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# ECONOMETRIC MODELING OF NATIONAL INCOME DETERMINATION IN LATIN AMERICA, WITH SPECIAL REFERENCE TO THE CHILEAN EXPERIENCE

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*The main purpose of this paper is to examine how to alter a macroeconomic national income determination model for a more developed economy to fit the conditions of a Latin American country. This type of model will be used to study stabilization and other short-run problems in a Latin American economy; at the same time, it will examine the applicability of modern stabilization analysis to the special situations of those economies. The empirical outcome in this case is a 172 endogenous variables annual macroeconomic model for Chile.*

## I. INTRODUCTION

The major concern of both empirical and theoretical macroeconomic analysis of the developing economies of Latin America and other regions has *not* been the question of stabilization within the framework of national income determination models.<sup>1</sup> In a recent survey of the state of the art regarding the use of economy-wide models for LDC's, for example, Blitzer *et al.* (1974) do not even include a chapter on macroeconomic income-determination models.

The dominant frameworks for macroeconomic policy analysis and policy recommendations, instead, have been provided by Harrod-Domar aggregate-growth models, static and dynamic linear-programming models and Chenery two-gap models.<sup>2</sup> Assumptions which generally are made in the construction of these models include: (i) that the degree of capacity utilization, the rate of inflation, and the extent of aggregate demand are not important considerations; (ii) that the financial constraints on government and central bank behavior (and, thus, the entire fiscal-monetary-income-international policy-inflation nexus) safely can be ignored; (iii) that short-run flexibility is extremely limited because elasticities of substitution are practically zero, because short-run price responses are very low, and because any responses which do occur are distributed over long time periods; and (iv) (at least for the programming models in the development of which the greatest resources have been expended) that the most interesting question is "what *could* happen if socially optimal readjustment of the economy occurred in response to policy changes," rather than "what *would* happen if independent economic units which make up the economy followed their traditional behavioral patterns in

<sup>1</sup> This paper focuses on the developing economies of Latin America, but most of the observations also apply to developing economies in other parts of the world.

<sup>2</sup> Examples (and basic sources) include Adelman and Thorbecke (1966), Blitzer, Clark, and Taylor (1974), Cabezón (1969), Chenery and Strout (1966), Clark and Foxley (1970, 1973), Eckaus and Parikh (1968), Fei and Ranis (1964), Lewis (1954), Manne (1974), UNECAFE (1960), and UNCTAD (1968).

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response to such changes.”<sup>3</sup> The resulting models usually include only real phenomena and are characterized by supply bottlenecks due to either foreign exchange or capital constraints.

Such an emphasis reflects two widely-held views. (1) Growth is relatively a far more important economic objective (and stabilization less important) in Latin America than in the developed countries. (2) Keynesian income-determination models are inappropriate or of very limited appropriateness for developing economies.<sup>4</sup>

Some exceptions to the predominant view have long existed. The participants in the “structuralist-monetarist” controversy in Latin America, for example, have accorded a significant role to stabilization policies.<sup>5</sup>

These exceptions, moreover, have been growing recently. The recognition of the existence of considerable underutilized capacity has increased interest in the use of national-income-determination models for stabilization purposes.<sup>6</sup> The more turbulent recent situation in international markets has intensified interests in the possibilities of using short-term policies to limit the domestic impact of international fluctuations. Partial-equilibrium econometric estimates recently have been made which imply significantly nonzero elasticities of substitution and price responses in both capacity utilization and capacity creation decisions for a number of developing economies.<sup>7</sup> Even the strongest advocates of supply-oriented capital-and-foreign-exchange-constrained analysis of the developing economies seem to be having second thoughts about the importance of short-run factors and stabilization problems. Throughout the above-cited survey by Blitzer *et al.* 1974, for example, references to the need to treat short-run features (e.g., price responses, capacity-utilization determination, aggregate-demand-related policies) are frequent.

Because of this growing interest in stabilization and other short-run problems, recently a large number of Keynesian-based national-income-determination models have been constructed and utilized for Latin American economies.<sup>8</sup> All too

<sup>3</sup> “Socially optimal” is used here not to imply that externalities are incorporated but to mean that which maximizes the objective function given the constraints imposed by the model itself, starting and terminal conditions, and exogenous variables. Some limited aspects of behavioral responses, of course, are incorporated in these studies, such as the sectoral pattern of income elasticities for private consumption.

<sup>4</sup> Rao (1952) presents an early statement of this view. Ranis (1974) gives a recent summary.

<sup>5</sup> For good summaries of the “structuralist-monetarist” debate, see Campos (1964) and Wachter (1974).

<sup>6</sup> For an illustration, see Schydlosky (1971, 1974).

<sup>7</sup> Behrman (1968) summarizes many of these estimates which relate to agricultural supplies. Morawetz (1974) gives references for a number of studies of elasticities of substitution. Behrman (1971a, 1972a, 1972b, 1972c, 1973a, 1973b, 1973c, and 1975c) and Behrman and Garcia (1973) present sectoral estimates for the Chilean experience, which is used as an example below.

<sup>8</sup> For examples for developing economies in Latin America, see Albertelli (1967), Barraza-Allande (1968), Barraza-Allande and Solis (1974), Behrman (1975e), Behrman and Klein (1970), Bello (1969), Beltran (1973), Beltran and Klein (1974), Cerboni (1975), Corbo (1971), Davila (1966), Deprano and Nugent (1966), Dutta and Su (1969), Escuela Nacional de Economía (1970), Fletcher (1965), Geithmann (1964), Gomez (1968), Gupta (1974), Harris (1970), Hernandez (1974), Iton (1968), Kelso (1973), Khan (1974), Lawrsen (1967), Liu and De Vries (1969), Manhertz (1971), Marwah (1968), Marzouk (1969), Meneshi and Reynolds (1964), Molina and Mellor (1974), Montemayor (1974), Monterio (1971), Naranjo (1972) and (1974), Nugent (1965), (1974), Pandit (1971), Perez-Castillo (1963), Pujol (1969), Reinafarje and Yopez (1972), SIECA (1973), Slooten (1968), Stahl (1965), Stavrou and Arboleda (1975).

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often, however, the structures of these models have been transplanted from aggregate-demand models of developed economies with little or no adjustments for the special conditions in the developing countries. Numerous shortcomings in the resulting specifications are quite common: (1) National income is determined by aggregate demand, with no testing of the existence of possible capacity constraints due to the stock of capital and labor or the supply of foreign exchange. (2) Aggregation is so great that there is no possibility of capturing the impact of policies on relative prices even though economists like Hansen (1973b) have maintained that policies in developing nations are primarily reflected in altered relative prices and Wachter (1974) has demonstrated that differing speeds of adjustment of relative prices may result in "structural" inflation. The possible importance of intersectoral flows, moreover, is lost by the high level of aggregation. (3) No attempt is made to explore the role of human capital despite the growing emphasis on its significance. (4) Underemployed or surplus labor and dualism in the labor market are not incorporated. (5) The role of social overhead capital, long emphasized by such leading development economists as Rosenstein-Rodan (1961), is not explored. (6) The significance of the foreign sector as a source of noncompetitive intermediate imports and of capital goods, as well as of a significant proportion of government revenues, is not well-presented. (7) The degree of endogeneity of fiscal and monetary variables is ignored, with the result that policy options are overstated. (8) The importance—due to fragmented and poorly functioning capital markets—of direct flows and of retained earnings in the real investment process is not explored. (9) The possible impact of quantitative restrictions, which are widely utilized in some developing nations, is not examined.<sup>9</sup>

At the same time that interest in and use of stabilization models for Latin American LDC's has been growing, controversies have emerged over the specification of income-determination models for the developed economies. In the past decade, critics have claimed that deficiencies in the theoretical structure make any analysis of stabilization policies based on such models suspect. Recently, however, some convergence seems to have occurred at least in regard to the nature of the issues. Ando (1974), Blinder and Solow (1973), Hansen (1973a) and others have attempted to adjust the IS-LM model to explore these controversies.

Given some convergence on the nature of stabilization issues in the developed countries and given the increasing preoccupation with stabilization problems in Latin American (and other) developing countries, the time seems ripe to re-examine the applicability of modern stabilization analysis to the special situations of the

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Steward (1966), Sutton (1968), Taylor (1969), Thorbecke (1969), Thorbecke and Condos (1966), Tintner, Consigliere and Carneiro (1970), Tintner, Den Hertog, Bello, and Carrino (1970), United Nations (1964), UNCTAD (1968, 1973), and von Rijkeghem (1965a, 1965b, and 1969). Beltran (1974) summarizes the features of a number of these Latin American models. Behrman (1975c) provides references for models for developing nations in other parts of the world.

<sup>9</sup> Many of the studies cited in the last footnote attempt to account for one or two of these features. Nevertheless, the list of shortcomings in any specific study generally is quite large. For example the most extensive previous study of Chile, Corbo (1971), does worry about the endogeneity of the money supply and does include supply constraints, but does not avoid most of the other shortcomings listed in the text. In the simulations in that study, moreover, because of convergence problems excess demand is exogenized so that there is no link between monetary and real variables or the money supply and prices!

latter. This paper begins such an attempt. The strategy is to examine, in turn, each of the components of recent models for stabilization in developed economies and to consider how they need to be altered for analysis of stabilization issues in developing economies. Then a recent model of one developing economy—Chile—is considered with emphasis on the question of how well does this example succeed in its attempts to incorporate the important features of this particular developing economy.<sup>10</sup>

The prototype model for the developed economies used as a starting point combines the features of the closed economy model of Ando (1974) and the analysis of international capital movements of Branson (1974). This model is somewhat complex in order to incorporate a number of features discussed in recent controversies. Solution by differentiation does not lead to simple elegant expressions. For understanding of it beyond that provided below, the reader is referred to the papers by Ando and Branson.

The Chilean model which is used as an example is the 172 endogenous variable annual macroeconomic model for 1945–1965 presented in Behrman (1975c). It is a nine-sector model with capacity creation, capacity utilization, export, import, price and wage determination relations for each sector. Consumption-savings decisions are estimated for households and nonprofit institutions, businesses, and the government. Many aspects of government fiscal and monetary policies are endogenous. In its specification the attempt is made to overcome the nine common shortcomings frequently encountered in Keynesian-based national-income-determination models for developing economies which are listed above. For understanding of this model beyond that provided below the reader should consult the above-mentioned reference.

Before proceeding to consider how the components of such a model must be modified in order to capture the features of Latin American countries, a caveat is in order. The developing countries are far from homogeneous. In terms of almost any relevant feature the range across countries is enormous. In what follows below, therefore, the suggested modifications reflect characteristics not necessarily common to all developing countries, but at least to a significant number of them.

## 2. COMPONENTS OF NATIONAL-INCOME DETERMINATION MODELS

Table 1 presents the prototype model for the developed economies which is used as a starting point for the discussion of this section. Each of the major components of that model are now examined in turn with focus on how they need be altered for analysis of stabilization issues generally in Latin American countries and on how they are treated in the Chilean example.

### 2.1. *Labor Market, Supply, and Determination of Prices and Wages*

Equations (1) through (4) are the relations for the labor market and for the determination of prices and wages in a recent model for developed economies.

<sup>10</sup> At least a paper, if not a book, could be written on data problems. In this presentation some allusions are made to these problems, but they are not treated systematically so that the paper can be kept of a manageable length.

TABLE I  
MACROECONOMIC MODEL FOR DEVELOPED ECONOMICS

I. Labor market, supply, price and wages

Demand for labor

$$E = E(Z) \quad [1]$$

Supply of labor and the definition of unemployment rate

$$u = u(E, N) \quad [2]$$

Determination of money wage level

$$\frac{W}{P} = W\left(u, L\left[\left(\frac{P}{P}\right)_{-1}\right]\right) \quad [3]$$

Determination of real wage rate and price level

$$P = Wf\left[L\left(\frac{E}{Z}\right), \mu, u\right] \quad [4]$$

II. Product market and aggregate demand

Definition of Net National Product

$$Z = C + I + G + X - IM \quad [5]$$

Consumption function

$$C = C(Y, A) \quad [6]$$

Investment function

$$I = I(z, r_k, \tau) \quad [7]$$

Government expenditure

$$G = G_{ex} + G_{end}(Y, N, r_k) \quad [8]$$

Import function

$$IM = IM(ER, P, Y) \quad [9]$$

Export function

$$X = X(ER, P) \quad [10]$$

III. Financial markets and assets

Demand for real assets

$$V = A \cdot f^V(r_k^h, r_b^h, r_s^h, Y) \quad [11]$$

Demand for bonds

$$B/P = A \cdot f^B(r_k^h, r_b^h, r_s^h, Y) \quad [12]$$

Demand for foreign securities

$$\frac{S \cdot ER}{P} = A \cdot f^S(r_k^h, r_b^h, r_s^h, Y) \quad [13]$$

Demand for money

$$M/P = A \cdot f^M(r_k^h, r_b^h, r_s^h, Y) \quad [14]$$

Definition of net worth

$$A = V + \frac{M + B + S \cdot ER}{P} \quad [15]$$

Relation between holding rate and capitalization rate

$$r_k^h = r_k - \frac{r_k^e - r_k}{r_k} \quad [16]$$

TABLE 1—(cont.)

Relation between real and nominal short-term interest rates

$$r_b^e = r_b - \frac{P^e - P}{P} \quad [17]$$

Relation between holding and international rate for foreign securities

$$r_s^h = r_s + \frac{ER^e - ER}{ER} \quad [18]$$

Generation of expected rate of change of  $r_k$

$$\frac{r_k^e - r_k}{r_k} = F^k \left[ L \left( \frac{r_k}{r_d} \right) \right] \quad [19]$$

Generation of expected rate of change of prices

$$\frac{P^e - P}{P} = F^p \left[ L \left( \frac{P}{P} \right) \right] \quad [20]$$

Generation of expected rate of change of exchange rate

$$\frac{ER^e - ER}{ER} = F^{ER} \left[ L \left( \frac{ER}{ER} \right) \right] \quad [21]$$

Expected income from capital

$$\pi^e = F^\pi \left\{ \pi, P \cdot L \left[ \left( \frac{\pi}{r} \right)_{-1} \right] \right\} \quad [22]$$

Market value of capital

$$P \cdot V = \frac{\pi^e}{r_k} \quad [23]$$

#### IV. Identities and miscellaneous relations

Definition of disposable income

$$P \cdot Y = P \cdot Z + r_b \cdot B - P \cdot T + r_s \cdot S \cdot ER \quad [24]$$

Definition of savings

$$d(P \cdot A) = P \cdot Y - P \cdot C + d^*(P \cdot V) \quad [25]$$

Definition of income from capital

$$\pi = P \cdot Z - W \cdot E - \tau_c(P \cdot Z - W \cdot E) \quad [26]$$

Capital gains on existing capital

$$d^*(P \cdot V) = d(P \cdot V) - P \cdot I \quad [27]$$

Balance of payments surplus

$$H = P \cdot X - P \cdot IM + r_s \cdot S \cdot ER - d(S \cdot ER) \quad [28]$$

Tax function

$$P \cdot T = T(P \cdot Z + r_b \cdot B + r_s \cdot S \cdot ER, \pi, \tau) \quad [29]$$

Government budget constraint

$$dM + dB = P \cdot G - P \cdot T + r_b \cdot B \quad [30]$$

TABLE 1 --(cont.)

## V. Variable definitions

<i>A</i>	Net worth of consumers
<i>B</i>	Government debt held by private sector
<i>C</i>	Consumption in constant currency
<i>d*PV</i>	Real capital gain on existing real assets in current currency
<i>E</i>	Employment in manhours
<i>ER</i>	Exchange rate in domestic currency per unit of foreign currency
<i>ER'</i>	Expected exchange rate in domestic currency per unit of foreign currency
<i>G</i>	Total government expenditures in constant currency
<i>G<sub>ex</sub></i>	Exogenous government expenditures in constant currency
<i>G<sub>end</sub></i>	Endogenous government expenditures in constant currency
<i>H</i>	Surplus on balance of payments in current currency
<i>I</i>	Net investment in constant currency
<i>IM</i>	Imports in constant currency
<i>L</i>	Lag operator
<i>M</i>	Money supply in current currency (currency plus reserves)
<i>N</i>	Vector expressing total population and its structure
$\mu$	Standard mark-up factor (i.e., the ratio of price of output to its minimized cost of production expected to prevail under normal employment conditions)
<i>P</i>	Price level for output
<i>P<sup>e</sup></i>	Price level expected to prevail
$\pi$	Income from real assets in current currency
$\pi^*$	Expected income from existing real assets in current (not future) currency
<i>r<sub>b</sub></i>	Nominal rate of interest on government debt
<i>r'<sub>b</sub></i>	Real rate of interest on government debt
<i>r<sub>k</sub></i>	Capitalization rate (in real terms) applicable to real assets
<i>r'<sub>k</sub></i>	Level of <i>r<sub>k</sub></i> expected to prevail
<i>r<sub>k</sub></i>	Holding rate (in real terms) applicable to real assets
<i>r<sub>f</sub></i>	Real rate of interest on foreign securities
<i>r'<sub>f</sub></i>	Holding rate (in real terms) applicable to foreign securities
<i>S</i>	Foreign securities held by private sector
<i>T</i>	Taxes in constant currency
$\tau$	Tax rates (subscript "C" refers to corporations)
<i>u</i>	Unemployment rate
<i>V</i>	Market value of existing real assets in constant currency
<i>W</i>	Nominal wage rate per manhour
<i>X</i>	Exports in constant currency
<i>Y</i>	Disposable income in constant currency
<i>Z</i>	Net National Product in constant currency

Equation (1) depicts the short-run relationship between output and the required manhours for production. Producers durable equipment is assumed to be in the form of putty-clay. At any point in time the economy has a collection of machines whose labor-output ratio were determined by the technology and the expected relative prices at the time each machine was manufactured. Given the relative prices of the current period, machines (and the labor associated with them) are used in production in order of their efficiency until the desired output is produced.

Equation (2) gives the unemployment rate as a function of manhours and population characteristics. It incorporates into one expression the determination of hours worked per person and the response of the size of the labor force to employment conditions and demographic features of the population.

Equation (3) is a Phillips-curve relation for the determination of the rate of change of wages as a function of the unemployment rate and price expectations.

Equation (4) determines the price level of output under the hypothesis that the price is determined by a (possibly lagged) mark-up on the minimized average cost. The price level should vary proportionally with the money wage level and reciprocally with long-run productivity. The mark-up factor is  $\mu$ . Since the mark-up may vary in the short-run with the utilization of capacity, the unemployment rate is also included in this function.

For Latin American economies modifications are necessary in order to capture two important features.

(1) Most of the Latin American economies are characterized by dualism in their labor and product markets. The modern sector is market oriented and pays wages approximately proportional to the value of the marginal product of labor. Its technology is fairly recent, and permits but limited substitution between primary factors.<sup>11</sup> In some countries unions are quite powerful in this sector.

The traditional sector is much less market oriented. In most countries a major component of this sector is noncommercial agriculture. For this subsector the marketed surplus often is a small part of total production and may be an inverse function of price.<sup>12</sup> Factor substitution usually is possible, but the relatively high labor-to-capital ratio often results in disguised unemployment with marginal products substantially below those in the modern sector. Because of family and communal arrangements, however, the share of individual laborers is determined by tradition and is closer to the average than the marginal product.

Equations (1), (2), therefore, may be appropriate for the modern sector (with all the included variables referring only to that sector). The traditional sector, however, is a residual claimant on labor.

Rao (1952) claims that the predominance of disguised unemployment in the traditional sector, instead of open unemployment as in more developed economies, implies a very limited labor supply response to changes in aggregate demand. This is the case, he maintains, because (i) the disguised unemployed labor is not aware of being unemployed and (ii) their share of income in the traditional sector is greater than the market wage (which reflects the low marginal product of labor). The supply of labor for the modern sector, he concludes, is very inelastic and expanded aggregate demand results primarily in price increases.<sup>13</sup>

The dominant view of the impact of dualism on the labor market, however, features the model of Lewis (1954). The average share of labor in the traditional sector, plus a differential for the costs of moving from the traditional to the modern sector, provides a floor for wages in the modern sector.<sup>14</sup> The average share of labor in the traditional sector is assumed to remain approximately constant over

<sup>11</sup> The movement towards *putty-clay* considerations in the macroeconomic literature for developed economies lags substantially the emphasis on *ex post* fixed proportions for the modern sector of the less developed ones. Eckaus (1955) provides an early statement.

<sup>12</sup> If this response is inverse or positive but small, changes in aggregate demand may cause primarily price and not output changes for basic wage goods. The analysis in Behrman (1968), however, suggests that while these responses may be inverse, they also may be positive and quite large.

<sup>13</sup> That the average labor share in the traditional sector is more than the marginal product of labor in that sector, of course, does not necessarily imply that the supply curve of labor for the modern sector is very inelastic. The Lewis model discussed in the next paragraph, in fact, comes to the opposite conclusion about elasticity with respect to the real wage.

<sup>14</sup> The discrepancy between the marginal products in the two sectors obviously leads to static inefficiencies.

a wide range of sizes for the traditional labor force.<sup>15</sup> Over a substantial range, therefore, the supply of labor for the modern sector will be quite elastic.

*Prima facie* this might seem to lead to a very Keynesian case in the modern sector with an "unlimited supply of labor" at a fixed wage. But this wage is fixed in real terms, so the situation is very classical in an important sense. In a one-good model with no money illusion on the part of laborers in the traditional sector, in fact, equation (3) could be replaced by an equality between real wages in the modern sector and the exogenously given traditional average labor share. Equilibrium employment and output would be unresponsive to changes in aggregate demand.

A more realistic assumption is that the elasticity of the wage with respect to the price on the labor supply curve for the modern sector is positive, but less than one. It is less than one for at least two reasons. (i) At least in the short run, laborers apparently have some money illusion. Because the laborers in the traditional sector receive much of their income in kind, however, such money illusion may be less for them than for workers in developed economies. On the other hand, this consideration may be offset by the less effective communications systems. (ii) The overall price index is a weighted average of the price for the modern sector and the price for the traditional sector. One characteristic of dualism is that the former is more responsive to aggregate demand changes than the latter. Moreover, government price ceilings are usually directed largely towards traditional goods because of their importance as basic wage goods for modern sector laborers. Therefore, the real wage in terms of traditional goods can vary much less than the real wage in terms of all goods. As a result some response to changes in aggregate demand is generally possible in the modern sector, although probably not as much as in many developed economies.

In some Latin American economies, however, unions or legal wage rates have substantial effects on the wage level in the modern sector. Where either of these factors are important, the modern-sector labor market may be extremely Keynesian with an exogenous fixed nominal wage. Shifts in aggregate demand should have substantial employment and output impact in those modern sectors. In such cases Harris and Todaro (1970) posit that in equilibrium, nevertheless, some unemployment which cannot be eradicated by aggregate demand policies should be expected in the modern urban areas. They claim that rural-urban migration occurs as long as the expected income (taking into account both the higher modern-sector wage and the probability of obtaining employment) exceed the traditional average labor share. The result will be some open employment as long as the government or unions cause a differential to persist between the traditional average labor share and the modern-sector wage.

(2) The foreign sector plays a much more important direct role in labor, production and price relations in most Latin American economies (and probably in most small open developed countries) than is indicated in the model of Table 1. Four modifications of the counterparts of equations (1)–(4) for the modern sector need to be made to reflect the impact of the foreign sector.

<sup>15</sup> The average share per laborer is generally assumed to be fixed by tradition until enough labor exits from this sector so that the marginal product of labor rises to this level and market prices begin to dominate (Fei and Ranis (1964)).

(i) Some imported intermediate inputs and raw materials are critical in the production process. The elasticity of substitutions between such imports and domestic factors is very low or zero. Especially in the disequilibrium exchange rate system common for many Latin American economies, the constraint on production and employment may not be the putty-clay stock of machinery and equipment but the availability of these imported inputs. Equation (1) needs to be modified to reflect this possibility.

(ii) The derivation of equation (1) also needs to be modified due to the fact that technologies used in the modern sector are largely imported from developed countries with much different factor endowments. Very little choice may be available (or may be thought to be available) even *ex ante* for the capital-labor ratio of the developing countries. Therefore, the putty-clay response to expected relative prices is constrained to a choice among relatively capital-intensive technologies. What Eckaus (1955) calls the "factor proportions problem" limits the absorption of labor by the modern sector.

(iii) The discussion above suggests that for many Latin American economies equation (3) should be replaced or modified by considerations relating to the real labor share in the traditional sector, government minimum wages and union pressures. If some version of equation (3) remains, however, one further modification needs to be made. In many Latin American economies an important and generally available index of inflationary expectations is the rate of change of the exchange rate. In addition to the history of past inflation, therefore, this variable (or some function of past values of it) should be included for such countries.

(iv) In light of the widespread importance of intermediate and raw material imports, equation (4) also should be modified to reflect mark-ups on imports as well as on labor. Changes in the international prices or in import policies, therefore, have direct effects on the domestic price level.

Within the Chilean model, labor market-product supply-wage-price relations are determined on the sectoral level by the following relations.

(i) *Sectoral capacity* (with capacity defined by a trend-through-the-peaks procedure) is determined by a CES production function of the sectoral stock of capital and the secular sectoral size of the labor force with Hicks neutral technological change. Estimated sectoral elasticities of substitution between capital and labor range from 0.0 to 0.9. The adjustment periods for substitution between primary factors are fairly long in several cases in which the long-run elasticities are high. For most sectors in the short and medium runs, therefore, the results provide some support for the assumption of limited flexibility which underlies Eckaus' (1955) technological explanation of the existence of under- or unemployed labor, the structuralist analysis of inflation, and the use of fixed coefficients in input-output based models.

Limited flexibility, however, is not the same as no flexibility. Some primary factor substitution apparently is possible in response to relative price changes. The sectors in which substitution is greatest in the short and medium runs, moreover, are not those which generally are thought to serve as the predominant absorbers of surplus labor (i.e., services, construction, agriculture and government). Instead, it is relatively high in manufacturing and mining. Under the assumptions that labor is homogeneous and overabundant at inflexible wages and that capital is

constraining production, therefore, society might benefit from wage subsidies (or other inducements) for sectors like manufacturing and mining in which labor has a relatively high marginal productivity so that they absorb surplus labor instead of the traditional sectors.

The same pattern of elasticities across sectors also suggests that the aggregate elasticity of substitution between capital and labor may grow and result in more overall flexibility if the government succeeds in its apparent policy of expanding the importance of manufacturing and mining.<sup>16</sup> Nevertheless the aggregate Chilean elasticity of substitution between capital and labor is likely to remain substantially below one. Such a value may constrain growth if the rates of increase of the primary factors differ significantly. Under neoclassical assumptions, such a value also implies that the relatively quickly growing primary factor will decrease its share of national product. According to the fragmentary evidence available, in fact, the faster growing factor—capital—has experienced a relative decline in its factor share.

Probable weaknesses in this specification of the capacity relations include the exogeneity of technological change and the lack of significance of differing qualities of human capital. Considerable efforts to incorporate the latter result in no evidence of a significant role. This failure may reflect the fact that the available data permit the representation of the stock of human capital only on an economy-wide level. Since policies might be expected to have effects on the transfer of technology and the stock of human capital, these inadequacies probably cause the model to understate the long-run potential impact of certain government actions. They do not seem to be very important, however, for short- and medium-run analysis.

Another shortcoming is the inability to distinguish among types of capital (especially imported versus domestic) and types of labor. The assumption of perfect substitutability in both cases overstates the degree of flexibility. In reality, for example, domestically-produced machinery and equipment often is a poor substitute for imported items. The treatment of capital stock as homogeneous, therefore, probably understates the impact of the generally-restrictive foreign-sector regime on capacity expansion.<sup>17,18</sup>

(ii) *Changes in sectoral capacities reflect sectoral investment decisions* (discussed in subsection 2.2 below) and *sectoral secular distribution of labor functions*. The demands for the sectoral secular distribution of labor are derived from the sectoral capacity functions under the assumption of accommodation in the long run to competitive-like behavior. The sum of these demands is then adjusted to equal the exogenous labor force by allocating any surplus (deficit) labor to agriculture and services. These two sectors, thus, serve to absorb excess labor in a manner related to the Lewis dual labor market hypothesis mentioned above.

<sup>16</sup> This statement is contrary in spirit to that which Nerlove (1967) makes about shifts towards manufacturing because he assumes that the elasticities of substitution between capital and labor are high in primary as compared to secondary and tertiary industries.

<sup>17</sup> In Behrman (1975c), however, the evidence is weak that the availability of imported machinery and equipment constrains investment.

<sup>18</sup> Behrman (1975a and 1975b) examines Chilean foreign-sector regimes during the postwar period in considerable detail. Generally foreign-exchange shortages—due in considerable part to the attempt to maintain a disequilibrium system with an overvalued exchange rate—have been accompanied by intensified quantitative restrictions which have discriminated relatively against imported investment goods.

In the Chilean model such duality does not completely eliminate the impact of aggregate demand policies, however, because the traditional sectors are smaller than in most developing countries and because relative price changes can occur which allow shifts in employment even though the real wage (in terms of basic necessities) does not change (see the discussion above).

The major weakness in this specification is the failure to distinguish among types of labor because of the lack of the necessary time-series data. A second short-coming is the treatment of the labor supply as exogenous, although this is much less important than it might seem *prima facie* because the variable of concern is the *secular* trend in the labor force and most changes in participation rates are merely fluctuations around this trend. For the capacity functions, of course, it is the secular labor force trends that are of interest. The impossibility of also incorporating actual labor force into the model, however, is a limitation of the model. Because of this limitation, judgments about short-run employment fluctuations have to be made on the basis of variations in capacity utilization.

(iii) *Sectoral capacity utilization* determinants include product and factor prices, the state of economic activity, the quantity of credit, public infrastructure development, taxes, anticipated inflation, and the availability of imported inputs and of imported competitive products. The widespread response to market conditions (including the state of aggregate demand) suggests that markets do play an important allocative role in the short run.

The trend-through-the-peaks measure of capacity utilized leads to a conservative estimate of foregone output due to underutilized production possibilities. Even by this measure, however, substantial excess capacity has existed in the Chilean economy during the postwar period. The utilization of this excess capacity could have resulted in a significant increase both in the level and in the growth rate of national product. Therefore policies should not distort the signals transmitted by the relevant markets under the false assumption that they will have no effect on allocation. Policies that distort market conditions may be justified, but the government should not ignore the resource allocation costs. Also, for short- and medium-term policy, recommendations based on fixed capital coefficients and full capacity utilization assumptions (such as in the Harrod-Domar and Chenery models) may be misleading because of the existence of unutilized capacity in addition to the possibility of substitution among factors.

(iv) The major direct determinant of the rate of change of *sectoral product and factor prices* is the rate of change of the money supply, with its impact distributed over a number of periods. Growth in the money supply, in turn, primarily reflects the size of the government deficit financed internally and foreign-exchange movements, with some modifications due to changes in Central Bank policy variables and in behavioral responses of commercial banks and of the public. In substantial part, hence, the money supply is a passive transmitter of inflationary pressure, as the structuralists have argued. Because of the lags in the price-determination process, moreover, stemming inflation is quite difficult unless expectations about future price movements can be lowered drastically.

Non-monetary factors, however, also significantly affect prices. Cost-push factors operating through intermediate input and unit labor costs are more important in transmitting overall inflationary pressures (including those which

arise from the role of expectations in the wage bargaining process) than previous studies, such as Harberger (1963), have maintained. Real changes in per capita GDP (and other indices of current activity), in labor productivities, in demands (final and intermediate) facing sectors relative to capacity, and in the distribution of factorial income and of sectoral product have significant effects. Foreign-sector policies, both price-related (i.e., exchange rates, taxes, prior deposits) and quantitative, are pervasive in their impact. Government minimum wages, although widely discussed in Chilean circles, do not have a very significant impact on wage changes once other prices are incorporated into the wage-change relations. The economy does not seem to be an extreme Keynesian one, therefore, with wages set by exogenous policy.

One important implication of the partial-equilibrium results summarized in the above points is that the price system is playing to some degree a role which could lead to greater efficiency. Sector-specific prices reflect sector-specific costs and capacity-utilization considerations. Hence signals are given at least in the right directions, assuming that any countervailing externalities are not completely offsetting. Both capacity-utilization and capacity-creation decisions respond significantly to these prices. Possibilities for increased capacity utilization and for factor substitution do exist.

To ignore the role of the price system and these other characteristics when conducting analysis and giving policy presumptions, therefore, may be costly in terms of foregoing the use of some policy tools, overemphasizing the role of "key factors" and creating incentives for misallocations. And yet the dominant macroeconomic frameworks utilized for analysis of development problems for the most part do assume that these factors can be ignored. More explicitly in the Chilean case, ODEPLAN (*Oficina de Planificación Nacional*, National Economics Planning Office) has utilized relative rigid fixed-capital-coefficient and/or foreign-exchange-saving gap models as the basis for planning and prediction.<sup>19</sup> Policy tools have included price ceilings, quantitative restrictions on international trade and on credit, and multiple exchange rates at overvalued levels.

The primary shortcomings in the product and factor price determination relations originate in the lack of key data. The absence of sectoral inventory and employment data, for example, precludes the estimation of direct responses to excess demands in the relevant markets. Instead proxies—such as capacity utilization rates—are used within somewhat eclectic functions which incorporate both economy-wide and sector-specific factors.

## 2.2. *Product Market and Aggregate Demand*

Equation (5) in Table 1 is the definition of net national product. Equations (6) through (10) describe the demand for real output.

Equation (6) is the *consumption function*. In a life-cycle hypothesis variant, real consumption depends upon expected real disposable income (approximated by a distributed lag of actual real disposable income) and net worth.

For Latin American economies, several hypotheses about private consumption behavior have been suggested. (i) Because of the existence of a large number of

<sup>19</sup> For example see Harberger and Selowsky (1966) or ODEPLAN (1970).

individuals at or near a subsistence income level, consumption may not be proportional to income even in the long run. If true, the high marginal propensity to consume at low income levels, *ceteris paribus*, may imply a relatively high multiplier. (ii) Retained business earnings (although not necessarily from corporations) are a relatively important source of savings. Therefore, a division at least between labor and non-labor income might be desirable. (iii) The marginal propensity to consume out of the income generated in some sectors—especially those related to exports—may be higher than elsewhere in the economy. The inclusion of a separate argument in the function for income from exports thus might be desirable. This modification would further increase the impact of the foreign sector on stabilization.

Mikesell and Zinser (1973) review the existing empirical evidence for private consumption behavior in Latin American and other developing countries. Some, although not unquestionable, support has been found for all three propositions.

In the Chilean model, private consumption-savings decisions are separated into those for households and nonprofit institutions and those for businesses. The major determinant is the appropriate net income variable—real permanent disposable income for households and nonprofit institutions and real after-tax profits for businesses. The estimated marginal propensities to save range from 0.04 to 0.38 for households and nonprofit institutions and from 0.55 to 0.63 for businesses. Income shifts from households to businesses within the private sector would tend to increase savings and reduce long-run multipliers. For households, shifts from the rest-of-the-economy to agriculture and from nonwage to wage income (*sic!*) tend to increase savings. Higher inflation also results in some forced savings by this sector. For households and businesses real monetary balances in excess of desired levels reduce savings. For both sectors there is some evidence that foreign savings at least partially substitute for domestic savings.<sup>20</sup> Increased aid or private capital inflows, thus, may in part go to higher consumption.

The primary inadequacy of the specification used is the exclusion of asset effects other than those for real monetary balances. This exclusion probably results in an understatement of the impact of monetary versus fiscal policies. The distortion is not so great as it would be for more developed economies because in Chile the stock of real monetary balances is far more dominant among public liabilities held by the private sector due to the very small market in government bonds.

Equation (7) is the *investment function*. For the developed countries in which capital markets are well functioning so that the cost of capital is well identified, investment decisions are based on a comparison of the present value of the expected stream of income generated by the investment and the cost of investment. Simultaneous variables which enter into the investment decision, therefore, include the capitalization rate applicable to real assets and net national product in real terms. The appropriate tax rates also have a role.

For some of the Latin American countries, some evidence exists which supports the use of the same basic formulation [e.g., Behrman (1972b)]. More

<sup>20</sup> Weisskopf (1972), among others, makes this hypothesis. Papanek (1972 and 1973) provides criticism.

generally, however, substantial modifications are needed to reflect special aspects of capital markets, social overhead capital, and international considerations:

(i) Domestic capital markets in Latin American economies often are not well functioning. Markets are very fragmented, especially between the traditional and modern sectors. In the modern sector legal limits on nominal interest rates frequently are effective so that credit rationing occurs in bank markets. Government planning organizations also often attempt to control the allocation of physical capital by nonmarket means.

The net result is that much of the domestically-financed investment does not pass through a capital market (or, at least not through "the" capital market). Instead it originates in retained earnings or in direct flows from the government. Government policy is often directed towards increasing the former source through changing the terms of trade by price ceilings and foreign trade policies in favor of sectors in which investment is desired. Quite commonly industry is so favored over primary production, and import substitution or nontraditional exports are favored relative to traditional exports.

To capture these features, direct financial flows from the government and the results of quantitative allocations mechanisms need to be included in the investment function. To represent the impact of policies which work through altering terms of trade, a multisector model is required.

(ii) The development literature emphasizes repeatedly the role of social overhead capital in the development process. Because of externalities and increasing returns to scale over the relevant range, Rosenstein-Rodan (1961) and others maintain that the government must increase substantially such social overhead capital in order to induce private investment. The role of social overhead capital in determining the stream of expected net income from investment therefore should be made explicit.

(iii) International considerations enter into investment decisions in at least two important ways.

First, in the modern sectors of many Latin American economies a not inconsiderable portion of the capital stock originates from direct foreign investment. One implication of this foreign ownership is that for such investment the relevant cost of capital reflects the opportunity cost in the international capital market (modified by local tax, repatriation and earnings regulations and expected exchange rate movements), not in the domestic market. Another implication is that net factor payments abroad may have a stabilizing influence if they are determined as a residual.

Second, for many of the Latin American economies much of the machinery and equipment for investment in the modern sector is imported. This relates to the factor proportions problem referred to above because of the concentration on developing relatively capital-intensive technology in the developed economies which produce these imports. It also means that exchange-rate policy and other import policies have important roles in the determinations of the cost of capital. If the elasticity of substitution between domestic and foreign investment goods is in fact very low and quantitative restrictions are an important component of trade policy as in many developing countries, moreover, the quantity of imported capital goods may constrain real investment and should be included as an argument

in the investment function. Particularly in such cases, the availability of foreign capital inflows (both official and private) may directly or indirectly affect investment [e.g., see Areskoug (1974)].

Estimated sectoral real physical capital investment functions suggest that the postwar Chilean experience has been substantially consistent with the putty-putty type of investment-behavior model which has been used for the developed mixed-capitalist economies. Determinants of Chilean investment include real replacement needs, neoclassical considerations based on CES production functions, uncertainty, government financial investment, and, to a lesser extent, capacity utilization considerations and imports of machinery and equipment. These partial-equilibrium results imply that government policies can induce greater real physical capital investment, particularly in the key sector of manufacturing, by larger government financial investment and by increasing the price of output relative to the price of capital services through reductions in the cost of capital or in the effective direct business tax rate, through increases in depreciation allowances or investment tax credits, and through changes in foreign-trade policy. Government fiscal and monetary policies which increase the degree of capacity utilization and reduce uncertainty also may result in greater real physical capital investment in some sectors. The greatest question about these estimates relates to the extent to which the cost of capital variable utilized reflects variations in the actual costs because of the far-from-perfect capital markets.

Equation (8) defines total *government expenditure* as the sum of exogenous central government expenditures and endogenous local government expenditures. The latter respond fairly strongly to cyclical conditions of the economy.

For Latin American economies current government expenditures often (but not always) are more centralized than in developed economies such as the United States. Nevertheless there remains a large effectively endogenous component. The government is a relatively large employer in comparison to total modern-sector employment, the wage bill makes up a substantial portion of its expenditure, and cuts in this expenditure as part of stabilization policy would be extremely risky politically in most cases.

Government expenditures also generally are affected directly by foreign-sector conditions. This is so because there usually is some response to available revenues, and taxes related to the foreign sector are a major source of variance in those revenues (see below). A further effect is through official capital inflows. The available evidence suggests [although not conclusively, see Mikesell and Zinser (1973)] that such flows are diverted partly to current government expenditures.

In the Chilean model current consumption-savings decisions are endogenous for the reasons mentioned above, although government investment financing is treated as exogenous. The major determinant of current government expenditure decisions is real government revenues, with an implied marginal propensity to save from 0.67 to 0.73. Shifts from the private to the public sectors thus would increase savings and reduce the multiplier (although the fact that government current expenditures are endogenous would increase multipliers, *ceteris paribus*). Government savings also respond inversely to foreign savings, in fact more substantially than do private savings. An improvement over the present specification

would be to tie government current expenditures more directly to the government wage bill.

Equation (9) is the *import function* and equation (10) is the *export function* for developed economies. Imports respond positively to the level of income and the domestic price level and inversely to the exchange rate (defined as the number of units of domestic currency per unit of foreign currency). Exports are assumed to respond directly to the exchange rate and inversely to the domestic price level.

For most Latin American economies, as is noted above, imports play a critical role in the provision of noncompetitive raw materials, intermediate inputs, and machinery and equipment capital goods for the modern sector. To capture the differential impact of various types of imports on growth and stabilization, therefore, some disaggregation is necessary.

Because many of these imports are noncompetitive and because import substitution policies often have reduced competitive imports to a low level, the price and exchange rate elasticities usually are low in absolute value. The income elasticities, on the other hand, are quite high. Some disaggregation, however, once again probably is necessary because of differential responses to different components of total income (e.g., the modern versus the traditional sector, investment versus consumption expenditures).

Policies to regulate imports are widely thought to be among the most potent available to the governments of Latin American countries in their quests towards growth, distribution and stabilization objectives. Among the policies often utilized are multiple exchange rate systems, tariffs, direct government imports, prior import deposits and quantitative restrictions.<sup>21</sup>

Quantitative restrictions frequently are used to maintain a disequilibrium system with overvalued exchange rate(s) and severe foreign-exchange constraints. Disequilibrium is allowed to persist because of perceived negative distribution, inflationary and political effects of devaluation and widespread convictions about inadequacies of allocation by prices. The existence of strong vested interests in the disequilibrium system (e.g., owners of factors in import-substitution sub-sectors, the recipients of import licenses, or the government bureaucracy) also help to perpetuate the continuance of these systems. Due to substantial excess demand, nevertheless, controls generally are relaxed when foreign exchange becomes available from export booms or increased capital inflows. The import functions need to be modified, therefore, not only to include the above-mentioned policy tools, but also the availability of foreign exchange.

Fluctuations in the value of exports from Latin American economies, according to the structuralists and a large number of other observers [e.g., Heller (1954) and Higgins (1968)], is a major source of instability for these countries. Not only do such variations directly affect total aggregate demand, they also change aggregate demand through the government deficit because of the dependence of government revenues on international trade revenues. Furthermore, they alter production in the modern sector because of the tight foreign-exchange constraint and the low elasticity of substitution for critical imported inputs. The holders of this view conclude that general fiscal and monetary policy will not be very effective in

<sup>21</sup> In some developing economies considerable smuggling exists in attempts to avoid these policies.

stabilization attempts. Instead emphasis must be placed on exchange rate and tax policies directly related to exports. Some observers further conclude that movements towards less dependence on the foreign sector is desirable in order to lessen its destabilizing influence.

The seminal investigation of MacBean (1966) has been followed by a number of studies which suggest that the above-hypothesized strong relationship between export instability and overall instability is exaggerated. Mathieson and McKinnon (1974) even conclude that there is some slight indication that "outward-looking" trade policies may increase stability. MacBean (1966) posits that two factors lie behind the lack of a strong relationship between domestic variables and export fluctuations: (i) the low value of the foreign-trade multiplier in part because of repatriation of factor returns to foreign owners and because of leakages into taxes on exports and (ii) the distributed lag nature of reactions to changes in exports.

These studies do bring into question the once-conventional wisdom about the destabilizing influence of international markets. The issue is far from resolved, however, because of the failure of such studies to specify adequately the structure (including the lags in responses, as MacBean's second point reflects) of the developing economies. Even the strongest doubters about the importance of international market fluctuations, moreover, grant that export variations probably are destabilizing in those cases in which exports are very concentrated in a few products.

The correct specification of the export function, therefore, is a critical component of a stabilization model for most Latin American economies. For many countries exports must be divided into two categories which differ substantially in exchange rate and tax-subsidy treatment: traditional (largely primary products) and nontraditional (often industrial products). The former often are major sources of government revenues. The latter frequently are subsidized in hopes of diversifying sources of foreign exchange and gaining entry into faster-growing markets. For the traditional exports of some Latin American countries, finally, the existence of some market power (perhaps within the framework of international commodity agreements) also needs to be represented.

For Chile partial-equilibrium estimates of import functions (by end use) and of export functions (by production sectors) indicate significant responses in a number of cases to relative prices (adjusted to incorporate the price-related effects of foreign trade policies), uncertainty, quantitative restrictions, demand and production. The implied price responses seem to suggest that the Chilean policy of maintaining a secularly increasingly-overvalued exchange rate exacerbated substantially balance of payments difficulties.<sup>22</sup> For example, the 63 percent drop in the PLD NER (Price-level-deflated nominal exchange rate) between 1946 and 1972 and the estimated elasticities, *ceteris paribus*, imply increases in imports of 57 percent for secondary consumption goods, 88 percent for transportation related investment goods, 18 percent for intermediate goods and 50 percent for services and drops in exports of 100 percent from industry, 50 percent from small- and medium-scale mining, 32 percent from agriculture, 19 percent from large-scale mining, and 13 percent for exports from services. These results also suggest that the

<sup>22</sup> Behrman (1975a,b) explores in detail Chilean exchange-rate policy and other foreign-sector policies.

foreign-sector regimes increased dependence on the traditional exports (i.e., those from large-scale mining) despite a number of stated intentions to encourage diversification.

The response to uncertainty in relative prices is widespread, although not generally large in magnitude. This pattern implies that there was a significant, but not substantial, payoff to the sliding-peg exchange-rate policy of 1965–1970.

The impact of quantitative restrictions on imports is pervasive and large. They apparently are the only effective direct policy instruments, in fact, for habitual and durable consumption goods and for machinery and equipment imports. From examination of the partial-equilibrium estimates, the intensification of quantitative restrictions seems to favor nondurable consumption goods over consumption and investment durables and to favor goods over services.

Domestic demand and credit availability variables affect a number of import categories. Production affects most export categories. These responses point to the need to integrate the foreign-sector functions into a general-equilibrium framework.

### 2.3. *Financial Markets and Assets*

The financial market for the developed economies in Table I is patterned on the extensions of Tobin's (1969) portfolio equilibrium model by Ando (1974) and Branson (1974). Equations (11)–(14) are demand functions of private-sector asset holders for four imperfectly-substitutable assets: equities, bonds, foreign securities and money. Equation (15) is the definition of the net worth of the private sector. The demand for each asset is a function of the rates of return (with a fixed zero rate of interest for money) and income (with a transactions demand for money). The nominal supplies of money and bonds and the interest rate for foreign securities are assumed to be exogeneous.

All assets are gross substitutes. Domestic asset-holders must hold given quantities of equities and bonds which are not traded internationally. Domestic asset-holders face an elastic supply of foreign securities at an interest rate fixed internationally. They are free to trade between money and foreign securities. Any purchase of the latter implicitly reduces domestic foreign exchange by an identical amount.

Equations (16)–(18) are relations between holding and capitalization, real and nominal, and holding and international rates for the three respective nonzero return assets. Equations (19)–(22) are simple hypotheses about the formation of expectations. Equation (23) determines the market value of real assets by capitalizing the expected stream of income from *existing* assets.

Branson (1974) analyzes a similar model for developed countries. His main results are two. (1) The inclusion of non-internationally-traded assets restores the effectiveness of monetary policy as measured by the possibility of altering rates of return on domestic assets relative to foreign securities. (2) The relative impact of open-market operations on domestic-asset rates depends on which asset is the instrument of open-market operations.

For Latin American economies a number of changes need to be made. As is discussed above, asset markets generally are quite fragmented, function very

poorly and are relatively unimportant in channeling investible funds. Dualism is a common feature, with changes in the organized market having but limited impact on the unorganized sector. Government-bond markets and private-security markets both generally are quite small.

Monetary policy usually is limited in scope, especially internally. The very small bond market precludes substantial open market operations. The nominal money supply is not exogenous, but is dependent on *de facto* or *de jure* obligations to finance the government deficit and on foreign exchange movements. Monetary instruments include marginal and average reserve requirements, rediscount rates, prior deposits on imports, and exchange rate(s). Also important are interest rate ceilings, and quantitative restrictions on internal credit and on international capital flows. The use of this latter group of policies requires that relations in the model be modified to reflect rationing due to quantitative variables. Uncertainty about future quantitative policies also may complicate the formation of expectations in equations (19)–(22).

The foreign sector impinges on the financial markets in a number of important ways. As is indicated in the previous paragraph, foreign exchange movements have substantial impact on the domestic money supply and the major discretionary<sup>2,3</sup> monetary operations are in the foreign sector. Foreign direct ownership of domestic capital in the modern sector often is important, so equation (22) or (23) must be modified so that only the value of the domestically-owned portion of the capital stock enters into domestic portfolio decisions.

In a few Latin American countries, such as Mexico, moreover, the interest rate in the international market may effectively create a liquidity trap for the organized monetary market. In general, however, the international interest rate does not peg the domestic rate for at least one of two reasons: (i) Quantitative restrictions on capital movements break the link between domestic and international capital markets. (ii) The existence of Bransonian internationally-nontraded assets which are not perfect substitutes for internationally-traded assets permits some independence in interest rate movements.

The Chilean model adequately incorporates some of these features. Changes in the monetary base reflect domestic financing of the government deficit and variations in foreign reserves, both of which often have been beyond the control of the Central Bank. For a given monetary base, the Central Bank can affect the money supply through average and marginal reserve requirements, discount policy, interest rate ceilings and quantitative restrictions, but behavioral decisions of the commercial banks concerning reserves and of the nonbank public concerning asset holdings and composition modify the outcome. Thus the effectiveness of Central Bank monetary policy is limited.

In other respects, however, the Chilean model does not satisfactorily represent the financial markets. Too little is known about the domestic capital market to permit an adequate specification. Some of the interactions with international markets noted above probably should be made endogenous. The net impact on the policies of improving the representation of financial markets, however, is not clear.

<sup>2,3</sup> This discretion may be limited to the short run, especially if the government attempts to maintain overvalued exchange rates.

## 2.4. Identities and Miscellaneous Relations

Equations (24) (28) define *disposable income*, *private savings*, *income from capital and the balance of payments surplus*. For the developed countries these definitions are basically self-explanatory. Note that capital gains on existing assets arise because of changes in the capitalization rate or changes in the expected stream of income from these existing assets due to varying economic conditions. They do not, of course, include additions to real assets from current net investment. For Latin American countries the major special problem is the evaluation of capital gains because of the virtual absence of markets for internal equities. The Chilean model presents no resolution of this problem.

Equation (29) is the *tax function* (net of transfers). For developed economies the major complication behind this simple representation often is the treatment of the corporation income tax. Therefore income from capital is included as an argument in this function in addition to total personal income.

In Latin America conditions are much different for tax collections. (i) The traditional sector is not monetized. (ii) Literacy is relatively low. (iii) Systematic accounting systems are not widely used. (iv) The legitimacy of government revenue collection is less widely accepted and the tradition of voluntary compliance is less strong. (v) Lack of resources, low civil service pay, and traditional social relations often make efficient and honest tax collection very difficult.

As a result, the relative importance of alternative sources of tax revenues differ from patterns in developed countries. General personal and corporation income taxes are much less important. Instead dependence is greater on import and export taxes, indirect taxes and taxes on income generated by foreign-owned corporations. Taxes related to the foreign sector are much more significant because generally they are relatively simple to administer and difficult to evade. This greater dependence on the foreign sector adds to the difficulties of stabilizing these economies because balance of payment considerations may conflict with the use of taxes for stabilization purposes. The more regressive nature of the tax structures with its greater dependence on indirect taxes, moreover, implies less "automatic stabilization" from the tax system than in more developed countries.

Within the Chilean model taxes are broken down into eleven categories so that their differential impact can be captured. Tax collections are endogenous because they depend not only on the legal rates and the tax base, but also on avoidance or delay in paying due to expectations of inflation and foreign-market conditions. This specification could be further improved by incorporating the legal changes in an explicit form for more of the tax categories.

Equation (30) is the *government budget constraint* which Christ (1968) and others emphasize repeatedly. In a closed economy or in an economy with balance of payments equilibrium, this relation need not appear explicitly. The model already contains the private sector accounts and a full recording of transactions between the private and government sectors. If the private sector accounting identities are satisfied, so must be those for the government sector. For the Chilean model, as is noted above, internal financing of the government deficit leads directly to an expansion of the monetary base.

## 2.5. Level of Aggregation

The model of Table 1 for the developed economies is presented on a very aggregative level. Actual empirical utilizations of such models often are on a more disaggregate level. The currently frequently-encountered hypothesis that a major source of inflation in the United States and in some other more developed economies is the combination of sectoral shortages with short-run rigidities points to the need for at least some disaggregation.

For Latin American and other developing countries, Hansen (1973b) argues that disaggregation is much more important since much of the direct policy impact is on relative prices. The estimation of Chilean sectoral relations provides support for this claim. There is a great deal of heterogeneity across sectors in technological substitutabilities and in both the degree and the time path of behavioral responses to economic variables. Relative prices play major roles in both short-run and long-run resource allocation decisions.

## 3. NATIONAL-INCOME DETERMINATION MODELS FOR LATIN AMERICAN COUNTRIES

One purpose of this paper is to consider how the paradigm for national-income determination models for more developed economies must be altered to fit the conditions of Latin America. Such a procedure, unfortunately, does not lead to a nice neat model whose differentials will tell the story for at least three reasons. (i) The initial model for the developed economies is sufficiently complex so that such a process is not very fruitful unless one has considerable empirical evidence about the size of parameters. (ii) The Latin American countries are not homogeneous. Conditions vary substantially across countries. (iii) Modeling of certain aspects of developing countries is at a very primitive stage. Many problems—such as how to treat the channeling of investible funds—have not been treated adequately. Nevertheless, this paper suggests several interesting general points about modeling national-income determination processes in Latin America.

(1) Fluctuations in the traditional sector originate primarily in variations in natural conditions and, in some cases, in variations in export markets. The focus of domestic-demand management stabilization questions, therefore, is the modern sector.

(2) If the traditional sector determines the real wage for the modern sector and there is no money illusion, the modern-sector labor market is very classical. Changes in aggregate demand will not alter its employment and production.

(3) The modern sector often is like a very small open economy in respect to its dependence on the foreign sector for critical raw material, intermediate and capital imports. Variations in noncompetitive raw material and intermediate imports may be a major cause of fluctuations in this sector (even if the real wage is fixed by the traditional sector). Attempts to maintain disequilibrium exchange rates exacerbate any destabilizing forces originating in the foreign sector.

(4) Because of the importance of the foreign sector as a source for government revenues, fluctuations therein not only have potentially destabilizing effects on the supply and possibly the demand side, but also through government deficits. Government deficits, in turn, affect the money supply quite directly because of *de*

*facto* or *de jure* obligations of the banking system to finance such deficits. The impact of changes in foreign exchange reserves on the money supply, on the other hand, may tend to be counteracting.

(5) The international capital market does not limit stabilization options in developing countries by fixing domestic interest rates. In part this is so because of the existence of Bransonian non-internationally-traded assets and because of quantitative restrictions which break the link between international and domestic markets. Probably more important is the lack of integrated and well functioning financial markets—which limit the impact of stabilization policies even if there is no access to international markets.

(6) International capital flows, nevertheless, may have significant destabilizing effects. The mechanism is through varying the constraint on imports, with the resulting supply effects noted above.

(7) International creditors, moreover, often limit the policy options open to developing countries. Because foreign debts frequently are quite large, developing nations cannot blithely ignore the views of such creditors.

(8) Given the important role of the foreign sector, perhaps stabilization policies should be directed towards it. Some attempts have been made in this direction, both on the level of individual countries and in cooperation with other countries. Stabilization problems, however, often are viewed as less important than concerns relating to growth, distribution and the foreign economic position. If a temporary foreign exchange surplus is available due to an export boom or increased capital inflows, for example, pressures are enormous to utilize it to alleviate other problems. Only rarely do governments find it feasible to conserve such an excess for use when the next foreign exchange deficit occurs. Only if such governments are convinced that the costs of fluctuations are larger than previously perceived or that there are gains in other policy dimensions of increased stabilization are more resources likely to be utilized for stabilization purposes.

Although the heterogeneity of structures across countries precludes the specification of an interesting general national-income determination model for developing economies, specific countries can be modeled. A second purpose of this paper is to use the Chilean model to illustrate what specific forms some of the components of a national-income determination model might take. Several points which originate in this exercise are as follows:

(1) It is possible to model at least some Latin American economies in ways which reflect their special characteristics (e.g. the list of nine features in the introduction).<sup>24</sup> Of course it may be more possible to develop satisfactorily a macro-econometric model for a relatively-developed country like Chile than for most of the developing economies. Even for a country like Chile, moreover, structural changes occur which require revision of the specification or of the parameters. Given the events since 1970, for example, a model based on the previous two decades could not be used satisfactorily without careful consideration of modifications due to structural changes.

<sup>24</sup> Section 2 suggests definite shortcomings of the Chilean model, but most of these limit its use for long-run concerns much more than for those of the short or medium run. See Behrman (1975c) for evidence of apparently quite successful predictions of developments in the sample and post-sample periods.

(2) The partial-equilibrium evidence of substantial technological and behavioral flexibilities suggests that models which assume too great rigidities (see the introduction) may distort the perceived choice set and over-emphasize the importance of "key" factors.

(3) The lack of a large traditional sector and the partial-equilibrium evidence of significant substitution possibilities and price responses suggest that macro-policies might have significant impact on aggregate variables. General-equilibrium simulations, however, indicate that these policies have much less aggregate impact than partial-equilibrium analysis might suggest due to overall resource constraints and indirect effects (such as those transmitted through the money supply-foreign exchange-price nexus). This result reinforces the pessimism about the potency of macroeconomic policies given the present structure of the developing economies which economists with as differing viewpoints as Friedman (1974) and Taylor (1974) have recently expressed. The lot of the policy maker in such an economy is a very difficult one.

(4) The general-equilibrium results also point to the existence of important trade-offs among various macroeconomic objectives (e.g., growth, distribution, nominal and real stability, resource allocation and structural change, and foreign economic position). Substantial movements towards any one of these goals are liable to be made only with significant costs for at least one of the others.

(5) The results of the analysis of the Chilean experience do not primarily support one side or the other in the structuralist-monetarist controversy. In contrast to the structuralist position, evidence is found for significant sectoral flexibility and price responsiveness—even in agriculture. In support of the structuralist position, relative price changes are important in the inflationary process, the money supply is largely passive and limits overall policy impact, and certain characteristics of the overall structure (e.g., price expectations) would have to be changed before most macroeconomic policies had large aggregate effects.

(6) Both the partial-equilibrium and the general-equilibrium analyses lend support to Hansen's (1973b) emphasis on the need for disaggregation to capture relative-price effects. The estimated partial-equilibrium relations are quite heterogeneous across sectors in regard to technological possibilities, behavioral responses, and patterns of adjustment. The general-equilibrium simulations suggest that policies have much greater impact on the composition of aggregates than on their size.

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