Trade, Development and the World Economy

Selected Essays of
Carlos Díaz-Alejandro

Edited by Andrés Velasco

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Preface

Robert Solow once claimed that economics faces a dilemma: "Whether to have more and more to say about less and less, or. . . less and less to say about more and more." Solow chose the former alternative, suggesting that economists should aspire to be competent technicians – "like dentists," in the words of Keynes.[1] The work of Carlos Díaz-Alejandro stands out as a counterexample to Solow's theorem. His research ranged from theory to history, always with an eye to the pressing problems of Latin America. Well acquainted with the policy intricacies of North and South, he was not reluctant to introduce unquantifiable variables such as politics and ideology into his analysis. Economists tend to distrust those who want to cover too much terrain or do too much good. Yet it was Solow himself who wrote of Díaz-Alejandro the MIT graduate student: "The characteristic thing about Díaz is that his primary orientation is always toward policy, but unlike so many people with that interest he has a good analytical mind and uses it on policy problems."[2]

While Carlos's agenda was lofty, his style of research was not grandiose. Like the policies he often suggested, his approach was cautious and piecemeal, blending abstract speculation and large doses of empirical observation. He was fond of paradoxes and little-known facts that ran afoul of dogmatism, such as the observation that socialist Cuba is the Latin American country whose trade policy most closely adheres to the principle of comparative advantage. In this he resembled most those economists he admired most: Raúl Prebisch, Albert Hirschman and Sir Arthur Lewis. It is a comparison one draws with some unease, and not only because of the world stature of those mentioned – they are also of an older generation, and economics would be a livelier discipline if more scholars of Carlos's own generation had shared in his style of doing economics.

Carlos's interests and outlook must be understood in the context of his background. An American citizen of Cuban birth and upbringing, he was the Latin American economist *par excellence*. A paradox-ridden approach is unlikely to give rise to a unified school of thought, Carlos wrote in a tribute to Albert Hirschman.[3] That statement is also applicable to Díaz-Alejandro's own work, but in the Latin American intellectual environment this potential liability turned out to be an asset. As the extravagantly long lists of acknowledgements at the start of many of his papers indicate, Carlos had friends throughout the hemisphere. He nurtured ties with structuralists, monetarists and other assorted local brands of economists, sometimes to the puzzlement of the parties involved. His support can be detected behind several of the many independent research institutes that sprouted across Latin America in the decade before his death in 1985, as well as behind the careers of dozens of students of development in the United States. Not everyone agreed with Carlos, but practically everyone respected and admired his work. In the context of the turbulent ideological debates Latin America not uncommonly experiences, that is a rare distinction.

Given his unusual role as a Southern economist writing in the North (as he might have put it), Carlos paid attention not only to what was said but also to how it was said. This led him to stress the role of perceptions and language in economic policy debates, in an attempt to get behind the rhetoric or misunderstandings that can block academic and economic progress. It also led him, as anyone who has browsed through his papers knows full well, to turn out some eminently quotable paragraphs of his own. He delighted in presenting to Northern audiences the historical roots and "hidden rationalities" of many Southern perceptions. At the same time, he excelled at distilling from the awesome formal structure of economics as practiced in the North what was relevant and useful to the nations in the South.

Carlos's perceptions were also inextricably linked to his politics. He was not shy about making his biases explicit – toward a democratic, pluralistic, mixed-economy development path, occasionally resorting to what he liked to label "social democratic stabilization policies." To those concerned with Latin America's fortunes, he was a constant source of information and an unwavering voice for moderation. For his advocacy of intellectual discipline and his unwillingness to issue blanket prescriptions, for his diligent research and his personal warmth, we are grateful to Carlos Díaz-Alejandro.

Andrés Velasco
New York City

NOTES

1 Quoted in Leonard Silk, *The Economists* (New York: Avon Books, 1976).
2 Quoted in C. P. Kindleberger's introduction to *Debt, Stabilization and Development: Essays in Honour of Carlos Díaz-Alejandro* (Oxford: Basil Blackwell, 1987).
3 "Comment" in G. M. Meier and D. Seers (eds), *Pioneers in Development* (Oxford and New York: Oxford University Press for the World Bank, 1984).

Contents

Part I

On Trade Policy and Development

Carlos Díaz-Alejandro's best-known early work focused on the impact of devaluation on absorption and output – an issue in open-economy macroeconomics, today's jargon would have it. His central contribution is contained in "A Note on the Impact of Devaluation and the Redistributive Effect" (1963), which appears as chapter 1 of this volume.[1] There he argued that if devaluation redistributes income from workers to capitalists, and the latter have a lower propensity to consume than the former, then devaluation may turn out to be contractionary, depressing output even as the trade balance improves. This argument stood in contrast to the absorption approach to devaluation popular at the time, but gave theoretical credence to a fear long voiced by Latin American policy makers.

Aside from this incursion into macroeconomics, Díaz-Alejandro's early efforts were largely in the field of trade policy. He entered professional life at a time when conviction that the "easy phase of import substitution" was over was spreading rapidly through Latin America. While providing for a couple of decades of reasonably steady growth, post-war import substitution had failed to end the foreign-exchange shortages and periodic balance of payments crises endemic to Latin American economies – it had arguably exacerbated them, critics charged. Certain countries (though by no means all) were moving toward greater reliance on exports, helped by the vigorous 1960s growth in world trade. But before import substitution could be dispensed with, a more detailed analysis of some of its pros and cons was in order. Hence the essay "On the Import Intensity of Import Substitution" (1965).

To the charges that import substitution had actually reduced the supply of foreign exchange by requiring the importation of large quantities of intermediate and investment goods the home country was not capable of producing, Díaz-Alejandro replied that in steady state the import intensity of production should not be a problem, as ". . . the direct impact of this year's investment on the demand for imports should be more than offset by last year's investment in the import substituting industry now coming to fruition." While at first glance a defense of import substitution, this argument also made it clear that such a strategy may fail to yield long-term sustained growth – by the same logic, when countries try to step up investment in the import-substituting sector, the current import costs could easily outweigh the benefits.

With a hoped-for transition to greater reliance on exports gaining speed, Díaz-Alejandro turned to analyzing its characteristics and possible consequences. In "Some Characteristics of Recent Export Expansion in Latin America" (1974) he asked three fundamental questions: Is import substitution a necessary precondition for export expansion? How drastic a policy change is necessary to switch a country from an import-substituting strategy toward an outward-looking one? How much help can successful export promotion be expected to provide in reaching the goal of equitable growth in less developed countries?

To the first question Díaz-Alejandro gave a mixed response. On the one hand, import substitution had endowed Latin America with a sizeable industrial plant and with much-needed know-how and experience. On the other hand, excesses had doubtless been committed. He identified a natural cycle of production – first for the domestic market, then for export – but doubted this cycle had to take place under the battery of regulations and protective controls then prevalent in Latin America. The case for prior protection has greatest validity in the case of "sophisticated" exports such as petrochemicals, but these exports are at the same time the least desirable, given their import and capital-intensity.

Countries need not revamp their whole economies or dramatically change the way resources are allocated in order to shift from import substitution to export promotion, Díaz-Alejandro added. Launching an export drive requires a package of government support measures, in many of which LDC governments have ample experience: "...some of the distortions associated with the 'import-substitution syndrome,' such as quantitative restrictions on imports and credit rationing with subsidized rates, can be turned around and used to encourage or pressure established firms to export." In this sense, export promotion is conceptually and practically separable from liberalization or across-the-board reliance on the market mechanism, in spite of the recommendations of some orthodox economists.

In two other essays he also dealt with the question of market vs. planning in economic development, and the prescription was vintage Díaz-Alejandro:

> The debate on this issue has unfortunately been surrounded by ideological prejudices. To the Right, the word "planning," even when applied to public sector expenditures and policy instruments, is an abomination, while the Left cries "Chicago!" at the first mention of a price system and decentralized decision-making.

He concluded elsewhere:

> Planning, in short, need not be the enemy of export growth and foreign trade. Defined as an instrument which corrects market failures and inefficiencies, it can in fact stimulate exports....Planners must establish a proper balance

> between direct controls, general policies, and market forces guiding resource allocation. The policy instruments are, in most cases, at hand. The need to use them, if nothing else to correct distortions introduced by misguided previous public policies, is clear in second best Latin American economies.[2]

Díaz-Alejandro also stressed that export promotion is not a panacea. If carried out properly, it can loosen the foreign exchange constraint and reduce the likelihood of stop–go macroeconomic cycles, but its effects on income distribution and employment are less clear. Income distribution depends, above all, on the pattern of ownership of the factors of production. If a good share of exports is based on land or mineral deposits and these are unequally distributed, export expansion will enhance the rents accruing to a small segment of the population.[3] Manufactured exports could work in the other direction, but only to the extent that they are labor-intensive. Unfortunately, many of the new manufactured exports coming out of Latin America have tended to be rather capital-intensive. This is particularly true of exports going to partners in preferential trading arrangements.

In the Latin America of the late 1960s integration was a paramount economic issue. An advocate and supporter of Latin American integration efforts,[4] Díaz-Alejandro feared that "too much of a good thing" might result in unnecessary trade diversion and lasting distortions. The key was to avoid at a regional level the mistakes of national import substitution, while taking advantage of the potential welfare gains arising from the creation of a large regional market. Moreover, given the pressures for reciprocity, regional trade arrangements may turn out to be limited sources of foreign exchange – if a million dollars' worth of sales to a neighbor must be matched with a corresponding level of purchases, exports to other areas of the world should also be emphasized if the balance of payments is to gain lasting relief. Finally, an effective common market should provide a shared set of general rules regulating direct foreign investment and the activities of multinationals in general. Besides ensuring that a fair share of the fruits of foreign investment accrue to the host country, such a common policy could do much to speed trade liberalization, by assuaging "...the fear that non-Latin American corporations will derive most of its benefits and that their investments will flow into a few relatively prosperous Latin American regions."[5]

If one word can summarize Díaz-Alejandro's approach to optimal trade policies for developing countries, it is "eclectic." While fully aware that future growth in Latin America requires softening the foreign exchange constraint via vigorous export growth, he never tired of repeating that successful export drives require more than "getting prices right." Furthermore, he cautioned against the unexpected (and sometimes unwanted) byproducts of single-minded commitment to any one narrowly conceived development strategy. What he said of the possible distributional consequences of international trade captures the spirit of his overall views;[6] modern academic economics at its best "...will not reach simple conclusions such as 'trade benefits everybody' or 'trade hurts everybody.' It all depends (to the dismay of the lazy, the impatient or the seeker of mass-mobilizing slogans) on the circumstances in which trade takes place."[7]

NOTES

1 This paper distills arguments originating in Díaz-Alejandro's doctoral dissertation, published as *Devaluation of the Exchange Rate in a Semi-industrialized Country: the Argentine Experience 1955–1961* (Cambridge, Mass.: MIT Press, 1965).
2 The first passage is taken from "Latin America: toward 2000 AD," in *Economics and the World Order*, ed. Jagdish Bhagwati (New York: the Macmillan Company, 1972). The second one is from "Planning the Foreign Sector in Latin America," *American Economic Review*, 60, 2 (1970).
3 Díaz-Alejandro was to return to this point in the essay "Open Economy, Closed Polity?" which appears as chapter 14 in this volume.
4 For Díaz-Alejandro's views on Latin American integration, see the papers cited above and also "The Andean Common Market: Gestation and Outlook," in *Analysis of Development Problems: Studies of the Chilean Economy*, ed. R. S. Eckaus and P. Rosenstein-Rodan (Amsterdam: North-Holland Publishing Company, 1973).
5 "Planning the Foreign Sector in Latin America."
6 For a somewhat idiosyncratic survey of the trade-and-development literature until the mid-1970s, see his "Trade Policies and Economic Development," in *International Trade and Finance*, ed. Peter Kenan (Cambridge and New York: Cambridge University Press, 1975).
7 "Open Economy, Closed Polity?"

1

A Note on the Impact of Devaluation and the Redistributive Effect[1]

It has become customary in the theoretical literature dealing with the impact of devaluation on the trade balance to distinguish two stages of such an impact: the initial effect and the reversal effect.[2] The sign and size of the first effect will be determined by the price elasticities of demand and supply of imports and exports.[3] While the first effect depends on changes in relative prices, the reversal effect depends mainly on the income mechanism and tends to offset the original impact of the devaluation on the trade balance. Although the initial and reversal effects arise from static models, a time sequence is suggested by their names and nature, with the reversal effect coming into play only after the first effect has taken place. A further implication is that a successful first effect will tend to increase real domestic output by stimulating the production of exports and import-competing goods. Through the multiplier such expansionary stimulus will spread to other sectors of the economy. As long as the reversal effect does not fully offset the initial effect, a successful devaluation will be associated with both an expansionary pressure on output and an improvement in the balance of trade. On the other hand, a devaluation yielding a negative initial effect (a worsening of the trade balance) will result in a decrease of domestic output. An observer of devaluations in the real world may thus be puzzled to find several devaluations that have resulted in quick improvements in the balance of trade and were accompanied by decreases in the level of total output in those economies. It could be argued that the decrease in output was due simply to deflationary fiscal and monetary measures adopted simultaneously with the devaluation of the exchange rate. However, it may be of interest to investigate whether at least part of the decreases in output may be explained solely as a *direct* result of the devaluation.

This note shows that the apparent paradox of a devaluation leading to an improvement in the trade balance *and* a decrease in domestic output can be explained by a redistributive effect caused by the devaluation. This redistributive effect is likely to precede the initial, or relative, price effect. Even "elasticity optimists" do not expect price elasticities to be very high in the short run and rely on such devices as short-term capital movements to fill the gap between the time a devaluation takes place and the time when the balance of trade will respond favorably to the change in relative prices induced by the devaluation. In many cases the redistributive effect may be a more powerful and speedy mechanism in filling this gap.

It is well known that a devaluation may have a redistributive effect,[4] but the importance and timing of it has received little emphasis in the literature. I suspect that the theoretical point raised here may prove important in any attempt to fit the empirical analysis of recent devaluations in semi-industrialized economies into accepted devaluation theories and models.

II

For the purposes of this note it will be sufficient to examine the relatively simple case of a small country faced with a perfectly elastic demand for its exports and a perfectly elastic supply of its imports, both in terms of foreign currency units. Let us originally consider three goods: importables (M), exportables (X), and the home good (H), which does not enter into international trade. Because we have assumed that the terms of trade for our country are set exogenously, it is legitimate to lump exportables and importables into a single Hicksian composite good,[5] which we may call the foreign good, (F).

Several assumptions regarding the domestic supply schedules could be made. To emphasize the redistributive effect it will be assumed that the domestic supply schedule for the output of F is perfectly elastic for downward movements of output and perfectly inelastic for increases in output, at least in the short run. Assume that the supply schedule for H is perfectly elastic. The supply schedules are both perfectly elastic with respect to downward movements of prices due to the rigidity of money wage rates (an assumption which will be introduced below). Thus, decreases in the demand for H will result in a lower level of output and higher unemployment, but no change in the price of H. The domestic price of F will be solely determined by its foreign price and the exchange rate. These assumptions imply that there are idle resources which even in the short run can be put to work productively in the H-industry, although this is not possible in the case of the F-industry because of the nature of its production function. If some elasticity were allowed to the domestic production of F with respect to increases in its price, a decrease in domestic output following a devaluation would become less likely.

Our country can be divided into two social classes: wage earners and capitalists. Each class will be assumed to be composed of individuals of identical tastes, who consume both H and F and save part of their income. Total money wages and profits will be determined by the total output produced domestically and by the money wage rate, assumed to be the same in both H- and F-industries and constant, at least in the short run.

Under these assumptions we can now show that following a devaluation the balance of trade may improve while total domestic output falls. To simplify the analysis, we shall deal only with the impact effect of devaluation without working out the full solution of the model.

Let

F_s = total initial local production of F
F_c = initial consumption of F by capitalists
F_w = initial consumption of F by workers
m_{fc} = marginal propensity of capitalists to consume F
m_{fw} = marginal propensity of workers to consume F
m_{hc} = marginal propensity of capitalists to consume H
m_{hw} = marginal propensity of workers to consume H
$s_c = 1-m_{hc}-m_{fc}$
$s_w = 1-m_{hw}-m_{fw}$
E_{hf} = cross-elasticity of demand for H with respect to the price of F, including only the pure substitution effect. For the sake of simplicity, this substitution effect is assumed to be the same for workers and capitalists.

It will be assumed that by an appropriate choice of units we originally set all prices equal to one and that the rest of the world adjusts passively to the changes in the balance of trade of our small country.

Devaluation will raise the price of F in domestic currency, p_f, in proportion to the increase in the price of foreign currency. Thus, the impact effect of devaluation will result in an increase of the real income of capitalists of $(F_s-F_c)dp_f$ and a decrease in the real income of workers by the amount $F_w . d_f$, since the money wage rate is unchanged.

The impact of the devaluation on domestic output will be examined first. As the domestic output of F is being assumed perfectly inelastic with respect to increases in p_f, the result depends on changes in the domestic output of H, which is in turn determined by the level of domestic demand. As a result of devaluation, the change in demand for H will be given by the following expression, which includes the real-income effect for capitalists and workers, plus the pure substitution effect arising from the change in the price of the foreign good:

$$dH = [m_{hc}(F_s-F_c)-m_{hw}F_w+HE_{hf}]\,dp_f. \qquad (1)$$

If we assume trade is initially balanced, then $F_s-F_c=F_w$, so that (1) can be simplified to:

$$dH = [m_{hc}-m_{hw})F_w+HE_{hf}]\,dp_f. \qquad (2)$$

The pure substitution effect in (2), HE_{hf}, will switch expenditures away from F and into H, thus inducing a higher level of output in the H-industry.