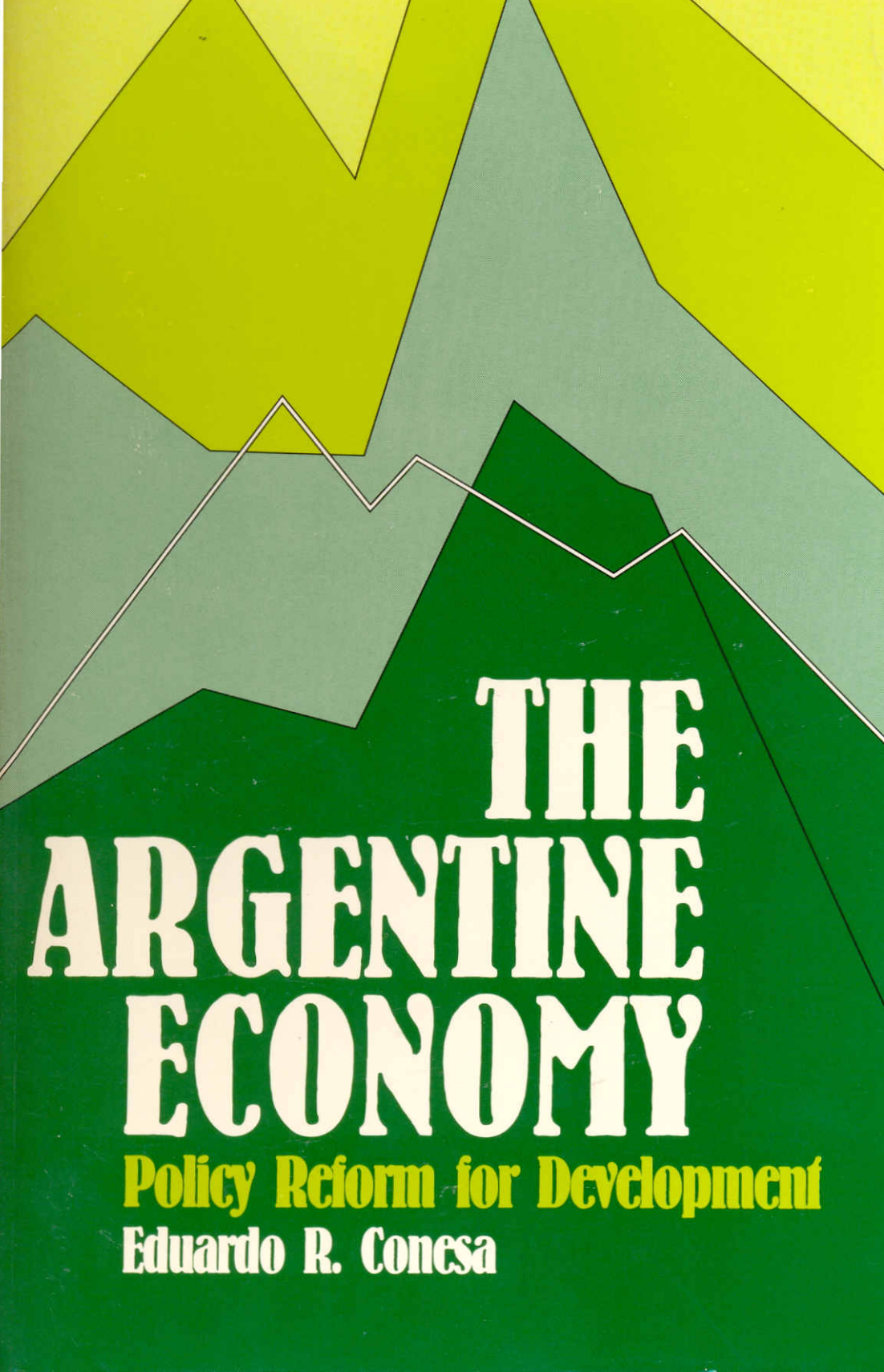
THE
ARGENTINE
ECONOMY
Policy Reform for Development
Eduardo R. Conesa

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About the Author

Eduardo Conesa was born in 1937 in Buenos Aires, Argentina. After studies at the University of Buenos Aires, where he graduated in Law and Economics, he joined the Argentine public administration in 1962. In 1968, he obtained fellowships from the Instituto Di Tella of Buenos Aires and the Fullbright Commission to study in the United States. He obtained a Ph.D. in economics from the University of Pennsylvania, and a Master's degree in development economics from Williams College, Williamstown, Massachusetts. In 1972 he was appointed Staff Economist of the World Bank, and in 1976-78 he served as Executive Director of the same institution. In 1979 he became Director of the Institute for Latin American Integration (INTAL), an autonomous department of the Inter-American Development Bank with headquarters in Buenos Aires. After serving six years in that position, he became Senior Economic Advisor at the Inter-American Development Bank. In 1984-85 he spent a sabbatical year at the Harvard University Center for International Affairs. He is currently a full professor of political economy at the University of Buenos Aires. He has written several books, including *Términos de Intercambio y Tarifa Optima en la Argentina*, (Buenos Aires: INTAL, 1983); *Fuga de Capitales de America Latina*, (Buenos Aires: IPES, 1986); and *La Deuda Externa Argentina, Puede Pagarse?*, (Buenos Aires: University of Belgrano, 1988).

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Last but not least, I wish to state that the opinions presented here are mine alone, and in no way reflect those of the individuals that I have just mentioned, or of the institutions

to which I currently belong or with which I have been associated in the past.

Eduardo R. Conesa
Harvard University
Cambridge, Massachusetts
March 1989

Introduction

Until the 1930s, Argentina ranked high in economic development. Since then, it has experienced economic stagnation and political instability. Nor has there been consensus on how best to tackle these problems.

This book suggests ways to resolve the dilemma posed by the two contradictory approaches to economic policymaking pursued in Argentina over the past few decades: the import substitution policy supported by the major political parties, and the agricultural devaluation policy, backed by Argentina's conservative sectors. Neither of these approaches is correct. The import substitution approach fails because it destroys the price system and favors inefficiency, while the use of agricultural exports as a lever for development fails due both to an inelastic demand for such products in the international markets and to political resistance at home. The result has been 40 years of stagnation.

Any proposed solution to Argentina's economic problems must take into account the constraints imposed by the popular majority. There is no escaping this. No government elected by popular vote can successfully implement policies that jeopardize the interests of blue collar workers and the middle classes. Nor is it possible in the long run for a military government to do so, because in the final analysis, the military is also responsible to

the people. Indeed, the social composition of Argentina's armed forces accurately reflects the composition of the country's population. Thus, any approach that ignores the majority interest will end up in inflation, stagnation, and frustration. Such efforts have failed in the past and are condemned to do so again in the future.

In this book, I have presented a proposal for economic adjustment that supports and improves upon an income distribution structure favoring the blue collar and middle classes and raising the standard of living of all Argentines, rich and poor, urban and rural. My proposal takes into account Argentina's domestic limitations and external debt obligations, as well as existing restrictions in international markets. The proposal presented here thus reconciles Argentina's traditional economic dilemma: social justice vs. economic freedom; the popular will vs. liberalism; democracy vs. efficiency—all while counseling strict adherence to the letter and spirit of the economic principles established in Argentina's Constitution of 1853. The implementation of this economic program demands authorities with vision and courage, capable of dismantling the system of economic privileges and sinecures that is currently destroying the native imagination and the work incentives for ablebodied Argentine citizens. It also demands a superior civil service in essential areas related to macroeconomic policy.

The system I have proposed here embodies a number of ideas similar to those implemented by the government of Argentina on June 14, 1985, although my own ideas were born and matured much earlier. In fact, on June 27, 1984, I published a long article in the Buenos Aires daily *Ambito Financiero*, outlining ten key economic measures aimed at restoring Argentina to economic health. These measures included balancing the budget, a ban on executive branch borrowing from the Central Bank to finance public expenditures, and a temporary wage and price freeze, and coincide with the actions taken by the government a year later.

My remaining seven proposals were ignored. I am convinced that sooner or later many of them will have to be implemented if Argentina is to grow. I believe with Keynes that in the end ideas prevail over vested interests. But ideas

must be published. Argentina's political leaders frequently entertain obsolete notions about government and economic problems. To their chagrin, their ideas turn out to be of little value; and as the country's problems become exacerbated they try new approaches for their own survival. Thus, it seems likely that my economic policy proposals will ultimately prevail.

My approach to economic policy is unoriginal beyond Argentina's borders; it reflects the current consensus among development economists. The key message is "getting the prices right"—that is, inducing the precise scarcity prices for the country's main products that will trigger the powerful market forces to spur development, allowing the government to perform fewer functions with far greater efficiency. For long-term development, it is essential that certain macroeconomic prices, such as the exchange rate and the interest rate, reflect an equilibrium value consistent with that development. Moreover, import tariffs must be low and uniform to permit the international price system to operate within Argentina, thus eliminating distortions and privileges of all types. I have proposed a relatively new system for privatizing public enterprises, which should lead to their efficient administration. Public finances must be in balance, or even in surplus. My proposed strategy is not old-fashioned laissez-faire, for I believe that government has a legitimate role to play in preventing the fundamental distortion of the exchange rate. Central to my proposal in this connection are "optimal" export taxes, leading to a more undervalued equilibrium exchange rate that will foster manufacturing exports.

On this basis, Chapter I presents the puzzle of Argentina's stagnation in the last 50 years. Chapter II emphasizes the difficulties of growth based on agricultural exports only. Chapter III proposes growth on the basis of manufactured exports, requiring an important real depreciation of the Argentine currency. Chapters IV and V outline the fiscal and monetary policies respectively that are required in order to maintain the exchange rate policy proposed in Chapter III. Chapter VI relates the topics discussed to other issues of a long-term strategy for growth.

Before concluding this introduction, I would like to draw the reader's attention to a fundamental contradiction in Argentina's development. The economic health of Argentina demands political stability and continuity of the "rules of the game"; but the present rules of the game do not favor development. They lack coherence and have a strong tendency to lead the country down the road to chaos, or at least stagnation. Fortunately, the institutional system the Argentine economy requires has already been established in the 1853 Constitution, which is theoretically in force today. Its economic philosophy is well described in a book published in the 1850s by Juan Bautista Alberdi, titled *El Sistema Económico y Rentístico de la Confederación Argentina según su Constitución de 1853* (The Economic and Taxation System of the Argentine Confederation According to Its Constitution of 1853). Argentina's economic development lies in the restoration of the economic system established in the Constitution, which has been consistently violated by every government without exception over the course of the last 50 years. True, the present international environment calls for a somewhat different economic policy than the one in force from 1880 to 1930, but any necessary changes can be absorbed quite easily by our 1853 charter. As a result, my proposals are distinctly reminiscent of the institutional normative economics of the Alberdi tradition. There is one additional point, little emphasized by Alberdi though mandated in Argentina's 1853 Constitution: a civil service of high quality, appointed and promoted on the basis of merit alone.

1
Post-1930 Economic Stagnation

Argentina's Growth Potential

Few countries have a potential for economic development as promising as that of Argentina, a country endowed with such significant natural resources as the Pampas (one of the most fertile areas in the world) as well as with oil, natural gas, and minerals. Argentina's vast territory, comprising close to 3,000,000 square kilometers, ranks seventh in size among the nations of the world; in contrast, its population of 30 million is surpassed by 28 countries. And Argentina is rich not only in natural resources. Its population is a mixture of European stock that took up America's challenge and despite the risks sought new horizons—a people characterized by its initiative, high educational level, and strong profit motive. As Gottfried Haberler notes:

> There are, finally, some potentially very rich countries with excellent human and material resources, which have no business being less developed. Argentina is the outstanding example.[1]

As a result of Argentina's impressive resources and the large market for cereals and beef created by England through its free food import policy (beginning in the 1840s with the abrogation of the "corn laws"), Argentina experienced a spectacular economic development from 1860 to 1930. By the 1940s, the backward and underpopulated country of 1860 had achieved a respectable level of development among the nations of the world. In this connection, Diaz Alejandro wrote:

> Most economists writing during the first three decades of this century would have placed Argentina among the most advanced countries, with Western Europe, the United States, Canada, and Australia.[2]

Although the actual figures may be questionable, there is abundant statistical evidence that ranks the Argentina of the 1920s at least 16th in the world by income per capita—well above Japan, Spain, Greece, South Africa, Mexico, Brazil, and Colombia.[3] Since 1945, however, Argentina has been losing ground. In 1984, the World Development Report ranked Argentina 34th without taking into account certain Socialist countries like the Soviet Union, Czechoslovakia, and East Germany—countries that, if figures were available, would probably show a higher income per capita than Argentina's meager U.S. $2,520.[4]

Economic Stagnation and Political Instability

Given this decline, a feeling of general frustration pervades Argentine society today. The old pride of the 1920s, '30s, and '40s seems to have completely evaporated. Pessimism is rife. Many superficial explanations for the country's decline are heard. Racial explanations are common: we are Latin and not Nordic or German—in defiance of the fact that Latin countries such as Spain and Italy once boasted civilizations far superior to those of the Nordic countries and today are again catching up. And Argentina herself was spectacularly successful from 1860 to 1930. In any case, with the widespread stagnation throughout the country, recriminations abound. Civilians blame

the military and vice versa, and accusations fly among social groups and political parties. For instance, the Peronist Party has accused the Radical Party of conspiring with the military to organize coups d'etat during the 1950s (and did the same thing itself during the '60s when the Radical Party was in power). Many prominent members of the Radical Party supported military coups against the constitutional presidency of Arturo Frondizi from 1958 to 1962,[5] and, in turn, there is no question that both the Peronist and the Developmentalist Parties welcomed the 1966 coup against the Radical Party.

Today, the witchhunt for scapegoats is obvious to anyone who reads Argentina's newspapers. However, there are rarely reports of any serious proposal to attack the country's problems at their roots. It is doubtful that normal republican institutions could have coped with the double calamity of terrorism and hyperinflation that prevailed in March 1976 when the Perón regime fell. In any case, the search for scapegoats is pointless. It will only aggravate the nation's wounds, and Argentina will simply continue its backward march at an even faster pace. The real source of the country's stagnation over the past 50 years is the ill-considered economic system that has prevailed since the 1930s. This system generates only frustration, pitting social groups against one another in the hope of capturing a larger share of a shrinking GNP, instead of fostering an increment in the social product to the benefit of all.[6]

The 1930s Crisis in the Economic System

Argentina's development from 1860 to 1930 came about as a result of the remarkable growth of its traditional exports, owing to the country's plentiful arable land and other resources. From 1881 to 1912, exports of grain, beef, and wool to world markets grew tenfold, from £11.6 million to £96.1 million.[7]

The worldwide economic depression of the late 1920s halted that growth and began a downward spiral in international trade, both in volume and in price. In self-defense, each country resorted to restrictive trade measures. The use of import tariffs and quotas, export subsidies, import permits, and similar measures spread worldwide, reinforcing the downward

spiral, to the detriment of the community of nations as a whole. In retrospect, the myopic view of the statesmen that guided the world economy at that time is clearly evident.

Argentina' export trade was deeply affected. The most Argentine of all products, beef, registered a sharp drop in exports (see Table 1).

TABLE 1

EXPORTS OF FROZEN AND CHILLED BEEF

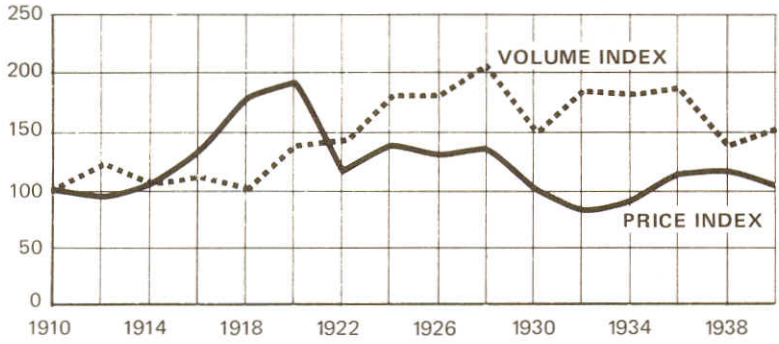
Year	Thousands of tons
1926	724
1927	788
1928	589
1929	575
1930	592
1931	524
1932	484

Source: Guido Di Tella, *Los Ciclos Económicos Argentinos*, Paidos, Buenos Aires, 1972, p. 222.

In cereals and wool the drop was manifested chiefly in prices, which were one-half those of the 1920s, although volumes remained at previous levels. Graph 1 provides an overview of export prices and volumes from 1912 to 1940.

Graph 1

Argentine Export Volumes and Prices, 1910-1940



Source: Adapted from Vicente Vázquez Presedo, *Crisis y Retraso,* Eudeba, Buenos Aires, 1978, p. 225.

Thus between 1930 and 1950, growing worldwide protectionism put a halt to economic growth through trade. Argentina had no alternative but to expand its internal market through import substitution. Its methods were questionable, but the approach was the only one available at the time.

Agricultural Protectionism and Free Trade in Manufactures

In the 1950s, and especially in the 1960s, there was a considerable liberalization in world manufacturing trade. However, with respect to agricultural products, the protectionist approach continued and even intensified, with disastrous results for Argentina. Agricultural products have continued to be subject to restrictions in the importing countries, which import grain or beef only when faced with a poor harvest or a temporary domestic shortage. The European Common Market established variable import duties—that is, duties that fall as the international price of a given product goes up and rise when it goes down, making it impossible to penetrate the Common Market through fair competition. Thus, domestic prices of agricultural products in Europe today are around 100 percent above the international prices. In turn, high domestic European

Argentina's Dilemma

Argentina, in contrast, failed to readapt her economic system for the export of manufactures. It therefore was unable to profit from the changed environment of the 1960s and 1970s. On the one hand, the country's production costs and comparative advantage made it advisable to export agricultural products; on the other, the international market for these goods was plagued with restrictive regulations. The export of manufactures was difficult, owing to the overvalued exchange rate in effect since the postwar period. As a result, manufacturing exports require subsidies, which are forbidden under the GATT. Moreover, the public sector, overwhelmed by unnecessary burdens and huge expenditures, is unable to allocate a substantial portion of the national budget to subsidies for manufacturing exports, as did Brazil beginning in 1967.

The upshot of Argentina's failure to follow the new rules of the game for international trade was a vicious cycle in which economic stagnation gave rise to political instability, which in turn generated economic stagnation and inflation. The major political parties were supported by industrialists, while conservative forces were backed by the traditional agricultural exporting interests. The industrialists were always willing to contribute handsomely to political campaigns in return for privileges, exemptions, and special ad hoc legislation on tariffs, taxes, and foreign exchange permits. The problem with this unholy alliance is that, by its very nature, it represents an attack on the development process itself, for the potential for import substitution has been exhausted in Argentina.

Since 1962 Argentina has been ripe for the export of manufactures. But because of its overvalued currency, prices are not competitive. At the 1985 exchange rate, production costs for Argentine manufactures average 50 percent above international levels. Heavy subsidies, on the order of 50 percent, or, alternatively, a similar real devaluation would therefore be necessary. There are difficulties associated with major export subsidies, however. One is the high fiscal cost, which is particularly burdensome for a bloated government because it entails an increase in public expenditures. Another is

that such subsidies can give rise to poor resource allocation and thus impede growth. Take, for example, the case of an export of steel sheeting with a 20 percent subsidy. If this sheeting had as inputs steel slabs costing 90 percent of the value of the exported product, the effective protection on the little value added that was exported would be 200 percent. The fiscal costs would be enormous and the net foreign exchange earnings very small. On resource allocation grounds, subsidy of manufacturing exports is as objectionable as a protectionist import substitution policy intensive in imported inputs purchased thanks to foreign exchange permits and with overvalued currency. In both cases a negative impact on development is produced by the distortions in resource allocation and by artificial profits that favor inefficient exporters on the one hand and "smart" import substitution industrialists on the other. Finally, export subsidies for manufactures are banned under the GATT. Any country that employs them is subject to retaliation and countervailing duties in the importing countries.[8]

There are also major objections to the alternative, a real devaluation of 50 percent or more. It would have regressive income distribution effects, induced by the immediate rise in the prices of wage goods such as bread, meat, and certain food staples of Argentina's lower classes. Second, by reducing the real purchasing power of the lower and middle classes, a devaluation of this type would also reduce the demand for industrial goods, thus provoking a recession. Finally, devaluation worsens the country's terms of trade.

Thus difficulties block the two obvious avenues toward the solution of Argentina's dilemma: export subsidies for manufactures, or a real devaluation. The country appears to be trapped. Lacking acceptable alternatives to spur development, it oscillates between import substitution with subsidies when the populist political parties are in power and agricultural exports when conservative forces prevail. Neither alternative has been able to rescue the country from economic stagnation.

Argentina's situation could be turned around through the policy of compensated real devaluation proposed later in this book. Unfortunately, however, this avenue has been blocked, in

large part because Argentina lacks a competent bureaucracy to advise its leaders on economic matters.

Quality of Public Administration

In predicting the growth potential for a given country, experts in development economics take two main factors into account: the country's human and natural resources. Argentina is well endowed in both respects. But in the allocation of its human resources for development, it is at the opposite pole from the most advanced nations, and the results are evident. This fact is so well known in the country that a new word was created: "kakistocracy", government by the worst.[9]

The strength of a people or a nation critically depends on efficiency in allocating its human resources. If this process ensures a long sequence of high-quality people in government, a country's future is assured—and the converse. The decline of Spain, for instance, was magnificently explored by Jose Ortega y Gasset.[10] After Ferdinand and Isabella, or perhaps Charles V or Phillip II, the long sunset of Spain was inexorably tied to the mediocrity of its rulers.

The Japanese have a system for ensuring competence in public office that is the exact opposite of the one existing in Argentina. Describing it briefly will therefore be useful for an understanding of Argentina's decadence. In Japan, bureaucrats are selected after a lengthy process that begins in primary school. Gifted students are sent to the best secondary schools, from which the most talented are admitted to the University of Tokyo. Admission to this university requires uncommon ability and determination on the part of students. The most able then go on to the Faculty of Law, where they study not only law, but public administration, economic policy, and political science. The graduates of this institution who have the highest grades join the most prestigious ministries and state agencies: the Ministries of Finance, International Trade and Industry, and Foreign Affairs, as well as the Economic Planning Agency. Grades alone are not enough, however. Candidates must pass long written examinations and demonstrate outstanding personal qualifications at in-depth interviews. Thus, about 20 officials

of the highest caliber join each ministry every year. Of these, 15 are usually from Tokyo University's Faculty of Law and a few other prestigious academic institutions. According to Ezra Vogel:

> This selection procedure ensures that elite bureaucrats are not only extremely able but also protected by an aura of respect, rivaled perhaps only by the elite bureaucrats of France.[11]

The Prime Minister may appoint a politician or a member of Parliament as a deputy minister, but the real manager of each ministry is the administrative deputy minister, a career officer appointed by his predecessor. Key decisions are made by the bureaucracy instead of politicians or the cabinet. A high proportion of the members of the Japanese Parliament, in turn, are former bureaucrats with a solid background and leadership abilities. The majority of post-war Japan's prime ministers have been former members of the country's prestigious bureaucracy.[12] In sharp contrast, Argentina's system for appointing public officials is based on political clientelism, nepotism, and alliances with those in office.

Competence in Public Office: The Achilles Heel of Interventionism

Given Argentina's potent human and natural resources, how do we explain its relative decline since 1940? This could have happened only through a combination of inept administration and a very peculiar allocation of its human and material resources. Gottfried Haberler cites the poor design of the country's economic system, particularly that of state enterprises, which he considers a major source of Argentina's problems.[13] (Interestingly enough, he does not distinguish between democratically elected and military governments; he sees the reasons for the country's poor performance in the economic system itself, not in the type of political system and officials it places in power.) From 1860 to 1930, material resources were allocated on the basis of competition and equality; but that system was supplanted by a regime of privileges, executive

decrees, import permits, and diverse sinecures whereby the entrepreneurs that profit most from the system are the most incompetent. Fast allies, they in turn promote those least competent in politics and government. The whole suffocating apparatus of state interventionism, selective policies, export promotion decrees, foreign exchange permits, import permits, and so forth merely stifles development. As a result, the despoiled country is slowly sinking.

Adequate laws and an able public administration establish the rules of the game for the individual players. If the competitive system in force before 1930 were restored, the correct allocation of the country's abundant material resources would again come about. A competitive system of examinations for entering public office would be a necessary complement for ensuring Argentina's recovery and long-lasting stability. The more interventionist the government's policy, the greater would be the need for a rigorous and competitive system for entering public administration, and promotion strictly on the basis of merit. Without a first-rate public administration, interventionism invites disaster.

NOTES

1. Gottfried Haberler, "International Issues Raised by Criticism of the U.S. Budget Deficits," in *Essays in Contemporary Economic Problems, the Economy in Deficit*, Phillip Cagan, editor, American Enterprise Institute, Washington, DC, 1985, p. 139.

2. Carlos Diaz Alejandro, *Essays in the Economic History of the Argentine Republic*, Yale University Press, New Haven, CT, 1970, p. 1.

3. See Domingo Cavallo, *Volver a Crecer*, Sudamericana Planeta, Buenos Aires, 1984, p. 18.

4. On the ranking of 34 and the $2,520 figure see World Bank, *World Development Report 1984*, Washington, DC, p. 219.

5. Robert Potash, *The Army and Politics in Argentina 1945-62: Perón to Frondizi*, Stanford University Press, Stanford, CA, 1980; for instance, pp. 126, 311, 378.

6. The relationship between economic growth and political stability is very complex. See Samuel P. Huntington, *Political Order in Changing Societies*, Yale University Press, New Haven, CT, 1968, p. 49.

7. Vicente Vázquez Presedo, *El Caso Argentino, Migración de Factores, Comercio Exterior y Desarrollo 1875-1914*, Eudeba, Buenos Aires, 1971, p. 147.

8. Arts. 9 and 14 of the GATT Code on Subsidies.

9. Jorge L. García Venturini, *Politeia*, Editorial Troquel, Buenos Aires, 1978, p. 319. In Greek, "kakistos" means the worst.

10. José Ortega y Gasset, *España Invertebrada*, Obras Completas, vol. III, Revista de Occidente, Madrid, 1955, p. 35.

11. Ezra Vogel, *Japan as Number 1*, Harvard University Press, Cambridge, MA, 1979, p. 55.

12. Ezra Vogel, op. cit., p. 63.

13. Gottfried Haberler, op. cit.

2
The Constraints Imposed by International Agricultural Protectionism

The Exchange Rate Policy of 1900

Few countries have experimented as much with the under- and overvaluation of the exchange rate as Argentina. The effects of these experiments on the country's development have on the whole been detrimental. However, there has been one success story in the country's economic history, resulting from an exchange rate undervaluation during the 1890-1914 period. During the external debt crisis of 1890-1898, Argentina experimented with a floating exchange rate that, in line with the orthodox fiscal policy in effect from 1890 to 1900, resulted in an undervaluation of the peso vis-à-vis the legal nominal parity, which at times reached 400 percent. This undervaluation of the peso was necessary for export promotion and to enable Argentina to meet debt service obligations that amounted to 50 percent of exports, as is the case in 1985. If the price quotations for the peso and gold before the 1890 crisis are taken into account, the real depreciation was on the order of 100 percent toward 1896.

As exports grew and the country was able to reassume its debt service, inflows of foreign capital resumed, and as a result, the peso once again tended to appreciate. This in turn produced a drop in farm income that favored the urban working class. At that time, the most influential sector in government was that of the exporting landowners, whose protests against the growing overvaluation of the peso led to passage of a law by which 100 paper pesos could be exchanged for 44 gold pesos, or, conversely, 100 gold pesos for 227.27 paper pesos. Thanks to this law, the revaluation of the peso was checked, and the flow of traditional exports continued to serve as the engine of growth until World War I. In this connection it is worthwhile to quote A.G. Ford:

> The considerable growth registered by the Argentine economy during those 15 years, 1900-1914, must be attributed primarily to the increased value of exports. The latter expanded at an annual rate of 7.5 percent, the growth of grains being greater in global terms than that of cattle products.[1]

There are major differences between Argentina's situation then and its present circumstances. From 1890 to 1914, political and social power was in the hands of the agricultural producers. Agriculture was the main sector of the economy. Today the agricultural population accounts for 13 percent of Argentina's labor force and landowners no longer command as much political and social power. The urban middle and working classes, who comprise the majority of food consumers, have grown considerably, and they have a vested interest in keeping food prices low in order to maintain their standard of living. While other sectors of society, such as the armed forces, have ties to the traditional export sector, they come from different social strata within Argentina's middle class. To apply the 1900s policies in 1985 would mean jeopardizing the majority interest and in the short run would amount to political suicide. Only through a dictatorship would it be possible to implement an exchange rate policy similar to that of 1900. Sacrificing the majority interest might be justified if there were obvious long-term benefits. In fact, even today distinguished Argentine

economists favor a strong expansion of agricultural exports[2] as the engine for development, contrary to the wisdom of the current mainstream in development economics that favors industrial exports. However, the numerous Argentine economists who, as in 1900, propose a resumption of economic growth based on agricultural exports appear not to have adequately pondered the political costs of lowering the urban standard of living and the enormous economic and social costs involved in reallocating resources, both human and capital, from industry to agriculture.

As yet no one has made an in-depth long-term forward-looking analysis of Argentina's international agricultural markets. This author has estimated the demand functions for the country's principal traditional agricultural exports in order to analyze the relationship between export volumes and export prices and then suggest a policy of optimal taxation.[3] The results are presented in Table 2.

TABLE 2

DEMAND PRICE ELASTICITY
FOR ARGENTINA'S EXPORTS

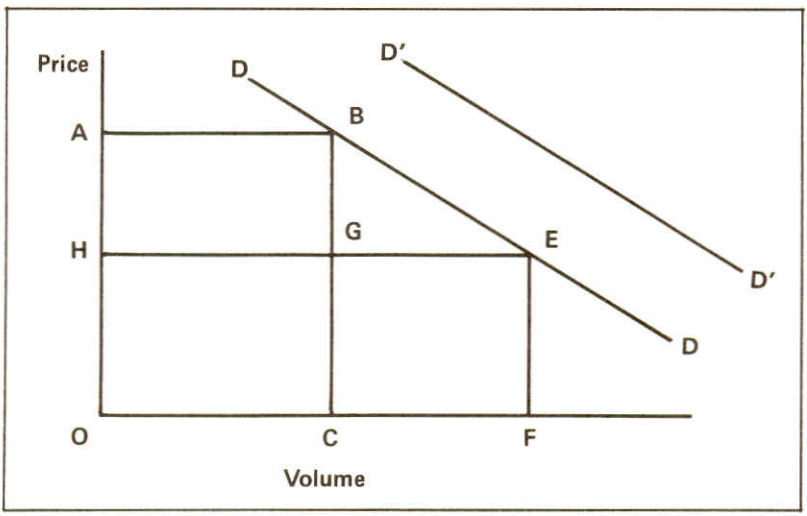
Product	Elasticity	Optimal Export Taxes
Wheat	-4.5 to -3.5	22 to 29 percent
Corn	-2.4 to -2.3	42 to 43 percent
Beef	-7.0 to -1.3	14 to 77 percent
Wool	-6.0 to -5.3	17 to 19 percent

For example, if the average price elasiticity for the main agricultural product (wheat, corn, beef, and wool) is -4 for traditional exports as a whole, what is the economic significance of this parameter? It means that if Argentina were to lower its price by 1 percent, it could increase the volume exported by 4 percent; or, to put the problem in simpler though less precise terms, a 100 percent growth in export volume would generate a 25 percent drop in prices on the average. In other words, a 100 percent increment in agricultural export volumes would bring only a 50 percent increase in the value of the country's sales,

measured in constant dollars. Graph 2 provides a rough illustration.

Graph 2

Long-Term Demand Curve for Argentina's Agricultural Exports



As the export volume increases from OC to OF, the price falls from OA to OH. Although the new sales in the rectangle OHEF are larger than earlier sales in the former OABC, the effort involved in exporting larger volumes does not pay off proportionately. The fall in price, of course, is predicated on a sluggish growth in world income. If world income were to grow fast, the demand curve would move to the right to D'D', thus counteracting the fall in prices.

In sum, a repetition of the 1900 experience in 1985 would require a considerable effort to achieve a 100 percent increase in the volume of traditional exports. Furthermore, it would likely produce riots and perhaps uncontainable social eruptions in urban centers, while reaping benefits of only 50 percent, since the export price would drop by 25 percent. That is, not only would the price of future augmented export volumes drop by 25 percent, but the prices received for the present volumes would

fall as well; thus the approximate losses would be on the order of 50 percent. Economics long ago provided the original policy answer to this kind of problem. To provide farmers with the correct price signal to encourage them to invest and produce, the appropriate parameter is the marginal revenue of the country's exports, not the international price. An old microeconomic formula states that marginal revenue is equal to one minus one over the price elasticity of demand (MR = 1 - 1/E).

Therefore, to stimulate farmers to visualize the "right price," it would be necessary to sanction export taxes equal to one over the price elasticity of demand (1/E). The optimal export taxes in Table 2 were calculated on this basis.

Many economists have observed that export taxes would do away with the traditional economic principle of comparative advantage. However, the problem of comparative advantage and development policy has been superbly dealt with in a noted article by Hollis Chenery, whose recommendation is precisely to tag the marginal revenue as the "right price" signal to exporters.[4]

The Long-Term Interests of Argentina's Farmers

Returning to 1900 to attempt growth on the basis of traditional exports, though inappropriate for the country as a whole, may nevertheless appear an interesting alternative for Argentine farmers and their leaders. Such a policy would imply the elimination of export taxes on traditional exports—taxes that ranged from 18 to 25 percent in May 1985. Moreover, it would imply floating the exchange rate and liberalizing imports. With these measures plus the burden of the external debt service, absorbing 50 percent of the country's exports would imply a real currency depreciation of about 30 percent. Farmers would see their sales rise by 50 percent in value terms alone over the next two years or so. Profits would soar. Assuming that urban protests could be quelled, in three to four years agricultural exports would increase in volume by 30 percent, 60 percent, and finally 100 percent. The international prices of Argentine agricultural export goods would gradually decline, and after four years, when the heroic deed of doubling export volumes had been accomplished, that drop would rob farmers of 50 percent of their efforts. By this time, the marginal costs of production

would have risen substantially due to the expansion of the agricultural frontier toward less fertile lands, through the use of fertilizer, investments in machinery, artificial irrigation and so forth. A goodly proportion of the newly modernized farms would go bankrupt, and farmers would be sorely disillusioned. In contrast, if the policy proposed in this book were applied, export taxes levied on products with inelastic international demand would be partly paid by the foreign importers, since they would be partly included in the price of Argentinian exports.[5]

The Soviet Agricultural Market

In the good old days, England and all of Europe bought Argentine grain and beef; today its main buyer is the Soviet Union. The markets of the large Western industrialized countries and Japan are substantially closed to Argentine agricultural products. This leaves the markets of the developing nations and the Socialist bloc. The developing countries are actively seeking import substitution in agriculture and, moreover, buy intermittently on credit or have no cash to pay for their eventual purchases. Socialist China is returning to a system of decentralized production with strong price-benefit incentives for its own agriculture, while making a great dialectical effort to demonstrate that socialist principles are being upheld.

As a result, the largest remaining buyer of grain and food for Argentina's traditional exports is the Soviet Union, a country unwilling to accept private initiative and profits in agriculture. Despite the sheer size of its land resources and the fact that it is the world's largest grain producer, in poor harvest years the U.S.S.R. has been compelled to acquire grain in world markets. As a result, more than 50 percent of Argentine grain exports is channeled to the Soviet Union.

Thus, the strategy of going back to 1900 today would imply accepting the standard inconveniences of barter trade and moreover, from the political standpoint, falling into the hands of the Soviet Union. There are two different theories regarding the desirability of this dependency. Some political economists argue that is harmless and even beneficial for, since Argentina

began selling wheat to the Russians in defiance of the embargo imposed by the Carter Administration in the late 1970s, international terrorism has disappeared in Argentina. It is unclear, however, whether the terrorism ceased because it was defeated or because it was terminated on orders from abroad. On the other hand, there are those who argue that as it exports growing quantities of grain and beef to the Soviet Union, Argentina would in turn be obliged to import growing quantities of Soviet weapons, technicians, technology, and capital goods, which would turn it into another Cuba, even if the argument that the wheat sales of '78, '79, and '80 helped Argentina free itself from the scourge of terrorism is accepted. The strategy of returning to 1900 has implications for the long-term geopolitical alignment of Argentina that must be carefully examined.

The Optimal Policy for Argentina's Farming Sector

The best policy for Argentina's farming sector is to increase production, simultaneously lowering costs through the adoption of the most up-to-date agricultural technologies available in the world today and adapted to the country's needs. Argentina's National Institute for Agricultural Technology, for example, with its 40 experimental stations and 230 extension offices must be strengthened to quickly adapt modern biotechnological improvements such as hybrid seeds and new methods of cultivation to local factors. Recent advances in biotechnology are being applied in the U.S. agricultural sector. For instance, new varieties of high yield and very adaptable hybrid wheat are being sold. The new varieties of seed, combined with new planting techniques, point to a productivity of 100 bushels per acre in areas where the normal productivity has been on the order of 30 bushels per acre. New varieties of "purple" wheat are being sown in California that have had a spectacular impact on productivity. In addition, the formidable effect of a new drug called bGH on beef and milk production is being felt. However, Professor Frederick Butel, of Cornell University, cautions that:

> Poorly managed small farms and the farms heaviest in debt would be most vulnerable. This would be the first major biotechnological impact on agriculture but it won't be as great as the hybrid wheat, rice and corn improvements that are sure to come . . . . Technological change tends to be production enhancing, exerting downward pressures on prices. And abnormal profits are fed back into the farmer's assets, so he doesn't reap the full benefits of technology.[6]

It must be remembered that studies on the relative impact of price policies versus technology policies on the growth of agricultural production assign far greater importance to the latter. From the statistical standpoint there is no question that the relative prices of the agricultural sector as a whole vis-à-vis other sectors of the economy are far less important than an effective policy for technological change.[7]

To overcome the future drop in agricultural prices in real terms, Argentina must strive to tackle the main cause of this decline—that is, technological change. It has been proven that farmers in Argentina and worldwide, in developed as well as less developed countries, quickly respond to profit and price incentives. They are relatively unresponsive to the aggregate prices of the agricultural sector as a whole compared with the prices of the rest of the economy, but highly responsive to the relative prices of their own inputs and output. It is very important, therefore, that the relative prices of agricultural inputs be reduced. The best example of a main agricultural input that has to have a lower price is fertilizer. Instead of maintaining a urea plant that supplies barely 25 percent of the local market and needs a protection of 70 percent, Argentina should install and operate a large, more efficient plant in the middle of the Pampas to produce cheaper nitrogen fertilizer, taking advantage of economies of scale. This would halve the price of fertilizer, offer farmers low prices, and permit the export of fertilizers. In order to achieve this, the government must call for bids to construct a large plant with private capital and choose the bidder who quotes the lowest price to farmers. The government should also provide at low rates the natural gas so abundant in Argentina that is currently squandered and

allowed to dissipate. Naturally, lowering production costs would also entail an improvement in road, silo, and port infrastructure to reduce trade margins that today are about 40 percent, thereby maximizing the producer's income. If silos and transport systems are privatized through the transfer of company stock at no cost to the users of such installations (as explained in Chapter IV), agricultural income will increase and the quality of the intermediate services will improve.

In sum, as a new wave of technological change sweeps agriculture worldwide, a foreseeable drop in world agricultural prices will occur.[8] To overcome this decline and increase exports, Argentina will have no alternative but to adopt many of the new technologies to reduce her own production costs and thus maintain a reasonable rate of agricultural export growth (on the order of to 4 percent in real terms).

Soybeans as an Escape Valve

One of the technological improvements that have contributed most to agricultural growth in recent years has been the introduction of soybeans, a crop that was mysteriously overlooked before 1976. Rotating soybeans with wheat increases production of the latter since soybeans fix nitrogen in the soil. It is worth remembering that at the Kennedy Round of trade negotiations within the GATT, the United States obtained the multilateral commitment of the European Economic Community not to impose variable duties on soybean imports.[9] Consequently, this product turned out to be one of the few that enjoys relatively free trade throughout the world. Argentina would become the world's chief soybean exporter if it provided farmers with healthy price incentives combined with a sound technology policy. Since there is no worldwide protectionism with regard to this crop, Argentina should have no fear of world demand elasticity or competition, since its production costs should be lower than those of its main competitors, the United States and Brazil.

Given the unique relative freedom of this product in international markets, Argentina should provide the appropriate signal to her farmers by eliminating or reducing export duties on soybeans as much as possible. The same thing, of course, should

be done with respect to other agricultural exports that are not consumer products in Argentina and whose world demand must necessarily be very elastic for the country, given its minimal share of the world market.

The Agricultural Policies of the United States and the European Economic Community

Following the drastic tax reductions of 1981, the Reagan administration became very concerned about reducing public expenditure in the United States. If the U.S. deficit of 5 percent of GDP were to persist, the United States could plunge into an economic crisis of serious proportions. Prime targets for cutbacks were agricultural subsidies, a good proportion of which are paid not to sow crops. If these subsidies were eliminated, American agriculture with its abundant technology would increase production and exports. This would depress international agricultural prices considerably further and damage still more the prospects for Argentinian agricultural exports—and thus the viability of a growth strategy for Argentina based on an increase in traditional exports.

The drop in world agricultural prices would increase the budget deficit of the European Economic Community and might force it in the long run to abandon its disastrous protectionism, instituted under the guise of a Common Agricultural Policy.[10] This would occur by the year 2000. Paradoxically, it may be appropriate for Argentina to return to the liberal policies of 1900 by the year 2000, but not at present or even in 1990. Although agricultural exports should grow at the historical rate of the last twenty years (that is, 2 to 4 percent annually in real terms), an economic development strategy for 1985-2000 that centers on the growth of traditional exports would be a political and economic mistake of tremendous proportions.

International Agricultural Protectionism: The Achilles Heel of Economic Conservatism in Argentina

The world agricultural market is governed by protectionism. Variable import duties, import bans, permits, and subsidies to agricultural exports, open or disguised, are the rule and not the exception in world agricultural trade. Because of this, instead of facing a horizontal demand curve in the world agricultural markets, Argentina is confronted by a curve like that in Graph 2—that is, with a slope that declines towards the right—meaning that any increase in export volumes will be counteracted by falling prices, unless income in the importing countries grows considerably.

This topic has unleashed an old polemic among prestigious economists, typified in the opposing views of Raul Prebisch[11] and the archetype of Argentinian economic conservatism, Federico Pinedo.[12] Whether prices drop as a result of increased export volumes is a typical empirical problem that hinges mainly on the elasticity of demand for traditional agricultural products mentioned before. An investigation using the appropriate econometric techniques gives Prebisch a clear upper hand, suggesting average price elasticities of demand for Argentine wheat, corn, beef, and wool in world markets of -4, as stated previously.[13]

As detailed in the next chapter, this low elasticity is the main source of the country's chronic currency overvaluation and stagnation. To compensate for the lack of profitability in industry, a consequence of overvaluation, Argentina has mistakenly resorted to excessive tariff protection, exchange controls, and import permits in addition to subsidies, when the clear-cut remedy is optimal taxes on exports and a devaluation to promote exports of manufactures.

NOTES

1. A.G. Ford, *The Gold Standard: 1880-1914 Britain and Argentina*, Clarendon Press, Oxford, 1962, ch. VIII.

2. The most recent pronouncement in that direction is that of Domingo Cavallo in *Volver a Crecer*, p. 76.

3. Eduardo R. Conesa, *Términos de Intercambio y Tarifa Optima en la Argentina*, INTAL, Buenos Aires, 1983. For a recent confirmation of these figures, see Montague Lord, *The Econometric Analysis of Latin America's Commodity Exports*, Inter-American Development Bank, Washington, DC, 1985. See also "Argentina" by Julio Berlinski and Daniel Schydlowsky in *Development Strategies in Semi-Industrial Economies*, Bela Balassa, editor, World Bank, Washington, DC, 1982. In the latter work the traditional export price elasticity of demand is considered to be -3.0, p. 97.

4. Hollis Chenery, "Comparative Advantage and Development Policy," in *Structural Change and Development Policy*, World Bank, Washington, DC, 1979, where it is said, "When export demand has a low elasticity, marginal revenue should be used in place of average revenue. Since it is quite likely that the market evaluation of the attractiveness of an investment in exports will differ from this social evaluation, some form of government intervention may be warranted," p. 279. The scientific opinions in favor of Chenery's point are overwhelming. They are summarized in my book *Términos*.

5. John Stuart Mill makes this point in general terms in "The Laws of Interchange between Nations and the Distribution of Gains of Commerce among Countries of the Commercial World," in *Essays on Some Unsettled Questions of Political Economy*, J. W. Parker, London, 1844.

6. Barbara Insel, "A World Awash in Grain," *Foreign Affairs*, vol. 63, no. 4, 1985.

7. "Growing Broke: Biotechnology Genie Heading for the Farm," *The Washington Post*, March 27, 1985.

8. On this important point see Raj Krishna, "Price and Technology Policy," in *Agricultural Development in the World*, Carl K. Eichen and John Strats, editors, John Hopkins University Press, Baltimore, MD, 1984. Carlos Diaz Alejandro also assigns greater importance to technology than to price policy. After devoting an entire chapter to the subject, he concludes: "Technological lag, in brief, may be taken as the most stubborn culprit of the post-1945 rural stagnation." Diaz Alejandro, *Economic History*, p. 206.

9. James P. Houck, "Trade Policy Issues in the Soybean Sector," in *World Soybean Research Conference III Proceedings*, Richard Shibles, editor, Westview Press, Boulder, CO, 1985. Japan has made a similar commitment in the Tokyo Round of GATT negotiations; see Houck, op. cit. The degree of free trade in the world soybean market is extraordinary. Almost 50 percent of world production is marketed internationally. Absorbed in its domestic controversies, Argentina neglected to take advantage of one of the few avenues left open for agricultural exports. The country began exporting soybeans in large quantities only in 1976, and these exports were well below its incredible potential.

10. The prediction of a price war is formulated in *The Economist*, January 5, 1985, pp. 10-11. Actually, the Common Agricultural Policy is a method for France to receive unpaid war reparations from World Wars I and II. France herself paid heavy war reparations following the Napoleonic Wars and her 1870 defeat. Conceivably, by the year 2000 she will have re-collected her reparations.

11. Raul Prebisch, "Trade Policy in the Underdeveloped Countries," *American Economic Review*, vol. 2, 1959.

12. Federico Pinedo, *La Argentina, Su Posición y Rango en el Mundo*, Editorial Sudamericana, Buenos Aires, 1971—especially Chapter XVI on the terms of trade, p. 635.

13. See Note 3 for references to that investigation.

3
The Exchange Rate Policy

The Exhaustion of the Present Economic System

Economists and businessmen all over the world with an interest in development problems cannot comprehend Argentina's failure to grow. They understand well why Chad or Bolivia are in desperate economic straits, but do not class Argentina with her wealth of human and natural resources with these countries. Yet Argentina seems to be condemned to economic decay.

Pessimism in Argentina has abounded in recent years. To overcome this destructive force, the government must concentrate on consolidating national unity behind goals acceptable to the country as a whole—goals such as fomenting development within the constitutional framework and setting aside domestic quarrels with the labor movement and the military. These sectors are a permanent fixture in Argentina, and enmity among them could cost democracy dearly in the long run.

The economic system that has reigned for 50 years in Argentina is exhausted. This is evidenced in the country's stagnation, underdevelopment, inflation, and recession. It must be remembered that inflation, economic chaos, and terrorism were the factors that swept away the Perón regime elected to

office in 1973. Currency overvaluation and other mistakes deriving from monetarist ideology were influential in bringing down the military government in power from 1976 to 1983. Profound structural reforms are urgently needed, and are a decisive step in bringing about true institutional stability.

The remainder of this work describes a realistic economic system for the future development of Argentina, taking into account the external and domestic constraints that must be taken as a given. Since these proposals represent major changes, many may consider them unrealistic. However, countries like Argentina, which has suffered through two wars, and a deep recession accompanied by many frustrations over the last ten years, become ripe for profound economic reform. The opportunity is there; if it is not seized now, it may not soon recur. Luckily, the external constraint of world agricultural protection, particularly that of the European Economic Community, coincides with the domestic restrictions imposed by the need to maintain the standard of living of Argentina's lower and middle class. The melding of the two constraints makes the solution to Argentina's growth problem so obvious that is difficult to understand why no recent regime—be it Perón's of 1973-76, the military government of 1976-83, or the present authorities—has adopted it as its own economic program. The solution is in fact to revert to the type of economic system in force from 1860 to 1930, which with some limited and very specific modifications would be thoroughly able to assimilate and overcome the two constraints. That system consisted of a small federal government with traditional limited functions; and free trade with a highly devalued exchange rate and automatic monetary policy, independent of the executive branch and tied to the exchange rate.

Relative Costs in Industry and Agriculture and the Exchange Rate

In many developing countries endowed with an extraordinary natural resource such as petroleum, or, in the case of Argentina, the Pampas with its ability to produce grain and beef at very low cost, the local currency tends to be overvalued to

permit exports of manufactures. These countries are prone to enter the "easy" stage of import substitution in consumer products by restricting import of these goods and importing capital and intermediate goods cheaply owing to the overvalued currency.

This system generates inefficiencies. Currency overvaluation creates an industry with excessive dependence on artificially cheap capital goods and raw materials, and whose growth is closely linked to these imports.[1] In turn, the supply of foreign exchange to import these inputs stagnates owing to the low growth of traditional exports; time and again the country comes up against the scarcity of foreign exchange as its main development constraint.[2]

It has been determined that at the exchange rates in effect in 1977, for instance, Argentina's industry registered prices that were 37 percent higher on the average than those of similar import products. Since the exchange rate in May 1985 was overvalued in relation to that of 1977, Argentina's industrial prices were on the order of 50 percent higher than their international counterparts—that is, higher still than in 1977 when the Berlinski study was published.[3]

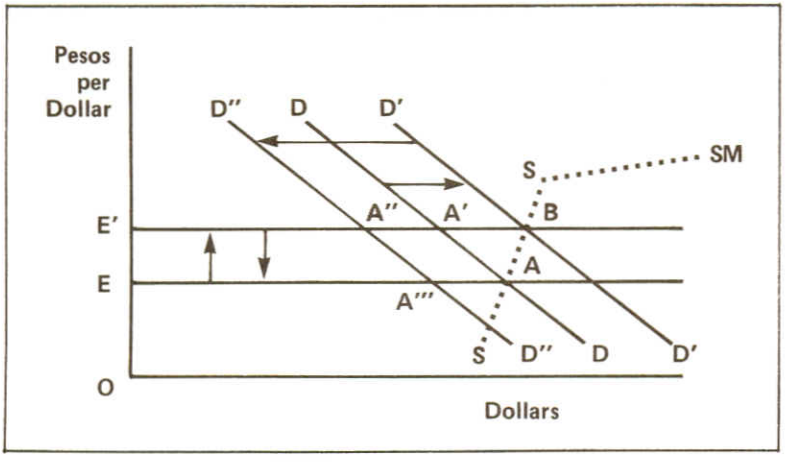
The Structure of Argentina's Foreign Exchange Market

Over the years, Argentina's traditional agricultural export sector has generated more than 80 percent of the country's total exports. The remaining 20 percent is somewhat artificial, because it owes its existence to subsidies and reimbursements of dubious desirability, given the economic distortions that they may create. Even with a highly appreciated exchange rate, the export supplies of grain, hides, beef, and wool are high. Thus, at the time of the currency overvaluation during the Martínez de Hoz tenure in the Finance Ministry in 1978-80 or the Juan Perón administration in 1948-55, Argentina continued to export agricultural products with ease. There is always a good supply of traditional exports, even if the exchange rate is overvalued. This is shown in Graph 3. If the price of foreign exchange—that is, the number of pesos per dollar—is placed on the ordinate axis, the supply curve for foreign exchange begins in

the lower right area of the diagram (curve SS). In other words, at low dollar prices the large supply is determined by Argentina's significant comparative advantage in agricultural production, and also by the fact that the prices the country receives go up when export volumes drop. If the exchange rate were depreciated, there would be an incentive to export greater quantities; but as prices fall, the amount of foreign exchange deriving from the greater volume exported does not translate into a proportionate increase in foreign exchange earnings. As a result, the supply of foreign exchange is inelastic. The roots of this lie in the terms of trade and the closure of world markets.[4] Numerous short- and medium-term factors exacerbate this rigidity, and these, in turn, stem from the supply rigidity of exportable agricultural products. In the cattle industry, for example, if the price of cattle increases because of a devaluation, the cattleman retains pregnant cows since they are a necessary input in steer production, and thus supplies the market with fewer animals. Instead of supplies increasing when prices go up, therefore, they decrease.[5] Instead of sloping upward toward the right, the supply curve for cattle slopes upward toward the left. This biological-economic fact in turn affects the supply curve for foreign exchange, since it depends on beef exports. Clearly, in the long term, cows that are not slaughtered so that they can reproduce will give birth, and in three years, the supply of beef will return to normal. In the interim, however, the supply curve bends backwards. Moreover, when the cattle industry decides to retain pregnant cows for reproduction, it must use more fields for pasturing. As a result, grain production suffers.[6] Thus the deterioration in the terms of trade and complications involving supply volumes in the short to medium term contribute to the rigidity of the supply curve for foreign exchange.

Graph 3

Traditional Devaluation and Recession



However, if the country devalues enough (by more than 50 percent in real terms), then at some point the prices of manufactures will become internationally competitive,[7] thus permitting their sale in the international market. As a result, after crossing the 50 percent barrier the supply curve for foreign exchange becomes very elastic. It must be remembered that Argentina's presence in the world markets for manufacturers is insignificant (one-quarter of one percent). Thus, if Argentina doubles, triples, or even quintuples its industrial exports, it will continue to go unnoticed. Argentina cannot attempt to alter the international price of manufactures for any item for some years to come. The country is a mere "price taker" in these markets and must build up its prestige and credibility as a permanent supplier through its constant presence with high-quality merchandise and competitive prices. The supply curve for foreign exchange stemming from manufacturing exports can then be drawn as a line that begins on the upper left of the diagram and slopes slightly upward toward the right. Exactly the opposite is true of the supply curve (SS) for foreign exchange derived from traditional agricultural exports, which starts in the lower right corner of the diagram.

Taking the curves for the supply of agricultural products and manufactures into account simultaneously will produce the broken line SSSM, where the lower portion (SS) represents traditional exports and the upper one (SSM) manufacturing exports. The demand curve for foreign exchange to import raw materials and capital goods would be DD, also an inelastic curve for reasons that will be analyzed further on. The point where supply and demand intersect would be the equilibrium point A, which reflects the historically overvalued pesos or australes represented by point E. Because of the external debt burden facing the country, the demand for foreign exchange increases by U.S. $5 billion a year. As a result, the demand curve tends to move toward the right to D′D′. The new equilibrium point would be 30-40 percent higher than the historical one. The new market price, however, would generate a recession, as will be seen later. Therefore, the demand curve would strongly recede toward the left (from D′D′ to D″D″), indicating that economic adjustment occurs through recession and not through prices. The corresponding balance of trade surplus would be A″B, but inflation and real exchange rate appreciation would make it tend to shrink toward A‴A.

This recessionary feature of traditional devaluation in Argentina is unfortunate. Moreover, it is atypical; normally, in most countries, devaluations are followed by expansion, rather than recession.

Why Not Float Argentina's Currency?

If, as a result of the external debt and the need to begin its repayment the new equilibrium exchange rate is 30-40 percent higher than the historical parity, why not let the market do its job and allow the debt problems to solve themselves automatically with the flotation of the peso, as in the 1890-1898 period? Although in the 1890s, as now, debt service absorbed roughly 50 percent of exports,[8] there are several fundamental arguments against this option. It should be fully explored, however, since it has the support of many conservative and progressive economists.[9]

Labor Union and Urban Middle Class Interests

The first objection to floating the peso while at the same time eliminating export taxes on traditional products is more political than economic in nature.

Argentina's experience with devaluations over the past 30 years has been widely analyzed, and many fine works have been written about it. Undoubtedly, the most detailed and outstanding—a model for its type—is by Cuban economist Carlos Díaz Alejandro.[10] His argument, solidly grounded in econometrics, clearly demonstrates that traditional devaluations in Argentina have an immediate impact, causing an increase in the domestic price of grain and beef, and thus of practically all major food products. A decline in real wages therefore takes place, which also causes the domestic market for industrial manufactures to shrink. Since industry cannot export owing to high production costs, a sharp recession occurs. The drop in the standard of living provokes riots and protests. The political system cannot withstand the pressure; either the government or business yields, and nominal salaries are raised. As a result, within a year the country has returned to square one with much of the devaluation erased by inflation. In the interim, the inelasticity of the supply of foreign exchange from the agricultural sector does not help, at least in the short run. The only service rendered by the traditional devaluation or flotation of the peso is a drastic temporary cutback in imports of intermediate and capital goods through industrial recession, which serves to adjust the balance of payments.

Argentina's history is too well known to bother going into details. Of course, some economists believe, not without factual support, that the country's recessions have been caused not by the devaluations themselves but by the monetary stringency that has followed them and the restricted growth of domestic credit imposed by the IMF. This explanation has some validity, although it is based chiefly on the decline in investments and thus in imports.

What the two views have in common is the assertion that devaluations are deeply recessive. This is because the domestic prices of manufactures are 50 percent above international prices, and a devaluation in real terms has never been sustained at these

levels, though nominally it has often been over 100 percent. A real devaluation of sufficient magnitude to foster non-traditional exports has historically been impossible owing to political pressures from labor unions and the urban middle class, which together comprise the bulk of consumers.

Economic Viability

If Argentina's currency were left to float in the foreign exchange market and the country had no external debt, it is quite likely that, taking into account all import and export duties and import licensing, the equilibrium parity would be close to the official exchange rate in May 1985, which is not much different from the official parities of 1969 and 1978. However, due to the burden of an external debt service of $5 billion a year, the long-term equilibrium exchange rate might be 30-40 percent above the official exchange rate in May 1985. This equilibrium parity would be politically unattainable in the medium term for the reasons stated above.

Even if it were politically feasible, there is an important technical consideration that would make a floating currency undesirable for purposes of medium- and long-term development:[11] the new parity would be around the threshold where the country could seriously consider exporting manufactures. Although Argentina exports $1.5 billion a year in manufactures, it will be demonstrated further on that the present system of promoting nontraditional exports is not viable and should be eliminated, and that exports of manufactures must be fostered through a highly devalued fixed parity exchange rate rather than subsidies. The point here is that a floating parity will sometimes encourage and sometimes discourage manufacturing exports. The difficulties inherent in this type of exchange rate system are considerable in the case of Argentina. No industrialist will invest to export manufactures under a floating parity—particularly if this parity renders his exports only marginally profitable. In order to export it is necessary to prepare market studies, establish a presence in foreign countries, adapt products to consumer tastes, ensure the continuity of export flows, and purchase modern machinery to increase output and improve product quality. All this is impossible if the industrial exporter

is not assured of a high, devalued, and stable fixed exchange rate in real terms for the long run.

If in a country like the United States with a potent export industry, havoc is produced by overvaluation of the dollar under a floating exchange rate,[12] imagine the effects of a floating currency on Argentina's industry, as yet unaccustomed to competition. The exchange rate is one of the most volatile variables in the nation's economic system. There are two explanations for this. The first is the inelasticity of both the supply of and the demand for foreign exchange stemming from the current account of the balance of payments and capital account considerations. With regard to the current account, not only is the supply of exports inelastic but the demand for foreign exchange is as well, since it depends on imports of intermediate and capital goods, which are highly inelastic to price. (This author's estimates point to -0.25.[13]) This inelasticity is obviously artificial, for it assumes the existence of a complex mechanism of high tariffs or import bans on consumer goods, as well as import permits and exemptions for industrial inputs and capital goods. Thus, the price inelasticity is understandable, because imports of these inputs depend chiefly on income growth rather than prices, which the import system inherently makes relatively cheap. If all import restrictions and structures were dismantled, the import price elasticity would obviously be much higher, possibly close to unity. Whatever the reason, the fact remains that both supply and demand for foreign exchange, insofar as they depend on exportable or importable goods, are extremely inelastic; and this combined inelasticity, a well-known phenomenon in elementary economics, produces large fluctuations in the adjustment parameter—that is, the price of foreign exchange. History demonstrates how to avoid these fluctuations; Argentine authorities have preferred to resort to exchange rate controls[14] or setting the parity at the Central Bank through buying and selling dollars at a fixed price.

The second reason for the exchange rate's volatility is the tremendous importance of financial capital movements, facilitated enormously in the last 20 years by the existence of a large international capital market and the improvement in

international communications. The exchange rate depends to a large extent on expectational variables—i.e., public expectations about future interest rates within the country and abroad, about future money supply and GDP,[15] and the like. Since expectations are highly unstable, particularly in Argentina, the price signal for the exporter indicated by the exchange rate represents a true calamity. To attempt to export industrial products from Argentina under such conditions would be suicidal. Assuming for a moment that trade unions and the middle class accept without protest the drastic reduction in their income caused by devaluation, the confidence that such an event would generate in the country, coupled with an eventual drop in interest rates in the United States, would promote a return of part of the wealth that had taken refuge in foreign capital markets. Thus, dollars would seek out Argentine currency: in one week the value of the Argentine peso would soar by 30 percent, obliterating all plans to export manufactures. Events of this nature would occur constantly, accompanied by erratic ups and downs in the currency, and would effectively block any serious effort at exporting manufactures. Clearly, if Argentina is to achieve significant development over the next ten years, it will come about only through manufacturing exports. There will be no considerable economic growth otherwise.

Devaluation, Export of Manufactures, and Economic Growth

If the recessionary effects of a devaluation and its regressive impact on income distribution stem mainly from the increase in the price of beef, wheat, and food products in general provoked by such a devaluation, the remedy is simple: devalue to promote only exports of manufactures, not of beef and grain. Since Argentine manufactures are 50 percent more expensive on the average than similar products in the international market, it can be inferred that the minimum industrial devaluation must be on the order of 50 percent. Thus, industry would set prices that, on the average, would be similar to international prices, and Argentina would begin to conquer new markets with products that have the greatest comparative advantage—that is, goods whose domestic prices are

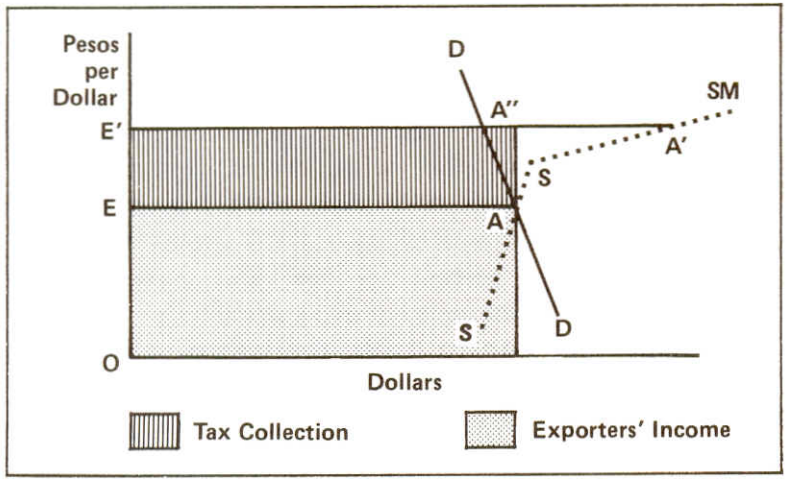
far below international levels. Fifty percent would appear to be a minimum appropriate level for an industrial devaluation, though it may not be enough. (For reasons demonstrated later in this study, it would seem that the threshold for successful manufacturing devaluation in Argentina must be on the order of 60 percent at the very least.) Moreover, the devaluation must be offset—that is, a devaluation of traditional export goods must be prevented—by levying export taxes on each product equal to the inverse of the world price elasticity of demand facing Argentina in world markets. This universally accepted conclusion in economics, known as the "optimal tariff theory,"[16] was developed by John Stuart Mill, champion of economic liberalism, back in 1829. It states that when world demand is more inelastic, export taxes must be higher; when it is more elastic, they must be lower. At present (May 1985) export duties are at the level of about 25 percent for beef and grains, with the exception of wheat, which is taxed at 18 percent.

Following this manufacturing devaluation, export duties must be raised by up to 50 percent, though they should be higher for beef and lower for some grains (even zero for soybeans), where world demand is very elastic or where Argentina's share of the world market is negligible. Graph 4 shows a considerable devaluation in real terms from E to E′. The distance A″ A′ represents the commercial surplus generated. The real devaluation, as indicated in the diagram, has surpassed point S where the supply curve for foreign exchange bends. Much of the current literature in the "structural adjustment" area of development economics is on tackling the problem of how to make the supply of exports more elastic. This can be done by fostering the export of manufactures through a sufficiently high devaluation while at the same time protecting social goals through other measures. In the case of Argentina, these other measures are export taxes on food products. Fiscal revenue, represented by the vertically shaded rectangle, is a wedge between the external and domestic price of food; it ensures that there will be no economic recession. This time the demand for imports does not veer to the left, precisely because there is no recession. The commercial surplus is considerable, owing to manufacturing exports and the fact that,

given the high domestic price of the dollar in local currency, industry is selective in its imported inputs, and Argentine tourists prefer to patronize local resorts rather than foreign countries.

Graph 4

Manufacturing Devaluation without Recession



Export Subsidies vs. Exchange Rate

Instead of relying on a clean, simple system for the promotion of manufactures based on a devalued exchange rate and optimal export taxes on traditional exports, Argentina currently employs a system of incentives to export manufacturers based on reimbursements, "drawback" subsidies, financing facilities, VAT refunding, guarantee of dollar prices for long-term export contracts, etc. It is an arbitrary system, however, frequently modified and especially tailored to firms with a strong government lobby. It is also very burdensome for the public finances. In the years from 1964 to 1983, subsidies to nontraditional exports have grown from $34 million (1984 dollars) to $266 million (1984 dollars).

The arbitrariness of the system reinforces its changeability, and thus its lack of continuity and security. Rumors of sordid financial and rediscounting affairs abound. Small firms lack the

resources and "pull" to enable them to benefit from the incentives. After 20 years of this system, manufacturing exports total only U.S. $1.3 billion. This constitutes a failure; not only is the system unstable, ad hoc, and bureaucratic, it is also uneconomical. For instance, a firm may import inputs of about 80 percent of the final value of its product and receive a tax reimbursement equal to 10 percent of the final value plus financing at subsidized rates. Granting that firm a 10 percent reimbursement, when foreign exchange earnings are only 20 percent after the value of imported inputs is subtracted, implies an effective protection of 50 percent for the firm—and this without taking the social costs of pre- and post-financing into account. Serious entrepreneurs will hardly invest large sums of money to produce and export to international markets under such preposterous conditions.

Thus, in Argentina, industrial investments are for the domestic market, while the external market merely serves as an escape valve for temporary situations. In countries like South Korea or Taiwan, where industrial exports are the engine of growth, the main "business" is not investment for the domestic market (that is, import substitution) but rather investment chiefly for export, which implies that there must be a potential for significant profits there. A simple, stable, permanent, and rational system must therefore be designed to ensure that Argentina's entrepreneurs will orient their activities toward the external markets. A real and stable devaluation of 60 percent would appear to be sufficient for the entire nontraditional export sector.[17] In addition, the present system of export promotion and privilege, where all hinges on the whims of a public official, must be scrapped.

The International Experience

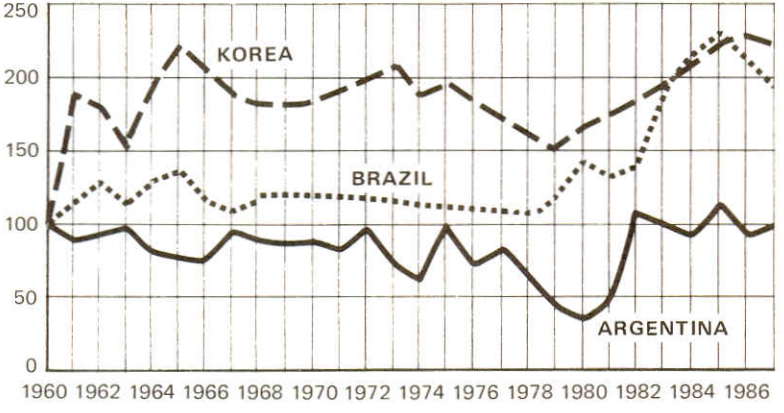
Numerous studies point out the benefits of economic systems designed for exporting manufactures. Perhaps the most thorough is that of Anne Krueger and Jagdish Bhawati, where, with the cooperation of well-known specialists in development economics, the experience of Turkey, Ghana, Israel, Egypt, the Philippines, India, South Korea, Chile, Colombia, and Brazil has

percent. The growth rate is maintained at a sound 12 percent in real terms after being on the order of 40 percent in the 1960s and early 1970s. (See Graph 5 for a comparison of the export performance of Argentina, Brazil, and Korea. For the year 1960, Argentinian and Brazilian exports of manufacture were so small that they cannot even be seen in the graph. In the case of Korea, both types of export were so insignificant that neither primary products nor manufactures show up in the graph. In line with this phenomenal export growth, Korea maintained a GDP growth rate of 8.6 percent from 1960 to 1982.[19])

The differences in export growth among the three countries are largely explained by the 100 percent real depreciation that took place in Korea and Brazil. (Graph 6 indicates that both Korea and Brazil devalued their currencies in real terms by 100 percent in relation to the value of their currency in 1960.) Argentina instead revalued or kept a similar real rate as in 1960.

Graph 6

Real Exchange Rate in Argentina, Brazil, and Korea
1960 = 100

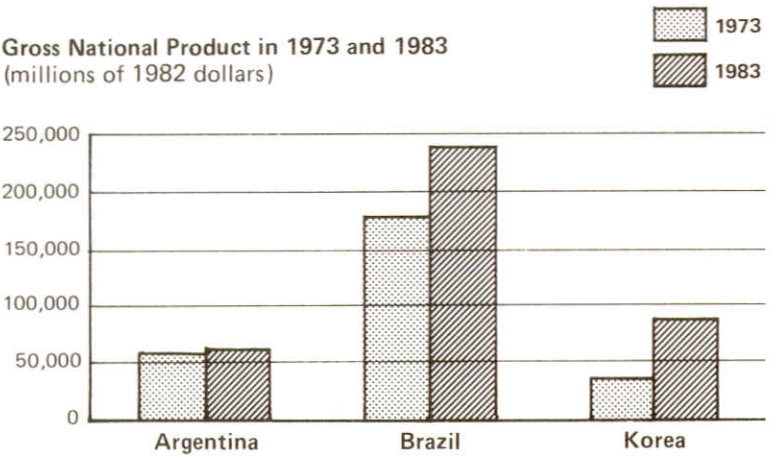


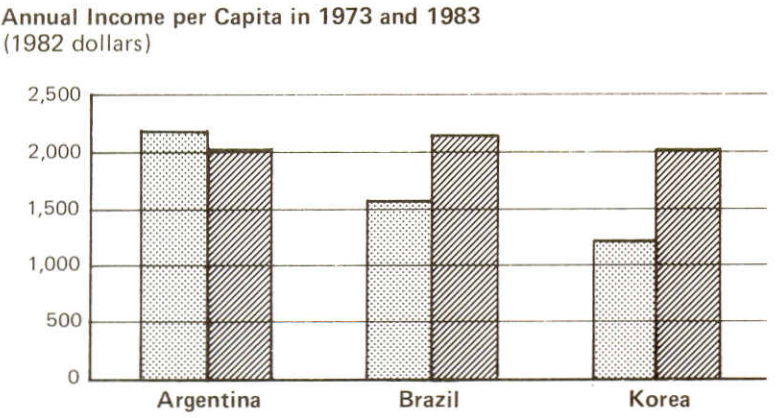
Note that from 1967 to 1978, Brazil highly subsidized nontraditional exports which therefore did not need a greatly devalued real exchange rate to grow conspicuously. Note also the stability of the real exchange rate in Brazil between 1970 and 1978, despite the high inflation suffered by the country.

Source: IMF, *International Finance Statistics Year Book*, 1974, 1978, and 1988.

Graph 7

Gross National Product and Annual Income per Capita in 1973 and 1983





Source: *The World Bank Atlas 1985,* Washington, DC.

Argentina, consistent with her policy of currency overvaluation, retains its export structure of 20 years ago, composed of 80 percent agricultural products or primary goods and 20 percent manufactures—the latter owing to current subsidies.

Graph 7 shows the GDP growth and per capita income in 1973 and 1983 that resulted from the export and exchange rate strategies implicit in Graphs 5 and 6 respectively.

It could be argued that Argentina lacks some element present in Korean society that is conducive to development. Korea, for example, demands competence in public office; Argentina does not. While there are many other differences between the social systems of the two countries, they have little to do with development. Anne Krueger rejects the hypothesis that there is something special about Korean society. She emphasizes that:

> While it seems to be very important that exporters be assured of the commitment of their government to an export promotion strategy, that commitment can grow from the very success of the export promotion efforts and the popular consensus that then emerges in its support. In a sense it may well be that the success of the export promotion strategy, itself, strengthens the government while simultaneously generating support at all levels for continuing the strategy. . . . Although economic theory suggests that incentives for export and for import substitution should be equated at the margin, in fact, neither Brazil, nor South Korea did so. During the rapid growth years, the bias in their regimes was towards exports.[20]

Bhawati for his part places less emphasis on the larger profits that the exporting entrepreneur should obtain from the system compared to the import substituting entrepreneur. He maintains that the chief superiority of export protection over import substitution is simply the degree of "neutrality" of the incentives for allocating resources under the former, and he considers the latter strategy chaotic and a major source of corruption.[21]

Exporting of Manufactures as a Strategy for Development: Diverse Opinions

Manufacturing devaluation may be viewed as a bold and original strategy in Argentina, but in fact it is not. It merely represents the consensus among internationally known specialists

in development economics, a fact that can be corroborated by any modern textbook in this field.[22] Specialized studies in this area are worth noting. According to the World Bank:

> Where domestic markets are relatively small the pursuit of import substituting policies beyond the early stages of industrialization should be viewed with caution. Several countries—the Republic of China, Israel, the Republic of Korea and Singapore—have demonstrated that the continued development of industry can be secured by an alternative approach—namely a switch to production for export. Apart from maintaining and even accelerating the rate of industrialization, the policy switch allowed these countries to avoid the costly mistakes associated with excessive import substitution and to reap a number of benefits . . . . Opportunities for acquiring technical and managerial skills were also expanded, and industry, no longer constrained by domestic demand, was able to take advantage of economies of scale and to increase capacity utilization . . . . Experience demonstrates that successful export drive depends crucially on easy access to duty free imported inputs."[23]

Bela Balassa, after recommending the application of optimal export taxes to traditional export products with inelastic world demand, says:

> An additional advantage of the described procedure is that the need for direct export subsidies for manufactured goods, and hence the possibility of retaliation on the part of the importing countries, decreases. This [is because] balance of payments equilibrium is reached at a higher exchange rate, thus increasing the amount of domestic currency received per dollar earned. With a more favorable exchange rate, the desired incentives to manufactured exports can be provided at a lower rate of (explicit) subsidy.[24]

Another renowned author, William Cline, observes that if Argentina had a "normal" level of exports commensurate with its income per capita and the size of its population, it would quadruple its current manufacturing exports—that is, these

exports would total not $1.3 but $5 billion. If Argentina had followed the "abnormal" model of Korea and Taiwan, its industrial exports would have multiplied 19-fold; in other words, they would have far exceeded $20 billion.[25]

It is evident that the appropriate development strategy for semi-industrialized countries is the one proposed here. In the work cited above, Cline ponders what would happen if every developing country were suddenly to follow the strategy of Korea, Taiwan, Hong Kong, and Singapore ("The Gang of 4")—that is, development via exports of manufactures. His answer is that these countries would run the risk of provoking a protectionist policy response from the industrial nations. Sudden action of this type among all developing countries is unlikely, however, and even in this hypothetical case, Latin American integration would provide an adequate policy alternative. In the latter case, the export strategy would still provide a good avenue for growth, but export (and import) growth would have to take place mainly among developing countries, such as those belonging to the Latin American Integration Association (LAIA) to which Argentina also belongs.

After an in-depth analysis of the problem, Cline states:

> The principal conclusion of this study is that developing countries appear to have considerable scope for continued expansion of their exports of manufactured goods at relatively rapid rates.[26]

Fostering Industrial Development Through the Exchange Rate

Graph 6 suggests that Argentina may need a real devaluation of her currency of the order of 100 percent to be in competitive parity with Brazil and Korea. An international price comparison study made in 1977 revealed that Argentina's industry had an average effective rate of protection of 39 percent.[27] To put Argentina on an internationally competitive footing might have required a real devaluation of 39 percent at that time. This may not be enough now, given the extraordinary growth in productivity in Brazil, Japan, and Korea, where per capita productivity grew at 5 or 6 percent per year in the 1977-84 period. It is easy to conclude that to implement a

growth strategy via exports of manufactures, Argentina now requires a real devaluation of at least 60 percent.

A devaluation of this magnitude in itself would constitute a respectable level of protection for local industry, equal to a 60 percent uniform import tariff and a 60 percent export incentive. Moreover, it would be particularly encouraging for industries that make intensive use of local labor and raw materials—the very industries that the government should be most interested in promoting to maximize employment, both directly and indirectly, and that would be in the best position to export. The shoe industry, for example, exported $20 million in 1977 and 1978. Later, due to the overvaluation in 1979 and 1980, exports dropped to just $2 million to $6 million. At the same time exports of leather rose substantially. The reason is simple; it is related to Graph 3 and the unresponsiveness of traditional exports to the exchange rate. By increasing local labor costs in dollar terms, the overvaluation of the exchange rate made it more profitable to export leather raw, with less value added than shoes. Other countries, such as Brazil and Italy, export high-quality shoes manufactured with Argentine leather, multiplying the value of the leather tenfold. Argentine industrialists have installed factories in Brazil to export shoes of Argentine leather. In 1984, Brazil exported 130 million pairs of shoes valued at $834 million to the U.S. market alone. It is absurd that Argentina, the world's foremost beef and leather exporter, is not also the first world's foremost shoe exporter.[28] This is merely one of many examples of a poorly designed economic system that explains Argentina's relative decline.

Another industry constantly discriminated against under the present economic system is the capital goods industry, which makes intensive use of engineers and technicians. Argentina produces an abundant supply of such specialists at salaries one-fifth of those paid in the United States or Western Europe. It is therefore obvious that a real devaluation of 60 percent would make qualified labor, essential to the capital goods industry, extraordinarily inexpensive by further lowering its price in dollars. The capital goods industry should thus develop a very strong export capability, as has Korea, for instance. One of the great advantages of exporting capital goods is the fact that,

owing to the widespread economic policy errors in most developing countries, these goods enjoy a lower tariff than other types of products.

Fostering industry through the exchange rate has the obvious advantage of not only encouraging efficient import substitution, but simultaneously promoting exports without having to resort to subsidies—an extremely important point, for subsidies to industrial exports are illegal.[29]

Under the GATT, to which Argentina subscribes, subsidies are subject to a variety of retaliatory measures and countervailing duties. If industry is protected with the appropriate exchange rate, resource allocation improves, since it tends to promote the equalization of export and import substitution incentives at the margin, as Bhawati emphasizes in his above-mentioned book. Of course, by promoting exports the new exchange rate will facilitate the generation of foreign exchange, and the abundant availability of foreign exchange, in turn, will make it possible to lift all restrictions on imports. This is essential, for should an industrialist need a part to assemble his export product and, owing to the arbitrary ruling of a public official, the necessary import permit is denied, it may well be that both the entrepreneur and the country will lose an export contract worth millions of dollars. To be consistent with the export philosophy, Argentina's entire interventionist government apparatus vis-à-vis imports must literally be dismantled, except where it is used to press for the opening of markets to the country's exports. This will eliminate current wasteful public expenditures and dry up the undeserved income of individuals who exploit the public through high tariffs or import bans on products similar to those they produce, so that they can sell theirs in the local market at exorbitant prices. By eliminating income derived from privilege, the proposed economic system will encourage initiative in a country that has been unfairly debased over the last 40 years by a poorly designed "industrial promotion system" that favors only a few special and antisocial interests.

The Advantages of a Manufacturing Devaluation

Without claiming to provide an exhaustive list and at the risk of seeming repetitious, I can easily give eight key advantages of a manufacturing devaluation—that is, a devaluation accompanied by increased export taxes for agricultural products with inelastic world demand and by the elimination of import restrictions.

1. Elimination of Unutilized Capacity in the Industrial Sector and the Use of Economies of Scale

The small size of the internal market is recognizably one of the most influential factors in increasing industrial production costs in Argentina. Thus, a devaluation for industry alone would not only reduce the dollar costs of exportable production, but allow for a drop in the fixed cost per unit of output by permitting greater capacity utilization.

Due to Argentina's current recession, unutilized industrial capacity is about 40 to 50 percent. Since the considerable restrictions on imported inputs would be removed with a devaluation, unutilized capacity could be eliminated, inducing a rapid growth of the country's nontraditional exports. Furthermore, when planning future investments, Argentine businessmen would now take into account the fact that the domestic market would constitute one-half half to one-third of their market and the external market the other half or two-thirds; thus there would be significant additional cost reductions owing to greater efficiency and economies of scale.[30]

2. Elimination of the Foreign Exchange Scarcity

As stated previously, one of the reasons for Argentina's stagnation is the country's chronic and cyclical balance of payments crisis, which occurred in 1949, 1952, 1959, 1963, 1975, and again from 1982 to 1985. The most recent crisis is also linked to the failure of the present system of import substitution, sinecures, and currency overvaluation. Argentina's overwhelming comparative advantage in grain and beef exports combined with heavy world agricultural protectionism generates an inelastic supply of foreign exchange. This leads to currency

overvaluation (why devalue if the dollar amount of traditional exports will not increase much?). A simplistic and erroneous solution to this problem is to protect the consumer goods industry with tariffs and trade restrictions and to import inputs and capital goods at an overvalued exchange rate. Since traditional exports do not expand rapidly, time and again the country comes up against the scarcity of foreign exchange constraint on imports of inputs and capital goods, because the manufacturing sector, which makes heavy use of foreign exchange, requires a growing supply of imported inputs. Thus, recessions are necessary to adjust the balance of payments; they have occurred six times in the past 35 years and are one of the reasons why the system is now exhausted.

With a compensated devaluation the industrial sector could generate its own foreign exchange, and the system would provide the correct price signal. Thus the use of domestically produced raw materials and capital goods would be accompanied by total foreign exchange availability in cases where industrialists have to import parts that the country cannot produce at reasonable prices. This approach would cure the industrial sector's addiction to imported inputs.[31]

3. Tax Increases and Reducing Duplication of Government Operations

With a compensated devaluation system Argentina can collect some U.S. $2 billion in duties on traditional exports, assuming an average tax rate of 40 percent. Moreover, an additional $1 billion could be collected in import taxes through a uniform tariff of 20 percent on all products. From this additional $3 billion in revenues, $1 billion must be subtracted—$0.4 billion deriving from existing export taxes and $0.6 billion in revenue from current import duties that would be eliminated. The remaining $2 billion would amount to 4.5 percent of GDP at the new parity proposed in this study. Furthermore, major savings could be achieved through the elimination of needless expenditures i.e., $0.2 billion in export subsidies and, an additional $0.2 billion in government funds misused in administering an obsolete bureaucratic system. Although detailed figures were not available during the

preparation of this book, it can be estimated that another 3 percent of GDP could be saved through the elimination of the "industrial promotion" system that currently undercuts Argentina's economy. In other words, by increasing revenue and eliminating expenditures it would be possible to reduce the fiscal deficit by more than 7 percent of GDP. Some of the revenue would be transferred from the present beneficiaries of tax exemptions, import permits, and other special arrangements to the treasury; the only "rentier" or "tax collector" under the proposed system would be the government.

4. Elimination of Corruption

Another advantage of the policy proposal presented here is that it eliminates inequities or reduces them to a minimum. Wealth would be amassed as the result of hard work and intelligence rather than government favors. Landowners and the wealthy would thus be more highly regarded, and constitutional property rights could be accorded due respect. To render property and proprietors respectable, however, it is necessary to liquidate illegitimate incomes deriving from the state interventionist apparatus, where import permits, commissions on large contracts by state enterprises, credits and debits in the account of monetary regulation, Central Bank swaps and insurance exchanges can be and are used for amassing undeserved fortunes. The moral restoration thus brought about, and the productive energy released, could be the most powerful forces leading to a rapid revival of the economic, political, and ethical health of Argentina.

5. Increase in Labor Demand and Real Wages

With the real exchange rate proposed, the industrial sector would see excellent opportunities for exporting. The anticipated rate of profit for industrial enterprises would climb sharply. In Keynesian terminology the "marginal efficiency of capital" would increase, and industrial exporters would immediately demand more labor, since the demand for labor is derived from the demand for final products. Increasing the latter through devaluation will also increase the former. Moreover, the additional labor demand will be a powerful force in driving up real wages.

This will occur slowly at first, for the industrial sector must absorb a great deal of unproductive labor from the public sector. This method of raising real salaries at a rate of 2, 3, or 4 percent a year, although moderate, is the only viable one. It is well known that the demand for labor curve is, in fact, the marginal productivity of labor. Real wages will rise under this proposal—not by fiat, only to be erased the next month by an increase in inflation, but by the displacement of the marginal productivity curve of labor to the right. These salary increases, though modest at the beginning, will permit workers' real consumption to double in ten years.

In Argentina there is a general belief that it is possible to increase wages by fiat. This belief ignores basic economics. Wage increases by fiat also raise production costs and therefore tend to move the global supply curve of the economy to the left, generating underemployment—except where salary increases are ratified by credit expansion, in which case a powerful inflationary force will be unleashed, quickly erasing the nominal wage increase. While it is true that monetary inflation could be alleviated to the extent that there are monetary reserves in the Central Bank or external credits available to finance wage increases with increases in imports, this would merely postpone the problem by creating adjustment difficulties and a drop in real salaries later on. If the government resorts to price controls to protect real wages, then investment, the engine of growth, will disappear, and with it future growth and future increments in real wages. Indeed, at some point a decline in those wages will take place.

Wage increases must come from increases in the demand for labor by enterprises. Business will demand more labor if it has a growing market for products and can substitute labor for capital, since the cost of labor is low compared to that of capital. After the compensated devaluation proposed here, imports of labor-saving capital goods would become too expensive. Since there would be absolute freedom to import, it would be appropriate to disaggregate investment packages and import some specific capital goods parts in cases where locally produced items are too expensive. Since on the other hand labor costs in dollars would shrink by 60 percent,[32] entrepreneurs would see

the advantage of employing more labor instead of using expensive machinery. If they purchased locally made equipment, the machinery would not be especially designed to save labor, which is not expensive. Rather, it would help raise the productivity of local labor. In sum, the demand for labor would increase under this proposal since there would be an increase in the demand for the final product, while imports of capital would be replaced with local labor.

Countries that pursue the strategy of exporting labor-intensive manufactures demonstrate the most egalitarian income distribution possible in the capitalistic developing countries. In Korea and Taiwan, for example, 5.7 percent of the national income corresponds to the poorest 20 percent of the population, compared to 4 percent or even less in present day Argentina.[33]

6. Revitalization of the Provincial Economies

Since an exchange rate devaluation would raise the price of imported raw materials, entrepreneurs would seek to replace them with locally produced inputs. This would affect wool and gas from Patagonia, minerals for the Andes, including its rich, untouched copper deposits, cowhide from the semi-arid zones, and oranges from Corrientes for the extraction of citrus juices for export. Under the proposed system not only would industrial exports require domestically produced raw materials, but goods from the country's interior would experience the direct impact of an external demand unknown in Argentina. The apple growers of Rio Negro and Neuquén, the bean and soybean farmers of Salta, the tomato growers of Mendoza, and the producers of countless other agricultural products would benefit enormously. Most significant, the economic development of Argentina's interior could be accomplished without artificial "industrial promotion" laws and tax exemptions. Everyone would be obliged to pay taxes but at reduced rates. In turn, the revitalization of the regional economies would bring about another round of secondary increments in labor demand, with beneficial effects first on employment, and in the longer term on real wages themselves—this time within Argentina's interior.

7. Stimulation of the Local Capital Goods Industry

One of the principal defects of Argentina's outmoded economic system is that with the present overvalued exchange rate, it is highly profitable to import capital goods through executive orders and import permits under the pretext that the country will thereby be capitalized and employment opportunities created.[34] This line of thinking contains a number of errors and simplifications that will not be examined here but are deserving of special treatment in themselves.[35] Suffice it to say that there are many contrary arguments grounded in economic theory—particularly general equilibrium economic theory. They are briefly summarized here.

- Massive imports of capital goods make it impossible to keep production costs down.
- Capital goods production makes intensive use of skilled labor, and since this by definition is much cheaper in Argentina, many capital goods would also be cheaper if produced locally. For this to be possible, however, there must be a constantly growing demand for capital goods, either for local use or export.
- Local production of capital goods adapts foreign technology to local conditions and prevents structural unemployment.
- The absence of a local capital goods industry renders the economy inflexible and incapable of responding promptly to price signals. Adjustment therefore takes a long time and has painful social consequences.
- The optimizing effects of a competitive price system on the economy are handicapped in a country that lacks a local capital goods industry.
- Technological progress, a key source of economic development, takes place primarily in the capital goods industry. Therefore, countries with economic systems designed for massive imports of capital goods will neither assimilate technology nor be able to adapt it to local production conditions.

The proposed system—a real devaluation of 60 percent with low and uniform tariffs on imports, be they consumer, intermediate or capital goods—would avoid the compounded discrimination to which Latin American countries in general, and Argentina in particular, are "naturally" subject. We in Latin America first overvalue our exchange rates, which artificially lowers the price of imports of foreign capital goods, and on top of that we provide a lower level of protection to the local capital goods industry in relation to consumer goods.

8. Reduction in the Real Interest Rate; Return of Expatriate Capital

The maintenance of an overvalued exchange rate in tandem with the state interventionist apparatus (perceived as deficient by the private sector) in a climate of high inflation and uncertainty induces Argentines to take their money out of the country and buy dollars. For domestic real estate transactions and savings alone, it is estimated that there are 3 to 5 billion "greenbacks" inside Argentina. To put a halt to capital flight, it is necessary to maintain monthly real interest rates of 15 percent in the local financial market.[36] With this usurious interest rate, investment as a percentage of GDP is scarcely 12 percent, the lowest in the country's economic history.

In contrast, with a devalued exchange rate at the appropriate level for long-term development plus fiscal austerity and a coherent monetary policy, capital flight could be arrested; and with an adequate development strategy and a buildup of confidence, capital flight could be converted to capital inflows for investment in highly profitable exporting enterprises. The Central Bank could buy up the excess supply of foreign exchange. This monetary issue backed by an increase in foreign exchange reserves would help to restore confidence. The sudden halt in inflation, described later, would substantially increase the demand for money, and as a result money issue would not be inflationary. On the contrary, it would induce a sharp drop in real interest rates in the domestic market, which would increase investment and development.[37] Once the ratio of the supply of money to gross domestic product surpasses the 15 percent limit, the steady purchase of foreign exchange by the Central Bank at

some point would begin to be an inflationary factor. To contain this, it would be necessary to implement a policy of low but positive real interest rates, together with a high anticipated rate of return on real investments (high "marginal efficiency of capital"). If this is done, a high investment rate promoting GDP growth would follow, and thus the demand for money would grow. Eventually a policy of fiscal surpluses might be necessary.

It must be clear that the exchange rate proposed here is the "equilibrium" rate, provided two factors worked for the undervaluation of the national currency: export taxes on the one hand, and the external debt on the other. If the external debt problem were eliminated by the return of the capital that had previously left the country, it would be necessary to maintain the proposed equilibrium exchange rate cum a real devaluation.[38] This could be achieved by accelerating development even further through a very tight ultraconservative fiscal policy coupled with an easy monetary policy,[39] to generate low but positive interest rates that ensure high rates of investment and imports without inflation. Argentina's underemployed human, natural, and financial resources would make this feasible.

Summary

In this chapter, the reasons for Argentina's chronic currency overvaluation are analyzed. Overvaluation is a main factor in the country's stagnation. It not only undercuts exports growth, but it generates high and uneven import protection, with further damage to the price system as an allocator of the country's material resources for growth.

Conversely, the policy of a highly devalued real exchange rate to promote export of manufactures followed by countries like Korea and Brazil was related to their growth between 1960 and 1985.

The problems emerging in Argentina due to a traditional real devaluation to promote the export of products such as meat and wheat, which have weak world markets, are also discussed. The mechanics of the internal recessionary effects of this type

Anne O. Krueger, *Exchange Rate Determination*, Cambridge University Press, Cambridge, England, 1983.

5. Carlos Díaz Alejandro, *Exchange Rate Devaluation in a Semi-industrialized Country. The Case of Argentina 1955-1962*, MIT Press, Cambridge, MA, 1965.

6. R. Mallon and J.V. Sourouille, *La Política Económica en una Sociedad Conflictiva. El Caso Argentino*, Amorrortu Editors, Buenos Aires, 1978, p. 156. Incidentally, these authors represent the gradualist-incrementalist approach as opposed to the "shock" policies proposed in this book.

7. Berlinski, op. cit.

8. A.G. Ford, op. cit., p. 235.

9. Inter alia, Domingo Cavallo, op. cit., pp. 74-75.

10. Carlos Díaz Alejandro, *Exchange Rate Devaluation.*

11. From late 1958 to June 1959, the peso was allowed to float. The same policy was in effect in March-April 1962. In neither case was it successful. Erratic and spectacular fluctuations forced the fixation of the exchange rate.

12. See, for instance, *The New York Times* and *The Wall Street Journal*, October 6 and 5 respectively, 1984.

13. Eduardo R. Conesa, *Términos*, pp. 178-179.

14. Luis María Otero Monsegur, *El Control de Cambios y la Constitución Nacional*, Emecé, Buenos Aires, 1965.

15. Under a floating exchange rate, what matters is not so much the current account as the capital account of the balance of payments, which in turn depends on expectational financial variables. See Anne O. Krueger, *Exchange Rate Determination.* Recent economic theory has developed many algebraic formulas that back up this theory. Typically, these algebraic models rest on four main premises: the quantity theory of money (MV = PQ), the direct relationship between the interest rate and velocity of money circulation [V=(1+i)^B], the so-called "covered interest parity" [E2/E1(1+i*)=1+i], and the theory of purchasing power parity (P = EP*).

16. These are optimal taxes because they optimize the price system. For a summary of economic theory on this point see Eduardo Conesa, *Términos*, p. 15. See also Harry Johnson, "Optimum Tariffs and Retaliation," *Review of Economic Studies*, 1954, vol. 21, pp. 142-53. Some economists observe that this proposal for optimal taxes ignores the principle of comparative advantage. This is definitely not the case, as demonstrated by Hollis Chenery's brilliant article, "Comparative Advantage and Development Policy," op. cit.

17. Rightly, Guido di Tella writes: "One must note development strategies like the Japanese one, based on industrial exports, based in turn on a perhaps too highly devalued currency," *La Estrategia del Desarrollo Indirecto*, Paidos, Buenos Aires, 1973, p. 115. It must be remembered that in the last 12 years Japan has revalued the yen. The revaluations are more apparent than real, however, because productivity growth in Japanese industry is greater than currency revaluation, which at best parallels productivity growth. See IMF, *Issues in the Assessment of the Exchange Rates of Industrial Countries*, Washington, DC, July 1984. Here is the second Japanese "secret" (the first is the competence in public office mentioned in Chapter I). There is no Japanese "miracle," because productivity growth feeds on the support to the capital goods industry and local engineering that is implicit in the devalued exchange rate and the heavy human investment in scientific education. On the importance of a local capital goods industry in order to create a local demand for engineers, see Eduardo R. Conesa, "Teoría Económica y Substitución de Importaciones," *Integración Latinoamericana*. July 1984.

18. Anne O. Krueger, *Liberalization Attempts and Consequences*, and Jagdish Bhawati, *Anatomy and Consequences of Exchange Control Regimes*, both Ballinger Publishing Co., Cambridge, MA, 1978.

19. World Bank, *World Development Report 1984*, Washington, DC.

20. Anne O. Krueger, *Liberalization*, pp. 281-2.

21. Jagdish Bahawati, op. cit., p. 209.

22. For example, Jan M.D. Little, *Economic Development*, Basic Books, New York, 1982, p. 136, and M. Gillis, et

al., *Economics of Development*, Norton and Co., New York, 1983, p. 453.

23. World Bank, *World Development Report 1979*, Washington, DC. p. 58.

24. Bela Balassa, *Policy Reform in Developing Countries*, Pergamon Press, New York, 1977, p. 26.

25. William R. Cline, *Exports of Manufactures from Dveloping Countries*, The Brookings Institution, Washington, DC, 1984, p. 204. Cline makes this calculation using the parameters of Hollis Chenery and Moses Syrquin in *Patterns of Development 1950-1970*, Oxford University Press, London, 1975.

26. William Cline, op. cit., p. 134.

27. Julio Berlinski, op. cit.

28. Guido di Tella in *La Estrategia*, p. 41, says, "It seems a real crime that Argentina does not control the world market for this item."

29. See Articles 9 and 14 of the GATT Code of Subsidies, Basic Instruments and Selected Documents, 26th Supplement, Protocols, Decisions, Reports 1978-1979, 35th session, Geneva, 1979. See also Gary Clyde and Joanna Shelton Erb, *Subsidies in International Trade*, MIT Press, Cambridge, MA, 1984.

30. Anne O. Krueger, *Liberalization*, p. 286. See also William Cline, "Economics of Scale and Economic Integration in Latin America," in *Terms of Trade and the Optimum Tariff in Latin America*, José Núñez del Arco and Eduardo R. Conesa, editors, Institute for Latin American Integration and Inter-American Development Bank, Washington, DC, 1984.

31. Eduardo R. Conesa, "Teoría Económica y Sustitución de Importaciones: Su Reconciliación," in *Integración Latinoamericana*, July 1984. See also *Términos*, p. 181.

32. However, the purchasing power of salaries in local currency will be maintained, due to the export taxes on food and the existence of many goods and services that are not tradeable internationally and whose price therefore depends not on the exchange rate but on local supply and demand.

33. World Bank, *Informe sobre el Desarrollo Mundial*, Washington, DC, 1984, p. 305. See also John C.H. Fei, Gustav Ranis, and Shirley W.Y. Kuo, *Growth with Equity: The Taiwan Case*, Oxford University Press, New York, 1979.

34. See, for example, *Lineamientos para una Estrategia de Desarrollo Económico*, Secretaría de Planificación, Buenos Aires, 1985, p. 65.

35. Eduardo Conesa, "Teoría Económica," op. cit. Incidentally, the "desarrollismo" economic approach supported by former President Arturo Frondizi emphasizes the steel, petrochemical, and capital goods industries as the basis for development. My article gives very specific reasons why only the local capital goods industry has characteristics that make it essential for development. Moreover, this industry does not need promotion by executive fiat; it must simply be free of the consistent discrimination it has suffered under Argentina's economic system for the past 50 years.

36. The short-term market rate when this study was finished in May 1985.

37. Remember the "covered interest parity" expressed by the well-known formula, $E2/E1(1 + i^*) = 1 + i$, where E1 is the present exchange rate, E2 is the future anticipated exchange rate, i^* is the interest rate in the international capital market, and i is the domestic interest rate. With an overvalued exchange rate, expectations of a devaluation are great. As a result, E2 will be greater than E1, and therefore the international interest rate i^* will be lower than the domestic interest rate i. If, through a strong devaluation followed by an austere fiscal policy, it is possible to convince the public that E2 will be equal to E1, it is clear that i^* must necessarily be equal to i.

38. It would be a good idea to avoid what W.M. Corden calls "exchange rate protection." See *The International Monetary System under Flexible Exchange Rates*, Richard Cooper et al., editors, Ballinger Publishing Co., Cambridge, MA, 1982, p. 17.

39. Robert Mundell, *International Economics*, McMillan, New York, 1968, chapters 8, 14, 15, and especially the brilliant 16, "The Appropriate Use of Monetary and Fiscal Policy under Fixed Exchange Rate."

4
Government Finances and the Exchange Rate

The Need for Fiscal Policy Reform

The previous chapter explained in detail the crucial importance of exchange rate policy reform if Argentina is to embark on the development path. However, the policy of a highly depreciated exchange rate cannot be maintained if it is not supported by a consistent fiscal policy. This chapter therefore outlines the features of an appropriate fiscal policy.

First, as mentioned earlier, a highly devalued exchange rate requires the enforcement of export taxes on commodities of inelastic and sluggish world demand such as beef, wheat, and corn.

Second, it requires an economy very open to import—that is, with low import duties and without import restrictions and nontariff barriers.

Third, fiscal deficits must be eliminated. This entails both reform of the whole federal taxation system to produce more revenue, and reform and privatization of public enterprises.

Next, to preclude the possible financing of deficits by merely printing money, the Central Bank and state banks laws must be reformed. Nor must deficits be financed through the

private internal or external capital market, because in one way or another both methods are connected with exchange rate overvaluation.

These elements of a sound fiscal policy to accompany the new exchange rate are discussed below.

In Defense of Export Taxes

Although many economists in Argentina propose a federal land tax instead,[1] high export taxes on meat, wheat, and corn are essential to growth. They tend to optimize the price system as the instrument for achieving the best allocation of resources and the fastest economic growth; they promote a more progressive income distribution; and as the key to a highly devalued exchange rate, they allow for the dismantling of the present machinery marked by protectionism, interventionism, and inequality.

Export taxes provide support for the new equilibrium exchange rate. The export tax to a large extent is not a tax but a kind of balancing charge for the traditional export sector: it compensates in part for the new equilibrium exchange rate, which is more devalued than the theoretical free trade rate that would emerge from the play of supply and demand in a market absolutely free of any tax restrictions. It must be remembered that for reasons related to general equilibrium, export taxes are consistent with a devalued exchange rate, as import duties are consistent with an overvalued exchange rate. It is curious to note that advocates of traditional export sector interests bitterly oppose export taxes, but overlook import duties, which, due to the currency overvaluation they cause, have the same effect.[2]

Without optimal export taxes on products with inelastic world demand, a free trade equilibrium exchange rate would adversely affect the optimizing properties of the price system. Agricultural producers would be encouraged to increase their exports substantially, and after three or four years would see the price of wheat, corn, beef, etc., fall in the face of the larger export volumes. Many farmers would go bankrupt.[3] Paradoxically, export taxes are the farmers' best defense, for they will encourage the right investment decisions. And while export

taxes would be high for beef, hides, corn, and wheat, they would be nil for soybeans and other agricultural products where there is a worldwide free trade system that allows the country to compete legally and openly in world markets, displacing other countries (see Chapter 2), or where Argentina's participation in world markets is less than 1 percent. Argentina's agricultural sector would therefore earn more than under the present system.

High export taxes on the products that make up the typical consumer basket keep food prices in the domestic market low. Without export taxes, a real devaluation of the magnitude proposed is politically and economically unfeasible. It must be recalled that only 13 percent of Argentina's work force depends on agriculture, while 87 percent is dependent on industry and services. Export taxes are thus in the majority interest if they improve resource allocation and growth.

The classical aftermath of a devaluation in Argentina is economic recession. Export taxes would serve to maintain real wages and urban income—and therefore purchasing power for locally produced manufactures, thus avoiding economic recession. Levied to produce government revenues of U.S. $2 billion (see Chapter 3),[4] export taxes could help eliminate the budget deficit and inflation and stabilize the economy.

In Defense of Low and Uniform Import Taxes

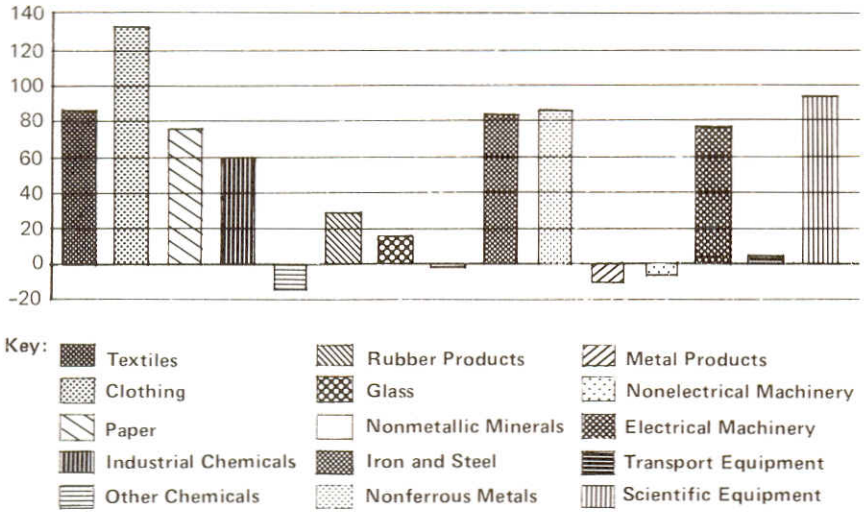
Adam Smith considered work the true source of wealth. In his view, producers, industrialists, and merchants—in sum, those who control the economic system—when attempting to obtain the greatest benefit for their own enterprises, as if guided by an "invisible hand"[5] act to maximize the benefits for society as a whole. For example, if shoe prices are high, the shoemaker increases production by hiring more people, and thereby earns more money; at the same time, he satisfies a market need demonstrated by the high market price. The increased supply generated by his actions and those of his competitors will provoke a drop in shoe prices, to the benefit of the consumer. Thus, the interests of the individual and society coincide.

Smith's "invisible hand" is actually the competitive price system itself. For the price system to work well, distortions

must be eliminated. The major source of the existing distortions in Argentina's economic system is foreign trade regulation: uneven import tariffs (see Graph 8 for variations of effective protection across products and sectors), foreign exchange and import permits, and the entire interventionist apparatus surrounding the entry of different products into the country. Clearly the "invisible hand" must be made to work, and price distortions must be attacked at their roots.

Graph 8

Present System of Import Tariffs
(Effective Protection in Percentage of International Price)



Source: Julio Berlinski, *Tariff Protection of Selected Activities in Argentinian Manufacturing Industry,* Ministry of Economics of Argentina, Buenos Aires, 1977.

Import duties should be low, and they should be uniform, just as export duties must be nonuniform. The reason is obvious: Argentina has no oligopoly power over her imports, unlike over her exports. With a high tariff on imports of a given good, it is more profitable to produce that product than goods with a lower tariff. As a result, more resources, capital and labor, will be allocated to that product than would be under

a system of tariff equality. Since resources are limited, fewer are channeled to less protected industries. The visible hand of the legislator or public official who establishes arbitrary tariffs to satisfy assorted pressure groups and political interests generates heavy welfare losses that are borne by the population as a whole.

Tariffs should be uniform not only from port to port but also from good to good. It is not so clear, however, that equal tariffs should be applied from good to good. Many Argentines ask why, if the industrialized countries, whose economic policies are presumably more enlightened, employ tariffs that vary from product to product, why not Argentina? The answer is that the abuse of tariff dispersion (see Graph 8) must be halted. And, although tariffs in the industrialized nations vary, import duties for industrial goods are generally under 10 percent, and the differences are therefore almost irrelevant—far smaller than in Argentina and other LDCs in Latin America and elsewhere.

Thus, in Argentina imports of shoes, for instance, must be subject to the same tariff as imports of textiles and steel.[6] Congress, of course, can always make exceptions, but these must be justified on the grounds of either welfare or development economics, that is, by rational argument.

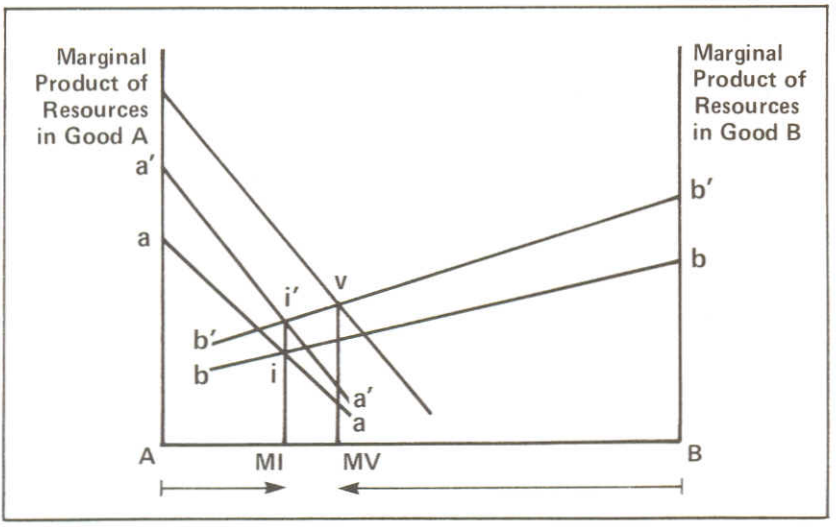
Chile successfully established a uniform tariff of 10 percent; it is now 20 percent. From 1975 to 1979 and from 1983 to 1989, Chile experienced a strong economic recovery characterized by high employment and growth rates, owing to an undervalued exchange rate and an implicit optimal export tax on copper—implicit because copper is exported by the CODELCO state enterprise, and its earnings therefore revert to the treasury, making them the equivalent of an optimal export tax. The country prospered except during the period 1980-83 when the government made the mistake of overvaluing the country's currency, which wiped out the economic progress of previous years.[7]

Uniform Tariffs and the Invisible Hand

Graph 9, developed by William Cline,[8] is useful in demonstrating the inefficiency of nonuniform tariffs. For simplification, it is assumed that there are two goods, A and B, that the resources available are allocated entirely to the production of both, and that any point on the horizontal axis represents the amount of resources assigned to the production of each of these goods. Thus, at point MI, AMI of total resources is dedicated to the production of good A, and BMI of total resources to the production of good B. The vertical axis represents the marginal productivity of the resources allocated to each good. Line aa shows that the marginal product of resources allocated to the manufacture of good A decreases when the resources designated for its production increase. Line bb shows a similar decline when the resources allocated to good B are increased. Obviously, the downward slope in both cases represents the law of diminishing returns, implying that at least one factor of production is not mobile.

Graph 9

Invisible vs. Visible Hand in the Allocation of Resources



MI = Invisible Hand
MV = Visible Hand

Source: William Cline, "Negotiating Strategy for Latin American Integration," in *Terms of Trade and the Optimum Tariff in Latin America,* Inter-American Development Bank, Washington, DC, 1964.

The optimum allocation of resources is point i, where the marginal productivity of resources employed in the production of each good is equal. To the left of i, marginal productivity, aa, is greater than mariginal productivity, bb, indicating that society could improve its welfare by withdrawing resources from the production of B for allocation to A. If a uniform import tax is introduced, the marginal productivity schedules for both goods increase in proportion to the ad valorem tax toward a′a′ and b′b′. Again, these new marginal productivity curves intersect at point i′. The new equilibrium allocation at this point implies the same allocation of resources between these two sectors as under the invisible hand at point MI. In other words, under the assumptions employed here, uniform tariffs do not distort the allocation of resources between the productive sectors A and B. They do not alter the workings of the invisible hand. On the contrary, it is quite likely that a higher tariff on product A will increase the marginal product in monetary terms for entrepreneurs, resulting in greater resources for the production of A and fewer for B and thus altering the allocation of i and i′. The new resource allocation is indicated by point v, and in the axis AB by point MV: the visible hand of public servants has altered the workings of the invisible hand implicit in the principles of uniform tariffs, free trade, and the general welfare.

Reducing Fiscal Deficits Through Reforms in the Taxation System

Economic policymakers in Argentina frequently ignore the concept of the elasticity of the fiscal system. Taxes are increased, new taxes imposed, or recessionary orthodox adjustment programs undertaken, without regard for the fact that enterprises faced with a decline in sales owing to a recession immediately reduce tax payments in one way or another. Thus, the surest way to shrink tax revenues is through a recession. This is basic macroeconomics.[9]

In contrast, the simplest way to augment fiscal revenues and reduce the government deficit is to increase production

while decreasing public expenditures. Although no precise figures on the elasticity of Argentina's fiscal system are available (or this author is unaware of them), some studies on the ratio between the growth of revenues from each tax and GDP growth point to an elasticity of greater than 1, meaning that when GDP increases by 1 percent, tax revenues increase by more than 1 percent. This is particularly true for the provincial turnover tax, which shows the highest elasticity, followed in descending order by the fuel tax, the sales tax (later replaced by the VAT), the provincial real estate tax, and import duties.

The conclusion to be drawn is extremely significant: to reduce its fiscal deficit Argentina must undertake a program that promotes economic growth, and above all the expansion of the industrial sector, while at the same time reducing public expenditure, or at the very least freezing it at current levels.

Elimination of Tax Holidays for Industrial Promotion

Argentina makes extensive use of tax holidays to increase the profitability of industry and thus industrial investments and growth. Tax holidays are simply tax exemptions conceded to specific enterprises and enforced by presidential decree, for the purpose of increasing the profits on investments to be made by those enterprises. The prospect of increased profit acts as an inducement to the entrepreneur to carry out those investments. These policies are ill conceived: they reduce fiscal revenues and they do not induce industrial investments on the whole, but only in the specific projects favored.

In order to increase tax revenues and reduce public expenditure, all tax exemptions for "industrial promotion" must be eliminated. Argentine and other tax experts question the appropriateness and efficiency of tax holidays for industrial "promotion,"[10] for they distort the allocation of resources, or the investment "promoted" would occur in any case. The key determinants in investment decisions are the stability and coherence of the economic system, the size and growth of the market, the availability of raw materials and qualified personnel, the quality of the infrastructure, and the government's general attitude toward investors. A positive attitude on the part of the government is reflected in a low rate of taxation, strict

enforcement of fiscal legislation, and no exemptions. Studies in Argentina point to a fiscal loss of around 3 percent of GDP a year due to tax holidays[11] a reasonable figure, since too many firms enjoy exemptions of this type.

Industrial promotion, as Juan Bautista Alberdi saw it, should come about through improvements in the quality of the industrial labor force by enhancement of the educational system. Better-educated workers are more productive. Greater productivity translates into lower production costs, larger profits, and thus further inducements for industrial investments and growth. The provincial governments have the responsibility of providing primary education and the federal government that of developing and supporting secondary and university instruction.[12] These functions of government must be reinforced. Interestingly enough, this conclusion, drawn in 1854, seems to be in line with modern studies in 1984. Richard Nelson[13] says,

> Over the long run improving the teaching of science and mathematics in primary and secondary schools may be more important in preserving the American lead in the high technology industries of the future than creating specific programs aimed at a narrow front of our high-technology industries today.

It should be stressed that a supply of technicians, however, is not enough. Demand for technicians stems chiefly from the capital goods industry, which has been constantly discriminated against in Argentina. The system proposed here offers a solution on the demand side as well.

Tax Evasion and the VAT

Argentina's fiscal system suffers greatly from tax evasion, particularly with regard to the value added tax (VAT) and the personal income tax. More than one million registered taxpayers are subject to the VAT, although only half a million submit their forms to the IRS, and of the total revenue, 30 percent is collected when goods pass through customs. Some 15,000 taxpayers account for 70 percent of tax revenues, discounting the duties paid at customs. The extra profits and the resulting industrial expansion enjoyed by tax evaders work to the

detriment of those who do pay, creating a strong disincentive for taxpayers to comply with the law. If the government lacks the energy and courage to collect taxes impartially, it is implicitly inviting tax evasion. Thus evasion may persist despite the efforts of Argentina's IRS, and this could mean that the VAT is not the most appropriate tax for Argentina.[14]

One factor that appears to encourage tax evasion is the tax rate. Already reduced from 20 to 18 percent, it is still too high; a much lower tax rate has proven far more effective. A case in point is the provincial turnover tax, which—with 2.5 percent as a general rate, 1.5 percent for manufacturing, and 1 percent for primary products—brings in 50 percent of the revenue collected by the VAT. Obviously, there is a complex issue of efficiency and justice here. Tax theorists generally defend the VAT because of its neutrality and its limited distortional effects. On the other hand, they attack the turnover tax, because it keeps increasing at a compound interest through successive sales as the merchandise passes from the primary stages of production to the secondary and tertiary. Clearly, the turnover tax favors the vertical integration of production as a legal means of reducing taxation and the consequent "compound interest," encouraging manufacturers of raw materials to merge with manufacturers of finished goods.

One of the largest distortions in Argentina's economy is precisely the excessive horizontal expansion of economic activity: too many types of consumer goods in relation to intermediate and capital goods. The turnover tax would have a positive effect, for it would work against this distortion, which is due to high import duties on consumer durables accompanied by tax exemptions and low tariffs on imports of intermediate and capital goods. In comparison, the distortion stemming from a turnover tax would be relatively minor. Furthermore, in view of the high degree of compliance with this tax, it would appear wise to establish a kind of simple, minimum nationwide sales tax, having as few exemptions as the turnover tax. This might produce more revenue than the present VAT, and if compliance were universal, the ethical benefits would spread throughout the system as a whole.

Personal Income Tax, the Return of Lost Capital, and Corporate Income Taxes

Although the personal income tax is fair, various practical, economic, and ethical considerations call for its modification. First of all, the tax in reality is largely symbolic because of its low yield (a mere 2 percent of total tax revenues), while the cost of monitoring and collecting it is high. Although there are more than 1,800,000 registered taxpayers and 250,000 businesses, the number of real taxpayers is insignificant. In fact, with the spectacular growth of the world financial markets in the last 20 years and the ease of communications among nations, the personal income tax is becoming obsolete, since it is easy to evade and difficult to monitor.

Part of the problem with the personal income tax stems from low growth, inflation, and economic instability in Argentina, which have provoked the flight of capital. Low growth means a low rate of return on real investments. The uncertainties generated by the 30 percent monthly inflation invites the public—even those who are outspoken about the need to pay taxes—to purchase dollars or somehow send money abroad, where positive real interest is offered, at least up to now, at no risk.

Argentina taxes patrimonial increments as if they were income. This feature of the income tax should be abolished for at least ten years and perhaps indefinitely. Such a tax seems anachronistic and pretentious in Argentina, where compliance with the income tax is low. (Indeed, even the United States, where the degree of compliance with the income tax is among the highest in the world, does not tax increments in net worth as such). Expatriated capital is unlikely to return if it is to be taxed when declared as income upon re-entry. Under such conditions, it would be impossible for Argentina to recover its lost capital, which is by no means an insignificant amount; estimates of capital flight in Argentina are around $20 billion,[15] with some as high as nearly $30 billion. The return of this capital could in itself be a factor in promoting economic growth. The external debt problem would be resolved: Argentina has not so much a debt problem as a capital flight problem stemming

from seriously deficient economic growth policies and political uncertainty.

As part of tax reform, the tax on corporate income must also be tightened, chiefly because foreign enterprises can deduct taxes paid in Argentina from the taxes paid in their mother country. The elimination of the corporate income tax would result in a transfer of funds from Argentina's treasury to that of generally more rich and powerful nations—clearly an absurdity. The tax rate, however, should not exceed 30-35 percent on net profits, in line with the recent bill presented by President Ronald Reagan to the U.S. Congress. Taxes on corporate profits will in no way interfere with the repatriation of Argentine capital, for it is one thing to be obliged to pay a tax on profits in the future and quite another to be taxed on a presumed patrimonial increment verified by the mere fact of the money re-entering the country. In addition, to prevent Argentina's enterprises from relocating to countries that have no corporate income tax, a law taxing such foreign income as if it were of native origin would be necessary; or tax treaties with neighboring countries would have to be negotiated.

Reforming the Social Security Tax and Increasing Labor's Share of the National Income

An important source of the fiscal deficit is the increasing deficit of the social security system. To reduce the latter, some structural reforms are necessary. To attempt the large-scale redistribution of income from the rich to the poor through the personal income tax is utopian. The three practical ways to redistribute income in Argentina today are through a) export taxes, b) increased demand for labor for the export of labor-intensive manufactures, and c) reductions in the social security tax. The most effective way to increase labor's share of GDP is to reduce taxes and other salary deductions that currently absorb more than 50 percent of the laborer's return, which would imply replacing these taxes with a less regressive way of financing social security.

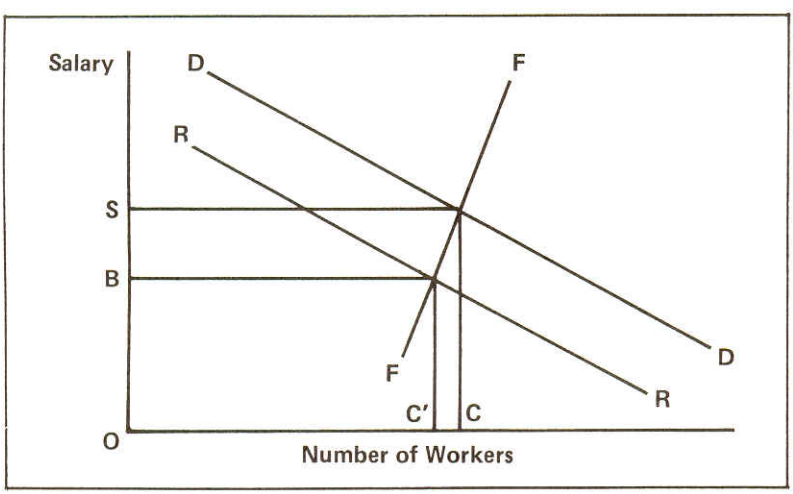
Economic theory holds that the demand for labor is determined by the curve representing the marginal product of labor (DD in Graph 10). This principle was unknown to the

designers of Argentina's social legislation 40 or 50 years ago, and thus, social legislation has been financed through taxes or charges that in the final analysis are paid by the workers themselves.

Entrepreneurs hire workers as long as labor costs (take-home pay + taxes and charges for financing social security) are lower than the marginal product of the worker under consideration for hire. Graph 10 presents the supply and demand schedules for labor. Labor costs and take-home pay are on the ordinate axis and the number of workers demanded on the abscissa axis. It is thus possible to see how social security costs, determined by the vertical distance between curves DD and RR, not only reduce the take-home pay of workers by the distance SB,[16] but also decrease employment from C to C′—both situations representing a disaster for labor.

Graph 10

Social Security Taxes: Take-Home Pay and Unemployment



Conversely, as stated earlier, a decrease in social security taxes would simultaneously increase workers' take-home pay and employment opportunities. Since the system is already in crisis (see Table 3), there is an urgent need to find some other source of funding to sustain and improve the current level of social

services. One alternative will be suggested further on in this chapter under the heading "Privatization: Distribution of Shares to the User." Other possibilities are indirect levies, such as taxes on gross income or value added taxes, to replace the payroll tax.[17] With their take-home salaries increased and freed up by the abrogation of payroll taxes, workers would voluntarily save part of their additional income, which, through insurance companies and diverse associations, could be channeled toward capital formation, and toward increased retirement benefits for those willing to make the additional savings.

TABLE 3

THE CRISIS IN THE PRESENT RETIREMENT SYSTEM

Year	Economically Active Population	Retirees	Percentage of Retirees
1960	8,125,000	929,600	11.44
1970	9,430,000	1,662,300	17.63
1975	10,179,000	2,047,500	20.11
1980	10,703,000	2,832,300	26.46
1983	11,028,000	3,200,000*	29.90

*Estimate

Source: *El Gasto Publico en la Argentina*, Fundacion de Investigaciones Económicas Latinoamericanas (FIEL), Buenos Aires, 1984, pp. 81-82.

Improved Tax Administration

A further important step that must be taken with regard to Argentina's tax system is administrative improvement. In view of the lack of compliance with the tax laws, tax rates must be reduced and reforms undertaken that promote strict enforcement. There is room for considerable administrative improvement, starting with better coordination between federal and provincial tax offices. This implies cooperation between the

federal Internal Revenue Service and the customs office on the one hand, and the provincial tax administrators on the other, with computerized checking, uniform taxpayer identification, and current tax accounts. There must be more efficient use of personnel in the federal tax offices. For instance, the IRS has about 9,800 employees and the customs office 3,500. With the proposed uniform tariff on imports, customs would need a staff of just 2,000, allowing the remaining 1,500 to be transferred to the IRS, where tax evasion is a very serious problem.

Fiscal Collection Delays and Inflation: The Vicious Circle

Under conditions of high inflation, Argentina's tax system generates enormous losses in fiscal revenue when measured in real terms. On the average there is a 40-day delay between the taxable transaction and the effective payment of the tax; with tax inflation at 30 percent a month, the government is losing one-third of its fiscal revenue to inflation. Moreover, lower tax revenues in real terms induce the government to issue additional money to cover the larger deficit. This produces greater inflation, with a further deterioration in tax revenues. Thus, in early 1985, Argentina became caught up in a dangerous vicious circle. If inflation could be drastically reduced, the real value of fiscal revenues would increase; this in turn would diminish the deficit and then reduce monetary issue, which would be reflected in greater price stability. Stable prices would favor further real increases in fiscal revenues, allowing for greater decreases in the fiscal deficit, and so forth. This would represent the "virtuous" circle.

If the vicious circle could be broken, it should be possible to solve the country's economic problems. As with a jigsaw puzzle, it requires a great deal of thought to make the right moves at first, but once this is accomplished, the remaining pieces fall into place. That is why this book is optimistic about the difficulties confronting Argentina's economy—the opinions of economists and the general public notwithstanding. With the measures proposed here, the national budget will be balanced and inflation halted. If this still does not occur, three possibilities remain: a reduction in government salaries or personnel, external financing of the deficit, or privatizing public

enterprises; or a combination of the three. In an expanding economy, the transfer of personnel from the public to the private sector would not be painful. On the contrary, it would be advantageous for public employees because of the larger remuneration that the private sector would offer.

Reducing Fiscal Deficits Through Privatization of State Enterprises

The government's main function in stimulating development is to set the major macroeconomic prices at the appropriate levels. An adequately devalued exchange rate promotes exports of manufactures and industry as a whole, and this exchange rate is consistent with low but positive interest rates that encourage investment. Once the function of providing the basic price framework, including the wages for unskilled labor and the related domestic food prices, is fulfilled through taxation and fiscal and monetary policy, it remains for the government to provide for the national defense, domestic security, education, health, social security, and the administration of justice. These government functions are essential if the private sector is to bring about the country's economic development directly. Yet in contrast to this concept of limited government, Argentina's federal government currently spends 38 percent of the national budget on "economic development," mainly through state enterprises.

A great deal of the public expenditure for "economic development" must be borne by the private sector. However, with the high real interest rates, inflation, and the revalued exchange rates of the past few years, the private sector is not profitable, and thus enterprises increasingly pass into the orbit of the public sector to avoid bankruptcy. Three hundred fifty-three firms, including financial entities and insurance companies, have been identified as having a total or majority government shareholding. Of these, the federal government owns 125, the provincial governments 222, and municipalities six.[18]

State enterprises thus spend more than 15 percent of GDP, and have acquired greater importance than essential organs such as the federal administration, with 9 percent of GDP, all the

provincial administrations combined, representing another 9 percent of GDP, and all the municipalities (except Buenos Aires, which is like a province), accounting for only 1 percent. The social security system for its part absorbs 10 percent of GDP.[19] On top of this monstrous irregularity, public enterprise expenditures are not included in the national budget; only their deficits or the government contribution required to offset their deficits are indicated.

State enterprises constitute an impediment to a competitive economic system. Moreover, they not only produce deficits, but since they pay no taxes, the rate of taxation for private initiative in industry and commerce must be greater. As discussed earlier, when taxes are too high, taxpayers evade their obligations and the country becomes bound up in a vicious circle of fiscal deficits, inflation, and chaos.

In the patrimonial state, state enterprises cannot be isolated from petty politics. The patrimonial state confers great economic power on the President, who is the head of the federal public administration, and therefore of state enterprises. Likewise, the political bosses and their clients who administer these enterprises amass economic and political power, suffocating economic and political freedom and jeopardizing efficiency. The patrimonial state neither makes a profit nor allows private citizens to do so. State enterprises can be efficient only if a management selection system based on technical and economic excellence is established, as in the case of some European nations, Canada, and Japan.

Transferring Utilities to Their Users

The solution—and it is a radical one—is to turn enterprises over to the people who use their services. In the case of public utilities, transfer to the private sector should be simple. For enterprises not yet legally constituted as corporations, the first step from the strictly juridical viewpoint would be to secure their legal incorporation. It would then be necessary to issue the shares in amounts that would make it possible to give one share at least to each user household. In addition, each industrial user, individual or corporation, would be given shares in amounts equal to his consumption divided by the consumption

of the modal user. In the case of electricity, for instance, the service to a home should give rise to the issue of one share. An enterprise that consumes 100 times more than an average family unit should generate the issue of 100 shares to that user, and so forth.[20]

Given the size of large state enterprises, their shares cannot be sold and perhaps should not be. There is not enough local capital to purchase them, and available foreign capital is unlikely to demonstrate an interest in buying shares of such politically sensitive businesses as Argentina's public utilities. Thus the government should donate its shares of these enterprises to their clients and thus pass them to the private sector. This will necessarily prove a popular measure, since few are likely to voice opposition to a gift. Since it gives shareholders the right to vote at annual meetings, it is thus a way of generating consumer interest in the administration of these enterprises. The consumer is interested in two main factors with regard to public utilities: first, that the service is actually rendered—i.e., the telephones work—and second, that rates are as low as possible. There is only one name for the simultaneous satisfaction of these interests under the proposed system: efficiency.

When public enterprise shares are distributed to users, the law must establish rate regulations that are objective and automatically cover production costs while generating enough funds to finance the necessary investments to expand services. Many cases may require major rate increases. Of course, the main group interested in reducing rates would be the shareholder-users themselves. Because their interest coincides with the general interest, the users must take charge. Since the government will be forbidden to subsidize services, costs must necessarily be covered by rates. If rates are high, the users will be the poorer; conversely, if they are low, the users will be the richer.

If this policy were implemented, the major users would join forces to capture seats on the boards of directors and take over the leadership of these enterprises. Since the major users would be private enterprises knowledgeable about business administration, a new spirit of efficiency would be brought to

public utility administration. The best executives in the country could be hired to manage public utilities, because the roughly $1,000 a month ceiling on salaries currently in force in public administration would no longer apply. If these new popularly based but privately owned public utilities were managed by the same criteria as private enterprises, it would be possible to cut costs considerably, invest more, and establish even lower rates in the medium term, to the benefit of the population as a whole.

The State Oil and Steel Companies

Of course, there are a great many enterprises that are not precisely utilities, such as the state oil company, Yacimientos Petrolíferos Fiscales (YPF), and the Sociedad Mixta Siderúrgica Argentina (SOMISA), the steel company. How should shares be allocated to the users in these cases? For instance, one share might be given to the owner of each automobile, while the owner of a truck might receive as many shares as the horsepower of his truck is above that of an average automobile; and so forth. There is also the question of the provinces where petroleum is produced, which can be resolved by granting additional shares to residents there. This would help encourage people to live in provinces such as those of the Patagonia, whose low population density would subsequently increase. It should be easy to develop objective criteria for share distribution; many methods and indicators are possible. YPF could also be split up into four or five entities that would be easier to manage. In any case, this is a practical matter that can be resolved equitably and in the national interest.

In enterprises like SOMISA, which produces steel, an intermediate good that does not reach the final users as such, statistical indicators could be used to estimate the user consumption of the final product. Company shares could thus be turned over proportionately to the presumptive users of steel products. In this case, even the possibility of selling the shares by public auction should not be discarded if the proper macroeconomic conditions are present.

Ensuring the Success of Privatization

For the privatization process to be successful, the managers of the new popularly owned private enterprises should be carefully monitored for competence for a year or two after the first annual shareholders' meeting. If the process is conducted appropriately, the management of these enterprises could hardly fail to be far more efficient than at present. Nevertheless, three problems remain: a) what to do when the users are foreign enterprises to which it would be politically impossible to donate the shares; b) what to do when the user is the government; and d) what to do when there are no satisfactory indicators to determine the final user, and the enterprise cannot be sold by auction. In these cases, it would be possible to turn over preferred stock, with the right to vote only when there are no dividends, to a kind of trustee composed equally of representatives from the General Confederation of Labor and the various associations of entrepreneurs, after the latter have unified their representations. This procedure would generate funds to finance social security through the revenues of the preferred stock. If that stock turns out to be highly profitable due to efficient administration of the new popularly owned enterprises, social security taxes on salaries could be reduced and the distribution of national income would thus be improved.[21]

Auctioning Small Government Enterprises

In addition to the utilities and other large enterprises, federal, provincial, and municipal governments own more than 300 small enterprises, from television and radio stations to hotels and airlines, taken over to prevent bankruptcy and hence personnel layoffs.

An enterprise goes bankrupt when it generates losses instead of profits. This means that it absorbs more resources from society than it delivers. Such enterprises constitute a daily drain on the nation's wealth. Therefore, firms with a chronic deficit must be quickly dissolved and their assets transferred as soon as possible to other enterprises with the capacity to render them more productive and thus generate more income than costs. Efficient institutions for the application of bankruptcy laws are

essential in a capitalistic economic system and are one of the main reasons for capitalism's superiority over socialism, which has no quick and effective means of ridding itself of inefficient enterprises. It is therefore urgent that the government proceed to the immediate sale of all its enterprises and their assets, for this will promote the overall efficiency of the economy and may constitute an important source of fiscal revenue, chiefly in the short and medium run.

To ensure the efficacy of the transfer process, managers whose specific task is to sell these enterprises or their assets must be appointed. Sales must be conducted with ample publicity and vigorous public bidding. The requests for bids must be carefully designed to permit an easy comparison of bids and a clear adjudication of the best price, accompanied by the proper guarantees. Administrator-sellers could be renumerated with a single payment—high, but payable only after the firm and its assets have been transferred to the buyer. This would provide a strong incentive for efficiency and speed. Otherwise, experience suggests that the managers of small-scale enterprises will attempt to maximize the length of their commission, making gestures at privatization but arranging things so that it is impossible to compare bids. This leads to disputes among the various interests and winds up in judicial proceedings, and the conversion of public enterprises to private firms never takes place.

Creating Favorable Macroeconomic Conditions

It must be stressed that such conversions can be successful only in the context of an overall plan like the one proposed here; only then will there be confidence in the country's future, and will the sale of state enterprises attract expatriate capital. Unless a favorable climate for investment is created, the bids could be unacceptably low, making privatization impossible. A system of compensated devaluation to provide a strong impetus for exports of manufactures and radically reduce the fiscal deficit to zero is essential if privatization efforts are to succeed.

The Fiscal Deficit and the Printing of Money

For the past 40 years Argentina has been under the scourge of a devastating inflation that has generated insecurity and instability and provoked a sharp drop in private investment. Inflation has destroyed the price system and the exchange rate as mechanisms for the allocation of resources, transforming the economy into a kind of roulette where long-term economic projections are impossible. At the root of this inflation is excessive public expenditure financed through monetary issue. Inflation has continually accelerated, exceeding 355 percent in 1975 and surpassing the 1,000 percent mark during the first quarter of 1976. In March of that year the monthly inflation rate was 37 percent; ten years later, in May 1985, it was 30 percent—a dangerous level for the stability of the political system.

If the country is to regain economic health, confidence in its currency must be restored. The executive branch must therefore be barred from using money issue, which averaged $3,127 million per year from 1960 to 1983,[22] as a source of revenue. Incidentally, with respect to the enormous public expenditure that is incurred by the Central Bank itself through its monetary juggling, Roberto T. Alemann says:

> The Central Bank distributes funds in secrecy . . . and is capable of enriching or bankrupting individuals and enterprises from one day to the next. It acts with no budgetary control whatsoever, caving in to pressure and the political temptations of easy expenditure without public discussion or obstacles of any kind.[23]

The Central Bank must be converted from a mere government office subordinate to the executive branch to an autonomous agency governed by the forces of production and labor. It must be even more independent than the Federal Reserve system of the United States or the Bundesbank of the Federal Republic of Germany, if 40 years of inflation are to come to an end. Its officials must be responsible only to Congress and be elected by vote of the industrial, agricultural, and service sectors and labor organizations.

Prudence in Public Borrowing

If a deficit still remains, the possibility of resorting to authentic public borrowing may be explored. Such operations, however, should be contracted with foreign banks on very favorable terms with the backing of the International Monetary Fund. At present, June 1985, credit operations to finance the government under the IMF plan include loans by private banks totaling $4.2 billion, plus $1.2 billion from the Fund. As authentic types of credit operations these loans will have no inflationary impact. There should be no major difficulties in carrying out such operations at lower interest rates than at present, if they are contracted in conjunction with an economic program like the one set forth here. However, as a matter of principle, external credit should be handled restrictively, because an excessive supply of it tends to overvalue the local currency and thus to ruin the basis of the development strategy outlined in this book.

In any case, the fiscal deficit must be reduced to zero. The government and its enterprises should be prohibited from "borrowing" from the Central Bank or from the domestic capital market for a three-year period. This will allow enough time to revise the Central Bank legislation completely, making the institution entirely independent of the government. Once this action is carried out, the government could borrow domestically from the local capital market reconstructed after inflation is eliminated. However, this source of money must be used with caution, for it causes the interest rate to rise, crowding out private investment and altering the equilibrium exchange rate.[24]

Summary

This chapter outlines in some detail the supplementary fiscal policy measures necessary to keep the real devaluation of the exchange rate proposed in Chapter III. These include income tax reform to permit the return of part of Argentine expatriate capital; a considerable reduction in the interventionist state apparatus; the elimination of fiscal holidays for industrial promotion; improvements in tax administration; sale of state

enterprises; increased public utility rates to eliminate the deficits of those enterprises; the transfer of utility shares to the users; and finally, a considerable increase in real tax revenues.

It must be emphasized that the fiscal policy reform proposed in this chapter is an essential counterpart to exchange rate policy reform. Without the measures outlined in this chapter, devaluation of the exchange rate would be dissipated in the fires of more inflation, recession, and political turmoil.

NOTES

1. A federal land tax poses three difficulties: it is politically unviable; it is unconstitutional; and economically, it lacks the Pareto optimality properties of optimal export taxes. It is, however, an excellent provincial tax.

   The substitution of export taxes by a federal land tax was attempted in 1969 under the administration of General Juan Carlos Ongania and Minister Adalbert Krieger Vasena. It is also proposed by Berlinski and Schydlowsky in the joint work cited previously. These authors, however, posit a price elasticity of demand of -3.0 for traditional Argentine exports—which would call for an optimal export tax of 33 percent rather than a federal land tax.

2. See, for instance, Kenneth W. Clements and Larry A. Sjaastad, *How Protection Taxes Exporters*, Trade Policy Research Center, London, 1984.

3. Eduardo Conesa, *Términos*, pp. 28-30.

4. The idea of using export taxes as a major source of revenue was first postulated in 1967 by Minister Adalbert Krieger Vasena who, however, considered them a temporary measure. See *The 1967-69 Economic Program in Argentina*, distributed through the Institute for International Economics, Washington, DC, December 1984, p. 7. In the approach presented here, export taxes possess a permanent price optimization function, at least until world agricultural protectionism is eliminated, perhaps by the year 2000.

5. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, W. Strahan and T. Cadell, London, 1776; reprint, Clarendon Press, Oxford, 1976, p. 199

6. The uniform nominal import tariff has been supported in Argentine circles by Guido di Tella. See *La Estrategia del Desarrollo Indirecto*, p. 116.

7. Eduardo R. Conesa, "The Openness of the Latin American Southern Cone Economies," in *The Economic Integration Process of Latin America in the 1980's*, Inter-American Development Bank, Washington, DC, 1984.

8. Reaching the same conclusions regarding tariff uniformity, see also Henry Bruton, "The Import Substitution Strategy of Economic Development," *The Pakistan Development Review*, vol. 10, 1970, pp. 123-40, and John M. Power, "Import Substitution as an Industrialization Strategy," *Philippine Economic Journal*, vol. 5, 1966, pp. 167-204.

9. See, for example, Rudiger Dornbusch and Stanley Fischer, *Macroeconomics*, p. 87.

10. E.g., Richard Goode, op. cit., p. 250. See also Jorge Macón, *El Mercado de Capitales y los Incentivos Tributarios*, document presented to the XIVth Seminar on Public Finance Córdoba, Argentina, 1981.

11. The Argentine National Budget for 1983 originally pointed to .5 percent. Recent studies put it at least at 2 percent.

12. Juan Bautista Alberdi, *El Sistema Económico y Rentistico de la Confederación Argentina según su Constitution de 1853*, Edición La Tribuna Nacional, Buenos Aires, 1886, p. 176.

13. Richard Nelson, *High Technology Policies. A Five-Nation Comparison*, American Enterprise Institute, Washington, DC, 1984, p. 86.

14. An advantage of the VAT is that under international law and GATT rules, its refund to exports is not considered a subsidy. See Gary Clyde Hufbauer and Joanna Shelton Erb, *Subsidies in International Trade*, MIT Press, Cambridge, MA, 1984.

15. Morgan Guaranty Trust Co. of New York, *World Financial Markets*, February 1985, p. 9. Other estimates made by the author yield only $16 billion. See Eduardo R. Conesa, *The Flight of Capital from Latin America: Causes and Cures*, Inter-American Development Bank, Washington, DC, 1987.

16. Economic theory is not alone in reaching this conclusion; empirical research supports it too. See John A. Brittain, *The Payroll Tax for Social Security*, The Brookings Institution, Washington, DC, 1972.

17. Jorge Macon, "Financiamiento de la Seguridad Social: IVA o Contribución sobre Salarios," *Integración Latinoamericana*, No. 63, November 1983. See also INTAL, *El Impuesto al Valor Agregado en el Financiamiento de la Seguridad Social y el Proceso de Integración Latinoamericana*, unpublished manuscript, Buenos Aires, 1980.

18. Fundacion de Investigaciones Económicas Latinoamericanas (FIEL), op. cit, p. xi.

19. Fundacion de Investigaciones Económicas Latinoamericanas (FIEL), op. cit., p. 87.

20. After this book was written, Miguel de Oromí Escalada sent me his book, *La Reforma del Estado según la Constitución Nacional*, Editorial Sudamericana, Buenos Aires, 1982, where Alberdi's ideas are also highlighted. In the case of public enterprises, Oromí proposes to donate one share to each voter. His solution is a good one because of its simplicity. However, the proposal presented here is more consistent with efficiency, because the shares will be turned over to users of the public utility in proportion to their consumption, thus including enterprises and private national entities that lack the political right to vote, but do have a clear interest in the efficiency of the service.

21. This distribution of shares could facilitate the return to a system of capitalization in the financing of social security, in contrast to the current system of "reparto" that encourages the populace to consume rather than save. See Roberto Pincemin, *Capitalización Popular*, Forum, Buenos Aires, 1981.

22. Fundacion de Investigaciones Económicas Latinoamericanas (FIEL), op. cit., p. xiii.

23. Roberto T. Alemann, op. cit., p. 23.

24. In matters of fiscal deficits and government borrowing, there are new currents of thought, such as the "rational expectations school" in the United States, headed by prominent economists like Thomas Sargent, Robert Lucas, and Robert Barro. In his article "Are Government Bonds Net Wealth?" (*Journal of Political Economy*, vol. 82, November-December 1974), and in his recent book, *Macroeconomics* (Wiley, New York, 1984, pp. 380-93), Barro maintains that under certain assumptions there is no difference between financing the government with taxes or with debt. He asserts that the rational public will realize that if the government is creating debt, at some point the debt will have to be serviced, which will require a tax increase. The present value of additional future taxes must equal the additional debt. The public will save more; therefore the additional income generated by the fiscal deficit and hence the supply of government bonds would equal the demand for them stemming from the higher savings—all this without an increase in interest rates. This theory was contested brilliantly by Nobel prizewinning economist James Tobin in his pamphlet *Asset Accumulation and Economic Activity. Reflections on Contemporary Macroeconomic Theory*, University of Chicago Press, Chicago, 1980. Barro's theory acquires special relevance as a theoretical backing for the large fiscal deficit of the United States.

5
Inflation, Monetary Policy, and External Debt

Inflation and the Velocity of Money

In the first quarter of 1985, the inflation rate in Argentina reached 1,400 percent a year. Inflation rates of this type are haunting the Argentine economy at every corner in the eighties. With inflation like this, people tend to spend money quickly and reduce their cash holdings and checking accounts to a minimum, or alternatively, to place their money at interest in the different types of short-term deposits available in the local financial market. Money in circulation, that is currency plus demand deposits, M1,[1] fell considerably in relation to GDP during the first quarter of 1985, reaching a low point of only 2.4 percent of GDP. This is in stark contrast to figures of the 1930s and 1940s, when the cash in circulation plus checking account deposits by far exceeded 30 percent, or more than ten times the present ratio. Even in the early 1950s, the figure was over 30 percent. In other countries, such as the United States, M1 divided by GDP is 15 percent. The demand for money expressed as a ratio between the quantity of money in circulation and GDP is the inverse of what is termed the

velocity of circulation of money. With high inflation, the public tends to disboard money, which then changes hands over 30 times a year. The high velocity of circulation confers great inflationary powers on any new money issue. In other words, a small issue has a tremendous inflationary impact.

In this context, the fiscal deficit, which is the main source of money creation, is of fundamental importance. If the demand for money is only 3 percent of GDP and the fiscal deficit financed by monetary issue is 3 percent as well, inflation, insofar as it depends on the fiscal deficit, will be not less than 100 percent. If the fiscal deficit is 6 percent of GDP and the demand for money only 3 percent, inflation will be not under 200 percent, and so forth. The demand for money tends to decline as the country falls into hyperinflation. Thus, if money demand drops to 2 percent of GDP, it means that a fiscal deficit of 16 percent of GDP will of itself generate an inflation rate of 800 percent annually.

The monetization of the fiscal deficit is not the only source of inflation. The indexation of the exchange rate is another force that pushes prices up, particularly via agricultural products that comprise the nucleus of the working class consumer budget.[2] If the salary increases generated by union pressures and the high interest rates that are themselves dependent on inflation are added, this inflationary situation would appear to have no solution. The strong connection between wages and inflation can be observed in Graph 11.

Short-Term Financing and the Crisis in the Financial System

Inflation discourages people from holding money. Checking account deposits had fallen from 50 percent of the total bank deposits to about 10 percent in 1985. The Argentine public naturally reacts to defend itself from the money issue to finance the fiscal deficit, which is a kind of inflationary tax, by placing its savings in short-term deposits with free interest rates. This is no real solution, since inflation creates a distorted financial system plagued by an extremely short-term and worthless capital market. A well-known author put it like this:

> The preferred strategy of high real rates of interest—where real finance is plentiful at those rates—may be nearly impossible in an economy with high and unstable inflation. Uncertainty and the desire to avoid risk may make nominal rates of interest that incorporate the expected future price inflation look too high to borrowers and too low to depositors. The former don't want to be trapped with high fixed nominal interest rate commitments if inflation should slow down, while the latter don't want to be wiped out if there is an anticipated acceleration in the upward price movement. Hence, none but financial commitments of the shortest term can be established.[3]

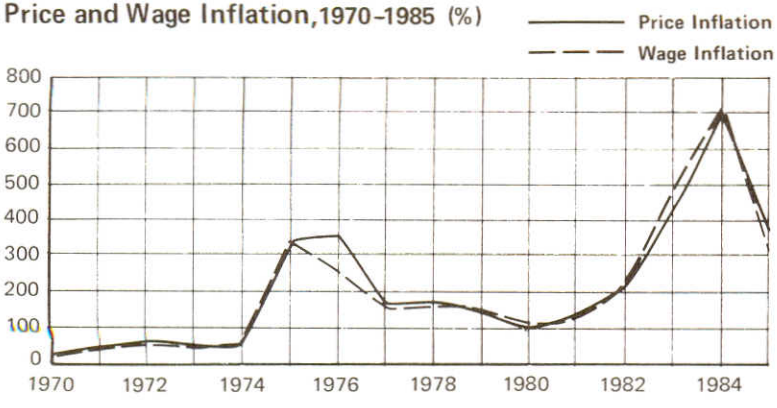
The spread of short-term operations by financial institutions and the tenfold increase in the turnaround time for checking account deposits have generated a sharp rise in operating costs throughout the entire financial system. Meanwhile the traditional subsidy enjoyed by the sector due to the zero cost of checking account deposits plummets, given the real reduction in demand for this type of deposit.

The "account of monetary regulation" has further complicated the problem. In traditional banking systems, the reserves required for demand deposits, which banks do not pay interest on, are higher than those for term deposits, which banks do pay interest on. In 1977, the predominant tendency among Argentine policymakers was to favor an equal reserve requirement for demand and term deposits (the latter paying free interest rates backed with a government guaranty to depositors). Monetary control would thus be facilitated, the authorities thought.[4] The single reserve requirement necessitated the creation an "account of monetary regulation," which levies an additional tax on banks with a high proportion of demand deposits to subsidize financial entities with an excess of term deposits. This mechanism, however, had undesirable effects: when money supply had to be restricted by raising the uniform reserve requirements, a fiscal deficit was generated; and when an easy monetary policy was the goal and the reserve requirement was lowered, a fiscal surplus resulted. Both deficits and surpluses run counter to the objectives of monetary policy.

Not only was this monetary invention of dubious utility for monetary control, but it created serious cost problems for many banks by removing the subsidy for demand deposits, which they provide free of charge to enterprises and individuals. If inflation were eliminated, demand deposits and thus the subsidy to banks would increase enormously.[5] A fair number of potential bankruptcies that put the stability of Argentina's financial system in doubt could be averted. In addition, the term for deposits and loans could be lengthened, and the banking system could play its traditional role of intermediary between savings and investments more efficiently, a powerful reason to mount a drastic attack on inflation.

Graph 11

Price and Wage Inflation, 1970-1985 (%)



Source: Central Bank of Argentina.

Monetary Policy under a Fixed Exchange Rate

The need for Argentina to have a highly devalued and fixed exchange rate has been argued in detail in previous chapters. However, this type of policy has important implications for the management of money and for stopping inflation. When the value of currency in relation to foreign currencies is fixed, two basic laws of political economy must be taken into consideration. The first is the "quantitative theory of money," which asserts that the quantity of money multiplied by its velocity is equal to the price level multiplied by the gross

domestic product. (In algebraic terms, this identity is usually written as follows: MV = PQ, where M is the quantity of money in circulation, V is the velocity, P is the level of prices, and Q is GDP.[6])

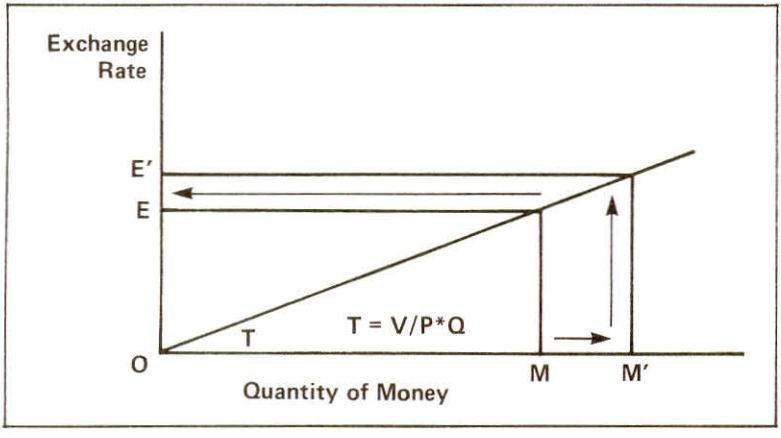
The second theory, or the law of one price, is a reminder that the level of domestic prices depends not only on the remaining three variables of the equation but also, when there is free international trade and market transparency, on the exchange rate and the foreign price level.[7] If foreign prices go up and the exchange rates with foreign countries is constant, there will also be an obvious trend toward an increase in domestic prices.

The law of one price has long-term validity in most economies; in the short and medium term, its applicability is questionable. The economic team headed by José Alfredo Martínez de Hoz in 1978-1980 mistakenly assigned it short-term validity, seeking to halt inflation through the so-called "tablita," a published, descending devaluation rate schedule issued in the belief that domestic price increases would adjust to the deceleration of the exchange rate.[8]

Graph 12 shows that fixing the exchange rate at a given level (assuming that velocity, external prices, and GDP are constant) determines the quantity of money in circulation. Thus by fixing the exchange rate, the political authority is setting monetary policy.[9] In the medium and long term the Central Bank cannot set a different course. This can be observed in Graph 12, where the tangent for angle T is simply the quotient of velocity over the index of external prices, multiplied in turn by GDP: tangent of T = V/P*Q.

Graph 12

Monetary Policy under Fixed Exchange Rate



If the exchange rate is set at point E, the Central Bank cannot increase the quantity of money from M to M′ unless there is a reduction in velocity (V), an increase in GDP (Q), or an increase in external prices (P*). If the Central Bank does increase the quantity of money from M to M′, the exchange rate will jump from E to E′, in violation of the political authority's right to fix the level E.

It should be reiterated that any increase in the quantity of money in circulation must be accompanied by one or a combination of three measures: a decrease in velocity, an increase in GDP, or an increase in foreign prices. If the Central Bank causes money to grow more than it should, this would constitute a usurpation of political authority. In the short run, there is thus little room for manipulating monetary policy under fixed exchange rates. This is not the place for a detailed discussion of an appropriate monetary policy under these constraints, for it would entail an entire book on the art of central banking. However, the most modern as well as the oldest trends in macroeconomics suggest the appropriateness of using monetary policy to maintain fixed exchange parities and fiscal policy to balance global domestic supply and demand with full employment of productive factors. The literature is vast

and growing.[10] This trend is consistent with present-day mainstream macroeconomics, which continues to revolve around the famous article by Sir John Hicks.[11] Thus the rediscount rate and the quantity of money should be correctly and almost automatically set according to production needs and economic development requirements, with complete monetary stability. It is worth repeating, then, that soon after the executive branch issues a decree prohibiting itself from resorting to the Central Bank for money, a new charter for the Bank must be drafted and approved by law of Congress. The forces of production must then be called upon to select a new board of directors and a new president of the Central Bank. This new institutional arrangement is essential for re-establishing confidence in the country's currency.

Overcoming Inflationary Inertia

Inflation feeds upon expectations. Argentina has suffered through 40 years of inflation, and the people have become accustomed to it. Therefore, the mere elimination of the fiscal deficit and an improvement in the country's economic prospects will not be enough to put an end to the powerful forces of inertia.[12] The economy has become a slave to indexation: merchants and industrialists tend to set the prices of the current month by taking into account the nominal interest costs, which reflect the anticipated rate of inflation; this in turn is influenced by the actual inflation of the previous month. Salaries are determined by the cost of living index. To attempt to overcome all this defensive machinery solely by restricting the quantity of money would push interest rates sky high and have a recessive and paradoxically inflationary impact in the short run.[13] If the Central Bank were suddenly to halt money issue, and prices continued to increase solely under the impetus of inertia, a scarcity of money would occur, causing a rise in interest rates in real terms. Investment would therefore be discouraged, and a recession would shrink tax revenues, which in turn would kill the balanced budget. Thus, the deep roots of inflation would remain.

There is no doubt that inflationary expectations can frustrate any stabilization plan and therefore must be eliminated. Substantive measures like the elimination of the deficit and the ban on executive branch borrowing from the Central Bank are not enough. Additional direct measures are necessary—for example, a three-month freeze on wages and prices. An emergency "shock" measure,[14] like any price control, attacks the freedom of industry and commerce. However, this is justified when inflation is at 1,000 percent a year. The purpose of the freeze is to break the inertia of inflationary expectations. After three months there should be a return to free trade and industry.

During the freeze the entire coercive state machinery must be galvanized, backed up by an aroused public conscience and the powerful government publicity apparatus. The citizenry must be exhorted to block wage and price increases in a brief but decisive war on inflation.[15] Wages should be set at a feasible level based on past experience. Since the subsistence of every family must be ensured, a high wage level that generates unemployment must be avoided. High wages would also have undesirable consequences with respect to exports of manufactures and inflation. The selected wage level must be a fair start for an economic program aimed at the recuperation of salaries, which in ten years must double in real terms. This can be achieved only through economic development and not by executive fiat.

One of the secrets of economic development lies in maintaining a healthy margin between domestic production costs and export prices for manufactures. If labor costs are increased beyond the average increase in productivity, the incentive to export will wither, destroying the engine of development, which, as stated repeatedly, must be the new dynamic force introduced into the industrial exporting sector. Therefore, under this plan, labor must be made to realize that any wage increases would be real and effective and would take place annually, though in small increments. There are no magic recipes to hike wages by 40 or 50 percent from one day to the next—an absolutely impossible and inflationary tactic that would undercut the proposed economic plan. If labor forces are assured of a reasonable and sustainable wage increase year after year, there is

little doubt of union support for the plan. Unions will accept this type of restraint if they see clearly how it promotes the country's development and workers' welfare.

It must be remembered, moreover, that with a uniform import duty of 20 percent, any unreasonable wage increases would act as a tremendous stimulus to imports, and steep unemployment would be the immediate result. Therefore, both entrepreneurs and labor would reject irrational recipes under the new system, which would then be "vaccinated" against inflation.[16]

The Increased Demand for Money and the Decline in Interest Rates

A three-month freeze on wages and prices is only part of the shock approach aimed at reducing the inflation rate to zero while avoiding a recession.[17] It must be accompanied by equally drastic measures that affect all other sources of inflation. The 60 percent industrial devaluation in real terms would represent another shock to Argentina's industrial sector. With the new exchange rate, additional possibilities for exporting would open up, and the country could reap substantial benefits from sales abroad. Industrial profits would soar, and new prospects for productive investment would be created.

However, a monthly interest rate of 45 percent as in May 1985 constitutes a major constraint for future investment and reducing export costs. Emergency powers must be invoked to impose a three-month reduction in interest rates to levels no higher than 4 points above the international rate, represented by the London Inter-Bank Offered Rate (LIBOR) or the U.S. prime rate. Subsequently, market forces and the new Central Bank would determine the rates. It is well known that throughout the world, the demand for money—that is, money holdings by private citizens, whether in-pocket or in safe deposit boxes or demand deposits—is negatively correlated with the anticipated rate of inflation.[18] If in May 1985 money supply over gross domestic product (M1/GDP) was only 2.4 percent, it can be expected to rise to 6 percent after three months of application of this strategy and to continue increasing until, after an

inflation-free year, it reaches 15 percent—that is, a level similar to that of the United States.

The reduction in the anticipated and actual inflation rates, which feed upon each other, will provoke a strong increase in money demand. Money demand, in turn, is an inverse function of nominal interest rates. If these rates are lowered from 1,800 to only 14 percent annually, the demand for money will grow appreciably on this account too. In addition, money demand is positively correlated with real income. Since real income must increase under this proposal, within a year a plan like the one outlined in this book should produce a money demand of around 15 percent of GDP.

The wisdom of reducing a real monthly interest rate of 10 percent to a real annual interest rate of only 10 percent can be questioned, in view of the experience of other countries in halting inflation. Perhaps the most famous such case is the German hyperinflation of 1923, which has been examined extensively. In November of that year inflation reached a level of 20 percent daily. From November 14 to 20, the German government decreed a nominal devaluation of 333 percent and a real devaluation of 100 percent. In addition, it banned the use of monetary issue to finance the treasury. Due to inflationary inertia, a scarcity of real money occurred. In other words, M1 fell in real terms, and correspondingly, monthly interest rates remained at 150 percent without inflation. Inflation was arrested in one month, but high interest rates persisted over a six-month period.[19]

Whether halting inflation requires draconian interest rates is therefore questionable. This author believes that it does not. Interest rates were kept high in Germany because of the tremendous increase in the demand for money provoked by the new higher-level price stability and the scarcity of money supply, the latter of which was probably less than 1 percent of GDP in November-December 1923. Thus, high interest rates were the means employed to decrease money demand to the point where it was equal to the existing real supply.

In fact, high interest rates have ambiguous effects, some inflationary, some deflationary. They are inflationary inasmuch as they push the velocity of circulation and effective demand up

(MV in the quantitative equation) and increase the financial costs for enterprises, thus exerting upward pressure on prices.[20] They are deflationary because they give rise to inventory depletion and employee layoffs to remove money from productive purposes and make it earn interest. Thus, high interest rates also provoke recession. Economics has not yet come up with a definitive assessment of the strength and timing of these two contradictory effects, but it is generally accepted that in the short run, inflationary effects prevail, while in the medium and longer term, deflationary effects assume the upper hand.

For the reasons cited above as well as the huge and fruitless social costs of high interest rates, interest must be no more than 4 points above the annual international rate. Recovery is possible only if the government's economic plan inspires confidence and offers the prospect of high profits on investments in real assets, not because of high unmatured and unsustainable interest rates in the domestic market. These rates provide astronomical benefits to only a small number of well-informed persons with close ties to the Central Bank and the government, who alone can get into and out of local financial market at the right moment.

The Repatriation of Argentine Capital and the Attraction of Foreign Capital

A significant problem emerges here: how to increase money supply five- to six-fold (from 2.4 to 15 percent of GDP) to meet the higher demand when issuing money to finance the public deficit is forbidden. The solution to this problem is rather obvious: with the 60 percent devaluation of the exchange rate in real terms and the confidence generated by the new policy measures, part of Argentina's expatriate capital would begin to return. Converted to local currency, this capital would have considerable purchasing power, owing to the devalued exchange rate. The sale of more than 300 state-owned enterprises or their assets at relatively low prices would be an attraction. New investment opportunities in manufacturing would no doubt be the major incentive. The interest rate in the

local market, slightly above the international rate, would be another. The abrogation of the income tax on "unexplained increments in net worth" would be crucial. Even the tax on net worth must be considered for repeal, since it prompts a taxpayer to declare debts contracted abroad so as to deduct them from his assets, thus evading the tax. Moreover, assets held abroad are not declared, and therefore present a neat, simple way to avoid taxation through undeclared capital flight combined with legal declared foreign borrowing. With anticipated devaluation, high rates of inflation, insecurity about property rights, and a misguided tax system, it is entirely rational for wealthy and middle-class Argentines to maintain assets abroad. International sources estimate capital flight during the 1978-83 period at the equivalent of $27.6 billion.[21]

These calculations do not include capital flight before 1978 and during the 1984-88 period. Certainly, they fail to take under-invoicing of exports and over-invoicing of imports into account. At the same time, the cost of arms acquisitions and contraband must be deducted. All in all, capital flight probably is about $20 billion. Of this figure, $8.2 billion are recorded as deposits in foreign countries in *International Finance Statistics*, an official publication of the International Monetary Fund, and $3-5 billion circulate as cash for domestic transactions, mainly in real estate.

If Argentina's external debt problem stems from capital flight generated by a lack of confidence, slow economic growth (the counterpart of low rates of return on real assets), and unsound fiscal legislation, the solution lies in an economic program that inspires confidence, alters the fiscal legislation that leads to capital flight, respects property rights, and generates prospects of high economic growth (the counterpart of high rates of return on real local assets). There is no doubt that if this proposal were implemented in its entirety, $2 billion to $3 billion per year (equivalent to 5 to 7 percent of GDP at the new exchange rate) could be expected to return and would then be exchanged at the Central Bank for the already stabilized local currency.[22] This would increase the monetary base by more than enough to deal with the new increase in the demand for money, M1, and allow it to reach the desirable level, M1/PIB =

15 percent. Furthermore, new flows of foreign investments into the country have not been taken into account. These could be substantial in a well designed economic program implemented with a firm hand, courage, and expertise. Needless to say, foreign capital must enjoy the same guarantees and treatment as local capital, except in the banking and public enterprise sectors, where monopolies or oligopolies may be prejudicial to the country. For the rest of the economy, freedom, competition, a devalued exchange rate, and a low import tariff are the best defense against monopolies.

The International Monetary Fund and the External Debt

The IMF is frequently and unfairly criticized because it promotes policies in developing countries that generate unemployment, unequal distribution of income, and recession.[23] Those who may actually be criticized for their lack of imagination are the authorities in the developing countries. Under the economic policy scheme proposed here, IMF requirements would exact virtually no social costs. The technical reason is obvious. The IMF is interested mostly in balance of payment adjustments, and for those it makes use of an old but practical and simple monetary theory. To the quantitative theory of money previously mentioned, MV = PQ, a second equation is added, taken from the accounts of the Central Bank,[24] where through an accounting identity, assets must equal liabilities (that is, international reserves plus domestic credit must equal monetary issue, that is, liabilities). Stated differently, R + DC = Mo. In this endeavor, the IMF emphasizes domestic credit, requesting that both credit to the government and rediscount to banks be curtailed, in the belief that any other money creation must generate a corresponding increase in reserves; in other words, monetary expansion must emanate from a surplus in the balance of payments, which is precisely the desired objective. To create a surplus in the balance of payments, the classical instrument is devaluation. However, devaluation normally implies reductions in real wages and recession—sound reasons to oppose it. Under these circumstances, the only way out is to shrink domestic credit, mainly by

reducing the fiscal deficit, which is also politically painful and recessive. Thus, developing countries usually resist the IMF's adjustment policies. The program outlined so far in this book would comply with IMF requirements and at the same time would minimize local social costs.

Summary

Given the proposed devaluation of 60 percent in real terms, accompanied by export taxes and the general liberalization of the economy, the growth of Central Bank reserves is ensured along with a good liquidity level for the growth of the economy as a whole. The real devaluation opens new and enormous opportunities for profit. Export taxes would considerably help reduce the fiscal deficit, although they cannot prevent the inexorable need for cutbacks in public expenditures. The reductions, however, may not need to offset completely the increase in the burden of interest payment for the national budget. In this regard two recognized authors point out that governments must realize that interest payments do not stimulate the local economy and must therefore be treated differently from ordinary government expenditures.[25] Moreover, those reductions should not be painful, for they would take place in an expanding economy with the capacity to reabsorb excess public employment.

Real salaries would not necessarily drop. As one author observes, "Draconian reductions in real wages are not necessarily required for external stabilization and the standard theory does not provide an automatic justification for the extent of real wage reductions that have often been observed in some of the more politically conservative stabilization efforts."[26] This is particularly true under the present proposal, because the export taxes would prevent food price increases in the local market. The optimization of the price system would ensure that the economy emerged from recession, unemployment, and low capacity utilization and reached its production possibility frontier.[27] There can be no objection to the highly devalued exchange rate on technical economic grounds because of the burden of the external debt and because the devalued exchange

rate is the counterpart of the high export taxes. From the legal standpoint, export taxes are unobjectionable under the GATT and IMF agreements.

This economic program, in the final analysis, would transform the external debt problem. Instead of blaming the debt for the nation's sickness, it makes it the springboard for development. In a few years, nontraditional exports growing at 10 or 20 percent annually in real terms would outstrip traditional exports. The country's solvency could be conclusively demonstrated with the "minimum standard models" of the World Bank and the Inter-American Development Bank. Argentina would receive new offers of credit at lower interest from private bankers, and the problem of the external debt would disappear after a year. It must be remembered that, in reality, the *net* external debt of Argentina as of 1985 is only $27 billion—that is, $47 billion minus the $20 billion in assets abroad.

NOTES

1. Friedman, after proposing M2 (M1 + time deposits) for years as the main variable for monetary control, then reverted to traditional economics, again using M1—that is, cash and checking accounts, the two goods with immediate purchasing power—over the rest of them. See Milton Friedman column, *Newsweek*, July 15, 1980, p. 49. The most recent and most sophisticated variation on monetarism presented in Robert Barro's book *Macroeconomics*, also uses M1. See Barro, op. cit., p. 111.

2. Eduardo R. Conesa, "Keynes Vuelve por sus Fueros," *Revista IDEA*, May 1982. In this article, the impact of the various sources of inflation is assessed through a multiple regression equation

$$\begin{array}{lcccccc} IN = & 0.26RM1 & + & 0.54REX & + & 0.23W & - & 0.75RY & + & 1.01 \\ & (t = 1.72) & & (t = 5.40) & & (t = 2.46) & & (t = -2.21) & & \end{array}$$

$$\bar{R}2 = 0.79$$

using quarterly data. Exchange rate devaluations (REX) are the main "cause" of inflation in Argentina. Next is recession (Y), followed by the nominal increases in

salaries (W). The weakest of all "causes" is money issue (RM1). The exchange rate influences inflation through food prices, as demonstrated by Carlos Díaz Alejandro in his book *Exchange Rate Devaluation*. The recession (fall in Y) operates through the increase in fixed costs per unit of production in industry, and also through the increases in financial costs provoked, in turn, by high interest rates. The impact of salaries is obvious. The statistical weakness of M1 stems from the fact that some of the increases in M1 are not inflationary, such as those that come through surpluses in the balance of payments or rediscounts to the private sector associated with production increases. The potency of money as inflationary force comes from the monetization of the fiscal deficit. If a good quarterly series for the fiscal deficit had been available at the time the regression was run, the fiscal deficit variable would have been highly significant.

3. Ronald McKinnon, *Money Capital and Economic Development*, The Brookings Institution, Washington, DC, 1973, p. 79. This book, the bible of some policymakers in Latin America's southern cone, unfortunately contains some errors.

4. Adolfo Diz, *Money and Prices in Argentina 1935-1962*, Ph.D. thesis, University of Chicago, Chicago, IL, 1965. The inconsistency of the monetary system of 1977 was pointed out early by Pedro Pou, among others, in "La Estabilidad del Sistema Monetario," *Revista Mercado*, February 16, 1978. The monetarists in power were perhaps more influenced by Ronald McKinnon than by Milton Friedman, as demonstrated by their emphasis on the growth of the financial sector and assets.

5. Carlos A. Carballo, "Anotaciones sobre el Problema Financiero Argentino," *Revista Argentina de Política Económica y Social*, May-August 1985, p. 75. The subsidy of interest free demand deposits is so important for the banks that, given monetary stability,it would even be possible to eliminate the questionable subsidy implicit in the state guaranty for bank deposits.

6. Footnote 2 questions the potency of M1 as an explanatory factor for inflation over short periods. If the same regression is run with biennial data, M1 recovers its power. In the long run, inflation cannot be maintained without the high growth of M1. The main factor that counters the explanatory power of M over prices is V,

which sometimes moves in the opposite direction to M and sometimes (as in hyperinflation) in the same direction. Attempting to halt inflation by simply restricting the growth of M is a major technical error that must be avoided at all costs, in view of its tremendous economic and social consequences.

7. For a discussion of the law of one price in Argentina see Carlos Díaz Alejandro, "Los Tipos de Cambio y la Relación de Intercambio en la República Argentina de 1913 a 1976," in *Comercio, Estabilidad, Tecnología and Equidad en América Latina*, Mosé Syrquin and Simón Teitel, editors, Inter-American Development Bank, Washington, DC, 1984.

8. In algebraic terms, the law of one price considers that P (the level of domestic prices) is a function of E (the exchange rate) and P* (the foreign price level), P = f(E, P*). Although there is some type of connection between the exchange rate and local prices, it is not clear-cut. Therefore, it is appropriate to present the level of domestic prices as a function of the exchange rate and the levels of external prices. If, for didactic purposes, reality is simplified and P = EP* is accepted, the quantitative theory of money and the law of one price could easily be combined. The conclusion will then be reached that the exchange rate is equal to the quantity of money in circulation, multiplied by its velocity and divided by the level of external prices multiplied by GDP:

(1) MV = PQ
(2) P = EP* and substituting in (1)
(3) MV = EP*Q
(4) E = MV/P*Q

9. Fixation of the exchange rate at highly devalued levels precludes further devaluation and thus induces abundant liquidity and a drop in local interest rates, as explained earlier. See Carlos Moyano Llerena, *La Ley de Conversión de 1899*, Facultad de Derecho y Ciencias Sociales, University of Buenos Aires, Buenos Aires, 1934. See also Rudiger Dornbusch, "Stabilization Policy in Developing Countries: What Have We Learned?" *World Development*, Summer 1982.

10. For example, see the excellent works of Ronald McKinnon, *An International Standard for Monetary Stabilization*, Institute for Internal Economics, Washing-

ton, DC, 1984, and Richard Cooper, "A Monetary System for the Future," *Foreign Affairs*, Summer 1984. Obviously, the schemes proposed by these authors assume that the executive branch has the power to modify the tax rates for domestic macroeconomic regulation.

11. John R. Hicks, "Mr. Keynes and the Classics: A Suggested Interpretation," *Econometrica*, April 1937. For an overall updated view of macroeconomics, see James Tobin, op. cit., and Gottfried Haberler, *The Problem of Stagflation. Reflections on the Micro Foundation of Macroeconomic Theory and Policy*, American Enterprise Institute, Washington, DC, 1985. Traditional macroeconomics has recently been brought into question by the "rational expectations school" or the "market clearing approach" as presented in the book by Robert Barro, *Macroeconomics*, who nevertheless recognizes that "this theory is still in its developing stages" and that "we cannot yet reach a final verdict on the explanatory power of this theory for business fluctuations," p. 460.

12. See Persio Arida and André Lara Rosende, "Inertial Inflation and Monetary Reform: Brazil," and Adalbert Krieger Vasena and Enrique Szewach, "Inflation and Indexation in Argentina," in *Inflation and Indexation Argentina, Brazil and Israel*, John Williamson, editor, Institute for International Economics, Washington, DC, 1985.

13. The inertia and rising trend in labor costs and interest costs have recently been labeled "core inflation." See Otto Eckstein, *Core Inflation*, Prentice Hall, Englewood Cliffs, NJ, 1981. Econometrics demonstrates that lowering the nucleus of inflation in a meaningful way simply thorough fiscal and monetary policies would require an extended period of deep recession approaching a depression, with an unemployment rate of over 10 percent (p. 3). Although the author refers to the United States, his theory of inflation is more applicable to Argentina, where severance laws are so strict and the power of unions is so great that the "rational expectations" models, which assume competitive and Walrasian labor markets, are unrealistic. See Robert E. Lucas and Thomas Sargent, *Rational Expectations and Econometric Practice*, University of Minnesota Press, Minneapolis, MN, 1981.

14. The shock treatment can be justified only if it serves to prevent a recession. Shock combined with recession is a policy error. As Rudiger Dornbusch comments in

Chapters 7 through 10 of *IMF Conditionality* (John Williamson, editor, MIT Press, Cambridge, MA, 1983, p. 229), "It used to be the case that monetarists favored shock treatment, and the people were on the side of gradualism. But here the sides are changing. If income policy can be mustered in a social consensus on the need for stabilization, then there is every reason to apply shock treatment: simultaneous and immediate credible moves to rectify the entire disarray. That includes a combination of changes in real prices, fiscal and public sector sanitation, cuts in absorption, wage controls, and sharing rents, but also includes, as an advantage, a full employment and growth policy."

15. This book was written before June 1985. Many of its ideas originally appeared in an article by this author in the June 27, 1984, issue of the Buenos Aires newspaper *Ambito Financiero*. This shows that the author's approach was conceived before the freeze imposed by the Argentine government on June 14, 1985.

16. Richard Cooper, in "An Assessment of Currency Devaluation in Developing Countries," in *Government in Economic Development*, Gustavo Ranis, editor, Yale University Press, New Haven, CT, 1971, recommends import liberalization as an antidote to inflation, p. 505.

17. Gradualism as an anti-inflationary approach is advised by both monetarists and structuralists. Representative of the first tendency is Roque Fernández in "The Short-Run Output Inflation Tradeoff in Argentina and Brazil 1975," in *Short-Term Macroeconomic Policy in Latin America*, Jere Behrman and James A. Hanson, editors, Ballinger Publishing Co., Cambridge, MA, 1979. Structuralist gradualism is well represented by Mallon and Sourouille, *Economic Policy in a Conflictive Society: The Case of Argentina.* The Argentine experience after these two works were published represents a judgment for the gradualist approach. World experience favors the shock treatment; see Leland Yeager, *Experiences with Stopping Inflation*, American Enterprise Institute, Washington, DC, 1981.

18. For instance, this author has estimated a demand for money in Argentina that complies with all *a priori* requirements for this type of function. The function takes the following form:

$$M1/P = -0.10RP - 0.21i + 0.96Y + 0.71$$
$$(t=-2.34) \quad (t=-2.86) \quad (t=6.1)$$

$\bar{R}2=0.48$

where RP is the rate of inflation, and i the interest rate. Both have negative signs. GDP (Y) has a positive sign, as expected. In all three cases the "t" values are significant.

19. Rudiger Dornbusch, *Lessons from the German Inflation Experiences of the 1920s. Stopping Hyperinflation*, mimeo, MIT Press, Cambridge, MA, May 1985.

20. Lance Taylor, "IS/LM in the Tropics: Diagrammatics of New Structuralist Macrocritique," in *Economic Stabilization in Developing Countries*, William R. Cline and Sidney Weintraub, editors, The Brookings Institution, Washington, DC, 1981.

21. Morgan Guaranty Trust Co. of New York, *World Financial Markets*, February 1985, p. 9. Rudiger Dornbusch also states that it was Argentina's external debt that was used to finance capital flight, not current account deficits in the balance of payments ("External Debt, Budget Deficits and Disequilibrium Exchange Rates," in *International Debt and the Developing Countries*, Gordon W. Smith and John T. Cuddington, editors, World Bank, Washington, DC, 1985, p. 227). See also World Bank, *World Development Report* 1985, where the figure of $19 billion in capital flight for Argentina is given for the 1979-82 period.

22. Referring to the Austrian case of 1922, Leland Yeager mentions that the growth rate of money in circulation after the successful stabilization plan of that year was 247.6 percent annually with no inflation. This phenomenal growth stemmed from the purchase of foreign exchange by the issuing Central Bank and was not inflationary because of the strong recuperation of the demand for cash balances. There are a number of examples of this type in world economic history. See Leland Yeager, op. cit., p. 51.

23. For a detailed discussion of this point see John Williamson, "On Judging the Success of IMF Policy Advice," in *IMF Conditionality*, John Williamson, editor, Institute for International Economics, Washington, DC, 1983, p. 130, and Jacques Polak, "Monetary Analysis of

Income Formation and Payment Problems," *IMF Staff Papers*, vol. 6, November 1957.

24. William R. Cline, "Economic Stabilization in Developing Countries. Theory and Stylized Facts," in *IMF Conditionality*, John Williamson, editor, op. cit., p. 175.

25. See Richard Cooper and Jeffrey D. Sachs, "Borrowing Abroad: the Debtors' Perspective," in *International Debt and the Developing Countries*, Gordon W. Smith and John T. Cuddington, editors, op. cit., p. 181.

26. William R. Cline, *Economic Stabilization*, p. 181.

27. In accounting terms, since Y = C + I + G + X - M (where C = consumption, I = investment, G = government expenditures, X = exports, and M = imports), it is obvious that the balance of payments is approached by X - M = Y - C - I - G. Therefore, to increase the surplus (X - M), this approach proposes to expand Y and reduce G. Moreover, the more expatriate capital returns, the smaller the sacrifice of reducing absorption, that is C + I + G.

6
Long-Term Development and Latin American Integration

The Natural Distortion and its Solution

Chapter 3 explored the case made by Anne Krueger, Jagdish Baghwati, and other authors for manufacturing export-based strategies versus schemes aimed at closing economies to promote import substitution. These authors cite three principal reasons for the superiority of the former: first, that the export of manufactures brings about economies of scale and thus unit cost reductions; second, that the exporting countries are not subject to the foreign exchange constraint, which imposes a stop-and-go sequence of growth owing to the scarcity of foreign exchange; and third, that by relying on the world price system, export-based strategies do not suffer the distortions and disequilibria usually generated by import substitution policies. These are valid arguments indeed, but there is yet another argument that points to the superiority of outward-looking growth strategies implemented through an adequately devalued exchange rate for manufacturing exports.

Assuming that a developing country like the Argentina of the 1930s liberalizes its domestic market and maintains high and

uniform protection for import substitution in manufactures, the law of supply and demand will cause the consumer goods industries to be the first to commence production, since there is already a demand for these goods. The demand for intermediate and capital goods is a derived demand, because it requires the a priori establishment of consumer goods industries. The need for consumer goods industries poses a problem for development, since the source of modern economic growth is growth in productivity—that is, technological improvement—which occurs mainly in the capital goods industry, an industry of engineers.}

The capital goods industry employs highly skilled labor in large numbers and at the same time trains its own workers and provides opportunities for invention, innovation, and the adaptation of foreign technology to local factor endowments and relative prices. Thus, developing economies with free domestic markets protected against imports are condemned to low growth because of the powerful natural tendency to give priority to the production of consumer items, while importing capital goods.

This point is extensively developed in the article frequently cited here, "Teoría Económica y Substitución de Importaciones" and the arguments will not be reiterated. It is important to point out, however, that with an exchange rate fixed at adequate levels for the export of manufactures, the intermediate and capital goods industries will not be constrained by domestic demand. On the contrary, capital goods could be exported, for two reasons. First, an engineer's salary in Argentina may be $1,000 a month, while in the United States it is $5,000. The difference in productivity does not justify the tremendous salary differential. Second, nearly all countries place low duties on imports of capital goods, which facilitates sales in the international market.

The only argument against exporting capital goods is the need for long-term financing, an obstacle that can be surmounted. With sound domestic and external financial policies, Argentina would be in a favorable position to organize international banking consortia to finance its sales of capital goods abroad. The use of the world price system, made possible by the devalued exchange rate, would eliminate the "natural" discrimination against the capital goods industry and thus would

open the doors to technological development, the true key to modern economic growth.[1]

The Role of Planning in Long-Term Development

In a closed or semi-closed developing economy, planning serves a useful function. In the case of large investments for industrial production with economies of scale and external economies, the market price system gives no indication as to which investment would be appropriate, nor does it provide the basis for making the correct cost-benefit analysis from the social standpoint.[2] The reason is obvious: current prices are but a weak guide for large investments. Once such investments are made, prices must be altered because the investments represent a large portion of sectoral activity. They are monopolies, and from the social standpoint, the optimal prices are those of perfect competition. Economic planning has a useful role to play in making up for the failure of the price system in small, closed economies.

In contrast, in an open economy with a highly devalued exchange rate, the relative prices in the industrial sector would be equal to the relative industrial prices of the world market. Distortions would be limited. Market prices would be adequate for making investment decisions. Under these conditions, the planning office might be considered a useless mechanism, but this is not the case, for there would still be massive investment in public utilities that would have to be coordinated with the general economic activity of the country. Government activities in sectors that must remain under federal jurisdiction, such as national defense, domestic security, justice, education, and social security, would still need planning.

Thus, a National Development Council, composed of a few high-level professionals, would fill an important vacuum. Moreover, the strategy for national development must be modified to adapt to changing technology, the international financial markets, and modifications in the legal and economic framework for international trade. This group of highly qualified professionals must retransmit the international signals to local leaders and discuss the possible responses to an

essentially dynamic international economic situation with entrepreneurs and key officials in the public sector. Because of the language barrier or the country's distance from the world's major economic and political power centers, Argentina tends to be provincial, to ignore the world economic situation and become absorbed in minor local political problems. A National Development Council or National Planning Office must essentially serve as an observation tower of the highest order to view world events so that a realistic national development strategy can be formulated.

Today there are a computer-based economic modeling techniques for macroeconometric models[3] and computable general equilibrium models[4] that permit the quantitative solution of a vast number of economic problems. Although the conclusions to be drawn from such models are implicit in the mathematical hypotheses that underlie their construction, there is no doubt that their availability could greatly stimulate technical discussion of certain issues, such as the impact of a decline in the growth rate of the OECD countries, or of a two-point drop in the U.S. prime rate, on Argentina's economy. For over ten years, the World Bank and the IDB have been using "minimum standard models"[5] to formulate consistent economic projections of the main macrovariables of an economy in less than one hour—a simple task. Much more complex but equally useful would be the construction and adaptation of macroeconometric models to simulate movements of the different control variables in Argentina's economy and their effects on the behavior of the remaining economic variables. The World Bank has recently constructed computable general equilibrium models that allow it to obtain approximate answers to long-term problems, like the effects of modifications in import duties, export taxes, exchange rates, oil prices, real wages, and so forth. Such models would permit a more precise management of the country's economy when used in conjunction with existing models in the industrialized countries.

The development and refinement of appropriate models in line with the levels achieved by current day economics, however, may take more than a year or two, and the preparation of a national development plan cannot wait. Furthermore, the

conclusions of any model must not be uncritically accepted. Models constitute a more sophisticated way of reasoning but are no substitute for the common sense of the statesman and the economist.

The occasional objections to scientific economic planning in some fundamentalist quarters of liberalism and development economics in Argentina are obsolete. In fact, the price system and competition work better in economies with high rates of economic growth. In the words of Robert Reich, "economies are like bicycles":[6] the faster they go, the better able they are to maintain equilibrium. A well-structured price system favors development, which in turn facilitates the smoother operation of the price system. The confusion in Argentina notwithstanding, there is no contradiction whatever between the need to make better use of the price system as the engine of growth and the simultaneous use of a planning office to improve the functioning of the price system. There is no contradiction between economic planning and Argentina's economic philosophy, inspired, according to Alberdi, by Adam Smith's *The Wealth of Nations*. More than two hundred years ago, Adam Smith wrote:

> The sovereign has only three duties to attend to . . . first, the duty of protecting the society from the violence and invasion of independent societies; secondly, the duty of protecting . . . every member of the society from the injustice or oppression of every other member of it . . . and, thirdly, the duty of erecting and maintaining certain public works and certain public institutions, which it can never be for the interest of any individual, or small number of individuals, to erect and maintain, because the profit could never repay the expense to any individual or small number of individuals, though it may frequently do much more than repay it to a great society.[7]

This quotation from the father of political economy makes it clear that in sectors with external economies, the government must intervene when the benefits are greater than the costs. And only the economic planning office can make this kind of cost-benefit analysis for society as a whole.

Designing an Economic System for the Future

The numerous economic policy measures suggested in Chapters 3, 4, and 5 of this study form a coherent whole that can be put into practice only as a coherent whole. Any omissions from this package could cause the failure of the entire system. For instance, freezing wages and prices and reducing the fiscal deficit to zero, while appropriate in principle, are not sufficient to promote development investment and restore investor confidence. Any partial implementation of this plan would be like a building erected on shaky ground—ready to collapse at the first tremor. Not only should the proposed measures be implemented simultaneously, they must also be accompanied by a coherent economic system designed for the long term.[8] New legislation will therefore be needed in the following areas.

- The financial sector. Legislation must be passed to create a national Central Bank with an independent political power base, not subordinate to the executive branch (see Chapter 5) There should also be new banking laws based on proven principles and practices.
- The industrial sector. Laws that guarantee a highly devalued exchange rate for manufacturing exports and a system of uniform customs duties are necessary (see Chapter 4). Proposed exemptions must be examined case by case. There must also be legislation to ensure the equitable distribution of the social costs of opening up new markets for industrial exports, to finance the sale of capital goods in the local and international markets, and to help keep the country abreast of world technological progress.
- The agricultural sector. Legislation must serve to attract advanced foreign technologies and facilitate their adaptation to local conditions of production (see Chapter 2). In addition, a system of private lobbies must be organized to ensure that the country can efficiently exercise its influence in favor of free world trade in agricultural products.
- The energy and transportation sectors. A mechanism must be established for transferring the shares of public utilities in these sectors to the users. New laws must also regulate the

objectives, rates, controls, financing, and investment coordination of the large, new, popularly based private enterprises that have replaced the former state enterprises.

- Education. In the final analysis, the country's success in development and its very existence depend on the efficiency of the educational system. Educational reform includes improvement in the quality of education and its relevance to the labor market, and must be grounded in an absolute guarantee of equal opportunity. Advancement must be based on merit, to permit the system to operate as a screening mechanism for competence and to serve as the springboard for access to public employment.

- Social security. The maintenance, rationalization, and financing of the social security system must be legislated to encourage individual savings and promote a better distribution of national income to benefit the working class (see Chapter 5).

Preparing a Development Plan

The chief benefit of a development plan is that its preparation provokes a substantive discussion among the country's leaders about the nation's objectives, its future, the problems it faces, and the policies necessary to overcome them. The best way to go about designing such a plan is by local consultants of international stature to prepare diagnostic studies and forecasts on the problems confronting the main sectors of the country's economy. These include finance, agriculture and agricultural export issues, industry and manufacturing export issues, energy and transportation (objectives, rates, monitoring, and investment financing), education, health (financing problems and the duties of federal, provincial, and municipal governments in delivering health services), regional development, and social security (savings, financing, rationalization, and equity). These diagnostic studies, oriented toward problem solving, should be undertaken by two or three individuals within each sector to obtain opposing views that would permit a deeper understanding of the issues. At the same time, macroeconomic programming must commence.

The diagnostic studies would be discussed, refined, and adjusted to global economic projections, such as the growth rates

for GDP, the sectors that comprise the GDP, traditional and nontraditional exports, imports, investments, and the external debt. The national development plan would then consolidate them into a consistent whole, which would serve as a yardstick for gauging the efficiency of economic policymaking and judging the success or failure of a given measure. The plan would cover a five-year period and would of course have to be updated annually.

Argentina and Latin American Integration

Latin American integration as an abstraction elicits enthusiastic support in virtually all the countries of the region. At meetings where integration topics are discussed, politicians and economists employ their most florid and sentimental language to elaborate on the integrationist beliefs of such founding fathers as Bolívar and San Martín. However, when it comes to adopting effective compromises, their enthusiasm dies, making serious commitments difficult to achieve.[9] Latin American leaders view integration as a historical and authentic mandate; nevertheless, the individual countries are very conscious of the benefits and costs for each partner country resulting from integration. They fear that economic integration may be a zero-sum game, in which the gains of any one country translate into losses for the others. A poorly designed integration system can indeed become a zero-sum game, but in a system that is technically well thought out, every country can and must gain something.

As a point of fact, Latin American countries accept integration as long as their exports to the integrated system exceed their imports, or at least as long as increases in their imports from the system are offset by a rise in their exports to it. No country in Latin America desires a trade deficit with its neighbors. Integration, yes, but no deficits. The rationale for this position may be questionable, but it is an inescapable fact. The solution to the dilemma of Latin American integration, therefore, lies in developing formulas to permit the expansion of reciprocal trade and competition, provided that no major trade deficit will result from this increase. Some countries add a

further constraint: there must be no deficits in their manufacturing trade either.

Other obstacles to Latin American integration are the real exchange rates that fluctuate erratically among Latin American countries, making the reciprocal opening of national markets for individual entrepreneurs extremely risky; the chronic tendency toward commercial deficits on the part of the less developed countries; and the fact that integration is attempted simultaneously with many countries, so that it takes the opposition of only one of them to veto the process, blocking any meaningful or innovative proposal.

To overcome these obstacles, a trade balancing mechanism for two or more countries that desire economic integration has been proposed by this author.[10] In brief, it is technically feasible to open markets reciprocally and overcome the problems of erratically fluctuating reciprocal exchange rates and rising trade deficits in the relatively less developed countries. The use of a trade balancing mechanism is compatible with the Latin American Integration Treaty signed in Montevideo in 1980, falling under the category of "partial actions." Argentina must take the lead and sign these types of agreement with its neighbors and Peru, with the assurance that the success of this flexible form of economic integration will encourage more and more Latin American countries to join the integration efforts. This would be necessary to alleviate fears and demonstrate that the model can work: with reciprocal support among countries, everyone can gain from integration and develop simultaneously.

Manufacturing Devaluation and Latin American Integration

The central theme of this work has been restoration of the Argentina's economic system to promote national development. However, the connection between this proposal and Latin American integration must be further clarified.

One of the pillars of the proposal is devaluation to spur exports of manufactures. But to whom and where? The answer is, to the rest of the world, to the industrialized countries, and especially to Latin America. A manufacturing devaluation lowers the prices of Argentina's nontraditional exports in the

world markets and raises the price of all imports in the domestic market. Although it would appear to be a strictly national measure having no impact on integration, this is not the case.

The Institute for Latin American Integration has been calling for a new approach to Latin American integration grounded in optimal tariffs for imports and exports. The majority of the countries of the region are victims of the so-called "Spanish disease" of 1600—that is, the chronic overvaluation of the exchange rate stemming from the low-cost production of a few abundant resources. For Spain, these were gold and silver from America; for other nations, they are currently the following: Argentina, beef and grain; Brazil and Colombia, coffee, other tropical produce, minerals; Mexico, Venezuela, and Ecuador, petroleum; Chile, copper; Bolivia, tin; and Central America, bananas and other tropical produce.

A manufacturing devaluation is economically justifiable not only for Argentina, but for almost any nation in Latin America. Brazil and Chile, in fact, have already carried out the sharp devaluation suggested in this book (as seen clearly in Graph 5 for the case of Brazil). If all the countries in Latin America were to proceed with a devaluation of their currencies, compensating with heavy export taxes on products with inelastic international demand, imports from the rest of the world would be more expensive, but those from Latin America would not. In other words, the relative prices of imports of Latin American origin would be reduced vis-à-vis import prices from the rest of the world. Thus, a coordinated manufacturing devaluation for the entire region, or at least some countries, would represent the equivalent of a significant tariff preference for the participating nations and would enormously favor reciprocal trade based on trade creation, not trade diversion.

Moreover, with the region's current system of ad hoc tariff exemptions, where roughly 50 percent of goods imported from the rest of the world pay no duties, there is no practical way to establish a preference for reciprocal trade other than by employing the simultaneous compensated devaluation proposed here. Such a devaluation would not only stimulate reciprocal trade but also help to reserve hard currencies for the payment of the external debt, since imports from the the region would grow

more rapidly than those from the rest of the world. The increment in intraregional imports would be offset, of course, by a rise in intraregional exports, made possible by better capacity utilization throughout the region—a sharp contrast to the unused capacity caused by recession, currently the chosen method of handling the debt. The multiple benefits of the proposed approach have been fully discussed for the case of Argentina, but this course of action can also be followed to a large extent in many other countries. Of course, each nation possesses different resources and institutions that would have to be carefully examined so that this vision of development could be adapted to its own circumstances. It must be clear, however, that this approach to policymaking in Latin America would have a colossal impact on development and regional integration if its true significance were understood and it were then put into effect by the governments in power.

Epilogue

For the past 40 years the growth performance of the Argentine economy has been poor. In 1985 the growth rate was minus 4.4 percent and the investment rate in relation to GDP was only 10.9 percent, the lowest in the century. The crisis of confidence is deep and the long-term prospect for growth is dim. Economic pessimism is stronger than ever before. The only bright spot is the newly signed integration accord with Brazil. Even there, in order to assist Argentina's long-term economic growth, the accord will mean the realignment of Argentina's exchange rate along the lines of the Brazil's. This would require a substantial real devaluation of the Argentine currency (see Graph 6). However, because of the overexpansion of the Brazilian economy in 1986, the integration accord is having a "pulling" beneficial short-term effect on Argentine growth in 1986. Those accords notwithstanding, the crisis is undeniable and the urgency for policy reform is great. Thus, I believe this book fulfills a real need for leading Argentines today, for whom it was primarily written. It also fulfills a necessity for better understanding of the "Argentine puzzle" in the United States.

There is a tendency in the United States to blame the failure of the Argentine economy to perform on such factors as "Hispanic culture."[11] Why then did Argentina in 1860-1930, with much more pronounced Spanish values than today, succeed in her development effort? Why was Spain a major economic power in the fifteenth and sixteenth centuries? My answer to the Argentine puzzle is to blame not Spanish values or mind set, but simply the "rules of the game," the system under which entrepreneurs and individuals operate in Argentina, which has not been correct in the last 40 years. The "signals" that the entrepreneur or individual receives from the economic system are misleading, starting with the exchange rate. Therefore, Chapters 2 and 3 explain why the exchange rate tends to be overvalued and then give concrete and direct policy prescriptions on how to get rid of this economic disease. Chapter 4 explains the complementary fiscal policies needed to support the would-be newly corrected exchange rate. This implies a policy of no fiscal deficit and even fiscal surpluses. To achieve that goal, structural changes are necessary, in public expenditure, particularly in state enterprises, as well as in the taxation system. Chapter 5 sets forth the monetary policies that are consistent with exchange rate policy. Chapter 6 explains the long-term planning policies that would be consistent with the development strategy outlined in the previous chapters.

Finally, I cannot ignore the fact that two of the main policy measures advocated here, namely elimination of the fiscal deficit and temporary freezing of prices and wages, were undertaken under the Austral plan inaugurated in June of 1985. But the Austral plan lacks consistency, and is filled with short-term macroeconomic gimmicks. The fiscal equilibrium is short term and implies no structural change of public sector institutions or of signals to the Argentine entrepreneur. Basically, the exchange rate continues to be overvalued, now by about 20 percent in relation to the 1970 real parity, and by 80 percent in comparison with the proposal of this book. The real interest rate is out of line too, since it is higher than 30 percent annually in real terms.[12] The issue of external debt is also poorly tackled in the Austral plan, ignoring as it does the problem of capital flight.

This author remains confident that sooner or later the proposals presented herein will be undertaken by the government. The country's economic growth will thus be restored; this will consolidate the political regime undertaking these policy reforms, and lead to long-term stability and prosperity.

NOTES

1. Robert M. Solow, "Investment and Technical Progress," and Edmund Phelps, "The New View on Investment," in *Readings in Modern Theories of Economic Growth*, J. Stiglitz and M. Uzawa, editors, MIT Press, Cambridge, MA, 1962.

2. Tibor Scitowsky, "Two concepts of External Economies," *Journal of Political Economy*, 1954, reproduced in *The Economics of Underdevelopment*, S.N. Agarwala and S.P. Singh, editors, Oxford University Press, London, 1964.

3. At the forefront of macroeconomic modeling technology for developing countries is the effort at the University of Pennsylvania under the direction of Nobel prizewinner Lawrence R. Klein and other renowned economists such as Gerard Adams and Jere Behrman.

4. The leader in technology in the construction of computerized general equilibrium models for developing countries is the World Bank. See for example L. Dervis, L. De Melo, and A. Robinson, *General Equilibrium Models for Development Policies*, Cambridge University Press, Cambridge, MA, 1982. See also Alan Gelb, "Adjustment to Windfall Gains, a Comparative Analysis of Oil Exporting Countries," World Bank, Washington, DC, 1984.

5. It is regrettable that these types of simple models so useful to planning were not in the hands of agencies like the Ministry of Planning and the Central Bank ten years ago.

6. Robert Reich, "Making Industrial Policy," *Foreign Affairs*, vol. 60, 1982, pp. 852-81.

7. Adam Smith, *The Wealth of Nations*, p. 311.

8. It should be possible to develop an Argentine legal system that is not only just but consistent with the needs of modern economic development. See, for instance, Richard Posner, *The Economies of Law*, 2nd edition, Little Brown and Co., Boston and Toronto, 1977, and *The Economies of Justice*, Harvard University Press, Cambridge, MA, 1981.

9. For an updated vision of Latin American integration problems see Eduardo R. Conesa, "Estrategias Políticas para la Integración Latinoamericana," *Integración Latinoamericana*, no. 91, June 1984.

10. Eduardo R. Conesa, "Un Mecanismo de Mercado Equilibrador del Comercio entre Países que Desean Integrarse Económicamente," *Integración Latinoamericana*, no. 82, August, 1983.

11. Lawrence E. Harrison, *Underdevelopment is a State of Mind. The Latin American Case*, University Press of America, Lanham, MD, 1985.

12. The Austral plan, with the currency overvalued and the high interest rates, brings to mind the British overvaluation of 1925, criticized at that time in the famous Keynes essay, "The Economic Consequences of Mr. Churchill," see John Maynard Keynes, *Essays in Persuasion*, Norton & Co., New York, 1963, p. 244. The article is worth reading because a great deal of the ideas of this author, published later, are already contained in it.

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