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Economic Mechanisms of Inclusion and Exclusion in Latin America

Barbara Fritz

1 Introduction: Economic Policy as a Dilemma between the Economic and the Political Sovereign

From a Keynesian point of view, well-functioning markets cannot be assumed to be institutions that automatically lead to a harmonisation of the interests of market participants. In line with this view, I argue that market transactions need to be understood as economic decisions made in order to deal with economic scarcity and hierarchies in a situation of uncertainty and incomplete foresight. According to this perspective, I show that debtor-creditor relations are the underlying driving force of markets. Therefore, I argue that it is the monetary sphere that dominates the real economy rather than the other way around. In contrast, neoclassical models assume a given resource endowment on the part of market participants that is driven by their individual profit maximisation calculus in their respective economic transactions.[1]

If a well-functioning economy is affected neither by war nor by an extraordinary scarcity of any other good, such as energy, I argue, money is the scarcest good. As full employment would disturb this hierarchy of scarcity, I argue that a situation of underemployment generally characterises well-functioning market economies, rather than a market equilibrium with full employment. Of course, the extent of underemployment may vary considerably. In the following, I use the terms 'inclusion' and 'exclusion' in relation to access to employment. In addition, I analyse inclusion and exclusion in terms of the benefits of social security systems that are in the majority of cases – albeit not entirely – linked to formal labour contracts.

In a well-functioning economy that is dominated by the monetary sphere as outlined above, wealth owners, such as commercial banks, becomes the economic sovereign as his portfolio decisions determine economic development. The composition of the latter is determined by the liquidity preference and degree of risk aversion of the wealth owner. He himself decides whether he prefers to hold his assets in the form of liquid money or real estate, whether he prefers to hold liquid money as demand deposits or even in cash, and whether he invests his assets in long-term income-generating investments. In other words, he becomes the economic sovereign of the economy. Thus, his decisions are determined by his underlying eco-

[1] For a more detailed discussion see Riese (2004); Schelkle (1992); Lüken gen. Klaßen (1993); Herr/Priewe (2005).

nomic calculus. The latter will decide on the provision of a loan for the profit-generating investment project of a capital-scarce entrepreneur depending on its assessment of the trustworthiness of the respective firm, and depending on its confidence in the situation in the economy. In this context, the central bank is equipped with asymmetric power as it may limit the formation of credits by raising the basic interest rate. However, the central bank may not be able to force the wealth owner into long-term investment financing through the reduction of the interest rate level.

In a world with more than one currency, the wealth owner decides not only between monetary and real estate asset holdings but also between generating income in domestic or foreign currency. The weaker the domestic currency appears to be in the eyes of the wealth owner, in other words, the higher the probability of wealth losses – either internally through inflation or externally through nominal exchange rate devaluation – and the lower his willingness to hold his assets in domestic currency. Therefore, wealth owners possess a crucial decisive power over the extent of investment and employment within the domestic economy. By threatening a change into another currency, wealth owners have considerable veto power in an economy, at least as long as the international economic system allows capital to move freely. As a consequence, economic policy makers are obliged to meet the requests of wealth owners, particularly in relation to the stability of the domestic currency.

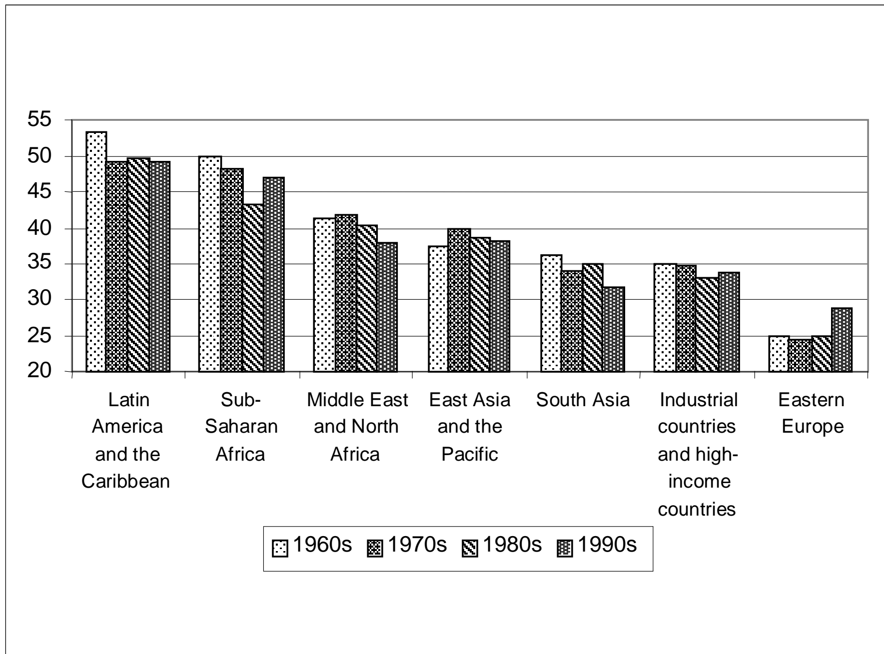
In the case of weak currencies, this implies that domestic production is being strangled by high capital outflow as the economic sovereign – the wealth owner – does not have any incentive to hold his assets in a relatively weak currency that is characterised by inflation and devaluation. Alternatively, the government may try to serve the interests of the economic sovereign and establish a high real interest-rate level in order to compensate for the relatively weak currency and potential future losses through higher interest rate earnings at present. Production and employment in the economy are limited to low levels in this way, too, as few investments bear a profit margin that can compete with a high real interest-rate level.

On the other hand, economic policy makers are faced with the legitimising pressure of the voting population – at least as long as the political will of the majority is not repressed. The political sovereign – the majority population – demands an economic policy that ensures a maximum of economic and social inclusion. In addition, this claim may be associated with the demand for the progressive redistribution of wealth. The power of the political sovereign in a democracy is defined by equal voting rights for each and every citizen who is allowed to vote. Yet, even authoritarian regimes require a certain degree of at least economic legitimacy (in terms of growth and employment) in order to avoid forced regime change. I thus argue that modern societies are generally characterised by this fundamental dilemma between the economic and the political sovereign. However, the mediation of the conflict between these diverging interests takes a variety of forms in different countries over time.

In a region such as Latin America, which is characterised by a relatively low level of economic development in comparison to industrialised countries in terms

of per capita income, the dilemma can be observed in the form of a very high degree of economic exclusion. Given prevailing intra-regional differences, economic exclusion in Latin America materialises as an exceptionally unequal income distribution that cannot be compared to any other region in the world, as shown in the following charts.[2]

Figure 1: Income Distribution in Latin America and Other Regions of the World (measured according to Gini coefficient, 1960s–1990s)



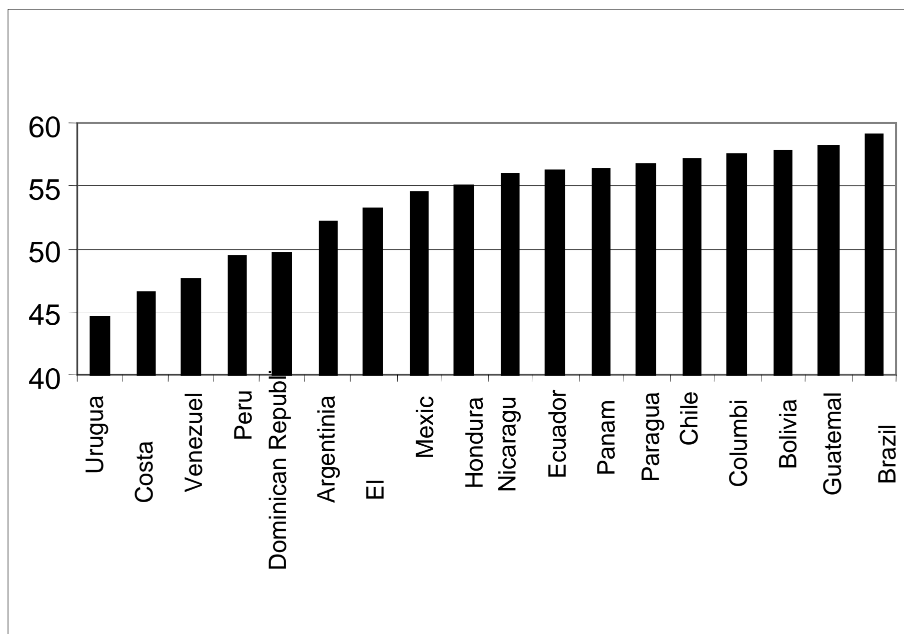
Source: Deininger and Squire 1996.

In Figure 1 we see that the Gini coefficient[3] – for which reliable international measures are only available from the 1960s on – is considerably higher for Latin America than for any other region in the world. Yet, it is noticeable that this difference decreased in the 1970s, before rising again in the 1980s. We will come back to these changes in the following discussion.

[2] CEPAL (2004) provides an overview of the present income distribution in Latin America; a good deal of data and analysis on general and specific aspects of Latin American income distribution can be found in the 2003 World Bank study, which additionally provides a historical perspective on the phenomenon.

[3] The Gini coefficient takes on values between zero and one in order to measure the degree of inequality of the income distribution in a country. Its value rises with rising income inequality.

Figure 2: Income Distribution in Latin America (measured according to Gini coefficient, end of 1990s/early 2000)



Source: World Bank 2003, Figure A.3.

In addition, these figures show that the picture of income distribution in Latin America is by no means homogeneous. For example, the level of income inequality in Uruguay is significantly lower than in Brazil – the country with the most unequal income distribution in the region, which I will therefore particularly focus on.

In the following sections, I discuss the economic mechanisms of inclusion and exclusion in Latin America. In section 2, I provide an overview of the structuring characteristics of inequality. In sections 3 and 4, I analyse the most important phases of the various economic policy focuses that led to differing mechanisms of inclusion and exclusion. I define the major structuring characteristic as forced indebtedness in foreign currencies, which has a destabilising influence on domestic markets and hinders long-term economic development. Further to this, I consider structural heterogeneity as a consequence of missing domestic market development, which leads to a limitation of employment opportunities. Finally, I define the overarching economic policy phases as (1) the period of import-substitution policies between 1930 and 1980 and (2) the second phase of economic liberalism in Latin America, underway since the 1980s.

2 Structures and Regimes of Inclusion and Exclusion in Latin America: Indebtedness in Foreign Currency and Structural Heterogeneity

The widely recognised concept of *original* sin by Eichengreen et al.[4] points to the fact that countries which have received loans exclusively in 'strong' foreign currencies from international capital markets ever since their nation-building process began remain unable to indebt themselves in their own currency today. Thus, they are tainted by a high level of foreign currency-denominated debt and, therefore, by a high degree of what the authors call 'original sin'. International financial market claims concentrate on a few currencies of the major industrial countries and international financial centres. Eichengreen et al. (2005) show that the majority of currencies – in other words, those of developing countries and emerging markets – have been rejected by international financial markets in an astonishingly consistent manner over the last two centuries.

The authors show in several empirical panel studies that the extent of original sin depends neither on institutional strength nor on the credibility of monetary policy or the strength of taxation policy. It is important to note that the only empirically robust indicator the authors find for the ability of a country to indebt itself in its own currency in international financial markets is the economic size of a country. Hence, it is the portfolio diversification strategies of international investors with a preference for the five major currencies, and not the economic policy orientation of the respective country that determines the financing options of countries that seek loans in international markets. This surprising conclusion by Eichengreen et al. (2005) has called a considerable portion of economic research on developing countries into question as the majority of studies had so far considered limited economic growth to be a consequence of domestic policy failures.

Further to the above finding, Eichengreen et al. (2005) also conclude that a high degree of original sin – in other words, the tendency to have a high share of foreign currency-denominated debt – leads to a significant increase in the instability of growth and in the volatility of international capital flows to such a country. They note three major underlying causes that had already been highlighted in the research on currency crises in emerging markets during recent decades:

> "First (…) original sin limits a country's ability of conducting a countercyclical monetary policy. Second, dollar liabilities limit the ability of central banks to perform their role of lenders of last resort. Third, the interaction between original sin and real exchange rate volatility increases the uncertainty over the cost of foreign debt service and leads to excessive volatility of domestic interest rates which also increase the uncertainty associated with the cost of domestic currency debt service. This increase in uncertainty leads to an increase of growth and capital flow volatility." (Panizza 2004, p. 5)

[4] Eichengreen/Hausmann (2005) provide an overview of the discussion on *original sin*; a shorter review can be found in Panizza (2004).

Indeed, the volatility of economic growth in Latin America is significantly higher than in the rest of the world (Hausmann/Gavin 1996, see also Rodrik 2001). According to the study of Ferranti et al. (2000), the fluctuation of Latin American GDP is twice as high as in industrialised countries. The highly fluctuating growth rates lead to a high volatility of labour supply and the wage level (Cortázar 1996: 215 pp.). The poor segments of the population are generally disproportionally affected by the consequences of high economic volatility since they cannot rely, except possibly to a very limited extent, on (monetary and non-monetary) savings in order to compensate for temporary income losses or reductions.

At the same time, the social security system in Latin American countries is typically very fragmentary. Due to its underdeveloped state, it mostly does not serve any insurance function. Hence, strong losses in times of crises easily disrupt the revenues that are made in economic boom phases. Thus, the higher vulnerability of low-income groups to economic volatility causes the polarised income distribution to become a permanent phenomenon, or even aggravates it. Among others, this is one explanation for the astonishing persistence of unequal income distribution in Latin America (World Bank 2003).

As a result of limited market dynamics and the interrelated exclusion of a wide range of people from the monetary economy, the coexistence of monetary, state-led, and family economies prevails in most Latin American countries. This situation is best described by the term ‘structural heterogeneity’, coined by Latin American social scientists in the context of the *dependencia* debate. By relying on this term, I underline its importance in understanding how institutional structures, political processes, and the mechanisms of economic inclusion and exclusion function.[5]

In particular, the family economy may appear in various facets of the subsistence economy or the informal sector, respectively, whereby the boundaries to the monetary and state economies typically overlap. In Latin America, economic heterogeneity historically goes hand in hand with an incomplete social modernisation process in which modern monetary economy structures were only partially established and were combined with persisting traditional forms of representation and clientelism. Without any doubt, there is no simple causal logic between an incomplete economic and an incomplete social modernisation. However, this holds true in the opposite direction too. In other words, economic underdevelopment cannot be explained by a state of ‘social underdevelopment’, although this is frequently proposed in development theory. Ultimately, economic development is a complex process of interdependencies, the understanding of which requires an intensive examination of specific historical processes.

[5] The most widely known contributions to the debate were made by Cardoso/Faletto (1969). The discussion on internationally induced dependency structures for so-called peripheral countries lasted over more than two decades. Within this debate, ‘structural heterogeneity’ was – among other things – discussed by Córdova (1973), and Oliveira (1972). For the linkage to Keynesian monetary theory see also Nitsch (1993) and Lüken gen. Klaßen (1993).

On the one hand, structural heterogeneity can be understood as a buffer that compensates for insufficient integration into the monetary economy. On the other hand, the political inclusion of the whole population may provoke a publicly expected promise of economic inclusion too. Economic policy is judged against this expectation – a promise it is usually unable to fulfil.

Apart from these structuring characteristics, two phases of economic policy have significantly shaped the forms of inclusion and exclusion since the twentieth century in Latin America: the policy of import substitution (from 1930 to 1980) and the policy of economic liberalisation (since the 1980s). I analyse both phases separately in the following sections.

2.1 Import-substituting industrialisation (ISI), 1930–1980

a) International context, economic policy arsenal, social project

The era of import-substituting industrialisation (ISI) was a long and by no means homogeneous period of time. It was, however, characterised by the relative rejection of world markets and the focus on the development of domestic markets in Latin American countries. While this domestic market orientation was set off by the Great Depression and reinforced by the Second World War, the collapse of the world economy following World War II provided the general conditions for its continuation for another two decades. Domestic market development combined with protectionism, fixed exchange rates, and rigid international capital controls characterised economic policy making in the ISI era.

Even beyond Latin America, this period was marked by expanded policy leeway for the political sovereign as the broad restriction of private international capital flows meant curbs on the implementing power of the economic sovereign. Although international capital controls did not completely eliminate the worldwide exchange between different currencies, they made international currency exchange extremely difficult.[6]

At the beginning of this period, in the aftermath of the Second World War, economic conditions had never been better before for most Latin American countries. The majority of them had been forced into foreign currency debt since obtaining political independence at the beginning of the nineteenth century and had thus suffered a series of currency and balance-of-payment crises. However, at the end of World War II, these countries were freed from foreign currency-denominated debt since the beginning of the ISI era coincided with the change from one key international currency, the British pound sterling, to another, namely, the US dollar. In fact, a few Latin American countries suffered economic losses due to this change: Argentina, for example, had become a creditor economy for England due to its rapid wealth accumulation in the nineteenth and early twentieth centuries. During the Great Depression, it then had to deal with a devaluation of its claims

[6] See Bord/Eichengreen (2003) on the international financial order.

against the former key-currency economy. Nevertheless, the majority of the debtor economies, for example, Brazil, experienced a devaluation of their liabilities against England while at the same time being able to accumulate foreign exchange reserves through earnings from exports to the USA. Brazil was, among other countries of the region, an important resource provider for the Allies, particularly the USA. At the end of World War II it had thus not only written off its economic debt but had also accumulated excess foreign exchange reserves.

The initial substitution of imports with domestic products during World War II and the Great Depression was primarily a market reaction to destroyed international market structures. Only after the Second World War was import substitution formulated as an intentional economic policy strategy in the context of the triumphant success of Keynesianism at that time. Under the direction of its Argentinian lead economist, Raúl Prebisch, it was first and foremost the UN Economic Commission for Latin America and the Caribbean (ECLAC/Comisión Económica para America Latina y el Caribe, CEPAL) which developed the theoretical framework as well as the economic policy instruments for a so-called catch-up development. At that time, the ISI strategy was also implemented by a large number of developing countries outside Latin America.[7]

The *cepalismo* assigned a fundamental role to the state in the implementation of the ISI strategy. The national industrialisation project should ideally involve all stakeholders in the country. In order to reach that goal, the 'developmental state'[8] employed a whole arsenal of economic policy instruments:

- High import tariffs and import prohibitions, or import quotas, respectively
- Capital controls and a system of multiple exchange rates that 'taxed' traditional commodity exports through an overvalued exchange rate (this holds true primarily for the 1950s, which were characterised by high international demand) and favoured capital goods and commodities over consumables
- Subsidies for exports (in some countries mainly practised during the rise of the export-oriented development strategy in the 1970s)
- The formulation of national and sectoral development plans
- The controlled permission of international foreign direct investment
- The creation of huge state-owned enterprises in central areas of the economy, combined with the provision of inputs for the national industry

[7] Cf. Prebisch (1949). A comprehensive explanation of the theoretical concept can be found in CEPAL (1969); an overview on the economic policy concepts of CEPAL during recent decades is provided by Bielschowsky (1998).

[8] 'Estado desarrollista' (Cardoso/Faletto 1969: 123 pp.); the term *desarrollista state became* established in the diverse use of languages in the international academic literature (see for example Schneider 1991: 218 pp.).

– The creation of public banks which provided state-owned and private enterprises with soft loans in domestic currency
– The acceptance of guarantees for foreign-exchange transactions and the assurance of market reserves for direct investments

The ISI policy in Latin America cannot be explained only by world market necessities. Rather, it took on a central, inward-oriented legitimating function and thus became a 'national project'.[9] The economic policy of ISI was directed at neutralising social tensions and conflicting interests between the different economic and social stakeholders in the developing society. It aimed to overcome the development blockade and solve the dilemma of the diverging claims of the political and the economic sovereign by accelerating economic growth that was focused on the domestic market.

This intention explicitly characterised the populist regimes of Latin America that emerged in the context of social changes in the 1920s. This era was marked by populist politicians such as Perón (Argentina) and Vargas (Brazil) who typically not only formed alliances with the domestic industrial elites but also created state-controlled trade unions. The ISI policy – which was mostly, albeit not always, motivated by populism – can also be understood as a 'redistributive regime'[10] that aimed to soften public budget constraints. The latter most often led to price inflation in the domestic currency. As a consequence, the domestic currency was under constant threat of capital flight by private wealth owners. The redistributive element of populism was not necessarily directed at a progressive redistribution of the national income or the implementation of an ubiquitous social welfare state.[11] Rather, we need to understand the expansion of domestic production (and thus of income and employment) in these weak-currency economies as the attempt to dispossess the private wealth owner of his restrictive sanctioning power and, at the same time, to enhance the entrepreneurial logic of the economy. Thus, the overall objective of the various market interventions was the support of market-made profits via direct and indirect subsidies – as domestic investment activities were at

[9] In Africa and Asia, where the decolonialisation process began only after the Second World War, the ISI period coincided with the process of 'nation building'. However, in Latin America, where political independence had already been achieved during the first half of the nineteenth century, the ISI economic strategy was accompanied by an emphatic debate about the redefinition of the nation, which needed new substance due to economic and social emancipation.

[10] Schelkle (1992: 64 pp.) outlines the redistributive as the alternative concept to the commercial regime. While in the redistributive regime, legitimation vis-à-vis the political sovereign is of vital importance for the definition of economic objectives, the commercial regime centres on the private wealth owner's economic calculus as the economic sovereign.

[11] On the exclusive character of the social welfare state in the Latin American tradition see Mesa-Lago (1978); on the concept of the 'populist redistributing state' see also Portantiero (1989: 89).

risk of strangulation due to high interest rates in the weak-currency economy (see Nitsch 1999: 197) – and the expansion of external budget constraints. The latter aim was supposed to be reached via import subsidies in the long term as well as via foreign-exchange liabilities in the short term.

Depending on the country and the respective era, this redistributive regime could show more or fewer participatory or authoritarian traits and could result in the end in either progressive or regressive income distribution. The case of Brazil in the 1960s and 1970s may be taken as emblematic here: The redistributive regime was an authoritarian regime that explicitly – and in the beginning with a considerable degree of state terror, for example, against trade unions – intended to implement redistribution on behalf of the domestic entrepreneurial elite. For a certain period of time, this caused very high economic growth rates combined with considerably increasing employment and thus increasing inclusion.

b) Brazil 1964–80: Inclusion via the labour market due to low-level employment through authoritarian redistribution on the part of the developmental state

In 1964, a military coup in Brazil initiated a long phase of authoritarianism. From an economic point of view, the authoritarian phase can be explained by Vargas's and subsequent presidents' attempts to compensate for declining growth at the end of the 1950s by increasing nominal wages (by bringing trade unions into action against the traditional commodity exporters). Among other things, the result was an inflationary push as well as a considerable demonetisation process at the beginning of the 1960s.

The military stabilisation programme, PAEG (Programa de Ação Econômica do Govêrno Castelo Branco/Economic Programme of the Government of Castelo Branco, launched immediately after the military came into power), is known as an important step in the so-called 'Brazilian economic miracle', that is, the explicit economic boom from 1967 to 1973. The latter brought about average growth rates of more than 10 per cent; even afterwards, between 1974 and 1980, the average annual growth rate was still at 7.1 per cent (IBGE, Instituto Brasileiro de Geografia e Estatística, National Statistical Institute Brazil).

With the military's seizure of power, the social pact changed from the import substitution phase of 'economic nationalism' to the 'authoritarian-modernising' developmental state, which primarily meant the repression of trade unions, including their wage claims (cf. Bresser Pereira 1996:37). The arbitrary indexation of nominal wages, often below the effective consumer prices index, became the decisive instrument in the repression of wages. It allowed the authoritarian state to develop broad discretionary leeway to employ income policy for economic stabilisation purposes, and to define – and repeatedly manipulate – specific inflation indices. As a consequence, the Gini coefficient rose from 0.49 to 0.56 between 1960 and 1970 (cf. Fishlow 1973:94).

In the 1970s, this policy led to extensive debate about the ISI strategy's impact on income distribution in the country.[12] On the one hand, mainstream authors ascribed the increasing concentration of income to the market-distorting policies of import substitution. Due to the resulting overvalued currency and cheaper imported capital goods, protectionist policies indeed led to the use of capital-intensive rather than labour-intensive technologies and, as a result, insufficient employment opportunities. The mainstream school of thought highlighted the connection between the concentration of income and the decade-long inflation that had led to losses in the purchasing power of mainly the lower-income groups (cf. for example Franco 1998: 61). On the other hand, proponents of the *dependencia* school explained the anti-egalitarian bias of ISI as being due to the incomplete social modernisation process, which reinforced the rural exodus and thus reduced the urban wage level. The programme of this camp was to identify the specific character of the Latin American industrialisation process. In addition, some, such as Baltar et al. (1986: 88p.), argued that the selective nature of employment-related social welfare provoked a reproduction of structural heterogeneity, even within the modern sector of the monetised economy. Thereby, the informal sector would take on compensatory functions due to its multifaceted peculiarities (the *dependencia* school argued against the dualist model, which divided the economy into a traditional subsistence sector on the one side and a modern monetised sector on the other side).

In addition to innumerable institutional changes over time, the authoritarian ISI period primarily caused an income policy where wage increases tended to remain below the productivity increases of the industrial sector (cf. Lara Resende 1990: 216p.). The resulting increase in profits became the most important self-financing source for investments. In addition, the PAEG policy played a central role in aggravating unequal income distribution, not only between wages and profits but also among wage earners. Followers of the *dependencia* approach argued that the Brazilian accumulation regime was responsible for the increasing concentration of income (cf. Tavares/Serra 1972: 157pp.). This complies with my point of view insofar as I argue that the recovery of relative monetary stability at that time was not built on growth-impeding monetary policy activation but rather on the repression of the wage level, which ensured entrepreneurial revenues within the weak-currency economy.

The maintenance of high growth rates throughout the post-war period resulted in a relatively high average income and a comparably high employment level, particularly in urban economic growth centres at the end of the 1970s.[13] From a heterodox point of view, Brazil was a case of ‘peripheral fordism’ (Hurtienne

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[12] Bacha/Taylor (1980) provide an overview of the discussion.

[13] In 1978, per capita income in Brazil was approximately US$1,786, which placed Brazil close to the ‘upper-income category’ of the middle-income countries following the classifications of the World Bank. The number of wage-related employed people rose in the 1970s from 16 to 18.7 million. At the end of this phase, approximately 60 per cent of urban households were at least partially integrated into the markets for long-term consumables (cf. Hurtienne 1985: 55p.).

1986: 98pp.) whose central development problem was the inequality between the rapid industrial modernisation process on the one hand and the lagging socio-economic structural change caused by the lack of welfare-state regulation by the state on the other hand. At the end of the 1970s, such a perspective suggested that a political democratisation process should induce a generalisation of the welfare state and thus an increase in wage rates and a continuous levelling of the structural heterogeneity in employment structures.

This aspiration lost ground with the outbreak of the debt crisis. In retrospect, we see that the reduction of structural heterogeneity in Brazilian society, in the sense of the inclusion of the largest possible part of the society into the modern state-regulated area of the domestic economy, reached its peak at the end of the ISI period (see also Pochmann 2000: 17). As a consequence, the long-lasting crisis of the 1980s resulted in a cutback that continued in the 1990s, albeit for other reasons. The unequal income distribution was aggravated during the debt crisis and became the central political topic in the context of re-democratisation. Economic concepts were evaluated by their efforts for the reduction of inequality. Thus, when Brazil experienced a step-by-step rebuilding of democracy the 1980s, the period was characterised not only by the cut-off from international capital markets and the need to end the cumulative inflationary process, but also by the vehement claims of the political sovereign regarding the need to balance the 'social debt' of ISI policy (particularly that accumulated during the military dictatorship). Thus, it seems symptomatic that the well-known sociologist and later president Fernando Henrique Cardoso closed his contribution to the standard book on Latin American democratisation processes by O'Donnell/Schmitter/Whitehead (1986) with the perspective that a political opening of Brazil

> "leads the country from stable transition to, if not liberal democracy – which is not the case at present – at least to a regime that is more compatible with the pressures of revindicative masses." (Cardoso 1986: 153)

c) Import substitution and debt crisis: Re-establishment of the (international) economic sovereign and increasing exclusion again

The whole ISI period was characterised almost completely by a growth-oriented policy that was accompanied by a softening of the public budget constraints and balance-of-payments restrictions. Thereby, the economic orientation alternated between prioritising the economic inclusion of hitherto excluded parts of the society on the one hand and satisfying the stability interests of the wealth owners on the other hand. In phases of a stronger orientation towards job creation and social welfare mechanisms, budget deficits tended to rise more than in phases when wealth owners' interests were prioritised. The extent of the softening of balance-of-payments restrictions, however, was primarily dependent on the respective international constellation. While, in the context of international capital market restrictions, the 1950s and 1960s were dominated by private direct investment and loans by international development banks, from the 1970s onwards the supply of private

bank credits developed rapidly. The latter emerged in the course of liberalised capital flows in the key-currency economies and the economic crisis in the industrialised countries in the aftermath of the breakdown of the Bretton Woods system and the oil crisis. Latin American countries as well as the majority of developing countries around the world took advantage of the beneficial financing conditions that prevailed during the 1970s.

From 1979 on, interest rate increases by the US Federal Reserve Bank led to a reversal of international capital flows, in turn causing deep and persistent debt crises in almost all developing countries, first and foremost in Latin America during the 1980s.[14] Latin American economies were forced to subordinate their economic policy to the primacy of balance-of-payments stabilisation. Due to erratically increasing financing costs for the state, this required a considerably contractionary policy and resulted in a dramatically accelerating inflationary process.

In the context of the debt crisis, the ISI strategy was no longer sustainable as it resulted in a twofold restriction of investment activities: First, the region was cut off from foreign-exchange loans, which were indispensable for maintaining high investment levels. Second, the debt crisis usually caused a deep fiscal crisis in the developmental state, which affected public and private investment capacities.

In the first half of the 1980s, the fiscal crisis in most Latin American countries resulted primarily from the socialisation of private foreign debt that was correlated with an increase in domestic public debt; in other words, private debtors paid back foreign currency debt in domestic currency to the central bank. Within the democratisation process, additional claims were raised to the state from the majority of voters. The state was called to 'serve the social debt' – that means, to increase social spending in order to re-reduce economic and social inequality that had been raised under the authoritarian regime.

This constellation caused a twofold process of exclusion: on the one hand, the decline in investment and the sharp shrinking of the economy resulted in reduced employment; on the other hand, welfare state expenditures were reduced. Both processes disproportionally affected the poor. I will analyse the period of the 1990s, when these exclusionary processes accelerated, in greater detail in the following section.

2.2 World-market orientation and liberalisation as development strategy: the 1990s until today

a) Combating inflation cum liberalisation: The exchange rate-based stabilisation strategy in the 1990s and its consequences

Indeed, the point in time when liberalisation policies started varied among the countries: As an exceptional case in Latin America, Chile had already committed

[14] See Sachs (1985) and Schwarzer (2002) for analyses of the consequences of the debt crisis in Latin America.

itself to economic liberalism in the 1970s. In its beginnings, economic liberalisation was considerably radical in Chile, while Brazil adopted a distinctly liberal, though somehow more moderate direction of market orientation only in the mid 1990s.

Often, for example, in the widely cited ‘Washington Consensus’ (Williamson 1990), liberalisation is described as a simple trio of economic policy instruments: liberalisation, deregulation, and privatisation. However, a more detailed look shows that the liberalisation process in Latin America was far more complex with respect to the phenomena of inclusion and exclusion. This was primarily related to the form of monetary stabilisation.

In the 1990s, a new type of stabilisation programme developed, which connected anti-inflation programmes with the economic opening up to world markets. These programmes started with spectacular promises. They pledged to ensure monetary stability and growth at the same time, that is, to equally serve the interests of the political and the economic sovereign.

In the 1990s, a multitude of Latin American countries opted for a more or less fixed pegging of their exchange rate in relation to the US dollar, the strongest currency of the region.[15] The best known case is Argentina, with its radical currency board. From 1991 to 2001, the country’s exchange rate was pegged by law at 1:1 to the US dollar. Further to this, Brazil (with the *Plano Real* from 1994 to 1998) and Mexico (with the so-called Stabilisation Pact fom 1988 to 1994)[16] chose the softer form of a relative exchange rate peg. Also, Ecuador, Paraguay, Uruguay, and Venezuela opted for a form of exchange rate peg, albeit in a more moderate form.

Fixing the exchange rate requires a relatively high stock of foreign exchange reserves by the national central bank in order to defend the exchange rate peg. Thus, employing the exchange rate as a nominal anchor – or in other words, the fixing (or quasi-fixing) of the national currency to a strong foreign currency – was actually only feasible at that time since it was only at the beginning of the 1990s that international financial markets began to gradually open up to developing countries and thus provide access to foreign exchange reserves.

The decisive advantage of the exchange rate-based stabilisation model was that monetary stability could be imported from abroad rather than being brought in at home with restrictive domestic monetary and fiscal policy. The fixed exchange rate ensured stable prices for imported goods from world markets. Thus, domestic suppliers were also forced into price stability. A precondition, however, was the considerable liberalisation of the economy, that is, price liberalisation in domestic

[15] A detailed overview of Latin American stabilisation programmes via exchange rate pegs can be found in Singh et al. (2005, p. 48pp.). A number of Eastern European transformation countries as well as East Asian ‘tigers’ also followed an exchange rate–based stabilisation policy – albeit under different circumstances and in individually specific forms (cf. for example Bofinger et al. 1997 and Horn/Schrooten 1999).

[16] For a systematic comparison of the exchange rate–based stabilisation programmes in Argentina, Brazil, and Mexico see Fritz (1999); Fritz (2002) provides a detailed analysis of the Brazilian *Plano Real*.

markets and an economic opening up to world markets. Thus, the stabilisation programmes were a good opportunity for governments to enhance economic liberalisation.

In most cases, the success of the exchange rate peg materialised immediately. Inflation rates were brought down from three- and four-digit to double-digit levels within weeks. Additionally, in the first months and years, a demand-driven economic boom could be observed due to overall higher demand and improved market expectations together with the end of the inflation-related losses of wage earners. Thus, in the beginning, ‘the best of all worlds’ was realised: an economic stabilisation without adjustment costs, which created a euphoric atmosphere and thus sustained further stabilisation and growth.

However, one of the main problems associated with this kind of stabilisation programme, particularly when combined with an anti-inflation policy, is that it leads to an appreciation of the exchange rate. This in turn decreases the competitiveness of a country since exports become more expensive and import prices decline. This appreciation can be explained by the residual inflation that results from the initial rigidity of wages and prices. Thus, the fact that the low inflation level of industrial countries was not achievable overnight became the Achilles heel of the Latin American exchange rate-based stabilisation programmes. Within the first two years after the implementation of the exchange rate anchor, real exchange rates in Argentina, Brazil, and Mexico increased by an average of 25 per cent; between the introduction of the currency board in 1991 and its collapse ten years later, Argentina's real exchange rate appreciated by about 60 per cent (Singh et al. 2005: 51 pp.). This caused a tremendous increase in export prices on world markets and a parallel price reduction of imported goods in these three countries.

No country in the region could compensate for the mostly erratic import increases with equally high export rates. Current accounts turned into deep deficits. In combination with increasing capital inflows – in other words, future liabilities vis-à-vis the rest of the world – this situation resulted in significantly rising trade deficits. Trade deficits again required new capital inflows in order to keep the economy solvent and to refinance foreign debt via new loans, whilst trade deficits were increasing.

This situation made the countries of the region highly dependent on permanent capital inflows. However, the international capital market turned out to be rather volatile. Following the rapid increase of capital flows towards so-called *emerging markets* in the first half of the 1990s, a dramatic breakdown at the end of the century eroded market confidence in the solvency of those countries. Due to the increasing trade deficits of the debtor economies, the markets’ mistrust spread like a large-scale fire throughout the major developing economies in Asia, Eastern Europe, and Latin America.

Thus, from the mid 1990s onwards, currency and debt crises became the other side of the coin of the initially quite successful exchange-rate stabilisation programmes. In 1994/95, the series of crises started in Mexico; Brazil followed in 1999, and in 2001/02, Argentina's currency board broke down – to mention only

the largest Latin American economies. Drastic growth reduction, massive fiscal crises, and increasing unemployment were the results. However, even in the beginning, when economic growth rates were still high due to successful anti-inflation policies, the impulses for employment remained limited as jobs were partly destroyed by new imports. In the following section, I draw general conclusions on the exchange rate-based stabilisation programmes in Latin America with respect to the economic processes of inclusion and exclusion.

b) The effects of anti-inflation policy, liberalisation, and financial crises on income distribution and employment in Latin America in the 1990s

The first-phase effects of anti-inflation policy, liberalisation, and the financial crises on income distribution were not as clear as the impact that the subsequent currency crises had on income distribution and employment as a long-term consequence of the exchange rate-based stabilisation programmes.

In the beginning, the reduction of inflation had positive effects for the poor. While the wealthier segments of the population had in the past developed a variety of mechanisms and institutions to protect themselves from inflationary losses, poorer people had only restricted, if any, access to banks and specific financial services. Among wealthier people, for example, credit cards were widely used; a certain amount of time passed between the payment and the billing by the bank, which reduced the real value of the respective expense. In fact, in high-inflation countries, low-income groups readjusted their expenditure practices too. For example, in order to avoid price increases in the following weeks after receiving their monthly salary, these people spent their income immediately on the monthly household shopping in the supermarket. With frequent price rises between 20 and 50 per cent this was of considerable importance. Nevertheless, poorer households had to cope with real income losses that were only absent at the beginning of the stabilisation programmes, when inflation rates came down sharply. These losses mainly resulted from, among other things, a mostly deferred or incomplete adaptation of nominal wages to inflation.

However, the initial success of the stabilisation programmes was enormous. Since inflation no longer ate up parts of their income, low-income groups achieved a noticeably higher degree of purchasing power. In Brazil, for example, the demand for typical middle-class food products such as yoghurt and beer strongly increased – a clear indication of the upgrading of the underclass consumer demand. However, even in the case of Brazil, where this aspect was of particular importance due to the country's especially unequal income distribution, the IMF subsequently concluded in a study that the progressive income distribution effects of the anti-inflation policies were limited and only of a temporary nature. A sustainable improvement of the extreme social inequality would have needed more profound instruments such as the redistribution of land ownership, etc.

The opening up of these countries to world markets had fewer positive impacts on the labour market. The simultaneous decrease in tariffs and appreciation of the

currency quantitatively influenced the domestic production structure. In countries such as Argentina, one could observe a downright deindustrialisation process. The latter was only partially justifiable as an unavoidable adjustment policy of the ISI strategy, which aimed to complete national industrial production. Less visible but probably even more important was the noticeable flattening of the industrial depth, that is, the growth of *maquiladora* (assembly) industries as a reaction by national producers to increased competition.[17] In addition, the relative importance not only of commodity products but also of commodity-based industries increased again (Benavente et al. 1996: 56pp.). The resulting employment losses could usually be only partially compensated for by increases in other areas, such as the services sector. Moreover, growth rates in Latin America were not high enough in the 1990s to initiate an inclusion dynamic via job creation that would be comparable to the 1970s.

This development meant not only a higher vulnerability of the respective countries to fluctuations in commodity prices, but also that competitiveness had to be built up via low wages. Similarly, the de facto observable increase in productivity was mainly reached by rationalising and outsourcing employment to sub-enterprises rather than through new investments. Altogether, this led to a drastic increase in unemployment and informal work in the region. Yet, the unemployment rate has only limited explanatory power due to the absence of social security systems and the mostly informal forms of employment. A clearer indicator of the employment situation is the extent of informal employment: for example, in Brazil, the rate of informal employment increased from 52 per cent to more than 60 per cent of total employment during the 1990s.[18]

Today, informal employment in Latin America typically comprises a broad range of activities and remunerations. This includes the high-tech computer company in the backyard that evades taxes and duties as well as street vendors and rural day-labourers. Yet, the absence of a social security system, which affects all forms of employment, poses a much greater difficulty to lower-income groups. In the case of retirement, illness, or unemployment, these groups can only rely on small amounts of savings, if any. Falling living standards become a sincere threat if an informal work place ceases to exist or if income declines significantly.

Not only were social security contributions shrinked by the increasing informalisation of employment. Additionally, spending cuts in the social budget and the general crisis of the welfare state led to significant upheavals in social policy. In this context, a new social-policy paradigm developed that focused compensatory public services on specific target groups of the deserving poor rather than defining

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[17] Messner (1996), for example, proves this in the case of the Argentine industry; Dussel (1997) describes the structural change in Mexico; Singer (1996) analyses the regression of the Brazilian industrialisation process.

[18] The sociologist Beck was widely recognised for introducing the buzzword "Brazilanisation" into the debate about the future of employment in Germany. The term describes the ongoing informalisation of employment in Brazil (see for example *Die Zeit*, 25.3.1999: 'Wir sind alle Brasilianer').

formalised and institutionalised claims for benefits as the old system used to do. The effect was a partially and temporarily higher efficiency in poverty reduction. Yet, it was recognisable that such a target group-oriented social policy was strongly pro-cyclical. In the event of a macroeconomic crisis, discretionary programmes are the first ones to be cut for operational reasons; the absolute social security expenses per capita shrink in the context of increasing poverty rates and shrinking social product, respectively (cf. Hicks/Wodon 2001, cited in Hujo 2005: 168).

This phenomenon was particularly evident in the context of the currency and financial crises during the second half of the 1990s. The latter resulted in significant economic collapses. Argentina experienced the most dramatic breakdown in national income – approximately 20 per cent – which led to massive, hitherto unknown, poverty problems after four years of severe crisis. In Mexico and Brazil, where the business cycles recovered relatively rapidly, negative growth rates also had to be accepted at the height of the economic crisis.

Thus, the currency crises affected the wage level significantly; for example, in Brazil, the wage level declined by more than 10 per cent in real terms between 1999 and 2002 according to DIEESE (*Departamento Intersindical de Estatística e Estudos Socio-Econômicos*); in Mexico, real wages regained their pre-crisis level from 1994 only in 2001, despite interim phases of high growth rates. Further to this, price hikes in energy, and partly also in food prices, because of the depreciation of the exchange rate disproportionally affected low-income groups.

All in all, at the beginning of the new decade, job losses, the informalisation of employment, a declining wage level, and new welfare state mechanisms that made public social spending highly vulnerable to economic crises had destroyed the economic progress that had been made during the first half of the 1990s in the course of successful anti-inflation policy together with economic growth. Between 1990 and 2001, the weighted Gini coefficient decreased only from 51.9 to 51.5 (World Bank 2003: 291); the poor segment of the population increased from 40.5 per cent to 44 per cent (CEPAL 2004:55).

Thus, the economic policy project of the 1990s, which aimed to combine stability and growth through economic liberalisation and the opening up of markets, failed. Latin America remains a region where the interest of the economic sovereign in economic and, particularly, monetary stability on the one hand and the preferences of the political sovereign for inclusion on the other hand appear to be specifically incompatible. This is a severe heritage for the future of the continent.

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