

# **“Celso Furtado and the Structuralist-Monetarist Debate on Economic Stabilization in Latin America”**

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The present paper deals the late 1950s and early 1960s debate between “structuralists” and “monetarists” about the interpretation of chronic double-digit but non-accelerating inflation rate in some Latin American countries (as shown in table 1) and the design of proper stabilization policies. This was the main topic of the international conference on “Inflation and Growth in Latin America” held in Rio in 1963 and attended by eighty influent economists. Such conference has been regarded as the climax of a decade of intense debate.

*Table 1. Selected Latin American Countries: Average Annual Rates of Change in the Cost of Living, 1950-1965*

	1950-55	1955-60	1960-65
Argentina	17	38	27
Brazil	18	28	62
Chile	47	24	29

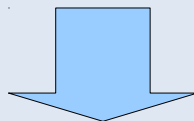
*Source: Thorp (1971, p. 184)*

## ■ **Monetarism Theory**

Monetarism is an economic theory formulated by Milton Friedman which focuses on the macroeconomic effects of the supply of money and central banking. It argues that excessive expansion of the money supply is inherently inflationary, and that monetary authorities should focus only on maintaining price stability.

## ■ **Structuralist Theory**

Structuralism is an approach that emphasizes the importance of taking into account structural features when undertaking economic analysis. The approach originated with the work of the economic development division of the United Nations “Economic Commission for Latin America” (ECLA or CEPAL in Latin American countries) and is associated with Brazilian economist Celso Furtado who was the director of the CEPAL from 1950 to 1957.



**The essay examines Furtado's views about growth, inflation and stabilization in order to illuminate historical issues about the structuralist-monetary controversy.**

# INTRODUCTION TO THE DEBATE (1)

- The analytical foundation behind the International Monetary Fund's (IMF) interpretation of macroeconomic disequilibria in Latin America was the monetary approach to the balance of payments, which argued that inflation is accompanied by an unfavorable balance of payments due to its effect on the price of domestic in relation to foreign goods, particularly in the fixed exchange-rate regime that prevailed at the time.
- According to Furtado, such approach was not applicable to developing countries; external disequilibrium in those economies, in fact, was caused by structural changes that are part of the industrialization process, which were also behind inflation itself.
- In those years Latin American structuralists called “monetarists” the economists who supposedly disregarded the “structural” features of the productive system of the region, and therefore believed that the perverse effects of stabilization on the rate of economic growth are at most temporary.

# INTRODUCTION TO THE DEBATE (2)

- The transition from inflation theory to stabilization policy was problematic and the lack of practical proposals to stabilize the economy in the short-run has been regarded by many as the Achilles' heel of Latin American structuralism; German economist A. O. Hirschman attributed the decline of influence of the structuralism in Latin America to the unwillingness to “forsake doctrinal purity” and the tendency to “condemn as “monetarist futility” the most elementary and obviously needed anti-inflationary measures”.
- Furtado formulated and tried to implement in 1962-63 the first structuralist stabilization plan in a Latin American country for the period 1963-65, called “Three-Year Plan for Economic and Social Development”. His Three-Year Plan is remarkable for its emphasis on the fiscal deficit as an increasingly important inflationary factor in Brazil since the mid 1950s, and its suggested “gradualist” strategy to stabilization, as opposed to the shock treatment. This unlucky Plan represented the culmination of his contributions to the structuralist approach to inflation and stabilization, although its emphasis in downsizing fiscal deficit was sometimes perceived as contradictory with structuralism.

# INTRODUCTION TO THE DEBATE (3)

## **STRUCTURE OF DEMAND AND SUPPLY vs. SUSTAINED EXPANSION OF MONEY SUPPLY**

- The structuralist-monetarist debate was essentially about causes of inflation. Latin American structuralists focused on the relation between economic development and inflation, which they interpreted as the outcome of unbalanced growth accompanied by changes in the composition of demand in economies with inelastic supply functions (these could work as starting factor). "Propagation mechanism" in the system, also known as "wage-price spiral", turn relative price changes into inflation.
- Monetarists, instead, underlined their respective levels, with emphasis on excess aggregate demand caused by a sustained expansion of the money supply associated with fiscal deficits. Anyway, changes in money supply were perceived by structuralists as essentially endogenous to the inflationary process; money itself was a "veil", to be treated as a passive factor. Furtado claimed that structural reforms were necessary to allow compatibility between rationality at the "micro and macro levels".

# INTRODUCTION TO THE DEBATE (4)

## **COSTS OF STABILIZATION**

- Furtado perspective was that inflation was caused by structural factors generators of instability, and inadequacy of fiscal policies. However, any attempt to bring inflation down, for a given economic structure, was bound to bring about a permanent reduction in the rate of economic growth. From this perspective, the debate was on how to interpret the double relation between economic development and inflation: inflation as the consequence of unbalanced growth, and the effects of inflation itself on the economic growth process.

# FROM GROWTH TO INFLATION (1)

## **FURTADO vs. NURKSE ON INFLATION AND BALANCE OF PAYMENTS**

- **Structuralists' Views**

According to Furtado, Brazilian balance of payments pressure was caused by the fact that the demand for capital goods (largely imported) tended to increase more rapidly than income when the rate of economic growth went up. Since the importing capacity did not in average keep up with the growth of imports, the tendency to external disequilibrium became a feature of those economies. It was indispensable to modify the structure of production so as to increase exports or to find substitutes for imports.



# FROM GROWTH TO INFLATION (2)

- **Monetarists' Views**

The starting point of the monetarist approach, on the other hand, was the notion that balance of payments disequilibria can only result from distinct paces of expansion of money supply in different countries; Nurkse, then, argued that balance of payments disequilibrium is necessarily the consequence of inflation caused by excess domestic money supply. The prediction of the monetary approach implied that maintenance of balance of payments equilibrium and an inflation rate equal to the world rate required the supply of domestic credit to be determined by the demand for it. About this, in Furtado opinion any policy of development necessarily acquires the external characteristics of an inflationary policy, and in order to defend stability, measures detrimental to development are often proposed.

# FROM GROWTH TO INFLATION (3)

## **BRAZILIAN MONETARISTS ON “STRUCTURAL VULNERABILITY”**

- According to structuralists, the basic factor behind chronic inflation in underdeveloped countries such as Brazil was that the pace of diversification of aggregate demand was much quicker than that of corresponding changes in the composition of aggregate supply, that is a “particularly inelastic supply function”.
- The same notion could be found in some Brazilian monetarists such as Campos and Bulhões called as “structural vulnerability”. It should be noted, however, that although Brazilian monetarists acknowledged that structural inflexibilities made Latin American economies more “vulnerable” to inflation, they denied that such factors played a causal role in the process.
- Furtado’s structuralist argument, on the other hand, was that the period of time required for aggregate supply to adapt to the modification of the pattern of demand was a primary force responsible for the creation of inflationary pressures, particularly when the capacity to import is inflexible in the short run. Supplementing the market system through planning could, in his view, solve both problems (external disequilibrium and inflation).

# FROM INFLATION TO GROWTH (1)

Furtado called attention to the inverse phenomenon, that is the positive effect of inflation on growth, as illustrated by the performance of the Brazilian economy since the rise of the international prices of coffee in 1949.

Whereas others authors, like Noyola and Sunkel, focused on the case of a slow growing economy, Furtado put forward an interpretation of the inflation-growth nexus in an economy going through a relatively intense process of industrialization.

# FROM INFLATION TO GROWTH (2)

## THE LIMITS OF THE KEYNESIAN FRAMEWORK

- Furtado's interpretation of the relation between agriculture and development reflected the influence of Lewis's article. Lewis's model of surplus labor had made clear the limitations of both neoclassical and Keynesian theories when applied to underdeveloped countries. As underlined by Furtado, Brazilian inflation could not be understood by a simple application of the Keynesian framework.  
The aggregate supply function in the Brazilian economy differed from the typical one in developed countries in two main aspects:
  - ➔ the supply of capital goods was essentially connected to the importing capacity;
  - ➔ labor supply was highly elastic even with full utilization of the capital stock.
- In developed economies, credit expansion and higher investment demand bring about a shift from the consumption goods to the capital goods sector. This argument is not valid for Latin American economies, for some reasons. First, the only important domestic capital goods sector in underdeveloped economies is construction activity, which, apart from labor, does not absorb inputs from other sectors. Therefore, increase in domestic capital formation does not imply contraction in the output of consumer goods.
- Furtado concluded that if Brazilian inflation were of the Keynesian type, it would never have lasted for so long, coexisting with a relatively high rate of growth.

# FROM INFLATION TO GROWTH (3)

## **FORCED SAVING IN THE OPEN ECONOMY**

- Furtado discussed how in an open economy with a fixed exchange rate and import controls, inflation favored one group of entrepreneurs (importers of capital goods) at the expense of another (exporters of primary goods). He asserted that “inflation is a process whereby the economy tries to absorb a surplus of monetary demand. Such absorption takes place through a rise in the price level, and its main consequence is redistribution in real income”.
- Furtado stated that the rapidity with which inflation spreads depends on the way the banking system operates. At this point he introduced the notion of passive money supply into the structuralist approach to inflation. One might expect that monetary authorities could prevent the banking system from expanding credit. However, the banks almost always act in a completely passive manner.

# FROM INFLATION TO GROWTH (4)

## THE CHANGING PATTERN OF THE INFLATION-INDUSTRIALIZATION NEXUS

- The inflationary process was the mechanism by which the industrial sector appropriated a substantial part of the increase in economic productivity caused by the improvement in the terms of trade.
- The notion that the industrialization of Brazil was an unintended consequence of inflation was generalized by Furtado. He distinguished three phases in Brazilian economic growth since the Great Depression, which he associated to three inflationary waves:
  - ➔ the first one corresponded to the start of the industrialization process in the 1930s, when the government policy increased the profitability of domestic industry;
  - ➔ the second inflationary wave, between the late 1940s and mid 1950s, was the joint effect of the improvement in the terms of trade and the exchange rate policy;
  - ➔ the third wave took place when import-substituting industrialization apparently reached its last phase in the second half of the 1950s: the domestic production of imported capital goods and the increase in overhead investment undertaken largely by the public sector.

# STABILIZATION: GRADUALISM VS. SHOCK TREATMENT (1)

## HOW TO STABILIZE?

- IMF sponsored stabilization programs that were based on some central principles:

the achievement of stability through a reduction in the rate of increase of money supply

the unification of exchange rates, devaluation and liberalization of imports.

- Furtado criticized the generality of the assumption made by the International Monetary Fund. He accepted that postulate applied to developed economies, where growth is accompanied by a small inflation rate. According to Furtado, by attempting to generalize those rules, IMF economists made a mistake with “serious consequences” for underdeveloped countries. The point was that “stability” means different things in developed and underdeveloped structures:
  - ➔ in the former it means full-employment growth, associated with a high level of investment;
  - ➔ in underdeveloped countries with structural unemployment stability cannot be defined in terms of full-employment of the labor force, it is formulated strictly as a price level issue.
- Hence he stated that “In this way, stability could imply a social cost higher than inflation itself”.

# STABILIZATION: GRADUALISM VS. SHOCK TREATMENT (2)

## **FURTADO'S *THREE-YEAR PLAN***

- Furtado was appointed Brazil's first Minister of Planning, in charge of drafting a stabilization program, after the publication of his book in 1962.
- ➔ Furtado's diagnosis of Brazilian inflation pointed to two primary causes of disequilibrium.
  - ➔ the first factor was then decline in the capacity to import and the required continuous "structural change" in domestic supply;
  - ➔ the second main factor was fiscal deficit financed by expansion of money supply.
- The Three-Year Plan was announced on the 31th of December of 1962.



# STABILIZATION: GRADUALISM VS. SHOCK TREATMENT (3)

- **PURPOSE:** planning a public expenditure which might be sufficient to avoid large unemployment created by the government itself and at the same time so small as to avoid inflationary pressures caused by the public sector itself




**to reduce progressively inflationary pressures**

- **HOW?** It would not be easy to reduce inflationary pressures to more than one half in the first year. This allow to have a fiscal reform and then to be able to reduce the inflationary pressure in the second year and up to the third year.
- The timing of stabilization was Furtado's own answer to the apparent lack of alternatives to the orthodox monetarist strategy associated with the International Monetary Fund. It was Furtado's attempted response to the "challenge of showing that it was possible to bring the economy to relative stability without incurring the recessive purge".

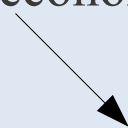
# STABILIZATION: GRADUALISM VS. SHOCK TREATMENT (4)

## THE DEMISE OF THE STABILIZATION PROGRAM

- The *Three-Year Plan* was short lived and did not succeed in bringing down the rate of inflation.
- The reasons for the breakdown of the plan are complex and remain an unsettled issue in Brazilian economic history. Furtado resigned to his position as Minister of Planning in June 1963, among complaints of difficulties to implement the stabilization plan, rising inflation and downfall in economic activity.



According to the CEPAL (Economic Commission for Latin America and the Caribbean) document, a main reason for the failure was the discrepancy between the rate of inflation projected by the stabilization plan and the price expectations of the private sector.



According to Furtado the lack of support from the American government - which had no sympathy for President João Goulart's left-wing government - played a decisive role in the collapse and abandonment of the stabilization program.

# FINAL REMARKS

- In his assessment of the structuralist-monetarist controversy in Latin America, Campos wrote that in the short-run, when entrusted with policy-making responsibilities, all structuralists become monetarists, while, in the long-run, all monetarists are structuralists, since they do not oppose economic reforms that increase the elasticity of supply functions in respect to price changes.
- Anyway, one way to interpret the debate would be that structuralists advocated gradualism instead of the monetarists' shock treatment.
- Regarding Furtado, we found that, as a policy-maker, he was not guilty of the “puritanism” Hirschman ascribed to him. As a theoretician, he showed the relevance of the structural interpretation of inflation to understanding the disequilibrium growth process.