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Cimoli, Mario and Correa, Nelson and Jorge, Katz and Rogério, Studart

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**Institutional Requirements
for Market-led Development
in Latin America**

Mario Cimoli, Nelson Correa,
Jorge Katz and Rogério Studart



NACIONES UNIDAS



Executive Secretary

Santiago, Chile. January 2003

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Contents

Abstract	5
Introduction	7
I. Analytical background of the reforms	9
(a) Market efficiency	9
(b) Market-led reforms	10
II. The labour market	13
(a). The overall result of the reform	14
(b) Sectors facing access difficulties	18
(i) Women.....	18
(ii) Young people.....	20
III. Financial markets	23
(a). Financial reforms and the conventional wisdom	24
(b) The overall result of the reforms	26
(c) Sector facing access difficulties.....	27
(i) Financing for SMEs.....	28
(ii) Financing for low-income housing	30
IV. Technology markets	33
(a) Industrialization and technological capabilities	33
(b) The overall result of the reforms	35
(i) Access for SMEs.....	36

V. Institutional requirements	39
(a). Market failures.....	42
(b). Entitlement failures.....	43
(c). Learning and knowledge-creation failures.....	43
(d). Coordination synergies.....	44
VI. Concluding remarks and policy implications	47
References	51
Serie Informes y estudios especiales: Issues published	58
Tables	
Table 1. Latin America: Composition of the Working-Age Population by Sex	15
Table 2. Latin America and the Caribbean: Annual Growth in Output and Employment, and the Employment Elasticity of Output (1980-1990)	16
Table 3. Latin America: Selected Characteristics of the Employed Population.....	17
Table 4. Latin America (eight countries): Changes in Women’s Position in the Labour Market, by Skill Levels and Relative Wages, 1990s	20
Table 5. Policy Implications	48
Figures	
Figure 1. Coordination and Hierarchies in Latin American Capitalism	40
Figure 2. Coordination and Complementarity	45

Abstract

This paper seeks to provide a systematized framework for the main ideas that have been developed by ECLAC concerning the effects that market-led reforms have had on labour, financial and technology markets. In order to explore these questions further, a research project has been undertaken by ECLAC with the sponsorship of the German Agency for Technical Cooperation (GTZ). The project deals with the institutional requirements for properly functioning financial, technology and labour markets. Particular attention is being devoted to the institutional forces affecting market access by traditionally excluded actors, such as small and medium-sized enterprises (SMEs) in the case of long-term financial and technology markets, poor households in the case of housing finance, and female workers in the case of the labour market.

As a consequence of the market-led reforms, Latin America has transformed its pattern of development and the way in which its brand of capitalism is configured. At the same time, the reform process is shown to have yielded unsatisfactory results when the performance level achieved in each factor market is evaluated. Labour markets exhibit a range of difficulties in reducing unemployment and informal employment. Financial markets are characterized by concentration and by the increasing difficulties encountered by the weaker agents in accessing resources. And, in most of the economies in the region, the role played by technology markets in creating and diffusing technology domestically is being downgraded. This poor performance has co-evolved along with a reduction in the State's participation in the economy and an increasing power asymmetry in favour of private agents.

The above difficulties seem to be related to the persistence of various types of market failures and the lack of non-market institutions capable of strengthening and supporting the operation of factor markets. The persistence of imperfect information, the lack of initial entitlements and gaps in learning capabilities have hindered the adaptation of various actors to the discipline of a new macro policy and incentive regime. Because of these underlying weaknesses in the institutional fabric inherited by the region, its factor markets have functioned very imperfectly and have failed to deliver what was expected of them in terms of a better long-term overall performance.

Introduction

Many Latin American countries made significant changes in their macroeconomic policies and regulatory regimes during the 1980s. Trade and financial liberalization, the de-regulation of markets and the privatization of economic activities were carried out as part of such programmes. These changes –which can be synthetically described as the transition from State-led industrialization (SLI) to a more outward-oriented, market-led regime– were strongly influenced by the belief that the political economy of the Latin American countries must be transformed if they are to enhance their long-term growth performance while simultaneously attaining significant welfare improvements.

Have these reforms been successful? On the one hand, given the overlapping effects that these reforms have had on macroeconomic management and on microeconomic aspects of labour, financial and technology markets, evaluating their impact is by no means an easy task. On the other hand, many of these structural changes are still in the process of being implemented and/or “digested”, so their ultimate outcomes are not yet clear (Stallings and Peres, 2000; ECLAC, 2000 and 2002; Katz, 2000a).

Although no definitive assessment has yet been made, a feeling of frustration with the results of these reforms seems to be spreading among both policy makers and academics throughout the region. Many experts are beginning to express the view that expectations regarding the likely benefits of these reforms may have been grossly overoptimistic. It is becoming clear that, while correcting

macroeconomic fundamentals may be a necessary step, it is not a sufficient condition for the transition towards a new equilibrium growth path (ECLAC, 2000 and 2002).

This paper constitutes an attempt to identify and examine possible causes of this poor performance, together with the institutional changes that appear to be required in order to overcome them. The emphasis of this analysis is on the institutional setting of the political economy that now predominates in Latin America as a consequence of these reforms. The region's political economy has been strongly influenced by the normative implications of the conventional view of how markets work. By locating the market at the centre of the analysis, this school of thought predicts that Latin American economies can attain an efficient behavioural pattern.

As a consequence of the above, Latin America has transformed its pattern of development and the way in which its brand of capitalism is configured. At the same time, the reform process is shown to have yielded unsatisfactory results when the performance level achieved in each factor market is evaluated. Labour markets exhibit a range of difficulties in reducing unemployment and informal employment. Financial markets are characterized by concentration and by the increasing difficulties encountered by the weaker agents in accessing resources. And, in most of the economies in the region, the role played by technology markets in creating and diffusing technology domestically is being downgraded (ECLAC, 1999, 2002). This poor performance has co-evolved along with a reduction in the State's participation in the economy and an increasing power asymmetry in favour of private agents. Thus, the increasing accumulation in key sectors (such as public services and exporting sectors), which has been encouraged by the State, has ended up reducing the State's ability to implement new policies.

More and more experts are voicing the view that other institutional and regulatory forces may be necessary to improve long-term growth and welfare results. In particular, the above difficulties seem to be related to the lack of non-market institutions capable of strengthening and supporting the operation of factor markets. The persistence of imperfect information, the lack of initial entitlements and gaps in technological capabilities have hindered the adaptation of various actors to the discipline of a new macro policy and incentive regime. Because of these underlying weaknesses in the production and institutional fabric inherited by the region, its factor markets have functioned very imperfectly and have failed to deliver what was expected of them in terms of a better long-term overall performance.

This paper seeks to provide a systematized framework for the main ideas that have been developed by ECLAC concerning the effects that market-led reforms have had on labour, financial and technology markets. In order to explore these questions further, a research project has been undertaken by ECLAC with the sponsorship of the German Agency for Technical Cooperation (GTZ). The project deals with the institutional requirements for properly functioning financial, technology and labour markets. Particular attention is being devoted to the institutional forces affecting market access by traditionally excluded actors, such as small and medium-sized enterprises (SMEs) in the case of long-term financial and technology markets, poor households in the case of housing finance, and female workers in the case of the labour market.

The present paper reports on the results of these studies. Section 2 examines the theoretical framework upon which the research has been founded. It is argued that conventional neoclassical tools are highly unsuitable for this research effort because they provide a very poor representation of what institutions are actually like and what role they play as determinants of social performance. Sections 3, 4 and 5 examine how the reforms have affected these settings and, based on a number of case studies, analyse the performance of the relevant labour, financial and technology markets. Section 6 describes some of the requirements for the incorporation of non-market institutions and

the complementarity between them and market-led reforms. Section 7 summarizes the findings and presents conclusions.

I. Analytical background of the reforms

The direction of the first-generation reforms was strongly influenced by a conventional view as to how markets function –one which, for the sake of simplicity, we will refer to as the “*equilibrium-welfare*” view of the roles that institutions and organizations play in society. This approach leads to important policy conclusions, and both it and those conclusions will be discussed in the following subsection.

(a) Market efficiency

In the tradition of the equilibrium-welfare approach, markets and competition are built entirely on the idea of the logical consistency between market environment, preference functions and adjusting variables (prices and quantities). The market is generally defined as the loci where perfectly informed and rational utility-maximizing agents meet in order to carry out transactions. This characterization plays a central role in resource allocation and in the selection of efficient market outcomes. Prices and factors are completely flexible and information is widely distributed.

Structural reforms were undertaken in Latin America under the expectation that a fully competitive economy would reach equilibrium at a Pareto-optimal level, a situation where all economic agents are rewarded according to their marginal productivity and no agent can, through further trade, be better off without reducing others’ welfare.

This is a very appealing and politically attractive conceptual basis upon which to operate, since it implies that any other institutional setting outside that of a fully competitive economy (full flexibility of prices and factors, and no “noise” created by government intervention in the economy) will lead to a general equilibrium that is below Pareto optimality. In such a view, State intervention in resource allocation or institutional features that lead to less price and factor flexibility will produce a misallocation of resources and hinder the achievement of a sustainable long-term equilibrium. Thus, the reforms were guided by the need for market “flexibility” and less government intervention.

The above approach is deeply described in market friendly strategies for development (World Bank, 1991).¹ In the case of the labour market, exclusion was seen as being due to a lack of institutional flexibility (to hire and fire workers) and an insistence upon industrial policies that did not generate a significant demand for the large unskilled segment of the labour force. A similar argument was applied in the case of financial markets, and financial market regulation was therefore regarded as the reason why financing was unavailable for many activities and actors in the economy. Finally, the insistence on the development of domestic technological capabilities through active public R&D efforts –involving the financing and/or production of knowledge and technology in public laboratories and research institutes– led to unnecessary expenditures which could have been avoided by leaving firms to acquire ready-made technology in foreign markets.

For our purposes here, it is sufficient to note that the prevailing belief was that once the government “got out of the way,” private markets would allocate resources better, thus generating faster growth and expanding access opportunities. In other words, the accessibility issue was considered to be a direct consequence of an efficient market resource allocation process.

In the following section it will be shown that these expectations were not fulfilled in any of the three markets under consideration. First, however, a brief analysis of the overall policy conclusions implicit in the conventional view may be in order.

(b) Market-led reforms

The pattern of development seen in Latin America prior to the structural reforms of the 1980s and 1990s was shaped by the SLI strategy adopted in the aftermath of the Second World War. Mixed economy have prevailed in the region, with an important role of non-market institutions as leading actors in the coordination of different markets and agents.

In the labour market, this strategy was closely related to the role played by the State as an “engine” of growth that induced the expansion of manufacturing output and the gradual development of a skilled labour force capable of supporting that expansion. Public-sector educational organizations (such as vocational schools) were created in order to train the workforce required by the production structure. A complex framework of legal codes and judicial procedures was gradually formed that governed such matters as dismissals, labour relations and so forth.

Public development banks such as Nafinsa in Mexico, BNDE in Brazil and BND in Argentina took the lead in providing long-term finance for public-sector involvement in the production of goods and services. Public institutions and organizations were created and/or strengthened with a view to implementing the SLI strategy. Policies were highly sector-specific and selective, and they paid very little attention to markets or the discipline of competition.

¹ These market led reforms –at a more microeconomic level– have been articulated with the implementation of the following macroeconomic recommendations: fiscal discipline, tax reform, market-determined interest rates, competitive exchange rates, liberal trade policies, openness to foreign direct investment, privatization, deregulation, respect for property rights and more public expenditure on education and health care, these recommendation are described in the Washington Consensus. (Williamson 1990).

Finally, in the field of technology, public R&D labs and State universities, together with public development banks that furnished long-term finance for major undertakings in fields such as energy, telecommunications and transport services, have played an important role in the industrialization process. Public firms engaged in these kinds of activities developed their own engineering departments and R&D facilities in order to supply themselves with the technology they needed for these ventures. As a complementary measure, public policies designed to attract foreign direct investment to manufacturing activities helped to obtain the required know-how in many technology-intensive sectors of the economy, such as the pharmaceuticals and automotive industries.

Within an economic climate marked by a lack of competitive discipline and difficulties in achieving macroeconomic stability, policy makers adopted the new policy package promoted by the Washington Consensus and market friendly strategies for development. Policies were designed and implemented at two different levels. At a macroeconomic level, the reforms were mainly designed to lower barriers to financial and commercial flows (external financial and trade liberalization), reduce government intervention (privatization of public enterprises) and maintain economic fundamentals (mainly through fiscal discipline). At the microeconomic level, the reforms were aimed at augmenting price flexibility (by reducing government's role in supplying public goods), factor flexibility (by allowing more flexible contracts, in such areas as employment) and increasing the role of private institutions in allocating resources (through financial- and labour-market deregulation). It was assumed that after a short period of time, during which inefficient enterprises would disappear, resources would be redeployed to more efficient and internationally competitive firms and sectors.

In order to assess the impact of these policies on each of the three factor markets to be considered here, the first step is to determine what the prevailing situation was like in each one, what the reforms were designed to attain and, finally, what the reforms' results were. These questions will be examined in the next three sections.

II. The labour market

During the period of SLI, the institutional setting for labour markets in Latin America was oriented towards the construction of a legal and training infrastructure that in many respects reproduced the main features of the prevailing institutions and organizations in developed countries: "The aim was to create a framework of social integration that responded to the sharp growth of employment in the industrial and tertiary sectors, and that could also satisfy the demands of emerging social strata... Thus, as had happened in the industrialized countries, the region's labour market institutions sought to regulate labour relations through direct State intervention and collective agreements between workers and employers... The two main components of the regime developed in industrialized countries were labour legislation and collective bargaining. In the context of a broad national pact (tacit or explicit) between firms, workers and the public sector, these dispositions (which included increasing real wages; decreasing working hours; protection against unemployment, illness and disability; and regulations on safety and hygiene at work) improved working conditions and helped increase labour productivity (through training and work organization)" (Weller, 2000a: 189).

A general consequence of this view was that the labour market was mainly regulated and coordinated by the State. This was reflected in aspects such as: centrally-set wages (which were usually indexed to past inflation), a high degree of job security stemming from the considerable cost of laying off workers, and restrictions on the use of temporary contracts, as well as the significant bargaining power wielded by trade unions.

Even by the end of this period, however, the labour market differed significantly from labour markets in developed economies: (i) the institutional framework was limited to a fraction of the workforce, which varied according to the level of development of the economies in the region; (ii) in several economies of the region and in some periods, relations among the State, entrepreneurs and workers were strongly influenced by populist policies; on the other hand, in other periods, social and political instability generated cycles in which established rights and obligations were often disregarded under authoritarian regimes.

It was believed that economic reforms would succeed in eliminating distortions in most markets and would therefore increase the demand for labour. The labour market was viewed as being no exception, and reformers assumed that the replacement of generally rigid systems in which the State regularly intervened in labour relations with a more flexible structure would generate a bias towards increasing the competitiveness of firms more than towards protecting job stability for workers. Labour reform would, in turn, do away with the countless distortions existing in the labour market, which served only to increase the cost of labour owing to the cost of laying off workers, the power of the unions, the existence of minimum wages, etc. In other words, even if only through the price effect, demand for labour ought to grow.

It should also be noted that these labour-market reforms amounted to more than simply a “deregulation” of that market. The reforms were carried out under two major assumptions.

The first was that they would bring particular benefits to the large sectors producing tradable goods, namely, agriculture and manufacturing. In agriculture, the elimination of existing distortions would improve the sector’s relative prices. This would stimulate agricultural production because of the region’s comparative advantages in this sphere, the result of abundant manpower and favourable natural conditions (World Bank, 1986). This expansion of agricultural production, a consequence of the elimination of the urban bias, would have a significant positive net impact on employment because of the high labour intensity of the sector as a whole (World Bank, 1990a).

The second was that these economies were intensive in unskilled labour. As Anne Krueger has argued, “Insofar as developing countries are relatively abundantly endowed with unskilled labour and relatively short of capital, trade with other LDCs is likely to increase the imbalance in factor availability, whereas trade with the developed countries may serve as a means of exchanging abundant factors for scarce ones” (Krueger, 1978). In this respect, trade liberalization would strengthen the region’s comparative advantages by allocating resources for these production activities and would thus boost demand for unskilled labour, narrow the wage gap and reduce the anti-export bias of the import substitution era, during which the labour factor had been underused. Anne Krueger has also stated, “What is already clear is that the findings of the country studies support the view that altering trade strategies toward greater export orientation will certainly be consistent with the objective of finding more employment opportunities: scepticism based on Lentief Paradox or factor-market distortion considerations does not seem to be warranted” (Krueger, 1978).

(a) The overall result of the reforms

According to ECLAC (2001) the population active economically expanded by 2,6% in the 1990s, while employment rate increased only by 2,2 % (see table 1). Thus, the unemployment rate rose from 4,6% to 8,6% (that means an increase from 7,6 million of people to 18.1 million)². This result is clearly a disappointing one. In fact, “the number of jobs generated was smaller than the increase in the labour force and, despite the increase in productivity and in real wages, income

² Other studies also confirm this fact, as for example OIT (1999) shows that between 1990-1998, the labor force increased in 3,1% while the employment rate grew by 2.5%. As result, the unemployment rate increased from 5,4% to 9,1%.

distribution was worse or no different from the decade before” (León, 2001). In order to explain why this situation arose, it is useful to view the labour market as being made up of three basic components: supply, demand and institutional setting.

Table 1
LATIN AMERICA: COMPOSITION OF THE WORKING-AGE POPULATION BY SEX a/

Description	National total (thousands)				Annual Average rate 1990 - 1999
	1990	1994	1997	1999	
Working-age population	274.619	302.852	324.685	339.680	2,4
Males	134.901	148.463	159.031	166.320	2,4
Females	139.718	154.389	165.655	173.360	2,4
Economically active population	167.485	186.446	201.417	211.833	2,6
Males	114.479	125.101	133.336	138.995	2,2
Females	53.005	61.345	68.081	72.838	3,6
Employed persons	159.841	175.632	187.824	193.714	2,2
Males	109.537	118.678	125.669	129.006	1,8
Females	50.304	56.954	62.155	64.708	2,8
Unemployed persons	7.643	10.814	13.593	18.118	10,1
Males	4.942	6.423	7.667	9.989	8,1
Females	2.701	4.391	5.926	8.129	13,0

Description	National total (percentages)			
	1990	1994	1997	1999
Participation rate b/	61,0	61,6	62,0	62,4
Males	84,9	84,3	83,8	83,6
Females	37,9	39,7	41,1	42,0
Employment rate c/	58,2	58,0	57,8	57,0
Males	81,2	79,9	79,0	77,6
Females	36,0	36,9	37,5	37,3
Unemployment rate	4,6	5,8	6,7	8,6
Males	4,3	5,1	5,7	7,2
Females	5,1	7,2	8,7	11,2

Source: Social Panorama of Latin America 2000-2001, ECLAC (2001), Table III.2.

a/ Aged 15 years and over. b/ Ratio of the economically active population to the working-age population. c/ Ratio of the employed population to the working-age population.

The factor of labour supply did not help to reduce unemployment because the slowdown in the growth rate of the working-age population was offset by a sharp increase in the labour force participation rate, which was largely attributable to the expansion of the female labour force. Upon further analysis, three major aspects are found to have affected the composition of labour supply:

(i) Over the last two decades the growth rate of the working-age population has declined from 2.7% (1980-1985) to 2.2% (1995-2000). As a result, the average age of the labour force has trended upward, together with its members' levels of work experience, and the pressure exerted by the supply of unskilled labour has eased (Weller 2000a pp. 25)

(ii) The labour force's level of education has also risen, reflecting higher enrolment rates in secondary and tertiary education. This tends to keep the labour force participation rate in check and allows the educational requirements of labour demand to be met more effectively.

(iii) Although these demographic trends have a contractionary effect on labour supply, this has been more than offset by the increase in labour force participation from 61% in 1990 to 62.4% in 1999. This increase can be explicated for the increase in the woman's participation rate, from 37.9% to 42%³.

One of the most powerful effects on the *demand* side was the decline in the economic growth rate. As shown in table 2, growth in the 1990s was lower than the average for the period as a whole. This, in turn, affected the growth of employment, which in the 1990s was also below the average for the period 1950-1999. The employment elasticity of output in the 1990s does not differ greatly from the average for the period from the 1950s to the 1990s. This indicates that the new technology introduced to transform the production apparatus during the post-reform period did not absorb more labour.

Table 2

LATIN AMERICA AND THE CARIBBEAN: ANNUAL GROWTH IN OUTPUT AND EMPLOYMENT, AND THE EMPLOYMENT ELASTICITY OF OUTPUT (1980-1990)

Period	Economic growth	Employment growth	Employment elasticity of output
1950s	5.1	1.9	0.4
1960s	5.7	2.3	0.4
1970s	5.6	3.8	0.7
1980s	1.2	2.9	2.6
1990s ^{a/}	3.8	2.2	0.6
1950s to 1990s	4.3	2.7	0.6

Source: Jürgen Weller, "Employment trends in Latin America and the Caribbean during the 1990s", *CEPAL Review*, No. 72 (LC/G.2120-P), Santiago, Chile, December 2000, p. 34.

a/ 1990-1997

Moreover, in the 1990s, the creation of new jobs was marked strongly by the informality, whereas close to 7 of each 10 new jobs has been created in the informal sector (close to 68,5%). Those, have been characterized by the low productivity and the insufficient laboral conditions as instability and social security lack (see table 3). Also, we can see that the activities which increased the share in the employment was construction, transport and telecommunications, commerce, finance and domestic services, while the industry and agricultural sectors decreased their participation.

In the same way, employment was mainly generated in non-tradable and low-productivity areas of the economy⁴, which would not be expected to benefit from technological change until after sectors that are more closely linked to international trade had done so. This suggests that the impact of technological change on the capital-labour ratio was detrimental to employment, with the least productive sectors absorbing the labour laid off from tradable sectors. This empirical evidence contradicts the neoclassical predictions: not only was growth slow, but new technology in the tradable sector failed to generate employment or absorb labour intensively.

³ For more information see ECLAC (2001); Weller, J. (2000a); León, F. (2001).

⁴ For more information see Weller (1998, 2000b), ECLAC(2000) and Stallings, Weller (2001).

Table 3

LATIN AMERICA: SELECTED CHARACTERISTICS OF THE EMPLOYED POPULATION a/

Description	Persons (thousands)				Percentage breakdown			
	1990	1994	1997	1999	1990	1994	1997	1999
Branch of activity	159.841	175.632	187.824	193.714	100,0	100,0	100,0	100,0
Agriculture	37.227	39.540	39.424	39.789	23,3	22,5	21,0	20,5
Industry	26.911	28.738	29.564	29.065	16,8	16,4	15,7	15,0
Construction	9.499	12.119	12.057	12.284	5,9	6,9	6,4	6,3
Transport and communications	7.159	8.129	9.337	9.839	4,5	4,6	5,0	5,1
Commerce	27.747	31.211	34.824	36.968	17,4	17,8	18,5	19,1
Finance	4.581	7.359	8.273	8.932	2,9	4,2	4,4	4,6
Social services	30.325	31.042	35.084	36.695	19,0	17,7	18,7	18,9
Personal services	8.131	8.546	9.572	9.960	5,1	4,9	5,1	5,1
Domestic service	7.886	8.552	9.273	9.754	4,9	4,9	4,9	5,0
Unknown	374	395	418	429	0,2	0,2	0,2	0,2
Employed persons in urban areas^{b/}	107.581	120.886	130.996	136.626	100,0	100,0	100,0	100,0
Formal sector	61.318	65.668	68.810	70.462	57,0	54,3	52,5	51,6
Informal sector	46.264	55.218	62.185	66.164	43,0	45,7	47,5	48,4
Absorption of new jobs	Thousands				Percentage			
	90 - 94	94 - 97	97 - 99	90 - 99	90 - 94	94 - 97	97 - 99	90 - 99
Total of new jobs	13.305	10.110	5.630	29.045	100,0	100,0	100,0	100,0
Formal sector	4.350	3.142	1.652	9.144	32,7	31,1	29,3	31,5
Informal sector	8.954	6.967	3.979	19.900	67,3	68,9	70,7	68,5

Source: ECLAC (2001), Social Panorama of Latin America 2000-2001.

a/ Aged 15 years and over. b/ Informal or low productivity employment includes persons working in microenterprises (establishments of up five persons), domestic service workers, unskilled own-account workers and unpaid family workers.

In general, it is recognized that the labour market has become somewhat more flexible. According to Tokman and Martínez (1999), greater flexibility has been achieved through cost reductions made possible the practice of hiring new workers and giving them temporary contracts or no contracts at all (since temporary contracts cost just 42% of what permanent contracts do, and the cost of employing workers without contracts is less than half of the cost of permanent contracts). "This practice reduced the cost of labour by 5% and the combination of contract types on which it is based did not vary between 1990 and 1998" (León, 2001). In order to increase their competitiveness, firms raised productivity by laying off workers; labour costs were also reduced by devaluations.

With regard to the third component of the labour market, its *institutional setting*, problems of access for excluded sectors and diminishing social protection remain unsolved. Although labour reform has reduced hiring costs, it has done so at the expense of labour quality, job stability and working conditions. In this regard, Reich (2001) and Cappelli (1999) affirm that the labour force is faced with a lack of job security, increasingly inequitable conditions and income levels, sorting and intense competition. He also argues that reliability and loyalty to the organization (firm or conglomerate) are no longer rewarded with stability, career prospects or access to the homogenized and homogenizing middle class. The institutional structure of labour markets has thus been destabilized and reorganized.

Sluggish and inconsistent job creation has been accompanied by an increase in informal employment, which undermines social protection mechanisms (see, table 3). Moreover, young people and women are over-represented in the informal workforce. Although the female labour force participation rate has increased, women are still subject to considerable employment and wage differentials with respect to men. This is a clear indication that serious access problems persist in these sectors (ECLAC, 2001).

In summary, it can be concluded that the reforms have failed to live up to expectations. They have not only failed to generate more employment, but have actually widened the wage gap between skilled and unskilled workers, led to a worsening of already substandard working conditions and made it apparent that the region's comparative advantages do not lie in unskilled labour. ECLAC (2000) sums up the situation as follows: "employment...in the region is significantly lacking in terms of its level", as well as in terms of "marked inequities in access to productive jobs and a deterioration in...social welfare systems." The reforms have, however, also had a number of positive effects, such as increases in productivity and in the educational level of a workforce in which a significantly larger percentage of women are participating.

Labour-market reforms have been guided, to a great extent, by the view that flexibility is a necessary factor in overcoming pre-existing problems and in easing the Latin American and Caribbean economies' adjustment to today's globalized economy. In point of fact, the region's experiences with labour-market reform tend to reflect a rather mechanical application of the concept of *flexibilization* as presented in orthodox textbooks.

The argument that difficulties in reducing unemployment are attributable to a refusal by labour to accept lower wages and more flexibility is not clearly supported by the facts. Unemployment in Latin America is not associated with high wages or widespread rigidities. Instead, variations in employment are associated with the level of economic activity and structural difficulties, as those associated to the specialization pattern and the structural heterogeneity of the production system (ECLAC, 2000 and 2002). Only a very small part of the current situation can be explained by what may be called voluntary unemployment, that is "the refusal or inability of a unit of labour, as a result of legislation or social practices or of combination for collective bargaining or of slow response to change or mere human obstinacy, to accept a reward corresponding to the value of the product attributable to its marginal productivity" (Keynes 1936, pp. 6).

The explanation for what has happened lies primarily in the concept of "involuntary unemployment" as expounded by Keynes and in the production system's structure. Low levels of activity (low investment, low propensity to consume) and biased specializations, which are adverse to the incorporation of non-skilled labour and do nothing to dispel balance-of-payment difficulties, are the structural reason for unemployment.

(b) Sectors facing access difficulties

Certain sectors typically face difficulties in gaining access to the labour market, often because of poor initial endowments –in terms of education, experience or the ability to delegate childcare responsibilities– that prevent their full integration into the labour market. Two groups that are particularly affected –women and youth– will be discussed here.

(i) Women

Studies conducted under the GTZ project have concluded that Latin American countries perform like other developed economies reducing the gap between male and female employment conditions. This outcome is, however, counterbalanced by the finding that, despite the regulatory flexibility introduced by the reform process, policies directed at expanding the "initial endowments"

of women (i.e., better education and support for working women, particularly those with children) are still needed in order to provide women with access to higher quality positions. Thus, problems of access –and especially access to good jobs– are also associated with excluded agents' lack of endowments (mainly educational background and training).

At a general level, it is still under debate whether the increase of women's participation in labour market: (i) has eliminated the structural difficulties of reducing the unemployment rate; (ii) is a direct result of the introduction of greater flexibility in the labour market; or (iii) can be regarded as an actual increase in access or simply as a replacement of existing workers with workers who are prepared (or need to) accept lower-paid jobs under more flexible contractual terms and conditions⁵. In the following, we shall discuss some brief answers to these questions.

Empirical evidences indicate that women labor participation increased from 37,9% to 42% in the 1990s, and 20 millions of women have been integrated in the labor market (see table 1). However, the women's employment growth rate (2.8% annual average rate between 1990 and 1999) did not increase in order to absorb the higher women participation growth rate (3,6% annual average rate, in the same period); thus, the unemployment rate of growth have been increased (13% annual average rate). This situation is also reflected by the difference of the unemployment growth rate in the period, which increased from 5,1% in 1990 to 11,2% in 1999 (this represent an increase from 2,7 to 8,1 million of women in the same period).

A number of the characteristics (most of which have a strong cultural component) displayed by Latin American societies make it difficult for women to become fully integrated into the workforce or to gain access to higher wage levels and positions of responsibility. Certain features can be identified, on both the supply and demand sides, which influence women's opportunities for joining the labour market and their incentives for doing so.

On the supply side, some of the important factors that influence women's participation in the labour market are: (i) the fact that domestic responsibilities are usually undertaken by women; (ii) within the family unit, their access to education tends to be more restricted than that of men⁶; and (iii) rates of participation are usually higher among young women and women at higher income levels.

On the demand side, influential factors include: (i) the higher cost (in the formal market), in terms of expenditures and medical leave, of hiring women; (ii) turnover costs and training replacements; (iii) the fact that in some societies women are still perceived as being incapable of performing certain activities; and, lastly, (iv) the greater flexibility of the labour market, which has increased the likelihood of women being hired because they are often willing to accept poorer working conditions.

The above characteristics together with urbanisation process growing (which in part this can be explained by the incapability of the agriculture sector to generate employment), with the increased educational levels of women (that give better conditions to labor market), and finally, the fact that the employment was generated in activities where the women have higher rate participation (for example, informal activities, commerce, finance and domestics services) can explain the huge increment in the labor participation rate of the women.

The wage gap between men and women has decreased as women with higher levels of education have joined the workforce. As shown in table 4, there is a strong correlation between women's education and the men/women wage gap. With the exception of Peru, all the countries that were studied recorded an improvement in the educational levels of the female labour force and all, except Peru, had managed to narrow the wage gap.

⁵ For further information, see Pereira de Melo (2000), Lavinas (2000), Barros, Corseuil and Santos (2000), and Comin and Guimarães (2000).

⁶ Although the educational gap between women and man has been reduced. It can be observed, however, that men level of education is higher (Weller, 2000a, León, 2001).

The increase in female unemployment rates is not the only negative aspect. As León's paper (2001) mentions, "Women's working life expectancy is lower; they experience a less continuous career path from one job contract to another; and, although women were found to have greater access to part-time employment, this occurred mainly in the under-25 and over-49 age groups, i.e., among those women who were less likely to be responsible for the care of young children. In addition, part-time work was mainly available in smaller firms, which meant that the persons filling those jobs were less likely to have an employment contract, social security coverage or an hourly wage comparable to that of full-time workers."

From the standpoint of women, the relative success of the reforms in raising the participation rate and narrowing the wage gap is therefore arguably insufficient, as no policy has yet been adopted to resolve their entitlement problems by, in particular, affording them better access to education within the family group and enabling them to dissociate themselves from household responsibilities such as child care. The female labour force participation rate may have risen, but this has been the result of an expansion of supply and has occurred within a framework of a more higher unemployment rate and worsening labour conditions, in which the labour-absorbing activities have typically corresponded to tertiary and informal nontradable and low-productivity sectors, respectively. In consequence, in the absence of policies to address access problems, it will be difficult for women to improve their status in the labour market.

Table 4

LATIN AMERICA (EIGHT COUNTRIES): CHANGES IN WOMEN'S POSITION IN THE LABOUR MARKET, BY SKILL LEVELS AND RELATIVE WAGES, 1990s

Country and period ^{a/}	Share of university graduates in female wage employment		Wage gap: men/women (%)	
	Year 1 ^b	Year 2 ^b	Year 1 ^b	Year 2 ^b
Argentina, 1991-1997	27.6	35.7	n.d.	n.d.
Bolivia, 1989-1996	17.9	23.0	137.3	125.0
Brazil, 1992-1997	16.9	18.1	140.9	128.2
Chile, 1992-1996	34.6	34.7	132.8	127.5
Colombia, 1988-1995	14.8	18.8	167.6	133.1
Costa Rica, 1990-1996	18.3	23.3	121.6	120.8
Mexico, 1991-1997	14.6	19.2	137.5	121.6
Peru, 1991-1997	33.5	32.2	132.3	132.4

Source: Jurgen Weller, *Economic Reforms, Growth and Employment: Labour Markets in Latin America and the Caribbean*, Libros de la CEPAL series, No. 66 (LC/G.2121-P), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), 2001. United Nations publication, Sales No. E.01.II.G.19, p. 136, table VI.8.

a/ The data refer to the national total, except for Argentina (urban areas), Bolivia (departmental capitals and El Alto) and Brazil (six metropolitan areas). b/ Years 1 and 2 refer to the initial and final years of the periods indicated in the first column.

(ii) Young people

Young people are another group that experiences considerable problems in accessing the labour market, and in this case the evidence points to increasing difficulties in the region. A decrease in youth labour force participation rates is a corollary to an increase in the amount of time spent in the educational system, but, at the same time, the percentage of young people who neither work nor study has also risen. "Lower participation rates were found to be most prevalent among young men and were on the rise in most countries... The proportion of young people working on an unregistered basis and without social security coverage increased from 42% in 1990 to 47% in 1998; in fact, only two out of every six were engaged in formal activities, and only one out of every six employed in informal activities was covered by health and pension provisions. The wage gap between young people in formal and informal activities increased from 39% to 44% during that same period" (León, 2001). Thus, in many cases, low skill levels and the associated decline in their

chances of finding jobs discourage young people from seeking productive employment and these youths therefore turn to more risky alternatives in an effort to escape poverty. It is well known that in many cases this situation is one of the causes of juvenile delinquency (ECLAC, 2000).

The overall decline in the labour force participation rate was not enough to prevent unemployment from increasing from 8% in 1990 to 16% in 1999. Those who were affected the most were young people from poor households, who pushed up both the participation rate (as they sought to augment their incomes) and unemployment. The position of young people from better-off households was slightly different, as their participation rate fell (though it continued to be higher than the rate for young people from poor households) while the number of such persons who were unemployed increased. The overall situation was exacerbated by the fact that almost all youth employment was created in the informal sector, which caused the level of social protection to fall. In summary, there is cause for major concern regarding access, rising unemployment and the worsening of working conditions.

From the above, we can observe that the insufficient growth rate of the economy has forced poor and younger people towards an early insertion in the labor market; thus, they are employed in jobs with low quality, affecting also their access to a better education and better jobs in the future (ECLAC, 1999). The insufficient economic dynamism and the lack of social security have affected also with more intensity to more weak sectors of society, who have been forcing to assume a over-representation in the informal sector, with jobs characterised by the insufficient laboral conditions. In the women case, the greater education and the new spirit of participation was hit strongly by the increase for finding a job. In the young people case, the great permanence in the educational system (and the decrease in the labor participation) was done in the same time with the unemployment increased, and the fact more worrisome of all, with the inequity difference between rich and poor householder, that aim towards to consolidation of inequity in Latin America.

III. Financial Markets

The case for the creation and expansion of public financial institutions was solidly based on the mainstream fiscalist-Keynesian approach of the 1950s and 1960s. It is important to note, however, that it was also founded upon more orthodox schools of economic analysis, such as that of Gurley and Shaw (1955). Using a completely orthodox approach to the question of development finance, the latter authors argued that financial underdevelopment meant that savers had no savings instruments available to them and that potential savings were therefore either left idle (via hoarding) or were simply spent on consumption. Financial underdevelopment thus led to lower levels of loanable funds being made available for productive investment and, hence, to lower investment in underdeveloped economies (with underdeveloped financial markets).

In the 1970s, however, this picture changed significantly, as did the way in which the problem of financial underdevelopment and its relationship with development finance were perceived.

From a political standpoint, by then most of the industrial economies of Europe and Japan had fully recovered, and development was a politically important issue only because of the Cold War. On theoretical grounds, following the development of orthodox finance theory, which is strongly based on the efficient-market hypothesis, the role of the State in the financing of productive investment was increasingly disputed. The most prominent works to promote this change in intellectual perspective were the seminal works of Shaw (1973) and McKinnon (1973), the founding fathers of the financial liberalization theory. The starting point for this approach was the idea

that *financial repression* –a mixture of financial policies, including interest-rate ceilings, selective credit and other forms of government intervention in capital markets– is the cause, rather than the consequence, of low levels of private saving and investment finance.⁷

In the 1980s this approach began to predominate in the views expressed by multilateral agencies, which increasingly included financial liberalization as part of their “conditionalities” for refinancing developing economies during the years of the debt crisis. Then, in the 1990s, most of the Latin American governments began to embrace the financial liberalization strategy, which entailed not only some deregulation of domestic markets (domestic financial liberalization) and the opening up of their capital accounts (financial opening), but also some deliberate steps towards downsizing public financial systems and the opening of their domestic financial sectors to foreign actors (particularly foreign banks). Of course, in many cases this simply involved a reduction in the number and role of certain public financial institutions, such as development banks.⁸

(a) Financial reforms and the conventional wisdom

As mentioned earlier, until recently the lack of a solid financial structure that would provide a supportive environment for the development process was mainly attributed to *financial repression*. Briefly stated, the advocates of this hypothesis contended that the lack of financial deepening and credit rationing of the type described above were caused⁹ by excessive controls (repression) on existing financial institutions and that the maintenance of interest rate ceilings created disincentives for saving and for the intermediation of saving, thereby placing supply-side constraints on the potential supply of finance.

Thus, in the 1980s it came to be widely believed that financial liberalization and a significant reduction in inflation would lead to the rapid growth of domestic saving, the development of domestic long-term loanable funds markets (e.g., capital markets, long-term securities markets and bank credit with substantially longer maturities) and wider access to foreign savings. In the 1990s, during the first generation of financial reforms, many development finance institutions in the region were either dismantled or downsized significantly, thus reducing the role of the State. Those that survived did not, in many cases, have the benefit of appropriate policies that would help them modernize their operations or adjust to the new conditions created by financial opening and financial deregulation.

The modernization of the banking system and its harmonization with the provisions of new international agreements have been addressed through a “second-generation” of financial reforms. As discussed in detail in Stallings and Studart (2002), most of these reforms have been aimed at achieving financial stability through improved domestic regulation and supervision. Indeed, although most of the changes in bank regulation and supervision in Latin America have been made in response to events in individual countries or, to some extent, in the region more broadly (especially in the case of the Mexican crisis of 1994-1995), developments at the international level have also played a role. In particular, the Bank for International Settlements and the Basel

⁷ As the argument went, low (or even negative) *real* interest rates led to low levels of private saving. Three consequences of low levels of saving were: (i) a limited supply of private funding for investment, which forced governments to introduce selective credit policies under which development banks were the main instruments; (ii) because of the inherently political nature in which the allocation of public credit was determined, an inefficiency bias tended to arise in the allocation of scarce capital that led to lower long-term growth; and (iii) because of the low interest rates, even the government was unable to finance its own deficit, which led to inflationary deficit financing and thus to inflation.

⁸ See: Acevedo (2000).

⁹ This is an extraordinary reversal of the causality found in the early works of Gurley and Shaw (1955), in which financial underdevelopment was seen as the cause of a poor allocation of existing savings.

Committee on Banking Supervision have been influential in putting these issues onto the agenda and moving towards a convergence of standards for developed and developing countries alike. At present, however, international standards themselves are in a state of flux, and the proposed changes pose new challenges for developing-country institutions.

The 1988 Basel Capital Accord (Basel I) was a milestone in banking regulation. The 8% minimum capital requirement for internationally active banks, which was adopted by over 100 countries (including most in Latin America), clearly improved financial stability. Nonetheless, the criticism began to emerge that the approach was too rigid and simplistic and that it did not correspond to actual levels of risk. Developing countries were especially concerned that the rules might provide incentives for short-term rather than long-term lending, and that increased the procyclical nature of financial intermediation.¹⁰

The revised Accord, or Basel II, is intended to correct the problems that have been identified by introducing more complex procedures for determining risk, including the use of models developed by individual banks. Experts studying the potential impact on developing countries fear, however, that the new approach could have a negative impact on those economies through three channels. First, they believe that the new risk categories are likely to lead to a significant decline in lending to developing countries or to a sharp increase in the cost of such credit. Second, as mentioned above, they view the new system as being inherently procyclical, a feature that would increase the frequency of crises that have an especially negative impact on the developing world. In part because of these criticisms, the implementation of Basel II has been postponed to allow for further study.¹¹ Third many feared that the more restrictive risk-management system introduced by the Accord would increase even further the discrimination against SME (e.g. Griffith-Jones and Ocampo, 2002).

In a parallel initiative, the International Monetary Fund and the World Bank have introduced some 60 standards and codes designed to increase financial stability by providing policy benchmarks. On this basis, Reports on the Observance of Standards and Codes (ROSCs) have been incorporated into the Fund's surveillance of member countries' economies through the Financial Sector Assessment Program. While agreeing that these measures could be helpful, developing-country representatives have expressed concern about the fact that they have no say in determining these standards and that implementing all of them would be an extremely expensive undertaking. At the same time, they fear that if they are unable (or unwilling) to comply, their chances of obtaining finance may be further reduced.¹²

By the end of the millennium, most financial systems in Latin America (or at least those of the largest economies) had implemented a majority of the first-generation reforms (financial liberalization, opening of the capital account and reduction of the role of the State in financial intermediation) and some of the second-generation reforms, particularly those relating to the 1988 Basel Accord recommendations along with the changes proposed in 1995. The question now is how such reforms have affected the stability of the system, its overall performance (in terms of the growth of credit, for instance) and access to the financial system for vulnerable sectors. This question will be discussed in the next two sections.

¹⁰ For an analysis of the procyclical nature of financial systems, see e.g. Borio, C., Furfine C. and Lowe, P (2001) 'Procyclicality of the financial system and financial stability: issues and policy options.' In, BIS Papers No. 1, Marrying the macro- and microprudential dimensions of financial stability. <http://www.bis.org/publ/bispap01.htm>. Many authors (e.g. Griffith-Jones and Spratt, 2002, and Ocampo and Chiappe, 2002) apply the procyclicality argument to criticize the. Ocampo J.A. and Chiappe, M.L. (2001) Counter-Cyclical Prudential and Capital Account Regulation in Developing Countries. Paper prepared for Swedish EGDI.

¹¹ For more details, see Griffith-Jones and Spratt, 2002.

¹² For a discussion of these codes and standards as seen from a developing-country perspective, see *IMF Survey*, 2 April 2001.

(b) The overall result of the reforms

As already discussed above, during the 1970s, most developing economies' financial systems were under the control of the State. In East Asia, the private ownership of financial institutions has been counterbalanced by strict government control over lending rates and the channelling of credit. In most Latin American economies, public institutions (commercial and development banks) have played a crucial role in financing specific –often “targeted”– economic sectors. In the late 1980s and early 1990s, this institutional structure began to be called into question, and reforms were undertaken. These financial reforms were initiated for what were often very different reasons, however. In many East Asian economies, financial reforms were in many cases introduced purely in response to pressure from multilateral agencies and governments, which is why some policy makers in these countries resisted them so strongly.

In Latin America, on the other hand, the reforms were facilitated and strongly supported by domestic economic agents due to a general perception that the institutional structures set up in many of these countries during the 1970s had seriously deteriorated. Indeed, given the macroeconomic uncertainties of the 1980s, when high inflation and highly volatile growth were common features, private financial institutions and markets tended to operate in the very short-term segment of the financial intermediation market. This was also a decade marked by difficulties in maintaining fiscal discipline and by large public debts. The combination of a risk-averse private financial sector and high levels of public indebtedness often forced public financial institutions to play an increasingly important role in refinancing domestic private and public debt, thereby tying their fates to those of national and/or subnational governments. Consequently, by the end of the 1980s many Latin American economies' public financial sectors were experiencing severe solvency problems.

Securities markets, for their part, have never been leading actors in the provision of development financing in most developing economies, except perhaps in some East Asian economies, where markets for corporate bonds have played an important role, particularly in the 1980s. In Latin America, however, the macroeconomic uncertainties referred to earlier have been a significant deterrent to their development, and in those cases where such securities markets have been significant, they have tended to be highly concentrated in few –often publicly owned– companies.

Although the pre-existing investment finance mechanisms (such as development banks) have been downsized (and in some cases, dismantled altogether), there is as yet little indication that private domestic markets will naturally or *spontaneously* fill this gap. Financial opening and integration have not created a sufficient condition for the development of domestic capital markets, and this is especially true in the case of primary markets, which could be a source of capital for business firms. In addition, many sectors –particularly small and medium-sized enterprises, low-cost housing construction, technology-related companies, etc.– continue to lack access to the scant supply of private financing.

In sum, in the early 1990s developing-economy financial systems, and particularly those of Latin America and the Caribbean, continued to suffer from the similar structural problems as those described by Goldsmith (1969) in the 1960s:¹³

- (a) The banking sector remained relatively small, its lending activity was quite limited, its operations were concentrated in short-term activities (including the refinancing of government debt) and it was highly vulnerable to external shocks;

¹³ Evidence to this effect is presented in Beck, Demirgüç-Kunt, Levine and Maksimovic 2000.

- (b) The supply of loanable funds to specific sectors continued to be strictly rationed,¹⁴ which means that, for many sectors, the credit market is *supply-constrained*, and these expenditures thus tend to be highly sensitive to changes in the supply of loanable funds;
- (c) Net interest margins in developing countries' banking sectors were still much higher than they were in developed economies; this points to the existence of very wide *spreads*, which resulted in non-competitive financial costs for domestic corporate sectors and high levels of self-financing (which is a deterrent to economic expansion);
- (d) Securities markets remained small, and the *primary markets* actually shrank in the 1990s (see Dowers, Gomez-Acebo, and Masci. (2000)).

Furthermore, in the late 1980s and early 1990s, Latin American economies opened up their capital accounts and their domestic financial markets to foreign investors. These reforms not only seem to have failed to increase domestic saving, but also appear to have increased the region's dependency on foreign capital for a number of reasons.

One of these factors was that bank credit was still highly cyclical and, in many economies, tended to favour consumption rather than investment in the 1990s. The problem of credit stagnation also became more acute after 1997/19-98 (Barajas and Steiner, 2002).

In addition, many sectors –such as small and medium-sized enterprises, low-cost housing construction, technology-related companies, etc.– continued to lack access to what little private financing was available.

Thus, as indicated by various ECLAC studies (see, for example, Held and Jimenez, 2001; Studart and Stallings, 2002), and in contrast to what the financial repression hypothesis would lead one to expect, in several cases financial liberalization (which in theory would make financial intermediation more flexible and markets more efficient) and the existence of high real returns on financial assets have not led to higher levels of aggregate saving or investment, or even to further financial deepening. In addition, as the project paper on financial markets indicated, even in Chile, where financial development in the 1990s was by far the best success story, access to financing for housing construction and access to credit for SMEs did not improve, and specific policies to deal with credit rationing in these excluded sectors were therefore required. The studies summarized by Dini (2001) also indicate that where access for SMEs has expanded, this has been made possible by the reform of pre-existing public financial institutions.

(c) Sectors facing access difficulties

In a recent report, the Inter-American Development Bank (2001) states that “... the major problem faced by businesses in Latin America and the Caribbean is accessing financial markets. In 18 of the 20 Latin American countries covered by the World Business Environment Survey, access to credit was reported by entrepreneurs as their most serious concern.” There is, in fact, a general consensus that problems of access to financing are one of the main pitfalls for smaller enterprises and for those seeking access to low-income housing (Held, 1999 and 2000; Szalachman, 2000; Alarcón and Stumpo, 2001).

This problem stems mainly from market failures, which arise when the conditions required for perfect competition do not exist and, as a result, resources are improperly distributed. The root of these market imperfections lies in significant problems of scale, which prevent these sectors from

¹⁴ The rationing of financing for low-cost housing, SMEs, low-income consumers and long-term productive investments is particularly marked in most Latin American economies.

gaining access to credit at market prices, and in the existence of information asymmetries, which make it very costly to establish the payment capacity of these agents.

Thus, unless the public sector allocates resources to resolve these distortions, these sectors will be excluded from the credit market. The amount of resources needed to resolve this problem can be expected to vary according to the differing degrees of development of the credit and financial markets in each country, with the more financially advanced economies exhibiting a smaller number of marginalized sectors.

(i) Financing for SMEs

The problem of providing financing for these smaller enterprises has always figured on the political agenda, but its significance has changed over time.¹⁵ During the period of SLI, the State was expected to take an active role and to provide adequate mechanisms for developing the local production base, but after the reforms this essential role was transferred to the market.

The traditional policies concerning credit for smaller enterprises were based on a system of "first-tier" banks and public lending institutions that offered subsidized interest rates, together with a few "second-tier" credit lines for intermediation with the small number of "first-tier" private lending institutions. Moreover, in order to offer an incentive for private-sector participation, guarantee funds were used to share the credit risk of smaller enterprises. Via this mechanism, the public sector took on the risk represented by non-performing loans. These efforts did not, however, succeed in resolving small businesses' access problems. They had no significant overall impact on the situation of such enterprises, while large losses were incurred owing to the difficulties involved in refinancing and collecting on non-performing loans (Held, 1999).

The reforms also brought a shift in the focus of the State in this area towards a more market-led allocation of resources. This policy can be divided into two specific aspects: (i) allocation of (public and private) funds by private institutions, together with a reduction in the role of public institutions; and (ii) market determination of interest rates. An associated argument was that subsidized interest rates were an obstacle to the development of the financial market because they allowed the implementation of less profitable projects.

Subsidized interest rates were discarded, and the focus shifted to reducing transaction costs so that marginalized sectors could have access to market interest rates. This change was motivated by the fact that the market tends to exclude smaller enterprises because of the low rate of return to the private sector on the provision of small-scale finance, which is in large part due to the high transaction (i.e., risk-evaluation, administration and collection) costs.

In larger countries such as Argentina, Brazil and Mexico, the public sector plays an important and wide-ranging role in first-tier financing. In other countries –such as Chile, Colombia and Costa Rica– new roles were assigned to the public and private sectors. Public credit institutions took assume important functions in the second-tier bank, while private credit institutions became the first tier. This helped to reduce the State's level of risk considerably. In this approach, the private sector is responsible for distributing and administering loans and takes on the risk of non-payment, while allowing the public sector to concentrate on bringing smaller enterprises into the financial sector and on trying to reduce credit risk and the high costs of loan disbursement, monitoring and collection. It can also hold competitive auctions for the funds allocated for this purpose in order to avoid giving implicit subsidies to the first-tier banks and credit institutions.

The implementation of economic reforms delayed the progress of credit and financing policies for smaller enterprises to some extent, mainly because of the greater degree of attention

¹⁵ See: Gutiérrez and Zamora (1999) and Zuleta (1999).

devoted to macroeconomic stabilization and adjustment policies. As noted earlier, these new credit and financing policies were focused on providing access to credit at the market interest rate, and many new instruments were devised. Some of them performed very well, but they did not succeed in having a significant impact because a very small proportion of such enterprises actually benefited from them (Held, 1999; Peres and Stumpo, 2002). In other words, "These experiences show the progress made in applying instruments at market interest rates and conditions. They have not, however, resulted in policies that are sufficiently clear at the institutional level, and that could resolve in an integral and coordinated manner the credit restrictions affecting those enterprises" (Held, 1999, p.5).

In relation to access to technology, the paper prepared by Dini (2001) also presents some interesting results regarding SME access to financial markets. This paper analyses the policies applied in support of SMEs in three economies: Chile, Brazil and Mexico. In Chile, (an early reformer) and Mexico, there was a reduction in financial support for SMEs in the 1980s, although in Mexico this was mainly due to the solvency problems¹⁶ whereas in Chile it was purely a result of the convictions of policy-makers. In Brazil, public financial institutions that assist SMEs –the Serviço Brasileiro de Apoio às Micro e Pequenas Empresas (SEBRAE) and the Banco Nacional de Desenvolvimento Econômico e Social (BNDES), for instance– were also involved in significant retrenchment efforts, but again this had more to do with fiscal problems and macroeconomic uncertainty (leading to lower demand for credit) than with any clear strategy for downsizing the role of the State in this field. In contrast to the situation in the 1980s, during the 1990s financial support for SMEs has increased in both Chile and Brazil, but no such rise has been seen in the case of Mexico.

In Chile, the most evident change has not been so much in the State's role in transferring funds, but in how these funds have been allocated, as an increasing portion of these funds have been transferred to private institutions that have been given the responsibility of administering their allocation. Programmes such as PROFOS, FAT, FONDEF and other small-scale projects have played an increasingly important role in supporting Chilean SMEs in their technological restructuring and outward-looking strategies. In the case of Brazil, resources allocated to support SMEs stagnated in the 1980s, but during the 1990s funds transferred by BNDES increased substantially, reaching record levels by the end of the decade. In Mexico, there is compelling evidence of a reduction in financial support for SMEs, while at the same time the allocation of those funds has been reoriented towards more horizontal policies.

Research on financing for SMEs indicate that a great deal of emphasis has been placed on "liberalizing the markets" (that is, freeing up interest rates and the allocation of private credit) while little priority has been assigned to institution-building. This lack of a "positive" approach to the problem is associated with the priority that has been given to the reduction of public expenditures in a context of fiscal adjustment.

Moreover, some of the problems that have typically troubled SMEs seem to be worsened. A higher degree of segmentation has been observed, for example, between large firms and SMEs. This segmentation usually leads to a suboptimal choice of projects, as the available financial resources are allocated to large enterprises while, very often, more viable projects planned by smaller businesses are left without financing. Some of the reasons for this are the following: (i) SMEs generally have very little banking history, so there is little information available for their credit applications; (ii) smaller enterprises usually have fewer assets to put up as collateral; (iii) the smaller amounts of credit that SMEs apply for do not necessarily involve lower transaction costs within the banking system; and (iv) many SMEs are unfamiliar with the procedures for applying for

¹⁶ In Mexico, many of the previously existing development finance institutions (such as NAFIN) faced significant financial difficulties owing to reductions in government funding and higher rates of default.

credit and may even lack the administrative capacity to follow them (Kesselman, 1998). In sum, as may be seen from this brief analysis, the theoretical and historical bases for the financial reforms that were pursued were –if not entirely erroneous– at least clearly flawed and, not surprisingly, their results were disappointing.

(ii) Financing for low-income housing

Public programmes have continued to be the main source of financing for low-income housing, but the allocation of funding through private financial institutions has been on the rise. The increase in allocative efficiency can be evaluated using three criteria: transparency and impartiality, neutrality, and the targeting of those agents that have the least access to private markets. Held's analysis points up clear advances in terms of the first two criteria, but very little progress in respect of the third. This finding is of special concern for the project, since it is precisely this third aspect that matters the most in evaluating access.¹⁷

How to go about providing access to housing for individuals and households with low incomes is a question that has not yet been satisfactorily resolved. The marginalization of this segment of the population is a consequence of the credit and financial market's inability to serve this sector properly. The low income levels of this sector of the population impedes access to credit and, even if access is obtained, the cost of the loan is the greatest risk factor for non-payment, together with the proportionally higher transaction costs for smaller loans. It should be noted that the concept of marginalization that is used here refers to difficulties in gaining access both to housing and to better living conditions. The absolute lack of housing is reflected in the quantitative deficit, while the deterioration in living conditions (i.e., the quality of housing and the supply of basic services) is reflected in the qualitative deficit (Szalachman, 2000).

The public policies implemented in an effort to correct this problem have usually involved supply-side subsidies, with the persons concerned making small, indirect contributions in the form of payroll deductions. These policies have not succeeded in eliminating the accumulated housing deficit, however, which is often the result of high population growth rates and high levels of rural-to-urban migration. The new housing policies established in the framework of the market-economy reforms have included a demand-side subsidy designed to increase the purchasing capacity of persons with lower incomes. Prior savings have been a condition for the award of these subsidies, since they are regarded as evidence of a capacity for home ownership, as well as reducing the amount of credit needed for the purchase.¹⁸

At the same time, the public sector has focused on facilitating access to housing loans on market terms and conditions by subsidizing the transaction costs of private credit institutions that offer such loans. The amounts of the subsidies allocated for this purpose depend to a large extent on the degree of development of the credit and financial market, its capacity to reach marginalized sectors and the availability of long-term funds.

Land policy, which is one of the determinants of the cost of housing, is becoming an increasingly influential factor, yet it is one to which countries have not paid sufficient attention. Steps should be taken to reserve land for use within the context of policies that would allow the increase in value of the land to be shared with targeted households or individuals, as otherwise the price of the land becomes another obstacle to access for this sector of the population. Another factor has to do with the tendency to focus on the provision of housing subsidies for the purchase of new homes, which reduces the quantitative deficit by facilitating the construction and subsequent purchase of new housing units. This type of policy has not, however, addressed the need to

¹⁷ See Grynspan and Meléndez (1999).

¹⁸ For further information, see Pérez and González (1999) and Chiappe de Villa (1999).

encourage housing mobility, and there is a lack of programmes for the improvement and expansion of existing homes. The latter factor, together with the lack of a secondary market for low-cost housing, has led to an increase in the qualitative housing deficit (Held, 2000; Szalachman, 2000).

IV. Technology markets

Market organization and microeconomic behaviour in the area of knowledge generation and dissemination have changed dramatically since the import-substitution SLI period. Many knowledge-generation activities have disappeared, while others that are more in line with the region's emerging production structure are gradually appearing. Public and private R&D labs and departments have either been closed or their agendas, aims and constraints have changed significantly following the privatization of major industries (ECLAC 2002).

(a) Industrialization and technological capabilities

During the Second World War and in the early 1950s, each of the Latin American countries developed its own strong sector of public enterprises responsible for the production of goods and services in fields such as telecommunications, energy or transport and in strategic industries such as iron and steel, aluminium or petrochemicals. These production activities demanded not only new production facilities – which were sometimes purchased on a turn-key basis from international subcontractors– but also a steady flow of new technologies and engineering services that had to be obtained *in situ*. Accordingly, many of them created R&D departments and project design groups whose main purpose was to generate new knowledge and adapt imported technologies to local circumstances. As part of this State-led process, some countries developed sophisticated know-how in vanguard industries, such as nuclear technology in the case of

Argentina and aeronautics in Brazil. These industries were to play an important role in these countries' technological development many years after the start-up of these activities. Three patterns of technological capability generation, which are associated with three different types of firms, can be identified (ECLAC, 2002).

(i) From the very beginning, foreign capital in Latin America has functioned as the engine for growth in knowledge-intensive branches such as motor vehicles, pharmaceutical raw materials, petrochemicals, production equipment and machinery. The presence of these firms has generated significant externalities. Indeed, capital goods and the flow of engineering, managerial and marketing knowledge from foreign enterprises has deeply affected the industrial culture of the region, introducing working habits, labour rules and practices, quality-control standards and forms of subcontracting that, in many cases, were previously unknown in the local environment.

Although transnational corporations did not come to the region with the explicit aim of developing a local technological infrastructure, in practice they often ended up doing so. Given the firm-specific nature of technology as a factor of production and the need to adapt it to the specific circumstances that surround its utilization in any one particular production facility, many of these firms were obliged to create engineering departments, as well as groups capable of providing technical assistance to production engineers, in order to operate in the domestic environment efficiently.

The technological efforts undertaken by such firms were generally aimed at taking product specifications, process technologies and organizational methods that had originally been developed by their parent companies for their home markets and then adapting them to local conditions. In this sense, these firms' technological efforts can be regarded as adaptive. They were not particularly interested in developing know-how that would enhance their export potential, since most of them were geared exclusively towards the local market.

(ii) Large public firms and locally-owned private conglomerates, which normally devoted themselves to the manufacture of consumer and intermediate goods or to the provision of services (energy, telecommunications) displayed a different model of technological behaviour. These firms developed their production and technological capabilities in sectors that were considered strategic for the industrialization policy at the time. The development of technological capabilities was more prominent and included everything from advances in the building and operation of new factories to the establishment of engineering departments and project offices that could design and optimize the use of production facilities. In many cases, these advances were promoted by public institutes, which took charge of many of the necessary tasks. Thus, for example, in the energy and telecommunications sector, State enterprises and research institutes were set up and provided with abundant financial resources.

(iii) In parallel with these larger firms, many SMEs were set up in the region in the immediate post-war years. Tariff protection and subsidized public credit spurred the establishment of thousands of family enterprises producing textiles, garments, footwear, machine tools, equipment for the foodstuffs industry, furniture, agricultural machinery and so forth. Many of these firms managed to grow rapidly during the 1950s and 1960s, *pari passu* with aggregate demand. Even though many of them entered the market on the basis of self-designed and sometimes quasi-artisanal product designs and production facilities, they gradually developed technological and engineering capabilities which allowed them to make significant improvements in plant layout, product design engineering and production organization technologies.

Some of these firms designed and even constructed their own machinery and equipment. It is quite clear that they underwent a highly idiosyncratic, long-term learning process. Unlike the subsidiaries of foreign firms that were examined earlier, in this case product and process technologies were created without any prior support from abroad, apart from the simple copying of

foreign technology and the technical training that many immigrant entrepreneurs brought with them from their home countries.

Perhaps this is the reason why many industries were able to start catching up with the international productivity frontier long before the introduction of recent market-oriented structural reforms. A domestic learning processes and the development of domestic technological capabilities were clearly present during the years of the SLI period, with many domestic firms moving along their long-term learning curve. Nevertheless, only rarely did they develop innovative products and production processes that had repercussions beyond their national borders.

In sum, local SMEs constituted another easily identifiable and circumscribed part of national innovation systems in the SLI period. They developed a technological “culture” based on the adaptation of foreign technology to local needs within a context of imperfect information, inadequate access to world markets for equipment and machinery, and scant competitive pressure in their home markets.

(b) The overall result of the reforms

As a consequence of the reforms, new patterns of production specialization and trade have emerged, with knowledge-intensive industries losing ground in terms of their contribution to GDP while non-tradable activities, natural-resource-processing industries and maquila-type assembly operations (catering mostly to United States markets) have gained ground. The production system of the 1990s engages the active participation of many new foreign firms that have recently entered the economy either through the privatization of public utilities or through takeovers of domestic companies (ECLAC 2000, 2002, Katz 2000b).¹⁹

These firms do very little in terms of domestic knowledge generation. The countries in the region are therefore moving towards a more complex production structure which is closer to international productivity standards, but which is also less intensive in the use of local technical knowledge and engineering services. This process entails a significant degree of structural fragility if countries are to proceed up the value chain and move from simple, low-value-added commodities towards higher-value-added goods and services. As a result, the relative technological gap separating the region from international best practices has become narrower in certain areas of each production structure (e.g., telecommunications services, the Internet, or energy production and distribution), but overall, that gap is still exceedingly wide, even after so many years of trade liberalization and market deregulation efforts (Cimoli and Katz 2001).

At a more micro level, dramatic changes in the sources of technical change and productivity growth have occurred, with a rapidly increasing proportion of technological development coming from external sources at the expense of domestic ones. Some of these sources are examined below.

(1) Latin American and Caribbean countries have never been big spenders on technological development. R&D allocations have rarely surpassed 0.5%-0.7% of GDP, as against 1.5%-2.5% of GDP in many developed countries and in some of the Asian nations. Moreover, State-run firms, technological institutes and laboratories, and universities account for an overwhelming proportion of this sum. Only a small portion comes from private-sector agents such as local subsidiaries of transnational companies, large locally-owned conglomerates and local SMEs.

(2) Productivity growth and competitiveness have increasingly been attained through the introduction of imported machinery and equipment, including new computer-based production

¹⁹ See: Crespi and Katz (2000); Buitelaar, Padilla and Urrutia-Alvarez (2000); Capdevielle, Casalet and Cimoli (2000); Bisang and Malet (2000); and Tigre, Cassiolato, Szapiro and Ferraz (2000).

organization technologies, Material Resource Planning (MRP) and Supply Chain Management (SCM) software, etc. One of the factors in this shift has been trade liberalization, since it has made imported capital goods cheaper, thereby inducing their substitution for domestic capital goods and engineering services. Just as older vintages of machinery and equipment are rendered obsolete by the rapid inflow of new, computer-based machines, so, too, do certain forms of human capital lose relevance in the new production organization environment. Thus, a number of engineering activities that used to be carried out on the shop floor, either to extend the life cycle of old machines or to perform technical activities which have since become embodied in new equipment, are rendered unnecessary, and quite frequently the engineers and technicians involved in those activities can be dropped from the payroll. By the same token, entire R&D and project engineering departments can be eliminated when firms become part of worldwide integrated production systems, since those activities can then be transferred to the system's headquarters.

(3) This has also occurred in the case of public telecommunications, electricity and transport firms which, after privatization, have closed down their local R&D and engineering departments and begin to rely on their central offices for technology and engineering services. These changes in production organization involve the "destruction" of human capital and local technological capabilities and their substitution for capital-embodied new technology, as well as for externally-produced R&D and engineering services. Some of the skills and technological capabilities rendered redundant by the new production organization arrangements can and have been successfully transferred to other areas of the economy (to, for instance, a newly emerging and rapidly expanding software industry) but there are clear differences across nations, regions and industries in the extent to which this kind of redeployment has actually taken place.

(4) Internationally integrated production systems have significantly increased their share of GDP during the course of the past decade throughout Latin America. The local operation has primarily turned into an assembly activity that uses imported parts and components as well as externally-supplied technological and engineering services. This model is likely to lead to an increasingly dualistic production structure. This type of structure is composed, on the one hand, of a small group of technologically modern firms (local subsidiaries of transnational corporations and large domestic conglomerates) and, on the other, a large sector of local SMEs that have significant difficulties in gaining access to the modern technology they need to upgrade their production activities. This pattern reflect the features of what has been called "structural heterogeneity in the production and innovation systems" ECLAC (2000, 2002).

In sum, the reforms have undermined efforts to upgrade local technological capabilities. Moreover, in a world where the production of knowledge enjoys increasing returns to scale and where externalities between firms and other repository institutions involved in the process of technology generation are clearly a factor, the globalization of economic activities is bound to generate a dualistic worldwide pattern of production organization in which R&D and engineering efforts are increasingly carried out by mature industrial countries while developing economies tend to specialize in the production of low-value-added industrial commodities and in-bound assembly industries.

(i) Access for SMEs

Confirming the above, the studies carried out during the present research project indicate that accessibility in knowledge and technology markets is strongly influenced by size differences across firms (Dini 2001, Peres and Stumpo 2000). SMEs have always had difficulties in accessing the new technologies required for successful restructuring, and they have lost ground in relation to large local conglomerates and subsidiaries of transnational corporations. The main outcomes identified by Dini (2001) in relation to access for SMEs have to do with changes in the principles underlying the

policies applied in this area, the institutional setting and the pattern of technological learning that takes place at the firm level.²⁰

Structural reforms have brought about a substantial change in the normative underpinnings of policies on SMEs. In most countries, policy makers generally espouse the principles of State subsidiarity and policy neutrality, place emphasis on industrial demand and take a horizontal view of the instruments that should be employed in order "to level the playing field," but major differences can be seen in how strictly these elements are applied. In addition, changes in policy orientation and in budget allocations for supporting actions have varied across countries. For example, Chile has been especially strict in applying these principles while, at the other extreme, there has been a great deal of flexibility in Brazil, with different policies being used for different sectors and geographical areas. Mexico is to be found in an intermediate point along this spectrum.

The emphasis placed on the role of demand has helped to increase the efficiency of support programmes and to encourage the private sector to participate in the management of economic policies, thereby increasing the relevance of the development actions being subsidized by the State. These new policy features have reduced discrimination, increased the transparency of the system and helped ensure the relevance of the actions taken, but they cannot overcome the effects of the production system's heterogeneity. In practice, these policies cannot be neutral, as there are transaction costs which constitute an entry barrier for access to the associated support programmes. The fact that such costs exist favours the enterprises that can pay them –which are usually those with the most resources and skills– and excludes all the other enterprises that "lack the minimum capacities needed to identify, formulate and manage their requirements" (Dini, page 28). At the same time, even when these problems of access are resolved, there is still the unknown factor of whether these enterprises have the necessary management skills to make efficient use of the resources made available to them.

What is remarkable about these experiences is not so much that the reforms have not reduced public support for SMEs *per se*, but that they have done very little to augment the access of such enterprises to the technology they need to adjust to the new economic environment. In other words, in all of these countries, trade liberalization has left SMEs more exposed to foreign competition, but their access to local engineering services and to foreign capital goods and technology has not been facilitated to any significant degree.

The instability of these policies has also been a constant problem since the implementation of economic reforms. Budgetary constraints have been one factor, since they have resulted in fewer resources being made available for the majority of institutions and programmes that support SMEs. However, instability is usually a reflection of changes in the significance of the policy within the government's agenda; this type of situation has led to a loss of accumulated skills and a lack of confidence in public policies on the part of the entrepreneurial sector.

Many aspects of the initiatives taken at the budgetary and institutional levels have been affected by a marked degree of instability, with components often gaining or losing priority depending on what Administration is in office. This instability has also reduced policy efficiency because it leads to a dispersion of accumulated capacities and to a lack of clarity regarding the incentives for industry and about what can be expected from public action.

Unlike the situation in the 1980s, during the 1990s the amount of financial support available for SMEs increased in both Chile and Brazil; this did not occur in the case of Mexico, however. In Brazil, resource allocations in support of SMEs stagnated in the 1980s, but during the 1990s the funds transferred by BNDES increased substantially, rising to record levels by the end of the

²⁰ See also De María (2001); Fajnzylber (2001); Dini, Corona and Sánchez (2001); Monsalves (2001); and Botelho and Mendonça (2001).

decade. In Mexico, there is significant evidence of a reduction in financial support for SMEs, at the same time that the focus of allocations has shifted towards more horizontal policies.

These policies have also affected the institutional setting. In Mexico, the role of institutions supporting SMEs was reduced, but the reasons, in this case, were slow economic growth and fiscal difficulties that diminished the government's capacity to play a more active role on this front. In addition, many of the existing development finance institutions –such as Nacional Financiera (NAFIN)– were experiencing significant financial difficulties owing to cutbacks in government funding and higher levels of default. In Brazil, public financial institutions that assist SMEs – SEBRAE and BNDES, for instance– were also involved in significant retrenchment efforts, but again this had more to do with fiscal problems and macroeconomic uncertainty (leading to lower demand for credit) than with any clear strategy for downsizing the role of the State in this field. Until the 1990s, Chile was the country that introduced by far the strongest reforms. In this case, the most significant change has not been so much in the State's role in transferring funds, but in how these funds have been allocated, as an increasing percentage of these funds have been transferred to private institutions which have been given the responsibility of administering their allocation. Programmes such as PROFOS, FAT, FONDEF and other small-scale projects have played an increasingly important role in supporting Chilean SMEs in their technological restructuring and outward-looking strategies.

The new economic model has created an environment that is conducive to modernization, as the greater degree of economic openness has facilitated access to new technology through the purchase of new equipment. In addition, "although no exact data are available on the size of the enterprises concerned, this process has also included SMEs, according to the managers that were interviewed" (Dini 2001, page 22).

The modernization of the production base has also, however, brought with it the obsolescence of knowledge. With the arrival of new equipment, existing knowledge and learning mechanisms cease to be useful and have to be adapted to new requirements through innovation of knowledge and the development of new management skills. This situation points up the importance of formal education, which facilitates the dissemination of new knowledge. Very few links have been found, however, between the educational system and the production base, and even R&D efforts have been limited. By the same token, mechanisms for creating linkages and generating complementarities among enterprises have been virtually non-existent, and networks of enterprises and institutions have not been established. On the few occasions that this has occurred, the links have not extended to the field of R&D.

To sum up, the difficulties experienced by SMEs in gaining access to technology can basically be attributed to the existence of market failures, as insufficient information and heterogeneity in terms of the sizes of agents prevent them from gaining access to the technology market on equal terms. Moreover, this problem of access, which is also referred to by Amartya Sen, arises when endowments include the availability of human resources and capital. Inequalities in the distribution of endowments among the agents competing in the technology market leads to a situation where the most efficient solution in this market is for only a few SMEs to have access to technology while the majority are excluded. This is why the institutional structure should identify the various types of agents and technologies with a view to modifying existing endowments, striking a new balance in the market and favouring the access of SMEs to technology.

V. Institutional requirements

The foregoing analysis clearly indicates that the market has been the repository of the institutional setting, which has determined the specific features of the type of capitalism prevailing in the region. Figure 1 outlines the hierarchies established within this Latin American brand of capitalism. As may be seen from this schematic depiction, market led mechanisms coordinate the main factor markets while also distributing access opportunities to the different agents. This hierarchical structure is thus the result of the above mechanisms, which not only account for how the factor markets function, but also predominate over the State's regulatory and active policy-making capabilities.

This pattern accounts for the reduction in the State's ability to influence and regulate the economy. National governments are penalized when they do not adopt the market preferences. The difficulties to adopt counter-cyclical policies, positive right to improve worker conditions and protective actions of learning process are examples for the financial, labour and technology markets, respectively. In this context, we can refer to this Latin American style of capitalism as "State-as-hostage" capitalism.²¹

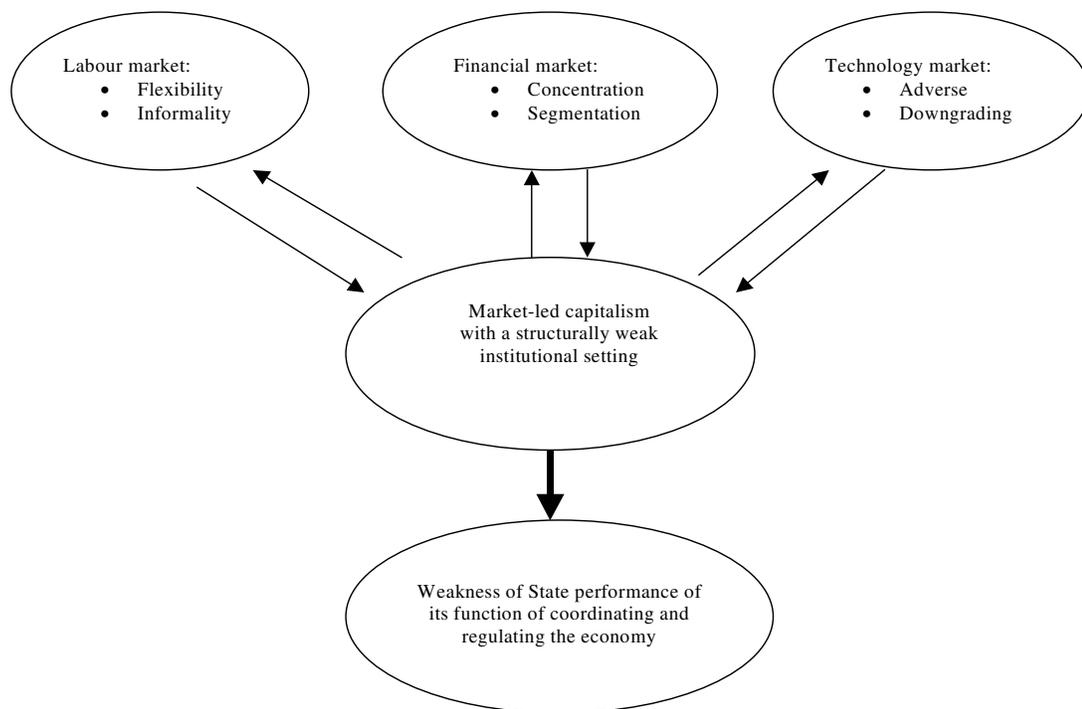
Markets do not operate under perfect competition; they incorporate various types of failures in information, entitlement and learning. As a consequence of these conditions of imperfect competition, established mechanisms tend to generate increasingly

²¹ See also Vanberg (1988 and 1993). On the definition of hostage patterns, see Williamson 1986, Newman 1998.

asymmetrical powers in favour of private agents. In the financial market, the predominance of commercial banks over banking institutions devoted to supporting industrial development (e.g., public development banks) and dependence on international financial markets have reduced the State's policy implementation capacity. In the labour market, because of the existence of poor social security systems and a weak regulatory capacity for enforcing workers' rights, bargaining mechanisms work to the benefit of private firms and allow them to play a preponderant role in determining levels of employment and accessibility. The technology market is no exception to this general rule either, since local capacity for creating and diffusing knowledge is concentrated and determined by the parent companies operating within internationally integrated production systems and by the pattern of international specialization.

Figure 1

COORDINATION AND HIERARCHIES IN LATIN AMERICAN CAPITALISM



The results of the reforms indicate that this form of coordination and hierarchy does not, at least by itself, produce the expected outcome. Unemployment remains high and a large part of society is excluded from employment in formal production activities. The countries' financial markets have lapsed into the same difficulties as those experienced during the 1970s, and their concentration has ushered in marked power asymmetries that reduce the State's capability to take policy action. In technology markets, the conditions described here suggest that the present pattern of production specialization –which is strongly biased in favour of industries producing little domestic value added– and the inhibiting effect on local R&D and engineering activities of the rapid expansion of internationally integrated production systems are pushing Latin American economies into a “trap” from which they may have difficulty escaping solely on the basis of free market principles. Moreover, the interaction of financial and technology markets reinforces the

monopoly power of large firms operating in different sectors of the economy while at the same time undermining the State's ability to play an active role within the political economy of the region.²²

Viewed from this perspective, it becomes clear that access for the weaker agents has not improved and may actually worsen in the near future. This situation can be illustrated by an examination of three different markets. First, in the labour market, although the situation of women has improved in relative terms, their increased access has mainly taken the form of low-quality jobs. Entitlement failures typify this market and women, in particular, are discriminated against in most service activities. Second, in financial markets, the credit rationing faced by SMEs has not been reduced, even though some policies have improved the efficiency and transparency of resource allocation. Moreover, SMEs are subject to strong discrimination in terms of their entitlements and hence in their ability to gain access to financial resources. Third, in technology markets, the reforms have widened the productivity gap between large firms and SMEs. They have also exposed both types of enterprises to stronger international competition, whereas their access to the technology and innovation needed to face the competitive challenges of an open economy is still lagging behind.²³

Some of the institutional approaches that have been taken come into conflict the most visibly with the equilibrium welfare approach and the majority of the policy strategies that have been employed (Langlois 1986, Williamson 1975, Hall and Soskice 2001). As discussed in the first section, the equilibrium welfare approach assumes that the market and property rights alone will guarantee an efficient allocation of resources. Within this framework, the institutional setting is mainly considered in terms of how it may affect the role that the market plays.²⁴

Institutions can also, however, be viewed as an answer to the endogenous inconsistencies of equilibrium welfare. Moreover, the institutional setting is a complementary market component which incorporates the interactive process between the different agents in production, financial and social activities (Langlois 1986). The market economy succeeds not because the interests of some agents, people and firms are suppressed while others are kept out of the market, but because each of them can profit from it. It has become increasingly clear that the European and other industrialized economies have benefited from a participatory economic climate in which people's entry into the market is greatly facilitated by the fact that they had been provided with social opportunities and guaranteed entitlements through such services and mechanisms as schooling, basic health care, basic land reform and micro-credit. These economies have been riding on the success of individuals' entry into the market. This is also demonstrated by the fact that specific legislation in the United States and elsewhere grant certain privileges to minorities in terms of access to the labour market (a specified minimum percentage of minorities in companies' overall staff), to credit and financial markets (e.g., differentiated access to finance for SMEs) and to the education market (e.g., special education grant systems for minorities and so on).²⁵

²² See also Rodrik (2000).

²³ The project financed by GTZ was mainly concerned with determining whether such reforms improved or reduced the access of excluded agents to three factor markets: labour, technology and finance. This project focused, in particular, on institutions and how they have changed following the implementation of these reforms in most Latin American countries. See Held (1999, 2000), León (2000, 2001) and Dini (2001).

²⁴ Using a different approach, the World Bank has also recognized that widespread institutional reform is required in most Latin American countries (World Bank, 1990 and 1993). Moreover, as pointed out by Camdessus, "too much attention is focused on how markets operate rather than on how they develop" (1999: 12). He also adds that "...but no historian has detailed the steps by which for example, the market economy was achieved in terms of government action or changing law; no historian has linked mercantilist with laissez-faire law to trace the chronology of legal and economic change. In this neglect, surely a major element for understanding of the industrial revolution has been overlooked." (Max Hartwell in Douglass C. North, "The Evolution of Efficient Markets In History", Washington University, St. Louis). See also World Bank (1998).

²⁵ Moreover, at a more analytical level, the European liberal tradition also recognizes the need for the integration of market and non-market institutions: "The ordoliberals redefined the tradition of economic liberalism and in so doing helped to resuscitate it. All but universally

Markets and non-market institutions are the two sides of the same coin, and the links between them cannot be understood if the failures endogenously generated by the market are not included in the picture. The theory of institutions is the counterpart of intrinsic market failures which can be attributed mainly to imperfect information, unequal distribution of entitlements, asymmetrical paths in the learning process and coordination between agents and institutions located in different spheres of the economy.

This perspective on the interaction between failures and markets makes it clear that a multi-directional relationship exists between them. These linkages are embedded into the broader institutional framework of the political economy of each country.²⁶ For example, an institutional perspective easily accommodates the idea that markets require "social and institutional constructs" which -depending on their rules and organizing principles- shape microbehaviours and adjustment mechanisms. The patterns of socio-economic systems can, in principle, be micro founded into underlying co-evolutionary processes. This fits in well with the views of many political economists and sociologists who consider the process of change in social norms, institutions and forms of collective organization to be a major ingredient in the development process. In the following section, each of the types of failures mentioned above will be examined.

(a) Market failures

This approach departs from a general equilibrium model, but relaxes the assumption that markets are perfect. Possible sources of market failure are: (i) the existence of monopolies, cartels and market power; (ii) externalities; (iii) collectively produced and/or consumed goods; and (iv) imperfect information. Even though all four types of market failures lead to less than optimal market results, most modern literature on financing constraints focuses on imperfect information (Stiglitz 1994, 1998).

In the modern literature on finance, it is assumed that information is asymmetrically distributed. Information asymmetry –i.e., an unequal sharing of information between the two parties in a transfer (for example, applicants for a transfer may hide certain information which may make them ineligible for that transfer)– can lead to adverse selection or moral hazard. Adverse selection occurs when there is an incorrect identification of intended beneficiaries, while moral hazard represents a situation where information asymmetries caused by the unobservability of actions by beneficiaries allows them to gain more programme benefits than they would under full information.

According to this view, because information asymmetries can potentially lead to adverse selection and moral hazard, credit and equity rationing is a structural feature of market economies. This has two important implications. The first is that if markets do not clear, they may "rest" in a below-optimum state, and policies can indeed help to improve welfare. A second implication is more important in terms of policy conclusions: if information asymmetry is a structural factor in markets, then some markets may never develop. Overcoming market incompleteness raises the problem of how institutions can be created that will "mimic" some of the market results obtained in general equilibrium models.

disparaged in Europe for decades, liberalism resurfaced under their aegis. In place of the nineteenth century laissez faire version of liberalism, however, the ordoliberals articulated a new version in which law was a necessary companion of the market, transforming it from a source of social divisiveness into a tool for social integration. In this new version of liberalism, the market was necessary, but no sufficient. The economy needed to be imbedded in a constitutional-legal framework that would both protect it and help integrate society around it" (Gerber 1994).

²⁶ While it is beyond the scope of this paper to discuss that issue at any satisfactory level of detail, it is nonetheless apparent that multiple links exist which are only beginning to be explored.

(b) Entitlement failures

There is an endogenous inconsistency in the equilibrium welfare approach that leads to asymmetries in access to different markets, goods and services (Sen, 1982 and 1984). At a micro level, discussions regarding the causes of access problems identify them with a lack of assets (land, credit, literacy, education, health, social connections), with low returns on these assets (low wages, low agricultural prices, low output prices) and with volatility in these returns (droughts, market recessions, fluctuations in commodity prices). Problems in relation to a lack and/or loss of assets, inability to obtain new assets, and low and/or volatile returns may be experienced by different agents in the national and international scenes.

Thus, since assets are not distributed freely, levels of access and consumption depend on people's "entitlements", that is, on the bundles of goods and services over which, using their own means, they can establish ownership through production and/or trade (Sen 1984). Exclusion and lack of access are caused by a severe loss of entitlements by one or more groups of agents which deprives them of the opportunity to command and consume goods and services. In general, even in a competitive and perfect market, entitlement failures and their asymmetrical distribution among people and other economic agents affect accessibility. Given that the distribution of entitlements is determined by institutional, cultural and historical factors, efficient equilibrium results can coexist with exclusion.

(c) Learning and knowledge-creation failures

As a consequence of the above, it should be noted that use of the term "technology market" narrows the perceived scope of policy actions, as the technological process is not merely a set of blocks of human resources that can be bought and sold freely on the market. The technological process also involves significant factors that determine the characteristics of this market, such as the generation and dissemination of knowledge. The concept of knowledge is based on specific characteristics that differentiate it from the concept of information. These elements thus have both potentially public and tacit aspects: the first consisting of the available formal knowledge (which may be only potentially available due to the different ways of conceptualizing and therefore codifying knowledge), while the second is derived from the concept developed by Polanyi (1957) and related to "those elements of knowledge, insight, and so on that individuals have which are ill defined, uncodified, unpublished, which they themselves cannot fully express and which differ from person to person, but which may to some significant degree be shared by collaborators and colleagues who have a common experience." Based on these characteristics, it is possible to draw a distinction between technology and information (Dosi, 1988), since "the latter spreads across firms, whereas the former includes 'tacit and specific knowledge that are not and cannot be written down in a blueprint form and cannot, therefore, be entirely diffused either in the form of public or proprietary information' (further discussion of what is known as the "appropriability issue" (Dosi 1988, Cimoli and Dosi 1995).

The institutional dimension is of central importance in the theory of innovation. This approach recognizes a bi-directional relationship between market structures and patterns of technological learning.²⁷ Even at a properly micro level, the momentum associated with single learning trajectories is itself a largely social concept: "it points to the organizations and people committed by various interests to the system, to manufacturing corporations, research and development laboratories, investment banking houses, educational institutions and regulatory bodies" (Misa 1991: p. 15). And, in

²⁷ Indeed, what the review by Mowery and Rosenberg (1979) demonstrates is that the perception of a potential market is a necessary condition for innovation, but not a sufficient one (Dosi, 1984).

turn, these interests and institutions are sustained by the increasing-return and local nature of most learning activities. Even more so, at a system level, the evolutionary interpretation presented here is consistent, and indeed complementary, with institutional approaches building on the observation that markets do not exist or operate apart from the rules and institutions that establish them and that "the institutional structure of the economy creates a distinct pattern of constraints and incentives", which defines the interests of the actors as well as shaping and channelling their behaviours (Zysman 1994: pp. 1-2).

Metcalf (1995) provides a policy-oriented definition of national innovation systems (NISs) that incorporates the above ideas: a "set of distinct institutions which jointly and individually contributes to the development and diffusion of new technologies and which provides the framework within which governments form and implement policies to influence the innovation process". He argues that both the division of labour and the peculiarities of information, which lead to a predominance of coordination by non-market means, fundamentally shape the nature of each NIS. The institutions that compose these systems (private firms, universities and other educational institutions, public research labs, private consultancies, professional societies, industrial research associations) "make complementary contributions but they differ significantly with respect to motivation and to a commitment to dissemination of the knowledge they create".

(d) Coordination synergies

Two or more institutions are complementary if they reinforce the efficiency (or the presence) of each other (Hall and Soskice 2001). The institutional requirements for SMEs are a clear example of such complementarity. Accessibility for SMEs can be viewed as a problem of information asymmetry and scale. Information is an asset whose absence or insufficiency results in a non-optimal capacity to determine what elements are required in order to adopt or adapt new technologies. Differences in scale are a factor because only firms that have reached a threshold scale and have already incorporated a certain amount of knowledge are capable of paying the transaction costs involved in gaining access to State subsidies.

Accessibility can also be regarded as being a problem of entitlements. An asymmetrical distribution of endowments that penalizes SMEs can be viewed as the reason for the difficulties they have in gaining access to the financial market and paying market interest rates. The same can be observed in the case of labour market, where SMEs cannot afford to hire members of the skilled labour force or to pay the cost of training staff.

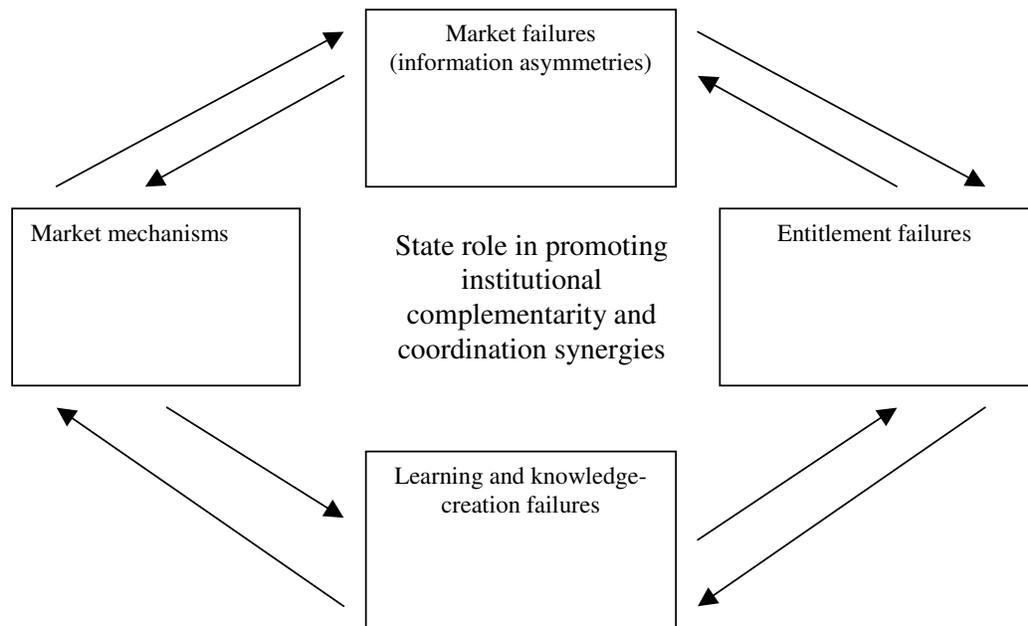
Finally, the weakness of existing linkages with organizations engaged in the promotion of technological change and the diffusion of knowledge can be viewed as a result of failures in the learning process. Institutions that provide access to SMEs, on the one hand, and those that support learning capabilities, on the other, could mutually reinforce their efficiency through coordinated action.

The institutional requirements of the labour market are another example. Employment can be promoted more efficiently if financial institutions and resources are focused on those activities that maintain and increase the demand for labour. Consider, for example, the role that development banks can play in supporting production and innovation. Employment in higher-productivity sectors can rise if people are able to increase their entitlements in such areas as education, services and social security. At the same time, the above interactions can be efficiently coordinated if learning capabilities and the diffusion of knowledge are actively supported.

In cases where coordination is not promoted and diffused across different markets, some models of capitalism can reproduce serious inefficiencies, while models that encourage

coordination can increase the efficiency of the economic system as a whole and reduce the degree of exclusion. The State has an important role to play here (Hall and Soskice 2001).

Figure 2
COORDINATION AND COMPLEMENTARITY



As indicated in the above figure, these three types of failures are an intrinsic part of market behaviours and explain why institutions play a crucial role in improving the functioning of markets and market access. Appropriate policies to mitigate all three of these types of failures are often required in order to improve performance and increase access for vulnerable sectors and agents.

VI. Concluding remarks and policy implications

In this paper we have discussed the wide variety of approaches (and differences of opinion) reflected in the current debate on the question of how a market economy functions and what role policies should play. In the post-reform era, Latin American policy makers appear to be faced with a number of dilemmas that mirror these divergent analytical schools of thought. While a sense of disappointment with the current results of those reforms seems to be almost universal, the question of what path the Latin American countries should now take is still under discussion. In this section, we will attempt to present a policy roadmap based on the institutional requirements for improving coordination and performance which have been identified.

The economic reforms introduced during the 1990s were aimed at enhancing market flexibility and scaling back the State's participation and intervention in the economy. In the labour market, it was assumed that greater flexibility was a necessary and sufficient condition for the achievement of a higher rate of employment and a better distribution of opportunities among agents. In the financial market, the aim of most Latin American policy makers was to eliminate the constraints that prevented supply and demand from being brought into equilibrium. Accordingly, they felt that an unregulated interest rate would guarantee SMEs a greater role in the market. Within this context, a similar policy conclusion has been espoused in relation to the technology market. According to this view, market signals provide the incentives that furnish an accurate indication of the "true" marginal costs and benefits associated with the production and dissemination of knowledge.

In general, the State's role in the economy has in fact been reduced, and greater flexibility has been obtained in most markets. However, many of the targets of these reforms have been not achieved. Evidence of these shortcomings is found in weak growth trends, higher levels of unemployment, the expansion of the informal sector and a deterioration in local technological capabilities. The need to increase the access of weaker agents is an as yet unresolved problem which may, moreover, grow worse in the near future. The picture that emerges is of a Latin American model of capitalism whose hierarchical organization is based on the predominance of market mechanisms, a low State profile and the weakness of non-market institutions. The associated weakness of the non-market institutional structure permits the spread and persistence of various sorts of failures, such as imperfect information, loss of entitlements and an inability to incorporate knowledge locally. Moreover, at the meso and macro levels, failures may be associated with the structural absence of coordination among what could and should be complementary institutions.

At a general level, the State has to put an end to the "hostage" situation that it faces today and assume a more active role in the political economy of the region. Its goals have to be reoriented towards supporting and redesigning institutions and enhancing their complementarity. The analysis presented in this paper clearly illustrates the weaknesses of the policies that have been implemented in an attempt to solve the three types of failures discussed here (see table 5). They require specific type of institutions, norms and rules. In the case of market failure, institutional policy should be oriented to promote access and diffuse information through different type of agents, sectors and regions. In the case of entitlement failures, specific norms should be dedicated to guarantee the opportunity of the weaker agents to access to different goods and services in the labour, financial and technology markets. The same could be said for the learning failures. In this case, state intervention and new incentive has to be put in place to guarantee the well functioning of innovation systems at the sector and regional level.

Table 5
POLICY IMPLICATIONS

Institutional requirements for:	Sources	Weaknesses of Latin American capitalism	Policy actions
Market failures	Imperfect information, predominance of monopolies, asymmetry in market power	Reduction of the State's role in the political economy and increasing presence of monopoly power Penalization of weak agents in different markets: informal workers, unemployed, young people, domestic firms and SMEs	Promotion of access and diffusion of information Normative regulation that mitigate the power asymmetries in favour of the private sector
Entitlement failures	Lack of assets in such areas as education, health, credit, social connections	Loss of financial, educational and knowledge endowments required in order to access labour, financial and technology markets	Policy actions and measures to guarantee access for the weaker agents in the three markets
Learning and knowledge-creation failures	Lack of capability to incorporate and diffuse knowledge	Difficulties of creating domestic knowledge and weak linkages between firms and institutions	Support of national innovation systems
Coordination synergies	Lack of mechanisms for reinforcing complementarity between institutions in different markets	Difficulties of coordinating institutions and policies Increasing difficulties encountered by the State in enlarging its field of action	State action in supporting policy stability and institutional coordination

In the case of the labour market, while both a reduction of entitlement failures and the provision of greater opportunities to increase learning capabilities are important objectives, a

modification of those factors that block attempts to increase the employment elasticity of output has to be considered as a necessary condition. This calls for policies to encourage improvements in the pattern of specialization, a reduction in the heterogeneity of the production structure and the continued development of the domestic market. A reduction in entitlement failures translates into increased opportunities to command and consume educational and other social services. Enhancing complementarity with other financial and technological policies is also an objective, however.

This critical assessment clearly differs from the perspective that guided the reforms, which emphasized the effects of "financial repression" on the availability of savings and on the efficiency of resource allocation.²⁸ The project findings suggest that the steps that will need to be taken in order to resolve the problem of insufficient access to finance go beyond the traditional recommendations of financial liberalization. There appears to be ample scope for policies to enhance the role of private institutions and markets in order to broaden the range of sources of non-inflationary financing for productive investment, especially if the current trend towards the growth of institutional investors is maintained in the future. In order to assess possible options for long-term market-enhancing policies in this case, further analysis will be required of the problems involved in financing productive investment in a developing market economy. In this connection, the potential role of development banks clearly has to be brought back into the debate.

In all the countries covered by the project papers mentioned above, there is compelling evidence that financial liberalization and opening *per se* did not lead to greater access for SMEs, since the private financial sector did not increase financing for this sector. Instead, as mentioned earlier, in cases where access has been expanded, this has been accomplished by reforming and enhancing the role of existing specialized public financial institutions. It is also clear that policy action has been required in order to provide greater access for the poor to house financing. The Chilean case, where the government has been successfully promoting mortgage-based securities markets since the early 1990s, indicates that policies of market enhancement can complement directed credit policies aimed at increasing poor sectors' access to house financing. Even in Chile, however, this market is still limited to middle- and upper-income sectors.

This analysis of institutional trajectories points up a clear need for an innovation system capable of enhancing the density of the cooperation networks linking research centres, bridging institutions, technological institutions and firms. It can be readily observed that isolated projects, such as those typically undertaken in the past, are seldom successful because an innovation system requires systemic support. The need for coordinated promotion instruments is also discernible within institutions that promote industrial development. Such instruments should also be in keeping with regional settings and capable of forming intermediate structures. Hence the importance of providing sufficient economic resources, training and publicity to create institutional networks, since this would allow firms to enhance their problem-solving abilities, as well as endowing research centres with greater leverage. Up to now, the State has played a central role, even during this last stage, in the promotion of production, but other social actors need to become involved (entrepreneurial associations, bridging institutions, research centres and regional technical consultancies) in order to overcome the tendency towards atomization. Efforts to move in the direction of more integrated systems that would provide means of rapidly addressing the technological and organizational problems encountered by business firms are also called for.

²⁸ For an analysis of this conventional view, see Studart (1995-6).

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