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# Latin America and the Caribbean: Economic Performance and Policies

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# Latin America and the Caribbean: Economic Performance and Policies

Guy P. Pfeffermann

## Introduction

This article reviews the economic performance of Latin American and Caribbean nations and relates it to underlying policies in order to forecast likely growth rates for the 1980s. The article is intended mainly for those who are not familiar with the Latin American economic scene and is thus not a detailed scholarly analysis of the many complex relationships involved. The views expressed are my own. My judgment is, of necessity, colored by the thirteen years I have worked as an economist in the Latin American and Caribbean Regional Office of the World Bank.

The first section provides background on the natural and human resource base of the Region—its strengths and weaknesses. These fundamental factors continue to influence the Region's economic performance and its potential. The second section reviews economic performance as well as related aspects such as population expansion, the urban/rural balance and social progress. The stress is largely on differences between countries. The third section deals with a few critical domestic policy areas—agriculture, finance and external debt—and relates them to performance.

Throughout, the work "Region" refers to the Western Hemisphere nations south of the United States, with the exception of Cuba for which comparable data are not available.

## Natural and Human Resources

This section looks at the principal elements of growth—natural and human resources—over time and stresses the rural/urban cleavage which has persisted throughout the Region's modern history.

### *Geography and Natural Assets*

The fortunes of Latin America have been profoundly influenced by its immensity and its mineral wealth. The continent is vast. The Indian subcontinent would fit

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more than six times into Latin America, and Brazil alone is almost as large as China. The continent extends from south of the United States to Ushuaia, the southernmost town in the world. There are vast stretches of desert, the world's largest river basin, and the Andes, separating the Pacific coast from the rest of South America, which are second only to the Himalayas in height. The Atlantic coast of Brazil is the mirror image of West Africa's, very similar in climate and vegetation. The fertility of the pampas is matched on a similar scale only in the Midwest of the United States and the black lands of Russia.

Table 1 shows some figures on the natural resource wealth of the Region today. The Region produces a significant share of the world's output of bauxite, copper, lead, tin, zinc, silver, tungsten, and crude oil. Its reserves of bauxite, copper, iron ore and nickel represent a larger share of world reserves than the Region's share of output, which suggests a potential for increased production. The Region's total resources (including those that are not profitably exploitable today) represent an even larger share of world resources in bauxite and tin. These sketchy figures convey a picture of a resource-rich continent. This is true also for the Region's hydroelectric as well as for its agricultural, forestry, and livestock potential.

### *Human Resources*

As late as 1800, three centuries after the Portuguese first landed, only about three million people lived in Brazil, and, according to Humboldt, 17 million in Spanish America. The scant population was dwarfed by the immense natural resource wealth of the continent. While the North American colonists had to make a living from agriculture, often in difficult ecological conditions and without the help of an Indian labor force, Latin America was developed from the start with the idea of exploiting natural resources and the labor of the Indians.

In this sense the existence of natural wealth has been a curse as well as a blessing. The Spanish historian Salvador de Madariaga noted: "That a man of quality, by fighting, acquires wealth more honorably and quickly than a meaner man by work has been called a basic belief of the Spaniards as they emerged from Reconquest" (Hirschman, 1977, p. 58). Or: "Spanish America was born of a gold rush, just as were, in later years, Australia, California, South Africa, and the Klondike. Men sold all they had, left their families, and journeyed to lands of treasure" (Herring, 1962, p. 198). As it turned out mining was a distinct success. By 1800, Spanish America and Portuguese Brazil were producing about 90 percent of the world supply of precious metals. Agriculture was based on slavery or, what amounted to much the same, the *encomienda* system of Spanish America. And even though manufacturing made surprising progress in the face of opposition by Spanish monopolists, the gambling spirit associated with mineral exploitation, the Spanish tradition that manual labor is demeaning, and the association between slavery and agricultural toil all help explain the fitful economic performance of the Region during the first four centuries after colonization.

Historically, lack of and inappropriateness of education is a recurring theme: "The provision for educating the people was meager and haphazard. Learning was chiefly a privilege accorded the sons of the more prosperous Spaniards, Creoles and mestizos (daughters, of course, were not regarded as educable). . . . As a result, Spanish America was largely illiterate at the end of the colonial period" (Herring, 1962, p. 209).

**Table 1. Natural Resources**  
**Relative Importance of Latin America and the Caribbean**

	LAC as a percent of World				Index (LAC = 100)			
	Output		1979		Output per capita (1979)		Resources per capita	
	1960	1979	Reserves <sup>d</sup>	Resources <sup>b</sup>	Other LDCs	Industrial Countries	Other LDCs	Industrial Countries
Bauxite	47	26	28	64	18	31	8	2
Copper	19	20	34	na	23	47	14 <sup>a</sup>	20 <sup>a</sup>
Iron Ore	8	9	13	12	31	146	20	106
Lead	17	11	9	10	22	115	33	129
Manganese Ore	15	8	2	4	89	117	100	303
Nickel	—	4	5	2	130	245	134	607
Tin	12	17	—	33	63	24	23	11
Zinc	15	14	12	11	17	84	43	99
Phosphate Rock	1	1	na	na	450	909	na	na
Silver	37	41	26	27	2	23	—	46
Tungsten	6	11	3	4	22	113	50	411
Crude Oil	18	8	na	na	103	87	137 <sup>c</sup>	45 <sup>c</sup>
Industrial Wood	3	5	—	—	45	257	26 <sup>c</sup>	39 <sup>c</sup>

<sup>a</sup> "Reserves" are deposits that can be profitably recovered under present technological and economic conditions.

<sup>b</sup> "Resources" are identified mineral deposits which may or may not be profitably recoverable with existing technology and economic conditions.

<sup>c</sup> Reserves, not resources.

na not available

Source: World Bank

Rather than assimilating through education the Spaniards and Portuguese virtually destroyed the local cultures. To this day the Indians have not been fully integrated into the modern cultural mold. In the Spanish-speaking countries the number of illiterates roughly coincides with that of mostly rural indigenous groups whose command of Spanish is imperfect or lacking. Despite enormous progress in education that number has remained almost constant corresponding to historical attempts at assimilation that were ruthless, sweeping but imperfect. While many Indians were assimilated individually through intermarriage, as a cultural group they were conquered, not assimilated, and this remains true today in the countries where large Indian groups live.

The major cleavage between the poorer population and the somewhat better off coincides rather closely with rural/urban differences. There are historical, cultural, and geographical reasons for this. The Spaniards developed cities first; they were their pride and glory, as can be seen by any tourist visiting Mexico, Lima, Arequipa, Quito or Cartagena. These cities were first and foremost administrative and religious centers. Usually they were financed out of mineral rather than agricultural surpluses. The earlier, pre-Colombian cities that they often succeeded, in contrast, had been sustained mainly through agriculture, as was the rule throughout Europe, North America, and much of the developing world. Except in the temperate countries of the Southern Cone—Chile, Argentina, Uruguay, and Southern Brazil—development of agriculture came later, an inversion of the historical process observed in most of the world. Thus, while in most of today's industrialized countries the rural and the urban sectors developed *pari passu*, in much of Latin America enclave mining financed the development of the cities without a concomitant development of agriculture. Therefore the benefits of growth largely by-passed the bulk of the population, which was rural. Today an even greater proportion of the native population lives in the rural areas, and this contributes to explaining rural neglect.

Distances and geographic obstacles also contribute to rural neglect. Two of Brazil's smallest states, Santa Catarina and Pernambuco, are each about the size of South Korea. Even Guyana, one of the smallest countries, is more than twice the size of South Korea. Many of the poorest people live in remote, mountainous areas. These economic, cultural, and geographic factors not only tend to depress incomes; they also make it extremely hard to build effective administrative systems able to deliver reasonably good public education, health and other services in these areas. Naturally, the sharp difference in conditions between rural and urban areas is the reality underlying the massive migration to the cities that is taking place everywhere in the Region, and the tendency may be reinforced with time. As more people cluster in the cities, it becomes cheaper to provide public services for them, and as fewer people remain in the rural areas, their political power becomes weaker. In spite of considerable progress achieved in improving rural social and economic public services, the gap between rural and urban standards of living remains enormous in most countries.

Immigrants who later contributed to forming the Region's middle class provided an essential stimulus to development. To quote Herring:

Throughout the colonial period a few migrants drifted in from Northern Europe, legally or illegally, and made their homes in the New World.

After independence, and particularly after the 1850s, immigration increased. Spaniards, Portuguese, and Italians came in large numbers, as well as French, English, Japanese, Germans, and Slavs. Over the length and breadth of Latin America, we find people who speak no work of the language suggested by their English, French, German, or Dutch names. With few exceptions these migrants became . . . nationals of the lands of their adoption—settled down, and intermarried (Herring, 1962, p. 16).

Any tourist will corroborate this. The main street in Punta Arenas, Chile is Calle Jugoslavia. There are large numbers of Japanese in Brazil, and a sizeable Chinese community in Peru.

A series of papers was issued by the Pan American Union in 1950 on the middle classes in Latin America (Crevenna, 1950-51). In Argentina immigrants made up 30 percent of the population in 1885 and 20 percent in 1935. By then 45 percent of industrial establishments were owned by foreign-born persons. In 1914, 49 percent of commercial employees, 18 percent of public administration employees, and 45.5 percent of professionals in Argentina were foreign-born. As late as 1942, 33 percent of employees in private establishments in Buenos Aires were foreign-born (Germani, 1950). A recent book on population in Brazil cites the results of a survey of domestic nonforeign industrial firms in the greater Sao Paulo area, the largest industrial area in Latin America. The 1962 survey shows that approximately one-half of the firms were owned and directed by first-generation immigrants and if second generation immigrants are included the proportion rises to 73 percent (Merrick and Graham, 1979).

Nineteenth and twentieth century European, Japanese and North American immigration not only provided a very important economic stimulus, but also helped create effective demand for reasonably good public social institutions in education, health, and so on. The waves of middle-class immigrants during the late nineteenth century and the twentieth century (notably those who came to Latin America because of the second World War and the attending political turmoil in Europe) played a decisive role in consolidating the middle classes in Latin America. The middle class had an important function in generating savings, investing in productive facilities both in industry and in agriculture, and constituted a new dynamic economic force in the traditional society. The remarkable acceleration in growth of the Region owes much to the contribution of immigrants.

### **Economic Growth**

This section considers the Region's growth record. It reviews the underlying demographic trends with special stress on the rural/urban balance, and then turns to output growth, concluding with a few remarks on social trends, income distribution and employment.

#### *Population Growth and Urbanization*

After centuries of slow population growth and labor shortages the population of the Region increased very rapidly during the twentieth century. Around 1950 the population had reached about 190 million, roughly that of the United States during the same period. Today the population is in the order of 365 million and exceeds that of the United States by 65 percent. Figures for Brazil illustrate this dramatic in-

crease. The population of Brazil passed the 10 million mark in the 1870s, reached 17 million in 1900, 52 million in 1950 and 119 million in 1980. There are considerable variations among countries with the lowest rates of population change in Uruguay, Argentina and the English-speaking Caribbean, but these areas represent a small share of the Region's total population.

The rate of increase in population has, however, begun to abate. In Brazil, the annual rate of population growth increased first from 2 percent in the late nineteenth century, 2.3 percent during the first fifty years of this century to a peak of 3 percent during the 1950s. It then came down very gradually to 2.9 percent in the 1960s and 2.5 percent during the 1970s. Slight as the slowdown may appear, it has favorable implications for social expenditures today and for future employment needs.

Brazil's trend is fairly typical for most of the Region. The total fertility rate for Latin America as a whole has fallen steadily since 1955-60 and has been estimated recently to be lower than rates in Africa and most of Asia. Many causes underlie the decline in fertility rates. Rural-urban differences in fertility are commonly found; migration to the cities tends to depress fertility. Furthermore, statistics suggest that fertility varies even more with education and income. In Brazil the fertility rates of women with less than three years' schooling are nearly twice those of women with six years' schooling and more (Merrick and Moran, 1979). It seems clear that social and economic development generally and education and urbanization particularly have contributed powerfully to reduce fertility rates. The following figures indicate the ratio of children per married woman with secondary vs. primary education: Buenos Aires (1.7), Rio de Janeiro (1.6), Bogota (1.2), San Jose (1.6) and Caracas (1.6). In "Financiamiento de la Educacion en America Latina" (Brodersohn, 1978). These trends can be expected to continue in most of the Region. Nevertheless, the population of Latin America continues to increase at high rates: around 2.4 percent per year. Furthermore, the full impact of the population spurt of the 1960s is yet to be fully felt on the labor markets.

Some parts of Latin America have reached a stage where the rural population is declining as a result of out-migration. This is an important turning point, because increasing scarcity of rural labor is a precondition for—and often a cause of—rising real wages in the poorest-paid jobs such as rural laborers and unskilled construction workers. The phenomenon is relatively recent, and because few of the 1980 population census results have been published yet, the quantitative evidence is limited. The example of Brazil is significant. Between 1970 and 1980 Brazil's population increased by 28 percent. While the urban population increased by 55 percent, the rural population declined by 6 percent. This compares to increases of 63 percent and 8 percent respectively in the 1960-70 decade. Absolute rural population declines were observed in all the states of the more prosperous Southeast and South. Declines were particularly sharp in Parana (-29 percent) and in the States of Sao Paulo and Minas Gerais (-19 percent). (Some of the declines are attributable to migration to out-of-State rural areas, particularly to Brazil's western frontier. All these figures are from preliminary census results based on a sample. Final results may turn out to be different.) But even in the poorer Northeast the rural population of Ceará, Rio Grande do Norte and Paraíba declined between 1970 and 1980, while that of the Northeastern Region as a whole increased by 6 percent—down from nearly 10 percent during the 1960s. A similar turning point is likely in Venezuela, Colombia and perhaps

some of the countries in Central America. However, in most countries including Mexico population continues to increase in the rural areas.

The following quote is from the 1981 *Annual Report* of the World Bank:

Latin America and the Caribbean is the developing region with the highest level of urbanization. In 1950, less than half the population of the region lived in towns and cities; in 1980, the region's urban population of some 200 million made up almost 60 percent of the total. By the end of the century, there may be nearly 400 million urban dwellers, and the level of urbanization may rise to more than three quarters. In the 1950s and 1960s, urban growth was for the most part a function of migration from rural areas, as national economic policies frequently discouraged the growth of agricultural output and employment and failed to provide adequate social services to the rural population. In the 1970s, it was primarily a result of the natural increase of an already urbanized population; nonetheless, the rate of urbanization in the 1970s showed little diminution from earlier years, and it exceeded 3 percent in most countries and 4 percent in several.

Within its general framework, there are important contrasts. The present level of urbanization, for example, exceeds 80 percent in Argentina, Chile, and Uruguay, whereas it is still less than a third in such countries as Bolivia, Haiti, and Trinidad and Tobago. The degree to which the urban population is concentrated in the largest city also varies—from more than half in Costa Rica, the Dominican Republic, Jamaica, Panama, and Uruguay to less than 20 percent in Brazil. Some of these cities are now among the world's largest; Mexico City, which has grown from a city of 3.6 million people in 1950 to one with an estimated population of 14 million in 1980, and Sao Paulo, whose estimated 1980 population of 12.6 million represents more than a threefold increase since 1950, are outstanding examples (pp. 62-63).

### *Output Growth*

Economic growth in the major countries of the Region can be viewed as having undergone three phases—the open trading phase between independence and the depression of the late 1920s; the phase of active import-substitution of the 1930s, 1940s and 1950s; and the phase of gradual return to somewhat more outward-oriented policies in the 1960s and 1970s. The evolution of the Region's economies is described succinctly in *Latin America—a Broader World Role* Vasena and Pasos, 1973).

During the open phase several major countries experienced rapid growth not only in agriculture but also in industry, spurred by massive foreign investment. "In Brazil the railway network expanded from 3,400 to 21,300 kilometers between 1880 and 1910, and between then and the beginning of the First World War coffee exports more than quadrupled. In Argentina the population doubled between 1890 and 1914, while cereal exports increased fivefold and exports of refrigerated meat rose from 27,000 metric tons to 376,000 tons" (op. cit., p. 24). By 1899 the GDP per capita of Argentina exceeded 50 percent of that in the United States. "Industrialization was also taking place in the medium-sized countries of the region, such as

Colombia and Peru, even if to a lesser extent. In Chile, for example, the rate of manufacturing expansion during the years 1914 is calculated to have run at an annual cumulative rate of some 4.8 percent" (ibid, p. 65).

The collapse of world trade caused by the Great Depression had a devastating effect on the Region. Governments adopted "a varied range of defensive policies aimed at maintaining employment levels . . . Governments increased public expenditure, issuing money to do so, and economies were closed to imports, through exchange controls, quantitative restrictions, or tariff increases . . . The process of "import-substitution" . . . was reinforced during the Second World War by the difficulty of obtaining supplies from the industrialized countries" (ibid, p. 32).

In the early 1960s "it began to be apparent that too much had been expected from policies of exaggerated protection. Industrial development was not continuing to accelerate as had been hoped, and the state of external trade was deteriorating (ibid, p. 33). The section on economic policies below discusses some of the pros and cons of reverting to a more "open" economic system.

During the third phase of development growth of the Region as a whole has been reasonably rapid until the "oil shock" of 1974 as shown in Table 2.

Comparable GDP growth figures for non-communist industrialized countries are 5.1 percent per year (1960-70) and 3.2 percent (1970-78). The GDP of the United States—to which about one-third of the Region's exports go—grew by 4.3 percent per year and 3.1 percent respectively. Growth in the Region thus exceeded that in the industrialized countries. Per capita growth rates also accelerated between the two decades but per capita growth in all middle income oil-exporting countries of the world (including Latin America and the Caribbean) exceeded that in the Region, especially during the 1960s (3.5 percent per year 1960-1970 and 3.2 percent per year 1970-1978).

Naturally, there have been many differences between countries. The following tables focus on the evolution of per capita income and on trends in crop production per capita in different Latin American and Caribbean countries. Agriculture—essentially crops rather than livestock—remains a major source of employment in many countries of the Region. For these, agricultural progress may well be a *sine qua non* for long-term sustained economic and social development without major tensions. The growth performance of some of the Region's countries can usefully be compared with that in the United States.

Table 3 shows the percentage by which per capita GDP changed during the last 20 years. Perhaps the most interesting finding is not the very wide divergence in per capita growth performance

Table 2. GDP Growth Rates Per Year

	1960-70	1970-78	1970-74	1974-78
Region:				
GDP Growth	5.7	5.9	7.5	4.4
Population Growth	2.8	2.7	2.7	2.7
Per Capita GDP	2.9	3.1	4.7	1.6

Source: World Bank

**Table 3. Per Capita GDP Growth, 1960-79  
(percent)**

<i>Countries Which Narrowed the Gap Relative to the U.S.</i>	Percent Change 1960-1979 <sup>a</sup>	<i>Countries Which Fell Behind The U.S. Trend</i>	Percent Change 1960-1979 <sup>a</sup>
Barbados	135	Bolivia	50
Brazil	122	Argentina	48
Belize	94	Grenada	42
Surinam	94	Chile	41
Paraguay	79	El Salvador	39
Costa Rica	75	Ecuador	39
Dominican Republic	73	Peru	32
Panama	70	Uruguay	24
Colombia	70	Honduras	23
Guatemala	67	Jamaica	10
Trinidad and Tobago	66	Nicaragua	7
Mexico	64	Bahamas	6
Venezuela	63	Haiti	5
United States (1979-80 average)	62	Guyana	1
		Netherlands Antilles	-2

<sup>a</sup>At 1977-79 prices and exchange rates.

Source: World Bank *Atlas*

between each country as much as the fact that 73.5 percent of the Region's population live in countries that have done as well or better than the United States in improving their standard of living since 1960. Brazil's performance stands out as a most remarkable achievement; per capita income there increased at nearly twice the United States rate over the last 20 years. Since Brazil's population represents over one-third of the Region's, its performance greatly influences the regional total. Some of the factors underlying the divergent performances are dealt with later.

National income information based on international price comparisons has recently been developed and can be used to give an idea of the relationship between the average standard of living in the Region and in the United States. Table 4 shows these relationships for 1960 and 1979.

A substantial proportion of the population still depends on agriculture for its living. Table 5 shows changes in crop production per capita (i.e. per head of the population—not per person employed in agriculture) during the 1970s.

While the countries which have experienced positive per capita crop production trends during the 1970s include nearly 60 percent of the Region's population, this owes much to the weight of Brazil. In 15 out of 24 countries crop production per capita stagnated or declined. Performance was particularly poor in Peru, Barbados, Trinidad, Jamaica, Nicaragua, Mexico, Guyana and Haiti. The unweighted average crop output per capita of the Region's countries declined by one percent during the period. This performance is in contrast to the good overall growth record of the Region and is contrasted in Table 6 to the overall growth record of the United States and regional groups.

Table 4. Per Capita GDP Expressed as Percent of U.S. Per Capita GDP

	International Price Comparisons		Change	Memorandum Item: 1979 <sup>a</sup>
	1960	1979		
Argentina	32	31	-1	21
Barbados	25	39	14	22
Bolivia	16	15	-1	5
Brazil	20	28	8	15
Colombia	22	23	1	9
Costa Rica	24	26	2	17
Dominican Republic	18	20	2	9
Ecuador	17	18	1	10
El Salvador	15	13	-2	6
Guatemala	17	18	1	9
Guyana	25	15	-10	5
Honduras	16	13	-3	5
Jamaica	25	17	-8	11
Mexico	29	30	1	15
Panama	22	25	3	12
Paraguay	18	20	2	10
Peru	22	19	-3	7
Trinidad and Tobago	50	48	-2	31
Uruguay	53	41	-12	19
Venezuela	44	42	-2	29
Chile	na	na	na	16
Haiti	na	na	na	2
Nicaragua	na	na	na	6

<sup>a</sup>World Bank *Atlas* method (current exchange rate conversion based on 1977-79 averages) rather than international price comparisons.

na - not available

Source: World Bank

Most of Latin American industry has grown rapidly during the last two decades. The most rapid growth rates were achieved in Central America during the 1960s and early 1970s when the Central American Common Market was making its effects felt, as well as in Brazil and in a few countries at the earliest stages of industrialization (Haiti during the 1970s, the Dominican Republic, Ecuador and Paraguay). The more "open" countries have expanded import-substitution as well as exports fairly rationally while the "closed" and particularly the smaller countries drew their dynamism mostly from (frequently uneconomic) import-substitution (see the section on economic policies below). A number of countries have found it desirable to reduce protection gradually in order to sustain the growth momentum into the future. Some of the countries which did not follow that path have experienced declining industrial growth rates (Professor Balassa concludes that exports and efficient import-substitution often go together [World Bank, 1981, notably p. 21]).

A physical indicator of the Region's growth is the output of automotive vehicles after many decades of supply restrictions of various kinds. In 1970 the Region produced 950,000 vehicles; in 1979, 2.1 million, of which 1.1 million were produced in Brazil, 450,000 in Mexico, 250,000 in Argentina and the remainder in Venezuela,

**Table 5. Percent Change since 1969-71: Per Capita Crop Production (1978-80)**

Paraguay	45
Argentina	39
Colombia	28
Guatemala	23
Surinam	15
Brazil <sup>b</sup>	14
Venezuela	9
Dominican Republic	2
Ecuador	0
Bolivia	-1
Uruguay	-3
Chile <sup>c</sup>	-3
Costa Rica	-3
Honduras	-4
Panama	-7
El Salvador	-9
Haiti	-11
Guyana	-12
Mexico	-13
Nicaragua	-18
Jamaica	-19
Trinidad and Tobago	-30
Barbados	-31
Peru	-31

<sup>a</sup>Crop trends are presented over a decade rather than two because of weighting problems with the longer-term series. Agricultural statistics are particularly deficient in most of the Region. Livestock is excluded because of its relatively small contribution to employment.

<sup>b</sup>These figures based on 1970 weights fail to capture fully Brazil's spectacular performance in soy expansion during the late 1970s. A rate based on 1980 weights would show substantially better performance during the 1970s.

<sup>c</sup>The weight problem also depresses Chile's rate because production shifted to high-value crops during the decade. This is not adequately reflected in the Table.

**Table 6. The Weighted Average for Food and Total Agricultural Output Growth Per Capita for the United States and Various Regional Groups**

	Percent Changes (1978-80 over 1969-71) per Capita	
	Food	Total Agricultural Production
United States	13	12
Industrialized countries	10	9
Developing countries	2	1
Latin America and Caribbean	9	7
East Asia (excl. Japan)	17	15
South Asia	-1	-1
West Asia	12	10
Africa (excl. South Africa)	-13	-14

Source: U.S. Department of Agriculture, 1981.

Colombia, Chile and Peru. Mexico exported 25,000 vehicles in 1979 (besides exporting components), and Brazil's exports reached 106,000 vehicles. Brazil's vehicle exports increased from 2.2 percent of output in 1972 to 13.8 percent in 1980.

The modernization and expansion of the services sector in the more advanced countries of the Region deserve mention. As will be noted, labor absorption in services can be (and has been in the Region over the past 20 years) associated with increases in productivity. This sector deserves much more research on productivity trends, policies and prospects.

The Region's share of world trade declined from about 8 percent in 1960 to 5 percent in 1979. Table 7 shows the Region's export performance compared to the trend in world trade and that for industrialized countries.

While the Region's share of world trade declined, performance during the 1970s improved considerably over that in the 1960s, and manufactured goods (SITC 5 through 9 minus 68) became significant, their share in regional exports rose from 3.3 percent in 1960 to 17 percent in 1978. On the whole, export performance has not been outstanding by world standards but this has not kept the Region's income from growing at rapid rates.

### *Social Developments*

Economic growth has been accompanied by social improvements. Between 1960 and the late 1970s life expectancy at birth in the Region increased from 55.7 to 63.7 years compared to 69 years in European middle-income countries; access to potable water increased from under 40 percent to 66 percent; the population per physician declined from 2,400 to 1,760; access to electricity increased from 46 to over 60 percent. The share of the labor force employed in agriculture declined from one-half in 1960 to about one-third in 1980. Finally women in the labor force increased from 18.6 percent in 1960 to about 23 percent in the late 1970s. As the population census results for 1980 become available many of these figures can be improved. But there is no doubt that the share of the population deprived of safe water, medical attention, access to electricity and other essentials declined sharply during the past two decades in spite of very rapid population growth. Urbanization, which facilitates access to basic services, has been a major cause of improvement.

A very important aspect of Latin American development is the educational effort of the past few decades. At the turn of the century, as noted earlier, the overwhelming majority of the population of Latin America was illiterate. Wealthy people frequently sent their children overseas for education, and public and private schools catered to a small minority. By 1950 the primary school population had risen to a little under half of all children aged 7 to 14. By the late 1970s most children attended primary school, and secondary school enrollment had reached about 35 percent in spite of a very rapid population growth. The increase in university enrollment is truly dramatic. Between 1960 and 1975 the number of students increased by over 300 percent in Central America and the Caribbean (including Mexico) and by over 600 percent in South America (UNESCO *Statistical Yearbooks*). While the urban areas are relatively well covered by educational institutions, rural areas continue to be neglected, with the average rural child spending less than three years at school in most countries. Furthermore, educational progress has, naturally,

**Table 7. Regional Export Trends in Perspective  
(percent share of world exports)**

Items (with 1978 share of total regional exports)	1955	1960	1970	1979
<b>All Exports (100)</b>				
LAC Region	9.8	7.7	5.4	5.0
Other LDCs	15.0	13.1	11.5	19.0
Centrally Planned	11.9	14.1	13.5	11.8
Industrialized	63.3	65.1	69.6	64.2
Total	100.0	100.0	100.0	100.0
<b>Food Items (38)</b>				
LAC Region	20.7	17.3	15.6	15.6
Other LDCs	22.3	19.6	15.8	14.9
Centrally Planned	7.7	11.1	9.5	5.7
Industrialized	49.3	52.0	59.1	63.8
Total	100.0	100.0	100.0	100.0
<b>Fuels &amp; Related Minerals (31)</b>				
LAC Region	26.6	23.9	13.6	8.4 <sup>a</sup>
Other LDCs	29.0	32.7	45.5	57.8
Centrally Planned	13.6	18.7	16.1	17.2
Industrialized	30.8	24.7	24.8	16.6
Total	100.0	100.0	100.0	100.0
<b>Non-Ferrous Metals (4)</b>				
LAC Region	14.2	11.4	10.8	8.5
Other LDCs	19.4	17.2	16.9	12.3
Centrally Planned	8.3	10.6	11.7	12.0
Industrialized	58.1	60.8	60.6	67.2
Total	100.0	100.0	100.0	100.0
<b>Manufactured Goods (7) (only SITC 6 + 8 minus 67 and 68)</b>				
LAC Region	0.9	0.6	1.6	1.9
Other LDCs	7.7	7.9	9.2	14.2
Centrally Planned	10.9	11.2	8.6	6.7
Industrialized	80.5	80.3	80.6	77.2
Total	100.0	100.0	100.0	100.0
<b>Machinery and Transportation Equipment (5)</b>				
LAC Region	0.1	0.1	0.4	0.9
Other LDCs	0.6	0.6	1.1	3.2
Centrally Planned	15.6	16.9	13.4	12.2
Industrialized	83.7	82.4	85.1	83.7
Total	100.0	100.0	100.0	100.0

<sup>a</sup>Mexico's petroleum exports increases are likely to have raised the Region's share after 1978.

Note: LAC refers to Latin America and the Caribbean. LDC refers to Less Developed Countries. SITC means Standard International Trade Classification.

Source: United Nations Conference on Trade and Development, 1955, 1960, 1970, 1979. *Handbooks of International Trade and Development Statistics*

benefited the newer generation while illiteracy among older people continues to be high in many countries. In Brazil, for example, 40 percent of the agricultural labor force had no formal schooling in 1973; 11 percent of those employed outside agriculture were in that situation (IBGE, 1973). Nevertheless, progress in this area has been very impressive, and human capital formation on a vast scale has been one of the main factors underlying economic modernization.

Much has been written about the development of a middle class in Latin America. One indicator of this phenomenon is passenger car ownership. It can safely be assumed that mainly middle and upper class families own passenger cars. Therefore the level and trend in the share of families owning cars gives a rough idea of the importance of the middle class. Clearly this is a very crude measure: it ignores the varying importance of multiple car ownership and of rented cars (which may distort particularly the statistics of some of the Caribbean tourist islands); it also ignores differences in family size between countries. Nevertheless, for what the figures are worth, they are shown in Table 8. For the Region as a whole, the "middle and upper classes" so defined have grown from under 6 percent in 1960 to over 20 percent in the late 1970s (the exact years of the latter observances vary by countries). The total number of cars in the Region increased from 2.3 million in 1960 to over 14 million. The most spectacular increase occurred in Brazil from 500,000 cars in 1960 to 6.2 million in the late 1970s.

The theme of poverty and income distribution in Latin America has been much debated (Fischlow, 1972; Webb, 1974; Bergsman, 1980). While there is little doubt that the distribution of income in most Latin American countries is very skewed—although perhaps no more so than in other developing countries—considerable debate has surrounded the question of trends: has the distribution of income improved or worsened over time?

The empirical basis for statements about income distribution trends is so weak even in the most advanced countries in the Region that comparisons in time lack statistical validity. So, for example, the Brazilian population censuses of 1960 and 1970 captured only 58 and 56 percent, respectively, of personal income as estimated in the national accounts. National household surveys of Brazil also failed to capture a substantial share of personal income (see "The Distribution of Income in Brazil," World Bank Staff Working Paper No. 356, 1979, by Guy Pfeffermann and Richard Webb, pp. 15 and ff.). Comparable data in other countries of the Region are weaker even than in Brazil.

What can be said on the basis of recent analyses is that in at least three major countries (Brazil, Mexico and Colombia) economic growth has been accompanied by substantial improvements for the poorer segments of the population. In Brazil, "The two main features of the change in employment patterns between 1960 and 1976 are a substantial move out of agriculture, and an upgrading of the urban employment structure" (Pfeffermann and Webb, 1979). By moving out of agriculture landless laborers can increase their incomes. "In all regions (of Brazil) the landless laborer doubles his income by moving to urban manual employment within his own region. Allowance for urban-rural cost of living differences would still leave increases of well over 50% . . . The rural-Northeast to urban-Rio move roughly triples income, while the family income of a Sao Paulo manual worker is 4.7 times that of a Northeast farm laborer" (Pfeffermann and Webb, 1979). At the same time the differential between agricultural and non-agricultural mean incomes in Brazil

Table 8. Percent of Families Owning Cars<sup>a</sup>

	1960	Late 1970s
Bahamas	35.5	86.5
Trinidad and Tobago	22.0	52.9
Barbados	17.5	50.4
Argentina	12.0	40.5
Venezuela	18.5	37.8
Brazil	3.5	26.8
Jamaica	1.0	22.5
Uruguay	19.5	22.3
Mexico	7.0	21.2
Panama	7.5	19.9
Guyana	9.5	17.5
Costa Rica	7.0	16.1
Chile	3.5	14.1
Peru	4.0	9.3
Colombia	3.5	9.1
Dominican Republic	2.0	8.0
Nicaragua	2.5	8.0
Guatemala	3.5	6.6
El Salvador	4.0	5.5
Ecuador	1.0	3.7
Paraguay	1.0	3.5
Bolivia	1.5	3.4
Honduras	1.5	3.2
Haiti	1.0	1.8
TOTAL	5.8	21.6

<sup>a</sup>Assumes average family of 5.

Source: World Bank data

has remained fairly constant since 1960, suggesting that the enormous labor absorption by urban areas occurred without a flooding of the lower income categories. Perhaps most important, real wage rates for casual rural farm laborers in Brazil went up by about 60 percent between 1970 and 1977 and have remained at that real level since then. Thus, an important group of workers who are among the poorest in the country experienced a substantial absolute improvement in their daily earnings.

The experience in Colombia is very similar. A recent study (Montoya, 1981) concludes after an exhaustive review of evidence focusing largely on wage trends.

The empirical analysis of income trends in Colombia during the last two decades is a difficult task, but it appears that absolute poverty was reduced, since the incomes of poor families rose during the 1970s at a rate matching or exceeding that of per capita income . . . There were increases in real agricultural day wages in the 1970s, especially during the latter half of the decade. There were also increases in the real wages of construction workers and other unskilled urban workers." The study notes that middle-class incomes rose more slowly. "Because the incomes of the wealthiest families also rose more rapidly than national per capita income, it is clear that the relative position of the so-called middle-class worsened. In the years prior to 1964, in contrast, that class benefited most from the economic development process.

Finally, in the case of Mexico a recent study (Gregory, 1981) concludes:

The rapid and sustained growth of the economy has been accompanied by a very substantial shift of the labor force from the agricultural sector, where productivity is relatively low, to the secondary and tertiary sectors, where productivities are much higher. Furthermore, this large shift has been achieved without depressing the productivity or wages of labor in the expanding sectors. Our analysis of the course of remunerations and productivities in those parts of the nonagricultural sectors that are likely to reflect the uninhibited forces of supply and demand in the labor market, recorded substantial improvements in both of these measures. Finally, I have set forth reasons for believing that the degree of underutilization of labor resources may be considerably smaller than most estimates have held.

The study covers the period 1940 to 1980, with particular focus on the last decade.

Even fewer reliable statements can be made about poverty trends in the Region as a whole. However, a recent paper by Peter Gregory (1980) which covers eighteen countries over at least one decade substantiates the following points: (1) agricultural employment has become less and less important over time; (2) industry has gained relative to total employment; (3) productivity has risen in the services sector, suggesting that the rapid increase in employment is not due solely to the expansion of marginal service activities. Gregory concludes: In none of the sets of data examined "which could be presumed to reflect the direction of qualitative changes in labor market conditions . . . have I been able to discern unambiguous evidence of deterioration." Gregory's findings are consistent with micro studies on Bogota, Lima, Rio de Janeiro, Santiago and other metropolitan centers, which all suggest that migrants do move up the scale; that their employment and earnings situations do not differ much from those of comparable city dwellers; and that migration is, indeed, the main mechanism through which rapid economic growth is translated into lifetime and inter-generational upward mobility.

### **Economic Policies**

Having reviewed the elements of growth and performance of the Region, this section turns to economic policies and relates them to success or failure in achieving sustained growth. The section deals with agriculture, financial policies—exchange and interest rate management in inflationary conditions—and external indebtedness. The section shows how domestic policies have been largely responsible for economic performance.

### *Intellectual and Economic Environment*

Some psychological and political features help explain the many instances of policies seemingly at odds with economic rationality. As in most developing regions many vestiges of an earlier mentality have survived in Latin America. Thus, persons close to the government might be given exclusive franchise to import a particular brand of cars. Others might be given an import ban on whatever their firms produce. Others again might be placed at the helm of state banks and so on. While these practices are common throughout the world (and not only the developing world),

the "closed economies" provided a particularly fertile ground for their proliferation. And efforts at dismantling barriers sometimes failed because of the highly personal nature of the political arrangements underlying them. The more open economies afford far fewer opportunities for this sort of "neo-feudal" nexus. These "neo-feudal" relations continue to exist in many parts of the Region and form an obstacle to sustained economic progress.

Second, with the rise of the middle classes during the past decades economic growth has become increasingly important in the political arena. While thirty years ago it was still possible—in some countries common—for a regime to remain in power for a long time while the economy was doing badly, this has become more difficult and rarer today (the eight-month presidency of General Viola in Argentina (1981) is a case in point). Middle classes expect governments "to deliver." Indeed, rapid growth has been used increasingly as a legitimizing force by non-democratic governments. The corollary is that governments "take economics more seriously" than they used to, and this in turn has favored economic progress. Ironically, the desire to remain in power has thus led to undermining the "neo-feudal" arrangements when they stood in the way of "delivering the goods."

At times the "neo-feudal" and the "meeting of expectations" combine on a large scale, when governments try to co-opt a whole segment of society—usually among the middle class—by delivering economic (and more often social) services. Generally they will try to do this without financing them through taxes. This has come to be known as populism. It may consist of attempts to deliver increases in consumption exceeding the productive sectors' ability to respond, usually through wage increases, price controls, or improvement and expansion in social security systems. It often consists as well in the expansion of public sector employment beyond reasonable limits. All these policies have in common the fact that they put a burden on the productive sectors—particularly agriculture—which depresses incomes and output thereby creating increasing stresses. One particularly common burden is the taxation of agricultural exports either directly or through overvalued exchange rates. These policies are unsustainable in the long run because the erosion of the productive base eventually undermines the very delivery of "additional welfare." Perhaps Latin America is more prone to this sort of policy than other regions because the spirit behind "milking the cow to death" is not so different from the drive that fired early colonists who sought to maximize mineral extraction.

Unsurprisingly, frequent episodes of excess demand ratified by governments have meant, especially in South America, frequent and often prolonged periods of high inflation. Inflation has indeed been "rationalized" on the grounds that it increased investible savings available to governments without explicit additional taxation. But the scope for such "inflation tax" is rather small and the public's defense mechanisms—notably an avoidance of money in favor of substitutes—cause harm which far outweighs the limited benefits of the "inflation tax." Economists of the "structuralist school" (Felix and Grunwald in Hirschman, 1980), without advocating inflation, believed that inflation was unavoidable because the supply of food, foreign exchange and other indispensable requisites for development could not meet the growing demands of the population. Therefore, their argument went (somewhat illogically), fighting inflation through demand curbs was futile and would cause only unnecessary deflation and unemployment. More is said below about "living with inflation." Suffice it to note here that empirical evidence for 36 developing countries

(including 18 in the Region) by Harberger and Edwards (1980) over a period of 15 to 20 years strongly suggests the existence of "a tendency toward a negative relationship between the rate of real growth and the rate of inflation" (pp. 35-36). Indeed the study comes to the surprising conclusion that only few countries suffered output losses (slowed down GDP growth) during periods when inflation was coming down, and that in most cases a reduction in inflation was indeed associated with accelerated growth. It is regrettable that this empirical evidence only surfaced more than a decade after the argument between "monetarists" and "structuralists."

This review of the intellectual and political environment touches on a policy debate that continues to divide the Region: "openness" versus intervention. Openness in this context refers to the role of the price mechanism in an economy. Advocates of closed economies see the market mechanism as prejudicial to welfare. This view rose naturally from the catastrophic effects on welfare of the drop in primary commodity prices of the 1930s. By contrast, economies like Japan, Korea, Taiwan, Hong Kong and Singapore never have been affected significantly by fluctuations in export prices. Following the early lead of the United Nations Economic Commission for Latin America many Latin American countries have attempted to shield themselves from the influence of external markets by stressing import-substitution, often at a very high cost to consumers and to the economy. Especially in small economies this has favored the development of domestic monopolies producing at high costs. In "closed economies" inflation is often suppressed through government price controls or sales by government enterprises at artificially low prices which generate fiscal deficits and in turn fuel inflation. Prices of food and other necessities in particular tend to be controlled at low levels to "protect urban consumers." As a result, scarcities and some form of rationing usually ensue. Farmers are not encouraged to produce, and food has to be imported. Likewise, financial markets are frequently repressed in an attempt to keep interest rates artificially low, often below the rate of inflation. The public is not encouraged to put their savings in the banking system. The available "cheap" credit is rationed to a small number of privileged recipients. These price distortions indeed contributed to bring about the very supply rigidities which the "structuralists" considered systemic obstacles to development. Conversely, in "open economies" there is less scope for price interventions. Even though the record of open economies has been better world-wide than that of the closed economies both in terms of growth and in flexibility to external shocks (e.g. the oil price increases of the 1970s) many of the Region's academic economists continue to support "closed economy" policies.

### **Development Policies**

*Agriculture.* Table 9 suggests that good agricultural performance may be a prerequisite to rapid per capita income growth.

The mediocre growth performance of Argentina coupled with the second-best growth in crop output per capita in the Region largely reflects the response to sharply improved internal producer prices for agriculture after 1976 and the adjustment problems of an inefficient industrial sector. Out of the five countries which combined good GDP per capita growth with poor performance in crops, three are oil or gas countries (Ecuador, Bolivia and Trinidad and Tobago); Barbados had to diversify away from agriculture because of an absolute shortage of arable land; and Costa Rica's growth was based largely on the expansion of public services which

**Table 9. Crop Output and Income per Capita Trends (1970s)<sup>a</sup>**

	Positive Trend in per Capita Crop Output	Negative Trend or Stagnation in Crop Output
Above-average growth of per capita GDP	Paraguay Colombia Guatemala Surinam Brazil Venezuela Dominican Republic	Ecuador Bolivia Costa Rica Trinidad and Tobago Barbados
Below-average growth of per capita GDP	Argentina	Uruguay Chile Honduras Panama El Salvador Haiti Guyana Mexico Nicaragua Jamaica Peru

<sup>a</sup>The fact that most countries are in the Northwest and Southeast segments is not due to the large share of crops in GDP. That share is too small to cause "auto correlation."

Source: World Bank statistics

proved unsustainable after the end of the 1970s. Of the countries on the bottom right-hand quarter of the table, several have shifted into the fast-growing category toward the end of the decade: Mexico (owing to its oil and gas), Chile and Uruguay (owing to successful restructuring of the incentives environment). Because of the continued importance of the rural population in Mexico, continued overall growth without rapid agricultural progress may spell increased social tensions in that country. In Uruguay and Chile agriculture represents a much smaller share of employment than in Mexico. Table 9 may point to a need to improve agricultural performance in Honduras, Panama, El Salvador, Haiti, Guyana, Nicaragua, Jamaica and Peru lest overall growth remain mediocre during the 1980s.

The agricultural policies of Brazil and Peru during the 1970s can be contrasted in synoptic form. Peru's land resources are far poorer than those of Brazil, but this is not enough to account for the sustained decline in agricultural output per capita during the 1970s. Table 10 suggests that production-oriented policies have contributed to Brazil's impressive agricultural growth. The question arises why Peru and other countries followed policies which led to agricultural stagnation. The rationale for the constellation of policies that retarded agricultural development in Peru and several other countries in the Region was a combination of self-defeating beliefs: that farmers do not respond to price incentives but rather that agricultural production is guided mainly by structural factors such as the pattern of land ownership and that therefore low agricultural prices benefit the population insofar as they raise the urban living standard without discouraging the supply of food—this often goes together with a belief that the most acute poverty problem is found in urban slums rather than in the rural areas; that widespread and substantial industrial protection

Table 10. Agricultural Policies of Brazil and Peru

Policies	Peru	Brazil
PRICES	Generally held much below world level	Price controls eased considerably after 1964
EXTENSION SERVICES	Virtually discontinued during 1970s	Well-established expanding service
AGRARIAN REFORM <sup>a</sup>	Caused great uncertainty, diverted government support services	Virtually none
EXCHANGE RATE and PROTECTION	Heavily biased against agriculture especially during fixed exchange rate period of early 1970s and subsequent lagging rate period	Flexible exchange rate stimulating export crops and strong bias of export promotion policies favoring processing industries

<sup>a</sup>The examples of Japan and South Korea suggest that agrarian reform can contribute to output growth. Until now, however, the experience of Latin America has been that for a host of administrative and political reasons and because of the farmers' very poor educational level, land reforms have not contributed to agricultural growth.

stimulates industrialization; and, finally, that state intervention in property relations can occur without reducing investment. Most of these attitudes are symptoms of an opposition to an outward-oriented, open economy that can be found, world-wide, much more frequently among countries that failed to grow rapidly than among the better performers (Balassa, 1981; Behrman, 1968). Policies with negative effects on growth and often distribution—as is the case of cheap credit—were invariably pursued in the belief that they would generate more growth, more employment, and a better income distribution than the open economy.

*Living with Inflation.* As noted, inflation has plagued South America for generations—and more recently also Central America and some Caribbean countries as well. The growth of food production and exports over the past decade has been rapid in several countries which suffered high inflation rates. This casts doubt on the structuralist proposition that inflation is due largely to the rigidity of agricultural output and of exports. Rather the sources of inflation must be sought in excessively expansive monetary and fiscal policies—including widespread subsidies—usually meant to mask more explicit conflicts between social groups over limited real resources. Whatever the political and sociological roots of inflationary policies the paper by Harberger and Edwards (1980) leaves little doubt (on the strength of observations in 33 developing countries of which 14 are in the Region) that the rate of credit expansion, in particular, credit to the public sector, is strongly associated with the rate of inflation. This is not to say that external events do not cause inflation—the increase in the price of imported petroleum undoubtedly exacerbated inflation in 1974 and 1979 in several of the region's countries (Galbis, 1981). But domestic policies do seem to play the decisive role. For an illuminating discussion of

the politics and sociology of inflation see Hirschman, 1981; while Hirschman considers a multitude of facets of the inflation issue, one sentence sums up succinctly the thrust of the argument outlined here: "the state hands over to inflation the disagreeable job of saying no."

The issue in this section is not how inflation can be best avoided but rather how well different governments have managed to "live with inflation." This description touches only on some of the effects of inflation on the management of the balance of payments. The issue of living with inflation is of course much broader and has spawned a debate on indexation. Indexation is the automatic (and usually legislated) increase of contractual payment obligations such as wages or debt service in line with an index of inflation, normally a general price index. Payments due during one period are increased by the percentage of inflation during a preceding period. The objective is to eliminate or at least lessen the adverse effects of inflation on financial mobilization, resource allocation, and the distribution of income. Latin American countries (particularly Brazil, Chile, Argentina, and Uruguay) have experimented with indexation for long periods. These experiences suggest that indexation, while possibly unavoidable once inflation reaches high levels for long periods, is imperfect and creates problems of its own. Partial indexation may lead to severe distortions; for example the privileged indexing of savings and loans obligations has led in some countries to excessive funds being channelled into construction at the expense of other investments. Full indexation by institutionalizing inflation has been held responsible for perpetuating it (even though inflation has recently come down to U.S. rates in Chile under wide-spread indexation). When inflation varies from period to period, payments to past inflation may prevent markets from being cleared; for example, when wages are indexed to past inflation a declining rate of inflation causes real wages to rise, and the same may occur with interest rates. General indexes of inflation, furthermore, are very rough yardsticks especially when inflation is high and when, as is the case when imports are liberalized, the composition of consumption changes over time. Therefore indexing may miss the mark and create distortions of its own on that account. Also, as inflation increases, so does the degree of dispersion between different prices, thereby undermining the ability of any one index to cancel out the effects of inflation for particular economic agents. Finally, one of the purposes of indexation is to maintain the existence of a private market for long term securities in the face of interest rate uncertainty; the experience in Latin America is that, while public debt instruments can be so maintained, the private sector has remained reluctant to incur fully indexed long term debt obligations at positive real interest rates (Moray, 1962; Friedman, 1974; Ginberg and Swoboda, 1974).

The management of two crucial variables, the exchange rate and the interest rate, is a crucial test of performance. It became clear a long time ago that a fixed exchange rate was eventually unsustainable when domestic inflation exceeded international inflation by a wide margin and/or for a considerable time. Even Mexico, traditionally a low inflation economy, had to devalue in 1954 and again in 1976 because it had outpriced itself; imports had become too cheap and exports too expensive at the old exchange rate leading to losses in international reserves and eventually to higher unemployment. Chile, Brazil, and Colombia pioneered the technique of the crawling exchange rate where frequent "mini devaluation" attempts to maintain internal-external price relations without the sometimes disruptive side

effects of "maxi-devaluation." This technique proved to be successful, but the virtual indexing of foreign exchange was thought by some governments to influence inflationary expectations. Hence they were tempted to use the exchange rate as an anti-inflationary tool by lagging it behind inflation, thereby undermining or defeating altogether the very rationale for a crawling rate. This was often offset by export subsidies but these usually benefited manufacturing firms rather than farmers and agricultural output and exports often suffered as a result as did food output, because lagging the exchange rate makes food imports artificially cheap. Of course, success or failure of exchange rate policies depends on the quality and consistency of overall economic policies including monetary, fiscal and income policies.

Because it is difficult to maintain tight fiscal and monetary policies, there is often a trade-off between maintaining a realistic exchange rate and curbing inflation. The matter is complicated further by the interest rate issue. For a long time the problem of short-term capital flows ("hot money") was associated mainly with the industrialized non-Communist economies. It has become very clear during the past decade, however, that developing countries are far from immune from the problem. Savers have a choice between investing their money domestically or (legally or illegally) sending it abroad. Therefore, unless domestic interest rates for savers (the passive rate) are close enough to foreign rates (say in the London market), it is highly likely that there will be capital outflow. Since developing countries need to be by definition, net capital importers, it implies that external debt is usually stepped up in periods of capital flight to finance not only the normal current account deficit but also to try to make up for capita flight. After some time such a situation can become unsustainable (i.e., force corrective action). The resistance to maintaining realistic interest rates arises out of the closed economy belief that cheap credit is socially desirable; cheap credit usually involves low passive interest rates, particularly in countries where the banking system is inefficient and the cost of intermediation high.

Furthermore, because savings invested abroad may not be taxed much (or escape taxation easily) while savings in domestic banks are often subject to substantial taxation, capital flight can only be discouraged at the cost of a fairly high "real" pre-tax domestic lending rate. This will be opposed by borrowers—industrialists and farmers—and also wrongly by government officials who believe that high interest rates are themselves inflationary in a cost-push sense.

Finally, some countries, notably Argentina (between late 1978 and early 1981), not only have lagged the exchange rate but announced in advance that the exchange rate would remain at a level generally judged below the likely difference between international and domestic inflation. With free capital movements, this policy assured high yields in foreign currency to foreign investors. Such policies indeed managed to attract substantial capital inflows. But while short-term capital can undoubtedly balance the books there is a danger that the exchange rate validated by these financial inflows will convey wrong signals to the importing and exporting sectors. If, in the future, capital flows should ebb for whatever reason the country could find itself saddled with a weakened export infrastructure and possibly a severe loss of output and income.

Foreign exchange crises in Latin America almost invariably occur when both the exchange rate and the interest rate are lagging. Figure 1 illustrates this for eight countries. When both lines swerve to the left, exchange rates are becoming more

overvalued and real interest rates more negative. This constellation of policies has been associated with a later foreign exchange crisis in Argentina (early 1970s), Chile (early 1970s), Costa Rica (1974), Peru (early 1970s), Bolivia (late 1970s), Mexico (mid 1970s) and Venezuela (late 1970s). I am indebted to Dr. Luis Landau of the World Bank for this analysis. The index of real exchange rates was computed as follows:

$$\frac{(\text{Pesos/US\$})_t}{(\text{Pesos/US\$})_0} = \frac{DP_t}{IP_t}$$

where:  $DP_t$  = index of domestic inflation;  
 $IP_t$  = index of "international" inflation.

International inflation is the CIF (Cost, Insurance, Freight) index of US\$ prices of manufactured exports (SITC 5-8) of industrialized countries to developing countries. The index of real interest rates was defined as:

$$100 + R_m - \dot{P}$$

where:  $R_m$  is the money rate of interest on savings or time bank deposits;  
 $\dot{P}$ : current rate of inflation as measured by the Consumer Price Index

Economies can stand a lagging exchange rate for some time, so long as capital inflows roughly offset the widening current account deficit; they can also stand increasingly negative passive interest rates for some time so long as the current account balance of payments remains fairly healthy; but they cannot sustain a deterioration in both prices without running into a foreign exchange crisis. Such a crisis and the ensuing convalescence almost always represent a cost in foregone economic growth. The corollary of this analysis is that in most if not all cases, market-determined interest and exchange rates can indeed minimize foregone output.

Economic management of these crucial variables has improved over the past decade, owing much, unfortunately, to unsatisfactory experiences (notably Chile, Peru, and Argentina during the early 1970s). The most acute problems remain in small economies (Costa Rica, Dominican Republic, and Jamaica, for example) while ten years ago some of the larger countries in the Region were suffering from them. This improvement augurs well for the decade of the 1980s.

*Foreign Debt.* While external borrowing has contributed only some 10 to 15 percent of the Region's fixed capital formation, the size of the Region's major economies is so large that they figure prominently among the world's borrowers. Most of the expansion in the Region's debt has been from commercial banks rather than at concessional terms. Brazil, Mexico, Argentina, Chile, and Colombia alone account for nearly one-half of the developing world's variable interest debt outstanding.

Over the last ten years many of the Region's countries have had debt problems (severe arrears and/or unplanned reschedulings). This section looks at the extent to which the debt problem can be traced to inadequate economic management.

Two aspects of external debt have a decisive bearing on whether or not there is a debt problem. One is the relationship between domestic investment and net external borrowing (the proportion of investment that is financed out of borrowing rather than domestic savings), hence the adequacy of the domestic savings effort. The other is the use to which borrowed funds are put. Whether the returns on invest-

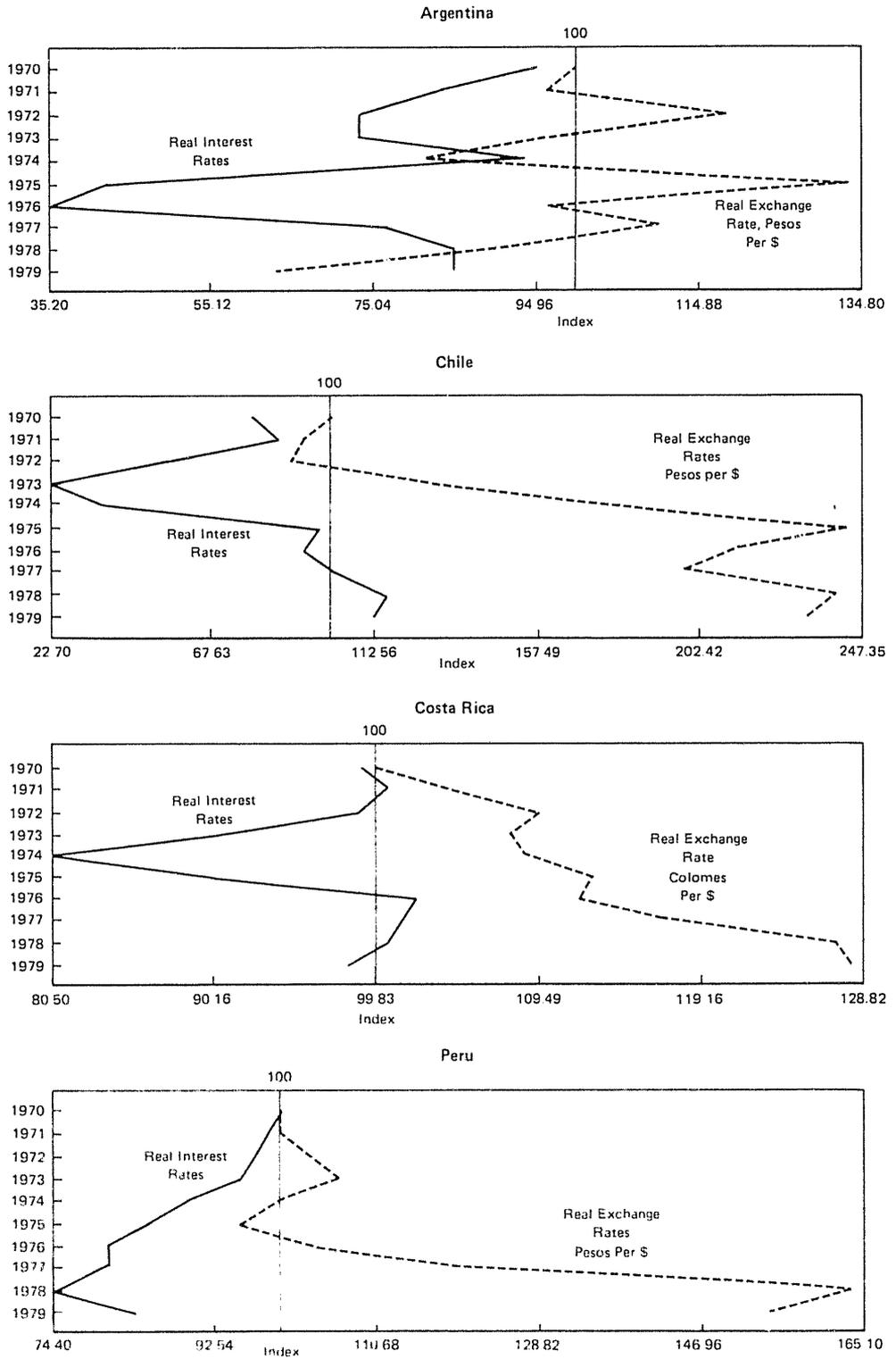
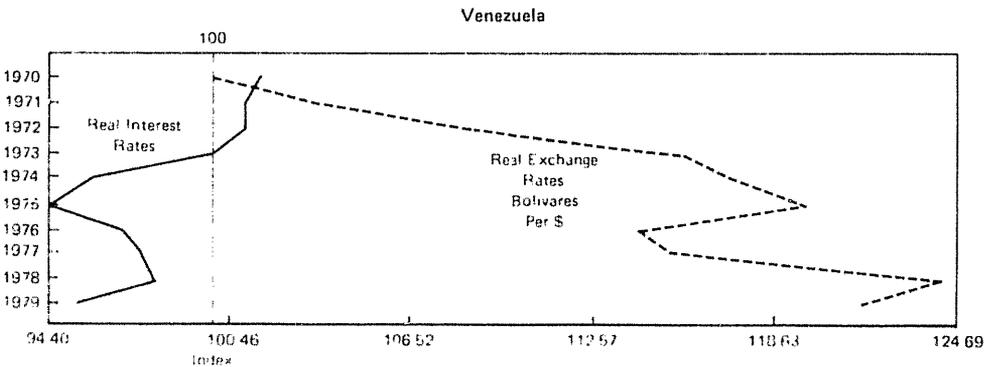
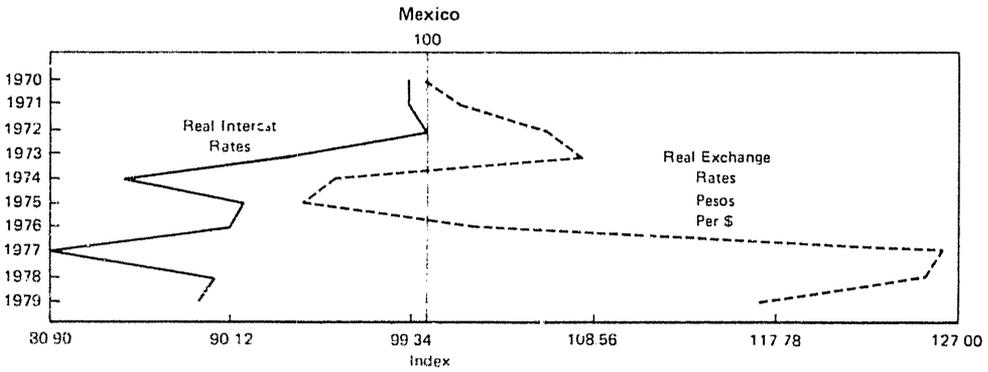
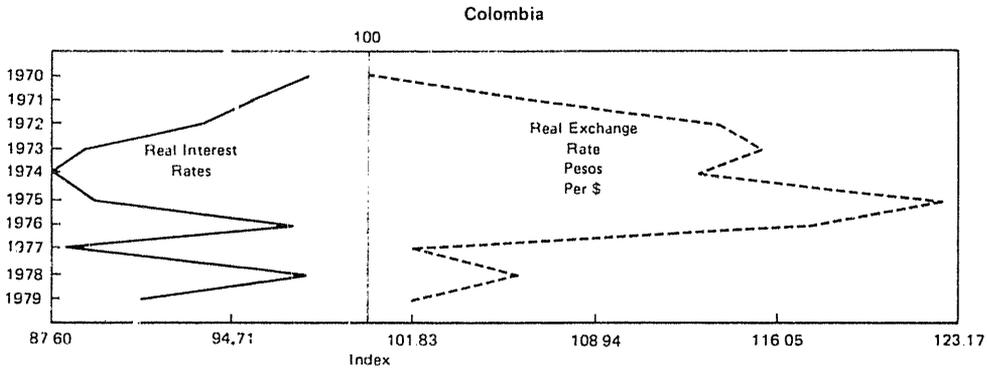
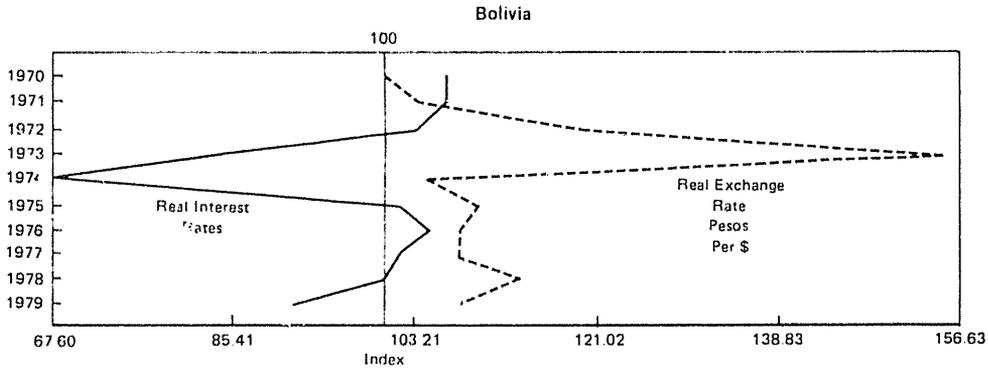


Figure 1. Trends in Real Interest Rates and Exchange Rates in Eight Latin American Countries



NOTE: Zero Real Interest Rates = 100 and Real Exchange Rate for 1970 Based = 100

ment—measured at world prices—exceed the interest costs of borrowed funds ultimately determines whether a country is gaining or losing by borrowing. This issue is of course particularly relevant at the present time when interest rates are high.

The following countries have experienced debt servicing problems during the last decade: Costa Rica, Argentina, Bolivia, Chile, Guyana, Jamaica, Nicaragua, Peru, and Uruguay. Brazil experienced debt servicing difficulties in the mid 1960s. There was some concern in 1980 with the size of the country's debt, but in the absence of arrears or unplanned rescheduling that country is not considered to have had debt problems during the 1970s for comparative purposes in Table 11. Weak domestic savings efforts are often associated with debt difficulties, in cases where investment itself continues at high levels.

The graphs in Figure 2 show savings (gross domestic savings) as a percent of GDP over the last decade (values are calculated at current prices). Even though Brazil has had no servicing problems the decline in its savings performance paralleled an increase in borrowing costs, suggesting growing concern on the part of creditors. The graphs for Bolivia, Chile (1973-75), Guyana, Jamaica, Nicaragua, and Peru (mid 1970s) all suggest association between faltering domestic savings performance and debt servicing difficulties. Conversely, the graphs for Colombia, Ecuador, El Salvador, Guatemala (until recently), Mexico and Paraguay suggest improved savings performance over time; these countries did not run into debt servicing difficulties.

The savings performance as shown in the graphs in Figure 2 reflects mainly the following factors: (a) changes in international terms of trade (i.e., windfall gains, as in the case of the Dominican Republic in 1975 when the country commanded high sugar prices or losses, as in the case of most oil-importing countries after 1973), (b) changes in a country's own savings effort; and (c) accidental events such as a bad agricultural crop or political disruption which can also depress the savings ratio but are unlikely to persist long enough to account for trends in the ratio over several years. The second of these factors is of decisive importance. Changes in the international terms of trade have caused peaks and troughs; they do not explain trends sustained over a number of years. Therefore, barring political disruptions the savings performance of a country is largely within the bounds of economic policy. Public savings depend directly on the management of current government revenues and expenditures, decisions about the efficiency of public enterprises, taxes, power and other public service rates. Private savings depend on pricing in the economy at large and also generally respond to financial incentives managed by the government. To a large extent, therefore, the presence of debt servicing problems is a reflection of poor economic management. Historically the variation of real interest rates over time has been too narrow to provide evidence in support of a correlation between interest rates on savings deposits and the volume of such savings. The recent experience with substantially increased positive real rates in Argentina and Chile should provide the possibility to carry out empirical explorations of this question soon. While national savings may be independent of interest rate policies, the share of such savings that is channeled into the financial system (as opposed to real estate for example) does vary with interest rates. The higher the share of savings channeled into the financial system, the more efficient overall resource allocation should

Table 11. ICOR and Debt Difficulties<sup>a</sup>

	ICOR <sup>b</sup>	Debt Problems
Jamaica	-	-
Guyana	-	-
Argentina	-	-
Nicaragua	-	-
Chile	-	-
Honduras	-	+
Peru	-	-
Uruguay	-	-
Venezuela	-	+
Mexico	+	+
Costa Rica	+	-
Colombia	+	+
Brazil	+	+
El Salvador	+	+
Bolivia	+	-
Dominican Republic	+	+
Guatemala	+	+
Haiti	+	+
Ecuador	+	+
Paraguay	+	+

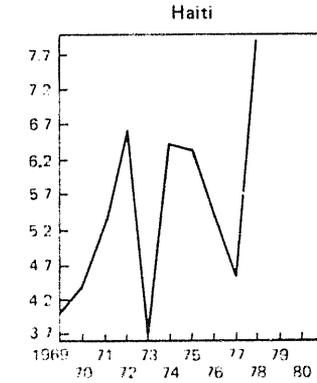
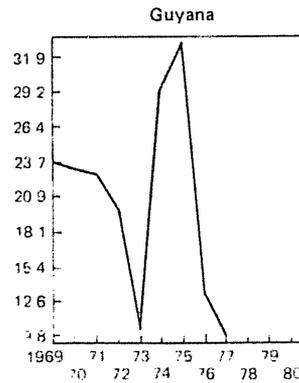
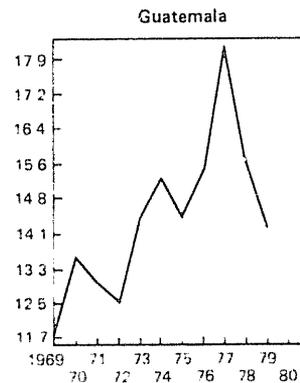
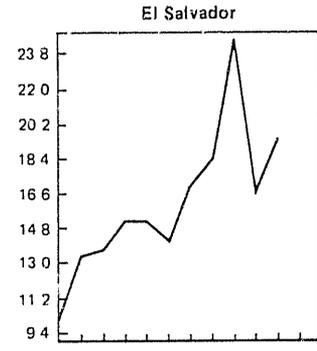
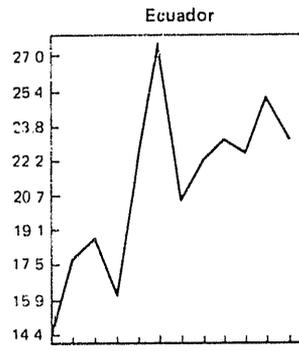
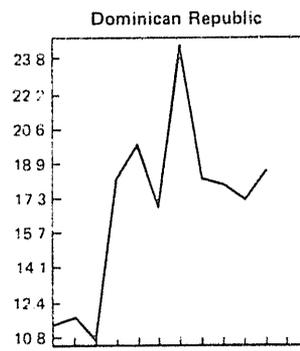
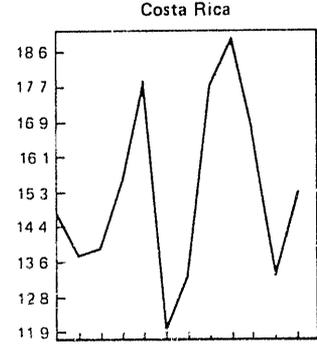
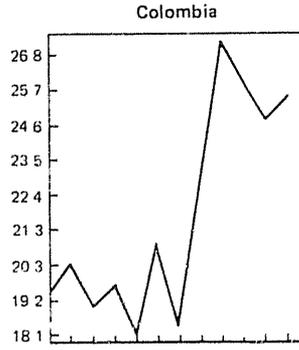
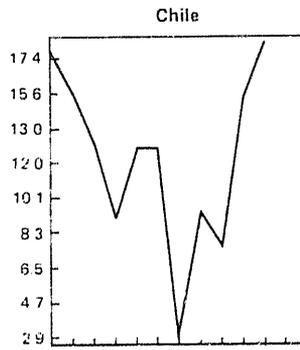
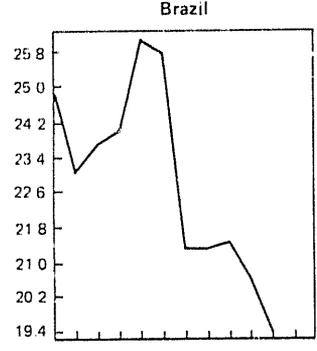
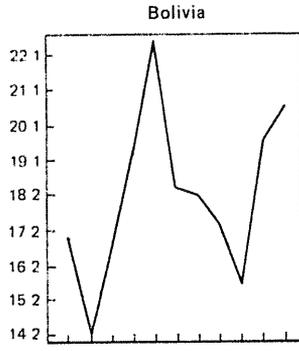
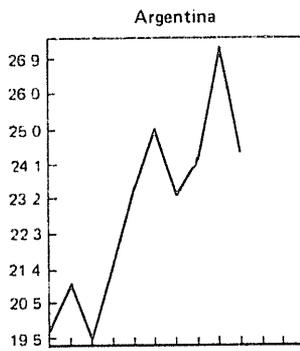
<sup>a</sup>Negative signs denote ICORs above the average for the Region; the ICORs reflect the relationship between 1965 and 1975 investment and 1970 and 1979 output growth. The absence of debt service problems is denoted by positive signs. Panama is not included in the table. Since its currency is fully convertible, external debt and internal debt cannot be meaningfully separated out.

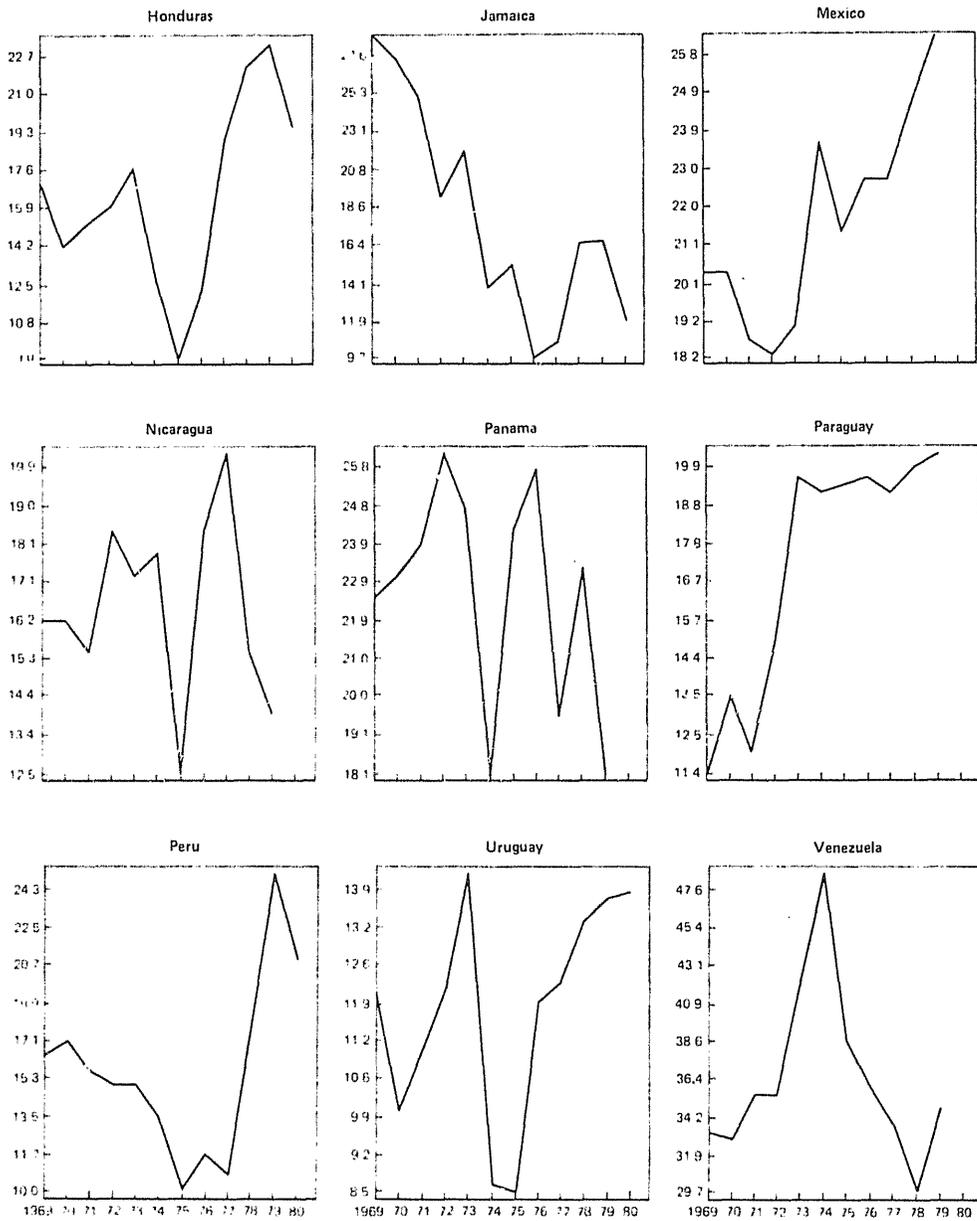
<sup>b</sup>ICORs generally bear a strong inverse (but non-linear) relation to the GDP growth rate. To the extent that this relation obtains rapid growth itself, if sustained over many years, can be viewed as enhancing creditworthiness.

be. Thus, interest rates policy does have a bearing on the efficiency of resource allocation even if one cannot relate it to the level of aggregate savings.

Turning to the efficiency of capital, we find that it is a very difficult thing to measure. One very imperfect and partial way to measure the efficiency of an economy—hence of investment—is by the incremental capital/output ratio (ICOR). The ICOR measures the amount of investment associated with a particular increase in output. The higher the ICOR, *ceteris paribus*, the less efficient is resource use in terms of growth. There are many methodological problems with using the ICOR in this manner. For example, the measure attributes to investment changes in output that may be caused by labor, technology or other factors contributing to output. It may be worth finding out, however, whether or not there is a relationship between unfavorable ICORs (which are usually the result of poor economic policy, especially a poor use of public funds or an excessive proportion of social investment) and debt servicing problems. Table 11 suggests that such a relationship may indeed exist. Countries are ranked in order of decreasing ICOR.

Nine out of the twenty countries have experienced (or are experiencing) debt servicing problems. Out of these, seven have unfavorable ICORs. Out of the eleven





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Figure 2. Gross Domestic Savings as a Percent of GDP

countries with favorable ICORs only two (Bolivia and Costa Rica) have experienced (or are experiencing) debt servicing problems. Bolivia's ICOR may be misleading because the growth period under consideration includes a once-and-for-all growth spurt due to petroleum exports during the mid 1970s; Bolivia no longer is a significant oil exporter, and its growth has resumed a more normal lower rate. It is therefore likely that Bolivia's normal ICOR is higher than suggested by the table. The debt problems of Costa Rica were brought about by poor financial management rather than by structural weakness; the overwhelming problem is one of excessive public expenditure.

Out of nine countries with unfavorable ICORs, seven are debt problem countries. Of the others, one is a petroleum exporter (Venezuela). The other (Honduras) combines an unfavorable ICOR and no debt problems mainly because most of the country's debt during the 1970s was at concessionary terms.

The ICOR thus emerges as a reasonably robust indicator of long-term creditworthiness. The foregoing suggests that the quality of overall economic policies— notably the savings effort and the quality of investment—is a basic determinant of creditworthiness.

This section suggests, then, that agricultural policies, the management of exchange and interest rates, savings incentives, and the choice of investment are all crucial in attaining sustained improvements in the standard of living.

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