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Stabilization and adjustment policies in the Southern Cone, 1974-1983

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Two economic problems contributed to the political upheavals which gave rise to the neo-conservative experiences in Argentina, Chile and Uruguay: galloping inflation and disequilibria in their external accounts. To be sure, these three countries had long tolerated, if not learned to live with inflation. Indexing was widespread, and most economic agents had long come to think in real, and not nominal terms. Yet the efficacy of such instruments was seriously eroded when triple digit inflation beset them. The costs of 600% inflation in Chile (1973), 300% in Argentina (1975), and close to 100% in Uruguay (1973) and the fear of hyperinflation made each of them, especially the first two, assign top priority from the very beginning to stabilization policies.

Not only were these countries beset with unprecedented rates of inflation, but with serious disequilibria in external accounts as well: the deficit on current account at the onset of the new regimes ranged from 20% of the value of exports of goods and services (Chile) and 27% (Uruguay) to 37% (Argentina); and their debt-to-export ratios were among the highest of Latin America at the time: 1.7 (Uruguay), 1.9 (Argentina), and 2.5 (Chile).

The purpose of this paper is to analyse the stabilization and adjustment policies pursued by each country; to establish at what cost, in terms of output and income distribution, these disequilibria were corrected; and to determine to what extent these costs were avoidable or not, and if so, what specific policies were responsible for these failures.

It goes without saying that no policy is ever purely a stabilization or purely an adjustment policy, for the problems of internal and external disequilibrium often come together, as they did at the onset of these neo-conservative experiences. Nevertheless, it is probably fair to say that in the first years, and specially in Argentina and Chile, the aim was stabilization, subject to a balance-of-payments constraint; whereas in the last years (1981 on) the aim was adjustment subject to an anti-inflationary constraint. Hence the analysis will stress the stabilization features of the first years and the adjustment process of recent years.

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I

The monetarist approach to stabilization; Inflation as a monetary phenomenon

The debate concerning the causes of inflation in the Southern Cone traditionally centered about two schools of thought: the monetarist and the structuralist.¹ Monetarists attributed inflation to an overexpansion of the money supply, normally the result of fiscal deficits. The solution was to correct such maladjustments and slow down the expansion of credit. Structuralists, on the other hand, while not challenging the general relationship between fiscal deficits, monetary expansion and inflation, affirmed that such an expansion was endogenous. That is to say, the monetary authorities often found themselves *forced* to increase the money supply in order to avoid falls in the product due to more deep-seated (structural) shortfalls: for example, the (allegedly) low price elasticity of exports and of agricultural output made these economies extremely vulnerable to disequilibria originating in these sectors. Hence, the attempt to overcome the negative consequences of such bottlenecks on the rest of the economy generated pressure to expand credit. Thus, any attempt to eliminate inflation without overcoming these structural bottlenecks would have either only passing success or would lead to recession.

While it is true, as monetarists argued, that in the Southern Cone there has been a very close relation *in the long run* between the rate of inflation and the growth of the money supply, in the short run this has not always been the case (see table 1).

This is the basis for the structuralists' arguments that in order to stop inflation it would not be enough to reduce fiscal deficits and slow down the growth of money supply, since the velocity of money could fluctuate in a compensatory fashion and, given the existing rigidities and bottlenecks in the economy, the deceleration in the rate of growth of aggregate demand (M_v) could slow

¹This controversy occupied a good part of the debate concerning inflation right through the end of the 1960s. The literature is extensive. See, for example, the articles by Oliveira Campos (1961), Felix (1961), Grünwald (1961), Baer and Kertenetzky (editors) (1964) and FCLAC (1962).

Table 1
SOUTHERN CONE: GROWTH OF MONEY, PRICES, AND GROSS DOMESTIC PRODUCT, 1950-1970
(Annual rates of growth)

	Argentina			Chile			Uruguay		
	Money	Con- sumer prices	GDP	Money	Con- sumer prices	c.DP	Money	Con- sumer prices	(r)DP
1950	23.2	26.0	1.6	16.4	15.1	4.8	22.0	-7.1	3.1
1951	22.7	30.8	3.9	32.1	22.6	5.3	-1.3	15.4	8.2
1952	13.2	41.2	-5.1	37.0	23.1	3.4	9.0	15.6	-0.4
1953	25.7	5.0	5.4	53.0	25.0	7.1	12.9	5.8	6.5
1954	19.7	16.0	4.1	47.0	71.0	0.7	7.3	14.5	5.7
1955	18.0	14.3	7.1	63.0	84.2	2.7	5.8	7.9	1.6
1956	16.6	12.5	2.8	38.0	37.5	0.7	11.9	7.4	1.7
1957	13.0	25.9	5.1	25.0	25.0	2.6	8.4	13.7	1.0
1958	22.8	32.4	6.1	33.3	30.8	4.8	20.4	18.1	-3.6
1959	50.7	100.0	-6.4	37.5	37.4	6.9	35.0	39.8	-2.8
1960	34.9	20.0	7.8	18.1	13.6	5.1	40.8	37.2	3.5
1961	17.9	16.7	7.1	27.8	9.0	6.1	25.3	23.4	2.9
1962	7.1	28.6	-1.6	25.0	12.9	4.6	7.2	10.8	-2.2
1963	20.0	22.2	-2.4	33.9	44.6	5.1	16.0	21.0	0.5
1964	38.9	22.7	10.3	41.1	50.0	4.2	70.7	42.4	2.0
1965	32.0	25.9	9.1	55.2	22.2	5.0	56.0	56.7	1.1
1966	30.3	35.3	0.6	51.4	27.3	7.0	70.1	73.3	3.4
1967	34.9	28.3	2.7	28.4	21.4	2.4	51.1	89.3	-4.1
1968	32.8	15.3	4.3	30.1	23.5	3.0	86.5	125.4	1.6
1969	16.9	8.8	8.6	24.0	28.6	3.5	69.2	21.0	6.1
1970	12.2	12.2	5.4	58.1	33.3	3.6	31.3	16.3	4.7
1950-1970	24.3	23.8	3.7	37.7	30.3	4.2	29.5	29.4	1.8

Source: International Monetary Fund (1976 and 1980); KC/LAC (1983).

either the rate of inflation (P) (the desired objective) and/or production (Q) (not desired).²

Possibly because of the greater simplicity of the monetarist model, or possibly because of the insufficient operationality of the structuralist approach, the fact remains that the stabilization policies followed during the 1950s and early 1960s tended to be monetarist in orientation. On

²The quantity *identity* states that money (M) multiplied by velocity (v) is equal to the level of prices (P) multiplied by the volume of output (Q). Consequently it is true by definition and by differentiation that $M/M + v/v = P/P + Q/Q$. The quantity theory in its traditional and simple form states that v is relatively constant. Consequently, $M/M = P/P + Q/Q$. If we suppose, at least for the short run, that the product remains constant, $M/M = P/P$ (the best known expression of the quantity theory). As shown in figure I, the quantity theory showed excellent explicative power in the period 1950 through 1970 for the three countries. Given the growth in money and product, the theory would have predicted a rate of inflation for the period of 20% in Argentina (as opposed to 24%); 33% in Chile (as opposed to 30%), and 20% (as opposed to 29%) in Uruguay.

the other hand, because such stabilization programmes almost invariably resulted in recession, such an approach slowly fell into disgrace.

Nevertheless, the monetary approach reappeared in the 1970s. For one thing the approach had been enriched theoretically. It was now recognized that velocity (that is to say, the reciprocal of the demand for money) varied; however, it was argued that it varied not in an unpredictable fashion, or in a fashion which automatically compensated monetary growth, but rather that such a variation in velocity was stable or at least predictable. On the other hand, while it was recognized that it was not at all clear in what way a deceleration in nominal aggregate demand would divide itself in the short run between a slower rate of inflation and/or a recession,³ it was argued that a recession could be avoided to the

³Friedman (1970) himself states that this is the single most important problem to be resolved in modern macroeconomics.

extent that inflation was correctly anticipated. Secondly, and possibly more decisively in practice, given the urgent need to combat triple-digit inflation, it seemed quite unconvincing to attribute significant causality for such high inflation to structural factors, or to insist that it was indispensable to eliminate them in order to avoid still higher inflation.

Given the neo-conservatives' preference for the market and aversion to administrative con-

trois, it is not at all surprising that these countries initially have adopted a monetarist approach, and more specifically the monetarist approach for a closed economy. With the passing of time, and with the increased opening of the economy, the approach was slowly modified and the key instrument came to be exchange policy. In any case, throughout the entire experience, the prevailing spirit was that of minimizing administrative intervention in the market.

II

Phase I - Monetarism for a closed economy

1. *The logic of the approach*

Quantity identity, in its dynamic form, offers a good starting point to explain the stabilization policy of phase I in the three neo-conservative experiences of the Southern Cone: $M/M + v/v = P/P + Q/Q$. If one wants to slow inflation, one needs to slow down the growth in nominal aggregate demand (Mv). Nevertheless, the relative impact which such a deceleration in nominal aggregate demand will have, be it on prices or on production, will very much depend on inflationary expectations.⁴ If such expectations are fairly uniform among the different economic agents and these coincide with the inflationary goal implicit in monetary policy, the deceleration in nominal aggregate demand will fall exclusively on prices (precisely what is desired). On the other hand, if there is a significant difference between the inflation expected and that consistent with monetary and fiscal policy, the deceleration in nominal aggregate demand will also fall on production (precisely what we desire to avoid). In short, however high inflation might be, it is

theoretically possible to bring it down without a fall in output.⁵ Problems emerge if in fact there are rigidities, especially as regards expectations, for these will slow timely adjustments to the new conditions which economic policy is trying to establish.

In other words, if inflation is really nothing else than "too much money chasing too few goods", it is not at all clear why in order to bring down inflation it should be necessary to produce even fewer goods. To be sure, stabilization policies often end in recession, but this is not because it is inevitable; rather, it is a sign of failure, a failure to harmonize the expectations of economic agents with the inflationary goal implicit in the fiscal and monetary policies which the government is carrying out.

In the three experiences, serious efforts were made to avoid the formation of 'erroneous' inflationary expectations. During the first phase efforts centered in the labour market, for if in-

⁴To be sure, the demand for money does not depend solely on inflationary expectations, but rather, among other things, on its alternative uses. More specifically, the creation of an internal capital market was to create financial instruments of a highly liquid nature, paying good interest rates, and this was to affect the demand for money. At the same time, the supply of money was not easy to control either.

⁵Thomas Sargent (1981) makes this point quite explicitly in arguing that the costs of checking inflation are proportional not to the rate of past inflation (the theory of inflationary "momentum") but to expected inflation (rational expectations). Thus, should the public believe that there has been a (permanent) change in the rules governing fiscal and monetary policy, and not just a transitory change, the cost of reducing inflation can be quite low. He cites as specific examples the cases of hyperinflation which were abruptly stopped after the First World War in Germany, Austria, Hungary and Poland, where the cost in terms of recession was either slight or non-existent.

flationary expectations became incorporated into labour contracts, especially if they were based on past inflation, wage movements would become terribly rigid. Thus, for example, if both entrepreneurs and workers expected inflation to be higher than the rate aimed at by the Government, labour costs would rise in line with them. If the Government persisted with its anti-inflation goals and followed the corresponding monetary and fiscal policy, real wages would rise more than expected, with negative consequences for employment and output. Thus, if the Government failed to harmonize the inflation expected in wage contracts with that implicit in economic policy, it would inevitably be confronted with the following dilemma: either to ratify such erroneous expectations, easing up its monetary and fiscal policy at the cost of sacrificing its stabilization programme, or else persist in its stabilization goals, with a consonant restrictive economic policy, but at the expense of recession.

We may call this the neo-classical variant of recession (as opposed to the neo-Keynesian one), inasmuch as unemployment and recession would be due to a rise in real labour costs. In other words, unemployment would be a reflection of a disequilibrium in the labour market and not, as in neo-Keynesian models, of a disequilibrium in the goods market. Thus for neo-conservatives any stabilization programme which seeks to avoid recession and unemployment must necessarily include wage controls in order to harmonize wage readjustments with the inflationary goal set by the Government, for the market left to itself cannot adjust wages to coming inflation, inasmuch as it cannot know in advance the seriousness with which the Government intends to apply its stabilization programme. Any doubt as to this would inevitably create rigidities in expectations and consequently lead to recession.

For reasons of this sort, neo-conservatism in the Southern Cone justified the use of administrative controls on wages to adjust expectations.⁽²⁾

⁽²⁾This is not to suggest that there were not other motives behind wage controls. For example, in Uruguay many argued explicitly that wages ought to fall in the short run in order to increase profit margins and thus raise the heretofore low levels of savings and investment. It is also possible that some believed that real wages had exceeded equilibrium levels

However, doubts as to the ability of the market to adjust rapidly in transition situations did not lead to the adoption of similar interventionist measures in other markets (for example, the goods or financial markets).⁷ There was apparently confidence that competition would assure rapid and converging adjustments in goods prices and interest rates, so that all possible disequilibria in such markets would be quite transitory.

2. The policies

Inasmuch as inflation was considered to be fundamentally a monetary phenomenon, the key instrument in reducing it was the control of the monetary supply. However, in order to avoid or minimize recessive costs, control of the money supply had to be accompanied by wage controls. Moreover, a deceleration in the growth of monetary variables required a reduction in the fiscal deficit, all the more so given the magnitudes involved at the beginning of the neo-conservative experiences (fiscal deficits ranged between 4% and 10% of GDP). This implied an increase in the prices of public services, increased taxes and reductions in current expenditures (principally wages) in all three countries and, moreover, in Chile, a decline in public investment.

According to the monetary framework such measures were the *sine qua non* for reducing infla-

during the periods of Perón in Argentina and Allende in Chile (the periods immediately preceding the onset of neo-conservatism). In point of fact, however, this was not the case in Chile, since real wages had already fallen by over 15% with respect to 1970 levels in the last year of Allende's administration. This argument is possibly somewhat more plausible in Argentina, since real wages grew 11% between 1970 and 1975, whereas per capita output grew only 8%. Nevertheless, even if it were true, given the rather small magnitudes involved the need of adjustment would have been minimal. Finally, there is no doubt that trade union power was looked upon with great suspicion, both for political as well as ideological reasons, for unions had been an important base of support of the preceding governments in Argentina and Chile. Moreover, the neo-conservatives tended to look upon labour unions as no more than instruments of incipient monopolistic control. Therefore, they tended to believe that wages had been artificially raised for a long period of time.

⁷Exchange-rate control was justified for other reasons: the need to have some reference price in the economy, with respect to which all other prices could freely adjust.

tion. They were also accompanied by two other measures which would prove to be of paramount importance in the future evolution of these economies. First of all, from the very beginning the three countries faced serious external disequilibria which required real devaluations (Chile and Uruguay) or the maintenance of a high real exchange rate (Argentina had recently devalued). It is important to note, however, that in order to improve the trade balance it is not necessary to depress domestic production in order to lower imports. What is required is to reduce domestic spending and switch output towards tradeables (by means of devaluation and/or an appropriate trade policy), substituting (not simply reducing) imports and promoting exports.

To the extent to which domestic spending (and income) has to be compressed, generally speaking one would expect a corresponding decline in real wages. The worsening in the terms of trade which Argentina and Uruguay experienced from the very beginning, and Chile as of the end of 1974, would thus necessarily involve some decline, though modest, in real wages.⁸

Secondly, there existed a widespread system of price controls in the three countries. As a result relative prices were severely distorted (creating downward pressure on food prices relative to industrial goods) and inflation was repressed.⁹ For these reasons price controls were eliminated in all three countries, so that prices would be more realistic. This policy was radical and abrupt in Chile, gradual in Uruguay, and erratic in Argentina.

Thus, the policy pursued in these three countries from the very beginning did not limit

itself solely to the fight against inflation or to tackling short-term problems; rather, in differing degrees, each country made serious attempts to restore equilibria in the external sector and correct the distorted system of relative prices.

3. The results

External disequilibria significantly improved during the first phase and inflation was reduced, although at a much slower pace than anticipated and at the cost of a sharp fall in real wages (of the order of 25% to 30% with respect to the normal or historical levels) and of a severe recession (Chile) or stagnation (Argentina). Only Uruguay avoided a deterioration in its level of activity, thanks to the strong increase in public investment and in exports, which more than compensated for the decline in domestic consumption.

As far as inflation is concerned, the policies pursued resulted in important reductions in the Fiscal deficit and the rate of expansion of the money supply (see table 2). The fiscal deficit fell from 9% to 3% of GDP in Argentina (between 1975-1976 and 1978); from 25% to 2% in Chile (between 1973 and 1976), and from 4% to 1% in Uruguay (between 1973-1974 and 1978). The annual growth of M_t in the same period decelerated from 250% to 140% in Argentina, from 260% to 220% in Chile, and from 70% to 55% in Uruguay. As a result of restrictive monetary, fiscal and wage policies, inflation fell sharply: from rates of the order of 300% during the last pre-neo-conservative year in Argentina to 175% at the end of phase I, 1978; in Chile from 440% to 230% between 1973 and 1976, and in Uruguay from close to 90% in 1973-1974 to 45% in 1978.

As might have been expected, there was a significant correlation between the fiscal deficit, monetary expansion and the rate of inflation (see Figure I); high rates of inflation were accompanied by large fiscal deficits and very strong monetary growth, whereas low rates of inflation coincided with lower deficits and rather modest monetary expansion. Nonetheless, these relationships were fairly loose in the short run.

It is reasonable to suppose that in periods of accelerating inflation the velocity of circulation of money will rise because of inflationary expectations, so that the rate of growth of prices will

⁸It is important to note that in none of the cases analysed did the deterioration in the terms of trade exceed the equivalent of 6% of GDP. Therefore, a similar decline in real wages should have maintained a neutral income distribution. However, inasmuch as the wage decline was far in excess of this, there must be other factors which explain the bulk of the fall in real wages, not just the adjustment to the external shock.

⁹Especially in Chile at the end of 1973, the repressed inflation was so severe that a generalized shortage of products emerged, not so much because output had declined but because there was an excess of money, capable of buying far more than the economy was able to produce at the then prevailing controlled prices.

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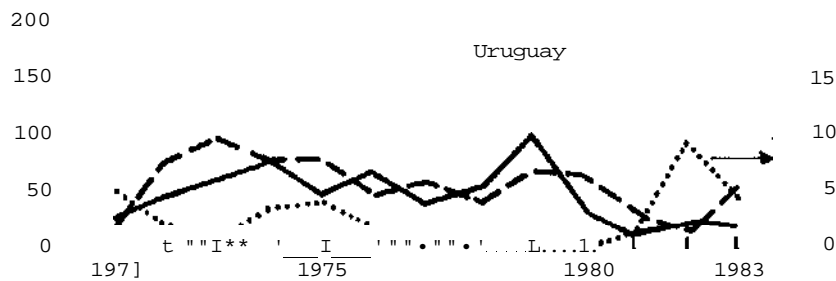
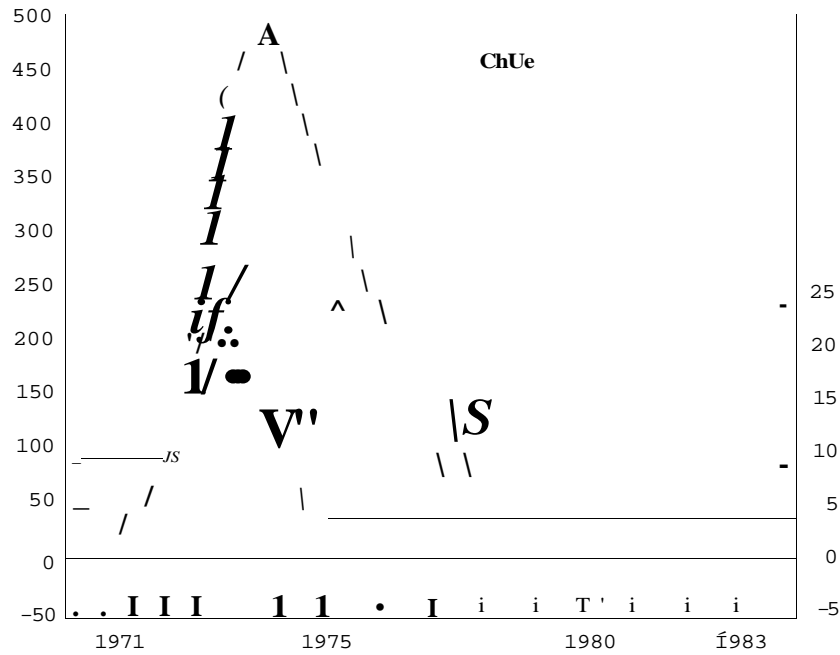
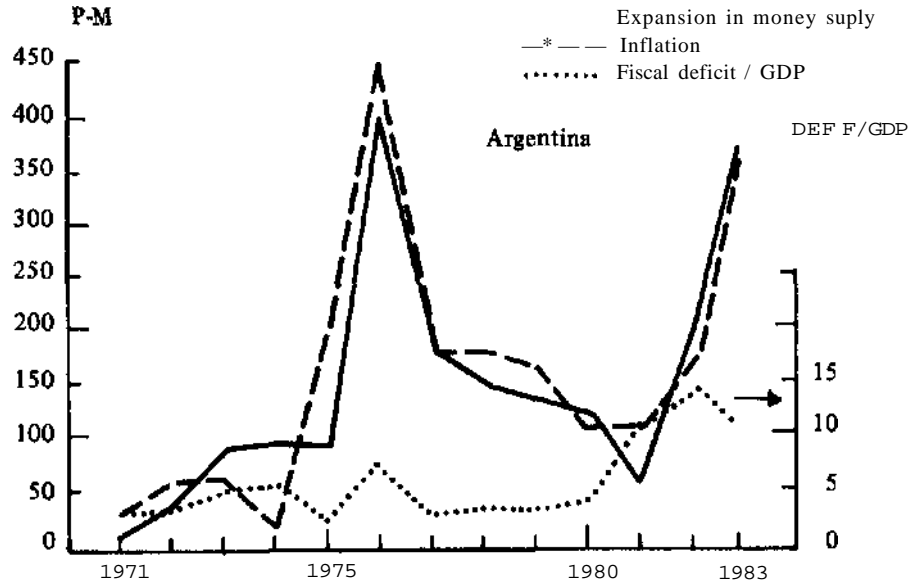
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Figure I
INFLATION (P), MONETARY EXPANSION <M>
AND FISCAL DEFICIT (DEF F/GDP)



be greater than that of monetary variables. Nevertheless, during this period (above all in Chile) prices appear to have risen not so much because of demand pressures as because of price decisions taken by the producers themselves in anticipation of a demand for goods which never materialized. For that reason, for example, the increase in prices in the first year (1974) of Chile's neo-conservative experiment exceeded the increase in money supply by almost 50%.

Once the inflationary process reversed itself, the contrary should have taken place, that is to say, expectations of decelerating inflation should have increased the demand for money, so that prices would rise less rapidly than the growth of money supply. This did not take place, however, in Argentina or in Chile. On the contrary, in the following years of phase I, though inflation slowed, it continued to advance at a rate well in excess of the growth of the money supply (see figure I). Consequently, during the three years of phase I, stabilization, the increase in prices exceeded the expansion of the money supply by 114% in Chile and by 25% in Argentina.

This resistance to a downward trend in the rate of price rises is attributable to the fact that the entrepreneurial sector harboured inflationary expectations which were higher than those foreseen by the Government in its monetary, fiscal and wage policies. The sharp devaluations, the sudden freeing of prices, the unexpectedly high domestic interest rates and the general uncertainty aroused by so many imbalances and policy changes upset the inflationary expectations of the entrepreneurs, who, because of the scant competition they faced, had previously had ample liberty to impose their expectations on prices.

In other words, the mixing of the objectives of balancing the external accounts and correcting the distortions in the system of relative prices, on the one hand, and achieving stabilization, on the other, thwarted the attempt to check inflation without causing a recession. It is not that a recession was inherent in the pursuit of these objectives, but rather that the combination of these with the use of instruments for their attainment which took no account of their repercussions on the other goals involved the risk that the slowing-down of demand would affect not only inflation but also the level of activity.

Moreover, the assumption that inflationary expectations express themselves solely or principally in the labour market through pressures for wage increases is rather doubtful, at least from a theoretical point of view. The validity of this assumption is brought further into question if one takes into account the fact that the policy was intended simultaneously to achieve the following: i) bring about a real devaluation, which implied raising the relative price of tradeables, and ii) raise, by way of price liberalization, the relative prices of goods previously controlled (generally speaking, foodstuffs). Moreover, inasmuch as the public could not know how much of the nominal devaluation was intended to be real (that is to say, how much would correspond to a relative improvement) and how much would be nominal (a purely inflationary increase), and nor could it know how long the policy of price liberalization would last (indeed, Argentina restored price controls within the year), it is easy to understand why producers set their prices, not in accordance with current demand or prevailing wage costs, but in accordance with what they expected these to be in the future. These variables are of course influenced not only by the cost of labour,¹⁰ but also the expected cost of importing, the rate of devaluation, the level of real interest rates, the evolution of public service prices, the evolution of prices heretofore controlled, and expectations regarding the behaviour of other prices, etc.¹¹

"High interest rates affected not only inflationary expectations but also production costs, thus pressuring prices upwards, at least in the first instance. In the short run, rather than inducing the sale of inventories, high interest rates and consequently increased financial costs tended to be passed on to prices (see Cavallo (1977)).

¹¹ Referring to Frenkel (1979) and Ramos (1977), Foxley (1982) pointed out: "In Argentina, Chile and Uruguay double and triple-digit inflation was experienced before and during the first years of the stabilization programme. It is precisely this type of context which is characterized by imperfect information, by uncertainty with respect to the future evolution of prices, and by huge risk, and in which the above factors become determining elements of the price decisions adopted by firms. Profit margins then become a function of expected inflation, and of the uncertainty and risk involved. During the phase of very high inflation, of maximum uncertainty and disequilibrium in the economy, prices become relatively autonomous, not only with respect to demand but also with respect to cost pressures".

To the extent to which the inflationary expectations of producers significantly exceeded the rate of inflation implicit in monetary and fiscal policy, the deceleration in nominal aggregate demand would fall on output (something undesirable) and not only on prices. If this were the case, then monetary and fiscal stabilization policy would prove to be too tight, and this was exactly what occurred. As a result there was a tendency towards the following: i) too little money for the level of prices which in fact prevailed (that is to say, real interest rates were too high); ii) real wages were too low, and iii) the level of output and employment was below the productive capacity of the country (that is to say, there was a recession).¹²

Had the divergence between the inflationary expectations of the public and the rate of inflation implicit in economic policy been quickly corrected, the contraction in internal demand would have been harmless. Unfortunately, inflationary expectations adjusted quite slowly, thereby prolonging and worsening the recession. Inflationary expectations adjusted slowly, since national income was redistributed towards producers: a fact which served to cushion, if not fully compensate, the costs of their erroneous price-setting policy.¹³ In short, what producers lost by virtue of lower sales they made up via prices and margins higher than the equilibrium levels. This explains why the disadjustment between inflationary expectations and the inflation implicit in the economic policy lasted so long (see table 3).

As a result of this 'rigidity' in inflationary expectations, prices remained well above equilibria, so that internal demand was insufficient to absorb all of the installed production capacity. The economies thus tended to fall into

¹²Farmers had fewer possibilities of setting their prices in accordance with inflationary expectations, either because farm goods are perishables subject to high storage and conservation costs or because this is a more competitive sector. The fact remains that the relative improvement in agricultural prices did not take place to the extent expected.

¹³To be sure, this is not a situation which can be maintained in the long run, at least in competitive markets, for each firm can improve its profits by lowering its prices and thus increasing its sales. Nevertheless, in periods of recession as in this case, with prices in disequilibrium, this effect operated slowly, for firms tended to see the demand for their products as much less elastic to price than it really was (Ramos, 1980).

Table 3
SOUTHERN CONE:
INDICES OF INCOME DISTRIBUTION
(Indices: 1970 = 100)

	Argentina		Chile		Uruguay	
	A	B	A	B	A	B
1970	100.0	100.0	100.0	100.0	100.0	100.0
1971	98.3	98.8	116.3	113.0	106.3	106.5
1972	81.1	81.9	108.9	105.7	88.3	89.1
1973	84.1	86.4	84.1 ^a	82.2 ^a	84.2	87.0
1974	97.9	94.5	64.9	63.6	86.4	86.9
1975	95.9	95.8	71.8	65.0	—	—
1976	64.4	64.3	71.1	64.2	75.2	73.1
1977	61.4	60.8	73.7	65.7	70.4	69.0
1978	64.2	63.5	77.5	68.7	62.3	61.5
1979	69.2	69.1	81.8	71.6	57.4	57.2
1980	76.9	77.5	86.1	74.1	58.1	57.7
1981	73.2	73.2	92.6	78.5	65.7	64.7
1982	70.4	69.8	99.1	78.5	70.3	69.2

Source: ECLAC, on the basis of official data.

Note: The variations in the index indicate whether the share of labour in gross domestic income has improved (above 100) or worsened (below 100) with respect to the base year.

A = The index is defined as $f^{SR}HO / t_{wne}re$ where SR = real wage; O = index of the number of employed; Y = gross domestic income (gross domestic product adjusted by the terms-of-trade effect).

B = An index defined as above (A), but which deflates by gross domestic product instead of gross domestic income.

^aFirst 8 months of 1983.

recession. This phenomenon was further aggravated in Chile by the sharp fall in public sector investment and external demand (inasmuch as the quantum of exports did not grow enough to compensate the very severe decline in the terms of trade). The cumulative effects of reduced consumption (due to wage reductions) and investment (cutbacks in public investment and a decline in private investment) and the fall in external demand resulted in a very sharp economic contraction. Thus, per capita GDP in Chile fell 13% between 1973 and 1976. In contrast, the restrictive effects of the stabilization policy were compensated in Argentina or even more than compensated in Uruguay by very sharp increases in public investment and in the volume of exports. Thus, in these two countries overall de-

mand was reoriented from domestic consumption to investment and exports, but it did not go down.

The differences in the behaviour of employment during the first phase in each of these three countries is largely explained by the very different evolution of their respective output and not by the trajectory of real wages, which was quite similar in the three (that is to say, a sharp fall). This is because in situations of product market disequilibria, where at the prevailing but inflated level of prices one cannot sell all one wishes, the demand for labour is no longer a function of wage costs so much as of the level of sales. Insofar as sales declined (Chile) or did not grow (Argentina), the demand for labour also fell or failed to grow, for however much real wages had fallen, the opportunity cost of unused machines in factories had fallen even more (it was virtually zero). As a result, the prime effect of the fall in wages was to reduce domestic demand for goods, rather than to induce the increased hiring of labour because of its lower cost. This would

explain why in subsequent years the growth of employment in Chile coincided with increases and not declines in real wages. In Uruguay, in contrast, where the product grew despite the fall in domestic consumption, employment also expanded. That is to say, the unemployment which was generated in this phase was not so much a symptom of a disequilibrium in the labour market —whose resolution would have required a further lowering of real wages— but rather was a result of a disequilibrium in the goods market (inflated prices with depressed sales). Consequently, the employment problem could not be resolved until the basic disequilibrium affecting the goods market was corrected.^M Notwithstanding the high rate of inflation, unemployment was due to a lack of aggregate demand, and the problem thus was not so much price rigidity as the rigidity in inflationary expectations, which meant that inflation went down much more slowly than the rate implicit in the monetary, fiscal and wage policies being pursued by the Government.

III

Phase II - The monetary approach to the balance of payments

1. *The logic of this approach*

The approach to stabilization was modified as a result of the failure of inflationary expectations to adjust rapidly enough, which limited the degree to which money supply could be decelerated without incurring excessively severe costs in terms of recession. Efforts began to focus on active exchange policy; monetary policy then became passive, being determined by the evolution of the balance-of-payments surplus. The exchange rate would thenceforth be devalued according to a pre-established programme rather than passively in accordance with past inflation. It was thought that in this way expectations could be brought into line with or at least rapidly adjusted to the inflationary goal implicit in government policy. Thus the immediate objective of exchange policy became the control

of inflation and no longer the maintenance of the exchange rate in real terms.

To be sure, it was not considered necessary to lower the real rate of exchange in order to slow inflation. Rather, it was hoped and believed that the announcement and application of this policy change would demonstrate clearly to economic agents the seriousness with which the government intended to pursue its anti-inflationary goal, and so bring inflationary expectations rapidly down to the rate of devaluation. Since the latter was programmed to decelerate, the rate of inflation

¹⁴The employment problem was less severe in Argentina, since output there did not fall but simply stagnated. Moreover, in Argentina other more specific factors came into play to reduce the employment problem; namely, the displacement of foreign labour and the big increase in self-employment.

could be expected quickly to equalize the rate of devaluation (or the target inflation).¹⁵ If this was achieved, the price disequilibria could be corrected without setting off a recession, while maintaining the real rate of exchange.

Exchange policy was expected to influence the behaviour of prices not only by moderating expectations, but also more directly: at least insofar as tradeables were concerned, it would tend to limit the price of domestic products to that of the imports competing with them. For, at this stage, the three economies had substantially opened up imports, so that domestic prices had a ceiling given by the international price of the imported goods plus transport, tariffs and retailing costs. This ceiling was the so-called "law of one price". Regardless of what the inflationary expectations of producers were, the price of domestic goods would necessarily have to converge towards this single price in the long run. The liberalization of the domestic capital market, however, had created substitutes for money which made it increasingly difficult to control the money supply. These difficulties were further complicated by the progressive liberalization of the inflow of capital, with greater financial opening up to the outside world. Money growth began to be explained largely by exchange operations, and not, as in the past, principally by the expansion of internal credit or treasury financing. Thus, the fact that control of the money supply became increasingly difficult with financial liberalization was a further argument on behalf of this new exchange policy.

The monetary approach to the balance of payments provided the underlying theoretical basis for this policy change. According to this view, differences in the amount of money demanded and supplied are resolved through the balance of payments (and not by changes in production). For example, given a certain demand for monetary balances, if the supply of internal credit were to contract, the domestic interest rate would rise. Two adjustment mechanisms would then automatically come into play to resolve this

difference. If the capital account were open, capital would come in, increasing the international reserves, till the supply of money came to equal the amount of money demanded and the initial monetary restriction ended up determining not the amount of money in hand but only its composition (between internal and external credit). On the other hand, were the capital account to be closed, the increase in domestic interest rates would lower the demand for goods, reducing imports, producing a surplus on the trade balance, and thus augmenting reserves and the money supply. If that did not take place, the price of domestic goods would fall, generating a trade surplus, increasing reserves, and thus expanding the supply of money to the level demanded. Implicit in this approach, be it with open or closed capital accounts, is that disequilibria between the supply and demand for money are resolved quickly and directly via prices and/or movements in the balance of payments. To ignore or minimize the possibility that the adjustment will take place to some extent at the cost of production is a central assumption which this approach has in common with the quantity theory of money, both in its earlier and in its more modern version, and it is this assumption which distinguishes this approach from most others. To be sure, the speed with which the so-called "law of one price" operates in order to equalize¹⁶ internal and external rates of interest and the prices of domestic and imported goods is critical in determining the validity of the implicit assumption that variations in the product are a second-order mechanism for adjusting monetary imbalances. The high degree of international liquidity available between 1975 and 1979 made possible the fulfilment of the first condition; the increased trade openness which the three countries of the Southern Cone underwent (at least insofar as eliminating non-tariff barriers is concerned) also made plausible that the second condition be satisfied.

¹⁵Strictly speaking, the rate of inflation would fall to that equal to the algebraic sum of the devaluation and the rate of international inflation. This sum would be the equivalent of the inflationary goal.

¹⁶Rather than equalizing, these should approximate each other, for in the case of interest rates a surcharge would have to be added to cover country risk and the higher cost which domestic financial intermediation might entail. In the case of goods, one would have to add the cost of shipping, tariffs, and additional domestic retailing costs.

2. *The measures applied*

In this theoretical approach, the crucial instrument for stabilization was exchange rate policy. Domestic inflation was expected to converge to international inflation plus the rate of devaluation. Moreover, domestic prices were expected to approach the level of international prices. At the end of phase I, however, the gap between domestic and international prices continued to be very large, even after taking into account differences in prices arising from transport, tariffs and marketing costs. In the new phase, domestic inflation would have to be *less* than international inflation plus devaluation, at least until internal prices equalled external prices. This assumption, critical though it was, tended to be overlooked by policy-makers.

At all events, it was expected that inflation would decline rapidly to the lower and declining rate of the devaluations. To be sure no one thought that exchange rates could be fixed immediately, for so long as inflation continued to be high and the internal factors contributing to monetary expansion continued to persist, the economic agents would see such a fixing of the exchange rate as an unsustainable policy. For example, if M_i were of the order of 10% of GDP and if a public deficit of the order of 5% of GM were expected, money growth would necessarily have to be of the order of 50%, with a comparable rate of domestic inflation; consequently, a devaluation rate of much less than 40% a year (assuming external inflation of 10%) would be considered unbelievable. On the other hand, once the public sector deficit had been eliminated, there would be no reason (according to this approach) why the exchange rate could not be fixed so that the rate of domestic inflation very rapidly came to equal the international rate. Indeed, if this approach were adopted, it would be necessary to fix the exchange rate to bring down inflation to the international rate. The key policy, then, was to devalue at diminishing rates (in order to affect expectations), according to a pre-announced calendar (generally for 6 months). This policy was begun, at least partially, in Chile as of mid-1976, and in Argentina and Uruguay towards the end of 1978. The fiscal deficit was eliminated in Chile in 1979, whereupon, in accordance with the approach adopted, the ex-

change rate was fixed. Notwithstanding the fact that the fiscal deficit was also eliminated in Uruguay (in 1979), the authorities there preferred not to fix the exchange rate, for domestic inflation was still of the order of 60% (compared with Chile's 33% and the international level of 10%).

At the same time, given the situation of growing international liquidity prevailing in this second phase, the three Southern Cone countries increased their financial openness to the outside world in the hopes of achieving an even more rapid convergence of internal and external rates of interest. Simultaneously, although to a lesser extent, trade was further opened up (a good deal in Chile, moderately in Argentina, and hardly at all in Uruguay), as a means of stimulating competition and thus further inducing prices to converge rapidly to external ones.

3. *The results*

While the stabilization programme was in effect, both Chile (in 1981) and Uruguay (in 1982) managed to lower inflation to international rates. This reduction was especially spectacular in the case of Chile, where six years before inflation had exceeded 200%. Inflation was almost halved in Argentina as compared with the first years of the conservative period, but nevertheless it never fell below 100% per year (see table 2).

Argentina's inability to control its public deficit explains why it was unable to make further progress in this plane. Its deficit was never less than 3% of GDP (in 1981, the year of lowest inflation (100%)), and it thereafter grew again to almost 4% of GDP¹⁷. This fact could not fail to have a negative influence on the credibility of its exchange policy. For as Rodriguez (1983) has argued, it was very hard to believe that the announced policy of devaluing at a rate of 1% per month between July 1980 and May 1981 could be long sustained when at the same time the rate of inflation was five times that and the expected public deficit was of the order of 6% or 7% of GDP (implying an annual rate of inflation of the order of 80%).

¹⁷The data in table 2 referred to in the text correspond to the central government deficit. Were provincial governments' deficits to be included—and these are important in Argentina—the deficit would increase by over 50%.

While an important component of the growth was merely recovery, nonetheless the growth in output in this period in all three countries was well above that experienced during phase I. Output per capita grew at a rate above 2% per year in 1979 and 1980 in Argentina, as opposed to -0.9% per year in 1976-1978; in Chile it grew at a rate of 6% per year in 1977-1981 as opposed to a fall of over 4% per year between 1974 and 1976; and in Uruguay it grew at over 5% per year in 1979 and 1980 versus a 3.6% annual growth in 1975-1978. In other words, the phase II stabilization policy did not

bring on any recession, at least in its first years.

Inflation, however, fell much slower than the rate of devaluation, creating a problem which would become increasingly serious in the course of time. Because of this 'exchange lag', at the end of phase II—just before the non-scheduled maxi-devaluations—the prices of domestic products had risen well above those of their international counterparts, exceeding them by 50% in Argentina (between 1978 and 1980) and almost 30% both in Chile (between 1976 and 1981) and Uruguay (between 1978 and 1981) (see table 4).

Table 4
SOUTHERN CONE: INDICES OF EFFECTIVE REAL EXCHANGE RATE¹
(1980=100)

	Deflated by the wholesale price index			Deflated by the index of wages and salaries		
	Argentina	Chile	Uruguay	Argentina	Chile	Uruguay
1970	144.6	133.2	110.5	166.6	80.5	62.9
1971	137.2	122.4	101.7	157.6	54.9	53.4
1972	155.2	128.4	125.7	210.8	54.0	117.1
1973	148.5	142.8	107.5	177.4	99.5	81.5
1974	126.9	124.5	103.6	130.0	164.0	80.4
1975	194.1	133.4	119.3	217.6	224.6	95.9
1976	127.9	116.0	127.1	234.6	181.0	108.4
1977	164.9	112.4	126.1	277.6	166.3	116.2
1978	148.8	130.2	122.9	227.7	129.7	120.5
1979	111.7	116.4	103.9	143.0	124.1	120.5
1980	100.0	100.0	100.0	100.0	100.0	100.0
1981	125.8	89.8	95.8	144.3	76.1	82.4
1982	163.2	105.1	110.8	281.7	85.5	90.8

Source: ECLAC (1982).

^d The lower the index, the cheaper are imports in domestic currency, and the more expensive are exports,

Indeed, the loss of competitiveness by domestic products that could be replaced by imports was even greater than the above would suggest, for during this period tariffs were lowered, especially in Chile, and this meant that foreign goods became even cheaper than before in terms of local currency. Moreover, real wages—perhaps an even better indicator of the evolution of domestic costs—tended to recover during phase II. Once one adjusts for both of these phenomena the increased relative cost of domestic goods with respect to international goods dur-

ing phase II exceeded 50% in Uruguay and 100% in Argentina and Chile (see table 4).^{1K}

^{1K}If the lag in the exchange rate had been compensated by an equivalent improvement in the terms of trade, no problem would have emerged, for the higher cost of domestic production would have been compensated by the increase in the international price of exports, thus maintaining their competitiveness. While there was a certain improvement in the terms of trade of Argentina in this period, it was not sufficient to compensate the strong increase in costs. In Chile for its part, the terms of trade worsened, so that the problem was accentuated rather than relieved. Finally, in Uruguay the terms of trade remained virtually constant.

That the exchange rate lagged is a fact. Let us look at some hypotheses as to why this happened and why the rate of domestic inflation did not fall rapidly to the rate at which the exchange rate was being devalued, plus international inflation, but instead exceeded it by a considerable margin.

i) The law of one price pertains directly and exclusively to tradeables, and these make up only half of the GDP. It is quite likely that many activities related to commerce, to the distribution of imports, to the financial system or to construction experienced excessive demand during this period, thus raising the prices of certain non-tradeables. To the extent to which the producers of tradeables tried to maintain their historical relation to non-tradeables, this fact might have generated upward pressures on the prices of some tradeables.

ii) Insofar as tradeables are concerned, there seems to have existed an excessive margin of tariff protection, so that reductions in tariffs did not, of themselves, bring about a proportional direct downward pressure on domestic prices.

iii) Similarly, high transport costs (especially for products of little value and high volume) and/or high financial costs (especially for imports with low turnover) meant that domestic prices need not converge directly to international prices but rather equalled international prices plus the cost of transport, financial costs and tariffs. The price of the domestic good could, therefore, vary widely within a band or range of prices, the lower limit of which was given by the price at which the good would be imported from abroad, the upper by the price at which it would be exported.¹⁹

iv) It was reasonable to expect, at the initial

stages of trade liberalization, that small-scale importers would set their price not at that equal to international prices plus tariffs, but rather at the level of domestic prices, or a bit less. In this way, price convergence took place, but *upwards* to domestic prices rather than downwards to international prices.

v) In a later stage, it seems reasonable to assume that many importers introduced differentiated products which heretofore had not existed in the domestic market (for example, whisky) and which, although they took away part of the domestic market from local products (for example, the local alcoholic beverage), did not affect the latter's price in any significant fashion. In short, inasmuch as the domestic product was only an imperfect substitute of the imported good, it would be very difficult to avoid the loss of part of its market simply by lowering price, for the imported good attracted consumers because of its quality, variety or indeed its novelty, but not solely because of its price.²⁰

vi) At the same time, many goods were imported by the very producers of the domestic goods with which they competed. To the extent to which these producers controlled the domestic market, they controlled the price both of the domestic and of the imported product, so that domestic prices would continue to remain above international prices, plus transport costs, plus tariffs, so long as there was insufficient competition in importing and distribution. Such competition was fully achieved solely in relatively standardized products with high turnover, such as television sets, radios and cassette players.

It must be acknowledged that all these reasons explain why domestic prices can remain above international prices plus tariffs and transport costs for some time, although none of these arguments denies the fact that, given enough time, the convergence of domestic prices with international prices would eventually have to take place. The point is that such an adjustment could be quite slow and costly.

In the Southern Cone countries, this delay made it increasingly likely that the government

¹⁹For example, and simply referring to transport costs and tariffs, a product which sold for US\$ 100 in New York would cost US\$ 110 in the Southern Cone, once transport costs were added. After adding the tariff, say 18%, its domestic price could not be less than the equivalent of US\$ 130. On the other hand, if it were desired to export the comparable domestic good, its selling price in New York would have to be no more than US\$ 100, which would mean that its price in the Southern Cone, before transport would have to be no more than US\$ 90. Indeed, it would have to cost even less were the US to place a tariff on the good. Hence, there would exist a wide band of prices between US\$ 90 and US\$ 130 within which the domestic good could fluctuate, without its being exported nor facing the competition of comparable imported goods.

²⁰Moreover, it is important to note that, thanks to the strong inflow of capital and the consequently high level of aggregate demand, domestic output tended to rise notwithstanding its loss of market share.

would find itself forced to abandon its exchange policy. The pressure became irresistible when it was seen that the Government could only continue with its exchange policy if it were able to keep up without interruption a massive inflow of foreign capital, which was doubtful. Thus, the economic agents sought rapid gains (through

high prices) rather than slower profits and bigger investments (bigger sales at lower prices), hence making the anti-inflationary success of the exchange policy very short-lived.

Obviously, the loss of competitiveness resulting from the exchange rate lag had negative consequences for the balance of payments, inasmuch

Table 5
SOUTHERN CONE: INDICATORS OF EXTERNAL ACCOUNTS

	ARGENTINA									
	1950-70		1971-75							
			1976	1977	1978	1979	1980	1981	1982	1983
1. Current account deficit/exports of goods and services		-9	-14	-17	-25	6	48	43	28	21
2. Terms of trade	109	119	93	89	90	98	110	100	89	86
3. Foreign debt/exports of goods and services		1.9	1.8	1.5	1.7	2.1	2.8	3.3	4.3	4.5
4. Tradeables/iiDp		44	43	43	42	42	40	38	40	
5. Annual growth of exports										
a) value	2.1	10.7	32	43	14	23	8	10	-17	3
b) volume	2.6	-3.2	32	41	6	-3	-10	15	-6	11

	CHILE											
	1950-70	1971-73	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
1. Current account deficit/exports of goods and services		29	13	27	-5	22	38	26	34	88	49	23
2. Terms of trade	67	81	88	55	59	54	49	55	52	45	40	41
3. Foreign debt/exports of goods and services		2.7	1.9	2.6	1.9	2.0	2.3	1.8	1.9	2.8	3.4	3.8
4. Tradeables/t;DP		45	47	45	46	45	43	43	42	41	40	
5. Annual growth of exports												
a) value	7.7	5.4	59	-21	31	8	13	58	29	-8	-9	4
b) volume	3.0	1.8	18	9	19	7	8	24	15	1	9	—

	URUGUAY										
	1950-70		1971-74								
			1975	1976	1977	1978	1979	1980	1981	1982	1983
1. Current account deficit/exports of goods and services		10	36	12	21	15	30	47	28	15	7
2. Terms of trade	104	115	80	79	85	89	97	95	89	88	88
3. Foreign debt/exports of goods and services		2.1	1.9	1.6	1.6	1.4	1.4	1.4	1.8	2.8	3.3
4. Tradeables/ciDP		44	43	43	43	42	42	40	39	32	
5. Annual growth of exports											
a) value	-0.4	15	-23	32	43	14	23	8	10	-17	3
b) volume	0	-0.3	-11	32	41	6	-3	-10	15	-6	11

Source: ECLAC, on the basis of official sources.

as exports were discouraged and imports encouraged. Nevertheless, its pernicious effects were not noted immediately (table 5). For some time, the deficit on current account due to the exchange lag could be financed through the heavy affluence of external credit. However, capital inflows of the order of 5% and 10% of

GDP per year were clearly not sustainable in the long run. As confidence in the maintenance of the exchange policy weakened, it was necessary to offer extraordinarily high domestic interest rates (of the order of 3% to 4% real per month) in order to attract foreign capital or to impede capital flight.

IV

Phase III - Adjustment (forced) to the external disequilibrium

1. *Its "logic"*

A price stabilization policy is never absolutely necessary, for inflation can be lived with if one so chooses. In the case of external disequilibria, however, adjustments need be made whether a country wants to or not. In the particular instance of the Southern Cone countries, it would be fair to say that there was no deliberately chosen policy to adjust to external disequilibrium (except for the first few months of this phase), but rather adjustment was forced on them by events.

The lag in the exchange rate, which increasingly left domestic prices above international ones, plus the extraordinarily high domestic interest rates, were steadily sapping domestic demand. To this was added an imminent large-scale domestic financial crisis. It was not possible for firms to keep on indefinitely paying real interest rates of the order of 20% per year, as they had been doing in preceding years while the economy grew at only modest rates, without risking insolvency and jeopardizing the financial system in its entirety. Because of firms' natural desire to postpone such a crisis, the demand for credit became increasingly inelastic, and this, together with the waning of confidence in the exchange rate policy, raised real annual interest rates to 26% in Argentina, 40% in Uruguay, and 58% in Chile the year before the maxi-devaluations were effected.

Thus it was finally recognized that a real depreciation was indispensable to correct the external disequilibrium. Discussion centered on the most suitable means: either raise the price of

imported goods (expressed in domestic currency) to that of domestic goods via a devaluation, or lower the price of domestic goods to that of international ones via deflation, with the exchange policy remaining unchanged.

These two ways of achieving a real devaluation are perfectly equivalent in theory, yet in practice they entail different risks. A devaluation, even though intended simply to correct a distortion in relative prices, could set off inflationary expectations, resulting in an upward spiral in inflation rather than a once-and-for-all shift in prices. Deflation, on the other hand, entails a very high risk of bringing about a severe recession and not just simply lowering prices and/or inflation, all the more so when the exchange lag to be corrected is, as it was then, of the order of 30% to 50%. Given the size of this disequilibrium it was difficult to imagine that the entire fall in nominal aggregate demand could be absorbed immediately and completely by a sharp deceleration in domestic prices (which was required and desired). Rather it was to be expected that there would be at least some fall in the level of activity (which was of course not desired).

2. *The measures applied*

Nevertheless, policy makers in all three countries preferred to maintain their exchange policy rather than devalue, for they feared an explosive resurgence of inflation. And, after all, lower inflation was one of their principal achievements. Hence, they placed their hopes on what was called "automatic adjustment": that is to say, that the deceleration in monetary growth would

rapidly lower inflation to a rate less than that of devaluation plus international inflation.²¹ It should be noted that this option entailed no action: all they needed to do was to maintain the exchange policy. If the balance of payments went into deficit, monetary growth would automatically slow. The impact of these measures was another matter: it was not certain whether they would affect only prices or have repercussions on the level of activity also.

There was confidence, however, that the bulk, if not all, of the impact of a slowing-down in nominal aggregate demand would affect inflation rather than production, thus bringing about a depreciation in real terms.

3. *The results*

The deceleration in nominal aggregate demand indeed lowered the rate of inflation in all three countries, but the real devaluation achieved by this means was not substantial (a few percentage points per semester): much too slow to correct significantly the large exchange lag accumulated in the past. In short, the bulk of the contraction in nominal aggregate demand fell not on prices, as desired, but on output. To be sure, imports were thus "automatically" curtailed, but at the cost of a severe recession in all three countries.

The severity of the recession increased the pressures of domestic producers on governments to abandon their exchange policy and replace it with a massive devaluation to correct relative prices quickly. This pressure became irresistible once it became clear that the only way the government could maintain its exchange

policy without an even more severe recession was to ensure that foreign capital continued to flow in massive proportions. Instead, however, the inflow began to go down. The decline in internal output, the deceleration in exports and the increasing signs of a domestic financial crisis eroded what confidence there was left amongst foreign creditors as to the capacity of these countries to service their foreign debt, and the inflow of capital was sharply curtailed: it fell 60% in Argentina in 1981, 75% in Chile in 1982, and over 100% in Uruguay in 1982 (see table 6, line 1).

It is difficult to exaggerate the adverse impact which this contraction in capital flows implied. Once interest and other factor payments were deducted, instead of being net importers of resources, the three Southern Cone countries became net *exporters*, in the year when they were finally forced to make maxi-devaluations (see table 6, line 3). The net transfer of resources was *negative* and of the order of 20% of exports in all three countries (see table 6, line 4), after having been strongly positive in previous years.

Put differently, the change of sign of the net resource transfer in the year of the maxi-devaluations was equivalent to a deterioration in the terms of trade of 25% in Argentina, 50% in Uruguay, and 80% in Chile. In the case of Chile, for example, this meant that instead of being able to import 80% *more* than the amount of its export earnings, as had happened in 1981 because of the positive effect of the net transfer of resources, the *negative* net transfer of resources in 1982 allowed Chile to import only 75% of the value of its export earnings (see figure II).

Given the lag in the exchange rate, the unprecedented reduction in capital inflows, and the severe internal recession and accompanying domestic financial crisis, there was no alternative but to proceed to a massive devaluation. Not only was there no longer any confidence in the sustainability of the exchange policy, but once capital flows were curtailed, the domestic resources (foreign exchange reserves) which had made it possible to sustain the policy of deflation and automatic adjustment were rapidly run down.

The maxi-devaluations were followed by sharp increases in the rate of inflation in all three countries. As the intensify of such inflation was considerably less than the devaluation, however,

²¹There was also asymmetry, both in theory as well as in practice, between these two options during the transition. The option of automatic adjustment or deflation, was limited by the fact that nominal interest rates cannot be negative, inasmuch as the mere holding of money pays a zero nominal rate of interest. This built-in inflexibility in the nominal rate of interest implies that deflation will automatically increase real rates of interest, for nominal rates of interest will necessarily be positive. So if domestic prices actually/a//, because of deflation, the higher real interest rates and financial costs will be. Hence, deflation creates its own brake in the form of real interest rates, which will tend to force the bulk of the monetary contraction on output rather than on prices. Moreover, this problem would be all the more serious, the greater was the lag in the exchange rate that needed correction, and consequently the greater the absolute fall in prices required.

Table 6
SOUTHERN CONE: EVOLUTION OF NET AVAILABLE FINANCIAL RESOURCES AND THEIR RELATIVE
IMPACT ON THE ECONOMY, 1980-1983
(Millions of dollars and percentages)

	Argentina				Chile				Uruguay			
	1980	1981	1982	1983	1980	1981	1982	1983	1980	1981	1982	1983
1. Net capital flows	2 176	1 519	1 807	1 900	3 345	5 008	1 096	440	811	494	-182	40
2. Interest and other factor payments	1 607	3 701	4 755	4 800	1 028	1 464	1 921	1 620	100	74	197	320
3. Net transfers of financial resources(1)-(2)	569	-2 182	-2 948	-2 900	2 317	3 544	-825	-1 110	711	420	-379	-280
4. Net transfers of financial resources as a percentage of the value of exports of goods and services	6%	-20%	-33%	-31%	39%	64%	-16%	-25%	47%	25%	-25%	-22%
5. Variation in the terms of trade as a percentage of the value of exports of goods and services	12%	-9%	-11%	-3%	-5%	-14%	-11%	9%	-2%	-6%	-1%	0%
6. Additional capacity to import because of improvement in items (4) and (5)	18%	-29%	-44%	-34%	34%	50%	-27%	-16%	45%	19%	-26%	-22%
7. Rate of growth of quantum of imports	40%	-12%	-44%	-17%	13%	20	-36%	-18%	16%	-11%	-19%	-39%
8. Rate of growth of GDP	1.1%	-5.9%	-5.7%	2.0%	7.8%	5.7%	-14.1%	-0.5%	5.8%	-0.1%	-8.7%	-5.5%

Source: ECLAC, on the basis of official sources.

the real exchange rate experienced a sharp improvement and much of the competitiveness lost during phase II was recovered (see table 4).²²

Thanks above all to the recession, the quantum of imports fell so sharply that by 1983 the current account deficit in all three countries had

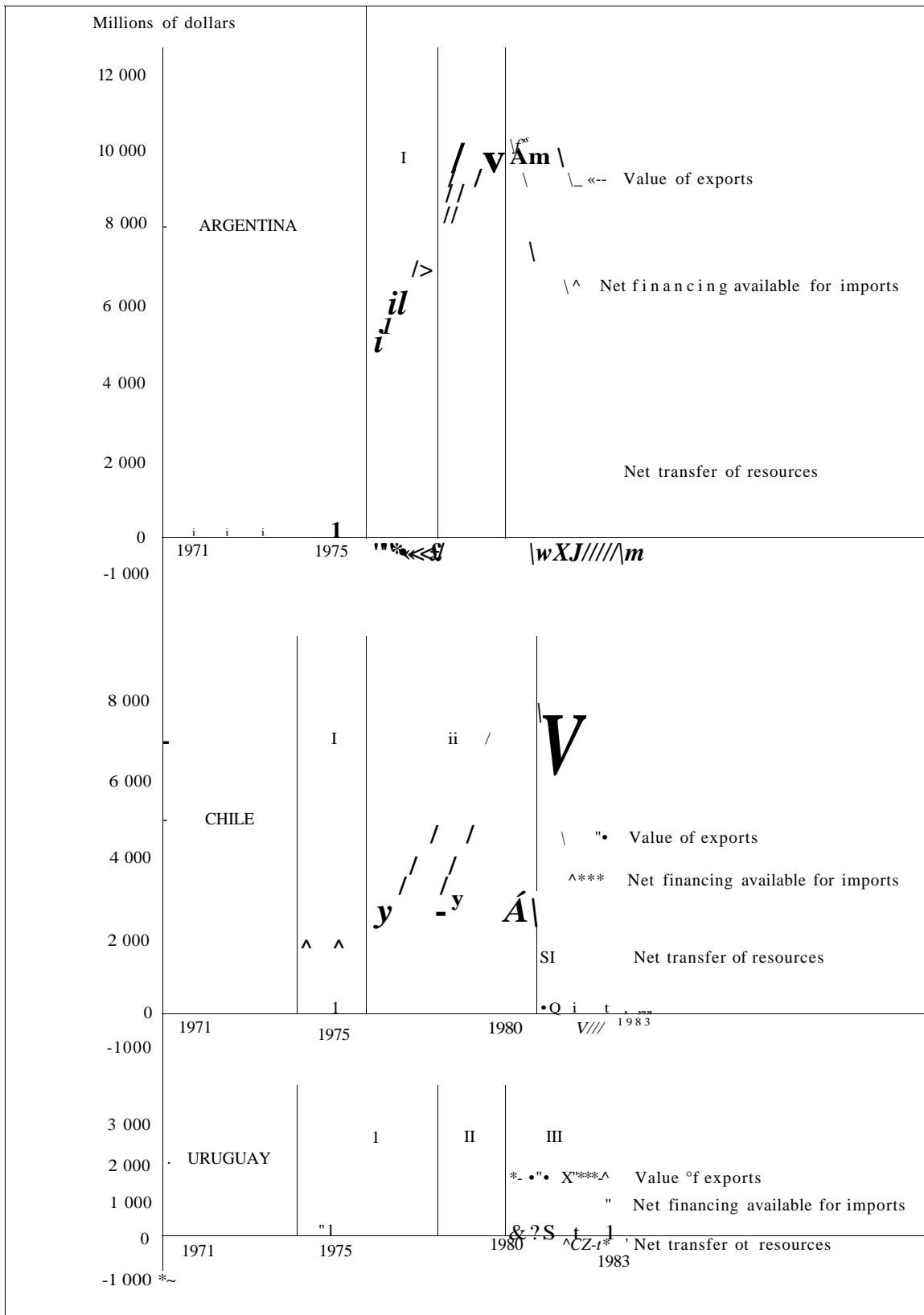
been sharply reduced (from almost 90% of the value of exports in Chile in 1981 to less than 25% in 1983; from almost 50% in 1980 in Uruguay to 7% in 1983; and in Argentina from over 40% in 1980 and 1981 to just over 20% in 1983). Moreover, all three countries moved from severe

²²If we insist on this point it is simply because many, while recognizing that there was an important lag in the exchange rate which needed correction, argued that a devaluation would be ineffective, since it would rapidly be wiped out by a similar rise in the rate of inflation. This need only be so, however, if the starting point were an equilibrium situation, for then any attempt to improve the trade balance via a devaluation would soon be limited by a fully utilized productive capacity, thus leading to a price rise which would rapidly eliminate whatever transitory balance of trade improvement had taken place. Nor would deflation improve the trade balance, for lower prices would raise demand; since an equilibrium starting point and full employment is posited, prices would begin to rise, wiping out the deflation and the

transitory gains in international competitiveness and in the balance of trade.

A devaluation of the exchange rate or relative deflation can, however, be effective if the starting point is one of *disequilibrium*, in which domestic prices are above international ones, for the resolution of this disequilibrium requires a real depreciation, either by raising the prices of international goods to those of comparable national ones (devaluation) or lowering the prices of domestic goods to international levels (deflation). The whole debate was really rather byzantine, however, for it was premised on a continuing equilibrium, whereas a lag in the exchange rate implied precisely the contrary,

Figure II
EXPORTS, NET TRANSFERS OF RESOURCES AND CAPACITY TO IMPORT



deficits in their balance of trade in 1980 and in 1981 to trade surpluses in 1982. Once again, most of these improvements were due to the extraordinarily sharp reduction in the quantum of imports which the recession entailed. In the two years 1982 and 1983, this reduction was 45% in Chile, 55% in Argentina and 63% in Uruguay. A recession is of course an extraordinarily rapid method of lowering imports but it does so at the cost of a severe contraction in output. Consequently, in the two or three years which this third phase of the adjustment lasted in the Southern Cone countries, output fell some 10% in each of the three countries (as opposed to 4% in the rest of the region) and unemployment sharply increased.

Finally, notwithstanding the fact that the inflow of foreign capital was sharply curtailed in these years, the level of foreign debt was extraordinarily high at the end of 1983. The ratio of such debt to the value of exports of goods and services varied from a low of 3.3 in Uruguay to a high of 4.5 in Argentina, compared with an average of 2.7 for the rest of the region. To be sure, the Southern Cone countries had already been among the most highly indebted countries of Latin America when the neo-conservative experiment began. What is truly remarkable is that they should not have slowed down their rate of indebtedness in the subsequent eight to ten years of strong export growth and firm allegiance to

the principle of strict financial discipline. That they should still stand out amongst the most indebted countries of the region in 1983 certainly does not speak well of the economic liberalization policies which they pursued, and, in particular, their policy of financial liberalization.

This latter seems to have heightened rather than reduced their dependence on foreign savings and consequently made them all the more vulnerable to swings in the international economy, for now they had to be prepared to offset unexpected movements in capital accounts as well as in their terms of trade. If their financial liberalization had only been furthered as the level of relative indebtedness approached more modest proportions this might have given them a greater degree of freedom with which to cope with the external disequilibria they faced in later years. Instead, rapid financial liberalization, in the face of an already very high level of debt added a further critical element serving to accentuate rather than attenuate unexpected movements in their external accounts. Consequently, rather than giving them more freedom, financial liberalization gave them even less. The adjustment (maxi-devaluation plus severe recession) was thus largely forced upon them rather than being a policy which they deliberately chose. Hence, the overindebtedness of phase II eventually led to the reversals in capital flows and the overadjustment of phase III.

V

Conclusions

A clear distinction must be drawn between two types of stabilization policies: those which are intended principally to overcome internal disequilibria (inflation and/or recession), and those designed to overcome external disequilibria (associated with deficits in the balance of payments). The most important distinction between the two is that the former need not be faced immediately (inflation can be lived with indefinitely), whereas measures to deal with external disequilibria cannot be put off. The ba-

lance of payments is a binding restriction, similar to a budget restraint.

Moreover, precisely because inflation can be lived with, depending on the country's tolerance, there is no reason (at least in theory) why an anti-inflationary stabilization policy need reduce output. To be sure, recession is all too often the (unwanted) result of a price stabilization policy, but this is not inevitable. In contrast, adjustment policies to deal with an external disequilibrium have an unavoidable cost for the country, since

they require that the quantum of goods and services available to the country for its domestic use decline in order to permit it to meet its foreign commitments. What is avoidable, however (though unfortunately it often accompanies adjustment processes), is that output should also decline, since a drop in output is by no means a necessary nor desirable condition for reducing the goods available to the economy. On the contrary, the optimum adjustment policy would maintain or increase output but would reorient it from domestic to foreign use: exports would increase and imports would decline, the latter being substituted, as needed, by domestic production. Furthermore, the output of tradeables would go down as that of non-tradeables rose. Thus, while adjustment inevitably implies a worsening, or at least a slowing down in the rate of growth, of the standard of living, it does not require a decline in the rate of growth of output. Hence, the challenge which faced the Southern Cone countries in the neo-conservative period was to avoid the unnecessary recession which often accompanies anti-inflationary programmes or balance-of-payments adjustment processes.

It is both theoretically and empirically beyond question that a decline in the rate of inflation should be accompanied by a deceleration in monetary growth and a reduction in the fiscal deficit. But a stabilization policy will be successful only to the extent to which the remaining principal variables —prices, wages, exchange rates, interest rates— decelerate at the same pace. Theoretically, the mere announcement of the deceleration in the inflation rate should be enough to ensure that the remaining variables adjust immediately and become compatible with each other and with the programmed monetary and fiscal policy. In practice, however, inflationary expectations do not adjust instantaneously. For one thing, the public normally is rather skeptical. It wants to see results first before believing that inflation is going to fall as fast as the government projects. Because of this inertia in the adjustment of expectations, however, the level of prices normally remains above that implicit in the economic policy, thus leading to recession. Moreover, it is often necessary not only to lower inflation but also to correct some relative prices, as was the case, in the three

experiences we have examined, of the exchange rate, the prices of some public services, and/or the prices of agricultural products in relation to industrial goods. Unfortunately, the increase in these heretofore repressed prices is often (wrongly) considered by many private agents to be an indicator of probable inflation, and not simply the expression of a needed corrective adjustment in relative prices. This being so, inflationary expectations exceed the inflationary goal implicit in monetary and fiscal policy, thereby forcing that policy to be eventually too restrictive and generating a recession.

Hence, while it is certainly true that in order to bring down inflation it is imperative to control monetary expansion and reduce the fiscal deficit, no stabilization policy worth the name can be based on these instruments alone if it wishes to avoid the costs of recession. Such a policy must necessarily also try to harmonize, or guide, or control, but certainly not repress, the movement of the other principal economic variables (prices, wages, exchange rate, interest rate, etc.), in such a way that it is compatible with the rate of inflation implicit in the monetary and fiscal policy programmed, for if some variables adjust more rapidly than others, a recession with regressive distributive consequences (at the expense of those variables which adjusted their prices downwards more rapidly) will ensure.

The neo-conservative stabilization efforts in the Southern Cone successively followed two criteria, each of which focused on and controlled some of the principal economic variables, but not all. During the first phase, efforts were centered on direct control of the money supply and wages: these measures, together with natural market forces, were expected rapidly to bring internal prices (including interest rates) into line with the programmed inflationary goal. During the second phase, efforts were centered on controlling the movements of the exchange rate and thereby slowing the growth of prices to a similar rate. In both cases there was some success in reducing inflation, but the cost was very high, inasmuch as the free variable, prices, adjusted far more slowly than the controlled variables, thus generating important disequilibria.

In the first phase, the principal disequilibrium emerged in the goods market. Prices shot up far more than wages, giving rise to a

severe Keynesian-type recession in Chile and stagnation in Argentina. Only Uruguay was spared, thanks to its very high level of public investment and to the positive evolution of the external demand for its products.

Although there is no reason why the cost—whatever its form—should be distributed unequally, the fact of the matter is that the "belt tightening" during phase I proved to be very uneven in all three countries. Income was sharply redistributed against wage earners, as can be seen by the very sharp fall in real wages (much sharper than the decline in the growth of national income) and, in the case of Chile, the cost was further accentuated by an unprecedented increase in the unemployment rate to levels two to three times above historic rates. This uneven cost was the result of the policy instruments applied during phase I: that is to say, controlling wages and pursuing a tight monetary policy while allowing the inflationary expectations of producers to adjust much more slowly in the goods market. Consequently, prices rose to inflated levels compared with wages.

In the second phase, the principal disequilibrium emerged in the market for foreign exchange, because domestic inflation declined much more slowly than the rate of devaluation. This lag in the exchange rate was due to the fact that the "law of one price" whereby domestic prices and interest rates should converge with international ones, acted extremely slowly. Contrary to what had been expected, the initial tendency was for international goods and loans to be priced at levels closer to their domestic counterparts, and not at their long-run values (their international prices, plus tariffs). In short, initial convergence was not downwards towards international prices and costs but upwards towards domestic ones.

Consequently, in phase II the lag in the exchange rate finally led to a serious disequilibrium in the balance of payments with recessive effects which were initially concealed by an unusually strong inflow of foreign capital but became obvious once such flows slowed at the end of phase II. The slowness of domestic prices to decelerate and the aggravation of the exchange rate lag thereby rendered ever less believable the continuation of the exchange and stabilization policy, and this contributed to the eventual slowdown

in the inflow of foreign capital and the consequent abandonment of the exchange policy. Massive devaluations were thus made necessary in order to close the huge gap which existed between domestic and foreign prices.

While this second phase lasted, that is to say, up until the maxi-devaluations, the distribution of income did tend to recover (partially), or at least come closer to the original distribution existing at the time these neo-conservative experiences were initiated. Such an improvement took place because employment (Chile and Uruguay) and/or real wages (Argentina and Chile) tended to rise. The recovery in wages was particularly marked in Chile, inasmuch as wages were readjusted in accordance with past, not current, inflation, and this latter was rapidly decelerating.

While it is undoubtedly true that capital inflows can mitigate balance of payments difficulties and thus reduce unexpected exchange rate variations, it is likewise true that the sudden reduction in such inflows can itself create or accentuate an external disequilibrium, forcing even more sizeable adjustments in the balance of trade. This is so because capital movements are sensitive not only to interest rate differentials and exchange lags but also, and more importantly, they are sensitive to uncertainty concerning the country's capacity to service its foreign debt. When such uncertainty arises, the magnitude of the adjustment that must take place is all the greater, and the time it must be completed in is all the shorter. These dangers manifested themselves clearly in the three Southern Cone countries, since capital inflows proved to be highly procyclical. During most of the period of programmed and pre-announced devaluations, capital inflows were sufficiently strong to minimize or compensate the negative effects on output of a lag in the exchange rate, and so maintain strong aggregate demand. Inversely, however, once doubts were created as to a country's capacity to service its debt, capital inflows diminished sharply, thus forcing exceptionally rapid and strong (over) adjustment to the external disequilibrium. Consequently, not only was there over-indebtedness (excessive capital inflows) in phase II, as can be seen from the extraordinarily high level which the ratio of debt to exports reached in all three countries, but there was overadjustment in phase III, for in this last

phase, all three countries were forced to adjust their economies not only to an external disequilibrium on their trade balance, due to the lag in the exchange rate, but had also to adjust to the procyclical reduction in capital inflows, which both increased the magnitude of the needed adjustment and shortened the time frame in which it had to be effected.

Hence, whereas in the last year of phase II the big capital inflows more than offset the movements in the terms of trade and increased these countries' capacity to import by some 20% to 40% of the value of their exports, once capital inflows receded and adjustment was forced upon them they were forced to make a net transfer of resources equivalent to 25% of the value of their exports. As a result, over a twelve-month period each of them was forced to reduce imports or increase exports by the equivalent of some 50% of the value of their exports. Moreover, since this had to be done in the course of a major international recession, the brunt of the adjustment had to be borne through a reduction in imports and not an expansion of exports. Consequently, given such a sharp reversal in their capacity to import, it is not surprising that in the two years following their maxi-devaluations (1981/1982-1983) these economies' output fell by the order of 15%.

Obviously it would be desirable, in the face of external disequilibria, to have permanent access to the external capital market to soften and prolong the adjustment process and enable it to be based on expansion of the production of tradeables rather than on a reduction of output. In the case of the three Southern Cone countries, however, they were so heavily in debt when the final crisis broke out that capital flows dried up precisely when they needed them most: on the contrary, they became yet another variable to which they were forced to adjust. A devaluation taken earlier or possibly of even greater magnitude than that finally made might have succeeded in reducing imports at a lower cost in output. In view of the magnitude of the external imbalance and the short time available for correcting it, however, the devaluation was in any case less effective than it would have been if more time had been available.

Thus, unlike a price stabilization programme where a "shock" policy may be effective,

especially for dealing with hyperinflation, there can generally be no efficient "shock" adjustment to external disequilibrium, since efficient adjustment implies changes in *real*, not simply in monetary, variables. Thus gradual measures are vital. Efficient adjustment implies not just reducing the output of non-tradeables, which can be achieved quite quickly, but also increasing the output of tradeables, which is slower; it is not just a question of reducing the volume of imports, which is usually fast, but increasing exports and the output of import substitutes, and this is necessarily slower.

Given the magnitude of the external disequilibrium the Southern Cone countries faced and the brief time frame in which they had to close it, their adjustment was inevitably not efficient. Its results were based almost exclusively on expenditure reduction (controlling demand, which can be effected with the requisite speed) rather than on expenditure switching (which involves supply and production shifts, which are necessarily much slower), and this, of course, is the worst of all possible adjustments. In fact, the cost to the three countries of improving their trade balance by a total of US\$ 16 billion in the first two years of application of their adjustment policies²³ was the sacrifice of nearly US\$ 37 billion in lost production.²⁴ In other words, the adjustment which took place was based much more on the reduction of expenditure than on its reallocation ("switching" policies), and it meant paying US\$ 2.30 in lost production for every dollar of foreign exchange saved.

Therefore, the basic principle of an efficient policy for achieving adjustment to external disequilibria with little or no decline in production is to weigh the cost of saving or generating foreign

²³Argentina 1980-1982; Chile and Uruguay 1981-1983.

²⁴The improvement in the trade balance is measured for each of the two years of the adjustment process, as compared with the base year (i.e., US\$ 5 700 million for the three countries in the first year of adjustment and US\$ 9 900 million in the second, giving a total of almost US\$ 16 billion in the two years). For its part, the cost consists of the growth of the product which did not take place (of the order of 3 1/2% per year), plus the fall registered (US\$ 14 billion less product in the first year and another US\$ 23 billion less in the second, giving a total sacrifice of the product of US\$ 37 billion for the two years).

exchange through expenditure "switching" policies with that of securing the same effect through the reduction of expenditure. This basic principle gives rise to at least three economic policy guidelines:

1. Precisely because policies of restricting demand can be expected to take effect more rapidly than those which reallocate expenditure, there is every justification for temporarily employing policies of marked "over-reallocation", both in order to discourage non-essential or replaceable imports and to promote exports. For the case of these three countries, this would mean that any combination of tariff surcharges or special export subsidies which saved or generated one dollar of foreign exchange at a cost of less than US\$ 2.30 of lost production (at the prevailing exchange rate) would have been preferable to the policy of over-reduction of expenditure actually followed. The incentives for "over-reallocation" would only be transitory, for although the reallocation of production operates but slowly, it does take place in the end: once its effects begin to be felt with all their force, further special incentives would be unnecessary and their maintenance for an indefinite period would be inefficient. Furthermore, since these incentives are transitory they should not be generalized (that is to say, a still greater exchange rate devaluation would not be advisable); instead, the special export incentives and tariff surcharges should be selective, as a direct function of the short-term price elasticity of the exported or imported product.

2. A more efficient adjustment policy would call for the equalling of the incentives (or costs) for saving foreign exchange through import substitution and for generating it through export

promotion. In view of the prevailing structure of incentives, especially in Argentina and Uruguay—high tariffs, plus few special export incentives—it would presumably be easier to earn additional foreign exchange by promoting exports than by increasing import substitution.

3. The last element in this sketch of an expansive and not recessive adjustment policy would be the inadvisability of reducing the production of non-tradeable goods until the output of tradeables has expanded to a similar degree. The traditional (recessive adjustment) policy, in contrast, generally assumes that the reduction of the former practically ensures the expansion of the latter (i.e., it assumes full use of installed capacity). The fact is that production of non-tradeables usually falls all too easily and rapidly, whereas the expansion of tradeables production is neither quick nor certain. In the first two years of the adjustment process in the three countries, for example, production of non-tradeables plummeted—construction activity fell by 30%—without the resources thus freed being used to increase the output of tradeable goods. Indeed, the production of tradeables also fell (by over 10%). Hence, in contrast with traditional programmes, it does not seem advisable to restrict construction or the production of other non-tradeable goods until these resources are actually required for the output of tradeables. To do it earlier would be to save foreign exchange at an unjustifiably exaggerated cost (of the order of the reciprocal of the marginal propensity to import, or, roughly speaking, at a cost which is approximately four times greater, in terms of lost production and at the prevailing exchange rate, than the total amount of foreign exchanged saved).

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