Adjustment with Growth in Latin America

Alberto Eguren
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Adjustment with Growth in Latin America

Alberto Eguren

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Washington, D.C.
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Library of Congress Cataloging-in Publication Data

Eguren, Alberto, 1940-
Adjustment with growth in Latin America / Alberto Eguren.
   p. cm. -- (An EDI policy seminar report ; no. 22)
1. Title. 2. Series.
HJ8514.5.E38 1990
338.98--dc20
90-30652
CIP

EDI Catalog No. 405/050

ISSN 1012-490X
Foreword

This document is one of a series reporting on policy seminars organized by the Economic Development Institute of the World Bank. Policy seminars provide a forum for an informal exchange of ideas and experiences among policymakers from different countries, leading experts in development, and World Bank staff with respect to major issues of development policy.

Policy seminar reports focus on issues raised during seminars that may be of interest to a wider audience. They are not intended to be comprehensive proceedings. They seek, however, to convey the essence of the discussion that took place and to bring out any principal areas of agreement or disagreement that emerged among those participating.

Christopher R. Willoughby
Director
Economic Development Institute
of The World Bank
Contents

1. Summary 1

Growing Economic Realism 1
Prolonged Fiscal Crisis and Its Implications 2
Policy Reform and Its Sociopolitical Underpinnings 2
Commercial Banks’ New Pessimism and Its Implication for Debt Relief 3

2. Main Topics of the Seminar 5

Growing Economic Realism and Sophistication within the Technocracy 5
Economic Stabilization 6
The Adjustment Process 7
Stabilization and Adjustment 7
Key Stages of the Adjustment Process in Latin America in the 1980s 8
The First Stages 8
Recent Differences in Economic Performance 8
The Politics of Heterodox and Orthodox Adjustment 9
The Search for Heterodoxy 9
A Renewed Social Pact 9
The Return to Orthodoxy 10
The Sustainability of Reform 11
The Prolonged Fiscal Crisis and Its Implications 12
The Debt Crisis as a Fiscal Crisis 12
Top Priority to the Short Run 13
Israeli Heterodoxy and Bolivian and Chilean Orthodoxy 13
Strategies of Commercial Banks and Debt Relief Options 14
Internal Orthodoxy and External Heterodoxy 14
New Pessimism of Commercial Banks and the Implications for Debt Relief 14
Conclusions 16

Participants 17
1

Summary

This is the report of a seminar for senior-level staff from Latin American Central Banks and Ministries of Finance, Planning, and Trade held at the Economic Development Institute (EDI) in Washington, D.C., January 25-29, 1988. The seminar was directed by Alberto Eguren of the Institute’s National Economic Management Division, assisted by David Baughman (Consultant) and Cecilia Guido-Spano (Seminar Secretary).

This seminar was the second in a series devoted to macroeconomic stabilization and structural adjustment experiences of middle-income, highly indebted countries. While the first seminar focused extensively on external policies, the second concentrated on specific country experiences with adjustment programs. The seminar confirmed that potentially controversial topics, such as those surrounding stabilization, adjustment, and debt relief, are best discussed and understood within the context of concrete country paradigms.

The participants were fairly senior officials from core economic ministries and central banks of ten Latin American countries—Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, Peru, and Venezuela—as well as a few regional organizations (CEPAL, Andean Pact, International Development Research Center (IDRC), and Instituto Centroamericano de Administración de Empresas (INCAE), and Romania. Many are currently engaged in, or are managers of, applied economic research and policy analysis. A benefit of focusing on one region was the openness and interaction that it fostered among the participants.

The objective of the seminar was to examine the major constraints facing middle-income, highly indebted countries in implementing both stabilization programs and structural reforms. The discussions revolved around four themes in particular:

• growing economic realism;
• prolonged fiscal imbalances;
• sustainability of policy reform, and its impact on social sectors; and
• pessimism about Latin America’s creditworthiness and commercial bank strategies.

Growing Economic Realism

Since the beginning of the debt crisis in 1982, marked by the Mexican debt moratorium, Latin America has undergone a period of intense and innovative experimentation. Many economies have suffered permanent and sizable shocks during this period. Policymakers have encountered enormous difficulties in implementing reform programs. Not surprisingly, this experience has engendered a growing sense of realism and even sophistication in the upper echelons of the Latin American technocracy.

As members of this technocracy, seminar participants reflected the emerging realism. They readily acknowledged the key role played by domestic policies in shaping economic performance, and the policy implications of this factor. They were eager to share firsthand experiences with adjustment and to learn which policies had been effective and which less so; what sequencing of adjustment measures had turned out to be correct; what effect different types of inflation had produced; and whatever other lessons might apply to their individual countries.
Prolonged Fiscal Crisis and Its Implications

Fiscal imbalances, which have plagued the majority of Latin American economies since the mid-1970s, were perceived to be the basic cause of failed stabilization policies. But unless a firm foothold is established on the fiscal front, the region will continue to be disappointed in its attempts at formulating a coherent development strategy. The experience of the newly industrialized countries (NICs) in East Asia suggests that strong fiscal discipline is a prerequisite to successful, sustained stabilization. However, chronic political instability, coupled with enormous inequalities in income distribution, make it extremely difficult to exercise fiscal discipline in Latin America.

Since many countries in the region are generating large trade surpluses, the current debt crisis cannot be attributed to the existence of large trade imbalances. However, a critical point to remember here is that most of the debt now owed is public sector debt, whereas the surpluses from trading have largely accrued to the private sector. In instances where the government is the major shareholder of an export activity, export revenues will accrue to the government. Since net borrowing abroad is no longer feasible, the public sector is forcing the domestic private sector to transfer massive amounts to the public sector via taxation, the sale of government bonds, and money creation by the Central Bank. Such policies have led to higher real interest rates and/or inflation.

Paradoxically, the deficit has also been fed by the successes achieved in reversing the region's external disequilibrium in the 1980s. Large real depreciations in exchange rates have increased effectively the real cost of servicing debts denominated in foreign currencies. And despite the recent surge in exports, the private sector as well as the banking sector remains rather weak, requiring frequent injections of funds. Governments, in order to ensure their own political survival, reluctantly bail out ailing firms and banks, thus aggravating an already delicate fiscal situation. Such a situation is clearly untenable in the long run.

A majority of the participants agreed that high priority should be accorded to the restoration of fiscal viability. History was, after all, littered with temporary stabilization arrangements that had eventually unraveled for lack of an appropriate fiscal agenda. Bolivia and Chile, on the other hand, had pursued orthodox programs with some measure of success.

Perhaps Chile provides the best paradigm of successful public sector reform. Since the mid-1970s, the restructuring of the public sector has constituted the basis for Chile's successful attempts at long-term stabilization and structural adjustment. The Chilean reform program was composed of tax restructuring; a revamping of the public enterprise system; a shift in the size and composition of public sector expenditure, together with a change in the decisionmaking mechanisms that determine this expenditure; and a reform of the mechanisms regulating the access to credit.

Policy Reform and Its Sociopolitical Underpinnings

To some extent the search for a heterodox response to the crisis can be traced to anti-IMF sentiment and to the orthodox philosophy espoused by this institution. Initially the region welcomed the new initiatives, which made use of such policy instruments as price and wage freezes, currency reform, and deindexation in an attempt to extirpate "inertial" inflation. However, it soon became clear that the heterodox approach was no panacea. These policies were only temporarily successful in curbing inflation. Since the underlying fiscal and distributional problems were not resolved, the end result has been high and ever-accelerating inflation rates and decreased credibility for the governments that implemented them. Meanwhile the standard of living in the 1980s has declined significantly in broad segments of the urban middle and working classes and thus has increased social polarization.
The failure (partial and/or total) of heterodox approaches has led to a greater appreciation of the fundamentals in economics. It has also fostered greater awareness of the constraints posed by the overall socioeconomic and political environment. Politicians have become acutely aware that the crisis calls for a more humane response. Bolivia’s experience is particularly relevant from this perspective. Bolivia not only managed to stabilize from a situation of hyperinflation but is also the only Latin American country to stabilize from hyperinflation within recent times.

Bolivia’s program of stringency was preceded by a prolonged period of economic decline and instability. At the height of the crisis, the authorities adopted a combination of orthodox fiscal measures and wide-ranging market liberalization. The government was able to sell this program for two main reasons. First, the government assumed full responsibility for the reforms. Bolivia was not coerced into adopting such a program at the behest of the IMF. Second, Bolivia suspended all debt service payments to foreign commercial banks, thereby ensuring that any benefits from the program would accrue to the nation, and not to external creditors.

Many countries in the Latin America Region are faced with the task of finding an ideal political coalition to launch and sustain the kind of policy reforms required to stabilize the economy and to change current economic incentives. Nowhere is this dilemma greater than in Peru. For a coalition to succeed in Peru it would require the support of large segments of the population that are not politically active at present. This coalition would have to engage and represent the interests of diverse groups, namely the vast informal sector, the relatively small rural sector, the incipient nontraditional export sector, and a certain segment of the professional classes. Furthermore, such a union would have to overcome opposition from the politically articulate urban middle and working classes as well as the influential private sector, which would no doubt feel threatened. Despite these obstacles, new political alignments are being formed in Peru, prompted both by the government’s ill-conceived attempts to nationalize parts of the financial sector and by the resurgence of high inflation.

Commercial Banks’ New Pessimism and Its Implication for Debt Relief

Pessimism among foreign commercial banks concerning Latin America’s creditworthiness clearly illustrates the kind of adverse external environment that has dampened the region’s adjustment efforts. In an attempt to reduce their exposure to developing country debt and to improve their balance sheets, commercial banks today are offering almost no new loans. Highly indebted countries can hope for little more than enough funds to roll over existing debt.

What this fundamental change in commercial bank strategy means to the highly indebted countries is clear. First, these countries must try to capture the discounts (debt relief) on the current stock of existing debt in the secondary markets. Bolivia, Chile, and Mexico are already employing this tactic by repurchasing discounted debt, by engaging in debt/equity swaps, and by securitizing their debt (exchanging existing loans for new semi-secured bonds). Second, debtor nations should seek to diversify and enlarge the range of financial options open to them—such as debt interest waivers or other forms of interest-reduction schemes. These countries should also make sure that negotiations with creditor banks do not break down, as this may stop the flow of vital short-term credit, and may further delay financial support from the World Bank and the IMF.

Another scheme that appears to be gaining favor in the region and elsewhere is the moratorium on debt service payments. This approach has garnered considerable domestic support as it does reduce the excessive level of net transfers to foreign creditors. But such a stratagem may also provoke capital flight, and in most cases leads to retaliatory action. Also crucial is the attitude of the IMF, which has traditionally opposed any accumulation of arrears. The IMF was, however, persuaded to overlook this condition in the case of Bolivia. And Costa Rica also recently signed a

1. Following the seminar, Brazil became a major user of this technique of debt reduction and transformation.
standby agreement with the Fund that did not mandate the clearance of arrears as a precondition of access to funds.

The mounting problems faced by the highly indebted nations as they struggle with adjustment and excessive net transfers should not be underestimated. Many of these countries have experienced stagnating and even declining net investment in this decade. To a certain extent, weak domestic policies are to blame for the predicament in which these nations find themselves today. But apportioning blame is not the solution. What these governments need now is assistance in the form of new loans, as well as some debt relief. Without some concessions there will be little prospect of renewed investment to ensure future growth in these countries. And unless an adequate response is devised by all parties concerned, the temptation to unilaterally repudiate debt obligations will become ever stronger for the highly indebted nations, with far worse repercussions than envisaged at present.
Main Topics of the Seminar

This report covers the central topics of a seminar entitled "Adjustment with Growth in Latin American Countries" held at the EDI, January 25-29, 1988. It was the second in a series of seminars on recent macroeconomic stabilization and structural adjustment experiences in middle-income, highly indebted countries. The first in the series, also held at the EDI, in June 1986, featured participants from Latin America, Eastern Europe, and the Near East. The second seminar was attended by the representatives of ten Latin American countries (Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, Peru, and Venezuela), as well as a few regional organizations (CEPAL, Andean Pact, IDRC, and INCAE), and Romania. These participants were fairly senior officials from core economic ministries and central banks. Many are currently engaged in, or are managers of, applied economic research and policy analysis at these institutions.

This report is a selective account of the major substantive issues discussed at the seminar. The aim is to highlight the key issues facing middle-income, highly indebted countries, particularly in Latin America. A further aim is to provide better feedback to those Bank departments involved in applied research and operational work on these countries.

Five main topics were discussed at the seminar. They concerned the issues, opportunities, and constraints faced by the middle-income, highly indebted countries of Latin America that are attempting to implement stabilization and structural adjustment measures. These topics may be summarized as follows:

- the growing economic realism and sophistication in the upper layers of the technocracy with regard to stabilization and adjustment policies;
- the key stages of the adjustment process in Latin America in the 1980s;
- the sociopolitical underpinnings of heterodox and orthodox adjustment programs;
- the prolonged fiscal crisis that has plagued most of the region's economies; and
- the potential conflict of interest emerging between the private commercial banks on the one hand, and the debtor countries and the Bretton Woods institutions on the other.

Growing Economic Realism and Sophistication within the Technocracy

Since the onset of the debt crisis in 1982, there has been a growing sense of economic realism among the technocrats of Latin America. They have been testing an intense and innovative approach to stabilization and adjustment in the region. It is ironic that this reduced role for ideology among Latin American elites has been accompanied by a resurgence of conservatism in some of the major industrialized countries, such as the United States and Great Britain.

Seminar participants noted that this emerging economic realism is reflected in the technocracy's growing awareness of the formidable difficulties that can arise in implementing policy reforms. Such problems plague economies that have suffered permanent and sizable external shocks, are beset with high inflation or hyperinflation, and have experienced declines in living standards and social conditions among large segments of the population.

Many agreed that the emerging realism is further reflected in the distinctions drawn between various types of inflation and the "right" types of stabilization policies. These distinctions must be made if governments are to better understand the nature of the adjustment process itself, and to determine the appropriate sequencing of stabilization and adjustment measures. Participants also
emphasized the key role played by domestic policies in shaping economic performance. The critical economic lessons drawn in this regard at the seminar are summarized below.

Economic Stabilization

The main criteria for differentiating among types of inflation, as they have emerged in the wake of recent experience, should be based on the following considerations:

- **Cause:** Whether inflation is essentially the result of continuous and self-reinforced increases in key prices, salaries, and the nominal exchange rate ("inertia" being the main cause); or alternatively, whether it reflects deeper disequilibria at the aggregate level, and perhaps some type of shock, either internal or external.

- **Magnitude:** Whether inflation is moderate (less than 30 percent, as in Costa Rica); high (greater than 100 percent, as in Brazil, Argentina, and Peru); or hyperinflation (Nicaragua today, and Bolivia in 1985).

- **Duration of the inflationary process:** This is a key factor as it determines the intensity of expectations formed by the public, as well as the pervasiveness of indexation mechanisms.

- **Situation of the external sector:** Whether the external disequilibrium has been eliminated (Brazil and Mexico); or persists (Argentina and Peru). The latter case makes inflation much more difficult to eradicate, as the changes required in relative prices may fuel the inflationary process itself.

- **Situation of the public sector:** Whether the disequilibria are large (Brazil and Peru), or small (Colombia).

- **Situation of key relative prices:** Whether these prices are largely distorted or not. This distinction is particularly important for heterodox programs, which attempt to temporarily freeze key nominal prices, including the nominal exchange rate (e.g., Argentina's Austral Plan, Peru's Economic Emergency Plan, and Brazil's Cruzado Plan).

Recent experience with inertial inflation mainly in Argentina and Brazil suggests that

- The initial and dramatic reduction in inflation due to the freezing of prices and the deindexation of contracts has been easier to obtain than was originally envisaged.

- Price freezes and the deindexation of wages and salaries, in themselves, will not succeed in stabilizing the economy. From the outset, the government must also target key relative prices, such as those of oil products and the exchange rate, as well as get its fiscal house in order.

- An initial dramatic decrease in inflation is usually accompanied by a windfall gain in tax revenues for the government. However, this is a one-time effect, and other things being equal, once revenues attain a new plateau, they remain at that level.

- More generally, if the fundamentals are not attacked with sufficient vigor, the credibility of a program quickly erodes, and future attempts at freezing the price level become less effective. Stabilization programs, particularly in high-inflation economies, need to be decisive. Indeed, the best stabilization policy is to avoid inflation altogether, and thus prevent inflationary expectations from ever materializing—as Venezuela did until recently.

- Hyperinflation seems easier to combat than high inflation. As inertia collapses in the former case, traded goods become automatically adjusted on the basis of an estimated U.S. dollar price, converted at the spot black market exchange rate. This is a major aspect of the "dollarization" process, which expresses the public's search for a stable unit of account and value (as in Bolivia in the first half of the 1980s). Dollarization may also be present in varying, though lesser, degrees in high-inflation countries.
The Adjustment Process

The chances of formulating a viable adjustment program often depend on a country’s ability to achieve a sustainable external balance in the medium term. The important lessons for Latin America in this respect are as follows:

- Coherent and stable macroeconomic policies are required especially with regard to demand management, key relative prices (including the exchange rate), and import tariffs.

- Longer-term policies should allow for adequate movements in tariffs and exchange rates, as well as appropriate investments in key sectors, such as energy (Brazil’s petroleum, fuel alcohol, and electric power projects in the second half of the 1970s, and Colombia’s oil and coal projects more recently).

- The supply response of the export sector has been much more dynamic than was originally envisaged (as in the Colombian, Chilean, and Venezuelan agricultural sectors, as well as the Brazilian and Mexican manufacturing sectors). This growing diversification in exports should quash the export pessimism that has dominated the region intellectually for the last two decades. It also confirms that the real exchange rate plays an important part in reorienting production and investment decisions.

- The overall lesson of the 1980s is that sustainable growth must be accompanied by an expansion and diversification of exports, but without the drastic declines in imports and economic activity that have all too often accompanied Latin American adjustment efforts.

Stabilization and Adjustment

Recent experience with the sequencing of stabilization and adjustment programs suggests that

- A simultaneous attack on both inflation and the external imbalance is warranted only when both are not too high. This is illustrated by Colombia, which succeeded in controlling inflation by addressing the fundamentals immediately following the devaluation.

- Countries facing high or accelerating inflation may find that devaluation or other changes in key price variables will do little to reduce or eliminate balance of payments deficits. This is because inflationary pressures quickly erode any gains achieved via devaluation.

- Efficient adjustment—adjustment accompanied by growth—requires a longer-term focus and presumes the availability of adequate external financing. Adjustment of this nature eventually brings about a reallocation of real resources toward the tradable sectors. But adjustment of the shock variety is highly undesirable owing to the recessionary impact of the resulting drastic fall in import volume. However, shock-type stabilization policies do not necessarily have to be recessionary. If inflation falls rapidly and without a corresponding fall in domestic absorption, then the recessionary overtones of this type of stabilization can be reduced or eliminated.

- Most governments have a tendency to postpone adjustment for as long as possible because of the negative domestic absorption costs. However, stabilization that aims to reduce the balance of payments deficit to sustainable levels of financing cannot be postponed for ever.
Key Stages of the Adjustment Process in Latin America in the 1980s

The First Stages

The first stage of the adjustment process in Latin America during the early 1980s (1982-83) was recessionary. In the wake of several formidable external shocks, it became necessary to reduce significantly, and quickly, the resulting current account deficits. This was largely achieved by cutting back imports. Neither external resources nor sufficient time were available to achieve an efficient adjustment (that is, adjustment with growth).

During the second stage, 1984-85, most countries in the region enjoyed some improvement in growth, import levels, and terms of trade. This was facilitated by an expansion of regional exports to the United States. As a result of the changes in the external positions of countries such as Brazil, Mexico, Venezuela, Chile, and Peru, current account deficits almost disappeared. With the large trade surpluses generated, these countries were able to repay 100 percent of their interest obligations to external creditors; for Argentina and Peru, the ratio was slightly less—about 60 percent. This dramatic turnaround gave rise to an excessive optimism about the prospects for high-debt countries—namely, that they would be able to meet their debt obligations while simultaneously resuming growth.

Recent Differences in Economic Performance

The third and most recent stage, 1986-87, has witnessed marked differences in the economic performance of countries in the region. This observation pertains essentially to the ability of a country to sustain its reform programs.

Several factors indicate that some countries in the region will not be able to sustain their reform policies. First, high rates of growth were achieved at the expense of the external balance. Second, drastic reductions in inflation were achieved by reducing domestic inflationary pressures, in effect via wage and price controls. Brazil, Peru, and to some extent Argentina fall into these first two categories. Third, although international reserves have increased substantially in recent years, spurred by a boom in manufactured exports and the return of flight capital, GDP has practically stagnated. This has been accompanied by a significant decline in real wages, while inflation has accelerated to triple-digit levels—as in the case of Mexico.

A different picture emerges in Colombia, Chile, and Uruguay, which have not only achieved real economic growth (averaging about 5 percent between 1986 and 1987), but have also reduced unemployment and substantially increased and diversified their export base. Moreover, inflation has been restrained in both Colombia and Chile, and is being curtailed in Uruguay. What is noteworthy about these three countries is that they adopted a more conservative approach to fiscal management, while maintaining competitive exchange rates. Largely as a result of these measures, they still have access to external credit and do not face the prospect of a large devaluation in the near future. All in all, the economic prospects for these countries appear to be considerably better than for those countries that neglected fiscal discipline.

But irrespective of which group has fared better, it is important to bear in mind the overall context in which the adjustment process has taken place. Not only has the international environment been uncertain and unstable, but external shocks have been formidable. And in spite of lower inflation worldwide and a sustained global recovery, growth in international trade has been slower than in any decade since World War II.

It is also worth noting that the adjustment process has not been sustained in most countries of the region. Inflationary pressures have again become one of the key obstacles to sustained growth.
in the late 1980s. This situation is all the more critical as growth in Latin America in the 1980s has been the lowest in decades, and per capita income and investment levels have fallen significantly. These factors, combined with the persistent lack of new external credit and the debt overhang, adversely affect the region’s growth prospects.

The Politics of Heterodox and Orthodox Adjustment

The Search for Heterodoxy

Heterodox policies are to some extent seen as a response to the growing conservatism exhibited by major industrial countries—notably the United States and Great Britain. This trend, ushered in by the Reagan administration in the early 1980s, was perceived by developing countries as a denunciation of the role of the public sector in favor of the private sector, and a move toward market liberalization. Other factors that also influenced the quest for unorthodox policies include a democratization of internal political processes, a resurgence of nationalism, and a general discontent with the role and views of the IMF.

The renewed search for heterodoxy, however, is probably more deeply rooted in the significant decline in living standards suffered during the 1980s by broad segments of the urban-based middle and working classes, and the almost inevitable social polarization that ensued. Some aspects of the socioeconomic and political elements of both heterodox and orthodox policies, as they emerged at the seminar, are discussed below. Emphasis is placed on those factors that contribute to the sustainability of policy reforms, or to their reversal.

Heterodox adjustment programs carried out over the past few years in Argentina, Brazil, and Peru stand out in sharp contrast to the orthodox approach adopted by Bolivia to eradicate hyperinflation. Predictably, the extent to which heterodox policies were politically acceptable determined the degree to which they were implemented. Changes in regime in both Peru and Brazil in 1985 expanded the political spectrum, enabling nascent center-left groups to mobilize public opinion in favor of heterodoxy. This took place in the wake of several IMF interventions in previous years, which, although successful in helping both countries restore external balance during the first half of the 1980s, fueled inflation without achieving significant recovery in GDP or investment. Heterodoxy is in fact associated with high levels of inflation—typically on the order of triple-digit inflation. To the growing dismay of the heterodox constituency, the end results of both the Peruvian and Brazilian programs were short-lived economic booms.

A Renewed Social Pact

Since heterodox programs include a freeze (and/or control) not only of key prices and of the nominal exchange rate but also of wages, they amount to a new kind of temporary social pact. Wage policy can be consistent with the overall policy package—as it was in Israel’s mid-1985 stabilization, where real wages were allowed to decline initially with the explicit agreement of unionized labor. Or it can be inconsistent, especially when accompanied by an appreciation of the real exchange rate—as in Peru and Brazil from 1985 onward, when real wages were increased significantly. In contrast to Israel, however, no close ties exist between the government and the labor movements in either Brazil or Peru. At this stage, any formal or informal pact that may have existed in these countries will most likely have been eroded by the resurgence of high inflation and its downward impact on real wages. Real wages have also been declining in Mexico in recent years, despite a steady increase in industrial workers’ productivity. There has further been a marked deterioration in the distribution of income for broad segments of the working class population.
In the wake of the most recent crisis in world domestic capital markets, Mexico has been forced to give higher priority to stabilization than to structural adjustment. In December 1987, it launched a program—revealingly announced as an “Economic Solidarity Pact”—that attempted to combine both orthodox and heterodox components. This time around, however, the program is intended to avoid the mistakes that plagued the Argentinian, Brazilian, and Peruvian plans, while providing a basis for a more sustainable social pact. The program includes the usual mandatory, but temporary freeze on wages, the exchange rate, and other key prices—particularly those of basic staples. But it also includes greater fiscal restraint as well as a mechanism whereby wage increases are triggered when inflation reaches a predetermined level. It is not clear, however, whether the degree of fiscal restraint will be sufficient to bring about a full and sustainable stabilization of the economy, particularly given the debt burden of the public sector (both domestic and external debt).

**The Return to Orthodoxy**

Rather surprisingly, perhaps, Bolivia constitutes the sole example of a politically acceptable and successful stabilization program within the region in recent times. Bolivia’s New Economic Policy (NEP), launched in mid-1985, managed to eradicate completely the most serious case of hyperinflation observed in Latin America in the postwar era—inflation peaked at an astounding rate of 26,000 percent a year in the final months before stabilization. Within the region this program is viewed as an orthodox approach, emanating from the right wing of the political spectrum.

The orthodox components of the Bolivian program included

- draconian fiscal measures, with a view to redressing the collapse in the terms of trade and restoring the tax base, which had been almost totally eroded by hyperinflation (the program also included steps to eliminate the sizable budgetary burden of the large parastatal mining sector); and
- a wide-ranging liberalization of the financial system, international trade, foreign exchange flows, and the domestic market for goods and labor.

After a massive devaluation, the reforms enacted made it possible for Bolivia to fix the nominal exchange rate for a period of several months. These steps also succeeded in eliminating the enormous parallel market that had prospered before the reforms were introduced. At the end of this period the economy was almost completely dollarized; prices in local currency were continuously adjusted to reflect fluctuations in the U.S. dollar spot and parallel market.

The Bolivian case clearly illustrates the important role played by socioeconomic and political factors. At the time the NEP was launched, Bolivia was in the midst of a profound crisis. The country had suffered a prolonged period of economic decline and high political instability. There was no alternative but to face up to the emergency. Fortunately, the relatively new democratic government provided the economic and political leadership needed at this time of crisis. It demonstrated a clear commitment to the program and brought on board some of the ablest and most talented technocrats in the country to deal with the emergency.

The Bolivian government was able to legitimize the call for austerity by recognizing openly from the beginning the depth of the crisis. It also suspended payments to foreign commercial banks, thus ensuring that any gains from the program would accrue to the nation rather than to external creditors. This relatively aggressive posture vis-à-vis “ownership” of the program (the IMF and the Bank supported it only at a later stage) enabled the government to push through stringent measures that may not otherwise have been palatable.

This stance vis-à-vis foreign banks constitutes the heterodox aspect of the Bolivian NEP. In spite of this tough policy against its external creditors, Bolivia did receive international financial support, but only after the program’s initial success had been demonstrated. It is not clear, however, whether Bolivia will be able to achieve sustained growth by consolidating the reform
process. Recent regional and municipal elections suggest a loss in public support for the current Paz Estenssoro administration.

The Sustainability of Reform

Like Bolivia, Peru adopted economic reform policies only after a period of prolonged economic and social decline. Subsequently, some of these policies were discredited—especially those relating to import liberalization and a crawling peg exchange rate regime. The latter were mistakenly blamed for the plight of domestic industry in the early 1980s. Today Peru does not appear to have a strong constituency for bringing about long-term stabilization or an outward orientation of the economy.

In 1980, after several years of military rule, President Belaunde became the head of the first democratic government in Peru for over a decade. But in an unexpected reversal of policies, his administration significantly reduced the profitability of domestic industry by slashing the level of export subsidies. At the same time, an excessively high exchange rate was maintained. Political factions singled out the IMF as the prime culprit of the economy's woes, when in fact it was Peru that had repeatedly failed to comply with IMF conditionality in the first half of the 1980s.

The economic collapse that ensued, widely attributed by public opinion to the ill-conceived "neo-liberalism" of the Peruvian right, paved the way for the populist government of President Alan Garcia in 1985. Not surprisingly, this administration also legitimized a particular brand of Peruvian heterodoxy. The elements of this approach were common to those of the previous administration, but in addition included the well-known and publicly announced policy of limiting external debt service payments to 10 percent of the country's exports. The irony of the current situation is that the present center-left administration has fallen prey to the same errors that had plagued the previous conservative administration.

In the wake of the severe exchange crisis currently facing the country and the resurgence of triple-digit inflation, some technocrats are reconsidering a change in their diagnosis of Peru's ills. These technocrats now seem more receptive to orthodoxy—particularly as regards the role of the fiscal deficit in fueling inflation, and the need for outward orientation. Such a drastic reversal in the overall policy framework would be difficult to sustain for two reasons. First, it is an agenda associated with a conservative regime. Second, and more importantly, there is growing opposition from the socially threatened urban, middle, and working classes, which have traditionally perceived the role of the state as essentially a nationalistic and redistributive one, including employer of last resort.

Even the profitability of the private sector seems to depend on the growth of the fiscal deficit. In exchange for its support, the private sector demands all kinds of subsidies, including sizable tax exemptions, as well as uneconomically low prices for the goods and services offered by public utilities and other public enterprises. This imposes powerful constraints on fiscal prudence, especially in an inward-oriented economy such as Peru's. According to the present government, private sector support has never actually translated into much-needed new investments. Dialogue with the private sector has suffered even further recently, following the government's attempt to nationalize the domestic financial system.

Given this sociopolitical context, public dialogue on economic policy is bound to be confusing and politically charged. The lessons for Peru, from Bolivia's experience, point to the necessity of gaining a broad political consensus in favor of reform policies, in order to change existing economic incentives.

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2. These measures have to be viewed against the backdrop of growing fiscal deficits, accelerating double-digit inflation, and the 1980-82 world recession.
A key issue for Peru, and one that also concerns other countries in the region has been the type of political coalition needed to carry out and sustain basic changes in the rules of the game. A coalition of this kind would probably have to seek support from a cross section of the populace—that is, the informal sector, the relatively small rural sector, the incipient nontraditional export sector, and a certain segment of the professional classes. According to some Peruvian researchers, a coalition of this nature would be tantamount to dismantling most rent-seeking activities. This would be an arduous task under any circumstances, especially as the potential coalition groups are not as yet organized in a politically effective way. But it is even more difficult when, as is the case of Peru, the more politically articulate urban middle/working classes and an influential group of private entrepreneurs (associated with the import substitution industry) are opposed to this type of reform.

Notwithstanding the above政治 configuration, current political realignments in Peru seem to be heading gradually in this new direction, helped by the adverse reaction from important social groups to an ill-conceived attempt to take over the financial system. An increasingly effective campaign to change the public’s perception of potential benefits from changing the policy framework in favor of the informal sector seems to be working. The countries that have been able to overcome previously dominant political alliances are the very countries that have fared better economically, namely Chile and Colombia.

The Prolonged Fiscal Crisis and Its Implications

A central issue discussed at some length at the seminar was the crippling effect of a prolonged fiscal crisis on the region’s economies. Wide-ranging public sector reform emerged clearly as a key component of any serious attempt at stabilization, or longer-term structural adjustment.

The Debt Crisis as a Fiscal Crisis

Fiscal imbalances, which are at the root of failed stabilization policies in recent times, have been prominent since the 1970s. If they are not brought under control, the region will continue to fail in its attempt to develop a coherent development strategy. Chronic political instability, however, makes fiscal discipline difficult to achieve. And in Latin America this instability is rooted in unusually large inequalities in income distribution. It is significant that the East Asian countries—for example, Japan, Korea, and Taiwan—that have been most successful in the postwar period began with far more equitable societies.

The current debt crisis is not in any fundamental way related to the existence of large trade imbalances. One has only to look at Mexico and Brazil. Both countries are generating large trade surpluses today, but at the same time are beset by deep economic crisis. The trade surpluses are accruing not to the public sector which is the major debtor, but to the private sector. And as net borrowing abroad dries up, the private sector is forced to effect massive transfers of income to the public sector via several mechanisms. These include taxation, the sale of government bonds, and money creation (largely because of an expansion of Central Bank credit to the public sector). The net effect is an increase in domestic costs, real interest rates, and/or inflation.

The heavily indebted public sector is a key aspect of the current crisis. As foreign borrowing dwindled in the 1980s, a number of governments issued domestic bonds—for example, Mexico in 1982-1985. But in the face of large increases in the stock of publicly held domestic debt, these governments often resorted to printing money to take advantage of seigniorage. They were, in effect, using the inflation tax to transfer resources from the private to the public sector. This was the case in Brazil, Argentina, Peru, Ecuador, Venezuela, and, earlier, Bolivia too.
The decline in foreign trade, which followed the collapse of key commodity prices and of domestic activity, also contributed to the fiscal crisis as it depressed domestic taxation. The high cost of bailing out the private sector and banks, or granting preferential exchange rates further aggravated an already delicate fiscal situation. Indeed, ascertaining the full extent of the financial crisis faced by the state would require including the deficit not only of the entire public sector, but also that of the subsidized private sector—use of this enlarged, but more appropriate definition of the public sector deficit has grown in recent years. Large depreciations in the real exchange rate have also increased the domestic currency cost of servicing foreign debt.

Top Priority to the Short Run

For many governments political survival in the short run often conflicts with longer-term fiscal responsibilities. It is not uncommon for the public sector to bail out ailing firms and banks to renew its political lease. However such a situation is clearly not a viable proposition for the long term. The recent Bolivian experience seems to demonstrate that when there is a significant improvement in taxation, the claims on this additional income from different groups in society as well as from commercial banks reemerge. These claims bring with them the risk of yet another fiscal crisis. Raising revenue or reducing expenditure is politically more difficult when conflicting claims exist on the surplus income. In the end, short-run political survival usually prevails over longer-term economic concerns. To prevent this sort of situation from arising in the future, countries should accord top priority to putting their fiscal houses in order. However, eliminating inflation, rehabilitating the financial system, and avoiding the risk of massive devaluations all require traditional orthodox remedies.

Israeli Heterodoxy and Bolivian and Chilean Orthodoxy

The kind of reversal of stabilization efforts that the region has witnessed in recent years are the downfall to sustainable reform programs. Any country today is capable of stopping inflation for a period of 6 to 12 months merely by fixing the nominal exchange rate for that period—assuming sufficient foreign exchange reserves exist to sustain that rate. But, as has been abundantly demonstrated by recent events, temporary stabilizations eventually fail unless appropriate fiscal policies are also implemented. The orthodox Bolivian program confirms this. But more important, so does the Israeli stabilization program launched in mid-1985, which was heterodox in nature. In 1985, faced with high inflation, the Israeli government applied shock treatment to the economy. This entailed a wage freeze that amounted to a cut in real wages and a fixing of the nominal exchange rate to the U.S. dollar (subsequent to a one-time devaluation of 20 percent). In addition, the government initiated a fiscal reform program, especially on the expenditure side. Although the program has been successful so far, a certain amount of skepticism exists regarding its sustainability over the medium term.

An important lesson to be drawn from the Israeli case is that adjustment policies should be narrow in scope, as administrative and analytical capability is constrained in most governments. It is better to concentrate on achieving genuine expenditure control and a competitive exchange rate. Reform of the capital markets and the tax system are best left to a later stage. This is not to imply that public sector reforms are not important, but rather to highlight the enormous difficulties involved in implementing reforms on a broad front.

Nowhere in the region, not even in Bolivia, have far-reaching public sector reforms been as successfully carried out as in Chile during the second half of the 1970s. The restructuring of the public sector, undertaken largely during 1976-77, has constituted the basis for Chile’s success in reforming the overall policy framework. The main components of the Chilean program were (i) tax
Adjustment with Growth in Latin America

reform; (ii) a shift in the size and composition of public sector expenditure, and a change of the underlying decisionmaking mechanisms; (iii) revamping of the public enterprise system; and (iv) a reform of the mechanisms regulating the access to credit.

These reforms were conceived and carried out entirely by Chileans, with no role at all played by the IMF or the World Bank. Unfortunately, this success has been overshadowed by the economic collapse of 1981-82.

Strategies of Commercial Banks and Debt Relief Options

Major issues discussed under this topic were the kind of financial support one could expect at this stage of the debt crisis from the commercial banks and the Bretton Woods institutions in carrying out adjustment, and the attitude and negotiating posture that countries could be expected to take toward those banks. One of the key observations made at the seminar was that there is a clear commonality of interests between these countries (the highly indebted countries, or HICs) and the Bretton Woods group, but not necessarily between the HICs and the commercial banks.

Internal Orthodoxy and External Heterodoxy

The Bolivian experience again seems particularly relevant. It suggests that the demands of foreign creditors are not sufficient reason to implement orthodox policies. An important consideration is the political and economic climate. An orthodox approach works best when complemented with an external heterodox approach—that is, by limiting or halting external debt repayments. At one point it was openly suggested that a tough stance should be taken toward commercial banks—even at the risk of bringing on the wrath of the IMF and the World Bank. If the country succeeded, both these international institutions would eventually change their initial assessments and, in stark contrast to the commercial banks, would be generous with additional financial support, and with generally sound advice as well. The concern of these two institutions with both stabilization and growth implied that they have the best interest of the country at heart, which is not usually the case with commercial banks.

Another factor that affects a country’s ability to implement reforms is its access to credit. But because of the pessimistic outlook recently adopted by commercial banks, new credit has been scarce. Nonetheless, it would still be unwise for the HICs to assume a confrontational or adversarial role with the banks. These countries would be better served by finding ways to reduce their current stock of debt. Such is the goal of Mexico’s potentially path-breaking issue of 20-year bonds, guaranteed in part by the U.S. Treasury, in exchange for a sizable reduction in existing debt (the U.S. guarantee constitutes 20 percent of the present value of the new debt service stream). However, the reduction in the stock of debt occasioned by this debt swap appears inadequate to provide Mexico with the kind of relief it requires to attain full economic stabilization and to consolidate its recent attempts at structural reform.

New Pessimism of Commercial Banks and the Implications for Debt Relief

The new pessimism among commercial banks regarding the creditworthiness of most Latin American countries illustrates the continuously changing and unfavorable external environment that surrounds the region’s adjustment efforts. Indeed, since the debt crisis erupted in 1982, the banks’ attitude toward the HICs has changed at least three times. In 1982-84, the commercial banks, like the international community at large, perceived the debt crisis as a liquidity problem. The main objective at the time was to safeguard the stability of the world financial system. This period was characterized by (i) “defensive lending” from the banks—that is, providing bridging loans and new
money with a view to protecting their income statements; (ii) association with IMF programs, and parallel treatment of official creditors; and (iii) the establishment of advisory committees to articulate a cohesive posture on debt restructuring.

The second phase, 1984-86, was characterized by (i) improvements in the financial position of the European and Japanese banks (via larger loss provisions and tax relief); and particularly by (ii) greater concern with protecting bank assets and reducing exposure. There was an increase in asset disposal/recovery operations (such as debt/equity conversions). The Baker Plan was only reluctantly accepted by the banks. The 1986 Mexican multyear rescheduling plan (MYRA) marked an important change in commercial bank asset management strategy—many banks thought the MYRA was too lenient.

The current pessimistic phase was brought about by (i) Brazil's interest payment moratorium in February 1987; (ii) Citicorp's momentous decision of May 1987 to provision US$ 3 billion as reserves for bad loans; (iii) a general acknowledgment that most debt indicators had worsened; and (iv) the recent Mexican bond issue mentioned above.

This pessimism is such that even Colombia, which would normally be considered creditworthy on the basis of traditional economic and financial criteria, has faced considerable difficulties in arranging for borrowing on a strictly voluntary basis. It recently resorted to a form of concerted borrowing involving World Bank, IMF, and U.S. Treasury support. But owing to factors similar to the ones mentioned earlier for Bolivia, Colombia may find it politically difficult to sustain its current policy of full repayment to the banks in the medium term.

In any event, at this stage the banks' strategic concerns are to position themselves as best as possible in today's more open but also more competitive national and international financial systems. Thus, small- and medium-sized banks want to reduce their loan exposures and more generally to improve their balance sheets. This should increase their stock prices and permit them to participate in the consolidations and mergers required to take advantage of growing market opportunities in the United States.

Similarly, the larger banks' strategy is to expand their equity base and increase the value of their stock. This is crucial for success in today's highly competitive international banking environment. It is all the more urgent as the banks are also competing with investment banks, which are not saddled with a depreciated loan portfolio as are the U.S. commercial banks.

The implications of this fundamental change in the commercial banks' strategy toward the highly indebted countries seem clear. These countries should (i) try to capture the discounts (debt relief) on the current stock of debt existing in the secondary markets (such as attempted by Bolivia, Chile, and Mexico) via discounted loan repurchases and debt/equity conversions, securitization (exchanges of loans for bonds), issuance of convertible notes, on-lending, direct loans, contingency lending, and so on; and (ii) seek debt interest waivers or other forms of interest reduction schemes. Debtors should, in general, seek more flexibility by following a menu of options for obtaining new money, while diversifying the range of their financial instruments. Countries should also avoid a breakdown in negotiations with the banks, as this may eventually bring about a reduction in financial support from the IMF and the World Bank, and of vital short-term trade credit too.

Another, this time quasi-automatic, device for reducing the excessive level of net transfers abroad is to accumulate arrears on the external debt. Faced with crippling foreign exchange crises, a growing number of countries in the region and elsewhere are adopting this practice. A key question is whether the traditional IMF attitude of conditioning its support to the clearance of such arrears is changing. Bolivia may have set a precedent in this connection. Both the IMF and the World Bank have lent support despite the continuing suspension of debt payments to foreign commercial banks. Similarly, Costa Rica has agreed more recently to an IMF standby program in which the financial gap has yet to be filled. The assumption is that arrears would continue to accumulate if sufficient
new money was not forthcoming from the banks, or from other (unlikely) sources.

Conclusions

Since the beginning of the debt crisis in 1982, marked by the Mexican debt moratorium, Latin America has gone through a period of intense and innovative experimentation. Unfortunately, these heterodox reform programs have met with little success. Consequently, the highly indebted countries in Latin America are being forced to review the efficacy of past policies. When devising new policies, they should bear in mind the following considerations:

- Commercial banks are not offering any new loans.
- Fiscal imbalances, which have plagued the majority of Latin American economies, are the basic cause of failed stabilization policies.
- Heterodox policies have only led to higher inflation, and have not produced the kind of stability that is sorely needed.
- It is important to distinguish between the various types of inflation—that is, hyper or high inflation—as well as the duration of inflation. Both these factors determine the correct policy response and the sequencing of reforms.
- Large sections of the working class have been impoverished by a combination of ill-conceived policies and inflation.

In the light of these facts, the consensus at the seminar was that the HICs in Latin America should heed the following advice:

- Fiscal management should be accorded top priority. The experiences of both Bolivia and Chile suggest that an orthodox approach (at least on the domestic front) is the most effective. A heterodox approach is not likely to succeed without appropriate fiscal measures.
- Stabilization measures that are largely demand-oriented (such as wage restraint and price controls) are not sufficient in themselves to bring about long-lasting reforms. In order to achieve sustainable reform, nations must implement longer-term adjustment with a view to affecting supply.
- The present level of net transfers to commercial banks is insupportable. Some countries have arbitrarily decided to curtail these outflows by fixing the total amount of net transfers; however, a negotiated settlement would serve the community far better. At the same time, the financial community must devise new schemes to reduce the debt burden of the HICs—such as debt/equity and debt/debt swaps. Since the commercial banks are reluctant to tender any new funding, the HICs will have to rely more on international organizations such as the IMF and the World Bank to fill the gap.
- Future growth prospects for these countries have been seriously jeopardized by the hemorrhage of net transfers to areas outside the region. Positive rates of new investment must be resumed as soon as possible to improve long-term growth prospects.
- It is no longer possible to ignore the social consequences of past policies. Many members of the working class have been impoverished while the middle classes have experienced declines in their standards of living. Such erosions must be halted or reversed in future adjustment programs. Measures should be devised to mitigate the social effects of adjustment and compensate the most vulnerable groups. In order to do this, ruling parties may have to forge new political alliances.
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