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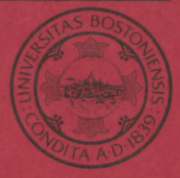
Center for Latin American Development Studies



FREE TRADE AND MARKETS—BUT ONLY AS LONG AS WAGES ARE UNDER CONTROL: THE CASE OF URUGUAY IN THE 70s

Jaime Mezzera

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I. The Recent Past

A. Introduction

This paper will refer to the consequences of a dramatic change in economic policy on factor rewards and, thereby, on income distribution.

Since the mid-seventies, Uruguay--as Chile, Argentina and, lately, Perú--has begun to implement what I shall henceforth call the "New Economic Policies" or NEPS. In all these cases, intensely interventionistic economic regimes have been drastically changed and strong moves toward the operation of free markets have been instituted. The three most relevant features of these NEPS are the opening up to foreign trade and financial flows, the restoration of the private entrepreneur as the dominant force in shaping the countries' economic development and the emphasis on fighting the inflationary processes which prevailed in all these countries during the late '60s and early '70s.

As I have argued elsewhere,[1] during the period 1968-72 the Uruguayan economy became one of the most intensely intervened of the non-socialist world. There were mainly two instruments to that effect. The first was protection against imports, represented by a host of tariff and non-tariff barriers which I will call "tariffs" as shorthand. There is no way to calculate any meaningful "average protection" but it should suffice to say that during 1970-72 the average import/GNP ratio was close to 12%, while

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[1] "La Política Económica Reciente en el Uruguay" (Recent Economic Policies in Uruguay) a paper I prepared in July/August of 1980 as a consultant of ECLA. That paper is being published by ECLA in mid-1982. The present paper, which is based upon my work for ECLA, has been awaiting that publication since December of 1980. The opinions expressed here are the author's alone and they in no way reflect those of ECLA or CLADS.

it rose to over 21% in 1979. In judging the impact of the pre-NEP protection levels, one must keep in mind that, in 1979, the model tariff had fallen to about 50%--which is not precisely free trade. In addition, nominal tariffs were extremely uneven, with some of them exceeding 500% while others were literally zero. Effective protection calculations show correspondingly high differences. One main consequence of this policy was that, since the mid-fifties, one could not buy any--and I mean that literally--imported consumer goods in Montevideo. Lowering tariffs down to 35% is a veritable policy earthquake when starting from such protection.

The other main instrument of government intervention in the economy was the control of domestic prices. In July 1968, a wage-price freeze was imposed and COPRIN--the Council on Productivity, Prices and Incomes--was created. COPRIN's job was to authorize each and every price and wage increase in the economy. Even self-employed workers who increased their prices--say, for an in-house plumbing job--were liable to COPRIN's action if the "damaged party" could prove, through witnesses or otherwise, that the plumber had raised his price after the wage-price freeze. COPRIN's modus operandi required all firms to justify their price increase requests through sworn declarations of increased costs. The Council always could--and sometimes did--conduct its own investigations to disprove the firm's allegations. Non-compliance with the freeze often entailed sizable fines and close-downs for up to a whole month in severe cases.

To a large extent, this extensive intervention was required because the government was politically inhibited from devaluing even in the face of rapid domestic inflation. During the period April 1968 through December 1971 the official exchange rate remained frozen at N$ 0.25 per dollar,

while inflation during that period was 125%.

This interventionist regime persisted for five years in full bloom and began to be torn apart by mid-1973. To a very minor extent, it still exists: some two dozen goods--ranging from bread to automobiles--are still price-controlled for different reasons. However, all other goods and services sold domestically are now price-free.

B. The NEP and Its Main Results

All major macroeconomic variables show correspondingly intense changes by comparison with their values during the years before the NEP. Output, which virtually stagnated during 1955-73,[1] grew by 4.3% a year during 1973-79. Considering that population has traditionally grown very slowly in Uruguay and that intense emigration took place during 1968-76, the above output growth probably translated into a 4 to 5% a year improvement in per capita income. Likewise, the investment ratio grew from 13 to 22% in that six-year span. The current account was chronically in deficit--mostly due to large imports of oil and, lately, to the real revaluation of the domestic currency--but international reserves have grown by half a billion dollars thanks to heavy inflows of short-term capital attracted by very high interest rates. The pace of inflation abated from the three-digit level which was observed during the late sixties and early seventies to a level of 35% in 1980. The fiscal deficit, which was 4.4% of GNP in 1974, turned into a surplus in 1979 and 1980. The real wage fell to an

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[1] It barely kept up with the 1% a year growth in population during 1955-65. During the following eight years, output grew by an average of 3/10 of 1% each year.

index of 63 in 1979 (using 1968=100 as a basis) after having been 112 in 1973. According to the statistical office (to which I will henceforth refer by its Spanish acronym DGEC), the share of wages in GNP fell from 41% in 1971 to 32% in 1976. The unemployment rate in Montevideo rose from 7.7% in 1972 to 13% in 1976 but later fell to 8.1% in 1979.

It is therefore unquestionable that there have been momentous changes in both policies applied and results obtained in terms, at least, of the major macroeconomic variables.

However, the above points encompass a huge variety of economic phenomena. I intend to narrow down the focus of the analysis to include only the effects of the new policies on wages and the level of employment.

Let me therefore begin by discussing what one might expect, on a priori theoretical arguments, as most likely outcomes of the policies that were implemented.

C. The Theoretical Arguments

The wage and employment outcomes will largely depend on the net effect of three main policy packages:[1]

- Opening up the economy to foreign trade and capital flows
- Changing factor prices towards a lower wage-rental ratio
- Fighting inflation while at the same time eliminating all price controls

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[1] I am using the term "policy packages" bacause there is not one policy to, say, fight inflation, but a host of them. Furthermore, some policies are expected to have effects on more than one front: for instance, slowing down the rate of crawl of the pegged exchange rate is expected to reduce domestic inflation by way of the operation of the Law of One Price (LOP) and to affect resource allocation via discouraging the production of tradeable goods.

In the models which assume competitive equilibrium the first two policies are usually taken to be favourable to employment while the third should have the effect of depressing employment if the economy is operating along a negatively-sloped Phillips curve.

Let me spell out those arguments in some detail since they play a rather important role.

1. The Growth Argument

Opening up to foreign trade is generally seen, in the conventional neoclassical view, as unequivocally pro-employment primarily because of the increased output which ought to be brought forth by the improved resource allocation resulting from "getting the prices right."

This latter issue has, of course, created a furious dispute among both development theorists and practitioners but the definitive point is probably Peter Timmer's phrase: "Though getting the prices right is not an end of development, getting them wrong often is."[1] Even so, there still remains the question of the trade-off between the static losses involved in distorted factor prices which generate large profits, and the dynamic gains in terms of the increased investment which may stem from those profits. Recent experiences suggest that the static gains implicit in "getting the prices right" indeed outweigh the dynamic gains from increased investment: while most Latin American countries struggled under their import-substitution schemes--the veritable epitome of distorted factor prices and

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[1] As quoted by G. Ranis in "Development Theory at Three-Quarter Century," Economic Development and Cultural Change, Vol. 25, supp. 77.

administrative allocation of profits--the Eastern nics were being hugely successful with their relatively distortion-free strategies.[1] This links, of course, with the fact that lowering protection tends to reduce the anti-export bias implicit in the import-substituting strategies. This may entail a surge in industrial exports involving greater capacity utilization and, hence, both a faster rate of growth and more job creation.[2]

2. The Output-Mix Argument

The second beneficial effect on employment expected of the NEP is through a more labour-intensive output mix. The argument is that under import-substitution schemes the highest levels of effective protection--hence, the strongest pulls on resources--are associated with the most capital-intensive activities. This argument, naturally, requires that the Heckscher-Ohlin theorem is applicable and that Uruguay's factor endowment is at the labour-intensive end of the spectrum--more strictly, that it is more labour-intensive than that of the average trading partner. Should that be so, eliminating or reducing the tariffs and other protective instruments would tend to enhance the share of the labour-intensive sectors in output, hence increasing the overall level of labour use per-unit of output. Since it also reduces the per-unit capital input, total demand for labour increases because the binding constraint is the short-run constancy of the capital stock.[3]

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[1] See for instance, G. Ranis, op.cit., and L. Westphal, "The Infant-Industry Argument and the Relation of Trade Policy to Industrial Strategy," (mimeo), Bar-Ilan University, April 1980.

[2] D.M. Schydlowsky, "Short-Run Policy in Semi-Industrialized Economies," Economic Development and Cultural Change, 1971.

[3] Naturally, the argument also assumes malleability of capital. A way to get around this problem is to leave enough protection so as to have capital-intensive sectors just cover their marginal costs. In that way, the policy will "keep them going" but will not allow them to reinvest.

The trouble with this argument is, in general, centered around whether the H-O theorem really holds and, since there is a voluminous literature on it, I will pursue the question no further.[1] I will only point out that the other assumption noted may well not hold. Though it is probably unquestionable that Uruguay's factor endowment is less capital-intensive than that of the "world market" (of which developed countries represent the dominant share) the point is that, to a very large extent, Uruguay trades within priveleged trade areas[2] in which the question of relative factor endowments becomes much less clear.

The traditional argument goes on to claim that, since lowering protection would reduce the relative price of the capital-intensive goods vis-a-vis those of the more labour-intensive ones, the Stolper-Samuelson theorem guarantees that wage-earners will gain at the expense of the sellers of non-labour services.

This is really an extension of the above argument in the sense of referring to the share of wages in output instead of to employment itself. What this means is that, under the first part of the argument, employment might increase but wage levels might plunge enough to determine a smaller share of wages in output. That possibility is precisely what the Stolper-Samuelson theorem rules out.

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[1] Possibly the strongest doubts refer to the issue of a third factor, land, which surely plays a large role since the main exports of Uruguay tend to be either agricultural or agro-based.

[2] Mainly LAFTA, the Latin American Free Trade Area, and the country's special trade agreements with Argentina, Brazil and Paraguay. All these arrangements contemplate low or vanishing tariffs among members and high protection levels against non-members.

Once again, the applicability of the Stolper-Samuelson theorem is open to discussion, most particularly because of its assumptions of full employment and non-distorted factor prices. With distorted factor prices, Stephen Magee has shown that free trade may lead to "trade reversals," i.e. to a country exporting the good(s) in whose production it is at a "true" comparative disadvantage.[1] In that case, it has been shown by Richard Brecher that an increase in exports will lead to higher unemployment and reduced welfare.[2] Naturally, one way out of this might be to eliminate the wage floor. However, this solution has several drawbacks: the first is that the resulting market-clearing wage may turn out to be so low as to become politically unfeasible. The second drawback is that, as I have argued elsewhere,[3] it is not necessary to have extraneous interventions in the labour market for two distinct wage levels to coexist, with at least one of them being clearly higher than the shadow price of labour. The third is that the subsidy to the use of fixed capital implicit in the present use of credit and tax policies will, for other reasons, remain in force in Uruguay in the foreseeable future. Obviously, to the effects of relative factor price distortions, having a subsidy on capital is tantamount to having an above-equilibrium wage, so the Magee-Brecher argument holds.

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[1] S. Magee, International Trade and Distortions in Factor Markets, New York, Marcel Dekker, 1976.

[2] R. Brecher, "Optimal Commercial Policy for a Minimum-Wage Economy," Journal of International Economics, #4, 1974.

[3] J. Mezzera, "Labour Market Segmentation Without Policy-Induced Labour Market Distortions," World Development, 1981.

3. The Factor-Price Argument

With import-substituting strategies, one generally finds that labour costs in the modern sector are above the opportunity cost of labour due--in the simplest approach--to minimum wages and social security payments, while the rental price of capital is held below its shadow price through a variety of mechanisms which include tax exemptions to investment in fixed capital, subsidized credit policies, etc. The NEP in Uruguay has significantly eroded the wage premium but has hardly--if at all--reduced the subsidization of capital. Even so, there has been a significant fall in the wage-rental ratio: according to the mainstream neoclassical theory, this ought to lead to a fall in the optimal capital-labour ratio at the microeconomic level, thus further enhancing employment.[1]

The first objection to this argument is that, once installed, technologies tend to lose flexibility so that changes in the wage-rental ratio would not induce changes in the pattern of factor use in installed activities. With a gross investment coefficient of close to 20% and a capital-output ratio of 3:1, only about 6% of all capital would be put into place each year, thus determining an extremely low relevant elasticity of factor substitution. A low elasticity would thus mean that a fall in the wage rate will entail a fall in the total share of wages in private output. More on this later.

The other important objection is that the conventional factor-price argument has been developed assuming, inter alia, constant returns to scale. Once that assumption is dropped it becomes possible that the

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[1]An argument which is not used in Uruguay but may be valid is that reducing the minimum wage may increase earnings in the informal sector.

export opportunity may induce a shift towards more capital-intensive techniques whose minimum scale of operations exceeds the size of the domestic market. This in turn might mean the destruction of the more labour-intensive firms which used to supply the domestic market--in which case the net employment effect might be negative.

4. The Issue of Anti-Inflationary Policies

The standard formulation of the negatively-sloped Phillips curve implies that reducing inflation will carry a cost in terms of increased unemployment.[1] In the practical application of the quantity theory of money which characterized Uruguayan monetary policy during 1973-77, this was translated into "tight" money and rising unemployment. After 1977, when the leadership of economic policy began to move decisively into the hands of the Central Bank (BCU) the rigid application of MV=PY was gradually replaced by more modern theoretical approaches to monetary policy in open economies. Thus, BCU decided to run an active crawling peg, in this case one which allows the domestic currency to depreciate by less than the differential between expected domestic and foreign inflation rates--and has been doing so since 1978. This active crawling-peg is expected to yield anti-inflationary results in two ways: in the first place, since it encourages imports and discourages exports, it tends to reduce international reserves and, hence, the money supply. In the second place, given a non-increasing level of protection, it puts a

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[1] The original Phillips formulation related unemployment to the rate of increase in money wages. However, most economists in both the labour and the macro fields seem to agree on the interchangeability of money wages and prices in the present context.

ceiling on domestic prices.

It turns out that the application of the theory has rendered defective results on both grounds. In the first place, given a very high level of domestic interest rates and the fact that the rate of devaluation is announced six months in advance, there has been a very strong short-run capital inflow which literally swamped the current account deficit: hence, international reserves have increased consistently and so have the money supply and domestic prices. The inflation rate was 88% in 1979 when the capital inflow was at its peak and then subsided to around 50% in 1980 reflecting some fall in the domestic rate of interest and the capital inflow.[1]

In the second place, the Law of One Price (LOP) has simply not operated. The increase in domestic prices has consistently outstripped the sum of world inflation plus the rate of devaluation, even in the face of falling tariffs.[2]

Explanations for this phenomenon revolve around two facts. In the first place, the Uruguayan economy is made up of non-tradeable goods in a proportion well above 50%. In the second place, it turns out that opening the economy to foreign trade not necessarily guarantees the disappearance of the domestic monopolistic supply of industrial goods.

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[1] Given perfect currency convertibility, there are two applicable definitions of the "real" exchange rate. One, which is relevant for the domestic saver, is the difference between the nominal interest rate and domestic inflation. On the other hand, what is relevant for the foreign saver is the difference between the nominal interest rate and the rate of devaluation of the Uruguayan peso. Since BCU devalues by less than the inflation rate, a barely positive domestic real interest rate is compatible with rates of return of close to 40% in dollars.

[2] The LOP assumes constant protection levels, of course.

What seems to be happening is that the very firms that used to produce, say, durable consumer goods are now importing them at a landed cost well below their previous production cost but selling them at a price determined by that of the domestically produced good.[1] The question, naturally, is how do these firms manage to remain monopolistic. The answer runs at two levels. In the short-run, the fact that imports of consumer goods have been, in practice, banned in Uruguay during the last 25 years, means that the opportunity to import remains largely theoretical in most cases: people simply no longer know how to import. Therefore, whoever was in contact with the foreign producer--through, say, a licensing arrangement for the domestic production of the durable consumer good in question--is in practice the only one who will manage to effectively import. However, this is an essentially short-run argument that relates to the lag implicit in the need to re-create a skill (that of importing) that had become extinct. The much more long-run argument which attempts to explain why this monopolistic importation result is still present in the third year of the trade-freeing policy,[2] relates to the service centers which are a component part of the utility rendered by durable consumer goods. Given that total demand for any given durable consumer good in Uruguay is no more than 15 or 20% of the demand

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[1] In fact the imported good sells at a price well above the domestic one, given that, at least in perceived terms, the imported good is of higher quality.

[2] What is more, the same phenomenon was observed in Chile and has not subsided in spite of the fact that the free-trade policy has been in force there for nearly five years now.

in, say, Massachusetts, the issue of the scale of operations of the service network becomes a constraining one. Therefore, a firm which has not been producing, e.g., washing machines, will not be able to offer service for them--because installation of the shop would not be profitable--and will therefore not be able to sell them either.

The consequences for income distribution of shutting down production and substituting an importing office for it, while maintaining prices roughly constant, must be very large. Precisely how large, is however, still a matter of research.

D. The Wage Policy

As has been said above, under the simplified neoclassical assumptions opening up the economy to foreign trade ought to have brought about a significant increase in the share of wages in output. Such a shift would go even further as the NEP cut down the size of government and hence increased the share of the private sector in GNP.

However, it turns out that this expected short-run result ran counter to the governmental policy regarding long-run growth. In truly Lewisian fashion, the Minister of the Economy stated the need to concentrate incomes in order to increase savings, investment and growth.[1]

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[1] In a public address at the beginning of 1980, the Minister said: "... our policy was, from the very beginning, one of concentrating incomes towards people with a high propensity to invest and away from those who have a high propensity to consume." Even the phrasing bears a striking resemblance to that chosen by W.A. Lewis in "Economic Development with Unlimited Supplies of Labour," The Manchester School, May 1954, reprinted in Agarwala and Singh (eds.) The Economics of Underdevelopment, Oxford U. Press, 1958, p.417.

Therefore, the NEP had to find a way of stopping the operation of the Heckscher-Ohlin and Stolper-Samuelson theorems in order to avoid increases in the share of wages (wage-earners were equated with "high propensity to consume") in total output. The chosen way to do it was to continue to intervene in the wage determination process through the operation of the minimum wage. In particular, the wage-policy component of the NEP was to decree quarterly increases in the minimum wage rate, keeping them below the inflation rate so as to achieve a fall in purchasing power of the minimum wage. Naturally, whether such a policy will in fact achieve a fall in the share of wages in output depends on what sort of labour market is operating.

The results are a subject of debate in Uruguay. On the one hand, the official wage series is the one published by the Statistical Office or DGEC. These figures, based on the purchasing power of the minimum wage, show the precipitous fall in real wages and in the share of wages in output to which I referred earlier, as appears in Table 1.

However, an alternate source is available which uses a different methodology and, unsurprisingly, comes to conflicting results. The source is BCU and its data on wages comes from its own industrial survey of over 600 industrial firms in Montevideo--where the overwhelming majority of industry is located. According to BCU figures, the total wage bill turned upwards by mid-1977 and has steadily increased ever since because the employment growth over-compensated for the then-falling real wage level. Furthermore, the BCU figures--see Table 2--suggest that the real wage itself may have begun to increase by mid-1979 and that, therefore, the share of wages must have stopped falling.

Table 1

Real Wage Index, DGEC

	(Base 1968 = 100)
1970 - Semester I	112.4
II	107.6
Average	110.0
1971 - Semester I	115.9
II	115.4
Average	115.7
1972 - Semester I	100.7
II	91.0
Average	95.9
1973 - Semester I	95.2
II	93.4
Average	94.3
1974 - Semester I	96.3
II	90.6
Average	93.5
1975 - Semester I	87.7
II	82.9
Average	85.2
1976 - Semester I	80.2
II	80.2
Average	80.2
1977 - Semester I	72.5
II	68.8
Average	70.7
1978 - Semester I	69.2
II	67.1
Average	68.2
1979 - Semester I	64.8
II	60.5
Average	62.6
1980 - January	56.8
February	63.5
March	62.6

Source: DGEC

Table 2

Real Wages in Manufacturing-BCU

(Base 1975 = 100)

Year	Real Wage Per Worker	Employment	Wage Bill
1976 - I	101.5	101.5	103.0
- II	98.8	103.5	102.3
- III	100.7	106.7	107.4
- IV	89.2	105.2	93.8
1977 - I	90.8	107.3	97.4
- II	99.4	108.4	96.9
- III	87.6	113.5	99.4
- IV	82.8	113.8	94.2
1978 - I	87.7	115.0	100.9
- II	87.4	115.4	100.9
- III	85.4	116.5	99.5
- IV	84.9	121.0	102.7
1979 - I	83.9	124.0	104.0
- II	88.2	127.0	112.0
- III	82.2	133.5	109.7
- IV	80.6	128.8	103.8
1980 - I	85.9	129.5	111.2

Source: BCU

Among a couple of others,[1] an important explanation for this divergence between two official sets of data is that BCU conducts its own survey and uses wages actually paid while DGEC assumes that the minimum wage is binding and that its evolution relative to that of inflation is what determines the real wage and the sharing of the pie. What is really going on, BCU claims, is that the minimum wage is no longer binding given, on the one hand, the expansion of industrial output and labour demand and, on the other, the emigration process of the early '70s which severely reduced the supply of skilled and semi-skilled workers.[2]

In summary, the main difference between the official wishes and the results suggested by the BCU figures is that the NEP was based on a market with significant excess demand for labour provoked by the binding minimum wage level. As long as unemployment persists, not only can one expand demand for labour without provoking wage increases, one can actually reduce the minimum wage in real terms as depicted in Figure 1.

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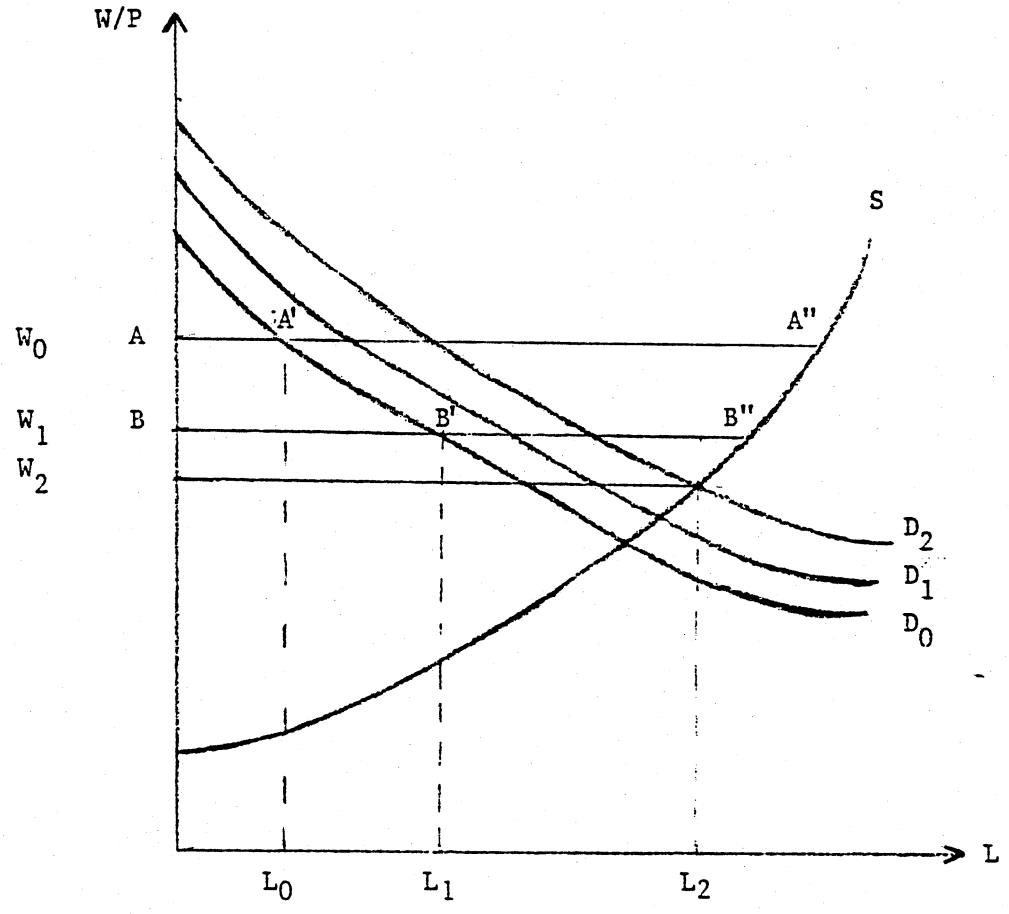
[1]The main two being that the BCU survey is held only in Montevideo and that it refers only to industrial workers. As stated above, the former point cannot explain much of the difference since almost all industrial firms are located or have an administrative office in Montevideo--in which case they were included in the universe from which the survery was drawn. The latter point can possibly explain an important proportion of the difference between the DGEC and BCU results because the legislated increments in money wages hold rigidly for public sector workers (except the military) who make up a large proportion of total employment.

[2]This interpretation coincides with the almost universal claim of industrialists who say that semi-skilled and skilled workers are in short supply and that firms are, in fact, competing workers away from each other. In the construction sector, for instance, it is well-known that the bidding up of skilled-worker wages has become so intense that firms resort to picturesque methods--like giving away well-prized raffle tickets to all those of their workers whose tenure exceeds two weeks--to reduce turnover.

Figure 1



Assume labour supply remains constant and that the minimum wage, given in real terms W/P, is initially W_0. Then, the effective labour supply is AA'A"S, employment is L_0 and the wage level is W_0. When demand expands to D_1 due to growth, if the policy succeeds in reducing the real minimum wage to W_1, the effective labour supply becomes BB'B"S, employment grows to L_1 and the wage has fallen to W_1. One ought to be careful not to interpret this as a movement along a downward-sloping labour demand curve, thus "proving" that the Uruguayan economy has a very high elasticity of factor substitution. The process may continue up to D_2 and W_2 at which point the excess supply of labour disappears. What BCU basically claims is that through recent growth and not-so recent emigration, Uruguay has gone beyond (L_2, D_2) and wages are increasing along an upward-sloping supply curve. The fact that sizable unemployment remains is explained as the natural rate of unemployment. In other words, the unemployed are either unemployable because of inadequate skills, or search-unemployed or straight frictionally unemployed.[1]

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[1] The two last categories are hard to tell apart. Let me reserve the former for those who have had job opportunities which they turned down awaiting better ones, and the latter for those who are either in the process of changing jobs or have just left or lost one without havig had access to any job openings.

II. Perspectives for Economic Growth

A. Effective Protection

The main instrument of "apertura"--the Spanish term for opening up the economy to foreign trade, which I will retain here--is the planned process by which after five years all tariffs will converge to a level of 35%, often coming down from prohibitive levels. At the same time, of course, all non-tariff protective instruments were phased out or outright eliminated.

What this implies is even less than going to "almost-free" trade. In fact, a flat 35% residual tariff will offer a sizable effective protection rate (EPR) of that same percentage. In general, one would think that 35 per cent is a reasonable translation, into tariffs, of the infant industry argument. The troublesome point is that Uruguayan industry has developed horizontally very far indeed, covering almost the whole gamut of consumer goods and a great many intermediates and capital goods. Estimates of EPRs before the tariff reform suggest that, for instance, glass products had a strongly negative EPR while many metallic products showed EPRs of close to 1800%.[1]

Thus, cutting EPR down to 35 will very likely entail the demise of many of the highly protected industries. According to one relevant study, about 25% of industry--as measured by present output-will have to shut

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[1] J.J. Anichini, J. Caumont and L. Sjaastad, La Política Comercial y la Protección en el Uruguay (Commercial Policy and Protection in Uruguay) Montevideo, BCU, 1978.

down by 1985, when the flat tariff of 35% is in place.[1] That would seem to be a reasonable price to pay for industrial rationalization and one ought to be willing to pay it, were it not for the following reasons.

In the first place, it is unclear that the resulting industrial structure will be optimal, or even close to it. For one, going some way towards first-best by no means guarantees a gain in welfare; so this "not-even-almost-free" trade policy may or may not be conducive to a higher level of welfare.[2] For another, when factor prices are distorted, the social desirability of different activities will diverge significantly from their private profitabilities; therefore, even going to a first-best free trade situation would presumably be quite suboptimal from a social welfare point of view.[3]

In the second place, one ought to question the timing of the move. According to one study[4] some 50 thousand industrial jobs would be lost through "apertura," thus adding approximately 5 percentage points to the open unemployment rate. This would not be an overwhelming cost if

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[1] C. Steneri and P. Barrenechea, La Rebaja de la Protección Arancelaria (The Cut in Tariff Protection) Montevideo, 1979.

[2] W. Lipsey and Landcaster, "The General Theory of the Second Best; Review of Economic Studies, 1956-57.

[3] To a large extent, this is no more than the general restatement of the Magee-Brecher point mentioned earlier. Extensive discussions can be found, interalia, in D.M. Schydlowsky "A Policy-Maker's Manual to Comparative Advantage," CLADS, D.P. #40, June 1980 and in J. Mezzera "Trade Policy and Industrial Job Creation," PREALC, 1977.

[4] C. Steneri and C. Barrenechea, op. cit.

the economy was expected to grow strongly during the tariff-cutting period, since in that case most of those jobs would reappear somewhere else. However, with a stagnant international economy adding to the domestic policy of fighting inflation regardless of its costs, the growth prospects are bleak and the jobs lost are unlikely to surface elsewhere. It is likely that one ought to give up not the "apertura" process but the deflationary goal.

B. Exchange Rate Policy

Much of the bleakness of the prospects is connected with the exchange rate policy in application since 1978.

I have argued earlier that, in terms of containing inflation, it has not been a successful policy. It should now be said that the policy is carrying a significant cost in terms of lost output.

Slowing the rate of devaluation below the difference between domestic and world inflation has the main effect of disprotecting the whole traded-goods sector. Unsurprisingly, since 1978 the previously booming export sectors have begun to falter. Again, there is a question of timing: the rate of crawl slows down simultaneously with cuts in both tariffs and export subsidies; during 1979/80 the new oil-price rise and the contractionary monetary/fiscal policy mix in several OECD countries—most notably Great Britain and the U.S.--have added world market depression to domestic disprotection.

To a large extent, the Uruguayan economy has kept going, in spite of its own exchange rate policy, bacause of the exchange rate policy followed by Argentina. The massive overvaluation of the Argentinian peso during 1979 and 1980 has meant that Uruguay has been able to export

almost anything--including beef!--to that market; several industrialists interviewed were clear in their statement that, without the bonus represented by these exports, their profitability would be highly dubious.

Quite clearly, more research should go into learning what has been the true evolution of the labour market situation; in other words, answering the questions of whether it is the BCU or the DGEC figures that tell the true story of the recent evolution of wages in the modern sector.

Three additional comments: in the first place, there is some evidence that the informal sector may have been shrinking. In fact, the employment groups that usually form the bulk of that sector (the self-employed, the entrepreneurs and the family workers) have been showing a clearly falling share in total employment, from 22% in 1974/75 to 19% in 1979. This in turn suggests that the evolution of wages as collected by BCU may be a better description of the true operation of the labour market.

The second point is that the controversy may have little actual policy relevance for two main reasons. In the first place, whatever improvement there was in the Uruguayan labour market was, to a large extent, predicated on the very intense emigration process that took place, roughly, between 1965 and 1976. Even if one were to leave aside the social dislocation involved in the exodus of about one-sixth of the population, the economic cost of "exporting" skilled labour is something no sane policymaker would want to take credit for--even if it had brought about equilibrium in the labour market. The second reason is that, as I will next discuss, growth perspectives for 1981 and onwards are not precisely brilliant and a deceleration of growth is likely to induce a depressed labour market.

The last point is that, regardless of the actual figures, the policy has been intensely successful is reducing labour's share of the pie. According to official figures the share of wages alone in GNP fell from 41% in 1971 to 32% in 1976.[1] The Gini coefficient for income distribution in Montevideo likewise rose from 0.37 in 1968 to 0.41 in 1976.[2] The neo-classical optimism about wage shares with apertura was thoroughly frustrated.

Of course, non-tradeable activities like construction and tourism have also received large benefits from spillover demand from Buenos Aires. This was particularly true in 1979 but the construction boom had already begun to falter in mid-1980 when even casual empiricism showed many paralyzed unfinished buildings, particularly in Punta del Este where the boom had been greatest.

C. Productive Investment and the Rules-of-the Road

Another major reason for the fairly pessimistic view of coming events is the issue of uncertainty about the directions of economic policy as seen by many private entrepreneurs.

With an "apertura" programme such as the one installed in Uruguay, it is hard to project future ERPs--hence, profit rates--emerging from the tariff cuts, even if absolute immobility of the rules is assumed.

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[1] A. Bension and J. Caumont, Política Económica y Distribución del Ingreso en el Uruguay (Economic Policy and Income Distribution in Uruguay) Montevideo, Acali, 1979.

[2] Ibid.

However, such immobility does not seem to be a very credible alternative in the view of investors. Many doubt, for instance, whether the tariff cuts will in fact be enacted as per the established calendar. It is also pointed out that the programme itself contains internal inconsistencies such as the fact that nothing is said as to what will happen with the significant number of tariffs which were below 35% when the process began. One would reasonably assume convergence to 35% in spite of the fact that the legal instrument refers to all tariffs decreasing yearly towards 35%. However, on January 1, 1980, when the first step of the calendar was applied, all tariffs below 35% remained untouched. A third doubtful issue is the level of export subsidies since the Minister of the Economy gave three conflicting versions between mid-1979 and mid-1980. In any event, with a residual tariff of 35%, it has been calculated that the average exporter suffers a cost increase of approximately 25% which would require that level of export subsidy;[1] however, none of the proposed alternatives even come close to that figure. A fourth issue, of course, is whether the present exchange rate policy is consistent with economic growth and what would be BCU's reaction if--as many predict--the answer to the above question is "no." Finally, the agricultural sector has been hit quite hard by abrupt changes in economic policy and its present profitability is almost universally deemed extremely low or

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[1] A. Banda, L. Sjaastad and J. Yerman, "La Incidencia de la Protección en el Uruguay" (The Incidence of Protection in Uruguay) (mimeo), BCU, 1979.

negative.[1]

Therefore, it is very hard to find a traded-goods sector where investment prospects look promising. Hence, there is very little productive investment in them and the apparently healthy investment ratio of 22% is concentrated in transport equipment and in residential buildings.

III. Summary

This paper has discussed the main traits of the recent economic policies in Uruguay and the perspectives for its continuation.

A fair summary probably is to say that, since 1973 through 1976, significant improvement was made in terms of growth, of investment and of foreign trade, while unemployment and a fall in real wages bore the brunt of the cost of the partial containment of inflation and of the generation of the savings compatible with the achieved investment levels. Since 1976/77 it is likely that continued growth along with the after effects of the previous exodus of skilled labour combined to produce some improvement in the real wage and in the total real wage bill though not in the share of wages in GNP.

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[1] The indebtedness of the rural sector with domestic banks is extremely large mainly because high beef prices--promised at the beginning of 1979, then violently reduced by mid-1979--encouraged producers to borrow heavily for investment; given depressed prices those investments turned out to be unprofitable. It is generally recognized that only their good cash position (thanks to the foreign capital inflow) allows banks not to execute delinquent loans. As a rural leader put it "if the Argentinian interest-cum-exchange rate policy changes, there goes the Uruguayan agricultural sector."

Since 1978, the fairly severe tariff-and-export subsidy reductions coupled with a significant fall in the real value of the exchange rate to generate a severe disprotection of the traded goods sector. A transitory phenomenon in 1979--the strong spillover into Montevideo of the capital inflow into Buenos Aires--generated expansion of the money supply, growth and accelerated inflation. By mid-1980, those phenomena played only a decreased role and economic recession began to set in; the more likely view being that a reversal of the Argentinian situation would probably spell serious trouble in the Uruguayan traded-goods sector.