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OSCAR ALTIMIR
Director of the Review

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Notes and explanation of symbols

The following symbols are used in tables in the Review:

(…)	Three dots indicate that data are not available or are not separately reported.
(—)	A dash indicates that the amount is nil or negligible.
	A blank space in a table means that the item in question is not applicable.
(–)	A minus sign indicates a deficit or decrease, unless otherwise specified.
(.)	A point is used to indicate decimals.
(/)	A slash indicates a crop year or fiscal year, e.g., 1998/1999.
(-)	Use of a hyphen between years, e.g., 1998-1999, indicates reference to the complete number of calendar years involved, including the beginning and end years.

References to "tons" mean metric tons, and to "dollars", United States dollars, unless otherwise stated.
Unless otherwise stated, references to annual rates of growth or variation signify compound annual rates.
Individual figures and percentages in tables do not necessarily add up to the corresponding totals, because of rounding.

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—**Footnotes should be kept to the minimum**, as should the number of tables and figures, which should not duplicate information given in the text.

—Special attention should be paid to the bibliography, which should not be excessively long. All the necessary information must be correctly stated in each case (name of the author or authors, complete title (including any subtitle), publisher, city, month and year of publication and, in the case of a series, the title and corresponding volume number or part, etc.).

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A new look at the *development agenda*

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This essay summarizes some of the main ideas behind proposals for a new development agenda. It highlights first the need to strike a new balance between the market and the public interest, and to understand by "public policies" any initiative organized in pursuit of common goals, and not just State actions. The author makes five proposals for a new agenda: i) more balanced globalization with genuine respect for diversity, underpinned by a network of regional institutions; ii) a broad view of macroeconomic stability and the role of countercyclical policies; iii) the use of development strategies to foster innovation and production complementarities, without which macroeconomic policies are insufficient to generate dynamic growth; iv) improved social linkages, through long-term equity and inclusion policies, complemented by economic growth to create sufficient high-quality employment and measures to reduce structural heterogeneity among production sectors; v) subordination of the economic system to broader social objectives.

I

Introduction

Liberalization was presented to the developing world as providing a way out of inefficient strategies associated with trade protection and high levels of State intervention, as well as the rent-seeking behaviour that those strategies encouraged. It was also seen as a means of fully exploiting the opportunities generated by globalization. This view represented a significant break with the idea, which underlay development strategies for several decades, that "late industrialization" required a significant degree of State intervention in order to succeed. The Washington Consensus provided one of the best summations of this reform agenda, although it certainly did not reflect its most radical version, which called for a minimalist State (Williamson, 1997). It was also, it should be added, a manifestation of the optimism that the reform agenda generated a decade ago.

During the last few years, the wisdom behind this vision has been called into question. The Asian crisis was what probably dealt it the hardest blow. That crisis made patently clear that, without an adequate institutional setting, financial liberalization could be the source of severe macroeconomic instability. The strong views expressed by "global civil society" since Seattle indicate that globalization itself is now being questioned and reflect a basic substratum of discontent in the industrialized world. In developing countries, disenchantment with reforms is also growing, but its political manifestations are more disorganized and its agenda unclear.

More broadly, dissatisfaction with the results of reforms is on the rise. Trade and foreign direct investment have boomed, but the "promised land" of high growth rates is increasingly regarded as a mirage. In Latin America –the region where reforms have gone the furthest– growth in the 1990s was only 3.2% a year, far below the 5.5% record set during the three decades of State-led development from the 1950s to the 1970s. Sub-Saharan Africa's performance, and that of the least developed countries in general, continues to be highly insufficient. Many transition economies still have levels of economic activity below those seen prior to the "big bang". Although most of the Asian economies that underwent the crisis did recover, they are still struggling with its financial repercussions. Notable exceptions are obviously China and India, which are certainly not on the list of the most highly reformed economies. Even in the industrialized world, growth in the 1990s was still far from what it was in the "golden age" of 1950-1973; the United States did reach those rates, but only during the second half of the decade.

Distributive tensions are running high and are probably intensifying. Income disparities between developed and least developed countries continue to increase (UNDP, 1999). Income distribution has worsened in a broad group of both developed and developing countries. According to one account, the countries where income distribution has worsened contain 57% of the world's population and those where it has improved 16%, with the remainder experiencing no clear trend (Cornia, 1999). The growing skills-based income differential is a worldwide phenomenon. Debate continues as to whether it is the result of trade liberalization, technological trends or a weakening of social safety nets. The asymmetry existing between factors that cross international borders (capital, highly skilled labour) and those that cannot (low-skilled labour), together with the increasing difficulties governments are having in providing social safety nets, are certainly part of the explanation (Rodrik, 1997).

Recent events and the discontent they have generated have, in turn, spurred a constructive debate that promises to enrich the development agenda. The last few years have indeed made the debate somewhat more pluralistic. Alternative views of development have made some headway. New areas of emphasis –institution-building, social safety nets and the "ownership" of development policies, to name a few– have been brought into the international policy debate. Is this an indication that the development agenda is in fact changing? Perhaps, but this is still unclear. Indeed, new concepts and areas of emphasis are often mere "add-ons" to what is, by and large, the same policy agenda, with new generations of reforms simply being appended to what are regarded essentially as the correct

☐ A prior version of this paper was presented at the American Economic Association Annual Meeting Panel "Toward a Post-Washington Consensus on Development and Security", New Orleans, 5-7 January 2001.

foundations. Seen in a less favourable light, they are merely new garments draped over the same ideas. Markets, particularly financial markets, have not really internalized the need for a new development agenda, and financial agents continue to call for more liberalization at the national and world levels, i.e., plainly for more of the "first generation" of reforms. This remains the dominant force in a world of weakened national polities and an even weaker transition to a global polity.

This paper summarizes some of the basic concepts underlying the call for a new development agenda.[1] Two intersecting themes in the literature on this subject should be emphasized at the outset. The first is the call for a new balance between the market and the public interest. This should not be viewed as running counter to the operation of the market, since actions that ensure an adequate supply of public goods, help to complete markets, assist non-competitive markets to function properly, exploit positive and avoid negative externalities, or ensure an equitable distribution of the benefits of development, can serve as powerful mechanisms for enhancing market development through a variety of economic, social and political channels. An assertive public policy approach of this sort will be, if correctly applied, more market-friendly than the alternative approaches that tended to predominate during the first wave of reforms.

The second theme is that, rather than being restricted to State actions, the concept of public policy should be understood as any organized form of action that pursues objectives of collective interest. This definition of public policy is in keeping with an awareness of the need to open up opportunities for participation by civil society and to work to overcome a crisis of the State that affects the developing world and, indeed, the world at large. It thus aims at correcting both "market failures" and "government failures" and, more generally, at building and rebuilding institutions (or, in the terminology of the new institutional literature, institutions and organizations). This is unquestionably one of the most complex tasks awaiting the developing and transition economies. Moreover, it is the most pressing task –yet at the same time one that has so far received insufficient attention– in the process of building a better international order.

II

A more balanced form of globalization based on a genuine respect for diversity

The need to "civilize" the global economy (Helleiner, 2000) or, in the words of the United Nations Millennium Declaration, "to ensure that globalization becomes a positive force for all the world's people" (United Nations, 2000) is the most crucial issue. Although powerful technological and economic processes underlie it, there is no doubt that the globalization process can be shaped, and indeed the form that it has been assuming has largely been shaped by explicit policy decisions.

The most troublesome aspect of this situation is the incomplete and even lopsided character of the current globalization process and the international policy agenda that accompanies it, which is reproducing long-standing asymmetries in the world economy and creating new ones. Four issues figure prominently in the current agenda: free trade, intellectual property rights, investment protection, and financial and capital-account liberalization. The latter has been the object of various qualifications during recent crises, including the proviso that it should be well sequenced and that emphasis should be given to longer-term flows and to institutional development. Moreover, in the area of trade, liberalization is, in turn, incomplete and asymmetric, as "sensitive" items of great interest to the developing countries are subject to the highest levels of protection in the industrialized world.

Meanwhile, other issues are conspicuously absent from the current agenda: labour mobility; international rules on taxation, particularly of capital (essential to guarantee adequate taxation of this highly mobile factor); the design of truly international competition

[1] References have been kept to a minimum, although the literature on the topic is extensive.

rules and codes of conduct for multinational firms; and compensatory financing to ensure the inclusion of those countries and social groups that tend to be left behind in the globalization process.

This is, in turn, a reflection of the most serious asymmetry of all: the imbalance between the rapid globalization of (some) markets and the conspicuous absence of a truly international social agenda. The latter is, in fact, largely confined to the definition of common international principles (through United Nations summits) and the as yet incipient emergence of international legislation. The decline of official development assistance (ODA) is one of the most compelling pieces of evidence of the lack of commitment to a truly international social agenda, as is the growing conditionality that is attached to international financial support in general.

More broadly, it is increasingly being recognized that globalization has underscored the need to provide a number of global public (political, social, economic and environmental) goods, as many previously national (and, further back in history, local) public goods are increasingly becoming global in nature (Kaul, Grunberg and Stern, comps., 1999). There is, however, a striking contrast between the recognition of this fact, on the one hand, and, on the other, the weakness of international arrangements to provide such public goods and the low level of funding allocated for this purpose.

These asymmetries obviously reflect basic political features and aspects of the world's political economy. The lopsided character of the current globalization process and agenda undoubtedly reflects the predominance of major countries and large multinationals. However, it also reflects the disorganization of many actors, particularly developing countries, in the international policy debate. This state of affairs is associated not only with a weakening of the historical mechanisms for concerted action by developing countries (e.g., the Group of 77), but also with the "policy competition" that globalization itself has generated (i.e., the strong incentive that each country has –in this era of mobile capital and increasingly footloose production– to claim that it is a more attractive investment site than other nations). Thus, the asymmetries characterizing world power relations and the high cost of generating international coalitions to compensate for those asymmetries have become even more important today.

A complicating feature of the political situation and of the political economy is obviously the reluctance of most countries to give up economic sovereignty to international organizations. Under the influence of the strong market forces characteristic of globalization, which tend to weaken nation States, and the unilateral national liberalization processes that have been taking place simultaneously, government regulations have weakened worldwide. Many analysts perceive this result as an advance, but it is also a source of significant distortions and risks, particularly –but not only– in the area of finance. It should be added that, although open regionalism is also a feature of globalization, and strong integration forces have been at work in many parts of the developing world (e.g., Latin America and South-East Asia), this has not led to strong developing-country coalitions. Indeed, the European Union aside (and even in this case only in a limited sense), countries are also unwilling to give up their sovereignty to regional organizations.

These political and political economy features have major implications for international reform. The most obvious are that the pressure for substantive reform will be weak, and thus that a more balanced globalization agenda and stronger global governance may not materialize, that any balanced negotiation process would be cumbersome, and that negotiation processes may underestimate or bypass the interests of certain actors altogether. The lack of truly international institutions also means that institutions that have developed in the past at the national level will not be available at the global level or will only have limited functions.

Because of the incompleteness of the relevant international arrangements, weaker actors should continue to demand national autonomy in crucial areas, particularly in terms of the choice of economic and social development strategies. Moreover, national autonomy is the only system that is consistent with the promotion of democracy at the world level. There is indeed no sense in promoting democracy if representative and participatory processes at the national level are given no role in shaping economic and social development strategies. This is also consistent with the view that institution-building, social cohesion and the accumulation of human capital and technological capabilities (knowledge capital) are essentially endogenous processes. To borrow a term from Latin American structuralism, development can only come "from within" (Sunkel, 1993). Support for these endogenous processes, respect for diversity and the design of rules that allow it to flourish are essential elements of a democratic, development-oriented world order.

A final, crucial implication is that no international architecture is neutral in terms of the equilibrium of international relations. In this sense, an international system that relies on a very small number of world institutions will be less balanced than one that relies on a network of regional institutions, and countries with very limited power in the international arena will be better off if they are active participants in regional schemes. These regional schemes can indeed provide degrees of freedom and mutual support that would not be available at the national level. The international order should thus provide ample scope for strong regional institutions while at the same time upholding a rules-based global order (i.e., a system of "open regionalism", to borrow a term from the literature on economic integration). Indeed, operating through regional institutions may be the best way to gradually build up a better international order.

III

A broad view of macroeconomic stability and the role of countercyclical policies

The concept of macroeconomic stability has undergone considerable changes in the economic discourse over the past two decades. During the post-war years dominated by Keynesian thinking, this concept was basically defined in terms of full employment and stable economic growth, accompanied by low inflation and sustainable external accounts. Over time, however, fiscal balance and price stability moved to centre stage, while the Keynesian emphasis on real economic activity took a back seat and eventually began to fade away altogether.

The consistency that ought to characterize macroeconomic policies should be oriented by a broad definition of stability that recognizes that there is no single correlation between its alternative definitions and that significant trade-offs may be involved. Two lessons are particularly important in this regard. The first is that real instability is very costly. A narrow view of inflation targeting may thus be as damaging as past macroeconomic practices that underestimated the costs of inflation. Recessions entail a significant loss of resources that may have long-run effects: firms may sustain irreparable losses in terms of both tangible and intangible assets (tacit technological and organizational knowledge, commercial contacts, the social capital accumulated in the firm, its goodwill, etc.); the human capital of the unemployed or the underemployed may be permanently lost; and children may leave school and never return. Volatile growth leads to a high average rate of underutilization of production capacity, reducing productivity and profits and thus adversely affecting investment (Ffrench-Davis, 1999). The uncertainty associated with variability in growth rates may consequently have stronger effects on capital accumulation than moderate inflation. Indeed, it encourages "defensive" microeconomic strategies (i.e., those aimed at protecting the existing corporate assets of firms that find themselves in an unfriendly environment) rather than the "offensive" strategies that lead to high investment rates and rapid technical change.

The second lesson is that private-sector deficits are just as costly as public-sector ones. Moreover, risky private-sector balance sheets may be as damaging as flow imbalances. In financially liberalized economies, both may interact in non-linear ways with capital-account shocks. The lack of rigorous domestic financial regulation and supervision typical of the early phases of financial liberalization is part of this, but is certainly not the whole story. Boom-bust cycles are an inherent aspect of financial markets. Private spending booms and risky balance sheets tend to accumulate during periods of financial euphoria and are the basis for crises once exceptional conditions normalize. During such bouts of euphoria, economic agents tend to underestimate the intertemporal inconsistency that may be involved in existing spending and financial strategies. When crises lead to a financial meltdown, the associated costs are extremely high. Asset losses may wipe out years of capital accumulation. The socialization of losses may be the only way to avoid a systemic crisis, but this will affect future fiscal (or quasi-

fiscal) performance. Restoring confidence in the financial system takes time, and the financial sector itself becomes risk-averse, which undermines its ability to perform its primary economic functions.

These two lessons are basically interconnected, as financial boom-bust cycles have been the predominant source of business cycles in the developing world. The essential task of macroeconomic policy is thus to manage them with appropriate countercyclical tools. The experience of developing countries indicates that managing volatility requires a combination of three policy packages, whose relative importance will vary depending on the structural characteristics and the macroeconomic policy tradition of each country (Ocampo, 2000). The first is consistent and flexible macroeconomic –fiscal, monetary and exchange-rate– policies aimed at preventing public or private agents from accumulating excessive levels of debt and at forestalling imbalances in key macroeconomic prices (exchange and interest rates) and in the prices of fixed and financial assets. The second is a system of strict prudential regulation and supervision with a clear countercyclical orientation. This means that prudential regulation and supervision should be tightened during periods of financial euphoria to counter the mounting risks incurred by financial intermediaries. The third element is a liability policy aimed at ensuring that appropriate maturity profiles are maintained with respect to domestic and external public and private commitments. Prudential capital-account regulations (i.e., those applied during periods of euphoria to prevent excessive borrowing) can play an essential role both as a liability policy –encouraging longer-term flows– and as an instrument that provides additional degrees of freedom for the adoption of countercyclical monetary policies.

Managing countercyclical macroeconomic policies is no easy task, as financial markets generate strong incentives for developing countries to overspend during periods of financial euphoria and to overadjust during crises. Moreover, globalization places objective limits on national autonomy and exacts a high cost for any loss of credibility when national policy instruments are poorly administered. For this reason, it may be necessary for macroeconomic policy management to be supported by institutions and policy instruments that help to provide credibility, including fiscal stabilization funds and independent central banks. On the other hand, the explicit renunciation of policy autonomy (e.g., by adopting hard pegs or a foreign currency) is hardly a solution to this dilemma. Instead, this simply predetermines the nature of the adjustment, and may make business cycles more intense. If this occurs, the market may not validate (through reduced country risk) the hypothetical increase in "credibility" generated by the decision to relinquish policy autonomy.

The basic solution to the dilemma created by the lack of adequate degrees of freedom to undertake a countercyclical macroeconomic policy lies in the international arena (Eatwell and Taylor, 2000; Ocampo, 2001). This means that a first, essential role of international financial institutions, from the point of view of developing countries, is to counteract the procyclical effects of financial markets. This can be achieved by smoothing out boom-bust cycles at source through adequate regulation and by providing developing countries with additional degrees of freedom to adopt countercyclical policies (e.g., adequate surveillance and incentives to prevent the build-up of risky macroeconomic and financial conditions during periods of financial euphoria, together with mechanisms to smooth out adjustments in the event of abrupt interruptions of private capital flows). A second, equally essential role is to counter the concentration of lending by providing access to those countries and agents that tend to be subjected to rationing in private international capital markets.

IV

Macroeconomic policies are not enough: the role of productive development strategies

The idea that the combination of open economies and stable macroeconomics –in the limited sense in which this term has come to be used, i.e., fiscal balances and low inflation– would by itself spur rapid economic growth has thus far not been borne out. This has sparked an unresolved debate concerning the underlying reasons for this result. The orthodox interpretation is that markets have not been sufficiently liberalized. This interpretation runs up against the fact, however, that the periods of fastest growth in the developing world during the post-war era, as well as the longest-lasting episodes of rapid growth (e.g., the East Asian or, most recently, the Chinese and Indian "miracles" or, in the past, the periods of rapid growth in Brazil or Mexico), have not coincided with phases of extensive liberalization, even in cases where they have involved the use of the opportunities provided by international markets on a large scale (which is a more common though not universal feature).

Two alternative interpretations emphasize other determinants of aggregate economic growth or market failures. In the first case, inadequate institutional development or human capital are seen as the explanation for slow growth. These factors are certainly crucial but, here again, this interpretation needs to explain why faster growth was possible in periods during which these factors were in even shorter supply. The second variant emphasizes the fact that, in order to be efficient, liberalized markets require full-fledged "mesoeconomic" policies: active competition policies, public regulation of non-competitive markets or markets with strong externalities, and the correction of market failures in factor markets, particularly the markets for long-term capital, technology, labour training and land. Policies to correct market failures are indeed essential to ensure more efficient markets, and they may also have effects on equity, but the relationship between these market failures and growth is less clear. Failures in long-term capital and technology markets are probably the most important in this regard.

A more promising line of inquiry draws upon the different historical variants of structuralism in economic thinking, broadly defined. This view emphasizes the close connection among structural dynamics, investment and economic growth. According to this view, economic growth is not a linear process, in which "representative firms" grow or new representative firms are added and then produce a given set of goods on an extended scale. It is rather a more dynamic process in which some sectors and firms grow and move ahead while others fall behind, thereby completely transforming economic structures. This process involves a repetitive phenomenon of "creative destruction", to use Schumpeter's metaphor (1962, chap. VIII). Not all sectors have the same ability to inject dynamism into the economy, to "propagate technical progress", according to the classical concept advanced by Prebisch (ECLAC, 1951). The complementarities (externalities) among enterprises and production sectors, along with their macroeconomic and distributive effects, can produce sudden jumps in the growth process or can block it (Rosenstein-Rodan, 1943; Taylor, 1991 and Ros, 2000) and, in so doing, generate successive phases of disequilibria, according to Hirschman's (1961) classical view. Since technical know-how and knowledge in general are not available in fully specified blueprints, the growth path of firms entails an intensive process of adaptation and learning, closely linked to production experience, that largely determines the accumulation of technical, commercial and organizational know-how (Katz, 1976 and Amsden, 2001).

The common theme in all these theories is the idea that economic growth is intrinsically tied to the structural context, which is made up of productive and technological apparatuses, the configuration of factor and product markets, the characteristics of entrepreneurial agents, and the way in which these markets and agents relate to the external environment. The leadership exercised by certain sectors and firms is, in this case, the essential dynamic factor that drives economic growth. In the developing world, many of the dynamic forces are associated with the successful adaptation of activities previously developed in the industrialized world, through import substitution, export promotion or a combination of both.

Although alternative formulations can be used, one approach that is particularly promising in terms of its policy orientation emphasizes two essential concepts: innovation and complementarities (linkages). In this formulation, innovation is viewed as any economic activity that introduces a new way of doing things. The best definition was provided by Schumpeter (1961, chap. II) almost a century ago: new goods and services, or new qualities of goods and services; new production methods or marketing strategies; the opening of new markets; new sources of raw materials; and new market structures. The second concept emphasizes the role of strategic synergies that –through the externalities that the various economic agents generate among themselves (Hirschman, 1961)– determine the "systemic competitiveness" of the relevant production structures (ECLAC, 1990). The existence of dynamic scale economies is the essential feature of both innovations and their diffusion, as well as of the development of complementarities. Institutional development may be viewed as an innovation, but it is also an essential ingredient in such complementarities.

These ideas have recently been used by several authors to emphasize the need for a productive development strategy as a basic component of a dynamic, open developing economy, a long-standing theme in "late industrialization" (or, more precisely, late development) literature. Thus, Rodrik (1999) has made a strong argument for a "domestic investment strategy" to kick-start growth, and ECLAC (2000) has referred to the need for a strategy of structural transformation. The essential role of strong State/ business-sector partnerships is set forth by Amsden (2001), as is the need for "reciprocal control mechanisms" that tie incentives to results in order to ensure that the former do not merely lead to rent-seeking behaviour.

This interpretation brings out a central feature of successful development experiences in the past: a strong industrialization drive built on solid State/ business-sector partnerships. Will opening markets with neutral incentives, arms-length government-business relations and multilateral (Uruguay Round) constraints on traditional development instruments produce the same result? Or, to be more precise, will opening markets provide a substitute for active productive development policies? It remains to be seen, but the results so far are not encouraging, although they may be skewed by certain features of the transition period. The "destructive" elements generated by the adverse structural shift in the growth/ trade deficit trade-off and the break-up of domestic linkages and national innovation systems have been stronger than the "creative" opportunities generated by the (still insufficient) market access and innovations introduced by the spread of multinational firms (Ocampo and Taylor, 1998; UNCTAD, 1999, chap. IV and ECLAC, 2000). In any case, if the past is a correct guide and structural interpretations are valid, then the use of explicit productive development strategies aimed at encouraging innovation (in the broad sense of the term) and helping to build up complementarities would appear to be a better route to take, even in the open developing economies of today. The international community should regard such strategies as an essential ingredient of successful development and should continue to search for instruments for implementing such strategies that do not degenerate into "beggar-thy-neighbour" competition for footloose production activities.

In the developing countries, a significant institutional and organizational effort is required to devise appropriate instruments for active production policies, as the old apparatuses of intervention were either dismantled or significantly weakened during the liberalization phase in many (if not most) of these countries. An effort must also be made to design instruments that, aside from being consistent with the open economies of today, avoid the "government failures" that characterized some of the tools used in the past (rent-seeking and cronyism).

The effective incorporation of the sustainable development agenda is an additional demand being placed on production strategies today. Indeed, the degree of environmental degradation generated by developing countries at intermediate or even low stages of development indicates that sustainability is hardly a luxury that can be postponed. This objective involves much more than conserving the natural resource base. In essence, it calls for the mobilization of investment in dynamic production sectors which use clean production methods and technologies and in which competitiveness is achieved through the accumulation of capital in the broad sense of the term (i.e., human, social, physical and natural capital). A shift in the developing countries from a reactive to a more proactive policy in this area is thus crucial, as is its necessary counterpart: the effective flow of resources from the industrialized nations to finance the global environmental agenda based on the principle of shared but differentiated responsibilities.

V

Improved social linkages

In economic terms, social progress may be thought of as the result of three basic factors: a long-term social policy aimed at improving equity and guaranteeing inclusion; economic growth that generates high-quality employment in adequate quantities; and the reduction of the structural heterogeneity of production sectors in order to narrow the productivity gaps between different economic activities and different economic agents. As the following section indicates, economic considerations are obviously not the only criteria to be used in designing social policy.

The World Bank (2001) has formulated three basic objectives for a poverty-reduction strategy: opportunity, security and empowerment. In a revised formulation, we could argue that equity and inclusion should be equated with broad access to resources, basic protections, voice and participation. Equitable access to resources is the key to equal opportunity, not only in the economic sense, but also in its social, cultural and political dimensions. In the specific case of investment in human capital, this brings out the essential character of social spending as a productive investment. Basic protections are necessary to free people from "negative risks" (sickness, unemployment and, worst of all, hunger) in order to allow and encourage them to take "positive risks", particularly those associated with innovation. Protection from "negative risks" is intrinsic in high-quality employment. Ensuring that people have a voice is essential to guarantee that the interests of the poor are adequately taken into account in decisions that affect them. Through participation, poor people become central actors in building their own future. In many instances, organized communities have been a basic instrument of social and economic change and thus a central element of institution-building.

To achieve these objectives, social policy should be guided by three basic principles: universality, solidarity and efficiency (ECLAC, 2000, chap. 3). This subject has been surrounded by a great deal of confusion in recent years, as instruments –targeting, criteria of equivalency between contributions and benefits, decentralization, private-sector participation– rather than principles have been guiding social-sector reforms. Moreover, these guiding principles emphasize the fact that social policy is a basic instrument of social cohesion (integration), and policy tools should therefore be clearly subordinated to the broader principles. Thus, targeting should be seen as an instrument for attaining universal coverage of basic services, and certainly not as a substitute for universality. Equivalency criteria should be applied in a way that is not inconsistent with solidarity. Properly managed, such criteria, along with decentralization and private-sector participation, are instruments for achieving efficiency.

To enhance equity, social policy should act upon the structural determinants of income distribution: education, employment, wealth distribution and demographic dependence, as well as their gender and ethnic dimensions. These factors are the key elements in the inter-generational transmission of inequality and poverty. Breaking these intergenerational links is therefore vital for a successful social strategy. This should be reflected, in particular, in integrated policies to assist the poor.

Education is a highly important element in equitable growth, particularly in the knowledge/ information age. But its objectives clearly go beyond these "human capital" dimensions: it is also a key factor in democratic development and strong citizenship, and more broadly, in self-realization. Its effects on equity may have been over-emphasized in recent discussions, however, since in a highly segmented society, education is also an instrument of segmentation. This factor has to be taken into serious consideration if education is to be used to improve equity. Moreover, inadequate high-quality job creation will defeat efforts made in the area of education, in terms of both the accumulation of human capital (at the extreme, it migrates; under more usual circumstances, it remains underemployed) and equity (occupational segmentation then multiplies the effects of educational segmentation). The link between economic growth and social progress is thus particularly crucial in this regard. In fact, this, in conjunction with the other linkages that are mentioned below, clearly emphasizes the fact that social policy alone is not enough: it must be supported by a sound macroeconomy and active production strategies if it is to bear fruit.

In the rapidly changing environment that characterizes modern economies, the adaptability of labour to technical change and the business cycle is

increasingly important. The crucial contributing factors in this regard are strong labour training schemes; institutions that enhance cooperation, both at the national level (social dialogue) and within firms; adequate social protection, both of an ongoing nature and of the type needed to cope with adverse events; and a prudent minimum wage policy. While flexibility may be an ingredient, provided it is accompanied by greater protection, it is only one of a number of alternative instruments. In this regard, it should be remembered that more flexible labour markets may adversely impact other factors that have positive effects on adaptability, particularly labour-business cooperation. Most importantly, flexibility should not be seen as a substitute for adequate macroeconomic policies. Indeed, in an unstable macroeconomic environment, or in the presence of slow economic growth, job creation will be weak in any case, and additional flexibility may lead to a rapid deterioration in the quality of employment. Flexibility has, in other words, negative externalities (it may undermine jobs that would otherwise be stable) that should not be ignored.

Poor economic growth affects equity in another way that plays a crucial role in developing countries: it increases structural heterogeneity. This term, drawn from the Latin American structuralist school, is preferred to "dualism" because the heterogeneity that characterizes developing countries and societies cannot be described in terms of a duality between a "modern" and a "traditional" sector and because low-productivity sectors are continually being created and transformed; only some of the sectors that are on the decline can be called traditional. In the absence of strong job creation in dynamic activities, low-productivity activities mushroom. This is what happened in Latin America in the 1990s: the region generated more "world class" firms (many of them subsidiaries of multinationals) that were able to integrate successfully into the global economy, but its low-productivity activities also increased; in fact, they absorbed 7 out of every 10 new workers during the years of growth preceding the Asian crisis (ECLAC, 2000, chap. 1). There is, in fact, no automatic mechanism that guarantees that rapid technological innovation in dynamic activities will fuel swift economic growth: in the absence of adequate domestic linkages –or if the "destructive" effects of productive restructuring, and the defensive microeconomic strategies that accompany them, predominate– it may simply increase structural heterogeneity. If this happens, the growth effects will be weak and additional tensions will be created in relation to equity.

The links between the modernization of leading economic sectors and the rest of the economy are thus crucial, not only for growth but also for equity. Productive development strategies can play a vital role in both dimensions. This also underscores the importance of a good distribution of production assets. Indeed there is strong evidence that an appropriate distribution of production assets which generates a universe of strong small firms is associated with a better distribution of income (and less concentration of power in general). Policies aimed at democratizing access to production assets (capital, technology, training and land) are thus critical for both growth and equity. Rural development policies, as well as those aimed at increasing formalization of microenterprises, fall within this realm. This should be accompanied by a gradual extension of social security schemes to workers in small firms and to the self-employed.

The interaction between human capital and high-quality employment and the effects of a better distribution of production assets are only two of the positive linkages between development and equity. There may also be favourable political economy linkages, as well as positive effects through the capital market and through the linkages among social cohesion, investment and productivity. Equity-development linkages were a favourite topic of development literature in the 1960s. Fortunately, they have now come back to the forefront of economic thinking (for a recent survey, see Aghion, Caroli and García-Peñalosa, 1999).

Given the crucial linkages between economic and social development, integrated policy frameworks should be designed. Such frameworks should explicitly take such linkages into consideration, as well as those existing among social policies (the supportive effects of different social policies, which may, in particular, be channelled through integrated poverty eradication programmes) and among economic policies (macro-meso connections, particularly to facilitate the development of dynamic small business sectors). One of the weakest links, in this regard, is the lack of appropriate institutions for integrated policy frameworks. Such institutions should provide for the active participation of social actors and give a strong voice to the poor, should be equipped with effective systems for coordination between economic and social authorities in which social priorities are "mainstreamed" into economic policy, and should be guided by rules that facilitate the "visibility" of the

social effects of economic policies. These rules should provide for the consideration of such effects by macroeconomic authorities (including central banks) on a regular basis, require budget proposals to include analyses of distributive effects, stipulate that these analyses be taken into account by Congress when a budget proposal is being considered, provide for similar practices in the case of proposals for tax reforms, etc.

VI
Broader goals

One of the most positive events of the past decade has been the full realization that development comprises broader goals (Stiglitz, 1998). The concept of "human development" or the even more recent concept of "development as freedom" (Sen, 1999) give expression to this perspective, but it is clearly a long-standing and deeply-rooted part of development thinking. Its most important manifestation is the gradual spread of global ideas and values, such as those of human rights, social development, gender equity, respect for ethnic and cultural diversity, and environmental protection. Nothing embodies this "globalization of values" more than the series of declarations issued by United Nations summits during the 1990s, including the Millennium Declaration. These global values, and particularly human rights in their dual dimension (civil and political rights, on the one hand, and economic, social and cultural rights, on the other), should be regarded as constituting the ethical framework for the design of development policy today.

The implications of this perspective run more deeply than current economic thought is willing to recognize. The central implication, drawing on Polanyi's work (1957), is that the economic system must be subordinated to broader social objectives. An emerging issue in this regard is the need to confront the strong centrifugal forces that characterize private affairs today. Indeed, in many parts of the developing (and industrialized) world, people are losing their sense of belonging to society, their identification with collective goals and their awareness of the need to develop ties of solidarity. This fact drives home how important it is to foster those bonds in order to "create society" and to arrive at a more widespread awareness of the social responsibilities of individuals and groups. Either the State or civil society can take the initiative. In this sense, as indicated in the introduction to this paper, "public affairs" should be viewed as the sphere in which collective interests come together, rather than as a synonym for State actions. It means, in other words, that all sectors of society need to participate more actively in democratic political institutions and that a wide range of mechanisms need to be developed within civil society itself to strengthen relationships of social solidarity and responsibility and, above all, to consolidate a culture of collective development founded upon tolerance of differences and a willingness to compromise.

The enormous intellectual challenges and practical tasks that are involved in the recognition of these factors should foster a sense of humility. The idea that "we already know what must be done" is nothing more than a sign of arrogance on the part of the economics profession, which has only worsened since the rise to dominance of orthodox development thinking in the 1980s. Consideration of the unsatisfactory results of reforms and of the existing level of social discontent should –and is– leading many experts to rethink the development agenda. This is most welcome, but it is at best an incomplete, ongoing process.

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Managing in the *public sector for* investment and growth

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This article will focus on the central role played by imperfect or incomplete markets in the spread and perpetuation of recessionary situations. It is a known fact that demand volatility perpetuates such situations, and this can only be mitigated by sustainable economic stimulus policies. Macrofiscal rules, which are important for enhancing the tarnished credibility of State action, need to combine two basic principles: responsibility and stability. This means preserving regulation mechanisms so that excessive macroeconomic fluctuations can be stabilized. The best thing the authorities can do is to use flexible intervention policies to prevent such fluctuations. The new paradigm of public management by results thus entails setting clear fiscal rules with medium-term targets and short-term stabilization capabilities, but it must also involve allocating a larger and larger proportion of public expenditure on a multi-year basis. In seeking to combine stable economic growth with proper implementation of the plans and programmes voted for by citizens, public management faces three essential challenges: adhering to a macrofiscal rule over the cycle, identifying structural deficits as they arise, and correcting the traditional bias against investment. This article will look at some recent efforts to deal explicitly with these serious obstacles by applying legal provisions designed to cope with the uncertainties that surround both the cyclical behaviour of the economy and calculations of its long-term growth potential.

I

Introduction

The prevailing economic philosophy regards macroeconomic shocks as essentially transitory and public-sector intervention as perverse. According to this view, stabilization policies are a wholly ineffective way of increasing long-term growth, and actually make fluctuations more pronounced. It is thus better not to interfere with the natural adjustment towards balance; taking action and then reversing it may be more costly than simply doing nothing. According to this rule of non-interference, good policies are ones that confer credibility by remaining aloof from interventionist pressures. In Latin America, accordingly, most public-sector reforms, and recent fiscal responsibility laws, have sought to do away with or curtail the macroeconomic regulation role that the public finances have traditionally been seen as playing.

It is striking, however, how large a gulf separates the confidence with which these recommendations are made from the intensity of the theoretical debate and the tentativeness of empirical analysis. Economic theory is still debating fundamental aspects of the causes giving rise to macroeconomic ills such as inflation, unemployment and fiscal insolvency itself. Again, identification problems are intractable enough to give economists pause; the complexity of the interaction among observable and unobservable variables makes it difficult to identify statistical patterns, and thus arrive at an empirical demonstration of any initial hypothesis. As Greenspan (1996) puts it: "There is, regrettably, no simple model of the American economy that can effectively explain the level of output, employment, and inflation. In principle, there may be some unbelievably complex set of equations that does that. But we have not been able to find them, and do not believe that anyone else has either."

The combination of prolonged recessionary situations, monetary authorities with some degree of independence in setting their own targets and extremely rigid fiscal responsibility laws has produced strange situations in which the monetary authority has concerned itself solely with inflation and the public sector with short-term balance targets, which are of course impossible to meet in an environment of uncertainty. With no coordination of targets and instruments, responsibilities may be diluted, as no authority has objectives or can be held to account for what happens to output, real stability or unemployment. The combination of policies applied in the region recently has not always been the most appropriate, and this has had major negative effects on overall performance. Fiscal policy also has a considerable part to play in preventing excessive fluctuations, but this aspect has not been taken into account in recent reforms.

The difficulties involved in understanding the structure of the economy and predicting the consequences of change are not an argument for confining macroeconomic management to a purely administrative role. Uncertainty means that the authorities need to address themselves time and again to two problems for which there is no simple solution: the mood swings of macroeconomic agents (such as euphoria and pessimism), which they need to restrain by providing a guarantee of stability that extends the time horizon for decision-making, and systematic conservatism and the loss of opportunities that this entails.

The present article, which synthesizes a more detailed work, consists of three sections besides this introduction. Section II reviews recent publications that have emphasized the role played by imperfect or incomplete markets in allowing recessionary situations to take hold and become entrenched. Demand volatility results in underutilization of the factors of production, which in turn leads to hysteresis and the entrenchment of recessionary situations. Many authors believe that the only effective way of mitigating volatility and uncertainty and coping with persistent weakness in overall demand and the devastating effects this has on aggregate supply is to apply sustainable fiscal stimulus policies.

Section III suggests that macroeconomic rules need to observe two fundamental principles: responsibility and stability. Generally speaking, recent reforms in our countries have aimed only at the former, so that the latter has been largely neglected. Indeed, stability, understood as the maintenance of a high level of output and employment, is not explicitly included as an objective in the fiscal responsibility laws of Latin America. Policies achieve credibility, however, by combining these principles in an appropriate way, which means having intervention mechanisms available to

stabilize excessive macroeconomic fluctuations. Applying countercyclical rules in normal times, while retaining freedom of action to cope with unforeseen situations, may be a way of responding to the challenges posed by the extraordinary volatility of the Latin American economies.

Section IV looks at some issues connected with the new public management model and the link between planning and budgeting, i.e., the need to allocate a growing proportion of public spending on a multi-year basis so that public plans and programmes can be implemented efficiently. Modern public-sector management has to cope with three challenges: adhering to a macrofiscal rule over the cycle, anticipating the appearance of structural deficits so that sudden adjustments can be avoided, and removing the bias against investment that traditionally emerges when spending is cut back. The task is difficult, but not impossible; we shall be looking here at some recent attempts to deal explicitly with these serious obstacles to the new paradigm of the results-oriented management model.

II

Macroeconomic fluctuations and aggregate welfare

"Economics is a science of thinking in terms of models joined to the art of choosing models which are relevant to the contemporary world."

John Maynard Keynes, letter to Roy Harrod, 1938

For some, the main source of macroeconomic fluctuations is the distorting nature of public-sector intervention. The most that monetary policy should seek to do, as Friedman (1968) puts the proposition, is to "prevent money itself from being a major source of economic disturbance". The market is self-regulating, and fluctuations are necessary to ensure the overall efficiency of the economy. For others, by contrast, these fluctuations are the result of market failures, and are damaging to growth; highly active public policies are needed to restrain them when markets are incomplete. If the right model is to be chosen for today's world, these two opposing stances need to be explained.

The emblematic economists of the neoclassical schools base their theories on simple market models whose characteristics are perfect information and competition, the absence of transaction costs and the presence of a full range of markets. There is a representative agent, which does away with the problems of asymmetrical information and risk, among other things. To explain macroeconomic fluctuations, theories in the neoclassical tradition focus on technological upheavals, the shifting balance of work and leisure, or real cycles resulting from changes in aggregate supply. Classical economists continue to interpret the economic cycle on the basis of a friction-free market model in the tradition of Arrow-Debreu. In a pure Walrasian economy, the level of output that prevails when prices are totally flexible is the optimum one.

The inability of those who followed Walras to describe the real world was attacked by Keynes himself (1936) in his General Theory: "Our criticism of the accepted classical theory of economics has consisted not so much in finding logical flaws in its analysis as in pointing out that its tacit assumptions are seldom or never satisfied, with the result that it cannot solve the economic problems of the actual world." Imperfections are the main difference between the actual world and the Walrasian model of Arrow-Debreu. In the words of Greenwald and Stiglitz (1993), "leaving them out of the model is like leaving Hamlet out of the play".

There are periods, often long ones, when there is an excess supply of labour at the real wage level prevailing. In other words, there is involuntary unemployment. Aggregate economic activity, whether measured by capacity usage, GDP or the unemployment rate, fluctuates sharply, to a greater degree than could be caused by short-term changes in technology, consumer tastes or demographics, for example.

As Tobin (1993) remarks, the great debate between Keynes and his opponents was over how effective the

natural adjustment mechanisms of market economies were in restoring the balance of full employment once some adverse demand shock had disrupted it. Keynes and the Keynesians held that these mechanisms were weak, or perhaps non-existent or perverse, and that public policy action was thus required. Blanchard (1996) argues that during the Great Depression it was irresponsible to expect the economy to return by itself to its natural level, and that trying to balance the public budget was not just stupid, but dangerous. According to this view, entrenched unemployment and economic fluctuations are central, permanent problems. Recessions and depressions are market failures on a grand scale, as Mankiw (1993) puts it.

Many authors dwell on the role that imperfect or incomplete markets can play in creating, amplifying, spreading and perpetuating macroeconomic fluctuations (Greenwald and Stiglitz, 1989 and 1993; Stiglitz, 1999 and Dreze, 1997 and 2000). A common assertion is that in markets that are lacking in automatic regulation mechanisms, quantities vary greatly because prices change too little and too late. These imperfections in market adjustments are at the centre of explanations for prolonged recessionary processes. A variety of factors may explain why markets are not self-balancing: monopoly situations, uncertainty, transaction costs, sunk costs and information costs, among others. We shall concentrate now on the first two explanations.

Macroeconomic fluctuations may be a perverse consequence of uncompetitive conditions (Mankiw, 1985, 1989 and 1993; Blanchard and Kiyotaki, 1987 and Romer, 1993a). In conditions of perfect competition, companies lower their prices in response to a decline in aggregate demand, thus avoiding a fall in output. But it may take no more than small barriers in the price and wage adjustment process to turn modest falls in aggregate demand into costly recessions. The frictions referred to mean that the gains to any individual firm from lowering its own prices are small. In a system of monopolistic competition,[1] companies set their own prices and accept real sales as a constraint. This is in contrast to a situation of perfect competition, where competing companies that are price takers can decide on their output level.

In a system of monopolistic competition, prices do not change when demand falls, and a recession occurs. Companies do not have much incentive to reduce their prices when the demand for their goods is lower, as their decisions have externalities. As Blanchard and Kiyotaki (1987) suggest, the aggregate demand externality indicates that the decisions of individual firms affect all others through aggregate demand.[2] We can define the aggregate demand externality as the additional welfare that would accrue if a monopolistic equilibrium situation gave way to one of perfect competition, as in the latter state aggregate demand would be higher.

When a situation of monopolistic competition is combined with price rigidities, small (second-order) costs in price adjustments can result in large (first-order) changes in output, in cases where nominal variations occur. Owing to the existing distortions produced by monopoly pricing, the benefits to society from a fall in prices can be large, even if they are small for the company. The microeconomics of price adjustments is crucial to the macroeconomics of nominal rigidities.

The reasons for fluctuations are to be sought in the risk-averse behaviour of companies (Greenwald and Stiglitz, 1993), whose decisions are affected by their perception of the risks, which in turn are associated with uncertainty about the consequences of their actions and the value of their assets. At least three factors influence companies' evaluation of risks.

The first is the situation of the economy as a whole. When expectations are pessimistic, this very perception has real consequences, as it affects all of a company's decisions from pricing to investment spending to employment levels. In other words, expectations have a strong influence on decision-making and generate multiplier effects that can assume large proportions. As Keynes (1936) put it: "Worldly wisdom teaches that it is better for the reputation to fail conventionally than to succeed unconventionally." The development of expectations is an eminently social phenomenon, and their tendency to become self-fulfilling is one of the greatest perils of the modern capitalist system.

[1] The concept of monopolistic competition, which is a contradiction in terms, refers to an economy made up of companies producing goods that are imperfect substitutes for other goods (Blanchard and Kiyotaki, 1987). In this situation, each company has some monopoly power, and thus the ability to set its own prices. The condition is that each firm has an objective function that can be differentiated in its prices. In other words, it can change these marginally in relation to its competitors' without its sales falling to zero.

[2] In the words of these authors: "If starting from the monopolistically competitive equilibrium, a firm decreased its price, this would lead to a small decrease in the price level and thus to a small increase in aggregate demand. While the other firms and households would benefit from this increase in aggregate demand, the original firm cannot capture all of these benefits and thus has no incentive to decrease its price."

Uncertainty means that the economic environment of the future is not known in the present. Complete markets are a utopian state in which economic agents can trade all goods and services in the light of future economic conditions. Markets are incomplete when risk coverage is limited, i.e., in the real world. Thus, a basic macroeconomic relationship, the balance between saving and investment, is constantly disturbed by the degree of uncertainty perceived by economic agents, as it is on this that actual investment spending will depend.

A second factor has to do with companies' liquid asset position. In a world where there is credit rationing and risk-averse behaviour, a company's liquidity takes on great importance. The liquidity position is affected by profits, which represent a residuum from previous decisions on pricing and quantity. To maintain the same cost level at a time of recession, when liquidity is less because profits are lower, companies have to borrow more. But the higher debt that results means there is a greater likelihood of future revenues being insufficient to meet the new liabilities. As a result, lower profits in a context of recession and credit rationing lead companies to invest less and produce less.

A third important factor is the change in relative prices, which has major effects on access to credit, on the interest rates paid and, thence, on companies' liquidity and net wealth. A rise in interest rates very rapidly erodes the net wealth of companies that are already in debt. The high speed at which asset prices and interest rates adjust to shocks, combined with flaws in the capital market that limit the ability of companies to diversify their risks, has profound implications for aggregate supply in the economy.

As different prices are set in different ways, and adjust at different speeds, shocks lead to large changes in relative prices, and these in turn severely exacerbate macroeconomic fluctuations. The aggregate supply curve moves markedly downward if the economy goes into recession. The risk of producing increases and the ability of companies to cope with this risk decreases.

When there is an aggregate demand shock, wage and price deflation, if this occurs, will not cause the economy to return to its full employment level, even in a situation of perfect competition. In the view of Stiglitz (1999), the large, simultaneous falls seen in prices, real wages and economic activity in certain countries during the recent Asian crisis have once again shown that price and wage flexibility in an imperfect market can have adverse effects far worse than those analysed in the traditional literature.

Dreze (2000) claims that "uncertainty and incomplete markets result in demand volatility and price and wage rigidities whose conjunction leads to multiple restricted supply equilibria, reflecting a lack of coordination that may cause weakness to become persistent". The availability of factors of production places an upper limit on output, but there is no lower limit. There are frequently long periods during which resources as important as labour and production capacity are underutilized or wasted.

There is a perfect synchrony between production and investment, which suggests that the volatility of the latter is a factor in the variability of the former. For a company, postponing investment decisions has second-order consequences for the benefits expected, but first-order consequences if overall investment demand declines significantly. The very existence of incomplete markets, then, is enough in itself to produce volatility in aggregate demand. Volatility results in underutilization of existing resources and, if investment is postponed, of future resources.

If there is underutilization, this will persist because of non-coordination until market conditions change. Underutilization leads to the perpetuation of weakness for at least three reasons: weak activity today tends to result in expectations of weak activity tomorrow; a low level of investment today reduces tomorrow's potential supply; and weak activity today tends to worsen tomorrow's financial situation, as price rigidities can prevent recovery in profit margins.

It is important to differentiate the concept of market failures, associated with the existence of imperfect markets (which can be perfected by introducing competition or appropriate regulation), from the notion of incomplete markets, which is explained by the existence of probabilistic expectations in a world where risk coverage is limited. In turn, these probabilistic expectations, which are perfectly rational, are associated with uncertainty about future scenarios. It is a matter not of anticipating situations on the basis of a macroeconomic model that everyone is familiar with, as in neoclassical theory with rational expectations, but of assigning probabilities in a context of uncertainty.

The programme, then, involves not just promoting competition, but also reducing volatility. From what has been said so far, three policy conclusions arise (Dreze, 2000):

i) Solutions to demand volatility have to be sought. There needs to be constant awareness of the possibility that labour and production capacity may

be underused. The natural way of ensuring that demand stimulus policies are sustainable is to focus them on investments that produce an adequate social return, such as investments in social housing, urban renewal and urban transport. Carrying out such investments in periods when other private investment has temporarily declined is an effective way of dampening volatility, persistent weakness in overall demand and the devastating effects that this has on aggregate supply.

ii) Wage and price rigidities are inevitable, which makes automatic adjustment policies very costly. The effects of rigidities need to be offset by specific temporary policies, such as *ex ante* wage moderation mechanisms to deal with recessionary situations, taxes on labour that vary depending on the unemployment rate and policies to alleviate the financial situation of SMEs.

iii) The problems of market asymmetry and coordination cannot be taken lightly. The possibility of insufficient coordination is always present. Coordination problems are characterized by their potential to recur, which suggests that a constant slight demand pressure needs to be kept up, with dynamic supply policies to guard against the tendency to inflation.

As Dreze (2000) puts it: "The economic policy debate has convinced me that the main obstacle to implementing effective policies comes from gaps in macroeconomic theory, particularly its relative disdain for aggregate demand."

If theories of hysteresis[3] are given any credence, a major challenge for the authorities is to avoid excessively conservative management. If economic policy is not relaxed when the conditions merit it, unemployment may persist and, because of hysteresis, come to bear out excessively high estimates of the structural unemployment rate. Thus, conservatism becomes self-fulfilling (Alsopp and Vines, 1998); structural unemployment is estimated at a high level (and potential GDP at a relatively low level) and a conservative economic policy is followed as a result, leading to entrenched unemployment which then becomes structural.

[3] Strictly speaking, the word hysteresis should be used only when the stationary equilibrium depends on actual conditions (for example, if the actual unemployment rate affects the equilibrium unemployment rate). Very often, the term is used for situations in which current conditions affect equilibrium conditions for an extended period.

In hysteresis models, the natural rate of unemployment is determined by macroeconomic policy and by its own history. Cyclical unemployment, which is produced by a prolonged recessionary environment, may over time turn into structural unemployment. On the labour supply side, the long-term unemployed adapt to their situation, ceasing even to look for formal work. This results in a higher natural unemployment rate, inasmuch as these unemployed do not exert any downward pressure on wages (Blanchard, 1997). On the demand side, employers prefer to hire those who became unemployed recently rather than the longer-term jobless, simply because the former can be easier to fit in. These types of behaviour also tend to raise the natural unemployment rate. When unemployment rates are persistently high, the concept of a natural unemployment rate is a misleading indicator for economic policy.

As Stiglitz (1999) points out, the consequences of action are not just uncertain, but costly to reverse. It is hard to win back a customer who has found another supplier, and even harder to rehire a worker who has found another job. The assumption of hysteresis, understood as the irreversibility produced by negative shocks, has major policy implications.

According to the conventional view of the economic cycle, fluctuations represent nothing but temporary deviations from an output trend. In hysteresis models, where temporary changes (such as movements in aggregate demand in conjunction with slow price adjustments) have persistent effects if a nominal shock in a context of rigid prices leads to a fall in demand, the level of output is going to be lower than it would have been had the shock not occurred, even once prices have fully adjusted. Models that incorporate rigidities thus show very different effects on welfare, as they assume asymmetry between periods of expansion and contraction in demand. The former increase social welfare and the latter reduce it. Asymmetry between expansions and recessions becomes possible when the natural output rate remains persistently below its optimum level, given the assumptions of imperfect competition.

When output falls below its equilibrium level, then, there are large costs for welfare if the decline affects investment decisions, and thence potential output. If this view is correct, countercyclical stabilization policies could mean significant gains in welfare (Romer, 1993a). Thus, the high variability of some prices, combined with the relative rigidity of others, plays an important role in perpetuating and amplifying shocks.

The risks involved in adjusting prices can be greater than those involved in adjusting quantities, and quantities can vary widely as a result. In a context of uncertainty and price rigidities, real volatility is greater than nominal volatility.

In a globalized world, the sources of uncertainty are multiplied and the authorities are faced with many challenges, as they have to combine credibility in their actions with the flexibility needed to cope with unforeseen situations. In the face of this dilemma (credibility presupposes stable ground rules for a prolonged period, while flexibility involves the ability to respond to changes in conditions external to the system), short-term credibility, to be achieved by establishing rigid budgetary targets and deliberately renouncing any power to respond to adverse events, is often enshrined as the sole objective of economic policy. Given the frequency of shocks that are asymmetrical among countries, regions and sectors, discipline cannot be the sole or even the dominant criterion when the authorities are called upon to cope with a whole range of situations requiring the kind of inherently discretionary and temporary action that is essential if perpetuation phenomena are to be attenuated.

III

Macrofiscal rules for investment and growth

In situations of uncertainty, there is no place for strict rules and rigid conceptions, just as there is none for improvisation or ineffectiveness. If the objectives of fiscal policy are to achieve economic growth targets while simultaneously ensuring the sustainability of the fiscal accounts, the rules used need to be informed by complementary criteria of fiscal discipline and budgetary flexibility. Uncertainty means that discretionary action frequently has to be taken in the interests of stability, and that excessively conservative management has to be avoided.

Now as never before, most countries in Latin America have laid the foundations for sound, efficient management of the public finances with the recent enactment of fiscal responsibility laws. But there are still challenges, especially as regards the way the macroeconomic cycle is dealt with in budgetary planning and the stabilizing role of fiscal policy, issues that are vital if public- and private-sector investment are to complement each other as they should. It seems to be the right time to consider medium-term strategies that look beyond short-term conflicts. Despite progress with budgetary planning, and considering the chronic financing difficulties of the public sector, recent fiscal policy rules still tend to focus on short-term goals that look no further than the budgetary cycle and do not include provisions for dealing with the contingencies that are continually cropping up. The Fiscal Transparency Manual itself (IMF, 2001) warns about this. The Manual proposes that any rule adopted by a government should be clearly specified. If a fiscal rule is to last, there obviously needs to be some flexibility built in for cases when a departure from it is justified by economic conditions.

In some cases targets are quantified by law, which makes it impossible for automatic stabilizers to operate fully, and thus means that the effects of the cycle on the budget are not allowed for. There cannot be any social or external sanctions on budgetary performance because of changes in variables that are outside the control of the public sector. The best thing is to incorporate conservative calculations into planning or, failing this, to provide for explicit divergence mechanisms. The type of management system, so common in our region, in which spending adjustments are continually being made because of deviations from overambitious quarterly balance targets cannot be regarded as an efficient one.

In some countries, the law states that the real rate of increase in primary public spending may not exceed real GDP growth. Given the climate of uncertainty in which the public finances operate, rules of this type seem too rigid. On the one hand, insufficient weight is given to the principle of stability, as the authorities' ability to react to recessionary situations (with extraordinary emergency employment programmes, for instance) is removed. On the other hand, an unrealistic limit is placed on spending growth, as this is related to actual GDP (known retrospectively) and not potential GDP (estimated in advance). It seems more appropriate

to base primary spending growth criteria on potential GDP, thereby eliminating the undesired effects of cyclical fluctuations on the planning and implementation of spending, and introducing a significant countercyclical component.

Spending rules are not risk-free, however, as the size of the public sector depends on factors that are not directly under the control of the authorities, such as demographic and economic variables. For a sample of 125 countries, Rodrik (1998) establishes a positive relationship between the size of the State (measured as the ratio between government consumption and GDP) and the economy's openness to the outside world. In the author's words: "The statistical association between openness and government spending appears to be a robust one. It is not a spurious relationship generated by omitted variables. Nor is it an artefact of the sample of countries selected or of a specific data source. The question is why this relationship exists." The explanation appears to lie in the fact that more open economies are more exposed to the ups and downs of world markets, and that these risks are transmitted more strongly to domestic economies. Governments play a role in insulating the economy from these disturbances, being a "safe" sector by comparison with the internationally tradable sector. External vulnerability can drive the public sector to play a greater role in the economy in transition stages, so it may be difficult to plan primary spending on an automatic basis without taking these mechanisms into account.

Generally speaking, our countries' laws are much stricter than those applying in the developed countries (Martner, 2000). A curious effort is being made to achieve macroeconomic credibility through legislation; but faith in rules or laws is no substitute for responsible policy action. The credibility of policies has more to do with the ability to internalize externalities, i.e., with bodies of law that provide for the consequences of changes in circumstances. The main objectives of fiscal policy should be as follows:

– In the medium term, maintaining sound public finances: i) by setting tax and spending priorities in such a way as to avoid unsustainable rises in the public debt and/or excessive tax rates, and ii) by ensuring, as far as possible, that the costs of the services consumed are met by the same generation as benefits from the public spending concerned;
– In the short term, supporting monetary policy: i) by allowing automatic stabilizers to operate fully and thus play their role in smoothing out macroeconomic fluctuations when there are variations in aggregate demand, and ii) when prudent and appropriate, by altering discretionary policies to provide further assistance.

Short- and medium-term objectives are interrelated. For example, the scope for helping monetary policy to stabilize the economy during a recessionary phase depends on the strength of the public sector's medium-term financial position.

There is a critical problem with fiscal institutions, however. When events call for a change in the direction of fiscal policy, this is very difficult to achieve quickly, owing to the organizational complexity of the public sector. For example, the tax changes that circumstances require may be the subject of protracted and intense parliamentary negotiations. Various suggestions have been made for achieving greater autonomy in this area. One interesting initiative has been put forward in Australia. The Business Council of Australia (Gruen, 2001) has proposed that the instrument used should be income taxes, both personal and corporate. There would be no need to make short-term changes in the rates laid down by law if use were made of a weighting that varied according to the position of the economy in the cycle. The fiscal parameter would initially be set by the executive in a range of 0.97 to 1.03, giving a tax buffer of no more than one percentage point of GDP.

On the spending side, changes generally require budgetary authorization; furthermore, project design and evaluation take time. In the history of the United States, for instance, many discretionary stimuli have been applied only once recession has technically ended (Gruen, 2001). Another very serious problem is the risk that what are supposed to be temporary fiscal stimuli may prove irreversible. The tendency towards deficit that results from the difficulty of reversing such stimuli is one of the main arguments for establishing binding rules that limit discretionary action of this type.

Despite the risks, note should be taken of Ball's position (1996) regarding the ideal policy combination: "Shorter time lags are the first major advantage of using fiscal policy as a macroeconomic tool… If policy makers used their fiscal tools…they would make fewer mistakes. And mistakes could be corrected more quickly."

The following equation for the public-sector deficit illustrates the dilemma of fiscal policy well:

$$d = d_s - (\alpha + \beta)\ GAP$$

where d is the actual public-sector deficit, while d_s represents the structural component of the public-sector deficit, α the marginal sensitivity of the deficit to the GDP gap (or cyclical deficit), β the discretionary reaction of the authorities to the cycle (or discretionary deficit) and *GAP* the GDP gap. Any macrofiscal rule needs to make provision for the following three components: a medium-term structural deficit objective, exception and transience clauses for when unforeseen macroeconomic fluctuations occur, and some room for manoeuvre for dealing with persistent recessionary situations (Buti, Franco and Ongena, 1998). This is what has been done in some countries' more recent legislation.

In New Zealand, for example, the Fiscal Responsibility Act of 1994 laid down the criteria of "maintaining total Crown debt at prudent levels by ensuring that, on average, over a reasonable period of time, total operating expenses do not exceed total operating revenues".[4] The definition of a "prudent" level of debt that allows some room for manoeuvre should adverse events occur in future is not specified in the legislation. No one level of debt can be regarded as prudent at all times. All the relevant factors, such as vulnerability to external shocks, the cost of servicing debt, demographic pressures and so forth are likely to change over time.

Governments may depart temporarily from the principle of prudence, but the legislation stipulates that they have to explain why this departure took place and how they propose to return to a prudent level. The aim is to avoid the problems associated with numerical objectives in legislation; the difficulty of anticipating the future means there is a need for some short-term flexibility, provided that deviations are temporary and transparent.

The laws of the United Kingdom are guided by a similar philosophy. The Code for Fiscal Stability, passed by the House of Commons in December 1998, lays down the criteria that are to guide the formulation and implementation of fiscal policy. Government fiscal rules were first set in July 1997 in the Financial and Budget Report and were ratified in the March 1998 budget. It should be noted that they were included not in the Code for Fiscal Stability, but in the annual budget acts.[5] An alternative approach would be to include these fiscal rules in the Act, but this would be excessively restrictive, as the process under way might require that the rules be supplemented. Furthermore, the prevailing view is that it is up to each elected government to choose and announce its policy rules and objectives, provided they are consistent with the fiscal principles laid down by the Act. The Government lays down two rules for the legislature: i) the golden rule: over the cycle, governments borrow only to invest and not for current spending; ii) the sustainable investment rule: the public debt, as a proportion of national income, is to be kept at a stable, prudent level over the cycle.

The golden rule seeks to achieve fairness between the generations by ensuring that the bill for today's spending, which mainly benefits current taxpayers, will not be passed on to future generations. By contrast, today's investment will benefit future generations as well as present ones. This does not mean that capital spending automatically ranks above current spending; both have a part to play, and both have lasting effects on the economy. The golden rule applies to net investment; it is implemented using a definition of the public-sector current account that is close to the concept of National Accounts, so that the depreciation of public-sector capital is included as a current expense. This ensures that today's taxpayers pay the cost of maintaining the capital stock. The definition of National Accounts is transparent and does not provide any inducement to pass off current spending as capital spending in order to comply with the rule. As for the second rule, the Government stipulates that, all other things being equal, it is desirable for net public-sector debt to be kept below 40% over the cycle. A debt objective that covers the whole cycle makes it possible to take account of the macroeconomic environment, to which this indicator is very sensitive, especially as regards the differential between the growth rate and the rate of interest on the debt.

Other legal provisions of great importance include those of the European Union's Growth and Stability Pact, which lays down medium-term objectives for achieving fiscal balance or surplus and obliges its members to submit three-yearly stability programmes that specify the route they propose to take to achieve these objectives. The Amsterdam resolution assumes that "adherence to the objective of sound budgetary positions close to balance or in surplus will allow all Member States to deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3% of GDP". The time period used to interpret the medium term is the macroeconomic cycle.

To judge the extent to which medium-term objectives are met, in practice it is necessary to evaluate the likely impact of immediate economic conditions

[4] See New Zealand, The Treasury (1996).

[5] See United Kingdom, Her Majesty's Treasury (1998 and 1999).

on the present and future position of the public-sector accounts, in accordance with some method accepted by all Member States. Both the Member States and the Committee of the European Central Bank[6] consider the method used by the Commission services to be appropriate and useful for examining the cyclically adjusted public-sector balances of each Member State.

At the beginning of each year since 1999, all the countries have provided the Council and Commission with three-yearly stability programmes (in the case of eurozone countries) or convergence programmes (in the case of the rest) that meet the criteria of the Pact. According to the first Council Regulation,[7] which has had legal force since 1 July 1998, stability and convergence programmes must include the following information:

i) The medium-term objective of a budgetary position close to balance or in surplus and the path of adjustment towards this objective for the general government balance, and the expected path of the general government debt to GDP ratio;
ii) The main assumptions regarding the developments expected and the economic variables relevant to the implementation of stabilization programmes, such as government investment spending, GDP growth, employment and inflation;
iii) A description of the budgetary or other measures proposed to achieve the programme objectives and, in the case of the main budgetary measures, an estimate of their quantitative effects on the budget;
iv) An analysis of how changes in the main economic assumptions affect the balance and the public-sector debt.

The information on movements in the public-sector balance, debt and the main economic variables tracked must be provided annually and cover the previous year, the current year and the next three years. Member States are to make their stability and convergence programmes public each year. The Committee has produced a technical report, to serve as a code of good practice, on the format and content of stability and convergence programmes, with a view to facilitating examination and discussion of these. The main components of these programmes are as follows:

i) The grounds of assumptions relating to GDP growth and the expected sources of this growth must be explained, with sufficient information to allow the position of the economy in the cycle to be analysed. Technical assumptions relating to changes in interest rates must also be set forth, owing to the impact of these on the public finances. Given the practical difficulties involved in using a common set of macroeconomic projections, the Committee prefers member countries to come up with their own forecasts for the domestic economy and the world situation. Where these differ significantly from the Commission's forecasts, however, the member country will have to justify its assumptions.
ii) Programmes should include sensitivity analyses estimating how changes in the main economic assumptions would affect the public-sector debt and balance. These analyses are to be supplemented by studies on the impact of different interest rate scenarios on the deficit and debt.
iii) The information on trends in the general government deficit and debt and the assumptions relating to the main economic variables should cover at least the next three years. Member countries may submit information for a longer period should they so wish.
iv) The annual updates should show how the variables have behaved in relation to the objectives of the previous programme and, when there are significant deviations from these, state what steps are planned to rectify the situation.

The Pact does, however, allow the balance objective to be interpreted more flexibly, so that larger deficits will be accepted, within certain limits, when they are the result of transitory cyclical factors. The steps to be taken are set forth in the Protocol on the Excessive Deficit Procedure,[8] article 2:

i) The excess government deficit over and above the reference value will be deemed exceptional when it is the result of an unusual event outside the

[6] See Council of the European Union (1998) for the opinion of the Monetary Committee on the content and format of stability and convergence programmes.

[7] See Council of the European Union (1997a) for the Council Regulation on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.

[8] See Council of the European Union (1997b) for the Council Regulation on speeding up and clarifying the implementation of the excessive deficit procedure, effective from 1 January 1999.

control of the member government and has a significant impact on the financial position of the general government, or when it is the result of a severely unfavourable change in the short-term economic situation. The excess will be deemed transitory if the Commission forecasting services judge that the deficit will fall back below the reference value once the unusual event or unfavourable change in economic conditions is over. The excess deficit must be fully corrected within two years from when it arises and one year from when it is identified, unless exceptional circumstances exist. The statistics used to apply the protocol will be provided by the Commission.

ii) As a rule, the Commission will consider an excess deficit to be exceptional only if there is a year-on-year fall in GDP of at least 2%.

iii) The Commission will decide if the situation is exceptional in cases where this fall is less than 2% and there is an excess deficit, taking account of the observations made by the member country, in particular as regards the steepness of the recession and the accumulation of GDP losses in relation to past trends.

The idea is to combine discipline with flexibility by means of multi-year planning with explicit objectives and short-term management that takes more account of macroeconomic fluctuations. These components help to improve the efficiency and effectiveness of public policies by extending the horizon of public-sector management and retaining room for manoeuvre so that unforeseen situations can be coped with. This is possible only where there is transparency and clear reporting mechanisms. The combination of properly explained medium-term goals (a situation of near balance or surplus under normal conditions in the euro zone, balance in the current account over the cycle and stable public debt over the cycle in the United Kingdom) and budget planning that sets out the path to attainment of these objectives allows a proper appreciation to be formed of the situation and direction of the public finances.

IV

Managing the public sector for the future

As macroeconomic stability makes it possible to look towards a medium-term horizon, it is becoming more and more feasible and necessary to focus anew on planning as a key public-sector management instrument in Latin America. This process has been proceeding piecemeal, rather than in the form of a preconceived project. Planning should shed light on medium- and long-term prospects for the body of citizens, clarify the public authorities' decision-making choices and explore new economic and social strategies that are feasible and desirable. Planning creates a bridge between the government's overarching political and economic objectives and the implementation of its plans and programmes.

Making an effort to predict the future so that forethought and a long-term horizon can be incorporated into the decision-making process is one of the most crucial tasks of public-sector management. One of the legacies of the adjustments carried out since the 1980s is that the bulk of Latin American countries have very limited time horizons. Notwithstanding this, the State has an inalienable responsibility to prepare for the future, improve forward thinking capabilities, resist the "destructive tyranny of the short term" and provide far-reaching vision. Forward thinking is a precondition for action, and this cannot become entangled with mere crisis management. The future is not just foreseen, it is constructed; anticipation in order to build a future chosen by free and mutual consent, this is the object of forward planning.

We can distinguish two opposing approaches to such planning. One is of an exploratory nature, setting out from the present to review the gamut of possible futures, while the other is prescriptive, setting out from a vision of the future that is desirable and constructing a road map of the actions needed to attain it. The risk of setting out from present conditions is that one may remain there without changing anything, or changing only at the margins. If the starting point is a vision, the risk is again that one may remain there, weaving fantasies. The natural course is to seek images of the future that are based on the present, but the opposite route, setting out from the vision, is attractive, since the key thing is to break away from inertia and mobilize

energies. The challenge in the latter case is to turn these ideas into new economic and social strategies that can be used to deal with the great problems faced by the region.

Preparing public-sector management for the future involves progress in seven well defined areas (OECD, 2001a): i) macrofiscal rules, ii) multi-year budgeting, iii) zero-base budgeting, iv) relaxation of internal controls, v) accrual-basis accounting and management, vi) result evaluation and vii) performance agreements. Note that this classification entails a sequence. Thus, the evaluation of results only makes sense if the preceding reforms are implemented.

As is well known, public-sector management has moved from programme budgeting to a results-oriented approach. The programme budgeting method sought to establish close links between the budget process, planning and the evaluation of public programmes. In its broadest conception, the results-oriented approach seeks rather to enrich budgetary discussion within a framework of flexibility (see Marcel, 1998). The process of modernizing institutional management is now closely linked to what is known as the management by results model, which involves providing management centres with a degree of decision-making autonomy while simultaneously constructing appropriate evaluation systems. Evaluation should be both internal, involving performance indicators and targets, and external, with evaluation rounds carried out by other bodies. The guiding principles have to do with the strategic planning of public bodies, the type of linkage between resource allocation and institutional performance, the transparency of State action and, as a corollary of this, the quest for change in the organizational culture of public institutions.

This process is not without difficulties, as it is obstructed both by current failings (the shift from a procedure-based culture to a user-oriented results-based one) and by external constraints (continuous restructurings that hinder the emergence of an appropriate organizational structure with specialized human resources). Every experience is unique; the factors specific to each country and institution mean that instruments and procedures must differ from case to case.

It is clear, though, that management by results can only become a day-to-day reality if agencies' capacity for independent action is strengthened by means of performance agreements. Such agreements have a variety of purposes: increasing efficiency/effectiveness, accountability and managerial capabilities, moving from a rule- and input-based approach to an output- and results-based one, and building trust. In general, performance contracts are not legally binding but are negotiated by mutual consent on the basis of agreements between ministers and executive heads, or between departments and agencies. These contracts are generated on the basis of agreements, which provide the basis for resolving disputes and coping with contingencies or adjustments when unforeseen events arise. Performance contracts are constructed on the basis of a "relational" contractual model rather than a traditional one, and draw their strength not from the threat of legal or financial sanctions but from the need of the parties to have clear relationships and stable agreements (OECD, 1999).

The transformation of public-sector administration can result in incompatibility between the need for central control of operations and the managerial freedom required for performance to improve. Here it is very important that budget offices do not confuse new public-sector management systems with short-term fiscal adjustments, and that managers do not interpret the reforms as a licence to spend as they please (Shick, 2001). Managerial innovation requires new models for the relationship between "spenders" and "allocators" so that an appropriate balance can be struck between the need for flexibility in implementing plans and programmes and the discipline involved in forming part of a public sector with explicit macrofiscal rules.

It is indispensable for policy decisions with a multi-year outlook to be clarified. The implementation of public-sector plans and programmes needs to take place within a multi-year budgeting framework, and this is nothing other than strategic planning. Until a few years ago, multi-year planning of this kind was synonymous with budgetary rigidity, in the sense of an accumulation of sectoral commitments that were radically incompatible with overall objectives. This "bad" type of multi-year planning has given way to a more optimistic view of public-sector financial planning. Today, "good" multi-year planning is the natural consequence of the enhanced role being played by performance agreements and public policy evaluation instruments. There is nothing new about taking a multi-year approach to public-sector management; the innovation consists in achieving growing linkage between the plan, the budget and the evaluation of results, formalizing processes around these instruments so as to ensure consistency over time in decision-making, and designing a chain that makes the results-oriented management model viable.

Public-sector management could facilitate decision-making and arbitration, both centrally and regionally, if it were designed on the basis of forecasting exercises and strategic plans, with medium-term fiscal rules, multi-year budget planning, performance agreements, effective coordination bodies and open systems for the evaluation of plans and programmes. For planning to fulfil its function properly, there is a need to introduce more pragmatism and lay the groundwork for flexible, decentralized management with greater accountability and freedom of action for those conducting it.

If medium-term rules are to be made consistent with public expenditure management, the new planning and control system needs to avoid, on the one hand, the tendency towards short-termism in decision-making and incrementalism in budget management and, on the other, the negative bias that generally affects investment spending. A clear separation between current spending (including depreciation) and capital spending, and the allocation of growing proportions of public spending on a multi-year basis, are changes that can unquestionably make a decisive contribution to the arduous task of creating an institutional environment that nurtures stability and growth.

The creation of an appropriate environment for private-sector investment and the proper administration of the scarce resources available for public-sector investment can only come about if management methods are able to deal with three fundamental challenges: firstly, adhering to a fiscal rule over the cycle, to avoid the economic and political costs of sudden fiscal adjustments; secondly, identifying structural deficits far enough in advance to avoid excessive public borrowing that will place a burden on future generations; and thirdly, removing the bias against capital spending which, by its very nature, is generally more sensitive to fiscal adjustments than current spending. Delaying or cancelling such spending also places a burden on future generations.

As regards the first challenge, that of adhering to the fiscal rule over the cycle, the right approach is to develop instruments that can guide the budget process towards a disciplined, flexible system in which temporary factors are clearly identified and management is consistent with the fiscal pact that is essential for our societies. The right approach seems to be to aim for a financial position that is corrected for fluctuations in the level of economic activity, which is equivalent to planning spending and revenue with a medium-term outlook in the management of the public finances. When budgetary policies are being designed, it needs to be remembered that the cyclical progression of the economy is inevitably uncertain and that projections for the determinants of revenue and expenditure are necessarily imprecise.

To deal properly with the second challenge, that of identifying structural deficits far enough in advance, the need is to ensure that the multi-year trend of the budget balance is consistent with the fiscal rule. Most multi-year planning errors are attributable to mistakes in forecasting the growth potential of economies, and these errors have permanent effects on the public finances. If actual GDP is below the trend estimated for the period covered by government planning, the result is a structural deterioration in the public-sector financial position.

It is thus important to take explicit account of the position of the economy in the cycle and to use moderate growth assumptions for multi-year planning. With lessons from the past in mind, such as the observation that the main reason multi-year budget planning exercises fail is excessive optimism about medium-term growth, a prudent strategy with the flexibility to cope with macroeconomic fluctuations should be determinedly embarked upon.

It seems necessary to confront this “optimistic bias” (whereby positive episodes are regarded as permanent and negative ones as temporary) if fiscal planning is to become more consistent and transparent. Sensitivity analyses should not be confined to the construction of scenarios incorporating different values for one-year GDP forecasts, but should also include less optimistic scenarios for trend GDP. This will provide a prudent set of multi-year assumptions, which is necessary in an uncertain environment to provide a margin of safety and thus internalize the possibility of unforeseen contingencies and of measurement errors in the budgetary planning process itself.

Orienting fiscal policy by a medium-term structural objective involves much more than just a simple criterion, as it means carrying out systematic measurements of the position of the economy in the cycle, and thus of the factors affecting potential GDP. Public-sector management should contain a large component of macroeconomic analysis; a much larger one, indeed, than is normal in our countries.

As regards the third challenge, that of removing the bias against capital spending, it is important to give explicit recognition in the budgetary planning process to the economic difference between current and capital expenditure. The State has an obligation to create or

maintain the capital stock that the economy needs and to ensure that its public-sector component is kept in good condition. Inadequate public-sector investment can do irremediable harm to the long-term performance of an economy.

Many countries are making great efforts to bring their budgetary processes into line with the objective of stimulating and protecting public-sector investment. To this end, it is helpful to plan and manage current and capital expenditure separately. With the results-oriented management model, spending should be planned, managed and accounted for on an accrual basis whereby capital costs, and likewise depreciation and interest on public-sector investments and other assets, are recorded as and when they arise. This provides a better link between the expenditure planning process and the fiscal rule.

The recent experience of the United Kingdom[9] is particularly intriguing. "Firm" three-year plans are drawn up for all government departments, in the form of the departmental expenditure limits (DELS). The idea is that these limits (roughly half of total spending) should provide a solid basis for planning and a strong incentive for costs to be administered efficiently. The Government is also seeking to improve management by making it more flexible, accepting that agencies are free to shift any proportion of their DEL-mandated spending from one year to another.

When spending cannot reasonably be covered by a three-year plan, it is subject to annual scrutiny as part of the budgetary process, and is known as annually managed expenditure (AME). Most of this spending is for social security, and it is subject to rigorous annual control. Current and investment spending, whether covered by DELS or the AME provisions, are planned and managed separately in a way that is consistent with the fiscal rule.

Since 2000, a new accrual-basis accounting system has been in operation for the public sector, to supplement the existing cash-basis accounts. The use of accrual-basis accounting principles recognizes that the economic effects of capital spending are not the same as those of current spending; in addition, outgoings are recorded when they are incurred and not once they have been disbursed. The objective of resource accounting and budgeting (RAB) is to plan, manage and account for DELS on an accrual basis, recording capital costs and depreciation and interest on public investments and other assets as and when they arise.

This provides a stronger link between the expenditure planning process and the fiscal rule, with the spending of agencies being accounted for on the same basis as is used for fiscal projections. It is worth noting, however, that the cash system will continue to be important, for example in accounting for the government's financial needs. Furthermore, the cash basis will continue to be used for tax forecasting.

Accrual-basis accounting has been fully implemented in Australia, Canada, Iceland, Italy and New Zealand, and other countries are currently developing such systems (see OECD, 2001b). High-quality information is the basis for good decision-making policy.

Public-sector management thus has to combine transparent design, involving rules that ensure medium-term control of the public finances, with a new budget planning system based on multi-year allocation of a growing proportion of public spending. These two pillars are inseparable; the first of them (fiscal rules) makes the second (multi-year planning) technically feasible by establishing norms that are independent of the macroeconomic cycle, while the second gives agencies greater incentives to manage their budgets more efficiently and thus contribute to the attainment of goals over the course of the cycle.

Strategy thus needs to concentrate on long-term planning, stress outputs more than inputs, distinguish current spending clearly from capital spending and, lastly, be grounded in prudence and stability, with a margin to cope with the inevitable uncertainties. The developments described reveal interesting changes in the way public-sector management is approached. After almost two decades of decline, planning, guided by multi-year plans and programmes, is being used to reverse the policy of administration by sector and by institution. The prescriptive approach is giving way to strategic management and forecasting. This means incorporating the multi-year aspect into investment plans and budgetary frameworks; the challenge is to coordinate public- and private-sector investment in the interests of growth.

In a context dominated by imbalances and a variety of emerging conflicts, the objective is to build new institutional structures with prudential systems designed to internalize positive and negative externalities to the greatest possible degree by means of rules, procedures and exception protocols. The idea is not to legislate for credibility, but to develop long-term strategies whose

[9] See United Kingdom, Her Majesty's Treasury (2000).

guiding aims are accountability, stability and growth. This is about much more than just semantics; our countries need fiscal responsibility laws that give due weight to the principle of accountability, but consideration also needs to be given to stability and growth laws. The difference is not a minor one!

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Corporate *competitiveness* in Latin America *and the Caribbean*

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This article looks at the evolution of international competitiveness in the countries of Latin America and the Caribbean in the 1990s, focusing on the microeconomic and sectoral aspects. It evaluates the competitive performance of the region's countries, contrasting it with that of their main competitors in the developing world; it analyses the corporate actors involved, including the subsidiaries of transnational enterprises and large locally owned firms; and it sets forth some political considerations. Although progress has been made with competitiveness in the region, this has been largely confined to just a few countries, sectors and firms. Differences in the institutional conditions under which the countries participate in the world economy, and in their comparative cost advantages, have resulted in the emergence of two distinct trading styles. In Mexico and the Caribbean Basin, exports of manufactures assembled for the United States market predominate. In South America, on the other hand, natural resource production and processing activities prevail, with more technologically advanced manufactures having some presence in intraregional trade, especially within Mercosur. Both sectoral specializations present opportunities and problems. Improvements in the competitiveness of large companies (whether transnational or locally owned) have enhanced their efficiency. But the same is not true of other agents in the countries' economies, whose production structures have thus become more polarized. This polarization needs to be dealt with by policy initiatives. Four areas of action are important: increasing efforts to attract selected foreign direct investment (FDI); strengthening the links between leading companies and the other firms in each country; supporting the creation of global knowledge networks; and enhancing the ability of domestic companies to enter into joint ventures and strategic alliances with their global competitors.

I
Introduction

For more than a decade, the countries of Latin America and the Caribbean have been proceeding with structural reforms aimed at improving production efficiency, promoting growth and generating employment in the region.[1] The new economic model that the reforms put in place to achieve these objectives entails far-reaching involvement in the world economy. Participation in what are growing and increasingly integrated international flows of goods, services, technology and capital is seen as a prerequisite for taking advantage of the benefits generated by the removal of restrictions on the operations of economic agents. Within this framework, the State has yielded leadership to private enterprises that operate in much less regulated economies than was the case until just over a decade ago. Openness, privatization and competition are thus the cornerstones of the new model (Reinhardt and Peres, 2000).

Globalization, understood as the movement towards a single world market, has been the result of microeconomic forces generated by the technological revolution now in progress. Lower information handling and transport costs have made it profitable for some industries to carry out production, marketing and research and development activities on a world scale (Turner and Hodges, 1992), and this has increased the importance of economies of scale in those sectors and given the ascendancy to large firms. The homogenization of preferences, technologies and products predicted by Levitt (1983) would appear to be taking place. Public policies of national or local scope are playing a secondary role in this process, since in general they can do no more than check it or slow it down, without changing its direction or effects (Oman, 1994).

The increasing integration of markets worldwide is opening up great opportunities and posing major challenges for developing countries, which may or may not take advantage of the former and take the right steps to deal with the latter (Sunkel and Mortimore, 1997). If the opportunities are to be fully capitalized upon, countries need to participate efficiently in this world market, which can only happen if companies become increasingly competitive (Lall and Mortimore, 2000).

The objective of the present study is to set forth some considerations that will assist in evaluating the competitive efficiency of the Latin American and Caribbean countries in the 1990s, paying special attention to two aspects: the groups of economic sectors that have been gaining or losing competitiveness and the types of companies (transnational or local, public-sector or private-sector) responsible for this sectoral and national performance. The study is divided into five sections. Following this introduction, section II looks at the way competitiveness has developed in the region's countries by comparison with their main competitors in the developing world, i.e., the more dynamic countries of East and South-East Asia. Section III analyses the companies that are playing the leading role in this process: transnationals operating in the region, and large locally owned firms. Lastly, sections IV and V offer conclusions and policy considerations.

[1] The term "structural reform" is used to refer to the strategies for change followed by most of the region's countries since the early 1980s, although important initiatives of this kind were pursued in the previous decade, for example in Chile. Its basic components have been trade liberalization, privatization of State enterprises, deregulation of markets and businesses, the opening up and liberalization of domestic financial markets and the capital account, and fiscal reform. Different authors employ terms such as "economic reform" and "structural change" to describe the same phenomenon (Stallings and Peres, 2000).

II

The region's place in the international economy in the 1990s

1. Competitiveness in the international context

Transnationalization and the growth of international trade have been central factors in globalization and the progress of developing countries. While the share of international trade in the GDP of the industrialized countries has held steady at about 40%, in developing countries it rose from about 35% in the early 1980s to close to 50% in the late 1990s. It is in fact developing countries that have capitalized most on international trade opportunities; greater competition among economies is the result of their eagerness to boost trade flows.

During the period from 1985 to 1998, manufactures (to three digits in the SITC, revision 2) continued on a growth course and increased their export share relative to primary products. In this period, the share of manufactures in the total value of world exports rose from 74% to 84%, while that of natural resources fell from 23% to 12% (CAN 2000).[2]

Table 1 shows in which activities and to what extent the developing countries have taken advantage of manufacturing export opportunities. They have surpassed the industrialized countries in this respect, gaining three percentage points of market share in the period 1985-1998. This progress was due to three types of non-natural resource-based manufactures (high technology content: 16.6 points; medium: 9.1 points; and low: 16 points) and not to natural resource-based manufactures or unprocessed natural resources, as might be expected if a simplistic view were taken of comparative advantages. Also unexpected is the increase in the developed countries' share of the market for natural resources, which rose from 37.8% in 1985 to 43.2% in 1998.

A more detailed breakdown of the information, using the CAN 2000 software, shows that in the three categories of manufactures in which developing countries have gained market share, four activities are particularly dynamic: electronics, continuous process industries, vehicle manufacturing and wearing apparel. These manufactures are not based on natural resources, and they are concentrated at the high-technology (electronics) and low-technology (apparel) ends; activities involving an intermediate level of technology (vehicle manufacturing and continuous process and engineering industries) have not developed to the same degree.

The developing countries of Asia took advantage of the opportunities open to them in all areas, even natural resource-based manufacturing; they made the greatest progress, however, with non-natural resource-based manufactures, especially those involving high (145% increase in market share) and intermediate (123% increase) levels of technology. In particular, while Asia tended to specialize further in high- and medium-technology sectors, Latin America did so in medium- and low-technology sectors.

The increases in market share achieved by Latin America were smaller than those achieved by Asia. In high-technology manufactures, the increase was one percentage point, as compared with over 16 points in the case of Asia. In short, of the almost 13 percentage points represented by the opportunities available in non-natural resource-based manufacturing, Asia took almost 11 points, while Latin America took less than two points.

Developing countries have thus been given an opportunity to enter the international market, and much of their success has had to do with the dissemination of integrated international production systems (IIPS) (UNCTAD, 1993 and Lall and Mortimore, 2000). Only a few countries, however, have managed to benefit from these systems. To take advantage of international trade opportunities, countries have to incorporate themselves into the strategies of efficiency-seeking transnational enterprises. And not all those that have participated have done so successfully.

[2] By CAN 2000 is meant the Competitive Analysis of Nations software, 2000 version, developed by the ECLAC Division of Production, Productivity and Management (for the user manual see LC/R.1258).

TABLE 1

World market share, by export type, 1985-1998

(Percentages)

Export type	Industrial countries		Developing countries		Developing Asia		Latin America	
	1985	1998	1985	1998	1985	1998	1985	1998
Natural resources	37.8	43.2	62.1	56.8	29.7	27.4	12.3	13.8
Manufactures based on natural resources	68.1	69.5	31.3	30.5	12.4	14.4	6.5	6.2
Manufactures not based on natural resources	82.4	69.7	17.5	30.3	11.6	22.1	2.5	4.3
Low-technology	51.5	35.5	48.5	64.5	39.1	49.8	4.0	6.7
Medium-technology	89.4	80.3	10.6	19.7	5.2	11.6	2.4	4.5
High-technology	83.0	66.4	17.0	33.6	11.3	27.6	2.0	3.0
Others	71.1	62.2	28.9	37.7	6.4	11.0	4.1	4.1
Total	*68.7*	*65.8*	*31.3*	*34.2*	*16.0*	*21.5*	*5.6*	*5.7*

Source: The authors, on the basis of the CAN 2000 software.

TABLE 2

World market share, by groups of countries

(Percentages)

Year	Latin America and the Caribbean	China	Hong Kong, Rep. of Korea, Singapore and Taiwan	Indonesia, Malaysia, Philippines and Thailand
1985	5.57	1.60	5.51	2.80
1986	5.03	1.76	6.02	2.57
1987	4.66	1.94	6.68	2.52
1988	4.63	2.22	7.09	2.65
1989	4.61	2.45	6.97	2.72
1990	4.53	2.82	6.95	2.89
1991	4.38	3.18	6.90	3.04
1992	4.41	3.74	7.25	3.38
1993	4.62	4.26	7.48	3.72
1994	4.81	4.62	7.66	4.00
1995	5.01	4.81	7.63	4.16
1996	5.27	5.06	7.59	4.30
1997	5.52	5.33	7.44	4.36
1998	5.66	5.50	7.37	4.37

Source: The authors, on the basis of the CAN 2000 software.

There are large differences between Asia and the Latin America and Caribbean region.[3] Table 2 shows that, in the period 1985-1998, the countries of this region as a whole barely maintained their world market share, in marked contrast with China and the countries of South-East Asia with a large natural resource base (Indonesia, Malaysia, the Philippines and Thailand). The region also failed to match the results achieved by the countries of East Asia that specialized in manufacturing, whose market share at the beginning of the period was already higher than the region's was in the late 1990s. The contrast is most marked at the beginning of the period, when the region's market share fell by more than a percentage point just as Asia was enjoying strong growth. In the second half of the decade, the pace slowed in Asia, with the exception of China, while Latin America began a gradual climb back to the levels of market share it had held 10 years before.

[3] Despite the crisis of the late 1990s, the countries of East Asia have also achieved much better results than Latin America in terms of GDP growth, industrialization and improvements in the competitiveness of manufacturing exports. In Asia, international trade has clearly operated as an engine of economic growth (Lall, 2000). In Latin America, on the other hand, progress with per capita GDP growth, industrialization and manufacturing exports has not been encouraging; by and large, the benefits expected from greater integration into the international market have not materialized (Mortimore, Bonifaz and Duarte de Oliveira, 1997).

TABLE 3

Technological specialization index, 1985-1998

Year	China	Hong Kong, Rep. of Korea, Singapore and Taiwan	Indonesia, Malaysia, Philippines and Thailand	Latin America	Mexico	Mercosur countries
1985	0.153	0.849	0.267	0.272	0.650	0.289
1986	0.173	0.858	0.269	0.297	0.765	0.309
1987	0.216	0.917	0.305	0.322	0.931	0.307
1988	0.273	0.991	0.344	0.336	1.007	0.303
1989	0.320	1.054	0.394	0.336	1.060	0.285
1990	0.339	1.082	0.454	0.340	1.107	0.274
1991	0.350	1.111	0.523	0.365	1.205	0.289
1992	0.360	1.154	0.603	0.402	1.336	0.308
1993	0.378	1.225	0.692	0.428	1.444	0.311
1994	0.420	1.377	0.802	0.437	1.483	0.295
1995	0.461	1.492	0.895	0.447	1.518	0.280
1996	0.500	1.566	0.979	0.465	1.514	0.294
1997	0.524	1.529	1.021	0.508	1.575	0.322
1998	0.534	1.508	1.048	0.526	1.582	0.343

Source: The authors, on the basis of the CAN 2000 software and the methodology of Alcorta and Peres (1998).

Latin America's world trade performance is technologically inferior to that of East and South-East Asia as well. Table 3 provides information on the dynamic of technological specialization indices (TSIs) for the exports of the region and its main Asian competitors.[4] Although the TSI of the region virtually doubled between 1985 and 1998, it was still lower than the index values achieved not only by Hong Kong Special Administrative Region, the Republic of Korea, Singapore and Taiwan Province of China, but also by Asian countries with a large natural resource base (Indonesia, Malaysia, the Philippines and Thailand). Furthermore, the dynamic of the region is determined by that of Mexico, a country which has achieved TSI levels similar to or higher than those of East Asia, while the best the countries of Mercosur can show is a modestly upward trend, with levels much lower than those of Asia and Mexico. The region is even lagging well behind China, which still has a low TSI.

[4] The TSI is calculated as the ratio between the market share of a country or group of countries in high- and medium-technology sectors and its share in low-technology sectors. Both the absolute levels and the rates of change of TSIs are significant. A value lower (higher) than one indicates that a country's market share in high- and medium-technology sectors is higher (lower) than its share in low-technology sectors. A rising (falling) value for the TSI over time indicates a shift towards higher (lower) market shares in high- and medium-technology markets. For further details, see Alcorta and Peres (1998).

Lastly, the contrast between East Asia and Latin America is also reflected in the ranking of the 10 economies that have most improved their international competitiveness (measured in relation to world imports) for the 50 product groups (down to three digits in the SITC, revision 2) that were most dynamic in world trade during 1985-1998. The 10 economies, in descending order, are China, Mexico, Singapore, Malaysia, Spain, Taiwan, Thailand, Ireland, the Republic of Korea and the Philippines. In other words, seven Asian economies, two European ones and one Latin American one. These are the economies that have managed to take greatest advantage of the shift in trade patterns and the international economy towards a single world market. With the exception of the Republic of Korea and Taiwan, whose trading success has been driven by local companies, the progress these economies have achieved with trade has been directly linked to the IIPS of transnational companies. Furthermore, six of the 10 also feature among the economies with the fastest per capita GDP growth, which would seem to indicate that their international trading success has served to stimulate and develop their economies. Neither Mexico nor Spain achieved any remarkable increase in per capita GDP over the same period, however, which suggests that for lasting success something more than the conquest of markets is required.

All the results described in this section indicate that the region is not very competitive, has made little progress in increasing its world market share and the technology-intensiveness of its exports, and has shown

only a moderate ability to adjust its export profile to the changing dynamic of international trade. The results also indicate that, within Latin America and the Caribbean, Mexico and the Caribbean Basin need to be distinguished from South America.

2. Subregional developments

Of the 25 Latin American and Caribbean countries included in table 4, only nine gained world market share between 1985 and 1998, while four saw no change. The largest number (12 countries) lost ground, some of them, such as Brazil and Venezuela, to a significant degree. Among the seven gainers were Mexico and six countries in the Caribbean basin. Although Argentina and Chile rank second and third, respectively, Mexico gained more than twice as much as all the other eight countries whose share increased put together.

The rise of the Central American and Caribbean countries (Costa Rica, Dominican Republic, El Salvador, Guatemala and Honduras) should not be dismissed because of their low absolute share of world trade. Rather, it should be appreciated in the light of the extremely low shares they held at the start of the period. The fact that their performance has been positive is in itself deserving of attention, given the difficult starting conditions. The advances made by Argentina and Chile have followed different patterns. While Argentina's trade has progressed essentially because of automobile and energy exports to Mercosur, Chile has developed an export trade that is quite diversified in terms of destinations, although it is largely confined to processed and unprocessed natural resources.[5]

If Latin America is divided into two groups, Mexico and the Caribbean Basin on the one hand and South America on the other, a very marked contrast emerges in their trade performance and international competitiveness.[6] While Mexico and the Caribbean Basin increased their competitiveness sharply (from 2.1% to 2.8% between 1985 and 1998), the opposite happened in South America, whose international market share fell from 3.3% to 2.8% between those years. In terms of products, the market share of South America increased in sectors that were not very dynamic in world trade (natural resources and manufactures based on them), while the exports of Mexico and the Caribbean Basin centred on non-natural resource-based manufactures whose international trade performance was highly dynamic. The same pattern can be seen in the export structure.

The 10 main exports of South America are almost all natural resources such as crude oil, animal feed, petroleum derivatives, coffee, copper, fruit and nuts, the sole exception being the compensated trade of the Mercosur automotive industry, which largely accounts for Argentina's increased competitiveness (table 5). Mexico and the Caribbean Basin, on the other hand, specialize in non-natural resource-based manufactures such as motor vehicles, electronics and wearing apparel. Where international competitiveness is concerned, they are two different worlds.

Brazil, an economy of continental proportions, merits special consideration. The domestic market has traditionally been very important for the strategic decision-making of companies located in the country, but other factors would suggest that Brazil's lack of

TABLE 4
World market share, 1985-1998
(Percentages)

Country	1985	1998	Difference
Mexico	1.55	2.24	0.69
Argentina	0.37	0.51	0.14
Chile	0.23	0.32	0.09
Costa Rica	0.07	0.10	0.03
Guatemala	0.06	0.08	0.02
Honduras	0.05	0.07	0.02
Dominican Republic	0.08	0.10	0.02
El Salvador	0.04	0.05	0.01
Colombia	0.24	0.24	0.00
Paraguay	0.03	0.03	0.00
Nicaragua	0.02	0.02	0.00
Jamaica	0.04	0.04	0.00
Uruguay	0.07	0.06	–0.01
Cuba	0.03	0.02	–0.01
Guyana	0.02	0.01	–0.01
Suriname	0.02	0.01	–0.01
Bolivia	0.04	0.02	–0.02
Barbados	0.02	0.00	–0.02
Haiti	0.03	0.01	–0.02
Peru	0.17	0.12	–0.05
Panama	0.10	0.05	–0.05
Ecuador	0.17	0.11	–0.06
Trinidad and Tobago	0.10	0.04	–0.06
Venezuela	0.66	0.41	–0.25
Brazil	1.37	1.01	–0.36

Source: The authors, on the basis of the CAN 2000 software.

[5] The differing importance of Mercosur in the two cases is illustrated by the fact that Argentina's share of industrialized country markets fell from 0.31% to 0.22% in 1985-1998, while Chile's rose from 0.21% to 0.26%.

[6] This has been described in Reinhardt and Peres (2000) as the existence of two different international trading styles "north and south of the Panama canal".

TABLE 5

South America: Competitiveness in world imports, 1985-1998
(*Percentages*)

	A	B	1985	1990	1995	1998
I. Market share			**3.34**	**2.74**	**2.73**	**2.81**
1. Natural resources[a]			7.12	7.59	8.93	10.03
2. Manufactures based on natural resources[b]			5.03	4.33	4.55	4.59
3. Manufactures not based on natural resources[c]			1.21	1.13	1.11	1.17
– Low-technology[d]			1.93	1.73	1.66	1.53
– Medium-technology[e]			1.16	1.18	1.32	1.51
– High-technology[f]			0.45	0.35	0.28	0.38
4. Others[g]			2.08	1.14	1.33	1.42
II. Export structure			**100.0**	**100.0**	**100.0**	**100.0**
1. Natural resources[a]			49.2	44.3	43.6	44.0
2. Manufactures based on natural resources[b]			29.2	28.3	27.6	25.7
3. Manufactures not based on natural resources[c]			19.7	26.0	27.1	28.5
– Low-technology[d]			8.2	10.6	10.1	9.0
– Medium-technology[e]			9.9	13.5	15.1	16.7
– High-technology[f]			1.6	1.9	2.0	2.8
4. Others[g]			1.9	1.4	1.7	1.8
III. Ten leading exports by contribution[h]	**A**	**B**	**52.3**	**44.6**	**40.8**	41.1
333 Petroleum oils, crude		+	12.3	10.0	11.2	11.1
081 Feeding stuff for animals (not including unmilled cereals)		+	4.4	4.4	4.7	4.3
334 Products derived from petroleum, refined		–	10.7	7.2	4.4	4.3
071 Coffee and coffee substitutes		–	9.9	4.6	4.1	4.1
682 Copper		–	3.2	4.5	3.7	3.6
057 Fruit and nuts (not including oil nuts), fresh or dried		+	2.9	3.9	3.6	3.6
281 Iron ore and concentrates		+	4.1	4.4	3.3	3.1
222 Oil seeds and oleaginous fruits		+	2.2	2.4	2.1	2.5
781 Passenger motor vehicles		+	0.6	0.7	1.2	2.3
287 Ores and concentrates of base metals		+	2.1	2.4	2.4	2.3

Source: The authors, on the basis of the CAN 2000 software. The product groups are based on the Standard International Trade Classification (SITC, revision 2).

[a] Contains 45 basic products that are simple to process, includes concentrates.
[b] Contains 65 items: 35 agricultural/forestry groups and 30 others (mainly metals, excluding steel, plus petroleum products, cement, glass, etc.).
[c] Contains 120 groups representing the sum of [d] + [e] + [f].
[d] Contains 44 items: 20 groups from the textile and garment category, plus 24 others (paper products, glass and steel, jewellery).
[e] Contains 58 items: five groups from the automotive industry, 22 from the processing industry and 31 from the engineering industry.
[f] Contains 18 items: 11 groups from the electronics category, plus another seven (pharmaceutical products, turbines, aircraft, instruments).
[g] Contains nine unclassified groups (mainly from section 9).
[h] In column A: groups belonging (*) to the 50 most dynamic in world imports, 1985-1998. In column B: groups where South America gained (+) or lost (-) world import market share, 1985-1998.

international competitiveness is worrying even from that point of view. For more than a decade, the country's overriding policy objective has been to increase its penetration of the world market. The results are not encouraging. Although some activities with a high technological content have been added to the country's exports (aircraft, cellular telephones, computers), their proportion of total exports is still small, and there is no sign of it being able to rise significantly in the short term (Miranda, 2000). Again, Brazil's long-term competitiveness indicators have declined, indicating a weakening in its international position that cannot be attributed to the size of its economy.

The countries of South America have failed to enhance their international competitiveness because they have only a small presence in dynamic manufactures, whether produced by local companies (as occurred in Japan, the Republic of Korea and Taiwan) or by transnational enterprises' IIPS. They have been unable to attract this kind of FDI, and are thus at a

TABLE 6

Mexico and the Caribbean Basin: Competitiveness in world imports, 1985-1998
(*Percentages*)

	A	B	1985	1990	1995	1998
I. Market share			**2.13**	**1.73**	**2.21**	**2.80**
1. Natural resources[a]			5.01	3.61	3.31	3.69
2. Manufactures based on natural resources[b]			1.43	1.15	1.30	1.53
3. Manufactures not based on natural resources[c]			1.17	1.41	2.22	2.95
– Low-technology[d]			1.06	1.44	2.40	3.40
– Medium-technology[e]			1.09	1.43	2.35	2.97
– High-technology[f]			1.50	1.34	1.84	2.55
4. Others[g]			1.83	1.84	2.18	2.60
II. Export structure			**100.0**	**100.0**	**100.0**	**100.0**
1. Natural resources[a]			54.4	33.3	20.0	16.2
2. Manufactures based on natural resources[b]			13.1	11.9	9.7	8.6
3. Manufactures not based on natural resources[c]			29.9	51.3	66.9	71.9
– Low-technology[d]			7.1	13.8	18.0	20.1
– Medium-technology[e]			14.6	25.7	33.1	32.8
– High-technology[f]			8.2	8.0	15.8	19.0
4. Others[g]			2.7	3.6	3.4	3.3
III. Ten leading exports by contribution[h]	**A**	**B**	**43.3**	**36.2**	**37.0**	**38.9**
781 Passenger motor vehicles		+	0.6	4.4	7.6	7.5
333 Petroleum oils, crude		–	33.2	15.6	7.6	6.2
773 Equipment for distributing electricity	*	+	1.8	3.3	3.8	3.9
846 Clothing accessories, knitted or crocheted	*	+	0.6	1.2	2.4	3.2
761 Television receivers	*	+	0.4	1.8	2.7	3.2
764 Telecommunications equipment and parts and accessories	*	–	2.4	2.2	2.9	3.2
752 Automatic data processing machines	*	+	0.1	1.3	1.9	3.1
782 Motor vehicles for the transport of goods		+	0.4	0.4	2.2	2.9
931 Special transactions and commodities not classified according to kind	*	+	1.9	2.9	2.8	2.8
784 Parts and accessories for motor vehicles		+	1.9	3.1	3.0	2.8

Source: The authors, on the basis of the CAN 2000 software. The product groups are based on the Standard International Trade Classification (SITC, revision 2).

[a] Contains 45 basic products that are simple to process, includes concentrates.
[b] Contains 65 items: 35 agricultural/forestry groups and 30 others (mainly metals, excluding steel, plus petroleum products, cement, glass, etc.).
[c] Contains 120 groups representing the sum of [d] + [e] + [f].
[d] Contains 44 items: 20 groups from the textile and garment category, plus 24 others (paper products, glass and steel, jewellery).
[e] Contains 58 items: five groups from the automotive industry, 22 from the processing industry and 31 from the engineering industry.
[f] Contains 18 items: 11 groups from the electronics category, plus another seven (pharmaceutical products, turbines, aircraft, instruments).
[g] Contains nine unclassified groups (mainly from section 9).
[h] In column A: groups belonging (*) to the 50 most dynamic in world imports, 1985-1998. In column B: groups where Mexico and the Caribbean Basin gained (+) or lost (-) world import market share, 1985-1998.

disadvantage to countries that have done so, such as China, Malaysia, Singapore and Thailand in Asia, Ireland and Spain in Europe, and even Mexico. In other words, South America has not been a magnet for FDI by the transnational companies that are developing IIPS to increase the efficiency of their operations. They have been able to attract FDI from transnational companies seeking to enter national markets for services (telecommunications,[7] electricity distribution, financial services), but these activities, while they may have a positive effect on the systemic competitiveness of the beneficiary countries, do not have a direct impact on their international market share.

[7] See ECLAC (forthcoming), chapter IV.

The case of Mexico and the Caribbean Basin is completely different (table 6). These countries have made great progress with their international competitiveness; this success, however, has not acted as an engine for growth in their economies, as has been the case in a number of Asian countries.

The ability of the Caribbean Basin to compete rests essentially on a single industry, wearing apparel or garments, and on a single market, the United States. During the period 1980-2000, many Caribbean countries took advantage of the new opportunities for exporting garments to the United States market that arose because of a production sharing mechanism[8] allowing greater access to that market with low tariffs and higher quotas for countries that assembled garments using United States inputs. Production sharing brought few benefits to the assembling countries since not only did this mechanism penalize the inclusion of local inputs, but the countries involved had little say in how the mechanism was used and tended to become embroiled in incentive wars to attract FDI from transnational enterprises (Mortimore and Peres, 1998). Ultimately, the system hindered efforts to create a local industry based on domestic inputs (Mortimore, 1999).

The experience of Mexico was similar to that of the Caribbean Basin, as production sharing was the key to the improvement in the country's international competitiveness. In this case, however, the product range extended beyond garments to include the electronics and automotive industries, with some of the world's largest transnational companies in these industries carrying out their international operations in Mexico (Dussel, 1999 and 2000). The initiative that set the Mexican experience apart from the Caribbean one was the North American Free Trade Agreement (NAFTA) (Mortimore, Buitelaar and Bonifaz, 2000), as a result of which Mexico not only obtained more favourable access to the North American market, but benefited from the application of the rules of origin which operate within that integration system. Investing companies have to comply with those rules for their output to be regarded as being of North American origin (Mortimore, 1998d and Calderón, Mortimore and Peres, 1996).[9]

Mexico has been one of the great gainers in terms of international competitiveness, something that has translated into the establishment of modern plants and a boost to the Mexican economy in certain internationalizing industries, such as the automotive, electronics and wearing apparel industries. Mexican export success has not resulted in balanced development and sustained economic growth. Two parallel economies exist side by side in the country: a modern one, whose growth is based on exports to the North American market, and a traditional one, based on agriculture and other undynamic activities. The linkages between the two economies are unsatisfactory and there is little integration between the modern economy and the rest of the national economy, which imports many of its inputs and draws its dynamism from abroad.

III

The structure and behaviour of economic agents

1. The transnationalization of the Latin American economies

The globalization process is clearly revealed by the preponderance of transnational companies. It is calculated that these companies account for three quarters of all FDI movements and two thirds of international trade (one third in the form of intra-company operations and one third in the form of trade with unrelated companies). Flows of FDI increased enormously in the 1990s to exceed US$ 850 billion in 1999, more than double the average for the period 1990-1996. The FDI going to developing countries thus grew

[8] The nature and effects of the production sharing mechanism are explained in greater detail in ECLAC (2000), chapter IV.

[9] A detailed analysis of the Mexican case can be found in ECLAC (2000), chapter II.

more strongly, becoming the main source of long-term financing (World Bank, 1999).[10]

These large FDI flows are due to the international expansion of transnational companies, and reveal the growing presence and importance of these companies in the emerging single market. Investment of this type has two main uses: the purchase of existing assets in the form of mergers and acquisitions,[11] and the creation of new assets in the form of IIPS. It is estimated that half of all the investment that arrived in Latin America in the 1990s went on purchasing existing assets. The result of the whole process has been to strengthen the strategic importance of transnational companies in the region's countries (ECLAC, 1998 and 2000 and Stumpo, 1998).

Mergers and acquisitions were of particular importance in the FDI going to Latin America in the 1990s, when the region increased its share in the world total of operations of this kind so that in 1999 it accounted for 13.5% by value. Estimates by Mendes de Paula, Pereira Silva and Couto da Silva (2000), based on 1,685 transactions for which *Thomson Financial Securities Data* gives values (out of a total of 3,291), show that foreign companies accounted for 53.6% of all mergers and acquisitions in Argentina, Brazil, Chile and Mexico in 1990-1999.[12] This share was particularly high in Argentina and Chile, where it exceeded 60%. The exception was Mexico, where domestic firms played a very active role in privatizations of public-sector enterprises, and took and retained control of the largest privatized firm (Teléfonos de México, or Telmex, acquired by Carso Group).

Domestic companies also participated in the mergers and acquisitions process, carrying out operations to the value of US$ 135.3 billion. The information available shows, however, particularly in the cases of Argentina and Mexico, that after an initial stage in the early 1990s when the main buyers of privatized enterprises were local companies or investors, ownership was restructured in such a way that foreign companies or investors took control of the formerly State-owned enterprises. Two cases whose scale makes them particularly important are those of commercial banking in Mexico and public services, including telephony, in Argentina (Garrido, 2000 and Kulfas, 2000). In both cases, privatized companies acquired by local investors in the first half of the 1990s were sold on to foreign partners or investors in the second half of the decade.

In sectoral terms, the situation in the four countries referred to varied greatly depending on the macroeconomic circumstances, the time of privatization and the economic structure of each country. For the four countries taken together, 35% by value of all operations took place in the infrastructure sectors (including telecommunications and electrical energy), 19% in the financial sector and 17% in manufacturing industry. Operations in the infrastructure and financial sectors exceeded those in industry in all the countries except Brazil, where industry accounted for 22% of the total value of operations, this being the result of privatizations in the iron and steel and petrochemical industries in the early 1990s (Mendes de Paula, Pereira Silva and Couto da Silva, 2000). In Argentina, on the other hand, acquisitions in the oil sector predominated, exceeding by a wide margin those carried out in communications, banking and food and drink (Kulfas, 2000).

The large net inflows of FDI into Latin America –unthinkable just a few years previously– had major effects on the economic structure of the region, with the main economic agents becoming transnationalized. One consequence of the globalization process and economic reforms in Latin America was the strengthening of foreign companies and the weakening of State ones, especially in the latter years. During the 1990s, transnational enterprises increased their activity in Latin America, consolidating their penetration of the manufacturing sector –particularly in the automotive industry (Mortimore, 1998a and 1998b)– and increasing their share of regional exports. In the service sector, they took advantage of liberalization, deregulation and privatization to enter areas where FDI had previously had only limited access. In the ranks of the region's largest firms, the rise in the number of transnationals coincided with the near disappearance of State-owned enterprises, while the number of locally owned private-sector companies remained virtually unchanged (ECLAC, 2000).

Further evidence of the transnationalization process in Latin America is provided by the constant rise of FDI-related indicators. Net inflows increased twelvefold between 1980 and 1998. Compared with gross fixed

[10] To the extent of 56.4% in 1998, as compared with 24.3% in 1990 (World Bank, 1999).

[11] In the industrial countries there are many merger operations whereby two firms are fused into one, as well as acquisitions of one firm by another. In the rest of the world, mergers are scarce, and acquisitions are the most common type of operation.

[12] These four countries received 75% of all FDI of this type arriving in the region.

TABLE 7

Latin America: Results of the leading companies in the 1990s
(Percentages)

Share in	1990-1992	1994-1996[a]	1998-1999
Sales of the 500 largest companies			
Foreign	27.4	32.1	43.7
Local private-sector	39.4	41.0	37.2
State-owned	33.2	26.9	19.1
Total	*100.0*	*100.0*	*100.0*
Sales of the 100 largest manufacturing companies			
Foreign	53.2	59.3	61.7
Local private-sector	42.6	38.6	37.3
State-owned	4.2	2.1	1.2
Total	*100.0*	*100.0*	*100.0*
Exports of the 200 largest exporters			
Foreign	...	29.2	43.2
Local private-sector	...	35.9	32.7
State-owned	...	34.9	24.1
Total	...	*100.0*	*100.0*

Source: Information Centre of the Unit on Investment and Corporate Strategies, ECLAC.

[a] The export data are averages for 1995-1996.

capital formation and GDP, these inflows grew more than fourfold. Again, more than half of the total stock of FDI in Latin America as of 1998 had arrived in the region during that same decade. In short, a major process of transnationalization took place in the region, and transnational companies became the dominant economic agents of the 1990s.

2. Changes in corporate structure and strategy

a) *The advance of transnationals*

Between 1990-1992 and 1998-1999, the best performance among the 500 largest companies in Latin America, measured by consolidated sales, was that achieved by the subsidiaries of transnational enterprises. The number of foreign firms in the list increased from 149 to 230 and their share of total sales rose from 27.4% to 43%. By contrast, the number of State-owned enterprises fell from 87 to 64 and their share of sales fell from 33.2% to 18.8% (table 7).

As regards the activities of these 500 companies, the most important changes took place in extractive and service businesses. The sales share of the primary sector fell from 27.7% to 19.3%, while that of the service sector rose from 29.9% to 38%. Manufacturing companies retained their dominant share of some 42% of total sales. The strong and steady growth of services is largely due to the liberalization of telecommunications and electricity and the privatization of the public-sector companies that supplied these services.

Changes among the 100 largest manufacturing companies were also considerable. Between 1990-1992 and 1998-1999, the share of sales accounted for by subsidiaries of transnational enterprises rose from 53.2% to 62.7%, while that of domestic private-sector companies fell from 42.6% to 37.3%. State-owned enterprises virtually disappeared from the equation. About half of all sales by foreign companies were in the motor vehicles and parts subsector, which indicates that the impact of transnational companies in the Latin American industrialization process has been concentrated in this area, primarily in Argentina, Brazil and Mexico.

In exports, the area where international competitiveness is most clearly reflected, transnational companies increased their share in the total exports of the region's 200 largest exporters from 29.2% in 1990-1992 to 43.2% in 1998-1999; at the same time, the share of domestic private-sector and State-owned companies declined. These 200 large companies had annual exports of US$ 134.9 billion in 1997-1999, or 47% of the region's total exports by value.

TABLE 8

Latin America: Twenty largest exporters, 1999
(Millions of dollars)

Company	Ownership	Activity	Exports
1. Petróleos de Venezuela (PDVSA)	State	Extraction of crude oil and natural gas. Refining and petrochemicals.	16 299
2. Petróleos Mexicanos (PEMEX)	State	Extraction of crude oil and natural gas. Refining and petrochemicals.	9 914
3. General Motors Mexico	Foreign	Production of motor vehicles.	5 050
4. Volkswagen Mexico	Foreign	Production of motor vehicles.	5 040
5. Chrysler Mexico	Foreign	Production of motor vehicles.	3 792
6. IBM Mexico	Foreign	Production of information technology, office and accounting machinery.	3 000
7. Cementos Mexicanos (CEMEX)	Local private-sector	Cement production.	2 665
8. Corporación Nacional del Cobre Chile (CODELCO)	State	Extraction of metal ores (copper).	2 501
9. Ford Mexico	Foreign	Production of motor vehicles.	2 330
10. Empresa Colombiana de Petróleos (ECOPETROL)	State	Extraction of crude oil and natural gas. Refining and petrochemicals.	2 170
11. Empresa Brasileira de Aeronáutica (EMBRAER)	Local private-sector	Aircraft production.	1 692
12. Nissan Mexico	Foreign	Production of motor vehicles.	1 586
13. Companhia Vale do Rio Doce (CVRD) (Brazil)	Local private-sector	Mining, cellulose, aluminium, transport.	1 542
14. Yacimientos Petrolíferos Fiscales (YPF) (Argentina)	Foreign	Extraction of crude oil and natural gas. Refining.	1 436
15. Fed. Nac. de Cafeteros (FEDECAFE) (Colombia)	Local private-sector	Coffee marketing.	1 418
16. Odebrecht (Brazil)	Local private-sector	Construction and engineering. Chemicals and petrochemicals. Cellulose.	1 317
17. CINTRA (Aeroméxico and Mexicana de Aviación)	Local private-sector	Air transportation of passengers and goods and allied services.	1 185
18. Philips (Mexico)	Foreign	Production of radio, television and communications equipment and apparatus.	1 095
19. Cargill Argentina	Foreign	Inputs for the agricultural sector. Ingredients for the food industry.	1 084
20. GRUMA-Grupo Maseca (Mexico)	Local private-sector	Manufacture of food products (maize flour and tortillas).	1 047

Source: Information Centre of the Unit on Investment and Corporate Strategies, ECLAC.

Table 8 lists the exporting companies in the region that had more than US$ 1 billion in foreign sales in 1999. Of the 20 companies in the list, which had US$ 66.2 billion in exports between them,[13] nine were local private-sector firms, seven were foreign and four were State-owned; foreign companies held five of the top 10 places, along with four State-owned companies and just one local private-sector one (Cemex). Only one local private-sector company is active in an area that is not directly linked with the extraction or processing of natural resources: Empresa Brasileira de Aeronáutica (Embraer), an aircraft manufacturer, which ranks eleventh in the list.

The fact that State enterprises still account for a quarter of all exports by the 200 largest exporters (table 7) shows that privatization has come up against limits in the region, something that is often forgotten. In particular, the region's two largest exporters are Petróleos de Venezuela (PDVSA) and Petróleos Mexicanos (Pemex), while the 10 largest also include the Corporación Nacional del Cobre (Codelco) of Chile and the Empresa Colombiana de Petróleos (Ecopetrol).

Combining the information from tables 7 and 8 makes it possible to study the strategies and performance of large companies, particularly transnational and local private-sector ones. Analysis of the impact of State enterprises is beyond the scope of this work, but could appropriately be carried out in studies on the oil sector and, to a lesser extent, copper mining.[14]

[13] This figure represents approximately half of all exports by the 200 largest exporters and a quarter of the region's total exports.

[14] Small and medium-sized enterprises, although they have made progress with exporting, still account for only a very small percentage, as almost all their output goes to domestic markets (Peres and Stumpo, 2000).

TABLE 9

Latin America: The strategies of transnational companies in the region in the 1990s

Sector \ Strategy	Efficiency-seeking	Raw materials-seeking	Market access-seeking (national or regional)
Primary		*Oil/gas*: Argentina, Bolivia, Brazil, Colombia and Venezuela *Minerals*: Argentina, Chile and Peru	
Manufactures	*Vehicles*: Mexico *Electronics*: Mexico and Caribbean Basin *Garments*: Mexico and Caribbean Basin		*Vehicles*: Mercosur *Agroindustry*: Argentina, Brazil and Mexico *Chemicals*: Brazil *Cement*: Colombia, Dominican Rep. and Venezuela
Services			*Finance*: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela *Telecommunications*: Argentina, Brazil, Chile and Peru *Retail*: Argentina, Brazil, Chile and Mexico *Electricity*: Argentina, Brazil, Chile, Colombia and Central America *Gas distribution*: Argentina, Brazil, Chile and Colombia *Tourism*: Mexico and Caribbean Basin

Source: ECLAC, Division of Production, Productivity and Management, Unit on Investment and Corporate Strategies.

In manufacturing, the direction of international markets and the renewed patterns of competition resulting from trade and financial liberalization aroused the interest of new entrants and forced transnational companies already operating in the region to reconsider their strategies. Macroeconomic stabilization and structural reform programmes meant a radical shift in the macroeconomic variables of the region's economies (exchange rates, interest rates) and in the institutions and regulatory frameworks applying to economic agents (Katz, 2000 and Stallings and Peres, 2000).

Some transnational companies withdrew (opting in some cases to supply local markets through exports), or rationalized their operations to defend or increase their market share (generally by means of defensive strategies designed to cope with competition from exports), or restructured their activities, which involved making new investments that took particular account of changes in the national, subregional (NAFTA and Mercosur) and international environments (Mortimore, 2000). In manufacturing industry it is possible to identify two sets of basic strategies, the objectives of which, respectively, are to increase the efficiency of the IIPS created by transnational companies and to obtain access to national and subregional markets for manufactured goods (table 9).

The first strategy has mainly involved investing in the motor vehicle and vehicle parts, information technology, electronics and wearing apparel industries in Mexico and the Caribbean.[15] The second has involved large investments in the automotive and food subsectors and in the chemical and machinery industries to supply local markets. In Mercosur, particularly, investments have been made by companies with a large presence to defend their market share, particularly for compact cars.[16] New entrants have also arrived in search of market niches.[17]

[15] The most representative examples in the automotive industry are the operations of General Motors, Ford, Daimler-Chrysler, Volkswagen, Nissan and Lear Corp., in Mexico. In the area of information technology, the largest investments are those of IBM and Hewlett Packard in Mexico and Intel in Costa Rica. The operations of Sony, Philips, Samsung, Matsushita and General Electric in Mexico illustrate what is happening in the electronics industry. As regards wearing apparel, the best examples are provided by Sara Lee and Fruit of the Loom in Mexico and the Caribbean Basin.

[16] For example, Ford, General Motors, Volkswagen and Fiat.

[17] This is the case with Chrysler, Renault, BMW, Toyota and Honda.

Meanwhile, deregulation and privatization in the Latin American economies have opened up new investment opportunities in sectors to which access was previously restricted for the private sector in general, and foreign companies in particular. This has led to a massive influx of companies that did not previously have a large presence in Latin America, especially in the areas of services, infrastructure and extraction. Two further strategies can thus be identified: foreign investors in the region are seeking access to national markets in service and infrastructure sectors, and access to sources of raw materials.

In service businesses, the size of the local market, regulatory systems and technological change have been determining factors in the decisions made by foreign investors. Their impact is measured by their contribution to the systemic competitiveness of the economy, the access to new products and services they give the population, and the spread of international best practice. This is of the greatest importance to Latin America and the Caribbean, as in recent years investment in the service sector has grown considerably, the prime examples being telecommunications, financial services and electricity, particularly in Mercosur and Chile.[18]

The entry of transnational companies into extractive activities has been characterized by renewal of the production organization model, the application of new technologies and the reform of regulatory systems in countries that have abundant natural resources.[19] In general, the impact of these investments, which tend to benefit from very favourable tax waivers, has been measured by the extent to which exports of natural resources have increased and to which the necessary infrastructure has been constructed.[20]

Of the strategies adopted by transnational enterprises, two have a direct influence on a country's trade performance: the search for raw materials, and efficiency-seeking. The search for raw materials has been a very important strategy, and still is for the countries that are invested in, even though primary products are not a very dynamic component of international trade. Foreign direct investment plays an important role in decisions on major projects relating to natural resources for export; but these projects come up against natural constraints, and their impact on the economic growth of a developing country has clear limitations. The development theory that deals with these issues states that, ultimately, the production of raw materials yields decreasing returns and displays low income elasticity in international trade.[21]

Efficiency-seeking is a strategy of growing importance to developing countries. In pursuit of efficiency, some industries have been relocated on a large scale, examples being the wearing apparel, automotive and electronics industries, with a view to taking advantage of lower assembly or production costs in particular places (UNCTAD, 2000). Manufacturing companies are investing outside their countries of origin to build IIPS and thereby adapt to the globalization process. Consequently, large transnational companies are setting up specialized modern plants in certain countries where they can produce more cheaply without losing access to their main markets. It is here that domestic policies in developing countries can have an effect by influencing the siting of FDI and thus the generation of the technology flows that come with such investment.

b) *Specialization by locally owned groups*

Large locally owned private-sector groups and companies[22] have a strong position in Latin American markets, owing to processes that have occurred as part of the structural changes seen since the early 1980s in national economies and internationally. These large local groups and companies, along with the subsidiaries of transnational enterprises, are the largest and most dynamic business units operating in the region's

[18] In telecommunications, the investments of Telefónica of Spain, Italia Telecom and BellSouth. In financial services, Banco Santander Central Hispano (BSCH), Banco Bilbao Vizcaya Argentaria (BBVA) and Citibank. In commerce, Carrefour, Wal-Mart, Royal Ahold and Groupe Casino Guichard. In electrical power, the leading operations are those of Endesa España, AES Corporation and Duke Energy.

[19] See ECLAC (forthcoming), chapter II.

[20] The leading companies involved include Repsol, Royal Dutch Shell, Exxon and Broken Hill Proprietary.

[21] Economic expansion derives from two sources: the increase in factors of production and the increase in production per factor unit. Where returns are decreasing, there is a limit to what growth can be achieved through greater utilization of factors of production, which means that efficiency needs to be improved if sustainable per capita income growth is to be generated (Krugman, 1994).

[22] Although the distinction should be drawn whenever reference is made to large companies and the businesses concerned are actually groups or conglomerates, the total number of large, independent locally owned companies in the region is very small. Most large companies form part of formal or informal groups, as different laws or investor practices dictate. This section has been based largely on Garrido and Peres (1998), and on the analyses of national cases included in Peres (coord., 1998).

industry. This shared dominance has tended to consolidate since most State companies were privatized.

The competitive position of these firms is jeopardized by their own structural characteristics, in particular their small size as compared with their international competitors and their position in technologically mature sectors that are growing relatively slowly in the world market.[23] They have not grown strongly enough to draw the rest of their national economies along with them, which means it is difficult to regard their position in the competition as one of real leadership.

The great majority of the large locally owned private-sector groups and companies that now hold a prominent place in Latin American business were created during the import substitution industrialization process,[24] although some companies date back to the early twentieth century, when industrialization began in the region's more advanced countries.[25] Alongside those companies founded before and during the import substitution process are some new ones, a number of them very powerful, which were founded or developed during the structural reforms carried out from the 1980s onward. These new organizations have emerged both from the privatization of traditional businesses (Enersis in Chile, subsequently sold to Endesa España) and from dynamic conglomeration processes based on a portfolio logic (the Carso group in Mexico).

One characteristic of these companies that is essential to any evaluation of their impact on the competitiveness of the region's countries is the sector of activity they operate in, and the influence they exert there. Garrido and Peres (1998), who studied the five largest companies in 19 industrial sectors in 1996, highlight the concentration of Latin American industry. The 83 companies (local and foreign) that featured among the five largest in each sector had sales of US$ 122 billion and accounted for almost 780,000 jobs in 1996, a year in which the gross industrial output of the region was some US$ 750 billion, with industrial employment standing at about 8.5 million people.[26] Local companies had a share of 39.8% in the total sales of this group.

The sectors in which the sales of the five largest local firms predominated (over 66% of the total) were traditional activities involving the production of mass consumption goods or basic inputs (non-alcoholic drinks and beer, glass, petrochemicals, steel, textiles, agro-industrial products, cement, and cellulose and paper), and one metallurgical industry, the production of car parts. While domestic companies had an intermediate share (between 30% and 66% of the total) in foods, machinery and equipment[27] and white goods and electronics, this share was very low or nil in certain highly technology- and marketing-intensive sectors, such as motor vehicles, computer and telephony equipment, tyres, chemicals, hygiene and cleaning items and tobacco products.

Although privatization has enabled locally owned private-sector companies to enter modern areas outside the industrial sector (one example being telecommunications, where they have had to go into partnership with large transnational firms to cope with the intense competition that exists),[28] they have not secured a major share in technologically advanced manufacturing activities at the international level.[29] This appreciation is confirmed by information on the 20 largest locally owned private-sector companies (industrial and non-industrial) in 1999 (table 10).

[23] Among the 100 largest industrial enterprises, Garrido and Peres (1998) show that, while large local companies increased their sales from an average of US$ 827 million apiece in 1990 to US$ 1.345 billion in 1996, they are still smaller than the subsidiaries of foreign firms (US$ 1.879 billion). Furthermore, the sales of these large local companies often do not amount to so much as 10% of those of the international enterprises they compete with.

[24] The proportion of the largest companies of today that were created or saw their peak development during the import substitution phase is strikingly large. By the end of the 1970s they already held a position as important as they do today, examples being Votorantim in Brazil, Acindar in Argentina and the Compañía de Acero del Pacífico in Chile, although they have all had to carry out profound restructuring to maintain their position.

[25] Bunge y Born in Argentina, Alpargatas in Argentina and Brazil, the core of Grupo Monterrey in Mexico, Bavaria in Colombia and the Compañía de Cervecerías Unidas in Chile, among others.

[26] This employment figure does not include microenterprises.

[27] Essentially because of the output of Condumex, a Mexican firm producing electrical conductors.

[28] In some cases, these groups have since sold on the privatized firms to foreign partners or investors.

[29] The cases where groups have entered advanced-technology industries have been very few, the most noteworthy being the investments made by Grupo Pulsar (Mexico) in biotechnology and some stakes, often short-lived, held by Brazilian groups in joint ventures for the development of software, computer equipment or consumer electronics, mainly while the reserved market policy was in force (Itautec Philco, Semp Toshiba, Sharp, NEC, CCE da Amazónia, for example). Of the 46 large companies studied in detail in Garrido and Peres (1998), just one (Sonda, Chile) could be regarded as specializing in one of the technologies characteristic of the current technological revolution (software production).

TABLE 10

Latin America: Twenty largest local private-sector companies, by 1999 sales

(Millions of dollars and number of employees)

Company	Country	Activity	Sales	Employees	Exports
1. Carso Global Telecom (TELMEX)[a]	Mexico	Telecommunications	10 242	73 321	930
2. Cementos Mexicanos (CEMEX)	Mexico	Cement	4 826	20 902	2 665
3. Grupo Carso	Mexico	Diversified (electrical components, services)	4 272	42 810	600
4. Grupo Alfa	Mexico	Diversified (petrochemicals, steel)	4 240	35 615	957
5. Fomento Económico Mexicano (FEMSA)	Mexico	Beer and non-alcoholic drinks	4 060	41 367	554
6. Companhia Vale do Rio Doce (CVRD)	Brazil	Extraction of metal ores	3 901	10 740	1 542
7. Tele Norte-Leste Participações (TELEMAR)	Brazil	Telecommunications	3 478	...	...
8. Techint organization	Argentina	Iron and steel, construction	3 407	28 461	647
9. Compañía de Petróleos de Chile (COPEC)	Chile	Extraction of crude oil and natural gas and allied services	3 169	8 076	854
10. Companhia Brasileira de Petróleo Ipiranga	Brazil	Extraction of crude oil and natural gas and allied services	3 106	1 643	...
11. Bimbo Industrial Group	Mexico	Manufacture of food products	3 026	63 371	965
12. Controladora Comercial Mexicana	Mexico	Wholesale trade	2 855	30 093	...
13. Grupo Votorantim	Brazil	Manufacture of non-metallic mineral products	2 815	...	...
14. Vitro	Mexico	Glass manufacturing	2 720	32 535	749
15. Savia	Mexico	Manufacture of food products and drinks	2 664	18 683	794
16. Viação Aérea Rio-Grandense (VARIG)	Brazil	Air transportation	2 486	15 600	170
17. Grupo Desc	Mexico	Diversified (petrochemicals, vehicle parts)	2 444	20 878	993
18. Grupo Gigante	Mexico	Wholesale trade	2 414	33 445	15
19. Soriana organization	Mexico	Wholesale trade	2 169	29 985	...
20. Grupo Televisa	Mexico	Entertainment, television	1 889	...	...

Source: Information Centre of the Unit on Investment and Corporate Strategies, ECLAC.

[a] Telcel exports.

Table 10 highlights three circumstances: firstly, the strong presence of Mexican firms, which have 13 places in the list, followed by five Brazilian firms, one Chilean one and just one Argentine one (the showing of Brazil, and even more so that of Argentina, is weak by comparison with the size of their economies); secondly, the continued predominance of the activities pointed to by Garrido and Peres (1998), to which may now be added telecommunications companies in Brazil and Mexico, large-scale retail trade, air transportation and activities linked to mining and the petroleum sector; and, lastly, the main exporters in the group are to be found in mining (CVRD), cement (Cemex), petroleum and petrochemicals (Alfa, Copec) and foods (Bimbo). In short, the latest information shows no change in the situation: companies specializing in mature-technology sectors, closely linked with the processing of natural resources.

Sectoral specialization in relatively homogeneous goods offering large economies of scale but produced by companies that are small compared to their main competitors lends a certain vulnerability to the competitive position of local private-sector companies. Protectionism meant that some of these sectors specialized in virtually untradable products, so that their performance depended entirely on the domestic market. As economies opened up, these sectors were increasingly confronted with competitors of global stature, whose power grew as their numbers shrank. As a result, local private-sector companies have lost the stability they enjoyed as leaders in these traditional sectors, and are now faced with the challenge of either growing or being absorbed by large international firms.

To complete this profile of local private-sector companies, it is necessary to describe the relationships they have established between their domestic markets and the international one. Their reaction to external competition, apart from the different strategies they followed to defend segments of their domestic markets, has been to branch out into non-traditional exports with the aim of extending their markets beyond the country, either within their historical regional ambits or in those they have developed as a result of integration, and even into the great markets of the industrialized countries.

Of the 41 domestic firms that belonged in 1996 to the top five in 19 industrial sectors, as examined in Peres (coord., 1998), 37 were exporters, although the sample does not record the value of their exports in all cases.

Of the sectors where local companies predominated, exports to sales ratios were particularly high in agribusiness, cellulose and paper, steel and glass. Considering only the 24 local firms for which export data were given, the average ratio for the 19 industrial sectors was 23.6%. This percentage, although almost double the equivalent 1994 figure (13.1%), was much lower than that recorded for the foreign companies in the sample (33.9%). This result was heavily influenced by the exports of automotive firms.

One group of local private-sector companies, generally the largest, internationalized their businesses more fully, exporting not only goods but capital as well. They have carried out direct investment abroad, whether by setting up new companies, taking over existing ones, or concluding strategic alliances or mergers.

This internationalization followed two models. On the one hand, some companies sought a regional presence as trade integration consolidated, as in the case of private-sector firms operating in Mercosur or within the framework of NAFTA. The largest investments in Mercosur were made by Enersis and the Compañía Manufacturera de Papeles y Cartones (CMPC) of Chile, Brazilian car part producers, and COFAP, in Argentina. In NAFTA, the largest investments were those made by Vitro (Mexico) in the United States. Some of the most noteworthy of these efforts, which seemed to promise a growing movement towards internationalization among local private-sector companies, were not followed through, either because the companies concerned were taken over by foreign investors, as Enersis was by Endesa España, or because they withdrew from some markets where they were unable to compete efficiently, one example being Vitro and its United States subsidiary Anchor Glass, which the Mexican company had to sell seven years after acquiring it in 1989. These groups did not achieve the scale and capabilities they needed to sustain their progress.

The other type of internationalization is more complex, and involves companies setting up a coherent system of subsidiaries in a number of countries in pursuit of a common strategy. These companies seek to become international, an aspiration that is heavily influenced by the form competition takes in their industries, examples being the manufacture of cement, steel tubes, bottled refreshments and beer. The most important cases in the region are those of Cementos Mexicanos (Cemex), which has investments in the United States, Spain, South and Central America and East Asia, and Techint, an Argentine firm which is a leader in the production of seamless tubes, and which has investments in Latin America and Europe.

The strategies of local private-sector companies can be classified as retreat, defence and offence,[30] although the first of these will lead in the long run to the company going out of business, or to the original owners losing control. All three strategies are found among local private-sector firms although, because of their size, retreat tends to take the form of transfers of full ownership or majority control to external investors rather than outright closure, as happened with the Astra oil group in Argentina, the car part producer COFAP in Brazil and the two large Mexican cigarette manufacturers (Cigarros La Tabacalera Mexicana, CIGATAM and La Moderna).

Different methods have been used to defend domestic markets, the principal ones being pre-emptive investment (especially in the two largest economies), importing finished products to market them through local distribution networks, increasing and enhancing the focus on customer service (especially in the food industries), creating industrial and financial groups (in countries where the law allows this),[31] and rent-seeking in the form of efforts to secure fiscal, commercial or sectoral promotion benefits which, although they count for less now than in the past, have not entirely disappeared, as is illustrated by the cases of the automotive industry in Argentina, Brazil and Mexico, the forestry industry in Chile and the support given to a variety of industrial sectors in Colombia.

Although it involves new diversified investments, one type of defensive strategy that has found favour is a move from industrial activities to modern non-tradable

[30] Defence, of course, is not a strategy that makes much sense in the long term. In the face of increased competitive pressure and the technological revolution now in progress, a defensive strategy can only be a stage on the way to retreat or offence. Experience also shows that there is no need for an initial defensive stage, as many of the largest companies adopted an offensive strategy right from the outset of the external debt crisis. Asset restructuring (mergers and acquisitions), investments abroad and linkage with the financial sector took place throughout the 1980s, although they were combined with strategies to defend domestic market share when the opening up process came into effect.

[31] Of the region's large and medium-sized countries, Chile stands out as the one with the lowest degree of formal linkage between industry and the banking system, this being a result of the crisis experienced in the early 1980s, although some of the country's industrial groups have clear links with banks. Again, in Chile, as in Brazil, pension funds (private-sector ones in the first case, those of the great State enterprises in the second) are holding a greater and greater proportion of the largest companies' share capital. This could open up new paths towards financially based conglomeration.

services, such as telecommunications, or television and entertainment (table 10). The tendency to leave the industrial sectors is driven by the signals arising from trade liberalization and the macroeconomic policy of maintaining exchange rates that overvalue national currencies, which puts pressure on the profitability of tradable sectors. Meanwhile, opportunities to invest in non-tradable services, and the potential for benefiting from such investments, have been opened up by the deregulation of certain markets or the privileged access that some groups have been given to privatizations in the areas of telecommunications, electricity distribution and infrastructure in general.

It would seem that structural reform has not altogether done away with the rent-seeking behaviour of major business sectors since, while some non-tradable services markets are fiercely contested among strong competitors, the conditions of this competition, and thus the profitability that is ultimately achieved, depend on State regulations and the different levels of access granted to the competitors.

Offensive strategies are more complex. Firstly, there is the strategy of growth through ever-increasing specialization around the essential core of the business, which is happening in some companies whose primary activity is the processing of natural resources, such as Klabin in Brazil, Alfa in Mexico and Pérez Companc and Bunge y Born in Argentina. This last is an extreme case, in that it is withdrawing from industrial activities to its original agricultural and trading base. Also belonging to this group are companies that have not increased what has traditionally been a high level of specialization, such as Cemex in Mexico and Grupo Matte in Chile.

A second strategy is growth through a moderate increase in diversification, which may combine vertical disintegration at the individual company level with greater vertical or horizontal integration at the group level as the result of participation in a few privatizations or in mergers or acquisitions involving other private-sector companies. In all cases, achieving potential synergies is the key objective when operations of this type are undertaken. Techint and Pescarmona in Argentina, Angelini in Chile, Suzano and Votorantim in Brazil, Santo Domingo (Bavaria) in Colombia and Pulsar in Mexico are examples of this moderate strategy.

Lastly, there is the strategy of growth through extreme diversification, largely by means of participation in numerous privatizations. These cases, which give rise to true conglomerates without obvious productive, commercial or even financial synergies, are often the result of a portfolio investment approach. The most striking cases are Sociedad Comercial del Plata (energy, construction and services) in Argentina, Vicunha (textiles, iron and steel and mining) in Brazil, and Carso (telephony, electrical conductors, tyres and restaurants) in Mexico. These conglomerates engage in very diverse activities, and the vigorous development they have achieved relatively recently has been based on strong links to the international capital market, the largest domestic banks and the political authority responsible for privatization decisions. Naturally, the financial risks and the benefits hoped for are high.

In each case, the strategies adopted depend on a complex set of factors. The sectoral factor is generally important, as competitiveness, and thus the ability to compete with imports in a liberalized economy, differs from sector to sector. The same is true of a sector's maturity, which is the result of a specific learning path along which greater or lesser progress may have been made, and of the range of promotional policies applying to it, as these, although they often go unrecognized, have been important in almost all the countries (petrochemicals in Argentina, the forestry industry in Chile and the automotive industry in Brazil and Mexico are some noteworthy examples). Nonetheless, the sectoral determinant is not enough in itself to account for corporate strategies.

The caution (or boldness) of corporate leaderships, as difficult as this is to define, is an important factor in explaining what strategy is ultimately adopted. Differences in management style –which are largely independent of systemic factors– would also seem to account for the varying levels of interest shown by different groups in relation to privatizations, ranging from extremely modest participation, or none at all, to an overwhelming presence both in the country of origin and elsewhere. Of course, management style and the quest for economic power are often inseparable in operational terms.

The above information, and the national case studies carried out for the region's three largest countries (Ferraz and Iootty, 2000, for Brazil; Garrido, 2000, for Mexico and Kulfas, 2000, for Argentina), reveal not only that local companies have lost ground to transnational ones, but that their pattern of specialization in production and international trade has retained its basic characteristic, with activities associated with the production or processing of natural resources predominating, but combined with a degree of participation in certain modern non-tradable sectors, such as telecommunications and the communications

media. If any shift is occurring, it would seem to be in the direction of yet greater predominance for primary activities, something that is most evident in the case of Argentina. It is for this reason that Kulfas (2000) has indicated that locally owned groups are going through a process of "primarization", the most striking example of which is the withdrawal of Bunge y Born from industrial activities. There are exceptions to the general trend, in the form of efforts by local companies to introduce more technology-intensive activities that are better placed to compete internationally. The most noteworthy examples are the production of aircraft by Embraer and the seed biotechnology activities of Savia (Grupo Pulsar, Mexico). These cases are a minority, however, and have not yet demonstrated the ability to survive in the face of international competition.[32] The activities that are most advanced and consolidated at the world level continue to be tied to natural resources; the most striking examples are the production of cement by Cemex (Mexico) and the construction of seamless tubes by Techint (Argentina).

Considering how local private-sector companies developed during the 1990s and how the dynamic of international trade and the sectoral and technological pattern of the region's participation in the international economy have been shifting, it has to be said that local private-sector companies, powerful agents in the region's economy though they still are, are increasingly being displaced from the first ranks of business.

IV
Conclusions

The results of this research show that the region's international competitiveness has improved, but that progress has largely been confined to a few countries, sectors and firms. Increased heterogeneity in the ways the region participates in the international market, something that has been pointed out, for example, by Stallings and Peres (2000) and Katz (2000), has been one important result of the economic reforms that strengthened the role of market mechanisms in the allocation of resources, prompting greater specialization in the production structure and increased linkage of this with the outside world.

The different conditions under which the countries have engaged, through trade agreements, with different segments of the world economy have given rise, in conjunction with differences in cost advantages, to two styles of international trade participation. In Mexico and the Caribbean Basin, exports of manufactures assembled for the United States market predominate, the main concentrations being in the automotive, electronics and garment industries and most exporting being carried out by subsidiaries of efficiency-seeking transnational companies, generally within the framework of their IIPS. In South America, by contrast, natural resource production and processing activities prevail, although some more advanced manufactures, such as automobiles, are produced and traded within the region, especially within Mercosur.

Both sectoral specializations bring with them opportunities and difficulties. Specialization in assembly in *maquila* plants or free trade zones has enabled countries, including some very small and undeveloped ones, to increase their exports significantly, as a result of which they have been able to penetrate dynamic sectors of strong demand in the United States economy (which grew very vigorously during the 1990s). This specialization, however, has largely been confined to the lower value added sections of IIPS. Although there are signs of technological upgrading in Mexican *maquila* plants (so that reference is sometimes made to "third-generation *maquila*"), in the Caribbean and even in Mexico it is straightforward assembly activities that predominate.[33] Even in cases

[32] The activities of Pulsar in biotechnology and seed production began in 1997 and have gradually been tied in with the global technological research and development strategy of Monsanto (Garrido, 2000). The success of Embraer has been the result of many years of public policy support, which is coming up against increasing opposition in the context of current international trade regulations (Miranda, 2000).

[33] First-generation *maquila* industries require few or no workforce skills and give preference to volume over quality. Second-generation ones have certain requirements as regards quality and precision, use modern machinery, and generally need workers to have a secondary education. They employ modern forms of labour organization. Third-generation *maquila* industries mainly employ

where more progress has been made, extension of the full package system to the Mexican apparel sector being an example, the activities that add most value (design and marketing) remain in the hands of head offices located in the United States.

The specialization of South America in sectors associated with natural resources is neither good nor bad in itself, and it has allowed countries such as Chile to increase their share of the world market. Analysis shows, however, that these sectors are not very dynamic in international trade (the dynamic defined by their low income elasticity of demand) and generally use mature technologies. The relatively small size of the leading local firms by comparison with their global competitors has meant that a number of them have withdrawn from the market, with their assets consequently being sold off to foreign investors. The strategy of these investors has generally been to explore new markets or sources of raw materials, by contrast with the efficiency-seeking strategy that prevails north of the Panama Canal.

The fact that progress with international competitiveness has largely been confined to certain economic agents, particularly large firms, be they transnational or locally owned, has been beneficial in terms of efficiency, to judge by the rising volume of exports and the share of these in the total. As these leaders have not drawn other agents in the local economy along in their wake, however, their strength has heightened the polarization of the production structure. Massive substitution of imports for locally produced inputs has made it possible to increase efficiency and to export, but has resulted in a breakdown of production chains. As a result the rest of the economy has lagged, so that Latin America has had export growth but not export-led growth (Stallings and Peres, 2000). In short, the opportunities opened up by globalization have not been capitalized upon.

The most negative part of the regional picture is the way progress with international competitiveness has been confined to just a few countries. This would seem to suggest that other factors, such as trade agreements and methods for attracting foreign investment, have played a more important role. In this respect, as in a number of others, the reforms have been unable to achieve the objectives that were set for them.

V
Policy recommendations

There is a need to consider what policy measures can best serve to overcome the shortcomings resulting from the fact that improvements in competitiveness have largely been confined to just a few countries, sectors and firms. There are four aspects of policy that seem to be of particular importance:

i) Given the decisive role played by transnational companies in the region's exports and competitiveness, there is a need for more effective policies to attract FDI, particularly new investments, rather than investment that goes into purchasing existing assets. Mortimore and Peres (1998) show that the countries use three types of mechanisms to compete for FDI: offering incentives (essentially fiscal in nature), introducing norms that enhance competitiveness (the rule of law, market access through trade negotiations, labour and environmental standards) or creating assets (infrastructure and human resources). The first mechanism, although it may be effective in the short term, risks descending rapidly into a negative-sum game. The second type of instrument may have positive or negative effects, depending on the competition, when the regulations introduced improve on or weaken previous standards, something that is particularly harmful when there is a race to the bottom in labour or environmental standards. The creation of assets, lastly, while it is the most difficult mechanism to implement, is the most efficient one for national economies in the long term.

ii) Considering that the integration of transnational companies into IIPS has been the most effective mechanism for raising international competitiveness, attention should be turned to ways of increasing this integration in the countries where it already exists or

university-educated human resources for more knowledge-intensive activities. Buitelaar and Padilla (2000) identify a sprinkling of third-generation *maquila* companies, in Mexico; most of that country's plants are second-generation. In Central America and the Caribbean, first- and second-generation plants coexist, with the latter gaining in importance.

achieving it in the great majority that are particularly isolated from the most dynamic chains of world trade. The key role in this respect is played by trade negotiations to open up new markets that make it profitable to expand IIPS to new sectors and countries. Consideration should also be given to how progress can be made in incorporating segments of IIPS that add more value and how these can be tied in to the rest of the national economy. Although there have been cases of spontaneous progress in this direction, such as the move towards third-generation *maquila*, examples from international and regional experience show how efficient it is to develop policies to attract specific foreign companies or to increase the supply of inputs by local producers. By way of example, it is enough to allude to the measures taken by Costa Rica to attract investment from Intel in microprocessor production and the efficient programmes implemented in Singapore to develop local suppliers. Competition to attract investment by creating assets has contributed to this success, and efforts of this kind are particularly important for small countries that cannot expect the lure of their internal markets to produce good results.

iii) Closely related to the above is the question of linkage with worldwide knowledge networks. Specialization by locally owned groups in natural resource-related activities requires local technological research and development efforts that, because of the very nature of these resources, cannot be undertaken away from their physical context (Katz, 2000). These efforts –as has been shown by the biotechnology research of Grupo Pulsar, which has tended to become tied in with the research and development structure of Monsanto– are difficult to undertake efficiently in isolation from world technology developments. The instruments needed to achieve this technological impetus are well known from both regional and international experience; particular mention should be made of economies such as Japan, the Republic of Korea and Taiwan, whose domestic companies have made long-term efforts to improve their technological level, and have as a result succeeded, over time, in becoming transnationals.

iv) Given the relatively small size of domestic business groups by comparison with their global competitors, there is a need to support and strengthen their ability to create joint ventures and strategic alliances with those competitors, preferably under circumstances where they do not lose control of their assets. To this end, there is a need to develop corporate governance systems that make it attractive for foreign investors to participate in such alliances as minority partners. Experience shows that corporate governance systems can coexist very well with efforts to strengthen policies that defend competition and even, where necessary, with regulatory frameworks that promote it.

In summary, what this work proposes is the development and implementation of national strategies and active policies to supplement reform. Although some results are to be looked for from the spontaneous working of the market, international experience with efforts to attract and capitalize on foreign investment suggests that passive policies tend to result in greater benefits being generated for the investing companies than for the countries they invest in (Mortimore, 2000).

These policies are not easy to apply, given the weakness of the State in terms of human and financial resources. Although some instruments only involve changes to regulatory systems and cost little, making a country more attractive by creating assets and nurturing suppliers requires substantial resources. If applied successfully, this policy would allow more countries in the region to participate in the world market, and would even marginally improve the sectoral and technological quality of this participation.

Changing the pattern of specialization more radically by creating dynamic comparative advantages is a challenge that should be addressed by economic development studies. The conclusions of this work raise questions about this point. The relatively balanced triad –the State, large local firms and transnationals– on which industrialization and growth in Latin America were formerly based has been virtually destroyed by privatization and the relative decline of domestic firms (Reinhardt and Peres, 2000). The new pattern of economic leadership is still being defined, although everything points to it centring on transnational corporations. Experiences such as those of Singapore and Ireland show that this is viable and can be an efficient way of generating rapid growth. The main doubts still remaining, which it is beyond the scope of this work to address, have to do with the political repercussions of this model, the economic conditions that would make it viable in the region's less developed countries, and its appropriateness for the larger countries.

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Globalization and *tax competition:* implications for *developing countries*

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This article analyses the effects of tax competition on developing countries. Since the 1980s, globalization and greater capital mobility have led many developing countries to adopt the policy of competing with one another to attract capital investment. One of the main forms taken by this competition has been the granting of tax holidays and other tax reductions to investing multinationals. This paper reviews the normative arguments for and against this type of tax competition, from a global perspective. It then examines these arguments in depth from the point of view of developing countries. The conclusion in general is that, since transnational companies would invest in developing countries even if they did not receive tax subsidies, but are able to receive them through a kind of bidding process among developing countries, it would be more advisable for the latter to agree to refrain from granting such subsidies. Lastly, consideration is given to some ways in which cooperation of this sort could be achieved, either regionally or globally (through the World Trade Organization, for example).

I

Introduction

The current age of globalization can be distinguished from the previous one (from 1870 to 1914) by the much higher mobility of capital than labour (in the previous age, before immigration restrictions, labour was at least as mobile as capital). This increased mobility has been the result of technological changes (the ability to move funds electronically) and the relaxation of exchange controls. The mobility of capital has led to tax competition, in which sovereign countries lower their tax rates on income earned by foreigners within their borders in order to attract both portfolio and direct investment. Tax competition, in turn, threatens to undermine individual and corporate income taxes, which remain major sources of revenue (in terms of percentage of total revenue collected) for all modern States. The response of both developed and developing countries to these developments has been first, to shift the tax burden from (mobile) capital to (less mobile) labour, and second, when further increased taxation of labour becomes politically and economically difficult, to cut government services. Thus, globalization and tax competition lead to a fiscal crisis for countries that wish to continue to provide those government services to their citizens, at the same time that demographic factors and the increased income inequality, job insecurity and income volatility that result from globalization render such services more necessary. This paper argues that if government service programmes are to be maintained in the face of globalization, it is necessary to cut the intermediate link by limiting tax competition. However, from both practical and normative considerations, any limits set to tax competition should be congruent with maintaining the ability of democratic States to determine the desirable size of their government.

II

International tax competition and the taxation of capital

From its beginnings late in the nineteenth century, the modern State has been financed primarily by progressive income taxation. The income tax differs from other forms of taxation (such as consumption or social security taxes) in that in theory it includes income from capital in the tax base, even if it is saved and not consumed.

Because the rich save more than the poor, a tax that includes income from capital in its base is more progressive (taxes the rich more heavily) than a tax that excludes income from capital (e.g., a consumption tax or a payroll tax). However, the ability to tax saved income from capital (i.e., income not vulnerable to consumption taxes) is impaired if the capital can be shifted overseas to jurisdictions where it escapes taxation.

Two recent developments have dramatically augmented the ability of both individuals and corporations to earn income overseas free of income tax: the effective end of withholding taxation by developed countries, and the rise of production tax havens in developing countries (Avi-Yonah, 2000). Since the United States abolished its withholding tax on interest paid to foreigners in 1984, no major capital importing country has been able to impose such a tax for fear of driving mobile capital elsewhere (or increasing the cost of capital for domestic borrowers, including the government itself) (Tanzi, 1995 and Gardner, 1992). The result is that individuals can generally earn investment income free of host country taxation in any of the world's major economies (Avi-Yonah and Swartz, 1997; Cohen, 1998 and May, 1996).

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Moreover, even developed countries find it exceedingly difficult to effectively collect the tax on the foreign income of their individual residents in the absence of withholding taxes imposed by host countries, because the investments can be made through tax havens with strong bank secrecy laws (Tanzi, 1995). Developing countries, with much weaker tax administrations, find this task almost impossible. Thus, cross-border investment income can largely be earned free of either host or home country taxation (Kant, 1996 and McLure, 1989).

For example, consider a wealthy Mexican who wishes to earn tax-free interest income from investing in the bonds of an American corporation. All he needs to do is set up, for a nominal fee, a Cayman Islands corporation to hold the bonds. The interest payments are then made to the Caymans corporation without any United States tax withheld under the so-called "portfolio interest exemption" (United States Internal Revenue Code section 871(h)). The individual does not report the income to the Mexican tax authorities, and they have no way of knowing that the Caymans corporation is effectively an "incorporated pocketbook" of the Mexican resident. Nor are the exchange of information provisions of the United States-Mexico tax treaty of any help, because the United States Internal Revenue Service has no way of knowing that the recipient of the interest payments is controlled by a Mexican resident and therefore cannot report this to the Mexican authorities. As a result, the income is earned completely free of tax (the Caymans, of course, impose no income taxes of their own).

When we switch our attention from passive to productive investment, a similar threat to the taxing capacity of both home and host jurisdictions emerges. In the 1990s, competition for inbound investment led an increasing number of countries (103, as of 1998) to offer tax holidays specifically geared to foreign corporate investors (Vernon, 1998 and UNCTAD, 1996). Given the relative ease with which an integrated multinational can shift production facilities in response to tax rates, such "production tax havens" enable multinationals to derive most of their income abroad free of host country taxation (Hines and Rice, 1994 and Altshuler and Newlon, 1993). Moreover, most developed countries (including the United States) do not dare impose current taxation (or sometimes any taxation) on the foreign source business income of their resident multinationals, for fear of reducing the competitiveness of those multinationals against multinationals of other countries (Peroni, 1997). If they did, new multinationals could be set up as residents of jurisdictions that do not tax such foreign source income (Hines, 1991). Thus, business income can also be earned abroad largely free of either host or home country taxation.

For example, Intel Corporation, a top 10 multinational, has operations in more than 30 countries around the globe. The company states that "[a]n Intel chip developed at a design centre in Oregon, might be manufactured at a wafer fabrication facility in Ireland, packaged and tested in Malaysia, and then sold to a customer in Australia. Another chip might be designed in Japan, fabricated in Israel, packaged and tested in Arizona, and sold in China" (Intel Corporation, 1998). Specifically, outside the United States, Intel has major manufacturing facilities in China, Ireland, Israel, Malaysia, the Philippines and Puerto Rico (Intel Corporation, 1999). Thus, outside the United States, all of Intel's manufacturing facilities are located in countries granting tax holidays. Nor does Intel pay current United States tax on its income from those foreign operations, because under United States law, active income earned by foreign subsidiaries of United States multinationals is not taxed until it is repatriated in the form of dividends, which Intel can delay for many years (Avi-Yonah, 1997). Thus, the effective tax rate on Intel's foreign source income is far below the nominal United States corporate rate of 35%.

If income from capital can escape the income tax net, the tax becomes in effect a tax on labour. Several empirical studies have in fact suggested that in some developed jurisdictions the effective tax rate on income from capital approaches zero, and tax rates on capital have tended to go down sharply since the early 1980s, when exchange controls were relaxed (Owens and Sasseville, 1997 and Rodrik, 1997). As a result, countries that used to rely on the revenues from income tax are forced to increase relatively regressive taxes. The two fastest growing taxes in OECD member countries in recent years have been consumption taxes (from 12% of total revenues in 1965 to 18% in 1995) and payroll taxes (from 19% to 27%), both of which are more regressive than income tax (Owens and Sasseville, 1997). Over the same period, personal and corporate income taxes have not grown as a percentage of total revenues (personal income tax accounted for 26% of total revenues in 1965 and 27% in 1995, while the figures for corporate income tax are 9% and 8% respectively) (Owens and Sasseville, 1997). The total tax revenue as a percentage of GDP in developed countries went up sharply during the same period (from

an average of 28% in 1965 to almost 40% in 1994), and this increase is largely accounted for by the rise of consumption and payroll taxes (World Bank, 1994). Moreover, there is evidence that as the degree of openness of an economy in OECD member countries increases, taxes on capital tend to go down while taxes on labour go up (income tax is imposed on both capital and labour, so that its stability may mask this trend) (Mendoza, Razin and Tesar, 1994 and Mendoza, Milesi-Ferretti and Asea, 1996).

The same trends can be observed in developing countries as well. In non-OECD member countries (outside the Middle East) total government revenues as a share of GDP rose from an average of 18.8% in 1975-1980 to 20.1% in 1986-1992 (World Bank, 1994). This growth was financed primarily by the growth of revenues from value added tax in the same period (from 25.5% of total revenues to 31.8%). At the same time, revenues from both individual and corporate income tax were flat or declined (World Bank, 1994).

III

Tax competition and the developing countries

The drawbacks of tax competition for developed countries are relatively clear, because such countries have an elaborate social insurance safety net that requires a high level of government expenditure and that is threatened by tax competition (Leibfritz and others, 1995). But how does tax competition affect developing countries?

First, it should be pointed out that developing countries need the revenues at least as much as developed countries do, if not more. A common misperception is that only OECD member countries are confronted by a fiscal crisis as a result of the increasing numbers of elderly people in the population. In fact, the increase in dependency ratios (the ratio of the elderly to the working population) is expected to take place in other geographic areas as well, as fertility rates go down and health care improves (World Bank, 1994). Outside OECD and the transition economies, the dependency ratio starts in the single digits in the 1990s, but rises to just below 30% by 2100 (McLure, 1996). Moreover, while outside OECD and the transition economies direct spending on social insurance is much lower, other forms of government spending (e.g., government employment) effectively fulfil a social insurance role. In Latin America, for example, direct government spending on social insurance is much lower than indirect spending through government employment and procurement programmes (Subbarao and others, 1997).

Moreover, it seems strange to argue that developing countries need tax revenues less than developed countries because they have less developed social insurance programmes. If one accepts the normative case for social insurance, it applies to developing countries with even greater force because of widespread poverty, which means that losing a job can have much direr consequences (UNDP, 1997). But the need for revenues in developing countries goes far beyond social insurance. In some developing countries, revenues are needed to ensure the very survival of organized government, as the Russian experience demonstrates (*The Economist*, 1998). In other, more stable developing countries revenues are needed primarily to provide for adequate education (investment in human capital), which many regard as the key to promoting development (Sen, 1997). For example, the United Nations has estimated that for only US$ 30 billion to US$ 40 billion, all people in the world can obtain basic social services, such as elementary education (UNDP, 1997). Given current trends in foreign aid, most of these funds have to come from developing country governments (United Nations, 2001).

Second, the standard advice by economists to small open economies is that they should refrain from taxing foreign investors, because such investors cannot be made to bear the burden of any tax imposed by the capital importing country (Razin and Sadka, 1991). Therefore, the tax will necessarily be shifted to less mobile factors in the host country, such as labour and/or land, and it is more efficient to tax those factors directly. But while this argument seems quite valid as applied to portfolio investment, it seems less valid in regard to foreign direct investment (FDI), for two

reasons. First, the standard advice does not apply if a foreign tax credit is available in the home country of the investor, which frequently would be the case for FDI (Viherkentta, 1991). Second, the standard advice assumes that the host country is small. However, an extensive literature on multinationals suggests that typically they exist in order to earn economic rents (Hennart, 1991). In that case, the host country is no longer "small" in the economic sense. That is, there is a reason for the investor to be there and not elsewhere. Therefore, any tax imposed on such rents (as long as it is below 100%) will not necessarily drive the investor to leave even if it is unable to shift the burden of the tax to labour or landowners.

This argument clearly holds in the case of rents that are linked to a specific location, such as natural resources or a large market. But what if the rent can be earned in a large number of potential locations (Dunning, 1988)? In this case, the host country will not be able to tax the rent if the multinational can credibly threaten to go elsewhere, although once the investment has been made the rent can be taxed. This situation, which is probably the most common (Hennart, 1991), would require coordinated action to enable all host countries to tax the rent earned within their borders. Some possibilities for such action are described below.

This relates to the final argument, which is that host countries need to offer tax incentives to be competitive. An extensive literature has demonstrated that taxes do in fact play a crucial role in determining investment location decisions (Bond, 1981; Boskin and Gale, 1987 and Hines, 1999). But all of these studies emphasize that the tax incentives are crucial *given the availability of such incentives elsewhere* (Guisinger and others, 1985). Thus, it can be argued that given the need for tax revenues, developing countries would in general prefer to refrain from granting tax incentives, if only they could be assured that no other developing country would be able to grant such incentives (Avi-Yonah, 2000).

Thus, restricting the ability of developing countries to compete in granting tax incentives does not truly restrict their autonomy or counter their interests. That is the case whenever they grant the incentive only for fear of competition from other developing countries, and would not have granted it but for such fear. Whenever competition from other countries drives the tax incentive, eliminating the competition does not hurt the developing country, and may aid its revenue-raising efforts (assuming it can attract investment on other grounds, which is typically the case). Moreover, under the proposals described below, developing countries remain free to lower their tax rates generally (as opposed to granting specific tax relief aimed at foreign investors).

Two additional points need to be made from a developing country perspective. The first concerns the question of tax incidence. Since the tax competition that is most relevant to developing countries concerns the corporate income tax, it is important to attempt to assess the incidence of that tax in evaluating the effects of collecting it on the welfare of the developing country. Unfortunately, after decades of analysis, no consensus exists on the incidence of corporate tax. While the older studies have tended to conclude that the tax is borne by shareholders or by all capital providers, more recent studies have suggested that the tax is borne to a significant extent by consumers or by labour (Pechman, 1987 and United States, Department of the Treasury, 1992). Another possibility is that the tax on established corporations was borne by those who were shareholders at the time the tax was imposed or increased, because thereafter it is capitalized into the price of the shares (Pechman, 1987). It is unlikely that this debate will be decided any time soon (in fact, the incidence may be shifting over time, especially as globalization may enable corporations to shift more of the tax burden to labour). However, from the perspective of a developing country deciding whether to collect taxes from a multinational, three out of the four possible alternatives for incidence (current shareholders or capital providers, old shareholders, and consumers) are largely the residents of other jurisdictions, and therefore from a national welfare perspective the developing country gains by collecting the tax. And even if some of the tax is shifted to labour in the developing country, it can be argued that as a matter of tax administration it is more efficient (as well as more politically acceptable) to collect the tax from the multinational than to attempt to collect it from the workers.

Finally, it should be noted that a developing country may want to collect taxes from multinationals even if in general it believes that the private sector is more efficient in using the resources than the public sector. That is because in the case of a foreign multinational, the taxes that the developing country fails to collect may indeed be used by the private sector, but in another jurisdiction, and therefore not benefit the developing country. One possible solution, which is in fact employed by developing countries, is to refrain from taxing multinationals while they re-invest

domestically, but tax them upon remittance of the profits abroad. However, such taxation of dividends and other forms of remittance is subject to the same tax competition problem that we discussed above. Thus, it would appear that overcoming the tax competition problem is in most cases in the interest of developing countries, and the question remains how to do so in the face of the collective action problem described above.

IV

What can be done about tax competition?

The tax competition problem is thus essentially a problem of coordination and trust. Each jurisdiction would prefer to tax investors from abroad to gain the revenue, but is afraid that by doing so it would drive the investors to other jurisdictions that do not tax them. If there was a way to coordinate actions among the relevant jurisdictions, they all could gain added revenues without running the risk of losing the investment.

A good illustration of how this dynamic works is the history of German taxation of interest income. In 1988, Germany introduced a 10% withholding tax on interest paid to bank depositors, but had to abolish it within a few months because of the magnitude of capital flight to Luxembourg. In 1991, the German Federal Constitutional Court held that withholding taxes on wages but not on interest violated the constitutional right to equality. The Government thereupon reintroduced the withholding tax on interest, but made it inapplicable to non-residents (Muten, 1994). Non-residents may, however, be Germans investing through Luxembourg bank accounts. To cope with this problem, the Germans have led a European Union effort to introduce a 20% withholding tax on all interest payments to European Union residents (European Union, 1998). However, both Luxembourg and the United Kingdom have so far blocked the adoption of this plan, arguing that it will lead to a flight of investors to Switzerland or the United States (Annells, 1998).

Thus, the key to finding a solution to the tax competition problem is to attack it on a broad multilateral basis, through an organization such as OECD. Under current conditions, OECD is the natural choice for leading such coordinated actions against tax competition, for three reasons. First, for individual investors to earn decent returns on their capital without incurring excessive risks, they need to invest in an OECD member country. Tax havens do not offer adequate investment opportunities, and developing countries are generally considered too risky for portfolio investment (other than through mutual funds, which do not offer tax avoidance opportunities). Thus, if all OECD members enforced taxation of portfolio investment, it could be subject to tax without requiring cooperation from the tax havens.

Second, about 85% of the world's multinationals are headquartered in OECD member countries. This is likely to continue to be the case for a while, because OECD members offer stable corporate and securities law protection to investors that is lacking in other countries. Thus, if all OECD members agreed on a coordinated basis to tax their multinationals currently on their income from abroad, most of the problem of tax competition from direct investment could be solved.

Third, OECD has the required expertise (its model tax treaty is the global standard) and has already started on the path of limiting tax competition. In 1998, it adopted a report entitled *Harmful Tax Competition: An Emerging Global Issue* (OECD, 1998). This report is somewhat limited, because it only addresses tax competition for financial activities and services (as opposed to, e.g., Intel's manufacturing plants). It also does not address the taxation of investment income. But it represents an extremely useful first step, and proof that a consensus can be reached on the tax competition issue (Luxembourg and Switzerland abstained, but did not dare veto the adoption of the report by the other 27 members of OECD).

A useful distinction is drawn by OECD between tax competition in the form of generally applicable lower tax rates, and tax regimes designed to attract foreign investors. This distinction is both normatively and pragmatically sound: restricting tax competition should

not and cannot mean that voters in democratic countries lose their right to determine the size of the public sector through general tax increases or reductions. But it does mean that countries should not provide windfalls for foreign investors at the expense of the ability of other countries to provide those public services their residents desire. Such limitations are particularly appropriate because those foreign investors themselves often reside in countries providing a high level of services, and yet refuse to pay the tax price that providing such services entails.

Depending on OECD for solving the tax competition problem suffers from one major drawback: developing countries are left out, and may perceive actions by OECD as a cartel of rich countries operating at their expense. In fact, as pointed out above, it is unlikely that tax competition benefits developing countries, which can also use the tax revenues they give up to attract foreign investors. If all developing countries could be prevented from competing in this fashion, they all could gain. But in the longer run, it may be better to entrust the fight against harmful tax competition to WTO, in which developing countries are adequately represented. This would also solve the problem of what to do about the 15% of multinationals that are not headquartered in OECD member countries (a percentage that can be expected to grow if OECD indeed moves to restrict tax competition for its multinationals).

To sum up: as a result of globalization and tax competition, tax rules can no longer be set by countries acting unilaterally or by bilateral tax treaties. In a world in which capital can move freely across national borders and multinationals are free to choose among many investment locations, the ability of any one country (or any two countries in cooperation) to tax (or otherwise regulate) such capital is severely limited. Any such unilateral attempt will be undercut by other countries, and will probably not be even attempted in the name of preserving national competitiveness. Thus, a multilateral solution is essential if the fundamental goals of taxation or other regulation are to be preserved. Private market activities that span the globe can only be regulated or taxed by organizations with a similar global reach.

This paper has attempted to outline some of the ways in which such global governance can be achieved in the area of capital income taxation. Achieving this goal will not be easy, given the expected resistance of both private actors eager to preserve their freedom from taxation and of governments concerned about preserving their sovereign ability to set their own tax rules. But it is not impossible. Moreover, since preserving the ability of nations to tax income from capital is essential to the achievement of several crucially important goals (like the preservation and development of adequate government services to the poor), it must be tried.

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The small *economies of* Latin America *and the Caribbean*

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Population, natural resources and domestic market size have been the traditional components of the equation determining the wealth of nations, according to classical economists. The new lines of research opened up by endogenous growth theories and the results of comparative statistical studies into the factors determining this growth have reawakened interest in the relationships between scale effects, market size and the role of international trade in the economic growth of small economies. At a time of ever-increasing globalization, these economies are being confronted with a number of challenges and opportunities in relation to which their small economic size is generally regarded as a disadvantage. Diseconomies of scale increase their production costs, while their relatively undiversified exports mean they are extremely vulnerable to shocks of external origin. All these factors weigh all the more heavily in that trade has become one of the key factors in economic development, as is demonstrated by the sharp increase in imports and exports as a share of GDP since the second half of the 1980s. The central role played by intraregional trade or the North American market as non-traditional export engines is heightening the importance of price competitiveness, and thus of subsidy or tax exemption programmes to ensure an outlet to these markets. For those small developing countries in the region that suffer relative disadvantages, success would therefore seem to depend on the preferential terms under which they do business with their main developed-world trading partners, namely North America and, for members of the ACP group (the developing countries of Africa, the Caribbean and the Pacific), the European Union. Again, excessive specialization to serve a large regional market (Brazil or the United States) entails risks that merit consideration.

I

Main economic characteristics

There is no universally accepted definition of a small economy. Theoretical analyses often go by whether or not a country is able to influence international pricing. A similar classification, but one which is more useful from the economics point of view, identifies small economies as ones that lack the freedom to take economic policy decisions and have to adjust to the environment created by the economic policies of the major economies. This is the definition used by De Sierra (coord., 1994), in particular. Definitions of this kind are unhelpful in empirical research, however, as they are difficult to observe and measure. For practical reasons, the size of an economy is usually measured by its population, land area or domestic revenue (Damijan, 1997). Gutiérrez (1996) remarks that in Latin America there is a strong correlation among the different indicators that are generally used in the literature on the subject and that a classification by population provides a simple but clearly acceptable way of ranking the region's economies.

If small economies are defined by population (10 million inhabitants or less at the beginning of the 1990s),[1] most of the Latin American economies are small: all those of the Caribbean except Cuba, those of the Central American isthmus, Bolivia, Ecuador, Paraguay and Uruguay. Many Caribbean islands are very small indeed, containing less than a million inhabitants (and in some cases fewer than 100,000), which heightens their specificity and makes them particularly vulnerable (table 1). Nonetheless, they are all very different in terms of natural resources, per capita income, culture and society, which means that the general conclusions formulated later on need to be kept in perspective if excessive reductionism is to be avoided.

1. Growth and competitiveness

The recent literature on economies of scale and endogenous growth in open economies tends to regard a small domestic market as a disadvantage, at least in the early stages of development. The freedom of access to external markets that globalization can provide should in principle help such economies to make up for this constraint. Nonetheless, there is no consensus about the results of trade liberalization and free trade when the trading partners are very unevenly matched in terms of size and development level. Both theory and practice tend to suggest that some countries move on to a slow track and specialize in declining markets, while others take advantage of external markets to develop a dynamic specialization (Ros, 2000).

Among developing countries, "large economies" have per capita income levels considerably higher than those of "small economies"; by contrast, "very small economies" have average per capita incomes comparable to those of the largest economies. The same relationships hold true when growth rates are examined. Seemingly, small economies (but not very small ones) suffer from certain comparative disadvantages (Salvatore, 1997). According to this author, those disadvantages are associated with development level and are generally not found when developed economies are analysed. These results are found to apply, albeit in an attenuated form, in Latin America and the Caribbean. Over the last 20 years, the smallest economies (less than a million inhabitants in 1990) have had a per capita income growth rate at least comparable to, if not higher than, medium-sized or large countries (over 10 million inhabitants). Small economies (between one and 10 million inhabitants) have generally grown more slowly than the other two groups.

Indeed, over a long period, only the very small economies have seen a significant rise in per capita output, while in the medium-sized and large ones the recovery in growth that occurred in the 1990s was barely enough to offset the losses suffered 10 years before as a result of the borrowing policies of the 1970s and the

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[1] This is a very relative criterion. Twenty years earlier, the limit would have been 6.1 million for a similar group of Latin American countries (Real de Azúa, 1997); today it is 13 million, and Cuba would now be considered a small economy (table 1).

TABLE 1

Latin America and the Caribbean: Selected demographic and economic indicators

	Population (thousands of inhabitants)	Average annual population growth rate	Population density (inhabitants/ km²)	Per capita GDP (dollars, at purchasing power parity)	Average annual GDP growth rate		External trade (% of GDP)
Period or year	2000	1991-2000	2000	1998	1981	1991	2000
Latin America and the Caribbean (total)[a]	519 752	1.7	25.0	6 340	1.2	3.3	43.4
Countries (by population)							
Saint Kitts and Nevis	41	–0.3	113.4	9 790	5.8	4.1	128.5[b]
Antigua and Barbuda	68	0.6	152.0	8 890	6.1	3.3	157.7[b]
Dominica	71	0.0	97.3	4 777	4.4	2.1	115.7[b]
Grenada	94	0.3	282.9	5 557	4.9	3.5	99.3[b]
Saint Vincent and the Grenadines	116	0.9	290.3	4 484	6.5	3.2	121.5[b]
Saint Lucia	154	1.3	249.2	4 897	6.8	2.2	133.1[b]
Belize	241	2.6	10.5	4 367	4.5	4.1	101.9[b]
Barbados	270	0.5	617.7	...	1.1	1.4	130.4[b]
Suriname	417	0.4	2.6	...	0.5	1.7	...
Guyana	861	1.0	4.3	3 139	–2.9	5.3	203.3[b]
Trinidad and Tobago	1 295	0.7	250.5	7 208	–2.6	3.0	97.7[b]
Jamaica	2 583	0.9	237.9	3 344	2.2	0.1	111.7[b]
Panama	2 856	1.8	37.1	4 925	1.4	4.4	146.8[b]
Uruguay	3 337	0.7	18.8	8 541	0.0	3.0	38.0
Costa Rica	4 023	2.8	69.1	5 812	2.2	5.0	94.6
Nicaragua	5 071	2.9	39.5	1 896	–1.5	3.3	117.8
Paraguay	5 496	2.7	13.1	4 312	3.0	2.2	81.2
El Salvador	6 276	2.1	292.4	4 008	–0.4	4.6	66.3
Honduras	6 485	2.9	55.0	2 338	2.4	3.1	101.5
Bolivia	8 329	2.4	7.3	2 205	0.2	3.8	41.8
Haiti	8 357	1.9	277.5	1 379	–0.5	–1.0	47.0
Dominican Republic	8 396	1.8	170.6	4 337	2.4	6.3	100.9
Cuba	11 199	0.5	101.1	...	3.7	–1.4	...
Guatemala	11 385	2.7	99.6	3 474	0.9	4.1	47.6
Ecuador	12 646	2.1	44.0	3 003	1.7	1.7	77.3
Chile	15 211	1.5	19.8	8 507	3.0	6.6	60.8
Venezuela	24 170	2.2	26.3	5 706	–0.7	2.0	51.1
Peru	25 662	1.8	19.4	4 180	–1.2	4.2	33.2
Argentina	37 032	1.3	13.2	11 728	–0.7	4.2	23.1
Colombia	42 321	1.9	39.3	5 861	3.7	2.6	36.5
Mexico	98 881	1.7	50.2	7 450	1.9	3.5	65.0
Brazil	170 693	1.4	19.6	6 460	1.6	2.6	23.1

Source: ECLAC and World Bank.

[a] Includes Aruba, Bahamas, Montserrat, Netherlands Antilles, Puerto Rico and Virgin Islands.
[b] Visible trade only, 1998.

economic crisis that followed (table 2). In the group of 14 small countries, average per capita income was lower in 2000 than in 1980, so that for them the famous "lost decade" would seem to have lasted 20 years. This indicator fell in eight countries of the group in the period 1981-2000, the worst affected being Haiti and Nicaragua (2.6% and 1.7% average annual falls in per capita GDP, respectively). The size factor is just one of many that can influence growth rates, so the workings of other possible causes need to be ascertained if the specific contribution made by a country's size is to be isolated. To this end, an equation has been developed to bring in the various other factors identified by Escaith and Morley (2000) for a panel of 17 countries in the region during the period 1971-1996, excluding the smallest economies. Although the authors' caveats

TABLE 2

Latin America and the Caribbean: Economic size and income, 1981-2000

Countries	Per capita GDP, 1990[a]	Average annual per capita GDP growth rate		
		1981-1990	1991-2000	1981-2000
Total [b]	...	*–0.9*	*1.5*	*0.3*
Of Latin America[b]	...	–0.9	1.5	0.3
Of the Caribbean[b]	...	–0.9	1.0	0.0
With over 10 million inhabitants[c]	7 029	–0.5	1.5	0.5
With 1 to 10 million inhabitants[c]	4 056	–1.2	1.1	–0.1
With less than 1 million inhabitants[c]	6 655	3.1	2.4	2.7

Source: Table 1.

[a] Dollars at purchasing power parity.
[b] Average weighted by GDP.
[c] Simple average.

TABLE 3

Latin America and the Caribbean: Empirical evaluation of growth determinants

Variable	Ratio	t-Stat.
Constant	3.237	0.96
Average population in 1971-1975 (logarithm)	0.261	2.02
Rural population as proportion of total, average 1971-1975	–0.033	–2.50
Per capita income at beginning of each five year subperiod	–0.001	–7.71
Investment ratio (in relation to GDP)	0.060	1.94
Change in developing country exports to OECD	0.175	8.51
Contribution of primary sectors to GDP	–0.125	–4.16
Change in export ratio (in relation to GDP)	0.127	2.46
Currency reserves as share of M2	0.007	1.72
Budget balance (in relation to GDP)	0.154	2.97
Fluctuations in real exchange rate	–0.097	–4.55
Change in proportion of credit going to private sector	0.037	2.83
Average structural reform index value at beginning of each subperiod	0.084	0.93
Square of this average index value at beginning of each subperiod	–0.001	–1.19
Change in average reform index during each subperiod	–0.097	–2.88

Source: Author's calculations. Origin and description of data: Escaith and Morley (2000).

[a] Annual change in per capita GDP.
[b] Generalized least squares method, weighted and corrected for heteroscedasticity. R-2: 0.83, using 85 observations (17 countries, five subperiods of five years between 1971 and 1996).

regarding the limitations of this type of analysis have to be taken into account, the results (table 3) tend to show that, other things being equal,[2] large countries had higher per capita output growth rates.

[2] Among the factors, international trade developments and the stability of the domestic macroeconomic framework are the most crucial. Structural reforms have not had a significant global effect, but the lack of progressiveness in their application has clearly had a negative impact.

The deviations seen in relation to the predictions of neoclassical theory, which are size-neutral, are due primarily to microeconomic considerations. When a domestic market is small, there are certain economies of scale and complementarities that cannot be achieved, which means higher relative costs and lower competitiveness. These costs, which affect both the public and private sectors, take various forms that can be summed up as below.

a) *Indivisibility, public goods and infrastructure*

Most public services are characterized by indivisibility, which means that for small countries their per capita cost is generally high. Furthermore, as will be seen further on, incomplete or deficient markets often force the State to play an important role in the economy. Furthermore, current public spending as a share of GDP, and the taxation ratio, tend to fall with the size of economies. The need to keep State spending under control also means that the coverage and quality of these services are often less than ideal.

b) *Company size and production costs*

Private-sector companies are faced with the same problems, as the small size of the domestic market prevents them from taking advantage of economies of scale. This is particularly true for the non-tradable goods and services sector, whose market is by definition domestic. These disadvantages are less marked in the case of the tradable goods and services sectors, as exports can make up for the small size of the domestic market. Even with access to external markets, however, it is difficult to achieve economies of scale, as even the "large firms" of small countries are small in comparison with their regional competitors and, like many small companies, find it difficult to keep up with the pace of technological progress. Furthermore, they have to incorporate locally produced non-tradable goods and services into their processes at prices that are generally much higher than those paid by their international competitors. In these circumstances, successful participation in regional or international markets must involve a degree of specialization sufficient for critical mass to be achieved. Such specialization tends to be detrimental to complementarity with the rest of the national economy.

c) *Market structure*

The smallness of domestic markets, with all this implies for competitiveness, has important consequences for the way they are organized. There are fewer viable firms in sectors exposed to external competition, owing to the high unit costs of production. In protected sectors, a monopolistic structure tends to prevail more or less unchallenged, as the initial costs of breaking into these small markets are high in comparison with the revenue that can be expected.

This monopolistic tendency of domestic markets requires public-sector intervention –be it spontaneous or forced from without by multilateral trade agreements– to correct market failures and regulate competition. Financial constraints and a lack of specialists, however, generally mean that the local public authority is unable to deal with the complex legal and technical implications of this type of regulation. The consequences in terms of lower market efficiency then create a suboptimal situation from the economic point of view.

Both the small size of the labour market and the relative lack of diversification in production activities entail substantial friction and adjustment costs. During growth periods, companies find it hard to take on the skilled labour they need. At times of recession, on the other hand, employment options are few because activities are not very diversified. The unemployment to which this gives rise is difficult to reverse, and shocks tend to be perpetuated.[3] This last aspect is particularly important if we consider the social costs of any production restructuring that would be required if an economy of this type opened up to free trade.

d) *Governance*

Small markets, on the other hand, offer advantages associated with the diseconomies of scale that characterize transaction and supervision costs. In a situation where information about trading partners (customers, suppliers) is readily available, the costs associated with information asymmetries and moral hazard diminish. Reputation, and pressure from society to follow recognized ethical standards, are a partial substitute for the creation of a formal system of regulation and oversight. The small size of the population is also a factor for greater social cohesion and greater citizen participation in the management of public affairs.[4] These advantages will only bear fruit, however, if the minimum conditions for governance are met, something that is far from being the case in the region.[5]

[3] Small economies are also characterized by large-scale labour emigration.

[4] Aristotle saw this cohesion as a source of strength for the State, an idea that was followed up on many occasions by eighteenth century writers (Real de Azúa, 1977).

[5] As is borne out by the civil wars that have ravaged Central America, the ethnic and religious conflicts of the Caribbean and the fractures that have opened up in Ecuadorian society.

2. Vulnerability

Over and above differences in growth or development levels, small economies as a group are intrinsically more vulnerable to external shocks than larger ones. In fact, vulnerability is one of the main issues for analyses of the relationships between economic size and welfare in open economies, to such an extent that many small countries have tried –unsuccessfully so far– to introduce this concept as an alternative differentiation criterion in the entitlement clause extending reserved treatment to the least advanced countries in WTO agreements. Three interdependent factors need to be distinguished: geography, demographics and economics.

In combination, the geographical and demographic factors translate into higher population densities that increase pressure on natural resources, threatening fragile ecosystems. Haiti is the most extreme example, but ecological vulnerability is to be found in many of the region's small economies, whose location in tropical regions prone to natural disasters (hurricanes, seismic or volcanic phenomena) compounds the problem yet further. These natural disasters are recurrent and each episode affects a large percentage of the population, or in some cases the whole of the country's territory. In certain Caribbean islands, the damage inflicted on infrastructure and productive activity may exceed GDP. In such situations, the resources available to the national authorities for coping with the emergency and meeting reconstruction costs are woefully inadequate.

As regards the specific issue of social vulnerability, particular attention needs to be paid to the small island developing States of the Caribbean, which are sometimes used as transit or money laundering points by international drug traffickers. Domestic crime linked to the trading and consumption of drugs undermines legal and financial systems and ultimately corrupts all the institutions involved in governance. The social fragility of these islands, and the effects this has on governance, are accentuated yet further by deep-rooted social and cultural fault lines in societies where income is unevenly distributed and ethnic or religious divides are hard to bridge.

The economic dimension of vulnerability in small economies is closely linked to the relative importance of international trade and the lack of export diversification. The coefficient of international trade openness (imports plus exports of goods and services) of the small economies of Latin America and the Caribbean is as much as 85% of GDP, compared with just 30% in the region's other economies (ECLAC, 1996). What is more, these exports are largely confined to a small group of products and markets, which makes foreign currency income from external sales highly volatile. Given that the openness coefficient is so high, and that these small economies are extremely dependent on imports to meet the bulk of their domestic demand, fluctuations in export revenue –which is usually not enough to finance imports even in normal times– have a significant impact on domestic activity and the generation of domestic revenue.

The preferential nature of the access that these countries' export products have to the European and United States markets (Lomé agreements, Caribbean Basin Initiative) also makes them dependent on the continuity of the unilateral preferences agreed on. Yet the very spirit of these preferences is being increasingly challenged by the new rules governing international trade since the end of the Uruguay Round.

Specialization in sensitive items such as agricultural, textile and clothing products makes export markets vulnerable to protectionist reactions by the developed economies. Furthermore, the manufactures exported by the countries of Central America and the Caribbean (from *maquila* industries) have a low capital intensity, which means that subcontracting firms can easily move and are highly sensitive to small changes in comparative production costs.

Nonetheless, this great vulnerability to external trade shocks is compensated for by relative immunity to shocks of a financial nature, which have been the main cause of the latest economic crises in Latin America. Because their financial markets are undeveloped, small economies have not attracted the interest of speculative capital, the scale and volatility of whose flows have given rise to large variations both in relative prices –because of distortions in real exchange rates– and income transfers.

The great trade-related external vulnerability of the region's small economies has led them to adopt macroeconomic policies that are generally more prudent than their neighbours'. Thanks to this relatively conservative approach and to their isolation from speculative capital movements, during the last 20 years the growth rates of the region's small economies have generally fluctuated less than those of larger countries. This result also confirms that the consistency and quality of macroeconomic policy have heavily influenced the long-term growth outcomes seen in the region as a whole over the last 30 years (Escaith and Morley, 2000).

3. Economic policy

Both their size and their external openness give a distinctive character to the economic policies followed by the region's small economies. Rather than being a voluntary choice, this character is due to their having little room for manoeuvre owing to the incompleteness of their domestic markets and an external openness that extends not just to trade, but to the currency markets as well. The small size of local financial markets and the unreliability of domestic saving reinforce the classic "trilemma" of open economies, where the objectives of openness to trade and capital flows, exchange-rate stability and an independent monetary policy cannot all be achieved simultaneously. Under these conditions, it is very difficult for the national authorities, when faced with a recessionary shock, to offset declining domestic demand by expanding domestic financing without running the risk of destabilizing the economy.[6]

Exchange-rate stability is one of the primordial objectives in these small economies that are so open to international trade, and their real exchange rates fluctuate less than those of their larger neighbours. During the period 1989-2000, the standard deviation in exchange-rate indices (normalized to a value of 100 for 1995) was 11 for the small economies, as compared to 21 for the other countries. Most small economies maintained a fixed exchange rate long after the dollar standard agreed on at Bretton Woods came to an end. Costa Rica was the first of the Central American countries to devalue (December 1980), but this was an isolated case, and fixed parities continued to be the rule during the 1980s, although a price was paid for this in the form of multiple exchange rates, non-tariff import restrictions and growing balance-of-payments disequilibria. In the Caribbean, the main economies (the Dominican Republic, Guyana, Haiti, Jamaica and Trinidad and Tobago) also tried to maintain their exchange-rate parities despite alarming domestic and internal disequilibria that finally resulted in hasty devaluations and the application of adjustment programmes.

Nonetheless, the smaller economies of the Caribbean have managed to preserve stable parities (first with the pound, then with the dollar) under normal fixed exchange-rate regimes (Bahamas, Barbados, Belize) or a conversion monetary system administered by the Eastern Caribbean Central Bank, which covers six countries. This strategy has only been possible because of conservative macroeconomic policy and resource transfers, be they direct (development assistance) or through the provisions of preferential trade agreements (specific protocols in the Lomé agreements with the European Union). In South America, for geographical and historical reasons, macroeconomic policy in the small economies during the 1980s was kept close to that followed by their larger neighbours. Exchange rates there were also generally anchored as part of the stabilization efforts of the 1990s.

Fiscal policy likewise has little independence, owing to the precariousness and external dependency of the public finances. Small countries tend to have higher budget deficits than their larger neighbours. In addition, current government revenues come largely from external trade. What is more, in less developed small countries, public-sector investment relies on what is a high level of external aid by regional standards.

Table 4 shows that the countries which are most vulnerable to economic fluctuations, according to the twofold classification of fiscal deficit levels and external dependency, are almost without exception small economies. Thus, macroeconomic policy in these economies remains very reactive, and is more focused than elsewhere on controlling inflation and preserving nominal exchange-rate stability, two objectives that are highly interdependent in economies of this type. Indeed, the facts show that small economies have fewer problems of inflation or devaluation than their larger counterparts in the region (ECLAC, 1996).

These structural constraints on the active and autonomous use of short-term macroeconomic policy, however, do not mean that development policy has to be given up on. Fiscal constraints have not prevented certain small economies –in particular Costa Rica and those of the English-speaking Caribbean– from setting up programmes to invest in human capital (health and education) or applying the fiscal instruments of an aggressive export strategy.

As they are unable to finance costly industrial development assistance programmes, many small economies have introduced productive investment subsidies in the form of exemptions from taxes, both direct and indirect. This has happened particularly in the case of the *maquila* activities that have been set up in free trade zones, in both Central America and the Caribbean. Some countries have cooperated to build up the infrastructure needed for new activities, as the

[6] Nonetheless, these constraints on the ability of macroeconomic policy to react to external shocks do not translate into more volatile growth rates, thanks to the isolation of small economies from speculative capital flows.

TABLE 4

Latin America and the Caribbean: Budgetary position and dependence on customs revenue
(Averages 1995-1999)

Budget balance / Dependence on customs revenue:	Surplus or small deficit[a]	Moderate deficit[b]	Large deficit[c]
Low	Trinidad and Tobago	El Salvador Mexico	Bolivia Brazil Costa Rica Uruguay
Moderate	Chile	Argentina Barbados Guatemala Panama Paraguay Peru	Ecuador Guyana
High	Dominican Republic	Netherlands Antilles Saint Kitts and Nevis Saint Lucia Saint Vincent and the Grenadines Venezuela	Antigua and Barbuda Bahamas Belize Colombia Dominica Grenada Haiti Honduras Nicaragua Jamaica

Source: Escaith and Inoue (2001).

[a] Budget surplus, or deficit of less than 1% of GDP.
[b] Deficit of between 1% and 2% of GDP.
[c] Average deficit in excess of 2% or highly unstable.

Dominican Republic did as part of its tourism development programme. These initiatives involve major costs, in the form of budgetary spending or uncollected taxes.[7]

These incentive programmes, however, are often necessary to counteract the structural deficiencies (diseconomies of scale, the costs of externalities) characteristic of small economies which, as we have seen, increase production costs and reduce the international competitiveness of local output. The fact is that they have very often been the key to the success of non-traditional export diversification programmes in the small economies of Central America and the Caribbean (Stallings and Peres, 2000).

The new conditions obtaining in the international market, in particular the rules agreed on within the framework of the Uruguay Round and the international and multilateral agreements that came out of this, are of particular importance for these economies, where the stability of the public finances depends on customs duties that are now being reduced, and where participation in the international economy depends on exports subsidies that are being used less and less. The quality of this participation and the conditions under which it takes place are a source of challenges, but also of opportunities, and these largely determine the economic policy options available.

[7] In the Dominican Republic, for example, funds to support the development of hotel infrastructure totalled 1.1% of GDP in 1986, while in Costa Rica revenue that has gone uncollected because of tax exemptions has ranged, depending on the year, from 5% to 9% of the total tax take (Escaith and Inoue, 2001).

II

Challenges and opportunities

1. Globalization, free trade and regional integration

Orthodox economics has it that small economies are the main beneficiaries of free trade; advocates of globalization argue that the disadvantages deriving from small size can be counteracted by regional integration and the internationalization of production activities. Market opening means that these disadvantages can be overcome as small countries, thanks to their lower structural inertia, would be the best placed to show the flexibility needed to adapt to the conditions of international competition, insofar as their governments adopted the "right" policies. Unfortunately, this optimistic outlook is highly uncertain, and a glance at the theoretical literature on the impact of free trade on economic welfare does not reveal any consensus about its consequences for small economies (Escaith and Pérez, 1999). Rodríguez and Rodrik (1999), after carrying out a critical reading of empirical works on the subject, conclude that the results are not very convincing.

To put it in a more concrete way, many of those running small economies have expressed reservations about their countries' ability to benefit fully from the initiative to create a large Free Trade Area of the Americas (FTAA) as a corollary of the process set in train at the first Summit of the Americas in 1994 to encourage trade integration among all the economies of the continent. They believe that the structural constraints weighing upon small economies such as theirs reduce the potential benefits that their (small) companies could attain through the expansion of their export markets, while the prospect of increased competition from large outside firms makes them fear for their survival.

These doubts should not conceal the net benefits that could be brought by new trade and investment flows, particularly if the opportunity costs of not integrating are taken into account. In fact, the small economies of Central America and the Caribbean do not have many alternatives to integrating into FTAA, the organization that should result from the signing (planned for 2005) of this free trade agreement. If they refused to submit to free trade rules, they would run the risk of being shut out of the markets that currently account for the largest and most dynamic share of their exports. While these countries' exports to the United States now benefit from treatment similar to that granted to Mexico, albeit still with many restrictions, staying out of FTAA would mean that these privileges, which were granted unilaterally, could also be revoked unilaterally. The mere possibility would reduce the advantages they could obtain from the liberalization of trade and, above all, investment movements.

2. Expected costs and benefits

From the point of view of a small economy, any assessment of potential costs and benefits should consider the aspects listed below.

a) *Trade creation versus trade diversion*

This is a classic case, and it refers to a situation where tariff barriers divert existing trade flows to a fellow member of a free trade zone, to the detriment of external partners that were originally more competitive. In this situation, considering all transaction costs, the creation of a free trade zone among comparable members ought in theory to be beneficial, provided this zone follows the lines that proximity naturally dictates (natural blocs). This proximity helps to minimize diversion effects. Unnatural blocs (i.e., those that bring together unlikely partners or partners separated by high transaction costs) are less likely to contribute to the improvement of their populations' economic welfare (Frankel, Stein and Wei, 1995). This last aspect is potentially of concern for small economies with high transaction costs, whether because they are islands (as in the Caribbean) or, conversely, because they are landlocked (Bolivia and Paraguay). This approach looks even less promising for these small economies –at least in certain theoretical situations– when account is taken of asymmetry among trading partners. In a theoretical frame of reference where competition is imperfect, the advantages obtained from membership of a free trade zone are ultimately linked to the relative size of the partners: large countries generally benefit to the detriment of small ones.

Nonetheless, as has already been suggested, small economies really have no choice: the threat of trade diversion is a cost for any outside country, which may see its market share collapse if it stays outside a free trade zone.[8]

b) *Membership and investment*

Joining a free trade zone not only allows a country to expand its markets (trade creation) but also reduces uncertainty as regards access to those markets. This greater security should translate in turn into a major stimulus for investment in the production of exportable goods and services. This predicted benefit is a poisoned chalice, however, when investments are highly specific to the markets chosen and involve large sunk costs. As we shall see later on, in the long run this situation results in a loss of negotiating power that is not without its costs.

c) *Positive externalities*

The macroeconomic authorities of a country that has a history of instability can gain credibility and reduce the perception of country risk by joining forces with more stable partners. Conversely, the contagion effect means that admitting many unstable partners can represent a cost for "well behaved" countries; it is for this reason that a certificate of good macroeconomic behaviour is generally demanded as a prerequisite for membership of a zone of this type.

Other induced effects can be foreseen, such as the consolidation of domestic reform or faster convergence towards internationally recognized quality standards, which should make it possible to enter new markets outside FTAA (Europe, Japan). By the same logic, the obligation to meet stricter environmental protection criteria should open up access to new markets, while also benefiting local populations. These externalities can be substantial for certain countries, when FTAA membership helps consolidate the commitment of the national community to the implementation of structural adjustment programmes and initiatives to restore the country to a sustainable place in the world economy (Finger, Ng and Soloaga, 1998).

More specifically, belonging to a large free trade zone opens up new opportunities for partnership with neighbouring countries so that large-scale projects can be undertaken jointly, particularly when it comes to the provision of specialized or particularly costly public services (such as higher education and vocational training, infrastructure and market regulation, among others).

d) *Dependency*

The balance of costs and benefits becomes even more complicated when account is taken of the political economy and the balance of power.[9] One element is the ability of each country to manipulate trading conditions to its own advantage by making unilateral tariff changes or introducing non-tariff restrictions, in the event that a trade war breaks out within the free trade zone. As this ability largely depends on respective size, for a large country the potential benefits of open conflict with a small one can easily outweigh the immediate costs. From a dynamic point of view, things become even more difficult for the small economy, as its degree of specialization in its trading links with its larger partner will be higher. Once specialization becomes irreversible, its negotiating power may be reduced to nil (McLaren, 1997). A theoretical figure of this type could be highly appropriate for describing industrialization phenomena based on subcontracting activities, like those that can be seen in certain Caribbean and Central American countries.

The same theoretical models suggest, however, that until the process is completely irreversible, specialization is not a crippling disadvantage if the large country attaches sufficient importance to the expected benefits of free trade (Park, 2000). This theoretical aspect may have interesting implications for small countries as regards negotiating and alliance strategies.

e) *Immediate costs and delayed benefits*

From both a theoretical and a practical viewpoint, it is generally recognized that any benefits from free trade are long-term and diffuse, while the costs are visible in the short term and affect some very specific groups. This latter aspect may militate, in particular, against membership of a free trade zone (although, as has already been pointed out, once the zone has

[8] The situation is not so clear, however, if the entirety of a country's trading relationships are considered. In the case of the Caribbean, particularly, a high percentage of whose trade is with Europe, joining FTAA could result in a large diversion effect vis-à-vis Europe and excessive specialization in relation to the United States. It would thus be preferable for the Caribbean to strike a degree of balance between its two major trading partners.

[9] For an analysis of the regional integration process in these terms, see particularly Dabène (1998).

been created third-country exporters tend to press for their countries to join in order to limit the effects of diversion). From another point of view, asymmetrical distribution of costs and benefits over time can be a critical factor if the great vulnerability of small economies to external shocks is considered. In extreme cases, if entry does not take place gradually and shocks accumulate in the early years, the small economy can go into crisis and be forced to leave the agreement. It is thus important to give explicit consideration to vulnerability when the preparedness of economies for entering a free trade zone is being considered.

3. Readiness

The final balance of the integration costs and benefits referred to will largely depend on how well prepared these economies are to join a free trade zone. Measuring this preparedness is one way of reaching an advance assessment of a given economy's ability to minimize the costs and maximize the benefits. Among the first studies published on the subject was that of Hufbauer and Schott (1994). One of the most complete evaluations of this readiness (ECLAC, 1996) was carried out to support the FTAA negotiations and developed in Escaith and Pérez (1999). The ECLAC methodology looks at 55 indicators, grouped into four categories: eligibility, fundamental variables, policies and risks, these in turn being subdivided by type (macroeconomic, trade, etc.).

Study of these indicators generally bears out the theoretical analyses presented above. Small economies do not differ significantly from large countries as regards their overall eligibility, since their fiscal and balance-of-payments difficulties are offset by greater monetary and exchange-rate stability. Their situation looks worse, however, if non-macroeconomic criteria are considered, as they tend to have fallen behind over time with the application of international labour or environmental protection standards.

As we have seen, the countries of the Caribbean and Central America bring up the rear when it comes to fiscal reform, and are still highly dependent on customs revenue. Their tariffs tend to be even higher and more dispersed than those of their larger neighbours, which implies a certain leaning towards protectionism. Again, the basic indicators generally show that small economies are less advanced, and thus need to apply industrial development and conversion policies in a more sustained way. This situation is often due to their relative development level or the limits placed on industrial diversification by the size of their domestic markets. For example, the agricultural sector generally accounts for a larger share of GDP in small economies, and their exports are less diversified. These indicators show great heterogeneity, however, owing in part to differences in development levels. The countries of Central America (except Costa Rica) and the small countries of South America (except Uruguay) lag behind the English-speaking Caribbean in workforce skills. The latter countries also benefit from better (albeit expensive) transport, energy and telecommunications infrastructure.

Ultimately, it is in their viability and risk levels that small economies are generally most disadvantaged, owing to their greater external vulnerability and a tendency to run larger trade deficits. Yet they do not counteract this vulnerability by building up international reserves. On the contrary, such reserves are generally lower in those countries than in the rest. Again, the governments of small countries depend on customs revenue and official assistance for their public finances, two income sources that are in danger of contracting sharply with the advent of free trade and the policy that industrial countries are adopting of replacing official development assistance with better access to their domestic markets.

III

Approaches and prospects

1. Economic policy[10]

As was pointed out earlier, vulnerability is one of the central characteristics of small economies. Reducing it needs to be a priority, all the more so since trade integration, accompanied by greater freedom and stronger guarantees for the movement of capital, can be expected to result in a situation of instability during the transition period. If the experience of the large and medium-sized economies of Latin America is any guide, capital inflows can create situations of excessive domestic demand growth and overvaluation of the exchange rate which are detrimental both to external competitiveness and to the stability of development, and boom-bust cycles can mire the domestic economy in weak average growth.

It is indispensable for countries to build up international reserves during expansionary phases (whilst sterilizing the monetary effect of this accumulation) so that domestic demand can be cushioned over the whole economic cycle. Greater exposure to financial risk, and the trend towards stricter international rules, require better supervision of the banking sector, both for economic reasons and in the interests of public security and foreign policy (particularly in countries that are a target for international drug trafficking).

Countries that are over-dependent on customs revenue to finance public spending need to begin on fiscal reform as soon as possible, with a view to strengthening domestic sources of direct and indirect contributions and thereby preparing for the dismantling of their customs barriers. This reform, together with a new and less procyclical approach to budgetary policy, should also aim to increase domestic saving, one of the weak points of small economies.

A task of the highest importance is to improve the quality of the economic and institutional environment in the region's small economies in the interests of modernizing production, taking into account the preponderance of small businesses in their industrial structure. Since the impact of trade liberalization on small businesses is heterogeneous to say the least, there are both opportunities to create new activities and risks of serial bankruptcies. Existing companies will have to adapt or go under, and it would be a mistake to try to protect them at any price. It is also unlikely, however, that a large group of competitive small companies will come out of nowhere to take advantage of the new opportunities that arise as borders are opened. There needs to be an industrial policy designed to facilitate the emergence of such companies and to stimulate and facilitate strategic adaptation in the case of existing firms.

This can be achieved in a number of ways, for example by amending and simplifying administrative and fiscal rules, providing training assistance and making funds available to help with exporting and technological modernization. Creating free trade zones and promoting clusters of companies is a particularly suitable approach for small economies. Those that have to compensate for the disadvantage of high transaction costs resulting from their geographical isolation (the Caribbean countries) need to capitalize fully on their natural advantages so that they can participate effectively in the regional and international economy. The idea is to concentrate on traditional exports, while increasing their value added and administering them sustainably. This is particularly pertinent to tourism, but it also applies to other natural products (agricultural produce). Investment in human capital, with the focus on creating comparative advantages in certain market niches, is also a real option, as is demonstrated by the transition to high-technology *maquila* activities that has occurred in Costa Rica. The linguistic specificity and geographical location of the English-speaking islands of the Caribbean also provide scope for diversification into service sectors based on information processing (data processing, trade and finance). Nonetheless, a special effort will have to be made to lower transaction costs as far as possible (development of communications infrastructure, deregulation and competition oversight).

The decade now beginning should give small economies new opportunities to introduce policies that support production development. New technological trends are making it possible to escape to some degree

[10] This section draws particularly on the recommendations set forth in ECLAC (2000).

from the restrictions imposed by economies of scale (electricity generation, telecommunications), while electronic commerce may open up new markets. Nonetheless, the level of investment in physical and human capital that will be required if these policies are to be applied, and the technical and regulatory demands of the new role being played by the State as intermediary and partner in its relations with the private sector, generally exceed the capabilities of small developing economies.

Consequently, official development assistance is now needed more than ever if these countries are to participate successfully in the new international economy, and the current tendency to reduce this assistance needs to be halted. External assistance is also needed to mitigate the risks entailed by natural disasters, which are recurrent in the region. Besides the direct effects and costs of disasters, these risks mean that insurance premiums for production activities are high. To cope with contingencies, emergency funds need to be created with international assistance; national efforts should focus on delimiting risk areas and carrying out rigorous land use zoning.

2. Trade negotiations

Small economies find it harder to gain a hearing in international forums. The few qualified staff they have, whether in their capitals or with WTO in Geneva, are spread among numerous trade meetings that deal with complex, highly specialized subjects, and that are sometimes held simultaneously. It is extremely hard for them to prepare themselves properly to defend their positions, let alone take the initiative.

When it comes to complying with commitments relating to labour legislation or environmental or intellectual property protection entered into at the international or regional level, their capabilities and preparedness are quite low as well. In the specific context of regional integration negotiations, the relative shallowness of domestic industrial networks means that small economies find it harder to comply with minimum thresholds for value added of regional origin. These rules of origin are all the more restrictive in that some of these countries have substantial trade with other regions of the world (those of the Caribbean, for example), which could result in considerable trade diversion once FTAA materializes.

In consequence, it is generally recognized that small economies need to benefit, during a transition phase at least, from specific, differentiated treatment. This should include a more extended timetable so that the obligations signed up to under trade agreements can be complied with gradually. Flexibility should also apply to thresholds (such as minimum levels of regional value added) or legal and institutional obligations. Again, small economies have to have access to considerable technical assistance, both during and after negotiations. Although these aspects are generally acknowledged, international negotiations have hitherto insisted more on the reciprocity of WTO obligations than on the necessary relationship between trade and development, which incidentally was what led to the failure to resume negotiations in Seattle in late 1999. The current regional negotiations look more promising, at least potentially.

At the second Summit of the Americas (18 and 19 April 1998), and recently at the Fifth Trade Ministerial Meeting (Toronto, 4 November 1999), the 34 Governments involved emphasized the need to ensure that differences in development level and economic size were taken into consideration during the FTAA negotiation process. As yet, however, no concrete steps whatsoever have been taken in this direction and there is complete uncertainty about the form and scope that any such differentiated treatment might have. This situation highlights how hard it is for small economies to make their points of view prevail. This being the case, it is obvious that only if small economies unite around a common position will they be able to tip the balance decisively, but an alliance of this kind is difficult to achieve when the three main groups of small economies –in the Caribbean, Central America and South America– do not always share the same ambitions or the same strategic objectives.

The countries of Central America are looking to strengthen their ties with Mexico and, above all, the United States, but they are going through a difficult stage as an integration group, so that they sometimes negotiate in an uncoordinated fashion. The small economies of South America are positioned around two poles: the North American market, but also Mercosur, especially Brazil. The case of the Caribbean countries is particularly complex. Benefiting in the same way as Central America from privileged access to the United States market by virtue of the Caribbean Basin Initiative (CBI), these countries –particularly Jamaica– have seen in the North American Free Trade Agreement (NAFTA) a threat that they may be squeezed out of that market by products from the Mexican *maquila* industry.

This concern has been responded to by the recent extension of the preferences granted by the United

States to the textile and clothing products exported by the CBI countries, among others. The CBI countries, however, are also part of an agreement with the European Union under the old or revised formula of the Lomé agreements, which raises a real problem.[11] As they were originally understood, the Lomé agreements represented a compromise between aid and trade that took explicit account of the economic asymmetry among those subscribing to them: developing ACP countries, on the one hand, and developed Europe, on the other. In particular, they recognized the importance of giving specific assistance to the least developed island or landlocked countries, so that these could take advantage of the benefits contained in these agreements. Numerous Caribbean countries have depended, and still depend, on these benefits to support much of their economic activity, employment and revenue. As agreements of this type conflict with the new principles governing international trade, however, the ACP countries ended up signing a new agreement with the European Union in Cotonou, after long technical negotiations that culminated in February 2000. The new system translates into potential losses for the ACP countries that could amount to 2% of exports by value (outside of protocols), calculating from the tariffs in force in 2000. In the case of protocols relating to certain items (plants, agricultural produce and clothing), the loss of preference resulting from application of the Generalized System of Preferences (GSP) is set to exceed 10% (ACP Group, 1999).

For certain ACP countries in the region, the economic and social consequences of this gradual reduction in the subsidies provided for by the Lomé Convention and the more immediate threats to preferential access for certain strategic products (bananas) are compounded by new obstacles to the development of their offshore financial sector, owing to pressure from countries of the Organisation for Economic Co-operation and Development (OECD) to reduce the tax privileges granted to this sector. But as the *maquila* example shows, these countries have few ways of attracting the attention of foreign investors and diversifying their activities other than by granting direct subsidies and, most importantly, indirect ones, mainly in the form of tax exemptions. The alternative strategy would be to have WTO classify economic vulnerability –which is a constant in small economies, particularly island ones– as a qualification clause so that the privileges granted to the least advanced countries could be extended to vulnerable economies. This option does not look very likely for the time being.

Excessive trade specialization and asymmetry in negotiating power work against small economies, but the more importance large countries attach to free trade, the less of a disadvantage this is. Consequently, it is in the interests of small trading partners to obtain the support of pressure groups in importing countries (consumer groups, civil society, etc.) to limit the risk of arbitrary protectionist measures, which are often fatal for small exporting companies. Again, the bodies responsible for resolving trade disputes in the region need to be as transparent as possible and work to simple rules that are made known in advance, in order to minimize power plays.

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[11] Most of the small economies of Latin America (Andean Group and Central America) benefit from a system of preferential access to the European market comparable to the one that covers the less advanced non-ACP countries, as a way of combating drug trafficking. The impact of this treatment has been marginal, however.

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The WTO entry *of China and its impact* on the countries of *the Caribbean Basin*

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The entry of China into the World Trade Organization, if it takes place, will unquestionably have a major impact on many nations. What is focused on here is the impact it would have on trade between the United States and the countries of the Caribbean Basin. The problems caused to the latter by Mexican membership of the North American Free Trade Agreement could be exacerbated by the shift of forces that would result from this new situation. The major expansion of textile and clothing exports from China to the United States that is in prospect would intensify the competition faced by the countries of the Basin and Mexico in that market. Nonetheless, the recent expansion of the trade benefits granted by the United States to the Caribbean Basin, which came into effect on 1 October 2000, gives a short respite (five years or so) in which these countries can seek to consolidate their exports, particularly of wearing apparel. In the case of footwear, increased trade between China and the United States could have adverse effects on the exports of the Dominican Republic to the United States market. As regards medical instruments, Chinese exports would compete strongly with those of Costa Rica and the Dominican Republic in that same market.

I

Introduction

The People's Republic of China[1] has become an important player in the world economy. After making great changes to its productive and organizational structure, the country has succeeded in sustaining high growth rates over recent years, and as a result has positioned itself as one of the world's leading exporters and importers as well. Its performance has been heavily conditioned, however, by the fact that it is not a member of the World Trade Organization (WTO), something that has limited its scope for trade expansion.

For this reason China is seeking to join WTO, half a century after it left that body's predecessor organization, the General Agreement on Tariffs and Trade (GATT). Its objective is to improve its trading position in the international economy, in order to take advantage of the gains offered by globalization. The bilateral agreement signed between China and the United States in November 1999 gave a considerable boost to the negotiations being conducted by China with a view to entering the organization that has replaced GATT.

The scope of this bilateral agreement as regards trade between the United States and China has yet to be seen. Nonetheless, consideration has to be given to the effects that it might have on trade between the Caribbean Basin countries and the United States. That is the primary objective of this article.

II

Background

China was one of the 23 countries that originally signed GATT in 1948. After the 1949 revolution, however, the Government of Taiwan announced that China would no longer form part of GATT. In 1986, China notified GATT of its desire to regain its status as a contracting party and its intention to do so. In March 1987, a working group was formed to analyse the status of China, the first meeting being held in October that same year (WTO, 2000).

China has about 1.3 billion inhabitants and has grown quickly in recent years. On average, its gross domestic product (GDP) grew by over 11% annually in 1990-1997, making it one of the fastest growing countries in recent years. Average inflation over the period was less than 8%, and in 1998 and 1999 prices actually fell by 0.8% and 1.4%, respectively (World Bank, 1999 and IMF, 2000b). As of about 1996, 71.2% of the country's gross industrial product was generated by private-sector companies,[2] and these accounted for 42.6% of urban employment (Lin, Cai and Li, 1998, p. 422).

Although per capita income in China is low, the country's total gross national product (GNP) in purchasing power parity terms is four times Brazil's and more than twice Germany's. Consequently, it is a strong potential customer for food, capital goods and basic electrical household appliances. Production for export in the country is largely confined to a small area of territory. Approximately 70% of the foreign direct investment (FDI) it receives goes to five coastal provinces situated in the east and south-east of the country: Guangdong, Jiangsu, Fujian, Shanghai and Shandong.[3] These provinces are regarded as a very important part of the "Chinese miracle", as they grew at rates of over 20% between 1985 and 1989 (Mody and Wang, 1997, p. 294). This is partly due to the location there of special economic zones (SEZs), but also reflects the geographical concentration of the

[1] This paper deals with the People's Republic of China, but for brevity's sake we shall refer to that country simply as China.

[2] This percentage should be interpreted with caution, as it includes some township enterprises as well as unequivocally private ones.

[3] For the purposes of this study, investment from Hong Kong Special Administrative Region and Taiwan Province of China, henceforth referred to as Hong Kong and Taiwan, has been classified as foreign investment.

organizations that the Chinese authorities have allowed to trade (USITC, 1999b, pp. 2-23). Companies situated in these zones receive substantial incentives, such as exemption from profit taxes and the payment of tariffs on capital goods or raw materials imported for reprocessing there. These zones are major recipients of low-processing operations from Hong Kong and Taiwan, especially for garment products (Bosworth and Ofer, 1995).

The importance of FDI in the Chinese economy is considerable. In 1998, 51.8% of all FDI in the countries of Asia and the Pacific went to China (UNCTAD, 1999).[4] Within China, FDI is heavily concentrated by origin. In 1997, almost half of all new FDI came from Hong Kong (table 1), with Japan (9.6%), Taiwan (7.3%), the United States (7.2%) and Singapore (5.8%) making more modest contributions. This concentration of FDI may be due to the restrictions that China places on capital inflows, which do not apply to Hong Kong; this could mean that some of this capital is really Taiwanese. Of the FDI received, 62% goes into manufacturing (USITC, 1999b, pp. 2-14).

Where export destinations are concerned, China's largest trading partners are Hong Kong (22.7%), Japan (20.2%) and the United States (18.2%) (IMF, 2000a). Labour-intensive manufactures, such as wearing apparel, footwear, toys, games, sports equipment and leather products are among the country's main export items. This reflects the fact that, in comparison with other countries, China is labour-rich and capital-poor.

As regards the country's suppliers, the largest are Hong Kong (34.8%), Japan (12.8%), Taiwan (9.8%), the United States (7.4%) and the Republic of Korea (7.1%). The main import products are aircraft, electrical machinery, fertilizers and non-electrical machinery (IMF, 2000a).[5]

The composition of China's trade has changed greatly over the last 20 years, shifting from a primary product-based structure to a manufactures-based one. In 1997, 85% of Chinese exports were manufactured goods.[6]

TABLE 1
China: Accumulated foreign direct investment, by country of origin, 1997
(Millions of dollars and percentages)

Country of origin	Value	Percentage
Hong Kong	20 630	45.6
Japan	4 330	9.6
Taiwan	3 290	7.3
United States	3 240	7.2
Singapore	2 610	5.8
Republic of Korea	2 140	4.7
United Kingdom	1 860	4.1
Germany	990	2.2
Macao	390	0.9
Canada	340	0.8
Australia	310	0.7
Subtotal	40 130	88.6
Others	5 148	11.4
Total	*45 278*	*100.0*

Source: USITC (1999b).

III

The negotiating process for China's WTO entry

China is one of 30 countries currently negotiating entry into WTO (formerly GATT). The country is carrying out major reforms and turning its economy into a more market-based one. The admission process is being negotiated by a working group composed of WTO members. Initially (from 1987), the working group attached to GATT analysed the Chinese visible trade regime. But from 1995 onward, the group attached to the newly created WTO included trade in services, the new rules on non-tariff measures and the rules on intellectual property rights among the subjects for analysis.

A very important part of China's WTO admission process are the bilateral negotiations being carried out

[4] These data do not include investment in Japan. If we include Hong Kong, which has been a region with special status within China since 1997, the figure rises to 53.7%.

[5] Some Hong Kong imports and exports are actually redirected, so this structure may not be altogether accurate.

[6] Authors' estimate arrived at using the PC-TAS world trade database.

between that country and interested members of the organization. These member countries are proceeding bilaterally to negotiate the prerequisites for entry. At the end of the process, China has to secure two thirds of member countries' votes to be allowed into the organization.[7] The working group is responsible for overseeing the general progress of these bilateral discussions.[8]

Figure 1 shows what stages China still has to go through before it can enter WTO. Firstly, it has to finish negotiating with the countries that have requested this, a stage that has involved difficulties with the European Union. After that, it will have to consolidate all its negotiations within the working group and each member country will have to decide whether it approves of China entering WTO. Then the General Council (made up of all the member countries of the organization) will have to pass or reject in its entirety a set of deadlines and conditions for Chinese entry. The Council generally takes these decisions by consensus, but if this is not possible membership can be approved by a two-thirds majority. Lastly, China has to begin complying with its obligations, and becomes a member of WTO (GAO, 2000, p. 9).

Unilateral opening by China

In 1998, China reported on some of the concessions it had granted during the 12 years since it had submitted its formal application for readmission to GATT (now WTO). Some of them (WTO, 2000) are as follows:

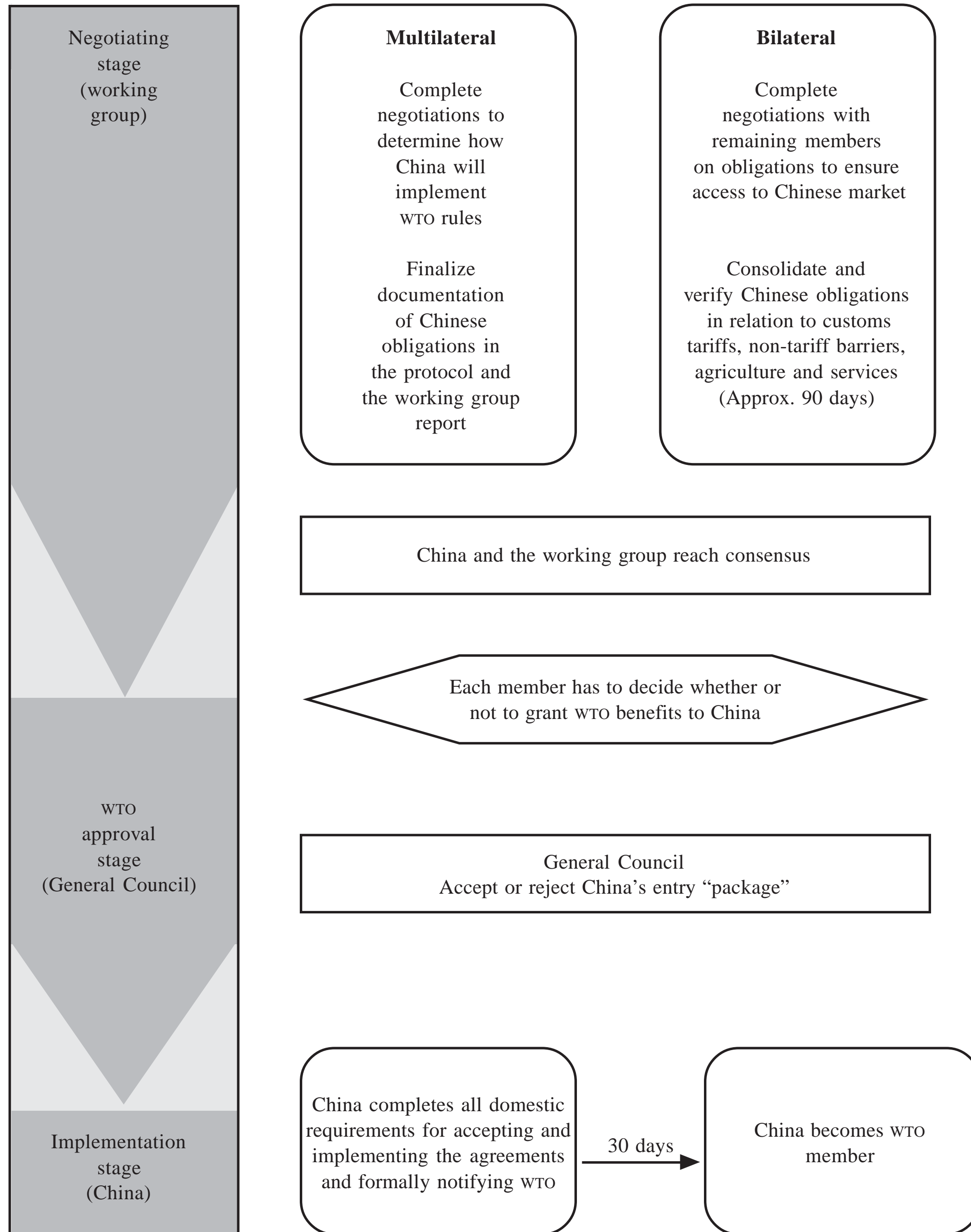
- China reduced its average tariff (other than for agricultural products) from 42.7% in 1992 to 17% in 1998, and planned to reduce them further, to 10% by 2005.
- It reduced the number of non-tariff measures from 1,247 in 1992 to less than 400 in 1998. There is a timetable for abolishing measures inconsistent with WTO provisions.
- It agreed to sign the Information Technology Agreement, which provides for tariffs on a variety of products in this category to be reduced to zero.
- It asserted that it did not operate any subsidy systems for agricultural exports.
- It maintained that it had progressed with negotiations on trade in services. At that time, there were 150 foreign banks operating in China.

[7] Although negotiations are bilateral at this stage, when China enters WTO it will have to extend any bilateral concessions automatically to all the other countries by virtue of the most favoured nation principle.

[8] By July 2000, China had concluded negotiations with 35 member countries. Agreement with the European Union had been delayed owing to disagreements over the opening up of service-related sectors in China, such as telecommunications, financial services and insurance.

FIGURE 1

China: Stages remaining in the World Trade Organization (WTO) entry process



Source: GAO (2000).

IV

Relations between China and the United States

1. Trade between the two countries

China is an important bilateral trading partner for the United States, with 7.2% of United States imports coming from China in 1997, a considerable increase on the 5.4% recorded in 1993 (table 2). As regards United States exports, sales to China remained stable from 1993 to 1997, accounting for about 1.9% of the total. This figure shows that the United States can aim to increase its shipments to the country substantially. China ranks fourth among countries of origin for United States imports and thirteenth among recipients of United States exports.

Seen from the Chinese side, the United States is a very important trading partner, taking 25.9% of its exports in 1997 and supplying 15.1% of imports. The situation was a very favourable one for China, as its balance of trade was in surplus by US$ 49.747 billion.

Table 3 shows the structure of trade between the United States and China in 1998. As can be seen, United States imports fell mainly into four sections: machinery and appliances, electrical equipment and parts (29%), miscellaneous manufactured articles (21.4%), footwear, headgear and artificial flowers (13.1%) and textiles and textile articles (10.1%). United States exports to China, meanwhile, centred on three sections: machinery and appliances, electrical equipment and parts (31.9%), transportation equipment (26.6%) and products of the chemical or allied industries (11.5%).

TABLE 2
United States and China: Importance of bilateral trade
(Percentages)

	1993	1997
United States imports from China as percentage of all United States imports	5.4	7.2
United States exports to China as percentage of all United States exports	1.9	1.9
Chinese imports from United States as percentage of all Chinese imports	13.0	15.1
Chinese exports to United States as percentage of all Chinese exports	22.4	25.9

Source: United States Department of Commerce, Module for the analysis of growth in international commerce (MAGIC), and United Nations (PC-TAS).

2. The China-United States Agreement[9]

On 15 November 1999, the United States and China signed a bilateral agreement that prepared the ground for China to enter WTO. This agreement covered subjects such as access for United States products to the Chinese market, opportunities for investing in services, trade and distribution rights, among other things.

This agreement is not a one-off. Rather, it forms part of a general shift in the way the United States relates to China, owing in part to the importance that the latter has taken on in recent years. After the tragic events of Tiananmen Square, relations between the two countries were subdued for over a decade. In 1996, however, President Clinton announced that the stabilization of relations with China would be a priority in his second term, and in 1997 the first summit between the presidents of the two countries sent out a strong signal of normalization.

The main items included in this bilateral agreement are as follows.

a) *General provisions*

The agreement includes a number of provisions which in practice mean that China's WTO entry will be subject to unilateral defensive measures devised by the United States in a number of areas. Firstly, it includes a special safeguard mechanism that will remain in force for 12 years after entry. This mechanism can be used to control rapid increases in imports from China that cause or threaten to cause problems in the United States.

b) *Antidumping methodology*

The United States can continue to apply a methodology for non-market economies in antidumping cases that concern imports from China. This provision, which will remain in force for 15 years after China enters WTO, will allow the United States to take the special characteristics of the Chinese economy into consideration when it identifies and quantifies possible

[9] The description of the main features of the China-United States Agreement is based on United States-China Business Council (2000).

TABLE 3

United States and China: Reciprocal trade structure by Harmonized System sections, 1998[a]
(Billions of dollars and percentages)

		Imports	Percentage	Exports	Percentage
XVI.	Machinery and mechanical appliances, electrical equipment and parts thereof	20 385.0	29.0	4 472.8	31.9
XX.	Miscellaneous manufactured articles	15 041.3	21.4	101.3	0.7
XII.	Footwear, headgear, artificial flowers	9 230.4	13.1	33.2	0.2
XI.	Textiles and textile articles	7 114.9	10.1	267.4	1.9
XV.	Base metals and articles of base metal	3 052.6	4.3	469.0	3.3
XVIII.	Optical, photographic and musical instruments and apparatus	2 991.7	4.3	682.2	4.9
VIII.	Raw hides and skins, handbags, etc.	2 972.4	4.2	166.6	1.2
VII.	Plastics and articles thereof, rubber and articles thereof	2 388.2	3.4	445.0	3.2
VI.	Products of the chemical or allied industries	1 453.9	2.1	1 613.6	11.5
XIII.	Articles of stone, plaster, cement, ceramics, glass	1 276.1	1.8	90.6	0.6
Subtotal		65 906.5	93.7	8 341.7	59.4
Others		4 473.4	6.30	5 692.2	40.6
Total		*70 379.9*	*100*	*14.034.3*	*100.0*

Source: The authors, on the basis of data from the United States Department of Commerce, MAGIC.

[a] The Harmonized System is divided into 21 sections.

benefits deriving from subsidies. At the same time, China can ask the United States to review specific sectors, or the Chinese economy as a whole, to determine whether they are market-oriented and thus not entirely subject to the special methodology applicable to non-market economies.

c) *Trade and distribution rights*

United States companies operating in China will be able to distribute imported products as well as products that they themselves have produced in that country, which should give them a great opportunity to expand exports to China. Formerly, companies could distribute their products only when they produced them directly in China, whereas if they imported them distribution had to be carried out through State enterprises created for that purpose. One of the reasons why United States companies decided to set up production plants in China was to be able to sell into such an important market. Under the terms of the agreement, United States companies will be able to sell their products regardless of where they are produced, which will enable them to increase exports.

d) *Services*

The agreement establishes that China will provide access to its communications sector and to those of insurance, financial services, professional services and computer-related services. In telecommunications, once China is a member of WTO, foreign operators will be able to own up to 25% of mobile telecommunications companies, and this percentage will rise to 49% from the third year. In Internet services, foreign companies will be able to own up to 30% of operators in the provinces of Beijing, Shanghai and Guangzhou, and this will rise to 50% after two years, when all geographical restrictions will have disappeared. Although it is true that China has opened up financial services to some extent, participation in this activity by foreign private-sector companies is still very low. At the same time, the strong growth seen in China's capital markets in the 1990s has become a major incentive for the United States Government to seek to secure access to these markets (United Nations, 1999).

e) *Industrial products*

Chinese industrial tariffs are supposed to fall from an overall average of 24.6% ad valorem in 1997 (higher than actually applied now) to a general average of 9.4% in 2005. Tariffs on industrial products of particular interest to the United States are to fall to an average of 7.1% ad valorem, and most of these tariff reductions will be in effect by 2003. Tariffs on automobiles will fall rapidly from today's 80-100% levels ad valorem to

25% in 2006, with the largest fall taking place the first year after China enters WTO. China agreed to reduce these tariffs in return for a slightly longer grace period.[10] It also agreed to do away with all tariffs on goods such as computers, telecommunications equipment, semiconductors and other high-technology products in accordance with the Information Technology Agreement, to which China is a signatory. Tariffs for products of this type will fall from the current average of 13.3% to zero by 2005.

For wood and paper, tariffs will be cut from their current levels of 12-18% for wood and 15-25% for paper to levels that will generally range from 5% to 7.5%. In the case of textiles, the agreement includes a protocol based on the textile agreements of 1997, under which United States companies and workers can respond to rising textile and garment imports by invoking a safeguard. This safeguard will remain applicable until 31 December 2008, i.e., four years after the WTO Agreement on Textiles and Clothing ceases to operate (White House, 2000).

f) *Agricultural products*

China agreed to allow private trade in agricultural products. Chinese tariffs on priority United States products will be reduced from an overall average of 31% ad valorem to 14% by January 2004 at the latest. Furthermore, the average Chinese tariff on agricultural products will be reduced from 22% to 17.5%. The tariff conditions set in the agreement for certain specific sectors of interest to the United States are listed in table 4.

China also agreed to abolish export subsidies, which were a key concern for United States producers of rice and cotton. Other commitments included doing away with sanitary and phytosanitary barriers not based on scientific evidence and granting the right to import and distribute products in China without the need to go through State trading bodies.[11]

TABLE 4
China: Tariffs negotiated with the United States

United States priority products	Current tariff (%)	Agreement tariff (%)
Grapes	40	13
Beef	45	12
Chicken and turkey	20	10
Fish	25.3	10.6
Cheese	50	12
Yoghurt	50	10
Ice cream	45	19
Pork	20	12
Wine	65	12
Chicken	20	10

Source: United States-China Business Council (2000).

3. The position in the United States as regards China's WTO entry

Labour unions in the United States opposed the agreement signed with China, insisting that the country should improve its labour practices before it was allowed to enjoy normal trade relations. They also argued that the low prices of Chinese products would result in the United States market being swamped by them, leading to job losses (*The Journal of Commerce*, 2000c).

The subject of respect for human rights in China was also a source of confrontation. Some believed that the United States should not sign an agreement with China until the situation of human rights in that country had improved and they had ceased to be constantly violated (*Public Citizen*, 1999). Others maintained that significant progress had been made and that it needed to be understood that changes in this area took place only gradually, so that the issue should not act as an impediment to the normalization of relations between the United States and China (Bates, 1999). These considerations seem to have been taken into account, as the legislation that was ultimately passed provides for the creation of a commission to monitor human rights conditions in China and inform Congress of the results.

The issue of the environment does not seem to have been a priority in the agreement. Some believe that the environmental problems that have arisen in China because of the economic boom of recent years threaten the country's fragile social and political structure, and its economic infrastructure. They have demanded that the United States take advantage of this opportunity to cooperate with China on this vital issue (Economy, 1999). On 19 May 2000, the two nations signed a joint

[10] There are complaints in the United States, however, that the tariff level agreed upon may still be too high and continue to restrict the United States export sector (*The Journal of Commerce*, 2000a).

[11] While the United States is asking the European Union, WTO and China to abolish agricultural subsidies, the country's domestic subsidies to agriculture in the last two years were US$ 6 billion and US$ 9 billion, respectively (*The Journal of Commerce*, 2000c).

Box 1
WHAT IS MEANT BY PERMANENT NORMAL TRADE RELATIONS?

Most favoured nation (MFN) trading status is what current United States legislation terms Permanent Normal Trade Relations (PNTR). The status of MFN is the instrument whereby all members of the World Trade Organization (WTO) guarantee to apply permanent normal tariff conditions to one another, so that if China becomes part of WTO it will have to be granted this by the member countries.

The United States will have to pass PNTR legislation for China, as the law at present, in the form of Title IV of the 1974 Trade Act, prevents this status from being granted to the country, as a result of which tariff conditions for Chinese goods currently have to be renewed each year. If this new status were not granted to China, the United States would not benefit from the most important concessions that China has made to become a WTO member, such as liberalization of financial services, telecommunications and distribution. As a result, it is important for the United States Government that the establishment of permanent normal trade relations with China be approved.

Source: Lardy (2000).

environmental cooperation declaration, which stresses issues relating to climate change, the use and transfer of clean technologies and the need to reduce greenhouse gas emissions. This declaration was issued in the framework of the Environment and Development Forum, which is a process of discussions that have been held between the United States and China since 1997. No concrete action has yet been taken, however, to turn United States cooperation with China in this area into a reality.

Apart from commercial considerations, the agreement has considerable geopolitical importance for the United States. The transformation of a poor, closed society (open only in small areas such as the SEZs) into a consumer market of 1.3 billion inhabitants makes economic sense, but it also makes strategic sense to ease the permanent dilemma of economic partnership and political and military confrontation between China and Taiwan, or between China and India or Russia. For this reason, six former Secretaries of State –from Alexander Haig, Henry Kissinger and James Baker to Warren Christopher– issued an open letter of support for Clinton.[12]

V

Possible effects on the Caribbean Basin

China's entry into WTO and the recent bilateral agreement signed with the United States could have adverse effects on the development of trade between the Caribbean Basin countries and the United States, owing to increased Chinese competition in certain specific sectors.[13]

As table 5 shows, there are four sectors in particular whose importance in Chinese exports to the United States could increase competition with Caribbean Basin products: i) wearing apparel, ii) footwear, iii) machinery and appliances, electrical equipment and parts, and iv) optical, photographic and musical instruments and apparatus. While wearing apparel is produced in all the Central American countries and the Dominican Republic, the footwear sector is important only in the latter country, where in 1999 it accounted for 6.6% of all exports to the United States, whereas for the other

[12] During the passage of this legislation, the United States Congress debated two closely related subjects: i) the agreement between the United States and China whereby the latter complied with one of its WTO entry obligations, and ii) the passing of legislation on normal trade relations with China, after which there would be no need for annual renewal of the tariffs on imported Chinese goods. In September 2000 this legislation was on the point of being passed, and this was only prevented because some lawmakers demanded the inclusion of conditions relating to greater respect for human rights and to the arms trade.

[13] This is a different matter from the opportunities opened up in trade between the Caribbean Basin countries and China, which will be analysed in another study.

TABLE 5

United States: Structure of imports from the People's Republic of China and the Caribbean Basin, by Harmonized System sections,[a] 1998
(Millions of dollars and percentages)

		China	Percentage	Caribbean Basin	Percentage
XI.	Textiles and textile articles	7 114.9	10.1	8 390.9	50.2
II.	Vegetable products	295.3	0.4	1 828.0	10.9
V.	Mineral products	696.8	1.0	1 291.0	7.7
XVI.	Machinery and mechanical appliances, electrical equipment and parts thereof	20 385.0	29.0	1 159.5	6.9
IV.	Prepared foodstuffs, beverages, tobacco	299.7	0.4	1 052.4	6.3
I.	Live animals and animal products	451.7	0.6	605.4	3.6
VI.	Products of the chemical or allied industries	1 453.9	2.1	535.9	3.2
XVIII.	Optical, photographic and musical instruments and apparatus	2 991.7	4.3	420.8	2.5
XII.	Footwear, headgear, artificial flowers	9 230.4	13.1	378.7	2.3
XIV.	Natural or cultured pearls, precious metals	399.5	0.6	315.4	1.9
Subtotal		43 318.9	61.6	15 978.0	95.6
Others		27 061.0	38.4	16 722.0	4.4
Total		*70 379.9*	*100*	*11 940.6*	*100.0*

Source: The authors, on the basis of data from the United States Department of Commerce, MAGIC.

[a] The Harmonized System is divided into 21 sections.

countries in the Basin the figure was less than 0.7%. Each of these sectors will now be analysed separately.

1. Wearing apparel

China is one of the largest suppliers of wearing apparel to the United States. As table 6 shows, however, its market share in these products fell between 1990 and 1998 from 13.9% to 11.4%. This was largely due to the existence of restrictive quotas that limit increases in the supply of these goods to the United States market. Many Chinese export products are subject to individual quotas, which has reduced their annual growth to 0.2% or 0.5% (USITC, 1999a).[14]

a) *Market share*

In February 1997, the United States concluded new agreements with China in relation to the trade in textile products and wearing apparel. One of them extended the life of United States quotas for Chinese non-silk goods for four years, until the end of 2000. This cut quotas for those products in respect of which China has constantly breached the limits by smuggling them through third countries (especially Hong Kong and Singapore), taking advantage of their unused quotas. At the same time, the rules against this type of trade were tightened (box 2).

The Caribbean Basin countries, meanwhile, increased their share of the United States market in the 1990s at the expense of the Asian countries that are subject to quotas, among which China is very important. Since 1994, Mexico has made use of the tariff advantages granted by the United States under the North American Free Trade Agreement (NAFTA) to increase its exports of wearing apparel to the United States. It is a fact that Mexico is the country that has increased its exports of these goods most quickly, so that it has taken most of the market share lost by the Asian countries; in 1998, the Caribbean Basin as a whole saw a decline in its market share, which had shown a rising trend over the decade. The increase in Mexico's market share since 1995 has also been influenced by the devaluation of that country's currency in late 1994, which further enhanced the advantages accruing to it from NAFTA (Gitli and Arce, 2000a).

[14] Contrary to what is generally believed, the cost of sea transport is not significant as a differential (Gitli and Arce, 2000a), but delivery times, the distance that has to be covered when specific problems need to be solved and the cost of air transportation may be far more important factors working against China.

TABLE 6

Selected countries: Share of United States wearing apparel imports, 1990-1999

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
China	13.9	14.5	15.8	17.4	15.3	12.9	13.2	13.4	11.4	11.1
Caribbean Basin	8.4	10.4	11.3	12.9	13.1	14.7	15.5	16.8	16.4	16.5
Mexico	2.8	3.5	3.9	4.3	5.3	7.4	9.6	11.4	13.1	14.3

Source: The authors, on the basis of data from the United States Department of Commerce. Wearing apparel products are those listed under codes 61 and 62 of the Harmonized System.

Box 2

THE CHINA-EUROPEAN UNION AGREEMENT

On 19 May 2000, China and the European Union reached bilateral agreement on the tariff preferences that the former is to grant to the latter, with the objective of giving the European Union access to China. The following are some of the main provisions of this agreement.

For the 150 priority products of the European countries, the average tariff will be cut from 18.6% to 10.6%.

Tariffs for five footwear products accounting for over 70% of European Union exports in this category will be cut from 25% to 10%.

For 52 products related to the "machinery and applications" sector that account for 26% of all European exports, tariffs will be cut to between 5% and 10% from the levels of over 35% currently applied.

Some of the concessions obtained by the European Union in respect of agricultural products were:

Product	Current tariff	Tariff agreed on
Butter	30%	10%
Powdered milk	25%	10%
Pasta	25%	15%
Wine	65%	14%
Mandarins	40%	12%

As in the case of the United States, China undertook to sign the agreement on sanitary and phytosanitary measures in the framework of WTO.

As regards telecommunications, foreign operators can own 25% of the total. This level will rise to 35% and 49% in the first and third years after the agreement comes into effect. In the field of insurance, seven new licences to provide this service were granted to European companies. Retail distribution businesses will no longer be subject to the 50-50 strategic alliance restriction, nor will they be limited to a maximum size of 20,000 square metres or no more than 30 outlets.

Source: European Union (2000).

A substantial proportion of Caribbean Basin products enter the United States on a special production sharing basis. In the garment sector, the countries of the Basin account for 83.7% of everything imported under this system (table 7). Of the total coming in on a production sharing basis, 63.9% by value is made from content of United States origin, so that the countries of the Basin do not pay tariffs on this percentage.[15]

There is a large difference between the United States component used by the Latin American countries and that used by all the others. In the case of the former the proportion is 43.2% at the lowest (in Guatemala), while elsewhere it is just 16.5%. This reflects the fact that countries further away from the United States, like the Asian ones, do not have much incentive to make clothing under the production sharing system, owing

[15] For the garment sector, entry on a production sharing basis means that the cloth has been cut in the United States and sent to the Basin for sewing, with customs duties payable only on the value added abroad. By contrast, China pays the tariff on the entire product. It is not very clear how much of an advantage this now represents for the countries of the Basin, as not only is Chinese labour cheaper, but cloth is as well.

TABLE 7

United States: Imports of wearing apparel entering on a production sharing basis, and United States content of these, 1997
(Millions of dollars and percentages)

	Total	Production sharing	Percentage of total	United States content	Production sharing percentage
Mexico	6 586	5 187	78.8	3 368	64.9
Dominican Republic	2 349	2 154	91.7	1 358	63.0
Honduras	1 875	1 586	84.6	1 130	71.2
El Salvador	1 170	1 006	86.0	580	57.7
Costa Rica	827	791	95.7	524	66.2
Jamaica	422	382	90.5	309	80.9
Guatemala	1 150	706	61.4	305	43.2
Haiti	225	211	93.8	155	73.5
Colombia	364	253	69.5	148	58.5
Nicaragua	232	67	29.9	47	70.1
Others	38 374	599	1.6	99	16.5
Total	*53 574*	*12 939*	*24.2*	*8 024*	*62.0*
Caribbean Basin	8 307	6 949	83.7	4 438	63.9

Source: USITC (1999b).

TABLE 8

Countries supplying wearing apparel: Possible losses and gains in United States market share owing to China's WTO entry and the abolition of quotas

	World market	United States
China	Increase of over 6%	Increase of some 3%
Mexico and Canada	Small reduction	Loss of 2%
All others[a]	Loss of some 3%	Loss of some 4%

Source: USITC (1999b).

[a] The "all others" category includes the countries of the Caribbean Basin, Brazil, the European Union countries and other small suppliers. The United States International Trade Commission (USITC) study does not isolate the impact on the Basin countries in any instance, so these figures are authors' estimates.

to the difficulties that would be involved in moving cloth and other United States inputs from the United States to begin producing the goods.

If China joined WTO, abolition of the quotas currently applied under the Agreement on Textiles and Clothing, which would happen in 2005, would enable the country to increase its world market share substantially, and this would greatly affect other regional suppliers of these goods. In fact, according to United States government estimates, if these quotas were done away with China could raise its world market share by more than six percentage points in 2005; this would help the country to maintain its position as the world's leading supplier of garment products, and then stabilize this share at about 37% (USITC, 1999b).

Where the United States market is concerned, China's WTO entry and the abolition of quotas would have considerable effects on the composition of countries supplying the United States with its imports of wearing apparel (table 8). For these products, China's market share could be expected to increase by three percentage points in 2005, with the abolition of quantitative restrictions. The countries of South Asia[16] would also benefit from the removal of these quotas: their share would rise by approximately four percentage points in 2005 or thereabouts and would continue to follow a rising trend in subsequent years. The increase in market share for China and the South Asian countries would mean a fall of some four percentage points in the market share of "all others", among which the countries of the Caribbean Basin would undoubtedly be hard hit.[17]

Again, by virtue of the Trade and Development Act passed in the United States in 2000, the countries of the Caribbean Basin now enjoy broader tariff preferences than they had under the Caribbean Basin Initiative (CBI). We believe that this law, which came into force on 1 October 2000, will undoubtedly give a

[16] Bangladesh, India, Nepal, Pakistan and Sri Lanka.

[17] Although the United States, as was seen in section IV, reserves the right to apply textile safeguards until 2008, which casts rather more uncertainty over the intervening period.

new impetus to production in the countries of the Basin and mitigate the effect that abolition of the quotas for Chinese goods will have on them. Thus, of the "all others" group, the Basin will be the only subregion that will not be adversely affected.[18]

The United States Government also expects a small decline in Mexico's market share from 2005 onward, owing to the abolition of quotas for wearing apparel. That country should be less affected, however, owing to the preferences it enjoys under NAFTA.

b) *Relative prices and competition*

We shall now look at the relative prices of Chinese supplies to the United States market by comparison with the prices of goods from the Caribbean Basin. To do this, we shall take the three main apparel products exported by the countries of the Basin to the United States in 1998: men's trousers and breeches, men's T-shirts and men's cotton shirts.[19] As can be seen from table 9, China is supplying the United States market with these products at prices quite similar to those of the Basin countries, so it seems that, in this instance at least, it is not competing on price. This could indicate that the main differentiation factor following Chinese entry into WTO would be the removal of quotas.

Today, however, China is not just one of the world's largest suppliers of low-priced clothing, but is also becoming a low-cost producer of high-quality, high-value garments, something that may be due to the imposition of quotas by the United States to prevent imports of low-quality products. This shift towards higher-value products is reflected in the way production of goods of this type is being switched from Hong Kong to China, as a result of which the number of employees in the Hong Kong garment industry fell from 128,000 to 45,000 between 1993 and 1998 (USITC, 1999b, section 8, p. 6).

In passing legislation to extend preferences for the countries of the Caribbean Basin, what the United States is promoting is its own domestic production. This is because activity in the Basin is very much centred on the production sharing system, whereby 64% of all clothing exported by these countries is made from United States content. Consequently, the legislation passed will increase the use of United States yarn and cloth in the countries of the Basin, so that future growth in the textile and clothing industries of those countries will enable the United States to counter the adverse developments seen in its domestic textile industry, where employment fell from 675,000 to 596,000 people between 1993 and 1998 (USITC, 1999b, section 8, p. 2). The production linkages deriving from intensive utilization of United States raw materials are considerable, so a rise in the market share of the Basin would benefit the United States textile industry.

The web of conflicts of interest among textile producers, garment producers and distributors is extremely difficult to untangle. Figure 2 summarizes the structure and interrelationships of these groups, and their sometimes contradictory approaches. Distributors tend to require "complete packages" (Arias, 1999; Zúñiga, 1999 and Gereffi, 2000). Such being the case, distributors (who often also produce clothing under subcontracting arrangements) will not be too interested in the provenance of the cloth, but only in its quality and specifications. Consequently, they will be ready to enter into negotiations with anyone (China, CBI, etc.). By contrast, United States textile producers are interested in expanding the scope and benefits of production sharing as a way of increasing the market for their cloth.

TABLE 9

Selected Caribbean Basin and other countries: Relative prices of the main apparel products imported from them by the United States[a-b]

(Average 1995-1998)

Country	Men's trousers	Men's T-shirts	Men's cotton shirts
China	0.97	1.00	1.42
Costa Rica	0.95	–	–
El Salvador	–	0.78	0.64
Guatemala	–	–	0.81
Hong Kong	1.14	2.85	1.70
Honduras	1.00	0.88	0.77
Jamaica	–	0.91	–
Mexico	0.98	1.01	0.77
Dominican Rep.	1.00	0.80	0.86

Source: United States Department of Commerce, MAGIC.

[a] The fact that no data on particular products are given for certain Caribbean Basin countries does not mean that these countries do not export them, but only that they are not among the region's top three suppliers of them.

[b] United States imports from Hong Kong are very likely to have originated in China, so these figures should be treated with caution.

[18] See the footnote to table 8 for a definition of "all others".

[19] These products account for 3.7%, 2.6% and 2.4%, respectively, of all United States imports from the Caribbean Basin countries and come under tariff classifications 6203424015, 6109100012 and 6105100010 of the Harmonized System.

Box 3
THE EXTENSION OF CARIBBEAN BASIN PREFERENCES BY THE UNITED STATES

The United States Trade and Development Act of 2000 extended the tariff preferences enjoyed by the countries of the Caribbean Basin as part of the 1984 Caribbean Basin Initiative.

For footwear,[a] tuna, petroleum and its derivatives, clocks and "flat" leather products such as wallets[b] the tariff will be the same as for Mexico, provided the North American Free Trade Agreement rules of origin are complied with.

Textile and clothing products remain subject to a special regime, whereby the following may enter free of quotas and tariffs:[c]

1. Wearing apparel manufactured from United States cloth and yarn and cut in the United States (production sharing or *maquila*), a range of additional washing and processing operations being permitted for these products. It is also permissible for United States cloth to be cut in the region, although in these cases it would appear that processes subsequent to assembly are not allowed.
2. Certain products knitted in a beneficiary country from yarn produced in the United States (with the exception of tights as listed in item 6115 of the Harmonized System) and wearing apparel knitted, cut and completely assembled in one or more beneficiary countries from cloth produced in the region using United States yarn. This concession is subject to an initial yearly limit of 250 million square metres equivalent of cloth, an amount that will increase by 16% a year until 2004, when growth in the quota will be set by law. In this case, it would appear that processes subsequent to manufacture are not allowed, as this option is not clearly provided for in the legislation.
3. Cotton T-shirts, knitted or crocheted, except underwear (61091000 in the Harmonized System) and T-shirts, knitted or crocheted, of other textile materials (61099010), made in one or more beneficiary countries from cloth produced in one or more countries of the region, using yarn made in the United States. For this case, a ceiling of 4.2 million dozens of T-shirts made from cloth complying with the rules of origin applies, this limit to rise by 16% a year until 2004, when the growth rate will be set by law.
4. Any apparel product classified under subitem 621210 (brassieres), if the article is cut and sewn, or assembled, in the United States or any of the beneficiary countries. These products will be eligible for preferential treatment if they contain at least 75% United States cloth.
5. Products assembled from fibres, yarn or cloth not available in commercial quantities in the region (NAFTA countries). Hand-made products, craft products and textile luggage.

Lastly, particularly sensitive agricultural products, such as sugar,[d] beef, frozen juices, tobacco and jewellery boxes, which were subject to quotas and subsequently to tariffs, are unaffected by the new legislation. For these, then, there is no parity with NAFTA.

Source: Gitli and Arce (2000b).
[a] *Maquila* footwear had entered tariff-free since 1990.
[b] Flat products had been subject to reduced tariffs since 1990.
[c] In certain cases, such as those noted in points 2 and 3, products are subject to quotas.
[d] Access to the sugar market for the CBI countries is subject to quotas but free of tax.

On this point, Gereffi (2000) analysed the way the garment sector in the United States had been restructured and reached the conclusion that established producers in both Mexico and Asia are aiming to produce the "complete package". In the case of Mexico, this tendency is accounted for by the opportunities for production integration offered by NAFTA, while in the case of Asia it would appear to be due to the strong linkages that exist among Asian producers. Ng and Yeats (1999) have found that the trade in components and inputs among the Asian countries is much greater than might have been thought. For example, of all imports of products of this type by these countries in 1996, 58.5% were from within the region, which gives an idea of the importance of the "production sharing" that appears to be going on among Asian countries.[20]

China has every opportunity to compete in the international market for wearing apparel, thanks to its low wage costs. Wages there are just 17% of those in Costa Rica, 28.5% of those in Mexico and 33.6% of those in Guatemala, which means that the final prices of the country's products can be considerably lower than those offered by the countries of the Basin (table 10).

Of the garment companies located in China, in 1995 some 42% were foreign-owned, almost 40% were township enterprises, 7% were private-sector companies

[20] Here we are considering "production sharing" not as a customs classification, but as a division of labour whereby each country carries out different stages of the production process, according to the labour and know-how it has available.

FIGURE 2

Textile-clothing chain: Production and sales flows, and views on China and on NAFTA parity for the CBI countries

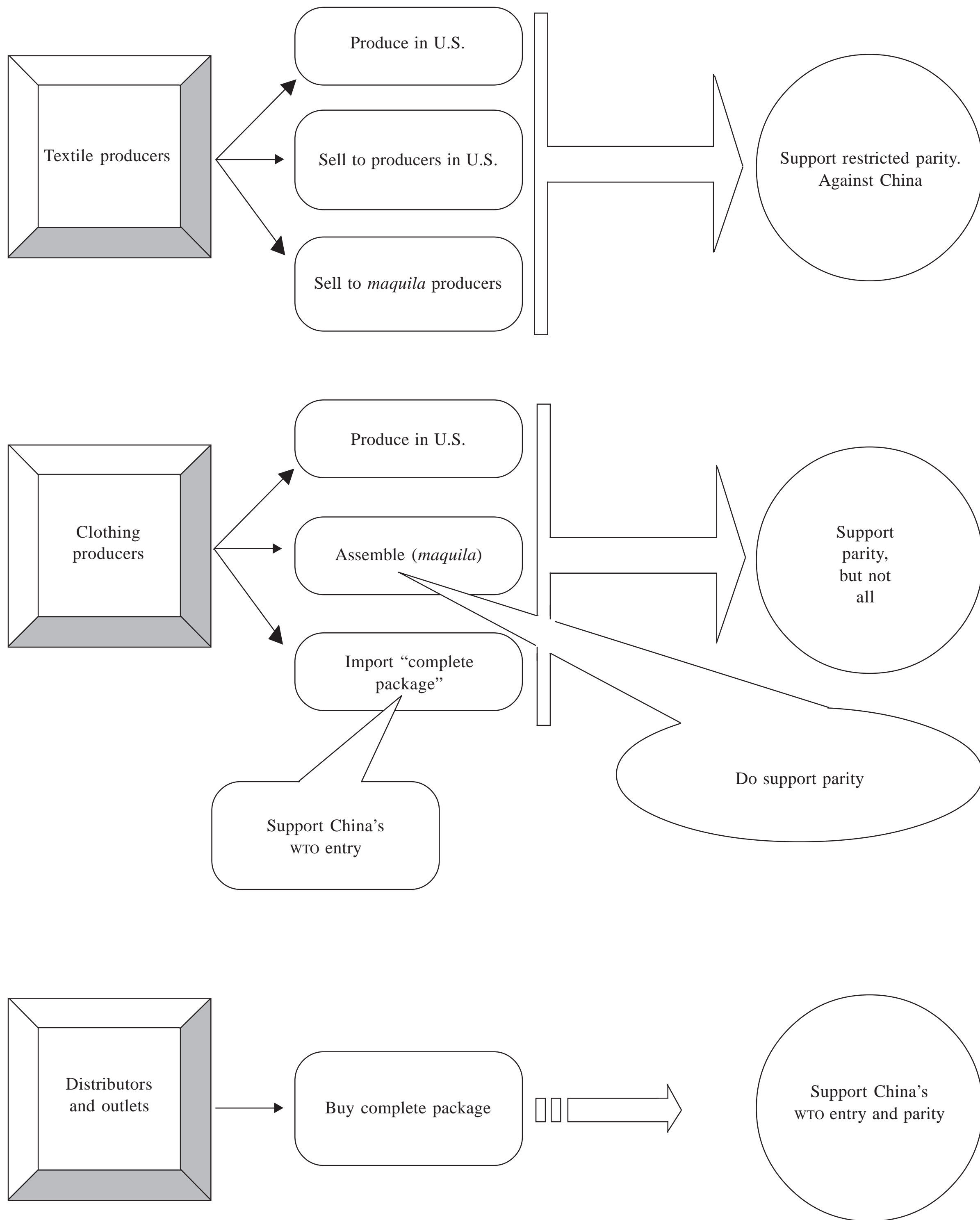


TABLE 10
Selected countries: Labour costs in the apparel industry[a]
(Dollars per hour)

	1996	1998
United States	9.56	10.12
Hong Kong	4.51	5.20
South Korea	4.18	2.69
Costa Rica	2.38	2.52
Dominican Republic	–	1.49
Mexico	1.08	1.51
Guatemala	1.31	1.28
Honduras	–	1.05
China	0.28	0.43
India	0.36	0.39
Bangladesh	0.31	0.30
Indonesia	0.34	0.16

Source: USITC (1999b, section 8, p. 7) for 1996 and 1998 data, and Gitli (1997) for data on the Dominican Republic and Honduras, which relate to 1997.

[a] Labour costs include social charges.

and just 6% were State-owned. Export production depends heavily on cloth imported from Hong Kong, Italy, Japan, the Republic of Korea and Taiwan, among others, some 55% of wearing apparel being made from imported cloth (USITC, 1999b, section 8, p. 5).

As we have seen, the combination of China's possible WTO entry and the opening up of quotas for textile products in 2005 threatens to unleash a major crisis for the countries of the Caribbean Basin, which need to address this challenge seriously. Decisions on investments to enhance their competitive advantages need to be taken within this time horizon.

2. Footwear

Footwear (Harmonized System code 64) could be another type of product for which China might pose an increased competitive threat to the countries of the Caribbean Basin. As we saw earlier in table 5, 13.1% of United States imports from China are "footwear, headgear and artificial flowers", the third largest category in the trade between the two countries. In the Caribbean Basin, as was mentioned earlier, footwear is produced overwhelmingly by the Dominican Republic, so the ensuing analysis will focus exclusively on that country.

It should be explained here that footwear is: i) excluded from the tariff preferences of the Generalized System of Preferences, ii) semi-excluded from CBI (if a country in the Basin makes footwear under the production sharing system, this product will be free of taxes when it enters the United States) and iii) included in CBI since the new act of 2000.

Of the Dominican Republic's footwear exports, 34.2% are produced under the production sharing system. Of this proportion, 66.5% is made with United States content and thus benefits from partially tax-free entry to the United States. In this respect it has an advantage over China, a country which could indeed take advantage of the benefits of production sharing, but does not do so because of the linkages that characterize the production structure in East Asia, which mean that inputs are supplied from within the region.

We shall now look at two of the main export products of the Dominican Republic, to see whether or not there is competition from China and, if so, under what price conditions. To this end, we shall analyse the first- and second-ranking products in the footwear category of the Dominican Republic's export trade with the United States: i) parts of footwear, other uppers and parts thereof other than stiffeners of leather (6406106500) and ii) footwear with outer soles rubber/ plastic or natural or regenerated leather (not for sports) and textile uppers (6404193515).

The first product –"parts of footwear, other uppers and parts thereof other than stiffeners of leather"– accounts for some 4% of the Dominican Republic's total exports to the United States, and thus is a very important part of the country's export structure, with a share in the United States market that rose from 47.3% to 60.5% between 1990 and 1998, although it peaked in 1994 at 63.3% and then began to decline slightly. Mexico has increased its share of the same market, especially since 1995, which could be due to the incentives to invest there resulting from NAFTA and, to some extent, the Mexican devaluation of late 1994.[21] China also increased its United States market share considerably between 1990 and 1998, from 0.5% to 7.7%, but this share peaked in 1995 at 10% and then began to decline.

If we analyse the relative pricing structures of each of the main countries supplying this product,[22] we find the following. The Dominican Republic supplies this product at prices 27% higher than the average for all the suppliers, while Mexican prices are 4% lower than this average. China sells at prices that are much lower

[21] In addition, United States inputs account for 8% by value of footwear imports from Mexico (USITC, 1999c).

[22] By relative prices are meant the price of imports from each country in relation to the average price of imports from all the countries.

even than those of Mexico, and 54% below the average for all the suppliers (table 11).

Let us now look at the second-placed export product of the Dominican Republic. This is "footwear with outer soles rubber/plastic or natural or regenerated leather (not for sports) and textile uppers", and represents 0.5% of the Dominican Republic's total exports to the United States. The Dominican Republic increased its market share considerably between 1990 and 1998, from 0% to 37.1%. Its main competitor, China, raised its share from 14.2% in 1990 to 35.5% in 1998. Mexico, which in 1990 was the main supplier with 82%, saw its share fall right down to 18% of the total in 1998.

A look at relative prices shows that the same situation obtains here as with the previous product: the relative prices of the Dominican Republic's supplies were above the average (approximately 60% higher in 1996-1998 and 100% in 1995-1998), while those of China were 28% lower in 1995-1998.

Given this situation, if the agreement signed encourages the United States to import this product from China, that country will be able to compete in the United States market at prices much lower than those of the Caribbean Basin countries and Mexico, whose competitiveness in that market could be affected. This would come about because China would be guaranteed the most favoured nation tariff, which is almost as important as a tariff reduction, since it would lend stability to the trade with that country.

3. Other instruments used in medical, surgical, dental or veterinary sciences[23]

Ranking fourth among the products imported by the United States from the Caribbean Basin is the category of "other instruments used in medical, surgical, dental or veterinary sciences". This category accounted for 2.8% of all United States imports from the Basin in 1998, the main suppliers being the Dominican Republic and Costa Rica, with market shares of 30.3% and 5.5%, respectively. Mexico also accounted for almost 30% of this trade. China supplied just 0.2% of United States imports of these products, so that it does not seem to be a major competitor for the countries of the Basin.

[23] This product is classified as 9018908000 in the Harmonized System.

TABLE 11

Selected Caribbean Basin and other countries: Relative prices of the main footwear products imported from them by the United States[a]

(Average 1995-1998)

	Parts, other uppers and parts thereof	Footwear (not for sports)
Dominican Republic	1.27	2.01
China	0.46	0.72
Mexico	0.96	0.92
Canada	–	1.54
Honduras	0.95	–
India	1.05	–
Costa Rica	1.59	–
Argentina	1.49	–

Source: United States Department of Commerce, MAGIC.

[a] Where relative product prices are not given for a particular country, this may mean not that it does not sell the product, but that it is not a major competitor for this product in United States imports.

4. Parts and accessories of automatic data processing machines[24]

This product ranks sixth among United States imports from the countries of the Caribbean Basin, accounting in 1998 for 2.6% of total imports from those countries. The country in the Basin that has been supplying it is Costa Rica, since Intel set up there in 1997; the country's market share the next year was 2.2%. Mexico also sells products in this category to the United States, accounting for 7.9% of all United States purchases of this type in 1998. That same year, China had a 5% market share in the United States, thereby showing itself to be a strong competitor to Costa Rica and Mexico. In this case, however, the monopolization of the world market is mitigating the problem for Costa Rica.

[24] This product is classified as 8473301000 in the Harmonized System.

VI
Conclusions

The entry of China into WTO will lead to major changes in the reciprocal trading relationship between that country and the United States, but it will also affect the way the two countries' trade with other trading partners develops.

One of the largest increases in Chinese exports to the United States could occur in the textiles and clothing sector. This trade has hitherto been restricted by the use of quotas, but from 2005 onward China could increasingly be a supplier of cheaper products to the United States market, which would not only prejudice the United States textile and clothing industry, but would increase the competition facing the countries of the Caribbean Basin and Mexico, currently major suppliers of apparel products. In fact, the United States Government expects China to increase its share of the United States market for these products by some three percentage points.

This could cause serious problems for the economies of the Basin, which have already seen the growth rates of their textile exports decline because of NAFTA and the Mexican devaluation of December 1994. Nonetheless, the recently passed legislation extending the tariff preferences enjoyed by the Caribbean Basin under CBI is producing a twofold change in the ground rules by favouring the countries of the Basin, and will mean problems for other exporters of wearing apparel.

The important thing where this sector is concerned is that, whether or not China enters WTO, the abolition of quotas in the United States market for apparel products is inevitable. The greatest winners look like being the countries of South Asia, and the main losers those of the Caribbean Basin and, to a lesser extent, Mexico. The entry of China into WTO would exacerbate yet further the situation described, as it would give the country greater access to the United States market and thus restrict yet further the growth opportunities of the countries in the Basin. As was pointed out earlier, however, these have been boosted recently by the expansion of trade benefits.

To sum up, the countries of the Basin have a window of opportunity between 2000 and 2005 in which to restructure their textile and garment sector so that they can take the initiative. This has implications that cannot be gone into here, but it suggests that consideration should be given to the need to organize support policies for the sector and the very basis on which investment is sought.

In the footwear industry, China is a strong competitor to the Dominican Republic, and is in a position to sell more cheaply, as it has been doing hitherto. Consequently, strong trading relations between the United States and China could have adverse implications for the future of imports of this type from the Dominican Republic.

In the "other medical instruments" category, China is a major competitor to the exports of the Dominican Republic and Costa Rica to the United States, so close attention should be paid to China's options for increasing its exports in this area. As regards "parts of data processing machines", China does not seem to be a major competitor to Costa Rica, as it supplies just 0.2% of the United States market.

From the above it follows that the sectors in the Caribbean Basin that could be most affected by the entry of China into WTO are wearing apparel and footwear.

Lastly, the countries of the Basin –and of the rest of the American continent– should see the extension of CBI preferences as the first practical positive sign sent out by the United States regarding the prospects of its negotiating the Free Trade Area of the Americas. In the particular case of the Basin countries, the legislation states that the President of the United States should take all measures necessary to set a timetable of meetings between trade ministers from the countries of the Basin and the Trade Representative of the United States, in order to reach an agreement between the United States and the CBI countries that is advantageous for both parties and contains provisions similar to those of NAFTA. This means that the door is open for the countries of the Basin to begin negotiations with the United States Government on an agreement that will make parity with NAFTA a reality.

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Reflections *on development* financing

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This article sets forth some reflections on the position of the region's countries and the different segments of their domestic financial structures in the international financial system. In the light of the financial globalization taking place in Latin America, it considers the circumstances of the largest countries in the region, looking beyond the stylized arguments of conventional wisdom to analyse different factors influencing the financial situation: sovereignty risk, financial globalization, the degree of financial integration, the cost of capital and the burden of country risk premiums, the link between sovereign risk and fiscal solvency and the consequences of segmented integration. Consideration is then given to courses of action that could reduce country risk. In addition, the role of the different institutional sectors in generating savings is analysed, and the main trends of financial intermediation in the region are considered: banking concentration, the increased involvement of foreign organizations and the role of the public-sector banking system in the circumstances that now prevail.

I
The region's place in the international financial system

1. Introduction

a) *Financial globalization in Latin America*

The involvement of Latin America in the financial globalization process is of 25 years' standing. It was interrupted by the external debt crisis, but in the early 1990s re-engagement took place, and certain emerging tendencies suggested that the region was undergoing a process of increasing integration. The short-lived nature of the Tequila effect seemed to confirm these tendencies. After the Asian crisis, however, the process did not resume. It is not just a case of crises not being "short", in the sense of their after-effects persisting in the economies that suffered them; questions also need to be asked about the tendencies displayed by the financial globalization process since the Asian crisis. Furthermore, new phenomena have appeared, such as financial instability in the United States and the spread of this to the emerging economies of Latin America. There is a potential for financial instability in that country which could have major effects on the weaker economies. Recent cuts in United States interest rates have had a favourable impact, and larger cuts with similar effects are predicted. This is a possible outcome, but it needs to be asked whether it is likely in the post-1997 context, characterized by the "learning process" that the market has gone through in the last three years and the absence of major institutional innovations at the international level. There must also be doubt about the size of renewed capital flows. Can the surge of inflows in 1996-1997 be expected to repeat itself? The financing needs of the region's largest economies require flows on a scale similar to what was seen then, if they are to achieve significant growth rates. If this does not happen, Argentina and Brazil will be in a very precarious situation.

b) *Changes in the countries' international financial position*

One change from the 1990s has been the shift in the circumstances of the recipient economies. The international position of the countries has been altered by the accumulation of external debt and foreign direct investment (FDI). Their balance-of-payments structures are different from what they were at the beginning of the decade. The main problem facing heavily indebted countries is debt refinancing and the funding of current-account deficits created by capital service payments (interest and profits). The balance-of-trade deficit has become less important by comparison with the permanent, growing deficits seen in the financial and factor services accounts. In this respect, the situation is closer to that of 1980 than to that of 1990.

The differences in the way economies developed in the 1990s can be analysed in terms of the routes taken towards international financial integration. The underlying idea is that this is a process characterized by hysteresis, where the conditions obtaining at any given moment depend on an earlier course of events. The most obvious example is external debt. Certain routes towards financial integration lead to situations of greater vulnerability, in which crises are more likely to occur. This issue has been closely studied by ECLAC, which has analysed policy options that avoid these routes. Its recommendations are largely based on comparative analysis of the courses followed by the countries, the different policies that were instrumental in determining them and the lessons provided by periods of crisis (whether locally generated or resulting from an increased propensity to contagion). The countries that followed routes leading to greater vulnerability, while they may have experienced and overcome financial and currency crises, now exhibit "structural" situations of greater vulnerability (the ratios between external debt and GDP, the current-account deficit and GDP, external debt and exports and the current-account deficit and exports, the structure of the current account and the structure of the financial system) as a result of the course taken in the past.

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The high country risk premiums demanded of these economies are a result of the market's assessments of the more vulnerable conditions obtaining there. These very assessments, however, tend to preserve or exacerbate those conditions, because of the effects of high interest rates and reduced capital flows on growth, the external sector and conditions in the financial sector. These countries are caught in a financing trap. They are more vulnerable to crises triggered by domestic factors or contagion, but the situation has not as yet deteriorated into a currency and financial crisis.

After the crisis, Brazil, for example, corrected a number of the features that characterized its previous approach (devaluation, establishment of a dirty float, fiscal adjustment). Nonetheless, the country could not rid itself of the "structural" inheritance from this previous approach, such as its borrowing ratios and the predetermined component of its current account. The market has evaluated these conditions and applied a high country risk premium, and the economy, although it grew in 2000, remains caught in a financing trap.

Argentina overcame its crisis of late 2000 with the help of an international rescue operation, but without making any changes to the policy that had set it on its previous course (this included a contractionary fiscal adjustment the year before, which had no effect on the risk premium). The market was reassured in the short term, but the risk premium continued to reflect the trap the country was in.

What follows looks beyond the stylized arguments of conventional wisdom to highlight factors that influence the situations faced by the region's largest countries.[1]

2. Beyond the stylized arguments

a) *Sovereignty risk*

A national border marks out a political and legal jurisdiction, within which the sovereignty of the government and other institutions of the national State prevails. Under particular circumstances, a nation's authorities may decide on or endorse non-compliance with certain contracts, an aspect of sovereignty that limits the ability of foreign economic agents to enforce contracts involving them. This is an irreducible risk of sovereignty. There is no reason to suppose in principle that this risk is a very significant one, but there is a tension between the financial globalization process and the institutional conditions of nation States, and this may result in situations where financial integration is segmented.

b) *Financial globalization*

This process is almost three decades old. It seems reasonable to date its beginning to between 1971 and 1973, when the United States broke the dollar's link with gold and the currencies of the main developed countries were floated. This was followed by a sequence of liberalization and deregulation of international capital movements and national financial systems. Competition in the market acted as a strong driving force, so that the liberalization of financial flows among countries stimulated and was stimulated by the liberalization of national systems. The emergence of new international business created pressure for lower costs and less regulation at the domestic level. Conversely, the new opportunities opening up in certain countries encouraged deregulation of transactions between countries. The reform sequence was paralleled by rapid growth in the volume of cross-border financial transactions.

This process of increasing integration was and is largely confined to the developed countries. The largest economies in Latin America were part of it from the outset, however. First Brazil, and later on Mexico, Venezuela, Argentina and Chile were major recipients of capital in the 1970s. The two last named, along with Uruguay, then pioneered drastic liberalizing reforms that foreshadowed those applied across the region in the 1990s.

The participation of Latin America in financial globalization was interrupted by the 1980s debt crisis. This resulted in a hiatus of eight years or so during which voluntary financing evaporated. In the 1990s –following Mexico's signing of the Brady Plan, say– Latin America once again became a vigorous participant in both aspects of globalization, through far-reaching liberalization reforms and increasing flows (and ebbs) of capital.

c) *The extent of financial integration*

In the experiments carried out first in the Southern Cone, then on a larger scale in the 1990s, international financial integration was clearly what the intellectual backers of the process had in view. Full integration is tantamount to the establishment of global financial

[1] The factors dealt with are mainly those affecting Argentina, Brazil and, to a lesser extent, Mexico, but in some cases they are also relevant to other countries in the region.

intermediation whereby the yield on the public's deposits, on the one hand, and the cost of capital for borrowers, on the other, are the same for transactions that are economically equivalent (in terms of maturities, risks, collateral, etc.), regardless of the geographical location of savers and borrowers.

Full integration would minimize intermediation costs, reduce the cost of capital to developed country levels and, insofar as the relative underdevelopment of our countries means there are greater opportunities for new business, result in investment and financing flows that would tend to narrow the development gap.

By comparison with the financial isolation that prevailed from the crisis of 1930 until well into the 1960s, it is unquestionable that the globalization process has brought about a significant degree of financial integration among the developed countries and between these and "emerging markets". However, financial integration among developed countries, advanced as it is, is still far from complete. Nominal interest rates are only aligned in cases where operations are insured in the currency futures markets. In general, there is no tendency for real interest rates to equalize. The citizens of each country show a marked preference for local assets. Investment rates are closely correlated with domestic saving rates. In short, although the level of integration is high by historical standards, there is still significant differentiation among the developed countries' financial markets.

The degree of financial integration between developed and underdeveloped countries is even lower. This is due not only to the fact that globalization involves just a small proportion of countries with "emerging markets", but also to the way in which these markets are integrating. Even at times of strong activity, the volume of financial flows is far lower than what theory would suggest in a situation of full integration. In the developed countries, investment in emerging markets is largely carried out by specialist agents and accounts for just a small proportion of their residents' assets.

d) *Segmented integration*

For the region's larger economies, the first stage in the reincorporation of Latin America into the globalization process in the 1990s, as discussed above, was the conversion of the hangover of public-sector external debt into Brady Bonds, which was negotiated in the 1980s. Readmission to the voluntary market coincided with the flotation of a large quantity of public bonds whose ownership diversified in an active secondary market. Public debt bonds were thus the basis for the region's new investment market from the outset. This public debt market was subsequently enlarged by government issues.

Since they represent dollar commitments, the only risk inherent in public external debt bonds is that of default. The price that the market sets on this risk (the country risk or sovereign risk premium) is measured as the difference between the yield that would be obtained if the bond were purchased at its current price and the yield from a bond with similar financial characteristics issued by the United States Government, the dollar borrower whose default risk is lowest.

The evolution of sovereign risk premiums provides no evidence to suggest that the international system that has developed with globalization is tending towards full financial integration. Quite the contrary. The experience of the last three years –the period that began with the Asian crisis– suggests that the system has developed into one of segmented integration, in which the cost of capital is systematically much higher for the emerging economies of Latin America than for the developed countries.

e) *Country risk premiums*

Convergence towards full financial integration would have meant a continuous reduction in Latin America's country risk premiums. This has not happened. As an example, let us look at how the premium, as measured by the J.P. Morgan Emerging Markets Bonds Index Plus (EMBI+), moved in the 1990s for Argentina, the region's most financially open and deregulated economy. At no time did the monthly premium average fall below 280 basis points, and it only went this low on a couple of occasions. After falling during the first part of the 1990s, it bottomed out at that level in the early months of 1994, only to begin rising again in March that year, when the United States raised interest rates. The monthly average then rocketed to 1,800 basis points with the Tequila effect before slowly sinking back to reach its previous low the month before Thailand's devaluation. Following the Asian crisis, the monthly averages never fell below 400 basis points, and the Russian and Brazilian crises took them back up to over 1,000. In 1999 and 2000, when there were no further national financial or currency crises, the premium never dropped below 500 basis points, and in 2000 it tended to increase in response to other events, first the NASDAQ fall, then the rise in the oil price.

Figure 1 shows the monthly average risk premiums for Argentina, Brazil, Chile and Mexico, measured by EMBI+. The relative level of the emerging Latin American economies' risk premiums is associated with certain structural characteristics in those countries, indicative of their solvency. For example, as table 1 shows, recent premium levels for Chile and Mexico, on the one hand, and Argentina and Brazil, on the other, are associated with their respective external debt/export ratios. Local ingredients, such as periods of political uncertainty in Argentina, have also influenced relative variations in Latin American premiums. If their evolution is tracked over the whole of the 1990s, however, it is plain that they all fluctuate in unison as a result of national crises and, more recently, outbreaks of uncertainty from other sources in developed country markets.

TABLE 1

Argentina, Brazil, Chile and Mexico: Debt ratios

(Percentages)

Year	Exports[a] / GDP	External debt[b] / GDP	External debt[b]/exports[a]
		Chile	
1997	28.1	35.2	1.3
1998	26.7	43.4	1.7
1999	29.0	50.8	1.8
		Brazil	
1997	7.6	25.5	3.4
1998	7.4	30.1	4.0
1999	10.2	44.1	4.3
		Mexico	
1997	30.4	38.1	1.3
1998	30.8	38.3	1.2
1999	30.7	33.4	1.1
		Argentina	
1997	10.6	42.6	4.0
1998	10.4	47.2	4.5
1999	9.8	51.1	5.2
2000	11.0	52.0	4.7

[a] Real goods and services exports.
[b] External debt of the public and private sectors.

f) *Contagion and herd movements*

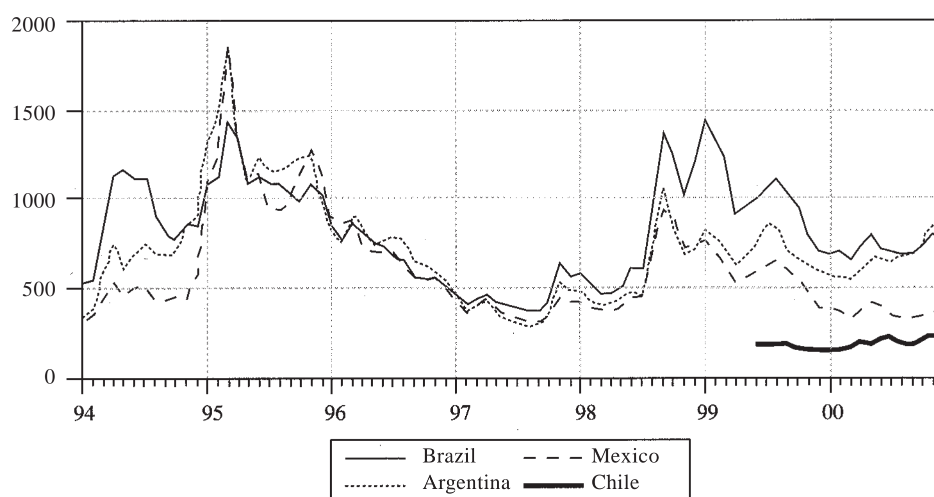
These synchronized fluctuations are the result of herd movements among investors. The very possibility of such movements was discounted in the first half of the 1990s by the orthodoxy that then prevailed both among international organizations and governments and among analysts. This diagnosis obtained recognition with the Mexican crisis, however, and was irrefutably confirmed by the Asian crisis and its aftermath.

The idea was then elevated into the concept of contagion, which has now been incorporated into the thinking of the International Monetary Fund (IMF) and provides the basis for some of its new lines of action. However, this concept is used only to characterize herd movements brought on by national crises. Yet, was it

FIGURE 1

Argentina, Brazil, Chile and Mexico: Country risk premiums

(Monthly values of EMBI+)



not a similar contagion effect that was triggered by the fall of NASDAQ technology shares, at the end of a long bubble? Do not the effects of the oil price rise fall into the same category? The impact of this rise on Mexico's premium illustrates this last point: although the rise in the oil price benefited the Mexican economy, the country's sovereign risk premium rose along with those of the rest of the region.

Recognizing that these phenomena are also a form of contagion is important for the design and promotion of international measures to foster the stability and improve the workings of the globalized market, as we shall argue later on.

We can imagine any scenario for the future, from a world financial crisis and a return to isolation and the negotiation of external debts, to market stabilization and gradual convergence towards full financial integration, because it is a fact that the future is irremediably uncertain. But before imagining the future, we need to recognize the fact that in the three years since the Asian crisis, and a decade after Latin America re-entered the international financial market, country risk premiums have meant that the cost of capital for government issues in Argentina and Brazil, under the best short-term conditions experienced during the period, has been approximately double the United States interest rate, and significantly higher than Mexico's. In Latin America, only Chile's premium is close to those of Hungary, the Republic of Korea, Malaysia and Poland, the emerging markets with the lowest sovereign risk premiums.

g) *Sovereign risk involves more than fiscal solvency*

It might be thought that to sterilize the effects of sovereign risk it would be enough to balance the budget and have no need of further issues. It could be argued, and many have done so, that the whole problem lies with the public-sector finances. This is not the case. Chile, for example, has a fiscal surplus, but its premium is far from negligible. Where is the sovereign risk in a case like that? A country's finances may be in balance or even in surplus, but this does not guarantee that its economy has the foreign currency resources needed to meet dollar-denominated debt servicing and repayment obligations. Furthermore, it is possible that the government may have the foreign currency resources it needs to meet its own requirements, but not those of the economy as a whole, so that there may not be enough dollars to service private-sector external debt. In these circumstances, the authorities may choose or be obliged to suspend the convertibility of the national currency (or payments abroad, in the case of a dollarized economy) and force agents to default on contracts. Sovereignty makes this possible. Sovereign risk involves more than the risk of fiscal insolvency.

h) *The country risk premium determines the economy's cost of capital*

The dollar interest rate yielded by public debt securities traded in the secondary market provides the entire market with a measure of sovereign risk and tends to determine the cost of capital for the country's businesses, in both foreign and local currency. In the first place, it is the opportunity cost for foreign direct investment (FDI) capital. Secondly, it sets a floor for the cost to local companies of obtaining international resources. Thirdly, it sets the floor for the international funding costs of banks, and thus for the marginal costs of those obtaining foreign currency financing locally. Lastly, it also tends to set the floor for the cost of local currency financing. Brief consideration of this last point will allow us to examine other peculiarities of segmented integration.

We mentioned earlier that local investors in the developed countries preferred assets in their own countries, denominated in their own currency. Even when financial systems are highly interconnected among countries, this preference means in principle that their monetary authorities can use policy to set a local currency interest rate that is systematically lower than the international rate (i.e., the rate that the investor would obtain from a foreign currency investment). In our economies, for a number of reasons which cannot be gone into in detail here, preferences are quite the reverse. As financial openness works both ways, local agents are in a position to carry out arbitrage between local currency assets and dollar assets. For this reason, other than in the exceptional case where there is a systematic and predictable tendency for the local currency to appreciate, the real local currency interest rate needs to be at least equal to, and generally higher than, the dollar interest rate.

i) *The consequences of segmented integration*

Persistently high country risk premiums are an unforeseen effect of financial globalization. They have a number of negative consequences. Firstly, high interest rates reduce investment and check growth. Secondly, they produce a regressive income distribution

trend. Thirdly, they make it necessary to transfer revenue abroad, directly through external debt servicing and indirectly in the form of FDI profits. Lastly, in some cases (notably Argentina and Brazil) they result in unsustainable macroeconomic tendencies, as external debt liabilities burgeon.

It might seem that one way of coping with this situation would be to go into reverse and take the country out of the financial globalization process. There does not seem to be any simple way of doing this, however. External public- and private-sector debt is currently the main factor anchoring countries to the international financial system. Regular debt servicing absorbs a large proportion of gross capital receipts.

In the early 1990s, the countries had some degree of choice about the type and extent of financial liberalization they introduced in the face of pressure from large capital inflows. The situation today is completely different for a number of countries, whose main problem is now to obtain financing for regular debt renewals and, crucially, to do so at prices lower than those currently being paid. Consider the examples of Brazil and Argentina. In the early 1990s, Brazil had a trade surplus of some US$ 12 billion and a balanced current account. The country was trying out ways of restraining capital inflows, because of their destabilizing monetary effects. In 1999, following a trade and financial stabilization and opening process, and a year on from the crisis and the corrective measures, Brazil's external accounts showed a trade balance that was in rough equilibrium and a current-account deficit of some US$ 25 billion, owing to interest payments and factor services. Between the early 1990s and 1999, the profit, dividend and interest servicing account deficit rose from 22% to 40% of visible exports. Similarly, Argentina in the early 1990s had a trade deficit of some US$ 2 billion and a US$ 6 billion current-account deficit. In 1999, at the trough of the recession, the trade balance was in deficit by US$ 700 million, while the current-account deficit was US$ 12.3 billion, because of interest and capital servicing. The capital service and interest account deficit rose from 20% to 33% of visible exports between the early 1990s and 1999.

j) *Multiple equilibria*

Relative risk premium levels reflect the market's assessment of different degrees of vulnerability and are correlated with solvency indicators, as we pointed out earlier. Greater relative vulnerability implies a higher likelihood of crisis in the face of an equivalent shock. The occurrence of a crisis, regardless of what triggers it, may be rationalized as a movement from one equilibrium to another in a multiple equilibria model (this is the main application of multiple equilibria models in the literature on the subject). Any economy can suffer a crisis when faced with a shock of sufficient magnitude, but there are configurations which are more likely to experience crises (to "jump" from the current equilibrium to a crisis situation). Thus, all economies have two "equilibria": the current equilibrium (the good one, if there is no crisis) and the crisis one. In some economies the current equilibrium is more unstable than in others, i.e., it displays greater vulnerability.

What has been said so far can be supplemented by two considerations. The first is that it is possible to reason in terms of tendencies, classified by their potential for growth and sustainability, rather than regarding any non-critical situation as a single "equilibrium". The economy may be stuck for a longer or shorter period in a "trap" of high interest rates, low growth and high vulnerability. It is then following a path that is unsustainable in the long term (owing to the tendency of debt ratios to rise explosively), but it may operate in this situation for a certain amount of time without actually going into crisis. This configuration is the combined result of past movement towards some degree of international financial integration and the assessment that the market makes of the risks of this. Thus, instead of distinguishing between two equilibria (crisis and non-crisis), we can distinguish between two tendencies: the low growth trap configuration and a virtuous growth tendency.

The second consideration is that the market's assessment, i.e., the risk premium it demands and the volume of the country's assets it is prepared to absorb, will be instrumental in determining whether or not crises occur and what type of tendency is followed by the economy. For example, all other conditions being equal, an economy may find itself in a trap configuration or in a virtuous growth configuration, depending on its country risk premium and the flows of capital it receives. The economy may have become caught in a trap configuration because of a contagion effect, but once it is in this position its indicators will tend to worsen and the market's negative assessment become a self-fulfilling prophesy. A lower country risk premium and an increased flow of financing could restore virtuous growth, but investors will not alter their expectations unless a coordinating signal is received.

From the multiple equilibria perspective, international action to reduce sovereign risk (for

example, the creation of a lender of last resort function) can be justified as a crisis prevention measure, as it reduces a country's propensity to make the jump to the crisis equilibrium. Similarly, the distinction between types of tendency can be used to justify intervention as being necessary in particular cases to allow the economy to escape from a low growth trap and enter a virtuous growth path, or at least to make this possible.

3. Courses of action that can reduce country risk

The ultimate reason for sovereign country risk premiums is that very sovereignty which nations have in our times. The financial globalization process could have had another issue, but the situation it is now in was always one of the likely outcomes. When dealing with the facts of segmented integration, we generally reason by analogy with national financial systems to identify the failings of the system created by globalization. We observe that this international system is lacking in many of the institutions that have been built up over time in national systems to improve their stability and the way they work. The institutions and track records of individual countries suggest that it would be advisable to design institutions that can play similar roles internationally. Establishing such institutions, however, would in each case mean putting an end to different attributes of national sovereignty. This is so even as regards the production and distribution of fiscal and financial information, which is the area where most progress has been made in the discussions and agreements of the International Financial Architecture (IFA) forums. It is even more essential when it comes to the establishment of international bodies to carry out prudential oversight and regulation, an issue with which little progress has been made and concerning which misgivings have been expressed by some developing countries, their fear being that risk provisions could restrict the flows of capital they so much wish to attract. The multilateral IFA debates are important, but we do not expect them to produce solutions in the near future. Other ways need to be sought.

Insofar as sovereign risk is essentially the danger of breach of contract resulting from the practical impossibility of compliance, it tends to fall when additional guarantees exist in the form of contingent access funds available to countries that encounter difficulties. This function is similar to that of a lender of last resort, a role played nationally by the central banks of many countries. It is possible to imagine this role being taken on by all sorts of institutions, and the United Nations should continue to encourage discussion of the subject in IFA forums. Considering the positions that the United States has taken, however, and will probably continue to take under its new Government, it seems clear that for the foreseeable future international financial functions will continue to be performed mainly by the Bretton Woods institutions.

The IMF instrument whose function comes closest in formal terms to that of providing guarantees to reduce sovereign risk is the contingent credit line, for which regulations were recently produced. The take-up conditions for this credit line are so stringent, however, that countries which are able to meet them feel no need to make use of it, while those that need it most do not meet the criteria. In parallel, IMF has established another credit line –the supplementary reserves service– whose amount is not predetermined and whose access conditions are far more discretionary. The Fund created this line during the Republic of Korea rescue operation, applied it in the operations that followed the Russian and Brazilian crises, and recently granted it to Argentina.

By creating this line, IMF has taken a significant step towards acting as something akin to an international lender of last resort. It would seem reasonable to try to progress further along this route, which looks to be the most viable one, although the conditions of access to the contingent credit line should continue to be discussed. If further progress is to be made towards significant reductions in risk premiums, the funds available will have to be increased, and the circumstances in which they can be drawn upon will have to be extended. Access would be more open, for example, if the idea of contagion were broadened to take in the effects deriving from outbreaks of uncertainty of various types in the developed world financial market, as discussed earlier.

Greater access to funds –whether made available by the public sector or provided in the markets and indirectly guaranteed by developed country governments– and broader and more automatic conditions of access could have a significant effect on risk premiums and would improve the workings of the system because they would reduce the likelihood of crises arising. But it will be difficult to achieve these conditions unless further sovereignty is ceded to multilateral bodies, because it is this cession of sovereignty, operating in conjunction with greater availability of contingent funds, that reduces sovereign risk. One example of this type of effect is the zero risk

premium paid by the Greek economy because the country is a member of the European Union.

In theory, ceding sovereignty to multilateral bodies does not mean losing it, but rather exercising it in a shared, negotiated manner. However, IMF and the World Bank are not organized democratically. It is going to become more and more controversial (and legitimately so) for countries to give up sovereignty without securing in return a greater say in the running of the bodies concerned. Consequently, the agenda should not only include extension of the functions discussed earlier, those of a lender of last resort, but should give priority to addressing the way multilateral bodies are run.

II

Domestic financial systems

Throughout the 1990s, the countries of Latin America followed, to a greater or lesser degree, the economic policy agenda inspired by the so-called Washington Consensus. The theoretical underpinnings of the measures involved were provided by a vast literature whose conclusions strongly backed a market-friendly approach to solving the region's main economic problems, including those connected with the financial system. But the results of applying these measures often fell far short of the expectations aroused by their backers, and on occasion were even diametrically opposed to them. Furthermore, too little account was taken of how specific the problems of each country were, and on occasion crucial "details" of their institutional structures were overlooked.

What is more, the policies applied were not informed by an objective reading of relevant international experience from outside the region. There are certain lessons that can be drawn, for example, from long-term processes in the countries of South-East Asia. Although some of the strategies applied there, such as the large-scale use of forced saving mechanisms and/or sectoral promotion policies involving an effective system of rewards and punishments, would seem to be difficult to replicate under the current economic and political conditions of Latin America, we believe they should not be dismissed out of hand, particularly if a sceptical view is taken of the results of the policies applied in the 1990s.

1. Saving

The literature on the subject recognizes the difficulties involved in determining with any accuracy the impact of certain key variables (such as the interest rate) on the saving rate. Only very rarely, however, is even the most tentative reference made to the possible influence of purely cultural factors on saving. This is consistent with the profession's "aversion" to accepting that variables of this type might be relevant. If it is acknowledged that they do play a role, it becomes obvious that "material incentives" to greater saving need to be combined with a communications policy that seeks to alter the consumption patterns of Latin American households. In a way, this argument reaffirms Prebisch's view that one of the factors holding back growth in Latin America is the imitation of consumption patterns originating in societies with much higher per capita incomes than the region's.

Again, studies seeking to guide policy-making often contain statements that, although they are supported by the theoretical literature and meet with general agreement among economists, should be expressed more cautiously. For example, reference is often made to the importance of a stable macroeconomic environment as a prerequisite for any strategy to increase saving, and stress is laid on the benefits of having a diversified array of financial instruments. Yet in the United States, where not only is this prerequisite met but agents have more saving vehicles available than in any other economy, the household saving rate has been negative over recent years. Paradoxically (from a conventional point of view), there is evidence of circumstances in which household saving reacts positively to increased uncertainty.

It does not seem such a simple matter to stimulate household saving in Latin America purely on the basis of market incentives. The household saving rate is very low, and in some cases negative. In our region, in fact,

saving is carried out mostly (and in a greater proportion than is the case in developed economies) by the corporate sector. Despite this difficulty, there can be no doubt that private-sector saving in Latin America will only increase if household saving is stimulated.

a) *The pension system*

In the first place, it is routinely claimed that an unfunded pension system has a negative impact on saving. This is true in the first instance. But it should not be forgotten that what ultimately matters is not what items in the public accounts show disequilibria, but how large the overall fiscal deficit is. It is possible to design an "unfunded" pension system that is actually fully funded through higher taxes and contributions (whereupon, according to the argument referred to, there would be no negative impact on saving). Yet if we accept that there is always a maximum limit, determined by the characteristics of the economy concerned, on the total tax burden that will be borne, the corollary of the equilibrium thus achieved in the pension system would be a larger imbalance in other areas of the public accounts, as the level of other taxes would have to be below what it might have been had pension contributions been low.

Secondly, while the rationality of agents should not be exaggerated, it would seem that in Latin America the future beneficiaries of pension systems generally apply a high discount rate to their future incomes, as it is highly likely that the promises incorporated into current pension laws will not be able to be kept in full. Again, the authorities should try to make people aware of the urgent need to carry out additional saving to supplement the income that will be provided by the pension system.

One view that has won growing support is that it would be advisable to bring in individually funded systems, as has already happened in a number of Latin American countries, in view of the way such schemes stimulate the development of the capital market. In practice, however, this connection is weaker than the literature suggests, and the empirical evidence does not show the kind of dynamic impact that was predicted by the backers of pension reform in the 1990s.

A large proportion of funded system assets are invested in public-sector securities issued by governments mainly for the purpose of financing the imbalance caused by the transition from one system to the other. In some cases, these bonds pay quite high interest rates, raising doubts about the long-term solvency of the public sector.

One possible solution that falls somewhere between the two extremes is a State-administered funded system. The administration costs of private-sector funded schemes are very high, and have undesirable consequences for distribution owing to the structure of the commissions charged by pension fund managers (PFMs). Early experiences in Latin America show that these systems are inefficient. Competition among PFMs is through advertising rather than performance differences, which means that scarce social resources are being used for a sterile activity that is short on the real information content needed to guide rational decision-making by contributors.

On top of this, there are the costs of regulating and overseeing the system. Indeed, it can be argued that the system would not be efficient even if agents based their decisions solely on the yields obtained by managers. This is because regulatory systems limit the scope for differentiating portfolios and because a good past performance does not always mean higher yields in the future. Taking the argument to the extreme, in more or less efficient markets the likelihood of exceptional yields being obtained is necessarily low, and for the system as a whole it is non-existent.

For these reasons, it can be argued that a State-run funded system may be the ideal. But the difficulties of implementing such a scheme in Latin America are not minor. The main objections centre on its potential vulnerability to any pressures from government and interest groups. Indeed, it is partly because of this vulnerability that the old unfunded systems are unviable. But consideration should be given to the possibility of giving a State system of this kind a degree of independence similar to that enjoyed by some central banks, with authorities whose terms in office are longer than those of the political authorities. Having a high proportion of public debt in the portfolios of government-run funded systems does not invalidate their "optimality", as private systems also have a high proportion of such securities.

If it is generally agreed, however, that the best thing is to continue along the route of replacing unfunded systems with private-sector funded systems, it is vital for the workings of the latter to be improved. There are two areas in which urgent progress is needed. Firstly, there need to be better incentives to bring down administrative costs that do not feed through to better customer service. Secondly, there have been instances of situations and behaviour that have raised acute conflicts of interest to the detriment of savers, arising because of a failure to separate PFMs properly from

banks. In some cases, PFMs have been "pressurized" to purchase packages of shares at above market prices on the occasion of mergers or the creation of holding structures. There have also been cases of banks "dumping" unwanted assets on to PFMs, sometimes by means of triangulation with other organizations.

These problems, which arise because dividing walls are weak or non-existent, and which affect more than just pension systems, have been found even in circumstances where strict compliance with the relevant legislation (which is mainly "imported" from countries with good practice) would have ruled out the operations we are referring to.

This shows how important it is to enforce compliance with existing regulations, something that appears to be inadequate in the region. In particular, regulatory bodies set up by governments show a tendency to be "captured" by the larger of the institutions being regulated. Consequently, it is vital to give greater stability to officials working in the regulatory agencies and guarantee their immunity to decisions by the political authority. Again, officials who leave these regulatory bodies need to be debarred from going straight over to work for the firms they were regulating, with no transition period.

One way of encouraging higher saving rates would be to introduce additional voluntary contributions, but with liquidity characteristics that would make them more attractive to future pensioners. It seems to be the absence of this factor that largely accounts for the low level of additional contributions in systems that permit them.

b) *Company saving*

We mentioned earlier that saving in Latin America is carried out mainly by the corporate sector. In the aggregate, retained profits account for a greater share of company financing in the countries of the region than in developed countries. In addition to the use of tax incentives and accounting rules to discourage dividend distribution, company saving could be stimulated by policies to make investment more attractive, since when projects yield high returns there is a "natural" incentive to reinvest profits. This is because the use of internally generated funds is the lowest-cost option, as is shown both by the theoretical literature on financing and the empirical evidence from industrialized and less developed countries. Companies have recourse to bank borrowing, bond placements or new share issues when internal funds are insufficient. This gap between the cost of internal and external financing, which constitutes the external financing premium, is relatively high in the Latin American countries, probably because information asymmetry problems are more severe there.

It would seem that the borrowing of Latin American companies is at a suboptimal level (they are "under-leveraged"), which is consistent with the existence of market failures in the financial system. This may seem paradoxical at first sight, as most of the region's tax systems provide strong incentives to borrow. What this brings to light is the need for financial deepening of the economy and the development of capital markets to stimulate saving and channel it towards the companies with the most profitable projects. A policy of this type, however, should try to correct the bias against small and medium-sized enterprises (SMEs) produced by any system that encourages company borrowing. It is vital to ensure that SMEs have better access to credit.

c) *Public-sector saving*

A prudent fiscal policy does not necessarily imply a fiscal surplus or zero deficit, since a growing country can finance moderate deficits without this necessarily being destabilizing. Again, warnings about the advisability of achieving balanced budgets or surpluses are formulated in very general terms and treat the countries of the region as if there were a level of homogeneity among them which does not in fact exist. The blanket imposition of fiscal surplus goals is too arbitrary and may be detrimental, even in terms of long-term fiscal solvency. The differences among the countries in terms of fiscal institutions and political organization mean they have varying degrees of freedom in the running of fiscal policy. These constraints, which are particularly important in large federal countries, will have to be taken into account if proposals are drawn up for reforms (regionalization, for example) that aim to tackle the root of the problem. Likewise, self-imposed budget deficit limits are difficult to justify when countries have very little room for manoeuvre in monetary and exchange-rate policy, as in practice these would mean that they were unable to moderate the shocks that affect their economies to even a small degree.

Again, there is unquestionably a need to free up resources (savings) for private-sector investment. In Latin America, however, there is no lack of projects offering a high social return, higher even than that

available from the projects that could be taken on by the private sector if more resources were freed up by the public sector.

Governments sometimes make heroic fiscal adjustment efforts to achieve fiscal targets laid down in agreements with IMF; this forces them to carry out operations that generate associated costs, which can be considerable in the long term. One example is the sale of public-sector companies or shareholdings or the granting of concessions at times when the circumstances are not at their most propitious, in a determination to comply with the letter of the fiscal targets accepted. This means that some of the revenue potentially obtainable from the private sector is foregone, and is actually detrimental to long-term fiscal solvency insofar as the present value of public-sector revenue is reduced.

On another level, the public sector often plays a further role: that of obtaining the currency needed to finance the current-account deficit. In certain of the region's countries, the private sector runs a structural deficit in its external operations and its contribution to the accumulation of reserves is negative, whereas the public sector obtains currency resources in excess of its external financing needs and thus does contribute to the accumulation of reserves and to the financing of the private sector's external deficit. Thus, a lower fiscal deficit could mean a weaker currency and/or difficulties in financing the current-account deficit of the private sector.

d) *How savings are used*

The effort made in the last decade to increase the range of the saving instruments issued by residents and of the tax and regulatory incentives used to encourage their take-up in Latin American markets has not had the results hoped for. In the region, there are numerous examples of financial savings rising while the saving rate has fallen or remained unchanged. There are many instances of successful development where the consumption of certain types of goods has only taken off once a considerable level of development has been attained. In Latin America, for example, imports of consumer durables have a large negative effect on the balance of payments. In this case, applying particular restrictions (such as tariffs) helps increase saving.

Apart from the investment financing aspects, one subject of key importance is the need to raise the efficiency or productivity of investment and improve on the very poor record our countries have in maintaining social capital (which implies a high depreciation rate). In Latin America there is undoubtedly a great deal of scope for improving the situation through better maintenance, even without changing the net investment rate.

2. Financial intermediation

a) *Bank concentration*

It has to be asked whether the tendency towards greater bank concentration is not a cause for concern. The answer is far from categorical. Not all the region's financial systems show a high level of concentration. Furthermore, any attempt to reduce this level may clash with other objectives, such as keeping a high market share in the hands of local banks. Indeed, at a time like the present, when financial globalization is making giant strides, local institutions can only retain a significant share by growing to a size sufficient to allow them to compete with foreign banks and/or to act as a barrier to entry for potential competitors. Ultimately, the problem of moral hazard deriving from the existence of organizations that are "too big to fail" (and thus enjoy a form of implicit insurance) needs to be tackled by strengthening the regulatory and bank supervision framework. The size of banks is not a problem in itself (as is demonstrated by the case of Canada, among others), unless the institutional framework is very weak.

Nor is there any justification for overdone concern about the perils of higher bank concentration if this is the result of greater participation by foreign companies, especially in the case of top-ranking international banks. The moral hazard is less in this case, as it is less likely (and less politically acceptable) that governments would go to the aid of foreign banks rather than public-sector or local private-sector banks. It may be argued that the risks of concentration are not unconnected with the nationality of the banks concerned.

b) *Greater participation by foreign companies*

Although in principle, and as a very broad generalization, the international correlation of systemic risks increases when foreign financial institutions have a larger presence, this does not appear to be a very important factor in the Latin American context. Preventing banking crises from being "imported" from the developed countries is not, and should not be, a priority concern in our countries, where local sources of upheaval loom much larger. Although in theory the correlation referred to increases, in the region this is associated with a moderation of risk since, in general,

large foreign banks are perceived as being more solvent than local ones.

This is the case, firstly, because banks coming in from outside are generally closer to financial "best practice" than Latin American ones. Secondly, because (up to a point) the head offices of foreign banks come to act as lenders of last resort for their local subsidiaries. In fact, there has even been a case of a large bank from an emerging market in Latin America (Banamex) capitalizing a bank it controlled in Argentina (Bansud) when this was in great difficulties, to avoid the reputation costs that would have resulted from bankruptcy. Consequently, it is to be hoped that banks whose parents are in more developed markets would act with similar or greater zeal to solve any problems that their subsidiaries in the region might face.

From another perspective, lastly, the presence of these banks means that depositors can diversify their portfolios among institutions with an international reach, which reduces the country risk they assume. This is better than local investors reducing their country risk by sending their capital abroad.

By and large, the experience of Latin America seems to show that in the region it is better to have a fairly concentrated system of universal banks. There have been cases in which competition within weak regulatory frameworks has led banks to adopt excessively risky strategies that have exacerbated instability in the financial system. By contrast, higher profitability and less competition mean a lower likelihood of bank runs and less of an incentive to take risks. Again, a universal banking system dominated by large organizations can help to improve the quality of management and governance in these institutions.

None of this means, however, that bank concentration and increasing participation by foreign companies do not have negative implications that need watching closely. Firstly, excessive concentration or oligopolization may allow the dominant companies to generate high quasi-rents; in this case, State intervention would be justified by the need to correct this market failure, and would require a regulatory framework that stipulated maximum percentages of market share and outlawed mergers that created obstacles to competition. It may, however, also justify the role of "first tier" or retail public-sector banks, insofar as they can operate as "controls" and oblige private-sector banks to set prices closer to what they would be in a more competitive situation.

Secondly, larger banks (and particularly foreign ones) usually follow more conservative lending practices. It is also common for regional banks, or banks catering to risky sectors, to be replaced in certain areas by these international banks, which drastically reduces the supply of credit for those very firms and individuals that find it hard to get sustained access to funding (farmers, SMEs, businesses in disadvantaged regions, low-income or medium/low-income families, etc.). What is more, the degree to which lending responsibilities are delegated falls as the participation of foreign banks rises. In practice, all loans for large sums, particularly when they are connected with the financing of investment projects, are approved in the country where the bank has its head office. This is clearly an undesirable result of greater foreign bank participation and suggests that there is a need to ensure the survival of a strong local banking system, be it public or private. Again, while it is difficult to quantify the scale of this effect, from a macroeconomic point of view the concentration of lending responsibilities in the head office increases the correlation of the cycle among the Latin American countries and between these and the home countries of the foreign banks. The sensitivity of investment to the risk premium would increase as well.

c) *Public-sector banking in today's circumstances*

For all the reasons given above, the centrality of the role that belongs to the public-sector banking system should not be underestimated. Unquestionably, though, the way this role is played has to be suited to the new international and local circumstances. In a number of the region's countries, many of the leading commercial banks are still in the hands of the State, which has retained a key position in domestic financial systems. Public-sector banking played a decisive role in Latin America during the import substitution industrialization period. Directed credit increased rapidly, covering many sectors, and became one of the primary tools for supporting the development of industry, agriculture and social programmes. Public-sector banks tried to make up for the shortcomings of weak domestic capital markets as a source of long-term financing, but serious management problems resulted in huge losses building up, and these have not yet been cleared despite the fact that directed credit policies have become more focused and less ambitious.

The vast majority of public-sector banks did not give credit risk assessment the importance it deserved, and their loan recovery rates were alarmingly low, while arrears were extraordinarily high. These institutions

were very vulnerable to pressure from interest groups, and often overreached themselves in their quest for profits. In short, they became an extremely inefficient mechanism for channelling subsidies. Even some developed countries have had costly experiences with public-sector first tier banks. A recent case is that of Crédit Lyonnais, in France, which has unveiled large losses despite having a highly professional staff.

Taking all this into account, what should be the function of State banking in Latin America? Both economic theory and the experience of East Asia suggest that focused, well administered lending programmes can work well in many cases. But it needs to be asked which channels are the most appropriate for implementing a policy of this type. Given the serious adverse effects that can be produced by a poorly functioning first tier State banking system, it seems imperative in many cases for the State system to be turned into a second tier one. First tier State banking would be justified in cases where the private system did not provide the necessary services in particular regions, or did so inadequately (presumably because profitability there was low), or because the market was segmented in a way that was detrimental to SMEs, or because the private-sector financial system was highly oligopolistic and the State bank could act as an effective control. There is also a further role that public-sector banking can play when financial systems have particular institutional configurations (for example, in a convertibility regime, when the central bank is restricted in its role as lender of last resort).

In any event, the continued survival of State banking, be it wholesale or retail, can only be justified if major reforms are made in the management of these institutions. First tier State banks need to apply the regulation, supervision and risk rating standards that prevail in the private sector. There is also a need to avoid pointless overlaps, with State banks "competing" with one another in the same markets; this is inefficient, and results in a waste of social resources. The need for a bank that can act as a control or follow countercyclical policies when private-sector banks are showing great risk aversion does not mean that there should be numerous public-sector banking institutions. Such multiplicity would create the risk of sterile competition among them for benefits of a political nature.

There are some basic principles that public-sector banks should observe, many of which require far-reaching institutional redesign. Firstly, any subsidy component implicit in the lending practices of these banks should be made transparent and budgeted for. Correct valuation of subsidies is a prerequisite if taxpayers are to understand the cost of maintaining these institutions, and it is also necessary so that parliament, which is responsible for passing the government budget, can give them their due weight within the ranking of government policy priorities.

Secondly, public-sector banks, like the central bank, should be completely independent of the political authorities. To guarantee this independence, the members of its board need to have a longer term of office than the members of the government executive. In addition, the boards of these institutions need to include directors appointed by the minority in parliament to carry out oversight and auditing functions. Once a certain level of transparency had been attained in the accounts of these banks, performance-related incentive systems could be created for the board and top management.

Thirdly, public-sector or development banks need to give priority to the financing of projects concerned with the production of tradable goods that can increase exports or replace imports. The projects submitted should be ranked by their potential for generating currency. In principle, sectors that can neither generate nor save currency should not receive much credit assistance from this system, but should seek it in the private sector.

Fourthly, the SME sector deserves special consideration. A subsidy component may be justified for these companies, even if their output is not tradable, if their potential for job creation is well above the average. In this case, it might be appropriate to use funds from the budget to subsidize interest rates on loans to SMEs, this subsidy being distributed among the banks on the basis of which of the lending rates proposed was lowest. This type of instrument is very efficient, as a large effect is produced for a relatively small outlay. Leasing is another instrument that can be very useful in counteracting the effects of the high interest rates and excessive collateral demanded before SMEs are granted loans for machinery purchases. In many Latin American countries the legal framework is not at all appropriate for operations of this type, and should be reformed. In particular, banks should be required to set up separate subsidiaries to enter into leasing contracts. It would also be advisable for the lessee to be allowed to write down the asset over the same period as, or a period shorter than, the life of the leasing contract. Furthermore, for contracts of this type to be attractive it is almost indispensable for the instalments payable to be tax-deductible for the lessee. On the demand side, experience shows that an aspect of no small importance

is the way the loan dossier is prepared for the bank. Thought could be given to introducing a Chilean-style consultancy system throughout the region (i.e., subsidizing part of the cost of engaging the services of professionals authorized for this purpose by the State), or to using a simplified submission scheme like that of the Small Business Administration in the United States. In this latter case, the simplified form could be drawn up in agreement with the banks. The two schemes could complement each other if the consultancy component were not confined to the processing of the loan but also included management of the project for which the credit was being sought.

There is broad agreement about the merits of creating or strengthening mutual guarantee societies (MGS). In the region's larger countries, where a significant number of operations could be expected (which would lower the average administration cost), the option of a public guarantee fund could also be considered. If a mixed system were decided on, this fund should act as a provider of counter-guarantees, taking upon itself part of the risk assumed by the MGS. Of course, the existence of a public guarantee fund should never obviate the need for MGS to demonstrate their effectiveness by adhering to rigorous professional standards when evaluating projects. Consideration could be given to a system in which the cost of reinsurance was inversely proportional to the effectiveness of the MGS, measured by the failure rate of the operations supported.

Other instruments whose use should be encouraged are venture capital funds and credit trusts. These can be used to increase the efficiency with which the public-sector resources available are employed and enhance lending capacity through the participation of large institutional investors in the private sector. To optimize the use of trusts, they should be focused on microenterprises and small businesses, as projects of this type are the ones that have the greatest difficulty in obtaining access to the banking system, and thus have few financing options. As regards microfinance, the role of saving and loan cooperatives should not be underestimated. Although the experience of the region is mixed, with some striking successes and failures, these institutions are particularly well placed to provide financing to SMEs and lower-income sectors, while at the same time achieving satisfactory levels of credit recovery. Regulatory standards and legal frameworks need to be adapted, however, to ensure that they can compete with the commercial banks and to solve the problems of governance that frequently afflict them.

Fifthly, public-sector banks should share financing with private-sector ones as far as possible. In other words, excessive participation by the former in project financing should be avoided if practicable. The ideal thing would be to keep public-sector financing down to a minimum, while seeking to share some of the risk (but not the financing) of projects through a system of guarantees.

The banking *supervision agenda* in Latin America

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The banking sector reforms that the countries of Latin America undertook in the 1990s were an important step forward, but proved insufficient. Although it is true that the region as a whole progressed significantly, particularly in reducing the role of the State, and that market mechanisms and the regulatory framework in which banking institutions operated were improved, while at the same time the presence of foreign operators increased, it is no less true that most of the Latin American countries continued to experience systemic crises or severe banking instability. This shows that there are still issues that need to be addressed before the region can have a sound banking sector. They include in particular the need to do more to increase the real independence of supervisory bodies by separating bank supervision from short-term economic and political decision-making. Bank supervision needs to be regarded as a matter of State, which means giving priority to its technical and professional aspects; to overcome the difficulties involved, it is essential that there be a real political will to carry through the changes that are required. This article highlights the need to deal with some structural issues, such as the supervision of financial conglomerates, excessive market concentration among a few institutions nationally and region-wide, and the relationship between this and the safety nets which are supposed to contain systemic crises, but which are unable to do so adequately. As regards the regulatory aspects, this paper argues that transparency and market rules in general need to be improved, as do mechanisms for evaluating portfolio and related-party credit risk, especially where effective application of existing rules is concerned.

I

Introduction

Traditionally, policy recommendations for reforming the financial sector in the Latin American countries have not addressed issues relating to the role played by bank supervision. This changed in the 1990s, when experts began to treat them as a matter of key importance for economic stability and growth. Meanwhile, international financial organizations and governments focused their attention on aspects of bank supervision as the last stage in a sequence of reforms which included, among other things, market opening, tax reform, deregulation of the financial sector and privatization. Bank supervision was put on the agenda largely in response to the financial crises that broke out in a number of countries around the world.[1]

The financial crises of the 1990s showed that bank liberalization needs to be preceded by regulatory and supervisory reform to provide the bodies responsible for these functions with the knowledge, tools and powers they require to carry out preventive supervision in a timely fashion. There also needs to be a properly structured and disciplined market that provides incentives for the different actors. Thus, the capital provided by bank owners should reflect the risk profile that their institutions wish to adopt, and it is the owners that should suffer the consequences of bad management decisions. Depositors, meanwhile, should inform themselves about the situation of the banks they keep their money in, and likewise take any adverse consequences that may result from their decisions. Again, supervisors should provide agents with the information they need in a timely and appropriate way, a task in which they can be assisted by private agents such as external auditors and risk rating firms. Lastly, supervisors should have the powers they need and be able to exercise them independently, so that they can respond promptly and proportionately to situations as they arise.

This paper analyses banking supervision problems in Latin America. Section II examines the reforms carried out in the Latin American banking sector in the 1990s. Section III reviews the main effects of banking liberalization in the region. Section IV summarizes the problems currently besetting Latin American supervision systems and, lastly, section V sets forth the main conclusions.

II

Banking system reforms

In Latin America, the financial sector reforms carried out in the 1990s differed from one country to another. Thus, some countries opted for fundamental legal reforms: Bolivia, Chile, Ecuador, El Salvador, Honduras, Mexico, Panama, Paraguay, Peru and Venezuela. Others decided on reforms which, while partial, still led to major changes: Colombia and Costa Rica. In other countries again, only selected aspects of the relevant legislation were amended, but this had a considerable impact: Argentina, Guatemala and Uruguay. Brazil, meanwhile, made significant changes in its market without amending the law (Aguirre, 1998).

Despite these differences, clear patterns can be discerned in the reforms undertaken in most of the region. Thus, State participation in the banking system was reduced in the leading countries. In Argentina, for example, between 1990 and 1996 the number of State banks fell from 36 to 20 (Leipziger, 1999). Again, most of the State banks in Brazil were restructured, privatization being one of the objectives that were kept in view.

Another striking aspect was the increase in foreign participation in the sector. In Brazil, for example, 20% of banking system assets were in foreign hands by early

[1] The absence of this issue from policy recommendations is surprising given the experience of countries such as Chile, which are often pointed to as examples of reform. The 1982 crisis in the Chilean banking sector was extremely costly and issued from a classic combination of inappropriate macroeconomic policies and very inadequate bank supervision (Marshall, 1991; Edwards, 1995 and Ffrench-Davis, 1999).

1999, as against some 5% in the mid-1980s. In Argentina, the figure is on the same scale; the number of foreign banks rose from 14% to 19% of the total and, what is much more significant, in 1999 foreign banks accounted for 25% of all lending. Four of the country's top 10 banks are now foreign.

One of the main purposes of the reforms was to increase the range of operations that banks could engage in. Thus, banks in all the countries were authorized to provide factoring, leasing and other financial services directly in their capacity as financial intermediaries. It was also made easier for banks to participate in stock market activities, particularly brokerage, underwriting and fund management. Banks do not generally carry out underwriting themselves, although in some cases they have been allowed to market insurance, albeit indirectly.

There are marked differences, however, in provisions governing the legal status under which banks can enter new areas of business. In some cases they can do it directly, while in others they can only act through subsidiaries or other types of legal entities.[2]

In the 1990s, not only did banking activities in the region expand as a result of financial system reforms, but State intervention in the banking system was drastically and systematically reduced, a development that is usually termed deregulation. All the countries freed up controls on interest rates (both lending and deposit rates, in most cases), reserve requirements and lending decisions, although some of them continued to subsidize certain types of development lending.

While the high reserve requirements that used to be the rule across most of the region have fallen, however, the reduction has been uneven. They have been lowered in many countries, but often by only a small amount.

A sound banking system is supported by two basic pillars (table 1), although other factors also count. The first pillar is the set of conditions under which the market operates; i.e., the existence or otherwise of restrictions on what banks can do and how they can do it. The second is the quality of bank supervision. It is important, therefore, to take steps to strengthen bank supervision before deregulation takes place, as otherwise there is a strong possibility that the process may lead to crisis in the sector. Furthermore, stronger supervision is a prerequisite for continued expansion of the areas of business that banks can engage in (Goldstein and Turner, 1996).

It is interesting to consider what happened to bank supervision at the time the legislation relating to this sector was reformed.[3] In Argentina, El Salvador, Nicaragua, Panama, Peru and Uruguay, changes in the banking sector were accompanied by the beginnings of major reform in supervision activities. In Bolivia, Colombia, Costa Rica, Ecuador, Guatemala and Honduras, changes to banking systems were not matched by reform on the same scale in the area of supervision.[4]

In a third group of countries –Brazil, Mexico and Venezuela– there were no changes to banking legislation or supervision, but deregulation did take place in the sector, involving the lifting of controls on interest rates, reserve requirements and lending decisions. In addition, foreign providers were allowed to enter local markets. Beginning in 1988, for example, Brazil authorized the entry of new providers, both local and foreign, and began to privatize a number of State banks. In 1989, Mexico also began to privatize the banks that had been nationalized after the 1982 crisis; in this case, deregulation was also stimulated by the North American Free Trade Agreement (NAFTA) negotiations, as the chapter on financial services meant that the Mexican market had to be opened up in stages to financial services providers from the member countries. These changes were not matched by stronger bank supervision, however.

An isolated case is that of Chile, which amended its bank legislation in the mid-1980s, the main planks of reform being the correction of the supervisory failings that had led to the 1982 financial crisis and the extension of business areas. In 1989, the law was amended again for the specific purpose of changing the terms and conditions agreed for the so-called "subordinated debt" maintained by the leading banks

[2] For a more detailed analysis, see Aguirre (1998). That author notes, for example, that in a sample of 17 countries banks could provide financial leasing services directly in 70% of cases and indirectly in 24% of cases. In 65% of cases they could provide direct underwriting services, while in 29% they could provide these services only through a subsidiary.

[3] Assessments of whether or not supervision instruments and methods underwent any substantive change can be subjective in some cases. We have opted, however, to use the information contained in Lora's study (1998), as it provides a general assessment of the reforms in Latin America and the Caribbean.

[4] According to Lora's information (1998), there was some progress in Bolivia, Ecuador and Guatemala. In Colombia, banking supervision was good before the amendment of 1990, while in Costa Rica no changes were made.

TABLE 1

Latin America: Banking reform and stronger oversight[a]

		Stronger oversight	
		Yes	No
Banking reform in the 1990s	Yes	Argentina (1992), El Salvador (1990), Nicaragua (1990), Panama (1998), Peru (1990), Uruguay (1985).	Bolivia (1993), Colombia (1990), Costa Rica (1988), Ecuador (1992), Guatemala (1991), Honduras (1991).
	No	Chile (1986 and 1989).	Brazil (1988), Mexico (1989), Paraguay (1988), Venezuela (1989).

Source: Based on Lora (1998) and Aguirre (1998).

[a] On the basis of information from Lora (1998) and Aguirre (1998), we have chosen to base the classification on whether or not oversight functions were strengthened in conjunction with banking reforms, where these were carried out. Cases in which modest improvements were made are classed as "unreformed". No opinion is expressed regarding the quality of oversight prior to reform, the only criterion being whether or not oversight was improved in parallel with the legal reforms deregulating the sector.

with the Central Bank so that the issuing body could acquire the non-performing portfolio as part of its crisis rescue operation. Subsequently, in 1997, a wide-ranging reform was carried out in the sector, whereby banking activities were extended to new business areas and at the same time internationalized, while oversight mechanisms were strengthened.

It is interesting to consider whether the region's banking supervision reforms took place before or during the process of deregulation in the sector, and whether or not this had consequences later. In table 2, we have classified the countries of Latin America by two criteria: whether or not they suffered some type of banking crisis, or saw their financial systems came under strong pressure that did not actually lead to crisis, and whether or not they strengthened banking sector supervision.[5]

As table 2 shows, of the countries that matched reform with stronger bank supervision, the only one to experience a crisis was Argentina. This crisis originated in an external shock, but was aggravated by the weakness of supervision in a key area, that of State banking. Three interrelated factors account for the severity of the crisis. Firstly, the non-performing loan portfolio of the provincial banks stood at close to 40%. Secondly, commercial banks had lent large sums to provincial banks that were not in a good financial position; the latter and their operations were difficult to supervise for political reasons. And thirdly, policy constraints deriving from the currency system were also instrumental in exacerbating the crisis (Leipziger, 1999).

Table 2 shows that those countries which strengthened bank supervision during the reform process did not suffer systemic crises or serious problems. Not that there were not isolated episodes that severely affected individual banks, as happened in Peru in early 1999, but these were properly handled, with supervisors in some cases sending out the right signals by winding up struggling banks.

The cases of Mexico and Brazil are particularly important because of these countries' weight in the region. The former's banking crisis was the result of a combination of factors, including the handling of macroeconomic stabilization policy, particularly as it concerned the exchange rate. There were, however, also factors associated with financial sector and supervision policies, particularly the rapid creation of banks after the privatization process that began in 1989 and the failure to assess the asset position of purchasers adequately. There was also a surge in lending, especially for consumption, during which banks failed to apply proper credit risk analysis policies, and the supervisory authority failed to foresee the consequences.

Brazil, for its part, also saw the number of lending institutions grow rapidly, from 111 in 1988 to 214 in 1994, when the crisis broke out. In 1989 alone, 73 new licences were issued. According to Bydalek (1999), the Brazilian banking system displayed a number of weaknesses when the crisis began. There was a dearth of transparent information; for example, the only

[5] The table does not seek to establish a causal link. As we reiterate throughout this article, banking crises have a variety of origins, among which macroeconomic shocks are of particular importance. Nonetheless, the good or bad quality of bank supervision is an essential factor in explaining why a crisis is triggered or subsequently worsens.

TABLE 2

Latin America: Banking crises subsequent to reform, and stronger oversight

		Oversight strengthened at the time of reform	
		Yes	No
Banking crises or significant problems subsequent to reform[a]	Yes	Argentina (1995).	Bolivia (1994), Brazil (1994), Colombia (1998), Costa Rica (1994), Ecuador (1995), Mexico (1994), Paraguay (1995), Venezuela (1994).
	No	Chile, El Salvador, Nicaragua, Peru, Uruguay.	

Source: Lora (1998) and Frydl (1999).

[a] By banking crises are meant runs on banks, sudden portfolio changes, bank closures or official intervention. By significant problems are meant failings that do not amount to a crisis, but that jeopardize the stability and integrity of the system. The years in which the crises began are shown in brackets.

information available on individual banks was what they published in their balance sheets. There were numerous gaps in the relevant legislation and the mechanism for applying it was weak, especially where the supervisory authorities were concerned, which encouraged risk-taking by managers and owners. As in the case of Mexico, Brazil's history of inflation had inhibited the creation of a lending culture that included proper risk analysis. Lastly, high turnover among the leading officials responsible for monetary and supervision policy created a serious stability problem. Both the Mexican and Brazilian crises revealed how deficient the accounting information available from banks was in terms of timeliness and quality.

In Colombia, the reform process included two legal changes, in 1990 and 1993, the aim of which was to rectify the weaknesses that had arisen in the banking sector as a result of financial repression (see Steiner, Barajas and Salazar, 1998). It was made easier for new operators to enter the market, and bank merger, acquisition and liquidation rules were amended. Access for foreign providers was also liberalized. Between 1991 and 1996, the public sector's share of bank assets fell from 55% to 20% of the total, while the share of foreign providers rose only slightly, from 7.6% to 9.7% of all assets, despite easier access.

In Peru, a similar tendency towards lower public-sector participation in the banking system has been seen. In the 1990s, commercial banks raised their share of total banking sector deposits from 55% to 87%, while the share of the public sector fell to 12% and development banks disappeared (Rojas, 1998).

III

The effects of liberalization on banking activities

When the outcome of financial sector reform is evaluated, it needs to be remembered that the second half of the 1990s was a highly unstable period, specifically because of the Tequila crisis in the first instance, then the Asian crisis, and finally the Russian crisis, and this obviously affected the way the main variables evolved.

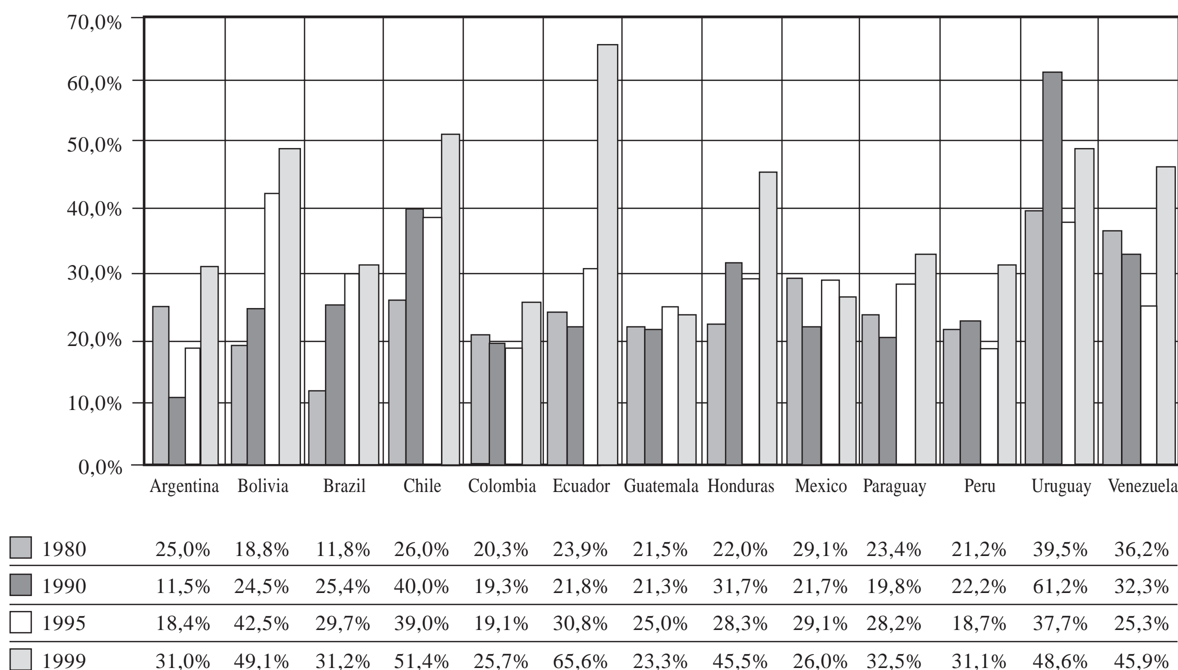
The depth of the banking sector (measured as the ratio of M2 to GDP) increased between 1990 and 1999. Thus, for example, this ratio increased from 24.5% to 49% in Bolivia, from 25% to 31% in Brazil, and from 22% to 31% in Peru. The rise is greater still if 1999 is compared with 1980, as the ratio increased over this period from 12% to 31% in Brazil, from 26% to 51% in Chile and from 25% to 31% in Argentina, although in Mexico it remained virtually unchanged (figure 1).

When financial indicators are analysed, it transpires that portfolio quality has moved in different

FIGURE 1

Latin America: Banking depth, 1980-1999

(M2 as percentage of GDP)[a]



	Argentina	Bolivia	Brazil	Chile	Colombia	Ecuador	Guatemala	Honduras	Mexico	Paraguay	Peru	Uruguay	Venezuela
1980	25,0%	18,8%	11,8%	26,0%	20,3%	23,9%	21,5%	22,0%	29,1%	23,4%	21,2%	39,5%	36,2%
1990	11,5%	24,5%	25,4%	40,0%	19,3%	21,8%	21,3%	31,7%	21,7%	19,8%	22,2%	61,2%	32,3%
1995	18,4%	42,5%	29,7%	39,0%	19,1%	30,8%	25,0%	28,3%	29,1%	28,2%	18,7%	37,7%	25,3%
1999	31,0%	49,1%	31,2%	51,4%	25,7%	65,6%	23,3%	45,5%	26,0%	32,5%	31,1%	48,6%	45,9%

Source: IMF, various issues.

[a] M2 is the sum of lines 34 and 35 of the tables in the source referred to. The figures for Brazil and Ecuador are for 1998.

TABLE 3

Latin America: Main banking sector indicators, 1980-1999[a]

(Percentages)

Country	Non-performing loans/ total		Provisions/ non-performing loans		Profitability		Capital and reserves/ assets	
	1980-87	1998	1980-87	1998	1980-87	1998	1980-87	1998
Argentina	25.2	10.4	19.9	65.2	28.7	2.3	10.1	11.5
Bolivia	20.6	4.5	44.4	57.9	-2.5	7.8	13.0	8.5
Brazil	1.1	7.4	87.7	113.3	62.3	6.9	7.4	8.9
Chile	4.5	1.6	136.4	133.9	4.3	11.7	5.8	6.4
Colombia	7.4	9.9	70.6	38.1	-14.6	11.6	5.6	10.5
Ecuador	13.4	5.3	...	138.5	20.7	7.7	5.5	15.2
Guatemala	...	4.4	...	46.5	8.2	13.3	8.2	8.1
Honduras	19.1	4.8	29.8	48.9	3.5	17.3	7.1	9.9
Mexico	1.6	9.1	60.0	67.4	40.3	6.3	2.0	8.8
Peru	3.7	6.9	148.8	92.0	25.5	9.5	6.5	9.0
Uruguay	26.0	9.7	4.8	68.2	-0.3	5.6	6.2	15.6
Venezuela	10.8	4.2	...	150.3	10.8	0.05	4.8	13.8

Source: Morris, Dorfman, Ortiz and Franco (1990), *Latin Finance*, various issues.

[a] The figures are not necessarily comparable owing to changes in the definitions used by the countries.

directions in the region (table 3),[6] improving in some countries and worsening in others. Where the non-performing portfolio index has worsened, this may be due to different factors, such as macroeconomic problems affecting borrowers' ability to pay, or stricter supervision rules established by the regulatory authorities, meaning that the index is more realistic and not necessarily that the portfolio has deteriorated. This was the case in Mexico after the Tequila crisis. Conversely, in some cases an improvement in the index needs to be treated with caution. In Ecuador, for instance, the 1998 index value was significantly better than the average for the 1980s, but the crisis the country went through in 1999 makes it clear that this value was not a true reflection of the system's non-performing portfolio situation.

The improvement in the ratio of provisions to non-performing loans in most of the countries shows that their systems have made efforts to secure the resources necessary to cope with possible losses associated with bank portfolio risk. Although the situation has got better, progress is still needed in some countries if bad debts are to be fully covered by provisions.

Where profitability is concerned, the figures in table 3 show a variety of situations in the countries of the region. In some of them, profitability in the late 1990s was clearly better than the average for the 1980s. In others, however, there was a marked deterioration (although it must be remembered that the figures show the situation in the year of the Asian crisis).

As regards levels of capital in these systems, there is a clear tendency for the ratio between capital and reserves and between capital and assets to strengthen, which reinforces the beneficial effect that improved bad debt provision has had on solvency. This is a reflection of the restructuring seen in most of the countries, as the privatizations, mergers and acquisitions that have taken place in most markets have resulted in better capitalized banking systems. Similarly, implementation of the capital requirements recommended by the Basel Committee in 1988 has given rise to particular concern about bank asset coverage, and the standard originally designed for the Group of Ten has come into general use.

If supervision systems now have the essential tools they need for effective oversight, as regulators themselves affirm, it needs to be asked why most of the countries have had some type of crisis or serious problem in the sector. Comparative analysis of legal frameworks, and the opinion of supervisors themselves, show that the tools needed for adequate oversight are now in place. Theoretically, supervisors have the power to authorize the operation of new banks, establish and monitor the requirements that bank shareholders and/or managers have to comply with, approve transfers of ownership (except in Argentina and Paraguay) and carry out structural audits. Again, most of the region's countries have limits on lending in general and related-party lending in particular. Consolidated information is used in 70% of the countries, and all of them monitor solvency, asset quality, liquidity and currency positions, while 70% supervise off-balance sheet operations (Livacic and Sáez, 2000).

The reason for the apparent contradiction referred to is that, despite the progress made, a large working agenda still needs to be dealt with in the field of supervision.

IV

Policy considerations and recommendations

As was noted in the previous section, Latin America generally made significant progress with bank legislation and regulation in the 1990s, albeit the process differed in speed and depth among the various countries considered. Nonetheless, a number of difficulties will need to be addressed if the shortcomings that still remain, or indeed those that have arisen from the reform process itself and from the changes experienced globally in the economy, the financial industry and technology, are to be corrected.

To facilitate analysis, we have grouped this pending work into four subject areas: market structure and operation, the powers and independence of supervisory bodies, better regulation, and stronger oversight.

[6] The authors are grateful for the information that Raúl Romero of the Chilean Superintendency of Banks and Financial Institutions supplied for use in preparing this table.

1. Market structure and operation

In the 1990s, there was a tendency for the number of banks to fall in most of the region. This should be seen as a good thing on the whole, since to begin with there were a large number of very small institutions, and these tend to be less efficient than larger ones (i.e., have higher intermediation costs), less solvent and more unstable.

Many factors lie behind the fall in the number of banks. Firstly, the banking crises that followed one upon the other in the region over the decade resulted in some banks leaving the market altogether, either because they went bankrupt or because the authorities wound them up. Secondly, in that decade the region was caught up in the global process of acquisitions, takeovers and mergers that was also seen in the banking systems of the United States, Europe and Japan. Furthermore, much of the banking consolidation that took place in the continent was a consequence of mergers between two or more institutions in developed markets. Thirdly, consolidation in the Latin American banking industry was also driven by the macroeconomic stabilization processes that took place in the region (such as Brazil's 1994 Plan Real, which brought down inflation sharply and thereby changed the nature of the country's banking business, which before price stabilization had amounted to nothing more than collection of the inflation tax). Lastly, particular mention should be made of the efforts of some national supervisory authorities which, in their determination to see more efficient and solvent banks, "induced" a process of industry consolidation within their national jurisdictions, something that was facilitated by the international wave of mergers and acquisitions, and by the interest of foreign shareholders in entering the market. This process accelerated in the second half of the 1990s, and was particularly vigorous in Argentina, Brazil, Chile, Mexico and Venezuela.

In these circumstances (fewer but larger banks), there could be risks from a pendulum effect, such as excessive concentration in the industry. Since the last bank merger authorized in Mexico (bbva-Banamex), the largest bank in that country has had a market share of over 30%. A similar situation could arise in Chile (Santander-Santiago) and has obtained for a number of years in Peru (Banco del Comercio). The same process has begun in Brazil, Colombia and Venezuela, although it has not yet taken on the proportions seen in Mexico. What is worrying about a high degree of concentration is its possible negative impact on competition and the stability of the financial system (especially if certain banks are considered "too big to fail"), and the excessive influence that a large bank could have on certain macroeconomic policies.

Another significant phenomenon that changed the structure of the Latin American banking industry in the 1990s was the large rise in foreign ownership of local banks. This development, which was part of world banking globalization, passed many countries by, particularly those that still had legal restrictions on the entry of foreign banks into their markets (Mexico until 1995 and Ecuador until 2000).

The presence of foreign banks in domestic markets helps to dynamize competition, bring in new technologies and products, introduce efficient management methods and strengthen the banking system capital base. What is more, in several systemic crises or episodes of severe financial instability, foreign banks operating in the country concerned have been a force for stability, with deposits being switched to them from local banks (the "flight to quality" effect), as they are perceived by the public as being safer (Paraguay in 1995, Argentina that same year and Chile in 1982). This has reduced capital outflows considerably.

It should be pointed out, however, that foreign ownership in Latin America is confined to a handful of banks, which tend furthermore to have high market shares in several of the region's countries. If one of these large banks, which have a global presence, were to fail or become unstable, there could be a regional or world banking crisis of unprecedented scale. At present, national laws and the international "safety net" architecture would be unable to cope with a situation of this kind. This mirrors the domestic situation that was seen in countries where deregulation was not preceded by measures to strengthen crisis prevention mechanisms (real oversight of bank stability).

Again, there are still countries in the region where State banks have a large market share. In Costa Rica and Uruguay, for example, the market share of State banks is some 50%, and in Argentina and Brazil, even after progress in privatizing certain provincial or state institutions, the two largest banks are still publicly owned.

Nonetheless, in the 1990s there were no mass nationalizations of banks in Latin America of the kind seen in Mexico and Peru the previous decade; furthermore, in the 1990s these two countries reprivatized all the banks that had been nationalized in the 1980s. Again, when the State took control of banks during the crises of the 1990s, this did not generally lead to nationalization, but only to temporary administration by some State body.

Although there is no consensus among specialists regarding the proper role of the State in bank ownership, the existence of State banks has been justified by the social and developmental function they are held to perform. It is clear that a high level of State involvement in the banking market brings difficulties, such as displacement of private-sector banks, political interference in lending decisions, the greater difficulty of achieving organizational efficiency and the provision of poorly targeted subsidies. From the point of view of bank supervision and regulation, it has been found in a number of cases that State-owned financial institutions have lower asset requirements and, in practice, cannot always be overseen with the same stringency as private-sector banks. In any event, it must be fully accepted that State participation in banking activities cannot be based on a discriminatory, less rigorous supervision code.

Lastly, one structural problem of the greatest importance that remains unsolved in Latin America is the difficulty that so many small businesses and microenterprises have in obtaining financing. The expansion of banking activity resulting from financial market deregulation has not yet reached these segments, owing in part to their informal nature, to biased lending policies and, at times, to regulations that discourage unsecured lending, and to the greater cost and higher risk that tend to be involved in these operations, which are for relatively small amounts. A similar situation obtains in respect of personal financing needs.

The difficulty small firms have in obtaining financing significantly constrains their ability to compete and acts as a brake on development, given that these sectors are relatively labour-intensive and account for the bulk of new employment. Again, the exclusion of vast sections of the population from access to financing is a barrier to opportunity and thus an obstacle to the real democratization of society.

2. The powers and independence of bank supervisory agencies

Over the last 10 years, bank supervision has evolved rapidly and dynamically in response to new conditions in the market and the new legal and administrative provisions that have allowed banking activity to expand.

One common feature of the legal changes made in Latin America in the 1990s was the inclusion in financial reforms of measures to improve banking supervision authorities. Thus, alongside measures to expand banks' areas of activity and remove constraints on their operations, efforts have usually been made to endow bank supervisory bodies, superintendencies or commissions with greater legal powers and more human and material resources with which to discharge their functions. Both multilateral bodies and governments themselves are committing increasing resources to this end.

The growth in banking activities has been extraordinary, as has the rate at which banks have expanded their sphere of operations. As a result of this, and of the banking crises that have occurred, supervisors have had to show great adaptability and responsiveness to cope simultaneously with amendments to legislation, the situation of banks in difficulties and overhauls of oversight rules and methods.

Among further measures still needed, supervisory bodies should be granted real independence in the political, legal, economic and operational aspects of their work.[7]

Where the political aspect is concerned, perhaps the greatest problem is the degree to which the leaders of supervisory agencies generally depend on the political authority, regardless of what the law might say. Where banking systems are liberalized and decisions are taken by private-sector banks on the basis of market criteria, oversight is a highly technical public-sector function that protects the system from certain risks, particularly the fiscal cost of bank insolvencies.

One of the ways in which political interference manifests itself in banking supervision is the high turnover of agency heads, whose term in office is unlikely to be as long as that of the president, let alone survive a change of government. In the 1990s, on average, agency heads in the region remained in their posts for about two years. Combined with the low level of development that generally characterizes these institutions in Latin America, the departure of the head results in a large proportion of the higher technical staff being replaced as well, so that it is very difficult to preserve and consolidate the progress made under each administration.

A second factor that has prevented more dynamic development of supervisory agencies is the difficulty

[7] Independence for bank supervision authorities should be regarded as an issue in its own right, regardless of whether or not they come under the central bank. Indeed, of the countries considered by this paper, only the Mercosur members have kept banking supervision within the central bank. The essential thing is to recognize the importance of this work and to provide the material and human resources and the legal powers that are needed for it to be carried out well.

of finding skilled staff who are able to adapt as rapidly and as thoroughly as is necessary to the changing conditions around them. The overstaffing seen in some of these agencies, the difficulty of removing officials, low pay, the influence of political criteria on appointments and the legacy of longer-serving staff who generally lack university education and are prepared only for supervision of a formal nature are the main obstacles that still need to be overcome in many countries if bank oversight is to be professionalized more quickly and become better able to respond to current and future needs.

Despite efforts to provide supervisory bodies with the financial resources they need to do their work properly, a number of them still face budgetary constraints that make it hard for them to perform. Besides the problem of pay referred to earlier, agencies need to have the resources to provide permanent, ongoing training and the technology and information systems that are indispensable to modern supervision. Again, political independence is underpinned by financial independence, but this in turn means there is a need for safeguards to ensure that funds are properly and transparently administered (external auditors, comptrollers, public management accounts, etc.). Looked at on a project assessment basis, supervision is a profitable activity, as it is much cheaper for the State to finance a good system of oversight than to pay the bill for crises resulting from inadequate banking supervision.

As regards legislation, lastly, steps need to be taken quickly to create forms of legal protection for supervisors in accordance with the international recommendations of the Basel Committee, so that they can carry out their work without fear of legal reprisals. It is par for the course for the leaders of supervision agencies in Latin America to have several lawsuits brought against them because of decisions taken in the performance of their duties. These lawsuits are brought by shareholders claiming to have been treated arbitrarily or with undue severity, normally during crises, or by depositors claiming in the wake of crises that the supervisor has been negligent and insufficiently zealous in performing his functions and that it is as a result of this that they have lost their savings.

While supervisory agencies should be made more independent, the grounds of the main rulings they arrive at should be subject to greater public scrutiny, and these rulings should be based on criteria that are known to the different agents involved, so that they can be satisfied that the agency is exercising its powers objectively.

3. Better regulation

Significant progress was also made in the legislative and regulatory field in the 1990s. There is a great deal still to be done, however, and further progress will require technical skill and, most importantly, great political will.

The most important of the tasks still pending is the regulation of financial conglomerates, which has many aspects. As the issue is most generally understood among specialists, regulation of financial conglomerates needs to be based on a body of laws covering the activities of business groups that act in different areas of finance –these may include banking, securities, underwriting and pensions– and perhaps in the industrial and commercial sectors as well. This approach to the regulation of conglomerates, which is the broadest and most comprehensive, has already been incorporated into legislation in some countries, such as El Salvador and Mexico and, to some degree, Ecuador and Venezuela. Almost without exception, however, these rules have yet to be applied effectively.

Nonetheless, this comprehensive view of conglomerate regulation is not the only one that the region should concern itself with. On the contrary, there are some far more serious and obvious deficiencies in the way conglomerates are regulated, such as the lack of thorough, consolidated regulation and oversight of what could be termed banking subconglomerates, which confine themselves to financial intermediation activities (deposit-taking and lending). In Latin America, there are in practice a whole range of organizations and mechanisms whose legal form is designed specifically to avoid regulation and which are used to carry out supervision-free banking activities that parallel, and are linked to, those of the parent bank.

The most commonly used mechanism is the unregulated offshore centre. A bank or its shareholders set up another bank in a different country that has fewer regulatory requirements and, in most cases, offers tax exemptions, where some of the banking activities they carry out in their country of origin are deemed to take place for accounting purposes. These offshore organizations are usually protected by very strong and wide-ranging banking secrecy laws, so that they are beyond the reach of the local supervisor. In some countries, operations carried out in this way now represent a very significant percentage of duly acknowledged local banking activity. Thus, for example, when banking crises occurred in Venezuela (1994) and Ecuador (1998), it transpired that a

significant proportion of banking activity was being recorded in the accounts of offshore subsidiaries.[8] Something similar happened with some of the banks involved in the 1995 crisis in Paraguay.

Another method used to avoid regulation and supervision is to set up unregulated or very lightly regulated organizations that are artificially "separated" from the bank by various devices. Of these, the most common type of organization in various countries is the trust. These unregulated bodies have been at the root of crises at individual banks in El Salvador, Guatemala and Paraguay, to name just a few.

In the regulatory sphere, there are also deficiencies in the regulation of market risks (currencies and rates), country risk and liquidity risk. Of these risks, the most important in the very short term is currency risk, as a large proportion of bank assets are denominated in dollars (Argentina, Peru and Venezuela, and Ecuador before dollarization). This will depend, however, on the tendency followed by the region's currency regimes.

Again, as banking markets continue to become more sophisticated and longer-term operations take on greater importance, there will need to be further progress with regulation of the risks inherent in these (rates and maturities).

Where the resolution of banking crises is concerned, some countries have launched worthwhile initiatives in recent years, and these need to be introduced in the rest of the region as a matter of urgency. The line followed has been that of the Federal Deposit Insurance Corporation (FDIC) in the United States, which aims to find the "lowest cost of resolution" for banks in trouble. In a lightning operation, which is usually carried out over a weekend, the struggling bank is divided into a "good bank" and a "bad bank". The "good bank" (with the corresponding liabilities) is transferred to third parties, normally an existing bank, and carries on operating. The "bad bank" is wound up. The final losses are absorbed by shareholders and the deposit insurance, and the end cost is lower than it would have been had the whole bank been liquidated. Initiatives of this type, and reform of deposit insurance systems to allow for more flexible and efficient action that is pre-emptive rather than merely remedial in nature, are among the regulatory and legal challenges that should be addressed.

Lastly, the countries of the region need to achieve significant improvements in the transparency and reliability of information. Substantial progress has been made, but more is needed. This aspect is vital if there is to be real market discipline. Agents need to have timely access to relevant information. Particular mention should be made here of accounting practices. Progress needs to be made towards information standards that facilitate comparisons among countries and, most particularly, that allow an accurate and reliable picture to be formed of the real situation at individual banks.

[8] To resolve the crises, the authorities of these countries extended State insurance to such operations.

4. Stronger oversight

Where bank supervision is concerned, i.e., in the actual work of ensuring that prudential provisions are really complied with, progress in the 1990s failed to keep pace with the growing complexity of banking activities.

In every financial system in the world, the greatest banking risk still derives from credit. In Latin America, where the degree of sophistication is lower than in the developed countries, the preponderance of credit risk is even greater. Although a growing number of Latin American countries have brought in regulations that provide for credit risk to be assessed with reference to the projected payment capacity of the borrower, in practice delinquency –i.e., the discovery of payment difficulties after the event– is still the most commonly used procedure. When this happens, supervision loses much of its preventive character and consists rather in the retrospective surveying of asset problems.

Something similar is true of related-party or insider loans, i.e., loans made to persons who have an ownership stake in the bank. Legal provisions and regulations in this area began to be introduced in all the region's countries in the 1980s. With a few exceptions, however, their application in practice has been quite limited, as serious information problems hinder the detection of these operations, and the subterfuges used by those carrying them out have hitherto defeated supervision capabilities. Again, the laws introduced have not provided supervisors with the powers they need to apply the rules effectively on the basis of a reasonable assumption that such a link exists.

The problem of related-party loans has a number of aspects and ramifications, but perhaps the most salient of them is that these loans, and the low credit quality that characterizes them, have been a factor in almost all the region's banking crises.

When the related-party portfolio exceeds paid-up capital and reserves, one of the key components of a stable financial system, i.e., solvency, is eroded, as the

incentive to follow prudent risk policies that derives from the possibility of shareholders losing their capital is weakened.

The weaknesses referred to above –in portfolio risk assessment and related-party loans– are the most obvious examples of a problem that is common in the region. This is the serious difficulty that the authorities have in applying existing regulations effectively, because of the above-mentioned constraints on their independence and lack of resources.

V
Conclusions

To sum up, it can be said that profound changes were made to Latin America's financial systems in the 1990s. Nonetheless, the reforms adopted were not always matched by stronger supervision in the sector. In a number of cases, this resulted in weaknesses that became evident when the economies concerned were subjected to some kind of external shock. The second half of the 1990s saw a transition towards sounder banking systems based on a good balance between market incentives and a regulatory framework involving preventive supervision.

Where market structure is concerned, Latin America still displays some old problems such as excessive State involvement, although clear progress has been made in this area. Again, new structural problems have emerged, among them a degree of market concentration that could become excessive not just in individual countries, but region-wide, where it would be beyond the purely domestic reach of "systemic safety nets".

Likewise, the rapid and dynamic development of the region's banking situation seen in the 1990s has still not made its effects felt sufficiently in the microenterprise and small business sectors, or among individuals, the result being a serious constraint on growth in jobs, output and participation in the benefits of progress.

If most of the shortcomings pointed out in this article are to be overcome, particularly those connected with bank regulation and oversight and the autonomy of Latin America's supervisory agencies, there is one overarching requirement, and that is the political will to carry through the changes that still need to be made. For this to emerge, banking supervision should cease to be regarded as an integral part of short-term economic policy and as an instrument of political power. Instead, the work of banking oversight needs to be regarded as State policy, and supervisory agencies need to be given the freedom of action they require, with emphasis on their technical and professional character.

As regards bank regulation, the most important task facing Latin America is the regulation of both the domestic and cross-border activities of financial conglomerates, especially those carried out in offshore centres.

In the field of supervision as such, further work needs to be done on preventive monitoring of credit risk and exposure to related-party lending.

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Reforming *health-care management* in Latin America

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Following a conceptual analysis of the term "quasi-market", this article will look at four national efforts to reform health-care management in what can be regarded, in respect of the degree of solidarity and universality applied, as three different health-care models. The changes in Chile are a continuation of the country's previous reform, which went further than any other in the region in undermining the solidarity and universality of the health-care model. The conclusion is that it would be beneficial to consolidate purely managerial aspects so that progress can be made with the use of administered prices, relevant information on the quality and cost of care can be produced, and efficiency and effectiveness criteria can be applied to clinical services. In Argentina and Colombia, while there are large differences between the two, the changes that have been made are part of a reform process aimed at encouraging competition while upholding the principles of solidarity and universality. Because change has mainly centred on the financing model, management has had a subordinate place since the outset. In the case of Colombia, the article highlights the excessive complexities of hospital financing, which have combined with regulatory shortcomings to inhibit management change. In the case of Argentina, where hospitals are excessively large, it describes the wide range of hospital management reforms that have resulted from past decentralization, the degree to which management is independent of fiscal discipline and the different ideas that exist of the part played by hospitals in referral systems. In the case of Costa Rica, where health care is primarily public and based on principles of solidarity and universality, the article looks at the creation of internal health markets that resulted from the introduction of a new performance-related organizational and financing model in the Costa Rican Social Security Fund; it notes that the management contracts used have interesting features as regards organization and information and the shaping of a health-care system, but that they are excessively complex and involve high transaction costs, and it analyses the difficulties involved in introducing real provider decentralization and creating performance incentives.

I
Introduction

Health quasi-markets promote competition among providers and/or insurers, but differ from conventional markets in certain respects. On the demand side, buying power is manifested in the form of a budget agreed with the public-sector purchasing organization. Consumers are represented by agents, i.e., by a buying organization whose character is determined by the way the quasi-market is organized and by the ground rules of the insurance system. Prices are negotiated or administered within a budgetary framework. Supply, meanwhile, can embrace various forms of ownership –State, municipal, trusts, consortia and non-profit-making organizations– which may be subject to different financing rules (Bartlett and Le Grand, 1993, pp. 23 and 24).

Competition can be introduced at different levels, by altering the public-private mix through the extension of private-sector involvement, or by changing the charters of public-sector provider institutions to give them greater independence in the way they use their resources in a competitive environment governed by the regulatory framework of a contract, or allowing them to operate under private law. Different mechanisms can promote competition among providers, such as freedom of choice in the referral system or among health-care professionals, or competition for budgets among hospitals.

Quasi-markets conform to two rationales.[1] Where public-sector providers are concerned, the aim is to introduce competition in the public sphere by separating functions, thereby improving efficiency and quality. Where a public-private mix is concerned (when health is regarded as a public good because its positive externalities are greater than the individual benefits, or as a merit good that actualizes a social right), the aim is to cater to demand, irrespective of providers' prices and individuals' state of health and ability to pay, by applying ground rules for insurance, financing and provision that establish conditions of solidarity by means of cross-subsidies among income strata or risk or age groups, or by means of subsidies to specific groups. In both cases, financing is linked to productivity, coverage, yield and success in meeting targets.

In Latin America and the Caribbean, management reforms now being implemented represent moves towards the creation of quasi-markets. These reforms have been applied to health-care models that are dissimilar in terms of their guiding principles, the responsibilities of the public and private sectors, service and population coverage, financing and insurance models, and regulation. In many cases, the legal basis for the mechanisms introduced is flimsy, pricing plays a strictly theoretical role, and consolidation would require changes in employment practices that would be politically very complex to achieve. Despite everything, the quasi-markets that are in prospect offer a promising route towards the goals of greater efficiency, accountability, responsiveness and choice, without adverse consequences for equity. This article analyses the management reforms implemented in Chile, Colombia, Argentina and Costa Rica, considering the progress they have brought about and the obstacles that have arisen in practice.

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[1] In conversation, Rebeca Grynspan distinguished two particular rationales that have usually been implicitly assumed in discussions of the subject.

II

Chile: adjusting management when solidarity and universality have been undermined

The Chilean reform of the 1980s, which was made possible by an authoritarian context, was unprecedentedly radical. It stands in complete contrast to the British experience under the Conservative Governments of Thatcher and Major. In Britain, the Conservatives mounted a radical challenge to the financing methods, scope of provision and public-private mix of the National Health Service (NHS). Following a variety of political developments that impeded radical change, the NHS was reformed, paradoxically, by increasing the separation of functions with a view to promoting competition.[2]

Compulsory insurance is a feature of public or national social insurance systems that seek to achieve stable risk differentiation and may aim at redistribution and social solidarity, with a variety of public-private mixes. The Chilean health-care system, therefore, is unique in the world. Under its dual logic, workers have to pay compulsory subscriptions, entirely at their own cost, which entitle them to membership of the public health service through the National Health Fund (Fonasa), whose distribution rationale favours solidarity, or the private health insurance institutions (Isapres), which operate on an individual risk-associated private insurance basis.

Fonasa gives access to public provision under the so-called institutional system or to private provision of choice, subject to co-payments of various kinds, and is also funded by other contributions deriving from the public budget. Isapres, contrary to the logic natural to a compulsory insurance scheme, provide individual insurance plans that are renewable each year and incorporate risk selection, as price and coverage are adjusted for the age, health risk and sex of the insured. They cover about 30% of the population, and their prices have risen by far more than those of other sectors of the economy.[3] The public-sector scheme, which has no barriers to entry, covers the lower-income and higher-risk populations, and provides blanket reinsurance for the system.

The measures taken so far to improve management in the Chilean public health-care sector have been in the nature of an adjustment, seeking to raise the efficiency and effectiveness of the public subsystem without altering the dual design of the public-private mix introduced in the 1980s.

1. Organizational aspects and contractual characteristics[4]

Management contracts between the central level and health services were introduced in 1995, with resources to be allocated and transferred to provider organizations under an annual service provision agreement establishing performance indicators. These organizations were encouraged in turn to enter into contracts with the public hospitals and municipalities to which they were linked.[5]

These agreements have gradually helped to organize relations between the health services and the centre, which were traditionally governed by formal and informal bilateral agreements between specific organizations, resulting in a lack of coordination, duplication and overlap, and in substantial resources being devoted to lobbying. With the Ministry of Health retaining provision functions, something that has been identified as a major obstacle to restructuring the health sector,[6] agreements were also structured and evaluated

[2] Out-patient care by general practitioners was already provided under contract; then hospitals were allowed to operate independently under NHS contracts, which led to providers being grouped into trusts. On the reforms to the British system, see Ferlie and others (1996), Walsh (1995), Bach (1999) and Winchester and Bach (1999). For a detailed discussion of the political process, see also Porter (1999, pp. 236-259).

[3] Some figures will illustrate this: whereas in 1990 the average additional contribution of Isapre subscribers was 0.7% of the system's average remuneration, by 1996 it had increased to 1.3%. Between the two years the cost of private medical consultations rose by 55% in real terms (Baeza and others, 1998, pp. 18 and 19).

[4] For details of Chilean management contracts and their context, see Sojo (1996, 1998 and 1999a).

[5] There are management contracts among other agencies in the health-care sector, but contracts with the health services account for the bulk of health spending, so we shall henceforth refer exclusively to these.

[6] Interview with César Oyarzo, former Director of Fonasa, on 22 August 1997.

in a fragmented way to start with, but progress has been made in rectifying this.[7]

The purchasing function, however, is still a "theoretical" one within the health system. With the exception of some special cases that have only a limited impact on the overall budget, such as complex provision or early treatment programmes, prices are essentially for reference purposes (Lenz, 1998, pp. 193 and 194) and are not laid down by the terms of contracts.

Although contract indicators cover the three levels of health care, they emphasize primary and preventive care. Goals are expressed mainly as indices of activity and coverage. Health indicators, which were very weak at first, have been improved, as has linkage with ministerial and government targets. A rapid rise in the number of indicators has led to an increasingly ritualistic approach being taken to their use, making proper assessment more difficult and creating high transaction costs.

Efforts have been made to optimize the provision network, with the aid of management contracts. Fonasa has become an intermediary among services, and has been restructured into five zones covering a number of services, to achieve network continuity in the regions. Regional committees have been set up to monitor compliance with agreements,[8] and contracts include activities to strengthen the Programa de Oportunidad de la Atención (Early Treatment Programme), in primary care, and to create a more cohesive system of rural primary care.

Paradoxically, however, implementation –which is the heart of management– has been left entirely to the discretion of the health services, and has not been fully integrated into the agreements.[9] Organizational objectives or details of which intermediate products have to be purchased have been specified only to a marginal extent, and the same is true of the introduction or improvement of information systems, the optimization of poorly functioning processes, or the development of new processes to make service provision more effective and systematic. There has been no major improvement in record-keeping as an instrument for strengthening management capabilities.

To increase the productivity of human resources, the recruitment and pay procedures currently followed will need to be modified. A variety of rigidities in the way human resources are handled are making innovative management difficult. The sectors affected have fought hard to block amendment of law no. 15.076, which governs recruitment and remuneration procedures for professionals in the health services. As a result, no action has yet been taken on a 1995 bill seeking to bring significantly more flexibility and decentralization to employment practices, secure recognition for performance, merit and effectiveness as well as length of service, encourage the allocation of individual responsibilities and link recognition of individual performance to that of institutional performance, and make competitive testing a requirement for remaining in the system (Sojo, 1996).

2. Integrating management into reform

Management contracts could play a role in dealing with issues that act as fundamental obstacles to reform. Where charging and cost policies are concerned, for example, the basic information of hospitals is inadequate; in the complex pathologies programme, there is no explicit national referral network. If management contracts included process innovation, useful information could be built up on the quality and costs of care, or criteria of efficiency and effectiveness could be introduced into clinical decision-making. Thus, the failure to integrate management issues properly into contracts limits the impact of these, by preventing beneficial and efficient interaction with sectoral reform.

For example, diagnosis-related pay has not replaced historical budgeting, but has been used experimentally in parallel with this in specific programmes, such as the complex provision and early treatment programmes. When it was first introduced at the hospital level, participation was high and it was not perceived as a threat, but it collapsed because information deficiencies and the diversity of initial conditions made mass take-up unviable.[10] Consolidating management, through contracts with health services or otherwise, would allow progress to be made with diagnosis-related pay, which could be based on agreed use of clinical protocols, for example. Such a shift would require caution and a sense of priorities.

[7] Interview of 3 September 1997 with Pedro Croco, then Director of the Management Unit in the Ministry of Health.

[8] Interview with Rony Lenz, then Director of Fonasa, on 26 May 1998.

[9] This aspect of the agreements was pointed out by Rony Lenz in the same interview. His references to the weakness of management contracts were made in response to our critical approach to the point in the interview, with which he agreed.

[10] This experience with diagnosis-related pay was described by Rony Lenz in the interview referred to.

There is also a need to simplify indicators relating to the fulfilment of tasks specified in goals and coverage targets, and to reduce their number greatly. If it were decided to include some intermediate products, processes and information systems, this would have to be done very selectively and for periods of time long enough for implementation to be consolidated. Management contracts must not be confused with planning by objectives.

III

Colombia: management reform in a universal cross-subsidized system, with competition

The redistributive impact of the Colombian reform has been substantial. In 1993, effective health cover was 13.6 times as great in the top quintile of the population as in the poorest quintile, but by 1997 this gap had narrowed to 1.86 times (Colombia, National Council of Social Security in Health, 2000, p. 13). Reform has aimed both at universal coverage in service provision and at competition among insurers and providers[11] in a decentralized, cross-subsidized system whose benefits and obligations are consolidated into two regimes: the contributory one, which is funded by worker-employer contributions, and the subsidized one, which focuses on the poorest. The first is regulated by the compulsory medical plan (plan obligatorio de salud, or POS) and the second by the subsidized compulsory medical plan (plan obligatorio de salud subsidiado, or POSS). The two are supposed to gradually converge.

The Solidarity and Guarantee Fund seeks to ensure equality and a balance of resources in the contributory system by means of a per capita payment that is adjusted to prevent risk selection in service provision. It has four sub-accounts: compensation, solidarity, promotion, and catastrophic events and traffic accidents. It transfers 1% of this system's subscriptions to the subsidized scheme, thereby topping up the funding this receives out of general taxation. The aim is to move towards a system in which services are financed by demand subsidy –i.e., financing is determined by actual demand from those insured– instead of by supply subsidy, which is the term given to the method traditionally used to finance providers that are overwhelmingly in the public sector, based on historical budgets. Distributive disparities and the position of suppliers as single providers in particular geographical areas have made it impossible to replace the one completely with the other, and no conclusion has yet been reached about the proportion that is desirable.

Both in theory and in practice, however, the Colombian reform shows serious deficiencies as regards the integration and complementarity of the service network and the different levels of care. There is an urgent need to take steps to increase microeconomic efficiency. Management has played a secondary role, and its shortcomings should be tackled as they hinder progress overall (for example, by blocking resources that are indispensable if coverage is to be widened). This is happening just as the contents and rising cost of insurance cover in the contributory system are being reviewed for balance and financial sustainability, while efforts to increase coverage in the subsidized system are being compromised by the decline in funding from the national budget, evasion in the contributory system that affects cross-subsidy resources, and the cost of moving from supply subsidies to demand subsidies (Colombia, National Council of Social Security in Health, 2000, pp. 13 and 20).

1. Complexities and complications of hospital financing: the repercussions for performance

In 1993, the intricate architecture of the reform included the transformation of public hospitals into State social enterprises (empresas sociales del Estado, or ESEs), which are decentralized public-sector bodies with a legal personality, ownership of assets and administrative

[11] Insurance for the two systems is provided, respectively, by health promotion organizations (entidades promotoras de salud, or EPS) and subsidized system insurers (aseguradoras del régimen subsidiado, or ARS), while health-care provision institutions (instituciones prestadoras de salud, or IPS) operate the actual health services. In all cases, they may be either public or private.

autonomy (table 1). Decentralization linked public hospitals with the departmental and municipal authorities in their area (table 2), as a result of which the influence of the national authority was weakened and unprecedented tensions arose among these three levels. It has been said that territorial autonomy in the sector is subject to frequent incursions in the form of national rules that detail how territorial health resources can be used (Vargas and Sarmiento, 1998).

Pressure from hospitals for the retention of historical financing, combined with the serious deficits run by some of them, resulted in the plan to replace supply subsidies with demand subsidies being frozen for three years. In the absence of a solid basis of information, the transition regime tolerates double payments to hospitals in the form of supply and demand subsidies, duplications in the insurance for the two systems and the frequent invoicing of policyholders for treatment in order to generate resources from provision (Londoño, Jaramillo and Uribe, 1999). Duplication of payments also takes place at other levels of care, and no adequate records are kept of the insurance and services supplied using specific funds for people displaced by violence.[12] There is an urgent need to identify, record, cross-reference and unify data on the beneficiaries of the two regimes or of ad hoc funds, on a national basis. This registration process is crucial to avoid leaks and duplication and to administer the insurance and provision systems, but progress has been fitful (Colombia, National Council of Social Security in Health, 2000, pp. 34 and 35).

The budgets for the three levels of public hospitals have risen greatly: between 1993 and 1997, the level I budget increased by a factor of 2.6, that of level II by a factor of 1.9 and that of level III by a factor of 1.5. Their medical staffs have doubled in the last 10 years, and the wage scales of civil servants in the sector have tripled, yielding a real increase that is higher than the average for public-sector employees. Hospital financing is highly complex, as its different sources each have their own access mechanism, logic, allocation criteria, budgeting systems and resource flows. To compound the complexity, transfers also vary. For example, general public funds earmarked for a hospital or health centre may initially be transferred directly to the municipality, the sectional health fund or the local health fund (Jaramillo, 2000, pp. 45-46 and 108).

[12] This subject was raised by Juan Fernando Alviar in a conversation of 22 May 2001.

TABLE 1
Colombia: Hospitals operating as State social enterprises (ESEs) as of June 1998

Hospitals	Total	ESES	Percentage
Level III	28	23	82
Level II	125	120	96
Level I	354	194	55
Total	*507*	*337*	*66*

Source: Colombian Ministry of Health, Programa de Mejoramiento de los Servicios de Salud, included in Londoño, Jaramillo and Uribe (1999).

Resources allocated in accordance with historical budgets come from the national and territorial levels, with funding from the general public budget still the main source of hospital financing. Hospitals and the public social security network are supposed to use these resources to treat people who have no insurance and are unable to pay. So-called “auxilios”, contracts with the State to treat poor people, which concealed unconditional transfers, have been abolished.

Large amounts of funding are transferred automatically, or at least are not linked to productivity. Both the complexity and the diversity of public hospital financing make it difficult for the expansion of funding to be linked to the attainment of specified efficiency and performance levels, which weakens these incentives enormously. When the excessive complexity of financing is considered, it needs to be remembered that hospital provision is largely indivisible in respect of the different sources of financing and the incentives underlying them, which makes institutional and organizational change difficult.

Nonetheless, some financing mechanisms do provide for performance incentives. These include the contracts to treat the uninsured population entered into between territorial health funds and public and private hospitals, which make financing conditional on real increases in productivity and efficiency, and which have mainly been applied in Antioquia and Bogotá, with a wide variety of financial and managerial outcomes.[13]

Hospitals need to sell their services to insurance policyholders, so their ability to generate resources of

[13] These range from successes at the El Tunal Hospital in Bogotá and the San Vicente de Paul Hospital in Medellín to the bankruptcy of institutions such as the Lorencita Villegas Hospital and profound restructuring of the type seen in the San Juan de Dios Hospital in Bogotá (Londoño, Jaramillo and Uribe, 1999, pp. 19 and 62).

TABLE 2

Colombia, official health sector: Distribution of powers and responsibilities after decentralization[a]

Function	Central or national level	Departmental level	Municipal level	Hospital
Financing	++	++	++	+
Direction, oversight and control	+++	+	+	---
Appointment of directors	---	++ (Levels II and III)	++ (Level I)	---
Planning and investment	---	++	++	++
Setting of pay rates	+++	---	---	---
Recruitment and dismissal	---	++(*) (Sectional services)	+(*)	+(*)
Procurement	+	++	++	+++

Source: Produced by Londoño, Jaramillo and Uribe (1999).

[a] The symbols mean the following:
(*) Subject to labour laws and governed by collective agreements.
+++ Full powers and responsibility.
++ Shared powers and responsibility.
+ Minimal powers and responsibility.
--- Absence of powers and responsibility.

their own and achieve real financial autonomy is partly dependent on a crucial variable that is beyond their control: the spread of insurance in the population. Thus, in 1996, services sold accounted for a fifth of hospital revenue, and of this fifth almost half went to the subsidized system. Estimates of the extent to which the coverage of the two systems has increased are controversial.[14]

Meanwhile, territorial organizations and insurers have run up payment arrears with providers, thus causing deficits and cash-flow problems among a large number of level II and III organizations. The rising debt owed by subsidized system insurers to hospitals is unaccountable, as these insurers' subsidized system operations have been in surplus: in 1996, 60% of their funds were not spent (Jaramillo, 2000, p. 104).

The transition towards municipal decentralization is also making it harder for hospitals to obtain resources, and thus to develop as ESEs; the organizational failings of municipalities militate against hospital decentralization, since in uncertified municipalities[15] the financing chain through which funds from the general public budget pass is a tortuous one.[16] There is also a fear that the obstacles to resource allocation may "reward local fiscal slackness", if national fiscal resources transferred through the municipality do not ultimately reach the health-care sector (Jaramillo, 2000) or, conversely, if there are delays in the flow of resources that force the territorial level into debt. Huge pension liabilities,[17] which have not yet been properly dealt with, are also swelling local authority debt (Londoño, Jaramillo and Uribe, 1999, pp. 23, 38 and 59).

With all these variables at work, the financial statements of public hospitals in 1998 and 1999 showed the whole array of situations from deficit to balance or surplus. Deficits have even been covered using resources from the Solidarity and Guarantee Fund that are meant for other purposes.[18]

[14] Eliminating duplications of data that exaggerate coverage can lead to erroneous estimates of falling or static coverage (Colombia, National Council of Social Security in Health, 2000, pp. 13-17 and 37, and Economic Research Centre, 2000, p. 7). Those who believe coverage has remained static since 1998 attribute this to the implementation of macroeconomic adjustments that had become overdue, higher unemployment, doubts about the subsidized system and vacillation at the national and departmental levels (Jaramillo, 2000, pp. 101 and 88).

[15] A form of transition has been established for the decentralization of resources to the municipalities. Although the distinction has been largely discretionary, municipalities that do not meet the technical, financial and institutional development prerequisites for receiving automatic transfers receive them with conditions attached through their respective departments.

[16] In this case, a public hospital cannot pay a provider for services or a supplier for inputs without the prior involvement of the Ministry of Finance and Public Credit, the Ministry of Health, the department and its departmental assembly, the municipality and its municipal council, and the relevant subsidized system insurer (Londoño, Jaramillo and Uribe, 1999, pp. 11 and 50).

[17] The pension liabilities that local authorities have built up with their employees.

[18] Such as the catastrophic disease and traffic accident sub-accounts, and the solidarity sub-account.

2. The regulatory deficit as an obstacle to performance and general effectiveness

The idea of regulation should be to lay the basis for and oversee the efficient, competitive operation of the market, in accordance with the principles of the health-care model: universality, integrality, decentralization, coordination, compulsory enrolment, solidarity, freedom of choice, gradualism, efficiency and quality. But there are serious regulatory shortcomings.

For one thing, the absence of clear rules has resulted in a proliferation of insurance organizations whose characteristics and diseconomies of scale mean that they do not necessarily meet the conditions for efficiency. The existence of 200 subsidized system insurers is evidence enough in itself of high transaction costs. Of these, just 4% have more than 25,000 subscribers, 84% have between 5,000 and 25,000, and 8% have less than 5,000 (Londoño, Jaramillo and Uribe, 1999, p. 48). This is reminiscent of the hypertrophy, inefficiency and rising costs of health intermediaries in Argentina, associated among other things with high administrative costs and restrictions on the actual health services guaranteed by the insurers known as “administradoras de cápitas” (Sojo, 1997, p. 47).

Clear evidence of insurers abusing their dominant position makes it urgent for rules and sanctions to be established. Thus, there are the “abuses of certain insurers, particularly subsidized system insurers, that really act as expensive intermediaries rather than carrying out a useful insurance role”. For example, there are subsidized system insurers that simply absorb a large percentage of the per capita payment and transfer the balance to a second intermediary, which subcontracts providers. Again, when there is no competition among insurers, payment arrears are compounded by abusive practices whereby tariffs are imposed on hospitals whose negotiating capacities are weak, sometimes in partnership with municipal authorities (Londoño, Jaramillo and Uribe, 1999, pp. 23, 49 and 50). This is quite apart from the fact that this per capita payment, being a non-risk-adjusted general average, is an incentive to adverse selection (Mora and Malabet, 1998).

Again, the way insurers in both the contributory system and the subsidized system delay paying hospitals highlights a serious lack of regulation from which the public hospital system suffers, regardless of performance.

The Ministry of Health is criticized for its weak regulatory capabilities when it comes to laying down general rules to unify the decentralization dynamic. The complaint is that there are no solid minimum guidelines to back up national criteria for employment terms, information quality standards or financial management. Of the fragmented standards of the territorial organizations, it has been said that “rather than a national reform, there may be said to have been numerous local reforms, with varying degrees of progress and little horizontal communication” (Mora and Malabet, 1998, p. 59).

Regulation has also failed to achieve territorial equity in health-care access and a sufficient degree of vertical and horizontal integration among the different levels of care, aspects that are interrelated. Regional or territorial coordination of the service supply network is the responsibility of regional and municipal health directorates, which are supposed to ensure that problems between public- and private-sector providers can be smoothly resolved and that the relations between the two are complementary. The responsiveness of private-sector providers and insurers in smaller and less developed territorial entities was overestimated, however; in economies with large distributional disparities, the market naturally draws private-sector suppliers, particularly high-quality ones, to the high-income sectors (Ocampo, 1996). Combined with the problems of public institutions, this has resulted in serious and costly imbalances in territorial supply (Londoño, Jaramillo and Uribe, 1999, p. 63).

Immediately, then, we have the paradoxes that arise when self-financing hospitals are left to themselves and are not tied in to any system of referral and counter-referral. To deal with these paradoxes there need to be regulations, which could well be incorporated into management instruments such as contracts. For example, the experience of Catalonia and, more recently, that of Costa Rica show that it is possible to create the conditions for integration of the different levels of care and for referral and counter-referral networks by using performance-linked financing contracts, with public-sector organizations and with private-sector ones (Gallego, 1999, pp. 55-57, 76-77 and 265; Franch, n.d., and Sojo, 1998, pp. 94 and 95).

With a few exceptions,[19] however, the reforms inexplicably neglect epidemiological factors and

[19] One exception is the Department of Huila, where steps have been taken to redistribute treatment services among the three hospital levels, strengthening level I and concentrating more specialist care in the other two (Londoño, Jaramillo and Uribe, 1999, p. 54).

necessary measures such as the promotion of preventive care programmes, integration of the different levels of treatment and the creation of referral and counter-referral networks. Since public hospitals were not restructured with reference to territorial supply, but in isolation, the range of services to be supplied by them was left to their own discretion. Most of these hospitals have still not determined fully and explicitly what it is they are supplying. Responsibility for referring patients has presumably been left in the hands of the two systems' insurers, and responsibility for epidemiological follow-up in the hands of the departments, but a systemic vision and the necessary instruments are lacking.

In the same way as in the private sector, public hospitals' need to provide for their own financing tends to restrict the services available to vulnerable sections of society that are unprofitable for them. At the same time as public hospitals, including level I hospitals, have tried to adapt to the new circumstances by creating management instruments such as invoicing and by considering profitability variables, they have allowed the range of services they supply to become unbalanced and have neglected the epidemiological profile as one of the determining factors in their activities, and this has led to an appreciable deterioration in preventive programmes such as vaccination, the early detection of diseases and integral treatment of particular illnesses.

Combined with the segmentation of epidemiological monitoring and the fragmentation of programmes, these factors have resulted in the coverage of vaccinations against tuberculosis, against diphtheria, tetanus and pertussis (DTP) and against poliomyelitis declining during the reform years, in some cases to levels regarded as too low to be effective (Londoño, Jaramillo and Uribe, 1999, pp. 66, 70 and 71, and Economic Research Centre, 2000).[20] Fundamental issues are also at stake, such as the need to redefine the traditional role of hospitals in vaccination programmes, the costs of which fall appreciably if they are carried out in less sophisticated parts of the health system. Furthermore, hospitals do not have the financing they need to do this work, and since full responsibility for it has not been taken by the municipalities or other bodies, coverage has fallen.[21]

Decentralization is still a work in progress. The much-criticized sectoral incursions into local autonomy represented by national standards setting out in detail how resources should be used (Vargas and Sarmiento, 1998) have not ensured the comprehensiveness of prevention programmes or the national and local consistency of epidemiological surveillance. Rules are being drawn up to unify promotion, early detection and prevention criteria, content and activities on the basis of "induced demand and the obligation to meet it" over and above passive user demand (Colombia, National Council of Social Security in Health, 2000, p. 27), whose institutional basis has yet to be determined.

3. From defensive strategies to management reform

The status of ESEs is ambiguous, and is complicated by the operation of two logics: they can be governed by private law, and they can invoke civil service employment clauses. While employment terms governed by private law allow for collective labour agreements and the creation of unions, civil servants cannot enter into collective agreements.

The manager and board of an ESE can hire non-permanent staff, buy inputs and invest in equipment, and decide how operating surpluses should be used. Surpluses may be used for employee bonuses, investments or cross-subsidies among services. Inputs, medicines or the services of specialists can be purchased on private system terms. Public-sector bodies are legally entitled, however, to use what are known as "exorbitant" public-sector employment clauses which allow them, for example, to terminate contracts unilaterally.[22]

Discretion in recruitment within a framework of rigidities has meant that most new jobs in hospitals are not permanent, but are generally subject to temporary contracts. Only 18% of new jobs are staff ones, and this has given rise to a "parallel staff" that has increased from 3,000 to 10,000 people and that can be managed very flexibly (Londoño, Jaramillo and Uribe, 1999, pp. 23 and 43).

The flexibility with which permanent staff members can be managed, meanwhile, is limited by the fact that they still have the status of civil servants

[20] This tendency is also manifested in the way human resources in the health sector have grown. Dentists have increased most in number (52%), followed by doctors (47%), promoters (19%) and sanitation technicians (18%) (Londoño, Jaramillo and Uribe, 1999).
[21] Concerns expressed by Juan Fernando Alviar, head of the Rivaralda Public Health Operations Department, in a conversation held in Santiago on 22 May 2001. In 1999, immunization coverage was extended by an ad hoc programme to purchase vaccines using Solidarity and Guarantee Fund resources (Colombia, National Council of Social Security in Health, 2000, pp. 31 ff.).
[22] This information was provided by Iván Jaramillo.

and official workers, in accordance with the public-sector selection, appointment and employment system as defined by current labour laws and collective agreements, and enjoy large extralegal benefits. The employment legislation is quite rigid and wage increases are agreed nationally by central government for all staff members in hospitals and welfare centres (Londoño, Jaramillo and Uribe, 1999, pp. 17-19, 60-66 and 88-90).

In cases where hospital reorganization has been a success, as in Antioquia, three crucial factors emerge: early measures to increase staff flexibility so that spending in this area can be rationalized, better leadership and management capabilities at the top, and a context in which insurance plays a stronger role (Londoño, Jaramillo and Uribe, 1999, p. 65).

Experiments with changes to public hospital incentives have involved instruments such as contracts, accountability mechanisms, greater autonomy in financial and administrative areas such as procurement and recruitment, the retention of efficiency savings to be used for productivity bonuses, information systems to follow up performance and productivity, surveys to measure user satisfaction, changes to staff composition and working hours in hospitals, and invoicing systems.[23] These experiments aside, there has been little innovation in employment practices. There are no general performance indicators to measure improvements in efficiency and equity in autonomous hospitals, and there have been no agreements relating to the use of forward payments and historical budgets; more than 60% of municipalities are under investigation for diversion and misuse of health-care resources (Londoño, Jaramillo and Uribe, 1999, pp. 50 and 59).

When solidarity and universality are being pursued within a competitive framework, public-sector management reform needs to foster genuinely competitive and complementary relationships between the public and private sectors, make it possible for the public sector to compete on cost and quality, and contribute to better design of the public-private mix. It is thus essential to systematize the positive and negative aspects of the experiments carried out so that reform can be undertaken, at least gradually, in the management of the hospital network as a whole.

Conversely, it does not seem advisable to apply strategies to defend and protect the public sector from competition, if this means delaying or avoiding urgent management reform. This is what the Social Security Institute (ISS) did, choosing to cope with competition within the contributory system by adopting an eminently defensive strategy, rather than increasing its efficiency and effectiveness by undertaking far-reaching management reforms at the time competition was introduced. It was then granted certain protective advantages or privileges: it could combine insurance and provision functions, it was not required to collect co-payments, and it was authorized to offer an extended benefits plan that was not subject to the waiting periods[24] prescribed by law (Londoño, Jaramillo and Uribe, 1999, p. 47). Despite all this, ISS ran up deficits and saw its asset position deteriorate, the result being a crisis of such proportions that it has been debarred from taking on new subscribers since mid-1998.

Again, to give greater security and protection to the public network and make the provision of health services to the poorest more attractive, Law 344 of 1996 required subsidized system insurers to contract for a compulsory minimum of services with public hospitals, equivalent to 40% of the resources of the subsidized system. In some regions of the country, hospitals or their unions have refused to turn themselves into ESEs and forfeit historical budget financing, and there has been pressure for the subsidized system to be tied to the public hospital network. Level I hospitals have been the most reluctant to turn themselves into ESEs. The transformation of supply subsidies into demand subsidies was frozen because of the illiquidity of some public hospitals (Jaramillo, 2000, pp. 37, 38 and 58).

As of late 1998, about a third of all high- and medium-complexity hospitals were resisting modernization. They had not adapted their organizational structure to the new legal framework, and in many cases they were being run by interim managements that were too unstable to bring about transformation and improvement. Some hospitals were prevented from adapting to the new model by the overwhelming inflexibility and inefficiency of their old structures, and had to close. Others, faced with the possibility of liquidation, pressed for greater resources that were not tied to productivity (Londoño, Jaramillo and Uribe, 1999, pp. 49 and 64).

Certain management changes are important because of their role in supporting other aspects of

[23] Examples include the Garcés Navas Hospital, the El Tunal Hospital and the Jorge Bejarano Children's Clinic.

[24] When an insurance policy is initially taken out, waiting periods apply. These require a set amount of contributions to have been paid before certain services and benefits can be taken up, the purpose being to ensure the stability of contributions.

reform. For example, to determine the cost of capitation units accurately and progress with price negotiation, it is essential to have reliable records on activity, costs and quality, and invoicing systems that enhance management capabilities.

Many of these challenges can be dealt with if consensus is achieved. As in the case of decentralization, the political realities of the process need to be recognized if general agreement is to be reached on the best way of dealing with new challenges and problems. Similarly, the fragmentation of responsibilities among the different levels of government and the complexity or lack of clarity characterizing regulations are often the result of unsatisfactory negotiations among the opposing interests affected (Chiappe, 1999, p. 3).

IV

Argentina: the diversity of hospital decentralization

In Argentina, reform has had two pillars. One has been the promotion of free choice and of efficiency and equity among health insurers, which are known as "obras sociales" (social organizations); there has recently been legislation to address the excessive proliferation of the financial intermediaries known as "administradoras de cápitas". The other pillar has been hospital self-management, which is supposed to raise efficiency and thus address the major challenges posed by the excessive size of hospitals, cross-subsidies to health insurers, inadequate referral and counter-referral systems, deep-rooted conservatism in management practices and vagueness about the way some functions are to be financed –teaching being an example– under the self-management system (Sojo, 1997 and Tafani, 1997).

1. The spirit and instruments of hospital reform

In 1993, the general legal framework for hospital autonomy was created by decree. This envisages self-managed public hospitals being grouped into a system of hospital-centred health service networks which are supposed to link up and coordinate the health services supplied by public- and private-sector providers in a system of universal, compulsory coverage, with a pluralistic,[25] participatory and administratively decentralized structure. It also stipulates that the health insurers should pay hospitals for the services received by their policyholders, and establishes a mechanism whereby the debts that the insurers accrue with hospitals are automatically deducted from the subscription transfers made to them.

The separation of functions has been carried out in accordance with the situation in the provinces, and regulation is envisaged, in certain areas, as being decentralized. This creates the risk that regulation may be fragmentary and atomized, lacking a national framework of rules to back up the minimum criteria, guidelines and standards applicable to the contractual relationships between insurers and providers, and to the quality of provision or management.

In the case of Salta,[26] for example, the board of the insurer lays down the provisions governing the different forms of contractual relationship between it and providers and participates in drawing up and

[25] The idea of pluralistic participation is reflected in the make-up of boards. In the case of a public-sector insurer such as the Salta Provincial Health Insurance Institute, for example, the board consists of a chairman and five directors. The chairman is appointed by the government on the recommendation of the Ministry of Public Health. The directors represent public-sector providers, private-sector providers, the health insurers with the most policyholders in the province, municipalities with institutional autonomy and policyholders themselves. The Ministry notifies the government executive of the candidates it has chosen from the shortlists of three submitted by the relevant organizations and is represented at the creation of the Standing Coordination Commission (Comisión Permanente de Concertación), which is chaired by the secretary of health services or his deputy and composed of representatives of the board of the Provincial Health Insurance Institute and the majority representatives of providers at the provincial level (Argentina, Government of, 1998b).

[26] By virtue of the bill to enact the Salta Provincial Health Insurance Institute constitutional law (Argentina, Government of, 1998b).

updating the regulatory instruments used. The Standing Coordination Commission is responsible for drawing up the rules, procedures and standards of usage that service provision must comply with, and for setting payment procedures and amounts. This last could blur the dividing line between the financing function and the provision function, and could lead to coordination in these areas becoming confused with regulation, a power that should remain in the hands of the purchasing body.

The management reform provides for improvements in processes, such as the creation of a unified medical register in the case of Mendoza, databases for identifying the patient population, the provision to all users of confirmation documents linking them to the relevant medical centres, and the maintenance of up-to-date medical records. An effort is also being made to raise quality standards by means of Citizen Charters (Cartas de Compromiso con el Ciudadano), which explain the services available and the quality standards that are to be met (Neirotti, 1999).

Factors that are believed to have helped create consensus among influential actors in relation to hospital reform include training for the professionals involved, early measures to increase understanding of the reforms applied to hospitals and health insurers,[27] and pilot projects that have placed a strong emphasis on organizational development in the city of Buenos Aires, in the provinces of Buenos Aires and Mendoza, and to a lesser degree in other places (Abrantes, 2000).[28]

Hospitals that operate under the self-management system can enter into contracts with insurers and with suppliers of services that the hospital itself does not provide. They can assign, promote and transfer employees within their staff. They can exercise a degree of control over their operating plan and annual budget. They can sell services, collect co-payments that vary by income group and use this income, along with the revenue from health insurers, for staff productivity incentives, investments or maintenance. Experiments are being carried out with independent financing of the training and education functions carried out by hospitals.

[27] The relevant documentation can be consulted at http://www.msal.gov.ar/pressal.

[28] Hospitals participating in these pilot projects hosted a resident team of hospital management consultants who worked with the hospital management to define their mission and objectives, develop a medium-term plan and coordinate short consultancy projects dealing with specific issues (Pressal, 1998).

2. Hospital management contracts

Management contracts for hospital financing, which are supposed to replace historical budget financing, have gradually been coming into use since 1998 as a "legal fiction" for familiarization purposes. Because of decentralization, hospitals were already attached to provinces, and in some cases to municipalities, when the process began. Consequently, hospital self-management has developed slightly differently from place to place, and no single management contract model has been applied, the idea being that contracts in each province should reflect the way the separation of functions has been organized there (Sánchez de León, 1998, p. 50).[29]

For example, the change in prospect is most radical in Salta, where the management contract should be instrumental in introducing what in Chile and Colombia has been called the "demand subsidy" resource allocation method. In La Pampa, on the other hand, the emphasis has been put on the economic incentives that can be redistributed in self-managing hospitals from the funds generated by invoicing health insurers. In Santa Fe, again, efforts are being made to consolidate a decentralization model that has been operating for several decades, by applying a management contract (Pressal, 1998, p. 11). A few hospitals in each province have been chosen to work with management contracts (ibid., p. 32).

Management contracts sometimes include quite detailed targets, with activity and efficiency indices (average days of hospitalization, number of discharges, number of operations) and quality indices (days of hospitalization before surgery, waiting time at the prediagnostic and laboratory stages, formation of hospital infection committees). As regards staff, the aim is generally to reduce absenteeism and encourage training (Argentina, Government of, 1998a; Neirotti, 1999; Abrantes and Días Legaspe, 1999 and Abrantes, 2000).

Other contracts include a wider range of aspects connected with process improvements and participation in the provider network, resembling the complex management contracts of Costa Rica. Thus, in the case of La Pampa contracts include (with differences of emphasis in each hospital): compliance with diagnostic and therapeutic protocols, referral and counter-referral procedures, resolution capabilities corresponding to the

[29] For examples of theoretical proposals and provincial experiences, see Pressal (1998).

level of complexity, updating of medical records and the registry system, consolidation of the gatekeeper system, measurements of user satisfaction, community education programmes, and implementation of prevention programmes (Pressal, 1998, p. 40).

Substandard invoicing systems are being upgraded. Recovery of costs from insurers has been improved, making it possible to offer individual performance bonuses that in some cases can double doctors' incomes. Because hospital reform is taking place within a framework of fiscal discipline linked to provincial reform projects, the provinces have restricted hospitals' financial independence and freedom to recruit staff. The financial slack from which incentives are paid has had to come essentially from efficiency gains, revenue from services provided to insurers, co-payments and reductions in the proportion of spending that goes on staff, where there is scope for this (Abrantes, 2000).

As was pointed out earlier, financing the incentive system from social security charges and invoicing, while it may initially boost production, carries with it an incentive to practise selection to the detriment of the uninsured population. In the interests of equity, therefore, it is important to design budgets with flexible components that can be used for incentives (Pressal, 1998, p. 51). It has also been noted that pay supplements financed out of charges to the different insurers have not always been linked to performance incentives. In Mendoza, for example, these incentives were granted in 1998 to professionals and non-professionals, while managers were excluded, but as part of a "more for the same" distribution scheme (ibid., p. 38).

3. The degrees of hospital autonomy

Where degrees of hospital autonomy are concerned, three basic situations can be broadly distinguished at the territorial level.[30] In the provinces of Entre Ríos, Formosa, La Rioja, San Luis, Santiago del Estero and Tucumán, most hospitals are still financed on a historical budget basis, and their autonomy is very restricted. In Salta and San Juan, on the other hand, hospitals operate as trusts, are governed by public and private law, have freedom to manage their staff and assets and can use the resources they generate as they see fit.

Management contracts have been concluded between hospitals and provinces and among hospitals; these contracts include some performance indicators relating to efficiency and service quality. Hospitals have to compete with other public- and private-sector providers, and the customer base is segmented between those who have insurance or pay for services on the one hand, and the uninsured poor who are treated for free on the other. Managers have fixed-term contracts that are not aligned to the political cycle. Internally generated revenue can be used for investments, maintenance and staff performance incentives. In Salta, Tucumán and San Juan, poor and uninsured users should be able to choose between public- and private-sector providers from 2003 onward.

The largest hospitals in Corrientes, Catamarca, La Pampa, Mendoza and Río Negro are in an intermediate situation. These are financed on a historical budget basis, have administrative and technical councils that appoint managers, and have acquired a degree of autonomy over inputs other than human resources. They can retain up to 80% of revenue from services to insured users and use this for performance incentives, investments and maintenance. Where staff are concerned, although the hospitals can promote employees and encourage them to take early retirement, they cannot recruit or dismiss them. While contracts contain performance indicators, only in Río Negro are individual performance bonuses linked to success in meeting targets. The provinces of Buenos Aires, Entre Ríos and Santa Fe have similar legislation, but change has been relatively slow or inconsistent.

The Dr. Juan Garraham National Paediatric Hospital in Buenos Aires, which is a level III (referral) one, and the José de San Martín Teaching Hospital, which is the University of Buenos Aires teaching hospital, are public-sector enterprises that have full control of their budgets and their own revenue, and full responsibility for the debts they incur, although the San Martín Hospital recently succeeded in obtaining a bail-out for a significant debt that it had accumulated. Both are remarkable for the amount of investment and maintenance revenue they are generating on their own, amounting to almost a third of their budgets.

[30] Distinction drawn by Abrantes (2000).

V

Management contracts in a predominantly public system: Costa Rica[31]

In the midst of an advanced epidemiological and demographic transition, Costa Rica, which has achieved effectively universal health cover with its public health system, is seeking to improve the efficiency and effectiveness of the public-sector institutions providing health services. The crux of the reform, which has been implemented gradually since 1996, is the introduction of management contracts.

The aim is to move beyond the implicit and explicit pattern of traditional management at the Costa Rican Social Security Fund (CCSS), a body which acts as both insurer and provider, and its underlying system of negative incentives, which is characteristic of traditional, non-performance-related financing: inequality in the supply of services, which is influenced by the leverage of each centre; indifference to user dissatisfaction; medical agendas that give rise to a kind of captive market controlled by specialists; administrative control of the budget and ignorance of the cost of services; pay determined by length of service and not by assessment of staff performance; a high level of absenteeism, replacements and incapacities; and self-regulation by professionals in the sphere of clinical management.

1. Reform instruments

In 1997, CCSS separated its internal financial and service provision functions, and it has since created a procurement function, although this is still at the gestation stage and has not yet been fully separated from the financial function. Management contracts with hospitals and health areas were introduced gradually and selectively until by 2000 coverage was complete, but the resources earmarked for the procurement function did not increase proportionately.

This quasi-market is subject to a great deal of internal regulation, as it is the central level of CCSS that has the power to collect funds directly, set rules, carry out regulation and make appointments to key posts. This entails intense internal negotiations, however, since the basic decisions are taken by the CCSS board. The procurement function is monopsonic, as there is no provision for micropurchasers or mesopurchasers, while the provision function is deconcentrated, being spread around numerous CCSS and cooperative bodies.

A new financing model is being promoted, the guiding principles being solidarity, universality and equity. The theoretical financing model includes a variable budgetary component that is tied to the achievement of goals and objectives. This amounts to 10% of the total budget and is divided equally between an incentive fund and a solidarity fund to cope with unforeseen expenses during budget implementation. At the first level of care, there is to be a shift from historical financing towards per capita payments adjusted for the pattern of service use as determined by the infant mortality rates and sex and age structures of the populations served, the aim being to reverse the current inequalities in local resource allocation. At the second and third levels of care, the overall activity of each hospital is broken down initially into four areas: hospitalization, out-patient care in specialist and non-specialist surgeries, emergency, and teaching, research and special welfare programmes. For these, a homogeneous unit of production is established, consisting of a standard equivalence coefficient known as the hospital output unit (unidad de producción hospitalaria, or UPH). The target values for the hospital output unit, the main factor in which is the length of hospital stays, are laid down in a schedule that is invariable for the life of the agreement. The objective at these levels is to move eventually towards a system of payment by case mix or related diagnostic groups.

Historical budgets were taken as the baseline for the change, and 1994 data were used to construct an output function. A dry run has been in operation since then, so that the resources provided are still not tied to compliance with agreements or to the new financing model.

2. Paradoxes of contractual complexity

Measuring performance, which is what these agreements are essentially designed to do, generates

[31] For a detailed study, see Sojo (1998 and 1999b).

process innovations that can help to systematize service provision, illuminate specific aspects of its effectiveness, restructure provider organizations and modify their management culture. To be effective, it requires the creation and maintenance of reliable records on activities, costs and quality, and information systems that can strengthen management capabilities. It also encourages the use of interesting and potentially very important instruments, such as clinical protocols. Contracts are specific to health areas, and to the second and third levels of care, although convergence is taking place where the aspects under consideration are concerned.[32]

By contrast with Colombia, where, as we have seen, preventive health care and referral systems have been neglected, these contracts promote improvements in the organization of the health system and service provision; in particular, they encourage interaction among the three levels of care. Where the health areas are concerned, they reward the ability to resolve cases and reduce referrals, and encourage prevention and promotion activities to reduce sickness and death rates and consolidate desirable health conditions over the medium and long term. Where hospitals are concerned, they lay down referral system rules and in some cases specify a hospital network that is to be consolidated. They encourage second-level institutions to carry out consultation and training activities for the first level, and promote measures to check the actual coverage of the enrolled population.

Importance is also given to the quality of care, which is envisaged as a continuous process of improvement. Quality measurement is provided for in the form of indicators relating to the effectiveness of medical services (patient health complications, trend of the death rate and causes of death, etc.), or in the form of procedures to ensure that medicines are properly used, improve individual health records or control hospital infections. There is concern to improve aspects relating to the promptness and accessibility of treatment so that resource use can be optimized. For this purpose, some efficiency indices have been established (reduction of waiting lists, handling of emergencies, better use of installed capacity such as operating theatres, reduction of medical absenteeism, improvements to support services such as pharmacy services). Measures to identify staff responsibilities and processes have been adopted, as have mechanisms to ascertain user satisfaction and deal with complaints.

Although progress has been made in creating the conditions needed for invoicing to be viable (something that is essential for the new financing model), these conditions have not yet been applied. Evaluation criteria have gradually been standardized and progress has been made in refining the criteria for classifying output and verifying production budgets in accordance with the activities of providers.[33]

The ever-increasing variety of indicators used in contracts, however, and the wide range of objectives, could make them difficult to apply, complicate any evaluation that looks beyond quantitative criteria to seek to identify the conditions that work for and against compliance, and result in excessive transaction costs. This suggests there is a need to rank indicators by importance, limit their number and ensure continuity, if changes in processes and information systems are to be consolidated.

For the same reason, objectives and goals should be scaled down. The format of agreements, the range of aspects and indicators included, and the fact that resource transfers have not yet been made conditional on compliance, mean that contracts resemble a form of planning by objectives, isolating or crystallizing certain priorities and aspects of organization and service provision that providers are asked to comply with. This may have something to do with the decision to make the process a gradual one, as this resulted in a “conservative” specification of the products to be purchased at an initial stage, both in quantitative terms, as historical budgets were used as the baseline, and also in terms of the classification of these products by factors, to determine both the objectives and the indicators to be evaluated (Guzmán, 1999, p. 60).

Although this decision may have helped to prevent turmoil in units by ensuring the coexistence of traditional elements that are tied in to the reform through

[32] For a detailed discussion of the characteristics of these agreements and of the financing model, see Sojo (1998).

[33] Where hospitals are concerned, for example, consideration has been given to the degree of comparability among centres, and they have been segregated so that four sets of activities can be assigned to them: a) social security, which is regarded as comparable and measurable in hospital output units; b) key specialisms, such as those of San Juan de Dios (burns), Calderón Guardia (liver transplants) or México (heart transplants); c) extraordinary activities, such as measures to combat dengue or cholera; d) investments, for which there was previously no systematic financing. Interview with René Escalante, manager of the Administrative Division of CCSS, 10 December 1998.

contracts, it could also result in agreements having an excessive degree of complexity that proves difficult to manage over time, complicates evaluation and entails high transaction costs –the amount of information that has to be obtained from providers, for example– that may result in the agreements being mired in bureaucracy, or becoming a dead letter.

Introducing financing by capitation, case mix or related diagnostic groups will allow progress to be made towards a set of agreements whose essential aims are the effectiveness and efficiency of provision. Other aspects of management reform, such as support for the use of evidence-based medicine, can be linked to other instruments that are integrated into essential activities, such as epidemiological surveillance. Organizational aspects and intermediate products, while not excluded, will undoubtedly have to be emphasized less in agreements.

3. The legal basis

It is essential for contracts to be legally sound, as it is this that determines not only the scope for applying effective sanctions in the event of non-compliance, but also the way conflicts are resolved within the market, the rank of the authorities involved and the mechanisms to be used for dealing with contractual omissions and oversights and resolving disputes, among other aspects (Walsh, 1995).

The management contracts of CCSS first acquired a legal basis when they were approved by the board of that institution. But in legal terms, these were “quasi-contracts”, since hospitals and clinics had no legal personality of their own. A crucial step towards legal solidity was the act of parliament deconcentrating CCSS hospitals and clinics, which made the management contract the instrument that articulated and delimited this deconcentration by establishing that hospitals and clinics enjoyed an “instrumental legal personality” for the purposes of “budgetary management, administrative recruitment and the management and organization of human resources subject to the legal provisions applicable, the limits set by the Fund and the management contract”. According to the person who promoted it,[34] an instrumental legal personality is stronger than that of a deconcentrated body but weaker than that of a decentralized one, as it is exercised strictly within the spheres determined by law and delimited by the agreement.

The deconcentration act also stipulated that the organizations were to be run by the director, who was to act in accordance with the objectives and obligations set forth in the management contracts, with general regulations and with the policy guidelines issued by CCSS.

But reality always makes change awkward, and in this case the provisions of the law reflect resistance to rule changes. The legal changes were sought by the CCSS executive, which has set itself no deadline for completing the process, as it is trying to ensure it is not traumatic. However, expectations and interpretations of the scope of the law are not uniform among different agencies of CCSS, where the prevailing interpretation is that administration will be deconcentrated only to a limited degree, while providers expect to achieve a high degree of autonomy in the very near future. The regulations support the view of limited administrative deconcentration more than that of decentralized powers and managerial independence (Guzmán, 1999, p. 82).

In addition, fundamental issues have yet to be resolved if the legal framework is to be consistent with new methods of assessing staff performance. There would need to be amendments to the statutes of the medical and nursing services that govern membership of their professional bodies and determine how recruitment and assessment are carried out within the civil service system.[35] The way professionals are regulated under these statutes is an impediment to managing them within CCSS. Among other problems, it gives rise to conflicts of supervision, hinders the effective performance of duties and encourages a trade unionist attitude among staff (Ortiz and Sequeira, 1998, pp. 99 and 100).

4. Staff performance

The preponderance of medical professionals and paramedical staff very largely determines the nature of the services provided, and the new incentive systems are reshaping their power and affecting their room for manoeuvre. To lay the basis for relationships of trust under a new management model, and to ensure that staff performance is adequately monitored, there is an urgent need to change the staff recruitment and selection practices and the retention rules currently followed in CCSS.

[34] Interview of 7 December 1998 with Rodolfo Piza Rocafort, executive president of CCSS.

[35] See University of Costa Rica (1998), cited by Ortiz and Sequeira (1998, pp. 36 and 37).

Security of employment that is detrimental to performance, career progression by length of service rather than merit, the agreement that four to five patients should be seen an hour, the tortuous procedures for dismissing staff[36] and the inability of patients to choose their doctor are all obstacles to thorough change in the situation and, in general, to modernization of human resource management in CCSS.

Changes need to be made to the criteria that govern public service recruitment and retention, as the inflexibility of employment terms is unquestionably a crucial element that can be an obstacle to innovative management. Staff appointments should be decided by competition, promotion and pay should be based on assessments of career performance, procedures for dismissing staff should be simplified, and terms of employment should be standardized. The efficiency and productivity gains thus achieved could feed through to improvements in pay based on the new criteria. In the interests of equity, steps will have to be taken to ensure that there is a balanced distribution of the necessary human resources in all geographical areas.

The range of CCSS-financed private-sector provision is currently being extended, to cut waiting lists for specialities. Care should be taken here to ensure that the movement of professionals between the two sectors and the moral hazard this may involve do not lead, for example, to CCSS professionals deliberately reducing their productivity or neglecting tasks such as proper equipment maintenance. It is worrying to reflect that as restrictions are removed, pockets of inefficiency may become entrenched in CCSS provision, when the process should actually be contributing to the reduction of waiting lists. Nor should this process place a constraint on CCSS infrastructure and equipment investment, as this would result in back-door restrictions on public-sector provision and possibly escalating costs, if the prices paid to the private sector were higher than the price levels that CCSS should be able to achieve if it were operating efficiently. Again, co-payments (e.g., to receive faster treatment in the private sector) should not be introduced if they undermine the solidarity of the system.

VI
Conclusion

By concentrating on insurance and financing, the health reforms carried out in the region have not always paid sufficient attention to the organizational and institutional variables associated with these. Management changes have taken place in systems that differ in terms of solidarity and universality. Chile lags furthest behind when it comes to changes in financing and action to remedy the shortcomings of management contracts. In Colombia, the country that has perhaps made most progress in building up a new financing system and the rules to govern it, hospital financing is excessively complex and suffers from the negative effects of financial intermediation. Although the country can show successes with pilot projects, most hospitals are relatively neglectful of management and are only loosely tied in to referral and counter-referral networks. In Argentina, the most striking feature of hospital reform is the variety of forms taken on by hospital self-management, as this was introduced in a decentralized context; there is currently discussion of regulating risk selection, improving performance measurements as a basis for the provision of incentives, moving towards financial autonomy and taking steps to deal with excessive hospital size. In Costa Rica, financing changes are still at the experimental stage; the country's management contracts are interesting because of the changes they imply for processes, decentralization and improvements to the institutional network, although their growing complexity may militate against their objectives.

[36] The procedures for dismissing staff need to be simplified nationally. At present, they involve due process applications, appeals, the local commission and the central commission for labour relations. The problem is that a bill is needed to regulate this issue, and the basis of employment needs to be standardized for the different sectors. These are some of the challenges described by Dr. Elías Jiménez, then director general of the National Children's Hospital, in an interview conducted on 5 February 1998.

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An econometric analysis *of private-sector* investment in Brazil

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This article analyses the main determinants of private-sector investment in Brazil during the period 1956-1996, using an empirical model employed in the most recent studies on developing countries. The econometric procedures followed not only take into account the non-stationarity of the data series examined, but allow for the possible difficulties involved in treating the conditioning variables as exogenous ones or as policy instruments. The findings –both the long-term equations and the short-term models– reveal the positive impact of the output, public investment and financial credit variables and the negative effect of the exchange rate. The results of the weak exogeneity and superexogeneity tests show the importance of credit and public investment as economic policy instruments, while obviating Lucas' critique.

I

Introduction

Capital goods investment decisions are of the greatest importance for a country's economic growth, and are generally taken in the private sector, which is expected to play a fundamental role in productive investment.

In developing countries, the decline in investment rates that began in the 1980s inspired empirical research into the main determinants of private-sector investment. This research was also motivated by the institutional and structural characteristics of capital formation in those countries, such as financial repression in the credit market, a strong government presence, foreign currency dependency and different forms of economic instability. More recent studies on private-sector investment in developing countries (among others, Greene and Villanueva, 1995; Servén and Solimano, 1993 and Agosin, 1994) have also extended empirical analysis to variables representing uncertainties in the investment decision-making process and external constraints. These last were included because of the external debt crisis and the deterioration in the terms of trade that affected developing economies in the 1980s.

In the specific case of Brazil, empirical studies have mainly sought to analyse the relationships between private- and public-sector investment. The most recent study along this line of research was that of Cruz and Teixeira (1999), which used the stationarity and cointegration tests to arrive at estimates that took account of the non-stationarity of time series. The results obtained showed that public- and private-sector investments were complementary in the long term and substitutive in the short term.

What has inspired the present paper, however, is the fact that empirical analysis of private investment cannot yet be considered wholly satisfactory from the point of view of modern econometrics. Not even the most recent empirical studies, of Brazil or of groups of developing countries, have investigated the exogenous character of the explanatory variables, which means that private investment has been treated, a priori, as a typically endogenous variable. Since the parameters of an econometric model are estimated on the basis of its explanatory variables, the direct assumption must be that the marginal process of each of these variables offers no information of relevance to the calculation. These hypotheses need to be verified empirically, however. Should the marginal process of some explanatory variable prove to be relevant, this variable could not be regarded as exogenous, as that would mean neglecting important information and would result in inefficient estimation of the parameters.

Another use of empirical exogeneity tests for the subject on hand is the identification of macroeconomic variables that can be used as policy instruments, i.e., of variables whose structure can change without affecting the model parameters. This would obviate Lucas' critique (1976), which holds that, assuming rational expectations, the parameters estimated from an econometric model would become inapplicable as policy changes led agents to modify their behaviour in order to adapt to the new situation. Consequently, econometric models could not be used for economic policy-making purposes. Lucas' critique was a powerful challenge to the way econometric modelling had traditionally been used as an instrument for economic policy evaluation. Although the empirical importance of this critique is still debated, it was instrumental in the introduction of new standards for the modelling of interactions between policy rules and the responses of private agents.

The objective of this paper is to analyse the main determinants of private investment in Brazil during the period 1956-1996, using modern instruments such as stationarity, cointegration and exogeneity tests that allow the Lucas critique to be obviated. The econometric model used is based on the most recent studies of developing countries and takes account not only of the more common variables, but of the influence of external constraints on private investment as well. Consequently, it has a more generic character than the models used in previous studies on Brazil. The main goal is to obtain a private investment model that is well specified and consistent with theory.

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The stationarity and cointegration analyses allow the short-term and long-term effects of the explanatory variables to be distinguished from one another. The exogeneity tests, meanwhile, demonstrate the efficiency of the model as an estimation tool and provide data for policies to promote private-sector investment. The results obtained indicate that, during the period under study, private investment was positively influenced by output level, public investment and financial credits, and negatively influenced by the exchange rate and conditions of uncertainty. The exogeneity tests reveal the importance of public investment and financial credits as policy instruments for encouraging private investment.

This article consists of five sections, of which this introduction is the first. The second section contains some considerations regarding the variables used in this analysis and the sources of statistical data. The third briefly describes the methodology that is to be employed. The fourth analyses the empirical results obtained, and the fifth sets out the conclusions.

II

Statistical data and variables

According to Servén and Solimano (1992), there are theoretical and empirical considerations which suggest that the variables of most importance in determining private investment levels in emerging countries are: domestic output, the real interest rate, public investment, credit available for investment, the size of the external debt, the exchange rate and macroeconomic stability. As a starting point for empirical analysis, we believe that this is a satisfactory description of the problem.

The private investment data used were taken from the private-sector gross fixed capital formation figures published in the system of national accounts of the Brazilian Institute of National Statistics and Geography (IBGE). They include private investment in construction, machinery and equipment.[1]

According to the neoclassical theory of investment, which originated in the work of Jogerson (1963), the value of the capital stock desired by a competitive enterprise is a positive function of its output level, which may be treated as a proxy for the level of demand. If this result is extended to more aggregate levels, a country's output can be considered as a measure of demand in the private sector as a whole. In this paper we have used gross domestic product (GDP) figures from the IBGE system of national accounts.

Another variable that neoclassical theory considers relevant in investment decision-making is the real interest rate, which in this case would represent the usage cost of capital or the cost of credit for the company. Given that increases in the interest payable are a disincentive to investment, it might be expected that the relationship between the two variables would be negative. However, some recent studies (Agosin, 1994, on a group of developing countries, and Cruz and Teixeira, 1994, on Brazil) have found that the relationship is not statistically significant, apparently because of the short-term nature of interest rates and the shortcomings of credit markets in developing countries. For this analysis, use has been made of the Over/Selic interest rate data for the period 1973-1996, which represent the average interest rate for federal bonds and are published by the Central Bank of Brazil. For the period 1956-1973, the series has been supplemented with Ronci's data (1987).

Developing country governments generally play a large part in economic activity, the justification being the private sector's lack of involvement in large investment projects. The presence of public-sector capital affects private-sector investment in two different ways. On the one hand, the public sector competes with the private sector to appropriate scarce resources, both physical and financial, and may even produce marketable goods that compete with those of the private sector. This is known in economic literature as "crowding out". As against this, public-sector capital can increase productivity by generating a positive externality, as happens in the case of investments in infrastructure and the provision of public goods, and may act countercyclically, increasing the demand for private-sector inputs and services. This positive effect

[1] Some empirical studies on Brazil have counted investment by State-owned companies as part of public-sector investment. Since the important thing is the nature of the investment and not its ownership, we have chosen not to follow this approach.

is known as "crowding in". The public investment data used were taken from the public-sector gross fixed capital formation statistics published in the IBGE system of national accounts.

In emerging countries, many companies encounter restrictions in the credit market, apparently as a result of information asymmetries between lenders and borrowers and a degree of precariousness in the workings of capital markets and financial intermediation systems. As a rule, it can be said that certain sectors of emerging capital markets, such as long-term financing and the futures market, are underdeveloped, and this means that bank loans and external borrowing may be the only sources of credit available for private-sector investment financing. When resources of this type are available, it becomes viable to invest even when investors' own funds are insufficient to finance their projects. This analysis uses BNDES disbursement data for long-term lending at low interest rates to finance spending on capital goods.

The size of the external debt is one of the variables that exemplify the influence of external credit constraints on the financing of production activities in emerging countries. According to Servén and Solimano (1992), low investment rates in the 1980s reflected the decline in external resources being transferred to heavily indebted countries. In addition, high debt levels meant that resources previously used to finance local companies had to be transferred abroad as service payments and charges. The data used here are those for the external debt/GDP ratio published by the Central Bank of Brazil.

The exchange rate can influence the level of private-sector investment, as it is one of the components that determine the real cost of imports. A currency devaluation increases the real costs of purchasing imported capital goods, thereby reducing the profitability of the private sector and possibly causing investment to decline. Furthermore, a real devaluation can mean a fall in the real income of the economy as a whole, thus reducing production capacity and activity to levels that businesses find uncomfortably low.

As against this, a real currency devaluation can have a positive impact on investment in sectors producing internationally traded goods, as it increases competitiveness and export volumes. The data used are those for the nominal exchange rate against the dollar (average selling rate for the period) as reported by the Central Bank of Brazil.[2]

According to the theory of investment irreversibility (Pindyck, 1988), spending on fixed capital cannot be recovered in full if the company concerned should decide to sell this capital at a later date. The fact that many capital goods are company-specific and have a resale value lower than their purchase price means that investment is an irrecoverable cost. As a result, installed capital cannot be used for other purposes without the company incurring costs.

Caballero (1993) holds that it is mainly in developing countries that investment is irreversible, as secondary markets for capital goods are imperfect and adjustment costs of various kinds have to be met. If this view is accepted, the existence of uncertainties may have a large influence on investment decisions, since if the future is unpredictable any increase in current production capacity may leave the company with an excess of capital that cannot be eliminated without costs. This would explain why companies prove reluctant to carry out major investments, even during periods of prosperity. Thus, it would appear that economic stability and the credibility of public policies play an important role in stimulating investment. For the purposes of this paper, changes in the inflation rate will be used as a proxy for uncertainty in the economy. These data are calculated from the general price index for domestic supply (IGP-DI) provided by the Getúlio Vargas Foundation.

Most of the data used for the explanatory variables are only available annually. This is the case, for example, with the data on public- and private-sector investment, credit and external debt. As we are going to analyse a reasonable number of explanatory variables, as well as models including lags for each variable, we tried to obtain a sample with the largest possible number of observations. Also, during the period 1956-1996 the Brazilian economy operated under a variety of different circumstances, which means that investigating Lucas' critique is an interesting subject for this empirical study.

[2] Although Brazil has quite a diversified pattern of foreign trade involving a number of countries of origin and destination, we believe that changes in the exchange rate against the dollar reflect, on average, changes in the effective exchange rate.

III

Methodology

The econometric procedures will be carried out in four stages. In the first, the order of integration of each of the series used in the analysis will be determined by applying the stationarity or unit root tests. To start with, the augmented Dickey-Fuller (ADF) test (Dickey and Fuller, 1981) will be applied. Decisions as to the stationarity of time series will also be based on visual inspection of their correlograms, as the unit root tests are a formalization of this inspection.

Given that the existence of structural breaks can result in the adf test wrongly indicating non-stationarity in what is actually a stationary series, the unit root test suggested by Perron will be carried out.[3] This test seeks to establish the order of integration of a time series by considering the likelihood of structural changes occurring in its behaviour.

In the second stage, the variables that are significant in the private investment equation will be identified, with their respective lags. Working "from the general to the particular", a general model known as the autoregressive distributed lags (ADL) model, will first be estimated.[4] Using the restriction tests, the model will be gradually reduced by eliminating variables and lags that prove to be statistically insignificant.

In the third stage, Engle and Granger's method (1987) will be used to verify the cointegration hypothesis in what prove to be integrated series of order one, followed by estimation of the differences model with the error correction mechanism. Johansen's method (1988) will also be used to analyse the cointegration vectors by means of a vector autoregressive (VAR) model, to determine more accurately the number of cointegration ratios and the coefficient vector estimates for these ratios. This stage is called for because the trend of a time series can be of two types, deterministic or stochastic. In the first case, the series may become stationary when the time variable is included in a regression model. With a stochastic trend, on the other hand, cointegration tests need to be carried out to check whether a linear combination of two or more time series may generate a stationary residual, even if individually they are not stationary. Cointegration of two or more time series suggests a long-term relationship between them, while the error correction mechanism only indicates the inclusion of the lagged stationary residual in the short-term model, to reconcile the short-term behaviour with the long-term equilibrium.

In the fourth stage, the weak exogeneity and superexogeneity tests will be carried out. According to Engle, Hendry and Richard (1983), the weak exogeneity hypothesis ensures that efficient inferences can be drawn from the parameters when the analysis is restricted to the conditional model. In the present paper, this model uses private investment as an endogenous variable. The weak exogeneity tests will be carried out on the parameters of the short- and long-term equations.

The combination of weak exogeneity and structural invariance in the parameters estimated leads to the concept of superexogeneity. If an explanatory variable were superexogenous, changes in its distribution would have no effect on the parameters of the conditional model. This being the case, its effects on the endogenous variable can be analysed in terms of policy simulations, with inferences being drawn in environments where intervention can take place. In this way, confirmation of superexogeneity obviates Lucas' critique, the thrust of which is to question the use of the estimated parameters of an econometric model to produce policy simulations, as agents are constantly revising their expectations in the light of changes in the economic environment.

[3] The test to be used is called the additive outlier test. For further details, see Perron (1989).

[4] For further information on the basis of this methodology, see Charemza and Deadman (1997).

IV

Analysis of econometric results

In all the econometric analysis carried out, use was made of the natural logarithm of the time series of each variable. This is because series expressed in logarithms present roughly constant variances, while the variance of a level series tends to increase with the size of the sample. As in Greene and Villanueva (1995) and Rocha and Teixeira (1996), the real interest rate variable was defined as: $\frac{(1 + i / 100)}{(1 + \pi / 100)}$, where *i* is the nominal percentage interest rate and π is percentage inflation.[5]

1. Stationarity tests

Visual analysis of the diagrams and correlograms of the level and first difference series indicates the possibility that the inflation rate variation and real interest rate series are stationary, while the other series seem to be integrated series of order one.[6]

a) *Results of the augmented Dickey-Fuller test*

The results of the augmented Dickey-Fuller (ADF) test for the level and first difference series are given in table 1. The second column shows the deterministic parameters (constant and linear trend) which presented a significant value t at the 10% level, and were therefore included in the regression of each of the variables. The third column shows the number of lags introduced into each regression to eliminate possible autocorrelation of the residuals, which were determined by minimizing the criteria of Akaike and Schwartz. The last column shows the value of the τ-ADF statistic or, where no lag has proved significant, the τ-DF statistic.

The results obtained show that the interest rate and inflation rate variation series are integrated ones of order zero or stationary, while the first differences of the private investment, public investment, external debt, exchange-rate and credit series refute the null hypothesis of non-stationarity and are therefore integrated series of order one. In the graphic analysis carried out previously, the GDP series was the only one whose result differed from what was expected. To obtain a more reliable result from this series, the Perron test had to be used.

b) *Results of the Perron test*

The Perron test was conducted for all the series that the ADF test showed to be non-stationary, to see whether they were really non-stationary or were affected by a structural break giving rise to a permanent change in their averages.[7] Table 2 shows the results of the Perron test for the level and first difference series. The second and fourth columns give the values obtained for the t-statistic. The upper critical values of t, supplied by Charemza and Deadman (1997, pp. 301-303), are –3.48 and –4.15 at the 5% and 10% significance levels, respectively.

The first-differenced GDP series was shown to be stationary, confirming the result obtained from analysis of its diagram and correlogram. Thus, the result of the ADF test for this series seems to be skewed by the presence of a structural break. For the other series, the results confirm those obtained from the ADF test and the correlogram analysis.

Following the unit root tests, it can be affirmed that in the period under consideration:

i) the private investment, output, public investment, external debt, exchange-rate and credit series are integrated series of order one I(1), being non-stationary in level while their first differences are stationary.
ii) the interest rate and inflation rate variation series are stationary in level or I(0).

[5] The values of the private investment, output, public investment, exchange-rate and credit series are expressed in millions of 1995 reais. For the investment series, we used the IBGE gross fixed capital formation deflator. For the other series, we used the general price index for domestic supply (IGP-DI). All the econometric results were obtained using the computer programs PC-GIVE and PC-FIML, version 9.10.

[6] For reasons of space, we have not included diagrams and correlograms.

[7] To determine accurately the period of occurrence of the structural break in each series (or the main break, if there was more than one), the recursion diagrams of the estimates of each series were analysed in a model with only a constant and a linear trend. With the exception of private investment and the exchange rate, the series presented large structural changes in the early 1980s, a period marked by low economic growth, high inflation and the debt crisis.

TABLE 1

Results of the ADF test: level and first difference series

Variable	Deterministic parameters	Lags	τ-ADF or τ-DF
Log private inv.	Constant	1	–1.756
Log output	Constant and trend	4	–2.406
Log interest rate	Constant and trend		–4.29[a]
Log public inv.	Constant	1	–1.864
Log external debt		3	–0.619
Log exchange rate	Constant and trend	4	–2.955
Log credit		4	–0.547
ΔLog inflation		6	–2.23[b]
ΔLog private inv.	Constant	1	–4.742[b]
ΔLog output		1	–1.603
ΔLog public inv.		0	–5.765[a]
ΔLog external debt		2	–3.959[a]
ΔLog exchange rate	Constant	4	–3.183[b]
ΔLog credit		3	–2.039[b]

[a] Denotes significance at 1% level.
[b] Denotes significance at 5% level.

TABLE 2

Perron's test for level and first difference series

Variable	t	Variable	t
Log private inv.	–0.839	ΔLog private inv.	–5.396[a]
Log output	–1.202	ΔLog output	–3.835[b]
Log public inv.	–2.528	ΔLog public inv.	–6.484[a]
Log external debt	–1.639	ΔLog external debt	–8.608[a]
Log exchange rate	–0.236	ΔLog exchange rate	–7.037[a]
Log credit	–2.080	ΔLog credit	–7.486[a]

[a] Indicates refutation of null hypothesis at 1% significance level.
[b] Indicates refutation of null hypothesis at 5% significance level.

TABLE 3

Values of the sum of squared residuals (SSR), estimated standard deviation of residuals (σ) and Schwarz criterion for ADL(3) models

Model	SSR	σ	Schwarz
ADL(3)	0.1008	0.0728	–4.1134
ADL(3) without debt var.	0.1341	0.0764	–4.2109

Model ADL(3) → ADL(3) without ext. debt var.: F(4,19) = 1.5691 [0.2231]

2. Restriction tests on variables and lags

The method used was to begin by estimating a general model and then, with the application of restriction tests, gradually to reduce its size by eliminating lags and variables that proved to be insignificant.

The general case will be described as an autoregressive distributed lags (ADL) model. This model uses private investment as a dependent variable, this being expressed as a function of its own lags and of the current and lagged values of the other variables whose series were given as I(1): output, public investment, external debt, exchange rate and credit.

Owing to the large number of explanatory variables and the relatively small number of observations, the analysis began with estimation of an ADL(3) model, with three lags for each variable. Nonetheless, there proved to be a strong correlation between the public investment series and the GDP, credit and exchange-rate series. To avoid the problem of multicolinearity, we decided to estimate two adl models separately for private investment. The dependent variables used for the first are GDP, debt, the exchange rate and credit, while the second only has public investment as an explanatory variable.[8]

The results of the Lagrange multiplier (LM) tests of joint significance for the first model indicate that the contribution of the three lags is significant at the 10% level. In addition, the LM tests for each variable show that external debt was not significant as a determinant of private investment in the period considered. The first step in reducing the model is to eliminate the variables that proved not to be significant. Table 3 presents the values of the sum of squared residuals (SSR), the estimated standard deviation of the

[8] The Ramsey specification test was applied to each ADL model and no specification errors were detected.

residuals (σ) and the Schwarz criterion for the ADL models with and without the presence of the external debt variable.

The values referred to did not differ greatly between the two models. The result of the F test does not rule out the hypothesis that all the coefficients of the external debt variable are equal to zero, confirming the possibility that these could be excluded. Analysis of the recursion diagrams of the model also confirmed that there was a structural break in 1995. A dummy impulse variable for that year was included in the model.

In the second model, the joint significance tests for each lag show that the second and third lags for private and public investment are not significant in the analysis. Table 4 gives the values for the sum of squared residuals (SSR), the estimated standard deviation of the residuals (σ), the Schwarz criterion for the ADL(3) and ADL(1) models and the F test for parameter reduction.

The values did not differ greatly between the two models. The outcome of the F test does not rule out the hypothesis that the coefficients of the second and third lags are jointly equal to zero, confirming the possibility that they can be excluded. Analysis of the recursion diagrams of the model also showed a structural break in 1990.

TABLE 4

Values of the sums of squared residuals (SSR), estimated standard deviation (σ) and Schwarz criterion for ADL(3) and ADL(1) models

Model	SSR	σ	Schwarz
ADL(3)	0.4372	0.1188	–3.7948
ADL(1)	0.5068	0.1203	–4.0300

Model ADL(3) → ADL(1): $F(4,31) = 1.233$ [0.3172]

3. Cointegration tests

For the cointegration analyses, use was made only of the integrated variables of order one that proved statistically significant in determining private investment: output, exchange rate and credit for the first model, and public investment for the second model.

a) *Results obtained using the Engle-Granger method*

The coefficients for the long-term relationship between private investment and the significant variables were obtained from the specific models of the previous section. The long-term equations estimated showed the following results (see models 1 and 2).

The ADF for the residuals of equations [4.1] and [4.2] indicate stationarity of level. As the private investment, output, public investment, exchange-rate and credit series are all I(1), we have two long-term equilibrium ratios given by [4.1] and [4.2].

In the first equation estimated, the output and credit coefficients are positive in the period 1959-1996, while the exchange-rate and dummy variable coefficients are negative. The positive coefficients for output and credit show that private investment was stimulated both by the level of activity in the economy and by the availability of long-term financing, which agrees with most of the empirical findings reported in the literature. The negative coefficient for the exchange rate shows that, over the long term, currency devaluation/ depreciation led to a fall in investment. This was probably due to the decline in the economy's real income and the increase in the cost of imported capital goods, resulting in a lower level of activity overall.

The second equation estimated, for the period 1957-1996, shows the predominance of the crowding in effect, with investment in public goods having a positive impact on private-sector investment. In accordance with the negative values of the coefficients for the dummy impulse variables in [4.1] and [4.2], it also shows a decline in private investment levels in the 1990s.

Once the long-term dynamic of private investment has been analysed, the next step is to determine the short-term relationships among the variables. These relationships are represented in the models with the first differences of the I(1) variables, incorporating the error correction mechanism (ECM) and the real interest rate and inflation rate variation variables, whose series proved to be stationary in level.

Tables 5 and 6 give the results of the estimates, along with the residual diagnostic tests. In the two models estimated, the ECM term showed a significant negative coefficient, which confirms, according to Granger's representation theorem, that the series cointegrate. The results of the residual tests indicate an absence of autocorrelation (LM test) and of heteroscedasticity (ARCH1 and White's tests). The residuals proved normal, in accordance with the statistical value X^2. Ramsey's tests show that the two regressions are well specified.

In the first model, estimated for the period 1959-1996, the first differences of the output and credit series presented positive coefficients, showing themselves to be important factors in private investment in the short term as well. The negative coefficients for the exchange rate (first-difference, no lag and two lags) indicate that

Model 1 [4.1]

Log private inv. = 0.7509 Log output – 0.2312 Log exchange rate + 0.1702 Log credit – 0.2424 i1995
(t-statistic) (70.2432) (–9.8593) (10.6842) (–2.3398)

Wald's test for joint significance: $Chi^2(4)$ = 2.3624e+005 [0.0000]**

ADF residual test: τ-ADF = –2.67**

Model 2 [4.2]

Log private inv. = 1.2120 Log public inv. – 1.9550 i1990
(t-statistic) (64.0931) (–1.9492)

Wald's test for joint significance: $Chi^2(4)$ = 6967.7 [0.0000]**

ADF residual test: τ-ADF = –2.126*

* Indicates refutation of null hypothesis at 5% significance level.
** Indicates refutation of null hypothesis at 1% significance level.

TABLE 5

Estimated short-term model and respective tests, 1959-1996

(Dependent variable: ΔLog private investment)

Variable	Coefficient	Standard deviation	t	t prob.
ΔLog private inv. –1	0.4918	0.1224	4.018	0.0004
ΔLog output	1.4152	0.2679	5.283	0.0000
ΔLog exchange rate	–0.4274	0.0881	–4.851	0.0000
ΔLog exchange rate –2	–0.1085	0.0613	–1.772	0.0865
ΔLog credit	0.1619	0.0357	4.542	0.0001
ΔLog inflation	–0.0598	0.0314	–1.906	0.0602
ECM 1	–0.7756	0.1389	–5.585	0.0000
i1995	–0.3314	0.1471	–2.253	0.0317

$R^2 = 0.7649$ σ = 0.0775 D.W. = 2.24

Test	Statistics	t prob.
Residual tests		
LM (autocorrelation)	F(2,28) = 1.0856	0.3515
ARCH 1	F(1,28) = 1.0029	0.3252
Normality	$X^{2(2)}$ = 3.3579	0.1866
White (heteroscedasticity)	F(15,14) = 0.2636	0.9925
Regression specification test		
Ramsey	F(1,29) = 0.1927	0.6639

TABLE 6

Estimated short-term model and respective tests, 1958-1996

(Dependent variable: ΔLog private investment)

Variable	Coefficient	Standard deviation	t	t prob.
ΔLog public inv. –1	0.2177	0.1164	1.871	0.0695
ECM 2	–0.1323	0.0329	–4.011	0.0003
i1990	–0.3104	0.1020	–3.043	0.0044

$R^2 = 0.5422$ σ = 0.1018 D.W. = 1.85

Test	Statistics	t prob.
Residual tests		
LM (autocorrelation)	F(2,34) = 2.0811	0.1404
ARCH 1	F(1,34) = 2.3777	0.1323
Normality	$X^2(2)$ = 4.246	0.1197
White (heteroscedasticity)	F(5,30) = 0.6392	0.6716
Regression specification test		
Ramsey	F(1,35) = 1.6402	0.2087

the fall in investment resulting from currency devaluation/depreciation occurred in both the long and short terms. Variations in the inflation rate also proved to be significant as a determinant of private investment, indicating that uncertainty in the economy was instrumental in reducing the investment level. The interest rate coefficients did not prove statistically significant, which indicates that short-term variations in this rate did not affect investment significantly. The coefficient estimated for the dummy impulse variable again points to a fall in 1995.

The second model estimated shows the positive impact of lagged public investment in one period, and the fall in private investment in 1990. The result obtained confirms the crowding in effect: as public investments came to fruition, they had a positive effect on the productivity of private capital, which agrees with Cruz and Teixeira's results (1999) for the long term.

b) *Results obtained using Johansen's method*

As use is being made of the VAR model, which does not specify the endogenous and exogenous variables *a priori*, and considering the possibility that there may be more than one cointegration vector, Johansen's method of cointegration analysis is more general in character than the Engle-Granger method.

Considering the results obtained in section IV.2, a three lag VAR was estimated for the private investment, output, exchange-rate and credit variables, and another VAR model with one lag was estimated for the private investment and public investment variables. Tables 7 and 8 show the results of applying Johansen's procedure

TABLE 7

Cointegration analysis using Johansen's method: VAR(3)

Hypothesis	$r = 0$	$r \leq 1$	$r \leq 2$	$r \leq 3$
$\mu_{minimum}$	39.29[a]	14.01	4.215	0.599
Critical value at 5%	27.1	21.0	14.1	3.8
Hypothesis	$r = 0$	$r = 1$	$r = 2$	$r = 3$
$\mu_{maximum}$	58.11[a]	18.82	4.814	0.599
Critical value at 5%	47.2	29.7	15.4	3.8
		Autovectors β'		
	Log private inv.	Log output	Log exchange rate	Log credit
	1.0000	–7108	0.2501	–0.1829
	0.0121	1.0000	0.4045	–0.2917
	–4.1359	–11.0740	1.0000	10.3610
	–1.0034	–2.1547	–0.4419	1.0000
		Coefficients α		
Log private inv.	–0.6334	0.8003	0.0011	0.0119
Log output	0.0733	0.0825	–0.0003	0.0079
Log exchange rate	–0.0254	–0.5612	–0.0114	–0.0033
Log credit	2.0316	2.1885	–0.0115	0.0002

[a] Indicates refutation of null hypothesis at 1% significance level.

TABLE 8

Cointegration analysis using Johansen's method: VAR(1)

Hypothesis	$r = 0$	$r \leq 1$
$\mu_{minimum}$	19.28[a]	3.112
Critical value at 5%	14.1	3.8
Hypothesis	r = 0	r = 1
$\mu_{maximum}$	22.39[a]	3.112
Critical value at 5%	15.4	3.8
	Autovectors β'	
	Log private inv.	Log public inv.
	1.0000	–1.9316
	–1.4506	1.0000
	Coefficients α	
Log private inv.	–0.1034	0.0461
Log public inv.	0.1797	0.0471

[a] Indicates refutation of null hypothesis at 1% significance level.

on the basis of the VAR(3) and VAR(1) models, respectively.[9]

In both models, the results for the lower and upper statistical values would seem to refute the null hypothesis of no cointegration while not refuting the hypothesis, at the upper level, of one cointegration vector. Consequently, the statistics suggest that there is just one cointegration vector in the two models estimated. The first line of matrix β' gives the coefficients estimated for the long-term equations that have private investment as an endogenous variable:

Log priv. inv. = 0.7108 Log output – 0.2501 Log exchange rate + 0.1829 Log credit [4.3]

Log priv. inv. = 1.9316 Log public inv. [4.4]

The results are similar to those obtained using the Engle-Granger method. The coefficient values of equation [4.3] are roughly equal to those obtained in equation [4.1]. The coefficient obtained in equation [4.4] is higher than the coefficient estimated in equation [4.2].

4. Exogeneity tests

The first exogeneity test was carried out on the parameters of the long-term equations obtained in section IV.3.b. On the basis of the works of Hendry and Mizon (1993) and Johansen (1994), the exogeneity hypothesis is formulated as a parametric restriction in matrix of adjustment α. Table 9 shows the results obtained in each of the models. The likelihood ratio (LR) statistical test was calculated for each of the variables included in the VAR models of the section indicated. The critical value, at a 5% significance level, is 3.84.

Going by the results, we can reject the hypothesis that the coefficients of adjustment α of the private

[9] Here we are using a procedure similar to that of section IV.2 to analyse the statistical significance of each variable and each lag in the VAR models.

TABLE 9

Weak exogeneity tests on long-term parameters

VAR(3) model				
Variable	Log private inv.	Log output	Log exchange rate	Log credit
LR statistic	4.3106[a]	0.7258	0.0028	5.0299[a]
VAR(1) model				
Variable	Log private inv.	Log public inv.		
LR statistic	4.7946[a]	8.8767[b]		

[a] Indicates refutation of null hypothesis at 5% significance level.
[b] Indicates refutation of null hypothesis at 1% significance level.

investment and credit variables in the VAR(3) model are null. The same is true of the private investment and public investment variables of the VAR(1) model. Consequently, the marginal processes generating these variables contain information that is relevant for the cointegration ratios. It therefore does not seem appropriate to include credit and public investment as exogenous variables in the long-term equations, as the estimates became inefficient.

a) *Weak exogeneity tests for the long-term model parameters*

The first step, before carrying out these tests, was to formulate the marginal models for the explanatory variables present in the short-term models. The attempt to specify the marginal processes began with estimation of an ADL(3) model. Working "from the general to the particular", the model was purged of insignificant terms. Table 10 shows the results of the marginal models obtained empirically.

For a variable to be deemed a weak exogenous one in the short-term model, it must meet the following conditions: i) its marginal model must not contain the ECM error correction term; ii) the residuals of its original model must not be correlated with the residuals of the short-term model.

Table 11 gives the results obtained for the estimates of the marginal models with the inclusion of the ECM term. The results of Wald's test are also given, so that we can analyse the significance of the residuals of each of the marginal models in the respective short-term models.

According to the results of the t-statistics for each ECM term, and of the F statistics of Wald's test, all the variables meet both weak exogeneity conditions. Consequently, we can conclude that inferences relating to the parameters of the two short-term private investment models can be drawn without any relevant information being lost.

b) *Results of the superexogeneity tests*

The most usual way of checking the structural invariance of the parameters of a conditional model is to verify the significance of the squares of the residuals estimated in the marginal models within the model itself. This type of test was proposed by Engle and Hendry (1993). For superexogeneity to be accepted, the squares of the residuals do not have to enhance estimation of the conditional model, but must be statistically significant. Table 12 gives the results of the LM tests that verify the significance of these residuals as variables left out of the two conditional models.

In all the marginal models, it has been found that their estimated residuals are not correlated with the respective conditional models. On the basis of these results, we can say that the parameters of the short-term models are invariant, as they are unaffected by structural changes in the marginal models. Consequently, all the conditioning variables can be admitted as superexogenous, as changes in their structure do not affect the parameters estimated, so that Lucas' critique is obviated.[10]

[10] We also carried out analysis of the recursion diagrams of the marginal and conditional models, which also showed that the structural breaks in the short-term models did not coincide with the breaks in the marginal models. These diagrams have been omitted for reasons of space.

TABLE 10

Marginal models estimated for explanatory variables

ΔLog output = 0.0279 + 0.4746 ΔLog output (–1)
t-statistic (2.784) (3.227)

R^2 = 0.2196 F(1,37) = 10.413 *D.W.* = 2.07

ΔLog exchange rate = –0.0842 –0.3780 ΔLog exchange rate (–3) + 0.6059 i94
t-statistic (–3.196) (–3.272) (4.212)

R^2 = 0.6530 F(2,34) = 11.667 *D.W.* = 2.16

ΔLog credit = –0.2345 –0.4836 ΔLog credit (–1) –0.4887 ΔLog credit (–2) –0.3873 ΔLog credit (–3) + 4.0646 ΔLog output (–3)
t-statistic (–2.055) (–2.862) (–3.004) (–2.164) (2.639)

R^2 = 0.3564 F(4,32) = 3.433 *D.W.* = 1.83

ΔLog inflation = –0.4476 ΔLog inflation (–3) –8.3259 ΔLog output (–2) + 9.0803 ΔLog output (–3)
t-statistic (–1.981) (–2.484) (2.648)

R^2 = 0.2115 *D.W.* = 1.86

ΔLog public inv. = 0.1042 ΔLog credit (–2) + 0.3565 i86
t-statistic (2.669) (3.054)

R^2 = 0.3054 *D.W.* = 2.11

TABLE 11

Results of the weak exogeneity tests: short-term parameters

ΔLog output = 0.0214 +0.3892 ΔLog output (–1) + 0.0943 ECM1
t-statistic (2.019) (2.537) (1.611)
Wald test for significance of residual: F(1,29) = 0.1189 (t prob. = 0.7328)

ΔLog exchange rate = –0.1043 –0.3661 ΔLog exchange rate (–3) + 0.6216 i94 + 0.1809 ECM1
t-statistic (–2.941) (–3.132) (4.268) (0.852)
Wald test for significance of residual: F(1,28) = 0.6297 (t prob. = 0.4341)

ΔLog credit = –0.2457 –0.4794 ΔLog credit (–1) –0.5076 ΔLog credit (–2) –0.3724 ΔLog credit (–3) +....+ 0.4091 ECM1
t-statistic (–2.107) (–2.807) (–3.038) (–2.043) (0.622)
Wald test for significance of residual: F(1,27) = 1.6518 (t prob. = 0.2096)

ΔLog inflation = –0.4535 ΔLog inflation (–3) –8.0688 ΔLog output (–2) + 9.6650 ΔLog output (–3) –0.4429 ECM1
t-statistic (–1.974) (–2.309) (2.449) (–0.313)
Wald test for significance of residual: F(1,28) = 0.4896 (t prob. = 0.4899)

ΔLog public inv. = 0.0875 ΔLog credit (–2) + 0.3440 i86 –0.0564 ECM2
t-statistic (2.213) (3.007) (–1.630)
Wald test for significance of residual: F(1,34) = 0.0468 (t prob. = 0.8300)

TABLE 12

Results of the LM tests to verify superexogeneity

Marginal model: ΔLog output		
LM test for significance of squared residual:	F(2,28) = 1.1731	(t prob. = 0.3241)
Marginal model: ΔLog exchange rate		
LM test for significance of squared residual:	F(2,26) = 0.0283	(t prob. = 0.9721)
Marginal model: ΔLog credit		
LM test for significance of squared residual:	F(2,26) = 0.8867	(t prob. = 0.4241)
Marginal model: ΔLog inflation		
LM test for significance of squared residual:	F(2,26) = 0.3661	(t prob. = 0.6970)
Marginal model: ΔLog public inv.		
LM test for significance of squared residual:	F(2,32) = 0.5460	(t prob. = 0.5846)

V
Conclusions

The objective of this paper is to reveal the main variables determining private investment in Brazil during the period 1956-1996. We started out from a set of explanatory variables based on the most recent empirical research for developing countries. By employing stationarity, cointegration and exogeneity tests, we sought to obtain a consistent, well specified model that was capable of furnishing information of relevance to the implementation of policies aimed at encouraging private investment.

Although the equations estimated for the long term showed deficiencies because some variables were regarded as exogenous, the two regression models for the short term presented weak exogenous regressors and structurally stable parameters. Consequently, it can be said that structural changes in the output, exchange-rate, credit, inflation variation and public investment models are not responsible for structural changes in the private investment models, and that Lucas' critique does not apply to these models.

Since the results obtained admit of each model's explanatory variables being used as policy instruments, at least three ways of bringing about a rise in private investment emerge: i) increasing economic activity, ii) increasing long-term credit and financing, and iii) increasing investment in public goods. It can also be said that, for the 1990s, analysis of indicators relating to the output, credit and public investment variables would be enough to explain the drop in private investment levels in Brazil.

Apart from the positive influence of output and the negative one of uncertainty, the following has been demonstrated in the case of Brazil: i) the importance of long-term credits from development banks, ii) the predominance of the crowding in effect that public investment has on private investment, and iii) the negative effects of currency devaluations on investment. Thus, measures involving large devaluations of the exchange rate or cuts in public investment are detrimental to capital formation in the country.

Consequently, we can conclude that the neoliberal policy recommendations of the Washington Consensus regarding reduction of the role of the State in the allocation and creation of resources (the doctrine that has prevailed among policy makers since the second half of the 1980s) are questionable. The revival of economic growth requires State participation, as this tends to stimulate the expansion of private investment, even in this era of globalization. Furthermore, the country needs to strengthen the fundamental balances of economic policy, something that involves: i) an appropriate real interest rate, ii) an inflation rate close to those of its trading partners, iii) a competitive and predictable exchange rate, and iv) long-term strategies for public investment projects. These goals need to be consistent with both internal and external equilibrium, so that a policy of self-sustaining growth, based essentially on productive investment, can become viable.

The models we have presented can be used to draw economic policy conclusions. It must be stressed, however, that they leave out certain crucial issues, such as non-linearity. It may be argued that the real process of capital accumulation and disaccumulation, and the effects of investment on income, involve considerations relating to the existence or otherwise of idle capacity and the occurrence of periodic crises. Consequently, interpreting econometric conclusions in terms of the historical accumulation and growth process is something that needs to be done with sensitivity and caution.

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Policies for *small and medium-sized* enterprises in Chile

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In 1991, the Government of Chile began to pursue a new business development strategy. The Small and Medium-sized Enterprise Support Programme (Programa de Apoyo a la Pequeña y Mediana Empresa) provides for a number of instruments to correct market failures and improve the efficiency, productivity, competitiveness and international trading position of Chilean products made by these firms. The importance of small and medium-sized enterprises (SMEs) in the national economy is illustrated by their number and by the share of jobs they create. The particularly adverse experience of the economic crises of the 1970s and 1980s, and the difficulty these companies had in adapting to the new ground rules of the open economy model, were what led the Government to decide on this new development strategy. The objective of this article is to identify and analyse the policies applied and the effects of the different actions undertaken and instruments used. Although the strategic development framework has included new instruments that have made important contributions to the SME sector, the overall impact of these is less encouraging. The challenge now facing companies of this type in Chile is to find ways of applying successful experiments on a mass scale and reformulating strategies that have not worked as well as hoped.

I

Introduction

In Chile, as in almost all the countries of Latin America, small and medium-sized enterprises (SMEs) are important for both economic and social reasons. Their contribution to job creation and output is substantial, and increased over the course of the 1990s.

The particularly adverse experience of the economic crises of the 1970s and 1980s, and the difficulty that most SMEs had in adapting to the new ground rules of the open economy model and the reduced and altered role of the State, led the Government to develop a support strategy designed both to correct the market failures that limited these companies' access to factor markets and to increase their efficiency, productivity and international trade participation. The Chilean experience includes some major achievements, at least where the introduction of innovative policy instruments and approaches is concerned. The results have probably been less encouraging as regards the mass application, and thus the overall impact, of these instruments and actions.

This article will analyse the place of SMEs in the country's economy, the characteristics of the different lines of business development action, the policies applied and the role these have played in solving the problems of such companies. Lastly, the impact of the policies is considered, and the article's conclusions are presented.

II

The place of SMEs in the economy

Different definitions of SMEs are used in Chile. The Ministry of Economic Affairs, Development and Reconstruction (Ministry of Economic Affairs), the National Institute of Statistics (INE) and other bodies use different criteria to define them, which makes their information difficult to compare.

Until 1993, the Ministry of Economic Affairs defined small companies as production units with net annual sales of between 2,400 and 25,000 development units (unidades de fomento, or UF), i.e., between US$ 72,000 and US$ 750,000, while medium-sized enterprises were deemed to be those with sales of between 25,001 UF and 50,000 UF (between US$ 750,000 and US$ 1.5 million).[1] Companies with higher sales were classified as large, while those with sales of less than 2,400 UF were classified as microenterprises. In 1994, the sales threshold above which a company qualified as medium-sized was raised to 100,000 UF (about US$ 3 million). This is the criterion currently used by the Ministry of Economic Affairs.

Table 1 shows the number of companies of different sizes, in accordance with the Ministry of Economic Affairs classification and information supplied by the Production Development Corporation (Corfo), which uses data from the Internal Revenue Service (SII). The change in the definition of medium-sized and large enterprises in 1994 meant a break in the series for these two categories, so that two four-year periods, 1990-1993 and 1994-1997, have to be considered separately.

In both periods, it can be seen that the proportion of all companies that were SMEs had increased by the end of the series. The 1994 change in the definition of medium-sized and large companies also affects the data on sales, so two four-year periods need to be taken in this case as well. The data in table 2 show that, in both the first and the second periods, large companies were the only ones whose sales grew by more than the average.

By contrast, the sales of the other categories (microenterprises and SMEs) grew by less than the average and thus lost market share (table 3). After accounting for 20.2% of total sales in 1990, by 1993 SMEs had seen their share decline to 19.4%. Similarly, after the medium-sized enterprise category was expanded, the sales share of SMEs fell from 25.9% in 1994 to 23.7% in 1997.

☐ This paper was last revised by the authors in July 2000.

[1] The UF is an inflation-indexed unit of real value. On 12 September 2000, one UF was worth 15,507.4 pesos (about US$ 27).

TABLE 1

Chile: Number of companies[a]

	Series 1				Series 2			
	1990	1991	1992	1993	1994	1995	1996	1997
Microenterprises	364 110	372 311	387 016	400 529	404 599	408 371	423 319	432 431
Small	52 473	59 249	65 611	69 489	71 984	75 570	77 798	78 805
Medium-sized	4 598	5 327	5 797	6 147	9 649	10 260	10 721	10 870
SMEs	57 071	64 576	71 408	75 636	81 633	85 830	88 519	89 675
Large	5 160	6 087	6 838	7 314	4 054	4 388	4 670	4 814
Total	*426 341*	*442 974*	*465 262*	*483 479*	*491 286*	*498 589*	*516 508*	*526 920*

Source: Production Development Corporation (2000), on the basis of SII information.

[a] The series 1 data are not comparable with those of series 2.

The employment information is also affected by statistical problems. Firstly, the data do not come from the same source as the one used for the other variables (company sales and number of companies). The employment data were collected through the National Socio-economic Survey (Casen) conducted by the Ministry of Planning and Cooperation (Mideplan) through the Economics Department of the University of Chile. As was mentioned earlier, the classification in this case is based on the number of people in work, and is therefore not compatible with the one used by Corfo, which is based on sales.

Until 1994, furthermore, production units employing between one and five people were defined as microenterprises, those employing between six and 49 people as small enterprises, those employing between 50 and 199 people as medium-sized enterprises, and those employing more than this as large enterprises. In that year, however, the upper limit for microenterprises was reduced to four, so that the threshold for small enterprises was lowered to five. As a result, the information for years prior to 1994 is not comparable with that for the following years, at least for microenterprises and small enterprises.

Taking these limitations into account, table 4 shows that SMEs account for some 50% of all employment in

TABLE 2

Chile: Total increase in company sales, 1990-1993 and 1994-1997

(Percentages)

	1990-1993	1994-1997
Microenterprises	22.8	10.4
Small	32.5	10.3
Medium-sized	32.9	13.2
SMEs	32.6	11.6
Large	41.0	26.8
Total	*38.3*	*22.0*

Source: Prepared by the authors on the basis of information from the Production Development Corporation (2000).

TABLE 3

Chile: Company sales[a]

(Percentages)

	Series 1				Series 2			
	1990	1991	1992	1993	1994	1995	1996	1997
Microenterprises	5.5	4.8	4.9	4.8	4.9	4.6	4.6	4.4
Small	14.1	13.3	13.9	13.5	13.8	13.2	13.0	12.5
Medium-sized	6.1	5.8	5.9	5.8	12.1	11.7	11.6	11.3
SMEs	20.2	19.1	19.8	19.4	25.9	25.0	24.6	23.7
Large	74.4	76.0	75.3	75.8	69.2	70.4	70.9	71.9
Total	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*

Source: Prepared by the authors on the basis of data from the Production Development Corporation (2000).

[a] The series 1 data are not comparable with those of series 2.

TABLE 4
Chile: Employment in companies
(Percentages)

	1990	1992	1994	1996
Microenterprises[a]	43.9	41.8	39.7	40.4
Small[a]	29.0	31.6	33.6	36.6
Medium-sized	12.7	13.2	12.8	13.0
SMEs	41.7	44.9	46.4	49.6
Large	14.4	13.3	13.9	10.1
Total	*100.0*	*100.0*	*100.0*	*100.0*

Source: National Socio-economic Survey (Casen).

[a] The definitions of microenterprise and small enterprise used for the 1994 and 1996 data are different from those used for the 1990 and 1992 data.

the country, while their share of total sales is about 24%. Comparison of these two figures gives an initial insight into the productivity differences between SMEs and large enterprises.

As regards sectoral distribution, SMEs have a very large presence in commercial activities (36.2% of the SME total) and a much smaller one (12.9%) in industry (table 5). The commerce sector, indeed, accounts for the highest percentage of production units in the cases of microenterprises and large enterprises as well: 40.5% of all the country's enterprises operate in that sector, as against a figure of only 7.5% for the industrial sector.

Analysis of these data shows that SMEs are very important for jobs, employing about half of all those in work. Their share of total sales, however, is much lower (about 24%). The performance gap between these companies and large enterprises in the 1990s was not only large, but widened over the decade. In other words, despite the positive employment and sales results achieved by SMEs, the relative weight of large enterprises increased over the 1990s in terms not just of absolute sales, but also of sales per worker and per company, and even of the number of companies.

TABLE 5
Chile: Sectoral distribution of companies, 1997
(Numbers and percentages)

	Company size							
Sector	Microenterprises		SMEs		Large		Total	
Agricultural production	54 174	12.5	8 672	9.7	121	2.5	62 967	12.0
Agricultural and hunting services	1 444	0.3	479	0.5	18	0.4	1 941	0.4
Silviculture	2 380	0.6	965	1.1	41	0.9	3 386	0.6
Fishing	1 223	0.3	427	0.5	74	1.5	1 724	0.3
Mining, petroleum and quarrying	966	0.2	476	0.5	97	2.0	1 539	0.3
Foods, beverages and tobacco	4 455	1.0	2 679	3.0	313	6.5	7 447	1.4
Textiles and leather	6 033	1.4	2 290	2.6	158	3.3	8 481	1.6
Wood and paper	7 675	1.8	2 363	2.6	174	3.6	10 212	1.9
Chemicals, petroleum, rubber and metals	5 668	1.3	2 903	3.2	442	9.2	9 013	1.7
Machinery and instruments	2 136	0.5	1 185	1.3	118	2.5	3 439	0.7
Other manufactures	638	0.1	157	0.2	6	0.1	801	0.2
Industry total	26 605	6.2	11 577	12.9	1 211	25.2	39 393	7.5
Electricity, gas, water	530	0.1	116	0.1	72	1.5	718	0.1
Construction	15 407	3.6	6 618	7.4	587	12.2	22 612	4.3
Commerce	179 320	41.5	32 462	36.2	1 765	36.7	213 547	40.5
Restaurants and the like	22 355	5.2	3 480	3.9	62	1.3	25 897	4.9
Transport	33 727	7.8	7 956	8.9	234	4.9	41 917	8.0
Financial services	7 329	1.7	2 956	3.3	166	3.4	10 451	2.0
Technical and professional services	21 954	5.1	6 654	7.4	230	4.8	28 838	5.5
State, social and institutional services	4 830	1.1	978	1.1	49	1.0	5 857	1.1
Recreation and leisure services	3 640	0.8	651	0.7	26	0.5	4 317	0.8
Personal and household services	33 407	7.7	3 626	4.0	41	0.9	37 074	7.0
Other activities	18 347	4.2	1 435	1.6	15	0.3	19 797	3.8
No information available	4 793	1.1	147	0.2	5	0.1	4 945	0.9
Total	*432 431*	*100.0*	*89 675*	*100.0*	*4 814*	*100.0*	*526 920*	*100.0*

Source: Production Development Corporation (1998).

III

Policies to support SMEs

The Small and Medium-sized Enterprise Support Programme (hereinafter the Programme) came into operation in 1991. This represented a major shift away from the strategy followed by the military Government, which saw no need to make distinctions in the way it treated economic units of different sizes (Labarca, 1997) and affirmed that “the beneficial effects of trade opening could be enjoyed on a symmetrical and equal footing by different economic agents” (Cabrera, 1994).

The diagnosis on which the 1991 programme was based, on the other hand, identified restrictions on access by SMEs to the factor and service markets, owing chiefly to information asymmetries, externalities, lack of appropriability, and indivisibilities and economies of scale.

Setting out from this diagnosis, the Programme took the approach from the outset that there were market failures which required correction. While Corfo took on the functions of an executive secretariat for SME development policy, the Ministry of Economic Affairs took responsibility for the strategic design of this policy.

The institutional structure designed to implement the Programme included different public- and private-sector bodies acting at different levels. This design has gradually been modified as the policies have been implemented. Initially, Corfo used a system of direct administration of the two main development instruments, with partial delegation to a subsidiary agency, the Service of Technical Cooperation (Sercotec). As the coverage of these instruments grew, however (because more and more beneficiary companies were being brought in), it had to alter the administration system owing to the impossibility of increasing the number of public officials significantly to meet the new demand.

For this reason, in mid-1994 a new operating scheme was introduced in which three levels or “tiers” were defined (Maggi, 1999). At the first level are the private-sector companies and consultants providing technical assistance services for SMEs. At the second level are intermediate operating agents, namely Sercotec and a number of Corfo-accredited private-sector organizations. The basic tasks of these agents are to promote the use of development instruments by companies; act as intermediaries between these and Corfo during the formulation stage, the application procedure and subsequent follow-up of the use and outcome of these instruments; administer the public and private resources involved in the programmes accountably, and oversee the contractual relationship between companies and providers.

“Right from the outset, the system established a strict separation between first and second tier functions, the intention being that intermediate operating agents should remain absolutely neutral among providers and should focus on reducing information asymmetries between the supply and demand for consultancy, so as to be in a position to arbitrate if any disagreements should arise between the providers and the companies using these services” (Maggi, 1999).

At the third and highest level is Corfo, which is the institution responsible for designing operations and regulating instruments, designing framework agreements with agents, allocating and transferring programme subsidies to these when they are approved, and evaluating programme performance.

The instruments used in SME development policies fall into six categories: financing, technical assistance, technology transfer and innovation, training, export promotion and partnership.

1. Financing

Access to financing is one of the most complex problems that SMEs have to face. The diagnosis carried out by the Government in the early 1990s revealed stark segmentation and discrimination by company size in product and factor markets, resulting among other things in inequality of access to these markets. For this reason, the Programme introduced an array of instruments to narrow the disadvantages faced by SMEs in the credit market.

Where credit and financing programmes were concerned, Corfo had previously acted as a direct lender, i.e., as a first tier institution. A quantitative evaluation of this experience concluded that it had resulted in large losses for the State. In 1990, Corfo closed down the direct lending mechanism and auctioned off its portfolio, which at that time had a nominal value of US$ 714 million. The difference between the value realized by the sale of the portfolio

and its nominal value meant a loss of US$ 514 million for the State (Foxley, 1998).

In 1990, Corfo began to operate as a second tier institution, direct lending to final users being replaced by financing for banks and other specialist intermediaries that channelled resources to the final customers. This considerably reduced the risk of losses to the State. The new second tier scheme now includes a range of programmes that can be classified as lending, quasi-capital and subsidy programmes. The main characteristics of these groups of programmes are described below.

a) *Lending programmes*

– *Investment financing for small and medium-sized enterprises*. This programme is for the financing of investment projects by companies with turnover of up to US$ 30 million. It covers investments in machinery, installations, construction, civil works and engineering and assembly services, plus the working capital required for these investments, up to 30% of the total amount with a maximum of US$ 5 million. Repayment periods are from two to 10 years.
– *Investment financing for small manufacturers*. This funding is supplied by the Government of Germany through Kreditanstalt für Wiederaufbau, and is used to finance investments and working capital for manufacturing companies with turnover of up to US$ 3 million in the form of loans of up to US$ 450,000. Repayment terms range from three to 10 years.
– *Financing for production inputs and marketing abroad*. This programme is for the purchase of inputs to produce exportable goods and services. It can be taken up by companies with turnover of up to US$ 30 million, the maximum loan is US$ 3 million, and the term is two to eight years.

b) *Quasi-capital programmes*

– *Purchase of subordinated bonds from banks to finance SMEs*. Corfo buys subordinated bonds from issuing banks, making the purchase conditional on these same banks lending to small companies with annual turnover of up to 25,000 UF (about US$ 750,000) and developing business platforms that specialize in dealing with small companies.[2]
– *Financing of Business Development Investment Funds (FIDES) for venture capital*. This consists of loans that Corfo grants to FIDES on condition that the funds be used to provide capital to SMEs that generate high value added or can be identified as having a high technology content.

c) *Subsidy programmes*

– *Credit Insurance Discount Coupons (Cubos)*. The aim of this programme is to remedy the inability of SMEs to offer any or sufficient collateral for lending by financial institutions. These institutions take out credit insurance with an insurance company to cover the risk of default by the borrower. The State uses Cubos to co-finance 72% of the premium for this insurance. The companies that can take up this subsidy are those with turnover of less than 25,000 UF (about US$ 750,000), which means that it is aimed at small enterprises. There are special rules for granting Cubos to companies seeking to implement projects in areas that have suffered severe economic crises and are undergoing economic restructuring.[3] In these cases the subsidy is 80% and is also available to medium-sized enterprises.

Other financial instruments, now discontinued, were also used in the 1990s to support SMEs. They included in particular the Financial Assistance Subsidy (Suaf), created in November 1991 to “do away with the discrimination suffered by small and medium-sized enterprises that apply for credit without having organized accounting information or without being able to submit their investment plan in the requisite form” (Cabrera, 1994).

Suaf could be applied for by companies with annual turnover of less than 25,000 UF (about US$ 750,000), and was to be used to engage consultants who would prepare and submit the information that financial institutions required before they would grant a loan to the Suaf beneficiary company. As the instrument aroused little interest, medium-sized enterprises were subsequently allowed to apply as well. In 1996, Suaf was abolished because of administrative shortcomings resulting from inadequate oversight of consultants. In any case, what made the instrument unsuccessful was the difficulty of “inducing financial institutions to rely

[2] “Subordinate bonds are publicly issued securities whose main characteristic is that they can be redeemed against the capital of the issuing bank in a proportion that decreases as the expiry date of the instrument approaches” (Foxley, 1998).

[3] This is the case with the coal mining zone (province of Arauco and communes of Lota and Coronel), the provinces of Arica and Parinacota, and regions XI and XII.

on evaluations of borrowers carried out by third parties, in this case consultants working for a State subsidy" (Foxley, 1998).

Another instrument that was abolished was a variant of the Cubos which operated from 1995 to 1997, and which subsidized 50% of small exporters' credit insurance premiums. It was discontinued because of possible incompatibility with World Trade Organization (WTO) rules.

TABLE 6

Chile: Number of operations financed by Technical Assistance Funds (FATS)

1994	1995	1996	1997	1998	1999
349	1 428	1 487	4 406	4 652	6 632

Source: Production Development Corporation (1998).

2. Technical assistance

In order to improve the management of SMEs and help them introduce new technologies, Technical Assistance Funds (FATS) were launched in 1993. These funds can be spent by SMEs on engaging a consultant to improve overall management or solve specific problems with issues such as market analysis, product design, production process redesign, pollution control and information systems.

The aim of FATS is to facilitate access by SMEs to advisory services of this kind, while at the same time encouraging the formation of a consultancy market specializing in these firms. The great majority of SMEs use this instrument on an individual basis, although it is permissible for a number of firms to join forces to purchase the same service. To use FATS, companies must have net annual sales of more than 2,400 UF but no more than 100,000 UF.[4]

Since 1999, financing for the diagnostic stage has been included in the programme. To start with, Corfo provides 12 UF and the business has to contribute 3 UF. At the actual technical assistance stage, Corfo co-finances up to 50% of the total cost of the consultancy work[5] up to a maximum of 450 UF (about US$ 13,000) per company, with an annual limit of 150 UF (about US$ 4,400).

In the case of a Group FAT (at least three companies), Corfo provides 30 UF for the diagnostic stage and the businesses contribute 10 UF. For the actual technical assistance, Corfo co-finances up to 50% of the total cost of the consultancy work, with a maximum of 100 UF per company per year.

Corfo delegates the administration of these funds to intermediaries ("second tier" organizations) whose specialization and closeness to the final users is supposed to make their operations more efficient. These organizations are responsible for assessing the relevance of consultancy services, approving consultancy contracts, monitoring execution and disbursing the subsidies once execution has been verified.

The central purpose of FATS is to remedy the information asymmetries that discourage the use of external consultancy services by SMEs, while deepening this market by showing applicant firms how useful external consultancies are for solving operational problems and drawing up business and modernization strategies. Although demand has grown, however (table 6), surveys carried out using samples of companies have not yielded conclusive results, mainly owing to the difficulty of isolating the effects of consultancy on the subsequent performance of the firm (University of Chile, 1997b). Nonetheless, one of these assessments affirms that "the FAT scheme has produced good results in two main areas: the creation of a supply of consultancies specializing in SMEs, which was not organized before, and a growing appreciation among SMEs of the technical assistance services supplied by private-sector consultancies" (Castillo, 2000).

One aspect of this instrument that is the subject of continuing debate is the fact that the main incentive is for those supplying the consultancy services, who often encourage their customers to make more use of the instrument than is really necessary. Companies taking up the service are often not fully aware of its value, perceiving as the full cost that minority share of it which is borne by them, and do not demand a minimum of relevance and thoroughness from the results. To prevent poor-quality consultancy services being chosen or subsidies being misused (simulated payment of the company's share), Corfo and the operating agents have taken steps to establish selection criteria in the register of consultants and to punish severely any illicit practices they detect (Maggi, 1999).

[4] Companies with net annual sales of less than 2,400 UF or more than 100,000 UF may apply provided that on the date of the application they are participating in some other Corfo development programme or in ProChile-financed Export Committees.

[5] The co-financing percentage rises to 60% in the case of companies with annual sales of less than 25,000 UF and to 70% for technical assistance in subject areas to which Corfo gives priority, such as irrigation, quality and the environment.

3. Technological development

The main instrument used to stimulate the technological development of businesses is the National Fund for Technological Development and Productive Research (Fontec). This fund, which was created in 1991, can be used by companies of all kinds (and is thus not an exclusively SME-oriented instrument), and is intended to promote, guide, finance and subsidize the implementation of technological research and development and technological infrastructure acquisition projects and, in general, projects to further any stage in the development of technology products.

This fund operates through five financing lines:

- *Technological innovation*. This covers research and development projects for product, process and services technologies, including models, prototypes and market testing. The funding provided by Fontec is a subsidy which may not exceed 50% of the total cost of the project.
- *Technological infrastructure*. This line includes investments in physical infrastructure, installations and science and technology equipment, and in technical training for staff connected with the infrastructure project who play a supporting role in the company's production processes and technological development. The maximum subsidy granted by Fontec is 20% or 30% of the total cost of the project, depending on whether the submission is an individual or group one.
- *Group transfer*. In this case, subsidy is provided for projects involving five or more companies in the same sector or in allied sectors. It generally covers the planning and implementation of technology missions abroad, for which Fontec provides a maximum subsidy of 45% of the total cost, subject to a US$ 100,000 limit.
- *Transfer organizations and centres*. This line is also for group undertakings, specifically when the purpose is to set up organizations (technology transfer centres) for the study, development, dissemination, transfer and adaptation of technologies with a view to modernizing the companies involved. The maximum subsidy is 50% of the cost of the project, with a limit of US$ 400,000.
- *Pre-investment studies*. This line is aimed at stimulating innovative investments by funding pre-investment studies. The maximum subsidy is 50% of the value of the study, with a limit of US$ 15,000.

Between September 1991 and July 1998, Fontec approved and financed 997 projects (tables 7 and 8). Although Fontec is not specifically aimed at SMEs, they are likely to have been the beneficiaries of a large percentage of the funding granted. In fact, data for the period from September 1991 to June 1994 show that 75.8% of the 236 projects approved, and 72% of the funds, were for small, medium-sized and newly formed enterprises (Cabrera, 1994).

4. Training

In 1976, the military Government privatized managerial and administrative responsibility for national training services by transferring control of almost 70 industrial schools and the National Professional Training Institute (Inacap) to the country's main business association (the Confederation of Production and Commerce) and by devolving to companies the responsibility for initiating and running training programmes financed by the State through the National Training and Employment Service (Salazar, 1997).

The main instrument in this field is a tax exemption that allows businesses to discount up to 1% of taxable annual remuneration, or a value equivalent to 13 monthly tax units (unidades tributarias mensuales, or UTM) (about US$ 660 dollars), when they file their tax returns.[6] It is therefore a demand subsidy for corporate training, in which different agents are involved. In the first place, the National Training and Employment Service (Sence), a decentralized State technical body that relates to the Government through the Ministry of Labour and Social Security, administers the tax incentive offered by the State to companies to train their staff (National Training and Employment Service, 1998). Secondly, there are the private training organizations (technical provider organizations, universities, professional institutes and technical training centres) which carry out the training programmes. Lastly, there are the companies themselves, which determine the demand for training.

The results of this instrument have not been very encouraging for SMEs. In fact, "between 1990 and 1994, only 18.84% of these companies used the tax exemption, taking up just 7.56% of the sums available"

[6] In accordance with article 8 of the Tax Code (Decree Law No. 830/74), the UTM is a legally determined, constantly recalculated sum of money that serves as a measure or reference point for tax purposes. In August 1999, its value was 26,153 pesos (about US$ 51).

TABLE 7

Chile: Projects financed by the National Fund for Technological Development and Productive Research (Fontec), by sector

Sector	Number of projects	Total cost *(thousands of dollars)*	Fontec contribution *(thousands of dollars)*	Company contribution *(thousands of dollars)*	Structure of Fontec contribution *(percentage)*
Agriculture	236	27 414	12 281	15 133	20.2
Forestry	28	3 537	1 628	1 909	2.7
Fishing and fish farming	74	13 338	6 018	7 320	9.9
Mining	36	7 522	3 141	4 381	5.2
Manufacturing	394	59 152	23 651	35 501	38.9
Energy, gas and water	5	1 188	763	424	1.3
Construction	28	3 173	1 318	1 855	2.2
Services	63	10 484	4 912	5 572	8.1
Information technology	104	14 495	5 395	9 099	8.9
Biotechnology	29	3 271	1 599	1 671	2.6
Total	*997*	*143 574*	*60 705*	*82 865*	*100.0*

Source: Production Development Corporation (1998).

TABLE 8

Chile: Projects financed by the National Fund for Technological Development and Productive Research (Fontec), by financing line
(Thousands of dollars)

Line	Number of projects	Fontec contribution *(thousands of dollars)*	Structure *(percentage)*
Technological innovation	812	50 882	83.8
Technological infrastructure	17	2 833	4.7
Group transfer	152	4 853	8.0
Transfer organizations and centres	6	2 014	3.3
Pre-investment studies	10	123	0.2
Total	*997*	*60 705*	*100.0*

Source: Production Development Corporation (1998).

(Salazar, 1997). The main problem is that the sum total of wages paid by a small business (and often by a medium-sized one) is quite small, which means that the exemption is not worth enough to justify paying for training services. For this reason, beginning in 1997, the limit up to which the exemption could be used was raised from three to 13 UTM, provided this was no more than 1% of all taxable annual remuneration. This change is unlikely to produce significantly different results, however.

For the same reason, since 1995 Sence has been operating a training programme for microenterprises and small businesses that contains two components, both designed to improve management. The first is aimed at owners, managers or those performing administrative functions in companies with annual turnover of less than 25,000 UF (about US$ 750,000). The second is aimed at small agricultural producers.

Another measure designed to improve smaller businesses' access to occupational training was the 1998 creation of the National Training Fund (Foncap), whose activities include the provision of subsidies that can be applied for by companies whose annual turnover does not exceed 13,000 UTM (about US$ 663,000). These subsidies are limited to a maximum of 26 UTM (about US$ 1,300) per company per year.

5. Export promotion

The way most of the export promotion instruments available in Chile have been designed does not take account, at least explicitly, of the different sizes of the

companies that may sell into external markets. Certain programmes have proved to be of some importance to SMEs, however.

The Simplified System of Refunds for Minor Exports, known as Simplified Refunds, allows companies exporting non-traditional products to claim back a small percentage of the fob value of their exports (between 3.5% and 10%). There is a general reimbursement mechanism in the country that enables companies to recover import tariffs paid on inputs used to produce goods that are then exported. This instrument involves a complicated application procedure, however, so that it is mainly used by large companies that have the staff and information needed to carry this out. Simplified Refunds was introduced to facilitate this procedure for SMEs and companies that export occasionally, and has been very effective in encouraging a variety of SMEs to begin exporting (Macario, 1998). The percentage of reimbursement varies, being linked to total exports of the product concerned: the higher total exports are, the smaller the percentage applied, until after a certain point the subsidy disappears.

Despite its success, however, Simplified Refunds is to be abolished soon, as it is possible for an exporting company to receive the reimbursement without having used imported inputs, in which case the instrument acts as a subsidy. This conflicts with the Uruguay Round agreements, which provide for all export subsidies to be abolished by 2002 (Macario, 1998).

A second instrument, aimed more explicitly at SMEs, is the Support Programme for the Management of Export Firms (Premex), whose objective is to enhance the export capabilities of companies producing manufactures and software. Premex co-finances the cost of engaging high-level consultants to carry out diagnostics and to design and introduce improvements in company management with a view to increasing the efficiency of production processes and production planning processes, raising product quality, optimizing the information systems that support production and furthering process automation.

At the diagnostic stage, Corfo finances up to 60% of the value of consultancy work through the same programme, the subsidy being limited to 80 UTM (about US$ 4,000). At the implementation stage, the contribution may be as much as 870 UTM (about US$ 44,000), covering up to 50% of the value of the process consultancy. Premex may be applied for by export companies with external sales of up to US$ 200,000 and total net sales of up to US$ 10 million the previous year. The emphasis on pre-competitive support, the absence of export targets and the small size of the subsidy suggest that it can be considered as a non-actionable subsidy, and thus one that is compatible with WTO rules (Macario, 1998).

As regards support for export activities, two institutions have proved to be particularly important: ProChile and Asexma. The Export Promotion Bureau of the Ministry of Foreign Affairs (ProChile) was set up in 1975 with the objectives of promoting and diversifying exports, particularly in non-traditional categories, and opening up new markets. This institution has an annual budget of US$ 22 million (of which US$ 10 million goes on agricultural promotion) and co-finances market research, the publication of catalogues and participation in trade fairs and missions. It also helps groups of companies open offices abroad. ProChile seems to have been more successful in introducing medium-sized enterprises to exporting than small ones.

The Association of Exporters of Manufactures (Asexma) is a trade organization that provides its members with information services relating to tariffs, export procedures and incentives open to them. It also helps with market analysis and participation in trade fairs and missions. The Small and Medium-sized Enterprise Development Project (Propyme), which it runs with technical assistance from Germany, aims to improve the export capabilities of some 40 SMEs.

6. Partnership

Since 1991, the Government has sought to use Development Programmes (Profos) to encourage partnerships among companies that operate similar or complementary lines of business and are located in the same geographical area. The basic thinking behind this instrument is that the main problem of SMEs is not so much size as isolation, and that resources should therefore be channelled to groups of companies rather than individual ones.

Formally, a Profo is a partnership with a legal personality in which small and medium-sized businesses participate for a maximum of three to four years. Up to 30% of member companies (of which there must be at least five in total) may have turnover higher or lower than the SME limits. It is run by a manager appointed by the members themselves, running costs being shared between the public and private sectors. Corfo may finance up to 70% of the total costs of the working programme in the first year.

The businesses, for their part, must finance at least 30% of the costs the first year, 40% the second and 50% the third. Corfo generally co-finances activities for no more than three years, but an extension for a fourth year may be obtained if positive results can be shown and if the group of companies decides to extend its partnership by forming consortia or undertaking joint investments.

The amount of the subsidy can be as much as US$ 100,000 or so a year per group, with a limit of US$ 12,000 per participating company. The activities and types of expenditure that these funds can finance are: the remuneration of the Profo manager and other support staff, technology transfer seminars, exhibitions, shows and consultancy work, travel, training and purchases of specialist books and reviews. Corfo is the body responsible for regulating the general framework in which these programmes are carried out and for approving and allocating funds. The intermediaries responsible for starting up Profos, and in some cases for administering them, include public-sector bodies such as Sercotec and private-sector trade associations such as the Textile Institute and Asexma. Corfo acts as a third tier agency, which means it has no direct executive functions. Its role includes deciding on the characteristics of the programme, approving the creation of a Profo when a group of businesses requests this from the operating body, making available to the group a percentage of the total resources required for the project and regulating the conditions under which they operate.

Management has become decentralized over time. Sercotec was the institution that promoted and administered the first Profos. In 1994, it was decided that implementation of the programme could be left to private-sector operatives duly authorized by Corfo. The objective of this decision was to make management more flexible and lower administration costs. One interesting innovation was the inclusion of trade associations as potential operating agents.

The first Profos began in 1992, since when the number has grown year by year. The importance they have taken on in government SME development policy is reflected by the increase in funding allocated to them and by the number of companies involved.

In 1996, Corfo asked the University of Chile to carry out an assessment of this development instrument. From an analysis of 257 companies grouped into 29 Profos, the assessment identified a number of positive factors associated with the use of this instrument (University of Chile, 1997a). More specifically, the results suggest that the main achievements have largely been in three fields:

- Company organization and management through the incorporation of planning elements, better specification of roles and functions, focusing of production to achieve economies of scale and introduction of modern marketing strategies.
- Accumulation of human capital through better access to management training for managers and to occupational training for production staff.
- Access to technology institutes, advisors, consultants and development funds such as Fontec and FATS.

The business people interviewed said that Profos had had a particularly positive effect as regards knowledge of markets and technologies and new business prospects (table 9).

The assessment of Profos shows that they can be useful for participating companies. Thanks to the assistance received, some of these have made quite substantial changes to certain production and business practices, as a result of which they have increased productivity and wages (University of Chile, 1997a).

The assessment also revealed that the type of intermediary involved was another factor that made a difference. It was found that, in general, private agents rooted in trade associations showed better financial results and were more likely to be able to achieve technical and business cooperation among participating companies.

As regards the make-up of the group, mention was made of the need for the companies involved to be reasonably diverse (the presence of one or two larger

TABLE 9
Chile: Benefits of Development Programmes (Profos) as perceived by companies
(Percentage of respondents)[a]

Benefit	%
Better knowledge of markets	48
New business opportunities	42
Knowledge of technologies	39
Improved competitive position	37
Increased profitability through higher sales volumes	27
Increased profitability through cost reductions	19
Improved financing capacity	18
Increased profitability through higher product prices	17

Source: University of Chile (1997a).

[a] Each respondent could identify more than one factor.

companies, particularly exporters, can be instructive for the rest) and to have little overlap among their individual markets.

The same assessment made it clear, however, that the programme did not go far enough to correct major market failures, such as the inability of SMEs to obtain access on the same terms as large companies to investment and innovation financing, and to qualified staff. All the firms surveyed said that these problems were among the main obstacles they faced (table 10).

Similarly, the assessment (University of Chile, 1997a) states that "the results of the programme are found to be less far-reaching when evidence is sought of significant improvements that make a real difference to the development and enhancement of production processes and/or products (except for changes in lay-out or computerization)". In other words, the impact of the programme on innovation processes seems to have been quite limited.

TABLE 10

Chile: Main obstacles identified by companies

(Percentage of respondents)[a]

Lack of financing	42
Shortage of skilled production staff	31
Customer concentration	31
Economic policy	27
Old machinery and equipment	25
Shortage of skilled administrative staff	22
Lack of installed capacity	21
Customer payment problems	21
Inventory problems	19
Lack of information about technologies	19
Staff resistance to change	18
Delays in responding to customers	15
Narrow product range	15
Unreliable suppliers	10
Inability to comply with technical regulations	9
Poor quality	7
Staff turnover	7
Obsolete products	1

Source: University of Chile (1997a).

[a] Each respondent could identify more than one factor.

IV

Reflections on policy

Unlike most Latin American countries, Chile has applied an explicit SME support and development policy for almost a decade. This policy was designed and has been implemented in the new framework of deregulation and State withdrawal from direct provision that has been in place in the country, albeit with different features at different stages, since the mid-1970s. The general characteristics of the instruments used have been based on a logic of corrective action to address market failures, horizontal intervention and demand subsidization.

The use of instruments with these characteristics was motivated by the desire to: i) ensure that the criteria on which measures were based were consistent all over the country, ii) limit the discretionary powers of public officials, both centrally and regionally, iii) achieve transparency in the use of public resources, iv) direct the resources available towards the spheres of action deemed most important, v) reduce the professional requirements of the institution managing the instruments, vi) determine the development level, degree of interest and response capacity of markets about which there was no direct and specific knowledge, and vii) obtain private co-financing for development measures (Dini and Katz, 1997).

Until 1994, i.e., during the SME support programme's early years, Corfo operated these instruments directly. In that year the action strategy was revised, and Corfo confined its SME development activities to the strategic level ("third tier") and encouraged the creation of a network of coordinating agents (in both the public and private sectors) "whose basic function is to design business development programmes for companies, using the instruments available to bring together customers (the companies) and providers of support services (consultants)" (Dini and Katz, 1997). One of the factors that led to this change was the impossibility of extending the coverage of the instruments in use without sharply increasing policy administration costs. Reorganization of the public-sector development agencies actually led to a reduction in the number of civil servants at Corfo (from 601 in 1994 to 464 in 1995) and Sercotec (from 315 in 1993 to 198 in 1995).

TABLE 11

Chile: Spending on SME development measures
(Millions of current dollars)

	Spent			Budgeted		
	1994	1995	1996	1997	1998	1999
Technical Assistance Funds (FATs)	0.33	1.43	4.58	6.97	8.42	0.00
Development Programmes (Profos)	1.00	3.54	8.48	4.96	6.69	15.26
Agricultural FATs and Profos	0.00	0.00	0.00	0.00	8.65	12.19
Credit Insurance Discount Coupons (Cubos)	0.41	0.30	0.27	0.46	0.96	0.83
Agricultural investment allowance	0.00	0.00	0.10	0.54	0.80	0.00
Financial Assistance Subsidy (Suaf)	1.95	0.39	0.06	0.00	0.00	0.00
Subtotal I (Corfo SME development measures)	3.70	5.67	13.49	12.93	25.52	28.29
Empresa Nacional de Minería (Enami) national mining company	7.97	6.48	12.61	11.31	12.35	10.84
Production Development Corporation-Service of Technical Cooperation (Corfo-Sercotec)	1.27	2.54	4.94	8.80	8.64	8.14
National Fund for Technological Development and Productive Research (Fontec)	8.01	11.92	11.80	12.78	12.03	11.76
Corfo-Premex[a]	0.00	0.00	0.00	0.11	1.08	1.02
Subtotal II	20.95	26.60	42.84	45.93	59.63	60.05
Training, except tax breaks	15.15	12.40	3.95	21.26	28.81	35.45
Total	*36.10*	*39.00*	*46.78*	*67.20*	*88.44*	*95.50*
Share of total production development spending (percentages)	8.1	7.5	7.9	10.3	13.4	15.8

Source: Prepared by the authors on the basis of Ministry of Economic Affairs data.

[a] Support Programme for the Management of Export Firms

In addition, a number of the administrative functions of Corfo and Sercotec were decentralized, and the powers of regional directors were increased. The changes made to the operating system, with the introduction of a network of "second tier" private-sector agents, have been very important in increasing the coverage of the instruments, owing to the constraints on the extension of direct public-sector "supply" referred to, and have probably helped to make SME support policy more acceptable to businesses.

As regards annual coverage, the number of companies assisted increased from about 2,000 in 1993 to over 4,000 in 1996 and over 8,000 in 1998. The resources allocated to SME support activities increased substantially between 1994 and 1999 (table 11). Both the two subtotals and the total resources allocated to SME development increased sharply. The total rose from US$ 36 million (actually spent) in 1994 to over US$ 95 million (budgeted) for 1999, a real increase of 140%. Furthermore, the funds earmarked for SME support policies also increased as a share of all resources allocated to production development policies in general, rising from 8.1% of the total in 1994 to 15.8% of the budgeted total for 1999.

In short, governments since 1990 have shown a real interest in the problems of SMEs, and this has been reflected in an increase in the resources allocated, both in real absolute terms and as a proportion of the total spent on production development policies. At the same time, thinking within Corfo itself has led to a change of approach that has enabled the private sector to play a greater role in managing and applying the instruments. This change of approach and the extra funding available have resulted in a very substantial increase in the number of companies assisted, which rose from just over 2,000 to more than 8,000 in five years.

This concern with SME support policies has led Corfo to bring in outside organizations to assess the impact of some of the instruments used, something that is almost unparalleled in Latin America. Despite all these positive developments, however, the problems affecting SMEs are very far from having been solved. Firstly, support policies reach somewhat less than 10% of the country's SMEs. It would be difficult to increase this coverage substantially without doubling or trebling the funding available, and this is a real problem given the budgetary constraints within which the public authorities have to work.

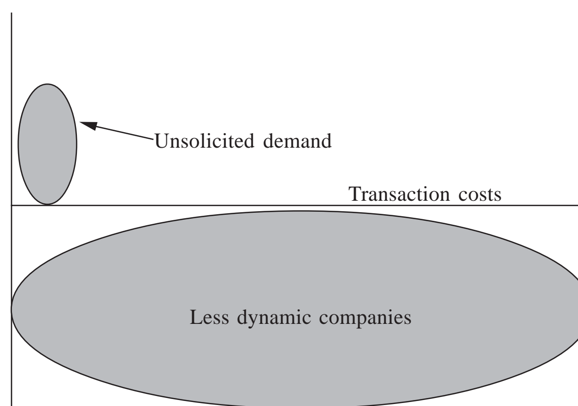
Secondly, it is not just a case of extending coverage by making greater use of existing development instruments. The interviews carried out with business people and trade association representatives by the

University of Chile for its assessments of Profos and FATS (1997a and 1997b), and the data presented in this section, show that many of the problems facing businesses stem from the serious difficulty they have in obtaining credit. The development instruments used are designed to solve management problems, but to promote investment or technological leaps they need to be supplemented by other instruments of a financial nature that can mobilize far greater resources than are currently available to SMEs.

A third problem is the very nature of the policies implemented and the instruments used. Although demand-led policies have made it possible to implement measures that are much better suited to the needs of companies and to increase the involvement of the private sector, they have not greatly enhanced the linkages between businesses and other institutional actors, particularly local ones, such as the municipalities and other organizations that have been crucial to the success of efforts to develop clusters and highly competitive networks elsewhere in the world. For this to happen, it would be desirable for the public authorities to make more active use of incentives to encourage linkage between groups of companies and local institutions.

Fourthly and lastly, the very logic of horizontality and demand subsidies that characterizes much of development policy itself poses a very serious problem. In a policy guided strictly by demand, "the State has to confine itself to responding to requests from the private sector and provide assistance exclusively to companies that know their limitations and are able to draw up proposals in the formats and within the time limits specified by the different development agencies" (Dini and Katz, 1997). Access to the production development system entails costs, however (the transaction costs shown in figure 1). There is a group of companies, quite few in number, that are in a position to defray these costs and formulate their proposals, but another group, which includes the great majority of SMEs, is not in a position to do this, and its demand for services needs to be induced. This being the case, extending the coverage of support policies and improving the efficiency of the instruments used must involve not just increasing the amount of resources available, but seeing that public agencies play a more active role in encouraging this second group of companies.

FIGURE 1
Company access to the production development system



Source: Dini and Katz (1997).

V
Conclusions

Small and medium-sized enterprises are an important component of the Chilean economy, particularly as regards jobs: they account for some 50% of all employment, a percentage that rose significantly in the 1990s. When their sales are considered, however, the situation is different. Although these increased in the 1990s, so that by 1997 they represented 23.7% of the total, percentage sales growth was much less than employment growth. What is worse, the figure has been declining over recent years. This has its counterpart in the large and widening gap between SMEs and large companies in sales per person employed.

Industrial SMEs (about 13% of all SMEs) are in a similar situation.[7] As regards SME development measures, since 1991 there has been an explicit support policy whose general approach is characterized by

[7] For information on industrial SMEs and an analysis of their participation in the manufacturing sector, industrial employment, productivity and exports, see Alarcón and Stumpo, 2000.

horizontality (there is no specific policy for industrial firms) and a focus on the correction of market failures. Among the wide range of instruments used, measures to encourage partnership among companies (Profos) have been quite successful, as assessments conducted by outside organizations have demonstrated.

The results have been less encouraging in the area of training, at least where the main instrument used (tax breaks) is concerned. The shortage of skilled labour in the areas of management and production continues to be identified as an intractable problem both by businesses themselves and by independent research into the subject (Salazar, 1997).

Difficulty in obtaining credit remains an unresolved problem for SMEs. The policies applied, particularly the production development instruments and the operations of Corfo in this area, are generally well regarded. Their impact on SMEs overall, however, seems to have been quite limited. This is partly due to the coverage of policy measures; although this has increased in the last eight years, it extends to barely 10% of SMEs and is severely constrained by the limitations on the human and financial resources that the public authorities can spare for this purpose. Other problems faced by SMEs range from the scarcity of credit and the inadequacy of the training system that supplies them with specialist personnel to the difficulty of building inter-company partnerships up into true networks and clusters that are internationally competitive.

If we look at average sales per worker employed (table 12), we find that in 1996 the figure for SMEs (about US$ 13,000) amounted to barely 7% of that for large companies (about US$ 183,000). There is likewise quite a large gap between small enterprises (about US$ 9,250) and medium-sized ones (about US$ 23,200).

TABLE 12

Chile: Sales per worker, by company size[a]

(Large company = 100)

	Series 1		Series 2	
	1990	1992	1994	1996
Microenterprises	2.4	2.1	2.4	1.6
Small	9.5	7.7	8.2	5.0
Medium-sized	9.3	7.9	19.0	12.7
SMEs	9.4	7.8	11.2	7.0
Large	100.0	100.0	100.0	100.0
Total	*19.4*	*17.7*	*20.0*	*14.2*

Source: Prepared by the authors on the basis of data from the Production Development Corporation and the National Socio-economic Survey (Casen).

[a] The series 1 data are not comparable with those of series 2.

Furthermore, the disparity between SME sales and those of large companies increased not only between 1990 and 1992 (when the policies analysed in this article were still at a very early stage) but also between 1994 and 1996, by which time the great majority of the instruments considered were being fully applied.

The wide productivity gap between SMEs and large companies, and the formers' lack of international competitiveness, are very much linked to the factors examined in this article. They pose SMEs with an array of complex challenges that will have to be addressed if these are ever to achieve the competitiveness they need to insulate themselves, at least to some degree, from the vicissitudes of their domestic market.

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Recent ECLAC publications

Periodicals

Foreign investment in Latin America and the Caribbean. 2000 report, LC/G.2125-P, ECLAC, United Nations publication, Sales No.: E.01.II.G.12, Santiago, Chile, June 2001, 240 pages.

As well as providing a wide-ranging, detailed overview of the foreign direct investment (FDI) situation in Latin America and the Caribbean, this report presents a thorough analysis of Chile's position as a destination country, of Japan's role as a major international investor, but one which has few interests in the region, and of the telecommunications industry, one of the sectors which best reflects the changes associated with globalization, and in which FDI is assuming increasing proportions.

In 2000, the Latin American and Caribbean region's FDI inflows fell for the first time in nearly two decades, declining by 20% from the previous year to just US$ 74.191 billion. Nevertheless, caution should be exercised in analysing this reversal in the trend, since the large inflows seen in 1999 were the result of a limited number of acquisitions of large Latin American companies by foreign corporations which are unlikely to be repeated. Close to 60% of total foreign capital inflows went to just two countries, Brazil and Mexico. In fact, Brazil was the top choice of foreign investors for the fifth year running and accounted for 40% of the region's total FDI inflows. In a continuation of the trend of earlier years, a very high percentage of FDI went on acquisitions of existing assets, primarily in service sectors such as telecommunications, energy and finance.

Statistical yearbook for Latin America and the Caribbean. 2000 edition, LC/G.2118-P, ECLAC, United Nations publication, Sales No.: E/S.01.II.G.1 (in Spanish and English), Santiago, Chile, March 2001, 772 pages.

This yearbook (which combines the Spanish and English versions) contains a selection, updated in early December 2000, of the main statistical series available on economic and social trends in the countries of the region.

The first part contains derived social and economic indicators (growth rates, proportions or coefficients) which give an overview of each area of interest and provide the background needed for the information to be used in specialist analyses. This group of indicators includes those utilized in the periodic regional appraisals of the Latin America and Caribbean development process conducted by the ECLAC secretariat.

The second part provides historical series in absolute terms, so that they can be used for a variety of purposes. Although there are currently 33 Latin American and Caribbean member countries of the Commission, the tables giving regional totals generally provide the sum of data on 25 countries. The statistics of the Caribbean countries are less complete, which is why regional coverage varies by subject area.

The Yearbook also includes preliminary estimates for the year of issue (in this case, 2000). These estimates are the result of an effort made during the last two months of each year to keep the international community informed about macroeconomic trends in the region's countries during the period covered.

This document is also available for consultation on the ECLAC web site (http://www.eclac.cl).

Latin America and the Caribbean in the world economy. 1999-2000 edition, LC/G.2085-P, ECLAC, United Nations publication, Sales No.: E.00.II.G.17, Santiago, Chile, July 2001, 333 pages.

This edition is divided into four sections. The first describes the main trends in the global economy between the beginning of 1999 and mid-2000, highlighting the uncertainties generated by integration among national economies, the structural components of recent growth in the industrialized countries and the challenges and opportunities that these pose for development in the region. It also examines the structural transformation of international trade, major dynamic trade flows, and the changes resulting from the dominant role systematically played by transnational corporations and from the close link between trade and foreign direct investment.

The second section deals with the region's trade policy and problems of access to major importing markets. It looks at trade patterns in the two-year period 1998-1999 and assesses the trade performance of the region's countries in the 1990s. It also considers some of the barriers that affect the region's exports to United States markets.

The third section analyses regional integration in Latin America and the Caribbean over recent years, then goes on to review the theory and practice of what is known as open regionalism in the light of the experiences of Asia and the Pacific and of Latin America.

The fourth section deals with the imbalances characterizing World Trade Organization (WTO) rights and obligations, problems of access to industrialized country markets, and the commitments made by the countries of Latin America and the Caribbean under the WTO General Agreement on Trade in Services.

Other publications

La dimensión ambiental en el desarrollo de América Latina, LC/G.2110-P, ECLAC, United Nations publication, Sales No.: S.01.II.G.67, Santiago, Chile, May 2001, 265 pages.

This book addresses a major challenge faced by Latin America and the Caribbean: ensuring that development is characterized by an adequate degree of environmental sustainability. To deal with a problem of this complexity, there needs to be a comprehensive approach to development in which the environment is an integral factor. The book analyses the need to define the ethical idea of the environment through cultural change, and it introduces the concept of environmental sustainability, which involves spelling out the deficiencies of economic thinking as this relates to the environment.

A brief account of the region's environmental history is given. The region is one in which the availability of natural resources and environmental goods generates revenue and currency that are very largely derived from the exploitation of natural resources. From this arises the need to develop a system of natural resource accounting.

The book covers issues such as agricultural and rural development, looking in some detail at the dynamic of the

predominant development style driven by what is known as "modernization of the countryside" before going on to highlight the main factors that are critical to environmental sustainability. It establishes a new categorization that has since come into widespread use in the region. It analyses the main forms of environmental deterioration and considers strategies and policies to reverse them. It examines biodiversity and the way it is valued, and considers the analyses and proposals produced in response to desertification. Proposals are made for a framework for the design of policies to curb deforestation.

Lastly, it describes the main tendencies and challenges that will need to be addressed in the region as a whole if the environmental situation is to be improved and environmentally sustainable development achieved, and it explains the need to explore the consequences of the environmental policies implicit in growth policies. Regressive attitudes and positions regarding the environment are identified as anti-ecological snares.

Protagonismo juvenil en proyectos locales. Lecciones del Cono Sur, LC/G.2098-P, ECLAC, United Nations publication, Sales No.: S.00.II.G.146, Santiago, Chile, March 2001, 170 pages.

This book presents a review of the experience and lessons obtained from the design and implementation of small-scale projects whose leading participants are socially and economically disadvantaged young people in rural and urban areas.

This review, which was based on the presentations and arguments of 40 young people from four countries (Argentina, Chile, Paraguay and Uruguay) who had participated in 20 youth projects, was held at the Economic Commission for Latin America and the Caribbean (Santiago, Chile, 8 to 11 November 1999).

The study looks at three aspects. The first is the conceptual and technical framework of the project approach followed, and here the emphasis is put on the need for projects to reflect young people's own ideas about change, to ensure that aspirations are not imposed and reinterpreted by the adult world. The study then goes on to analyse the challenges and strengths of the projects in relation to the youth issues and sectoral priorities considered, particularly as regards social participation, employment, education and health. It then examines real-life experiences to discover which factors are favourable and unfavourable to project implementation.

Juventud, población y desarrollo en América Latina y el Caribe. Problemas, oportunidades y desafíos, LC/G.2113-P, ECLAC, United Nations publication, Sales No.: S.00.11.G.131, Santiago, Chile, December 2000, 457 pages.

The young of Latin America are faced with a huge challenge. They will have to lead an economic and social development process that can reduce poverty and the appalling indices of socio-economic inequality that undermine stability and social harmony, promoting economic growth on foundations of international competitiveness and long-term sustainability and improving quality of life in the region's countries.

All this will be difficult to achieve, and indeed has eluded earlier generations. Nonetheless, the young of today have some advantages. They are better educated, they are familiar with new information production, communication, handling and processing technologies, they have experienced the relentlessness of change, which will make them able to cope more quickly and flexibly with future transformations, and they will be operating in a more manageable demographic framework, both because the numbers of young people are stabilizing and because more options are available for guiding demographic behaviour.

Nonetheless, the empirical evidence available tends to qualify the encouraging conclusions that might be drawn from reasoning of this kind, since social exclusion not only remains highly prevalent among the young but is worsening, as youth unemployment rates demonstrate, while they are at least as likely as previous generations to engage in high-risk pursuits (particularly where sexuality and reproduction are concerned) and illegal, violent, escapist and anomic behaviour, and there is no sign of their playing a more active role in decision-making.

This document discusses and analyses two opposing aspects: the potential advantages of the young, and their actual difficulties. Particular stress is laid on the influence that sociodemographic decisions have on their ability to move up through society and accrue assets and skills. Discussion of the important role played by youth-oriented public policies highlights the obstacles that arise in the design and application of these, the advisability of involving the different social agents, and particularly the young themselves, in their preparation, implementation and evaluation, and the need to coordinate action of a sectoral nature so that joint activities that are transversal in scope can be undertaken.