

INTERNATIONAL TRADE POLICY
IN THE ECONOMIC GROWTH
OF LATIN AMERICA

by

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Abstract

The basic conundrum of Latin American economic growth arises out of the foreign exchange using nature of its industry. Unless the industrial sector becomes foreign exchange producing, it can no longer function as a leading sector and act as the engine of growth for the whole economy.

Similarly, the industrial sector has not provided the solution to the unemployment problem expected of it due in large measure to the low level of capacity utilization which is prevalent in Latin America.

The foreign exchange using nature of industry is largely the result of policy. The exchange rate system is structured in such a way as to implicitly tax industrial exports while creating at the same time an industrial inefficiency illusion.

The low level of capacity utilization is policy induced as well. Government policy has generated distortions by creating deviations between the market price and the corresponding shadow price of production for export, and by legislating higher effective corporate rates on profits from the second and third shifts of operation. At the same time, Government has tolerated discrimination of lending in favor of fixed investment and against working capital.

The basic policy conundrum drastically limits the possibility of success in obtaining the major policy targets of increased growth, increased employment, greater price stability and more equitable distribution. Whereas conventional devaluation is inappropriate to deal with the conundrum, either a compensated devaluation or export subsidies are likely to be effective. These policies will at the same time make it possible to place the output from additional capacity utilization in industry and earn foreign exchange needed to pay for the imported inputs required to sustain such higher levels of utilization. Full capacity utilization requires additional policies as well, however, centering mainly on an increase in the price of capital goods imports, the lending for capacity utilization, and the equal taxation of profits from different shifts of operation.

International trade policy thus can be said to lie at the heart of the development prospects for the region. One must now look to policy makers to increasingly recognize the conundrum as well as the quasi-Keynesian situation in the labor market. Once adequately recognized and diagnosed, the appropriate policies can follow.

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I

The Setting

Perusal of official documents as well as conversations with policy makers reveals that the main goals of Latin American economic development policy are fairly clear. Latin American nations want a rapid increase in per capita income, the disappearance of unemployment, an increase in the equity of the distribution of income and wealth, price stability, and no balance of payments problems. While there is considerable agreement on this list, there exist important differences in emphasis between the different Latin American countries; thus some emphasize both price stability and lack of balance of payments problems whereas others emphasize equity and employment. In the terms of the economist's jargon, the arguments of the utility function are the same but the relative weights attached to these arguments vary from country to country.

The attainment of these goals in the postwar period has proved to be surprisingly difficult. Most countries have achieved a respectable rate of per capita growth, but despite very valiant struggle indeed, many countries still have very high rates of inflation, almost all have

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recurrent balance of payments crises, all have a rate of unemployment considerably above what they regard as acceptable, and almost none have a high degree of equity in distribution.

The particular features of the situation such as high rates of inflation with unemployment and unutilized installed capacity, tight money leading to even greater inflation, devaluations nullifying themselves through almost instantaneous price increases, etc., have puzzled observers technical and non-technical alike and added no little fuel to debates between conflicting and contradictory "explanatory theories". Thus monetarists and structuralists, protectionists and free traders have debated each other for years in the attempt to decisively and permanently influence policy (Baer 1967). Yet after twenty-five years of postwar development, a consensus is not yet in sight. The same conflicting theories are still used to explain the Latin American economic situation and any one of them still only fits some of the facts. Nonetheless, most Latin American policy makers are believers of one or another of these "partially true" faiths and as a result they view reality through prisms which introduce distortions of varying magnitude. As a result, the policies that are adopted are biased in a manner that often tends to aggravate the problems they are intended to deal with. Economic policy formulation in Latin America requires thus not only a more accurate theoretical framework but also the abandonment by policy makers of outdated and only partially correct theoretical schema and their replacement by more appropriate eclectic views (Diamand 1971, pp. 50-53).

II.

The Latin American Policy Conundrum

A few basic and interrelated features of Latin American economic development explain in very large measure the mix of growth, balance of payments and employment problems that Latin American countries have faced in the postwar period and continue to face today.

In simple terms, the heart of the policy conundrum lies in the role and nature of Latin American industrial development. The industrial sector was chosen early in the postwar period as the motor of growth, employment and better distribution. Policies of various sorts but mostly involving protection and tax exemptions were designed to aid and intensify its rate of growth. These policies were successful in the sense that industry has indeed been the leading sector in Latin American growth, with a growth rate consistently above that of GNP as can be seen from Table 1. At the same time, however, industry in Latin America has been almost everywhere a foreign exchange using activity in the sense of requiring some imported inputs into the production process. As a result, as industrial growth proceeded, the import bill required to maintain industrial output grew. On the other hand, foreign exchange producing sectors have typically been the primary ones whose growth rate was in most cases below that of industry.^{1/} In consequence, the increase in demand for foreign exchange arising out of fast industrial growth rapidly put pressure on the slower growing supplies of foreign exchange from primary activities. These inherently different rates of growth

^{1/} The Peruvian fishmeal industry is the exception. Yet even it consists of a manufacturing as well as primary part.

Table 1

**The Growth of Domestic Product and of
Manufacturing in Selected Latin
American Countries
1950-52 to 1964-66**

<u>Country</u>	<u>GDP</u>	<u>Manufacturing GDP</u>
Argentina	3.2%	4.4%
Brazil	5.3	7.8
Chile	4.0	5.0
Colombia	4.6	6.4
Dominican Republic	5.1	5.9
Guatemala	4.8	6.3
Honduras	3.6	6.8
Jamaica	7.4	8.1
Mexico	6.1	7.6
Nicaragua	5.8	7.5
Panama	6.4	9.8
Paraguay	3.1	2.6
Uruguay	1.5	2.5
Venezuela	6.4	9.3

SOURCE: OECD, National Accounts of Less Developed Countries



would have imposed an early slowdown in industry's rate of growth had it not been possible to free foreign exchange from existing uses through import substitution in industry. Such import substitution behind ever increasing protective barriers managed for some time to bring into balance the disparate rate of growth of production and use of foreign exchange. Table 2 shows this process at work in Brazil and Chile.

In the early seventies, the process of import substitution is virtually exhausted for the large Latin American economies and will very soon be for the medium and small ones. At this point a continued high rate of growth of industry is only possible if either (a) increased foreign exchange is forthcoming for the primary industries, (b) new sources and ways of import substituting are devised, or (c) industry becomes a foreign exchange generator, not only a foreign exchange user. It is tempting to add foreign aid and foreign private investment to this list of options; however, this would not be strictly correct. Foreign aid by itself is likely to delay the reduction in the industrial rate of growth for some time; however, for repayment to take place, a very large contraction of industrial activity would be required to free the foreign exchange from other uses. Only if the public foreign debt arising from aid were to increase continuously at a compound rate of growth, a situation unlikely to be tolerated by either aid givers or receivers, could repayment be postponed forever. Foreign private investment is on balance only slightly more helpful. If it is in new industrial products, it will be foreign exchange using; indeed, it is likely to be

Table 2

THE DECLINING SHARE OF
IMPORTS IN TOTAL SUPPLY

BRAZIL^{1/}

1949 - 1964

Imports as Percentage of Total Supply of Manufactured Products by Use

	Year <u>1949</u>	<u>1955</u>	<u>1959</u>	<u>1964</u>
Consumer Goods				
Durable	60.1	10.0	6.3	1.6
Non-Durable	3.7	2.2	1.1	1.2
Producer Goods				
Intermediate	25.9	17.9	11.7	6.6
Capital	59.0	43.2	34.5	9.8
All Manufactures	19.0	11.1	9.7	4.2

CHILE^{2/}

1914/15 - 1963/64

Share of Imports in Domestic Supply

	<u>1914-15</u>	<u>1927</u>	<u>1937-38</u>	<u>1952-53</u>	<u>1963-64</u>
Food, beverages and tobacco	22.5	11.4	7.2	11.6	12.2
Textiles, clothing and shoes	57.6	50.3	35.5	6.1	6.6
Wood products	23.2	4.9	3.2	1.5	2.0
Paper and printed matter	40.0	42.0	23.9	29.6	13.9
Leather and rubber products	24.6	36.5	16.3	31.1	17.3
Chemical products	91.3	71.3	60.6	51.8	38.5
Nonmetallic products	81.0	75.5	29.5	14.3	11.1
Metallic products	87.0	85.0	71.1	53.3	46.9
Total	51.5	43.8	29.9	26.0	24.6

^{1/} Joel Bergsman and Pedro S. Malan, "The Structure of Protection in Brazil", in Balassa et al, The Structure of Protection in Developing Countries, Johns Hopkins Press, 1971, Table 6.1.

^{2/} O. Munoz, "Long-run Trends in the Manufacturing Industry in Chile since 1914", as quoted in T. Jeanneret, "The Structure of Protection in Chile", in Balassa et al, op.cit., Table 7.4.



even more import intensive than most existing industry.^{1/} Only if foreign private investment directs itself to the export oriented industries will it contribute in some measure to alleviate the conundrum.

The employment problem is also connected very closely to industrial development. In the early postwar period, industry was chosen as a leading sector in part because of the promise it seemed to hold of solving the unemployment problem then existing. Examination of the current situation shows that such hopes were not fulfilled. Instead, there is now considerable disillusionment with industry's potential for providing employment (Baer and Herve 1966). Explanations for the lack of success in this regard focus mostly on the relative prices of capital and labor, it being argued that capital goods have been too cheap and labor too dear to produce an adequate factor mix for leading to full employment. Such an analysis, while a natural outgrowth of the economic theory of factor use, leaves out a very important element, namely that installed capital is itself also substantially underemployed in Latin America. Thus unemployed labor coexists with unemployed capital and there is a quasi-Keynesian situation (Schydrowsky 1971). With capital utilized on the average at approximately one shift per day rather than the technical maximum of three, it would appear that the employment giving potential of industry has been utilized approximately to a third of its real potential.

^{1/} For a discussion of the effect of changes in the composition of demand, cf. Felix 1963.

It should be borne in mind, however, that the low degree of capital utilization has resulted from private decision making which can be presumed to derive from profit maximization and is therefore "rational" in the economist's sense. At the same time, it does seem to be clear that from a public policy point of view, this outcome is not the most desirable. Therefore, it becomes imperative to investigate the factors that cause such a divergence between the private profit and the public good.

III

The Foreign Exchange Using Nature of Industry

It is important to realize that the foreign exchange using nature of industry is not an immutable fact of life, but very substantially the result of the particular industrialization policy adopted by Latin American countries. The growth of industry was fostered by a set of import restrictions which cumulated over time and eventually led Latin American countries to have an exchange rate structure which is systematically biased against industrial exports and makes these unprofitable. Whereas the usual discussion focuses on "the" exchange rate, the amount of units of local currency which must be given up to obtain one dollar for purposes of financial transactions is best called the financial exchange rate. From the point of view of its impact on the economy, however, the financial exchange rate must be analyzed together with the trade taxation and other trade restrictions in force. Indeed, it is useful to think of an "exchange rate system" composed of the financial exchange rate and a large

number of "commodity exchange rates" which are the multiple exchange rate equivalents of the existing taxes and other restrictions on commodity trade. Each commodity rate is defined as the number of units of domestic currency for which a dollar's worth of imports at CIF prices (or exports at FOB prices) of each particular commodity sells for on the internal market. Each commodity rate is equal to the financial rate plus all the trade taxation and restrictions assessed on the import or export of that particular commodity. In general, there will be as many commodity rates as the economy has commodities tradeable internationally and often a single commodity may have more than one rate.^{1/}

In Latin America, most countries operate with a set of import restrictions which raise the commodity exchange rates for imports substantially above the financial rate. On the export side, some countries have operated at times with an export tax on traditional export commodities

which has reduced the commodity exchange rate for traditional exports below the financial exchange rate. Thus, for example, Argentina was operating in 1966 with approximately the following exchange rate system:^{2/}

<u>RATE</u>	<u>COMPOSITION</u>	<u>PESOS PER \$</u>
Agricultural Export	= Financial less 10% tax	= 200
Financial	= Financial	= 220
Non-traditional Export	= Financial+18% tax rebate	= 260
Raw Material Import	= Financial+50% duties	= 330
Semi-manufactures Import	= Financial+120% duty	= 460
Components Import	= Financial+175% duty	= 600
Finished Products Import	= Financial+220% duty	= 700

^{1/} The most general case arises when the same commodity has different import rates; preferential import and export regimes differentiate rates even further.

^{2/} Taken from CARTTA 1966.

A quick inspection of this rate structure will show why industry fails to generate foreign exchange. Industry buys its raw materials at an exchange rate of 330 pesos per dollar, its imported semi-manufactures at 460 and its components at 600. This implies an average cost exchange rate for imported inputs of approximately 400 pesos per dollar. Domestic inputs have implicit exchange rates only slightly lower since most domestic producers do not sell at prices much below those of similar imports. Thus, industry's cost exchange rate for all material inputs is roughly between 380 and 420 pesos per dollar. At the same time, the wage rate industry pays reflects the average industrial exchange rate of about 600 pesos per dollar.^{1/} Hence total industrial costs are based on an exchange rate averaging 450 to 500 pesos per dollar. At the same time, a dollar's worth of exports yield only 260 pesos per dollar. The would-be industrial export producer thus faces an implicit tax levied through the exchange rate system of close to 50%. The implications of this situation for the profit rate are rather dramatic.

The Argentinian exchange rate structure is typical for Latin America as can be seen from Table 3 which tabulates the import commodity rates by sector for Brazil, Chile and Mexico. In turn, Table 4 presents for each industry in these three countries the factor remunerations payable on the basis of export business as a proportion of remunerations currently being paid

^{1/} $w = \text{Marginal physical product (MPP)} \times \text{price of output}$. If the unit of output is set at an amount costing \$1 CIF, then we have $w = \text{marginal physical product} \times \text{average commodity exchange rate for output}$.

Table 3

Import Commodity Rates in Selected Latin
American Countries

(Financial Rate = 1.00)

	Brazil 1967	Chile 1961	Mexico 1960
Non-Metallic Mineral Products	1.40	2.39	.96
Metallurgy	1.34	1.66	1.30
Machinery	1.34	1.84	1.30
Electrical Equipment	1.57	2.05	1.25
Transport Equipment	1.57	1.84	1.26-1.52
Wood Products	1.23	1.35	1.14
Furniture	1.68	2.29	-
Paper and Paper Products	1.48	1.55	1.35
Rubber Products	1.78	2.02	1.33
Leather Products	1.66	2.61	1.20
Chemicals	1.34	1.94	1.21
Pharmaceuticals	1.37	-	1.12
Perfumes and Soaps	1.94	-	1.10-1.22
Plastics	1.48	1.50	-
Textiles	1.81	2.82	1.30
Clothing	2.03	3.55	1.10
Food Products	1.27	1.82	1.13
Beverages	1.83	2.22	1.28
Tobacco	1.78	2.06	1.31
Printing and Publishing	1.59	1.72	1.13
Metal Products	-	1.59	1.31
Fertilizers and insecticides	-	-	1.09

Source: Bergsman, J. and Pedro S. Malan "The Structure of Protection in Brazil", Table 6.6, Col. 5

Jeanneret, T. "The Structure of Protection in Chile", Table 7.8, Col. 1

Dean, G. "The Structure of Protection in Mexico", Table 8.7, Col. 3

in B. Balassa et al. The Structure of Protection in Developing Countries, Johns Hopkins Press 1971.

Table 4

THE ANTI-EXPORT BIAS OF THE EXCHANGE RATE
SYSTEM IN SELECTED LATIN AMERICAN COUNTRIES

Percentage of actual factor remuneration
payable on the basis of export sales

<u>Industry</u>	<u>Brazil</u> 1967	<u>Chile</u> 1961	<u>Mexico</u> 1960
Non-Metallic Mineral Products	.64	NVA	1.06
Metallurgy	.68	NVA	.49
Machinery	.71	.03	.57
Electrical Equipment	.36	.11	.71
Transport Equipment	.46	.15	.57**
Wood Products	.78	.30	.75
Furniture	.32	NVA	----
Paper and Products	.54	.21	.38
Rubber Products	.41	NVA	.53
Leather Products	.43	NVA	.61
Chemicals	.66	NVA	.5
Pharmaceuticals	.66	----	.65
Perfumes and Soaps	NVA	----	.56-.77
Plastics	.49	.34	----
Textiles	.68	NVA	.79*
Clothing	.34	NVA	.83
Food Products	.66	NVA	.59
Beverages	.14	NVA	.55
Tobacco	.40	.04	.53
Printing and Publishing	.52	.31	.77
Metal Products	----	.28	.48
Fertilizers and insecticides	----	----	.77

NVA = negative value added, i.e.: the cost of inputs exceeds the receipts from exports, hence no payments to factors are feasible.

* Cotton textiles

** Railroad equipment only; motor vehicles have NVA

SOURCES:

Bergsman, J. and Pedro S. Mallan, "The Structure of Protection in Brazil", Table 6.6.

Jeanneret, T., "The Structure of Protection in Chile", Table 7.8.

Bueno, G., "The Structure of Protection in Mexico", Table 8.7.

Malassa, B. et al. op. cit.

on the basis of sales to the domestic market. A ratio of .6 means that export sales would only allow payment of 60% of the current wages, salaries, interest, profit, etc. By the same token, a ratio of .6 signifies that export sales can only go forward if the industry concerned has (marginal) costs of or can cut costs to 60% of current factor payments.

An additional and very important effect of the exchange rate structure is what may be called the "inefficiency illusion" of Latin American industry. It is generally "known" that Latin American industry is inefficient and uncompetitive. This "fact" is easily demonstrated by translating domestic industrial costs into dollars, which turn out to be substantially above the price of comparative imports. This computation uses the financial exchange rate. Since we know that domestic costs are based on the commodity exchange rates that are usually considerably above the financial exchange rate, it should not surprise us very much to find that domestic costs will be higher than international prices when converted at an exchange rate lower than the one on which they are based. This phenomenon, in the absence of the obvious explanation, has produced the inefficiency illusion effect and given Latin American governments and public the impression that they have an industrial structure totally out of kilter and hopelessly inefficient. The fact of the matter is, however, that much of the inefficiency is merely the result of an improper comparison by the use of an exchange rate that is not applicable to the respective costs. When domestic costs are deflated by an appropriate exchange rate, i.e., one that is related to the commodity exchange rates,

it turns out that Latin American industry is substantially more efficient than generally believed. Table 5 gives an indication of the size of the inefficiency illusion in Brazil by converting domestic production costs into dollars with an exchange rate reflecting the average cost rate for industry.^{1/}

The inefficiency illusion and the anti-export bias in the exchange rate system have interacted to the mutual reinforcement of both and the hindrance of a change in policy. The inefficiency illusion reinforces the belief of policy makers that industry is not efficient enough to export. The anti-export bias in the exchange rate structure makes exports impossible. The resultant lack of exports confirms the policy makers' view that industry is unable to export. In view of the obvious scarcity of foreign exchange, however, the impossibility for industry to export means that additional import substitution must be undertaken. This in turn implies higher import restrictions which cause an increase in the inefficiency illusion. As a result, the policy makers become even more convinced of the inefficiency of industry and its inability to export and at the same time the higher import restrictions increase the anti-export bias thus making it ever less likely that industry will become foreign exchange generating.

^{1/} Note that for a more accurate calculation each sector's costs should be converted at that sector's cost exchange rate. If this were done, the numbers in the second column would change once again. However, the general result would not be negated.

Table 5

THE "INDUSTRIAL INEFFICIENCY ILLUSION" IN BRAZIL

Excess of domestic price ("cost) over international price

<u>SOURCE</u>	At Financial Exchange Rate	At Industrial Cost Exchange Rate ^{1/} _{2/}
Non-Metallic Minerals	40%	- 5%
Metallurgy	34	-10
Machinery	34	-10
Electrical Equipment	57	6
Transport Equipment	57	6
Wood Products	23	-17
Furniture	68	13
Paper and Products	48	0
Rubber Products	78	20
Leather Products	66	12
Chemicals	34	-10
Pharmaceuticals	37	- 7
Perfumes and Soaps	94	31
Plastics	48	0
Textiles	81	22
Clothing	103	37
Food Products	27	-14
Beverages	83	24
Tobacco	78	20
Printing and Publishing	59	7

^{1/} Derived as follows - rate for intermediate products 1.49
rate for wages 1.48
1.48

^{2/} A negative sign indicates domestic price is below international price.

SOURCE: Joel Bergsman and Pedro Malan, "The Structure of Protection in Brazil" in B. Balassa and Associates, The Structure of Protection in Developing Countries, Johns Hopkins Press.
Table 6.6 and 6.8

IV

The Low Employment Generation of Industry

It has already been pointed out that industry's low labor absorption is related to the underutilization of existing plant and equipment, and that with multiple shift-work industrial employment would be substantially increased. An understanding of the reasons underlying the single shifting decision of most industrial firms in Latin America requires the resolution of the apparent paradox that while private profit maximizers find it preferable to operate three plants at one shift, from society's point of view it would appear preferable to operate one plant at three shifts, thus economizing on the scarcer resource, capital, and using labor extensively. The paradox is resolved if it is borne in mind that the private sector makes its decisions at market prices whereas the public sector evaluates these private decisions at "social" or "shadow" prices. If market and shadow prices are sufficiently different, it is perfectly possible for the decision at private prices to lead to the installation of several factories all of which will be operated at one shift while the same decision when evaluated at shadow prices would lead to the installation of a single factory to be operated on a multiple-shift basis. The inquiry then has to shift focus to the causes for divergence between market and shadow prices.

The systematic distortions between private and shadow prices existing in most Latin American economies are the following:

(a) the price of output: Under the existing exchange rate system only the marginal revenue in the domestic market is relevant from the private point of view. Given the oligopolistic nature of many commodity markets in Latin America, each seller perceives a low demand elasticity for his sales and a MR well below the going price. From society's

point of view the output is worth (potentially) the foreign exchange it would earn if exported multiplied by the shadow price of foreign exchange. This value is without exception a multiple of the privately perceived marginal revenue.

(b) the price of capital goods: Most Latin American tariff structures and industrial promotion laws provide for the duty-free import of capital good. Such a procedure implies charging the private buyer of these capital goods too little both for the scarce foreign exchange which he is using and for the scarce investment funds that he is allocating. On this count, one would expect operation to be overly capital intensive.

(c) Market wage rate: In most Latin American economies, the wage rate in the industrial sector is set by a combination of institutional processes involving government wage setting and unions. In all cases, the result is substantially above what a free labor market would produce. As a result, the market wage lies above the social marginal cost of labor, i.e., labor's shadow price. On this account, private decisions would tend towards underutilizing labor in their operations. The impact of the wage rate goes further, however; many times the legislation requires overtime pay for night labor which distorts the market wage from its shadow price even further.^{1/} Finally, social

^{1/} Note that the premium for night labor may be exactly "right", i.e. may accurately reflect the social disutility of night work. Nonetheless, night pay may exceed the night shadow wage (just as the day wage exceeds its shadow wage).

security legislation and other fringe benefits,^{1/} severance pay, and firing regulations^{2/} may increase the cost of employing labor beyond its take-home pay and further widen the differential between the market cost of labor and its social cost.

(d) credit structure: In most Latin American economies, credit to finance installation of fixed capital is available on considerably easier terms and in larger quantities than is credit for working capital. Yet it is precisely the latter which is necessary for multiple shift working of plant since inventories of goods in process as a ratio of total capital investment increases substantially in these plants. As a result once again, the private production decision is biased towards excess fixed capital intensity.

(e) tax structure: In most Latin American tax legislations, the depreciation deductible from corporate income tax is based on the number of years of the life of the equipment, with no allowance made for intensity of use. As a result, second and third shift originated profits are taxed at an effectively higher corporate income tax rate than are first shift profits. This progressive corporate income tax by level of utilization of course is a disincentive for private decision makers to install capital intensive multiple shifting operations.

(f) unavailability of skilled and supervisory personnel: Skilled

^{1/} The magnitude of the fringe benefits is considerable. Ferrero (1957) found them to be 45% of wages in Peru, while Gregory (1967) found them to be about 100% of on-the-job earnings.

^{2/} For a discussion of labor force hiring as a fixed investment Cf. Vernon (1970).

and supervisory labor are inputs complementary to capital, unskilled labor and foreign exchange. The total unavailability of labor could therefore prevent any production from taking place. The extreme case of such unavailability arises in the family firm wherein the management is fully concentrated in the owner himself who, of course, cannot work twenty-four hours a day. In larger firms, with hired management, the availability problem becomes a cost problem. With this type of labor very scarce, it is obvious that its price will be high, both in the market place and in terms of its shadow wage. It is likely, however, that the market wage will be above the shadow wage even in this case, since private supply price of nighttime labor is in part at least a function of the lack of nighttime amenities such as transportation, security, etc. etc. From society's point of view, if the social context is reorganized to include as a matter of course triple shifting everywhere in the economy, these nighttime services would be available in a volume similar to the daytime level. As a consequence, the private supply price would fall. Thus through the interdependence of social arrangements, the shadow price of nighttime supervisory labor may well be below the market price.^{1/}

It may be well at this point to remember that the distortions listed will tend to lead private decision makers to underutilize installed capacity, and indeed to plan their investments in such a way as to leave capital idle a certain proportion of the time. It does not

^{1/} I owe this point to Dr. Stephen Guisinger.

follow, however, that the social optimum would be a twenty-four-hour-a-day operation throughout the year. Such a conclusion would require a particular configuration between the shadow costs of factors and the shadow price of output. The general arguments presented so far do not enable such a conclusion to be drawn, although it is not unlikely that upon the empirical quantification of the relevant values, round-the-clock operation throughout the year would turn out to be the social optimum in a wide range of industries.

V

Implications of the Conundrum

The inconsistency in the growth rates of sectors using and supplying foreign exchange has effects of the greatest importance on the major policy problems confronting Latin American governments. In what follows, the impact of the conundrum on the following four areas of policy concern will be discussed: (a) balance of payments; (b) stabilization; (c) employment; and, (d) distribution.

(a) balance of payments: Economic theory teaches us that a balance of payments deficit can be corrected through recourse to relative price changes and to real income changes. Price changes are usually implemented through a devaluation which raises the price of traded goods compared to non-traded goods. As a result, a country exports more and imports less. At the same time, a lower real income ensues which reinforces the fall in the demand for imports as well as reducing domestic demand for

exportables thus supporting the increase in exports.

Under Latin American conditions, the price effect is virtually null for several reasons. On the import side, substitution possibilities between existing imports and domestic production are small or nonexistent since the overwhelming proportion of imports consists of industrial raw materials which are not available domestically. Price elasticity for imports then comes primarily from substitution in final demand between commodities of different import intensity. With imports making up a small proportion of costs only, however, the price increase of imports themselves has to be substantial in order to cause the price of the commodities into which they are embodied to rise differentially. Thus even respectable own price elasticities for final goods translate into quite low elasticities for the imported components. On the other side of the balance of payments, it has been very difficult to incorporate new commodities into the export trade because of the size of the devaluation necessary to overcome the cost differential between traditional and non-traditional commodities. Indeed, devaluations of the magnitude required would be so large as to set off reactions on the part of income receivers that would rapidly nullify the devaluation. Thus any elasticity in the overall supply of exports results from increased production of traditional export products as well as from diversion to the export market of quantities destined to the home market.

The importance of the income effect for the balance of payments adjustment process is reinforced by these rigidities. With imported inputs being almost a fixed proportion of industrial output, an adjustment

on the import side requires a fall in final demand, i.e. a reduction in real income. On the other hand, on the export side, a fall in real income can contribute to export revenue through reduction in the domestic consumption of exportables.

If industrial exports existed in the economy, the balance of payments adjustment process could rely much more than at present on the price effect since in that case the supply of exports would be substantially more elastic due to the greater ease with which existing industrial products are converted into new export products.

(b) price stabilization: Traditionally, Latin American stabilizations emphasize adjustments on the demand side of the market. It is argued that if demand is reduced sufficiently, prices can no longer rise. As a result, the main policy tools traditionally used are tight money and a reduction in the government deficit. In fact, this approach is often self-defeating since lower demand may well lead to a lower level of activity with the concomitant reduction in government revenue both directly and through a lower level of trade taxes.^{1/} The only clear success which this approach can guarantee is an improvement in the balance of payments through the real income effect on imports.

More recently, some attention has been paid to cost push inflation originating in wages and attempts have been made to stabilize through Phase-Two type wage and price agreements. This approach has been followed in Chile (Cauas 1970) and Argentina (IDES 1967, 1968). In the latter

^{1/} For an empirical estimate of tax multipliers in a quasi-Keynesian situation see Schijlowsky 1971a.

case, due consideration was not given to the impact of the conundrum since the possibility of cost increases originating from changes in the exchange rate were not built into the policy framework and as a result not enough emphasis was given to the need to increase export earnings in order to prevent devaluation and the consequent break-up of the price-wage agreement.

The underlying problem arises from the difficulty, in the face of a balance of payments constraint, of increasing domestic production in order to dampen price increases from the supply side of the market. Under these circumstances, stability at low growth is possible but an increased rate of growth cannot be sustained.

In the presence of industrial exports, a policy reducing domestic demand can be effectively supplemented by one increasing export demand through selective or general devaluation, thus creating a stabilization in total demand and improving the balance of payments by diverting supplies from the domestic market to the foreign market. At the same time, the ensuing availability of foreign exchange would allow maintenance and even expansion of domestic production with the consequent anti-inflationary impact of increased supply. Furthermore, economic growth could be accelerated with increased participation in the export market thus creating the availability of foreign exchange needed for expanding supply to the domestic market and the further dampening of domestic inflationary situations.

(c) employment: Three possible routes to raising the level of employment exist:

(i) increasing the growth of capital stock with a constant capital labor ratio.

This alternative is directly affected by the conundrum since it implies raising the growth rate and hence the required level of imports.

(ii) better use of existing level of capital formation through investment in more labor intensive industries, i.e. change in the capital labor ratio.

This alternative does hold more promise of not being totally inhibited by the basic policy conundrum but it should be noted that it is not at all certain that labor intensive technologies are also import saving. Indeed, it may well be that the opposite occurs (e.g. higher raw material wastage) in which case greater labor intensity would mean an aggravation of the growth problem.

(iii) more intensive use of the capital stock.

While the underutilization of labor has been recognized in Latin America for a long time, evidence is only gradually accumulating on the underutilization of capital. Not only do many of the Latin American economies periodically use installed productive capacity at levels below their own customary norm, the norm itself is based on utilization of capital at less than twenty-four hours a day three-hundred-and-sixty-five days a year less maintenance. While detailed information on the amount of shift work is unavailable, it appears that multiple shifting takes place primarily in the process centered industries in which twenty-four-hour operation is required for technical reasons. In Colombia, available data show that capital is used at about 50% of twenty-four-hour capacity on the average (Thoumi 1972). Available data from Argentina show deviations from the usual norm of utilization to have fluctuated between 55% and 67% of this norm.

Tackling this problem, however, requires coming to grips with the basic conundrum itself. Expanding capacity utilization would have only minimal foreign exchange investment requirements, however, and the resulting expansion of the level of industrial output means larger imports of industrial inputs. Thus a higher level of employment through capacity utilization is possible only if the foreign exchange availability increases and the most plausible source of such an increase is in the sale abroad of some of the product arising from increased capacity utilization itself. Such a solution would, however, imply making industry foreign exchange generating and therefore is identical with solving the basic policy conundrum!^{1/}

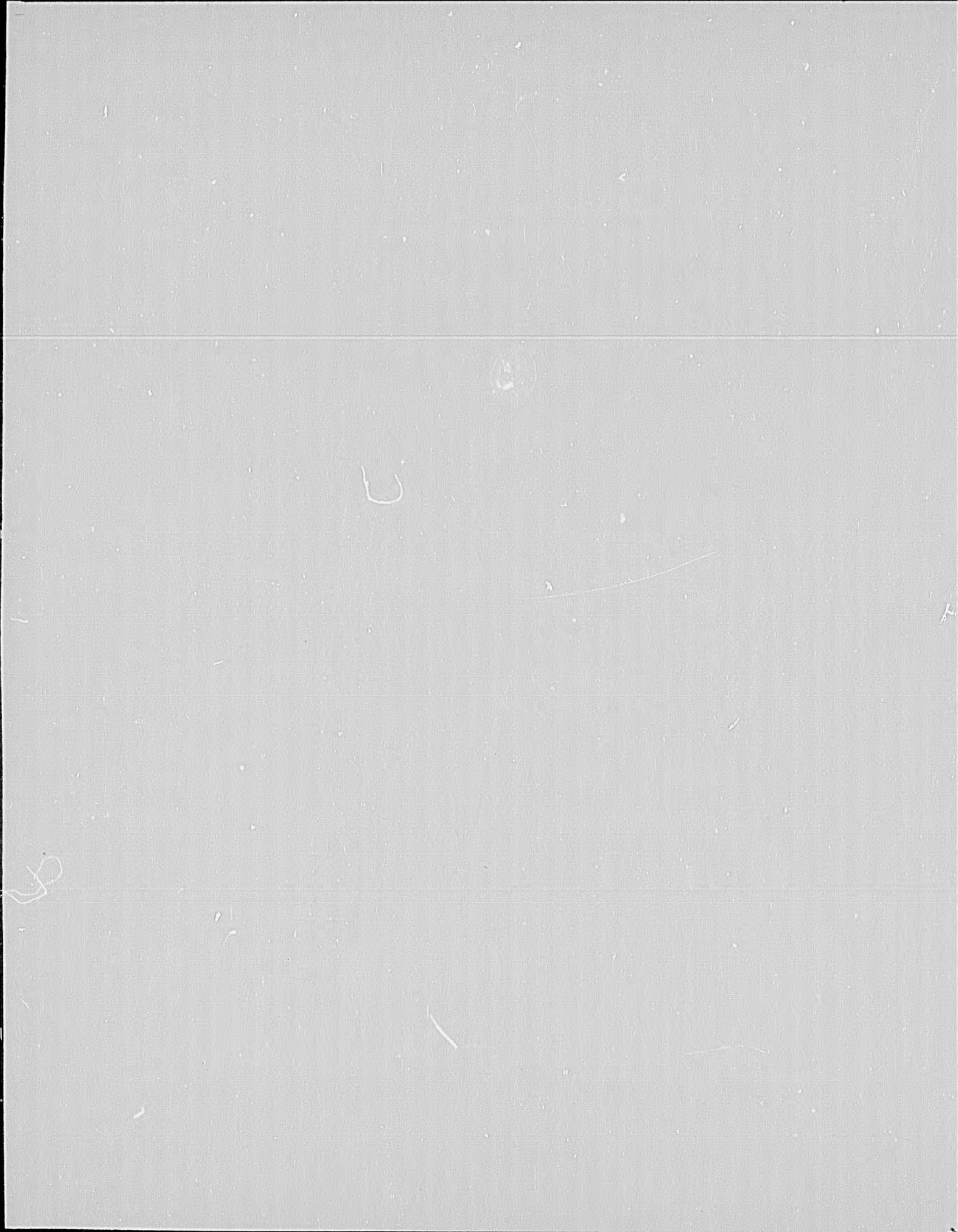
^{1/} For a more complete discussion, cf. Schydrowsky, D.M., "Fiscal Policy for Full Capacity Industrial Growth in Latin America", presented at the 21st Annual Latin American Conference, University of Florida, February 1971, Center for International Affairs Economic Development Report No. 201, Harvard University, 1971.

Table 6

Argentina
Utilization of Installed Capacity

Sector	Percentage of Actual Output with Respect to Maximum Output			
	1961	1963	1964	1965
Food and beverages	48.8	53.2	48.9	51.5
Tobacco	82.7	81.9	88.6	91.2
Textiles	83.2	59.2	68.9	77.1
Clothing	88.3	64.2	72.5	78.4
Wood	72.7	48.6	55.2	70.4
Paper and cardboard	55.1	48.3	52.7	62.4
Printing and publishing	73.3	58.3	62.4	70.8
Chemicals	73.4	59.9	68.1	73.8
Petroleum derivatives	87.9	78.2	84.7	83.6
Rubber	80.5	54.0	66.2	77.6
Leather	84.2	66.8	77.8	79.9
Stones, glass, and ceramics	70.2	59.0	68.7	71.8
Metals, excluding machinery	59.4	40.8	50.3	66.6
Vehicles and machinery (excluding electrical equipment)	78.6	44.6	56.5	65.6
Electrical machines and equipment	59.2	43.5	47.6	61.0
Weighted average	67.2	54.6	59.5	66.1

Source: CONADE, Results of the Survey on Production and Investment: Expectations of Industrial Enterprises (Buenos Aires: CONADE, March 1965), table 3.



(d) distribution: Changes in the regional and personal distribution of income as well as changes in the income shares of the public and private sectors are an increasingly important policy goal for Latin American governments. In addition to the greater difficulty of achieving such readjustments under the conditions of relatively slow growth forced upon the economy by the continuation of the basic conundrum, there are some direct connections between the sources and uses of foreign exchange and the possibility of executing a successful redistribution policy. One major connection runs from the exchange rate to export prices and to the income of exporters as compared to urban laborers. This is most obviously the case if wage goods are also the country's primary export products. If the exchange rate goes up, agricultural producers get higher incomes and the cost of living rises.^{1/} If agriculture is in the hands of large landowners, this will mean a negative redistribution of income, although it may at the same time be a necessary adjustment in the incentives to provide foreign exchange. Thus distributional policy clashes directly with the balance of payments policy. If industrial exports existed, balance of payments policy could accommodate a lower increase in prices for farmers, increasing instead the foreign exchange earned by industry.

On the other hand, a reorganization of land tenure or the institutionalization of worker participation in management of the mines or indeed of government participation in mining or the merchandising of export products may lead for a time at least to some disorganization, lower productivity and lower value of exports thus causing contraction in the rest of the economy and producing reductions in everybody's income

^{1/} The same distributional effects obtain even if the export products are not wage goods. In that case, devaluation will increase export earnings and reduce the real wage via price increases of importables.

rather than redistributions. Were industry foreign exchange producing rather than foreign exchange using, adjustments of an organizational nature in the primary sectors would be much more bearable since the economy would be able to compensate a short fall of earnings from these sectors through an increased amount of industrial exporting.

VI

Generating Foreign Exchange from Industrial Production

The basic policy conundrum will only be solved when industry becomes foreign exchange generating as well as foreign exchange using. Two necessary conditions for such a conversion are price competitiveness of industrial output in the world market and the availability of marketing channels.^{1/}

Price competitiveness

The achievement of price competitiveness requires a modification in the exchange rate system. Two techniques are available for this: (a) compensated devaluation, and, (b) export subsidies.

A compensated devaluation is one in which simultaneous and offsetting adjustments are undertaken in the financial exchange rate and in the trade restrictions such that all the commodity exchange rates for imports and traditional exports stay unchanged, the only net change taking place in the financial rate and in the nontraditional export rate. As a result, non-traditional exports obtain the equivalent of a subsidy. An example can be given with the Argentinian exchange rate system cited before (CARTEA 1966).

^{1/} These two conditions may by themselves not be sufficient, however. In addition, quality of product, regularity of supply, minimum quantity and other elements may be required.

<u>Pre-Compensated Devaluation</u>				<u>Post-Compensated Devaluation</u>		
<u>Total</u>	<u>Tax/Subsidy</u>	<u>Basic</u>	<u>Rate</u>	<u>Basic</u>	<u>Tax/Subsidy</u>	<u>Total</u>
200	- 10%	220	Agricultural Exports	330	- 40%	200
220	0	220	Financial	330	0	330
260	+ 18%	220	Non-traditional Exports	330	+ 18%	390
330	+ 50%	220	Raw Material Imports	330	0	330
460	+120%	220	Semi-Manufactured Imports	330	+ 47%	460
600	+175%	220	Component Imports	330	+ 80%	600
700	+220%	220	Finished Product Imports	330	+115%	700

Inspection will show that with a compensated devaluation, the exchange rate for nontraditional exports has had a real increase of 50% in comparison with the remainder of the rates, being much closer now to the industrial cost rates, and, indeed, exceeding the raw material imports rate.

The export subsidy directly affects the commodity exchange rate for nontraditional exports and therefore eliminates the preexisting bias. If the export subsidy is given across the board as a fixed percentage of the FOB value of exports, its administration is extremely simple.

The main objection to export subsidies arises from the supposed fiscal cost. It is argued that such subsidies, if successful, imply substantial disbursements from the treasury which, under the stringent fiscal conditions in Latin America, are better used elsewhere. This

objection is not generally valid, however. If the subsidy program is indeed successful and exports take a place under it, additional economic activity would result which in itself and through the foreign trade multiplier would generate a substantial increase in the tax base. This increase in the base would, in turn, generate additional revenue for the exchequer. This new revenue would then serve to cover in part or in whole the subsidy necessary to generate the exports in the first place. Thus through a combined foreign trade and fiscal multiplier, export subsidies generate their own (partial or total) financing. Under the Latin American conditions in which the marginal import propensities are rather low, foreign trade tax multipliers tend to be high and as a result fairly large export subsidies can be supported by the revenue generated in this form, particularly if they are paid only to new exports. In essence, such a view of the fiscal impact of export subsidization implies the use of a full capacity utilization budget. This full capacity utilization budget is analogous to the full employment budget introduced recently in the United States. The difference is that in the United States version an expenditure by government or a reduction of revenue will generate domestic activity and additional domestic employment which will in turn then finance the change in the fiscal situation. In Latin America, it is the expenditure of public funds for the creation of exports that generates a higher level of economic activity and therefore an increase in revenue.

A simple model of the following kind allows the calculation of a full utilization budget and specifically the maximal subsidy payable without net fiscal costs to the exchequer.

Define:

P = total expenditure of the private sector

p = marginal propensity to spend of the private sector

M = imports at CIF prices

m = marginal (= average) propensity to import

Y = income at market prices

E = exports at FOB prices

G = government expenditure

T = fiscal revenue

a = rate of ad valorem import duties

td = rate of direct taxes on income

ti = rate of taxation on domestic transactions expressed
as a percentage of national income

Then:

$$P = p_0 + p(1 - td - ti - \frac{M}{Y}) Y \quad (1)$$

$$M(1 + a) = m(1 - td - ti - \frac{M}{Y}) Y \quad (2)$$

$$E = E_0 \quad (3)$$

$$G = G_0 \quad (4)$$

$$Y = P + G + (E - M) \quad (5)$$

$$T = aM + (td + ti) Y \quad (6)$$

This system of equations tells us that gross private disposable income^{1/} determines the level of final demand for domestic goods and for imports

^{1/} Note that this is defined at factor cost -- hence, the terms for indirect taxation and import duties.

measured in domestic prices (eqq[1 and 2]), that exports and government expenditure are exogenously determined (eqq[3 and 4]), that income must equal expenditure (eq 5) and that fiscal revenue comes from several kinds of taxes.

The total differential of fiscal revenue with regard to income from exports will show the net increase in fiscal resources per peso of additional income of exporters.

$$dT = \frac{am(1 - tx) + (1 + a)(td + ti)}{(1 + a)\{1 - (1 - tx)[p - m/(1 + a)]\}} \quad (7)$$

where $tx = td + ti + a\frac{M}{Y}$

Incorporating export subsidies explicitly requires substituting E by $E^* = (1 + s)E$, where s = rate of subsidy on FOB value of exports. The net fiscal change after export subsidy payments can now be written as

$$dT_n = \frac{am(1 - tx) + (1 + a)(td + ti)}{(1 + a)\{1 - (1 - tx)[p - m/(1 + a)]\}} dE^* - \frac{s}{1 + s} dE^* \quad (8)$$

Applying these formulae to Argentina with $tx = .43$; $td = .0467$; $ti = .07$; $a = .024$; $m = .159$, $p = 1$, one obtains

$$dT_n = .566 dE^* - \frac{s}{1 + s} dE^* \quad (9)$$

To obtain the maximal subsidy rate, s, which causes no net deficit, equation (9) is set equal to zero and $s = 1.3$ which means that in Argentina a subsidy rate of up to 130% of the FOB value of the export will not disimprove the fiscal balance.^{1/} Other countries will surely

^{1/} For more detail on this model including period analysis, sectoral disaggregation and sensitivity analysis of the parameters, Cf. Schydlosky, 1971a.

have different and probably lower cutoff points but economies as closed as the Latin American ones cannot fail to have high foreign trade multipliers and hence room for substantial export subsidization without a negative net fiscal impact.

An estimate of the excess of costs of production over prices in developed countries and hence of the subsidies required for export competitiveness in Brazil, Chile and Mexico on the assumption of fully competitive markets all around and no excess capacity is shown in Table 6. These figures overestimate the true price/cost gap to the extent that exports are additional, to rather than substitutes for, domestic sales and that excess capacity exists; marginal cost may then well be below the average cost for the domestic market. A similar offset would come from monopolistic pricing in the domestic commodity markets of potential Latin American export products, which would also imply marginal cost below price. Finally, monopolistic pricing in developed countries by producers of potential Latin American export products would also generate an offset by providing a higher price floor which must be undercut.

If the compensated evaluation and an export subsidy yielding precisely the same commodity exchange rates were compared, the following differences would emerge:

(1) Under compensated devaluation, the financial exchange rate has been raised whereas this does not take place under a subsidy program. This modification implies a net loss (gain) in wealth for all individuals and firms in the domestic economy with net foreign liabilities (assets). Also implied is a reduction in

the expected profitability of foreign private investors.^{1/}

(2) The fiscal impact of the new exports will be identical under both systems. However, the shift in tax base under the compensated devaluation is likely to produce an increase in revenue if the balance of trade was initially in surplus and a decrease in revenue if it was initially in deficit.

In most real world cases, the adoption of a compensated devaluation would produce a somewhat different structure of exchange rates than would result from the adoption of an export subsidy program. The main difference would arise from the impossibility of fully compensating the devaluation on the import side since some tariffs will initially have been below the level of the desired export subsidy equivalent for non-traditional exports. As a result, some increase in import commodity exchange rates will take place, albeit at the lower end of the spectrum. As a result, compensated devaluation will have a slightly higher tax yield, and a small increase in prices as well as perhaps a slightly weaker net export incentive, if the nontraditional exports are heavy users of the commodities whose import exchange rate has been raised.

In choosing between these two alternative policies, consideration must additionally be given to some factors that, though not fundamentally economic in nature, are nonetheless very important. These are the

^{1/} New foreign investors will find offsetting effects: (i) their dollar capital expenditure goes down in so far as they purchase non-traded goods and domestic labor; and (b) the dollar repatriation value of their profit stream will be reduced proportionately to the devaluation. Unless the capital expenditure is totally in local currency, the result will be reduced profitability for a given size operation. Foreign investors may, however, find ample compensation from the higher growth rate attendant upon a successful compensated devaluation. For a discussion of devaluation as perceived by the foreign investor see Vernon 1968, pp. 341f.

following:

(1) effect on the inefficiency illusion in industry: Compensated devaluation, through its modification of the financial exchange rate, affects the inefficiency illusion, reducing it proportionately to the change in that financial exchange rate. The export subsidy program has no effect whatsoever on the inefficiency illusion.

(2) the national commitments regarding export subsidies: Under GATT rules, an explicit subsidy may well be illegal whereas a compensated devaluation falls outside GATT rules and into the IMF rules under which it is perfectly acceptable; indeed it is regarded as liberalization and therefore "good". This difference is less definitive than it might seem, however, since tax refunds have repeatedly been accepted by the GATT and it is very hard to distinguish in practice between the tax refund and an explicit export subsidy.

(3) the apparent distribution of the tax burden: Under compensated devaluation, traditional exporters seem to be paying a substantial export tax. As a result, charges of discriminating against the goose that produces the golden foreign exchange may well be levied. On the other hand, the explicit export subsidy policy may well appear a give-away program to industrialists and the charge will be levied that the high income groups are milking the tax system.

Marketing Channels

Marketing channels are equally as necessary a condition as price competitiveness for industry to become rapidly foreign exchange generating.

It is useful in this context to divide potential export commodities into two kinds: (a) standardized commodities; and, (b) differentiated commodities. Into the first group fall items such as steel and chemicals which are sold on a specification basis and which have highly competitive international markets. In these, the marketing problem is no different from the price competitiveness problem. Any preexisting import house can become an export house and sell standardized commodities on the world market by simply having an attractive quotation. Price is everything and quality is easily determined with standard rebates existing for quality differences. In the case of standardized commodities, therefore, the existence of price competitiveness alone will very soon generate the necessary marketing channels.

The marketing problem for nonstandardized commodities is much more complex since it is in these in which brands, user preferences and product quality are important elements. For the marketing of this type of product, the multinational enterprise offers a unique potential since it controls internally a very substantial market and is able to monitor quality and guaranteed performance worldwide. Governments interested in stimulating the establishment of marketing channels, therefore, are well advised to look into the possible conversion of the production facilities of multinational enterprises within their jurisdictions from foreign exchange users to foreign exchange producers.^{1/}

^{1/} Mexico and more recently Brazil have successfully used this technique.

VII

Generating Industrial Employment

The industrial sectors of Latin America will only become significant contributors to the solution of the Latin American unemployment problem if the rate of capacity utilization is increased substantially. If such an increase occurs, a doubling of industrial employment should be achievable at a minimum.

Increased capacity utilization concurrently with a high rate of growth requires a substantial expansion of the market for Latin American industrial products. On the other hand, an increased capacity utilization and a higher level of industrial output also requires a greater availability of foreign exchange to pay for the imported inputs. A convenient way of solving both these problems simultaneously consists of routing a part of the additional output onto the foreign market and in the process earn the foreign exchange necessary to acquire the imported inputs.

In policy terms, the generation of industrial exports in order to utilize capacity is no different from the generation of industrial exports for any other purpose. Therefore, the policies outlined in Section VI are directly applicable.

In addition to making a market available, it is necessary to go at least some part of the way towards correcting the distortions which exist in factor prices. The main element in this instance may be the high cost of labor which exceeds the shadow wage by a considerable extent. This is an item which is very difficult to affect by policy

precisely because of its magnitude, i.e. the theoretically desirable wage subsidies are simply not fiscally feasible. It is therefore necessary to look to the other cost distorting elements for an improvement.

The cost of capital goods can be affected rather easily through an increase in the import tariff on these items. Such a policy change would bring the ratio of the prices of capital goods and labor closer to the ratio of their shadow prices and thus is likely to lead private decisions on the scaling and utilization of plant to conform more closely to the socially optimal level. Furthermore, rules governing depreciation should be amended in order to allow depreciation for the use of capital equipment to vary as a function of utilization. In this way, the progressive taxation by level of utilization existing at present would be eliminated and the incentive to single shift in multiple plants reduced accordingly.

Finally, special lending programs in which funds would be made available as working capital for the utilization of plant and equipment rather than for its installation would provide a substantial anti-distorting measure in the capital market. Such an innovation of lending for capital use would, however, constitute an important departure from existing practice in which lending against the real security of the machine is extremely common and in which borrowers are expected to provide the major part of their working capital.

It should be noted that a full-fledged capacity utilization program requires recognizing the existence of some externalities in the multiple shifting decisions of different plants. These arise through the requirements of shift orders for social services such as trans-

portation, electricity, restaurants, etc. etc. As a result, a synchronized plan in which numerous plants convert to multiple shifting at the same time may well be socially more efficient and easier to accomplish than the piecemeal transition to multiple shifting of individual plants.

VIII

Contribution of Trade Policy to Latin American Economic Growth

In the foregoing it has been argued that the basic conundrum of Latin American economic growth arises out of the foreign exchange using nature of its industry. Unless the industrial sector becomes foreign exchange producing, it can no longer function as a leading sector and act as the engine of growth for the whole economy.

Similarly, the industrial sector has not provided the solution to the unemployment problem expected of it due in large measure to the low level of capacity utilization which is prevalent in Latin America.

The foreign exchange using nature of industry is largely the result of policy. The exchange rate system is structured in such a way as to implicitly tax industrial exports while creating at the same time an industrial inefficiency illusion.

The low level of capacity utilization is policy induced as well. Government policy has generated distortions by creating deviations between the market price and the corresponding shadow price of production for export, and by legislating higher effective corporate rates on profits from the second and third shifts of operation. At the same time, Government has tolerated discrimination of lending in favor of fixed investment and against working capital.

The basic policy conundrum drastically limits the possibility of success in obtaining the major policy targets of increased growth, increased employment, greater price stability and more equitable distribution. Whereas conventional devaluation is inappropriate to deal with the conundrum, either a compensated devaluation or export subsidies are likely to be effective. These policies will at the same time make it possible to place the output from additional capacity utilization in industry and earn foreign exchange needed to pay for the imported inputs required to sustain such higher levels of utilization. Full capacity utilization requires additional policies as well, however, centering mainly on an increase in the price of capital goods imports, the lending for capacity utilization, and the equal taxation of profits from different shifts of operation.

International trade policy thus can be said to lie at the heart of the development prospects for the region. One must now look to policy makers to increasingly recognize the conundrum as well as the quasi-Keynesian situation in the labor market. Once adequately recognized and diagnosed, the appropriate policies can follow.

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