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THE COSTS AND BENEFITS OF STABILISATION PROGRAMMES SOME LATIN AMERICAN EXPERIENCES

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The Costs and Benefits of Stabilisation Programmes - Some Latin American Experiences

1. Introduction

With a view to considering their comparative costs and benefits, stabilisation programmes are divided in this chapter into three categories. While there is considerable overlap between the categories and many programme might not fit exactly into this framework, the classification highlights some of the characteristics of the programmes, and of the contexts in which they are framed, which bear directly on this theme. The categories are loosely defined as follows:

(a) Conventional programmes: the key characteristics of these programmes are first, that the objective is essentially a short-term one, usually the resolution of an immediate balance-of-payments crisis; and secondly, the instruments employed are usually exchange rate adjustments and the conventional demand management techniques of fiscal and monetary policy. This case will be illustrated by reference to, in particular, the Peruvian stabilisation programmes of 1976 to 1979, and also aspects of the Mexican pprogramme of 1976 and the Bolivian programme of 1972.

(b) Monetarist programmes: in these cases the short-term balance of payments objective is pursued in tandem with the longer-term aim of creating a laisser faire economy. Short-term policy relies heavily on the use of monetary, rather than fiscal, instruments while the longer term objective is pursued through measures designed to reduce the size of the public sector, increase the efficiency of product and capital markets, open the economy to international trade and to foreign capital. The general case is illustrated by reference to the experience of Chile from 1975 to 1978, and also that of Argentina in 1976 to 1978 and Uruguay in 1974 to 1978.

(c) Structuralist/populist programmes: as in (b) above the short-term balance-of-payments and/or inflation related target cannot be divorced from the longer-term aim of structural transformation of the economy. In these cases the immediate problem is considered to be rooted in an economic structure featuring resource immobility, market segmentation and disequilibria between sectoral demands and supplies. As growth proceeds these characteristics manifest themselves in bottlenecks in the supply of, for example, foreign exchange, intermediate inputs, domestic savings or food. In the short-run the instruments employed to deal with inflation will usually include price controls while balance of-payments disequilibria will be alleviated by import controls. In the longer run the objective will be the removal of the structural bottlenecks and this will involve extensive government intervention in the economy. The years of the Popular Unitygovernment in Chile (1970-1973) and the Peron government in Argentina (1973-1976) will illustrate aspects of this approach.

The first two stylised types are variants of what might be called orthodox stabilisation policies in that they are grounded in neo-classical economic theory and share to some extent the view that inflation is a monetary phenomenon. In this chapter, however, the distinctions between the two variants, rather than their similarities are stressed, since these may have a bearing on the issue in question namely, the comparative costs and benefits of various kinds of stabilisation programmes. One important distinction between the "conventional" and "monetarist" types might be postulated in terms of the speed at which the corrective adjustments are carried out, the first exemplifying a relatively gradual implementation of stabilisation measures and the second seeking an abrupt shift in signals. The latter strategy is sometimes advocated on the grounds that while this kind of "shock treatment" may increase the short-run disruptive effects of the stabilisation programme, it may also facilitate its completion. A gradualist approach, on the other hand, given that there is likely to be some resistance to change, may lessen the chances of the programme being fully implemented.

The theme of this chapter begs a question: In what sense may one discuss the costs of a stabilisation programme? Adoption of such a programme implies a recognition that existing policies are unsustainable. Usually a balance of payments deficit is at or near the point where it can no longer be financed by running down reserves or by borrowing. In addition the rate of inflation may be considered to be unacceptably high. Correcting this situation is likely to involve short-term dislocations. If the underlying problem is diagnosed as resulting from excess domestic demand the solution will be sought in a reduction of demand to a level commensurate with the real productive capacity and sustainable net borrowing ability of the country. Fiscal and monetary contractions may be large and may adversely effect real output and employment, at least in the short run. Since continuation of the status quo ante is not an option there is no costless way of proceeding. (In addition, of course, the prior instability was not costless - see Ch. 2). The question at issue therefore is whether the course decided upon in the stabilisation programme was the least cost way of overcoming the immediate problem and, if not, what alternative policy measures might have achieved the same or better results at less cost to the economy. A major consideration in this regard is whether or not the cause of the problem was correctly specified. If the initial diagnosis was incorrect or became incorrect as time went on and the policies were not altered it is more likely that the policies implemented may have involved unnecessarily high costs.

The focus of this chapter will therefore be on weighing the costs of stabilisation programmes in terms of, for example, output forgone and unemployment, against the benefits in terms of the relief of the immediate balance-of-payments problem and, in some cases, significant reductions in the rate of inflation. The discussion will also examine the distribution of the burden of adjustment among social groups. This will depend in the short run on the nature of the policies chosen to stabilise the economy and will be influenced in the longer run by any changes in the structure of the economy that may accompany or result from the short-run stabilisation measures. A third theme will be the role of the IMF in the stabilisation programmes under consideration focusing in particular on the differing extent of Fund influence in the three categories of programmes. The impact on their relations with the Fund, of the increased access of Latin American LDCs to international commercial lending during the 1970s will also be considered.

The Latin American focus in this chapter reflects the fact that analysis of stabilisation programmes in the Latin American context has a relatively long history and the comparative costs and benefits of different approaches to stabilisation are more readily observable there. This history has had three phases. In the late 1950s there was a series of orthodox stabilisation programmes aimed primarily at reducing inflation. These programmes relied on the use of a small number of policy instruments, principally, control of the money supply, reduction of the government deficit and devaluation to remove the disequilibrium. Partly in response to the failure of many of these programmes, there emerged in the later 1960s and early 1970s a number of populist and structuralist programmes. These programmes grew out of a tradition which stressed that the historical and political contexts in which stabilisation programmes are implemented differ in important respects from the circumstances implicitly assumed by the liberal capitalist theories underlying the orthodox approach. The common features of the structuralist and populist experiments tended to be expansion of public expenditure, the money supply, wages and government intervention, price and import controls, and a last minute retreat into contractionary policies. Finally, in the middle and late 1970s there was a return to orthodox policies, in some cases within an authoritarian political setting and with greater emphasis than before on the long-term transformation of the economy, by means of for example a reduction in the size of the public sector, strengthening of private capital markets, opening up of the economy to freertrade, as a condition of price stability.

In the remainder of this chapter the focus will be on examples of "conventional" and "monetarist" stabilisation programmes implemented with IMF assistance, and populist and structuralist experiments with non-orthodox programmes, in some Latin American countries during the 1970s.[1] Since, chronologically, the "structuralist/populist" experiments in Chile and Argentina preceded the adoption of "monetarist" programmes there, the sequence followed below departs from that followed in the presentation of categories above with the section dealing with "structuralist/populist" programmes following that dealing with "conventional" programmes and preceding that dealing with "monetarist" programmes. The Latin American concentration in this chapter will complement the African, Caribbean and Asian in-depth case studies which follow.

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1. This chapter considers only a part of the large literature on stabilisation policies in Latin American countries. There is a rich literature dealing with stabilisation programmes implemented during the 1950s and 1960s and a significant Spanish language literature which is not considered here. There is also an extensive literature on Brazil (including, for example, Wells, [1979], Morley [1971] and Bacha [1979]) and some material on Columbia (notably, Diaz Alejandro [1975]) - two countries not directly considered in this chapter.

2. Conventional Stabilisation Programmes: the Case of Peru 1976-1978

Stabilisation programmes of both the "conventional" and "monetarist" types are grounded in a belief in the efficiency of the price system as an allocative mechanism. They are based on the view that internal and external disequilibria can be corrected by a combination of reductions in demand and shifts in relative prices. The stabilisation programmes adopted in Bolivia in 1972, Mexico in 1976, and Peru in 1976 to 1979, were orthodox programmes in that they relied on fiscal and monetary restraints and devaluation. However, the degree of commitment to the restoration of market forces and to opening up to international trade was significantly less marked than, for example, in Chile (1975-1978), Argentina (1976-1978) or Uruguay (1974-1978). The Peruvian stabilisation programme, for example, included a tightening of import controls while in the Mexican case subsidies, in the form of price controls, for essential consumer goods and raw materials, were allowed to continue during the stabilisation period. The Bolivian, Mexican and Peruvian programmes exemplify what we have termed conventional programmes while the Chilean, Argentine and Uruguayan cases belong to the monetarist category. Below, we look in particular at the Peruvian case, examining the background to the crisis, the content and efficacy of the stabilisation policies employed and their appositeness in the Peruvian context. The attempt by the Peruvian government to avoid negotiating a stand-by arrangement with the IMF by seeking balance of payments support directly from private commercial banking interests is a special feature of the Peruvian case that is particularly pertinent to the concerns of this study. The experience of the banks in the Peruvian case was to greatly influence their attitude to providing balance of payments support to other LDCs.

The Velasco regime which came to power in Peru in 1968 had continued the import substitution strategy begun in the early 1960s. Between 1968 and 1972 major ownership reforms including nationalisation of petroleum, mineral and fishmeal enterprises, limited land reform and reorganization of industry to provide for worker participation were introduced. Economic performance was relatively satisfactory up to 1973 with average real growth of over 6% between 1970 and 1973, an average inflation rate of just over 7%, a stable exchange rate and adequate foreign exchange reserves (see Table 1).

Table 1. Peru: selected economic indicators, 1970-79

YEAR	(1) Real growth rate of GDP %	(2) Increase in Consumer Price Index %	(3) Terms of Trade Index	(4) Quantum Index of Exports (1975=100)	(5) Unemployment (% of labour force)	(6) Index of Wages	(6) Index of Salaries	(7) Total Reserves (minus gold) $ mn	(8) Debt Service Ratio	(9) Index of Real Exchange Rate
1970	7.3	4.9	141	146	4.7	76	86	296.3	13.9	100
1971	5.1	6.9	119	134	4.4	84	92	380.9	19.6	97.7
1972	6.0	7.1	110	140	4.2	92	96	442.5	18.5	97.7
1973	6.2	9.5	154	105	4.2	100	100	526.1	30.4	104.1
1974	6.9	16.9	134	107	4.0	94	92	925.2	22.9	105.7
1975	3.5	23.6	100	100	4.9	94	88	425.5	25.0	98.3
1976	3.1	33.5	126	95	5.2	98	77	389.3	26.9	107.6
1977	-1.0	38.5	120	106	5.8	79	65	356.8	30.4	122.5
1978	-1.8	57.8	103	123*	6.5	...	...	389.7	31.1	...
1979	3.8	66.7	97	...	7.1	...	...	1520.7	31.6	...

Sources: For cols. (1) (2) (4) and (7) IFS Yearbook 1980, for col. 3 Handbook of International Trade and Development Statistics, UNCTAD, Supplement 1980, Table 7.2; for col. (5), Yearbook of Labour Statistics 1980, ILO, Table 10, p. 281; for col. (6) quoted by Thorp et al, p.49, from figures published by the Ministry of Labour, Peru; for col. (8) World Debt Tables, Vol. 1, World Bank, Document EC-167/80, table x (1980); for col. (9) estimated by Cline, 1979, Table 5.

*Calculated from Cline, 1979, Table 5.

Table 2. Peru: The Balance of Payments 1972-1979. ($US mn)

	1972	1973	1974	1975	1976	1977	1978	1979
Exports (fob)	1037	1122	1520	1227	1361	1726	1933	3469
Imports (fob)	-892	-1106	-1927	-2272	-2100	-2164	1600	-2088
TRADE BALANCE	145	16	-407	-1045	-739	-439	333	1381
Invisibles and transfers	-180	-280	-325	-420	-454	-487	-531	-764
BALANCE ON CURRENT ACCOUNT	-35	-265	-732	-1465	-1193	-926	-198	618
Direct Investment and other long term capital	117	411	727	1229	807	953	264	752
- of which exceptional financing	-	-	-	-	165	280	252	539
BASIC BALANCE	82	147	-5	-235	-386	27	66	1369

Source: Balance of Payments Yearbook, International Monetary Fund, Vol. 31, December 1980

Note: Due to rounding error in converting from SDRs to $US the basic balance figure may not be exactly the sum of its components.

In the early 1970s discovery of oil in the Amazon Basin generated much optimism about growth prospects and made the country an attractive client in the eyes of the international commercial banks, from whom Peru began to borrow in 1972. The government launched ambitious development programmes in the spheres of electrification, irrigation, communication, fishing and minerals. International prices strongly favoured Peru's traditional exports (copper, iron ore, fishmeal, sugar) until 1974, masking the underlying production trends. Between 1972 and 1975 the volume of exports fell by 28%. The visible trade balance swung from an annual average surplus of $207mn for the period 1968 to 1972 to an average annual deficit of $479mn for the 1973-75 period (see Table 2).

Macroeconomic disequilibria became acute in 1975. The current account deficit reached 119% of total export receipts, the debt service ratio was 25% and net reserves were negative by the end of 1976. The balance of payments crisis was accompanied by increasing signs of internal disequilibrium as the rate of inflation reached 24% in 1975 from 9% in 1973. Exogenous factors contributed significantly to the crisis. Chief among these were the disappearance of anchovies from the coastal waters in 1973 leading to a decline in the volume of fishmeal exports of 78% in that year; the fall in copper prices from the very high levels of 1972-74, which coincided with a fall in production in Peru; and the disappointing outcome of oil exploration coupled with the increase in the world price in 1974 while Peru was still an importer.[1]

In a report published in 1977, the International Monetary Fund identified the endogenous causes of the crisis as the expansion of public sector spending without adequate taxation measures and a passive monetary policy which had led by 1975 to demand pressures which were manifested in the acceleration in the rate of inflation and the widening of the current account deficit. The deterioration in the current account was also due, in the Fund's view, to the increase in domestic costs of production relative to those abroad which had been nurtured by import prohibitions, licencing and tariffs.[2] The appropriate instruments for dealing with the crisis were therefore compression of aggregate demand and exchange rate reforms.

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1. An attempt to quantify the impact of these exogenous factors together with that of military imports (which accounted for approximately 10% of total imports in 1976 and 20% in 1977) concluded that "the four factors together represented a cost of over half a billion dollars annually in the period 1974-1977, representing over one-third of actual export earnings and nearly one-half of the average current account deficit". See Cline, 1979 (p.5).
2. International Monetary Fund, "Peru - Recent Economic Developments," Washington DC, 1977, p.1, quoted in Thorp, 1979 (p.123).

Internal balance would be restored by cutting government expenditure and raising revenue by increasing controlled public utility prices and by restraining credit to the private sector. The external balance would be improved directly by the exchange rate depreciations and indirectly by the measures to improve the internal balance since these would involve preventing increases in foreign borrowing and reducing import-intensive investment programmes.

As the crisis grew, the controlled prices of food and petrol were increased in June 1975; in August President Velasco was replaced by President Bermudez (his former Finance Minister); the following month there was a moderate devaluation of the Sol followed in January 1976 by budget cuts, tax increases and further price rises. In March 1976, President Bermudez, facing urgent debt repayment problems, began negotiations with the major US banks[1] for a loan to support the balance of payments. The banks agreed to roll-over Peru's debt provided Peru agreed to a stabilisation programme designed by the banks. This programme involved a devaluation of the Sol by 31% in June 1976, increased excise taxes, further increases in the controlled prices of petrol, electricity and transportation, more favourable treatment of foreign investment and a reversal of many of the anti-private sector policies of the Velasco regime (for example, the fishing fleet was sold back to private enterprise). The agreement brought to Peru an initial $200 mn in loans with a second $200 mn to follow contingent on adherence to the agreed package of measures.[2] Agreement of 75% of the lenders (by $ participation) that Peru was making satisfactory economic progress would ensure the release of the second tranche of the loan.

For the first six months of the agreement (June to December 1976) Peru fulfilled its commitments and the banks released the second instalment of the loan. By the first quarter of 1977 however, government spending far exceeded the agreed bounds. The banks refused to negotiate further loans without IMF participation. When the Peruvian authorities then began negotiations with the Fund, they were in a weak bargaining position. The attempt to by-pass the Fund had failed and the economy was in crisis. Inflation was running at an annual rate of 40%,

1. These were Citibank, Bank of America, Chase Manhattan, Manufacturers Hanover, Morgan Guaranty and Wells Fargo.

2. The loan carried an interest rate 2.25% above LIBOR (the London Inter-Bank Offer Rate) and had a maturity of five years.

industrial output was declining, real wages had fallen by almost 40% compared with their 1973 peak, more than 50% of the labour force were estimated to be underemployed[1] and gross reserves were likely to be exhausted by July 1977.

The Fund mission of March 1977 set stringent conditions for a stand-by arrangement. The target inflation rate was to be 15%, and the budget deficit was to be reduced from 48.4 bn soles in 1976 to 20 bn soles in 1977. The package also included increased gas prices, tax reform, a 30% devaluation, elimination of import quotas and wage increases limited to 15%. The Central Bank proposed milder measures involving a 25% inflation target and a budget deficit of 40 bn soles. Negotiations failed and the Finance Minister resigned. His successor negotiated a draft agreement with the Fund which the Cabinet rejected. The new Finance Minister resigned but the government implemented the price increases proposed in the draft agreement. The increases in food and fuel prices provoked a wave of strikes and riots and these protests together with the difficulties being experienced by the government in cutting public expenditure led to the price increases being rescinded and negotiations with the Fund being broken off. Following these two unsuccessful attempts at negotiating an agreement with the Fund the Peruvian authorities again attempted to by-pass the Fund by negotiating directly with their creditors who, lacking confidence in the proposed economic policies, insisted that Peru work out an agreement with the Fund. In October 1977 an agreement was finally reached with the Fund. Under its terms the deficit in the current budget of the Central Government, which was equivalent to 3.4% of GDP in 1977 was to be succeeded in 1978 by a surplus equivalent to 2% of that year's GDP. The exchange rate system was reformed involving a new system of controlled depreciation.

By February 1978 it was clear that public spending far exceeded the agreed limits. Fund credits were suspended and foreign banks halted plans to provide $260 mn in rollover loans. In May 1978, with net reserves at approximately -$1.2 bn and debt service of approximately $1 bn falling due in 1978, the economy was near external bankruptcy. The government now devalued the Sol from 130 to 150 per $, put the exchange rate on a crawling peg system, increased the price of fuel by 60% and milk and bread by 40%, eliminated most subsidies,

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1. Schydhowsky and Wicht, 1979, quote figures from Ministry of Labour showing unemployment in 1977 at 5.8% of the labour force and underemployment at 48%.

introduced new tax measures, raised interest rates and restrained government spending. The measures were designed to reduce the budget deficit by 31 bn soles in the second half of 1978. The international banks then agreed to roll over $200 mn in amortization owed to them during the rest of 1978, conditional on the signing of a new agreement with the Fund by September 1978. An agreement was reached with the Fund in August 1978 and this paved the way for a complete rescheduling of Peru's foreign debt.

The terms of the agreement reached with the Fund in the Summer of 1978 were considerably softer than the terms of the November 1977 agreement. The Fund team now "pressed the Peruvians to plan on more imports and a larger public deficit than they had intended in order to maintain the level of investment."[1] The agreement covered a longer period than usual (15 months) and was more flexible, allowing, for example, that credit limits would be applied only to the Central Bank, rather than to the entire banking system. The programme was an attempt at gradual adjustment co-ordinated with an investment programme worked out with the World Bank. The short term goals of the programme were ambitious. The public sector current account was in deficit to the tune of -2% of GDP in 1977; the programme aimed at a surplus of 5.8% in 1979 and 1980 to be achieved by tax reform, increases in public enterprise prices and cuts in current expenditure, while public investment was to maintain its share of GDP. Interest rate reforms were to bring about gradually a positive real rate of interest. From mid-1978 to mid-1979 the Peruvian government adhered strictly to the programme's conditions. During the same period the external sector began to improve as imports declined due to tighter restrictions, a reduction in military imports and the fall in GDP while export earnings increased due to higher mineral prices and the coming on stream of petroleum exports. By 1979 the medium term prospects for Peru had improved considerably. Real GDP in 1979 was 3.8% higher than in 1978, and the trade balance showed a surplus of $1,384 mn. The targets in the stand-by were in general reached with, for example, tax revenue running in early 1979 at 6% above the target figure.

1. Angell and Thorp, 1979, p.880.

However, the balance of payments crisis and the failure to adjust to it between 1975 and 1978 involved very high costs to the Peruvian economy. Per capita GDP fell by approximately 8% between 1975 and 1978; investment fell by 35% in real terms between 1975 and 1977; the numbers of unemployed and underemployed increased by 6.9% between 1975 and 1978 to 54% of the labour force;[1] real wages declined by 16% and salaries by 26% between 1975 and 1977; and the rate of inflation increased from 23% in 1975 to 67% in 1978 (see Table 1). Were these costs unavoidable or would alternative policies have solved the immediate balance of payments crisis at less cost in terms of lost output? Were the stabilisation policies adopted appropriate to Peruvian circumstances and did they in the end succeed in alleviating the balance of payments crisis?

Defenders of the Peruvian stabilisation programmes argue that the policies were appropriate and that they were successful as soon as they were fully implemented. Cline, for example, argues that the programme launched in 1976 would have worked had not the government shattered it with an excessive budget in 1977.[2] In Cline's view the government's pursuance of excess demand policies for two years after the disequilibrium had reached crisis proportions, coupled with an inappropriate exchange rate, was responsible for the loss of output in 1977 and 1978. The shock of corrective adjustment became much greater than it would have been had it been undertaken earlier. He hypothesises that, had the government introduced its 1978 stabilisation measures in 1975, "the external imbalance would have been corrected in 1976 and 1977, Peru would not have approached bankruptcy, and ... the total sacrifice in growth would have been much smaller."[3]

Other commentators argue however, that the stabilisation policies adopted were inappropriate and succeeded only in suppressing the balance of payments problem. Thorp et al, for example, argue that between 1975 and 1978 the Peruvian problem had appeared intractable because because the orthodox policies being applied were costly, inefficient and unsuccessful in the Peruvian context. The analysis on which they were based ignored, in their view, important features of Peruvian economic and political reality. The balance of payments crisis was part of a

1. Schydlowsky and Wicht, 1979, p.1-29.

2. Cline, 1979, p.41.

3. Ibid., p.43.

4. See e.g., Thorp, 1979, Angell and Thorp, 1980, Thorp, Buchdahl and Behr, 1979.

long-term structural crisis in export supply. This supply problem was evident since the 1960s and was due in the case of sugar, cotton and anchovies to natural resource constraints. The problem was compounded by the fact that the multinational corporations who controlled much of Peru's mining industry had been slow to carry out major investments during the 1960s because of the increasingly aggressive Peruvian tax legislation.[1] In these circumstances export sales would be expected to be insensitive to the exchange rate in the short run. Further, in an atmosphere of credit squeeze, depression and political instability, exchange rate policy was not likely to prevent capital flight. Since 50% of imports were for the state sector and the political will to comply with strict fiscal controls was lacking, and the remainder were intermediate inputs and capital goods which could not be substituted in the short run the effect of higher import prices would be to fuel cost-push inflation. Therefore, in the Thorp et al view, the instrument of relative prices could be expected to contribute little to closing the external gap and the burden of the stabilisation policies would have to fall on demand contraction. The realities of the Peruvian economic and political situation placed severe limits on the potential effectiveness of this approach. Debt repayments and defence commitments were large and growing and internal consumption of exportables was low. Contraction of import demand was a costly strategy since it would be achieved at the cost of a decline in investment.

Thorp et al see in the economic developments in Peru between 1975 and 1978 proof of the ineffectiveness of the policy measures employed. They point out that after the emergence of the crisis in 1975 the balance of payments position deteriorated further in 1976 before showing some improvement in 1977. In both years export earnings increased and export volume increased significantly in 1977, due primarily they argue to new copper production coming on stream. Imports declined slightly in 1976 and remained constant in dollar terms in 1977. In 1978 imports were finally compressed. Angell and Thorp estimate that almost half the reduction was due to import substitution in fuel, 44% to the fall in defence imports and only 4% each to declines in items directly affected by the stabilisation measures, that is, consumer goods and intermediate inputs.[2] The loss of reserves continued in 1976

1. Thorp, 1979, p.123.

2. Angell and Thorp, 1980, p.879.

and both long-term and short-term debt continued to rise until 1977. Thorp et al concede that non-traditional exports responded strongly to the exchange rate reforms and export subsidies (see p.14) but they attribute the turnaround in the economy in 1979, not to a sudden responsiveness of the internal economy to the stabilisation policies, but to an abrupt upturn in the export sector due in large part to buoyant mineral prices.

Schydlowsky and Wicht[1] provide another viewpoint. They argue that the Peruvian problem was misdiagnosed by the policy makers. In their view there was no general problem of excess demand. The balance of payments problem was rather the result of the inability of the primary sector to provide the foreign exchange requirements of the industrial sector. This was, in their view, the inevitable outcome of the import-substituting industrialisation strategy followed by Peru since the 1960s. They contend that the Peruvian government compounded the fundamental error of continuing to pursue an import-substituting strategy, by applying counterproductive stabilisation policies once the inevitable crisis had arrived. The policies adopted - devaluation, import controls and tight money - led inevitably in their view to recession, inflation and an increased government deficit. Devaluations had, they contend, minimal effectiveness in promoting exports of manufactures because costs of inputs went up; the exchange licensing system starved export producers of imported inputs and the supply elasticity of traditional exports was low in the short run. Schydlowsky and Wicht argue that the balance of payments crisis could have been solved at minimum social and economic cost if policy had been directed towards breaking the foreign exchange constraint primarily from the supply side by exporting more industrial goods and that this could have been accomplished by bringing existing idle capacity into production.

Which of these conflicting interpretations does the empirical evidence support? A key contention in both the Thorp et al and Schydlowsky and Wicht arguments is that Peruvian exports are not responsive to exchange rate changes. Thorp et al further contend that imports will tend to be unresponsive to price changes since they are in the main - apart from military imports - intermediate and capital goods and that general demand restraint will do little to reduce imports

1. Schydlowsky and Wicht, 1979. Similar arguments have been generalised by Schydlowsky to semi industrialised ldcs in Schydlowsky, 1979.

since they are concentrated in a small number of sectors. The empirical evidence casts doubt on these contentions. Results of statistical tests reported by Cline[1] and based on Peruvian data for the period 1959 to 1978 indicate that Peruvian trade is responsive to the exchange rate and to aggregate demand. These results indicate that a one per cent increase in aggregate demand causes a three per cent increase in imports and a one per cent increase in the real exchange rate causes a one per cent fall in imports. Similarly with regard to exports, the model indicates that a one per cent rise in the real exchange rate calls forth about one half of one per cent rise in exports. The model employs the IMF quantum index of exports which reflects traditional mining and agricultural exports. There is little disagreement about the responsiveness of non-traditional exports. Sheahan[2] has traced the behaviour of non-traditional exports and the effective exchange rate for the period 1969 to 1977 and has shown that these exports respond strongly to the exchange rate. In 1975 non-traditional exports accounted for 8% of total export earnings. Following the devaluations of 1976 and 1977 they rose two and a half times in dollar value between 1975 and 1977 accounting for 13.9% of total exports in the latter year.

In support of his findings on traditional exports Cline quotes the developments in Peru's trade balance between 1977 and 1978 when stabilisation measures including devaluation and demand restraint were being applied. He notes the decline in the value of imports from $2.3 bn in 1975 to $1.6 bn in 1978 and the rise in the value of exports from $1.2 bn in 1975 to $1.9 bn in 1978. As noted above however, Thorp et al contend that the year to year developments in Peru's trade balance were largely unrelated to the stabilisation measures.

However, the empirical data appears to be consistent with the predictions of the Cline model. While it is true that the basic balance deteriorated further in 1976, the implications for the efficacy of the stabilisation measures are not clear. The trade balance improved in 1976 although the volume of exports declined. However, the devaluation of 1975 had been less than the rate of inflation in that year leading to a continued decline in the effective exchange rate (see Table 1).

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1. Cline, 1979, p.27 ff.
2. Sheahan, 1980, p.13.

A considerable part of the increase in the volume of exports in 1977 was due to increased copper production as the Cuajone mine began production. Copper exports increased by 70% in volume terms in 1977. Of the total increase in export earnings in 1977 of $366 mn, 45% was accounted for by increased earnings from copper. There were however significant increases in the volume of iron ore (37%) and sugar (44%) exports in addition to the increase in non-traditional exports. The evolution of export volumes over the 1975 to 1978 period indicate responsiveness to the devaluations of 1976 and 1977 and are consistent with the Cline model. The model predicted an increase of 15% in the quantum of exports between 1975 and 1978 and Cline attributes the larger than predicted increase (of 23%) to increased copper and petroleum exports.[1] The behaviour of imports also indicates responsiveness to the exchange rate and the level of aggregate demand. The fact that non-military imports declined in 1976 and remained constant in 1977 in value terms, suggests a decline in volume terms. This is consistent with the Cline model which predicted a 10.4% decline in the real value of non-military imports in 1976 and a 16.7% decline in 1977. Cline calculates actual reductions of 17.8% and 19.1% respectively. The very large increase in export earnings in 1979 (see Table 2), was due in large part to buoyant mineral prices and to the 75% increase in the volume of oil exports. However, the volume of copper and silver exports increased (by 5.1% and 4.3% respectively) and the volume of fishmeal exports increased by 38%. The continued growth of non-traditional exports was a major feature of 1979 with earnings increasing from $330 mn in 1978 to $680 mn in 1979 (representing respectively 17% and 19.6% of total export earnings).[2]

However, even if exports and non-military imports were responsive to the devaluations this alone could not guarantee the success of the stabilisation programme. The Peruvian balance of payments problem was diagnosed by the banks and the Fund as the product of generalised excess demand fuelled by government budget deficits. Restraining public sector expenditure was therefore the lynchpin of the successive programmes. In such a situation the devaluation induced changes in the relative prices of traded and non-traded goods would tend to be eroded by increases in the prices of non-traded goods unless the monetary and fiscal targets were also achieved. In the case of the Bolivian

1. Cline, 1979, p.33, footnote 1.
2. Economist Intelligence Unit, 1980, p.20.

stabilisation programme of 1972/3 it is estimated that the gains from the 40.6% devaluation of the peso in October 1972 had been dissipated by early 1974.[1*] The aim of the programme had been to correct for the over valuation of the peso that had developed since 1959. The cornerstone of the programme was to be fiscal policy with restraint in government spending being complemented by revenue-increasing measures such as a twenty per cent ad valorem tax on exports. However, the failure to achieve restraint in government spending led to domestic price increases that had eroded by early 1974 the decrease in the ratio of nontraded goods prices obtained by the devaluation.

In Peru fiscal restraint was not achieved between 1975 and 1977. Current expenditure rose as a percentage of GDP largely due to the rise in military expenditure (see Table 3). In 1977 the fall in capital goods imports was more than matched by an increase in arms imports leaving the value of total imports the same as in 1976.

Table 3. Public sector revenue and expenditure at current prices

(% GDP)

	1974	1975	1st half 1976	2nd half 1976	1977
Central Government					
Current expenditure	14.0	16.3	14.9	16.6	18.5
Wages and salaries	5.4	5.8	5.6	5.3	5.3
Military outlays	3.5	4.6	4.4	5.5	7.3
Other	5.1	5.9	4.8	5.7	5.9
Investment	4.5	5.0	4.0	5.4	3.8
Total expenditure	18.5	21.3	18.9	22.0	22.2
Revenue	15.3	15.8	14.0	14.4	14.3
State enterprises					
Current expenditure	12.7	15.2	17.9	15.8	19.8
Investment	4.7	5.2	5.3	4.7	3.6
Revenue	11.9	13.0	16.5	18.6	22.0
Total public sector					
Current expenditure	29.0	34.0	34.4	34.5	38.3
Investment	9.2	9.4	8.7	9.9	7.4
Revenue	31.3	33.0	33.6	35.7	36.3
Overall deficit	-6.3	-10.3	-9.4	-7.7	-9.4

Source: Angell and Thorp, 1980, p.28.

1* please see over

Angell and Thorp view the one achievement of the 1978 programme as the attainment of some degree of control over public spending.[2] They are however, critical of the Fund for failing to appreciate the political realities in Peru. They view the failed 1977 programmes as unduly harsh and argue that there was a case for more gradual adjustment and greater flexibility. The fact that the mid-'78 agreement between the Fund and the Peruvian authorities was considerably milder than the 1977 programmes suggests that the Fund had, by 1978, moved some way towards this view.

The relative harshness of the 1977 agreements between Peru and the Fund contrasts sharply with the agreement negotiated with Mexico one year earlier.[3] When the Mexican authorities allowed the peso, which had been pegged to the US dollar since 1954, to float in August 1976 its dollar price fell by more than one-half before stabilising at around 60% of its former value at the end of the year. In September 1976 the Mexican government applied to the IMF for immediate assistance to replenish its foreign exchange reserves and longer term support while it implemented a three-year plan of economic stabilisation. In October, the Fund agreed to make available nearly $1 bn under the Extended Fund Facility and the Compensatory Financing Facility.

The agreement with the IMF imposed conditions on Mexico's external borrowing, its internal reserve build-up, the deficit of its non-financial public sector, changes in the net domestic assets of the Bank of Mexico, payments restrictions for current transactions and the use of import restrictions for balance-of-payments purposes. When agreement with the Fund was announced there was also a specification of measures the Mexican government had already taken. These "preconditions" included the imposition of some export taxes to prevent windfall profits from the peso devaluation and to augment government revenue, suspension of many export incentives and some dismantling of import licence requirements. Subsidies, in the form of price controls, for essential consumer goods and raw materials were allowed to continue.

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1. For a description of the Bolivian programme and its impact on income distribution see Johnson and Salop, 1979. (from previous page)

2. Angell and Thorp, 1980, p.880.

3. For detailed discussions of the Mexican stabilisation programme see Fitzgerald, 1979; Reynolds, 1978; Weintraub, 1979; Whitehead, 1980.

However, the Mexican agreement specified a relatively 'soft' programme. The letter of intent was "neither very precise nor very harsh" by comparison with those signed by many debtor countries in recent years".[1] The only specific commitment was on the public sector deficit which was to be cut to 2.5% of GDP by 1979. Further, the letter of intent stated that the objectives of the three-year stabilisation programme would be to accelerate the underlying rate of growth, expand the provision of new jobs for the growing labour force, and stimulate savings in order to reduce dependence on external sources of finance. After these came the objectives of price stability and balance of payments equilibrium. Whitehead suggests that one reason for the relative "softness" of the programme was that the Mexican authorities had carefully planned their approach to the Fund, "making a well-informed assessment of what disagreeable conditions they would have to accept, and on what issues they could refuse to budge."[2] With differences in priorities between different branches of the Mexican bureaucracy and between the outgoing and incoming administrations having been resolved before the Fund was approached "the Fund found itself presented with a united front, but more than that, with a front that had united around proposals that could be accepted as realistic according to Fund criteria".[3]

In any case, Mexico's potential for oil and natural gas exports radically altered the original calculations made at the end of 1976 about the seriousness of the balance-of-payments current account deficit and the debt service burden. The amount of financial resources directly prodided by the Fund was small both in relation to Mexico's balance of payments needs and its normally available resources. Fund financial assistance was needed for little more than a year. Early repayments were being made by the autumn of 1978. The main function of the agreement with the Fund was "to provide an external guarantee to the private sector and the international banks."[4] Mexico had had access to international loan capital since the 1960s. When its creditworthiness was momentarily in doubt the Fund "seal of approval" helped to re-establish it.

1. Fitzgerald, 1979, p.51.
2. Whitehead, 1979, p.849.
3. Ibid.
4. Ibid,, p.860.

While the range of options open to a small, dependent economy such as Peru are narrower than those of Mexico, a resource rich country with access to international loan capital, Thorp et al criticise the failure of the Peruvian authorities to consider alternative courses of action. In their view, when the balance of payments situation became critical in 1975 instruments such as direct controls and selective taxes ought to have been considered. By 1977, given the severity of the crisis, all options appeared to be removed. Two attempts to formulate alternative stabilisation plans had failed. One, involving wage and salary increases and more credit to the private sector, was abandoned since it contained no consistent proposals to deal with the external gap; the other failed to convince Peru's creditors that it was coherent and workable. In the failure to seriously consider other options Thorp et al see the real significance of Fund conditionality. They believe that "the effect of pressures from the Fund or from other external agents is not seen so much in the specific bargaining over the extent of the devaluation or the permissable public sector deficit, as in the discarding of alternative routes such as direct controls ... long before the negotiating table is reached".[1]

The decision of the banks in 1977 to make further loans to Peru conditional on the negotiation of a stand-by arrangement with the Fund, reinforced the dependence of ldcs faced with balance of payments crises on the Fund. The evolution of private bank lending in the 1970s had seen the banks advancing balance of payments loans to ldcs. This area had previously been the almost exclusive province of the Fund and the entry of the banks had encouraged some ldcs to hope that their dependence on high-conditionality Fund facilities might now be reduced.[2] This trend towards commercial bank involvement in areas previously reserved to the Fund reached its peak in the Peruvian case when the banks, not only extended balance of payments loans but having made the loans conditional on meeting macroeconomic performance tests, monitored the economy to ensure compliance. The negative outcome of the Peruvian experiment led the banks to take the view in later cases that the Fund was the appropriate source of advice for LDCs in balance of payments difficulties. The banks' involvement in Peru "demonstrated the frailty of such direct intervention by banks; for reasons of data availability,

1. Thorp et al, 1979, p.34.

2. For a detailed discussion of the relationship between Peru and the banks see Stallings, 1979.

technical capacity and political sensitivity it proved impossible for the banks to enforce their lending conditions, and the adverse publicity for the intervention (and its ineffectiveness) caused the leading bankers involved to resolve that they would not become entangled again in similar packages in the future".[1] The experience of the banks in Peru was critical in re-asserting the importance of the Fund "seal of approval".

1. Cline, 1979, p.17.

3. Structuralist/Populist Programmes: the Cases of Chile (1970-75) and Argentina (1973-76)

The Latin American structuralist school disputes the appositeness of the neo-classical economic theory on which 'conventional' and 'monetarist' stabilisation programmes are based, in the Latin American context. Policy implications derived from an analysis of liberal capitation do not, in the structuralist view, retain their validity in situations of dependent capitalism. The structuralists differ from orthodox theorists particularly in their analysis of the causes of Latin American inflation. They reject the view that inflation is typically the product of excessive aggregate demand. Rather they view inflation as primarily the product of the pressure of economic growth on underdeveloped economic structures. Disequilibria between sectoral demands and supplies, resource immobility, market segmentation and institutional rigidities, particularly in the agriculture, foreign trade and government sectors, result in bottlenecks in the supply of, for example, food, foreign exchange and intermediate inputs. While the money supply may expand as the price level rises, this expansion is, in the structuralist view, a response to inflation, not its cause. The fundamental cause of inflation is rather the failure of price signals to call forth appropriate supply responses.

What are the implications of this analysis for stabilisation policy? Clearly, a central aim of economic policy will be the removal of the supply bottlenecks that are forcing the economy to go through inflationary cycles. This is essentially a long run objective since it involves reallocating investment and possibly initiating far-reaching institutional changes such as land reform or alterations in the structure of taxation. Bringing inflation under control will therefore be a gradual process. A stabilisation policy that failed to adopt a gradualist approach could in the structuralist view, only succeed in reducing one disequilibrium (such as the rate of inflation) at the expense of accentuating other disequilibria (such as unemployment or excess capacity). When faced with an immediate balance of payments problem structuralists tend to emphasise the need to avoid reducing public expenditure and advocate reliance on import controls to deal with the immediate problem. In practice struturalist/populist programmes have tended to have two stages.

The typical features of the first stage are increased public expenditure, significant across the board wage increases, money supply growth, increased government intervention in the economy and extensive price and import controls. The second stage of such programmes has typically involved a reversal of these policies, erosion of distributional gains achieved in the first stage and a return to orthodox stabilisation policies.

Below, we examine two structuralist/populist programmes. They are the radical structuralist programme of the Allende administration in Chile (1970 to 1973) and the populist programme of the Perons in Argentina (1973 to 1976). The evolution of these programmes parallels in broad outline that of earlier attempts at populist programmes in both Chile and Argentina, particularly the programmes of the Peron government (1946 to 1952) and the Radical Party government (1963 to 1966) in Argentina and that of the Frei administration (1965 to 1970) in Chile. There are similarities also with the experiences of Jamaica in the middle and late 1970s (see ch. 11).

The two examples discussed below illustrate the nature of the problems typically encountered in such programmes.

In Chile, in the second half of the 1960s real GDP growth averaged 4.1% per annum while the increase in the Consumer Price Index averaged 24.4% per annum (see Table 4). In 1965 the Frei administration had introduced a gradualist stabilisation programme aimed at reducing inflation coupled with a programme of structural reforms designed to overcome bottlenecks in the agricultural, external and fiscal sectors. Between 1965 and 1967 inflation and unemployment declined and the real growth rate increased (see Table 4). The expansion of government expenditure was more than matched by the growth of revenue. The balance of payments deficit on current account was reduced and foreign exchange reserved increased. While, after 1967 inflation and unemployment began to rise again, leading the government to introduce mildly contractionary policies, at the change of government in December 1970 the balance of payments position was strong and net international reserves were at an historically high level (see Table 5).

The Popular Unity coalition government led by Salvadore Allende, diagnosed Chile's poor economic performance since the 1930s by reference

Table 4: Chile: Selected Economic Indicators 1965-1979

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Real growth rate of GDP (%)	Increase in CPI (%)	Terms of Trade	Unemployment (Greater Santiago) %	Index of Wages, Sals. (1970=100)	Total Reserves minus gold ($ US mn)	Debt Service Ratio
1965	5.0	22	97			93.6	12.4
1966	6.9	27	113			126.9	10.5
1967	2.5	21	86			81.3	12.6
1968	2.9	23	93			162.0	19.9
1969	3.3	29	107	4.6		296.0	18.3
1970	3.7	33	100	4.1		341.8	18.9
1971	7.5	19	71	4.2		170.1	21.2
1972	0.0	79	65	3.3		96.8	9.9
1973	-3.7	352	81	4.8	84.0	121.6	10.9
1974	6.0	506	66	8.3	67.6	41.1	11.5
1975	-11.2	374	42	15.0	65.7	55.9	28.6
1976	4.1	212	43	17.1	70.3	405.1	31.3
1977	8.3	92	50	13.9	88.3	426.5	33.2
1978	6.0	40		13.7		1090.1	38.2
1979		33		13.4		1938.4	26.2

Sources: For cols (1), (2), (6) IFS Yearbook 1980; for col (3) UNCTAD, Handbook of International Trade and Development Statistics Supt. 1980, Table 7.2; col (4) UN Monthly Digest of Statistics, January 1977, December 1979, and January 1981, Table 8; (5) quoted by A. Foxley in "Stabilisation policies and stagflation: the cases of Brazil and Chile", World Development, November 1980, Table 4; col (7) World Bank, World Debt Tables, 1978 Vol. 1, Table II, p.12 and 1980 vol. 1, table x.

Table 5: Chile: The Balance of Payments 1970-1979 ($US mn)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Exports (fob)	1113	1000	851	1316	2244	1570	2116	2187	2459	3841
Imports (fob)	-832	-892	-1001	-1326	-1821	-1682	-1504	-2047	-2544	-3955
TRADE BALANCE	281	108	-150	-10	423	-112	612	140	-25	-114
Invisibles and Transfers	-372	-306	-321	-269	-601	-453	-442	-693	-805	-762
BALANCE ON CURRENT ACCOUNT	-91	-198	-471	-279	-178	-565	170	-553	-890	-876
Direct Investment and Other Long-term Capital	140	-11	297	278	274	106	29	107	1522	1891
of which exceptional financing	-	50	366	349	560	234	—	—	—	—
BASIC BALANCE	49	-209	-174	-1	96	-459	199	-446	632	1015

Source: Balance of Payments Yearbook, International Monetary Fund, Vols. 28 and 31.

Note: Due to rounding error in ~~converting from SDRs~~ to $US the basic balance figure may not ~~always~~ be exactly the sum of its components.

to its economic structure. Structural features such as dependence on the industrialised capitalist economies, control of local markets by domestic and foreign monopolists and concentration of agricultural resources in the hands of a small land-owning élite, had resulted in concentration of income and wealth, a pattern of production biased towards luxury goods and exclusion of a large section of the population from the mainstream of economic activity. The new administration aimed to fundamentally restructure the economy and establish a socialist state. The government's immediate objectives were re-activation of the economy, acceleration of agrarian reform and establishing state control over those sectors of the economy essential to the fulfilment of its development plan.

The existence of idle productive capacity throughout the economy was the base on which the design of Popular Unity's short-term economic policy rested. The strategy aimed to reactivate the economy by expanding public expenditure on, for example, housing construction and other public public works programmes, and by significantly increasing the wage share of national income. While inflation was seen as rooted in Chile's economic structure, Popular Unity aimed to control it in the short run by price controls, maintenance of a fixed exchange rate, special financial assistance for the removal of supply bottlenecks, and proper programming of the fiscal deficit and of the expansion of money and credit.

During its first year in office the Allende administration made considerable progress towards its major goals. Expansionary wage, fiscal and monetary policies, involving a general wage increase averaging 55% and biased towards lower paid workers, an increase in central government expenditures of 66% in nominal terms and a doubling of the money supply, resulted in increased domestic production, while the rise in real wages and employment led to a substantial redistribution of factor shares in favour of labour. Gross domestic product increased by 7.5% in 1971; industrial output was 11% higher than in 1970; the rate of open unemployment in Greater Santiago fell from 8.3% in December 1970 to 3.8% in December 1971; the share of national income received by wage and salary earners increased from 52% in 1970 to 62% in 1971 with the average real wages of blue collar workers increasing by approximately 18%.

The official Consumer Price Index showed the rate of inflation to have decreased from 33% in 1970 to 19% in 1971.[1] At the same time the process of establishing state control over key sectors of the economy was progressing. During 1971 over 80 enterprises, including mines, banks and manufacturing enterprises had been taken over. Land reform was greatly accelerated with almost as many hectares being taken over during 1971 as had been in the previous six years.

The foreign sector fared less well during 1971. The Allende government had inherited in 1970 a historically high level of international reserves ($342 mn, equivalent to three months of imports) but also a large outstanding debt (equivalent to 38% of GDP) and debt service requirement (19% of exports in 1970). During 1971 a fall in the world price of copper and a decline in output at Chile's three major mines led to a 16.5% fall in the value of copper exports, which was only partly offset by the expansion of non-mining exports. Further, loans to Chile from its traditional creditors fell steeply during 1971 causing a net outflow of US $52 mn compared to a net inflow of US $156 mn in 1970. Food imports rose 43% in real terms and consumer goods 17%, while capital goods imports fell by 15%. The balance of payments basic balance swung from a surplus of US $49 mn in 1970 to a deficit of $209 mn in 1971 (see Table 5). As reserves fell to the equivalent of only one month's imports, the government suspended debt service payments in November 1971 while it negotiated a rescheduling agreement. In 1971 foreign exchange reserves were half the level of the previous year.

The advances of the first year were unsustainable. By the end of 1971 serious supply shortages were becoming evident as inventories and foreign exchange reserves were exhausted and capacity limits were reached in a number of sectors. The growth of black market activity undermined the government's anti-inflation and redistribution objectives and eroded the tax base. Continued expansion of public expenditure and the money supply gave rise to generalised excess demand.

A further sharp deterioration in Chile's terms of trade in 1972 (see Table 1) and the credit squeeze imposed by its traditional

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1. The official CPI probably understates the extent of inflation during 1971. A World Bank Country Study quotes two attempts to construct alternative price indices one of which estimates the inflation rate for 1971 at 27% and the other at 53%. See World Bank, January 1980, p.70.

lenders[1] contributed significantly to Popular Unity's economic problems. Domestically, the fact that Allende's coalition government did not control the Congress meant that it could not employ some of the major traditional instruments of economic management. It was restricted to using those instruments controlled by the executive; the exchange rate, public sector pricing, wage setting and the allocation of credit. These instruments were insufficient to regulate the economy for more than a short time. With Allende's opponents in Congress unwilling, for example, to enact legislation curbing black market activities or raising taxes, economic management was extremely difficult. Fundamentally, however, it was the government's inability to control the demand pressures set in motion in 1971 that resulted by late 1973 in the erosion of the initial gains.

Production stagnated in 1972, with output in agriculture, mining and construction falling, and manufacturing output increasing only slightly. These was no growth of GDP in 1972 and a decline of 3.7% in 1973. Employment continued to increase despite the drop in real economic activity, with average employment in Greater Santiago 2.1% higher in 1972 than in 1971 and 3.4% higher during the first semester of 1973 as compared with twelve months earlier. Employment fell by 28% in the construction industry reflecting shortages of materials and curtailment of public works programmes during 1972 but this decline was more than offset by the growth of jobs in the government and service sectors. Service sector employment continued to expand in 1973 and there was new growth in manufacturing employment. Inflation was accelerating rapidly by the end of 1971. The official CPI showed a December 1971 to December 1972 increase of 163% while unofficial indices showed increases of over 200%.

The government's wage policy of full compensation for loss of purchasing power due to inflation since the last adjustment, with greater increases for the lowest paid groups, was continued. Thus in January 1972 the minimum wage was increased by 22% (the rise in the official CPI during 1971) and the minimum wage for blue collar workers was increased by 50%. Further wage adjustments were announced in October 1972 (100%) and May 1973 (61%). The redistributive gains of 1971 were

1. Official lending to Chile from US government agencies (USAID, PL 480, Eximbank, Commodity Credit Corporation and Housing Investment Guaranty) totalled US $236 mn between 1968 and 1970, US $44 mn from 1971-73 and $433 mn from 1974-76. Lending from the World Bank/BID for the same periods was $136 mn, $30 mn and $304 mn. See Whitehead, 1979, p.73.

2. Two unofficial indices quoted in a recent World Bank country survey show increases of 254% and 212% (see World Bank, 1980, p.70).

rapidly eroded as inflation accelerated. The official CPI did not reflect the real rate of inflation, as more and more transactions shifted to the black market and shortages became acute. It is estimated that by the third quarter of 1972 the real minimum wage had fallen below the average level of 1970 and that by the third quarter of 1973 it had fallen to or below the levels of the mid-1960s.[1]

The central government budget continued to expand in 1972 and 1973 with nominal expenditure increasing 85% and 400% respectively. In real terms however, the increase was 10% in 1972 and there was a decrease of 17% in 1973. Real investment spending declined in 1972 and 1973 due to increasing supply shortages and disruptions in the transport sector. By 1972 the revenue yields of almost all tax categories were falling in real terms and the Congress rejected proposals to raise property and capital taxes while the Executive vetoed Congress legislation imposing a tax on foreign exchange transactions. The central government deficit was equivalent to 22% of GDP in 1973. Domestic credit expansion continued with Central Bank local currency credit to the public sector growing a further twelve-fold between December 1971 and August 1973. The money supply grew 576% over the same period bringing the total expansion between the end of 1971 and August 1973 to 1,345%.

In view of the deteriorating balance of payments situation and falling reserves the government devalued the escudo in December 1971 and again in August 1972, May 1973 and August 1973. However, since the exchange rate lagged behind domestic inflation the escudo appreciated in real terms. Copper prices declined a further 11% in 1972 before recovering in 1973. The value of Chile's copper exports fell by $83 mn or 12% in 1972 but rose by $438 mn or 71% in 1973. Imports grew by 9% in 1972 and 31% in 1973 in nominal terms. However, in real terms imports grew little between 1970 and 1973 but the composition of imports changed markedly with food imports accounting for over 30% of the total in 1973 compared with 14% in 1970, while the share of capital goods fell from 29% to 17%. The current account deficit in 1972 was equivalent to 4% of GDP, but fell in 1973 to 2.5% of GDP due to increased copper revenues. The capital account improved in 1972 and 1973 as loans from socialist countries and Latin American countries replaced traditional

1. World Bank, 1980, p.79.

credit lines. A rescheduling agreement was reached with private US banks in early 1972 and later that year the Paris Club group of creditors agreed to reschedule debt service falling due between November 1971 and the end of 1972. As a result of these improvements in the capital account the overall balance of payments improved relative to 1971 but remained heavily in deficit. Before its violent overthrow in September 1973 the Allende government had agreed, in view of the large financial disequilibria and the acute need for external finance and debt renegotiation, to discuss a stabilisation programme with an IMF team scheduled to visit Chile in October 1973 to prepare for the forthcoming negotiations of the Paris Club.[1]

The radical structuralist programme of the Allende years failed because the short-term economic strategy was only viable while there was significant excess capacity in the economy and while the strain on the balance of payments could be absorbed by running down reserves. When this situation no longer obtained the Popular Unity government was unable to curb the demand pressures set in motion in 1971.[2] By September 1973 it is estimated that inflation was running at 20% per month. However, Popular Unity was engaged in an attempt to transform Chile into a socialist state against strong domestic and foreign opposition. It has been argued that"for most supporters of the Allende government the recruitment of popular support had to take precedence over any coherent strategy of economic management, and for many of its opponents currency speculation, black marketeering and even economic sabotage became legitimate instruments of political struggle".[3] Although the populist programme in Argentina was not constrained in this way its evolution followed a similar two-stage sequence.

The economic policy of the Peron government which came to power in June 1973 comprised a stabilisation programme and a set of reformist measures.

1. Griffith Jones, 1980, p.6.

2. Stephany Griffith Jones points out that when, after 1971, the electoral, gradualist path to socialism had been implicitly chosen by Popular Unity,there was a 'dysfunctionality' between the political and economic strategies. The economic strategy exhausted the full range of positive effects during the first year so that by the time the crucial electoral confrontation occurred in the Congrees elections of March 1973, all the negative effects of the excessive demand growth had manifested themselves. See Griffith Jones, 1978, p.1025.

3. Thorp and Whitehead, 1979, p.266.

The reforms, which were mild by comparison with those introduced in Chile under Allende and in Peru under Velasco, included tax reform, changes in the foreign investment law (for example, restricting some areas to local ownership) and agrarian law (for example, allowing expropriation of unproductive estates) and greater State intervention in the export trade with official policy being the development of trade with the Eastern bloc. These measures were never fully implemented. The stabilisation programme aimed to reduce the rate of inflation which had reached 58% in 1972 (see Table 6). This objective was to be accomplished principally by means of an agreement between wage-earners and business - the "social pact" - involving a strict wage and price freeze.

The stabilisation programme was initially successful due in particular to the strong authority of the government which had a large majority in Congress and was viewed by much of the business community as the only government capable of containing social tension. This lent credibility to a programme which was also assisted in its early stages by a favorable international environment. Argentina's exports increased by 68% in value terms in 1973 contributing to a current account surplus of $710 mn in that year compared with a deficit of $227 mn in 1972 (see Table 7). Domestically, the 'social pact' involved a freeze on wages for two years after an initial increase of 20%. This increase and a slight fall in unemployment resulted in an increase of 4% in the share of national income received by wage-earners.[1] Initially there was strict compliance with the price freeze which helped to break inflationary expectations. The absolute price level fell in June by 2.8%, and between July and December it increased by only 4%, while the 30% gap between the black market and official exchange rates disappeared. The external situation and expansionary internal policies almost doubled the real rate of growth in 1973 while unemployment fell (see Table 6).

However, after 1973 the strains imposed on the economy by expansionary fiscal and monetary policies combined with a price freeze, as increasingly overvalued exchange rate and a sharp deterioration in the international environment began to manifest themselves in shortages, a decline in investment, loss of reserves and re-opening of the gap between the official and black market exchange rates. The "social pact" began to disintegrate in 1974 with wage increases being granted

1. See Di Tella, 1979(1), Table 6.6.

Table 6. Argentina: Selected Economic Indicators 1970-1979

	(1) Real growth rate of GDP %	(2) Increase in CPI %	(3) Terms of Trade	(4) Unemployment (Greater Buenos Aires)	(5) Total Reserves minus gold ($US mn)	(6) Debt Service Ratio
1970	4.1	13	107	...	533	21.0
1971	5.9	35	119	5.7	192	19.5
1972	3.7	58	126	6.6	313	20.3
1973	4.8	61	142	5.3	1,149	17.9
1974	6.2	23	119	3.3	1,144	16.6
1975	-1.1	182	100	2.5	288	21.9
1976	-1.6	443	90	4.5	1,445	18.7
1977	4.9	176	83	2.8	3,154	15.3
1978	-3.7	175	76	2.4	4,966	26.7
1979	8.7	159	77		9,388	16.8

Sources: For cols (1) (2) and (5) IMF International Financial Statistics, Yearbook 1980; for col (3) UNCTAD, Handbook of International Trade and Development Statistics, Supt. 1980, Table 7.2; for col (4) figures compiled by the National Institute of Statistics and Censuses of the Argentine, quotation in Di Tella, 1979, Table 6.12, for 1971 to 1977, and UN' Economic Survey of Latin America for 1978, average of April and October figs; for col (6) World Bank, World Debt Tables, Vol. 1, 1975, Table 6 , and Vol. 1, 1980, Table x.

Table 7. Argentina: The Balance of Payments 1970-1979 ($ US mn)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Exports (fob)	1773	1740	1941	3266	3930	2961	3919	5654	6405	7816
Imports (fob)	-1499	-1653	-1685	-1978	-3216	-3510	-2765	-3793	-3482	-6013
TRADE BALANCE	274	87	256	1289	714	-549	1154	1861	2923	1804
Invisibles and Transfers	-433	-474	-483	-578	-596	-738	-499	-566	-1055	-2230
BALANCE ON CURRENT ACCOUNT	-159	-387	-227	710	118	-1287	656	1295	1868	-426
Direct Investment and Other Long-term Capital	97	340	187	42	-2	-170	843	405	1524	3099
BASIC BALANCE	-62	-47	-40	752	115	-1457	1498	1700	3392	2673

Source: *Balance of Payments Yearbook*, International Monetary Fund, Vols. 28 and 31.

Note: Due to rounding error in converting from SDRs to $US the basic balance figure may not always be exactly the sum of its components.

in April and November. Increased import prices and expansionary domestic policies necessitated changes in relative prices and some flexibility was introduced during 1974. However, the government continued to act "as if it accepted an extreme cost-push interpretation of inflation"[1]. The money supply (M_2) increased from 20% of GNP in the second half of 1973 to 24.5% in 1974 while public sector current and capital expenditure continued to increase. Following the death of Juan Peron in July 1974 there was an attempt by the right-wing faction of the Peronist alliance to devise an orthodox stabilisation programme involving fiscal and monetary restraint and devaluation. However, the programme was not implemented until the second quarter of 1975. In the interim prices had increased by 12% in the last quarter of 1974 and by a further 25% in the first quarter of 1975 and wage adjustments averaging 20% were agreed in March 1975.[2] The peso was devalued in March (from ten to fifteen to the dollar).

The deterioration in the foreign sector during 1975 precipitated the introduction of a much more severe programme in June of that year. The programme aimed to establish a realistic exchange rate, improve agricultural prices, encourage private investment, increase prices of public goods and services, diminish the fiscal deficit, keep down wages and curb the power of the unions. The peso was devalued (this time from fifteen to thirty pesos to the dollar) and public goods prices were increased, in many cases by over 100%. A wage increase of 40% was offered and rejected whereupon increases averaging 160% were negotiated on a union by union basis. Di Tella estimates that the cost of living increased 102% in the three months from June 1975. The external situation continued to be critical and reliance on short term financing and particularly "swaps" (foreign short-term loans with Central Bank forward coverage) increased. The crisis brought down the right wing faction of the executive which gave way to the trade union based faction. It introduced, in August 1975, a gradualist programme aimed at resolving the balance-of-payments crisis, re-activating the industrial sector and bringing inflation under control. The government now began negotiations with the IMF which resulted in drawings of $250 mn from low-conditionality facilities (CFF, oil facility and reserve tranche).

1. Di Tella, 1979, p.194.

2. Ibid., p.196.

In November a general wage increase of 27% was granted with an agreement that quarterly adjustments, designed to ensure that the average real wage would be about 95% of the previous year's level, should be instituted. Some public service prices were also indexed. However, there was a second price explosion beginning in January 1976, partly due to the increasingly unstable political situation. The balance of payments situation was still critical and the government now sought high-conditionality assistance from the Fund. At the end of March 1976, however, the government was overthrown in a military coup.

Thus, as in the case of Chile the successes of the first stage were rapidly eroded as the demand side of the economy was neglected. The price freeze succeeded, during the first six months of the "social pact", in breaking inflationary expectations. By the end of 1973 requests for consideration of 'special cases' had begun as increases in the prices of imported goods and the expansionary domestic monetary and fiscal policies rendered the existing price structure increasingly irrational. Di Tella stresses that as the 'social pact' disintegrated during 1974 there were very great oscillations in relative prices and incomes. During the price explosion of mid-1975, for example, wages were increased by 80% in some sectors and by more than 230% in others and the oscillation of relative prices increased substantially relative to the rate of inflation. These oscillations were both the consequence of the accelerating inflation and a major cause of its continuation as intra- and inter-sectoral distributional struggles intensified. He suggests that this characteristic of Argentine inflation may help to explain its subsequent resistance to orthodox anti-inflation measures (see section 4).[1]

The experiences of Chile in 1970 to '73 and Argentina in 1973 to '76 illustrate the crucial weakness of structuralist-based programmes. In practice, the emphasis on the need to remove supply bottlenecks in the medium to long run has tended to justify neglect of short-run economic management. As Foxley has stressed, in order to be successful, a typical structuralist stabilisation programme would need to advance cinsistently on the free fronts of price stability, structural reform and income redistribution.[2] If the achievement of this triple objective is jeopardised by expansionary policies in the early stages which result in a higher than desired inflation rate and/or a balance-of-payments problem

1. De Tella, 1979(2), pp. 1049-1052.

2. Foxley, 1979, p.10.

then immediate corrective action is necessary. However, structuralist/ populist programmes have tended to reject the traditional demand management techniques of fiscal and monetary policy but without replacing them with other instruments. As the problems mount there has tended to be an eleventh hour retreat into orthodoxy.

Does the poor empirical record of structuralist/populist stabilisation programmes indicate that the underlying analysis is incorrect? It has been argued in Ch. 2 that the balance of the argument on the causes of inflation has moved against the structuralist school. However, as was pointed out there, the structuralist argument does not lend itself easily to statistical testing. Wachter's recent attempt using Chilean data to rigorously state and empirically test the structuralist hypothesis that supply bottlenecks in the agricultural sector cause inflation found evidence that inflation did vary with excess demand in agriculture as well as with overall excess demand. In these circumstances an appropriate policy package aimed at controlling inflation might include policies designed to control inflationary expectations and improve agricultural productivity as well as traditional policies of fiscal and monetary restraint. In the Chilean and Argentine cases discussed above, failure to establish and maintain an appropriate balance between these policies contributed to hyperinflation which eroded the progressive income redistribution of the first stages, while the structural reforms were reversed by the succeeding regimes.

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1. Wachter, 1979.

4. Monetarist Programmes: the Case of Chile (1975-78)

Monetarist stabilisation programmes are based on the view that inflation and balance-of-payments disequilibria are monetary phenomena. The kernel of such programmes is, therefore, control of the money supply and of the factors affecting it, particularly the fiscal deficit. Typically, government expenditures are reduced with limits being placed on credit to the public sector, while revenues are increased by raising the prices of public utilities and eliminating subsidies. With a view to creating a structure of relative prices conducive to an efficient allocation of resources price controls are removed and key prices such as the exchange rate and interest rates are adjusted. Import controls are removed and limits are placed on money wage increases.

However, while earlier monetarist stabilisation programmes tended to focus on short-term balance-of-payments and inflation targets, the programmes implemented in Argentina in 1976 to 78, Uruguay in 1974 to 78 and Chile in 1975 to 78 were part of a longer term strategy aimed at altering the structure of the economies so that they would operate to the maximum possible extent on laisser-faire principles. Such transformation was viewed as essential to the achievement of price stability. Thus, in these three cases the goals of the programmes included reduction in the size of the public sector, removal of barriers to international trade and development of local private capital markets. Another feature of these programmes relates to the political context in which they were implemented. In the past, proponents of monetarist stabilisation programmes had argued that, when these programmes failed, their failure was often due to premature reversal of the policies in response to the adverse reactions of the groups most affected by them. In the Argentine, Uruguayan and Chilean cases authoritarian regimes reversed previous trends towards increased economic and political participation, leaving the way open for a thorough implementation of the stabilisation policies.[1]

The Argentine and Chilean monetarist programmes followed, as we have seen, the implementation of unsuccessful, non-orthodox programmes in these countries. In Uruguay, the stabilisation programme was part of a National Plan adopted following a change of government in 1973.

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1. Many commentators argue that authoritarian political structures are a prerequisite for the full implementation of monetarist stabilisation policies in the Latin American context. For a discussion of this thesis see Sheahan, 1980.

The Plan opposed the interventionism of the import-substituting period in Uruguay (1945 to 1973) and proposed greater reliance on the price system as an allocative mechanism. Below, we concentrate primarily on the Chilean programme which is of particular interest for two reasons. First, while in Argentina and Uruguay various modifications were introduced which tempered the impact of the programmes, in Chile the policies were applied thoroughly and consistently. Secondly, the speed and magnitude of the changes sought were considerably greater in the Chilean case. In the sphere of foreign trade, for example, while the Uruguayan authorities did not reduce tariffs at all until the fifth year of the programme, and the Argentinians aimed to gradually reduce the nominal tariff rate from 55% in 1976 to 15% by 1984, the Chileans reduced the nominal average rate from 94% in 1973 to a uniform rate of 10% in 1979. Between April 1975 and mid-1978, the Chileans opted for a policy of "shock treatment", taking the view that the disruptive effects in the short-run would be outweighed by the benefits in the medium and long-runs. The contrasting records of the Uruguayan and Chilean programmes may be instructive on the relative merits of the "gradualist" and "shock" approaches.

When the Popular Unity government of Salvadore Allende was overthrown in September 1973, inflation was estimated to be over 20% per month, production was falling, net international reserves were negative, debt service payments were in arrears and the central government and public sector enterprises were running large deficits. On the other hand, Chile's traditional creditors who had suspended or greatly reduced their activities in Chile during the Allende years, were now prepared to resume lending. Negotiations with the IMF began in November 1973 and a stand-by arrangement in the first credit tranche was concluded in January 1974. In March 1974 the Paris group of creditors, with the Fund acting as consultant, agreed to roll over 30% of debt repayments outstanding for 1973 and 1974. Further, world copper prices were still high and rising. Dollar export revenues nearly tripled between 1972 and 1974.

During 1974 the main emphasis was on political consolidation of the new regime. However, a number of key economic decisions were implemented. These included the freeing of prices, introduction of a very rapid programme of tariff reductions, establishment of a capital market, devaluation and unification of the exchange rate, reform of the tax system, introduction of a new foreign investment code, and reversal of the structural changes fostered by the previous regime, by, for example, cessation of land expropriation, settlement of outstanding expropriation claims of foreign investors, and return of socialised enterprises to the private sector. Chile's GDP rose by 6% in 1974, having declined by almost 4% in 1973. Recovery was particularly marked in agriculture, mining and construction, but industrial output remained depressed. Unemployment increased from 4.8 to 8.3 per cent of the labour force and the official Consumer Price Index shows inflation to have increased from 352% in 1973 to 506% in 1974 (see Table 4).[1] Despite an 82% increase in the value of imports the balance of payments improved due to high copper prices and increased output, growth in non-copper exports and the return of foreign and domestic capital (see Table 5).

A number of factors combined in early 1975 to persuade the Chilean authorities of the need to introduce a severe austerity programme. Inflation began to accelerate. The CPI rose by 61% in the first three months of 1975 compared to an increase of 39% in the last quarter of 1974. Further, it was clear by the end of the first quarter of 1975 that Chile was facing a severe balance of payments crisis. The price of copper which had been very high during most of 1974 collapsed towards the end of that year as an indirect result of the oil price rise. Chile's export earnings from copper almost halved in 1975 and the increase in non-mining exports was not sufficient to compensate. Foxley estimates that the net effect of the deterioration in Chile's terms of trade in 1975 was equivalent to a loss of income vis-a-vis the rest of the world of 5.6% of GDP. Chile had virtually no international reserves and prospects for substantial medium or long term private finance were very limited due to the tightness of international capital markets and the lack of confidence in Chile's economic management and political stability. The Fund 'seal of approval' was crucial for Chile at this time and the Fund was very critical of Chile's demand management during 1974. It was clear that negotiation of a new stand-by arrangement would involve more severe deflation than in 1974.[2*] Cabinet changes in April 1975 strengthened the position of those who argued in favour of a policy of 'shock treatment'. The argument was that without a sharp contraction of the economy stabilisation would not be achieved. If, on the other hand,

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1. As previously noted, the accuracy of the official CPI is disputed. There are two unofficial indices, one constructed by a 1974 World Bank mission to Chile and the other by the Department of Economics at the University of Chile. The former shows inflation to have declined from 405% in 1973 to 376% in 1974, and the latter from 616% in 1973 to 376% in 1974. See World Bank, 1980, tables 9.3a and 9.3b.

2* Please see over

drastic treatment was applied rapidly and logically an 'economic miracle' would follow after an apparent two to three year economic collapse.

The severe programme of demand restraint introduced in April 1975 had two objectives: to reduce inflation to the world level and to remove the foreign exchange constraint that had emerged in 1975. Meanwhile, the policies introduced during the previous eighteen months aimed at the fundamental restructuring of the Chilean economy were continued. For example, in pursuance of its goal of trade liberalisation, Chile's average tariff which had been reduced from 94% in 1973 to 52% by January 1975 was further reduced to 27% by the end of 1976 and 10% by mid-1979. The stabilisation programme relied on monetary policy, supported by fiscal restraint, and on devaluation.

In Chile monetary policy had been virtually non-existent as an independent tool of macroeconomic management since the 1930s. Central Bank reserve creation and credit expansion were functions, by and large, of the public sector deficit. The stabilisation programme now aimed to combat inflation by controlling the growth of the money supply and eliminating the fiscal deficit while at the same time structural alterations in the functioning of the financial system were being introduced. These structural changes were intended to transform the financial system into a competitive market in which the allocation of resources would be determined by the forces of supply and demand reflected in the interest rate, and, at the same time, to make the system more responsive to the control of the monetary authorities.

Money and credit had expanded rapidly during the last quarter of 1973 with M_1 more than doubling in nominal terms. Credit to the public sector contributed to monetary expansion during 1974 but growth of credit to the private sector was a more significant factor. The net domestic assets of the banking system grew by 85% during 1974 and the nominal money supply increased almost three-fold. As copper revenues declined, the expansion of credit to the public sector accelerated in the last quarter of 1974

2* The Chilean Finance Minister in an interview on Euromoney, July 1978 stated "After the price of copper went down in 1975, we projected a deficit in the balance of payments of US $1.2 bn. In conversations with the IMF, we were told we could not have a bigger deficit than US $50 mn because we could not get financial support for more than that. After a lost of haggling, we came to an agreed deficit of US $240 mn. The only way to do that was to cut down drastically."

and the first quarter of 1975 and the nominal money supply increased by 43% and 33% respectively in the two periods. The expansion of credit to the public sector slowed during the first three-quarters of 1975 with the virtual elimination of the public sector deficit (see below), while the growth of bank credit to the private sector was restricted by higher reserve requirements and limits on the growth of bank loan portfolios. Despite the efforts to reduce liquidity however, the nominal money supply increased by more than 250% during 1975 (see Table 8).

Table 8. Chile: Money, Quasi-Money, and Domestic Credit, 1973-79
(millions of pesos)

	1973	1974	1975	1976	1977	1978	1979
Money Supply (M_1)	225	838	2,995	8,795	18,314	30,578	47,434
% increase		272	257	194	108	70	55
Quasi-Money	256	1,269	4,516	11,168	27,623	57,092	99,165
% increase		396	256	153	147	107	74
Domestic Credit	1,213	9,661	42,091	146,648	321,188		
% increase		696	336	248	119		

The major source of expansion had now become foreign exchange operations resulting from increased capital repatriation and short-term inflows as well as the growth of non-copper exports and severely depressed imports.

Meanwhile, the public sector deficit had become progressively less important as a source of money supply growth. The deficit of the central government, in late 1973, had been 20% of GDP. It was reduced to about 7% in 1974 but was still a significant source of inflationary pressure. With the introduction of 'shock treatment' in 1975 the expenditure of the central government was reduced by 28% in real terms. Current expenditures were cut by 15% while net investment fell by 54% (see Table 9). As a result of the tax reforms introduced at the end of 1974 and improved tax collection, tax revenues rose from 17.8% of GDP in 1974 to 20.4% in 1975. The central government budget was in surplus in 1975 for only the second time in the previous twenty-five years. Current expenditure was increased by 10% in 1976 but the further 28% cut in investment spending left total central government spending increasing by less than 2% in real terms. Current real transfers to state enterprises were reduced by 40% in 1975 and by a further 23% in 1976. The upward adjustment of public utility prices, restriction of credit to public sector institutions, and increased fiscal discipline resulted in the operating deficits of those public enterprises that remained in state hands being eliminated by 1976.

Table 9. Chile: Central Government Revenue and Expenditures, 1973-1977
(Millions of pesos at December 1969 prices) a/

	1973	1974	1975	1976	1977 p/
Current Revenues b/	9.9	19.3	18.6	20.0	22.0
Current Expenditures	18.6 d/	16.9	14.4	15.8	19.0
Current Balance	-8.6	2.4	4.2	4.2	3.0
Capital Expenditures c/	3.2	8.5	3.9	2.8	2.8
Overall Balance	-11.8	-6.1	+0.3	+1.5	+0.2

a/ Nominal data for 1973 are deflated by an average of the official and IBRD adjusted CPIs; deflation thereafter is by the IBRD adjusted CPI.

b/ Includes nontax current revenues.

c/ Net of capital revenues and excluding debt amortization.

d/ Includes expenditures financed directly by the banking system.

p/ Provisional.

Source: World Bank, 1980, p.118.

The exchange rate had been put on a crawling peg in October 1973 and the real rate devalued slowly throughout 1974. The devaluation was accelerated during 1975 in view of the deteriorating balance of payments situation (see Table 5). The deficit on current account was six per cent of GDP in 1975 despite severely restricted imports and strong growth in non-traditional exports. Recovery of export earnings from copper and further declines in imports brought the current account into surplus in 1976. The improved balance of payments situation enabled Chile to meet its full debt service obligations without rescheduling for the first time in five years.

There was some relaxation of the austerity measures in the second half of 1976. The elimination of the public sector deficit permitted a relaxation of limits on lending to the private sector and the deceleration of inflation (the official CPI showed a decline in the rate of increase from 374% in 1975 to 212% in 1976) was deemed to justify gradual restoration of normal liquidity levels. Therefore, quantitative credit controls were ended in May 1976 and there was a progressive reduction of reserve requirements initiated in the second half of 1976 and continued in 1977. The build-up of international reserves (see Table 4) was the major source of reserve money creation in 1974. Concerned with the impact on the money supply and with a view to further lowering inflationary expectations, the peso was revalued by 11% relative to the US $ in June 1976 with a second revaluation following in March 1979. Fiscal restraint continued in 1976 with total central government expenditure increasing by 2%. In 1977 however total central government expenditures increased by 17% in real terms as in view of the relaxation of the foreign exchange constraint and some further deceleration in inflation (to 42% in 1977) transfers and wages of public sector employees were increased. The balance of payments on current account deteriorated again in 1977 as copper prices again declined and imports increased as the austerity measures were relaxed. However, this deterioration was more than offset by Chile's improved access to foreign private bank loans and suppliers credits.

Did the policy of "shock treatment" succeed in producing the promised "economic miracle" and how serious did the prior "economic collapse" turn out to be? On the one hand, the programme succeeded in removing the balance-of-payments constraint. Capital inflows were more than adequate to counteract current account deficits in 1978 and 1979 and the basic balance was strongly in surplus in those years (see Table 5). On the other hand, however, service payments on medium and long-term debt reached 38.2% of export receipts in 1978 with interest service payments alone amounting to 12% of export earnings in 1978 and 1979. Inflation proved a more persistent problem. By 1979 it had been reduced to 33% which was the same level as in 1970 and almost three times the world level. Chilean GDP increased by 8.3% in 1977 and by 6.0% in 1978 (see Table 4).

However, the goals of the Chilean programme comprised both short-term stabilisation and long-term structural transformation of the economy. The long-term objective requires that the private sector within Chile together with foreign investors should take over the investment role previously filled by the State. The gross investment ratio however, having fallen to 10.1% of GDP in 1975, declined further to 8.7% in 1976. It recovered marginally in 1977 to 9.0% and in 1978 (the last year for which figures are available) reached 11% of GDP. This level of investment is well below the historical rate (of around 15%) and is scarcely sufficient to cover depreciation. One reason for the very low level of investment has been the performance of short-run interest rates since their freeing in May 1975. The nominal monthly rate jumped from 9.6% in April of that year to 19.0% in May and 21.2% in July (the latter implying an annual rate of over 900%).[1] Simultaneously the monthly inflation rate was declining and the tightness of credit together with the lag in inflationary expectations resulted in real interest rates averaging 7% per month for thirty day money during the last six months of 1975. The gross spread between deposits and loans was 5½%. The average real monthly rates declined to 4.24% in 1976, 3.85% in 1977 and 3.0% in 1978 (or annual rates of 65%, 57% and 43% respectively), while since early 1977 the gross spread has declined steadily reaching 0.9% in late 1978. Real short-term interest rates have greatly exceeded the rates attached to indexed long-term securities and loanable funds have been concentrated in the short-end of the market. A recent World Bank study suggests that during 1976 the very high short-term interest rates did not represent an important impediment to long-term investment since the uncertainties created by the thorough and rapid abandonment of the development path followed during the previous decades would have dampened investment in any case. The study adds,

1. World Bank, 1980, p.132.

however, that given the recovery evident since 1977, the persistence of such high short-term interest rates "inhibits the development of a capital market and makes it difficult to achieve the level of investment required to complete the structural transition intended by the Government's economic programme and to set the basis for accelerated long-term growth."[1]

However successful the programme is in the long run it is clear that the deterioration in the terms of trade and the stabilisation policies adopted in 1975 imposed very great costs on the Chilean economy. Industrial production declined by 27%,real GDP fell by 11.2% in 1975 while open unemployment reached 20% of the labour force in Greater Santiago in early 1976 as the economy suffered "its worst recession since the 1930s".[2] While GDP growth recovered in 1977 unemployment has remained very high with open unemployment in Greater Santiago still over 13% in 1979. To what extent were these costs the inevitable consequence of the deterioration in the terms of trade and to what extent were they the result of the stabilisation policies adopted in 1975? The World Bank country study cited above stresses that the massive foreign exchange constraint which Chile faced in early 1975 made recession inevitable. The study quotes the finding of another Bank report that the terms of trade loss suffered by Chile as a result of the world recession was the largest of the 120 countries in the survey. The Bank report estimates that the loss of copper revenues in 1975 in current prices was equivalent to about 10% of the previous year's GDP and that when the rise in import prices is added, the terms of trade effect equalled about 12% of GDP. Given a decline of this magnitude in the capacity to import and the hostility of foreign official lenders to the Pinochet regime, domestic recession was unavoidable. The Bank Mission recognised that"... better economic management in late 1973 and in 1974, including a more gradual relaxation of price controls in an effort to influence expectations, and a more cautious restimulation of the economy in view of the precarious debt and reserve situation, might have reduced the system's vulnerability to the balance of payments crisis of 1975." The Mission considered that it might have been possible, through the selective use of price controls and import controls to alleviate some of the impact of the

1. Ibid., p.136.
2. Ibid., p.96.
3. Ibid., p.106.
4. Ibid., p.166.

crisis in production and employment and to divert some additional resources to the relief of the greatest hardship. Further, the government could have acted sooner to restimulate the economy in 1976 given the build-up of international reserves and the evidence of declining inflationary expectations.

Foxley argues that the Chilean authorities overreacted to the acceleration of inflation at the beginning of 1975 and to the drop in copper prices. Imports were reduced mainly by contraction of internal demand and the contraction was so severe that by the middle of 1975 the accumulation of reserves was having an expansive effect on the monetary sector. Fiscal policy, involving sharp reductions in public investment, strengthened the recessionary tendencies. He contends that eschewing price controls and relying instead on reducing inflation by restraining aggregate demand lengthened the stabilisation period and accentuated the depression in industrial production. It was not until the middle of 1976 that the authorities decided to attack the problem of expectations through manipulation of a key price, the exchange rate. Foxley also points out that the difficulties involved in controlling the money supply in developing countries (due to factors such as instability in the world price of basic export products) were accelerated in Chile by the drive to establish a private capital market. The capital market created short-term assets which served as near substitutes for money during the period of maximum inflation. He notes that monetary expansion, with money defined to include these short-term assets, was twenty points higher than figures covering only money, as traditionally defined (bank notes plus demand deposits).[2] Foxley contrasts the approach adopted in Chile in 1975 with that of Brazil in 1966 and '67 noting important differences in both the nature and the timing of stabilisation measures. For example, while in Brazil current government expenditures were sharply reduced and tax revenue increased due to reform of the taxation system, public sector investment grew by approximately 20% in 1967. Thus, unlike in Chile in 1975 public investment was used as a countercyclical instrument and contributed to the raising of the investment rate from 18% of GNP in 1965 to 22% in 1968. Also, in contrast to Chile, when after a year of "corrective inflation" following the freeing of prices in 1964, inflation appeared to be accelerating,

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1. Foxley, 1980.
2. Ibid., p.895.

the Brazilian authorities introduced a system of price controls and an incomes policy in 1965. These instruments reduced inflationary expectations and contributed to the decline in inflation from its 1964 level of 90% to 35% in 1965. Further, while the development of a private capital market was also an objective in Brazil, the development of new monetary instruments was much more gradual in Brazil than in Chile. It was not until 1968 when the economy was in an expansionary phase that the new financial instruments had a significant impact on the money supply. Similarly, while the long-term development strategy in Brazil, as in Chile, involved opening-up to foreign trade, this process was much more gradual in Brazil, allowing industrialists to adapt to the new conditions over a period of years. (A major difference between the positions of Brazil and Chile in these two periods was that Brazil did not experience any marked fluctuation in its terms of trade.)

Of the three monetarist stabilisation programmes adopted in Uruguay, Chile and Argentina in the mid-1970s, the Uruguayan programme was the most successful.[1] The immediate balance of payments problem had been considerably eased by the end of 1976; the rate of inflation had been reduced from 77% in 1974 to 44% in 1978; the investment ratio increased from 10.1% in 1974 to 14.6% in 1977 and real per capita GDP grew at an average annual rate of 2.6% between 1973 and 1977 compared with an average annual rate of increase of 0.5% between 1954 and 1974. The long-term objective of the Uruguayan programme was, as in Argentina and Chile, the restructuring of the economy so that it operated on free market principles, and the principal instruments of short-run policy were restriction of the rate of growth of the money supply and of public expenditure. However, the Uruguayans rejected the "shock treatment" approach adopted in Chile and opted instead for gradualism and for a wider range of policy instruments. For example, in April 1975 when the inflation rate for the previous twelve months was reaching 100%, prices, wages and the exchange rate were frozen with a view to lowering inflationary expectations. Price controls were lifted in early 1976 but reimposed in March 1977 when inflation again began to accelerate. While, in the sphere of fiscal policy the main aim was to reduce the ratio of government spending to GDP, a subsidiary objective was to alter the composition of government spending in favour of investment.

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1. For a detailed discussion of the Uruguayan programme see Finch, 1979.

The share of total central government spending allocated to investment increased from 10.1% in 1974 to 12.0% in 1977. Closer integration in the world economy was also an objective of the Uruguayan programme. However, as previously noted, the speed of opening up to foreign trade was much slower in Uruguay than in Chile. Further, the very rapid growth of non-traditional exports was fostered by export subsidies.

Another important aspect of the Chilean case concerns the distribution of the burden of adjustment. Some of the difficulties involved in determining the distributional consequences of stabilisation programmes have been discussed in Chapters 2 and 3. Normally, "the ideal data set, which would provide the distribution of income both prior to and at some stage after the implementation of a programme, does not exist."[1] However, while figures on the distribution of personal income in Chile are not available, Foxley quotes indirect evidence suggesting that the very high rates of unemployment and the decline in real wages over the years of the stabilisation programme, increased urban income inequality. In 1970 wages and salaries had accounted for 52.3% of national income. By 1972 the share had risen to 62.8%. Between 1973 and 1976 it fell from 47.2% to 41.1% before rising to 46.0% in 1977. Figures for the distribution of household income in the Greater Santiago area for 1969 and 1978 show consumption of the highest quintile to have risen in the period from 43.2% to 50.0% of total consumption while the share of the lowest 20% decreased from 7.7% to 5.2% of the total.[2] Similarly, in Uruguay unemployment increased from an average of 8% in the previous five years to 13% in 1976. Figures for Montevideo show the income share of the lowest quintile to have fallen from 6.5% to 5.5% between 1973 and 1976 while the share of the upper 20% of families increased from 43.5% to 46.7%.[3] In the case of Argentina the rate of unemployment did not increase during the years of the stabilisation programme (see Table 6), partly due to the fact that public sector employment remained high throughout the recession and partly because of the tendency for Argentina to export its unemployment to neighbouring countries. However, Foxley estimates that real wages in the public sector fell by 5.3% between 1975 and 1978 while average wages in the industrial sector fell by 32% between 1975 and 1977.[4]

1. Johnson and Salop, 1979, p.15.
2. Foxley, 1979, p.20.
3. Ibid., p.21.
4. Ibid., p.20.

The asymetrical treatment of goods prices and wages, wherein prices are set free and nominal wages are fixed is a common feature of orthodox stabilisation programmes. As Foxley stresses, in an economy, which at the beginning of the stabilisation period is in a state of disequilibrium with repressed inflation, this change in relative prices will have a direct effect on income distribution with a fall in real wages and unless this is compensated by higher employment levels, a decline in the wage share. Similarly, the method chosen to reduce the fiscal deficit could have regressive distributional effects if, as in the case of Chile, public expenditure in such areas as health, education, housing and social security is severely curtailed and indirect taxes become relatively more important. The impact of the stabilisation programme on the rural/urban terms of trade may also have important distributional consequences in ldc circumstances. In the case of Chile, with 21% of the population employed in agriculture, the relative improvement of agricultural prices and continuous growth of output during the stabilisation period, suggests a shift of income towards the agrarian sector. However, the data are insufficient to indicate how it was distributed within the sector.[1]

A final pertinent aspect of the Chile case concerns the role of the IMF during the 1973-78 period. The Fund played a crucial role in 1974 and 1975 in granting credits to Chile and in facilitating Chile's access to other sources of credit especially through the renegotiation of official loans. At the expiry of the 1974 Stand-by the Fund attributed the continuing high inflation to excess demand caused primarily by the wage and salary increases granted in January 1974, and insisted that a sharp reduction in the rate of inflation was contingent on the adoption of more austere policies than had been implemented during 1974. The Fund pressed for lower real wage levels than proposed by the Chilean team and set quarterly limits on government expenditure. It also, however, suggested that in the light of the severe balance-of-payments difficulties anticipated for 1975 they should postpone further tariff reductions.[2] A stand-by arrangement in the second and third credit tranches was agreed in March 1975. Access to the funds was conditional on Chile's meeting quarterly performance targets related to government expenditure, bank credit to the public sector, the net domestic assets and international reserve position of the banking system

1. World Bank, 1980, p.154.
2. See Griffith-Jones, 1980, p.26 ff.

and new foreign indebtedness. Griffith-Jones suggests that given the increased opposition to renegotiation of official loans in 1975 because of increasing disapproval of Chile's human rights record, the signing of a stand-by with the Fund was even more important in 1975 than in 1974. The "Paris Club" of Chile's creditors postponed its meeting to allow stand-by negotiations to be completed.[1]

The Fund's direct influence on economic policy in Chile diminished in 1976. In that year Chile began to obtain access to loans on the private international capital markets. These markets had become more liquid and the 1975 stabilisation strategy had increased Chile's credit worthiness. Chile's need of the IMF "seal of approval" was correspondingly reduced. Chile's first major medium-term loan from the private capital markets was negotiated with a consortium of United States and Canadian banks in May 1976. Although it was originally contingent on the negotiation of a new stand-by arrangement it went ahead even after Chile and the Fund failed to conclude an agreement. The 1976 negotiations failed, according to Griffith-Jones, because the Fund wanted further reductions in real wages which the Chilean authorities resisted and because of Fund criticism of what it considered to be excessive adherence by the Chileans to the principles of a free market economy. She states that the Fund counselled the Chileans to increase public investment and fund it by additional direct taxation and hinted in documents prepared in 1976 at the possibility of introducing price guidelines of even some kind of incomes policy.[2] Although a stand-by was not agreed in 1976 Chile made substantial drawings under the Oil Facility and the Compensatory Financing Facility. No further credits were requested in 1977 and by 1978 Chile had repaid virtually all its Fund stand-by credits.

The record of the Chilean stabilisation programme of 1975 to '78 is mixed. As in the cases of Argentina and Uruguay the programme succeeded in quickly removing the immediate balance-of-payments constraint. The hyperinflation of the 1973 to 1976 period has also disappeared, but by 1979 Chilean inflation was still almost three times the world level.

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1. Ibid.
2. Ibid., p.43.

The costs of the programme in terms of lost output and unemployment were extremely high and the long term objectives of the programme continue to be jeopardised by the very poor investment performance. Reviewing the progress of the Chilean economy since the last 1960s, the World Bank report cited earlier points out that by 1977 per capita output in Chile was roughly equivalent to the level of 1968 "suggesting that the shocks Chile had endured since 1970 had, in a global sense, cost the nation a full decade of economic growth."[1]

1. World Bank, 1980, p.96.

Summary and Conclusions

In this chapter we have focused on some Latin American stabilisation programmes of the 1970s dividing them into three categories viz. the conventional, monetarist, and structuralist/populist programmes.

The discussion of 'conventional' programmes dwelt in particular on the stabilisation policies adopted in Peru between 1975 and 1978. We noted the very high costs imposed on the Peruvian economy by the prolonged failure to adjust to the balance-of-payments crisis of early 1975 and the conflicting views on whether or not the policy instruments employed were suited to the Peruvian context. On the efficacy of devaluation, the balance of the evidence in the Peruvian case suggested that exports and imports were responsive to exchange rate changes and we noted in Peru, as in each of the cases discussed in this chapter, the very strong performance of non-traditional exports. We also discussed the attempt by the Peruvian authorities to avoid recourse to the Fund by negotiating directly with the North American banks for balance-of-payments support, and the effect of the failure of the Peruvian experiment in re-asserting the importance of the Fund "seal of approval". We noted that increased awareness on the Fund's part of the political exigencies, and on the Peruvian part of the economic, appeared to contribute to the relative 'softness' of the 1978 stand-by arrangement. The experience of the Peruvians with the American banks and with the Fund contrasted with that of Mexico and emphasised the narrower range of options open to small, dependent economies with balance-of-payments problems. While resource rich countries such as Brazil and Mexico may, by virtue of their access to international capital, be in a position to pursue heterodox financial policies, ldcs who do not share their advantages may have little alternative to pursuing the conventional approach.

In discussing recent monetarist programmes in Chile, Argentina and Uruguay we noted that, in addition to short-term aims, these programmes also attempted a structural transformation of the economy intended to result in its operating to the maximum possible extent on laisser-faire principles. These programmes tend to achieve their quickest success in removing the immediate balance of payments constraint. The problems involved in controlling inflation, often exacerbated in the 1970s by volatility in the terms of trade and increased short-term capital mobility, have proved more difficult of solution. We noted differences between programmes in the uses made of instruments such as price controls, export subsidies and public investment, and stressed the very high costs, in terms of lost output, unemployment and the lag in capital formation, associated with the adoption of a "shock treatment" approach in Chile in 1975/1976. The role of the Fund in relation to these monetarist programmes was qualitatively different to its role in the "conventional" cases since given the domestic commitment to orthodoxy the Fund was essentially lending credibility to domestic initiatives and latterly, at least in the Chilean case, arguing for greater flexibility and gradualism.

Stabilisation programmes in the "structuralist/populist" category also seek structural transformation of the economy with a view to removing the supply bottlenecks which are seen as the fundamental cause of inflation. Our review of two such programmes in Chile (1970-73) and Argentina (1973-76) indicated a poor empirical record for this approach. We noted the typically two-stage evolution of these programmes wherein, in particular, the distributional gains of the early stages tend to be reversed in the second phase of the programme. In both these cases the structural changes effected during the structuralist/populist period were also quickly reversed by the succeeding governments. The poor record of such non-orthodox programmes in relation to short-term economic management coupled with the dearth of theoretical support for many of the structuralist arguments had tended to make the structuralist/monetarist debate an uneven contest. However, the structuralist emphasis on the importance of supply-side factors and the need for more gradual adjustment has had a significant impact on orthodox thinking about stabilisation. The recent agreement between the IMF and Guyana, for example, wherein the Fund is supporting, in collaboration with the World Bank, a medium term programme of structural economic reforms designed to increase domestic supply capacity through a re-allocation and expansion of investment, illustrates the Fund's increased emphasis on supply-side factors.[1]

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1. For a description of the Guyana programme see IMF Survey, August 4, 1980.

As suggested in the Introduction to this Chapter, in the abstract, an ideal stabilisation programme would seek to minimise the short-run costs (which are inevitable) and maximise the long-run gains resulting from the stabilisation policies. In practice however, the importance assigned to particular short-run costs varies. In structuralist programmes an explicit policy goal will be to protect the weakest sectors from bearing the burden of adjustment. Therefore, priority is assigned to maintaining employment and real wage levels. In monetarist programmes the distribution of the burden of adjustment will be decided by the interplay of market forces (although as Diaz-Alejandro points out modern monetarist programmes often include "a special kind of incomes policy consisting primarily of tough limits on money wages increases").[1] Thus, while much of the monetarist/structuralist debate can be seen as "an argument about the speed of adjustment and the relative efficacy of various instruments, rather than a crude distinction between the primacy of 'supply' and 'demand'"[2] the remainder is ultimately a debate about political priorities and the weights to be assigned to particular short-run costs and long run benefits.

1. Diaz-Alejandro, 1979, p.6.
2. Fitzgerald, 1979, p.24.

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