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Working Paper

INTERNATIONAL EMPLOYMENT POLICIES

Working Paper No. 8

EMPLOYMENT, REAL WAGES AND EXTERNAL CONSTRAINT:
THE CASE OF BRAZIL AND CHILE

by

René Cortázar

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Preface

This Working Paper by René Cortázar from CIEPLAN in Santiago compares the consequences of experience of adjustment in Brazil and Chile for employment and real wages. Since the paper spells out clearly various definitions of imbalance and external shocks and provides in the appendices further theoretical elaboration of a labour market model and the interaction of real wages and employment, it is also of more general interest.

The author considers the various sources of the external shocks which Chile and Brazil underwent as well as actual policy responses and investigates whether those policy responses were the most appropriate.

One of the author's important findings is that Brazil is currently able to expand exports, keep up employment levels and achieve a considerable surplus on the current account as a result of complex set of interventionist policy measures taken in the past decade which increased capacity in the tradeable sectors, and which go against current orthodox advice.

In Chile, on the other hand, a wrong sequencing of various liberalisation policies continued to be associated with high unemployment rates.

One general conclusion of the paper is that stabilisation policies should take a country's existing social infrastructure into account and should not neglect the need for long term increases in capacity.

Peter J. Richards
Rolph van der Hoeven

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INTRODUCTION

The purpose of this paper is to analyze recent adjustment policies in Brazil and Chile, with special reference to their impact on employment, real wages and poverty.

How did we arrive to this crisis? How hard has it hurt the workers and the poor? What are the main characteristics of recent adjustment policies? Are there any alternatives?

In Chapter One we describe the evolution of wages, employment and poverty since 1970. In Chapter Two we analyze the origins of the crisis and the adjustment policies applied by Brazil and Chile during 1980-84. In Chapter Three we discuss some aspects of the equity impact of those policies. Finally, in Chapter Four, we present some of the main trade-offs and alternative policies.

I. EVOLUTION OF WAGES, EMPLOYMENT AND POVERTY: MAIN
RESULTS

Adjustment policies during the 1980-84 period in Brazil and Chile have been accompanied by a sharp drop in real wages, together with an increase in unemployment, underemployment and poverty. In the following sections we will discuss each one of these results.

(1) Real Wages

First, let us consider that nominal wages in Brazil and Chile have been basically determined, during at least the last decade, by the readjustments implemented by official wage policies, and up to a much lesser extent by the economic conditions of the labor market.

Utilizing a very simplified framework we would argue that the rate of change in nominal wages (\dot{w}) has been the result of official wage readjustments (\dot{R}) and the gap between the present rate of unemployment (u) and the one associated to full employment (u^*) (equation [1]).

$$[1] \quad \dot{w} = \dot{R} + f(u^* - u)$$

Therefore, the rate of growth of the real wage ($\dot{w} - \dot{p}$), where \dot{p} stands for inflation, would be determined by the excess supply of labor

$(u^* - u)$ and by how close and how frequently wage readjustments (\dot{R}) replicate the actual inflation rate (\dot{p}) (equation [2]).

$$[2] (\dot{w} - \dot{p}) = (\dot{R} - \dot{p}) + f(u^* - u)$$

Furthermore, most of the econometric evidence for Brazil and Chile indicates that the excess supply of labor $(u^* - u)$ has very little or no effect at all over the rate of growth of nominal wages. At least over the nominal wages recorded in the statistics utilized to run these regressions. These wage-indexes are normally the result of a sample of the more modern and organized sectors of the economy.

For example, Modiano (1984) has argued in the case of Brazil, using data for the 1966-82 period, that an increase of 10% in idle capacity would reduce the rate of growth of nominal wages by only 2.6%. Cortázar (1983) concluded for Chile, using data for the 1974-82 period, that unemployment was not a significant variable in explaining the evolution of wages.

The presence of a persistent excess supply of labor in the modern sector together with active wage policies, are the causes of the results we have just described.

In this setting of downward wage inflexibility and widespread indexation the IMF stabilization package, that typically consists of fiscal retrenchment and credit restriction together with sharp devaluations

(Williamson, 1983) is applied.

These sharp devaluations tend to have a direct negative impact over real wages. The empirical evidence on price formation for Brazil (Modiano, 1984) and Chile (Jadrecić, 1985; Cortázar, 1983) shows that domestic prices (P) are a direct function of nominal wages (w), the cost of imported goods (eP^*), the real interest rate (r) and profit margins (x) (equation [3]).

$$[3] \quad P = P(w, eP^*, r, x)$$

(+ (+) (+) (+)

where,

P = level of domestic prices

w = nominal wages

e = nominal exchange rate (net of tariffs and subsidies)

P^* = world prices

r = real interest rates

x = profit margins

Equation [3] suggests that for a certain profit margin (x) and real interest rate (r), we will observe an inverse relationship between the real exchange rate and the real wage.

Using a more specific functional form, consider the following price equation (equation [4]), that corresponds to a slightly modified version of equation [3].

$$[4] \quad P = (aw + b e P^*) (1 + x),$$

where a and b are technical coefficients.

If we calculate rates of change with respect to time then, if productivity does not change, we obtain

$$[5] \quad \dot{P}_t = \theta \dot{w}_t + (1 - \theta) (\dot{e}_t + \dot{p}_t^*) + (1 + \dot{x})_t$$

where

\dot{z} = rate of change of variable z with respect to time.

Then, as shown in (Cortázar, Foxley and Tokman, 1984),

$$[6] \quad (\dot{w}_t - \dot{p}_t) = \left(\frac{1 - \theta}{\theta} \right) (\dot{e}_t + \dot{p}_t^* - \dot{P}_t) + \left(\frac{1}{\theta} \right) (1 + \dot{x})_t.$$

This equation illustrates the potential trade-off between the real wage and the real exchange rate.

As a matter of fact this inverse relationship between the real exchange rate and the purchasing power of wages is observed in most countries in Latin America during recent years, including Brazil and Chile.

The induced recession, a frequent companion of IMF-style

adjustment policies, does not have --contrary to what is assumed by Phillips-curve estimates in North Atlantic countries-- a significant effect over the inflation rate. On the contrary, the supply shock associated with the devaluation generates, acting in conjunction with the rest of the IMF policy-package, strong stagflationary trends, as those observed in Brazil and Chile during recent years (Tables 1 and 2).

Finally, given widespread indexation, as is the case in these countries, it can easily be proved that, given other policies, a devaluation gives origin not to a temporary but to a permanent increase in the rate of inflation.

If we transform equation [5], and add the simplifying assumption that $\dot{p}^* = 0$, then

$$[7] \quad \dot{p}_t = \dot{p}_{t-1} + \theta (\dot{w}_t - \dot{p}_{t-1}) + (1 - \theta)(\dot{e}_t - \dot{p}_{t-1}) + (1 + x)_t$$

If there exists 100% indexation of wages and the exchange rate then, for a constant mark-up, $\dot{p}_t = \dot{p}_{t-1}$, that is inflation probably will have a strong component of inertia.

In this situation a devaluation, defined as an increase of the nominal exchange rate over and above past inflation, will produce a permanent increase in the rate of inflation.

Brazil

Table 1 shows, for Brazil, a persistent increase in real industrial wages until 1982 with a drop in 1983-84. Minimum wages, on the contrary, suffer a reduction during 1973-74 to start a recovery during the rest of the decade. In 1983 and 1984 we observe a decline of almost 20%.

Wage policies have changed several times during the last 15 years (de Carvalho, 1982). In the 1970-79 period they considered a frequency of at least a year between readjustments, and the change in wages was supposed to reflect productivity gains and to contribute in the war against inflation. The formulas utilized to calculate the readjustments were highly discretionary.

At the end of 1979, at a time when inflation was accelerating, a new wage policy was implemented. Readjustments were to take place every six months on the basis of the change in the CPI during the semester prior to it. The degree of indexation would not be the same for wages belonging to different income brackets. For example, during 1980, workers earning 3 minimum wages or less would increase their nominal wages each semester in 100% of the inflation rate of the previous semester, whereas employees with more than 10 minimum wages would increase their remunerations in only 80% of past inflation. These regulations changed several times during the last four years, always in the direction of reducing the degree of wage indexation. At present

workers earning less than 3 minimum wages (m.w.) have a 100% indexation rule, those between 3 and 7 m.w. have readjustments that correspond to 80% of past inflation, between 7 and 15 m.w. readjustments of 60%, while those with more than 15 m.w. have official readjustments of only 50% of past inflation. These figures correspond to the "floor" of the bargaining process. Increases over and above these figures as well as the increments associated to productivity gains may be bargained between workers and employers on a regular basis.

It is the presence of these wage policies together with the sharp acceleration in the inflation rate, that increased from a plateau of around 100% in 1981-82 to more than 200% in 1984, that explain the sharp reduction in real wages during 1983-84. Since wage indexation is related to inflation in the previous six months, rising inflation automatically produces a short-run drop in the real wages, even in the presence of 100% indexation.

When using these wage statistics we must keep in mind that in 1983 more than 40% of brazilian workers earned less than one minimum wage (Table 3), and that the evolution of their wages is not necessarily described in an adequate form by the indexes we have been analyzing.

Table 1. BRAZIL. ECONOMIC INDICATORS

Year	R e m u n e r a t i o n s		Unemployment rate	Per-capita GDP	Inflation rate
	Real industrial wages	Real minimum wages			
	(1)	(2)	(3)	(4)	(5)
1970	64.3	98.3	6.5	55.7	n.a.
1974	75.2	90.0	n.a.	78.5	33.8
1975	82.4	94.5	n.a.	80.8	31.2
1976	85.3	95.6	n.a.	86.6	44.8
1977	88.9	96.0	n.a.	89.5	43.1
1978	93.4	97.7	6.8	91.8	38.1
1979	94.9	97.7	6.4	95.5	76.0
1980	100.0	100.0	6.2	100.0	86.3
1981	106.5	98.9	7.9	96.3	100.6
1982	114.4	99.4	6.3	95.0	101.8
1983	103.0	87.8	6.7	90.0	177.9
1984	103.6	81.3	7.1	92.0	208.7

Sources:

Col. (1)(2): FIBGE and INPC - Rio, as estimated by PREALC.

Col. (3): Unemployment rates of urban areas from FIBGE; "Pesquisa mensal de emprego", as estimated by PREALC.

Col. (4): FGV, as recorded by ECLA.

Col. (5): INPC of Rio de Janeiro.

Chile

In the case of Chile real industrial wages dropped sharply --in more than 35%-- between 1970 and 1974, mainly as the result of the abrupt acceleration in the rate of inflation, that increased from 36.1% in 1970 to 369% in 1974, together with the less than 100% indexation clauses that prevailed after September 1973.

The overdue readjustment of wages, to take place in October 1973, was postponed until January 1974. Then, in January 1974 the government decreed a wage readjustment of 400% of wages as of January 1973. Inflation in 1973, according to the official CPI calculated by the National Statistics Office (INE) was 508.1%. But the actual inflation rate was of 813.6% (Cortázar and Marshall, 1980) as was recognized afterwards by government officials.

In 1975 industrial real wages fell again, this time by 10%. As in 1974, wage readjustments were not calculated on the basis of a stable indexation formula and therefore the evolution of wages was essentially determined by discretionary and restrictive wage policies.

Throughout 1976-81 the government committed itself to following a 100% indexation rule. With the inflation rate decelerating wages did, in fact, start a steady recovery, reaching their 1970 level in 1980 (Table 2). But during all these years the 100% indexation rule was based on the results of the official-CPI, as calculated by the INE. And again, for the second time in this short period, the INE committed serious "errors"

in the computation of the CPI. This time the "mistake" affected the inflation rates for the years 1976-78. The "official" inflation rates for 1976, 1977 and 1978 were of 174.3%, 63.5% and 30.3% respectively; whereas the true inflation rates were 197.9%, 84.2% and 37.2% for these three years (Cortázar and Marshall, 1980).

According to equations [1] and [2] each percentage point of "error" in the official CPI meant about one percentage point less of increase in nominal wages. A similar phenomenon occurred when the nominal exchange rate was indexed to the CPI during most months in 1976 and 1977.

These lower rates of growth in nominal wages and the nominal exchange rate affected the actual inflation rate. Utilizing the cost structure implicit in Chile's 1977 input-output matrix, and assuming a constant mark-up over wages and imported intermediate goods, it is possible to show that these "errors" in the computation of the official CPI were responsible for more than half of the reduction in the rate of inflation in 1977, 1978 and 1979 (Cortázar, 1983).

Even if we take into account the lower inflation rate that resulted as a consequence of these "statistical errors", the latter meant that real wages dropped around 20% with respect to what they would have been had the policy rules remained invariant and had the INE computed the CPI accurately.

Inflation which had been brought under control by late 1981 jumped

to an average of 4% a month in the second half of 1982, shortly after the successive devaluations that took place as part of the "adjustment" policies. At the same time, the government postponed the wage readjustment due in the last quarter of 1982. A similar scenario appeared in 1983 and 1984. And real wages of the industrial sector dropped by almost 16% between 1981 and 1984 (Table 2).

The evolution of the real purchasing power of pensions followed a similar pattern to that of wages (Table 2).

(2) Unemployment and underemployment

Brazil

If we analyze the unemployment figures for Brazil in Table 1, the first thing that strikes out attention is that they have been relatively stable, as compared to the sharp variations in per-capita output (Table 1). While per-capita output has decreased by 8% between 1980 and 1984, unemployment has risen in less than one percentage point. Why is this so?

A good part of the answer is contained in the figures of Table 3. We distinguish the sector of workers with labor contracts, that we will call the "wage-fix" sector, and the segment conformed by employees without contracts and the self-employed, that we will denominate the "wage-flex" sector 1/.

The labor force increased by more than 7% between 1981 and 1983

and employment in sectors where labor contracts exist decreased in about 2.5%. The latter was the result of a decrease in GDP of about 3.0%. But the excess supply of labor of the "wage-fix" sector did not remain fully as unemployed. A great part of that excess supply of labor increased the labor force of the "wage-flex" segment of the labor market constituted by the self-employed and that part of the labor market that is not regulated by contracts. This "wage-flex" segment of the labor market clears through variations of their average income 2/. That is why the number of people employed in the "wage-flex" segment could increase between 1981 and 1983 in almost 12%, contemporaneously with a general recession. In Appendix I we develop a formal model of the labor market with the two segments we have just described 3/.

In Table 3 we also observe that almost 95% of the new jobs created between 1981 and 1983 correspond to workers that earned less than one minimum wage. It is therefore apparent that the "wage-flex" segment of the labor market is located in its lower tier. On the contrary, between 1978 and 1981 at the time of the expansion, the absolute number of workers that earned less than one minimum wage decreased (Table 3).

As we mentioned above, in 1983 around 40% of total employment in Brazil is located in this "wage-flex" segment. That is why the variation of unemployment rates does not reflect adequately the changing

Table 2. CHILE. ECONOMIC INDICATORS

Year	R e m u n e r a t i o n s		Per-capita government social expenditure	Unemployment rate		Per-capita GDP	Inflation rate
	Real industrial wages	Real pensions		Open	Total		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1970	96.3	116.5	119.8	5.9	5.9	91.7	36.1
1974	62.5	69.1	109.8	9.1	9.1	87.5	369.2
1975	56.1	67.6	89.8	15.6	17.6	74.9	343.3
1976	63.1	70.4	85.2	16.7	21.9	76.4	197.9
1977	72.4	76.7	94.2	13.3	18.9	82.7	84.2
1978	80.9	83.6	94.6	13.8	18.0	88.2	37.2
1979	89.1	97.1	99.2	13.5	17.3	94.2	38.9
1980	100.0	100.0	100.0	11.7	16.9	100.0	31.2
1981	111.7	103.2	101.1	10.4	15.1	103.8	9.5
1982	108.4	101.4	104.1	19.6	25.7	87.9	20.7
1983	96.2	98.1	99.5	18.7	31.4	85.9	23.1
1984	95.6	n.a.	n.a.	16.3 ^{c/}	24.7 ^{c/}	89.6	23.0

Sources:

Col. (1): INE; Cortázar and Marshall (1980).

Col. (2): Social Security Bulletin and Cortázar and Marshall (1980).

Col. (3): Marcel (1984).

Col. (4)(5): Jadrecić (1985,a); Col. (5): Counts as unemployed the workers of the PEM and POJH, that earn less than one minimum wage (see text).

Col. (6): Central Bank, Cuentas Nacionales de Chile: 1960-83.

Col. (7): Central Bank, Boletín Mensual, and Cortázar and Marshall (1980).

Notes: c/: Estimated

Table 3. BRAZIL. UNEMPLOYMENT AND UNDEREMPLOYMENT

(in millions)

	1978	1981	1983
(1) Labor force	43.9	47.5	50.9
(2) Employment	<u>42.9</u>	<u>45.5</u>	<u>48.5</u>
(a) With labor contract	15.9	17.0	16.6
Without labor contract and self-employed	<u>27.0</u>	<u>28.5</u>	<u>31.9</u>
Total	42.9	45.5	48.5
(b) Above 1 minimum wage	22.9	27.3	27.5
Below 1 minimum wage	<u>20.0</u>	<u>18.2</u>	<u>21.0</u>
Total	42.9	45.5	48.5
(3) Unemployment	1.0	2.0	2.5
(4) Unemployment rate	2.3%	6.0%	6.9%
(5) Unemployed (+) workers earning below 1 minimum wage as a percentage of the labor force	46.6%	42.4%	46.0%

Source: Elaborated on the basis of FIBGE; Pesquisa Nacional por Amostra Domiciliar (PNAD).

conditions of the labor market. Moreover, since the wages of those that earn less than one minimum wage and of the self-employed are not adequately reflected in the wage statistics as they are collected, this indicator does not reflect the deterioration of the level of earnings of workers in the "wage-flex" segment of the labor market. Therefore the figures on unemployment and wages of Table 1 do not capture the magnitude of the changes in the labor market that have taken place as a result of the adjustment policies pursued during recent years in Brazil, and that are better illustrated by the statistics reported in Table 3. There has been an increase in the level of unemployment and underemployment, if we define the latter as accounting for those workers that earn less than one minimum wage. Unemployment and underemployment as a proportion of the labor force, increased from 42.4% to 46% between 1981 and 1983, reversing the trend of the 1978-81 period (Table 3). Finally, we must be aware that this methodology underestimates the increment in the level of underemployment in 1983 since the minimum wage dropped sharply during that period (Table 1).

Chile

One of the most striking outcomes of recent economic policies in Chile are the high unemployment rates, which have fluctuated in the neighborhood of 17% during the past ten years (Table 2). These rates are almost three times the average rate of the sixties.

In a country like Chile that has almost no unemployment compensation benefits, the social impact of this high and persistent unemployment has been devastating. Since unemployment has a higher incidence among bluecollar workers and the poor than whitecollar workers, it is probably one of the most significant redistributive results of the period.

Open unemployment increased from 5.9% in 1970 to 19.6% in 1982. Total unemployment rate jumps from 5.9% in 1970 to 31.4% in 1983 (Col. [5] of Table 2), if one considers as unemployed the workers of the government make-work programs PEM and POJH. These are programs designed to alleviate the effects of massive unemployment, that pay significantly less than the minimum wage.

Between 1970 and 1976 total unemployment rose from 5.9% to 21.9% (Table 2), at a time when the participation rate decreased (Jadrecić, 1985,a). It was the result of the reduction in the absolute number of jobs with a growing labor force (Jadrecić, 1985a). This recession was due to the restrictive monetary, fiscal and wage policies applied during this period.

Incidentally, as revealed in Table 2, movements in real wages paralleled those of employment, falling during depressions (1974-75, 82-84) and rising during expansions (1977-81). The same result is obtained if we deflate nominal wages by the wholesale price index. Therefore, it was not the high cost of labor but mainly closed economy

orthodox monetarism with its emphasis on balanced fiscal budgets, that caused the high unemployment rates observed during these years.

After the 1975 depression, employment grew along with output while real wages also advanced at a rate of about 9% a year. Again the evolution of employment (unemployment) was more closely related to shifts in effective demand than to variations in the cost of labor (Table 2).

The peak of the recovery was reached in 1981. From 1982 on, once the adjustment policies started to be applied, total unemployment rates rose dramatically from 16.9% in 1981 to 31.4% in 1983, as a consequence of the sharp recession that reduced per-capita GDP by more than 15% in 1982 and then by almost 1% in 1983. At the end of the recovery of 1984 still per-capita GDP was 10% below its 1980 level.

As in the case of Brazil open unemployment rates tend to reflect only part of the evolution of the employment conditions in the labor market. Even though we still lack a consistent series, fragmentary data suggests that the self-employed 4/ that belong to the "wage-flex" segment of the labor market, together with the make-work programs PEM and POJH, played a similar role in Chile to the one that the "wage-flex" segment of the labor market played in Brazil. The "wage-flex" segment of the labor market together with the PEM and POJH increase their employment levels during recessions 5/. On the other hand, the PEM and POJH pay a remuneration below the minimum

wage. Finally, the same as in Brazil, these wages below the minimum and the remunerations of the selfemployed are not recorded in the "wage-index" as computed by the National Statistics Office (INE).

(3) Poverty

Fragmentary data suggest that the incidence of poverty, that is the percentage of households that do not have access to the goods and services required to satisfy their basic needs, has increased sharply in recent years, both in Brazil and Chile.

Brazil

There has been a well known and longstanding debate on income distribution and poverty in Brazil in the 60s and 70s. Most authors arguing forcefully that there was a deterioration in distributional equity. Others denying that any such thing occurred (Bacha and Taylor, 1980; Camargo, 1984).

But there can be little doubt about the increment of poverty during the application of the adjustment policies of 1981-83.

As García (1984) has shown, the percentage of families that lack the level of income required to satisfy their basic needs has augmented dramatically (Table 4).

The main causes can be found in previous sections: an increase in unemployment and underemployment, together with a significant drop in real wages.

It may prove useful to describe some characteristics of the poor families. In table 5 we present indicators that show the access of urban households in Brazil to water supply, electricity and some durable consumer goods. Those results are compared to similar indicators for Chile. Brazil's urban sector tends to have a relatively better performance with respect to durable goods than in terms of water supply and electricity, as compared to Chile.

Finally, with respect to the employment characteristics of the poor in Brazil, Table 6 indicates the incidence of workers below one minimum wage in non-agricultural sectors.

We observe that poverty has a higher incidence in the non-traded goods sector (construction, commerce and services).

Chile

Adjustment policies were applied in Chile after a decade of acute deterioration in income distribution, and of increase in the incidence of poverty. The high unemployment rates and low wages together with the recovery of per-capita income by the end of the seventies suggests a more skewed distribution of household income and consumption. There are no accurate statistics on the distribution of personal income. The only reliable data for analyzing the distribution of consumption, are the Household Budget Surveys undertaken by the National Statistics Office (INE), in Santiago, in 1969 and 1978 (Table 7).

Table 4. BRAZIL. PERCENTAGE OF HOUSEHOLDS BELOW THE POVERTY LINE

	1981	1983
Arcaju	61.2	66.2
Bello Horizonte	41.0	59.4
Porto Allegre	40.4	62.5
Sao Paulo	33.9	44.4

Source: García (1984), on the basis of IPGE/PNAD.

Table 5. PERCENTAGE OF URBAN HOUSEHOLDS WITH ACCESS TO WATER SUPPLY, ELECTRICITY AND SOME DURABLE CONSUMER GOODS

	Brazil (1980)		Santiago (1983)
	Total Urban	Sao Paulo	
Water supply: - connected	76.1	90.4	99.3
- other	23.9	9.6	0.7
Electric power	88.2	96.9	98.6
Radio	79.1	86.2	93.0
Refrigerator	65.7	77.9	69.7
Television	73.0	86.1	73.1
Automobile	28.2	37.9	23.9

Source: FIBGE and Rodríguez (1985).

Table 6. BRAZIL. INCIDENCE OF WORKERS BELOW ONE MINIMUM WAGE IN
NON-AGRICULTURE SECTORS, 1983
(percentages)

Sectors	Percentage of workers below one minimum wage
Industry	18.8
Construction	28.8
Commerce	30.7
Services	34.7
Average	30.1

Source: R. Infante, "Mercados de trabajo: análisis de la coyuntura con un enfoque estructural", September, 1985.

Table 7. CHILE. AVERAGE MONTHLY CONSUMPTION PER HOUSEHOLD (SANTIAGO)
(in dollars of June 1981)

Households	1969	1978
20% poorer	164	113
20% lower-middle	255	203
20% middle	337	297
20% upper-middle	443	456
20% richest	962	1112
Average	432	436

Source: INE, Household Budget Surveys, Cortázar and Marshall (1980) and CPI of USA.

As Table 7 shows, average consumption in Santiago is the same in both years. But its distribution has undergone important changes. While the households in the lowest quintile consumed an average of 164 dollars a month in 1969, in 1978 its consumption level had dropped to only 113 dollars a month (in dollar of June 1981). This means a reduction of almost one third. Similarly, the 20% of lower-middle income families consumed in 1969 and 1978, on the average, 255 and 203 dollars a month respectively.

Only the 20% with the highest incomes became better off in 1978, as compared to 1969. They were obviously the winners of the decade.

As we have shown above, between 1980 and 1984 total unemployment has increased from 16.9% to 24.7% reaching a peak of 31.4% in 1983 (Table 2). Underemployment has also augmented at the time that real wages have dropped in around 5%. These indicators clearly suggest that the incidence of poverty has increased as a result of the application of the so-called "adjustment" policies. This situation has been aggravated by the 5% drop, in 1983, in per-capita government social expenditure, that is expenditure in education, health, housing and social security (Table 2).

In Table 5 we present indicators of the access of urban households in Chile to water supply, electricity and some durable goods.

Finally, with respect to the employment characteristics of the poor, recent data indicates a higher incidence of unemployment and of the

self-employed among the poor (Rodríguez, 1985). On the other hand, even though we lack actual data about the sectoral incidence of poverty, statistics collected at the end of the sixties show that urban poverty tends to have a higher incidence, as in the case of Brazil, in the non-traded goods sector (construction, commerce and services) (Cortázar, 1977).

II. BALANCE OF PAYMENTS CRISIS, EXTERNAL CONSTRAINT AND "ADJUSTMENT" POLICIES.

In Table 8 we present the balance of payments and the evolution of the stock of the debt for Brazil and Chile, during the 1978-84 period. We can observe the rapid deterioration of the current account in both countries, the sudden drop in foreign lending to Brazil in 1983 and to Chile in 1982 and the fast accumulation of the external debt throughout the period. The current account deficit reached 6.1% of GDP in Brazil in 1982, and 15.1% of GDP in Chile in 1981 (Table 8).

Moreover, we can observe a clear improvement in the current account deficit in Brazil starting in 1983 and in Chile beginning in 1982, once the "adjustment policies" were applied.

(1) External shocks and domestic policies

How did we get there? We will refer both to the external shocks of 1979-82 and to the characteristics of domestic policies during recent years.

(a) The external shocks

The external shocks comprised a sharp cutback of new lending in 1982-83, a deterioration in the terms of trade and a sharp increase in

world interest rates.

Following Carlos Díaz-Alejandro (1984) Table 9 summarizes the key developments surrounding the crisis that emerged. From 1979 through 1981 net new loans were a high proportion of exports, especially in Chile, but also in Brazil. After paying for interest and oil both countries had a comfortable residual (loans plus exports minus oil minus interest). This residual collapsed dramatically in 1982. The behavior followed by lenders is difficult to reconcile with collective economic rationality.

Secondly, the decline in world growth and in the terms of trade contributed to the decline in exports in 1981 and 1982 in Chile and in 1982 in Brazil (Tables 9 and 10).

Finally, the sharp increase in world interest rates is known to explain most of the increase in net interest payments. As compared with the early 1970s, the 1978-83 period is characterized by very high real interest rates (Table 10). And as Díaz-Alejandro (1984) has convincingly argued, we must also take into account that since 1980 nominal dollar price indexes for Latin American exports and imports have declined. The ex-post real interest rate paid by Latin America during the early 1980s is about 9 percentage points higher than the already high rate calculated using US price indexes.

Table 8. BALANCE OF PAYMENTS AND EXTERNAL DEBT

(millions of dollars)

	1978	1979	1980	1981	1982	1983	1984
<u>Brazil</u>							
Current account	- 7,039	-10,482	-12,848	-11,760	-16,314	- 6,840	166
Capital account	11,666	7,582	9,379	12,381	11,119	4,945	5,065
Variation in reserves	4,640	- 2,860	- 3,322	747	- 4,157	- 1,214	5,636
External debt				71,878	83,205	91,362	102,443
Current account (as a percentage of GDP)			5.3%	4.4%	6.1%	3.0%	0.0%
<hr/>							
	1978	1979	1980	1981	1982	1983	1984
<u>Chile</u>							
Current account	- 1,111	- 1,205	- 2,024	- 4,817	- 2,378	- 1,111	- 2,109
Capital account	1,854	2,261	3,345	4,952	1,038	594	2,126
Variation in reserves	683	1,061	1,331	164	- 1,112	- 424	33
External debt	6,664	8,484	11,084	15,542	17,153	17,431	18,466
Current account (as a percentage of GDP)			7.4%	15.1%	11.0%	6.0%	11.2%

Source: ECLA on the basis of Official Statistics. The last row corresponds to the estimates of IDB (1985).

Table 9. LOANS, EXPORTS, INTEREST, AND OIL IMPORTS, 1979-83

(billions of dollars)

Country and measure	1979	1980	1981	1982	1983
<u>Brazil</u>					
Net new bank loans	5.08	6.51	6.29	6.48	1.38
Merchandise exports, f.o.b.	15.24	20.13	23.28	20.17	21.90
Subtotal	20.32	26.64	29.57	26.65	23.28
All interest payments, net	4.10	6.31	9.16	11.35	9.56
Oil imports	6.44	9.85	11.01	10.21	7.90
<u>Residual</u>	9.78	10.48	9.40	5.09	5.82
Terms of trade (% of change)	- 8.8	-15.6	-16.8	- 3.7	- 0.2
<u>Chile</u>					
Net new bank loans	1.78	2.17	2.91	0.86	0.52
Merchandise exports, f.o.b.	3.83	4.71	3.84	3.71	3.83
Subtotal	5.61	6.88	6.75	4.57	4.35
All interest payments, net	0.63	0.85	1.34	1.79	1.63
Oil imports	0.79	0.73	0.60	0.25	0.19
<u>Residual</u>	4.19	5.30	4.81	2.53	2.53
Terms of trade (% of change)	7.2	- 8.2	-21.2	-10.4	7.5

Source: Díaz-Alejandro (1984)

Table 10. PRIME RATE, WORLD GROWTH AND PRICE INFLATION IN WORLD TRADE.

(Average annual percentage rate)

	Prime rate	Inflation rate in world trade	World growth
1970-73	6.7	12.4	4.7
1979-82	15.5	4.4	1.1

Source: Dornbusch (1984)

(b) Domestic policies

To analyze domestic policies it may prove useful to consider, as a framework, the following identities.

The balance of payments B (or the change in official reserves) is equal to the current account surplus, CA, plus the capital account surplus. The latter can be broken up, as suggested by Dornbusch (1984), into three components: net direct and long-term portfolio capital inflows, KD, foreign borrowing, D, and gross private capital outflows, KO (equation [8]).

$$[8] \quad B = CA + KD + D - KO$$

Rearranging terms:

$$[9] \quad D = -CA + (B + KO) - KD$$

Increased gross external debt can have broadly three sources: current account deficits not financed by long term capital inflows, borrowing to finance an official reserve build up, or private capital flight.

In Table 11 we present Dornbusch's estimates of the components of gross debt increase, using data from different sources. In both cases increased debt reflects current account deficits, more than capital flight. At least as compared with Argentina, México or Venezuela (Díaz-Alejandro, 1984). At any rate, estimates of capital flight for both countries suggest that this phenomenon was much more present in Chile (Díaz-Alejandro, 1984; Corbo, de Melo and Tybout, 1985; Carneiro,

1985). In Chile capital flight in recent years has been significantly above 10% of the value of the debt.

These very significant current account deficits had different causes. In Chile overvaluation and expectations of sharp increases in wealth are the key, while in Brazil the budget deficit assumes a central role.

To develop the argument in a more systematic way considers the following identity:

$$[10] CA = (S - I) + (T - G)$$

where,

CA = current account surplus

I = private investment

S = private saving

G = government expenditure

T = taxes

The current account deficit in Brazil reached over 6% of GDP in 1982 (Table 8). It was a direct result of higher world interest rates and higher oil prices. The latter increased the government deficit because of government subsidies that maintained a low domestic price of oil, while at the same time higher interest rates meant more government external borrowing through state enterprises to finance the increased debt service. Dornbusch (1984) has argued that this "terms of trade" deterioration "explains" most of the increase of Brazilian

Table 11. COMPONENTS OF THE INCREASE IN GROSS EXTERNAL DEBT: 1978-82

(Billion dollars)

	Increase in Gross External debt	<u>C u r r e n t</u> Total	<u>A c c o u n t</u> Trade	<u>I n t e r e s t</u>	Direct and portfolio capital inflow	Residual (Reserve gains + capital outflows)
Brazil	48.8	-58.4	(-4.7)	(-33.7)	11.5	1.9
Chile	11.5	-11.4	(-3.9)	(- 5.1)	1.3	1.4

Source: Morgan Guaranty, Data Resources, Inc. and I.M.F., as presented in Dornbusch (1984).

external debt, and that the budget deficit was the main macroeconomic channel through which these shocks were translated into external deficits and debt accumulation.

This "terms of trade" deterioration was aggravated by a significant real appreciation of the exchange rate at the beginning of the 80s.

In Chile the current account deficit reached in 1981 over 15% of GDP (Table 8). The main cause was a drastic overvaluation of the exchange rate that increased real wages and consumption.

This overvaluation of the exchange rate through the change in the composition of spending reduces the demand for domestic goods as the demand for importables increases. Therefore a reduction in output and employment, savings and taxes is induced (see equation [10]).

On the other hand, the increase in asset prices together with expectations of high future growth rates also tended to increase consumption levels, reduce domestic savings and therefore to increase imports.

Finally, the whole process was accompanied by a slow recovery of investment rates and a gradual increase in budget deficits (see equation [10]).

(2) Adjustment policies in Brazil and Chile

Contrary to what occurred in the early 1930s Latin American

countries have continued servicing the public external debt. And for that purpose drastic "adjustment" policies have been applied.

IMF-type policy packages were prevalent in Brazil after 1982 and in Chile after mid 1982, as in many other countries in Latin America. Credit restrictions, fiscal retrenchment and sharp devaluations were the typical prescriptions. Brazil added to the orthodox package strict import and exchange controls.

As we have argued above, this orthodox policy package produced a dramatic reversal in the deterioration of the current account of Brazil in 1983 and in Chile in 1982 (Table 8).

With respect to the trade balance between 1980 and 1984 it improved in Brazil and Chile by almost 7% and 9.5% of GDP, respectively.

If we go into greater detail we will observe the differences in the type of adjustment followed by these countries.

Consider as a framework for our analysis the following identity:

$$[11] CA = (Q_E - D_E) + (Q_I - D_I) - D_I^{NC} + \frac{1}{p} (Q_N - D_N)$$

where,

CA = current account

Q_E = domestic production of exportables

D_E = domestic demand of exportables

Q_I = domestic production of importables

D_I = domestic demand of importables

- D_I^{NC} = domestic demand of non-competitive imports
 p = relative price of tradables and non-tradables
 Q_N = domestic production of non-tradables
 D_N = domestic demand of non-tradables

Brazil

The reduction in the fiscal operational deficit in Brazil from 6.6% of GDP in 1982 to less than 2% in 1984, together with the credit restrictions and the contractionary effects of the devaluation reduced overall aggregate demand.

The "expenditure-reducing" effect of the policy package produced an increase in the excess supply of exportables ($Q_E - D_E$), a reduction in the demand of importables (D_I), and therefore of competitive imports ($Q_I - D_I$), and a tendency to reduce output in the non-traded goods sector 6/. The capital goods component of the demand of non-competitive imports (D_I^{NC}) was diminished as a result of the sharp drop in the investment rate (Table 14) whereas its intermediate goods component decreased pari-passu with GDP.

Moreover, the sharp devaluation of more than 30% in 1983 made an additional contribution to the expansion of exports and the contraction of imports.

As we observe in Table 12, the export volume increased by 13.4% in 1983 and another 18.0% in 1984, while on the contrary the volume of imports dropped by about 22% in both years.

Chile

When we analyze what occurred in Chile in this same period we observe that although imports dropped dramatically with the acute recession of 1982, that reduced GDP in 14.1%, and with the sharp devaluations of 1982 and 1983, exports grew at a much more moderate rate than those of Brazil, and finally stagnated in 1984 (Table 13). Why these differences?

One possible explanation lies in the fact that most of Brazilian exports are also sold to the domestic market. Few industries export more than 20% of their output. Furthermore, manufactured exports, represent almost two thirds of total exports in 1984.

In Chile, on the contrary, primary goods, produced mostly for foreign markets, represent almost two-thirds of total exports, and manufactured goods less than 20% of them. So when domestic aggregate demand falls it does not generate a significant exportable surplus ($Q_E - D_E$). For example, a drop in domestic demand does not mean there is much more copper to be sold abroad. So the "expenditure-reducing" effect of the policy package affects the trade balance only through the channel of import reduction.

A second possible hypothesis, complementary to the one above, refers to the supply-side effects of the IMF-style policy package. The effect of a devaluation on the output of tradables will be an inverse function of the degree of utilization of the productive capacity in that

Table 12. BRAZIL. GROWTH IN FOREIGN TRADE VARIABLES AND GDP

(percentages)

	1981	1982	1983	1984
Exports of goods				
Volume	23.6	-6.0	13.4	18.0
Unit value	- 6.5	-7.8	- 4.3	4.5
Real exchange rate (for exports)	-16.5	-9.6	30.7	- 3.6
Imports of goods				
Volume	-13.2	-8.9	-15.2	- 5.8
Unit value	10.9	-3.6	- 6.1	- 4.1
Real exchange rate (for imports)	-14.5	-9.5	31.8	- 3.0
GDP	- 1.6	0.9	- 3.2	4.5

Source: Estimates of ECLA on the basis of official statistics.

Table 13. CHILE. GROWTH IN FOREIGN TRADE VARIABLES AND GDP
(percentages)

	1981	1982	1983	1984
Exports of goods				
Volume	- 5.9	16.0	6.5	- 0.8
Unit value	-13.4	-16.7	- 2.4	- 4.4
Real exchange rate (for exports)	-10.9	18.2	6.1	- 0.8
Imports of goods				
Volume	10.9	-39.4	-15.4	16.3
Unit value	7.4	- 7.7	- 7.9	1.7
Real exchange rate (for imports)	- 6.7	20.9	7.3	- 1.8
GDP	5.5	-14.1	- 0.7	6.3

Source: Estimates of ECLA on the basis of official statistics.

sector. The latter is related to the size of the capital stock and the investment rates of the pre-crisis period (Bruno and Sachs, 1985).

Even though we lack reliable information on investment rates in the exportable or tradable goods sector, aggregate investment rates for Brazil and Chile are highly suggestive (Table 14). In the 1974-81 period average investment rates were 27% of GDP for Brazil and less than 16% for Chile.

In addition, the elasticity of exports with respect to the real exchange rate is normally much higher in the manufactured goods sector than in primary goods (Schydowsky, 1982). And as commented above, the proportion of the former in total exports is three times higher in Brazil than in Chile.

Finally, even the causes of import-reduction differ in the cases of Brazil and Chile. In the latter the reversal of the import boom of 1980-81 plus the contraction in imports as a result of the 1982-83 slump were the main causes of the results reported in Table 13. On the contrary, an import substitution boom, specially in oil and other close substitutes explains a great proportion of the decrease in brazilian imports. Only the reduction of imports of oil between 1980 and 1984 implies an improvement in the trade balance of more than four billion dollars.

Summarizing, our hypothesis is that the relative success in export-promotion and import-substitution in Brazil was not only due to

the sharp devaluation of 1983, but also to the high investment rates of the preceding period. Especially due to those investment projects in oil and other close substitutes. These investment programs were part of the Brazilian attempt to develop a "structural adjustment" designed to redirect the economic structure to import substitution and export-promotion. This program was described in the Third Development Plan (1975) (Carneiro, 1985). Supply-side policies in Brazil were of a very different type than those normally prescribed by the IMF. Government played a crucial role in redirecting development, controlling directly around half of total investment. It also affected indirectly a significant part of private investment, through the availability of finance intermediation by government agencies such as the National Development Bank (BNDE).

It was mainly this heterodox component of the policy package, present in Brazil but not in Chile, that rests on a medium and long term view of the adjustment process, the one that made possible the more successful results of Brazil, as compared to those of Chile.

Simultaneously with this improvement in trade balance Chile had, during these years, significant private capital flights whereas Brazil avoided this problem through stricter controls (Carneiro, 1985; Corbo, de Melo and Tybout, 1985).

Table 14. INVESTMENT RATES IN FIXED CAPITAL. BRAZIL AND CHILE

	Brazil	Chile
	(at constant prices of 1970)	(at constant prices of 1977)
1970	23.8	20.4
1974	27.3	17.4
1975	29.2	15.4
1976	29.0	12.7
1977	26.8	13.3
1978	27.0	14.5
1979	26.4	15.6
1980	26.3	17.6
1981	23.5	19.5
1982	22.3	15.0
1983	19.0	12.9
1984	n.a.	13.2

n.a.: Not available.

Sources: Brazil: Boletim do Banco Central do Brazil and National Accounting Tables (FCV), as reported in Carneiro (1985).

Chile: Central Bank, Cuentas Nacionales de Chile: 1960-1983.

III. EQUITY IMPACT OF RECENT POLICIES

To analyze the potential equity impact of the recent adjustment policies applied in Brazil and Chile it may prove useful to separate the policy packages in several components. We may distinguish the expenditure reducing effect of restrictive monetary and fiscal policies and also of devaluations, from the shifts in the composition of demand and from increases in output of tradables (Marfán, 1985).

(1) Reductions in the level of demand

The reduction in absorption through restrictive monetary or fiscal policies or even through the expenditure-reducing effect of devaluations, should reduce output mainly in the non-traded goods sector (Q_N). That is, if we assume that the excess supply of exportables will in fact be sold abroad ($Q_E - D_E$), and that there do not exist any "sales constraints" in world markets (see equation [11]).

This contraction of the output in the non-traded goods sector will increase unemployment in the "wage-fix" sector and reduce the real wage or increase underemployment in the "wage-flex" segment of the labor market 7/.

In Chapter I we argued that the adjustment policies applied in Brazil and Chile had reduced per-capita GDP in both countries, and

increased unemployment and underemployment. We also presented some order of magnitudes of the impact these policies had had on each one of these variables.

The percentage of the labor force unemployed or earning below one minimum wage in Brazil increased from 42.4% in 1981 to 46% in 1983, while total unemployment rose in Chile from 15.1% in 1981 to 31.4% in 1983.

But the distributive impact of these expenditure-reducing policies will also depend very much on the instruments utilized to restrict credit expansion or to cut fiscal deficits. The distributive effects will be very different if, for example, the fiscal deficit is cut through an increase in personal taxes or if government expenditure in social sectors, such as health, education, housing and social security, are reduced. In Table 2 we estimate, for Chile, the reduction in per-capita government social expenditures in 1983 in almost 5%.

One of the main problems with expenditure reducing policies is their reversibility. Unless the only cause of the balance of payments problems is an excess demand in the goods market, even though the contraction of absorption will improve the trade balance, as soon as aggregate demand increases to attain internal balance (full employment) the trade balance will deteriorate again. This is part of what happened in Chile in 1984 (Table 13). As soon as the recovery began after the 1982-83 depression the trade balance immediately deteriorated.

(2) Shifts in the composition of demand

Devaluation of the exchange rate has been the main policy instrument utilized in Brazil and Chile to attempt a shift in the composition of demand. In general, these devaluations have a strong expenditure-reducing effect, and other distributive impacts that we discuss in the following sections.

But up to the extent that shifts in the composition of demand have been attained, increasing the demand for non-tradables and decreasing the demand for tradables, this probably has a positive impact over employment, underemployment and poverty.

As we assumed above, a reduction of the demand for tradables should not diminish output while the increase of demand for non-tradables, under conditions of underemployment of resources, as is the case of Brazil and Chile for this period, should increase output in that sector. This increment of production would probably generate a reduction of unemployment in the "wage-fix" segment of the labor market and an increase of wages or a reduction of underemployment in the "wage-flex" sector. In both cases the policy would contribute to poverty alleviation.

Comparing the cases of Brazil and Chile, Arellano (1985) concludes that whereas Brazil concentrates most of its adjustment on the tradable goods sector, Chile shows a sharp drop in output of the non-traded goods sector.

(3) Supply policies: export promotion and import substitution

Export promotion defined as an increase in Q_E , and import substitution defined as an increase in Q_I , may be attained through several policy instruments.

Typically IMF-style packages emphasize the need of devaluations. Other "supply-side" policies sometimes proposed by the IMF are a turn towards free trade and greater emphasis on market prices.

We argued above that the success of devaluations in export-promotion or import-substitution will be contingent on the productive capacity unutilized in the economy. When excess capacity exists, a devaluation may increase output and employment, reducing unemployment in the "wage-fix" segment of the labor market as well as underemployment in the "wage-flex" sector. Both effects would contribute to poverty alleviation. On the contrary, the drop in real wages associated to the increase in the real exchange-rate would act on the opposite direction.

A very important indirect effect of these supply-side policies is that the higher output generates an increase in tax-revenues. These new resources can be utilized by the government to reinforce the poverty reduction effect of the higher employment levels.

When excess capacity in the traded goods sector does not exist, given the severe constraints on foreign savings, an effort of domestic saving will be required. And the redistributive impact of the required reduction in consumption will depend on the specific policy instruments utilized.

(4) Other distributive effects: devaluations and capital flight

Devaluations have been utilized as an instrument for expenditure-reducing, as well as to attain shifts in the composition of demand and increases in the supply of tradables. In the preceding sections we discussed the distributive impact of each one of those effects. Let us now add the direct distributive impact of the variations in the real exchange-rate.

First we should consider the impact of a devaluation on real wages. Cline (1983) has argued that it is possible to achieve external stabilization through devaluation without reducing real wages. That wages need to fall with respect to the price of tradables, but could increase with respect to non-tradables, in a compensatory fashion. Yet unless there is a drop in real interest rates, an increase in productivity or a reduction in profit rates in the non-traded goods sector, that will not be the case (see equation [6]).

Recent evidence for Latin American countries lends support to the view that the real exchange rate and the purchasing power of wages will tend to show an inverse relationship, given the external constraint.

Secondly, devaluations affect dollar denominated assets and liabilities of households, firms and the government. The wealth effects of recent sharp devaluations have not only had important redistributive effects but also a strong impact over aggregate demand and output (Arida, 1985).

Finally, the exchange rate policy has been one of the crucial determinants of short term capital inflows (hot money) and private capital flights. As expected depreciation increased, huge capital flights took place in Argentina, Mexico and Venezuela. And Chile had very significant capital flights as compared to those of Brazil (Carneiro, 1985; Corbo, de Melo and Tybout, 1985). A partial counterpart of the public external debt is conformed by private assets in foreign banks. Again, the more strict and hetherodox exchange controls of Brazil proved useful in avoiding the negative and regressive impact of private capital flights.

(5) The impact of adjustment policies on the poor

The relative importance of the different components of the policy package described above may be determinant with respect to the impact of the adjustment policies on the poor. But also the type of policy instruments utilized in each component will strongly influence the distributive result of the exercise.

It is highly probable that the greater the relative incidence of supply-side policies and of expenditure switching the smaller will be the negative impact of adjustment policies on families below the poverty line. On the other hand these supply side, expenditure switching or expenditure reducing policies can be pursued through a wide range of policy instruments, that have a very different distributive impact.

We will restrict our analysis to the case of the urban poor that were characterized above as having a high relative incidence of unemployment and of the self-employed. We also indicated that the lower income workers tend to concentrate in the non-traded goods sector [see Section I, (3)].

Supply-side policies, when they succeed in increasing the domestic production of exportables or importables, tend to reduce poverty by diminishing unemployment and underemployment. But there is a whole range of policies that may be classified under this general heading.

Both the efforts of the governments of Brazil to invest in the tradable goods sector and the movement of the Chilean economy towards free-trade and greater emphasis on market prices are usually classified as supply-side policies. But, besides the fact that the Brazilian effort proved successful whereas the rate of growth in productive capacity dropped sharply in Chile, the distributive impact of both types of supply-side policies can be very different.

We believe that, at least in part, the regressive results of the Chilean experiment comes from the attempt to follow, since 1975, the strong emphasis of the IMF on market prices and free trade, at a time when they differ sharply from shadow prices. For example, in the Chile of 1985, the shadow price of the exchange rate has been estimated in around three times its market value whereas, given the external constraint, the shadow wages would be close to zero. There exists also

a general agreement, for obvious reasons, that market factor prices will not approach their shadow prices in the near future. Under these conditions, should one still retain invariant the emphasis on the movement towards market prices? Are these wide gaps not a good reason for more selective and interventionist policies?

Also the initial conditions will be crucial to the distributive impact of the so-called supply-side policies. When excess capacity in the traded goods does not exist and domestic savings are needed these policies have to take into account the redistributive impact of the required reduction in consumption.

Finally, these supply-side policies are frequently accompanied by devaluations or other trade policies that tend to reduce the purchasing power of wages. Since the incidence of self-employment among the poor is greater than average, this drop in real wages is relatively less damaging for them.

Expenditure switching policies increase the demand and therefore output of non-tradables. Besides the positive impact of this on the unemployment rate the fact that the poor tend to concentrate in the non-traded goods sector contributes to the relatively positive impact of this component of the policy package on the poor.

As we mentioned above, the apparently more regressive impact of adjustment policies in Chile arises both from the sharp increase in unemployment and from the relatively more significant drop in the output

of the non-traded goods sector (Arellano, 1985).

These expenditure switching policies may also be pursued through very different policy instruments. And as we indicate below, Schydlofsky (1982) and Marfán (1985) have analyzed the ways through which a long menu of policy instruments, associated with very different redistributive effects, may attain the same results in terms of the external balance.

Finally, expenditure reducing policies are the component of adjustment policies that normally produce the most regressive effects on the living conditions of the poor. They increase unemployment and underemployment, especially in the non-traded goods sector where the poor concentrate. On the other hand, these policies tend to produce a direct regressive impact on the poor through the reduction of government expenditure. In the case of Chile, the reduction of government expenditure in social sectors, such as health, education, housing and social security has reinforced the damage that expenditure reducing policies were having on the poor through their impact on the labor market (Table 2).

The distributive impact of each one of the components of the adjustment policy package described above could, in principle, be compensated by other redistributive policies. Or aggravated by them.

In the case of Chile, the adjustment policies have been accompanied by a redistribution of subsidies towards big private conglomerates and

by a reduction of taxes that favours high income families (Marfán, 1984a). For example, the subsidy to those firms that were indebted in dollars had represented since 1982, almost 3% of GDP each year.

IV. TRADE-OFFS AND ALTERNATIVE POLICIES

Maybe a useful way of organizing our discussion of trade-offs and alternative policies would be to follow the traditional classification of deficits by the IMF. Each one of which had associated an appropriate policy response (Williamson, 1983a).

Temporary deficits were due to climatic factors or cyclical variations in the terms of trade or foreign demand and could be expected to reverse themselves automatically without adjustment action. They should just be financed.

On the other hand, there exist three types of deficits that require the application of adjustment policies: excess demand deficits, fundamental disequilibria and structural deficits.

(1) Excess demand deficits

Deficits due to excess demand could in principle be corrected through expenditure-reducing policies without increases in unemployment or underemployment, or reductions in the real wage.

According to equation [11] the current account deficit could be corrected by a reduction of the demand of exportables (D_E), importables (D_I), non-competitive imports (D_I^{NC}) and non-traded goods (D_N). Since we assumed that initially there existed an excess of demand in the non-traded goods sector, this contraction need not

produce a drop in output (Q_N).

At any rate the policy instruments chosen to reduce aggregate demand may affect income distribution and poverty. Fiscal retrenchment may come, for example, from an increase in property taxes, a cut in social expenditures or a reduction of wages in the public sector. In the recent experience of Brazil and Chile typically public investments have been sharply reduced. This will obviously affect intertemporal income distribution since the slower pace of capital accumulation will produce higher unemployment rates or lower wages in the future. With respect to credit restrictions governments have to decide whose credits are going to be curtailed.

There is, already, in this first case, a close connection between the policies chosen to overcome the external constraint and the possibilities of advancements in poverty alleviation.

If aggregate demand is to be reduced one of the lessons of the Brazilian and Chilean recent developments is that these contractionary policies should be very selective in terms of the instruments to be utilized.

(2) Fundamental disequilibria

These are defined as deficits that would persist over the cycle, even in the absence of excess demand. The standard IMF policy prescription includes a devaluation to improve competitiveness and to

produce a shift in the composition of demand. The IMF typically reinforces this policy with demand restraint to prevent the expected expansionary effects of the devaluation on aggregate demand. Contrary to this latter presumption the fact is that devaluations have normally produced in Latin America short-run contractionary effects (Arida, 1985; Meller and Solimano, 1985).

Let us develop a simple analytical framework to discuss the trade-offs under "fundamental disequilibria".

Consider that an increase in total output may come about because of an increase in the output of traded or non-traded goods (equation [11]). Output of traded goods will grow, given a capital stock and world demand, only if there is a gain in competitiveness. Output of the nontraded goods sector may expand because of an increment in domestic demand (D_N), but if we do not want the current account to deteriorate the latter must be the result of a shift in the composition of demand and not of a generalized increase in absorption (equation [11]). Therefore, an increase in total output, for a given current account deficit, requires a shift in the composition of demand or of supply policies (export promotion, import substitution).

Although there exist several ways of shifting the composition of demand or expanding output in the traded goods sector, the IMF typically prescribes sharp devaluations as the best policy for attaining both objectives.

Consider also that, as we argued in Chapter I, and as the recent Latin American experience indicates, there will exist an inverse relationship between the real exchange rate and the real wage.

Then, under these policy prescriptions, and for a given current account deficit, we would observe an inverse relationship between the output level and the real wage (Figure 1).

In point A we would be in the presence of a "fundamental disequilibria". To reach the desired current account deficit we could follow an "expenditure-reducing" policy that would move the economy to B, correcting the external disequilibria but reducing output in the non-traded goods sector, and therefore total output (Q). Unemployment and underemployment would increase deteriorating the living conditions of the poor, but real wages would not fall.

If the policy package considers a devaluation, and fiscal and monetary policies that avoid a reduction in total output, the economy would move from A to C. We would observe an expansion of employment in the traded goods sectors whereas the number of jobs in the non-traded goods sector would diminish. The presumption is that total employment would not deteriorate while real wages decrease.

Under these policy prescriptions there would exist a trade-off between real wages, and unemployment or underemployment. And a potential source of social conflict between unionized workers, who care mainly about the real wage, and those unemployed or working in the

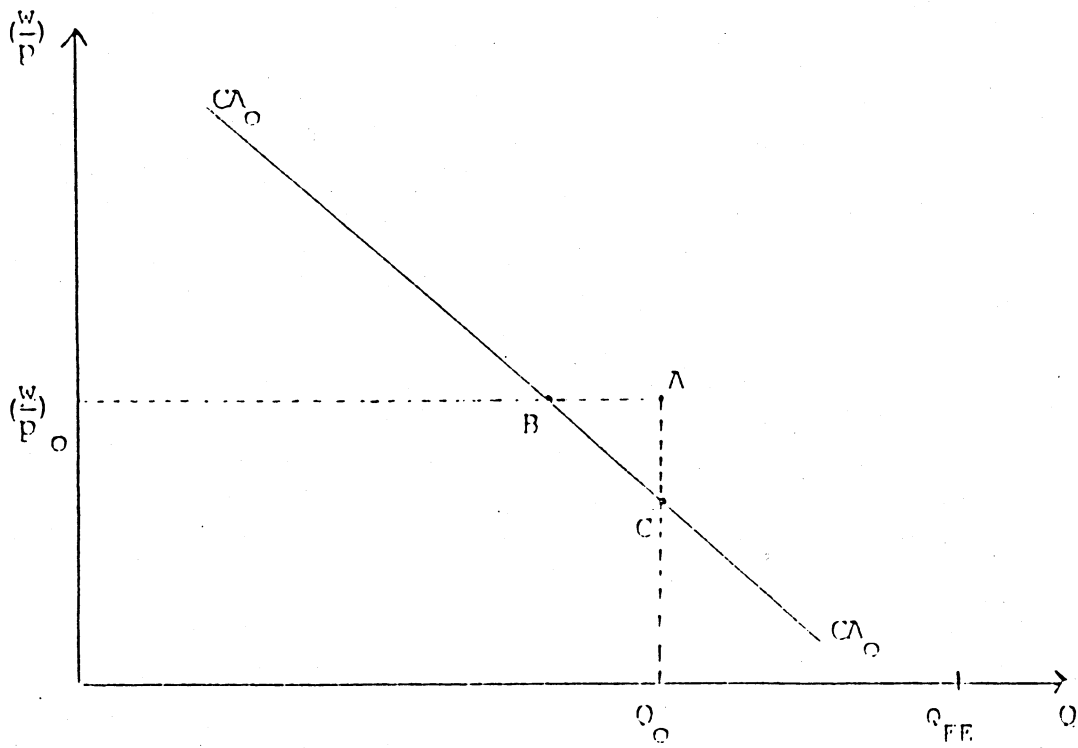


Figure 1.

informal sector, who are more interested in avoiding the increase of unemployment and underemployment (see Appendix II).

One of the main criticisms of IMF policies that aim at correcting "fundamental deficits" is that they lack enough selectivity. Therefore the drop in real wages would be unnecessarily large.

Schydrowsky (1982) has argued that policies should aim at operating on the elastic section of the supply curve of exports. And that is better attained through a differential devaluation between sectors.

Marfán (1985) has emphasized that to attain the desired shift in the composition of demand, as well as to stimulate output of tradable goods, taxes, subsidies and the composition of government expenditure may prove at times to be more efficient instruments than exchange rate depreciations.

These and other criticisms and policy alternatives may be classified under the heading of neo-structuralism. And as French-Davis (1985) has argued, the most distinctive trait of neo-structuralist policies is their emphasis in "selectivity" and a higher degree of "interventionism".

(3) Structural deficits

The fourth type of Balance of Payments deficit has been named "structural". Williamson (1983,a) has defined it as a case where

"domestic output of tradable goods is already as high as capacity permits and the economy lacks the elasticity for short-run substitution between tradables and non-tradables in production or consumption, ... (so that) price signals alone are not sufficient".

Let us consider that a structural deficit exists when shift in the composition of demand and short-run supply policies do not permit to attain simultaneously "external" and "internal" equilibrium. The latter is defined as "full employment" of domestic resources. In terms of Figure 1, assume that full-employment output level (Q_{FE}) is to the right of the maximum output that can be attained in the short run by an improvement in competitiveness.

Policies designed to correct "structural deficits" necessarily have to have a medium or long-run perspective.

Probably one of the major shortcomings of "adjustment" policies prescribed by the IMF is that they treat all deficits as if they were excess demand or fundamental deficits.

Because the "structural adjustment" had taken place through very high investment rates in the tradable goods sector since the mid-seventies (Table 14) (Carneiro, 1985) it may be possible to classify the balance of payments deficit of Brazil in 1982 as a "fundamental deficit". But the evidence for Chile strongly suggests that we were in the presence of a typical "structural deficit". In terms of Figure 1, the relatively high investment rates in the tradable goods sector in

Brazil has shifted its CA_0 curve more to the right than in Chile.

In addition, disagreements with the IMF do not only refer to the source of Balance of Payments problems but also to the theory of economic policy utilized when policies are to be designed (Avramovic, 1983).

Even when an agreement is reached in terms of the need of supply-side policies or of "structural-adjustments" this does not mean that convergence has been attained with respect to the specific policies that should be applied.

The IMF "supply-side" policy package normally consists of free-market and free-trade policies. The World Bank frequently follows a similar path.

And as we have argued above, the impressive "structural adjustment" of Brazil during the late seventies was implemented through very heterodox policies (Carneiro, 1985). Had Brazil followed restrictive fiscal policies in the late seventies, cutting public investment, it is probable that the "structural adjustment" would not have taken place. Up to a certain extent, IMF-type policies are having more successful results in Brazil than in Chile, because Brazil followed more neo-structuralist "supply-side" policies in the recent past whereas Chile has persisted in these same IMF-type policies since 1975.

We do not pretend to argue that policies pursued by Brazil, or any other country, were entirely rational or consistent. But to highlight the

fact that as compared to the case of Chile, and that is not a very high standard, there are several lessons that arise from the relatively better results of the Brazilian experience.

Finally, high-conditionality for "structural adjustment" should focus on expanding investment in tradables more than on reducing aggregate expenditure. The main objection to this proposal has been that savings is not a policy variable and that statistics on overall savings are unlikely to be available promptly (Williamson, 1983,a). But since in Brazil and Chile more than half of investment is directly public investment and the rest is up to a great extent determined by government credit, it is fair to say that total investment is very much a policy variable subject to the same degree of control as most of the other government policies.

(4) Selectivity and interventionism: a neo-structuralist approach to meeting the external constraint

(a) Selectivity

When discussing different types of Balance of Payments deficits the theme of selectivity appeared once and again.

In the case of excess-demand induced deficits one must be selective in the cut of expenditures or in the taxes to be raised. With respect to "fundamental deficits" the drop in real wages associated to a devaluation

could be reduced if differential devaluations are pursued or if taxes, subsidies and changes in the structure of government expenditures are utilized as instruments to shift the composition of demand or to increase the supply of tradable-goods. Finally, selective support to investment projects has been suggested as one of the causes of the relatively more successful "structural" adjustment of the Brazilian economy.

One possible conclusion in this respect is that you need to be more selective in choosing policy instruments, than the typical IMF policy package, to advance simultaneously in meeting the external constraint without deteriorating efforts in terms of poverty alleviation.

This issue of the optimal degree of selectivity is also at the center of the debate in Brazil and Chile with respect to the solution of the problem of the "internal debt" (Fraga Neto and Lara-Resende, 1985; Arellano, 1984,a). In the case of Brazil the abnormally high domestic debt corresponds primarily to government debt while in Chile it is private debt. Even though we have not referred to this topic above, it is probably one of the most discussed economic issues in Brazil and Chile today.

(b) Interventionism

A higher degree of selectivity is normally associated with a higher degree of interventionism. This is especially so in the case of the investment projects required to attain structural adjustment. The

"free-market" solution to supply-side policies, and in particular to the needs of higher investment rates in the traded-goods sector, seems to be, if we compare the recent experiences of Brazil and Chile, less adequate than a more systematic coordination of the public and the private sector towards that objective.

And as we argued above, the most distinctive trait of neo-structuralist policies, as compared to the IMF-type adjustment, is their emphasis on, precisely, selectivity and interventionism.

APPENDIX I

A TWO-SECTOR LABOR MARKET MODEL ^{8/}

The aim of this section is not to build a complete and well-finished model but rather just to illustrate some of the possible links between the segment of the labor market with labor contracts and the sector of workers without labor contracts or self-employed. The segment subject to wage contracts will be modelled as a "wage-fix" sector with nominal remunerations determined basically by wage policies; whereas the self-employed and those segments not regulated by contracts conform a "wage-flex" sector that clears through variations of the wage level.

The second assumption is that the rate of change in employment of workers with contracts is a direct function of the rate of change in output. This follows directly from the assumption to the effect that the only factor of production which is variable in the short-run is labor (equation [1]).

$$[1] \quad L^A = \theta_1 Y \quad \text{where,}$$

L^A = rate of change in employment of workers with contracts in period "t".

Y = rate of change of output in period "t".

On average, in Latin America the value of θ_1 has fluctuated around 0.5 over the last two decades. We have, for simplicity's sake, assumed that changes in employment and in output take place contemporaneously, although, in fact, there tends to be a lag between a change in output and its effect upon employment, especially when the change in the level of output is marked.

Thirdly, we assume, again for the sake of simplicity, that there is no change in the short run in the size of labor force 9/ (equation [2]).

$$[2] \quad l_A L^A + l_T L^T + l_D L^D = 0$$

where L^A , L^T and L^D are the rates of change of the number of workers among, respectively, those employed with contracts, those employed without contract and self-employed, and the unemployed, while l_A , l_T and l_D measure the percentage of the total labor force to be found in each of these categories.

Finally, we assume that there exists an inverse relationship between the rate of change of the number of workers employed with contracts and the rate of change of the number of workers unemployed, with both being appropriately weighted (equation [3]). This is equivalent to assuming that part of a drop in employment among workers with contracts is reflected in an increase in the number unemployed and part

in an increase of the supply of workers without contracts and those self-employed (such, for example, as the increases in street sellers and workers offering personal services which are seen in developing countries at times of recession).

$$[3] \quad \dot{L}^D = -n l_A L^A \quad \text{with } 1.0 > n > 0$$

Changes in the supply of workers without contracts and self-employed workers are found as a residual. Substituting [3] into [2], we obtain equation [4]:

$$[4] \quad \dot{L}^T = \theta L^A$$

$$\text{where } \theta_2 = - \frac{A(1-n)}{T} \quad \text{with } \theta_2 < 0$$

Finally, by substituting [1] into [4], we can express the rate of change of the number of workers without contracts and self-employed workers as a function of the rate of growth of output (equation [5]).

$$[5] \quad \dot{L}^T = \theta_2 \theta_1 Y \quad \text{with } (\theta_2 \theta_1) < 0$$

Figure 1 represents these relations geometrically. The second quadrant shows the positive relationship that exists between the rate of

change of total output and the rate of change of employment in the sector with contracts (equation [1]), while the first quadrant shows the inverse relationship between the rate of growth of employment in the sector with contracts and the one without contracts and self-employed workers (equation [4]). Finally, the fourth quadrant represents the relationship between the rates of change of real wages or average income and of employment among self-employed workers and those without contracts.

A reduction in the rate of growth of output from Y_0 to Y_1 will lead to a reduction in the growth of employment in the sector with contracts from L_0^A to L_1^A which, together with increasing unemployment (equation [3]), will increase the rate of growth of the supply of self-employed workers and workers without contracts from L_0^T to L_1^T and reduce their real wage from $(\dot{w}^t - \dot{p})_0$ to $(\dot{w}^t - \dot{p})_1$.

Therefore, relative incomes and the growth of informal sector incomes depend not only on the rate at which the labor force shifts from one sector to another. Real wages in the "wage fix" segment of the labor market are basically determined by wage policies whereas the average income in the informal sector is a function of the supply of labor in this segment and demand conditions in the goods market. The former is influenced by the rate at which the labor force shifts between sectors.

Several possible results may arise. For example, a sharp reduction

of wages in the "wage fix" segment of the labor market would have an impact on the average income of the informal sector if this drop in wages diminishes aggregate demand in the informal sector and/or employment in the "wage fix" segment. The latter would increase the supply of labor in the informal sector. The final result will be influenced, among other variables, by the elasticity of aggregate demand with respect to real wages; the elasticity of the demand for labor in the wage-fix segment with respect both to real wages and aggregate demand and the proportion of the excess supply of labor in the wage-fix segment that moves to the informal sector.

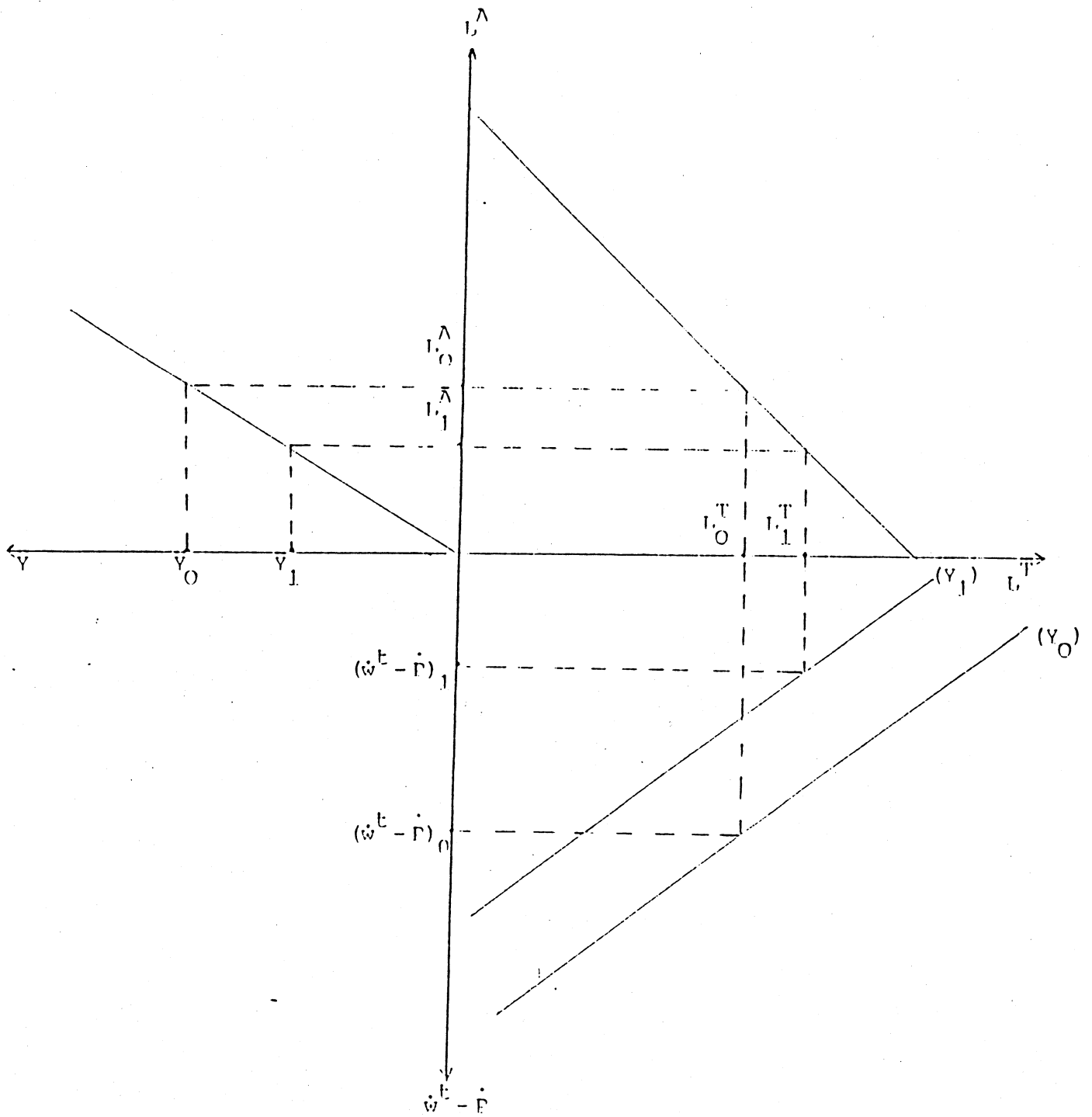


Figure 1.

APPENDIX II

REAL WAGES AND EMPLOYMENT

Consider the following simple model for the wage-fix segment. Output is produced with capital (k) (fixed in the short run) and labor (L). This gives rise to the marginal productivity of labor schedule (MPL). The supply of labor is fixed in the short run. In Figure 1 we present the equilibrium wage $(\frac{w}{p})_0$.

If the goods market is in equilibrium (no sales constraints exist) the demand for labor coincides with the marginal productivity of labor schedule (MPL) and unemployment is the result of the cost of labor being too high $(\frac{w}{p})_1$. We are therefore in the presence of "classical unemployment". In this case an inverse relationship between real wages and employment would exist.

If sales constraints prevail, even though the real wage may be at its "equilibrium" level, unemployment is the result of a lack of aggregate demand. Therefore the demand of labor $D_L D_L$ is to the left of the MPL. In this case, we may observe a positive relationship between real wages and employment (this is the case of Chile during the second half of the seventies and the beginning of the eighties). Unemployment is of a keynesian nature.

Finally, if the lack of aggregate demand is due to a lack of foreign

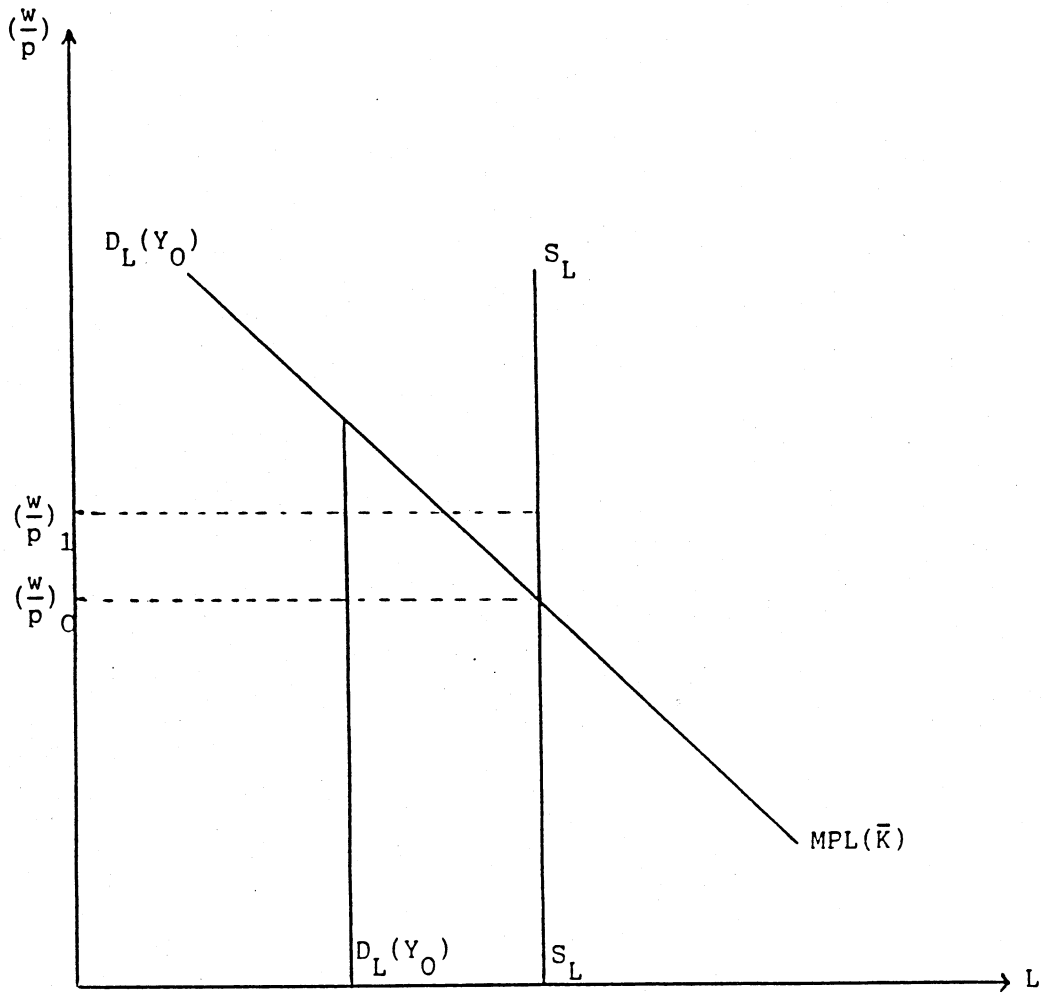


Figure 1.

exchange we have argued that for a given trade balance there exists an inverse relationship between the real wage and output and employment (Section IV, 2). To increase employment we need to increase aggregate demand. This economic recovery would tend to deteriorate the trade balance unless we devalue or follow other trade policies, which are normally associated with a reduction in the real wages.

If the trade balance (T_0) must remain invariant, and is a positive function of the real exchange rate ($\frac{ep^*}{p}$) and an inverse function of the level of output (Q),

$$T = T \left(\frac{ep^*}{p}, Q, \dots \right)$$

(+) (-),

then given the trade off between the real exchange rate and the real wage described above (equation 6), we would observe a trade-off between the real wage and output; if other variables (policies) do not change.

This inverse relationship between output and real wages can be avoided, for example, when trade policies that do not affect the real exchange rate are pursued, or when the change in competitiveness ($\frac{ep^*}{p}$) is obtained through shifts in the profit rate, the real interest rate, or productivity (Cortázar, Foxley and Tokman, 1984).

FOOTNOTES

- 1/ We also include in the "wage-flex" sector those workers that although employed, do not perceive any remuneration.
- 2/ In the case of the self-employed the "wage" coincides with the average labor income.
- 3/ See also Cortázar (1983), Cortázar, Foxley and Tokman (1984) and Labor Ministry (1985).
- 4/ And workers employed but without a remuneration.
- 5/ See INE, Encuesta Nacional de Empleo (several years). And estimates by PREALC for recent years.
- 6/ We will assume throughout the paper that output in the non-traded goods sector is demand-determined.
- 7/ See Chapter I.
- 8/ The model developed in this Appendix is based in Cortázar (1983) and Cortázar, Foxley and Tokman (1984). A very similar model is presented in Labor Ministry (1985).

9/ This assumption in no way affects the results of this section.

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