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## ECONOMIC DEVELOPMENT OR MONETARY STABILITY: THE FALSE DILEMMA

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### I. INTRODUCTION AND SUMMARY

#### 1. INFLATION AND MONETARY ORTHODOXY

The economists of ECLA are often thought of as having a certain leaning towards inflation, as being prompted by the belief that this phenomenon is inevitable in the economic development of Latin America. Nothing could be further from our thoughts. This erroneous interpretation arises perhaps partly from the fact that the problem of inflation has not yet been systematically dealt with in our studies. An attempt to do so is now being made and, pending its conclusion, I have thought it convenient to avail myself of the opportunity offered by the Sixth Meeting of the Central Banks<sup>1</sup> to present a few ideas arising from my own observations and from our extensive discussions on this subject within our organization. They are my personal opinions and do not necessarily reflect the views of my colleagues. Happily there is no monolithic thinking in ECLA, either in this or in any other aspect of our intellectual activities.

Two facts largely explain why our thinking is wrongly judged. We reject the theory, which is so current, that inflation is caused solely by the financial disorder and lack of monetary restraint of the Latin American countries, not because we deny the existence of these patent aberrations but because there are extremely powerful structural factors in Latin America which lead to inflation and against which monetary policy is powerless. This is the first fact.

The second is the critical position we have adopted towards certain measures aimed at monetary stabilization. We all agree that a supreme effort must be made to arrest inflation and to achieve stability on sound bases. But we are seriously worried about achieving this at the expense of a decline in over-all income, of its stagnation or of a slowing-down in its rate of development.

<sup>1</sup> The present article was the subject of a very partial and incomplete oral statement made at the aforementioned meeting, held in Guatemala in 1960, to which I was kindly invited by the authorities of its Central Bank. It is offered here in a considerably amplified version in which some of the obvious gaps in the original presentation have been filled.

Those who profess this type of anti-inflationary policy — both those who suggest it from outside and those who live in the midst of this harsh and hazardous reality of Latin America — sometimes entertain the esoteric notion that sin can be redeemed by sacrifice. The evil of inflation must be atoned for by retrenchment. But very often the conventional punishment is not visited upon those who unleashed inflation or who thrived on it, but on the broad masses of the people who were suffering its consequences.

The general mistake persists of considering inflation as a purely monetary phenomenon to be combated as such. Inflation cannot be explained as something divorced from the economic and social maladjustments and stresses to which the economic development of our countries gives rise. Nor can serious thought be given to an autonomous anti-inflationary policy, as if only monetary considerations were involved; it must be an integral part of development policy.

Economic development calls for constant changes in the form of production, in the economic and social structure and in patterns of income distribution. Failure to make these changes in time or to undertake them partially and incompletely leads to these maladjustments and stresses which release the ever-latent and extremely powerful inflationary forces in the Latin American economy.

This should not be construed as meaning that inflation is inevitable in our countries. Far from it. To avoid inflation, however, there must be a rational and far-sighted policy of economic development and social betterment, in other words, an essentially new approach in which an answer other than inflation is sought to these maladjustments and stresses arising from development.

This is not a merely technical problem; it is essentially a political one in which the paramount task for us economists is to clarify and to persuade. We have often seen politicians who, imbued with the genuine desire to improve the measurable well-being of the masses, frequently succumb to the corrosive illusion of inflation. Have we offered them any other alternative? Have we come to them with a coherent and feasible set of principles which would have enabled them to escape from the dilemma of choosing

between inflation and an over-simplified and perplexing monetary orthodoxy? We Latin American economists are indebted to the politicians of our countries. I should like, by the present contribution, to requite them as far as it befits me to, do so.

The object of these pages is to demonstrate that there is a solution to the problem of monetary stabilization that is different from the one so often recommended by the orthodox school. Before going into this any further, however, the structural factors usually leading to inflation should be examined. Perhaps a general picture should be presented here which will allow us, from the very outset, to grasp the nature and trend of our argument, even at the risk of indulging later in possible repetitions.

## 2. THE WHY AND WHEREFORE OF THE DILEMMA

It is common knowledge that the economic development of a peripheral country is very closely linked to the course that its exports follow. On the one hand, the rate of growth of its exports sets a limit to spontaneous economic development. On the other hand, continuous fluctuation in this rate contribute to serious internal instability. When there is a cyclic increase in exports, income in the aggregate expands with relative ease, and this calls for a volume of imports easily paid for by exports. But when exports fall off, these imports cannot be maintained and, as a result, neither can the level of income formerly attained. Under an orthodox system of monetary stability, the external and internal disequilibrium thus produced necessarily leads to a contraction of economic activity, and the balance tends to be restored at a lower income level.

This contraction usually arouses the ever-latent inflationary forces lurking within the Latin American economy, that is, if they are not already at work. Recourse is then had to the expansion of credit and this, while counteracting the downward trend of income, also impedes the readjustment of imports and, consequently, restoration of the internal balance.

Disequilibrium is one of the factors which renders it very difficult for our countries to apply an anti-cyclic policy that does not compromise monetary stability. Hence, the solution does not lie in counteracting the effects of contraction but in *preventing them* by means of effective structural changes. The purpose of these changes is twofold: to allow the rate of development to exceed the limit imposed by exports; and, at the same time, to keep internal activity operating at the highest level of employment without being affected by export fluctuations.

Structural rather than cyclic measures should be resorted to in order to overcome the external vulnerability of our economies, although some anti-cyclic measures are also helpful as a complement to the structural solutions.

Another — and perhaps the most significant — factor hampering an anticyclic policy is the inadequacy of savings, which becomes more acute when exports decline. Any attempt then made to maintain the level of investment previously achieved is usually one of the chief causes of the inflationary expansion of credit.

The savings coefficient is relatively low in our countries, not only because average *per capita* income is also low but, in addition, because of the form in which this income is distributed and the prevailing patterns of consumption. An increase in this coefficient calls for work on distribution and consumption — in other words, on the social structure — and, at the same time, for a change in the structure

of production and imports so that the increased savings can be converted into capital goods. In order to do this and to facilitate a rise in the savings coefficient to a level which would accelerate the rate of economic development an additional contribution in the form of international funds is usually needed.

Resistance to these structural changes, which are essential to a rise in the savings coefficient, often leads to inflation in our countries. Inflation not only makes possible to raise the level of public and private expenditure and investment but, by swelling the profits of entrepreneurs and, through them, of other high-income groups, also causes them to increase their consumption, generally on a much higher scale than that of investments. It is therefore a socially costly and regressive method of raising the savings coefficient.

Since the inadequacy of savings becomes more acute during the period of contraction, it is extremely difficult if not impossible, for monetary leaders to oppose an expansion of credit to cover expenditure and investment which tend to shrink. It could not be concluded, however, that this type of inflation of expenditure and investment — different from inflation of costs — is attributable solely to the structural vulnerability of the economy. The effects of inflationary forces are usually also felt in periods of prosperity, when increased economic activity stimulates expenditure and creates new investment opportunities.

These forces tend to burst forth whenever a market change takes place. When the change is favourable however, inflationary expansion cannot be attributed to the vulnerability of the economy — as it can when the change is unfavourable — but to the weakness of the central banks to arrest these inflationary forces; indeed they may well be operating within the banks themselves.

It is therefore an expression of the aforementioned lack of financial and monetary restraint which, while it may not explain our inflationary phenomena in all their great complexity, is nevertheless a very important element thereof.

The simple orthodox formula of credit containment — perfectly correct when rising exports stimulate domestic activity — completely ignores the phenomena of structural vulnerability and, once the decline sets in, irremediably exposes the economy to the inflationary forces.

All this relates to the inflation of expenditure and investments, where the inflationary pressure of demand first causes prices to rise and then brings about an increase in wages and salaries in order — very rightly — to restore the real income of the workers. This is the traditional type of inflation in our countries, although there are new aspects to structural vulnerability.

However, inflationary phenomena of another type emerge as the process of development continues. Either because of the form in which the structural changes required by development are carried out, or because they are undertaken only partially or inadequately, regressive movements come into operation in income distribution. Efforts to compensate for their effects lead to higher wages and salaries and their inevitable impact on prices.

There are three main elements in these regressive movements which derive from economic development itself: the cost of import substitution; the higher cost of agricultural products; and the rise in taxes and duties which affect mass consumption in one way or another.

Import substitution policy, while reflecting an inevitable

structural change, has been carried out with very serious flaws. Very often considerations of economic feasibility have not been given their due, and it was not until recently that an attempt was made to break the confining bonds of national markets by means of the gradual economic integration of our countries. First and foremost, this policy has been applied in a discriminatory way, without promoting a corresponding expansion in exports, and thus it has been carried farther than it might have been under other circumstances.

The cost of substitution has thus been exaggerated to the detriment of mass consumption, particularly when the increase in productivity has been small in the rest of the economy.

This is particularly true of the productivity of the land and it constitutes one of the chief obstacles to economic development. Antiquated systems of land tenure have contributed to the relative rise in the cost of food in some Latin American countries as demand increased with population growth.

If to this is added the greater cost of some elements or inputs of agricultural production as a result of substitution policy and agricultural wage increases arising from higher productivity in other branches of the economy, an answer may be found to the question why in some countries costs and prices relative to agricultural production have risen with a marked effect on mass consumption.

To raise wages and salaries is a very understandable reaction. However, it fails to solve the problem either in the present or in the previous case; it is merely reflected in the aforementioned inflationary spiral. Nor does the solution lie in the policy of credit containment; if central banks do not increase the amount of currency in circulation when salaries and wages rise, they cause a contraction in economic activity. Hence, the contraction may be due not only to the external vulnerability of the economy but also to the endeavour to use monetary instruments to ideal with the consequences of its structural flaws.

In the case of an inflation of expenditure and investments, and not of costs, the inflationary rise in prices likewise involves a corresponding readjustment of salaries and wages. Unlike the previous case, however, this increase is not inflationary but is the corrective of an

inflationary phenomenon. Nevertheless, what happens very often is that the entrepreneurs, instead of absorbing it at the expense of their inflation-swollen profits, resort to credit expansion and transfer it to prices, thus generating the inflationary spiral.

Inflation is asymmetrical in so far as its distributive effects are concerned. It is used by entrepreneurs to modify distribution to their advantage and to the detriment chiefly of the workers. Yet it does not help the latter to achieve the opposite effect but, at best, to restore their earlier share, if the credit system is handled fairly and firmly.

Hence, inflation is not an effective means of redistributing income from the point of view of the broad masses. In those cases where positive results are achieved at the expense of social groups other than the entrepreneurs, there is no doubt that taxation, if judiciously applied, is a more efficacious and less disruptive method. In fact, taxation is the income redistribution instrument *par excellence*, and the Latin American masses must learn to wield their growing political power so that it can be used for economic and social purposes. Likewise they must learn to wield their trade union power — already very substantial in some countries — to effect sizable increases in productivity and thus raise their real income, instead of wasting their energy on securing salary and wage increases which are soon cancelled out by the inflationary spiral. What is needed, therefore, is a salary and wage policy which leads to this goal and at the same time ensures the growing participation of the broad masses in the process of national capital formation.

All these considerations allow us to approach the problem of inflation in our countries in all its vast complexity. In actual fact, it merges with the problem of development. There is inflation because the economy is structurally vulnerable, because there are regressive income distribution factors, because there are not enough savings to expedite investment within a given economic and social structure. The resulting maladjustments and tensions encourage latent inflationary forces to burst forth. By means of regular and intensive economic development the maximum resistance can be offered to these inflationary forces and the policy of monetary stability can thus be upheld on sound bases — which do not exist today — as an integral part of economic development policy.

## II. STRUCTURAL VULNERABILITY OF THE ECONOMY AND INFLATIONARY FORCES

### 1. GROWTH AND VULNERABILITY

#### (a) *Structural character of the solution*

This section attempts to explain how the growth of income at a more rapid rate than exports permit, and continual fluctuation of exports, release inflationary forces that upset monetary stability in Latin American countries.

The solution of this problem is fundamental because it calls for structural changes that will allow the economy to grow beyond the limit imposed by exports, while at the same time giving it the strength it must have to prevent, rather than correct, the internal consequences of these export fluctuations.

In the absence of such structural changes there will inevitably arise the dilemma of choosing between a policy of monetary stability that subordinates economic development to the tempo and fluctuation of exports, on the one

hand, and an attempt to counterbalance the effects of these factors through inflation on the other. In our countries, a corrective policy of a compensatory nature is difficult to apply for reasons that will be explained in due course.

I shall begin by explaining the nature of the structural phenomenon, summarizing briefly what we have been expounding for some time in ECLA.

#### (b) *Exports as a factor limiting growth*

The growth of exports places an upper limit on the rate of development in a peripheral country. This limit is set by the intensity with which the demand for imports expands with the growth of *per capita* income. A simple example will serve to illustrate this point. Let us suppose that primary exports grow at an annual rate of 2 per cent *per capita*. *Per capita* income can rise at the same

rate only if the demand for imports also increases at 2 per cent, that is, if the income elasticity is 1. But if imports expand at a higher rate, it will not be possible for *per capita* income to rise spontaneously at the same rate as exports. If imports tend to expand by 1.50 for each 1 per cent of increase in *per capita* income, the latter cannot rise by as much as 2 per cent, since in that case the demand for imports would go up by 3 per cent, thus exceeding the rate of 2 per cent at which exports increase. Obviously an external imbalance of this kind could not continue for long.<sup>2</sup> If development is to be accompanied by external balance, the annual growth of *per capita* income must not exceed 1.33 since this rate, given the income elasticity of demand for imports, will result in a growth of 2 per cent in imports, that is, the same rate as for exports.

Consequently, if *per capita* income is to rise more rapidly, import substitution is essential. In the example given above, an annual *per capita* import substitution rate of 1 per cent is required if income is to grow by 2 per cent. A 3-per cent rise in income would require an expansion of 4.5 per cent in import demand, of which 2.5 per cent would have to be met from domestic production in order to maintain this rate of growth in conjunction with dynamic equilibrium.

The rate of growth of exports in Latin American countries has in fact generally been much lower than that in the above illustration, and in some cases exports have declined instead of grown. Hence the great proportions which the substitution process has had to assume.

This disparity in the trends of external trade is a consequence of the well-known fact that, as *per capita* income grows, the demand for industrial goods tends to expand more rapidly than the demand for primary commodities. Peripheral countries import the former and export the latter, whereas the position of the major industrial countries is exactly the reverse. In the industrial countries, import substitution can in no way be justified on the grounds of growth; if it takes place for other reasons, income-elasticity of demand for primary commodities tends to become weaker still, with the result that the peripheral countries which export those commodities have to intensify their substitution policy in order to maintain the same rate of income growth.

It follows from the above arguments that, even with the same population increase, a peripheral country cannot attain the same rate of spontaneous growth as the industrial centres with which it trades, because of differences of elasticity, which are generally rendered even greater by the protectionist policies applied by these centres. Hence import substitution (and the development of industrial exports to the centres) is a *sine qua non* for rectifying these differences. Since the peripheral countries of Latin America have a much more rapid population growth than the industrial centres, the process has to be proportionately more vigorous.

The substitution process has to be steadily maintained so long as income continues to grow more than exports, even when the coefficient of elasticity of demand for imports is not constant, as was assumed for the sake of simplification in the illustrative example. This depends on the rate of growth of *per capita* income, on the changes

in import demand arising from technical developments and consumer preferences, on changes in the composition of imports caused by substitution policy, and on the cost of the substitutions.

### (c) *Improvisation of substitution policy*

If there were in practice a regular and constant increase in exports, it would be comparatively easy to determine the extent of the substitution effort required annually. Unfortunately this is not so, since exports are subject to a continuous undulating movement which makes the systematic application of this policy difficult.

When exports increase comparatively rapidly during the favourable phase of this cyclical movement, the domestic economy can obtain all the imports required for its development and there is no apparent need for substitution. All is well so long as exports continue to rise or are maintained at a high level and provided that a prudent monetary policy has been pursued. This latter aspect will be dealt with below. But as soon as exports fall off, the country finds that its income in the aggregate has grown to such an extent that the volume of imports required is higher than what can be paid for by its declining exports. An import substitution policy therefore has to be improvised. It is generally applied not as a prudent measure that anticipates the demands of development, but as a step imposed by critical circumstances when external disequilibrium has already occurred.

The frequent result of this has been that considerations of economic feasibility and of anti-cyclic flexibility are left out of account. Moreover, the inescapable need to protect substitution activities, and the various extreme forms which such protection usually assumes, create conditions unfavourable to export development, and thus increase the tendency to disequilibrium. All this points to the need for a review of substitution policy.

Above all, it is essential to adopt substitution measures in advance without waiting until external disequilibrium imposes them as an unavoidable necessity. It is precisely in the ascending phase, when savings are mounting and there are greater resources for importing capital goods, that special emphasis should be laid on substitution policy.

How can substitutions be planned in advance? How can the pressure of future events be forestalled? This is a problem to which the secretariat of ECLA has long been devoting attention, and it was with this in mind that the first attempts at analysis and projections of economic development were made. I believe that sufficient progress has been made to enable us to determine the requirements of an import substitution policy; consequently, I shall not dwell on this point, which is beyond the scope of the present article, despite its intrinsic interest.

### (d) *The economic feasibility of import substitution*

Much less progress has been made in elucidating the problem of the economic feasibility of substitution activities. Generally speaking, it has been tackled in the light of considerations of circumstance rather than on the basis of a selective criterion. When external disequilibrium arises, the reaction often is to restrict imports of finished consumer goods by measures which, albeit unintentionally, involve the promotion of substitution production, regardless of the type of goods concerned.

The laudable aim of thus facilitating imports essential

<sup>2</sup> In the interest of simplification a balance of payments consisting only of imports and exports is assumed; at this juncture it would be pointless to include other balance-of-payments components.



to economic activity at the expense of finished consumer goods has led to increasing rigidity in the composition of imports, with serious consequences for some countries. These consequences may also fall to the lot of other countries if a rational and far-sighted substitution policy is not followed.

What has happened is that the structure of imports has become so distorted that they are limited to raw materials, intermediate goods vital to the maintenance of economic activity and a few capital goods, together with essential items for direct consumption. As a result, any subsequent appreciable contraction in the capacity to import has a depressive effect on the economy because it becomes difficult to obtain these essential and urgently needed goods from abroad. It remains a paradox that industrialization, instead of helping greatly to soften the internal impact of external fluctuations, is bringing us to a new and unknown type of external vulnerability.

All this is of great importance not only for the proper functioning of monetary policy but also for economic development policy itself, and consequently it is essential to formulate a substitution policy whereby the requirements of economic feasibility and the aim of endowing the economy with the strongest possible structural resistance to external fluctuations are combined.

Reasons of economic feasibility should induce us again to create a situation in which it would be possible to import a wide range of finished consumer goods for which substitution production would be less economic than that of other goods whose manufacture would enable the reducible margin of imports to be restored in whole or in part, an essential condition of anticyclic flexibility.

#### (e) *Discrimination against exports*

Obviously the development of new exports, in addition to traditional lines, would help considerably to achieve this aim. This brings us to the other fundamental error: an asymmetrical development policy. The need for import substitution and for consequent protection of substitution activities has been unavoidable. But there has been a failure to boost exports to the same extent. There has been discrimination in favour of industrial substitution and against exports, mainly industrial exports. The ideal policy would have been to promote exports in order to place them on an equal footing again with substitution activities, which does not necessarily mean equal incentives.

This aspect is sufficiently important to merit examination; in a nutshell, it is the following. Limitation of external demand for primary exports makes it necessary to devote part of the *increase* in the factors of production to substitution activities. As their productivity is lower than in the industrial centres, they need to be given a certain subsidy in the form of tariff protection. Yet there would be possibilities of using a smaller subsidy to develop new industrial export activities, whereby a greater quantity of industrial goods could be obtained through trade than those that could be manufactured by substitution production.

By subsidizing substitution production rather than production intended for *new* exports (industrial or primary), export opportunities have been lost which, had they been properly used, would have reduced the scope of substitution policy or made more rapid economic growth possible.

This is admittedly a problem for which there is no simple practical solution, but it is unquestionably true that

the lack of subsidy policy, especially for new exports and, even more, the negative subsidy that monetary overvaluation sometimes constitutes, have caused the Latin American countries to miss export opportunities to the detriment of their economic development.

However, it should be recalled that some countries, conscious of this need to encourage exports, have resorted to multiple rates of exchange. It is open to question whether this is the best formula. At all events, multiple rates of exchange have been rejected by the school of monetary orthodoxy, without the application in their stead of any rational subsidy policy, which, it might be added, might come up against other forms of doctrinaire opposition. All these questions should be thoroughly debated, and it is to be hoped that, when countries review their policies of economic co-operation with Latin America, this subject will receive the attention it deserves.

I should now explain why I referred to new exports and not to exports already established. In this connexion, there is one thing that is self-evident: if external demand makes it possible to employ the whole of the increase in the active population and other factors of production on customary exports, it would be absurd to embark on substitution activities that would yield a lower net product. This is, in essence, the classic argument of an essentially static character.

However, it can happen that, by increasing exports beyond a certain point, prices fall both for the increment and for those that already existed, and the resultant net product is often lower than what could be obtained by substitution activities, and may even be negative. This is the basic argument in favour of protection in countries in the course of development, whose exports have a much lower income-elasticity of demand in the rest of the world than industrial imports have in the Latin American countries.

## 2. THE INTERNAL IMPACT OF EXTERNAL FLUCTUATIONS

### (a) *The internal cyclic rise*

In the preceding section it was explained how, when exports underwent a cyclic decline, the economy's overall income — as a result of its previous growth — required a volume of imports larger than exports permitted. Thus income would have to contract until the consequent reduction of imports restored the export-import balance. This is the requirement of an orthodox policy of monetary stability.

Thus, through successive expansions and contractions, the spontaneous growth of the internal economy follows the tempo imposed by exports, if no substitution policy has been followed. The country is then faced with the dilemma, referred to above, of choosing between monetary stability, which requires domestic activity to contract until over-all income has been reduced to a level consistent with exports, and inflationary credit expansion to counteract the contraction in the economy to the detriment of monetary stability. Before analysing this question, however, it is advisable to consider the course followed by the internal economy during this undulating movement of exports.

This movement is generally accompanied by a change in the terms of trade, which improve during the ascending phase and deteriorate when exports decline, with a consequent change in the profits and other returns from this branch of production. Thus there is heavier demand

for goods and services in internal activities and production increases, both because of a greater use of productive capacity and because that capacity is expanded by new investment.

Entrepreneurs in internal activities also get a higher return on these new investments, because of the fall in costs that accompanies the better utilization of capacity and because of the rise in domestic prices. The extent to which this occurs depends mainly on the form and methods adopted for limiting imports in order to protect domestic production. If this is done by customs duties that merely compensate for differences in productivity between domestic and foreign output, without providing any excessive margin of profit for the entrepreneur, the rise in domestic prices tends to be moderate, since foreign competition makes itself felt instantly. If, on the other hand, the protective margin is large, or if imports are limited by bans or direct restrictive measures, domestic prices may rise considerably, even without the stimulus of an inflationary credit expansion.

However this may be, the general rise in profits facilitates further investment, with a consequent increase in employment, although generally not at the expense of consumer activities. Employment shows an upward trend in both forms of activity, but more especially in investment activities, because of the growth of the active population. Public investment and expenditure also tend to increase, as a result of higher tax returns, especially when these are closely linked with foreign trade.

When the over-all income of the economy is thus expanded, there tends to be a stronger general upward movement in the growth rate of imports — that is, there is a cyclic increase in their coefficient — owing to changes in income distribution in favour of entrepreneurs and other social groups high on the income distribution scale.

In this ascending phase, easy credit and new opportunities for expenditure and investment stimulate the expansion of credit beyond the point required by the increment in business activity. This expansion tends to speed up utilization of the economy's idle capacity, and to broaden it, so that imports proceed at a brisker pace. In general terms, it can be stated that inflationary credit expansion tends to increase imports to a corresponding extent.

#### (b) *The cyclic decline*

A decline in exports and a deterioration in the terms of trade naturally lead to phenomena of an opposite kind. Firstly, over-all demand falls off as a result of contracting demand in the export sector; this, coupled with the decrease in revenue, discourages investment, thereby opening the way to reduced employment in export activities with further depressive effects on over-all employment, income and imports.

The State, of course, suffers from the same depressive effects as a result of falling tax revenue; and the endeavour to maintain the level of its expenditure and investments generally leads to a deficit with its inevitable inflationary effects. These effects tend to relieve the contraction of the economy and to give private investment further encouragement, and for this purpose recourse is usually also had to credit expansion which leads to further compensatory effects on over-all economic activity.

However, if the impact of a contraction in exports on over-all income is counteracted in this way, the decline in imports is prevented or attenuated, thereby intensifying

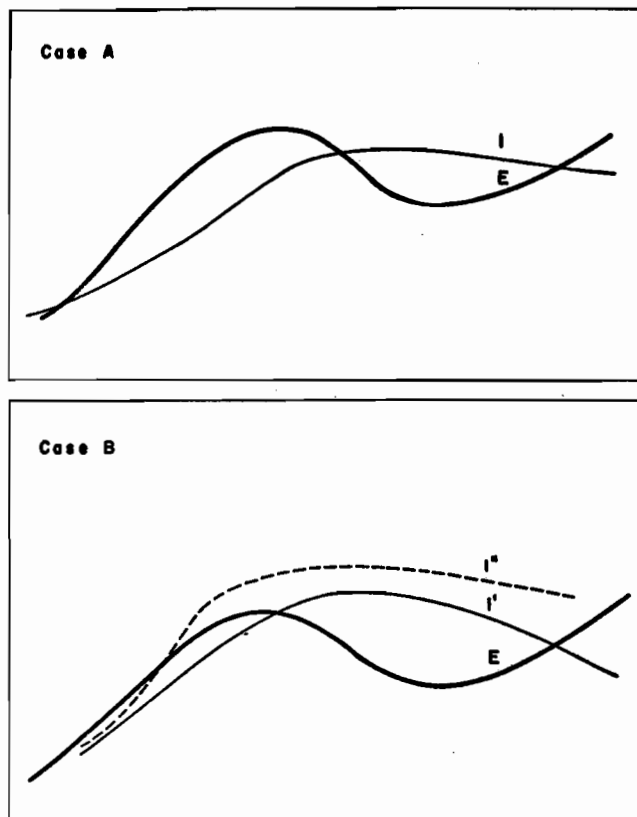
external disequilibrium. The continuation of such a policy makes monetary depreciation inevitable.

#### (c) *The import lag*

In order the better to understand the nature and magnitude of this external disequilibrium, attention must be given to the way in which a growth in exports entails an increase in imports as part of the undulating movement. This phenomenon could be explained in the following way (see the figure). Curve E represents exports and curve I imports. When there is no inflationary pressure, curve I always drops below curve E, but while, during the upward swing, this lag indicates a surplus of exports over imports and accordingly an accumulation of foreign currency, during the downward swing the exact opposite occurs, because the previously accumulated foreign currency reserves are used up. These reserves will not be completely exhausted if exports stop declining at a level higher than their starting point, which is customary in their growth process.

If inflationary pressure makes itself felt — i.e., if part of public or private investment is financed with bank credit instead of genuine savings — imports will tend to rise with greater rapidity ( $I'$ ) and approach or even exceed exports during the upward phase ( $I''$ ). At all events, inflationary investments — or inflationary expenditure covered by bank credit — by accentuating the growth of imports will tend to bring about external disequilibrium proportionate to the magnitude of such investments. For these reasons, monetary reserves tend to shrink more than they otherwise would; and if inflationary pressure is very strong, monetary reserves may not only lose all the ground they have gained but may even fall below their previous level. This phenomenon usually occurs

THE LAG OF IMPORTS IN THE EXPORT CYCLE



in an acute form during the downward swing when inflationary pressure originating in the previous phase, added to the pressure that continues to develop later, intensify the external disequilibrium characteristic of this phase of the cycle.

(d) *Compensatory effects of inflation*

The decline in exports is evidenced both by the inadequacy of internal demand and by excess demand for imports until the contraction in income re-establishes external equilibrium. Thus, if exports decrease by 1,000 and the import coefficient is 0.20 — we shall suppose it to be constant for purposes of simplification — the first impact of the reduction will be a fall of 800 in internal demand and of only 200 in imports, compared with the drop of 1,000 in exports.

The fall in internal demand will bring over-all income down with it until the latter is sufficiently low to bring about a decrease in imports to the same extent as exports. On the basis of the foregoing example, this will occur when over-all income falls to 5,000.

The credit expansion which usually occurs then is not always a spontaneous consequence of economic contraction, for it is sometimes the expression of an anti-cyclic policy. At all events, expansion tends to correct the inadequacy of demand. At the same time, however, it wards off a decline in imports and thus runs counter to the re-establishment of external equilibrium. In our example, an expansion of 1,000 will offset the fall in exports and the gap of 800 in internal demand. But imports will fail to decline and external disequilibrium will be equivalent to the amount of the drop in exports. Naturally, disequilibrium leads to monetary devaluation which, in its turn, tends to bring about external equilibrium by restricting imports and promoting exports.

But this policy of an inflationary nature has very serious defects, since its positive effects depend essentially on the regressive redistribution of income. In fact, devaluation leads to price rises — if this has not already occurred — with the resultant redistribution of income in favour of entrepreneurs and high-income groups in general.

Such income redistribution generates certain changes in the composition of demand: it reduces the demand of the broad masses and boosts that of the high-income groups. Apart from its social effects, this would have no adverse effect on the total volume of internal demand if the investment coefficients of demand of the broad masses and of the high-income groups were the same. But this does not happen in practice; the coefficient of the latter is usually higher.

Thus a new problem arises. An understanding of the import coefficient is essential to correct external disequilibrium. But, as the demand for imports of the high-income groups tends to remain at the same level or to rise, depending on the intensity of inflationary pressure, it necessarily makes itself felt on the rest of the imports. The very decrease in consumption suffered by the mass of the population has depressive effects on internal activity and thereby facilitates the regressive readjustment of imports.

As a result, the inflationary redistribution produces two opposite effects. By expanding investment, it tends to maintain internal economic activity at a level higher than is justified by exports. At the same time, however, the incentive that the relevant imports offer to the forces

favoured by the redistribution tends to limit the scope of this process.

It is therefore not strange that intensive credit inflation may be accompanied by inadequate use of productive capacity or may result in a slow rate of income growth, if no direct measures are taken to modify the composition of imports.

(e) *Possibilities of an anti-cyclic policy*

Inflationary expansion is far from being a satisfactory anti-cyclic instrument. Would it be possible to pursue a policy of expansion without inflationary consequences? Can a deficit fiscal policy possibly be used in our countries to counteract external contraction without inflation ensuing?

It should be remembered that, even if inflationary credit expansion counterbalances the inadequacy of internal demand, such expansion constitutes an obstacle to the re-establishment of external equilibrium by preventing a readjustment of imports. An apparently simple problem thus arises: to divert excess demand for imports towards internal demand to compensate in a non-inflationary way for the shortage resulting from the fall in exports. In practice, however, such an operation involves serious difficulties. Let us examine the chief of these.

For it to be possible to divert the surplus demand for imports, it is essential that there should be an easily reducible margin. The most favourable case is when this margin consists of articles, imports of which can be cut or abolished without lowering the level of employment nor affecting mass consumption unfavourably.

Let us suppose that the articles concerned are for the high-income groups. Part of the surplus demand can be absorbed by import taxes. These taxes must be high enough to divert the rest of surplus demand towards the internal market. This diversion will be converted into inflationary pressure of demand to the extent that there is no idle capacity in the economy. And the only way to avoid this is by absorbing this remaining demand by new taxes of an internal nature.

In this way all the surplus demand — except that part which has been covered by the aforesaid idle capacity and the resultant rise in employment — will have been collected by the State in the form of taxes. The resources accumulated in this way enable the State to cover the investments which formerly were made in an inflationary manner and thereby to ensure employment for that part of the labour force which was not absorbed by fuller utilization of the available capacity to which reference was made.

In a nutshell, the operation consists essentially in shifting surplus demand for imports to internal demand for the factors occupied in investment activities. This is, however, a simple case. Let us now examine the complications, first those arising from the composition of the reducible margin and then those resulting from the inadequacy of that margin.

Let us suppose that, in order to restore external equilibrium, the imports for the high-income groups are insufficient and that it is essential to resort to imports that form a direct part of mass consumption. To carry out an operation similar to the previous one would be tantamount to placing a direct burden on such consumption; and if this burden is eschewed, inflationary pressure will emerge which will, in any event, make prices rise in the same way as if the burden had been applied. In both cases

there is the danger of setting off the spiral already referred to. There is no alternative but to obtain financial aid from international sources to cover investments to an extent equivalent to the inflationary pressure. And this is even more cogent if the reducible margin is insufficient or if resources are lacking to cover all the imports essential to the maintenance of the level of economic activity. The only solution is international aid.

Careful examination of the problem reveals that the policy we are considering consists of maintaining the volume of investment which was previously made in an inflationary way, but covering it with savings provided by taxes and with international financial assistance. Such international aid is essential when imports vital to mass consumption or economic activity cannot be reduced. It is conceivable that a higher level of internal savings might be achieved which would cover all investment, but this would not solve the problem because the lack of resources for essential imports would make it necessary to restrict mass consumption or lower the level of economic activity which would also have unfavourable effects for the population at large.

This is not, however, all. Covering essential imports in this way is a temporary device until structural transformations are introduced to restore dynamic external equilibrium on firm rather than precarious bases. It is therefore essential to invest capital in local industries that will replace imports and in export activities. In so far as the absence of internal savings or the extent or composition of the reducible margin does not leave room for corresponding imports of capital goods, international financial assistance will also be required.

All that I have just said follows a logical line of reasoning. In practice, however, it would run into two serious difficulties. Firstly, a greater internal savings effort through taxes or the floating of loans is required when a drop in exports has already weakened saving capacity. Secondly, resort is had to international aid as a normal part of an anti-cyclic policy. Let us dwell on this aspect for a moment.

#### (f) *International financial assistance*

The difficulty does not reside solely in the deep-rooted reluctance of international credit institutions to cover internal investments which, as we shall attempt to demonstrate below, would seem to have no very serious basis, but also in a consideration far more deserving of attention. The amount of international assistance which a country requires must correspond to the rate of growth which it wishes to maintain or attain and to the savings effort which it can make. But if considerations connected with anti-cyclic policy enter into the picture, the amount of international resources required could easily be exaggerated.

Again, a compensatory policy might require a type of internal investment — public works and construction, for example — which would exceed the level proper to a rational distribution of available resources among the various investment requirements. In other words, as a result of this type of anti-cyclic policy excessive resources might be used for such investments to the detriment, to cite one example, of the production or importation of machinery and equipment.

International financial assistance can be justified as a means of supplementing the scant savings in our countries but not as a normal part of anti-cyclic policy to

cover the imports required for the maintenance of economic activity. The solution does not lie there, but in a far-sighted policy of import substitution that anticipates the cyclic decline of exports so as to obviate — or at least mitigate — its consequences on the internal economy.

These considerations are relevant to anti-cyclic policy but not to means for stemming inflation. Contributions from national resources to cover external disequilibrium while the above-mentioned measures are being taken to deal with it fundamentally are usually a *sine qua non*. We shall return to this later.<sup>3</sup>

### 3. STRUCTURAL EQUILIBRIUM

#### (a) *Currency devaluation as an agent of structural equilibrium*

Are direct measures likely to be necessary to deal effectively with structural disequilibrium or is devaluation sufficient? The school of monetary orthodoxy usually advocates devaluation in all cases, whether the phenomenon is basically structural or merely a temporary departure from structural equilibrium. Neither the nature nor the effects of devaluation are the same in the two cases.

A departure from structural equilibrium usually occurs in our countries in the event of currency overvaluation. A rise in internal prices unaccompanied by a similar movement in export and import prices leads to disequilibrium by encouraging the former and discouraging the latter. This disparity may originate in inflationary pressure on prices or in upward movement of wages and salaries to a figure unjustified by the level of productivity.

So long as there are no obstacles to an increase in imports, the rise in internal prices will be confined to those goods and services which are not linked to external trade, so that external disequilibrium is merely a direct consequence of inflationary pressure. If direct restrictive measures are applied to lessen or correct disequilibrium, the rise in prices will spread to the whole economy and occasion a readjustment in salaries and wages.

Such a readjustment will make the cost of exports go up without their prices rising owing to monetary overvaluation; and likewise it will affect those branches of production that compete with imports of articles which, for one reason or another, are free of restriction. The damage which exports and the other afore-mentioned branches of production suffer makes devaluation indispensable if competitive conditions are to be re-established and the flow of external trade is to be restored on a balanced basis. The same occurs when the increase in prices is caused by a rise in wages and salaries unjustified by productivity.

The case is very different when disequilibrium results from growth of income beyond the level justified by exports. This is structural disequilibrium which happens when exports fall off as we saw earlier. If, in order to maintain or raise the level of internal activity, recourse is had to credit expansion with resulting devaluation, this will tend to re-establish equilibrium even though accompanied by the regressive effects mentioned earlier.

Now, in this case, devaluation acts in a different way. The prices of exports and imports rise and, as costs are not adjusted simultaneously, an extraordinary margin of profit is generated which, while encouraging traditional exports and promoting the development of new lines, brings into being hitherto non-existent import substitu-

<sup>3</sup> See section V of this article.



tion activities and offers an incentive to those that are already in operation.

But, as wages and salaries mount, these effects gradually diminish; and, in order to keep productive activity at the higher level achieved, it becomes necessary either to resort to further devaluation or to take steps to place direct restrictions on imports or subsidize specific exports.

It might be argued that the rise in remuneration need not keep pace with devaluation, since competition will prevent prices from moving up except in the case of new activities which may have cost more to develop. It is possible to think along these lines, although practices restricting competition frequently combine to push up prices to the extent permitted by the greater margin of protection afforded by devaluation.

When this fact sooner or later entails an adjustment in wages and salaries correlative to devaluation, the latter loses its effectiveness. In other words, devaluation acts in this case solely as a stabilizing factor so long as it has regressive effects on income distribution.

It is true that import prices may be prevented from rising — except for imports to be replaced by nationally-produced items — if devaluation is accompanied by a proportional cut in customs duties for all existing industries, so as to avoid double protection. The protection provided by tariffs would thus be wholly or partly replaced by the protection resulting from devaluation. Consequently, the rise in prices would be confined to items produced by the new substitution activities, whose cost is higher than that of the articles previously imported.

An adjustment in wages and salaries, which is justifiable when there are extraordinary profits, would not be an adequate solution in this case, since there would be no such profits, and would lead to an inflationary spiral. Other measures should therefore be adopted to prevent the rise in prices from affecting the consumption of the population at large.

From the point of view of exports, the incentive given by devaluation to traditional items might bring about a deterioration in the terms of trade, if one country's products constituted a substantial proportion of the international supply. Steps would then have to be taken to restrict exports, either by taxes and duties which would absorb all — or part — of the extraordinary profit, or by direct controls. The incentive to devaluation would thus be confined to new exports.

Measures of this kind imply deliberate intervention in the economy and lessen the prestige which devaluation normally enjoys as an automatic method of restoring equilibrium "by allowing money to find its own level". Moreover, such action is very seldom taken, because the amount of devaluation is usually determined by the particular effect that it is desired to produce.

The question is therefore one of economic policy and the advantages and disadvantages of such a method have to be compared in practice with those of other measures such as direct export subsidies, import substitution and protective tariffs.

#### (b) *The gold standard and structural equilibrium*

Those who uphold the theory of monetary orthodoxy usually fail to see the problem of Latin American structural equilibrium as clearly as they might, despite the constant prompting of a reality which they usually prefer to ignore. They have inherited the fundamental principles of the gold standard and apply them to the policy of

monetary stability. The adherents of the classic theory did not notice the structural problem, nor had they any reason to notice it in the golden age of the gold standard under British hegemony.

The operation of the gold standard did not jeopardize in any way the structural equilibrium of the world economy, since the British centre, with its individual structure, had found in the peripheral countries and the dynamic centres a structural adaptability which facilitated the movement of gold in either direction. It is not surprising, therefore, that equilibrium was believed to be inherent in the operation of the gold standard. But, at the end of the last century and early 1900's the main dynamic centre began to feel the consequences of certain structural changes in the rest of the world which were accompanied by constant signs of instability. I refer in particular to the repercussions of the rapid process taking place in the other dynamic centres (e.g. Germany) and of protectionism, and to certain monetary procedures that tended to keep gold in the leading countries.

One result of this was of great importance: the British centre began to lose its knack of drawing back the gold that it sent out. Clear proof of the perplexity and distress which this caused the monetary authorities is to be found in Sir John Clapham's book on the Bank of England, the first written by an author with access to that institution's confidential files. An interpretation of those structural phenomena was, of course, still very premature in those days. But ideas were beginning to emerge for mitigating the consequences of the centrifugal tendency of gold. Thus, long before Keynes and earlier than the First World War, it was already thought desirable for the holdings of the world's central banks to be concentrated in the British centre.

It is not surprising therefore that fairly similar events now occurring in the main dynamic centre which superseded the British centre after the First World War should be reflected in measures whose objectives are basically analogous. It is undeniable that the new dynamic centre has operated in structural conditions very different from those that prevailed in earlier times and which made it very difficult for the gold standard to operate. These conditions became much less favourable when, during the great world depression, the dynamic centre reduced its import coefficient while continuous increases in productivity and technical innovations stimulated the expansiveness of its exports. It was impossible for the gold standard — monetary stability — to be maintained, and in the rest of the world, the other dynamic centres and peripheral countries were obliged to adapt their structure to the structural changes in the focal dynamic centre.

The process of adaptation had lasted nearly a quarter of a century, and, as soon as it was completed, contrary phenomena affecting the main dynamic centre and posing a grave problem have emerged in the other dynamic centres. These other centres either have to liberalize their policy as regards imports from the rest of the world, including the principal dynamic centre, without prejudice to other measures of readjustment, or, by *force majeure*, they will be instrumental in inducing the principal centre to seek equilibrium to the detriment of international trade.

Our countries could not fail to take an interest in the solving of this problem since the more active development of world trade, by enhancing their export and import opportunities, is a factor of prime importance for the acceleration of their economic growth.

### III. THE STRUCTURAL RESISTANCE OF THE ECONOMY AND ANTI-CYCLIC POLICY

#### 1. THE STRUCTURAL SOLUTION TO THE PROBLEM

##### (a) *Maximum employment and imports*

The following are the salient conclusions reached in the foregoing section: given the structural vulnerability of the economy, monetary stability is usually incompatible with the maintenance of economic activity when exports decline; stability leads to a contraction of the economy and any measures taken to remedy the contraction are generally conducive to inflation, or, if this has already begun, give it greater momentum.

It is, of course, possible to devise an anti-cyclic policy that is not inflationary, but it would call for a greater savings effort precisely when the requisite capacity has been reduced by the drop in exports. It would also be necessary for international credit institutions to have a clear concept of the nature of anti-cyclic policy. It is not surprising, therefore, that circumstances lead to inflation.

If inflation has any positive effects, they are attributable to its regressive influence on income distribution. Hence, it is far from being a recommendable policy.

Apart from the measures of international co-operation which may be taken to reduce the scope of external fluctuations, the solution to the problem is structural in nature.

The ideal solution would be to make the internal structure of the economy strong enough to divert the effects of such fluctuations outwards so that internal economic activities could progress without periodic interruptions. What has to be done to come closer to that goal? One simple fact in particular should be borne in mind. If the aggregate income of the internal economy tends to shrink when exports decline, this is because exports are not yet sufficient to satisfy the import demand corresponding to that level of income. In other words, the import coefficient is too high for income to continue to increase at the maximum level of employment, despite the drop in exports.

It is therefore indispensable to reduce the coefficient by changing the composition of imports and transforming the production structure radically enough to ensure that the factors of production are employed to the maximum in internal economic activity when exports — and consequently the capacity to import — are at the lowest point of the cycle. Once this aim has been achieved, and exports begin to climb again, the corresponding increase in income will swell aggregate demand. But in view of the fact that the economy is operating at the maximum level of employment, any surplus demand relative to the domestic product will tend to be met by stepping up imports.

##### (b) *The pressure of demand and imports*

What imports will tend to increase in this way? In order to answer this question, imports should be divided into the following categories, according to the possible scale of their cyclic fluctuations: (i) the raw materials and intermediate goods that are essential for maintaining economic activity at the maximum level of employment, whether it consists of the production of consumer goods and services or of capital goods; (ii) the end consumer goods needed to satisfy the regular demand of the wage- or salary-earning active population, as well as of the remainder of the population with fixed incomes; and (iii) the consumer or capital goods required to satisfy

the demand of the variable-income groups, chiefly entrepreneurs.

If the top level of employment has been achieved when exports are at their nadir, there is no reason whatsoever for imports in the first category to increase when exports take a fresh upward turn; instead they will simply follow a normal course of growth in accordance with the development of internal activity. Nor is there any reason why demand for imports of final consumer goods in the second category should be cyclic, since, if economic activity were to continue developing at a steady pace, there would be no fluctuations in wages and salaries and fixed incomes, except in the export sector. On the contrary, the repercussions of external fluctuations would tend to focus on demand for imports of consumer and capital goods falling into the third category.

This does not mean that when a cyclic increase takes place in entrepreneurs' profits, the entrepreneurs would be likely to devote the whole amount to importing these goods. There would merely be an upsurge in demand for certain goods, whether domestically-produced or imported. But as internal activity cannot expand cyclically, and maintain its normal rate of growth, the heavier demand would tend to be satisfied by the cyclic increase in such imports.

As a result, the only imports subject to the undulating movement would be those that satisfy the demand of groups whose income fluctuates cyclically. These imports would go up as the cycle rose and decline as it fell. Thus, the fluctuation in exports would be rapidly reflected in imports but would not affect the regular growth of internal activity.

This is the purpose of the structural changes referred to earlier. From this standpoint, the import coefficient could be divided into two: on the one hand, the coefficient that corresponds to the imports in the first and second categories which are not subject to cyclic fluctuations; and, on the other, the coefficient for imports in the third category, which is highly sensitive to fluctuations in exports.

The composition of the two coefficients would not only depend on the nature of demand, but also on economic policy decisions with respect to the articles that would still have to be imported and those that should be replaced by domestic products. But both coefficients would have to decline uninterruptedly while the growth of income exceeded the rate imposed by exports — one steadily, and the other in accordance with the fluctuations of the cycle.

##### (c) *Formulation of a substitution policy in advance*

The structural changes required to lower the two import coefficients need not wait until an import surplus occurs; on the contrary, they must be planned in advance in keeping with the development requirements anticipated. In other words, it is essential to anticipate the forthcoming drop in exports while they are still in their upward phase and to begin the process of import substitution, so that when decline is imminent the economy is prepared to resist it and to continue its course without setbacks.

It is clear that these forecasts involve a number of very important conjectures. Past experience has shown that everything that goes up has to come down again. But there is no way of telling when the descent is likely to

take place or how substantial it will be. Hence, the structural changes may be excessive in some instances and insufficient in others. For this reason they should be combined with measures for ensuring flexibility. If they are excessive, the substitution process should be slowed down and, in the meantime, the resulting surplus of exports should be used to build up monetary reserves. If the changes are insufficient, the reducible margin of imports should be brought into play to restore dynamic equilibrium in both the balance of payments and the internal economy, and, if this is not enough, international resources should be drawn upon.

In the present case, it is perfectly justifiable to resort to international assistance, not, as explained before, as a normal part of a compensatory policy, but as an emergency measure when the inadequacy of the substitution policy or an unusually steep drop in exports have made it necessary to call on such resources to help restore the balance.

## 2. SUPPLEMENTARY ANTI-CYCLIC MEASURES

### (a) *The cyclic variation in certain imports*

It has just been seen that the fundamental solution to the problem of external vulnerability is structural in nature. This does not mean that the possibility of certain supplementary anti-cyclic measures should be discounted. First of all, it ought to be asked whether the rise and fall of imports, in which the fluctuation of exports is reflected, would be spontaneous or would need other measures. If the economy succeeds in developing at the maximum level of employment of the factors of production, no such measure would seem to be required, since the pressure of additional demand would be enough to send imports up once productive capacity had been exceeded. There will, of course, always be a certain measure of idle capacity in the economy, not because domestic demand is insufficient but because, in a developing economy, its eventual expansion should always be anticipated. In such a case, the increase in demand will lead to the utilization of idle capacity and will be gradually transformed into imports as income circulates. But when the limits of capacity are approaching, imports will expand at an increasingly rapid pace and an ever-larger proportion — and eventually all — of the additional pressure of demand will be reflected in heavier imports.

In any case, the cyclic increment in demand will tend to push prices up. The intensity with which it does so depends, apart from the elasticity allowed by available capacity, on the margin of protection that exists for the production of import substitution goods. If the margin is fairly small and only offsets differences in costs, the rise in prices will soon be checked by the increase in imports.

This margin also conditions the downward trend of imports when internal demand is reduced by a fall in exports. A slight cut in internal prices will, if import prices remain steady, divert the impact of the fall in demand towards the latter instead of towards internal activities.

In the absence of such flexibility, it would be indispensable to establish a variable duty, which could be lowered or abolished during the upward phase of the cycle in order to stimulate imports, and raised during the downward phase in order to reduce them more rapidly with a view to safeguarding domestic production.

### (b) *Promotion of cyclic imports of capital goods*

There is another case in which a variable duty might be established on both imports and production for import substitution, but for different reasons. The problem is the following. The fluctuation in profits in the export sectors is one of the prime factors behind the movement of imports. Any increment in these profits automatically tends to expand investment and consequently imports of capital goods; however, it also tends to increase consumption of capital goods, particularly those with a high income-elasticity of demand and, as the pressure cannot find a local outlet, it will turn towards imports.

This is where a flexible duty would enable the increment in external resources to be put to better use for expanding investment. It is conceivable that the upswing in demand for capital goods might be absorbed by means of a duty applied equally to imports and to domestic production. Of course, there is no reason why a rise in the price of these goods should effect the level of living of the population at large.

In order to achieve the purpose in mind, the resources thus obtained by the State would have to be used for importing capital goods, either for the activities of the State itself or for the private sector, if such resources are devoted to strengthening the lending capacity of the economic development institutions.

When exports begin to decline, the correlative reduction in the duty and the consequent drop in the price of goods would stabilize effective demand for such goods without leading to a shrinkage in imports or internal production. Applied in this way to goods with a high income-elasticity of demand, a flexible duty would enable capital investment to be expanded at the expense of the consumption increment in the high income groups. I refer to the cyclic increment and not to the regular growth of consumption in the course of economic development. Many different solutions undoubtedly exist as to the amount of duty, depending on the extent to which it is desired to influence consumption so as to boost investment. But whatever they may be, all the solutions should have one element in common: the State should not use the special revenue from the flexible duty to add to the number of employees in the current public administration or to increase its investment, since the subsequent lack of these same resources would bring unemployment in its train.

Apart from the effect of such resources on the investment coefficient, their employment to import capital goods would lessen internal instability. This would also be lessened if the State were to use the aforesaid resources to buy abroad the consumer goods it requires to continue its activity, or to expand internal demand for these goods, thereby indirectly causing a rise in imports. But in this way, a favourable opportunity for raising the rate of capital formation would be lost.

The same considerations are applicable in the event that the State taxes exports directly and thus participates in the cyclic increment of the economy's aggregate income. By allotting resources to the importation of capital goods, for its own investment or for that of the private sector, the State could ward off an inflationary deficit when exports declined, and at the same time raise the coefficient of capital formation. It is essential for the State to pursue an anti-cycle policy if the economy is to develop at a steady pace with the maximum employment of its productive forces.

This means that to reduce the vulnerability of the economy to external fluctuations, the State must also introduce structural reforms with respect to its expenditure. A clear distinction should be made between current administrative expenses and internal investments. The latter must grow steadily at a rate imposed, on the one hand, by considerations of economic and social policy and, on the other, by imports of capital goods. Current administrative expenses should be paid for out of resources made available by the steady growth of the domestic economy, whereas imports of capital goods should reflect the variable rate of exports.

(c) *Investments to absorb cyclic unemployment in export activities*

Let us consider another aspect, of this problem. We have spoken so far of the fluctuation in entrepreneurs' profits. When the trend is upward, profits in export activities are the first to rise; the resultant expansion of internal demand then forces up prices and profits of entrepreneurs in the other branches of the economy. If the economy operates at a maximum level of employment within a steady growth process, the rise in prices will be limited by the brisk flow of imports, except in respect of services for high-income groups for which imports offer no competition.

If the margin of protection is high, or if direct or prohibitive restrictions are imposed so as to discourage imports, price rises will obviously not be kept within these bounds. This is an additional argument in favour of also introducing into these aspects a number of reforms designed to ensure the smoothest possible functioning of the economic system.

In any event, and all other conditions being equal, the fluctuation of entrepreneurs' profits in the rest of the economy will not be as marked under maximum employment conditions as when the economy is subject, as it is to day, to the impact of external fluctuations. These cause internal activity to go through a succession of expansions and contractions, with profits rising and falling not only because of price movements but also because of the changes that take place in the utilization of the productive capacity.

If external fluctuations were only reflected in entrepreneurs' profits, the measures to counteract external vulnerability would be confined to those we have just explained. However, they are also reflected in changes in the level of employment in export activities, although these changes are usually smaller in scope than the movement of prices and profits. Anti-cyclic measures are thus complicated and further preventive measures must therefore be taken.

What can these measures be? That is the problem. Unemployment in export activities is not structural but cyclic. It is, in other words, temporary. Hence, the unemployed cannot be permanently shifted to other activities but must be temporarily absorbed. They should therefore be employed in internal investment and this means that savings must be brought into play if the inflationary consequences of that action are to be avoided. However, these savings cannot be achieved at the expense of internal consumption; otherwise we should be creating one phenomenon — that of insufficient demand — in order to correct another. By avoiding insufficient demand in export activities, we would be creating insufficient demand in the rest of the economy. That is why the cost of these

investments must be covered at the expense of imports rather than by saving on the consumption of domestic goods.

In fact, what is required is a mass of savings which would grow steadily as the economy developed. These savings would be used to import capital goods when exports were on the rise and for internal investment when exports fell off. In the latter case, the savings achieved at the expense of imports would be converted into consumption by those for whom the investments had provided employment, thus filling the gap in demand caused by falling employment in export activities.

(d) *Investment flexibility*

Investment flexibility is an essential component of anti-cyclic policy, not only with respect to the investments just mentioned but also to investments in general.

We shall attempt to explain this point in outline. Careful examination reveals that, from the anti-cyclic point of view, investments consist of two parts: one that fluctuates and another that grows steadily as the economy develops. The fluctuating part consists of imports of those capital goods in which the movement of exports is reflected. The steady growth part is represented by the remainder of capital goods imports, which are not subject to cyclic changes, and by the entire range of internal investments.

If internal economic activity grows steadily with the maximum level of employment, it might well be assumed that a steadily-growing rate of savings can be maintained. To these stable savings of internal origin, intended for steady growth investments, must be added the fluctuating savings of external origin in the export activities, intended for the fluctuating part of capital goods imports. However, this does not fully solve our problem. Internal investments are closely linked to capital goods imports. Thus, the installation of imported machinery and equipment requires large-scale investment in industrial plants. This close link is a factor of internal instability, because construction activities would be left exposed to these imports. For this reason, in this case too, internal investment requires a measure of flexibility. In our countries, the State usually has the machinery with which to do this. It must merely use them in such a way as not to cause sharp fluctuations in construction activities. A compensatory type of movement is required. When the cycle of industrial construction — in the broadest sense of the term — increases cyclically, other forms of construction should be curtailed. Through its own public works and low-cost housing construction, on the one hand, and the mortgage credit system, on the other, the State is in a position to introduce this anti-cyclical element, without prejudice to possible recourse to taxation if necessary. In other words, anti-cyclic considerations should play a very important role in the long-range planning of all these investments, which is essential to the steady growth of the economy.

(e) *Nature of anti-cyclic measures*

Before going on to the other aspects of this vast problem which we are considering, let us now sum up the major conclusions deriving from our earlier discussion. We have sought to show, in the first place, that the basic solution to external vulnerability lies in structural measures. The structure of the economy must be changed so that internal



economic activity — in spite of the alternatives offered by the international economy — may grow steadily at a maximum level of employment.

The internal economy thus loses its vulnerability and acquires the resistance necessary to ensure that export fluctuations are promptly reflected in imports whose movements do not affect internal activity.

We have also shown that enforcement of a simple anti-cyclic policy would be difficult without these structural changes. However, if these changes are effected, additional anti-cyclic measures are required for the following purposes:

(a) to assist the movement of imports subject to cyclic fluctuations by means of a flexible tax;

(b) to increase cyclic imports of capital goods at the expense of consumer goods imports by means of a differential tax which would be combined with the tax mentioned above;

(c) to earmark the fluctuating part of the State's revenue — closely linked to foreign trade — for capital goods imports;

(d) to absorb cyclic unemployment in export activities by means of the funds that were used, during the upward phase of the cycle, for capital goods imports additional to those just mentioned;

(e) to change the composition of construction activities to compensate for cyclic movements deriving from capital goods imports.

Emphasis has been placed on the importance of a structural solution because the problem of applying an anti-cyclic policy to correct external instability has often been viewed as something unrelated to the problem of economic growth, as if fluctuation were not a characteristic feature of our

growth pattern. I myself have on earlier occasions advocated an anti-cyclic policy unrelated to structural considerations and bear some responsibility for its application in one of the Latin American countries. To sum up, demand has to be dealt with in its rising phase by the public sale of bonds designed to absorb savings. By thus curtailing demand, and not using savings to import capital goods, the savings are available as monetary reserves. When the declining phase begins, the monetary authorities buy back these bonds on the market and thus restore the purchasing power previously withdrawn. The effect of the contraction of demand is thus mitigated, as was its expansion earlier, without entailing any inflationary consequences because of the use of the monetary reserves previously accumulated.

While this idea is right from the anti-cyclic point of view, it leaves aside the essential problems, which are structural in nature. But, for the sake of an anti-cyclic policy savings are accumulated in the form of monetary reserves in countries which do not have enough savings to expedite their growth. It is not only a question of the accumulation, which is obviously temporary, but of the need to make use of the relative abundance of funds in order to introduce those structural changes which, apart from preventing a contraction of the economy when exports fall off, allow the economy to continue to grow at the maximum level of employment.

It is true that, at the time when these ideas emerged in our countries, we were all still very much under the strong influence of the great world depression; and we were therefore mainly concerned with economic stability. Since then, however, we have gained experience which changes essential for ensuring steady economic growth in a régime of monetary stability.

#### IV. REGRESSIVE FACTORS IN INCOME DISTRIBUTION AND INFLATION

##### 1. THE REACTION AGAINST REGRESSIVE MOVEMENTS

Economic development policy, as we have said, means a deliberate attempt to act on the forces of the economy in order to expedite its growth, not for the sake of growth itself but as a means of ensuring a steady improvement in the living standard of the lower — and middle — income groups and their progressive participation in the distribution of the over all income.

This movement is usually interrupted by regressive factors which tend to lessen their share in income distribution. Certain structural phenomena implicit in economic development raise prices and naturally produce reactions in the mass of consumers that tend to restore the real value of their wages and salaries. Similar reactions occur when taxes are levied on the broad masses in order to cover the cost of social benefits or of increased State expenditure, or when some groups succeed in restricting competition and thus are able to raise the prices of their goods and services. In either case, the original price increments, followed by these defensive reactions, set off the inflationary spiral of prices and wages; and the monetary instrument, originally unaffected by this phenomenon, is compelled to go along with it by expanding credit in order to avoid a contraction of economic activity. In such cases, the monetary instrument is a simple passive element in the inflationary process.

This reaction against these regressive effects on income distribution is easily explained. An increase in wages and salaries does not provide the answer, for it merely sets off the inflationary spiral or accelerates it if it is already in motion, or, worse still, when an increase in wages and salaries is not simply a reaction aimed at correcting a regressive effect but an attempt to secure progressive redistribution effects. Inflation is not the proper way to achieve this.

This case therefore differs from those in which the monetary instrument assumes an active role either because the State uses it, instead of resorting to taxation, when there is no contraction of the economy, for the purpose of maintaining or increasing consumption or investment, or when private groups wield their economic or political power to achieve the same end. The resulting price rise derives from the monetary instrument and not from factors outside the purview of the central banks. The defensive reactions aimed at correcting this regressive movement in distribution have no reason to set the inflationary spiral in motion; it is then for these banks to use credit facilities in order to compel the entrepreneurs to absorb the wage and salary increments by means of their inflation-swollen profits. This section will be devoted to an examination of these phenomena.

There are three main structural or functional factors implicit in price increases: (a) the cost of import sub-

stitution; (b) the higher cost of agricultural commodities; (c) the movement in the terms of trade.

(a) *The cost of import substitution*

Production designed to replace imports is generally more costly than importing. Such is the price of industrialization. If all the productive factors of our countries could be channelled into exports without raising their cost or substantially reducing their prices, there would be no need to industrialize. But the reality of the matter is different.

This process implies an increase in costs with respect to the imports that were obtained in exchange for exports. Why then is industrialization advocated as a means of raising the standard of living of the masses? The answer is very simple. Even if *per capita* output is smaller in industry than in exports, it is much higher than in the rest of the activities into which modern production techniques have barely penetrated. This is typical of agriculture for internal consumption, of cottage industries, and of that vast range of unspecified personal services which are one of the features of under-development. Thus, a shifting of manpower from these relatively unproductive activities into industry and other more highly productive activities, at a rate commensurate with the growth of the active population, represents a net increase in the average *per capita* product for the economy as a whole.

The higher cost of substitution is thus absorbed in the over-all economy. There would otherwise not have been any improvement in real income *per capita*. Yet, some groups of workers suffer while others benefit. Adversely affected are those already employed in industry or other activities with a relatively high rate of productivity which absorb the labour force. They have to pay higher prices for products which are no longer imported but are manufactured by national industries. Of course, the productivity of these adversely affected groups has also increased and, to the extent that this is so, the effects of the dearer prices are lessened or overcome. If these conflicting phenomena occurred gradually and steadily, the phenomenon might be much less noticeable than it is in actual fact. This phenomenon also occurs — perhaps more acutely — among groups of workers remaining in jobs of low productivity.

We thus come to the second explanation referred to earlier. Import substitution does not take place gradually; it is particularly intensive in periods when shrinking exports call for measures to correct external disequilibrium. During the upward phase, the rise in average *per capita* income could be expedited because, thanks to heavier exports, it was unnecessary to resort to import substitution. The opposite occurs during the downward phase. Average income falls and import substitution becomes a matter of obvious necessity and has to be undertaken rapidly instead of progressively.

A few figures may help to make this clear. Let us assume that the import coefficient was 17 per cent before the rise in exports and that it is then pushed up to 20 per cent by the export boom, as usually happens. During the downward phase the coefficient must be reduced not to the previous level of 17 per cent but to an even lower figure, say 16 or 15 per cent, in order to cope with the income growth that has occurred in the meantime.

It thus becomes necessary to curtail imports by an amount equivalent to 4 or 5 per cent of the income figure within a relatively short period of time. Some imports will drop spontaneously, but taxes or restrictions will

have to be applied to the rest in order to achieve external equilibrium and, at the same time, to mitigate the effects of reduced exports on internal activity. This leads to internal price increases even before the substitution process, with its higher costs, takes effect.

If this process were carried out gradually, as we have suggested, and the cyclic rise in the import coefficient affected only those goods which have no impact on the level of living of the broad masses, the higher cost of substitution activities could also be absorbed gradually. But this is not what happens, and the increase in costs occurs precisely when *per capita* income declines or when its growth is arrested or slowed down. Its impact is therefore much greater than it would otherwise be.

All this is greatly simplified because the actual phenomenon is more complicated. A few qualifications are therefore called for. In the first place, the impact of the rise in real costs resulting from the substitution process on the rate of income growth does not depend only on the higher cost itself but also on the difference in the product per actively employed person as between the export and substitution sectors. Moreover, the larger the difference between *per capita* income growth and *per capita* export growth, the greater the impact because of the more pressing need for substitution. The impact is strongest when imports decline instead of rising and when there is a very wide gap in *per capita* product as between exports and substitution activities.

Apart from its inflationary effect, this impact could severely hamper income growth if the greater productivity in existing activities is largely absorbed by the higher cost of the substitution process. This is not a mere academic exercise, but a practical possibility which ought to command our attention in connexion with Latin American development.

Let us review the reasons for which the cost of substitution is exorbitant: (a) substitution has had to be improvised in critical situations when no reasonable criterion of economic feasibility has been applied; (b) the smallness of national markets makes it necessary to incur exorbitant costs of substitution; (c) the substitution process has assumed excessive proportions because of the failure to establish parity of conditions as between substitution and export activities.

The fact that a radical change of policy is required to deal with this does not mean that nothing can be done in the meantime to counteract the increase in cost. If the new substitution activities are protected by subsidies instead of customs tariffs, a rise in the cost of activities which in one way or another affect the level of living of the broad masses can be prevented. The impact varies according to the items for which substitution is undertaken. If they are consumer items for the high-income groups, we need only concern ourselves with considerations of economic feasibility in substitution activities. But if these items affect the level of living of the community at large, recourse to subsidies would ensure that the social cost of economic development is defrayed by the groups which can better afford to absorb it.

This is a purely anti-inflationary measure calculated to correct these effects rather than to avoid them. To avoid them entirely or at least to mitigate them radical measures must be taken, as we said earlier, to reduce the scope of the substitution process and to enhance its economic feasibility. That is why the common market is of decisive importance.

(b) *The relative increase in the cost of agricultural commodities*

Some Latin American countries are familiar with certain phenomena which raise the cost of domestically-produced agricultural commodities. Their effect on mass consumption seems to have been an important factor in inflating costs in such cases. The root of the problem clearly lies in the antiquated land tenure system prevalent in many of our countries. But this is only one aspect of the problem, very important though it may be. There are other factors which tend to add to the cost of agricultural production; they help to push up prices or to discourage production when the price rises are checked without an attempt to get to the root of the problem. This is a subject that has been discussed at length in our countries but so far the facts have not been fully recognized. We shall, at this juncture, venture a few remarks aimed at explaining the nature of the problem and its relationship with other inflationary phenomena.

Apart from the causes deriving from the land tenure system, there are two important factors which add to the cost of agricultural commodities: (a) the cost of import substitution, to which we have just referred; and (b) the slower rate of increase of agricultural productivity compared with that of the rest of the economy.

Jorge Ahumada has given a lucid explanation of this first factor.<sup>4</sup> If the prices of machinery, fertilizers and insecticides and other inputs in agricultural production rise in the substitution process, the increase is reflected in the cost of production.<sup>5</sup>

As to the other factor, productivity, when this shows a general increase, the tendency is for wages and salaries to rise, rather than for prices to fall as has happened in capitalist development. But if agricultural productivity has not risen, or has risen less, the extension of wage increases to agricultural production results in higher costs reflected in higher prices.

The land-tenure system prevailing in many Latin American countries often impedes productivity by seriously obstructing the introduction of advanced techniques. Except in a few cases, there has been no decisive governmental action for vigorously promoting the use of modern techniques, and there is not much point in attacking the land-tenure problem if such action is not forthcoming.

In some cases this situation has taken an even more serious turn, especially when an attempt is made to control price rises, caused by higher agricultural production costs, by means which have harmed producers, because of the form in which they were applied, without being of any real benefit to the consumer in the long run.

Attempts have also been made to mitigate or avoid price rises in certain agricultural commodities by facilitating imports. For this purpose the substitution policy has often had to be extended to high-cost industries when it would have been better to promote agricultural production by introducing advanced techniques on an adequate scale.

All this relates to production for domestic consumption.

<sup>4</sup> *Inflation in Latin America. Notes for a working hypothesis* (awaiting publication).

<sup>5</sup> The rise in the cost of living that occurs when the higher substitution cost of other goods is not absorbed by greater productivity leads to wage increments, adding yet another factor to the increase of agricultural costs. However, as the same process takes place in other sectors, there is no relative rise in the cost of agricultural commodities which merely participate in a general process.

Cost increases attributable to higher-cost inputs or labour also occur in production for export and, if the increase is not absorbed by greater productivity, the following dilemma arises: either exports are discouraged and production is limited to the relatively better land and stopped on marginal land, or recourse is had to monetary devaluation in order to restore a proper relationship between prices and production costs for agricultural products and also for other items for export.

(c) *Terms of trade and effects of devaluation*

This dilemma becomes even more serious when rising costs coincide with a deterioration in the terms of trade. This does not usually happen by chance; the deterioration makes the need for import substitution more pressing, with its inevitable effects on internal costs. The perplexity of those caught between the two horns of this dilemma is easy to understand. If they avoid monetary devaluation, they discourage exports and weaken the rate of economic growth if they accept devaluation, they raise the price of mass consumption goods. In either case there is no avoiding a regressive effect on income distribution, although in the first case the effect is not as immediate and obvious as in the second.

The worst feature is that devaluation leaves income from land unaffected, or even pushes it up; in other words, it tends to perpetuate an outmoded form of tenure. This is because there are two aspects to the problem: first, the unavoidable necessity of compensating for the high cost of inputs and wages so that agricultural production can continue; and, second, since the same, or a larger, area of land is used for this purpose, the tendency is for income from land to be maintained or increased, if the heavier demand for agricultural commodities cannot be met by increases in productivity.

This does not mean that the problem is insoluble, although it is if there is unwillingness to go to its very roots. Here we are faced with another disturbing feature of the doctrine of the free play of economic forces, as it is usually interpreted in the Latin American countries. Naturally devaluation, in the case under consideration, is not always a consequence of this free play, but rather a deliberate measure taken to attain a specific end. Once this has been attained, the free play doctrine is usually an excuse for not going any further, for not attempting to find a radical solution; why do so, if the free play of economic forces will solve the problem of production spontaneously, once the incentive to private enterprise has been restored?

What is really needed is strong governmental action, not only to promote the introduction of advanced techniques but also for the precise purpose of establishing a land tenure system that will make possible and encourage such progress. There are extreme cases where direct land redistribution measures are required, and others where taxation can be an effective instrument for promoting better land utilization. I refer to the tax based on the potential capacity of the soil, which compels the transfer of land that is not being properly worked. Clearly if this tax is not applied progressively, according to the potential capacity of the holdings, the inefficient use of the soil inherent in this outmoded system of land tenure will be remedied, which is in itself a step of considerable importance, but the discrepancies of distribution will persist and can only be changed by the effective use of income tax.

## 2. THE INFLATIONARY SPIRAL

We now come to another aspect of the subject. Price rises resulting from the higher cost of import substitution, relative increases in the prices of agricultural commodities, and higher prices caused by devaluation aimed at correcting cost increments and lower prices for exportable production, are all symptoms of problems whose radical solution calls for the changes in production systems, economic structure and distribution patterns repeatedly referred to in this paper. In the absence of such changes, the inflationary spiral is usually regarded as the easiest way out, through reluctance to resort to taxation as a method of distributing more fairly the burden that these maladjustments involve and of ensuring that they are not borne solely by the mass of the people.

There is a great difference between the spiral that originates in rising costs and that initiated by an inflationary increase in demand. In both cases the spiral is a means of spreading inflation, but whereas in the first case the central banks are powerless to check it, they can do so in the second case if they take firm and determined action.

Inflationary demand leads to bigger profits, and a policy of tighter credit can oblige entrepreneurs to use these profits to absorb wage increases, while at the same time further inflationary expansion in demand is prevented. As higher costs, on the other hand, are not accompanied by extra profits, generally the chances of absorbing them are poor, and they are necessarily reflected in prices. If the central banks attempt to prevent this by tighter credit, they only succeed in depressing economic activity without interrupting the inflationary spiral, which, on the contrary, continues unchecked, to the dismay of those who have always regarded the orthodox formula of retrenchment as the infallible method of bringing about a fall in prices and the end of inflation.

The cases of higher costs and prices just considered are of internal origin. There are other cases in which the situation derives from external factors: increases in import and export prices. As is common knowledge, the movement is concurrent in each case, but not equal in magnitude; when there is a rise, export prices usually climb more; and when there is a fall, import prices drop more rapidly than export prices. An increase in import prices naturally always affects mass consumption goods, whereas rises in export prices have this effect only when the products concerned are important items in domestic consumption.

In these cases, too, the inflationary spiral is not the solution. Consequently, other steps are required to counteract the internal effects of these movements. Some propose a flexible policy of multiple exchange rates so designed that foreign currency prices move in the opposite direction to import and export prices. This method, while technically correct, is difficult to apply, because it means introducing practices conducive to instability which weaken the position of the central banks when it comes to protecting monetary stability in other circumstances. Furthermore, the periodic changes in the exchange rates give rise to speculative activities which can seriously hamper the execution of this policy. The same purpose could be achieved by flexible export duties the revenue from which could be used to subsidize imports, especially those that have an appreciable effect on mass consumption.

I am fully aware that this means resorting to disci-

minatory practices that have fallen into disrepute in Latin America. Consequently I believe that it is better to reject these partial compensatory methods in favour of more general measures.

This relates especially to those cases where exportable items are important for domestic consumption. A flexible duty on such goods would have the advantage of reducing the fluctuation of domestic prices, but it would put those articles on an unfavourable footing in relation to goods that carry little weight so far as domestic consumption is concerned.

## 3. OTHER CASES OF COST INFLATION

The cost increases thus far considered are attributable to the partial or inadequate way in which the changes in production systems and in the economic or social structure are carried out, or result from the actual operation of the economic system. Let us now consider other cases where such increases are a result of practices that restrict competition or of methods of taxation.

Practices restricting competition are common in Latin America. In industry they have been greatly encouraged by extreme forms of protectionism and certain types of import control. They also occur in trade, especially in staple items the distribution of which is often inefficient. Apart from their unfavourable effect on the utilization of the country's factors of production, these restrictive practices have regressive effects on income distribution and consequently encourage inflationary reactions.

Restrictive labour practices have similar effects. I am not referring to practices that impede greater productivity and are governed by deeper-rooted factors that can be counteracted only by a rapid rate of growth and manpower absorption, but to practices that, by severely restricting access to certain occupations, make possible higher wages than those paid in other occupations for the same level of skill and training. When this happens in activities that hold a key position in the economy, the resulting rise in costs is general and consequently becomes an inflationary factor.

With respect to taxes, increases in taxes on mass consumption goods usually have inflationary consequences. These taxes usually constitute a major contribution to total tax revenue for two main reasons: first, the regressive character of the tax system, which does not tax consumption by the higher-income brackets sufficiently or permits a considerable degree of tax evasion; second, the narrow tax basis which, precisely because of the low level of development, makes it necessary to include taxes on mass consumption goods.

Often this fact is not taken into account when disproportionate increases are made in governmental expenditure or in social transfers. These expenditures and social transfers can play a very important part in income redistribution. If the higher-income groups are taxed to provide more extensive and better education, public health services and other social benefits, the aim of income redistribution is attained. If, on the other hand, recourse is had instead to taxes affecting the masses, or if such taxes are resorted to once the higher-income groups are already being taxed beyond a reasonable limit, the result is merely that certain forms of consumption of goods are replaced by other forms of consumption of services provided by the State. This social policy requires careful consideration to be given to



the relative advantages and disadvantages, which in practice are generally ignored.

The most notorious example is that of the social services in certain countries, which often cost over 50 per cent of total wages and salaries. This high proportion is due partly to the nature of the social benefits provided, such as retirement pensions at an early age, and partly to high administrative costs. To pay for these services, taxes are levied on entrepreneurs or workers that generally cannot be absorbed by the former's profits. They are then shifted to prices, thus encouraging the inflationary spiral.

From this standpoint and from others, social policy in Latin America is not usually the outcome of any rational plan. But there is a further point to consider: taxes that fall on the masses also contribute to excessive increases in Government expenditure, both on general administration and on military items, which absorb such a high proportion of the budgets of some countries. Consequently, in such cases the State plays an important part in inflating costs, as it does in inflating expenditure and investment.

#### 4. CONTROLLED INFLATION

It is now appropriate to consider efforts to avoid the effects of inflation on prices. I shall not deal with those measures of control or rationing that are adopted in highly critical situations, when inflation is more or less inevitable or very difficult to avoid, as in time of war or when exports decline disastrously; I refer to those measures to which Latin American Governments have often had to resort to control the effects of an inflation that they could well have avoided or lessened if they had been willing to go to the roots of the problem.

One such anti-inflation measure, perhaps the most important and the most disruptive is monetary overvaluation, as explained in section III. The desire to avoid an increase in the cost of imports with its consequent impact on mass consumption leads to the stabilization of the exchange rate while there is an inflationary rise in internal prices, or to the establishment of rates favourable to certain imports.

Naturally this policy cannot be maintained indefinitely. Latin American experience shows that sooner or later this maladjustment has to be set right by currency devaluation and a consequent rise in prices. If these rises are followed by wage increases, the spiral is set in motion irrevocably, or, if it is already in operation, it is intensified and subsequently further devaluation becomes necessary.

In some cases currency overvaluation has been resorted to not only to soften the impact of inflationary price increases, but also to shift to wages the favourable effect of the improvement in the terms of trade. All is well so long as this improvement is maintained, but when the opposite

trend begins, the loss of real income is so great that it becomes very difficult to check the spiral.

The problem is still more serious when the terms of trade continue to deteriorate beyond their level prior to the improvement. To continue resorting to currency devaluation in this situation means that the real income of export activities is restored at the expense of the real income of the workers, that is, the latter are made to bear the brunt of the deterioration in the terms of trade.

A phenomenon of this nature makes it all the more imperative to introduce changes in production systems and in the economic and social structure. How far is the aim of maintaining or raising the real income of export activities conducive to such changes? It may well be that it would hamper or prevent them. It must also be asked whether in such cases the general incentive of improved prices operates satisfactorily, or whether it is necessary to resort to special incentives aimed at achieving as rapidly as possible increments in productivity through which the unfavourable impact of the deterioration in the terms of trade can be absorbed. However, this device of using special incentives to cope with certain structural problems is not part of the doctrine of the free play of economic forces, invoked to justify a devaluation that undoubtedly arises usually not from these forces but from certain designs for the regressive distribution of income.

Another important method of controlling the effects of inflation has been not to allow the prices of public services or of certain goods produced by the State to be adjusted in line with the rise in costs, taking higher productivity into account. The result has been to deprive enterprises of the funds required for capital replacement, and, what is more, it has often left them with a chronic deficit, thus intensifying the inflationary process. Moreover, when these enterprises are in private hands, there is a complete absence of incentive to expand productive capacity. In some countries, this has constituted a serious structural obstacle to economic development. Hence it is clear that, in certain cases, inflation is not merely the outcome of structural factors but can become an active agent in bringing about structural maladjustments.

Lastly, I would like to say a very few words about the use of price control to counteract the consequences of inflation. Currency overvaluation and the stabilization of public service rates and of rents have proved effective means, although extremely disruptive of shifting real income to offset or overcome the regressive effects of inflation on income distribution. Price control, on the other hand, has proved ineffective in Latin American experience. In most cases it has been no more than a psychological expedient that has upset production and trade without producing any redistributive effect.

### V. THE DEPRESSIVE EFFECTS OF ORTHODOX ANTI-INFLATIONARY POLICY

#### 1. THREE POSSIBLE CASES OF CONTRACTION

The foregoing considerations will help us elucidate a problem of great current importance. Since inflation, despite the serious disturbances that it involves, has certain positive effects, there is reason to ask whether the mere execution of a policy of monetary stability with a view to checking inflation does not involve the loss of those positive factors and lead to contraction of the economy, stagnation and a slackening of the

pace of development. Is this the price that must be paid to check inflation and achieve monetary stability? One cannot overstress the importance of these questions and the urgent need to discuss this problem which is giving rise to so much controversy in Latin America.

There is in fact no real reason why anti-inflationary policy should necessarily lead to contraction, except in the extreme case where basic services are insufficient to maintain the level of economic activity. A contraction in economic activity is the result of the type of anti-inflationary

policy adopted rather than the inescapable result of checking the inflationary process. There are three main cases in which such a policy could bring about a constriction of economic activity: (a) when there is restriction of investment or inflationary expenditure without simultaneous measures to offset their effects; (b) when an attempt is made to neutralize the effects of the public deficit by a deflationary policy in the private sector of the economy; and (c) when rates of remuneration are stabilized at a level so low that the effective demand of the workers cannot absorb the production intended for them.

(a) *The contraction of inflationary investment, taxation and international assistance*

As was mentioned earlier, inflation in Latin America, whatever the extent to which structural factors are involved, usually entails inflationary expansion of credit brought on by a surplus of investment in relation to the actual resources available.

In examining the first case, let us begin by recalling the expansive effect of inflationary investment (or expenditure) on the economy. The effect is similar to a rise in exports. The corresponding heavier internal demand stimulates use of the economy's idle capacity and encourages new expansive investment. Inflationary investment tends this way to increase employment and over-all income, although at the same time it brings external disequilibrium in its train since higher income leads to more imports.

Herein lies the radical difference from the expansive effect of an increase in exports: the circle is simply closed with a rise in imports, while in inflationary investment the circle remains open in the form of external disequilibrium. Similarly, the circle remains open when, at a time of declining exports, inflationary investment is made which tends to maintain employment and income, with resulting external disequilibrium. In both cases inflationary investments allow a level of investment higher than is justified by exports given the coefficient of imports.

To check inflation it is essential to restrict the credit behind these inflationary investments. But if this step is not accompanied by other measures of a compensatory nature, income will shrink in the same way as it expanded previously as a result of inflationary investment. Contraction then leads to a cut in imports and the re-establishment of external equilibrium.

The essence of the orthodox formula for monetary stabilization is therefore to squeeze income until imports decline to a level coverable by exports. The advocates of this policy make no secret of the fact that a temporary sacrifice must be made for the good of the economy.

Once this orthodox view has been established as an irrefutable dogma, no search is made for other types of anti-inflationary policy consistent with the requirements of economic development. Some countries have suffered very greatly from having pursued such a policy out of conviction or as a result of circumstances. Some other non-orthodox formula for monetary stabilization is therefore urgently needed.

The essential idea behind the formula must be to close the open circle without bringing about a contraction in income. In section II an explanation was given of what such an operation consisted of: surplus demand for imports must be eliminated and diverted internally to maintain the demand for the factors of production employed in investment activities in a non-inflationary way.

Likewise it was stated that taxation — combined with

internal loans — was the most suitable means for achieving this purpose. A reducible margin is, however, necessary in imports; the margin must be such that its use will affect neither economic activity nor mass consumption. In the absence of such a margin, international assistance alone could avert the damage. That, however, means using such resources for internal investment.

The fundamental error of the orthodox anti-inflationary policy resides in exactly these two points. Use has been had neither of taxation nor of timely international assistance. These two operations should have been combined with restriction of credit for inflationary investments.

Such investments need not be reduced but rather progressively financed from taxation and international resources as restrictions on inflationary credit are progressively imposed. A cut in investment would be understandable if these were excessive from the point of view of economic development. This case is not, however, to be found in Latin America. Yet this does not mean that there is no reason to change the composition of investments in order to align them more closely with economic development needs, with particular emphasis on the re-establishment of external equilibrium.

In addition, credit restrictions are usually applied without a savings effort having first been made. This is left until later when income has already fallen, bringing the capacity to save down with it.

All this is a result of the prevalence of the dogmatic concept of monetary policy. Credit is restricted without application of such other measures as will tend to maintain and develop economic activity without creating external disequilibrium, in the hope that once inflation has been eliminated and monetary stability achieved, spontaneous forces in the economy will first bring about recovery and later growth.

This oversimplified approach to anti-inflationary policy may well be inspired by static reasoning which takes no account of the dynamics of Latin American growth. In the industrial centres the idea of spontaneous economic recovery is conceivable because their external trade trends are usually contrary to ours. The nature of their imports is such that demand for them tends to increase more slowly than income. In our countries, on the other hand, the opposite phenomenon occurs. In the industrialized countries, therefore, there is no need to introduce the structural changes which growth in Latin America requires.

Likewise, in the industrialized countries a relatively slight contraction in income is usually sufficient to enable exports, given their composition, to increase at the expense of internal consumption; while in the Latin American countries the proportion of exportable goods which are consumed internally is not usually high. Accordingly, no effects of comparable magnitude can be expected. With the growth of exports from the industrial centres combined with a decline in imports, the stimulus which an export surplus gives to internal economic activity may lead to spontaneous recovery.

I do not maintain that an orthodox policy would be advisable in the industrialized countries to slow down the process of inflationary expenditure or investment, but it would at least have a rational basis which is entirely lacking in our countries. Credit restriction, however, if really forcefully applied can also lead to an export surplus in our countries by violently squeezing income. And such a surplus would not be long in stimulating economic recovery if the credit restrictions associated with an anti-

inflationary policy are simultaneously lightened. But, in climbing further, income would reach a point beyond which it would not be possible to go without causing external disequilibrium, unless in the meantime the structural readjustments already referred to had already been introduced. Why not therefore introduce them before initiating the contraction process and when the savings capacity of the economy to achieve them is greater?

From whatever angle the problem is viewed, no justification could be found for this contractionist anti-inflationary policy. Perhaps the only positive argument in its favour is that, once external equilibrium and monetary stability have been achieved, foreign private capital will be given the necessary confidence to invest. There can, however, be no doubt that private capital would be still more strongly attracted if the rehabilitation were achieved while the level of economic activity was maintained, as the incentives to invest would be greater.

Clearly, an anti-inflationary policy of the type we are advocating requires foreign financial assistance as an element simultaneous — and not subsequent — to a tighter credit policy. But it is very unlikely that foreign private capital will be forthcoming at such a time and to the required extent: it will be more likely to await the success of the said policy. Accordingly, in the first stage of the stabilization policy external contributions can come only from international credit institutions. If these credit institutions adopted the same wait-and-see attitude as private capital before affording their help, this policy would be deprived of one of its essential conditions for success.

To what extent could internal investments continue to be covered by contributions from international sources? The reply to this question is part of a broader problem than the struggle against inflation and is considered in section VI. Here a few brief remarks will suffice. If the amount of inflationary investment which it is sought to finance with actual resources is higher than a country can meet out of an investment programme using national and international resources, this means that employment in internal investment activities is excessive and a shift of manpower to consumer activities is required. Viewed from another angle, the labour force which is thus transferred from investment activities will not consume what others have ceased consuming as a result of saving but will have to make its own contribution to producing consumption. Such an increase in consumption in its turn requires a corresponding increase in imports; and, to avoid a further surplus of imports, a greater advance than before will have to be made in the import substitution policy — or in the encouragement of exports —, with a resulting expansion of investment in the relevant sectors. Once this aim has been achieved, investments will not have to be repeated — as the matter was one of provisional readjustment — and it will be necessary only to continue making those investments required to ensure regular economic growth at a tempo compatible with the rate of capital formation that available resources allow.

(b) *Compensation for inflation of fiscal origin by the contraction of economic activity in the private sector*

It was stated above that contraction of the economy brought on by tighter credit led to a decline in the capacity to save. This is not, however, all that has to be said: fiscal resources will also diminish, leading to a deficit or aggravating the already existing deficit. In addition, it is no easy task to eliminate a deficit particularly

when tightening of the economy has reduced fiscal resources.

This usually leads to another of the errors of anti-inflationary policy: the belief that the inflationary effects of a deficit in the State investment budget can be counteracted by tighter credit in the private sector depriving enterprises of resources for their circulating capital.

If a firm line is taken, there is no reason whatever why it should not be possible to avoid a rise in prices which inflation of fiscal origin would otherwise involve. But this is achieved at the expense of a contraction in the economy. To avoid such a situation, it is essential that the private sector should continue to have available the same amount of credit as previously, for if prices rise as a result of inflationary pressure of fiscal origin, profits will also rise and this makes it possible to meet the increased requirements for circulating capital. But if enterprises have a smaller amount of credit available, they will be obliged to reduce their level of activity in a deflationary movement which will neutralize the inflationary pressure of fiscal origin.

The effects of tighter credit in the private sector of the economy are aggravated when restriction is applied not through quantitative credit regulation but through an increase in interest rates. This increase is usually considerable and it renders the position of enterprises even more difficult by raising operating costs while demand declines. Furthermore, a rise in interest rates is accentuated in some cases by a certain strange procedure of limiting imports by means of prior compulsory deposits which absorb enormous sums of money. It should be asked in passing: why not do this by means of flexible taxes and duties? Such taxes and duties would have the advantage of providing the State with additional resources to counteract inflation instead of increasing bank gains and the profits of private money-lenders.

(c) *Depressive effects of the inadequate readjustment of wages and salaries*

Another of the measures essential to achieving monetary stability without detriment to economic activity is the stabilization of wages and salaries. The point at which this is done is not without importance. Sufficient readjustment must be made to compensate the workers for the rise in prices brought on by *inflationary demand*. I wish to emphasize this expression because this case must be distinguished from those others in which the price rise results from higher costs. The rise in prices brought on by inflationary demand or by devaluation exceeding the increase in costs augments the profits of enterprises, and it is thus possible to restore the previous level of real wages without a further rise in prices by the use of a policy of tighter credit, provided that inflation has been attacked simultaneously on other fronts.

In the wage-prices spiral, the relationship between the real amount of wages and prices and entrepreneurs' profits fluctuates continually. When a large-scale increase occurs, real wages may rise not only at the expense of profits but also of inventories of goods, as prices do not adjust themselves immediately to the new costs. But as the process develops, the level of real wages goes down again and profits rise. In addition, entrepreneurs seek to reconstitute their inventories and this contributes to pushing up prices higher than the rise in costs would justify.

If wages were then to be stabilized, their real level would be lower than the average level resulting from these

fluctuations and, if there were no further adjustments, the activities providing the workers with goods and services would suffer a decline in demand which would swiftly bring about a contraction in that sector. Similarly, with a drop in entrepreneurs' profits, the activities satisfying their demand would also be involved in the contraction.

How far will this movement induced by the inadequate readjustment of wages go? There is a force which tends to arrest it. The fall in prices and profits tends to lead to a further increase in real wages which will continue until demand by the workers can absorb the entire output. That is the moment at which the process of contraction stops, but at a level of activity lower than had previously been reached. Will activity remain at that level or will it tend to recover spontaneously? In the case under consideration — in which no other depressive factors come into play — spontaneous recovery will occur since, with the contraction of economic activity, imports will fall off and the surplus of exports will have the stimulating effects already referred to. But was it really necessary to go through this process of contraction and recovery when it could have been avoided by choosing the right point at which to stabilize wages?

Attention should be called to one aspect of this phenomenon. We have just seen that contraction is checked when the fall in profits ensures absorption of all the goods and services intended to satisfy the demand of workers. What sometimes happens, however, is that prices are prevented from dropping by restrictive practices in which enterprises engage in order to regulate prices. If this is the case, the longer this readjustment is delayed or the more it is obstructed, the more severe the contraction will be in activities which produce for the workers. One cannot say whether or not this will result in a sharper import drop because, since there is less of a decline in entrepreneurs' profits than in the previous case, it may well be that the

larger share of imports in the demand of entrepreneurs which will not result in the spontaneous generation of the destined to meet the demand of employees and workers, which will not result in the spontaneous generation of the recovery movement.

## 2. COMBINATION OF VARIOUS MEASURES IN ANTI-INFLATIONARY POLICY

In short, anti-inflationary policy calls for the combination of a series of measures if it is to be compatible with the exigencies of economic development. The first would be to channel surplus import demand into the domestic market, and the second to replace inflationary investment or expenditure by investments covered by savings before credit restrictions are applied. If the reducible margin of imports or the savings potential is inadequate, contributions in the form of international funds must be resorted to *at the same time* and not afterwards. Devaluation is essential if internal costs have climbed more than the international prices of commodities, but it should not be applied to bring about changes in the structure of production and the composition of imports unless other measures are adopted as well.

This will not suffice to arrest the spiral if wages are not stabilized at a level which would absorb entrepreneurs' inflation-swollen profits because inadequate readjustment would have depressive effects, as would an attempt to tighten credit in order to counteract wage increases provoked by rising costs.

I am referring to immediate measures to arrest the process of inflation. But more will have to be done. An anti-inflation policy must be the starting point of an economic development policy which, by effectively attacking the structural factors of inflation, will strengthen the position of the central banks against the inflationary forces continually threatening the stability of the currency.

## VI. INADEQUATE SAVINGS AND INFLATION

### 1. CONSUMPTION PATTERNS AND INADEQUATE SAVINGS

In another part of this article we have stated that, although the phenomenon of contraction usually caused an inflationary reaction, it would be a serious mistake to attribute inflation of expenditure and investment merely to the structural vulnerability of the economy. The importance of monetary and financial policy has been demonstrated on more than one occasion in the experience of the Latin American countries. There is no mechanical relationship between structural vulnerability and inflation or the intensity with which it develops. In equally difficult situations, inflation has been avoided or eased where persons responsible for that policy have displayed, in addition to ability and wisdom, a firmness of purpose and a depth of conviction without which it would have been impossible to resist the pressure of inflationary forces. If these human qualities are lacking, monetary stability will be constantly threatened, however weak the structural factors conspiring against it.

For all these reasons, great caution should be exercised in approaching the argument that inflation is usually the result of inadequate savings. In many of our countries, the high-income groups have a relatively low savings coefficient because of prevailing consumption patterns in which to the superfluity and ostentation of the past

is added the incitement of new consumer items of the more developed countries.

In such circumstances, it cannot be denied that reluctance to save usually leads to inflation, not because opportunities for saving are lacking, but because there are no effective means of exploiting these opportunities. Inflation, for its part, aggravates this state of affairs since it destroys the savings habit where it already existed or was beginning to develop among the broad masses, and renders extremely difficult, if not impossible, any attempt to instill it.

As has been shown elsewhere, inflation is far from commendable as a compensatory policy. But it is understandable that, in face of a contraction in economic activity the central banks should be induced to yield to the pressure of inflationary forces. Such a proceeding can hardly be condoned, however, when, at the height of a boom in economic activity under the aegis of a developing export trade, credit expansion is advocated to supply the lack of saving, or when recourse is had to inflationary expedients to speed up the rate of economic growth.

I unhesitatingly uphold the belief that much might be done to change consumption and saving patterns, especially among the higher income groups in Latin America, by means of tax reform. Not only the system of taxation itself calls for improvement, but also the current methods of



tax collection, particularly in respect of income tax, where evasion is common and the sums thus lost to public revenue are considerable.

In the first connexion, the reform needed is the abolition or at any rate the reduction of the tax on that proportion of income which is invested either by enterprises or by individuals; conversely, the part used for consumption should be subject to a *reasonably* progressive tax. I underline the modifying adverb because in some countries — especially those where inflation has been intensive — progressive rates have soared so high that they have given rise to all sorts of manoeuvres to evade payment of the tax. Apart from this, there are other effective means of discouraging certain forms of consumption of durable goods — luxury building, for example — which militate against saving or against its application in the best interests of society.

Unfortunately, serious studies on the possibilities of amplifying the tax instrument in order to boost investment have not as yet been undertaken in Latin America. Moreover, the situation is far from uniform. In some countries the tax burden could be increased without difficulty, since the proportion of aggregate income to which it corresponds is relatively small, and, in addition, the capacity of the higher income groups to raise the investment coefficient by more substantial saving is strikingly obvious. In others, the proportion of income represented by taxes is so high that the possibility of increasing them is non-existent, or very slight, and only the growth of aggregate income could gradually solve the problem.

The trouble is that in the second group the heavy incidence of taxation is usually accompanied by an expansion not of the State's productive investment but of its current expenditure — and not of precisely those aspects of the latter which, like education and public health services, contribute to economic development and the improvement of social conditions. This has helped to weaken the savings potential and, in consequence, the rate of growth.

It is thus understandable that the idea of using the tax instrument to augment State investment has few adherents in the countries where this procedure has been tried out, not so much for doctrinary reasons as in consequence of their own experience. But there is no justification for such an attitude when the aim, as indicated above, is to use the tax instrument to stimulate private investment. It might be objected that the total abolition of taxation on the latter would lead to an even more inequitable distribution of capital than already exists. This effect could be offset, however, by means of an inheritance tax.

In any event, there is little sign that Latin American countries where inflationary expenditure or investment is prevalent are making a serious and tenacious effort to use taxation as a means of incentive to greater capital formation. Much less is there any evidence of a long-term plan to stimulate capital formation on the part of the masses as one aspect of an income redistribution policy. The inflationary response to the problem of inadequate saving has been the easiest way out.

## 2. THE DUAL ROLE OF INTERNATIONAL RESOURCES

How far would it be possible to achieve by means of such an effort, in a relatively short space of time, an appreciable improvement in the investment coefficient in order to expedite economic growth? Here, as was said before, there is room only for conjectural estimates. But it is

highly doubtful whether, even if efficacious incentives to save more were applied, an adequate rate of development could be achieved, especially in view of the magnitude of unsatisfied investment requirements in a large number of the Latin American countries.

From this standpoint, the co-operation of international resources might help to supply the needs in question and to bring about the reforms in the pattern of production and the structure of the economy which are indispensable requisites for the acceleration of development.<sup>6</sup> An attack on these and other strategic points might in most cases secure a relatively rapid increase in *per capita* income, which would enable the national savings coefficient to be raised in a certain number of years.

This raising of the coefficient will not be an automatic process. Habits of saving and consumption are not easily altered, and recourse to the tax system and to other measures and incentives will be necessary. This again is an aspect which has not been carefully studied in the Latin American countries, although it is of decisive importance in economic development policy. For if the savings coefficient were not to rise as *per capita* income increases with the co-operation of international resources, the limit of absorption of such resources might easily be reached without the achievement of what seems to me vital both from the standpoint of development and on other grounds: namely, the creation of the capacity to maintain a high capital formation coefficient on the basis of the region's own resources.

Once this aim has been fulfilled, further international contributions will no longer be indispensable, as they usually are at present — although they may still be desirable — especially if the position of the national entrepreneur has meanwhile been successfully strengthened.

Besides playing this role — in itself highly important — of helping the Latin American countries to raise their own savings coefficient, international resources must be channelled towards the attainment of another objective, since the problem lies not only in achieving an appreciable increment in savings, but also in the possibility of allocating that increment to imports of capital goods. If the consumer expenditure for which the income concerned was formerly used had an import content much smaller than that of the investment in which the new saving is reflected, as is usually the case, an external disequilibrium would be registered even in the total absence of inflation. The application of international resources to imports of capital goods for substitution industries or export activities, besides other investments, would permit the creation of the necessary margin for the increase in national savings to be switched to capital goods imports. All this, of course, with due regard to the possibilities for domestic production of such goods.

## 3. BANK FINANCING OF CIRCULATING CAPITAL

I am unwilling to bring these remarks to a close without touching on two points that claim attention, since their neglect often reinforces inflationary trends. One concerns investment in circulating capital and the other the obli-

<sup>6</sup> This is not the place for discussion of an exceedingly important aspect of the question — the need for a substantial proportion of these resources to be devoted to strengthening private enterprise in the Latin American countries themselves, as I have long been advocating.

gation to finance the internal part of investment with national savings.

As regards the former, even those who insist on the absolute necessity of covering fixed capital investment with domestic or foreign savings consider the expansion of credit by the banking system admissible as a means of meeting the increase in the circulating capital requirements of entrepreneurs which economic growth involves. If the banking system can draw upon a correlative increase in savings deposits, no inflationary consequences will ensue. But if this is not so, or if the increment in the deposits in question is absorbed by the financing of fixed capital investment, such consequences are inevitable.

This fact acquires greater significance when the increase in circulating capital relates to activities in which the production process is relatively lengthy. A typical case in point is that of agricultural and particularly livestock production. It is a mistake to suppose that in such circumstances credit expansion is not inflationary because its purpose is to increase production. Expansion stimulates demand immediately, whereas the growth of supply is a more or less long-term process, in the course of which the inflationary pressure of the aforesaid additional demand will meanwhile be developing.

Hence the need for the banking system to have at its disposal genuine savings with which to meet requirements in respect of both circulating capital and the financing of fixed capital, especially in the case of banks operating in connexion with agricultural production.

#### 4. THE STIPULATION THAT DOMESTIC INVESTMENT BE FROM INTERNAL SOURCES

The other point relates to the international credit institutions' stipulation that the proportion of investment which is effected within the country itself must be covered by domestic savings, international resources being earmarked solely for imports of capital goods. The difficulties encountered by the entrepreneur or the State in complying with this requirement customarily lead to the inflationary expansion of credit.

What is at fault is not only the lack of an ample capital market by means of which sectors with a deficit could avail themselves of the surplus savings of other sectors, but, first and foremost, the limitations of the savings coefficient itself. This is one of the reasons why over-all development programming should include a programme for investment. Briefly, such a programme must determine the volume of investment required to attain a specific rate of growth, establish the potential extent of internal savings (given adequate incentives) and, lastly, assess the amount of international resources that must be regarded as indispensable.

At the same time, the stipulations under discussion are explicable in the light of possible misgivings as to what might happen if certain investments were entirely financed with external resources. A country might well neglect to make the necessary effort to utilize its own sources of savings; or the availability of the outside contribution might mean that sums which could otherwise have been used for capital formation were diverted towards consumer expenditure. It has already been explained that the essential objective of such international contributions is precisely that of helping a country to raise its own savings coefficient; and if the resources in question lead it to forgo

the measures required to this end, they will have proved self-defeating.

Undeniably, experience in Latin America in general affords grounds for such apprehensions. The solution lies, however, not in the restrictive attitude referred to, but in the programming of investment. For this purpose an analysis must be made of the immediate prospects of increasing internal saving and of those likely to be opened up as the rate of growth of *per capita* income rises. This done, the amount of international resources needed to supplement internal saving can be determined. Of course, the gradual inflow of such resources depends not only upon the satisfactory quality of the individual projects presented, but also on the progressive implementation of the basic measures which are the mainstays of the programme, and which include those designed to raise the savings coefficient.

Once the amount of international resources has been established, it does not matter if in the case of certain investments these resources are used to cover some proportion of the expenditure effected within the country, and in others only to defray the value of capital goods imports, or, in the remainder, an amount less than the value of those goods. The essential point is that investment as a whole be effected in accordance with the programme, and that, when the country has made its savings effort, a bigger international contribution than was originally contemplated be not needed.

Yet again, the contribution of international resources to aggregate investment may conceivably suffice to cover more than a given country's total imports of machinery and equipment. I do not think this has been typical of Latin America's experience, since the funds contributed generally fall far short of the amount represented by such imports; but it might happen in the course of some countries, development, especially if, thanks to the common market, intensive expansion of the machinery and equipment industries takes place. In reality, there would be no economic reason why international contributions should not exceed the cost of the imports in question and finance, in addition, the purchase of domestically-produced capital goods. I cannot help wondering whether the restrictive position so often noted in this respect does not smack of commercialism, or may not be a survival of the old-fashioned belief that the production of capital goods is the prerogative of the great industrial countries alone.

The question is fundamentally one of economic expediency and of the availability of savings. If it is more economic to substitute domestic production for imports of certain machinery and equipment rather than for those of particular consumer goods, because the costs differences between the domestic manufactures and the corresponding imported articles are smaller, there seems to be no reason why international resources should not be applied to finance internal purchases instead of imports of capital goods, if domestic savings are not available for the purpose. Total purchases of such goods remain the same in both cases; the difference lies in the fact that less machinery and equipment and more consumer goods are imported in the former than in the latter instance, because this happens to be the more economic solution.

And supposing the consumer goods thus imported were non-essential or luxury articles? Here the issue should not be confused, as it so often is. Undoubtedly, in critical periods when a country lacks foreign exchange for essential goods, such imports would be unjustifiable. But this

is not the point; the problem under discussion is that of steady economic development by means of a programme which determines, on the basis of economic criteria, what must be produced at home and what must be imported. As regards non-essential or luxury goods, the important decision incumbent upon economic and social policy relates to how far such consumption should be restricted by means of taxation, with due regard to capital formation requirements and the redistributive aims of a given programme. Once this vital question has been settled, it is immaterial whether these goods are imported or domestically produced, so long as the course chosen is adopted on its economic merits.

Another objection which might be adduced is that the country concerned would be importing consumer goods — whether non-essential or luxury articles or not — while factors of production were available to manufacture them. There are no grounds for confining this argument to con-

sumer goods. If factors of production are available, and still more if idle capacity exists in the economy, the proper solution is to utilize them, for which purpose, as has been explained elsewhere, import substitution will have to be accelerated in so far as exports cannot be expanded.

If, as may well happen, economic development is accompanied by maximum utilization of factors, there is no need for concern as to whether international resources are applied to imports of consumer goods, provided, it must be reiterated, that the substitution policy pursued is based on considerations of economic expediency. The essential point is that all investment be covered with genuine savings, either internal or external, and that the amount of the international contribution be correctly related to the country's external payments capacity and its future evolution as a result of the structural transformations which the implementation of the development programme entails.

## VII. A POLICY OF MONETARY STABILITY COMPATIBLE WITH ECONOMIC DEVELOPMENT

### 1. DYNAMIC NATURE OF THE INFLATIONARY PROCESS

Steady and intensive economic development calls for a series of reforms in the pattern of production, in economic and social structure and in income distribution. These reforms will enable the economy to grow faster than primary exports and to cushion the internal impact of fluctuations in these latter, while at the same time removing local obstacles to development. If such reforms are effected only in part, or inadequately, or not at all, maladjustments and tensions arise which call into play or stimulate the inflationary forces latent in the Latin American economy. This is the contention sustained in the foregoing pages.

Rightly considered, it is *change* in economic conditions that favours the action of these inflationary forces. If an energetic economic development policy were to promote the steady growth of the economy, if *per capita* income were to increase persistently enough and on a satisfactory scale, without the fluctuations registered at present, and if income distribution were modified not regressively but progressively — if all this were carried out with a reasonable degree of efficacy — the maximum degree of resistance to the action of inflationary forces would be ensured, whereby to maintain monetary stability.

There are also cases, not so much of resistance to inflationary forces, as of weakness on the part of these forces themselves. In reality, it is not usually difficult to maintain monetary stability in situations of relative economic and social stagnation based on an out-dated system of land tenure and income distribution, with little social mobility. But sooner or later social pressures emerge to militate against this precarious equilibrium, spurring on inflationary forces which quickly put an end to monetary stability.

These forces are not always associated with adverse circumstances. They are also intimately allied to prosperity. A favourable change in economic conditions opens up new opportunities for consumption or investment which, when they exceed the genuine resources available, precipitate inflationary expansion.

True, inflation is not a purely economic phenomenon, and a thorough understanding of its nature and significance calls for sociological research of a kind in which Latin America is behind the times. If the stagnation or

slow progress of the economy provokes those social pressures which degenerate into inflation in default of an enlightened development policy, rapid growth also brings about conditions favourable to the increased mobility of dynamic elements, to changes in the existing social complex, likely to stimulate the action of inflationary forces.

New social groups force their way into politics and economic affairs — in close combination — and resort to inflation to establish and consolidate their power, altering income distribution in their own favour. History has afforded examples of other highly efficacious ways of redistributing income, among them that concentration of land ownership which is still widely prevalent in the Latin American countries. But inflation perhaps outdoes them all in its flexibility and the far-reaching scope of its consequences.

Thus, inflation is a manifestation of economic and social change, an essentially dynamic phenomenon. Consequently, campaigns to prevent or combat it cannot be waged through autonomous monetary measures, but must form part of a vast and deliberate effort to channel economic and social forces towards the attainment of clearly-defined objectives.

### 2. ORTHODOXY AND THE FREE PLAY OF ECONOMIC FORCES

Hence the irremediable fallacy of the orthodox position. It heedlessly ignores the phenomena of economic development. Whether a Latin American country is enjoying a boom or suffering a slump in its exports, whether it is growing at a rapid rate or barely developing at all, the formula is the same; inflationary forces must be combated by means of a firm credit restriction policy and certain other expedients which, as a general rule, do not venture beyond the monetary sphere.

But does this mean that orthodox monetary policy is indifferent to a country's economic development? Does it set up monetary stability as a primary objective, for the sake of which such development must be curbed or smothered? This would be an unjust assumption. The difficulty is not lack of interest in economic development, but a concept that is perhaps even more serious: the implicit negation of the need for a development policy, of the need for reforms in the pattern of production, in economic and

social structure and in income distribution — of the need, that is, for a conscious and deliberate endeavour to influence economic and social forces.

Deliberate action of this kind is unnecessary because economic development is a spontaneous phenomenon. Herein lies the basic error — in the belief or the supposition that, once monetary stability is assured and the economy relieved of any kind of State intervention, the free interaction of its forces will suffice to bring about maximum efficiency in the utilization of the factors of production.

The orthodox application of anti-inflationary policy generally implies economic contraction and social distress; it is the present price that must be paid for a welfare shortly to be enjoyed, the indispensable sacrifice whereby to earn the remission of our economic sins and the grace of foreign private capital. Emanating at times from profound conviction, and at others from the impression that without it external contributions to help control inflation will be unobtainable, a policy of this type demands qualities of energy and firmness which — however admirable in themselves — end by foundering amid the tensions, antagonisms and resistances of every kind which the contraction or relative stagnation of the economy brings in its train.

All this is much to be regretted, for such qualities are highly necessary in any campaign against inflationary forces. But monetary policy should not be expected to yield results which it cannot produce alone. It is impossible to combat inflation or prevent its reappearance by purely monetary measures; they must be incorporated in the framework of an energetic economic development policy which ensures the structural equilibrium of the economy. Only then can monetary policy be required to give what it is capable of achieving, namely, stability, an essential requisite for economic development, but not the only one.

Structural equilibrium is not static, but dynamic; that is, it must perpetually adapt itself to the new demands of economic development. In the Latin American countries this means a continuous transformation of the structure of production and the composition of imports so that the rate of growth of the economy may exceed that of exports. These changes cannot result from the spontaneous interaction of economic forces, but must be the outcome of measures which forestall the claims of future events. Nor should they be the consequence of successive devaluations of the currency; this is a fantastic theory, which purports to show that if the exchange rate is left to find its own level through the machinery of free interplay, the readjustments referred to will be achieved without the necessity of deliberate action.

In this whole field there is a deplorable confusion, resulting from the static reasoning on which the orthodox conception of monetary matters is based, and which fails to reckon with the dynamic process of development. Of course, the main objective of a sound monetary policy — to which I unconditionally subscribe — is to stabilize the external equilibrium of the economy; not, however, its structural equilibrium, but the deviations from this which take place in the course of the operation of the economy.

Structural equilibrium is not a matter for monetary policy, nor is the remedying of external vulnerability. For such purposes structural reforms are indispensable, and without them the risk of inflation will continue to be very great. A tax policy planned to provide incentives to investment, and measures which actively promote capital

formation on the part of the broad masses of the population, will give monetary and financial leaders a more stable base from which to operate against the inflationary expansion of credit.

Nevertheless, this concerns only one aspect of inflation. Not all inflationary pressures originate in credit. The inflation of costs must also be guarded against. It is expedient to do so by means of measures which equitably distribute the social burden of heavier costs. But the fundamental solution lies in changes in the pattern of production which will obviate such increased costs or permit their absorption.

### 3. INFLATION AS AN INSTRUMENT OF REDISTRIBUTION

Redistributive aims never have been and never will be efficaciously achieved through inflation. In the course of history, inflation has shown itself to be an effective instrument of regressive redistribution in favour of the higher-income groups. But it has not proved an instrument of progressive redistribution in favour of the masses, since the credit system makes sure that the burden of illusory wage increases, or of social security contributions that cannot possibly be absorbed by productivity instruments or entrepreneurial profits, is shifted back on to their own shoulders.

It is readily understandable, however, that pressure for the amelioration of social conditions should have become a persistent inflationary factor in some of the Latin American countries. The inflationary spiral usually constitutes a psychological safety-valve when the contraction of income, its slow growth, or maladjustments in its distribution, militate against any lasting upward trend in the level of living of the population.

I refer, of course, to the use of the inflationary instrument to achieve social improvements, which must not be confused with the protection of workers against the rise in prices and profits generated by inflationary expansion. This defensive posture is not inflationary, but a corrective to the effects of inflation.

That wage increases higher than can be absorbed by profits or productivity infallibly culminate in the inflationary spiral is an incontrovertible truth. But it must not be supposed that as a preventive step the stabilization of wages — however high the level chosen — constitutes a basic solution to the problem. It is impossible to stop the clock at the present moment, since the stabilization of wages also implies the stabilization of the existing disparities in income distribution. And an anti-inflationary programme which does not set resolutely to work to correct these irregularities lacks economic efficacy and social significance, while incurring a very serious risk of a relapse into inflation.

### 4. INCOME REDISTRIBUTION AND CAPITAL ACCUMULATION

This problem of redistribution assumes new characteristics in the Latin American countries. In the capitalist evolution of the great industrial centres capital accumulation preceded redistribution. In our countries the two operations have to be performed simultaneously. Hence the need to seek new formulae by means of which the broad masses of the population can play an active part in national capital formation as redistribution policy makes progress.

Those who believe that inflation is the readiest expe-



dient for the satisfaction of popular aspirations in the direction of income redistribution are falling into an error whose political projections are incalculable. And the same is true, at the opposite extreme, of those who advocate inflation as an instrument of saving.

The solution of the problem of inadequate saving is not to be found in inflation, but in a rational combination of measures to increase thrift within the framework of a development policy. The consumer expenditure of the higher-income groups must be restricted. But this is not enough. The inflationary solution of restricting mass consumption cannot be perpetuated, however, firstly because present levels are unsatisfactory as they stand, and secondly because such inflationary restriction of consumption is effected by transferring the margin of saving to the entrepreneurs, and only a fraction of it — not as a rule a very large one — is used for capital formation. Moreover, a proportion of the latter represents investment stimulated by the increase in demand on the part of the higher-income groups resulting from this transfer of real income in their favour.

Within a socially acceptable programme to raise the investment coefficient, the capacity for saving of the bulk of the population is at present very limited. Here too the solution is dynamic in character: namely, to increase *per capita* income through the co-operation of international resources and the more efficient utilization of the factors of production, and to apply the income increment in such a way that investment increases more rapidly than consumption.

The masses in Latin America must be assigned their share in the basic task of capital formation. But their intervention in this process must not be passive, deriving from the spoliative effects of inflation, but conscious and deliberate. They must be allotted an active role in the formulation and application of development programmes and a clear and effective responsibility in respect of internal capital formation.

That inflation may have dynamic effects is undeniable. It mitigates the intensity of a contraction of the economy, and, in favourable circumstances, allows the investment coefficient and therefore the rate of development to increase. What is more, in certain cases, the transfer of income is effected not so much at the direct expense of popular consumption, as by diverting towards the higher-income groups a considerable part of the increment in

productivity or of the effect of an improvement in the terms of trade. But this is not a typical phenomenon, and furthermore implies a regressive redistribution of income which is inadmissible from the social standpoint. Moreover, as the workers gradually develop their capacity for self-defence, the efficacy of inflation as an instrument of capital formation diminishes or disappears, and the distortions it causes are accentuated.

Neither inflation, nor orthodoxy. The time has come to formulate a monetary policy which meets the requirements of an economic development policy, which fits into its framework perfectly. Orthodoxy, owing to the dogmatic complacency with which it is administered, owing to the uncompromising finality with which it is generally presented to our countries, acts as a severe brake on the effort to devise this new form of monetary policy. I greatly fear that its continued application will increasingly strengthen the notion that economic development and monetary stability are incompatible concepts.

And that they certainly are not. If dynamic equilibrium is ensured by means of the reform of the economic and social structure, a firm foundation will have been laid for a policy of monetary stability, which is, moreover, indispensable to the steady development of the economy. Once structural equilibrium has been established by virtue of an energetic development policy, monetary policy can efficaciously discharge its proper function of correcting deviations therefrom; and the instruments of monetary orthodoxy may then be very useful — although not all-sufficing — in restoring external and internal equilibrium.

Doubts are sometimes expressed as to the possibility of putting a rational development policy into practice because of our countries' lack of political maturity and the want of understanding on the part of the masses. And the idea of popular capital formation is repudiated as impracticable. Perhaps some misgivings are entertained lest all these advances may prove incompatible with the conservation of certain economic and social complexes.

But it must not be imagined that inflation is an alternative. If the system under which we live cannot develop without it, inflation will be an alternative that leads nowhere. For it corrodes the economy and dangerously disrupts society. Impossible, then, to deny the rationality of inflation as an instrument, not to infuse the system with dynamic vigour, but to sweep it inexorably onward to disintegration.