disaster.

e) *The El Niño phenomenon of 1982-1983.*<sup>11</sup> The modification of the general atmospheric circulation over the South Pacific in 1982-1983 affected Bolivia, Chile, Ecuador and Peru in different ways and intensities. Extensive flooding occurred in the coastal areas of Ecuador and Northern Peru, as well as in the Amazonian region of Bolivia, while a severe drought affected the Bolivian-Peruvian highlands. Sea-water temperature and salinity were adversely modified.

The death-roll and the number of injuries were not significant, but 298 000 persons in marginal urban and rural areas were rendered homeless by the floods, and a total of 3.7 million persons were directly affected by the partial or total loss of their means of production, absence of health and education services, insufficiency of food and declining nutrition levels, increased morbidity levels, and shortages of agricultural and food inputs.

The drought in the highlands brought the most impoverished population groups in the Continent to the brink of widespread famine, and originated further migration to other areas and countries. Pre-disaster conditions in that region were restored only recently.

Both individual fishermen and commercial enterprises were greatly affected by the severely diminished fishing production brought about by the changes in the sea-water characteristics. Some fish varieties emigrated elsewhere or died. The annual catch has only recently recovered pre-disaster levels.

Direct losses in Bolivia, Ecuador and Peru were estimated at US\$1 311 million. They included capital stock and inventory losses in the agricultural, transport, oil production, fishing industry and social infrastructure sectors. Indirect losses amounted to US\$2 659 million, including losses of production in the agricultural, industrial and fishing sectors, as well as increased costs and diminished revenues in the transport sector.

Total losses thus amounted to US\$3 970 million, making this the second most costly sin-

gle disaster in the region in recent history (see table 2). Furthermore, they represented about 10% of the countries' combined GNP, or 50% of their annual public sector revenues at the time. Bolivia, the weakest economy, was by far the most seriously affected.

Secondary effects on economic development were extremely severe. In the two-year period 1982-1983, the negative effect on the balance of payments reached an estimated US\$621 million, due to decreased fishery, agriculture and livestock exports and to imports of foodstuffs and agricultural inputs. Public sector deficits and their ratio to GNP increased notably. This was due to decreases in value-added and export tax revenues and to unforeseen expenditures to undertake relief, rehabilitation and reconstruction activities.

Gross national and per capita product growth decreased in the three countries at rates of up to -10%. Consumer prices rose up to 50% in some cases, due mainly to increases in food prices because of production shortages and speculation.

f) *The 1985 Mexico City earthquake.*<sup>12</sup> This earthquake of extraordinary magnitude (8.1 on the Richter scale) originated in the Michoacan Gap and its effects —magnified by special sub-soil conditions— caused extensive damage in a populous section of downtown Mexico City in September 1985.

The earthquake and subsequent aftershocks resulted in the death of more than 10 000 persons; 30 000 more were physically or psychologically injured, and around 150 000 people were rendered homeless.

Some 33 600 dwellings were destroyed and 65 000 more sustained substantial damage. Health sector facilities were seriously reduced as many hospitals and clinics were destroyed or damaged beyond repair. About one-fifth of the capital city's educational establishments were destroyed or badly damaged. Water-supply, electricity and communications services in the downtown section of Mexico City were also affected, albeit less seriously.

<sup>11</sup>See ECLAC, *The natural disasters of 1982-1983 in Bolivia, Ecuador and Peru* (E/CEPAL/G.1274), Santiago, Chile, 1983.

<sup>12</sup>See ECLAC, *Damage caused by the Mexican earthquake and its repercussions upon the country's economy* (LC/G.1367), Santiago, Chile, 1985.

Direct losses were estimated at US\$3 793 million. They included infrastructure and inventory losses in public administration buildings; housing, health and education facilities; communications; and small-scale industry and commerce. Indirect losses were estimated at US\$544 million, and reflect the decrease in revenues and/or increased costs in small-scale industry and commerce, and in the communications, tourism and personal services sectors. The total losses caused by the earthquake thus amounted to US\$4 337 million, making it the most damaging natural disaster of recent years in the region (see table 1).

However, even more serious than the impressively large absolute losses—which an economy the size of Mexico's would perhaps be able to absorb under normal circumstances, since total losses represented only 2.7% of GNP at the time—is the effect of rehabilitation and reconstruction needs on the main macroeconomic variables. It must be borne in mind that the disaster occurred at a time when the government was applying an austerity policy in public expenditures, when banks were short of liquidity to face the increased demand for credit, and when external restrictions were looming.

In the five years after the earthquake, the negative effect on the balance of payments is expected to reach US\$8 579 million in spite of considerable reinsurance income and donations from abroad. Furthermore, the public-sector deficit is expected to increase by approximately US\$1 900 million due to rehabilitation and reconstruction expenditure requirements (see table 1).

The requirements for reconstruction made the Mexican authorities revise their economic policy to accommodate the increased demands for public funds, credits and imports. Furthermore, priorities for public activities were reoriented to permit the reassignment of resources to reconstruction, leaving aside for the time being the solution of long-standing problems in the capital city.

g) *The Nevado del Ruiz volcanic eruption.*<sup>13</sup> In late 1985 mudflows originated by the melting of snow after the eruption of the Nevado del

Ruiz volcano in Colombia caused the death of 22 800 persons. That figure includes more than 90% of the population of the city of Armero, which did not have an appropriate early-warning system. In addition, 5 200 persons were injured and 10 000 more were left homeless. Some 200 000 people were directly or indirectly affected by the disaster.

In this most-atypical disaster, the dead exceeded the affected survivors by a 3 to 2 ratio. While the death-roll represented a great human loss, the tragedy of the survivors cannot be over-emphasized. They were rendered homeless, many were severely injured—some even lost limbs to enable their rescue—and many lost their entire families. In addition, they required physical and psychological rehabilitation yet lacked the essential permanent health and education services.

A preliminary estimate places total losses at US\$224 million. Direct losses of capital stock in social and physical infrastructure—including the total destruction of a city of 25 000 inhabitants—were estimated at US\$150 million, and US\$4 million worth of inventories were lost. Indirect losses were estimated at US\$70 million; they include production losses of US\$17 million and losses of revenue or the need for increased expenditures to provide vital services (see table 1).

The secondary economic effects were not estimated, but were small when compared to national macroeconomic variables, due to the small size of the affected region. It was estimated that the only measurable effect might be a slight increase in national public expenditure for emergency and immediate rehabilitation aid.

The true measure of this disaster lies, without a doubt, in the tragic loss of life and human suffering it caused.

h) *The 1986 San Salvador earthquake.*<sup>14</sup> This disaster caused the death of about 1 200 people; more than 10 000 were injured, and nearly 500 000 suffered partial or total loss of their homes and small shops. The living conditions of the poorest sectors of the population

<sup>13</sup>See United Nations, *The Nevado del Ruiz volcano natural disaster* (SG/SM.1/1), New York, 1985.

<sup>14</sup>See ECLAC, *The 1986 San Salvador earthquake: Damage, repercussions and assistance required* (LC/G.1443), Santiago, Chile, 1986.

were seriously affected through losses of housing, essential services and sources of income.

This earthquake caused considerable damage to housing and to the basic services of water supply and sewerage, electricity and telecommunications. It totally or partially destroyed a large number of buildings in the health and education sectors, as well as infrastructure, machinery and inventories belonging to the industry and commerce sectors. Moreover, the administrative functioning of the government was temporarily interrupted by the destruction of public buildings and by the loss or destruction of archives and communications systems.

A total loss of about US\$937 million was estimated. Direct damage, including capital stock and inventory losses, was estimated at US\$710 million; indirect losses amounted to US\$227 million more. The most serious material losses in infrastructure were those affecting housing, commerce and public buildings. Commerce was the sector most affected by production losses, while the basic services utilities suffered heavy losses due to higher expenditures and diminished income.

While other disasters in the region have caused higher material and production losses, the San Salvador earthquake had a greater relative economic impact. In this case, the total losses amounted to approximately one-quarter of the country's gross domestic product or about 40% of its external debt at the time.

The secondary effects on the economy will be felt for several years to come. Due exclusively to the disaster, in 1986 the growth rate of the gross domestic product went down by 2%; the fiscal deficit rose by more than 24%; the public administration was severely disrupted, and the external sector experienced the doubling of its current account deficit due to increased imports for reconstruction. In the five years following the disaster, the public sector is expected to suffer a negative impact of US\$935 million due to increased expenditures, despite increased tax revenues, while the external sector position is likely to suffer a deterioration of some US\$350 million, due to increased imports for reconstruction and in spite of reinsurance payments from abroad (see table 1).

The social impact is even more significant. The already considerable housing shortage

increased substantially and unemployment rose from 26 to 35% in the metropolitan area of San Salvador. There was also a drastic reduction in public health services and facilities. These social consequences of the disaster came on top of the hardships of a population suffering from the effects of an internal war.

i) *The March 1987 earthquake in Ecuador.*<sup>15</sup>

This event caused the death of about 1 000 persons. More than 5 000 people had to be evacuated from the disaster area and re-housed in temporary shelters. About 3 000 dwellings were completely destroyed and 12 500 more had to be repaired. Several hospitals and health centres were also affected. Water-supply and sewerage systems were damaged, as well as many educational establishments.

Mudflows caused by the quake and subsequent rains destroyed more than 40 kilometres of the trans-Ecuadorian pipeline used to transport oil from the Amazon region to the refineries and export centres located on the Pacific Coast, as well as severely damaging the only highway connecting the Eastern provinces with the rest of the country. Moreover, agricultural production was affected by the erosion of arable land caused by landslides, and the floods carried away thousands of head of livestock and deposited silt over large areas of grazing land.

The total damage caused by this disaster was estimated at US\$1 000 million. Direct damage to the capital stock and inventories of the country's social and economic sectors was estimated at US\$186 million. Indirect damage —which include extremely large losses by the petroleum-exporting sector, together with the higher costs incurred to satisfy domestic energy demands, and production losses in the agricultural sector, was estimated at US\$815 million (see table 1).

Even though it affected a relatively small area, the disaster brought about a considerable fall in Ecuador's production and export capacity. It has been estimated that in 1987 there was a 3% drop in the gross domestic product, instead of the 2.5% growth foreseen before the disaster. The external sector suffered losses of about US\$790 million due to reduced exports of oil and

<sup>15</sup>See ECLAC, *The natural disaster of March 1987 in Ecuador and its impact on social and economic development* (LC/G.1465), Santiago, Chile, 1987.



other products (US\$635 million) and to increased imports for rehabilitation and reconstruction. The public sector finances experienced an increased deficit of about US\$397 million due to increased outlays and decreased revenues (see table 1). The projections indicate still further deterioration of these macroeconomic variables in the future as an effect of the disaster.

The disaster had harsh consequences for the welfare of some 400 000 people who were directly affected. The brunt of the disaster was borne by population groups living in rural and marginal urban areas located in a number of provinces where unemployment levels and rates of illiteracy are high and where the provision of basic social services —health, sanitation and education— is limited. In addition, approximately 75 000 persons living in the Amazon region were isolated from the rest of the country for several months; essential supplies needed by the population had to be transported by air and it was impossible to bring their produce to the markets.

j) *Hurricane Joan*.<sup>16</sup> In October 1988 the tenth hurricane of the Caribbean season gave rise to a major disaster in Nicaragua and also caused damage in neighbouring Costa Rica, Panama, and El Salvador. With sustained winds of up to 217 kilometres per hour, the hurricane entered Nicaraguan territory and destroyed several cities; after traversing the continental divide and causing extraordinary rainfall and floods, its winds lost force and it slackened to a tropical storm before petering out in the Pacific Ocean.

In Nicaragua, approximately 310 000 persons were evacuated from the danger areas before the hurricane struck; they were housed in temporary shelters to protect them from the winds, rain and floods while they awaited the re-establishment of minimum environmental and health conditions in their original settlements. About 230 000 low-income peasants and fishermen saw their homes and working capital destroyed or damaged. A total of 2.8 million people were directly or indirectly affected by the disaster.

<sup>16</sup>See ECLAC, *Damage caused by Hurricane Joan in Nicaragua: its effects on economic development and living conditions, and requirements for rehabilitation and reconstruction. Note by the Secretariat* (LC/G.1544), Santiago, Chile, 1988.

Direct damages were estimated at US\$745 million. They included total or partial destruction of social infrastructure, especially housing; erosion of agricultural soils and devastation of extensive areas of tropical forests; destruction or damage to the economic infrastructure, particularly transport facilities; and damage to the agricultural and industrial infrastructure, as well as losses of products. Indirect losses were estimated at US\$95 million; they refer to the greater expenditure needed to supply health services and attend necessary emergency and relief operations, and to production losses in the near future. Total losses were thus estimated at US\$840 million (see table 2).

These losses constitute a very heavy burden for Nicaragua. They represent slightly less than 10% of the country's accumulated capital stock or about 40% of the gross domestic product for 1988. Furthermore, the disaster came at a time when the Nicaraguan economy was showing signs of growing weakness as it continued to undergo a state of semi-permanent crisis brought about, in part, by the marked deterioration of the external sector —which has been severely hurt by an economic blockade since 1985— and by the need, in recent years, to allocate to defence a large share of the country's scarce resources.

Secondary effects on economic performance will be felt for a number of years. In 1988 alone, the fall of the gross domestic product increased by 2 percentage points and per capita income was further eroded; in addition, the already large fiscal deficit will be increased due to the additional expenditure needed to meet emergency requirements. In 1989 and the following years, even though some recovery is expected in the productive and construction sectors, public sector finances will deteriorate further due to the new investments and expenditures required for rehabilitation and reconstruction, and the balance of payments will exhibit greater disequilibrium as a result of the need to increase imports and the inevitable fall in exports (see table 2). No doubt this will lead to a further speed-up of the hyperinflationary trend which existed before the disaster.

The government will be forced to revise its most recent goals for re-establishing macroeconomic equilibria. Moreover, the country does not

have the capacity to undertake the necessary rehabilitation and reconstruction work on its own while at the same time continuing its long-term efforts to achieve sustained development and to improve the living conditions of the population. It may be necessary to postpone major economic and social development programmes which were underway or about to be initiated.

The above considerations are even more important in view of the fact that the people most affected by the disaster include about 62 000 low-income peasant families who lost their subsistence crops and their very limited belongings and who are now faced with the task of rebuilding their highly fragile family-based economy.

## II

### The effects of natural disasters

#### 1. Region-wide estimates of losses

The following conclusions can be drawn after analysing the available information on the type and amount of the social and economic losses caused by selected recent major disasters in Latin America and the Caribbean.

Depending on the *origin* of the natural phenomena which caused the natural disaster:

- natural disasters of meteorological origin—such as floods, hurricanes and droughts—usually cover a more extensive geographical area than those of geological origin;
- due to population density, the number of victims caused by natural disasters of geological origin—such as earthquakes—is likely to be higher than in the case of those caused by meteorological phenomena;
- losses of capital stock in the physical and social infrastructure caused by earthquakes are usually much higher than those caused by floods;
- losses of production and indirect losses, on the other hand, are likely to be much higher in cases of floods and droughts, and
- when a geological phenomenon gives rise to floods or mudflows, losses of production and indirect losses are much higher than in straight cases of geological disasters.

The following *general* effects are common to all types of natural disasters:

- a significant number of victims which reduces the already limited quantity of trained human resources in the affected countries;
- a substantial reduction in the availability of

housing, health and education facilities, thus increasing pre-disaster deficits;

- a temporary reduction in the income of the least-privileged social strata and a corresponding increase in already-high rates of underemployment and unemployment;
- temporary interruptions of water supply and sanitation, electricity, communications and transport services; and
- temporary shortages of food supplies and raw materials for agricultural and industrial production.

On the quantitative side, the analysis of the case studies described earlier gives an idea of the size of the losses caused by major natural disasters in the region. However, additional significant losses arise from less-severe natural disasters which affect the region on a more frequent basis.

In regard to the latter, ECLAC has estimated that during the 15-year period between 1962 and 1976, the Central American countries alone were affected by different types of natural disasters which inflicted 39 600 deaths and losses of capital stock, production and inventories amounting to about US\$8 500 million 1987 dollars.<sup>17</sup>

<sup>17</sup>The following is the breakdown of losses:

Type of disaster:	Deaths	Millions of 1987 US\$
Floods and winds	6 054	1 896
Drought, hail and cold fronts	-	163
Volcanic eruptions and earthquakes	33 500	6 453
<b>Total</b>	<b>39 554</b>	<b>8 512</b>

If the latter figures are combined with those of the case studies analysed and of other less-studied disasters, it may be concluded that in the Latin American and Caribbean region as a whole more than 6 000 lives and over US\$1.5 billion 1987 dollars are lost per year due to natural disasters.

### 2. Economic and social effects

Although the amount of direct and indirect losses indicated above is very large, the social and economic effects of natural disasters are even more striking.

Thus, depending on the size and degree of diversification of the affected country's economy, the secondary effects of natural disasters include:

- a reduction in economic growth and in the improvement of social conditions in general;
- an increase in the public sector deficit because of unforeseen emergency relief, rehabilitation and reconstruction expenditures and reductions in tax revenues;
- a deterioration in the balance-of-payments position due to the fall in exports and the increases in imports of equipment and materials for relief, rehabilitation and reconstruction; and
- an increase in the cost-of-living index due to shortages of essential goods and speculation.

The short-term effects of emergency relief and immediate rehabilitation activities have been absorbed thanks to the efforts undertaken by the affected governments, with generous assistance from the international community. The disasters have longer-term effects, however, whose solution has often called for great sacrifices by the affected country's population.

In fact, in the case studies analysed, rehabilitation and reconstruction have been made possible through a combination of the following measures, depending on the specific economic position of the affected country:

- reassignment of existing fiscal resources and internal savings;
- reorientation of existing bilateral or multi-lateral loans; and
- securing of additional external financing.

The above measures have resulted in the deferment or cancellation of development projects which had been included in already-approved long-term development plans, and in the delay of improvements in social conditions in general.

### 3. The need to reduce losses and cushion their effects

While the natural phenomena which give rise to these disasters cannot be avoided, it is possible to take measures to reduce their social and economic effects to more manageable levels and thus contribute to long-term development. Such measures, while costly in themselves, would represent only a small fraction of the present level of losses mentioned above. They include preventive, planning and preparedness activities or systems which are briefly described below.

*Disaster prevention* measures are designed to prevent natural phenomena from causing disasters or at least to limit their consequences.

A first group of prevention measures is related to the forecasting and warning of natural phenomena, and is based on a thorough scientific study of the intensity and chronological and spatial distribution of the natural phenomena which may originate disasters. They include the setting up of networks to monitor the development and evolution of meteorological events, and the implementation of early-warning systems in the vicinity of human settlements.<sup>18</sup>

The second set of prevention measures refers to the adoption of technical and legislative regulations, such as zoning laws based on vulnerability analysis and special building codes, to ensure that buildings are able to withstand the anticipated effects of natural phenomena. The education and training of the population to make people aware of disaster risks and of prevention requirements also comes within these measures.

There are two main areas of action in connection with *disaster-related planning*. First, physical planning should include disaster vulnerability analyses of all large-scale develop-

<sup>18</sup>No similar monitoring and early-warning systems have been developed as yet for disasters of geological origin, except in a few isolated cases of volcanic eruptions.

ment works—including human settlements—to decide their optimum location and anti-disaster characteristics. Second, long-term development planning should include potential disaster effects as a new variable—giving due consideration to the need for the adoption of emergency relief programmes and contingency measures in cases of disaster—as well as taking account of the rehabilitation and reconstruction requirements generated by a major disaster.

Finally, *disaster preparedness* involves the adoption of measures to organize and facilitate

rescue and relief operations in cases of disaster. They include the formulation of emergency plans, the setting up of effective relief organizations, the training of personnel for these activities, the stockpiling of supplies and the setting up of special funds for emergency relief.

In addition to its work on damage assessment, ECLAC is assisting its member countries in the design and installation of flood forecasting and early warning systems. Additional efforts are required, however, in order to reduce losses brought about by natural disasters in the region.



## Institutionalism and structuralism

*Osvaldo Sunkel\**

In this article the author undertakes a comparative analysis of two economic approaches: institutionalism and structuralism. In so doing, he examines the origin and development of both schools of thought and explores a number of ways in which they might enrich one another. So far, neither of these schools has demonstrated much familiarity with the views of the other, and this is especially true of structuralists' knowledge of institutionalism — a situation which should be rectified.

The institutionalist and structuralist schools share a vision of economic development which stresses the dynamic role of technological progress, its contradictions with established institutions and social structures, and the importance of the ideological and power systems as expressed in the political and governmental spheres — all variables which determine the course of the development process.

Structuralism could profit from the institutionalist critique of conventional economic approaches, of its theory concerning technological change and economic growth, and of its analysis of the institutions of the United States economy. Institutionalism, for its part, has something to gain from the structuralist analysis of the interaction between the world economy and national economies, the role of transnational corporations, inflation and the role of the State.

\*On the occasion of its 1988 annual meeting, the Association for Evolutionary Economics named the author of this article as the Clarence Ayres Visiting Acholar and invited him to present a paper on institutionalism and structuralism at its session in tribute to the memory of Clarence Ayres in New York on 29 December 1988. This article is a shorter and revised version of that paper.

The institutionalist school of political economy in the United States dates back almost a full century. Its founders, Thorstein Veblen and John R. Commons, began publishing their work in the 1890s. Their thinking represented a radical break with the classical political economy of Ricardo and its *laissez-faire* policy corollary. Those who carried on this tradition, particularly Clarence Ayres, pursued this line of criticism with respect to neoclassical economics. Their contemporary followers are equally at odds with today's conventional neoclassical paradigm and they largely identify with the thinking of well-known and, among us, respected heterodox economists of such stature as Joseph Schumpeter, Gunnar Myrdal and Kenneth Galbraith.

Institutionalism rejects individualistic hedonism as a basis for the behaviour of individuals in favour of a cultural concept of the formation and evolution of values and social behaviour. Its main emphasis is on technology and institutions and on the conflict between the dynamics of the former and the resistance of the latter as a central aspect of its theory of social change. It takes a dynamic historical and evolutionary view of the process of economic and social change. It ascribes great importance to the role of power in the functioning of the society and economy and stresses the part played by the State in development. At the methodological level, it rejects conventional economics' self-proclaimed neutrality in respect of values.

It follows from the above that institutionalists have by nature a deep interest in the subject of development, and their approach is of inarguable significance from this standpoint. Some of them, notably James Street (whose recent death we deeply regret), have focused on Latin American development and have found many of the structuralists' propositions and interpretations, as well as their concepts of dependence and the centre/periphery system, to be particularly attractive and kindred to their own ideas. Ever since they first came into contact with this literature several decades ago, they have been stressing how much these two schools of thought might benefit from a greater amount of convergence and mutual knowledge.

However, there has been a situation of unequal exchange between institutionalists and structuralists. Institutionalists have read and stu-

died the work of the Latin American structuralists. Several papers by Street (1967, 1987), Bath and James (1976), Street and James (1982), Dietz (1980, 1986) and Glade (1987), among others, are proof of their interest and appreciation which is not without criticisms. Through their publications a wider readership of institutionalists has been made aware of the contributions of Prebisch, Furtado, Pinto, Noyola, Ferrer, Urquidi and Seers, to mention only some members of the generation of the founding fathers, and of the United Nations Economic Commission for Latin America and the Caribbean, the main institution in or around which they worked. Since these institutionalist authors have already presented the basic characteristics of structuralism and dependency, and there is an excellent recent survey available in English (Blomström and Hettne 1984), I will not dwell on those aspects here.

Unfortunately, the Latin American writers in the structuralist and dependency tradition have not done their homework with respect to institutionalism. To the best of my knowledge, there are only three articles on the subject, published in an important Latin American journal many years ago by the Argentinean economist Santiago Macario (1952). Macario was a student of Clarence Ayres around 1950. On his return he tried to bring the writings of the institutionalists to the attention of Latin American economists. He provides an excellent introduction to institutionalism and suggests there is much to learn from it. Macario informed me that on completion of his studies he joined ECLAC and that he thoroughly discussed the papers he was preparing with Raúl Prebisch, Víctor Urquidi and José Antonio Mayobre. They showed great interest but there was no follow-up. He also informed me that he was not aware of other such initiatives. I must also report that, while the existence of the institutionalist school of thought is of course known and mentioned here and there, their writings have not been systematically studied and used in Latin America.

In order to appreciate similarities and differences between these approaches, I have had to become better acquainted with institutionalism. What I have done is to sample several volumes of the *Journal of Economic Issues*, the journal of the Association for Evolutionary Economics,

around which the institutionalists are grouped. As a result I have come to five tentative and preliminary conclusions with respect to: i) some reasons why there has not developed closer collaboration in the past; ii) some areas of coincidence between the two approaches; iii) some fields where it would be particularly fruitful for structuralists to study the work of institutionalists; iv) some areas where, conversely, it might be interesting for institutionalists to look more closely at the work of structuralists; and v) suggestions for a conceptual perspective that might be useful for generating certain convergence between the two approaches.

Let me then begin with a word about some possible reasons why we have ignored the work done by institutionalists despite its obvious usefulness for the understanding of the economic development problem.

One fundamental reason, it seems to me, is the fact that the discipline of economics is, among other things, a system of power organized in such a way that it reproduces itself over time (Earl, 1983; Canterbury and Burkhard, 1983; Hamilton, 1984). But it is not only a national system of power in the United States; it is also an international or transnational system of power (Sunkel and Fuenzalida, 1979).

In most Latin American countries, economics did not become a separate discipline and a distinct profession until the 1940s or early 1950s. During the 1950s, schools of economics became separate entities, but were frequently combined with the study of accounting and business administration. The next stage in the modernization of the economics discipline came through three main channels: i) the use of foreign textbooks, mostly American and British; ii) foreign economists who came to teach, to introduce *curricula* reform and to plan and conduct research; and iii) students who went to study abroad, mostly at United States universities, and who returned to become the new local faculty. These three channels were greatly enhanced during the decades that followed, as they became conscious and systematic activities of development aid, supported through international agencies, government channels and private foundations.

In this way many of the most prestigious Latin American schools of economics eventually

became imitations —almost subsidiaries in certain cases— of their United States alma maters. They were thereby incorporated into the international academic system of power devoted to the reproduction of the conventional paradigm of the discipline of economics, through similar orientations in research, teaching, publications, academic exchange and funding for all these activities. As with institutional thought in the United States, structuralist and dependency work and thought in Latin America has been segregated and marginalized from these institutions. The result is obvious: Latin American students of economics in the better-known universities are not given the chance seriously to study structuralism, either in Latin America or in the United States.

Some perceived the dangers of this process and tried to suggest a more reasonable system of international academic co-operation and exchange, which, while helping to improve and modernize the discipline, would keep it relevant and capable of addressing the development problems of our countries in the context of their historical, environmental, cultural, political and socio-economic realities (Pinto and Sunkel, Harberger, 1966).

Moreover, in the last decade and a half, the study of the problems and crises of the economic development process —which presumably are at the centre of Latin American concerns and where structuralist and dependency approaches have made significant contributions— has been expurgated from the departments of economics of United States universities. The same trend has of course been replicated in our region (Sunkel, 1984; Griffith-Jones and Sunkel, 1986).

The worst cases have been those where conventional academic thinking has become associated with military governments and therefore has become not only an implicit but a very explicit part of the system of power, where most of those who were not true believers in neoclassical economics of the Chicago variety have been expelled from academia and where reference to economic thought and literature not sanctified by the system of power has been largely suppressed. For this reason, in countries that have suffered long periods of military dictatorships and where neoconservative ideology has prevailed, independent academic work could only be

carried on, under great difficulty, in independent research centres outside the university (Street 1983, 1985).

Structuralism has been engaged in a running battle with neoclassicism from its very inception, in the work of Raúl Prebisch and through its evolution during the last decades, when it has met increasing difficulty resisting the revival of neoclassical and monetarist orthodoxy (Prebisch 1979, 1981). Structuralism also has had to contend with the other main school of thought having a strong presence in Latin America—that is, Marxism. Although in the origins of structuralism, the Marxist perspective was supportive and helpful, and although both approaches developed more or less in parallel without much conflict, this situation changed in the mid-1960s. After the Cuban revolution Marxists became more militant and revolutionary and began denouncing import-substitution industrialization as a bourgeois and pro-imperialist strategy. In this way structuralism and its outgrowth—dependency— came in for a strong attack from the Left. This became, in fact, one of the most important aspects of the dependency debate. Over the years, structuralism has therefore had a very difficult time defending itself both from the Right and from the Left. This is probably another reason why structuralists have not made the effort to become aware of the contributions of institutionalists. The challenges came from neoclassical orthodoxy and Marxism, and for a long time there seemed to be no need for allies. The situation may be changing now, and new perspectives may be opening up.

Let me now move to some parallels and coincidences between the two approaches. The origins of both perspectives in Thorstein Veblen and in Prebisch are apparently related to the overwhelming prevalence at the time of *laissez-faire* doctrine and policy prescriptions (Mayhew, 1987; Prebisch, 1984). In both cases this influence came mainly from abroad, particularly from the United Kingdom. The North and South American reaction was influenced by the German Historical School, but was mostly endogenous, reflecting national interests, peculiarities and concerns. Sharing some of Marx's insights, capitalism—and in particular industrialism and technological progress— were seen as tremendously dynamic forces of progress and change, but



hampered by institutions and structures. These institutions must be transformed to allow capitalism and industrialism to develop, while also retaining control over the unbound and partly destructive power of capitalism.

Both approaches are, therefore, reformist and not revolutionary in character; capitalism as a system must be tamed, controlled and guided, rather than abolished. Keynesianism and post-Keynesianism are welcome, and so is government activism, i.e., the participation of the public sector in economic and social activities, the promotion of institutional and structural reforms and change, and governmental planning. But civil society too, at local, regional, or national levels, is encouraged to engage in reformist activities. Advocacy of social and economic change is clearly a characteristic of both approaches.

The economic process is not seen as a static, circular, repetitive, equilibrating mechanism, limited mainly to what happens in various markets, but as an ongoing socio-historical evolutionary process —the cumulative cause and effect of conflicts and changes in economic, social, cultural and political forces. Individuals are not considered equivalent to computers programmed to maximize a welfare function, given certain constraints, nor are firms seen as computers programmed to maximize profits, given a production function and certain financial restrictions. They are conceived as social and cultural entities, relatively autonomous but institutionally and structurally shaped and circumscribed as regards values, norms, behaviour, forms of association, and organization. As a consequence of this vision the recent revival of the neoclassical paradigm, carried to extremes of individualism, hedonism and utilitarianism, and its corresponding neoconservative ideology, represents to both approaches a formidable challenge to the welfare and integration of society and must be exposed and overcome.

Institutionalist and structuralist thought is always centrally concerned with contemporary or current socio-economic reality and the corresponding preoccupation with economic policy. As a matter of fact, moral values and pressing problems, rather than deductive reasoning and controversy, are at the origin of most research and thought. Concern about crisis and injustice

seems to be a major initiator of research and policy prescriptions. Prebisch's initial contribution is the outgrowth of his experience as head of the Central Bank of Argentina during the great crisis of 1930, and of his perception of the profound inability of his country to face the crisis, and of the irrelevance and perverse consequences of the application of received doctrine and the policies derived from it. As in the case of Veblen and the founders of institutionalism, Prebisch's thought was a vernacular reaction to foreign *laissez-faire* intellectual and practical predominance, which was seen as detrimental to the national interest. The great crisis seems to have been a great challenge and stimulus to both schools of thought, generating much activity and creativity in both theoretical and policy matters. As reported by K. Parsons, K. Boulding and J.K. Galbraith, John Commons and his students contributed significantly to Roosevelt's New Deal in the 1930s (Parsons, 1985).

The further development of Prebisch's thought occurs during the 1930s and 1940s when, having had to leave Argentina when Juan D. Perón took over, he travelled through Latin America advising central banks, particularly in Mexico and Venezuela. He was tackling problems of economic policy resulting from the Depression, its aftermath, and the Second World War. Observing these economies, he realized that there were great differences among them; he was particularly struck by the socio-cultural contrast between Argentina, with a rural sector that was thinly populated with European immigrants, and Mexico, with its massive rural population of ancient culture. But he also saw fundamental similarities: the virtual absence of an industrial sector and the dependence on a few primary exports. Observation, the inductive method and comparative historical analysis were central to his approach, as is also the case with institutionalists.

I could go on, but as can easily be concluded from the above, institutionalists and structuralists indeed share a common ground or —as Schumpeter would put it— a similar "vision" of the economic process.

Let me then look at a first aspect of some of the disparities between these approaches. The institutionalist literature, as it is represented in its *Journal of Economic Issues*, presents certain

areas of inquiry that appear particularly strong from the perspective of structuralism. I am struck, for instance, at the thoroughness and comprehensiveness of the philosophical, epistemological, methodological, conceptual, theoretical and analytical critique of the conventional neoclassical and monetarist paradigm. Although structuralism shares many of these critiques, it is much weaker and more superficial in this regard and has much to learn from this aspect of the institutionalist literature.

Institutionalism is also much stronger as regards the theoretical and conceptual grounding of its approach and its theory of socioeconomic change as a distinct and positive alternative to neoclassical orthodoxy. A substantial amount of the effort of institutionalists goes into the analysis of the philosophical basis of institutionalism, the theory of human nature, the theory of institutional and technological change, and the criteria of social value. Structuralism is particularly strong in its conceptual approach and historical interpretation of Latin American underdevelopment and dependency (Blomström and Hettne, 1984; Di Marco, 1972; Palma, 1978; Gurrieri, 1982; Rodríguez, 1980). But as regards its theoretical and philosophical foundations only a few references come to mind (Cardoso, 1977a and 1977b; Sunkel and Paz, 1970; Valenzuela and Valenzuela, 1979; Jameson, 1986). One main reason for this weakness is the fact that there is not much place for such fundamental inquiry in the academic and research institutions of Latin America. As already mentioned, many universities either exclude structuralism or do not allow the time, resources and research environment conducive to the accumulation of fundamental knowledge. This is partly for ideological reasons but also because the universities are geared toward professional training rather than the pursuit of scientific knowledge. Therefore, if one follows the life and work of the main contributors to structuralist thought, they will be seen to have spent little of their time and effort in academia, except for periods in exile outside Latin America. Most of their time has been accounted for by work either in international organizations or in government bodies, where critical thought, economic philosophy and method are not particularly valued. Institutionalists and structuralists

have a different institutional base and it shows in their intellectual output.

One interesting and promising development in the structuralist approach is the attempt in the 1980s to give some of its central propositions a more formal and mathematical expression (Taylor, 1979 and 1983; Jameson, 1986). This has been called neostructuralism. Although this interesting effort has revitalized structuralism, it has tended to concentrate on short-term equilibrium and adjustment problems rather than on questions of economic development. Nevertheless, more recently neostructuralists have been making an effort to relate to and rediscover their roots in structuralism, as shown in the review of this literature by Rosales (1989).

Institutionalism is also particularly strong in the area of technology, of course, and devotes a large proportion of its literature to its study. Technology is absolutely central to institutionalist thought, so much so that it is the driving force of evolution and change in this approach. Technology is seen as closely related to cultural change, thereby bringing into the picture a dimension of development that is completely absent from structuralism. Technological change is seen as a dynamic, transformation-inducing aspect of culture, deriving from the accumulation of knowledge and transcultural inducements; but cultural patterns, in turn, define the extent and nature of its incorporation into cultural change. This intimate relationship of technology—seen as the cumulative development of ideas, tools and skills—to the culture from which it derives and to which it contributes is a fundamental element of institutionalism. It is an aspect of development theory that has been badly neglected by structuralism, which has had a more restricted view of technology.

But this does not mean, as I think some institutionalist critics have suggested, that structuralism does not give sufficient importance to technology (Street, 1977; James, 1979). From Prebisch onwards, structuralism has placed great importance on industrialization, which is seen as the bearer of technological progress and the key to modernization. Great emphasis was put on this aspect, but some confusion seems to have arisen about the dependency critique. What structuralism, and particularly dependence thought, has argued is that the nature of the

process of transfer of technology has inhibited the development of endogenous technical capabilities in Latin America. The building-up of a national base of technological capability is certainly crucial to development, and Latin American countries have attempted to create it in various forms. But we have remained great consumers of imported technology, which, as a neoclassical economist would put it, is cheaper and more readily available. Except perhaps in the case of Brazil, we have not yet developed the will and the capacity to produce, adapt and select technology, but we are most definitely convinced that this is a central feature of the development process. As a matter of fact, the process of institution-building in this field, aimed at channeling resources into this area and promoting science and technology, was quite significant in the 1960s, before the onslaught of neoliberalism.

Another area where structuralists have much to learn from institutionalists is in their extensive analysis of the institutional characteristics and corporate structure and dynamics of the United States economy, both in general and as regards its different sectors and regions and its main markets and institutions, including particularly governmental regulations and policies. The United States economy is a determining factor in the evolution of Latin American economies and societies through all sorts of channels: monetary and fiscal policy, interest rates, tariff and non-tariff barriers, volume and value of imports and exports, transnational corporations, migration policies, technological innovation and consumption patterns, to name just a few. It is at least as important for Latin American students in the United States to become intimately acquainted with the intricacies of those aspects of the United States economy that are crucial for their own countries, as it is for them to spend time and effort mastering the latest twist in some highly abstract and probably irrelevant theoretical debate or methodological or statistical refinement. This might in fact be a practical and straight-forward avenue for significant co-operation among us.

My second set of disparities concerns some areas of structuralist and dependency research that institutionalists might find of interest.

I have the impression, for instance, that institutionalist thought has given very high

priority to understanding the domestic economy of the United States, almost to the exclusion of understanding the structure and evolution of the international economy and the relationships between the two. Take such fundamental recent statements of institutionalist thought as Marc Tool's *The Discretionary Economy* (Tool, 1985) and the two issues of the *Journal of Economic Issues* bearing the title *Evolutionary Economics* (vol. XXI, Nos. 3 and 4, 1987), "...intended to provide a comprehensive, contemporary formulation of institutionalist political economy...". Marc Tool's book does not list any international aspect in its index and has only passing references in the text. In the two issues of the *Journal of Economic Issues*, only the article by John Adams (1987) out of 30 articles deals with international trade and payments. In his words: American institutional economists have devoted very little attention to the international economy (Adams, 1987, p. 1841).

I would submit that we have here probably the greatest difference between our two approaches: the institutionalist approach is State—or nation—centered; its object of study is the national economy, and fundamentally the national economy of the United States. The structuralist-dependency approach is world-centered. The national economy of the United States, together with other industrial economies, is seen as dominant, and Latin American and other under-developed economies are seen as dependent subsystems of the global world economy. All national economies are therefore significantly influenced, although in different ways, by their participation in the system. United States multinational corporations, for instance, which from almost any conceivable perspective constitute a critical institutional core of the United States economy, derive a very high proportion of their profits from their operations abroad. Therefore, the United States economy is structurally and institutionally interrelated in a very profound sense with the world economy, quite apart from the more obvious external economic relations of trade and finance.

I can think of some powerful historical reasons why we should have developed these different approaches. The United States is a continental economy and society, with a strong isolationist tradition, and institutionalism was

born in Middle America and Texas rather than on the east or west coasts. Structuralism and dependency approaches reflect almost the opposite historical circumstances. But given the progressive, massive and pervasive interpenetration of the United States and world economies in recent times, there seems little doubt that a purely domestic vision of the United States economy will fail to give a reasonable account of its evolution. The work of the structuralist/dependency school —although you may have to turn it on its head— might give some interesting clues to a better understanding of the highly transnationalized United States economy of the late twentieth century.

There are other significant areas of structuralist socio-economic research that might be worth a glance. There is, of course, the structuralist approach to inflation, which has been frequently reviewed and is well known. But there are other important fields: the debt and development crises of the 1980s; planning and regional development; the State and the transition from authoritarian to democratic régimes; the interrelation between the environment and development; and the whole area of poverty, underemployment, the informal economy, marginalization, urbanization and social change.

Finally, I would like to outline a conceptual perspective that I have found useful in differentiating the neoclassical synthesis from the structuralist approach, particularly as regards the understanding of economic development processes. I believe this may also be a convenient way of exploring the differences between conventional economics and dissenting schools of economic thought in general and of perceiving the similarities among the latter —including in this particular instance structuralism and institutionalism.

My proposal is simply to distinguish among them according to the emphasis that each one places on stocks *vis-à-vis* flows in the economic process. By stocks I mean the classical view of the endowments of human, natural and capital resources that a society has at its disposal at a certain *point of time*; by flows, the production, income, expenditure and transfer streams per *unit of time* obtained from those endowments. Classical political economy placed a great deal of emphasis on resources, without neglecting the

flows derived from them. Conventional neoclassical economics, the mainstream paradigm, on the contrary, has managed to expurgate from its theoretical framework, its teaching and research, and its policy recommendations, almost all reference to the productive resources of society and has concentrated almost exclusively on flows, both at micro and macroeconomic levels.

This difference in preference of focus has profound implications. The exclusive emphasis on annual or semiannual monetary flows brings to the forefront of interest questions related to the *short-term* adjustments of the economy, particularly in regard to *equilibrium*, both macroeconomic —the balance of payments, the budget, the monetary accounts— and microeconomic —firms, consumers, markets and prices. Mainstream economics excludes from the field of economic inquiry and policy almost all that pertains to that other major part of the socio-economic process which deals with resources, their dynamics, the relations among them, and with the flows which derive from them, with technology, institutions, power and culture, which are responsible for the way in which those resources are created, owned, combined, used, abused and reproduced.

Neoclassical economics, of course, mentions these matters in introductory chapters of economic textbooks, but strips them of their real significance by transforming them into “factors” of production which can be manipulated in any way you wish according to the logic of the corresponding markets.

Apart from a mechanical kind of demography that allows population projections from which to derive the supply of labour, labour becomes a disembodied commodity without relation to the man or woman who performs it, to the family to which they belong, to the social class of which they form a part, an in short to the society and culture that determines skills, habits, values, stratification and aspirations. This exercise in abstracting labour from its socio-cultural environment and making it responsive solely to changes in wages, furthermore prevents any meaningful co-operation between conventional economics and the other social sciences —sociology, psychology, anthropology— which presumably have something to say about performance, creativity, co-operation, motivation,

union activism, and so on, and which, in fact, play a major role in the training of managers in schools of business administration —economists notwithstanding.

Moreover, producers and their families are, of course, also consumers, another disembodied category of neoclassical economics. The degree to which the nature of the labourer's place in the process of production determines his pattern of consumption is glaringly obvious to the most superficial of observations: working-class, middle-class and upper-class areas in any city display consumption patterns with respect to housing, health, education, entertainment, food, clothing and transportation that are worlds apart and that have much to do with what one does for a living. Not to mention marginal and slum areas where there is little labour to speak of, or conditions prevailing in the rural areas —not the ones used for upper-class recreation purposes, but where actual agricultural production takes place.

Labour is also disembodied from institutions: the State, the firm, the judiciary, the union, the school, the mass media, the party, and the corresponding rules of the game and bureaucracies. Presumably ownership, control, information, knowledge, power —the stuff of political economy— also have something to do with labour, work and consumption, but again neoclassical economics refuses to have anything to do with such disturbing and confusing matters.

If we move from human resources to natural resources, the process of disembodiment takes the form of stripping down the environment to square acres of land. There might be some reference to different qualities and diminishing returns of land to show that David Ricardo has not been totally forgotten. But any notion that natural resources are dynamically imbedded in ecosystems, that soils, flora, fauna, water, weather, forests, topography and human activity interact in multiple and complex ways, with generally deplorable consequences for land and also people in the longer run, is certainly not to be found in conventional economics textbooks. The

devastation caused in rural (and urban) areas the world over might have been averted to some extent if economics had also opened a door to the hard sciences —physics, chemistry, biology and hydrology— rather than closing it with the parametric nails of the technical coefficients of the production function, and abstracting furthermore from the material, spatial, locational, physical and environmental base of all social processes.

Last but not least, there is capital. In recent work on environment and development we have assimilated accumulated capital to the built-up and artificialized environment: the final product, over time, of the progressive transformation of nature through labour, knowledge, technology and social organization (Sunkel 1980, 1987).

The accumulation of capital, in this sense, is therefore at the centre of the process of economic development, since it incorporates technological innovation, brings about specialization and productivity increases, and allows for additional investment and further expansion of the capital base of society. An artificial environment is thereby built-up which sustains progressively increasing levels of living and productivity, although at the risk of undermining this environment through the abuse of its life-supporting ecosystems.

By focusing explicitly in this way on stocks, their dynamics, the relations among them, the ways in which they generate flows, and the feedback of flows on stocks, structuralists and institutionalists have further common ground to support a joint intellectual effort aimed at a better understanding of economic development and of the strategies and policies that might bring it about and contribute especially to the improvement of the living conditions of the poor.

I sincerely hope that this suggestions, as well as the previous explorations of the common ground and disparities among structuralists and institutionalists, will help in building bridges between our two schools of thought.

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The editorial board of the Review are always interested in encouraging the publication of articles which analyse the economic and social development of Latin America and the Caribbean. With this in mind, and in order to facilitate the presentation, consideration and publication of papers, they have prepared the following information and suggestions to serve as a guide to future contributors.

— The submission of an article assumes an undertaking by the author not to submit it simultaneously to other periodical publications.

— Papers should be submitted in Spanish, Portuguese or English. They will be translated into the appropriate language by ECLAC.

— Papers should not be longer than 33 double-spaced letter-size pages (U.S. quarto), but shorter articles will also be considered. The original and one copy should be submitted, as should the diskettes, if any (in IBM or compatible WordPerfect format).

— All contributions should be accompanied by a note clearly indicating the title of the paper, the name of the author, the institution he belongs to, and his address. Authors are also requested to send in a short summary of the article (no more than 250 words) giving a brief description of its subject matter and main conclusions.

— Footnotes should be kept to the minimum, while bibliographical references and direct quotations should be carefully checked, since they are the responsibility of the author. It is also recommended that the number of tables and figures should be reduced to the minimum and that they should not duplicate information given in the text.

— Special attention should be paid to the bibliography. All the necessary information must be correctly stated in each case (name of the author or authors, complete title (including any subtitle), publisher, city, month and year of publication and, in the case of a series, the title and corresponding volume number or part, etc.).

— The editorial board of the Review reserve the right to make any necessary revision or editorial changes required by the articles.

— Authors will receive a courtesy copy of the Review in which their article appears, plus 30 offprints of the article, both in Spanish and in English, at the time of publication in each language.



## Raúl Prebisch Prize for Economics

The shortcomings of the form of development achieved by the countries of Latin America and the Caribbean have become glaringly evident during the present decade. Today, after almost 40 years of development efforts, these countries have seen their growth processes and social progress stifled by internal and external factors which call for new interpretations, both in the realm of theory and in the field of economic policy.

In the light of these realities and based on the belief that greater strides are made in the domain of theory when due attention and encouragement is forthcoming, the Association of Economists of Latin America and the Caribbean (AEALC) has established the Raúl Prebisch Prize for Economics in order to make a genuine contribution to the search for solutions in keeping with the interests of our peoples.

There could be no better name than that of Raúl Prebisch to stimulate the efforts of theorists in pursuit of the economic development of the Latin American and Caribbean peoples. His work, in both the theoretical and practical domains, was unfailingly directed towards this objective, and he remained true to it even in his final writings, which attest to the flexibility and brilliance of his powers of analysis and his dedication to this goal. The prize that bears his name is intended to honour this precursor of today's economists and to inspire those who have embarked upon the difficult task of economic analysis and projection as they strive to uncover the defects of the Latin American economy and to search out new paths.

- The first Raúl Prebisch Prize for Economics will be awarded in April 1990 and will take two forms:
1. An award for an unpublished writing on economics by a Latin American or Caribbean author which makes a contribution to the analysis of the economic and social realities of the Latin American and Caribbean countries and/or to the solution of theoretical or practical problems affecting the countries of the region. This award of the Raúl Prebisch Prize for Economics will be made annually and will include US\$3 000 and the publication of the work in question.
  2. An award granted to Latin American, Caribbean or other economists or institutions for their work as a whole in recognition of its breadth and depth, its unquestionable stature and its significance for Latin America and the Caribbean. This award of the Special Raúl Prebisch Prize for Economics will be accompanied by a certificate and a plaque.

### RULES

1. Economists or institutions of Latin America and the Caribbean or of any other part of the world whose work has made a contribution to knowledge concerning the region and to its economic and social development are eligible for the prize.
2. The prize shall be awarded every three years and shall be attested to by a certificate and a plaque.
3. Each nomination of an economist or institution must be accompanied by a description of his or its work and of the work's content and economic significance for Latin America and the Caribbean.
4. Candidates may be nominated by:
  - Organizations of economists of AEALC member countries,
  - Regional bodies directly concerned with the economic problems of Latin America and the Caribbean,
  - Academic and research institutions,
  - Economists and other persons of recognized international stature.
5. Nominations must be submitted before 31 December 1989 to: member associations, Embassies of the Republic of Cuba, or the AEALC office at Calle 22 y Ave. 9na., Municipio Playa, Ciudad de La Habana, Cuba (Telex: 511804 ANEC-CU).
6. The prize will be awarded by an international jury formed by renowned Latin American and Caribbean economists selected by AEALC.
7. The jury will hold its deliberations in Havana in April 1990.

## Recent ECLAC publications

**Desarrollo agrícola y participación campesina (Agricultural development and peasant participation)** (LC/G.1551-P), Santiago, Chile, December 1988 (404 pp.).

In 1987 the Joint ECLAC/FAO Agriculture Division embarked on a project concerned with rural agriculture development strategies involving peasant participation. The main objective of this project was to compile, with the help of qualified experts from the countries, a number of different elements relating to the formulation of coherent strategies for dealing with the problems and needs of the rural population and particularly of small-scale peasant producers.

Farm policies purportedly intended to serve all agents of production, whether they be large landowners, entrepreneurs or peasant farmers, have actually provided support almost solely to medium- and large-scale agricultural enterprises because of their emphasis on capital formation, technological modernization and market shares. The policy tools used by the State, public investment, subsidies and credit have a coverage of no more than 25% of the sector's production units and typically reach those controlling a substantial amount of land and capital. The result is that the peasantry continues to work and produce with only very limited collaboration from public institutions. Those rural development projects that have been undertaken by governments in the region (most of which have been financed with external resources) are small-scale efforts mainly concerned with improving infrastructure or particular economic and social circumstances, and have failed to change the overall conditions under which peasants lead their lives. What progress has been made has consisted of piecemeal advances in such areas as the improvement of local infrastructure, the extension of some public services, the achievement of technological changes, or productive investment, but there is no indication of any change in the terms under which the peasantry participates in society, the economic system or political institutions.

This publication sets forth a number of proposals concerning important strategy and policy considerations which have been formulated on the basis of an overall perspective by experts in the field. It also describes some positive experiences with peasant participation which public or private bodies have had in connection with various subject areas.

The central thesis of this study is the conviction that peasant agriculture makes an important and dynamic contribution to society and the economy and, above all, that the development of this broad social stratum is indeed possible, provided that peasants are given greater opportunities for political and economic participation.

Peasant agriculture can make progress in terms of know-how, technologies, control over its resources, investment, employment, income levels and the quality of life. In short, this sector is capable of carrying forward its own development and modernization if a genuine change is brought about in the terms under which it participates in the social system. This is the thread running throughout the essays contained in this publication.

**Bibliografía (Bibliography)** (LC/G.1548-P), Santiago, Chile, January 1989 (654 pp.).

This volume is a compilation and classification of the publications of the ECLAC system from 1948 to 1987. The headings under which the documents have been classified are as follows: 1) International co-operation, international relations; 2) Economic policy, social policy, planning; 3) Economic conditions, economic research, economic systems; 4) Institutional framework; 5) Culture, society; 6) Education, training; 7) Agriculture; 8) Industry (includes energy); 9) Trade; 10) Transport; 11) Public finance, banking, monetary relations; 12) Management, productivity (includes technology); 13) Labour; 14) Demography, population; 15) Biology, food, health; 16) Environment, natural resources; 17) Earth sciences, space sciences; 18) Science, research, methodology; and 19) Information, documentation.

The bibliography includes subject matter, geographical, author, and title indexes.

**Políticas macroeconómicas y brecha externa: América Latina en los años ochenta (Macroeconomic policies and the external gap: Latin America in the 1980s)** (LC/G.1532-P), Santiago, Chile, March 1989 (201 pp.).

Due to the internal and external impacts to which they have been exposed, the Latin American economies have been obliged to carry out what in some cases have been violent and large-scale adjustments. This has particularly been the case in recent years as the countries have found themselves confronted with the oil crisis, a mounting external debt, rising nominal and real international interest rates, and a deterioration of their terms of trade.

The various economic policy approaches adopted in order to cope with the resulting imbalances provide an opportunity to explore the strengths and weaknesses of each such approach on a systematic basis. Clearly, the lessons to be learned from this type of analysis can be usefully applied to economic policy-making. Accordingly, ECLAC carried out a project under which some countries' experiences with such adjustments were examined within the context of specific case studies using analytical approaches that had been selected with a view to reaching conclusions of use to economic policy-makers.

Essays by various authors on the following topics are included in the publication: a) External constraints and adjustment, options and policies in Latin America; b) A survey of theoretical approaches to the question of external adjustment and their relevance to Latin America; c) External impacts, devaluations and raw material prices; d) Adjustment and interdependence in Latin America; and f) The external position of Brazil and stabilization policies in the 1980s.

**Planificación y gestión del desarrollo en áreas de expansión de la frontera agropecuaria en América Latina** (Development planning and management in agricultural frontier areas) (LC/G.1542-P), Santiago, Chile, March 1989 (113 pp.).

A number of projects already completed by ECLAC through the Joint ECLAC/UNEP Development and Environment Unit have highlighted the need to translate theoretical postulates concerning the extension of the agricultural frontier into practical, operational terms. These projects have also focused on the need to make new methodologies and operational tools available to settlement programme directors and decision-makers and to those responsible for planning or executing global, regional and/or sectoral agricultural programmes in areas where such expansion is an important factor. Thus, in order to make further progress in this regard it became necessary to undertake another project; this was done in mid-1985, and the above publication is one of its results.

For the purposes of this project, a questionnaire was prepared containing questions on 36 topics selected from earlier studies. The questionnaire had a dual focus: ecology and agriculture in terms of the ways in which it transforms the ecosystem, and socioeconomics and demography. Insofar as was practicable, these two dimensions were brought together and interconnected. The responses referred to general concepts, specific regions within countries, selected cases or a combination of the above. The compilation of these responses provides a survey of the present status of knowledge about the various topics covered in this publication.

**Towards sustained development in Latin America and the Caribbean: Restrictions and requisites** (LC/G.1540-P), *Cuadernos de la CEPAL* series, No. 61, Santiago, Chile, May 1989 (93 pp.).

Since the beginning of the 1980s the countries of Latin America and the Caribbean have been faced with a series of circumstances which, against the background of an extraordinarily long-lived economic crisis, have restricted their possibilities of attaining sustained economic growth. For its part, the Secretariat has taken the position that it is neither realistic nor advisable to look outside the region for a solution to this crisis. Notwithstanding the adverse conditions confronting them, the countries of the region cannot resign themselves to the perpetuation of this situation but must instead tackle, mainly through their own efforts, the many obstacles standing in the way of their recovery and development.

However, in the face of the persistent and simultaneous phenomena of depressed prices for the region's basic commodities, a heavy debt servicing burden, and reduced levels of fresh external financing—all of which are reflected in the outward transfer of financial resources being made by many of the countries of the region—the extent of the countries' autonomy in the formulation and implementation of economic policies, while capable of expansion through intra-regional

co-operation efforts, is nevertheless extremely limited. An even more serious problem is the fact that this situation poses new and difficult dilemmas, since the principal means by which the countries of the region can bring about a qualitative change in their position within the world economy and achieve equitable development based on the dynamic satisfaction of basic needs—i.e., the diversification and modernization of their production capacity—will ultimately require fresh investment, whose financing is limited by the external constraints referred to above.

Consequently, the main focus of this paper is on possible ways in which national and regional efforts as well as multilateral co-operation can be brought to bear on the series of constraints which are reflected in the region's outward transfer of resources. In so doing, it provides a different perspective on the broad range of options for surmounting the crisis in the short term and for once again taking up the challenges of development in the medium and long terms.

In this regard, the paper presents three main conclusions. The first is that the servicing of the external debt, while not the only obstacle to development in the region, has become the greatest impediment to the achievement of an expansionary adjustment and lasting stability, which are essential conditions for overcoming the serious problems affecting the majority of the region's economies during the 1980s. The second conclusion is that, while it is indeed necessary to overcome this hurdle, this in itself will not be enough to put the countries back on the road to development; a series of other changes will also have to be made. The general features of these changes are then briefly outlined on the basis of previous studies. The third and final conclusion is that a judicious combination of short-term economic policies and medium- and long-term changes will be required in order to resolve the crisis and that, in order for such a combination to be attained, the management of macroeconomic balances and the planning of public action will have to be more closely co-ordinated.

**La gestión de los recursos hídricos en América Latina y el Caribe** (Water resource management in Latin America and the Caribbean) (LC/G.1523-P), *Estudios e informes de la CEPAL* series, No. 71, Santiago, Chile, April 1989 (256 pp.).

This publication presents the findings of a number of case studies as part of a general analysis of water resource management in Latin America and the Caribbean. It begins with a review of the history of the institutions responsible for the management of this resource, together with a discussion of the origins of the different institutional systems which have been used at various times in the countries of the region. In addition, a brief description is given of the way in which the theory and principles of water management have evolved and how they have influenced the policies on water resource management adopted by the governments of the region. The connections between the theoretical developments in this field and the general course of events as regards State participation in the region's economies are also discussed.

The information which these case studies provide in respect of the characteristics of contemporary water management in Latin America and the Caribbean is then evaluated in detail on the basis of a comparative analysis of their findings, especially as regards the following aspects of water management:

—The types of arrangements used for the management of water systems;

—The management strategies used to ensure that such water systems will play a proper role within the broader process of regional and national economic development and that due consideration will be given to the effects of operational decisions on the natural resources associated with water systems;

—The adoption of improved methods for the management of water systems.

Finally, general conclusions are drawn concerning the current status of water resource management and possible means of improving it. Special attention is devoted to the potential role of international co-operation in raising the quality of such management and thereby increasing the efficiency of water system operations.

**El medio ambiente como factor de desarrollo** (The environment as a factor in development) (LC/G.1549-P), *Estudios e informes de la CEPAL* series, No. 75, Santiago, Chile, February 1989 (123 pp.).

This publication is a synthesis of the prefeasibility studies carried out as part of the ECLAC/UNEP Project on Technical Co-operation for the Integration of Environmental Considerations into Development Projects and Programmes in Latin America and the Caribbean.

For the purposes of this project, "prefeasibility study" was defined as the preliminary analysis of the economic and

technical viability of a proposed project. Such an analysis involves comparing the various contributions to be made by different elements and recommending the most suitable option in each case, as well as estimating development and operation costs and the benefits to be obtained.

Due to the varied nature of the studies and the differing amount and type of information available in each case, however, this definition was not strictly applied. Some of the studies were closer to what is usually understood by the term "project idea", whereas others approached what might be more properly regarded as a feasibility study.

Despite these differences, all the prefeasibility studies fulfilled their main objective: to call attention to new projects which, generally speaking, do not call for an intensive use of scarce resources (capital goods and foreign exchange) and are aimed at reactivating the economy of the region or area in question as a means of improving the people's living standards by creating jobs, raising incomes and bringing about a sustainable transformation of the environment.

The following studies are covered in this publication: a) National programme for the conservation of infrastructure: prefeasibility study for Zone 8 (Salta and Jujuy provinces, Argentina); b) Development of the agricultural frontier in Colombia: the decline of the Tame-Hato Corozal area; c) Utilization of marginal natural resources in the Magallanes region of Chile: burned-over forests and peat bogs; d) Environmental studies for hydrocarbon projects in Ecuador: the Shushufindi-Aguarico oil fields of the Trans-Ecuadorian Oil Pipeline system; e) Integrated rural development of the southern region of Honduras: agro-forestry production component providing for the use of soil, water and forest reclamation and conservation practices; and f) Rehabilitation of agricultural terraces and production innovations in Andean environments in Peru.

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*CEPAL Review* first appeared in 1976 as part of the Publications Programme of the Economic Commission for Latin America and the Caribbean, its aim being to make a contribution to the study of the economic and social development problems of the region. The views expressed in signed articles, including those by Secretariat staff members, are those of the authors and therefore do not necessarily reflect the point of view of the Organization.

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