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A Contribution to the Critique of Southern Cone Monetarism

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1. Introduction

This is an initial attempt at providing a framework for the study of critical aspects of the stabilization policies followed under military rule in Argentina, Chile and Uruguay, during the 1970s and early 1980s.

The paper is divided into three main parts. The next section provides an interpretation of why these countries initially succeeded in promoting an export-led growth path. Section 3 goes on to argue that policy makers in the Southern Cone misinterpreted the nature of the economic constraints, which their countries faced and then erroneously proposed to substitute import liberalization for export promotion. The *coup-de-grace* to their model was also self-inflicted: their frustrating attempt at reaching price stabilization through exchange rate prefixation is analysed in Section 4[1].

2. Instant Success: Export Growth and Diversification

The anti-export bias is well documented of the development strategies followed in LA from WW II to the mid-sixties. Incentive policies were manipulated in such a way that it become much more profitable to produce for the domestic market than to export. QRs protected the activity of import substitution, typically leaving to the tariff system only a marginal role to play. At the same time, the low level and high variability of the real exchange rate, associated with first serve rules for the domestic market and unfavourable fiscal and credit systems, tended to make non-traditional export activities rather unprofitable.

Under such circumstances, it became untenable to argue – as the old LA Structuralist School used to do – that the growth of exports was limited by foreign demand, even though domestic resources tended to go idle, because of periodically restrictive fiscal and monetary policies, which were adopted to maintain the balance of payments in equilibrium. Actually, LA economies seemed to suffer from a peculiar type of “classical unemployment”, as applied to developing economies.

Import substitution had been explored to its limits, but a foreign exchange shortage continued to occur, as non-competitive imports of raw materials, intermediate products and capital goods were still required to guarantee “normal” rates of GDP growth. However, under existing export propensities, not enough foreign exchange was generated and, therefore, growth lagged and unused industrial capacity emerged.

The diagnosis was clear for all those who cared to compute existing low levels of export

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profitability in LA. Only traditional exports, with a strong natural resources base, could compete in foreign markets. This situation can be described as the "Southern classical unemployment" case. In the Northern version employment is directly limited by excessive real wages. By contrast, in LA, employment levels and capacity growth were restricted by the low profitability of the critical export sector.

The verdict was proven correct by the results of policy shifts occurring in the sixties and seventies. As LA countries started following outward oriented policies (by which we essentially mean raising the expected rate of profits in export activities), exports boomed thus increasing the ratio of exports to potential GDP and lowering the foreign exchange barrier that previously constrained the growth rate of output in these countries. The growth of exports and the associated increase in foreign reserves raised the international creditworthiness of LA countries and for a while allowed them to have unlimited access to the Eurodollar market.

The promotion of exports was accompanied by various efforts at import liberalization. In the cases of Brazil and Colombia, this meant restricting the use of QRs and moderately attempting to lower the general level of tariffs, especially those higher up in the protection scale. As the real exchange rate was maintained at relatively favourable levels by a system of minidevaluations, these tariff reforms in Brazil and Colombia, while rationalizing somewhat their protection systems, seems to have hardly affected the rate of profits in most import substitution activities.

3. Spoiling the Outcome: The Lerner Symmetry Theorem Misapplied

Different was the intent in the Southern Cone. In words if not in deeds, the aim was to achieve a complete liberalization of imports, letting international markets free to decide which import substitution activities should remain in the country. Frequent appeals were made to the Lerner Symmetry Theorem, to justify these import liberalization measures. In a fully employed economy with balanced trade of the 2 by 2 textbook variety, the theorem in fact applies. More protection for the relatively less efficient industry means more punishment for the industry with a comparative advantage. In this general equilibrium world, it is thus irrelevant whether exports are promoted or imports liberalized. In practice, it matters a lot.

If the diagnosis in the previous section is correct, initially at least LA. Countries were in a "Southern classical unemployment" situation. Abruptly lowering the import barriers under these circumstances would be rather odd. For if prices and wages were not flexible, the consequence should be still higher unemployment rates. Clear enough, export promotion needed to take precedence over import liberalization. Later on, as foreign exchange accumulated, more liberal fiscal and monetary policies could be adopted, raising domestic employment levels while maintaining balance of payments equilibrium. At this stage, it would seem appropriate to liberalize imports to help promote a more rational allocation of resources in the economy.

Even then, account should be taken of the fact that complementary inputs of capital goods and intermediate products are critical expenditure items in a growing semi-industrialized economy. Hence, the extent to which competitive imports should be allowed into the country need to be conditioned to export prospects. Maybe that those are so bright that imports can be fully liberalized. Recent world economic events, however, dramatize the limitations of the “small country” assumption. Small market shares are not a safeguard against non-tariff protectionism in industrial countries or indiscriminate import cuts in LDCs.

Moreover, at least in the case of Brazil (whose share in world imports of manufactures is less than 3 per cent), the behaviour of manufactured exports in the 1972-80 period is much better explained by a fully specified supply-and-demand econometric model than by a single supply equation with given world prices. This is in line with the increasingly popular Linder view according to which the intricacies of world trade in manufactures cannot be captured by purely competitive models, but need to be formalized at a minimum as an imperfect competition affair.

The lesson is that the foreign exchange gains of domestic price changes favouring the export sector is conditioned on the State of world aggregate demand, even in the case of a “small country”. If world demand weakens, the real devaluation needs to be much higher than otherwise would be the case to yield the same gain in terms of foreign exchange. Hence, a long-run case may be built in a world of uncertain foreign demand for the maintenance of a residual degree of protection against competitive imports.

Turning now to facts it must initially be noted that even in the Southern Cone it was only in Chile that import liberalization measures hit very deeply.

In Uruguay, a recent analysis notes that: “Until 1980, the protected activities were not displaced by import competition, although imports did increase in domestically produced items. Rather, the industrial boom between 1974 and 1980 was centered on the protected industries. The reduction in nominal protection did not translate itself into a reduction either of the tariff, which is implicit in the differential between domestic and foreign prices, or in the effective tariff. Consequently, the evolution of protection levels were not related to the phase of industrial expansion” (Macadar, p.264).

The case of Uruguay is noteworthy because this country succeeded in maintain an unprecedently high rate of GDP growth (5.0 per cent a year in 1974/80, compared with 1.9 percent in 1968/73, and 0.3 percent in 1961/68), while raising the share of manufacturing in GDP. This case is clearly suggestive of our contention that export promotion and not import liberalization was the critical factor explaining the recovery of the growth potential, after the depressed economic conditions experienced by LA economies in the sixties.

The lowering of import barriers in Argentina was carried further than in Uruguay. According to Canitrot, on average nominal tariffs for industrial goods (excluding those with tariffs lower than 25 per cent before 1976) declined from 94 per cent at the end of 1976 to 35 per cent at the end of 1979 (with 70 per cent of the reduction occurring in November 1976). However, the margin of excessive protection seems to have been sufficiently high to prevent effective import competition until late 1979.

At this stage, the policy of continuously overvaluing the real exchange rate, which started in May 1978, "progressively reduced the margin of excessive protection of industrial activities, until its elimination towards the end of 1979. It was only then that firms effectively felt the impact of successive tariff reductions" (Canitrot, p. 183).

Hence, both in the case of Argentina (after 1979) and in the case of Uruguay (after 1980) what is at issue is not import liberalization as such but rather exchange rate management. We turn to this question in the next section.

Chile, however, is the paradigm of import liberalization. Starting from an average level of 94 per cent in 1973, by 1979 tariffs had been reduced to a uniform level of 10 percent (excepting the motorcar industry), effectively opening up the economy to import competition.

This process was damaging to more than one industrial sector, as reported in Foxley (1982), among others, but the surprising fact was that Chilean industry not only did not disappear, as some feared, but apparently managed to grow at a very healthy rate after 1976.

From our perspective, the quiz to explain is how this could have occurred without provoking a foreign exchange crisis. For an attempted answer, we need to proceed in stages.

The first thing to reiterate is the brilliant behaviour of exports (including copper after 1977), which generated both foreign exchange and aggregate demand. Foreign capital became available following the expansion of exports, allowing a temporary coverage of an increasingly high current account deficit without major problems.

The second element to note is that capital formation took very long to recover from its doldrums in the mid-seventies. It was only towards the end of the decade that capital goods imports began again to put pressure on the capacity to import.

Finally, industrial *production* went up sizably from 1976 until 1980, but the domestic component of investment remained depressed and industrial employment hardly increased. At the same time, the ratio of imports to manufacturing production increased significantly. This suggests a process of substitution of imported for domestic inputs in manufacturing, with several consequences. The statistically more intriguing is that the growth of industrial production maybe in part illusory, as it is not reflecting a commensurate expansion of domestic value added. The quantitative importance of this point is suggested by the fact that the ratio of value added to industrial production went down by 20 per cent between 1976 and 1979.

This point needs to be emphasized because the dismal behaviour of employment and investment in face of increasing industrial production has baffled more than one observer of the Chilean scene. The above hypothesis, on the substitution of imported for domestic inputs, is intrinsically different from the reverse substitution process, which occurred in oil importing countries after the oil shocks. In the latter case, the substitution elasticity may be expected to be low, under given technology.

In the former, however, at issue is the degree of processing, not isoquant substitution as such. As imports are liberalized, the option is opened to import goods further up in the production stage, hence leaving to domestic inputs only the “final touches”.

In the limit, “manufacturing” can be done entirely outside the country whereas only “trading” remains to be added domestically.

In this limiting case, statistically recorded industrial production may remain constant or even increase while domestic value added goes to zero.

Another indication that something like this went on in Chile is the maintenance of very high unemployment rates in spite of increasing production levels. In principle, a sufficiently fast wage deflation could have cured this problem, as the process of input substitution would be deterred when the ratio of the wage to the import price started declining. Alternatively, a slowing down of the import liberalization process could have performed the same role without causing as much social trauma.

4. Ruining the Model: The Delusion of Price Stability

Brazil shares with the Southern Cone countries the story that, three to four years after the military take-over, a critical decision had to be taken between fostering economic growth or aiming at price stability.

Brazil's military coup occurred in April 1964. After an initial reordering period, economic growth resumed in 1966. However, inflation, which apparently had been tamed in 1965, rebound from 29 percent a year in the fourth quarter of 1965 to 39 percent in the second quarter of 1966. The government responded by severely tightening domestic credit expansion, but this put the economy back in the recession track. A power shift followed, with the emergence of a new economic team, headed by Delfim Netto, whose economic philosophy was quite distinct from that of Roberto Campos and Gouvêa de Bulhões, who had been in command since 1964. Campos and Bulhões believed in the “magic of the market place” and in the need of a purgation period of economic recession to bring down inflationary expectations. Delfim Netto was of a more pragmatic mind and closely attuned to the immediate interests of São Paulo industrialists.

Among other “bizarre structuralist ideas”, as Campos later put it (Simonsen and Campos, p.

66), Delfim Netto interpreted the resumption of inflation in 1966 as cost determined (Delfim Netto, 1967). Acting on this diagnosis, he tightened direct price Controls and, keeping a tight rein on wage deals, promoted active credit expansion for firms, consumers and government. Monetary policy, in the words of Mario Simonsen, "started to be passively conducted in accordance with the principle that real output growth should not be affected by liquidity crises...This resulted in an expansion of the means of payment at rates above what would normally be accepted by a believer in the quantity theory of money. Actually, this passive monetary policy was compatible with inflation control only because the government started to adopt an intense policy of price Controls". (Simonsen and Campos, pp.85-6, 114). The rest of the story is well known: Brazil's GDP grew at an average annual rate of 11.2 per cent until 1973, with inflation slowly declining to 18 percent in 1972.

Argentina was at a similar crossroad in 1977.

During 1976, inflation had fallen very fast from 50 per cent a month to the neighbourhood of 7 per cent a month, but then it started showing a stubborn resistance to further declines. Meanwhile, an economic boom had started, but Martinez de Oz decided that inflation control was the exclusive priority. This decision is depicted in dramatic tones by Canitrotip. 150):

"Until June 1977, the economy was booming. Firms operated at full capacity and made high profits in virtue of an open policy of wage repression... It is not impossible to imagine that this situation might have continued and be channelled into a process of rapid growth, an Argentinian miracle... The government, nonetheless, gave up this perspective and decided to give exclusive attention to the inflationary process. It took decisions expressly directed at breaking the boom... This way it showed its own order of priorities. First, social discipline; economic growth, later on. It put in evidence the intensity of its convictions and the strength of its purpose of social reform. At the Service of a political project, born from the liberalism that it shared with managers and owners, it did not vacillate to hurt the immediate interests of these social classes, thus betting all of its political capital. Henceforth, it would survive only if it succeeded". (p.150)

After some vacillation, a passive monetary policy stance was adopted and anti-inflation policies started focussing exclusively on the preannouncement of the exchange rate path. Various were the ingredients to this decision. First, the growing intellectual prestige of global monetarism and the monetary approach to the balance of payments. Second, a political inability to continue repressing wages in the context of an economic ideology, which loathed price control measures. Third, a sizable accumulation of foreign exchange reserves plus the perspective of unlimited access to international financial markets. Fourth, and perhaps more importantly, the possibility of establishing a formidable indirect way of disciplining domestic credit expansion and, hence, of controlling the growth of government budget deficits.

To appreciate fully this last point, one needs to take into account that Argentinian technocrats, differently from their Chilean colleagues, did not have a *carte blanche* from the military establishment. Their possibility of controlling government expenditures and domestic credit expansion more generally remained conditional on military approval. Now, if Controls over the balance of payments in capital account were dismantled, the domestic financial system would become intimately linked to international financial markets. Hence, any attempt at “excessive” domestic credit creation would tend to be curbed by an immediate foreign exchange crisis. Budgetary austerity would become the sine qua non of foreign payments stability.

This schizophrenic context helps explaining the apparently absurd decision of Martinez de Oz to completely liberalize capital flows, even before trade flows were made sufficiently free to give at least a fighting chance for the law of one price to curb domestic inflation.

Canitrot comes near to the above explanation, when he notes that “the abandonment of the contractionary anti-inflation policy which had started in the second half of 1977 resulted not from an impossibility of controlling the money supply in the presence of capital mobility, but from the refusal of the government to face the social and structural consequences of such policy. Invoking reasons of security, the Armed Forces had vetoed from the beginning any economic policy that meant a high level of unemployment” (p. 155). In our view, Canitrot is only partially correct in asserting that the partisans of the monetary approach won over the adepts of the quantity theory because they offered price stabilization without the cost of unemployment.

In both models, full employment is an assumption, not a conclusion If domestic prices and wages are not fully flexible, either a policy of monetary contraction or one of prefixing a sliding scale for the exchange rate should eventually lead to unemployment The conclusion is immediate if capital flows are under government control. In this case, the distinction relates only to which element of aggregate demand leads the contraction: domestic absorption, when credit is squeezed, net exports, when a pre-announced sliding peg applies. Unemployment occurs under both scenarios, but the current account improves in the former, while it worsens in the later.

Consider now the case of free capital flows. One consequence of preannouncing a reduction of exchange rate devaluations under sticky inflation rates is a reduction of the real cost of foreign credits in domestic currency. If capital flows are uncontrolled, such lowering of interest costs can cause a foreign debt financed expansion of domestic demand, which at least initially may more than compensate the fall in net exports.

Employment may then expand in the first stages of exchange rate prefixation. Eventually, as foreign debt accumulates and the current account deteriorates, both the “country risk” (on the supply side of the credit market) and the “exchange risk” (on the demand side) increase continuously. On both counts, the expected[2] real domestic currency cost of foreign credits begin to rise. Domestic demand recedes and unemployment starts growing, as a foreign exchange crisis quite unsimilar to that envisaged by the global monetarists builds up.

With the quantity theory, the costs of unemployment are up front. The monetary approach postpones the day of reckoning at the cost of an increasing foreign debt. In favour of the "old monetarists", one at least can say that the country is left with some foreign reserves, after they are gone, for a fresh start under more reasonable policies. By contrast, unpaid bills seem to be the only legacy of the "global monetarists", after they finish their job.

The foreign exchange market panic that accompanied the demise of global monetarism in Argentina in early 1981 was not replicated in Chile or Uruguay. However, the point that needs stressing is that in all three cases a significant exchange rate overvaluation was the result of these attempts at controlling domestic inflation through International price arbitrage. The negative trade balance consequences were clear enough in both Argentina and Chile. Uruguay, a small economy, closely linked to Argentina, until 1980 benefitted tremendously in terms of foreign exchange earnings from the overvaluation of the Argentinian peso, for it started its own venture into exchange rate prefixation at a slower speed than its main trading partner. Moreover, Uruguay did not play strictly by the rules: wages continued to be set at the government discretion and the anticipated rate of the exchange rate crawl was more observant of trade balance circumstances. The case of Uruguay is not given as much attention in the literature as it probably deserves, as a counter-example to orthodox preaching: its longer duration seems to be related to the less doctrinaire approach that Uruguayans adopted towards[3] government intervention, trade liberalization and exchange rate management.

In Chile, the foreign payments unbalance, financial troubles and industrial recession that started in 1981 did not impose a closing of the foreign exchanges as in Argentina, but they did force Central Bank interventions plus a reversal of the exchange rate and trade policies in mid-1982. In this case, remaining Controls on foreign exchange transactions seem to have been sufficiently strong to prevent large scale substitution of foreign for domestic currency.

5. Conclusion: Nothing Fails like Failure

Why didn't global monetarism work in LA? An important part of the answer is that domestic price and wage formation in high inflation developing economies are much more intricate social processes than either global or local monetarists are prepared to accept. The practical orthodoxy argues, however, that the government deficit was out of control in Argentina and that wage indexation

[2] For a modelling attempt along these lines, see Frenkel (1981).
[3] On this point, see Macadar (1982), esp., pp. 258-63.

rules were inconsistent with the exchange rate policy in Chile (McKinnon, 1982). A similar scapegoat is not yet available for Uruguay but in time, certainly it will be, for dominant paradigms do not change easily.

It does not matter anymore. Southern Cone monetarists and their Northern advisers may unearth many "ifs" to explain what went wrong. History will only register that they failed miserably in their promise to bring stable growth and price stability to LA.

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