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DEVELOPMENT STRATEGIES AND POLICIES IN LATIN AMERICA

A Historical Perspective

Vittorio Corbo

INTERNATIONAL CENTER FOR ECONOMIC GROWTH

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PREFACE

The International Center for Economic Growth is pleased to publish this paper by Vittorio Corbo as the twenty-second in its series of Occasional Papers, which present the reflections of noted scholars and policy makers on issues of economic development and growth.

In this paper Dr. Corbo surveys the twentieth-century history of development policies in Latin America, with a particular focus on questions of macroeconomic and trade policy. He discusses how, after the Great Depression, most Latin American countries turned away from classical theories of international trade, instead adopting policies of import substitution. Dr. Corbo then examines the difficult and halting process whereby most of the area's governments, faced with economic stagnation, made a major policy shift toward export-led growth and fiscal restraint in the 1980s. This new program is still continuing, with positive results for those countries that have more fully implemented its policies, including Chile, Mexico, and Bolivia.

Dr. Corbo has built a distinguished academic career in Chile, Canada, and the United States, and also served for several years as an executive of the World Bank. We are confident his work will prove invaluable to students of development policy around the world.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

Panama City, Panama
April 1992

ABOUT THE AUTHOR

Vittorio Corbo is a specialist in open economy macroeconomics, trade, and development. He received his undergraduate education at the University of Chile, and earned a Ph.D. in economics from the Massachusetts Institute of Technology. He began teaching at Concordia University in Montreal in 1972, and served as director of Concordia's Institute of Applied Economic Research (1976–1979), and as professor of economics (1979–1982); in 1979 he was also appointed visiting professor of economics at the University of Chile. In 1981 he became a professor of economics at the Institute of Economics at the Pontifical Catholic University of Chile in Santiago, a position he still holds. While on leave from the university (1984–1991), Professor Corbo served as an executive at the World Bank, originally as acting division chief of the Macroeconomics Division, and later as division chief of the Country Operations and the Macroeconomic Adjustment and Growth divisions. He also was named visiting professional lecturer at Georgetown University in Washington, D.C.

Professor Corbo has published two books, collaborated in the editing of five others, and written over eighty papers in professional journals, as well as many monographs and major research reports.

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VITTORIO CORBO

Development Strategies and Policies in Latin America

A Historical Perspective

In this paper I review development strategies and policies in Latin America from a historical perspective.

The first section reviews development strategies in the period up to World War II. Economic policies in most Latin American countries were guided by the classical theory of international trade until the Great Depression, when the region's countries responded to the economic upheaval by pursuing a strategy of import substitution. Growth was now to be led by import-substitution industrialization.

By the end of World War II, most countries in Latin America had accumulated substantial foreign reserves, and it seemed certain there would be a resurgence in world trade. The logical next step was to reduce the antiexport bias resulting from the trade policies that had been implemented in the previous fifteen years in response to the crisis of the 1930s. Instead, as described in the second section, Latin America pursued, even intensified, the import-substitution strategy, influenced in large part by the recommendations of the Economic Commission for Latin America (ECLA). This strategy of import-substitution industrialization is called here Structuralism I. When the increasing cost of this approach, especially for the medium-sized and small countries of the region, could no longer be ignored, and the times seemed to call for a lessening of import substitution, most countries simply switched to another version of the same strategy—regional integration—ideally to be complemented by foreign aid. This second phase of import-substitution industrialization, called here Structuralism II, is reviewed in the third section. The first attempts at reducing the antiexport bias of economic policies in the 1960s are reviewed in the fourth section.

The fifth section focuses on the eventual response of the Southern Cone countries to the continued economic difficulties that dogged their import-substitution strategies. Their positive experience with some of their liberalization reforms was unfortunately overcome by an ill-fated stabilization program and, in Chile and Uruguay, by the severe external shocks of the 1970s.[1] The sixth section reviews the major policy shift of the 1980s. The final section presents the main conclusions.

The Period before World War II

In the period before the Great Depression, economic policies in most countries in Latin America were shaped by classical trade theory, and those countries were still open to international trade. Although some countries raised their average tariff levels in the 1920s, they did so moderately and mainly for fiscal reasons. Furthermore, most of them returned to the gold standard after World War I, and their macroeconomic adjustment was thus closely related to balance-of-payments adjustments (Furtado 1976).

Critics of the prevailing free-trade orthodoxy pointed to signs of growing protectionism in the most advanced countries (the United States and the European nations), but they did not have much influence on policy. At the country level, Argentina continued with export-led growth based on extensive agriculture that in part involved bringing new land into production (Díaz-Alejandro 1970; O'Connell 1986). At the same time in Argentina, discussion on the convenience of pursuing protectionist policies had already gotten under way in the second half of the 1920s, as access to export markets became more restricted.

Chile benefited during World War I from favorable external markets, whereas its import channels were interrupted. Its export levels remained constant, but imports fell to almost half. As a result of this temporary natural protection, there was a substantial expansion in manufacturing output (Muñoz 1968; Palma 1984). At the end of the 1910s, the price of nitrate, Chile's main export product at the time, collapsed; it temporarily recovered in the second half of the 1920s. The final collapse of the nitrates industry was a result of the Great Depression and the development of cheaper fertilizers.

Nevertheless, Chile raised its tariffs during this period, first in 1916 and again in 1928. The 1928 revision further gave the president the right to increase tariffs on individual products up to 35 percent, a power that would be used extensively during the late 1930s (Ellsworth 1945). Chile also borrowed heavily in the second half of the 1920s to finance some ambitious public investment projects. As a consequence of the large increase in expenditures, it had to contend with important real appreciation of the currency in the 1925–1929 period, with negative effects on the profitability of tradable activities.

Brazil's economic evolution was still tied to the coffee cycle. Nevertheless, some import-substitution measures had been taken during the previous fifty years, and intensified during World War I. By 1920, import substitution was important in the consumer goods sector, especially with respect to textiles. In the middle of the 1920s, however, when the real exchange rate appreciated as a result of an expenditure boom resulting from good coffee prices, the import-competing sectors lost some of their dynamism (Furtado 1963).

Mexico was a special case; it was in the process of restructuring following ten years of revolution that had started in 1911. Its most dynamic sectors were mining and agriculture. The Mexican economy followed closely the economic cycles of the United States, its main market. Mexico also differed from the rest of Latin America in discouraging direct foreign investment except where it involved new manufacturing technology. Only a little industrialization took place in this period in light industry, and it was more the result of high income growth in agriculture and mining and of internal integration than one of increased protection (Díaz-Alejandro 1982; Cárdenas 1984).

Colombia came to export-led growth later. After a long period of stagnation following the civil war at the end of the nineteenth century, the country experienced an important expansion of exports in the first quarter of this century. This export boom was associated with the introduction of coffee into the economy and good performance of minerals and banana exports. For the period 1925–1928, important public works—financed by heavy external borrowing and good export performance—resulted in substantial growth. During this period, protection was moderate and imposed with some selectivity; tariffs were used mainly for fiscal purposes. Manufacturing output had already expanded at the beginning of this century, partly as a result of the natural protection provided by the interruption of import channels during World War I (Ocampo 1984).

The picture that one gets from the above review is that the economic policies of most Latin American countries in the period 1914–1929 were very much guided by the classical theory of international trade. At this time, economic ideas were to be found in political writings or general essays on Latin America (Hirschman 1961). Some import substitution did develop, however—both naturally, as part of the normal development process following income growth, and artificially, when the flow of imports was interrupted during World War I. Nevertheless, in general, trade policies were fairly neutral between incentives for the local and foreign markets. International trade faced few restrictions; these were mainly in the form of low tariffs and export taxes on primary products. At that time, tax revenues came primarily from the foreign trade sector, and government expenditures were oriented toward the development of physical infrastructure. Macroeconomic policies were mostly governed by the rules of the gold standard, and prices were relatively stable. Capital inflows became important in the second half of the 1920s but fell substantially in 1929. Until that time, balance-of-payments crises were the exception.

The Great Depression sent many unfavorable shocks through Latin America's economies. First, as international commodity markets collapsed, export prices fell more than import prices, and the terms of trade in individual countries dropped between 21 percent and 45 percent (CEPAL 1976). Second, the capital inflows that had been important up to 1928 had almost disappeared by 1929. Third, the collapse in export prices increased the real burden of external debt substantially.

A fourth factor was rising protectionism in the key industrialized countries, which made the prospects for world trade very discouraging. Protectionist pressures in this period resulted in the Smoot-Hawley tariff of 1930 in the United States, the British Abnormal Importation Act of 1931, and the Ottawa Commonwealth Preferences of 1932.

The Latin American economies were forced to adjust as a result of these large external shocks and the lack of foreign financing.[2] In modern terminology, there were, in principle, three adjustment policies or policy combinations available to them. The first, a gold standard policy, involved engineering a monetary contraction and, through domestic deflation, reducing imports and increasing exports. The second was to alter the exchange rate so as to accelerate the switching of expenditures, without waiting for domestic deflation. The third was to encourage selective switching through import restrictions, combined with exchange controls and expansionary demand policies. The dark prospects for foreign trade had an important effect on the way these adjustment options were viewed.

The first course was judged politically infeasible for countries with a high proportion of their population in the urban sector and well-organized labor unions. Downward rigidities on domestic prices would have resulted in a sharp recession. Therefore, this option was not followed.

Given the pessimistic view of future world trade, the second option was also disregarded. During and following the depression, most industrialized countries were closing their doors to international trade, a situation that significantly reduced the market for Latin American exports. Furthermore, because most of the goods imported by developing nations did not have close domestic substitutes, their short-term import price elasticities were very low. Within this framework, a real devaluation was not favored as the main instrument for restoring an external balance.

Thus, most Latin American countries ended up following the third option—a mix of discriminatory switching and aggregate demand policies. To implement it, they abandoned the gold standard, imposed exchange controls and discriminatory trade restrictions (such as quotas, tariffs, and multiple exchange rate systems) on imports of consumer goods, and adopted countercyclical fiscal and monetary policies.[3] This set of policies has been called the model of domestically oriented growth. Import-competing manufacturing activities were given an advantage not only through protective trade policies but also through tax and credit incentives. Specifically, the dynamic growth element, instead of being the export sector as it was up to the eve of the Great Depression, was private and public investment in import-competing industries.

It should be noted that, although most Latin American countries ended up pursuing the third option, they did so not as a conscious policy choice, but as the end result of their implementation of ad hoc policy measures designed to accelerate adjustment to the severe external shocks they were facing. Indeed, those countries that broke away from the gold standard while they followed active public expenditure policies—in particular Argentina, Brazil, Chile, Colombia, and Mexico—still pursued a fiscal policy aimed at achieving a balanced budget. This approach did not keep them, however, from running small deficits. Even in Brazil, with a coffee price support system dating from 1906 that resulted in a large increase in expenditures, the fiscal implications of these measures were only moderately expansionary (Furtado 1963; Fishlow 1972; Silber 1977; Cardoso 1979). In Argentina, Raúl Prebisch, then the director of research at the Central Bank, was recommending fiscal discipline to avoid an outburst of inflation. With respect to the appropriateness of the use of orthodox fiscal policies, Prebisch (1986, 134) has stated:

> I do not think it was mistaken, given the need to stop inflation and check the fiscal deficit before they become uncontrollable. What did this orthodox economic policy, for which I was totally responsible, consist of? In the first place, it took the form of a considerable fall in public expenditure including a 10 percent cut in public sector wages; these were brutal measures that allowed for a drastic reduction. In the second place, it meant an increase in taxation; in this area we decided to seek new paths by introducing an income tax.

In Colombia, the Lopez government introduced a major stabilization program in 1934, and a fiscal surplus was achieved in 1935.

Thus, in most Latin American countries in the pre–World War II period, a balanced budget was still the stated policy, and departures from this objective were the exception rather than the rule. In Argentina, however, monetary policy was more active. As shown in Table 1, growth in the real money supply in Brazil, Chile, and Colombia was higher than in the United States, in spite of a sharp drop in international reserves. Thus, in those countries an expansion of domestic credit more than compensated for the drop in reserves.

On the relative price side, three main factors were at work: (1) the world depression, with the resultant collapse in the prices of primary commodities; (2) widespread exchange controls and devaluations following the devaluation of the pound in September 1931; and (3) the multiple exchange rate system and an increase in the levels

TABLE 1 Real Money Supplies, 1928–1939 (1931 = 100)

	Argentina	Brazil	Colombia	Chile	United States
1928	99.6	76.4	111.9	n.a.	105.9
1929	97.4	78.5	91.2	n.a.	104.4
1930	96.5	85.6	91.3	n.a.	104.4
1931	100.0	100.0	100.0	100.0	100.0
1932	110.5	106.1	143.2	126.2	100.6
1933	96.6	104.1	172.6	120.9	93.6
1934	109.8	113.3	147.7	139.0	99.7
1935	103.2	118.6	145.3	154.4	116.2
1936	104.5	128.2	164.9	164.2	124.9
1937	108.1	122.5	166.9	154.7	120.7
1938	106.7	147.3	164.1	159.7	127.7
1939	108.3	151.2	162.2	172.8	142.2

SOURCES: The data for the nominal money supplies and the price indexes, except for Chile, are taken from Díaz-Alejandro 1983, Tables 1.9 and 1.6, respectively. The Chilean price-level data come from Ellsworth 1945, p. 165, Table V (which refers to the cost of living index in Santiago). The data for nominal money stock in Chile refer to the end-of-year stock figures given in Deaver 1970, p. 60, Table 11.

and dispersion of nominal tariffs, with effective rates of protection many times the nominal rates and increasingly a function of the stage of fabrication. Grouping output into three categories—importables, exportables, and nontradables—the prices of importables and nontradables increased relative to those of exportables. Among importables, the sharpest increases were for consumer durables.

Real exchange rates, exclusive of the tariff and nontariff effects for importables compared to nontradables, are presented in Table 2. It can be seen that large real devaluations took place in most of the

TABLE 2 Real Exchange Rates, 1929–1939

	Argentina	Brazil	Colombia	Chile
1929	1.00	1.00	1.00	1.00
1930	1.09	1.19	1.22	0.97
1931	1.41	1.84	1.34	0.89
1932	1.61	1.61	1.46	3.00
1933	1.15	1.45	1.65	2.35
1934	1.50	1.68	1.68	1.84
1935	1.41	1.87	1.71	1.74
1936	1.32	1.89	1.64	1.79
1937	1.23	1.63	1.65	1.59
1938	1.30	1.73	1.48	1.49
1939	1.43	1.83	1.37	1.45

NOTE: The real exchange rates are calculated in 1931 constant prices and converted into indexes with 1929 = 1.00 as follows:

$$\text{Real exchange rate} = \frac{\text{Nominal exchange rate} \times \text{U.S. price index}}{\text{Price index of each country}}$$

SOURCE: The data for the nominal exchange rates and the price indexes, except for Chile, are taken from Díaz-Alejandro 1983, Tables 1.5 and 1.6, respectively. The Chilean price-level data come from Ellsworth 1945, p. 165, Table V (which refers to the cost of living index in Santiago). The data for the Chilean nominal exchange rates are from de la Cuadra and Cortes 1984.

large countries during the 1930s. If the effects of the tariffs and other constraints on trade—such as multiple exchange rates and import quotas—are added to these rates, the increased incentives for import substitution are even sharper. Indeed, the evidence shows that protection became redundant in Chile (Ellsworth 1945), Argentina (Díaz-Alejandro 1970), and Brazil (Reynolds 1985). The nontradable sector expanded not only as a response to improvement in its relative price but also because government services and public investment in infrastructure (an important nontradable) grew. Not surprisingly, there was substantial government intervention in the 1930s, not only in economic management but also in important infrastructural projects.

With respect to overall economic performance, Latin America did quite well in 1931–1940 period in comparison with the most advanced countries. The average annual rate of growth in gross domestic product (GDP) for the decade was 4.8 percent in Chile, 4.2 percent in Colombia, 3.6 percent in Brazil, 2.5 percent in Argentina, and 2.4 percent in Mexico, with the countries that followed the more expansionary monetary and fiscal policies growing at the highest rates (Corbo 1988). In the same period, the average annual rate of growth was 2.7 percent in the United States, −1.2 percent in France, 3.4 percent in Great Britain, and 4.1 percent in Japan (Maddison 1982). In all Latin American countries for which we have comparable information, manufacturing was the leading sector, followed by construction, services, and finally the primary sector. Initially, the discrimination against exportable activities, mostly agriculture and mining, did not create large efficiency-loss costs. This was because the expanding area of activity was labor-intensive light manufacturing, where the cost disadvantage with respect to imported goods was not significant. Besides, most of the export markets were highly protected or in major recession.

The creation of a domestic industry geared to the production of previously imported nondurable consumer goods and some raw material inputs obviously decreased imports of these goods. At the same time, however, imports of other raw materials and of the capital goods required for those same industries increased. To relieve the pressure on the external accounts, "nonessential" imports were restricted, a move that accelerated the process of import substitution and its costs. Finally, World War II created both a boom in the prices of mineral exports and a natural suspension in the flow of imports from industrial countries. These conditions also stimulated demand in the import-competing sector.

Latin America, 1945–1960: Structuralism I

As the postwar period opened, most Latin American nations found themselves with substantial foreign reserves in their central banks (although there were convertibility problems with the pound sterling). Despite conflicting signals about the future evolution of world trade, the Marshall Plan and the creation of international institutions geared to avoid the trade wars of the previous twenty years provided positive indications of an expansion in world trade. It seemed that the stage was set for a reduction in the high level of protection of import-competing industries and in the discrimination against exportables that had evolved over the previous fifteen years.

An important initial condition had been built up during the previous decade, however. New industrialist and labor groups in the emerging manufacturing sectors strongly lobbied for the enactment of tariff protection to replace temporary natural protection; differentiated tariffs and multiple exchange rates were important elements in the arsenal of import-substitution policies deployed in the 1945–1960 period. As is a common pattern in the early stages of import substitution, manufacturing output initially achieved substantial growth; but it started to decline when the easy import-substitution phase was completed. One common result of these policies was slow growth in total exports and in manufacturing exports in particular: exports practically stagnated between the early postwar years and the beginning of the 1960s. This was especially the case for the Southern Cone countries (Argentina, Chile, and Uruguay), where protection was higher, and to a lesser degree for Brazil and Colombia.

Some exceptions to these policies were observed during this period. Thus, by the early 1950s, Mexico and Peru realigned their exchange rates and lifted import-repressing policies so as to increase incentives to foreign trade (Díaz-Alejandro 1983). Peru, the most important exception, continued an export-led growth process until 1960, when the ideas of the Economic Commission for Latin America (ECLA) began to be influential (Nogués 1985).

At this time, however, a debate emerged over what long-term development strategy Latin America should follow. Initially, the debate was at the country level. On the one side were the producers of exportables (agriculture and mining) and the traders of imported goods, who argued for reducing the bias of the trade regime against them. They were supported at the time by the mainstream economists of the region, who also favored a more balanced trade regime. On the other side were the leaders of the manufacturing associations, the new industrialists and organized labor in the new manufacturing industries, all of whom advocated keeping and even intensifying the protectionism. Clear manifestations of this debate appeared in Argentina, Brazil, Chile, and Colombia.

ECLA was set up in the United Nations in 1948 (initially as a temporary body), and it soon entered the debate. Consisting of a group of economists under the leadership of Prebisch, ECLA proposed a development strategy for Latin America that differed from the early recommendations of most economists that trade be liberalized. ECLA's was the first school of thought about regional economic development to emerge in Latin America (Hirschman 1961). A 1950 article by Prebisch that summarized the thinking of this group proved very influential with a large number of Latin American economists, including Furtado in Brazil, Noyola in Mexico, and Ahumada and Sunkel in Chile (all of whom became part of the staff of ECLA when it became permanent in early 1951). Prebisch (1950) presented what is called today the structural critique of the export-led growth model of the pre-1930 period. A central argument in Prebisch's thesis was that the main determinant of the rate of growth of per capita GDP was technical progress, a thesis few economists questioned.

Prebisch also asserted that the international terms of trade of primary exports from peripheral countries had a secular tendency to deteriorate with respect to the terms of trade of their imported manufactured goods. He therefore concluded that countries needed to industrialize if they were to keep the fruits of technical progress. A second component of Prebisch's thesis was that import-substitution manufacturing produced dynamic externalities.

Lipsey (1963), Kravis and Lipsey (1981), and Michaely (1985) have since concluded that there is no evidence of secular deterioration in the terms of trade. As to the dynamic externalities of import-competing manufacturing, the evidence shows that export-oriented manufacturing and agriculture can create as many dynamic externalities as can import-competing manufacturing (Little, Scitovsky, and Scott 1970; Krueger 1978).

Prebisch recommended that the state should promote industrialization through protection and investment in the infrastructure to support import-competing manufacturing. Prebisch's ideas had the most impact in Chile, the country that had called for the creation of ECLA and that became its home. ECLA economists taught at the then prestigious Universidad de Chile and gave lectures all across Latin America. They were also influential in Brazil, where Prebisch was invited to lecture by local manufacturing interest groups in the late 1940s. In Argentina, in contrast, the Perón government was quite hostile to Prebisch from the beginning (Prebisch 1986; Díaz-Alejandro 1983; Furtado 1985), and thus ECLA's ideas were not easily disseminated. At the same time, it should be noted that under Perón's first administration, from 1945 to 1954, import-substitution industrialization with a heavy bias against agriculture was pushed further than anywhere else. This was a result of price controls and export taxes imposed to help urban workers, Perón's main source of political support. One could safely say that import substitution resulted from side effects of the control and expansionary policies rather than from a deliberate development strategy.[4] Here we see in action Prebisch's "dynamic externality" argument for industrialization.

Receptivity to policies of import-substitution industrialization and state intervention through production and regulation was intimately linked to political developments in the region. Popular movements and populist governments came to power in Chile, Brazil, and Argentina in the late 1930s and the 1940s. Political developments in these countries had a common theme: removing power from conservative agrarian oligarchies and vesting it increasingly in mass movements of urban workers. These latter groups made important alliances with the new industrialists against export-oriented landowners and foreign-owned mining companies. As a part of this scenario, programs of import-substitution industrialization and state intervention built up strong institutional and political support.

By the early 1940s, Keynesian demand-management policies were becoming fashionable in Latin American academic circles and in ECLA, and they soon started to influence government policies (Prebisch 1947; Pinto 1960). At a time when it was increasingly difficult to keep balanced budgets, demand management intended to stabilize output provided analytical respectability for expansionary demand policies, starting in the late 1940s.

The expansionary demand policies and rapid use of the foreign reserves accumulated during World War II combined with increasingly restrictive trade regimes to produce accelerated inflation, balance-of-payments difficulties, and slow export growth in the early 1950s. By that time, ECLA was developing another argument for import-substitution industrialization. It was based on a foreign trade gap that could be reduced only by decreasing import requirements through further import substitution.[5] Prebisch (1959a) postulated that the relation between the rate of growth of imports and the rate of growth of output (a total income elasticity concept) was a substantially higher ratio than that of the rate of growth of exports to the rate of growth output. Therefore, without further access to external financing, the only way to increase output growth without a balance-of-payments crisis was to reduce the income elasticity of imports through further import-substitution industrialization. It was not considered that, given the industrialization of the previous thirty years, manufacturing exports—not to mention primary exports—could respond to price incentives.

These policies not only failed to halt steady import growth; they also led to stagnation of exports, periodic balance-of-payments crises, and other undesirable effects (Little, Scitovsky, and Scott 1970; Balassa and associates 1971; Bhagwati 1978; Krueger 1978).

First, an inefficient, ever-growing bureaucracy emerged to enforce the often contradictory regulations enacted to support an overvalued currency.

Second, although the creation of a domestic industrial sector geared to the production of previously imported consumption goods led to a decline in imports of these goods, it simultaneously raised imports of the raw materials and capital goods required to produce consumption goods, resulting in a greater dependence on importing. The availability of raw materials and capital goods became fundamental to the smooth functioning of the economy: if the supplies of foreign inputs were interrupted, not only would consumption levels fall as before, but unemployment and underutilization of the industrial capacity would result as well.

Third, there was a lack of competition within the industrial sector. The small size of the market precluded the existence of many efficient firms, and the few firms that were present did not compete among themselves. This was a more acute problem in the smaller countries of the region, Chile and Uruguay.

Fourth, resources were socially misallocated, as indicated by the substantial dispersion in the computed domestic resource cost of the different import-competing industries (Taylor and Bacha 1973; Berlinski and Schydlowsky 1982; Bergman 1970). This outcome was attributable mainly to the protectionist policies that closed the door on external competition, and to the whole range of government intervention built up to promote industrialization.

Finally, in many cases, subsidized imports of capital goods led to factor price distortions that penalized employment (mainly because they attracted the lowest rate in a multiple exchange rate system).[6]

The proponents of the import-substitution model probably did not clearly envisage the protective regimes that finally emerged. Indeed, their recommendations were designed to achieve a degree of industrialization as a precondition for future growth based on manufacturing exports. Over time, however, since the typically small and scattered industrial sector could not compete internationally, it sought and got higher protection. Political economy and rent-seeking considerations sustained these policies. In this connection, it is illuminating to make a comparison with the South Korean model, where the government also intervened to promote industrialization. In Korea, however, although import restrictions (tariffs and nontariff barriers) were used as major protective devices, the government simultaneously provided important export incentives to compensate for the bias of the import regime. Therefore, the trade regime resulted in a bias against nontradables rather than against exportables. Indeed, one of the most careful studies of the system of incentives in South Korea has concluded that it was equally attractive for a Korean producer to produce for sheltered local markets and for world markets (Westphal 1978). This was hardly the case in Latin America. Even in Brazil, despite the export promotion strategy of the 1960s, there was still an important antiexport bias in the trade regime (Carvalho and Haddad 1981).

The Crisis of Import-substitution Industrialization: Structuralism II

In the late 1950s and early 1960s, as a result of expansionary macroeconomic policies and a pronounced antiexport bias in trade policies, an important group of Latin American countries—Argentina, Chile, Colombia, Uruguay, Bolivia, and Brazil—were facing recurrent balance-of-payments crises and periodic outbursts of inflation. As a consequence, some of these countries entered into International Monetary Fund (IMF) agreements to obtain temporary financing while putting a stabilization program in place. Most of the time, the IMF-type recommendations called for control of aggregate expenditures and exchange-rate adjustment and unification; not surprisingly, these recommendations were in direct conflict with the policies being followed.

A structuralist view of inflation was developed in response to the stabilization prescriptions of the IMF (Baer 1967; Noyola 1965; Pinto 1960; Seers 1962; Sunkel 1958). (For an evaluation of the monetarist and structuralist views of inflation, see Corbo 1974, Chapter 5.) This new view proved very influential in delaying the implementation of the policies required to reduce inflation. The structuralist focus on supply response diverted attention from important ways of cutting inflation, such as achieving a permanent reduction in the public-sector deficit and eliminating the monetization of government deficits (Harberger 1964).

The main constraint on growth, however, was viewed as the scarcity of foreign exchange by the structuralists. Their view was that to deal with the foreign-exchange constraint, Latin American countries needed to plan their economic integration. Since planning was new to most Latin American governments, the need arose to develop an institutional capacity for the preparation of plans. A new United Nations institute, ILPES (Instituto Latino-Americano de Planificación Economica y Social) was created in the early 1960s to assist Latin American countries in the preparation of their development plans. The first director of ILPES was Raúl Prebisch—an indication of the importance attached to planning in the early 1960s. Development banks were to play a central role in the implementation of the planning effort by providing financing for the development and expansion of public enterprises.

The programming exercises taken with the help of ILPES in many countries in Latin America followed quite closely the guidelines already laid down in CEPAL 1955. They consisted of simple, static input-output models. The strongest incentive for the preparation of plans came about with the establishment of the Alliance for Progress in 1961; it required that countries prepare a plan as a precondition for aid.

By this time ECLA was becoming increasingly concerned with the inefficiencies arising from import substitution at the country level. It therefore recommended that Latin American countries move on to a second stage of import substitution (Hirschman 1961, 18–19). Prebisch (1959a, 1959b) concluded that further import substitution would have to take place at a regional level.

Thus, in the 1960s, ECLA started to promote regional economic integration. Prebisch 1959 wrote:

> Trade between Latin American countries forms only 10 percent of their total foreign trade, and industrial exports are relatively very small by contrast with countries such as Italy, Japan, and others with similar income level. All this has resulted in the splitting of the industrialization process into as many watertight compartments as there are countries, without the advantages of specialization and the economies of scale (1959a, 267-8).

This result was only to be expected, given a strategy that encouraged import-substituting industrialization and discriminated against actual and potential export activities, many of the latter in labor-intensive manufacturing. Prebisch, however, did not conclude that the system of protection should be rationalized to reduce its antiexport bias, as Korea and Europe did in the 1960s; instead he recommended that

> The response to this should be the enlargement of national markets through the gradual establishment of a common market. . . . Without the common market, there will be a continued tendency by each country to try to produce everything—say, from automobiles to machinery—under the sheltering wing of very high protection. (1959a, 268)

With the intellectual leadership of ECLA and the support of the United States, the Latin American Free Trade Association (LAFTA) was created in 1961. Reduction of the trade barriers within the region was, however, to be negotiated commodity by commodity, and the industrialists in the highly protected manufacturing sectors were to play a central role as members of the national negotiating teams. These industrialists had vested interests in protecting the benefits they had obtained from import-substitution policies in their countries. Those benefits were being put in jeopardy by the regional integration. Not surprisingly, it proved difficult to reach agreement on tariff reductions, except in regard to a small number of commodities whose production within the region was minimal.

Parallel with this development, Professor Hollis Chenery and his associates in the United States were formalizing the ECLA-type foreign-exchange constraint on growth, first in a Harrod-Domar framework (Chenery and Bruno 1962; Chenery and Strout 1966) and later in a more neoclassical framework that allowed for substitution in production (Chenery and Raduchel 1971). In Chenery's type of framework, growth is limited *ex ante* by the larger of two gaps, one being the difference between investment and saving, the second being the trade gap—the difference between imports and exports of goods and services (including financial services). These models were mostly used to articulate the potential contribution of foreign aid to growth in a foreign-exchange-constraint (trade-gap-binding) economy.

The latter solution was given a boost by the Alliance for Progress and by the creation of the Inter-American Development Bank. It soon became apparent, however, that the foreign aid being provided would not be sufficient to finance a resumption of growth. As a result, regional economic integration became the central strategy.

Findlay (1971) pointed out that the binding gap (usually the foreign-exchange one) must result from imperfections in the relevant markets or from the nature of the assumptions built into the model. In particular, he questioned the assumption that trade flows do not respond to the relative price of tradable goods in terms of nontradable goods. More important, the shadow prices of foreign resources implied by two-gap models are absurdly high.

In 1969, with the LAFTA initiative going nowhere, a subset of middle-sized LAFTA members formally approved the Andean Common Market Pact, an initiative that had first been launched in August 1966. In designing its rules of operations, members of the Andean Pact took into account many of the lessons learned from the LAFTA initiative. Tariffs and nontariff barriers were to be fully eliminated among member countries by the end of 1980; Chile and Colombia had advocated an even faster decline (Díaz-Alejandro 1975). Instead of proceeding commodity by commodity, tariffs were to be reduced each year by 10 percent of the minimum ad valorem tariff then existing in Colombia, Chile, and Peru, which in no case was to exceed 100 percent. Thus, reduction of the tariffs was going to be automatic. The less developed members (Ecuador and Bolivia) were, however, given more favorable terms.

Parallel with the general rule of automatic reductions, the Andean Pact called for the allocation of new manufacturing activities to individual countries to avoid duplication and to reap the benefits of economies of scale. The result would be import substitution at a regional level. The countries were also to negotiate a common external tariff.

If the alternative to regional integration was continued import substitution at a country level, the Andean market was a definite improvement, in that it allowed countries to carry out intraindustry specialization and to create trade. To increase the benefits of this integration, however, a mildly protective common external tariff had to be implemented. This goal was never achieved, a failure that undermined the allocation of specific branches of manufacturing. That process involved a tricky calculation of the costs and benefits for individual countries, and without agreement on a future common external tariff it was difficult (if not impossible) to allocate activities among member countries rationally. The main thrust of the sectoral agreements was to continue import substitution, but at a regional level. This shift by itself could have reduced the economic cost of import substitution, in comparison with the alternative option of developing these industries at a country level. Here again, however, unless the common external tariff were moderated, the welfare cost of this further import substitution could have been substantial.

The politics of import substitution at a regional level proved much more difficult than that within a country, and the Andean Pact lost its dynamism in the second half of the 1970s. The final blow came when Chile, which had played a central role in the creation of the pact, withdrew from it after failing to obtain agreement on its proposals for sharply reducing the common external tariff and for lifting the pact's restrictions on direct foreign investment.

In the meantime, new developments were taking place on the analytic front, especially in the area of applied commercial policy. The concept of effective protection, which had been in the process of development since at least the early 1950s, became widely known to professional economists through the seminal paper of Corden (1966). His work was particularly important in producing a framework for evaluating the effects of the tariff structures on value added, as well as the economic effects of different types of distortions. In addition, the difference between promotion and protection was made explicit. These developments in applied commercial policy were used to evaluate the trade regimes of developing countries. Interestingly enough, Macarios (1964), then the director of research at ECLA, had already used effective protection concepts to evaluate industrialization in Latin America critically.

The studies (an important set of them is summarized in Little, Scitovsky, and Scott 1970; Balassa and associates 1971; Bhagwati

1978; and Krueger 1978) highlighted the large economic costs associated with the import-substitution strategy and the strong anti-export bias that arose out of these policies. The costs were inversely related to the size of the economy and directly related to the intensity of import substitution. To make matters worse, according to work by Krueger et al. (1981) and Krueger (1983), in general the strategy of import substitution also hindered the growth of employment.

It is ironic that as early as 1950, Viner, in a series of lectures delivered in Rio de Janeiro, had rejected most of the arguments for protecting import-competing industry and had recommended eliminating the discrimination against exports and improving the operations of the price system (Viner 1953). (See Furtado 1985 for an evaluation of ECLA's reception of Viner's talk.) Nor was Viner's the only challenge in the region to ECLA's ideas. They were questioned both by some academics and by other economists in the public and private sectors.

One of the early critics was Roberto Campos in Brazil (1961), who questioned the favoring of industry over agriculture; the theory that by substituting public initiative for private initiative, new resources would be created; and the assumption that inflation could be used to increase capital formation in a sustainable way. In particular, Campos stated that economic incentives are one of the main factors accounting for the economic performance of Latin America. Nevertheless, it was ECLA's thoughts on the role of the state in providing protectionism that reigned supreme up to the early 1960s. With inflation a major problem in the region, rationalization of the protection system did not seem as pressing as stabilization.

Still, in the context of the stabilization programs, overvalued exchange rates were adjusted, and the multiple exchange rate system was eliminated or improved, as ways to reduce part of the antiexport bias. Public-sector deficits were not reduced, however, so the overvalued exchange rate returned fairly quickly, and the antiexport bias remained. There were a few more substantial departures from excessive import-substitution policy, stimulated in part by the exposure of a new generation of economists to alternative schools of economic thought. In the late 1950s, and especially in the 1960s, there was a substantial increase in the number of Latin Americans abroad pursuing graduate studies in economics, both in the United States and in Europe. On returning to their countries, most of these newly trained economists contributed to a marked improvement in the level of economic debate. In particular they called into question stabilization policies, trade policies, and the selection of public investment projects (Diz 1966; Universidad de Chile 1963; Ffrench-Davis 1971).

The first major break from import-substitution policies was initiated by Brazil in 1964, some fifteen years after Viner questioned these types of policies. This and subsequent policy initiatives in the direction of greater liberalization are discussed in the next section.

Liberalization Attempts of the 1960s

As noted, while the rest of Latin America was still struggling to deepen import substitution, Brazil undertook a set of reforms designed to improve the functioning of its markets and the profitability of its export activities. The measures included (1) a more realistic real exchange rate and elimination of most export taxes; (2) introduction of subsidized credit and tax incentives for export activities; (3) reduction of the public-sector deficit and control of inflation; (4) development of a capital market; and (5) downward adjustment of real wages.

After three years of adjustment without growth, Brazil's economic performance in this period was remarkable. Its GDP at constant prices grew at an average yearly rate of 11 percent between 1968 and 1973, and 7.7 percent between 1973 and 1977. The value of exports rose by 23.1 percent a year on average between 1968 and 1977. By way of comparison, South Korea's GDP grew at an average yearly rate of 10.2 percent between 1968 and 1973, and 10.3 percent between 1973 and 1977.

Colombia also moved in 1967 to reduce the bias against exports and to establish a more predictable and realistic real exchange rate policy. Export incentives were introduced to compensate for the antiexport bias of tariffs, and the average tariff level was reduced. The exchange rate was adjusted through the use of a crawling-peg formula. The value of Colombia's exports grew at an annual rate of 2.7 percent between 1961 and 1967, and 19.1 percent between 1968 and 1977.

The favorable export performance of the late 1960s and the 1970s allowed Colombia to avoid the periodical balance-of-payment crises of the previous fifteen years. Indeed, it has been argued that the macroeconomic gains from liberalization were more important than the static resource allocation gains (Díaz-Alejandro 1976).

Some reduction in the antiexport bias also took place in Mexico and Argentina. In Mexico a free-trade regime was established for offshore assembly plants on the border with the United States. Argentina, during the Onganía government (1966–1971), made progress in controlling inflation and in reducing the bias against manufacturing exports; the large bias against primary exports was not reduced, however.

In Chile the stabilization attempt of the Alessandri administration (1958–1964) had to be abandoned as the aggregate demand and exchange rate policy mix resulted in a real appreciation that could not be sustained. Chile attempted again to introduce some liberalization and stabilization measures during the Frei government (1964–1970). The Chicago-trained economists who were running the central bank at the time announced that inflation (then running at an annual rate of close to 40 percent) could not be reduced abruptly without substantial unemployment; and they devised a system to adjust the value of the nominal exchange rate in accordance with the evolution of domestic inflation, international inflation, and the terms of trade. The main contribution of this policy, subsequently adopted by many other governments, was to accomodate countries to 30 percent annual domestically created inflation, to avoid stop-go macroeconomic crises, and to reduce the uncertainty facing exporters. On the trade side, the antiexport bias of the tariff structure was reduced with the introduction of a drawback system and later on with a reduction in tariffs, when the copper boom had produced an accumulation of foreign reserves that was having unwanted monetary consequences. Attempts to make a more substantial cut in tariffs, however, faced strong opposition from an alliance of workers and entrepreneurs in the highly protected sectors. Again, rent seekers had their day and consumers and producers in actual and potential export sectors were the big losers.

Thus, a number of economic experiments were carried out in Latin America in the late 1960s and early 1970s. Meanwhile, however, countries in the subcontinent did not perform as well during the 1960s as other countries at a similar level of development. Their average annual growth during the decade was 5.0 percent in Latin America, whereas the world's upper-middle-income countries (a group that included most of the large nations in Latin America) grew at 6.4 percent. In the area of inflation, Latin America did even worse.

The early 1970s witnessed accelerated inflation in most of the regions as well as chronic balance-of-payments problems. At that time, a strong reaction against the extreme distortions that had been accumulating during the previous forty years emerged in the Southern Cone of Latin America. The attempt of the previous fifty years to follow an overall development model, based on import substitution and state interventions, was being called into question. Integration into the world economy and reduction in the role of the state as producer and regulator were two of the key reforms advocated. It was well understood, however, that stabilization had to come first. Some have called this liberalization effort a monetarist experiment; others have called it neoliberalism. As with most reform programs, it had a little of everything.

Latin American Policies of the 1970s

Following the first oil shock, the balance-of-payment crisis became more acute. At the same time a combination of low growth and periodic crisis resulted in the first serious questioning of the overall development strategy that had been followed in the previous forty years, in particular state intervention and import-substitution policies. Disenchantment with import-substitution policies and government intervention was deeper in those countries that were suffering from extreme macroeconomic problems, widespread microeconomic distortions, and dim prospects for sustainable growth. The countries where these sentiments were most pronounced were those in the Southern Cone of Latin America. When military governments took over in the 1970s, they implemented, to different degrees, important economic reforms that aimed not only at controlling inflation but also at changing the overall development model, with a reduction of the role of the state, an increasing use of markets, and a greater integration into the world economy. Along with the earlier policy recommendations of the ECLA school, they have had the strongest effect on the design of economic policies in Latin America. A group of Chicago-trained economists played a key role in the Chilean reforms and a somewhat smaller one in Argentina and Uruguay.

The reforms started around 1974 in Uruguay and Chile, and in 1976 in Argentina. At that time, all three countries were not only facing widespread distortions in resource allocation but also experiencing severe macroeconomic disequilibrium, with acute foreign-exchange shortages and severe fiscal deficit-induced inflation. Moreover, the state had an important role as producer, regulator, and distributive agent. Hence, the reform packages entailed short-term stabilization policies, as well as long-term policies aimed at progressively removing government intervention in product and factor markets (Corbo and de Melo 1987).

In Uruguay and particularly in Chile the severe external shocks of 1973–1974 created a response in the form of less regulation and a more open trade system. The first task facing the new economic teams in each country was the control of galloping inflation. The teams also diagnosed excessive government intervention as a fundamental cause of inefficient resource allocation and low growth. In their view, they had to deregulate the commodity and factor markets, including reducing the barriers to free trade and capital flows. They also had to replace a cascading tax system by one that would create fewer distortions in resource allocation. Such measures would contribute to a sustainable stabilization and would benefit resource allocation, eliminate recurrent bottlenecks, and lead to higher growth.

Chile went the furthest in its economic liberalization. Uruguay was in the middle, and Argentina moved the least.

Reform measures. In the first phase, the countries based their anti-inflationary policies on major reductions in fiscal deficits and monetary growth. (The fiscal deficits were substantial long before the collapse of the civilian governments.) The substantial chronic fiscal deficit of Chile was eliminated by drastic across-the-board expenditure cuts (15 percent in 1975), together with a later tax reform. In Uruguay, the fiscal deficit was reduced with the introduction of a value-added tax (VAT). After Uruguay reached a balanced budget in the period 1979–1981, however, its total deficit increased to 10 percent of output in 1982. In Argentina, the fiscal deficit was never really controlled. These "orthodox" measures were recognized to be contractionary, but it was thought that the potential benefits would easily outweigh the temporary costs of recession.

Expenditure-reducing policies by themselves were viewed as insufficient to correct the internal and external balance. Hence, stabilization policies in each country also included major attempts to switch expenditures. Switching policies were implemented concurrently with policies designed to change relative prices among importables and between importables and exportables. In Chile, switching, accompanied by a price adjustment of tradables, was achieved through a large real devaluation and a reduction of the barriers to imports. In Argentina, this same process was accomplished with a combination of real devaluation, reduction of taxes on exports, and some reduction of import barriers. In Uruguay, the switching included a combination of real devaluation, reduction of barriers to imports, and subsidies for nontraditional exports. To avoid a repetition of the external crises, the initial adjustments in each country were complemented by a passive, crawling-peg exchange rate regime aimed at maintaining purchasing-power parity, adjusted by changes in the terms of trade.

These initial policies successfully eliminated the balance-of-payments crises. However, although the rate of inflation came down considerably in each country, it remained disturbingly high several years after the contractionary policies had been implemented. This was so even in Chile, a country that had achieved a fiscal surplus in 1976 (Corbo 1990). The persistence of inflation motivated a major shift in stabilization tactics toward the use of the exchange rate as the main stabilization device. Expectations about devaluation were recognized as important in determining the dynamics of inflation, and it was assumed that exchange-rate targets—announced up to six months in advance, with forward devaluations at a decreasing rate—would break inflationary expectations. In practice, the rate of devaluation, set according to a preannounced schedule known as the *tablita,* was less than the existing difference between domestic and world inflation. This policy corresponded to an active crawling peg.

Important reforms took place on the microeconomic front. With different timing and intensity, all three countries removed price controls, liberalized interest rates, decentralized government intermediation, and partly deregulated the labor markets. All three countries also relaxed the restrictions on international trade and liberalized capital inflows. The sequencing of the reforms differed in each country, however, with the exception of domestic financial market deregulation, which proceeded rapidly in all cases. Uruguay removed all controls on capital flows and many commodity price controls early on, but progressed more slowly on the liberalization of foreign trade. Chile, to the contrary, went the furthest in eliminating domestic price controls and the endemic fiscal budget deficit and in reducing trade barriers, but it kept the controls on short-term capital flows for a long time and maintained important labor market regulations. On the other hand, Argentina also eliminated price controls and removed most restrictions on short-term capital flows and quantitative import restrictions (with some important exceptions) before it implemented some ad hoc tariff reductions.

Rapid deregulation of the domestic financial markets, a common feature of the reforms in the three countries, was important because of the many years of nonprice allocation of credit and highly negative real interest rates. All three countries substantially deregulated the domestic capital markets in two ways. First, they progressively eliminated the ceilings in interest rates. Second, they reduced the restrictions on financial intermediaries. Argentina went from 100 percent reserve requirements and directed credit programs to a decentralized fractional reserve system. The Chilean government first loosened its control of the financial system by allowing nonbank intermediaries (financial houses) to operate without interest rate controls. Then, in the next several years, it removed the interest ceilings on commercial banks and returned publicly held commercial banks to the private sector. In Uruguay, dollar deposits were legalized early on, and direct credit programs were dismantled. Later, in 1977, the controls on entry to the banking system were lifted.

Each country also tried to open its economy to international capital flows, but the speed and extent of this action varied. Uruguay legalized movements of private capital as early as 1974 and reached full convertibility by early 1977. Argentina eliminated most controls on capital movements in 1979. Chile progressively deregulated medium-term capital flows, eliminating the global limits on borrowing in 1979 and the restrictions on monthly inflows in April 1980. Restrictions on short-term capital inflows were not dismantled until late 1981.

In all three countries, there was relatively minor liberalization of the labor markets. These markets continued to be controlled through penalties or prohibitions on labor dismissals, legislated wages, or wage indexation. The weakening of trade union power amounted, however, to de facto deregulation in the early stages of the reforms.

The results. In the early stage of the reforms, when the markets were being liberalized and inflation was being reduced through a macroeconomic policy mix that was trying to keep an appropriate real exchange rate and a sustainable current account deficit, the three countries did quite well. Most of their problems started when major macroeconomic imbalances developed in the post–1978 period, as they were implementing a second stabilization attempt. In Argentina, the preannounced decreasing rate of devaluation was incompatible with the financial reforms (Calvo 1989) and the irreducible fiscal deficit. As a consequence, significant capital inflows followed to finance the government deficit. In turn, the capital inflows fueled a large real appreciation that became unsustainable. When real domestic interest rates sharply increased in anticipation of a major devaluation, the stage was set for a deep recession and the collapse of the heavily leveraged financial sector. In Chile, 100-percent-plus backward wage indexation was incompatible with a preannounced decreasing rate of devaluation and resulted in a peso appreciation that the country was unable to reverse without a crisis (Corbo 1985). Furthermore, the availability of easy external financing at a time when it was very profitable to borrow abroad sustained the real appreciation of the peso for a long period. This situation hurt the exportable activities, which had started to make inroads in the external markets, and the import-competing sectors, which had just completed a quite successful adjustment to the commercial policy reforms (Corbo and Sanchez 1985). In addition, the abrupt reduction in inflation, together with some contractionary monetary policies, resulted in 1981 in a large increase in real interest rates that created substantial hardship, especially for firms in tradable activities (Tybout 1987). Uruguay was somewhere in the middle. By historical standards it did quite well up to 1979, when it suffered from external shocks originating in Argentina; and then in early 1981 a fiscal deficit emerged that was incompatible with the exchange rate policy. The ensuing real appreciation discouraged the new export activities and, to a lesser extent, the still highly protected import-competing activities.[7]

In the rest of Latin America, there was not much reception to the reform ideas of the Southern Cone countries. Indeed, Brazil, Colombia, Mexico, and Peru responded to the external shocks associated with the first oil crisis by reinforcing their antiexport bias, introducing further restrictions on imports. Following the second oil shock and the debt crisis, however, the reform movement became more widespread. The reforms of the 1980s are analyzed in the next section.

Liberalization Attempts of the 1980s

The need to adjust to the second oil shock, especially when the easy option of foreign borrowing all but disappeared, resulted in a major reexamination of economic policies in Latin America. Not surprisingly, given the severity of the crisis that was developing, the 1980s saw a major change in policies all over Latin America.[8]

After 1982, countries in Latin America recognized their in-capacity to continue financing large current account deficits. They also recognized, one by one, the need for major policy reforms to enable them to achieve a sustainable reduction in current account deficit with a higher level of output than otherwise, while creating the conditions for sustainable growth. A key reform has been the introduction of a comprehensive program of structural adjustment that addresses stabilization, efficiency, and growth objectives concurrently. There are two principal components to the reform programs being undertaken. One involves restoration of macroeconomic balances, with the emphasis on bringing the level of demand and its composition (tradables relative to nontradables) into line with the level of output and the level of external financing that can be mobilized on a recurring basis. In addition, the high rates of inflation and the external deficit must be reduced; these are objectives that usually require a credible and sustainable reduction in the public sector deficit. The other component aims at increasing efficiency and restoring growth, with the focus on creating more appropriate incentives, removing the constraints on factor mobility, and increasing saving and investment. A major component of these structural reforms has been a redefinition of the role of the state, including its roles as producer, regulator, and distributive agent. Therefore, the restructuring of public enterprises and privatization are key areas of reform.

These types of reforms were implemented in Mexico starting in 1983 and at an increased pace there after 1985, starting in 1984 in Uruguay, in Bolivia in 1985, in Venezuela in 1989, and in Costa Rica in 1985. Chile, the country that had made the most progress on structural reform before its own severe crisis of 1982–1983, starting in 1984 concentrated on creating a stable macroeconomic situation as a way of providing a framework for a sustainable expansion in tradable activities. Brazil and Argentina are still struggling to control inflation. Peru and Nicaragua postponed the adjustment, and they have had the largest deterioration in social welfare. Lately, El Salvador and Honduras have also initiated major reform efforts.

In the implementation of these reforms, political resistance has been greatest to reforms of the public sector, the trade regime, and the labor and domestic markets, in that order. Reforms of the public sector and of the trade regime have faced strong opposition from rent seekers who have traditionally benefited from a large public sector, from suppliers of the public sector, from the trade unions (Argentina and Brazil are good examples here), and from the owners and employees of highly protected industries. Major progress has been achieved in controlling inflation in Bolivia, Costa Rica, Chile, and Mexico. Mexico, Costa Rica, Bolivia, Venezuela, and lately El Salvador and Honduras, have made major inroads in the liberalization of foreign trade. Good progress on restructuring the public sector and reducing the role of the public sector in production and distribution has been made in Bolivia and Mexico. Achieving sustainable high growth in income per capita has, however, been difficult in most of the region. The debt overhang that accumulated in the period of easy spending of the late 1970s and early 1980s and the associated macroeconomic crisis of the 1980s have most likely played a negative role in setting the investment and growth response.

In spite of the difficulties encountered, however, there is an increasing acceptance in Latin America of the notion that to emerge from the current crisis the reform effort has to be sustained. The eventual recovery of growth needs not only less distortionary policies (Easterly 1990) but also more investment and higher savings. The eventual recovery of investment requires a stable and predictable macroeconomic situation where long-term commitments can be made (Serven and Solimano 1990). On the other hand, higher saving to finance higher investment and avoid large real appreciation requires a major fiscal effort (Corbo and Schmidt-Hebbel 1991).

In the 1980s in Latin America there emerged a consensus that included three key components: stabilization, a restructuring of the public sector, and the need to integrate into the world economy. In particular, it has become increasingly accepted that some otherwise desirable reforms could have negative effects if the macroeconomic situation is not brought under control early on. Therefore, a credible and sustainable fiscal, public-sector-wide reform effort will be the core of successful reform. In this sense, Chile and Mexico are the countries that have made the most progress in laying the foundation for implementing other efficiency-enhancing reforms.

Conclusions

At the risk of oversimplification, it could be said that, up to World War I, economic policies in Latin America were based on comparative advantage. During that period, growth was led by exports. Although industrialization in light manufacturing was progressing, that progress was the result of increased demand caused by income growth rather than government intervention.

By the early 1920s, most of the countries returned to the gold standard and had put in place trade regimes that discriminated slightly against exports as a result of taxes on exports and mild tariffs on imports. When the Great Depression hit and the export and international capital markets collapsed, these countries intensified their import controls by increasing tariffs and instituting nontariff barriers to trade. Although some reduction in import restrictions took place in the second part of the 1930s and the early 1940s, the trade regime in existence at the outbreak of World War II was biased in favor of import-competing manufacturing and against export activities.

As world trade resumed in the post–World War II period, Latin American exports grew, but at a slower rate than that for the world as a whole because of the antiexport bias. The average annual rate of increase for Latin America between 1951 and 1960 was 1.4 percent, as against a worldwide rate of 4.0 percent. (Latin America did experience unusually high average annual rates of growth immediately after the war—from 1945 to 1950 it was 15.5 percent—as a result of the reconstruction in Europe and the resultant high level of demand for raw materials.) In addition, industrialization was already under way, spurred by import substitution stemming from the biases in the trade regimes and by the concomitant growth in income.

Although world trade picked up at this time, many countries in Latin America were pessimistic about the possibility of returning to export-led growth. This pessimism led to what I call import-substitution industrialization or Structuralism I. This strategy was articulated by Prebisch at ECLA, where he recommended import-substitution industrialization as a development strategy.

As countries started to experience balance-of-payments and inflation problems, and as the dynamism of the manufacturing sector was slowing down once the easy import-substitution phase had been completed, the import-substitution model began to be questioned. The proponents of the import-substitution model had to alter their model. Their response in the late 1950s added a new twist to the structuralist theory, one that I call Structuralism II.

According to this version, further growth was being limited by the unavailability of foreign exchange. Given that import substitution had already been pushed too far, a new form of this strategy—regional integration—had to be pursued, preferably in combination with increased foreign aid. Economic planning would provide the coordinating framework for evaluating the policy options.

The first element in this policy prescription found expression in a movement toward regional economic integration, as ECLA had recommended in the late 1950s. The second element, based on the two-gap model of limits to growth, gave rise to the gap theory of foreign aid, given the virtual absence at the time of international capital markets for medium- and long-term capital flows and the pessimistic outlook on export growth. As to economic planning, although ECLA had been pushing planning techniques, especially projections for the trade sector, since the mid-1950s, the Alliance for Progress, established in 1961, provided the strongest incentive: it made an overall economic plan a precondition for aid. Development financial institutions were used to channel aid and foreign loans to the "key sectors" that were supposed to expand.

It should be noted that despite Prebisch's prescription of government intervention to pursue import substitution, he early on expressed concern about the antiexport bias of extreme import-substitution policies. Indeed, after his period as director of ILPES, Prebisch's move into the United Nations Conference on Trade and Development (UNCTAD) showed his clear interest in improving the trade prospects of developing countries. Clearly, import substitution was carried to extremes in the later 1950s and early 1960s, and the cost of the resulting distortions became all too apparent. Moreover, in those countries that had gone the furthest with this approach, macroeconomic stabilization became a major problem in the face of recurrent balance-of-payments crises and accelerating inflation.

Some countries recognized the dangers and began some reforms. The first was Brazil in the mid-1960s, followed by Chile in 1965 and Colombia in 1967. Somewhat later, in the mid-1970s, Argentina, Chile, and Uruguay initiated a set of reforms oriented toward liberalizing their economies and controlling inflation. For a time their efforts proved quite successful, and they might well have worked had it not been for the substantial appreciation that resulted from ill-fated stabilization efforts and ill-advised capital inflows during the late 1970s. External shocks, particularly the oil price increases, the rise in international interest rates, and the subsequent worldwide recession, coming on top of the macroeconomic errors contributed to the collapse of the three economies. Starting in 1984 Chile initiated a second reform effort aimed at restoring the basic macroeconomic balances and restoring growth. The results of these reforms have been impressive.

Following the second oil shock and the debt crisis, receptivity to reforms became more widespread in Latin America. Bolivia, Costa Rica, Mexico, and Venezuela became major reformers. Lately, El Salvador and Honduras have followed the same route. Key areas of reform have been the public sector, the trade regime, and the regulation of domestic markets.

NOTES

1. The sections covering the period from before World War II through the 1970s draw on Corbo 1988.

2. For the policies followed by the most important Latin American countries in the 1930s, see also Maddison 1985.

3. By the end of 1933, all Latin American countries except Argentina stopped full service of their external debt. Argentina continued meeting its obligation only because most of its debt was held by Great Britain, which also happened to be its largest export market—though a confrontation was developing as a result of the increasingly restricted access of Argentinian exports to Great Britain.

4. Prebisch was called on during the Libertarian Revolution of 1955 to advise on Argentina's economic policies. He recommended stabilization of the economy and development of the basic metal industry, which he believed should serve as the engine of growth.

5. This argument was derived from a comparison of the relations over time in individual Latin American countries between import and output growth, on the one hand, and export and output growth on the other. The rationale for the first type of calculation, after accounting for relative prices, is clear. The relationship between exports and domestic output growth, however, could hold only in countries where exports were residual after satisfying the domestic market. This hardly applied to most Latin American countries.

6. For another evaluation of the structuralist-ECLA types of policies, see Fishlow 1985.

7. Another problem common to all three countries was the expansion of risk taking by the financial system. The lack of appropriate supervision and evaluation of portfolio quality on the one hand, and the de facto deposit insurance on the other, resulted in extremely risky loan portfolios and very high real interest rates. Lately, McKinnon (1988), one of the strongest advocates of financial liberalization, proposed that, to avoid adverse selection, a cap should be put on real interest rates, with financial intermediaries spending more to evaluate the quality of their loans.

8. For an assessment of the consensus on policy reforms, see Williamson 1990.

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