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effectiveness of these rules should be ensured by a universal duty to consult prior to the realisation of any trade-restricting intervention planned by an individual country.

The reforms of trade policy achieved so far within the framework of the Tokyo Round – the code governing subsidies and countervailing duties, the code governing the practice of state procurement, the definition of assessment standards for customs valuation and the simplification of the procedure on import licensing – should not, of course, be underestimated. Nevertheless, they do not yet ensure the necessary breakthrough to a universal codification of the application of national protective measures against market disruptions, especially those introduced outside GATT.

Farther-reaching reforms are therefore urgently necessary. At the same time – according to Bergsten¹⁰ – there is no need for the creation of entirely new institutions provided the well-tested consultation

provisions of the International Monetary Fund can successfully be combined with the technical competence of GATT. It would then be the responsibility of the IMF to judge the necessity of trade-restricting interventions *ex ante*, as a matter of general principle, while the GATT Secretariat would be responsible for the definition of the modalities of the specific restrictions and for their supervision.

In whatever shape the reform is effected, it is important that the industrialised countries above all, from whom the most painful trade restrictions have originated, take the decisive first steps. For it will ultimately be up to them whether they exploit the inclination towards trade restrictions present in many developing countries in order to justify their own protectionism or whether they restrain such inclinations by their own example.

¹⁰ C. F. Bergsten: Reforming the GATT: The Use of Trade Measures for Balance-of-Payments Purposes, in: *Journal of International Economics*, Vol. 7 (1977), p. 1 ff., esp. p. 10 ff.

LATIN AMERICA

Friedman versus Keynes in Latin America

by Jürgen Westphalen, Hamburg*

In a number of Latin American countries, the influence of John Maynard Keynes and his Latin American proponent Raúl Prebisch, was forced during the seventies to give way to the liberal-monetarist principles of Milton Friedman. What advantages and disadvantages have ensued from this change of course? Do Friedman's theories point a way out of Latin America's present economic and social problems?

The influence of John Maynard Keynes – a German journalist¹ wrote – came “to an end even before a quarter-century had elapsed since his death. For the legacy of the great Englishman, the doctrine that boom and growth can be induced by controlling State demand, is increasingly dissolving into nothingness”. This “process of disintegration” had been triggered off by the American economist Milton Friedman, “who was the first to provide empirical evidence that the development of the national product depends . . . on the amount of money in circulation”.

Latin America is generally regarded as an interesting and successful field of experiment for Milton Friedman's economic theories and policy recommendations. Certainly a clear change of course in economic policy is taking place in a number of Latin American countries. It is a change from Keynes to Friedman or – to label the old economic policy with the name of a Latin American

economist – a change from Prebisch to Friedman. Throughout several decades, development policy, foreign trade policy and trade cycle policy in Latin America had largely been shaped by the UN Economic Commission for Latin America (CEPAL – Comisión Económica para América Latina) set up in Santiago in 1948 and, in particular, by its former Executive Secretary Raúl Prebisch.

Prebisch repeatedly refers to Keynes; but such references are really unnecessary for the kinship between the principles of these two economists to emerge clearly. For example, a few observations may be quoted from Keynes's *General Theory*² and from the paper *Transformación y Desarrollo*³, presented by

¹ P. C. Martin in his introduction to the German edition of M. Friedman: *Capitalism and Freedom* (Kapitalismus und Freiheit, Munich 1976).

² J. M. Keynes: *General Theory of Employment, Interest and Money*, London 1936.

* Deutsch-Südamerikanische Bank AG.

Prebisch in 1970 as Director General of the Instituto Latinoamericano de Planificación Económica y Social. According to Keynes, "the duty of ordering the current volume of investment cannot safely be left in private hands"⁴; instead he "expect(s) to see the State . . . taking an ever greater responsibility for directly organising investment"⁵. Similar statements – with regard to a suitable economic policy for Latin America – are to be found in Prebisch: "The State must deliberately intervene to encourage private households and entrepreneurs to increase savings, and it must intensify its own savings on the basis of higher taxation – either for the purpose of direct investment of these savings or of using them to promote private initiative"⁶.

Keynes's rejection of the *laissez faire* principle is found clearly and concisely in the following quotation from the Prebisch paper: "One must not demand from the market mechanism something it cannot accomplish"⁷. With an eye on Latin American reality, Prebisch adds the following: "During the world-wide economic depression, Keynes demonstrated that the economic system by no means spontaneously achieves a state of equilibrium with full employment, but that instead a multitude of equilibrium situations are possible with varying degrees of underemployment. Similarly, it is true of Latin America that different equilibrium situations may exist without full utilisation of the labour force; in such situations the market mechanism is totally ineffective and intervention by the State becomes indispensable"⁸.

On the question of foreign trade Prebisch bases himself not on the early Keynes, who, as is well known, was a champion of unrestricted free trade⁹, but on his later principles, according to which domestic employment must be given precedence over a liberal foreign trade policy and adjustments to the rate of exchange and/or import controls must be applied if the employment situation at home demands them¹⁰. For

Latin America Prebisch considers "state activity in foreign trade downright indispensable; . . . (because) the more the progress of science and technology gains ground in the economy of Latin America, the more markedly will our demand for imported products increase, while simultaneously, in the highly industrialised countries, the trend of declining raw material imports will intensify. This imbalance of effects cannot be left to spontaneous correction through the free interplay of economic forces"¹¹.

A scepticism vis-à-vis the free interplay of market forces has survived in CEPAL even after Prebisch's departure. Thus the present CEPAL Executive Secretary, Enrique V. Iglesias, stated in December 1979 that the energy crisis and – in a wider sense – the problem of the environment had "made economic planning a political *conditio sine qua non*" for Latin America. From this Iglesias concluded: "It would be an anachronism to assume that market forces could represent an alternative to the imperative of economic planning – though this should not, on the other hand, mean that the potential influence of the market forces should be left unutilised"¹².

A policy oriented along the principles supported by CEPAL was practised for a long time in the overwhelming majority of Latin American countries; various countries continue to follow these principles more or less extensively to this day. Essential characteristics of such a policy are in particular:

- ☐ the establishment of economic and social development plans, such as was demanded for the first time for all Latin American countries in the "Carta de Punta del Este" of August 17, 1961,
- ☐ the extension of state influence and state activity in the economy,
- ☐ selective promotion of industrialisation and creation of new jobs in industry,
- ☐ an – often restrictive – control of foreign investment activity by means of state regulations,
- ☐ a foreign trade policy aiming primarily at import substitution and export promotion through state measures.

Advantages and Disadvantages

In view of the – sometimes by no means unjustified – criticism which is often nowadays directed at this policy,

³ R. Prebisch: Transformación y Desarrollo. La gran tarea de América Latina. Informe presentado al Banco Interamericano de Desarrollo, Washington 1970.

⁴ J. M. Keynes, op. cit., p. 320.

⁵ Ibid., p. 164.

⁶ R. Prebisch, op. cit., p. 190.

⁷ Ibid., p. 188.

⁸ Ibid., p. 190.

⁹ J. M. Keynes, op. cit., p. 334.

¹⁰ Cf. A. Paulsen: Neue Wirtschaftslehre. Einführung in die Wirtschaftstheorien von John Maynard Keynes und die Wirtschaftspolitik der Vollbeschäftigung (New Economic Theories. An Introduction to the Economic Theories of John Maynard Keynes and Full Employment Policy), 3rd revised and enlarged edition, Berlin/Frankfurt a. M. 1954, p. 312.

¹¹ R. Prebisch, op. cit., p. 190 f.

¹² CEPAL (ed.): Notas sobre la economía y el desarrollo de América Latina, No. 309/310, Santiago 1980.

a brief outline of its successes seems to be appropriate. If one looks a little further into the past of the economy of Latin America, one is struck by downright astonishing rates of expansion in a number of important fields of production. Between 1950 and 1975, the national product of Latin America quadrupled. The expansion of various branches of industry was greatly disproportionate: thus output of manufacturing industry rose by a factor of 5, cement production by a factor of 6, energy generation by a factor of 8, production of machinery and plant by a factor of 9 and steel production even by a factor of 15. Over that period of 25 years the population of Latin America approximately doubled, from 160 million to 313 million. A quadrupling of the national product parallel to a doubling of the population among whom this national product is distributed means a doubling of per capita income in Latin America within 25 years.

On the other hand, however, this policy also had negative effects. Not infrequently the preparation and execution of development plans massively promoted the growth of state bureaucracies, and in some countries the attainment of plan targets was impaired by the inefficiency of the government authorities concerned. The more or less far-reaching replacement in the economy of profit-oriented entrepreneurs by government officials frequently proved an obstacle to dynamic economic development. Forced industrialisation, on the one hand, was usually conducted to the advantage of existing centres of production and population, and, on the other, was frequently accompanied by a neglect of agriculture, or – in the wider sense – of the development of rural regions; this was bound to lead to an increased drift from the land, to growing economic and social problems in the big cities, and to an increasing dependence of Latin America on foodstuff imports. State intervention in the economy has to be financed; it therefore represents a burden on the public budget and frequently acts as an almost uncontrollable motor of inflation.

The protectionist import policy with its restriction of imports for the purpose of expanding domestic production has led to the emergence, behind protective customs barriers, of production capacities which are far from being competitive on international markets. And although export promotion by means of selected subsidies to branches whose production is suitable for export has not been unsuccessful, as can be seen from the statistics of so-called non-traditional exports from numerous Latin American countries, it has promoted the emergence and even vigorous growth of certain production enterprises which, the moment their

subsidies were to disappear, would rapidly lose their foreign markets to competitors from other countries.

Finally, the state's restrictive intervention in the activity of private foreign investors frequently led to stagnation in investment of private foreign capital. This experience was made, in particular, by the member countries of the Andean Pact¹³ with the application of what is known as "Decision 24" on the treatment of foreign capital as well as trade-marks, patents and other protected titles¹⁴.

From Keynes to Friedman

There is no doubt whatsoever that the outlined negative effects require a thorough examination of the economic policy which causes them as well as certain corrections to the course of economic policy. Certain Latin American countries, however, have not contented themselves with touches on the tiller but have performed, as it were, a 180 degree change of course – in other words, a change of course from John Maynard Keynes (or Raúl Prebisch) to Milton Friedman. The first to plot this new course was Chile after the seizure of power by General Augusto Pinochet in September 1973. Previously there had been a formal agreement between 1956 and 1964 concerning cooperation between the University of Chicago, where Milton Friedman teaches, and the Catholic University of Santiago. This arrangement naturally resulted in numerous personal contacts between American professors and former Chilean students¹⁵. In recent years, however, Chile and the other Latin American countries pursuing a monetarist economic policy at home and a liberal course in foreign trade have found confirmation and support in the USA under President Ronald Reagan and in the financial principles of the World Bank and the International Monetary Fund.

Let us also outline the basic principles of this policy by means of a few quotations, on the one hand from Friedman's book *Capitalism and Freedom*¹⁶ and, on the other, from a publication by two of his most prominent and most successful followers, the Chilean Minister of Finance, Sergio de la Cuadra, and the President of the Banco de Santiago and former Minister of Economics, Jorge Cauas¹⁷. Comparison of the following quotations

¹³ The member countries are Bolivia, Colombia, Ecuador, Peru and Venezuela.

¹⁴ Cf. Deutsch-Südamerikanische Bank AG (ed.): *Andengruppe – Vorschriften über ausländische Investitionen* (The Andean Group – Regulations governing Foreign Investments), Hamburg 1977.

¹⁵ K. Brunner: *Friedman und Chile. Dialektische Spiele mit der Wahrheit* (Friedman and Chile. Dialectical Games with the Truth), in: *Neue Zürcher Zeitung*, foreign edition, No. 295, Dec. 17, 1976.

¹⁶ M. Friedman: *Capitalism and Freedom*, Chicago 1962.

with the earlier ones from Keynes and Prebisch reveals the extent and implication of the change of course.

"... the scope of government", Friedman¹⁸ demands, "must be limited. Its major function must be to protect our freedom . . . to preserve law and order, to enforce private contracts, to foster competitive markets." The Chileans Cauas and de la Cuadra say much the same¹⁹ about the policy of the present Chilean Government: "The economic policy programme is based on the principles of economic and personal freedom. It is clearly designed to reduce to a minimum the influence of public authorities." Among other things, the reduction of the state's powers is to be achieved by the "transfer to the private sector of enterprises expropriated or illegally taken over by the preceding government (under President Salvador Allende)". Present-day Chilean policy thus bases itself, in Friedman's words²⁰, "primarily on voluntary co-operation and private enterprise, in both economic and other activities" in order to "insure that the private sector is a check on the powers of the governmental sector".

However – as recommended by Friedman –, it has remained the government's task in Chile to provide "a stable monetary framework for a free economy" and to legislate "rules for the conduct of monetary policy"²¹.

On the subject of tariffs, Friedman says that they "hurt us as well as other countries. We would be benefited by dispensing with our tariffs even if other countries did not"²². One feels reminded of the bold – subsequently to be corrected by almost 180 degrees – statement by the young Keynes²³: "Is there anything a customs tariff can do that an earthquake could not do better?" Chile kept to Friedman's recommendations and – apart from some very few exceptions – reduced its import tariffs to a maximum of 10 %, in other words, it opened its domestic markets to the competition of foreign products. Admittedly, as Cauas and de la Cuadra point out, "the reduction of customs duties was merely one of a package of numerous measures of similar or even greater importance. All these measures complement each other in a decisive manner. It is difficult to give up some of them while accepting others. Thus, for instance, the policy of free prices and interest rates must be complemented by a liberal policy with regard to foreign trade and capital markets"²⁴.

To sum up it may be stated that the policy practised by the "Chicago boys" – to quote a widely used slogan – is marked by the following characteristics:

□ limitation of the competence of the state – in line with the principles first established by Walter Eucken²⁵ – to the fashioning of the framework of the economy;

□ extreme restraint by state authorities in respect of influencing the course of economic events, and indeed – as far as possible – limitation of their activities to monetary and financial policy;

□ abolition of existing subsidies and promotion of private initiative in the economy;

□ liquidation of all state export-promoting measures and abolition of all customs duties and other barriers to imports;

□ equal treatment under the law of foreign investors and their domestic competitors.

There is probably no need to explain in detail that such a policy is apt to remove various serious shortcomings of a *dirigiste* domestic economic policy and a foreign trade policy based on the principle of import substitution, or indeed even to prevent these shortcomings from emerging. With the reduction of the state bureaucracy, all possible negative effects of the activities of inefficient government officials in the economy are simultaneously reduced to a minimum. Abolition of the granting of subsidies greatly simplifies the reduction of deficits in national budgets; thus one of the most dangerous causes of inflation is rendered harmless or indeed totally removed. The opening up of domestic markets to foreign competition gives rise to an industry hardened in the bracing climate of international competition, one that will stand its ground in domestic and foreign markets even against competitors from the highly industrialised countries.

The Examples of Chile and Argentina

The real effects of an economic policy based on Milton Friedman's recommendations will be illustrated by the development of a few selected Latin American countries. These principles have been followed most consistently in Chile since 1973. But Argentina too, after 1976, under its then Minister of Economics Dr. José Alfredo Martínez de Hoz, switched to a liberal-monetarist course. Similar trends can also be observed

¹⁷ J. Cauas, S. de la Cuadra: The economic policy of open trade in Chile, Hamburg 1981 (mimeographed).

¹⁸ M. Friedman, op. cit., p. 2.

¹⁹ Cf. J. Cauas, S. de la Cuadra, op. cit., p. 5.

²⁰ M. Friedman, op. cit., p. 3.

²¹ Ibid., pp. 38, 51.

²² Ibid., p. 73.

²³ Quoted from A. Paulsen, op. cit., p. 312.

²⁴ Cf. J. Cauas, S. de la Cuadra, op. cit., p. 5.

²⁵ W. Eucken: Grundsätze der Wirtschaftspolitik (Principles of Economic Policy), Tübingen/Zürich 1955, p. 336.

for instance in Uruguay and in Peru, and in Brazil the government is also anxious to achieve more competition in the economy, even though State intervention aimed at export promotion and the throttling of imports continues to be practised.

During the first few years after General Pinochet's assumption of power in September 1973, Chile achieved astonishing successes. The overall economy has grown vigorously since the mid-70s; Chile's annual growth rates invariably were above the figures for Latin America as a whole. By 1980 exports likewise had increased substantially year by year; at the same time the country reduced its dependence on copper exports, which in 1974 were still responsible for nearly 80 % of total export revenue as against some 45 % in 1980. Inflation, which in 1973 had been above 500 %, was reduced to barely 30 % in 1980 and cut back further to under 10 % in 1981 – a success which in inflation-plagued Latin America may be described as downright sensational. There is no doubt that the governments of various Latin American countries could profit from a detailed study of Chilean economic policy, from an examination of whether and to what extent it might be applicable to the solution of their own problems.

Admittedly, there have also recently emerged certain negative effects, and criticism of the government's economic policy is therefore being increasingly voiced. Thus, for example, doubts are being expressed about whether a developing country such as Chile can in the long term afford such far-reaching abstinence by the government with regard to social policy. There is also criticism that the use of scarce foreign currency is being left too much to the free interplay of market forces, with the result that imports necessary on development-policy grounds are displaced by imports of high-cost consumer goods for the prosperous middle class. Numerous firms have not survived the abrupt withdrawal of the state protection and promotion²⁶: during the period from 1971 to 1975 there were, on an annual average, 90 business failures in Chile; during the period from 1976 to 1980 this figure shot up to 295; in 1980 alone 427 firms were reported to have failed. Banking in Chile could not remain unaffected by the difficulties experienced by certain branches of industry. That is why there have recently been demands for increased government intervention, at least for the mitigation of unreasonable hardships.

The limitations of Chile's present economic policy emerge most clearly in the field of foreign trade, which

admittedly also suffered from the unfavourable copper price trend in 1981. The balance of trade deficit in 1980 rose by 120 % and in 1981 it rose, according to provisional data, by no less than 236 % to approximately US \$ 3.4 billion. In 1980 imports exceeded exports by 21 %, by 1981 the figure was 84 %. This gives rise – no doubt with justification – to the critical question as to how long the country will be able to afford such a liberal import policy in the face of the increasingly difficult markets for Chilean export goods. It is understandable that Chilean exporters have recently been urging the reintroduction of selected export subsidies and, in particular, a readjustment of the rate of exchange of the peso to the US dollar; this rate has been frozen since June 1979 and has since, in consequence, become considerably overvalued. Chile's foreign debt in 1981 increased by 37 % to approximately US \$ 15.3 billion. This foreign debt amounts to US \$ 1,350 per capita as against "only" US \$ 911 for Mexico and barely US \$ 500 for Brazil, which is likewise regarded as being heavily indebted to foreign countries.

Argentina's economy has developed a lot more unfavourably still. However, Argentine economic policy is comparable to the Chilean only with certain reservations. Although Martinez de Hoz, the Minister of Economic Affairs, has since March 1976 pursued a course which exhibits extensive similarity to that of neighbouring Chile, the Argentine politicians from the very start have not acted nearly as consistently or rigorously as their Chilean colleagues. Added to this was the fact that for Argentina, which is relatively far more highly industrialised, the opening up of the markets and free access of foreign competition was bound to have much weightier consequences than for Chile. Finally, following the change in the Presidency in March 1981, Martinez de Hoz's work was continued by his less effective successor, Dr. Lorenzo Sigaut, who in turn was relieved in December 1981 by the determined liberal economic expert Dr. Roberto Aleman. Liberal-monetarist policy in Argentina, therefore, lacked the long-term continuity ensured in Chile by President Pinochet.

The unsatisfactory results may be illustrated by a few statistical data: Argentina's gross domestic product, which in 1980 had grown by only 1.1 %, declined in 1981 by 6.1 %. Industrial capacity last year was utilised to only some 50 %. Unemployment in this country, which for a long time could boast an exemplary high level of employment, has lately been increasing alarmingly. The rate of inflation, which in 1980 had been reduced from 140 % in the previous year to 88 %, rose once more in 1981 to over 130 %.

²⁶ Las quiebras de empresas, in: *El Mercurio*, Santiago, September 21, 1981.

Mexico: the Opposite Course

A striking contrast to these two countries is provided by Mexico, which has refused to be distracted by the liberal trends in Latin American economic policy and which can be regarded to this day as a very nearly perfect example of Raúl Prebisch's economic principles. According to the annual report of President Lopez Portillo for 1980²⁷, state subsidies to the economy during the year under review amounted to 16 % of the gross domestic product or 35 % of the budget. The government is pursuing a policy of placing orders with industry, financed by the creation of money, i.e. a deficit-spending policy which would have delighted John Maynard Keynes. And Mexico's policy of import substitution and export promotion may be sure of Raúl Prebisch's approval.

Private foreign capital experiences a somewhat restrictive treatment in Mexico on the principle that only foreign investments in line with the government's development policy objectives should be permitted. The country's economic development is quite impressive: the growth rate of gross domestic product has for a number of years been between 7 and 8 %, i.e. considerably above the growth rate of the Latin American economy as a whole. Exports underwent an enormous increase from US \$ 8.6 billion in 1979 to US \$ 19.4 billion in 1981; simultaneously, on the other hand, imports increased from US \$ 12.0 billion to US \$ 24.2 billion, so that Mexico's balance of payments deficit increased from US \$ 3.4 billion in 1979 to US \$ 4.8 billion in 1981. Private foreign investments increased in 1978 by 12 %, in 1979 by 20 % and in 1980 by 23 %, to reach US \$ 8.9 billion by the end of 1980. Considering Chile's far less successful efforts to attract foreign private capital, it appears that legislation attractive to foreign investors may sometimes be less important than the circumstance that the country in question, alongside other necessary conditions, also possesses extensive domestic markets with interesting prospects for the future.

Mexico may be expected to continue the policy outlined above during the next few years. Miguel de la Madrid, Mexico's President Designate who will assume the Presidency in December 1982, declared in his "Plan básico 1982-1988" that state guidance of the economy ("La capacidad rectora del estado") would be strengthened in future²⁸.

²⁷ Cf. Gleichgewichtsprobleme in Mexikos Wirtschaft (Equilibrium Problems in Mexico's Economy), in: Neue Zürcher Zeitung, Dec. 23/24, 1981.

²⁸ M. de la Madrid: Plan básico 1982-88 y plataforma electoral (Resumen), Mexico 1981.

Admittedly it would appear reasonable to pose the question – which cannot be answered here – as to whether Mexico could have afforded its economic principles, or what Mexico's economic situation would have been today, if the country, with a crude oil production of approximately 2.6 million barrels per day, oil exports of approximately 1.14 million barrels per day and with reliable oil reserves of 72 billion barrels, had not within a few years moved up to become the fourth most important oil producer and oil reserve owner in the world. Oil exports in 1981 already amounted to US \$ 13.3 billion or 69 % of Mexico's total exports.

The Lessons of Keynes and Friedman

In conclusion let us once more – with reference to the present situation in Latin America – return to our initial assertion that the influence of John Maynard Keynes had been forced to give way to the liberal-monetarist principles of Milton Friedman. The economic development of Chile and Argentina, as well as of Mexico, permits only of the conclusion that in economic policy one should never, as it were, "put all one's eggs in one basket". Chile, and up to a point Argentina, undoubtedly benefitted from exposing their economy to domestic and foreign competition. In both countries, however, one is entitled now to ask whether an unrestricted continuation of this policy may not in the long run damage rather than benefit the economy. Certainly one would not advise a change of course by 180 degrees back to the *dirigism* and protectionism of the past – but one would advise selective localised state intervention in the economic process as well as a reintensification of the government's activities in the sphere of social policy.

In Mexico, on the other hand, one would be entitled to ask whether a little less protectionism and a little more competition – including foreign competition – might not benefit the country's economy in the long run. One vigorous stimulus for the strengthening of their international competitiveness could be provided to Mexican enterprises by the mere fact that all export promotion measures and protective measures against foreign competition could from the outset be clearly limited in duration. John Maynard Keynes' influence has certainly not come to an end, as the economic journalist quoted at the beginning of this article maintained; equally, Milton Friedman cannot alone point the way out of Latin America's present economic and social problems. Neither Keynes nor Friedman can offer a panacea suitable to every Latin American country. Latin America's politicians can and should instead learn from both these great economists.