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Policy, Governance, and the Management of Conflict

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1. INTRODUCTION

This paper is concerned with a simple puzzle. Why have Latin American economies proven so remarkably fragile in the face of the macroeconomic shocks of the 1970s and 1980s? Even a decade ago, there was great optimism in the region. Growth was high, per capita incomes compared favorably with the rest of the Third World, industrialization and urbanization were proceeding apace, and even though there were problems, they did not appear insurmountable. Today, that optimism has disappeared. In many countries growth has been negative for a succession of years, inflation has skyrocketed, and foreign debt has reached alarming proportions. No one today places much faith in the ability of the governments or economists in Latin America to find a way out of this deepening quagmire.[1] In contrast, Asian countries have been able to maintain respectable rates of growth, and in some cases, even to exceed their earlier performance despite the recent crises.

The crisis in Latin America, and the relatively 'successful' outcomes in Asia have been explained by a group of neoclassical economists as the result of massive government interventions and erroneous and misguided policies by governments of the former group of countries. Part of the motivation for writing this paper is our profound disagreement with this line of reasoning. Our argument is that the crisis emerged not from the use of 'wrong' policies, but because the nature of political constraints on policy-making in Latin America had rendered most conventional policies ineffective, infeasible, or undesirable. Thus, in a sense, policy-makers were right in refusing to adopt the policies recommended by neoclassical advisors and bureaucrats, since their results would not have been very wholesome. On the other hand, Latin American governments were not entirely blameless, since they had failed in creating arrangements which would allow effective policy intervention when it was needed.

[1]Of course, Latin American countries are not the only ones in trouble. Africa is in a similar crisis, and even most of the industrialized countries have not recovered from the recent recession. Yet, Africa's fragile ecology, persistent droughts, and civil wars are reasons enough. In the industrialized countries, too, growth has not been consistently negative. Clearly, Latin America is a case apart.

In other words, we see the failure of Latin American policy-making not in short run, contemporary terms, but in terms of their historical actions -- in not creating institutional and political bases for effective action when the opportunities still existed. In this perspective, economic liberalization and openness can be interpreted as one among many different ways of re-creating policy effectiveness, but one which is neither very desirable, nor even feasible in the circumstances prevailing in Latin America today.

To make this argument, we shall use the concept of 'governance', namely of a perspective which sees the goal of state action in a contemporary society to be the maintenance of economic and political stability, the management (not elimination) of social conflict, and the creation of institutions and arrangements in which various social groups can cooperate with each other in the economic life of the country. This is by no means a radical perspective. The problem of governance was central to much of Keynes' writings, and distinguishes the Keynesian perspective on economics from its competitors.

The organization of this chapter is as follows. In section 2, we begin with the presentation of a political model of economics, which is then applied, in Section 3, to the analysis of political constraints on policy-making. Section 4 applies the lesson to the crisis of policy-making in Latin America, and Section 5 summarizes the argument and provides some concluding observations.

2. A POLITICAL MODEL OF ECONOMICS

There is a curious inconsistency in the neoclassical attitude towards government policy: On the one hand, the government is seen as being completely omnipotent and unique in its ability to choose policies and to pursue macroeconomic objectives; and on the other hand, it is seen as being almost completely impotent and incapable of actually improving anything (except when they chose policies to ensure the freedom of markets). The extreme political naivete of this view, which underlies much of the theorizing in favor of economic liberalization, has been noted by many influential writers including economists as well as political scientists.[2]

We believe that, contrary to what is suggested by economists' monistic vision of politics, governments are neither all-powerful nor completely powerless in most areas of social activity. First, polities as well as governments are characterised by differentiation and tension, rather than by monolithicity of structure and function. In order to understand the functioning and consequences of social decision-making, it is important to replace monistic perspectives with more pluralistic views; to make greater use of analytical tools, particularly those of political scientists, which are designed to analyse conflict; and to see policy-making as the constrained decisions of one among many actors actor operating in a situation of conflict and tension, rather than autonomous actions of an independent and omnipotent actor.

Second, the government plays an important and unique role in maintaining social peace, managing social conflict, and facilitating social cooperation. The ineluctability of this role invalidates the perception of the powerlessness of governments to achieve any social ends

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[2] A symmetrical criticism can be made of those non-neoclassical economists, who believe in the omnipotence of government policy, and its impotence in maintaining 'truly' free and competitive markets. Indeed, Albert Hirschman (1986) places the blame for the economic disasters in Latin American countries not on the use of policies considered by economic theorists to be wrong, but rather for following too religiously policies considered by theorists to be right -- of the structuralist variety in the 1960s, and the neoclassical one in the 1970s and 1980s.

whatsoever: Even if one believes the neoclassical assertion that governments cannot optimize social welfare, it is still possible to argue that governments can be more, or less, successful in managing conflict and pursuing the goal of social peace -- and not only by freeing markets!

The view that the nature and intensity of social divisiveness and polarity can constrain the autonomy of governments to use certain policies or to pursue certain objectives has been expressed by many influential social theorists. Vito Tanzi has argued, for example, that policy prescriptions for developing countries differ inherently from those for industrial countries because, inter alia, changes in policy instruments are often neutralized by reaction of forces outside the control of the government, and that authorities often find unacceptable the policies which are seen as desirable by economists.[3] Similarly, Margaret Weir and Theda Skocpol suggest that the structural features of the state affect the ability of the government to innovate, institutionalize, and implement different types of economic strategies.[4]

On the other hand, the pragmatic role of governments in facilitating social cooperation has also been emphasized by many writers, most notably by Albert Hirschman, who has repeatedly questioned the theoretical certitudes of economists and social theorists, and has shown that governments have erred most often when they gave up a pragmatic attitude in favor of a blind obedience of theorists' prescriptions.[5] Similarly, Tony Killick draws upon a vast literature in political science and sociology to argue that:

> Decision making in the face of major divisions becomes a balancing act rather than the search for optima; a process of conflict-resolution in which social tranquility and the maintenance of power is a basic concern rather than the maximization of the rate of growth or some such.... The maintenance of government

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[3]See Tanzi, 1986.

[4]Weir and Skocpol, 1985.

[5]While this theme runs through several of Hirschman's writings, a recent example is Hirschman, 1986.

> authority and social peace will tend to be dominant themes, with adoption of a development objective conditional on the extent to which it furthers these higher-priority, 'non-economic' concerns.[6]

A conceptual framework for the above line of reasoning has recently been provided by Jukka Pekkarinen, 1987, who draws upon the work of Weir and Skocpol to suggest an illuminating distinction between the 'theory model' and the 'policy model' of economics in Scandinavian countries (which can just as easily be applied to Third World countries). While the term, 'theory model' refers to a conventional, axiomatic theoretical system (neoclassical, neo-Keynesian, or neo-Marxian), a 'policy model' is defined as a nationally specific and coherent framework of ideas, which comprises structural, ideological, cultural, and institutional factors, and:

> is not the kind of closely-specified conceptual framework that is characteristically developed by economists. Rather, it consists in a more diffuse set of cultural biases that delimit the agenda of economic policy-making. Professional economists who rely on international economic theories, can meet serious problems of communication with these diffuse, yet powerful, policy models. If hostile to the policy views implied by an economic theory, the policy model usually does not generate an analytic argument but rather a broad consensus that the economic theory is 'unrealistic' or 'irrelevant'.[7]

Given this perspective, we can understand why the adoption of liberalization packages, for example, has taken place in but a handful of countries (and that too under considerable duress),[8] in spite of the immense intellectual and financial pressures on Third World governments from major international institutions. As we argue elsewhere in this volume,[9] Latin American countries, with their high levels of political tension and their long history of political mobilisation and organisation along functional lines, are faced with a problem quite different from that confronted by East Asian countries where these developments are extremely recent, or by South Asian countries whose long history of political mobilization

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[6] See Killick, 1983, p. 360.

[7] Pekkarinen, 1986, p. 3.

[8] For a complaint of this nature, see Krueger, 1986.

[9] See Banuri and Amadeo, this volume.

is not characterised by a similar evolution of functional organisation and polarisation. The reluctance to accept liberalization has derived, arguably, not from some deep-seated pathology in these countries, but rather from the greater sensitiveness of policy-makers to the specific institutional arrangements prevailing in their countries, or, to their 'policy model' of the economy, which seems to differ considerably from the 'theory model' of neoclassical advisers. We now turn to a discussion of the underlying determinants of this 'policy model'.

2.1 A Taxonomy of Policies and States

In analyzing the connection between politics and economics, use has often been made of Gunnar Myrdal's illuminating distinction between 'hard' and 'soft' states. While we are critical of the simplistic manner in which this distinction has often been used, it would not be out of place to describe its evolution in the literature. Myrdal argued that the latter term described most South Asian governments -- Burma, India, Indonesia, Pakistan, Sri Lanka (then Ceylon) -- which were reluctant to impose social discipline in their societies, the implication being that these governments dealt with social conflict by seeking to postpone rather than to manage or control it.[10] In this respect, he contrasted these countries unfavorably with Japan and China -- which supposedly had hard states, willing and able to impose social discipline, i.e., to suppress social conflict -- and suggested that softness was an aspect of underdevelopment which would have to be overcome for these societies to modernize themselves. (South Korea had not yet caught the eye of economists, but presumably Myrdal would have approved).[11] He was careful, however, to

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[10]See Myrdal, 1967, particularly, Chapter 18, Sections 13-14, Chapter 19, Sections 3-4, and Appendix 2, Section 20.

[11]The model of hard states spans the (Western) political spectrum from, on the one hand, right-wing authoritarian regimes (e.g., South Korea, Taiwan, Singapore, Chile, 1973-88, Argentina 1976-83, Brazil, 1964-78), which denigrate, if not ignore entirely, the role of social conflict or human rights of their citizens; and on the other hand, left-wing regimes

explain that the nature of the state depended upon cultural and structural features of the larger societies (in addition to, say, the regimes' willingness to use force) and that these underlying features are not transformed completely into their opposites overnight. Nevertheless, given the tenor of the times, particularly the unequivocal priority of growth and modernization in national agendas, such views could not help but give a strong ideological support to emerging authoritarian regimes in various parts of the Third World.

In recent years, the optimistic view of hard states has been questioned, partly because of their association with social repression, but more importantly, because attempts to construct hard states in countries with a high degree of political mobilization seems to have resulted in endemic political instability.[12] In an influential monograph, aptly entitled No Easy Choice,[13] the eminent political development theorists, Samuel Huntington and Joan Nelson argued that neither of these two choices were internally stable. Populist (soft) regimes brought about improvements in economic and political equality at the cost of rising aspirations and declining incomes, while bureaucratic-authoritarian[14] (hard) regimes improved economic growth at the cost of political repression and worsening inequalities. Both led to increasing political instability and a swing towards the other extreme.

In economic terms, hard states would be expected to take the 'economically correct' policy decisions, with little regard for their political consequences. For example, if it is believed that adjustment to external shocks requires a change in the distribution of

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(e.g., China, North Korea, Burma, Vietnam), which rely on central planning by an efficient state to introduce desirable forms of social change in the country.

[12]As has recently been discovered numerous authoritarian leaders, including the Shah of Iran, Ferdinand Marcos of the Philippines, U Ne Win of Burma, Duvalier of Haiti, General Galtieri of Argentina, and perhaps even General Chun Doo-Hwan of South Korea.

[13]Huntington and Nelson, 1976.

[14]The concept of bureaucratic-authoritarianism was introduced by Guillermo O'Donnell, 1973, to describe the spate of military regimes which came into power in Latin American countries in the 1960s and early 1970s.

income through changes in real wages or the real exchange rate, or reductions of subsidies or transfers, the government will try to bulldoze through with the decision over the heads of representative groups.[15] In the presence of organized political forces in the country, repeated instances of this nature can lead to growing unrest culminating in the overthrow of the regime by populist groups. Soft regimes, on the other hand, would resort to any number of ad hoc regulatory actions to protect incomes and to avoid having to face conflict. But this has problems as well. Although there will be instances when the conflict simply disappears with time, the more common situation will be that postponed conflicts will accumulate, and eat into the political and fiscal resources of the state, until they cannot be postponed any longer. This would create an opening for groups which favor hard regimes to come into power.[16]

There are exceptions, however. On one hand, three of the four successful East Asian countries (Singapore, South Korea, Taiwan) are said to have stable authoritarian regimes going back almost three decades or more, with Burma, China, Indonesia, and Thailand providing other examples. On the other hand, India as well as Mexico have had stable and soft states for an even longer period.[17] The presence of such exceptions creates the hope that they could be replicated in other, hitherto less stable, polities; and also that the adverse features of one's preferred type of state would turn out to be transitory and disappear over time -- hard states would become more democratic, and soft states more efficient in economic terms. These hopes have been surprisingly persistent despite repeated refutation by experience.

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[15]While this is not intended as a normative exercise, concern must be expressed about the denial of democratic and participatory rights entailed in this vision of the state, bordering, in extreme cases, on torture, terrorization, and brutal repression.

[16]Recent examples include the Bhutto regime in Pakistan, the Aquino regime in the Philippines, or the Garcia regime in Peru.

[17]On the political economy of India, see Bardhan, 1984.

The advocacy of economic liberalization, like the promises of political development experts of the 1960s, stems precisely from the hope that stable as well as hard regimes (such as South Korea) can be created everywhere, and will generally benefit society. The strong association of liberalization experiments with political authoritarianism, particularly in Latin America, has been noted by many writers.[18] This is not surprising, since the hard state is the one most compatible with economists' monistic view of politics: since there is only one 'right' theory, there is no scope for conflict on what is desirable for society.

The present paper argues, however, that the contrast between hard and soft states is a false dichotomy, and that most regimes fall into a third category, which can be entitled a 'pragmatic' state, and which may occasionally include nominally hard or soft states.[19] The unstable exceptions to this generalization are provided by governments which blindly obey the advice given by social scientists on the basis of their theoretical priors; or, to use Pekkarinen's categories, governments which will accept the replacement of their 'policy model' by the 'theory model' of theoretical economists. Albert Hirschman has brilliantly analyzed the growing crisis in Latin American countries as the result precisely of such a blind adherence to theoretical dogmas.[20] The same analysis could easily be applied to similar cases in other regions -- Pakistan during the 1960s, the Philippines during the martial law period (1972-85), India during Mrs. Indira Gandhi's emergency rule (1974-77), and several countries pursuing the liberalization dogma in recent years.

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[18]See, e.g., Sheahan, 1983, Hirschman, 1981.

[19]This is not meant as a moral approval of these regimes. What is possible, given the political, moral, and ideological circumstances of a particular country, need not lie within the bounds of the morally desirable.

[20]See Hirschman, 1986. He argues that Mexico's rigid reliance on Structuralist/Keynesian theories was just as harmful to it, as was Chile and Argentina's adherence to monetarism in the 1970s. Hirschman finds the recent turn to pragmatism in Latin America a reason to be optimistic about the future.

The notion of a 'pragmatic' state is derived from the perspective of 'governance', which was central to Keynes' writings on political economy. In contrast to hard and soft states which seek, respectively, to repress or postpone social conflict, pragmatic states seek to manage (not eliminate) conflict. In purely economic terms, the idea can be expressed in the form of a support for government intervention to guarantee economic stability. This perspective has always distinguished Keynesian economists from their neoclassical counterparts. For example, a leading Keynesian economist, the Nobel Laureate Franco Modigliani used the following words to describe the difference between Keynesians and Monetarists (in the US):

> [Keynesians] accept what I regard to be the fundamental practical message of The General Theory: that a private enterprise economy using an intangible money needs to be stabilized, can be stabilized, and therefore should be stabilized by appropriate monetary and fiscal policies. Monetarists by contrast take the view that there is no serious need to stabilize the economy; that even if there were a need, it could not be done, for stabilization policies would be more likely to increase than to decrease instability; and, at least some monetarists would, I believe, go so far as to hold that, even in the unlikely event that stabilization could on balance prove beneficial, the government should not be trusted with the necessary power.[21] [emphasis in original]

In broader, socio-political terms, it means that in order to live together people have to cooperate with each other notwithstanding conflicting interests, that this can be accomplished only through institutions which can channel incipient conflict into manageable directions, and that the state is the paramount social agency which can contribute to such institutionalization.[22]

Most regimes try to manage social conflicts with available political, economic, bureaucratic, and ideological resources. Given that the nature of conflicts as well as the nature and magnitude of available resources differs from country to country, and from time period to time period, the requirements of governance will be different as well. The failure

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[21] The excerpt is from Professor Modigliani's Presidential address to the American Economics Association, September 17, 1976. See Modigliani, 1977, p. 1.

[22] Many of these ideas are expressed in the recent literature on 'social corporatism'. See, e.g., Przeworski, 1987.

of a state does not derive from its refusal to adhere to a theoretical dogma. On the contrary! The failure of states derives, in the short run, from its abandonment of the goal of governance in favor of theoretical certitudes; and in the long run, from its inability or unwillingness to create or modify institutions to facilitate the management of conflicts, which are forever changing in form and intensity.

This can be stated differently. The existence of political pressure groups makes the task of governance that much harder by creating countervailing forces which can nullify the effect of certain government policies. It makes sense for a pragmatic state to try to shift to alternative policies; this is not a problem. The problem emerges if the short run solution becomes permanent, allowing the underlying imbalance to persist and to grow increasingly unmanageable. The next section tries to illustrate this argument with an example.

3. THE POLITICAL ECONOMY OF CONSTRAINTS

To discuss the issue of 'governance', and in particular, the failure of Latin American governments in this respect, we shall begin by looking at the conditions which determine the effectiveness of government policies. Whether a policy can be implemented at all, whether if implemented it will have the desired effect, and whether or not it will be associated with undesirable side effects, is determined by the nature of economic institutions and the balance of political forces in a particular country.

For this purpose, it is convenient to think of an economy not as a collection of markets, but rather, as Joan Robinson once described it, as a collection of groups who use political action to safeguard (or increase) their legal rights to a share of the total output[23] -- by direct action (e.g., industrialists raising output prices), or indirectly, by imposing costs on other groups or on society at large. The ability of a particular group to protect its share within a given amount of time will depend on the specific institutional arrangements and the nature of political organization, and generally differ from country to country and from situation to situation. Two conflicts which are prominent in economic analyses are those between labor and capital (the Marxian conflict) and between finance and industry (the Keynesian conflict). Recognition of these conflicts implies that government policies which affect the distribution of income between these groups could have unanticipated consequences. In particular, policies which seek to alter key relative prices -- the real wage rate, the real exchange, and the real interest rate -- which in turn affect the income shares of labor, capital, and finance will be less effective, and often counter-productive in more conflict-ridden societies.[24]

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[23]We restrict the discussion to conflicts over income distribution only for purposes of simplicity. In many countries, other forms of conflict -- e.g., fears of minority groups about cultural domination by the majority -- may be more significant.

[24]Much of economic policy is concerned with the proper exercise of the government's control over nominal values of these prices. We argue that the link between nominal and real prices is determined by underlying political processes and institutional arrangements

These two conflicts are relevant to the discussion of policy effectiveness, particularly in the context of economic liberalization, because they have a bearing on the choice between market-oriented and regulatory policies. It is well known in the political economy literature that labor will often oppose government policies based entirely on market considerations; while financial institutions are generally perceived as being the bastion of laissez-faire ideas, and staunch opponents of interventionist or regulatory policies. Industrial capital falls somewhere in the middle of the spectrum. While an extensive discussion of the reasons for this preference would take us too far afield, the simple explanation is that the income of the financial sector, as well as its ability to influence national economic and political choices, derives precisely from its anarchic nature, from its quickness and flexibility, its ability to take advantage of transient profit opportunities without being bogged down by longer-run considerations and obligations. On the other hand, while industrial capital requires a stable environment in order to be able to translate potential profit opportunities into realized profits, it does need room for maneouvre to be able to take advantage of these opportunities. Lastly, labor's earnings depend upon a stable and growing economy; its ability to affect economic outcomes derives from the need for cooperation in production activity, while its influence on national choices emerges mainly from its organizational capacity. In general, therefore, labor will suport regulations which try to create stability and to encourage growth; industry will support stability-seeking policy interventions and restriction of competition, but will oppose the extension of similar privileges to others -- workers, foreigners, and so forth; while finance will tend to favor laissez-faire and the existence of the maximum possible opportunities.

Parenthetically, a curious interesting asymmetry may be pointed out here. Economic liberalization proposals typically recommend the liberalization of capital as well as labor

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in addition to market forces. Other relative prices which hide underlying conflict include the terms of trade between agriculture and industry and those between traded and non-traded goods.

markets. However, while the liberalization of labor markets is intended to weaken the influence of the workers, the financial liberalization has the opposite effect, of increasing the influence of the financier class in economic and social decision-making. Thus, the liberalization proposal, far from being neutral, is strongly allied to groups whose commitment to the local economy is the least secure.

Be that as it may, the question for the state is, first, how to minimize the adverse consequences of these conflicts, without stifling either the willingness of various groups to cooperate with each other, or the incentive for them to contribute to national economic and social progress. A second question is how to ensure that the need for policy intervention is minimized, and the effectiveness of such intervention enhanced. Both these tasks require management of the conflicts which exist in society. Conflicts between labor and capital were handled typically by a) encouraging organization, negotiation, and bargaining; b) legal guarantees of income stability; and c) macroeconomic policies designed to reduce economic instability. Conflicts between finance and industry were addressed through the institution of central banks, which restrained destabilizing speculation, guaranteed liquidity, helped insured deposits, and regulated and supervised financial institutions. However, as the nature of conflict changes, the demands of governance also change. The differences between Latin American and Asian countries reflect precisely the different circumstances surrounding these two conflicts, and therefore differences in the demands which governance places upon the governments in the two regions. Below, we shall examine each of the two types of conflict.

3.1 Wage-Resistance

The effectiveness of government policies will be affected by the nature and intensity of the conflict between capital and labor, which, while influenced to some degree by the existence of labor organizations and labor legislation, is not totally dependent upon these

institutions. Since production requires cooperation between a large number of people, a conflict over wages can affect labor productivity and profits, even in the absence of labor organizations, through a widespread reluctance to cooperate voluntarily.[25] The economic consequence of this type of conflict is <u>wage-resistance</u>.[26] A clarification is necessary before we proceed further. Wage-resistance is not the same as wage-rigidity, which is defined as the empirical observation that (real or nominal) wages do not change. Rather, it means that **smooth and sustained changes in wages are resisted by political factors, and can be overcome only by political means**, such as consensual agreement, political concessions by workers in an emergency or crisis, or even direct repression.[27] In what follows, we develop a simple model which illustrates the impact of wage-resistance on the effectiveness of protectionist and adjustment policies.

Consider an economy with three sectors, a nontraded (services) sector, an exportable goods (agriculture?) sector, and an importable goods (manufacturing?) sector, with output prices, p_n, p_x, p_m respectively (all variables are in rates of change).

(1) $$p_x = e + p_x^* = q_x + w$$
(2) $$p_m = e + t + p_m^* = q_m + w$$
(3) $$p_n = w$$
(4) $$p_x^* = p_m^* = 0$$

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[25]In his discussion of wage-rigidity, Keynes emphasized that this did not depend upon the existence or strength of formal trade unions. Non-union resistance can effect the labor productivity, and hence profits, presumably through absence of motivation, deliberate slowdown of work, or even sabotage. Some of these ideas have recently be taken up in the 'efficiency wage' literature. See, e.g., Akerlof and Yellen, eds., 1986.

[26]To simplify the discussion, we focus only on the effect of the capital-labor conflict on the wages, ignoring, e.g., conflicts over the pace and intensity of work, or the control of the labor process.

[27]Latin American countries, for example, have been characterised by wage-resistance but not by wage-rigidity in recent years: Despite the existence of a strong labor movement and other impediments to unilateral reductions of labor's income share, real wages have declined by as much as 50% in some episodes of the recent adjustment crisis. Indeed, it could be argued that in polarised or conflictual situations, one of the consequences of wage-resistance must be the absence of wage-rigidity, or at least the presence of a high variance in the observed real wage. If non-political means are not sufficient to bring about a decline in wages, the government might be inclined to over-compensate whenever it has the opportunity to bring about such a reduction.

The starred variables are the (rates of change of) world prices of the two traded goods (assumed constant), e is (rate of depreciation of) the exchange rate, t is the (proportional increase in) the tariff rate, w the (growth rate of) money wages assumed to be the sole determinant of the changes in the nontraded goods price, and q_x and q_m are the normalized prices of export and import goods, normalized in terms of the wage rate. If labour is the only input in production, the normalized prices will also index the rate of increase of the profit share, and thus of the level of protection for each industry.

Now, consider the situation where the government wishes to shift the terms of trade in favor of tradable goods, i.e., to increase q_m, or q_x, or both. There can be three different reasons for seeking this outcome. First, the desire to stimulate the import substituting or the export industry in the pursuit of economic growth. A second reason is the desire to correct persistent balance of payments deficits, which necessitates the contraction of demand for and the expansion of supply of the traded goods sector, both of which, in the conventional approach, are approached through changes in relative prices: a real devaluation of the exchange rate, which influences the economy largely through a reduction of real wages.[28] Third, the need to adjust to an external terms of trade shock may also necessitate a depreciation of the real exchange rate (i.e., an increase in the relative prices of the two traded goods), in order to stimulate the traded goods sector.

In a static economy, either of these will require a transfer to the traded goods sector from some other sector. In general, the transfer is expected to come out of a decline in the wage share,[29] and the success of the policy to depend on the behavior of wages. Given

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[28]This will accomplish both ends: fall in consumption, and an increase in the profit share and hence, hopefully, investment and output in the traded goods sector.

[29]In a dynamic analysis, an increase in wages could also provide a stimulus through aggregate demand effects. See Marglin and Bhaduri, 1988. We are abstracting from these issues here, because in Third World countries, the aggregate demand stimulus applies mainly to the nontraded goods sector, while the contractionary effect of higher wages applies

that foreign prices are stable, if nominal wages are constant as well ($w=0$), a devaluation (i.e., an increase in e) will raise both q_x and q_m, while an increase in the tariff rate, t, will raise q_m alone.[30] These will fulfill the objectives of the policy, but only by retarding the share of wages in income. This means, first, that the success of the policy will depend upon the willingness of workers to accept a decline in their incomes (which will differ from place to place); and second, there may be no such thing as 'appropriate' or 'equilibrium' real wages, since it is not necessary that a certain level of wages produce both internal balance (full employment) and external balance (payments balance), in addition to being acceptable to workers. The discussion will focus on the implications of the last point.

To discuss real-wage resistance, assume that wages adjust with a lag to increases in the domestic price level (a weighted average of the prices of the three goods). This could be represented by the following formula:[31]

(5) $$w_{+1} = a_x.p_x+a_m.p_m+a_n.p_n; \qquad a_x+a_m+a_n=1$$

After some manipulations, this will yield a dynamic equation describing the path of normalized trade goods prices, $q_x=a_n.(q_x)_{-1}$. In other words, the positive impact effect of the devaluation on relative prices will erode over time, at a speed determined by the share of the nontraded goods prices (or, the pure wage sector) in the economy. This means that the maintenance of a desired level of the terms of trade between traded and nontraded goods will require repeated devaluations, and consequently a constant rate of inflation. However, if this leads to a progressive shortening of the lag between the devaluation and the

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primarily to the preferred traded goods sector.

[30]These two policies are the simplified versions of the textbook recommendations on 'export promotion' and 'import substitution' policies respectively.

[31]The three weights (a_x, a_m, a_n), which add up to unity, can be thought of as shares of the three goods in the consumption basket.

wage-adjustment, then an ever increasing level of inflation will be needed to produce the same effect.[32]

If wages adjust instantaneously, some other sector in the economy will have to bear the resource burden of the protection. Assume that real wages are constant, i.e.,

(5a) $w = a_x.p_x + a_m.p_m + a_n.p_n$; $a_x + a_m + a_n = 1$

In addition, at least one price in the economy, say p_n, adjusts with a lag. Or,

(3a) $p_n = w_{-1}$

In this case, since the lagging sector will bear the distributional burden of the protection, its size will determine the short run effectiveness of policies.[33] The remaining results are similar to the previous case.

Lastly, devaluation will be completely ineffective in two cases. First, if wages as well as relative prices adjust instantaneously, devaluation cannot produce any change in relative prices. Second, if the traded sector is effectively isolated, and wages are tied to the exchange rate, i.e., w=e (although in this case, tariffs could help protect the import sector). The last assumption is not intended as a curiosum, however. In many Third World countries the exchange rate is a 'sensitive' price, changes in which will often trigger immediate adjustment of a wide range of domestic prices.[34] In fact, the shift towards somewhat flexible exchange rates in these countries may have the hidden advantage that it has helped 'de-sensitize' this price, and therefore made it possible for small changes in it to have real effects.

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[32]For example, in indexed countries such as Brazil and Argentina, conflicts developed over the speed of indexing, since the retardation in relative prices is the greater, the slower a nominal price is adjusted to the price level.

[33]This can be demonstrated readily. Substituting from (1), (2), and (3a) into (5a), and setting t, p_x^*, and p_m^* at zero, we get: $q_m = q_x = a_n.(e - w_{-1})$. The larger is a_n, the larger is the protective effect on the traded goods industries.

[34]See Katseli, 1986.

To go from prices to output, protection will stimulate industry only if output adjusts more rapidly than relative prices. If the expansion of output depends on the installation of new capacity, the long run effect will depend crucially on expectations of future profitability, which, in turn, will be based on expectations of future protectionist policy and changes in speed of adjustment in lagging prices. If the policy is successful in offsetting any increases in domestic factor costs, and is credible, output will expand in the long run. In the short run, however, the expansionary effect will be negligible, and will generally be swamped by the contractionary effect of macroeconomic policies which accompany devaluations.[35] Be that as it may, the extent to which factor costs can be restrained by government policy will depend on the nature of labor market and other institutions, and therefore will differ from country to country.[36]

Furthermore, even if the policy is successful in restraining wages, it could be counter-productive in the face of worker resistance. It could actually lead to lower profits, because of strikes, work-stoppages, and a general decline in productivity. It would thus fail to stimulate investmentor output; indeed, the decline in wages could restrain aggregate demand, and thus lead to lower output and employment.[37]

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[35]This pattern is well-recognised in the literature, as the 'J-curve' effect of devaluation on output. Output first declines (due to contractionary macrpolicies which normally accompany devaluations during adjustment phases), and then rises as the response to stimulative effects filters through. The effect was first demonstrated by Cooper (1971) in a classic article. Recent theoretical explanations from somewhat different perspectives are in Krugman and Taylor (1978), van Wijnbergen (1986). The importance of restraining wages in a successful devaluation has been emphasized by Khan and Lizondo, 1987, Blejer, 1979, Connally and Taylor, 1976, Rodriguez, 1978.

[36]Comparison of two different experiences then, would generally be irrelevant unless one is willing either (1) to argue that the two sets of supporting institutions are broadly similar, or (2) to prescribe that the "successful" country's institutions be reproduced in the other country. Most mainstream analysts assume both (1) and (2).

[37] On this point, see the analysis of Bowles and Boyer (1987) and Marglin and Bhaduri (1987).

This approach can be extended to analyze anti-inflationary objectives. As has been argued in well known structuralist macroeconomic models, lowering the rate of inflation requires the retardation of one of the relevant nominal prices, which can be accomplished only if relative prices are flexible and, in particular, if workers are willing to accept a decline in their purchasing power.[38] If workers resist the decline and demand higher money wages, inflation will tend to increase, and the real devaluation will have a short life.

Where do the above considerations lead us in terms of the choice between various policy options? First of all, it seems to us that a recognition of institutional and political sources of wage-resistance would lead to the exercise of a certain amount of caution in the use of policies which rely on the retardation of the real wage rate in order to be effective. Whenever wages are not determined solely by market forces or solely by government fiat, however significant the two might be, such policies will be relatively ineffective and policy makers will tend to resist using them, no matter how ardently they are espoused by the orthodoxy of the times.[39] Secondly, as has been mentioned already, the emergence of real wage resistance means that changes in the general price level will no longer have the effect of redistributing income and expenditure, nor of moderating the conflict over the distribution of income between wages and profits. If the adjustment mechanisms adjust money wages with a lag, then an increase in the rate of inflation will have a redistributionary effect, but this will also erode, as the increase in inflation will generate pressures to shorten the period between successive wage adjustments.

There are two inter-related solutions to this dilemma. First, the problems related to growth strategy could be avoided by resorting to ordinary or tariff protection. Since this

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[38] See, e.g. Ros (1987).

[39] For example, Krueger (1986) identifies the 'liberalization' of labor markets as an essential component of the desired policy reform. Fields (1984) showed that export promotion policies were successful only in countries which had low-wage (or 'tight' labor) policies, and not in countries which had high-wage (or 'loose' labor) policies.

seeks to protect only a subset of the traded goods sector, it requires a lower resource transfer. A simple version is to examine the effect of a neutral tariff, which discriminates only between exports and imports but not among different imports. The impact effect of such a tariff on the imported goods price is: $p_m = a_x.(t - w_{-1}) + a_x.t$; recall that an equivalent devaluation will produce $p_m = a_x.(e - w_{-1})$, which is smaller. However, the effect will not be that much different if the export sector is too small to provide an adequate surplus; or, if it sufficiently organized to resist the extraction of this surplus.[40] Moreover, since part of the burden is taken up by the export sector, even though the protection erodes over time, it never goes to zero. The protection will be even higher, and the resistance lesser, in the more realistic case of selective tariffs; however, these will create incentives for rent-seeking as well as other efficiency costs.

Second, it might be possible to maintain growth rates, or to avoid adjustment dilemmas by resorting to foreign borrowing. This will keep wages high by allowing the maintenance of an overvalued exchange rate, and will keep profits (and hopefully investment) high by protecting import substituting industry with tariff and other barriers. In general, this will require some selective forms of protection, to single out industries where investment is highly elastic to profit rates, and where it might be socially most desirable. Foreign borrowing can be increased indefinitely as long as the real interest rate is less than the growth rate of the economy,[41] and as long as the financial markets consider the country to be a good credit risk. If borrowers cannot respond quickly to short term fluctuations in

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[40]Such resistance can be political (lobbying, political unrest, conflict between states and the federation, etc), or economic (decline in output or shift towards smuggling and capital flight through currency black markets, thus creating balance of payments difficulties).

[41] This condition simply means that the debt-GNP ratio can be stabilised at any level if further borrowing becomes unnecessary. If the interest rate is higher than the growth rate, then the debt-GNP ratio will explode even without fresh net inflows.

perception of credit risk, or to overvaluation of the currency or other policy measures, the economy will be reasonably insulated despite the debt exposure.

However, with the emergence of financial openness, this channel can become weaker. Financial openness can lead to destabilising speculative runs on the currency, i.e., to destabilising capital outflows. Such capital flight can be caused by the overvaluation of the currency, expectations of a devaluation, the use of low interest rate policies at home, politicial disturbance which influence expectations of future variables. Under fixed exchange rates, capital flight, will of course lead to rapid increases in foreign debt, and may help impair the creditworthiness of a country. Under flexible exchange rates, we get back to the earlier problem of wage resistance. If exchange rates are flexible, capital flight will, by inducing a depreciation, initiate a wage-price inflationary spiral. More importantly, if there is real wage resistance, it may not be possible to protect the industrial sector by government policy.

3.2 Financial Openness

Unlike the capital-labor conflict, which revolves around the maintenance of a given distribution of income of the two groups, the finance-industry conflict revolves around the maintenance of conditions under which each of the two groups is best placed to maximize its profit opportunities. Thus, the political and economic influence of financial groups will be aimed at the effectiveness of government policies which seek, not to reduce a particular level of income, but those which affect the rules of the game, and inhibit the unencumbered pursuit of profit. Whether or not such political influence will exist, or will be called into play, will depend on the nature of the financial system in aparticular country.

Consider the relationship between finance and industry. Here, by industry is meant the productive sector of the economy, comprising manufacturing, construction, and nonfinancial services, especially merchandise trade; finance refers to the financial intermediation

sector, covering banks, insurance companies, investment banks, and commodities, stock and bond markets. The traditional view of the relationship of these two sectors is that of 'finance as a handmaiden to industry and trade', in other words of finance as a passive activity which accommodates itself to the imperatives of the active sectors. In this perspective, the task of finance is to transfer resources from surplus to deficit economic units, and to ensure the optimal distribution of risk across the economy. The return to finance is then equivalent to the social value of channelling resources and assuming the risk of the transfer from one level to another.

This, however, is a non-institutional view of finance, which ignores the effect of specific features of financial intermediation arrangements upon rates of return as well as on the quality of the service and the nature of the outcomes. To look at these effects, one can start with a distinction between 'dependent' and 'autonomous' financial institutions, where the degree of dependence or autonomy derives from the degree of control of the state or of industrial capital upon decision-making in financial institutions.

'Dependent' financial institutions can be further divided into 'bureaucratic' or 'industry-dominated' systems. The former refers to a financial system which is comprised mainly of government bureaucrats, and which therefore tends to represent and implement the economic and other objectives of the government. The efficiency and quality of the service will depend upon the degree of efficiency in the public sector in general. South Korea and Taiwan are illustrations of an efficient bureaucratic financial system, while Bangladesh, India, and Pakistan have competent but inadventurous institutions.

'Industry-dominated' institutions correspond to the case where financial institutions have strong symbiotic ties with industrial houses, particularly when they are the subsidiaries of these industrial houses. The Philippines is the best example of this pattern, although many countries went through this stage in the early period of financial development --

e.g., the UK in the 18th and 19th centuries, the US in the 19th and early 20th centuries, Pakistan in the 1950s and 1960s.

'Autonomous' finance can also be subdivided into 'conservative' (or 'bank-dominated'), and 'anarchic' (or 'market-dominated) systems.[42] The former represent the domination of conservative, quasi-bureaucratic personnel of commercial banks, who take the long run view of the economy and resist actions, no matter how profitable, which would over-extend the system, or over-expose their financial portfolios. Japanese and continental European financial systems, particularly until the 1970s, could be placed in this category. 'Anarchic' financial systems are dominated by internal groups, who perceive their role, in classic Smithian fashion, as one of profit maximization as an end in itself, and one which is independent of any connection to industry, the state, or to industrial labor. The US in the 1970s and 1980s has begun to resemble this pattern, as have many Latin American countries.

In other words, while there is often a symbiotic relation between industry and finance, on occasion this relation can break down. In such a case, finance can become a source of macroeconomic instability; and the desire to avoid instability will result in an excessive solicitude for the concerns of financial groups. This has become increasingly the case since the break down of the Bretton Woods system. As Stephen Marris puts it, 'We were brought up to believe that finance was the handmaiden of industry and trade. But, as many observers have noted, we increasingly seem to be living in a world in which capital flows have a dominating influence on the conditions under which production and trade takes place.' The reasons are not hard to discover. The Bretton Woods system was built upon extensive domestic arrangements for regulating and supervising the financial sector, and ensuring its domestic orientation; the breakdown of this system was at the same time a cause and an effect of the increasing autonomy of the financial systems of key member countries.

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[42] In terms of behavior, these categories correspond, roughly, to Frankel and Froot's (1986) distinction between 'fundamentalists' and 'chartists' in the currency markets.

The ability of finance to influence the economy stems from two sources: the stock market, which is very sensitive to investor psychology, (but which, however, is relatively unimportant in the Third World); and international capital flows, which figure very prominently in policy discussions and economic analyses of Third World countries. This influence is higher in countries whose financial systems are relatively more autonomous, and those where there is greater financial openness, i.e., where there are strong connections between domestic and international financial markets, and where there are limited or ineffective capital controls.

This view of the role of the financial sector is in direct contrast to the neoclassical position, such as the one presented by Ronald McKinnon (1973), where financial activity is necessary not only for the mobilisation and efficient allocation of resources, but also as a stabilizing force in the economy. The neoclassical perspective leads unequivocally to a prescription for deregulating and privatizing the financial sector, while the Keynesian perspective leads in some instances towards regulation and in others towards deregulation. At issue in the former view is the removal of distortionary controls, while the latter view is concerned not with controls but with governance, the requirements for which could vary in different circumstances.

Thus, autonomous finance, particularly when it acquires an 'anarchic' orientation, can create problems for economic policy and performance. Speculation will tend to become destabilizing in nature, economic instability will increase, as even small and transient changes in economic performance, future expectations, or investor psychology will lead to large swings in economic activity.[43] More importantly, it will influence economic and political decision-making at the national level. An increase in interest rates (and the

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[43]This view has come to be associated with Keynes (even though it pre-dates Keynes) and with prominent Keynesian economists, most prominently, Hyman Minsky. See Minsky (1975).

return to finance) is likely to result,[44] as is the inability of governments to pursue protectionist policy.[45] In fact, it is well known that the election of pro-labor governments in Western countries affects the economy adversely through the reaction of the stock markets.

Given this situation, consider a government which seeks to stimulate economic growth or to facilitate macroeconomic adjustment by one of the following actions: 1) low interest rates combined with preferential access of industrial investors to institutional credit; 2) currency devaluation; or, 3) an overvalued currency combined with tariff barriers and preferential access of industrial investors to foreign exchange. However, in the presence of financial openness, none of these policies will be effective. High capital mobility will permit capital flight if the domestic interest rate is lower than the world interest rates. Because of the possibility of large international capital flows, exchange rate policy will become purely reactive rather than active, in order to avoid speculative pressures and balance of payments problems (high debt, reserve losses). Furthermore, even trade restrictions will be difficult to sustain without capital controls, since easy availability of foreign exchange can facilitate low cost smuggling operations. In such a case, therefore, governments will be unable and unwilling to pursue those social objectives -- e.g., income distribution or economic stability -- a belief in whose urgency and need is not shared by the financial groups.

To summarize, we have made two points. First, the existence of well-organized labor groups will, by creating wage-resistance in the economy, erode the effectiveness of 'market-type' economic policies. This has implicitly been recognized by most advocates of economic liberalization, namely that in order for their prescriptions to be effective and

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[44]The inter-locking nature of financial institutions means that there will be strong variation in the distribution of benefits, and therefore the support for higher interest rates. For example, during the 1970s in the US, the savings and loans associations were badly hit by the rise of interest rates, because of the nature of their portfolios, which had short-term liabilities and long term assets.

[45]For example, see OECD (1982: pp. 58-61).

successful, the political influence of organized labor will have to be considerably diminished. Second, the existence of financial openness will reduce the effectiveness and increase the costs of interventionist and regulatory policies. This, too, is well known from another context, namely the opposition of financial groups to interventionist policies. In the next section, we shall apply these results to an analysis of the Latin American situation.

4. THE LATIN AMERICAN CRISIS

The relevance of the above analysis to the current crisis derives from the differences between Latin American and Asian countries in terms of the two characteristics of wage-resistance and financial openness. Elsewhere in this volume we have examined the nature of labor market institutions in Latin American and Asian countries, to discover that the former are characterized by a long history of worker mobilization and extensive legislation guaranteeing rights and benefits to workers; in South Asian countries, while such legislation has existed for a significant number of years, the labor movement is fragmented vertically as well as horizontally; and, in East Asia (except the Philippines), labor mobilization has a relatively shorter history, and labor laws are weak and often loosely enforced.[46] As a result, it can be ventured that there would be a strong element of real wage resistance in Latin America, and relatively little in East Asia. In South Asia, since the labor movement has been unable to organize itself at the national level or to acquire a national identity, the main form of wage resistance is at the enterprise level, and pertains to nominal rather than real wages.

4.1 Financial Openness

With regard to the financial sector, contrary to the impression obtained by looking at trade shares, it turns out that countries in East Asia are relatively more 'closed' than Latin American countries. While the nature of financial institutions has been changing very rapidly in Latin America,[47] at the time of the recent crisis period, 1979-82, most Latin American economies had open capital markets. The two exceptions, Brazil and Colombia, are

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[46]See Banuri and Amadeo, this volume.

[47]For instance, Chile, Argentina, and Uruguay initiated a process of financial liberalisation in the early 1970s, but some controls were re-introduced in the 1980s with the worsening of the economic picture. On the other hand, Mexico which had always had an open capital account and a privately-owned banking sector, nationalised its banks, ended the convertibility of dollar accounts, and introduced capital controls in 1982.

often singled out for strong economic performance and low incidence of capital flight. The presence of foreign-owned banks,[48] currency black markets, and multinational corporations[49] has also been much more extensive in Latin America.

In Brazil, although the process of the internationalization of the financial system was far more timid than, say, Chile or Argentina, it has come a long way since 1964 when the new military regime, despite its nationalistic rhetoric, opened the Brazilian economiy to foreign capital. While there are stringent capital controls (which are being opposed by the financial institutions), there are other links to the international financial system. Despite the legal restrictions on foreign banks, their participation in the economy increased dramatically during the last two decades. In 1970 11.6% of the deposits, and 13.3% of the lending was by purely foreign-owned banks; by 1980, these numbers had increased to 15.2% and 28.9% respectively. The number of banks with foreign participation increased from 11 in 1970 to 22 (out of 40) in 1980; and their share of hte total credit went up from 44% to 67% in the same period. The number of foreign banks with representative offices in Brazil increased from 67 in 1969 to 408 in 1981. The exposure of the Brazilian economy to international capital has also been influenced by the influx of transnational corporations (which financed a significant part of their investment with foreign capital), and by the rolling over of the foreign debt after 1977.

In Asia, only Indonesia and Malaysia have no restrictions on capital outflows. India, Pakistan, Bangladesh, and South Korea have always had strong capital controls. All three countries have had a nationalised banking structure dating back from before the first oil shock, and have had low participation of foreign banks in the domestic financial sector. In

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[48]Except for Brazil, no Latin country placed strong restrictions on the ability of these banks to do domestic business.

[49]In their influential reference volume, International Finance Handbook, George and Giddy remark that these enterprises can and do transfer funds in and out of the country with much greater facility, because it is possible for them to enter into reciprocal contracts with similar institutions who need to transfer money into a country.

all three cases, however, there has been a gradual move towards liberalisation beginning in the early 1980s. Capital restrictions have been eased, as have been the restrictions on foreign banks, and dollar accounts have been allowed in limited cases.

Take the case of Korea. As Cole and Park (1984) have so painstakingly documented in their study of financial development of Korea, until recently all major financial decisions were controlled by the government or the central bank:

> ... the government allocates anywhere from 50 to 70 percent of domestic credit, depending on the classification of 'directed' or 'policy' loans, to predesignated sectors, industries, and uses. The remainder is then, in theory, allocated at the discretion of the D[eposit] M[oney] B[ank]s, but, in reality, these banks exercise little control over even the residual banking funds.[50]

The Taiwanese financial institutions are remarkably similar to those of South Korea. As Cheng (1982: pp. 143) notes:

> Whereas other Pacific Basin nations have liberalised their financial regulations since 1980 in the face of domestic and international market forces, Taiwan, China stands nearly alone in the region in retaining a system dominated by bureaucratic government banks, continuing to ration credit at below market-clkearing interest rates under behind-the-scenes direction of the central bank.

In other words, the Latin American financial system would be characterized as 'autonomous', while the financial systems in East and South Asia are generally of the 'bureaucratic-dependent' type. The autonomy of the former derives in large part from the links between domestic and International financial markets.

Policy Ineffectiveness

The upshot is that Latin American countries are generally characterized by wage-resistance as well as financial openness; South Asian countries by wage-resistance but not financial openness; and East Asian countries by neither. Therefore, policy effectiveness

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[50]Cole and Park (1984: pp. 173). However, this situation is changing as South Korea proceeds towards its stated policy objective of complete financial liberalisation and openness. Already banks have been given almost complete autonomy in loan sanctioning, and are allowed to engage in foreign exchange transactions. The stock market and other domestic markets for financial assets are also intended to be opened up to international investment and competition.

will be highest in East Asia, and lowest in Latin America, and any objectives of economic policy, say adjustment, will be more difficult to pursue in the latter region.[51]

This is where the choice between hard and soft options becomes relevant. A hard option, as in the neoclassical prescription of liberalization, is to eradicate wage-resistance and to re-establish market forces in labor-capital relations. In this scenario, the government would, for example, cease the automatic wage increases of indexation mechanisms, leaving the decision entirely to employers. Alternatively, it might freeze wages, while allowing prices to increase or even devaluing the currency. This could require dealing with labor unrest, strikes, lockouts, productivity declines, riots, and the use of police or military force. This strategy was employed in Chile and Argentina during their liberalization episodes, with disastrous consequences: Decline in output, increase in unemployment, capital outflows, capital flight, payments crises, exchange rate depreciation, and inflation. However, the adoption of this strategy is often based on a willingness to accept short run economic as well as political costs, under the assumption that in the long run the new rules of the game will be accepted by all parties, and that such conflicts will not recur in the future. The experience of the Southern Cone countries does not bear out even this limited degree of optimism.

An alternative policy is the soft option of postponing the conflict by relying on ad hoc measures, such as increased foreign borrowing, selective protection for industries in crisis, social welfare spending, consumer subsidies, or selective credit controls. It must be stated that this option is not without its strengths. First, in case of temporary shocks it may be wiser to incur a balance of payments deficits rather than to seek to modify the

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[51]It may perhaps be clarified that this does not mean that governments in Latin America do not do anything. When either the disturbances, or the impact of policies are small, they will generally be effective. It is only when a major re-ordering is called for that the policy effectiveness becomes an issue.

economic structure.[52] Second, given political resistance, selective policies will work without significant social or political costs. Third, the dynamic efficiency of expanding output could offset static inefficiencies of selective policies.[53] Lastly, in a situation of polarization and confrontation, the acceptance of controversial policies by social groups may be facilitated by the shared perception of a crisis. Postponement could be a pragmatic choice: if the shock turns out to be temporary or if production responds to growth incentives, there will be no problem; if the shock is permanent, and the long-run stimulative policies do not work, the resulting crisis will mobilize public opinion behind the need for corrective measures.

The problem is, however, that rarely is postponement of conflict a long run option. Perhaps this is best explained by an example -- the relatively greater propensity of Latin American countries to use inflation and foreign debt for resource mobilization. In a situation of differentiation and tension, inflation and debt can play an important role in maintaining social harmony and postponing social conflict. Inflation enables the postponement of conflict primarily through its ambiguity: it can help retard real wages, redistribute income from workers to capitalists and from the private to the public sector, but not through an explicit mechanism which is likely to be resisted by the affected groups. Similarly, foreign debt-accumulation can postpone conflict because at the time the debt is contracted, those who will pay for it in the future are not mobilized and are not likely to resist the initial

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[52]This may constitute something of a problem, since it is difficult to know ex ante which shocks will be temporary and which permanent. The case of the two oil shocks is an illustration that general perceptions may be more often wrong than right. Many economists expected the 1973 oil price increase to be temporary, and the 1979 increase permanent, but the first turned out to have permanent type of consequences, while the second reversed itself soon afterwards. For a discussion of these perceptions, see Bianchi et. al. (1986).

[53]For example, in the 1970s, Brazil and Colombia adopted a strategy to maintain a high and stable aggregate demand, and use selective policies to shift incentives towards investment in the traded goods sector. As Hirschman (1986) and Bianchi et. al. (1987) have shown, it led to their relative success in expanding exports in the 1980s.

action. As a result, these two processes are of great potential use to a government faced with escalating tensions without adequate institutional means of managing them.

The level of inflation in Latin American countries was significantly higher than in the rest of the world, even in the 1950s and 1960s, and can be argued to have resulted from the need to transfer resources into the industrial sector without excessive social cost in terms of heightened conflict. Beginning in the mid-seventies, however, inflation as a tool for mediating social conflict appeared to have lost its efficacy in Latin America. Inflation rates escalated from one-digit to two-digit to three-digit and even to four-digit levels in some countries. A major reason for this escalation was the ubiquity of indexing arrangements, which considerably weakened the distributional effect of inflation and hence its effectiveness for resource mobilisation. As a result, serious efforts began to be made to bring down the level of inflation often at high cost, rather than to rely on it any further.

Similarly, most Third World countries with access to the expanding international credit market in the 1970s borrowed extensively to finance investment while maintaining (or even expanding) consumption, thus effectively postponing the distributional conflict which would have been precipitated by the high investment programme. However, from the late 1970s onwards, the changes in world interest rates, the perception of increased risk in Latin American borrowing, private capital outflows, and finally the debt crisis ensured that debt as a tool for maintaining social harmony had also outlived its utility. Analogous to the earlier situation, efforts began to be made (perhaps under duress) to bring down the level of the debt often, indeed always, at a high cost.[54] In other words, while inflation and foreign debt accumulation were not irrational choices, given their importance for maintaining

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[54] At the risk of gross over-simplification, it could be argued that when inflation ran out of steam as a social lubricant, foreign debt came along at just the right time. However, when debt ran out of steam, a few years later, no other instrument emerged to take its place. Hence the crisis.

social peace in several countries, what the emerging crisis simply has revealed is that such solutions cannot work forever.

Thus, we are back at the earlier dilemma. The hard option is costly in the short run and ineffective in the long run. The soft option is less costly in the short run, but equally, perhaps more, costly in the long run. To see our way out of this dilemma, we will have to go back to the notion of governance with which we started this paper.

5. CONCLUSIONS: THE CASE FOR PRAGMATISM

In order to discuss the notion of the pragmatic state, a few points have to be noted. First, the analysis is relevant mainly for major conflicts in the country, which impact upon the nature of the society as a whole: such as the conflicts between labor and capital; between finance and industry; or even conflicts between various ethnic groups in culturally heterogenous societies. Unlike smaller or local conflicts, which can be handled by all but the most inept of governments, these conflicts cannot be suppressed without adequate firepower (and the willingness to use it) relative to the organizational and other resources of countervailing social groups. Nor can they be managed unless institutional arrangements exist to facilitate management. Finally, even postponement requires the expenditure of fiscal or communicative resources of the state, which may not always be available in an adequate magnitude (this often happens when the conflict has been postponed too many times and for too long). Where a conflict of major proportions can be neither suppressed, nor postponed or managed, the result is a breakdown of the civil order, such as in Lebanon, or in some African states.

This brings us to the crux of the issue. Faced with an unmanageable conflict, a pragmatic state may, in the interest of social peace, choose either appeasement and postponement, or neglect and civil war, or even confrontation and suppression, but it will make the choice not as a permanent solution to the crisis, but rather as a tactic to buy time in which to construct appropriate institutions for managing similar conflicts in the future. Latin American and South Asian governments were right in refusing to pursue policies which would not have worked in their institutional and political circumstances; but they erred in not trying to create institutions which would have facilitated social cooperation and restored policy effectiveness. In talking about the economic instability which can be produced by the instability of wages, Keynes once said that it was fortunate that workers, though unconsciously, were instinctively more reasonable economists than the classical school. In

an analogous manner, it could be said that it is fortunate that (some of) the policy makers, though unconsciously, are instinctively more reasonable economists than the neoclassical school.

The mainstream analyses of the Latin American dilemma are not ignorant of this dilemma, even though they do not talk about it overtly. The suggestions of Balassa, Krueger, or Bhagwati can be understood as attempts to achieve wage-flexibility by weakening trade unions and rolling back the so-called impediments to the smooth functioning of labour markets. Likewise, in Jeffrey Sachs' venture into political economy, the alliance of the state with rural groups is identified as the key to effective policy-making in East Asia, and by implication as the appropriate direction of political reform in Latin America. Our suggestions differ from these authors mainly on account of our different reading of the region's history. Both the mainstream proposals require a concerted effort aimed at weakening the political and economic influence of industrial labor. Implicitly or explicitly, the first group allocates this task to the power of the state which is expected to railroad over any opposition. Sachs is more ambivalent in his prescriptions, but the obvious implication is that the alliance with rural groups will provide a counterforce to the political influence of urban groups.

What is missed in these analyses is the fact that urban labor is politically influential in Latin America, partly because of its organizational strength, and partly because of a shared consciousness emerging from a long history of conflict and struggle. The task of destroying this political influence is not comparable to policy-making in the absence of such influence in South Korea or in the rest of East Asia. First, while the actions of the latter governments can be considered 'pragmatic' in nature, Latin American governments would have to be 'hard' (and, therefore, unstable) states in order to be able to accomplish the tasks set for them by neoclassical theorists. Furthermore, just as policies are often constrained by institutional factors, the feasible range of institutional reform is also

conditioned by the history of political conflict and reform. As is revealed by the example of liberalization experiments in the Southern Cone, attempts to destroy union organization and influence were, in the last analysis, unsuccessful in addition to being undesirable and costly. They did not succeed in changing the perceptions of industrial workers of their rights and responsibilities in a democratic society. The problem with history is that it is often too resilient to succumb at the frequent attempts by interested groups to rewrite it.

The strengthening of the financial sector also appears in a new light from this perspective. By making government policy reactive rather than active, it has the effect of inhibiting legislation protecting the rights of industrial workers, and thus of reducing their influence. However, given the nature of the social consensus, the result has only been a stalemate.

To discuss alternative paths of institutional development, the state will have to acknowledge the high level of mobilization and political influence of organized labor; as well as the ability of finance to resist policies which appear to be against its interests. The question for a pragmatic government is how to channel these sources of influence into economically fruitful directions. In other words, how to create conditions in which these powerful groups will be willing to cooperate with each other and with other groups in society. Noting that the economic stalemate as well as the ineffective of economic policies derives from the emergence of wage-resistance and financial openness, policy reform will seek to minimize the effect of these two factors in a manner which is politically feasible.

First, the restoration of wage flexibility does not require the destruction of labor unions. It does, however, require that the flexibility be based on a credible and stable compromise between labor and capital. For this purpose, it will be important to institutionalize the political influence of workers into more manageable channels. In other words, instead of seeking to destroy labor unions and to push wage bargaining down to the plant level in an attempt to divide and weaken the workers, the government would encourage

the participation in national level negotiations to agree on real wages, employment, investment and growth. This is an analogue of the rise of labor unions within each plant. Instead of destroying the unions, and bringing down the wage negotiations to the level of each worker, the strengthening of the unions allowed the money wage bargain to be made at the centralized level of the plant at discrete intervals, and thus ensured long periods of peace as well as improvements in productivity because of an increase in worker loyalty. This did not mean that the conflict between labor and capital disappeared -- indeed, the current crisis is in part a result of the success of the earlier compact -- nor that the conflicts between workers were also taken care of. It simply meant that the most potent form of conflict was neutralized for the time being.

Latin American governments in the 1930s and 1940s were successful in constructing precisely such institutional arrangements, but they were overtaken by an ideological shift in favor of hardness, and repeated though ineffective attempts to destroy these institutions. The optimistic aspect of the current crisis is that the mood of polarization and confrontation has given way to a new period of search for social peace through participation, democracy, negotiation, compromise, and consensus. The greatest danger posed by liberalization attempts is their potential of derailing these new initiatives.

Second, most countries would be well advised to maintain some form of barriers against international financial flows, and some central control or influence over the domestic financial sector. This would require regulation or mediation by the central bank, which would not only supervise the activities of financial institutions, but will also act as their representative in national decision-making. The idea behind this reform is also to compensate the actual level of influence of a social group, with an equal amount of social responsibility.

It should be noted here, however, that the changes in the international financial arrangements as well as the increasing sophistication of internal financial markets (both

official and unofficial) in Third World countries are such that it may have become impossible for any government to maintain overvalued exchange rates, or to protect itself against sustained pressures on its currency. This means that our proposals for maintaining restrictions on capital flows is intended not as long-term policy instruments, but rather as means of insulating the economy from the short run instability which these flows can generate. As the OECD report on capital controls (OECD, 1982) points out, even in this limited role, capital controls can perform useful functions. First, in normal times, they might help to influence capital flows sufficiently to ensure that minor disturbances causing pressure on exchange rates or domestic capital markets are minimised. Second, in the event of a major disturbance, they might help to gain time while more fundamental policy adjustments are being made. Third, they can help the government in demonstrating, for political reasons, that action is being taken to stem the more obvious channels of capital outflows and to prevent windfall gains to speculators.

Similarly, regulation of financial institutions is proposed not to enable the government to pursue arbitrary policies, but to give it leverage in meeting unanticipated crises. Likewise, the managerial approach to labor organizations will lose its effectiveness if it is used consistently in the interest of political expediency.

The generality of these suggestions is meant to underscore the fact that detailed solutions will have to be found for each country in the context of its own political and institutional development. For too long, the Third World in general, and Latin America in particular has served as a testing place of universal social theories which deny the uniqueness of every experience. It is time that the Third World began to write its own history.

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