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CONTENTS

In memory of Pedro Vuskovic 9
Jacobo Schatan

Regional integration in the 1990s 11
Gert Rosenthal

The integrationist revival: A return to Prebisch's policy prescriptions 21
José Manuel Salazar

Trade liberalization in Latin America 41
Manuel Agosin and Ricardo Ffrench-Davis

Growth, crises and strategic turnarounds 63
Joseph Ramos

Market failure and technological policy 81
Jorge M. Katz

The monetary crisis, dollarization and the exchange rate 93
Paulo Nogueira Batista Jr.

Financing decentralization 109
Dolores María Rufián Lizana

Intraregional migration of skilled manpower 127
Jorge Martínez

Social sciences and social reality in Central America 147
Andrés Pérez

The history of the social stratification of Latin America 163
Enzo Faletto

Socio-economic structure and collective behaviour 181
Rodrigo Baño

Index of CEPAL Review, Numbers 1 - 50 201

Guidelines for contributors to *CEPAL Review* 237

Recent ECLAC publications 239

Growth, crises and *strategic turnarounds*

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The import-substitution strategy was entirely justified in the 1930s and continued to make sense until the late 1950s, so long as export opportunities were being dampened by the Great Depression, the Second World War and the reconstruction of Europe. From the 1960s on, however, it afforded diminishing returns as international trade burgeoned. During the 1980s, the macroeconomic instability caused by the debt crisis compounded the problems associated with this development strategy, which had begun to become apparent in the 1970s. Evidence to this effect was provided by the region's declining productivity and increasing vulnerability to external shocks. This is why today's infant industries are concentrating their attention on gaining a foothold in external markets rather than on the acquisition of production skills. Despite the consensus that is taking shape with respect to this outward-looking orientation, significant differences still remain between the neostructural and neoliberal visions of society in respect of both their development focus and instruments. The role of the State: How active or passive should it be? The bias of export incentives: Should they be temporarily pro-export, or neutral? Social equity: Should we see distribution as just a question of time (the trickle-down strategy), take a parallel approach whereby economic policy is devoted to growth and social policy to distribution, or, as the author suggests, apply an integrated approach in which economic policy would incorporate objectives of both distribution and social equity? The article closes with a counterpoint between the orthodox focus, which concentrates entirely on liberalization and deregulation, and the neostructuralist approach, which advocates the use of more active instruments by a more effective public sector to eliminate critical bottlenecks.

I

Introduction

This essay presents an overview of Latin America's economic growth since the 1930s, as well as of its main problems in this regard and the strategies it has employed. This analysis of the last 60 years will revolve around three events, three questions and three hypotheses.

1. Three events

It is well known that, increasingly promising indications of a recovery notwithstanding, in the 1980s Latin America experienced the longest, most severe crisis to affect it since the Great Depression of the 1930s. Production bogged down, with the result that the region ended the decade with a level of per capita income almost 10% below the 1980 figure, and inflation soared so high that the region marked up an incredible average annual rate of over 400% for the decade and did not return to its customary, more moderate rates of around 20% until 1992. All this demonstrates just how apt a description of the 1980s is provided by the term "the lost decade".

Second, the economic and social crisis of the 1980s was coupled with a crisis of ideas as the very foundations of the development strategy in use since the 1930s –i.e., industrialization based on import substitution– were called into question. Indeed, the region's development strategy is undergoing a complete turnaround as it shifts from inward-looking to outward-looking growth, from broad-ranging interventionism to a much greater reliance on market forces, and from growth directed by the public sector to growth led by the private sector.

Third, this strategic about-face is taking place despite the fact that between the end of the Second World War and 1980, Latin America grew more rapidly and more steadily than ever before in its history, expanding at a rate of somewhat over 2.5% per year; this was much higher than its historical rate of 1%, although, even so, it was still far below the rates attained by the newly industrializing economies (NIEs) of Asia.

2. Three questions

Three questions arise. The first is: Why were the 1980s such a disastrous decade for the region? The answer obviously has to do with the external debt crisis and the costly adjustment and stabilization processes that were required in order to deal with the macroeconomic disequilibria it generated.

If the crisis was nothing more than a problem of macroeconomic instability, however, then a second question arises: Why should the region change its development strategy? One answer might be that the import-substitution strategy was a mistake from the very start.

If it is true that the import-substitution strategy was a mistake from the start, then how (and this is the third question) can we account for the fact that the period during which it was applied was also the period when Latin America achieved the most rapid pace of economic growth in its history?

3. Three hypotheses

Our first hypothesis is that the 1980s were a lost decade not only because of the region's macroeconomic instability but also because of problems stemming from its development strategy. During the 1970s these problems began to be manifested in declining productivity and an increasing vulnerability to external shocks, but were not expressed outright because of the heavy inflow of capital being received during that time. (This hypothesis is almost universally accepted now.)

The second hypothesis is that, the criticisms of the orthodox school of thought notwithstanding, the import-substitution strategy was not a blunder from the very outset. In fact, it made a great deal of sense during the 1930s, when the contraction of world trade as a consequence of the Great Depression made it nearly impossible to export and the State had to find some way of stimulating a stagnant private sector. And it continued to make sense at least until the late 1950s, since the Second World War made it almost impossible to import manufactures and, later, during

the reconstruction of Europe and Japan, it would have been very difficult to export any significant amount of manufactures because those markets had virtually closed down. In the 1960s, however, the import-substitution strategy started to yield sharply diminishing returns as the "easy" substitution stage came to an end and international trade embarked upon a period of extraordinary growth. (This hypothesis is somewhat more open to debate, but it still probably represents the majority opinion among experts on the subject.)

Our third hypothesis is that what surely does need to be corrected is the orientation of the development strategy so that an outward-looking, rather than inward-looking, approach may be taken. The inward-looking orientation has already fulfilled its function in history. The "infant industry" of today is no longer aiming at production alone, as in the past, but now strives to carve out a place for itself in foreign markets. If there is any justification for an active role for the State, it is the need to promote entry into new markets, especially for non-traditional products. Accordingly, the debate regarding this subject does not refer to the reorientation of the strategy but rather to the role of the State, i.e., whether outward-oriented growth should be promoted by the State or whether it should proceed without State interference. In the past, the debate was conducted as if there were only two options: (i) an active State combined with inward-oriented growth, or (ii) outward-oriented growth and a passive State. The participants in this debate overlooked the fact that two possibilities along two different axes meant that there were four options, not two. Most importantly, they were ignoring the option of outward-oriented growth in combination with a State that actively promoted that growth, which is not only theoretically possible but is also a characteristic of the development strategy pursued by Japan and the Asian NIEs; this is also the option now advocated by ECLAC.

These are, in an extremely condensed form, the three events, three questions and three hypotheses on which this essay is based. In the following discussion, these topics will be explored in chronological order:[1] the origin and implications of the import-substitution industrialization strategy; the crisis of the 1980s and its causes; and the strategic turnaround now being performed by the region.

II

The import-substitution industrialization strategy: its origin and its implications

1. Its origin

Between the time the Latin American countries won their independence and the Great Depression of the 1930s, the region's development was based on the pillars of classic orthodoxy: private ownership, market economies and relatively small, passive States. The Great Depression of the 1930s changed all that, however, by giving rise to a deep mistrust of the virtues of the market as a mechanism for automatically resolving major economic problems. In developed countries, the market's ability to generate a rapid, spontaneous solution for cyclical unemployment was called into question. In developing countries, the "confidence crisis" was much greater still, and it came to be believed that therein lay the reason why Latin America was growing so slowly (about 0.5% per capita since independence, as compared to a 2% rate for the United States) and why its per capita income as of the 1930s was only one-sixth that of the United States, which was also a new territory that had been colonized about the

[1] At this point I should remind the reader that talking about "Latin America" as such is an oversimplification, even though the countries within it have many similarities. The structures and sizes of the different Latin American economies vary substantially. Furthermore, no matter how alike their development strategies may have been, the focuses and intensities of those strategies have differed considerably. A somewhat stylized representation of those strategies will help us to bring out some important points in the course of this discussion, but no actual country in the region behaves exactly like the "typical country" to which it refers.

same time as Latin America. Hence the market, private ownership and a small, passive State did not, in and of themselves, automatically lead to economic development.

The questioning of this state of affairs gave rise to the idea that the State, especially in a region of belated growth, should play an active role in overcoming "structural" problems (e.g., a lack of entrepreneurial drive, exceedingly imperfect markets, a concentration of power and wealth, etc.) that hold back its economic development. This idea ran counter to the premise, which until then had been generally accepted, that the State should play a passive role, or at the very most should act as no more than a facilitator for private activity. Moreover, in view of the close correlation between per capita income and the level of industrialization (regardless of which might be the cause and which the effect), it was concluded that the State should make a special effort to promote industrialization, since it was this process that appeared to be the primary vehicle for technological progress. Thus, as a consequence of the depression of the 1930s, the active promotion of industrialization came to be seen as a special function of the State, and the region abandoned what had until then been the orthodox strategy of outward-looking development based on commodity exports.

Nevertheless, the choice of an inward-looking industrialization strategy rather than an outward-oriented one appears to have been an accident of history, rather than the outgrowth of any particular theoretical stance. [2] The Great Depression of the 1930s and the region's deteriorating terms of trade made it more difficult to import manufactures and thus more attractive to produce them domestically. In addition, the marked protectionism of the industrial countries during that crisis made an outward-looking form of industrialization unthinkable, while shortages of manufactures unrelated to the war effort and the difficulty of importing such products during the Second World War naturally set the scene for their domestic production. Furthermore, the presence of exchange controls and the tariff protection that characterized the period of European and Japanese reconstruction also made it unfeasible for Latin America to adopt an outward-oriented industrialization strategy during those years. It therefore comes as no surprise that the region opted for an inward-looking strategy based on import substitution. This was reinforced by the virtually "natural" sequence of events whereby the countries' industrialization would first be based on the domestic market and only later, once experience had been gained, would exports come into the picture.

2. Policies and their outcomes

The import substitution-based industrialization strategy made use of a wide variety of instruments. The chief such tool was tariff protection, which was generally greater for final products than for intermediate inputs, and less for capital goods. This protection was usually supplemented by such measures as quotas and import permits, total bans, national content requirements applying to the value added during production, soft loans (often at interest rates that were negative in real terms) and others.

a) Progress

Actually, the region turned in a good economic performance during the period 1945-1980 –surprisingly good, considering how harshly the import-substitution strategy has been criticized. In fact, the annual per capita growth rate for the gross domestic product (GDP) was 2.7% for the period in question (see table 1). This rate was unusually high for the region; indeed, not only was it far above its previous historical rate (1% per year), but it was actually even higher than the 2.5% per year target set by the Alliance for Progress in 1960. What is more, it was accompanied by a relatively moderate rate of inflation of 20% per year; in fact, 11 countries averaged single-digit rates and no country experienced triple-digit inflation.

[2] The theoretical argument for an industrialization strategy based on import substitution was formulated by Raúl Prebisch and ECLAC many years after the implementation of that policy. In his famous call for industrialization, Prebisch justified it by pointing to the supposed asymmetries existing with respect to the benefits of the dissemination of technological progress. In raw materials-producing countries, the fruits of such progress are quickly passed on to consumers via price declines, whereas technological inroads in the manufacturing sector generally lower costs but not prices owing to the oligopolistic structure of markets for manufactures. Hence the long-standing downward trend in the terms of trade for raw materials producers, such as the countries of Latin America (see ECLAC, 1949). Of course, other authors –including W.A. Lewis in what has become a classic essay (Lewis, 1963)– also championed the cause of industrialization, but it was Prebisch's argument that had the most influence in Latin America.

TABLE 1

Latin America: growth and inflation, 1945-1992
(Annual percentages)

	Growth of gross domestic product				Inflation		
	1925-1945	1945-1980	1980-1990	1991/1992	1945-1980	1980-1990	1992
Latin America	3.5	5.6	1.2	3.2	20	Over 400	Under 20 [a] 410 [b]
Per capita GDP	1.0	2.7	-0.9	1.1			
Argentina		3.1	-1.5	6.7	57	650	18
Bolivia		3.4	-0.7	3.8	28	1 000	11
Brazil		6.9	1.9	-0.3	33	450	1 130
Colombia		5.2	3.5	2.6	14	23	26
Costa Rica		6.7	2.1	2.6	6	28	18
Chile		3.6	2.7	7.7	77	21	13
Ecuador		6.8	2.1	3.9	8	40	66
El Salvador		5.1	-0.6	3.9	5	19	17
Guatemala		4.6	0.5	3.6	4	12	12
Haiti		1.3	-0.5	-2.7	5	5	18
Honduras		4.4	1.8	3.4	4	6	6
Mexico		6.7	1.2	3.1	9	70	13
Nicaragua		4.7	-1.3	-	6	5 000	2
Panama		5.3	-1.0	8.3	3	3	1
Paraguay		4.8	3.0	1.9	22	20	17
Peru		5.1	-1.0	-0.3	17	1 000+	6
Dominican Republic		6.2	2.5	3.3	2	22	5
Uruguay		2.6	-0.4	4.3	36	57	59
Venezuela		6.7	-0.2	8.9	5	26	33

Source: ECLAC, Division of Production, Productivity and Management.

[a] Preliminary figures; Brazil is not included.

[b] Preliminary figures; Brazil is included.

This growth trend was led by the manufacturing sector (see table 2), whose share of GDP climbed from 14% in 1930 to 25% in 1980. As was to be expected, imports' share of GDP slipped from 20% in 1930 to 15% in 1980 and the region became less dependent upon them.

The region's social progress was perhaps even more impressive than its economic achievements (see table 2). Despite the post-war population explosion, adult illiteracy dropped from 45% in 1945 to 20% in 1980. Indeed, education –which in 1945 had been a clear reflection of a classist society in which opportunities for utilizing educational services were limited– expanded enormously. Primary education's coverage became virtually universal, and access to what until then had been the remote possibility of post-primary education was opened up; as a result, the percentage of young people of the corresponding ages who were enrolled in secondary educational institutions trebled and the percentage in higher education increased fivefold. Enormous progress was made in providing the population with drinking water and electricity in the home as well, with the coverage of these services expanding to include two thirds of the population (as compared to one third or less in 1945). Life expectancy at birth increased by 15 years to 65 years of age by 1980, which was not much less than the figures registered for many developed countries. It is also important to note that all these social advances were progressive, i.e., severely underprivileged social groups benefited much more than others, since wealthier classes had long enjoyed most of these services. This improved distribution of social benefits (or non-monetary income) partially offset the concentration of monetary income that tended to be a characteristic of post-war economic growth.

b) Problems

Although the region's economic and social performance during its implementation of an industrialization strategy based on import substitution certainly was impressive, it was actually so only in comparison to its past performance. Indeed, it seems quite

TABLE 2

Latin America: social and economic indicators, 1930, 1945 and 1980
(Percentages)

	1930	1945	1980
Economic indicators			
Manufacturing-sector GDP/GDP	14	18	25
Imports/GDP	20	13	15
Traditional exports/total exports	Over 88	Over 82	76
Social indicators			
Adult illiteracy		45	20
School enrolment rates			
Primary education		55	90
Secondary education		10	30
Higher education		2	10
Life expectancy at birth (in years)		50	65
Percentage of dwellings with:			
Running water		20	65
Electricity		35	70

Source: ECLAC, Division of Production, Productivity and Management, on the basis of figures from ECLAC, the World Bank and the United Nations Children's Fund (UNICEF).

lackluster if it is compared with the opportunities for rapid growth available to late-developing countries –opportunities which the Asian NIEs used to achieve a growth rate more than double that of Latin America during the same period.

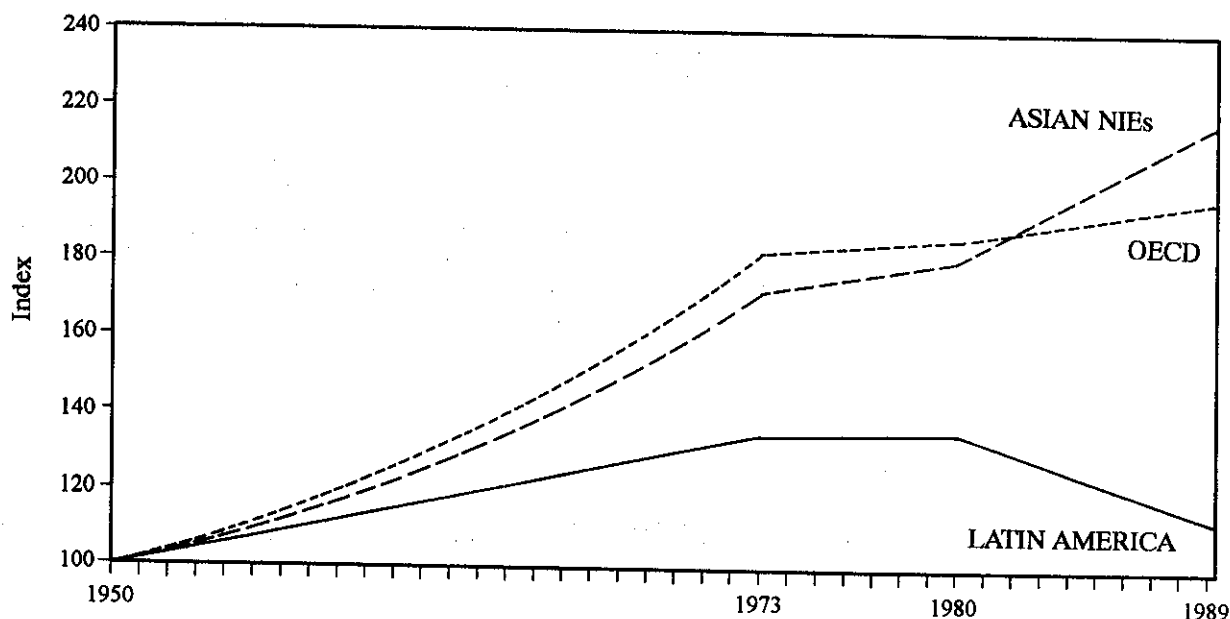
In fact, there were a number of signs that the import-substitution strategy was becoming increasingly problematic for the region. First of all, as the substitution process moved on from final products (which are easier to find replacements for) to the production of intermediate inputs and capital goods, it became more and more expensive and inefficient. The productivity of capital (the scarce factor in this case) declined either because plants were too large for the size of their market, or because they were underutilized, or because their technological requirements and quality standards were too sophisticated for the region's production capacity. Thus, the marginal capital-output ratio climbed steadily, from around 4 in 1950-1965 to over 5 in 1974-1980 and to more than 8 by the 1980s. In fact, a recent study (Hofman, in press) of trends in total factor productivity, [3] or technological improvements, in various regions of the world between 1950 and 1989 indicates that it had been falling sharply in Latin America since 1973 (see figure 1). Thus, GDP grew during this period only because there was a larger supply of factors, especially capital (from external borrowing), since there was no increase in efficiency during the period 1973-1980 and it actually decreased during the 1980s. In contrast, total productivity, or efficiency, grew far more in the Asian NIEs: 2% per annum for the period as a whole, as opposed to just 0.3% in Latin America. Even during Latin America's "golden age" (1950-1973), total factor productivity in the region grew by only one half as much as in the Asian NIEs (annual rates of 1.3% versus 2.7%).

Second, precisely because of its import-substitution strategy, the region became extremely vulnerable to external shocks. Since, by reducing imports, tariffs cause the real exchange rate to move downward, import substitution is an implicit tax on exports and is particularly a hindrance for non-traditional exports. Hence the fact that exports' share of GDP in 1980 was not only small (15%) but was also primarily accounted for by traditional exports (75%) that were

[3] The term "total factor productivity" refers to the ratio between output and all factors of production (rather than any single factor), including both capital and labour, with each factor being weighted according to its share in total output.

FIGURE 1

Total factor productivity: Latin America, Organization for Economic Cooperation and Development (OECD) and newly industrializing economies (NIES) of Asia
(Indexes: 1950 = 100)



Source: A. Hofman, Economic Development in Latin America in the 20th Century. A Comparative Perspective, in S. Adams, *et al.* (eds.), *Explaining Economic Growth. Essays in Honor of Angus Maddison*, Amsterdam, Elsevier/North Holland (in press).

generally price inelastic for both demand and supply. Consequently, non-traditional exports represented less than 4% of GDP.

Third, in practice, tariff protection was excessive in every sense and had no more economic justification than an attempt to offer each sector the protection it wanted. As may be seen from table 3, this protection was grossly excessive, unusually disperse and clearly tended to be used as a permanent, rather than temporary, measure. Effective protection generally verged on or exceeded 100%, which was far greater than any sort of distortion that it might reasonably be expected to offset. Merely as an example, even if urban wages (for the reasons adduced by W. Arthur Lewis) were to exceed the real or social scarcity price of labour by as much as 50%, and if wages were equal to 30% of costs, this would justify a countervailing tariff of no more than 15%. Similarly, cross-sectoral or cross-country tariff dispersion had no solid economic or social basis; effective protection was often low or even negative for labour-intensive items such as food products, but was extremely high for capital-intensive products (i.e., products intensive in a scarce factor), such as consumer durables.[4] Protection was also highly discretionary, since there were many exceptions, and tariff revenues on total imports were therefore much lower than the average nominal tariff.

Despite all these problems, the benefits of import substitution outweighed its costs at least until 1973; hence the sharp acceleration of the region's economic growth during the post-war period. This was because, at least until the late 1950s, the relative prices of manufactures were clearly an incentive for their production, while the protective measures being used by most industrial countries in the 1930s, during the Second World War and during reconstruction would have made an outward-oriented industrialization strategy quite

[4] Effective protection for electrical goods was 195% in Argentina in 1969, 609% in Uruguay in 1976 and 740% in Chile in 1967 (Ramos, 1989).

TABLE 3
Latin America (six countries): effective protection and tariff spreads in the late 1960s
(Percentages)

	Effective protection	Tariff spread
Argentina	95	-10 to 1 300
Brazil	80	4 to 250
Chile	220	-23 to 1 100
Colombia	90	-8 to 140
Mexico	39	-4 to 1 000
Uruguay	385	17 to 1000

Source: R. Ground and A. Bianchi, 1988.

impractical. Even in the 1960s, the inward-oriented strategy was not too costly (except for the fact that it caused the region to miss a splendid opportunity for adopting an outward-looking orientation at a point in time when world trade was about to enter into a stage of extraordinarily rapid growth) so long as the substitution process was still chiefly in its easier stages. And a learning process was also clearly taking place which led to greater productivity, less inefficiency and lower costs. The net result of all this was that, even though the region should have started to reorient its strategy towards an outward-looking stance in the 1960s, the period 1945-1980 was still the time of the greatest economic and social growth in the region's history.

III

The crisis of the 1980s and its causes

Why, after 35 years of solid, steady –if not spectacular– growth with moderate inflation, were these accomplishments wiped out in the 1980s by recession and stagnation, on the one hand, and an almost across-the-board outbreak of inflation, on the other?

1. The main events

The economic crisis of the 1980s was so severe that, far from growing during the period, the region's per capita GDP fell to a point where, by 1990, it was nearly 10% lower than it had been in 1980. In fact, an increase –and a very modest one at that– was seen in only three countries (Chile, Colombia and Paraguay), while decreases were registered in all the rest; in some cases, the drop amounted to over 20% (Argentina, Bolivia, Haiti, Nicaragua, Peru and Venezuela). It was not until 1991-1992 that signs of a recovery began to be observed (see table 1).

During the 1980s the region also witnessed an exceedingly strong upsurge in inflation. In the period 1945-1980, the region's average annual rate of inflation had been 20%, and in 11 countries it was under 10%, but in the 1980s the average rate shot up to over 400% and only three countries held their annual average rates of inflation down to one digit. Thus, inflation became endemic in virtually the whole of the region: eight countries recorded annual rates of over 100% –an unprecedented state of affairs for the region– and three of them (Bolivia, Nicaragua and Peru) experienced hyperinflation, with average rates of inflation reaching four-digit levels for the decade.

2. The causes

Clearly, the crisis of the 1980s was caused by the external debt problem. Earlier, however, we postulated (as our second hypothesis) that the severity and protracted duration of that crisis stemmed not only from the disequilibria generated by the external debt overhang and faulty macroeconomic management, but also from the region's extreme vulnerability to external shocks in 1980 owing to its import-substitution strategy.

Briefly, the recession and stagnation of the 1980s, as well as the inflationary spiral seen at that time, arose out of the region's difficulties with respect to resource transfers, in terms of both outbound transfers from the region and transfers from the public to the private sector. The reversal of the region's net resource transfers was equivalent to 6%

of GDP; in other words, whereas prior to the crisis the region had been a net recipient of resources amounting to about 2% of GDP, by its end the region had become a net supplier of resources representing around 4% of GDP.

The severity of this recession is attributable to the fact that it was impossible to carry out an "efficient" adjustment of the required magnitude by expanding non-traditional exports, since the level of such exports was exceedingly low owing to the implicit disincentive generated by protectionist policies; nor was it possible to substitute non-essential imports, since the policy of substitution had already whittled such imports down to a bare minimum. Accordingly, the adjustment had to be a recessionary one, with draconian cuts in imported intermediate inputs and capital goods that were needed for production.

The inflationary spiral, for its part, was caused by the fact that the public sector had to absorb the lion's share of the cost of the region's outward resource transfer. Since it had little leeway in which to raise its revenues and little desire to reduce what were regarded as essential expenditures, in most cases the public sector resorted to money creation in order to "finance" its deficit.

The economy's post-1983 stagnation was a result, on the one hand, of the instability generated by high inflation rates and, on the other, of the recessions that generally accompany stabilization programmes that lack credibility or are poorly managed.

At a more detailed level, it is useful to distinguish among three phases in the crisis of the 1980s. The most salient aspect of the *first phase*, from 1979 to 1981, was the increase in oil prices following the fall of the Shah of Iran. This sparked the simultaneous implementation of inflation-control programmes in the developed countries, whose inflation rates as of 1979 had still not dropped back to the levels recorded prior to the first oil crisis. These countries not only gave priority to anti-inflation policies, but, under the influence of the monetarist approach that prevailed at the time, they all also adopted targets for the expansion of the money supply while allowing interest rates to find their own level. As a result of this decision, the LIBOR (the rate to which the region's external debt was tied) jumped by nearly 10 points between 1978 and 1981 to a high of 17% in the latter year. A final factor was that the implementation of such harsh stabilization programmes led to recessions or economic stagnation in the central countries, which had an adverse impact on raw material prices. The region's oil-importing countries were thus subjected to three severe exogenous shocks: an increase in the price of their oil imports (oil made up 40% of Brazil's imports, for example); a steep rise in interest payments on their external debt; and a decline in the prices brought by their export products. As becomes evident upon examination of the various components of the balance of payments (see figure 2), the countries either had to cut back sharply on their imports (which would be quite difficult since so few imports were non-essential), boost their exports (a slow process, especially since any expansion of traditional exports would tend to push down their prices, particularly during a time of worldwide stagnation), or increase their borrowing. Given these options, it comes as no surprise that all the countries (except Colombia) chose to increase their borrowing. What is considerably less understandable, however, is why the banks approved these requests and readily granted loans to oil exporters (countries which were apparently well able to service larger loans) and oil importers (which found themselves in straitened circumstances) alike. The end result was that the region's external debt climbed by 85% during the period 1979-1981.

Of all the oil importers, only Brazil invested a significant portion of the borrowed funds (primarily in import substitution, which eased its adjustment when capital inflows began to dry up in 1982). The other countries wagered that the crisis was a cyclical, short-lived phenomenon and thus used the funds to maintain their existing consumption levels or, particularly in the case of the Southern Cone countries, to boost their imports, at pre-set exchange rates, and thus help to lower inflation (which led to increasingly undervalued real exchange rates). The oil exporters, for their part, did raise their investment rates, but much of these investments were made in poorly designed, overpriced projects. They also devoted a generous share of the borrowed funds to consumption, in expectation of receiving a much higher level of income on a permanent basis. Therefore, when oil prices started to edge downward rather than continuing to climb as they had expected, these countries' capacity for servicing their public sectors'

FIGURE 2

Latin America: balance of payments components

1.	INBOUND FOREIGN EXCHANGE			=	OUTBOUND FOREIGN EXCHANGE		
2.	EXPORTS	+	NEW CREDITS (NET INCREASE IN EXTERNAL DEBT)	=	IMPORTS	+	INTEREST PAYMENTS
3.	$P_x Q_x$	+	ΔD	=	$P_m Q_m$	+	iD
4.	ΔD	-	iD	+	$P_m Q_m$	-	$P_x Q_x$
	(NET INCOMING RESOURCE TRANSFER)				(IMPORTS - EXPORTS, OR TRADE DEFICIT)		

Source: ECLAC Division of Production, Productivity and Management.

external debts collapsed, and a considerable portion of these (public-sector) borrowings took the form of (private) flight-capital. This capital flight cut deeply into international reserves, making it impossible to continue propping up the exchange rate. Hence Mexico's moratorium in August 1982.

The Mexican moratorium marked the beginning of the *second phase* of the crisis of the 1980s (1982-1983). The reaction to the moratorium was a sharp drop in bank loans to the entire region, with the result that net resource transfers did an about-face from a net inflow to the region equivalent to 2% of GDP to a net outflow equivalent to 4% of GDP. The impact of a reversal of this magnitude in the direction of flow can hardly be overemphasized. It may suffice to note that the sum involved exceeded the draconian war reparations imposed on Germany by the Treaty of Versailles following that country's defeat in the First World War.

The only way the region was able to finance that reversal in the transfer of resources was by moving from a trade deficit of US$13 billion in 1981 to a trade surplus of US$27 billion in 1983. Obviously, changing the trade balance by the equivalent of 6% of GDP in just two years could only be accomplished by relying primarily on a drastic reduction in imports (the volume of imports dropped by 40% in those two years), rather than a rise in exports. After all, no matter how costly it may be to cut back on imports used in production, they can be reduced as much as necessary right away, whereas expanding exports (obviously the more desirable way to go about making an adjustment, since it does not entail a drop in production) is necessarily a slower process because it requires prior investments as well as time in which to win over external markets.

The difficulty of making a non-recessionary adjustment by increasing exports and reducing unessential imports was heightened by the region's extreme vulnerability to external shocks. As a result of the import-substitution strategy, non-traditional exports (in most cases, the only ones that could be increased significantly without affecting their price) represented less than 4% of the region's GDP; moreover, the substitution process had advanced to the point where the imports that

the region could most easily do without –i.e., consumer goods (many of which, actually, were food and medicine that were not really so dispensable)– made up less than 2% of GDP. In order to make an adjustment equivalent to 6% of GDP in the space of just two years, the region would therefore have had to double its non-traditional exports and completely eliminate all imports of consumer goods –which was clearly impossible. Consequently, the adjustment was based on a severe, costly reduction of imports of intermediate inputs and capital goods, both of which were essential for the region's production activities.

In contrast, a non-recessionary adjustment based on an expansion of non-traditional exports was a much more feasible proposition for the Asian NIEs because these products constituted 30% of their GDP and were composed almost entirely of manufactures, and therefore enjoyed relatively high price elasticities of demand. Thus, an adjustment equalling 6% of GDP based on an increase in a category of exports representing 30% of GDP called for the much more reasonable effort of raising exports by 20% in two years. We can therefore see how the outward orientation of these economies put them in a much better position for carrying out a non-recessionary adjustment, in sharp contrast to the Latin American countries. The latter's vulnerability to external shocks following an overlong period of import substitution made it very difficult for the region to adjust to the debt crisis, and this is part of the reason for the turnaround in the orientation of its growth strategy which began to take place in the 1980s.

The *third phase* of the crisis (1984-1990) was marked by near zero-growth in the economy along with unbridled inflationary spirals. Both of these phenomena were closely related to a second resource-transfer problem: the domestic transfer of resources from the public sector to the private sector. By this time, 75% of the region's external debt was public-sector debt, partly because the public sector had incurred debts on its own prior to the crisis (50%) and partly because circumstances had made it necessary for the public sector to assume a large portion of the private sector's external debt (another 25%). Thus, of the six points of GDP represented by the reversal in resource transfers, more than four points corresponded to the public sector. Since public revenues constituted only around 20% or 25% of GDP, it was almost impossible for the public sector to absorb another four points, especially since the vast majority of the countries in the region already had fiscal deficits when the crisis began. Consequently, with the notable exceptions of Chile and Colombia, they had to "finance" these increased resource requirements, at least to a large extent, through money creation. Since the ratio between the money supply (M1) and GDP was approximately 5%, it is not surprising that increases in the deficit and in money creation amounting to around four points of GDP led to a dramatic upsurge in inflation. The larger deficits, together with the cost pressure exerted by steep devaluations, triggered inflationary spirals which, especially in cases where automatic indexation mechanisms were in operation, often pushed the economy into hyperinflation.

The stagnation or recessions that were characteristic of this phase were largely due to the instability caused by runaway inflation; this is what happened in Argentina (1988-1990), Bolivia (1982-1985), Brazil (1990-1991), Nicaragua (1987-1990) and Peru (1988-1990). Other recessions stemmed from anti-inflationary programmes that were poorly designed or lacking in credibility (Venezuela in 1989 and Peru in 1990). Indeed, although both theory and experience (e.g., Mexico in 1988, Argentina in 1991 or Israel in 1985) demonstrate that it is possible to lower inflation without causing a recession, stabilization efforts often do have highly recessionary effects if the programmes lack credibility and expectations far outstrip the stabilization plan's inflation targets or if fiscal restraint is based to a disproportionate extent on spending cuts rather than increases in revenue.[5]

[5] Since spending cuts are usually concentrated in just a few items (public-sector wages or investment) but increases in revenues are usually more widely and evenly distributed, a reduction of the fiscal deficit based on increases in fiscal revenues is likely to slow down the rise in prices rather than to dampen production, whereas reductions in expenditures, because they are so highly concentrated, will almost inevitably lead to a drop in output.

IV

The strategic turnaround of the late 1980s

Just as the Great Depression of the 1930s sparked increasing mistrust of the virtues of market mechanisms and thus led the State to adopt an active industrialization strategy based on import substitution, the crisis of the 1980s brought to light the limitations of both an over-extended State and an inward-looking development strategy. This prompted a turnaround in strategy which led to the adoption of an outward orientation, a greater use of market mechanisms and a redefinition of the roles of the private and public sectors whereby production was reserved for the former and the latter tended to be confined to its most essential functions and to highly selective intervention only in cases of major flaws in the market.

1. The events

The first important event was the region's initiation of an about-face in its development orientation as it shifted its attention away from the domestic market and towards the external market (ECLAC, 1992, table II-1). This has led to the following: (i) the region's nominal average tariff has been lowered from 45% to under 20%; (ii) the tariff structure has been greatly simplified and streamlined (from as many as 30 different rates it has been reduced to no more than seven) and in some cases a uniform tariff is applied to all imports; (iii) many non-tariff barriers have been dismantled and replaced with tariffs (e.g., in Mexico the percentage of imports subject to advance permit requirements has been reduced from 90% to less than 20% and in Argentina it has been lowered from over 60% to less than 20%); and (iv) interregional integration (with Canada and the United States) and intraregional integration (MERCOSUR) processes, as well as some bilateral accords (Chile with Mexico, Venezuela and possibly Costa Rica, and Colombia with Venezuela), are making great inroads and are now generally using the tariff rates of the country having the lowest levels as a basis (in the case of common markets, rather than free trade zones).

Second, economic agents have come to have a greater appreciation of the merits of the market –with all its imperfections– because now they are comparing its performance with that of a real public sector (which has its own limitations and imperfections) rather than with some utopian vision of State intervention. The prevailing attitude now is a more pragmatic one directed towards improving both the market and State action rather than towards expanding one at the expense of the other. The great majority of price controls have been lifted thanks to the realization that such controls are at best short-term palliatives which, if allowed to remain in place, will ultimately have an adverse impact on resource allocation. For this reason, in addition to the fiscal crisis, the vast majority of direct and implicit subsidies have also been eliminated. All the countries of the region have also rejected the idea of keeping interest rates at negative levels in real terms, although there is some disagreement as to how freely these rates should be allowed to float once they rise above the real LIBOR plus some sort of surcharge to reflect their status as developing countries in which capital is particularly scarce.

Third, the roles of the public and private sectors have been redefined, and the preeminence of the latter as an agent of production has been acknowledged. This has prompted an extensive move to privatize State-owned firms not only in competitive activities such as manufacturing, banking, agriculture, mining and transport where there is little justification for State control of production, but also in monopolies such as telecommunications and electricity generation and transmission systems, for which private operation in combination with government regulation is considered to be the best option. Only large enterprises devoted to the extraction of natural resources (such as oil in Mexico, Venezuela and Ecuador or copper in Chile) have generally been left in the hands of the public sector owing to the fact that, because they generate such a large percentage of the region's exports, they inevitably have an influence on macroeconomic variables. The

corporate sales associated with these privatization processes generated (one-time) income for the Treasury amounting to about 4% of GDP per year in Argentina during the 1990-1991 biennium, around 1.6% of GDP per year in Chile during the period 1986-1989, approximately 2% of GDP per year in Mexico in 1990-1991, and around 4% of GDP in Venezuela in 1991; in the rest of the countries, the income from such sales has not yet reached significant proportions.[6]

2. Areas of agreement and disagreement

a) Areas of agreement

There is now some degree of consensus about the need for the region to position itself in the international economy. Certainly, from a neoliberal perspective, import substitution was a mistake from the very outset, since the economy should always have been oriented outward. The neostructuralists, for their part, feel that import substitution-based industrialization made sense under the circumstances prevailing in the world from the time of the Great Depression of the 1930s up to at least the late 1950s, but they have always regarded this strategy as an initial stage of the industrialization process. They therefore believe that the necessary learning process was allowed to go on too long and that now it is time to take advantage of the industrial base created during that process while changing it over to an outward-looking orientation. This would allow the region to take advantage of the production know-how it has acquired, the stimulus to attain higher levels of quality and efficiency which is generated by international competition, and the economies of scale available in external markets, especially for small countries.

[6] These privatization processes have by no means been problem-free, however, due in particular to their insufficient transparency, the Governments' haste to make the sales, the conclusion of sales during times of crisis, the lack of a sufficient number of potential buyers to make the bidding truly competitive and a lack of clarity about the regulations to apply to the activities in the future. All these problems depress the sales price and, hence, make the Treasury's proceeds less than they would have been if the sale of these firms had been based on their actual value to potential buyers rather than their prior (lower) value for the Government (because of their previous bureaucratic, inefficient form of management). For a thorough analysis of this subject and information on the sums involved, see Devlin, 1992.

FIGURE 3

Development orientation and role of the State

	Outward development	Inward development
Passive State	Orthodox position	
Active State	Current ECLAC position	Past ECLAC position

Source: ECLAC Division of Production, Productivity and Management.

There is also agreement that, just as the market has flaws, State intervention, too, has its limitations, especially when it encompasses too many different spheres. When the State becomes overextended, it usually ends up doing a poor job even in those functions which are inarguably its exclusive responsibility (e.g., maintaining macroeconomic equilibria, providing access to an acceptable quality and quantity of educational and health services and social security, and ensuring the safety of the general public). Hence the recognition of the production function as essentially within the purview of the private sector and the disavowal of the notion of an entrepreneurial State; this probably implies a smaller State in terms of expenditure, but a larger one in terms of income if it is to be an efficient, modern State that performs its essential functions satisfactorily.

b) Areas of disagreement

There continues to be disagreement, however, on the following major points: (i) *The role of the State*: Should it be active (and if so, how active) or passive? (ii) *The extent of outward orientation*: Will neutral incentives (a high exchange rate and low, uniform tariffs –or no tariffs at all) suffice or is a temporary pro-export bias necessary? (iii) *Social equity*: Can

growth be coupled with an increase in social equity or are growth and social equity necessarily mutually exclusive objectives? And, if that is the case, then will it be necessary to wait for the benefits of growth to "trickle down" to the needy or should we mitigate this clash between the two objectives by means of compensatory social policies? and (iv) *The type of instrument*: Is it simply a question of having the "correct" prices (i.e., allowing prices to be freely determined) or are more aggressive promotional policies needed to deal with the most critical bottlenecks?

(i) *An active or passive role for the State.* Neostructuralist thinking –and certainly that of ECLAC– on this point recognizes, in no uncertain terms, the urgent need for the region to increase its share in international trade at the present time. Unlike the contemporary orthodox school of thought, however, it holds that this task, as well as the promotion of development, calls for an active State (see figure 3). What is more, in order to penetrate external markets –the challenge now facing the region– much more stimulus and cooperation appear to be needed from the State than were required to carry forward the import substitution process.

In more general terms, the history of Latin America and other developing regions clearly indicates that although the market and private ownership are necessary conditions for development, neither growth nor social equity are automatic results of a naturally-operating market. On the contrary, in economies which have been relatively late to develop (such as Japan, the Republic of Korea and the Chinese province of Taiwan), the State has played a major role in helping those economies to leapfrog various stages of development and to grow at remarkably rapid rates while at the same time ensuring that the population receives an ample share of the fruits of that development.

Furthermore, we know that it is not only the market that suffers from imperfections; after the State has performed its basic economic functions satisfactorily (macroeconomic stability, infrastructure and social investment, basic social security), it, too, has only a limited amount of capacity remaining. State intervention must therefore be highly selective and must address important development issues, such as export promotion, the achievement of higher saving rates, the improvement of the capital market, the dissemination of technology and others specific to each case. Unlike past approaches, however, when State intervention was not only excessive but also tended to supplant market forces, the present view is that intervention should not only be selective but should also, in every case, bolster the operation of the market. It is thus not a question of having "more State" or "more market", but rather of having a better State and an increasingly effective market.

(ii) *The extent of outward orientation.* The typical formula for achieving an outward orientation –maintenance of a high, stable real exchange rate and of low tariffs that are as even as possible– does nothing more than to blunt the anti-export bias of a protectionist policy, but so long as tariffs (at least the permanent ones) are not brought down to zero, that anti-export bias will persist. Even drawbacks will not completely offset it unless their coverage is expanded to include all "indirect exports" (i.e., the products made by national industries to supply inputs for the production of exports).

But the key question is whether a set of neutral incentives is enough or whether the present situation calls for a temporarily pro-export bias. In the past, infant industries produced for the domestic market and the most suitable instrument for promoting them was a protective tariff; now, neostructuralism sees today's infant industries as poised to penetrate external markets with non-traditional exports. It therefore proposes that a set of special incentives having a temporarily pro-export bias (e.g., larger drawbacks, credit at international rates, tax exemptions) should be created for new or pioneering exports or as a means of opening up new export markets. Blazing a trail in these two directions demands a highly innovative effort that will impose significant externalities upon other producers; these Schumpeterian innovators therefore deserve a premium analogous to the one awarded to a technological innovator under today's patent laws.

(iii) Social equity. The various schools of thought differ considerably on this point. According to the trickle-down theory derived from Kuznets' studies, something analogous to the "law of the jungle" comes into force, at least during the early stages of development, whereby economic growth inevitably leads to a deterioration in income distribution. Apart from the fact that the length of time needed for the trickle-down process to take effect may be socially unacceptable, a number of recent empirical

studies have cast doubt upon the conclusion that such a conflict is unavoidable.[7] Another school of thought (espoused by, among others, the World Bank) allows for the possibility of a conflict between growth and social equity but argues that the social benefits of a better distribution may well be worth the price of slower growth. This school of thought usually endorses a "parallel" strategy whereby economic policy is focused on economic growth and social policy on compensating for the economic policy's distributive effects. The problem is that, in practice, social policy is rarely able to offset the regressive effects of at least some types of economic policies. Hence, a third approach (advocated by ECLAC, among others) has been developed.[8] This school of thought contends that the relationship between growth and social equity entails significant areas of complementarity, as well as conflict. This is exemplified by policies such as the maintenance of macroeconomic equilibria, investment in human resources and the promotion of permanent, productive jobs. Thus it is indeed possible for an economy to grow while at the same time increasing social equity if the policies being applied reinforce areas of complementarity and mitigate conflicts in areas where the two objectives appear to run counter to one another. This brings us to an integrated approach in which economic policy incorporates distributive goals as well as growth objectives and social policy incorporates considerations of efficiency as well as of equity, thereby permitting growth and increased social equity to be attained simultaneously (rather than sequentially, as was usually posited in the past).

(iv) *Types of instruments*. Major differences of opinion exist as to which instruments are the most appropriate. Almost without exception, orthodox theorists place emphasis on decontrolling prices and on deregulating markets and making them more flexible. This is because, in their view, underdevelopment is essentially caused by government intervention in the market; an assumption implicit in this proposition is that a freely-determined price in a deregulated market is the "correct", equilibrium, price. Neostructuralists, on the other hand, believe that markets have major flaws which can cause them to generate a freely-determined price –i.e., one that balances supply and demand at any given point in time– that is not necessarily the equilibrium price, which is the price that reflects the actual scarcity of goods and, most importantly, factors. For example, the absence of a currency futures market causes the exchange rate to be extraordinarily variable; State intervention in order to determine the price of the dollar (a particularly crucial aspect at the present time) would therefore be justified if that intervention would simulate the effect of the missing futures market, smooth out the fluctuations in the dollar's value and help guide medium- and long-term investment. By the same token, given the pivotal importance of external-market penetration for the region's development, there may be grounds not only for maintaining a high, stable exchange rate with low, fairly uniform tariffs, but also, as mentioned earlier, for the provision of temporary subsidies for non-traditional or pioneering exports or for opening up new markets (see table 4).

In order for a country to develop it must also raise its saving rates and allocate capital to the most profitable projects. In order to accomplish this, orthodox theory stresses the importance of decontrolling interest rates. Certainly, the negative interest rates observed in the past discourage saving. Experience shows, however, that once these rates have reached a positive level, saving is fairly insensitive to further increases (owing to the counterbalancing effects of substitution and income). In order to raise saving rates further, policy makers will have to resort to "compulsory saving" measures, whether through heavier taxation or more institutional saving (e.g., increasing the rate of social security contributions). In either case, there will be State intervention.

[7] One of the classic arguments is that development requires an increase in investment and, since only the rich tend to save, then in order to boost saving and, hence, investment, it is necessary to transfer resources from those who save very little (the poor) to those who save a great deal (the wealthy). The truth of the matter is that Kuznets' thesis is an empirical finding for which this and other explanations were sought to serve as a foundation. In fact, the experiences of the Asian NIEs contradict it. Furthermore, the evidence presented by Kuznets was primarily drawn from countries that began their growth during the nineteenth century. It does not take into account the situation of recently industrializing countries, which are less dependent upon investment for their growth because they can leapfrog various stages by taking advantage of technologies developed by others. One recent study that denies the existence of any consistent relationship between growth and social equity is that of Fields (1991).

[8] See, for example, ECLAC (1992).

TABLE 4

Neoliberal and neostructural approaches: differences in terms of policy tools

Key areas	Neoliberal tools	Neostructural (ECLAC) tools
1. Exports	Neutral: high exchange rate and low tariffs	The same, plus temporary bias in favour of non-traditional exports, especially new or pioneering products, and the penetration of new markets
2. Saving (increase) (a) Public	Reduce expenditure	Increase currently light tax load of private sector (broaden tax base and reduce tax evasion)
(b) Private	Decontrol interest rates Restrain real wages	Real positive interest rates, compulsory saving: raise saving rate of social security system (or reduce actuarial deficit)
3. Investment (improve its allocation)	Decontrol interest rates	Develop capital markets and eliminate their segmentation by opening them up to small and medium-sized businesses through the use of leasing contracts with purchase options, factoring and the use of venture capital
4. Employment	Deregulate the labour market; restrain real wages	Tie wages, at least in part, to each company's output in order to boost productivity and stimulate employment
5. Private investment in human capital	None	Develop the capital market for private loans to finance higher education and training, using the individual's pensions fund as collateral
6. Technological development	None	Strengthen technological infrastructure, especially as regards information sciences and telecommunications; link up scientific and technological research with production sectors; promote modernization and consultancy market by co-financing a certain percentage of a firm's advisory services; undertake industrial outreach efforts
In general	Passive measures/ deregulation	Active measures/promotion

Nor is the interest rate the only criterion for resource allocation, since the region's capital market is as yet very rudimentary, especially as regards long-term funds, and access to it is highly segmented, which works to the detriment of small and medium-sized firms and militates against private investment in higher education or training. In fact, much of the investment needed for these activities is financed by the parties directly involved or is not carried out at all, regardless of how profitable it might be. To overcome these voids and segmentations, neostructuralism suggests the promotion of leasing arrangements that include a purchase option, the use of venture capital, factoring, and the use of pension funds to secure private credit for investment in human capital.

Orthodox theory attributes unemployment primarily to labour-market rigidities; hence its insistence upon measures that facilitate lay-offs, limit unionization and impede strikes, deregulate job entry and eliminate or lower minimum wages. Certainly, union monopolies are hazardous, as are entry barriers for certain types of jobs (just think of the high cost –especially for economies, such as ours, that are trying to forge a place for themselves in world trade– of having our ports controlled by limited groups of

workers). By concentrating entirely on these types of measures, however, it overlooks rigidities of another sort, which stem from the use of conventional fixed-wage labour contracts, under which income bears no relationship to a company's performance; by using such contracts, firms sacrifice significant potential gains in productivity and force themselves to lay off workers as the only practical means of dealing with recessions. Neostructuralism, on the other hand, advocates labour contracts that provide for wage flexibility, as in Japan, the Republic of Korea and the Chinese province of Taiwan, since this not only promotes better intra-firm labour relations, but also boosts productivity and reduces unemployment.

Finally, the orthodox approach completely neglects a key factor in the development of nations: the promotion of technological progress and its dissemination. Although promotional measures in this field are not as clear-cut as we might like, their qualitative, institutional character does not make them any less important. The development of a scientific/technological infrastructure closely linked to the production system, the promotion of technological and organizational dissemination through the selective cofinancing of consultancies and business training courses, or the creation of industrial outreach services are some of the steps that would take us in the right direction.

In sum, whereas the orthodox approach, based on an assumption of perfect markets, focuses exclusively on liberalization and deregulation, neostructuralism calls for the use of more active instruments for overcoming critical bottlenecks based on the actual capacity for action –and for effective action– of the State.[9]

[9] This list of instruments by no means constitutes a basic minimum (or maximum) policy package. It is presented only as an illustration of the types of measures that could be taken if a particular problem in a given economy were to reach critical proportions, provided that the State truly had sufficient institutional capabilities to support such measures once it had fully performed its fundamental tasks.

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