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Notes and explanation of symbols

The following symbols are used in tables in the *Review:*
Three dots (...) indicate that data are not available or are not separately reported.
A dash (—) indicates that the amount is nil or negligible.
A blank space in a table means that the item in question is not applicable.
A minus sign (-) indicates a deficit or decrease, unless otherwise specified.
A point (.) is used to indicate decimals.
A slash (/) indicates a crop year or fiscal year, e.g., 1970/1971.
Use of a hyphen (-) between years, e.g., 1971-1973, indicates reference to the complete number of calendar years involved, including the beginning and end years.
Reference to "tons" mean metric tons, and to "dollars", United States dollars, unless otherwise stated.
Unless otherwise stated, references to annual rates of growth or variation signify compound annual rates.
Individual figures and percentages in tables do not necessarily add up to corresponding totals, because of rounding.

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Macroeconomic policies: in search of a synthesis

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This article analyses the evolution of the macroeconomic concepts which have prevailed in Latin America from the 1950s until the present. Two main concepts —structuralism and monetarism— have kept up an ongoing counterpoint over this period. The author analyses the main arguments of both currents of opinion and appraises their impact on the design of macroeconomic policies in the various stages of the region's development.

Around 1985, a new pragmatism appeared on the scene, and the analytical bases of this are examined in detail. The author concludes that this pragmatic approach requires a good deal of fine-tuning, both as regards the economic and social cost of its policies and with respect to the need to overcome sectoral differences through economic growth.

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Introduction

The Latin American macroeconomic experience in the last few years has been frustrating. The heterodox experiments of Argentina, Brazil, Peru and Venezuela have crumbled; orthodox stabilization in Bolivia has generated price stability but also the absence of growth; while the returns from Mexico's orthodox-like efforts are by no means in yet. Chile is growing steadily, with low inflation, but its per capita income is barely 3% above the level of 1980 and only 12% above the level of 1970. If Chile is the example for Latin America as a whole, the implication may well be one of a wait of another 10 to 20 years before any net gain in income is realized. Costa Rica could be candidate for a rosy spot: its record on inflation and growth in 1986-1987 was most encouraging. But despite Costa Rica's extraordinary access to foreign aid, inflation was substantially up again in 1988 and per capita growth was negligible. In addition, were an attempt made to replicate Costa Rica's experience hemisphere-wide, its US$80 per capita per year of unrequited capital inflow would translate *mutatis mutandis*, to some US$33 billion of capital *inflow* a year, a clear impossibility.

Hope for a better macroeconomic situation in Latin America has to lie in the continued learning of policy-makers from past experience and from new insight into the way Latin American economies function. Fortunately there has never been lack of macroeconomic policy debate in the hemisphere. It even appeared briefly in the mid-1980s that a consensus on a pragmatic Latin American macroeconomic policy was emerging. Whether such a consensus will ultimately arise still remains to be seen. In the interim, it is worthwhile reviewing the ebb and flow of the debate since the post-war years to see where it now stands.[1]

[1] Sections I and II draw heavily on Schydlowsky, D.M., "Interdependent Development", *Harvard International Review*, November 1985.

I

Point and counterpoint from the 1950 to the 1980s

In the 1950s and early 1960s, the debate was between structuralists and monetarists, and became one of the classics among economic debates. The structuralists, drawing largely on insight from experience in the southern cone of the hemisphere (Argentina, Chile, Uruguay) argued that the development process inexorably brought about inflation and balance-of-payments problems; those were essentially symptoms of growth. To try to cure inflation by monetary contraction would simply stop growth without eliminating the causes of inflation. To try to cure balance-of-payments problems by devaluation was useless because the relevant price elasticities were far too low to make devaluation effective. Inflation and balance-of-payments problems, rather, would eventually disappear as a consequence of the development process itself, which would in time rebalance the economy. In the meantime, one could repress inflation somewhat with price controls, but otherwise would have to live with it. The balance-of-payments problem was best resolved by tariffs and quantitative controls, which would at the same time lead to import-substituting growth and thereby gradually cause the problem to disappear. Prices, in this view of things, served mainly a distributive function; their allocation role was thought to be severely hampered by low price elasticities, monopolies, oligopolies and other institutional circumstances which made markets function in a manner very different from competitive assumptions.

Monetarists, on the other hand, drawing from established economic theory and viewing the world largely from the vantage point of the International Monetary Fund (IMF) in Washington, argued that, without excess demand, no inflation or balance-of-payments problem could exist. Excess demand, in turn, was caused by excessive government expenditure and loose monetary policies. Thus, fiscal discipline was of the essence, government expenditure needed to be cut back, the printing press correspondingly slowed down, and, if necessary, the currency devalued to re-established its true international parity.

It will be noticed that the monetarist view is more aggregative, less specific to any particular institutional situation and thereby more broadly sweeping.

By late 1960s and early 1970s, monetarism had won the intellectual battle for control of macroeconomic policy. The level of technical training of government economists was continuously increasing and with it the influence of established economic theory. Structuralism, on the other hand, had not been able to make a good enough intellectual case. Concurrently, central banks acquired more influence compared to national planning agencies, which had earlier flourished with the support of the Alliance for Progress. But while monetarism was winning the intellectual debate for macroeconomic policy, structuralism was capturing the development policy: import-substituting industrialization swept the hemisphere.

The essence of import-substituting industrialization (ISI) is the furtherance of domestic production of as many of the country's existing imports as possible. It implies a deliberate violation of static comparative advantage on the basis of dynamic arguments relating to infant economies and infant industry laims, learning by doing, externalities, etc. Moreover, ISI is asymmetrical with regard to industrial growth. It stimulates industry in so far as it supplies domestic demand; no comparable export drive is part of the plan. Inward-looking industrialization is buttressed by tariffs and quantitative restrictions which constitute a *de facto* multiple exchange rate system. Industrial labour participates in the benefits of industrialization by an increase in wages, be it through expanded unionization or through political pressure and legislative action on minimum wages and fringe benefits. Increased labour migration to the cities follows; new migrants cannot be absorbed into organized industry and thus a so-called "informal sector" appears which makes markets more monopolistically competitive, while incomes are determined increasingly by mechanisms which in one or another way imply work and incomesharing. The investment policy furthers the accumulation of capital stock in industry. However, there is no concern with the level of utilization of real capital stock. Indeed, the relative price of machinery and labour, the structure of the tax system, the depreciation rules, the import licensing, and the natural proclivities of entrepreneurs all interact to generate very substantial levels of unused capacity.

Growth under ISI implies that industry expands rapidly, well in excess of the rates of growth of the primary sectors. But, since industry requires imported raw materials while selling to the domestic market, it is a foreign-exchange-using sector. In turn, foreign exchange is supplied only by the primary sector. The growth pattern is therefore one in which the foreign-exchange-demanding sector is growing much more rapidly than the foreign-exchange-supplying sectors. As a result, ISI produces balance-of-payments crises due to the inconsistent sectoral growth of productive capacity which this policy furthers. Too much of the country's savings go into the foreign-exchange-using industrial sector, and too little into the foreign-exchange-producing primary sectors. This imbalance in the distribution of capital stock means that full utilization of existing capital and labour (internal balance) is inconsistent with balance-of-payments equilibrium (external balance).

When the structuralist-inspired growth policy produced balance-of-payments problems, the monetarist technocracy responded in the only way they knew: by devaluing the currency and deflating the economy. The deflation part typically worked. The price adjustments through which the devaluation was to rebalance the economy typically did not work: the ISI policy had succeeded in substantially reducing elasticities and removing flexibility from the economic system. With deflation being the principal effective macro-policy tool, the underlying imbalance rooted in the maldistribution of capital stock between foreign-exchange-using and foreign-exchange-generating sectors was not touched. Rather, the symptoms of this imbalance were being temporarily repressed while the deflation lasted. Whenever reflation was undertaken, the same problem would reappear. Argentineans called this the "stop-go" economy.

The frustration generated by successive stop-go cycles combined with the impact of the first oil crisis and some particularly inept experiments in populist macroeconomic policies (Perón II, Allende) helped usher in a new macroeconomic conception accompanied by a new macroeconomic instrument. The conception was the new monetarism, which basically accepted the structuralist argument of a fundamental imbalance in the productive structure but which resolved to clean house so that markets could in the future work the way they should. It was necessary to "get the prices right". This would be accomplished by opening the economies to imports. The domestic price level would be controlled courtesy of East Asian exporters and thanks to the law of one price (i.e., domestic prices cannot diverge from ceilings set by import competition). Domestic economic efficiency would be achieved by virtue of the "winds of competition", which would also blow from East Asia. To this end, the exchange rate would be suitably managed while any transitory problems that this policy might cause in the balance of payments would be dealt with by the newly available policy instrument: capital inflow. Along with opening the economies to import trade, they would also be opened to private capital flows. Interest rates would be encouraged to rise to a level sufficient to bring in world capital in whatever amount was necessary; indeed, the *proper* amount would flow in *automatically* by virtue of the workings of the free market.

The new fashion first appeared, as is usual in the economic policies of Latin America, in the southern cone; the time was the second half of the 1970s. In its original habitat, the new monetarism coincided with a turn towards authoritarianism. However, the fashion spread to other countries with different political climates such as Costa Rica, Colombia and Venezuela.

Reality was not kind to the economic policy of the new monetarism. Import competition did not work quite the way it was supposed to. To begin with, it turned out that importing is a business that requires know-how and commercial connections. Thus, in many instances, the first importers were the same firms who were marketing the corresponding domestic products. That, however, meant non-competitive markets. Combined with the novelty value of imports, it soon appeared that import prices were not setting the ceiling to domestic prices, but rather domestic costs were setting the floor to the pricing of imports. As these import monopolies began to be eroded, the pendulum swung to the other side. The novelty of owning import goods caught on and spread like wildfire, demand shifted massively from the purchase of domestically produced goods to the purchase of import goods.

Domestic producers attempted to ride out the loss of markets by going into debt. Since the capital markets had been opened, money for lending was readily available. The interest rate on this debt was not initially very high. Part of the new monetarism involved pegging the exchange rate or having it devalue more slowly than the domestic rate of inflation, since otherwise world prices would not have an anti-inflationary effect. The by-product was that high rates of interest in dollars translated to low or negative real rates of interest in local currency.

Consumers also went into massive debt; the financial liberalization meant for many of them that they had access to credit for the first time. What interest they were charged was secondary compared to their previous inability to borrow at all (i.e., an infinitely high interest rate), so that rates demanded did not seem unreasonable, particularly when they made it possible to buy coveted import goods. The inflow of foreign capital thus fuelled an import boom. The winds of competition had become a tornado which blew a sizeable part of the industrial sector into bankruptcy. At the same time, it inflated a huge foreign debt balloon, which was bound to burst at some time.

The foreign debt resulting from the new monetarism added to the debt Latin America had accumulated from the oil deficits and the oil boom (for both oil-importing and oil-exporting countries had borrowed generously). When interest rates rose in the early 1980s, the balloon burst. The Latin American debt crisis had arrived.

In the midst of the scramble to contain the fallout from the debt crisis, the new monetarism was largely abandoned; most governments reverted to old monetarism under the IMF's supervision; exchange rates were devalued, fiscal expenditure was cut, credit was tightened and interest rates were raised. The gross national product (GNP) fell in many countries of the hemisphere. In Argentina, the fall was 11% from 1980 to 1982, in Chile it was 15% from 1981 to 1983, in Peru it was 12% in 1983 alone, etc. Industrial output showed even greater reductions, particularly in Brazil, Chile, Mexico and Peru. Inflation did not fall together with output, as the old monetarism might have predicted. Instead, it sky-rocketed; Argentina reached an inflation of 344% and rising in 1983, Chile's inflation went from 9% to 23%, Peru's went from 73% to 125%. On the other hand, open unemployment went to double digits while underemployment was above 25% for the labour force. The only positive achievement of this incarnation of old monetarism was the improvement in the balance of trade which resulted from the depression.

At work in this unravelling of the new monetarism seems to have been a combination of elements. Nominal wages seemed to reassert a fundamental indexation to the price level, even though real wages did suffer some erosion. Profit rates in turn, seemed to maintain their levels, making up in the rate of mark-up any fall in volume of sales. Relative prices inside the Latin American economies began to deviate again from world relative prices, and, thanks to a new protectionism, moved closer to their earlier "traditional" levels. Fundamental societal forces determining the income distribution which had been repressed during the period of the new monetarist policies were now reasserting themselves. When the government, in the pursuit of old monetarist policies, administered a price shock such as the removal of subsidies or a devaluation, all it achieved was to accelerate the inflation; structural rigidities had reasserted themselves with a vengeance and were now more powerful than ever.

II

The new pragmatism, *circa* 1985

The collapse of the new monetarism led to the simultaneous appearance in different parts of Latin America of an approach to macroeconomic management which attempted to combine elements of earlier views with lessons from experience in a pragmatic fusion.

The new approach took from structuralism the recognition that history matters and that institutions and the structure of the capital stock and of production must be taken into account. As distinct from the new monetarism, however, it did not regard these structures as illegitimate and worthy only of being swept away. Rather, it declared them legitimate and attempted to enlist them in the evolution towards an improved future. The hallmark of these policies was pragmatism; their goal was maximizing the achievement of the possible.

On the real side, the new pragmatism started from the recognition that the well-nigh intolerable social stress caused by the recessive policies of old and new monetarism was unnecessary. Since there was idle labour and idle capital stock in the economy, production and income could be substantially higher. However, such a mobilization of idle factors of production would require complementary foreign exchange. Thus, a proper macroeconomic activation policy required taking into account differential import requirements. Enter, therefore, selective import protection and a new phase of import substitution. Concurrently, however, and drawing on historical experience of the past, the new pragmatism emphasized the promotion of non-traditional exports, trying to convert installed capacity and available industrial labour into export revenue from industrial goods. Since excess capacity was understood to be spread unevenly throughout the economy, and costs of production were by no means thought to be uniform across sectors, the export policy would have to be selective, just like the import-substitution policy. The result would be an exchange-rate system which combined one or more exchange rates, import duties, export taxes and export subsidies in a coherent manner.

The gravity of the debt situation further underlined for the new pragmatism the importance of saving and earning as much foreign exchange as could efficiently be done. However, efficiency would need to be assessed in "macroeconomic" terms, i.e., on the basis of shadow rather than market prices.

On the control of inflation, the new pragmatism took into account that a substantial fraction of product prices and factor returns were formed in markets that did not conform to the standards of perfect competition. The existence of a large informal sector of the economy was held to lead to levels of labour income constrained by the need to share poverty. Such a situation implied, at best, labour incomes set by monopolistic competition in the (informal) product markets. Formal sector wages, in turn, were recognized to be governed by legislation and union/enterprise bargaining. Hence, these wages were not set by competitive markets either. In turn, the monopolistically competitive and oligopolistic nature of product markets allowed mark-up pricing and non-competitive returns to investment in most non-agricultural activities. Two major consequences resulted from these features. On the one hand, the existence of "administered" prices and incomes provided a pivot on which to base a prices and incomes policy, including temporary price and wage freezes as well as offsetting changes in nominal wages and interest rates. The second important implication arose for the evaluation of efficiency in production. With factor incomes not determined competitively, private profitability of production is no longer a good measure of national economic efficiency. The latter needs to be measured at shadow prices. It follows that tax and commercial policy should be set so as to bring private profitability and national economic benefit into equality. A proper underpinning for the differentiated features of the import-export régime is thereby provided.

The new pragmatism also recognized that response to policy would vary across the economy. In part, such differences would arise from non-uniformity of underlying conditions (e.g., some sectors would have plentiful excess capacity, others would not); other differences would result from the distribution of decision-makers across sectors (some would be tight oligopolies of a handful of firms while others would be relatively competitive). Throughout, the new policy view attempted to gear macroeconomic policy to take advantage of these differences by looking for high-response-elasticity sectors and tailoring policy accordingly.

Finally, the new pragmatism had a much more sophisticated view of expectations. Rather than assuming that economic agents directly extrapolated the past (adaptive expectations) or that they truly knew how the economic system operated or at least acted as though they did ("rational" expectations), the new pragmatism started from the recognition that the key economic agents were relatively few in number and that their expectations (and actions) could be critically affected by enlisting them in the implementation of the economic policy. The old central banking technique of "moral suasion" was thus combined with the principles of indicative planning to yield a policy tool which could support short-term stabilization policy.

The new pragmatism was the intellectual source for the stabilization policies of Brazil (*Plan Cruzado*), Argentina (*Plan Austral*), Peru, Venezuela and Mexico; however, in none of these countries was the full package of the new pragmatism adopted. The feature most generally put into practice was the prices and incomes policy, ranging from outright freeze (by agreement or by decree) through controlled slide. The least applied part of the package was activation through export promotion. However, without a rapid increase in exports, the lack of foreign exchange could not help limiting the level of activity. In turn, without a rising GNP the incomes policy would perforce be subject to inordinate distributional strains. Policy-makers around the hemisphere saw the problem and dealt with it by running down reserves (Brazil), limiting debt payments and running up arrears (Brazil, Peru, Argentina) or repeated external debt renegotiations (Brazil, Argentina, Mexico, Venezuela). However, none of these efforts yielded more than a very temporary relaxation of the foreign exchange constraint.

The recognition of sectoral differentiation of costs, market structure and control did not spill over into a generalized policy. Brazil, Venezuela and Peru adopted the most differentiated trade restriction systems. Venezuela's and Peru's broke down fairly rapidly under the combined weight of foreign exchange scarcity and wide differentials (which made corruption much more irresistible), while Brazil's survived thanks in good measure to being much more solidly established and of longer duration.

Moreover, the new pragmatism did not offer a clear stand on public finance, on the general notion that activation would yield a fiscal dividend, which could be used to cover a pre-existing deficit or could be used to expand government expenditure for worthy purposes. However, with activation hampered due to the lack of foreign exchange, the risks inherent in fiscal deficits loomed distinctly larger.

The failure of the "heterodox" stabilization policies in Brazil, Argentina and Peru gave the new pragmatism a bad reputation and prompted wistful longing for the old monetarist simplicity. However, significant parts of new pragmatist thinking had become received wisdom as evidenced by the heterodox elements in President Menem's stabilization plan. Moreover, there was also extensive consensus in interpreting the new pragmatist experience in regard to the breakdown of administrative control systems. Combined with the fiscal deficit, this breakdown eventually led to a general conviction that the State was a very poor administrator capable of nothing other than the most elementary functions. By contrast, Bolivia became the shining example: the stabilization of prices had been accompanied by simplification of taxes, wholesale dismantling of public enterprises, the installation of free markets, the reduction of import duties and high real interest rates. The Bolivian State had been trimmed down to size in an attempt to set the stage for growth. Mexico heeded the example and applied many of the same policies. But doubts survived: Bolivia appeared to have stabilized but it was also stagnating;[2] in Mexico even price stability was not assured.

[2]Official GNP estimates show growth of 2.8% for 1988, i.e., about as much as population grew. However, cognoscenti claim that all that has happened is that the statistics now pick up a range of informal activity that had been there all along; therefore, the true growth of GNP is alleged to be zero.

III

Point and counterpoint *circa* 1990: a retrospective and prospective view

Over the last four decades tension has continually existed between the policy needs of the real side of the economy, segmented sectorally, differentiated with regard to costs of production, market structure, market adjustment mechanisms, income distribution and response elasticities, and the requirements of a unified and implementable macroeconomic policy. Over the decades, policy has swung back and forth, as intellectual fashion waxed and waned and political enthusiasm and disillusion with easy-sounding prescriptions alternated.

Thus, the ebb and flow between the attention to sectoral differentiation and the emphasis on "implementable" undifferentiated macro-policy has been a constant in the policy cycles of the hemisphere. Structuralism (read recognition of sectoral differentiation) did battle with the old monetarism (read aggregate simplicity). The latter won on points, but the former had a lasting impact on the economic landscape of the hemisphere. The result was the new monetarism, cognizant of the existing sectoral needs but dedicated to eradicate them. The collapse of the new monetarism briefly re-established the hegemony of the old monetarism, but not for long. The new pragmatism appeared, attempting to legitimize sectoral differentiation within a coherent macroeconomic conception. However, running a highly differentiated policy, even if based on sophisticated concepts, turned out to be beyond the administrative capability of Latin American governments. Hence the pendulum has very recently swung once more to "automatic mechanisms", i.e., to use of the free market in microeconomic matters and to a version of the old monetarism combined with official capital inflow at the macro level.

While the sectoral fissures in the economic landscape of Latin America have become increasingly undeniable, the trend at present is once again to let the market rip, in the hope that whatever segmentations exist will thereby be made to go away. In part, this represents the view that it is largely the government itself that creates the segmentations and distortions; therefore, they will disappear as soon as the government gets out of the way. While this happy outcome is gestated, government should attempt to become really good at doing a few very central things (such as collecting taxes).

No doubt the pendulum will eventually swing back. As it will become increasingly obvious after a few years that trimming back the government has not caused the fundamental differentiations in the economy to disappear, because these are rooted in the development process itself and at bottom define the stage of development at which Latin America finds itself, policy will once again turn towards a more disaggregate mode. Then, perhaps, an even more pragmatic new pragmatism will emerge, one that incorporates limits on the administrative capacity of the State as a basic building block of policy choice, one that more clearly targets the priority areas which require State intervention, but does not give up aggregate balance in the process.

Out of such a truly balanced pragmatism may come a transition policy which will eschew the economic surgery and the attendant social and economic costs that are at present argued to be unavoidable, and will instead allow Latin America's economies to evolve towards an effectively working market system by growing out of its sectoral differentiations.

Point and counterpoint will then have become resolved in a final accord.