



International
Labour
Office
Geneva

**Employment Sector
Employment Working Paper No. 79**

2011

**Macroeconomy for decent work in
Latin America and the Caribbean***

Ricardo Ffrench-Davis**

**Employment
Sector**

* I am grateful for the substantive comments received at the *Encuentro Crecimiento y Empleo* organized by the ILO on 13 January 2010 and a Workshop with ILO experts in March 2010.

** Professor of Economics, Universidad de Chile. Former Director of Studies at the Central Bank. Chilean National Award in Social Sciences and Humanities, 2005.

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First published 2011

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Ffrench-Davis, Ricardo

Macroeconomy for decent work in Latin America and the Caribbean / International Labour Office = Macroeconomía para el empleo decente en América Latina y el Caribe / Oficina Internacional del Trabajo. - Geneva: ILO, 2011
1 v. (Employment working paper ; No. 79)

ISBN: 978-92-2-024821-8 (print) ; 978-92-2024822-5 (web pdf)
ISSN 1999-2939; 1999-2947 (web pdf)

International Labour Office; Employment Sector

decent work / employment / economic reform / macroeconomics / economic policy / Caribbean / Latin America

13.01.1

Also available in in Spanish: Macroeconomía para el empleo decente en América Latina y el Caribe, ISBN: 978-92-2-024821-8/ISSN1999-2939, Geneva, 2011.

ILO Cataloguing in Publication Data

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Printed in Switzerland

Preface

The primary goal of the ILO is to contribute, with member States, to achieve full and productive employment and decent work for all, including women and young people, a goal embedded in the ILO Declaration 2008 on *Social Justice for a Fair Globalization, and*¹ which has now been widely adopted by the international community.

In order to support member States and the social partners to reach the goal, the ILO pursues a Decent Work Agenda which comprises four interrelated areas: Respect for fundamental worker's rights and international labour standards, employment promotion, social protection and social dialogue. Explanations of this integrated approach and related challenges are contained in a number of key documents: in those explaining and elaborating the concept of decent work², in the Employment Policy Convention, 1964 (No. 122), and in the Global Employment Agenda.

The Global Employment Agenda was developed by the ILO through tripartite consensus of its Governing Body's Employment and Social Policy Committee. Since its adoption in 2003 it has been further articulated and made more operational and today it constitutes the basic framework through which the ILO pursues the objective of placing employment at the centre of economic and social policies.³

The Employment Sector is fully engaged in the implementation of the Global Employment Agenda, and is doing so through a large range of technical support and capacity building activities, advisory services and policy research. As part of its research and publications programme, the Employment Sector promotes knowledge-generation around key policy issues and topics conforming to the core elements of the Global Employment Agenda and the Decent Work Agenda. The Sector's publications consist of books, monographs, working papers, employment reports and policy briefs.⁴

The *Employment Working Papers* series is designed to disseminate the main findings of research initiatives undertaken by the various departments and programmes of the Sector. The working papers are intended to encourage exchange of ideas and to stimulate debate. The views expressed are the responsibility of the author(s) and do not necessarily represent those of the ILO.

José Manuel Salazar-Xirinachs
Executive Director
Employment Sector

¹ See http://www.ilo.org/public/english/bureau/dgo/download/dg_announce_en.pdf.

² See the successive Reports of the Director-General to the International Labour Conference: *Decent work* (1999); *Reducing the decent work deficit: A global challenge* (2001); *Working out of poverty* (2003).

³ See <http://www.ilo.org/gea>. And in particular: *Implementing the Global Employment Agenda: Employment strategies in support of decent work*, "Vision" document, ILO, 2006.

⁴ See <http://www.ilo.org/employment>.

Foreword

What should be the aim and mechanisms of macroeconomic policy if its primary objective is the promotion of decent work? The question, which is addressed in this paper, is both a bold and relevant one to ask of a region that adopted the then macroeconomic policy prescriptions of the international financial institutions, yet reaped advantages that could be described as more monetary than real; that is, the taming of inflation or the return to health of fiscal balances were achievements that failed to translate into job-generating growth.

Among its many helpful policy implications, this paper – written by one of the region’s most prominent macroeconomists – usefully takes a favorable view of the scope for macroeconomic policy reform at the national level. That is, the paper’s argument does not rely on the overhaul of the international financial system, however beneficial this might be, but on policies well within the control of national governments in the region.

In a nutshell, the paper lays the blame for stop-and-go persistent deviations from potential to actual GDP growth at the foot of macroeconomic volatility, itself the result of lax (or no) real exchange rate management particularly in relation to dealing with the (“financierist”) tendencies of international short-term capital flows. The former, in turn, engenders a deviation in economic performance from being primarily geared to productive investment and the real economy – and decent work. The author’s argument becomes one for more hands-on exchange rate management and the judicious use of capital controls, as has been practiced in Chile, but also in Malaysia and China.

The paper is a stimulating inquiry into just what constitutes an appropriate macroeconomic stance if the intended macroeconomic outcome is productive employment.

Duncan Campbell
Director for Policy Planning in Employment
International Labour Organization

Contents

	<i>Page</i>
Preface	iii
Foreword	iv
Introduction.....	1
1. Macroeconomic reforms since the 1990s.....	2
1.1 Successes and failures in terms of stability and growth.....	2
1.2 Precarity of employment and stagnant income	6
2. Globalization of financial volatility as the main source of instability of the real economy	8
3. Why instability is recessive and regressive	9
3.1 Instability and investment for growth and employment	9
3.2 Growth, employment, and exchange instability.....	11
4. Ingredients of a macroeconomy for decent work.....	12
5. Conclusions.....	17
References	19

Introduction

A persistent trait in Latin American societies is precarious employment. Notwithstanding the progress made in terms of poverty reduction since the 1990s, employment still fails to show sustained and vigorous progress towards a predominance of more stable jobs, with social protection, and worker organization and capacity for collective bargaining, in the framework of the ILO Programme for Decent Work.

The countries of Latin America have made profound economic reforms in the context of what was known as the Washington Consensus – among others, intense commercial and financial liberalization, privatization, and introduction of fiscal discipline – under the conviction this would ensure stability, economic growth, and greater wellbeing. As a result, employment and equity were expected to improve ostensibly. The actual fact is that stability was achieved in price levels (in general, inflation is under control) in the course of the two recent decades, but with meagre GDP growth and instability of the real economy –that is, of output and employment. In spite of the significant progress registered in the recent period of social and economic recovery in 2004-2008, precarious employment was an urgent reality even before the region was caught up in the world economic crisis. Naturally, shortcomings were aggravated with contagion of the global economic crisis. This explains the great interest aroused by the topic, which led to agreement on the Global Jobs Pact at the ILO General Conference in June 2009, and the G-20, at the Pittsburgh Summit, bearing in mind this Global Jobs Pact, to make a commitment to place *quality jobs at the centre of recovery*.

A common view, reiterated in assessments of the reforms carried out, is that the region faced the macroeconomic challenge with efficacy, but failed in some of the microeconomic tasks. In this respect, the executors of the Washington Consensus highlight lack of action with regard to *job flexibility*. This paper focuses on the macroeconomic view, that, countering the usual belief that macroeconomic policy has been efficient, a fundamental fault is observed in this respect, in the disappointing evolution of the economy and employment in recent decades. It may be observed that the world of production and employment has undergone intense cyclical ups and downs in economic activity, global demand, access to credit, and the exchange rate. These are key variables in the macroeconomy; that is, the general environment where the producers of goods and services perform. The volatile behaviour of these macroeconomic variables has discouraged capital formation, employment, and productivity of the overall economy. The flows of financial capital have played a key role in this regard.

The macroeconomic context is principally the outcome of the effects and inter-relations among the fiscal, monetary, and exchange rate policies, domestic capital markets, and the foreign capital account. In turn, the macroeconomic context affects the speed and stability of economic growth, which has incidence on the distribution of its fruits, through impact on the labour situation and the vigour of social policies.

The core argumentation in this paper is that it is necessary to transit from the strong short-term financial bias in the approach imposed by the Washington Consensus to an approach explicitly prioritizing the effect of policies on productive development and their impact on equity. It is further stressed that the creation of more and better jobs – that is, decent work- is a determinant for a major reduction of the intense inequalities observed in markets and societies. An explanation follows of why and how macroeconomic policy must pay explicit attention to differentiated effects on large- and small-scale enterprise, investment, and consumption, in addition to skilled and non-skilled workers. Gradualist policies and the degree of coordination among monetary, exchange-rate, financial and fiscal questions, for example, make a substantial difference to economic growth and its

distributive effects, particularly with respect to job level and quality. The contrast between the remarkable intensity of reforms with a neo-Liberal tinge and the mediocre outcomes obtained, confirm the validity of the proposals discussed below.

While appreciating the advance of inflation control and improved fiscal discipline, it is also necessary to move ahead in the creation of a friendlier macroeconomic context for the operation of drivers of economic growth: that is, the various agents that create GDP: enterprises, entrepreneurs, and workers.

Section I summarizes the main achievements and failures of the countries of Latin America as a whole since the early 90s, emphasizing the evolution of output and the labour situation. Section II documents the high instability of the real economy and its association to the intense instability of the aggregate demand and the exchange rate facing the various agents. This harmful instability is shown to have originated, in this period of history, mainly in the globalization of financial volatility, with recurring external shocks in financial capital flows. Section III focuses on examining the recessive and regressive effects of the instability described. How these gaps have a negative effect on the corporate balance-sheet, expectations, and employment is discussed, and the dynamic consequences are examined of frequent recessions on productive investment rates and job sources. Section IV provides a summary of fiscal, monetary, exchange rate, and financial ingredients needed to build a macroeconomy that creates decent work. Section V presents the conclusions of this paper, the key message being the need to apply deep corrections to the macroeconomic environment and the financial reforms to encourage capital formation, reduce structural heterogeneity, and achieve vigorous creation of jobs of increasing quality.

1. Macroeconomic reforms since the 1990s

1.1 Successes and failures in terms of stability and growth⁵

In the decades prior to the reforms of the so-called Washington Consensus, many countries of the region had experienced intense inflationary processes. They frequently sprang from major fiscal imbalances financed via currency issuance by central banks, which led to aggregate demand in excess of productive capacity. Many of these countries had sharp macroeconomic imbalances stemming from flaws in internal management. External shocks were added to this originated by fluctuations in the terms of trade, and which implied frequent ups and downs in the availability of foreign currency.

Aware of the sources of such macroeconomic instability, reforms during the decade of the 90s prioritized the fight against inflation and imposing fiscal discipline. One ingredient of this strategy was the endeavour to isolate monetary management from pressures and direct it to combating inflation as a priority. This meant that central banks frequently tended to operate monetary policy independently of the other areas of macroeconomic policy and focus their action on controlling inflation.

⁵ Ffrench-Davis (2005) examines financial, trade, and macroeconomic reforms and policies implemented in Latin America in the framework of the Washington Consensus and its effects.

Towards the mid-nineties inflation had been successfully overcome, a result associated to substantive improvements in fiscal balances. In fact, in the five-year period before contagion from the Asian crisis in 1998, the fiscal deficit averaged only 1.5 per cent of GDP, a result remarkably superior to the deficit of 3.9 per cent recorded in the eighties. In turn, monetary expansion to finance public deficit had practically ceased. Simultaneously, the volume of exports was rapidly increasing – close to one-third more vigorously than world trade. Performance during the boom which began in mid-2003 is particularly noteworthy. The significant growth of fiscal revenue was reflected in increased spending, but of such magnitude that allowed remarkable improvement in fiscal balances and reduction of public debt as a percentage of GDP. Thanks to this progress, with positive counter-cyclical implications, by the time the world economic crisis struck, several countries in the region had funds available in good time and/or had created space for access to loans. As a result, they were able to enact counter-cyclical policies to mitigate the recessive and regressive impacts of contagion from the financial crisis (ECLAC, 2008 and 2009c).

Evidently, most of the countries of Latin America fulfilled the requirements for macroeconomic equilibrium under the Washington Consensus. Notwithstanding, the outcomes in terms of level and stability of economic growth and social equity have been very meagre, in spite of the significant recovery of activity in 2004-2008; that is, not even considering the drop undergone in 2009. Indeed, as observed in Table 1, annual growth averaged barely 3.2 per cent from 1990-2008; when adjusted by population increase, it is reduced to 1.6 per cent per year. The table also shows the evolution of output by member of the labour force. Given that in these two decades the labour force grew by 2.6 per cent per year, GDP per worker rose by only 0.5 per cent per year.

Table 1. Latin America (19): Growth of GDP, population and labour force (1970-2009), (annual variation rates, year 2000 constant prices)

Latin America	1970-1980	1981-1989	1990-1997	1998-2003	2004-2008	2009	1998-2008	1990-2008
Total GDP	5.8	1.6	3.2	1.5	5.4	-1.8	3.2	3.2
GDP per capita	3.2	-0.5	1.4	0	4	-2	1.8	1.6
GDP per worker	-	-1.4	0.2	-0.9	2.9	-3.3	0.8	0.5
Population	2.4	2.1	1.7	1.5	1.3	1.1	1.4	1.5
Labour Force (ILO)	-	3	3	2.4	2.4	1.6	2.4	2.6
Gainfully employed	-	-	2.7*	1.6	3.3	0.5	2.4	2.5*

Source: ECLAC for GDP and population. ILO for labour force and gainfully employed. The gainfully employed line was constructed using as inputs the rate of employment and labour force reported by ILO.

*For the gainfully employed series, growth rates exclude 1990.

The above very modest economic growth amounting to 1.6 per cent per inhabitant is markedly lower than the 4.1 per cent rate in East Asia. The per capita figure is similar to that of the United States (where income per inhabitant is more than four times that of the region). Such meagre growth means that the gap in GDP per capita between the countries of the region and developed countries remains remarkably high. For example, GDP per

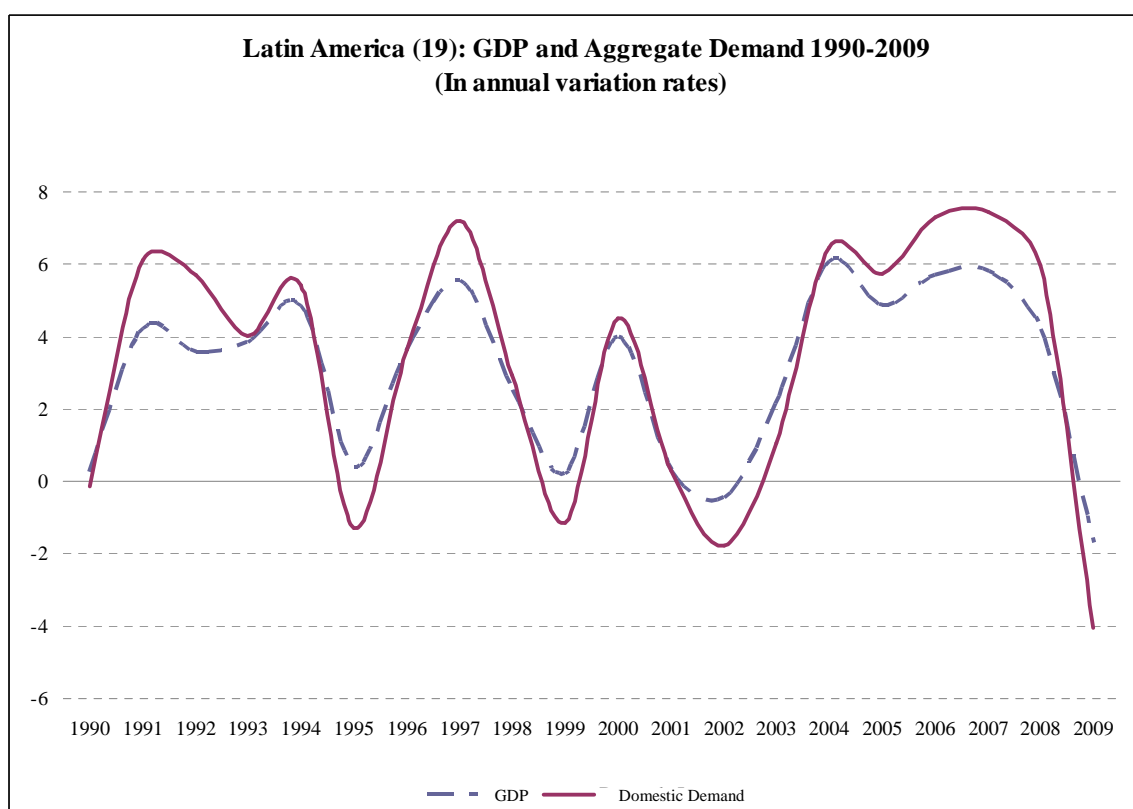
capita in Latin America is currently only 23 per cent of the United States figure.⁶ In turn, the notable social gap persists, for the ratio between the richest and poorest quintiles (Q5/Q1) of Latin America more than doubles that of the US (17 times versus 8 times). Accordingly, the region continues to be highly regressive in the global context (World Bank 2003) and this is determinantly associated to the productive structures. The high structural heterogeneity among enterprises of different sizes and among workers of different skill levels involves inequalities sustained in the ensuing market operation. To grow vigorously, the productivity of lower-income sectors must be improved and with it the employability of medium and poor sectors. One unavoidable challenge is to ensure that economic growth and reduction of inequality, instead of being opposed, should definitely complement one another (Bourguignon and Walton, 2007). This requires making deep corrections to market performance, particularly in the design and implementation of macroeconomic policy and the operation of financial markets.

Indeed, weak growth is closely associated to instability of determinant variables in the real economy; i.e. global demand faced by producers of goods and services (GDP), macro prices (exchange rates and interest rates), and availability and cost of credit. Such variables are essential ingredients of the macroeconomic (im)balances suffered by workers and entrepreneurs. It is evident that the remarkable success in controlling inflation and improving fiscal accountability was not enough, by itself, to provide stability to the context where GDP producers operated (Ffrench-Davis, 2005, Chapters. I and II; Ocampo, 2008).

Chart 1 shows the evolution of aggregate demand, where, indeed, this macroeconomic variable, so influential in the performance of the production of goods and services, therefore of employment, is observed to behave like a kind of roller-coaster. What entrepreneur could feel at ease trying to produce from a roller coaster?

⁶ Figures already adjusted for the different purchasing power in each market (PPP). At current dollars the difference between the average income of countries in the region and the USA is much greater than the difference in PPP.

Chart 1



Source: French-Davis (2005) and updates, based on ECLAC (2009c) data for 19 countries.

It may be observed that fluctuations in demand are rapidly followed by fluctuations in GDP; the foregoing, by definition, involves fluctuations in the rate of utilization of available capital and jobs. If the economy were in macroeconomic equilibrium, potential GDP (GDP*) and actual GDP would be similar. As a result, to give an example, high and persistent rises for several years in domestic demand (as happened during 1990-94, 1996-97, and 2004-07) would have been followed by relatively constant levels of GDP growth and new outbreaks of inflation and/or similar impairment of the external balance. In general, this is not what has happened. Instead, increases in domestic demand have involved notable increases in actual GDP, which is **exclusively** possible when there is a gap between potential GDP and actual GDP. The conclusion, with major implications, is that routinely, since the 80s, the region has been operating significantly below the productive frontier, with substantive ups and downs bringing the region closer or moving it farther away from its potential GDP, but never settling there. This means severe macroeconomic disequilibrium. Operating below potential involves unemployed labour and capital, lower employment quality, a disincentive to productive investment and less fiscal revenues.

Consequently, the antecedents of fluctuating GDP (and of the resulting negative economic and social effects, which are discussed below) show that the macroeconomy focused on the two pillars mentioned, i.e. low inflation and fiscal discipline, led to substantive disequilibrium of the real economy, and was evidently unsatisfactory from the standpoint of development.

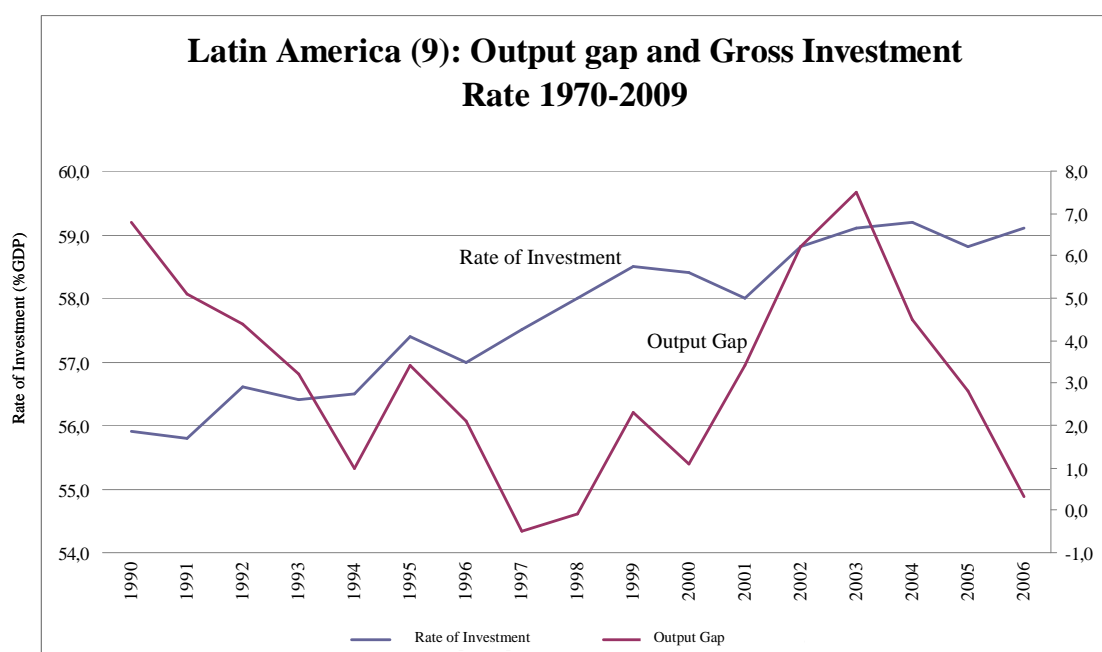
1.2 Precarity of employment and stagnant income

The most determinative variable in these macroeconomic changes, which created recessive gaps between available productive capacity and its utilization, for most of the 1990-2009 period, has been the cyclical variations in capital flows to and from abroad. The resulting instability produces effects with a clearly regressive bias. This has contributed to the scant outcomes obtained in the social dimension by the functioning of markets in the region. The labour situation, especially in economies with modest levels of social expenditure, is the most determinative variable of distribution of income and opportunities.

The labour situation depends on both demand by employers and supply by those seeking employment. It is interesting to point out that whereas the population increased by 1.5 per cent per year, the labour force increased by the above 2.6 per cent in 1990-2008. Accordingly, the dependency ratio improved owing to significant reduction in the number of dependents per employed person, and also of members per household. This is due to a major transition in the age structure of the population and, in addition, the natural increase of the share of women in the labour force. The combination of both factors reveals a demographic bonus or dividend for the family welfare. The counterpart is that with this substantial annual increase of 2.6 per cent of individuals who have or seek employment, pressure on the labour market intensifies (it fell to 2.4 per cent in 2004-2008).

The larger share of women is reflected in the slow but persistent rise in the rate of participation in the labour force, from 56 per cent in 1990 to 60 per cent in the late 2000s (Chart 2). In recessive situations and with increasing unemployment, as occurred in 2009, the rising trend tends to be slower for the region as a whole.

Chart 2



Source: French-Davis (2005) and updates, based on ECLAC data.

Note: Includes Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Mexico, Peru, and Venezuela. The investment ratio measures the ratio between gross fixed-capital formation and actual GDP. The output gap measures the difference between actual and potential GDP, in percentage of the latter.

At present, the real average wage is slightly above the current level before the debt crisis exploded in the early eighties; that is, after three decades, undoubtedly alleviating the situation of households on account of the above improved dependency rate. ECLAC data report that the real average wage in 2007 was only 12 per cent above the depressed level of 1990 (Weller, 2009, pp.16-19). According to Table 1, this involves an annual rise similar to the slight GDP increase per member of the labour force amounting to 0.5 per cent per year in 1990-2008. This is notwithstanding the substantive rise in wage incomes in the period 2003-2008, which compensates the impairments suffered in preceding years.⁷

Table 2. Latin America (19): Labour share, unemployment and wages 1990-2009 (averages for each period, year 2008 constant prices)

Latin America	1990-1997	1998-2003	2004-2008	2009
Share rate (per cent)	60.0	63.3	65.0	65.4
Unemployment rate (per cent)	6.6	9.8	8.8	8.5
Labour force (million persons)	176.6	210.9	240.6	255.1
Gainfully employed (million persons)	164.8	190.2	219.5	233.5
Rate of growth real minimum wages (per cent)	2.1*	0.1	6.0	-

Source: ILO. The share rate is the ratio between the economically active population or labour force and the population over the age of 14.

*For real minimum wages, the rates of growth exclude 1990.

Naturally, wages only reflect what is happening in the formal segment of the labour market. This remark is relevant for labour market precarity in the region drove many workers to informalization during recessions. From 1990 to 2005, the number of the gainfully employed in the informal economy appears to have risen from 57 per cent to 63 per cent in non-agricultural employment (Tokman, 2009, Table 2); precarity includes not only some of the gainfully employed in the informal sector but also the fraction of precarious wage-earners in formal enterprises, according to ECLAC surveys checked by the author. The same ECLAC data, based on household surveys, show that in 12 of the 17 countries covered, the share of *low productivity* jobs increased from 1990 to 2002 (ECLAC, 2007). Consequently, the precarity of the labour world is more serious than as suggested by average wages in formal markets.

The significant recovery of employment and wages between 2003 and 2008 involved a reduction of inequality. In these years unemployment dropped more than 3 percentage points of the labour force (from 11 per cent in 2003 to 7.4 per cent in 2008, for the regional average, and wages showed remarkable recovery) (ECLAC, 2009c). Notwithstanding this partial progress, income distribution persists in highly unequal terms in 2008 (ECLAC, 2009a), before the onset of contagion from the global crisis.

Evidently, poverty, income distribution, and job precarity deteriorated with contagion of the global crisis, when the boom came to an abrupt halt in 2009, with drops in output and investment, and rising unemployment.

⁷ See 1998-2003, in Table 2.

2. Globalization of financial volatility as the main source of instability of the real economy

What is the origin of the fluctuations in aggregate demand that cause instability of output and precarity of employment? It has been shown that for the majority of countries in Latin America and on most occasions, in economic boom periods occurring since the Washington Consensus was imposed, the external balances have deteriorated; that is, the difference between total spending (overall resident demand) and output (GDP) has increased. Activity booms with such external deteriorations, among other expressions of disequilibrium, have recurrently led to crises and recessions. Since fiscal accounts have become more stable and balanced, it may be concluded that instability of aggregate demand and of the external balance concentrates mainly in the private sector, as documented by Marfán (2005).

In general, the significant increases in net spending in the private sector have responded to macroeconomic signals resulting from the combination of shocks to the supply of external financing and permissive pro-cyclical domestic policies (Kaminsky, Reinhart and Vegh, 2004; Ocampo, 2007). It is remarkable that these national policies were often praised by financial markets and credit-rating agencies during the boom, with no warning of the coming disequilibrium. A process similar to those of 1990-1994 and 1996-1997 was repeated in 2004-2008, but this time with a boom headed fundamentally by an improvement in the terms of trade, but subsequently boosted by capital inflows. As noted earlier as a positive, stabilizing trait, a substantial part of the improvement of export prices involved higher collection of public revenues; the foregoing resulted in reduction of public liabilities and, at times, establishment of stabilization funds, with an increasing primary fiscal surplus between 2003 and 2007 (Box 1). The intensity of improvement in the terms of trade meant that in those years the region showed a significant surplus in the current account of the balance of payments, which reversed abruptly in 2008-2009 with the international crisis. Nevertheless, import spending rose quickly while the exchange rates revalued substantially in response to higher domestic spending financed with such portion of the terms of trade as the public sector failed to save and inflows of private financial capital.

The greater diversity observed in the capital account in the recent era of financial globalization makes it essential to distinguish between the behaviour and the effects of its various components. New foreign investment (creator of new or greenfield direct foreign investment or new productive capacity) and long-term loans associated to imports of capital goods, show relative stability in the cycle and are firmly bound to productive investment (gross investment in fixed capital), undoubtedly a positive attribute. In the meantime, financial and stock flows have shown much procyclical volatility and, because of their very capacity to fluctuate, have been little allocated to financing gross investment in fixed capital (Uthoff and Titelman, 1998; Ffrench-Davis, 2005, Chapter. VII). Something similar occurred with revenues from the acquisition of domestic enterprises by foreigners (also accounted for as part of direct foreign investment). Indeed, financial flows to and from the region, instead of stabilizing the macroeconomy have destabilized it. Even the procyclical behaviour of credit-rating agencies aggravated the disequilibrium by stimulating first the over-optimistic, then the over- pessimistic, expectations of the financial agents (Reisen, 2003).

In this way, during boom periods, emerging economies move into *vulnerability zones*, experiencing deviations of macro variables in respect of their sustainable levels (external liabilities and liquid components, currency mismatches, current account deficits, real exchange rate, stock indices, real estate prices, and others). This highlights the imperative

need to apply effective counter-cyclical regulations to ensure that capital flows strengthen productive investment and are consistent with a sustainable macroeconomic environment. The composition, level, and *deviations from the trend* of flow volume are crucial variables. Explanation of the importance of counter-cyclical regulation for equity and employment hinges on the diverse capacity for action and reaction of typical agents in various markets, as discussed below.

Capital flows have also been a source of instability of the real exchange rate (RER), which is one of the most influential variables in the decisions of economic agents on output and consumption. It is a grave contradiction to aspire to an efficient market economy in a developing economy, and overlook macroeconomic prices as strategic as the RER. Experience in the region is that RER behaviour has been extremely pro-cyclical. Its evolution has been closely correlated to capital flows, which, it should be reiterated, are remarkably cyclical. The pro-cyclical behaviour of flows is transmitted to the RER, in the sense that a surge in inflow of financial capital has often led to major exchange revaluations, which have turned out to be destabilizing for the current account (usually by over-running it) and vice-versa in periods of crisis. The foregoing introduces severe inefficiency of the effects of RER in allocation of resources, quality of exports, and the production of small- and medium-scale enterprises for the domestic market.

In sum, the fluctuations and composition of aggregate demand, as well as the exchange rate have been excessively determined by the capital account. Transmission to domestic economies of its pro-cyclical tendency has proved detrimental for productive development and equity. In responsible economies, as the Latin American countries have proved to be, a totally open capital account, rather than impose macroeconomic discipline, has been a source or reiterated macroeconomic disequilibrium widespread throughout the region.

3. Why instability is recessive and regressive

Instability involves static and dynamic effects. Static, such as the utilization rate of the productive capacity available for work and capital; the ups and downs of this rate have recurrently produced substantive gaps between installed capacity or potential GDP and effectively created GDP. These gaps, and the volatility of variables such as the real exchange rate, have implied deep dynamic effects on the rate of investment and its incidence on the trend of future development, on the intensity of added value created in exports, and its inter-relation with the rest of domestic output, as well as with respect to the development of small and medium size enterprise, and the formality or precarity of the labour market. This is the focus of analysis on the impact of the investment rate (productive capital stock additions, conducted by national and foreign players on national territory, as a proportion of GDP). Capital formation creates new jobs when realized, and also provides permanent work by virtue of the greater production of the goods and services which it sustains.

3.1 Instability and investment for growth and employment

The degree of dynamism of GDP and of employment depends on a series of factors, among which the rate of investment is highly determinative. Expenditure in equipment and machinery, residential and commercial building construction, and infrastructure – constituting investment in fixed assets- has been remarkably low during recent decades (Table 3), low in respect of the rate of investment observed in other successful emerging

economies as well as in respect of the region's achievements in the 70s. Indeed, in most years while the Washington Consensus was in effect, the rate of investment was closer to the low level reached in the last decade of the eighties rather than the rate of the seventies (when Latin America averaged 5.9 per cent GDP growth). In 1990-2009, the rate of fixed capital formation averaged 18.4 per cent compared to 23.7 per cent in the seventies. Capital stock per member of the labour force is closely associated to the level of GDP per inhabitant, average wages, and probably their distribution.

Table 3. Latin America (19): Gross fixed capital formation 1971-2009 (annual averages, in percentage of GDP)

	1971-1980	1983-1990	1992-1998	2000-2003	2005-2009
GFCF	23.7	17.7	18.5	17.4	20.4
GDP average growth	5.9	2.1	3.9	1.5	3.7

Source: ECLAC data. Figures for 2009 are preliminary (ECLAC, 2009c).

The low investment rate is linked to the instability of domestic demand. In a stop-and-go context, unstable global demand inevitably means **average net use lower than productive capacity and lower effective output** in comparison to a situation of stable proximity to the productivity frontier. Of course, the greater the instability, the greater the recessive gap in output and a deteriorated labour market, with more informality (Weller, 2009).

The link between instability of real macroeconomy and inequality rests on the extensive structural heterogeneity that characterizes developing economies. This includes the diverse capacity for action and reaction of typical agents in different markets (such as large- and small-scale businessmen, highly skilled and unskilled workers, productive investors or GDP creators, and financial investors or purchasers of existing assets, productive investors, and consumers), in addition to the asymmetries among their responses to instability of economic activity and macro-prices. For example, in the various periods of booming financial flows, a substantial part of the latter was consumed, for consumption responds more rapidly than productive investment. Then, after the boom the liabilities are left unmatched by the ability to pay.

Consequently, the regressive impact in terms of labour is associated to whichever sectors are usually most affected by cyclical adjustments. It is important to break down between output addressed to foreign markets (exports) and the balance of the GDP, that is, what remains in domestic markets. In 1990-1997 and 1998-2003, the bulk of adjustment in GDP growth (mean annual fall by 1.9 percentage points in the growth rate of the economy in the region) focused on production for the domestic market. Close to 95 per cent of the drop in GDP evolution between the two periods under comparison was concentrated in the domestic economy (Ffrench-Davis, 2005, Chapter. IV). As the latter depends on the local macroeconomy and exports depend more on the world macroeconomy, the records show that the real instability took place more intensively in the domestic markets. This fact is directly related to the quality of macroeconomic policy. Given that management of the latter has been highly pro-cyclical, it has multiplied the transmission of external commercial and financial shocks instead of moderating it.

In short, real instability is asymmetric and inevitably implies underutilization of potential productivity; on average, lower effective output and less employment. Indeed, higher rates of capital utilization tend to mean that the average level of employment is higher and the labour force is combined with a larger stock of capital assets in use. The ensuing

productivity increase observed means that the welfare of workers and investors (wages and capital profits) might improve by virtue of the higher average index of capacity utilization. This occurred in significant terms during the reactivation of 2004-2008 and deteriorated in 2009.

With regard to dynamic effects, the higher utilization indices and associated increase in average effective output will tend to stimulate investment in new capacity. The dynamic effect will be much more significant if strong expectations are created among economic players to the effect that public policy will maintain effective demand close to the productivity frontier and if, in addition, the authorities undertake reforms to complete long-term capital markets, and improve labour training and productive innovation. When economic reactivation has been more prolonged, in increasing escalation, the rate of investment is observed to reach higher levels. The reason is that as the economy moves closer to full capacity, effective output rises, corporate profits and liquidity increase, and expectations improve. Unfortunately, after the seventies the region has been unable to sustain prolonged output processes close to potential GDP. Most usually, high rates of GDP underutilization have prevailed.

Empirical studies confirm the close link between the output gap or recessive gap (between potential GDP and actual GDP) and the rate of investment in fixed assets in Latin America (Ffrench-Davis, Chapter. II). This is a reflection of one of the main dynamic and negative effects of underutilization of productive factors, resulting from the instability created by volatile capital flows and procyclical macroeconomic policies (Ffrench-Davis, 2005, charts II.1 and II.2). Experience in the region, in contrast to that of Asian countries, has been highly negative, for the low rate of capital formation has involved scant innovation and precarious employment. Conversely, in several Asian countries, the rates of investment have been strikingly higher than in the countries of the region. For example, the Republic of Korea invested approximately one-third of its GDP (with 7 per cent to 8 per cent GDP growth and creation of full employment) contrasting with the rate of investment amounting to less than one-fifth of GDP in the region. The meagre performance of Latin America is associated, beyond the insufficiency of indispensable productive development policies, to the above macroeconomic flaws and to the (*financier-ist* instead of *productive-ist*) nature of reforms to the capital markets that followed the Washington Consensus.

3.2 Growth, employment, and exchange instability

Real exchange rates in the region have been most unstable, showing strong cyclical fluctuation, frequently associated to financial capital flows. This has proved detrimental for the evolution of exports, diversification of their make-up, and degree of integration of national economies (Agosin, 2007). Rates as fluctuating as these certainly do not reflect similarly variable levels of *sustainable equilibrium*. *Sustainable* levels of *equilibrium* respond to the evolution of relative productivities among the countries of Latin America and their trade partners. *Structural* variables do not usually experience abrupt but gradual changes over time. Hence, in general, the highly cyclical evolution of RER in many countries has reflected misaligned rates, disoriented by changing or volatile capital flows. Such flows have distorted decisions on productive investment, promote speculative investment over and above productive investment, artificially displace importable tradables (many produced by small- and medium-scale enterprises), and discourage adding value to traditional exports, with negative effects on employment and employment quality.

This flaw in exchange policy – because it is a flaw, and a serious one- is a heavy burden for a development strategy led by exports, especially for non-traditional exports and those

with higher value added. Management of exchange policy is an essential component of the array of variables required for this achievement (Rodrik, 2008; Williamson, 2000; Agosin, 2007; Frenkel and Repetti, 2009).

In addition, with exchange appreciation, not only the level and quality of exports have suffered. Indeed, appreciation imprints a markedly pro-cyclical effect on the external sector, with depressive repercussions on the productive sectors that compete with imports, many of them composed of smaller-scale enterprises. Waiving regulation of the exchange rate – which is what it means to let it float free of intervention by the economic authorities- is profoundly contradictory to an export-led development strategy, as well as to a strategy aiming to create more competitiveness in the economy as a whole (systemic competitiveness).

4. Ingredients of a macroeconomy for decent work

Domestic macroeconomic policies face the challenge of achieving an environment of reduced real volatility, sustainable external and fiscal accounts, and price level stability. The challenge is a complex one. A deficient level of integral stability, with its regressive impact on employment, has been closely linked to capital flows and their volatility.

Volatile and pro-cyclical flows are part of the external savings required to supplement domestic savings, in order to finance a substantive increase of the investment rate and access to innovations. Therefore, an *all or nothing* option has no validity. Consequently, one fundamental aim of macroeconomic policies, and of reforms to the domestic financial market, ought to consist in making the most of the *potential* benefits of external savings to develop domestic output, while at the same time mitigating the intensity of capital account cycles and their unfavourable effect on domestic economic and social variables.

A consistent set of counter-cyclical policies – fiscal, monetary, exchange rate, of the domestic financial market, and capital account- is essential, accompanied by efforts to *complete* capital markets by establishing vigorous, inclusive segments for long-term financing of active development banking.

In economies highly vulnerable to external shocks, relying on only one particular policy instrument during adjustment processes (e.g. monetary policy only) could lead to squalid macroeconomic outcomes, in comparison to a more balanced framework of fiscal, exchange rate, and counter-cyclical monetary policies, in addition to prudential regulation of capital flows. Distributing the adjustment among these various policies usually involves better macroeconomic outcomes, in terms of macro-prices aligned with their sustainable levels and an effective GDP closer to its potential level.

The international financial crisis revealed the key importance of fiscal policy as a tool for macroeconomic stabilization (Krugman, 2009; Griffith-Jones, Ocampo and Stiglitz, 2009). As part of the package of counter-cyclical policies, the concept of structural fiscal balance is an outstanding component. It's essential trait is measuring the budget over the economic cycle, estimating which would be the revenue and public spending consistent with full employment of productive capacity, in a sustained fashion. Several countries of the region have made headway in budget programming beyond narrow annual margins. Box 1 summarizes the experience of Chile, involving the accumulation of funds in fiscal revenue boom periods and disbursing them to mitigate the recessive effects of contagion of the world crisis in 2008-2009.

Box 1

Structural fiscal balance policy in Chile

Fiscal policy can address macroeconomic instability in two ways. On the one hand, ensuring a public spending track consistent with sustained compliance with Government permanent development aims (including social policies and public investment). On the other hand, fiscal policy also plays a macroeconomic role, in terms of regulating aggregate demand and contributing to the attainment of *correct* macro-prices, such as the real exchange rate.

As part of the package of counter-cyclical policies, the concept of structural fiscal balance is an outstanding trait. There are several varieties of structural fiscal balance; however, the essential feature of the Chilean rule is budget measurement throughout the economic cycle, estimating public revenue consistent with full employment of productive capacity, in sustained fashion. If, in addition, fluctuations of the terms of trade are important to fiscal accounts, structural public revenues should also be corrected based on a trend estimate. With a given level of tax burden, these two medium-term trends guide the evolution of public spending. Thus, structural fiscal spending is not bound to follow the cyclical ups and downs of revenue, thereby achieving stability in the execution of public spending.

In practice, this approach has meant sustaining a level of fiscal spending that is cycle-neutral. This implies significant improvement by comparison with the classical pro-cyclical behaviour of fiscal policy, characteristic of many countries in the region and usual IMF recommendations in the past. However, constant structural balance is insufficient from the counter-cyclical point of view. In persistent recessive situations, governments may consider carrying out expansive, temporary shocks, of higher expenditure or lower taxation, thereby incurring in current deficits, even also contemporary structural deficits, so as to stimulate domestic demand and employment as long as the recessive situation persists. Naturally, the opposite is required in boom periods. That is why, in the current global crisis, Chile has carried out an intense reactivation agenda, financed from part of the resources accumulated in previous years of high terms of trade.

Source: R. Ffrench-Davis, "The structural fiscal balance policy in Chile: Toward a counter-cyclical macroeconomics", in *Journal of Globalization and Development*, No 1, January 2010 (Berkeley Electronic Press-Journals).

Part of an approach of this nature is the formation of stabilization funds with fiscal revenue coming from exports whose prices are typically unstable (see Box 2). These funds can contribute to stabilizing normal fiscal spending, add funding for critical situations like the present, and stabilize the exchange market, regulating the supply of foreign currency. To achieve this, close coordination is essential between fiscal and exchange rate authorities, usually residing in different departments. Insufficient coordination could hinder reconciling the macroeconomic environment and achievement of sustained development, creating imbalance among various aims such as e.g. regarding inflation, employment, export quality, and growth (Martner and Tromben, 2005).

Box 2

Stabilization funds in the region

A significant percentage of fiscal revenue in several countries of the region comes from revenue associated to export of natural resources, i.e. copper, oil, gas, sugar, coffee, and soy beans. To attenuate the high volatility imposed on public finances by this dependence, some countries have set up stabilization funds.

Such funds, on the one hand, help to prevent all *surplus* resources in times of **BOOMING** export prices from entering the economy via higher fiscal spending and, conversely, to become *savings* that enable such countries to avoid significant reductions in public spending in the event that the prices of natural resources undergo major downturns. To the extent that funds attain significant dimensions, they represent an important reform towards structural fiscal balance. On the other hand, such funds should also serve to stabilize the supply of foreign currency reaching the exchange market. The need to reconcile both stabilization challenges – fiscal and exchange rate- is significant.

Stabilization funds employ rules of accumulation and withdrawal, which are set by means of parameters linked to *long-term reference levels* of the price of the natural resource, or which accumulate or employ resources from such funds depending on the deviation of observed prices *vis-à-vis* prices contemplated in the national budget. It is worth noting that several countries, in the present situation, have applied the resources accumulated in such funds to attenuate the severe contraction of fiscal revenues and as an effective counter-cyclical tool to reactivate domestic aggregate demand and finance special employment programmes. The existence of their own funds has enabled them to take more timely action to mitigate the recessive effects of contagion with world crisis. As shown in Box 1, Chile was an outstanding case due to the magnitude of the funds accumulated in 2004-2007 and disbursed in 2008-2009.

Nevertheless, even though the counter-cyclical role of fiscal policy were improved, it will normally prove to be insufficient. The fact that in the countries of the region fiscal spending has a clearly minority share – about one-fifth – of aggregate demand is critical. Little can an active fiscal policy obtain if the other policies, strongly influencing private spending, depend on volatile flows and the opinions of pro-cyclical financial agents. Therefore it is essential to ensure coordination among the various policies of macroeconomic scope.

Productive investors have undergone great instability of the real macroeconomy, with high recessive gaps, in a highly incomplete financial market and facing high average interest rates in particular in the case of smaller-scale enterprises. This contributed to depress capital formation and undermine employment and equity.

One determinative point of monetary policy is the weighting or relative importance of each variable in central bank performance and coordination with other economic authorities, as mentioned above. Lack of consideration of aims other than combating inflation by central banks has lost the importance it had acquired in contexts of fiscal irresponsibility and high rates of inflation. The mediocre outcome of growth and equity is correlated to imbalance among aims and to flaws in coordination among the various macroeconomic policies, as explained above.

The exchange rate is an essential macroeconomic variable for the sustainability of macroeconomic equilibrium and for allocation of resources. Conventional approaches to the effect that the sole exchange options are a fixed nominal rate or a totally free floating rate, assume that the market will determine, benignly, a sustainably balanced real exchange rate. On the contrary, the problem created by the new free exchange rate regime in many countries of the region was that the rate became extremely sensitive to temporary changes in the supply of external funds, which are intrinsically volatile; thus a profound contradiction, with serious implications, was incurred. Indeed, reforms liberalizing imports ensured a leading role for tradable goods, implying that the exchange rate acquired a determinant role in international competitiveness (Rodrik, 2008; Agosin,

2007). Paradoxically, they adopted a policy resulting in a volatile exchange rate, dominated by short-term financial operators.

Intermediary regimes, with managed exchange rate flexibility – such as different variations of mobile thresholds and/or dirty flotation- represent a serious pragmatic attempt to reconcile these conflicting demands (Williamson, 2000). Neoliberal views tend to state any exchange intervention involves going against *the market*, and that this is always defeated by *that market*. On the contrary, it is about an alternative approach, to achieve the real market forces – export producers and importers, and the producers of importable goods- who are the key players for productive development and equity, should prevail in determining the exchange rate. This is *the market* that must prevail, and not the market of short-term operators and rent seekers instead of innovation creators and greater productivity. To achieve this consistent and selective intervention by the economic authority is fundamental, and of course is not free of flaws.

In sum, a profound correction of the exchange policy is required. This would also contribute to achieving systemic competitiveness; that is, developing productive capacity for external markets and for the domestic market. Most workers and enterprises are in this market. This greater systemic competitiveness contributes to reducing domestic structural heterogeneity, which would create more equal conditions in terms of jobs and business.

Capital markets provoke remarkable repercussions on macroeconomic equilibrium, employment, and capital formation, as explained above. This is associated to two features of the economies in the region. On the one hand, one outstanding feature is the *incompleteness* of capital markets, with weak or non-existent segments. The distributive and resource-allocating incidence, of the flaw in capital market is further aggravated by the considerable structural heterogeneity among various economic agents, to the detriment of SMES, self-employed workers, innovation, and agents with little equity capital. The close links with the more volatile international financial markets in recent decades accentuates the gravity of these deficiencies and contributes to explain the scant productive investment and precarity of labour markets.

As for interest rates, once liberalized, they frequently turn out to be unstable and much higher than international rates, with markedly higher rates for long periods. Systems with high financial costs prevail and, instead of *deep markets* as the neo-Liberal approach expected, they have turned out to be profoundly segmented markets. These markets are excessively focused on the short term, particularly discriminatory regarding smaller-size enterprises and their capacity to create more jobs.

Reform of domestic capital markets under the Washington Consensus led to weakening development banking and the long-term segment. Accordingly, they have not been known for agreeing with the recommendations originated at the Monterrey consensus (United Nations, 2002 and 2007), which pursued raising the level of resources allocated to economic and social development in the region, endowing them with an actually inclusive character, counter-cyclical to the operation of capital markets.

National financial systems were quite imperfect and insufficient; nevertheless, in the seventies they financed a higher rate of investment than under neo-Liberal reforms, and sustained substantially higher GDP growth. To ignore these two facts and the contrast between them is extremely serious.

Consequently, reorganization of the national financial system should aim for channelling resources towards saving and productive investment, creator of sustainable jobs. Institutions are needed comprising a vigorous long-term segment for intermediation of savings in the direction of productive investment financing, under prudential and counter-

cyclical regulations. Such institutions should include the active role of public and private development banking.

In emerging economies such as those of the countries of Latin America, domestic market reform becomes extremely difficult in the face of an indiscriminately open capital account. Effective and efficient counter-cyclical regulation of the capital account emerges as an essential condition for advancing towards a macroeconomy for development, approaching decent work, simultaneously opening space for consistent and counter-cyclical monetary and exchange policies (Ffrench-Davis, 2005).

Extreme financial opening to the foreign sector, as developed since the nineties, involves integration to the more speculative segments of international financial markets. Consequently, the most dynamic segment of the capital market has been of high financial activity with short-term flows to and from abroad, characterized not only by pro-cyclical volatility, but also by weak connection to productive investment.

Counter-cyclical regulation of capital-account inflow and outflow provides space for reorganization of the financial system aimed at channelling funds towards savings and productive investment, directly connected to the productive apparatus, and reducing structural heterogeneity among various productive and social sectors.

Regulation of the more volatile capital-account, if designed along the lines suggested in this article, can operate as a counter-cyclical macroeconomic instrument, acting on the direct source of boom and contraction cycles. They reduce the appreciating exchange pressures and allow contractive monetary policies to be adopted during periods of financial euphoria. It is a most important point that during recessive situations such as the present, prior application of such regulations helps to create space for expansive monetary and fiscal policies.

In general, experiences with restrictions on the inflow of short-term or liquid capital reveal their efficacy for development and employment, making it possible to adopt counter-cyclical macroeconomic policies (Ocampo, 2007; Williamson, 2003). Such regulations aim to create a more sustainable macroeconomic environment during booms and reduce to a minimum the costly recessive adjustments during downslides from positions of imbalance due to overheating.

The successful experience of Chile in the first half of the nineties is striking proof of the efficacy that counter-cyclical regulation of the capital account can attain (Ffrench-Davis, 2008a, Chapter. IX). The amount and composition of capital inflows were regulated, raising the entry cost of short-term capital, whether in loans or stock. A non-remunerated reserve requirement was applied, deposited in the Central Bank, with a proportion of gross flow and a term, both variable, according to the intensity of total fund supply. The reserve, by regulating the composition and amount of income, provided effective space for active counter-cyclical monetary and exchange policies (Magud and Reinhart, 2006), which enabled Chile to maintain aggregate demand consistent with productive capacity and a sustainable rate of exchange. Such equilibriums led to significant increase of the rate of investment and growth of potential GDP, while GDP averaged annual expansion above 7 per cent. In the second half of the nineties, Chile joined the most fashionable policy and allowed the regulating power of reserves to weaken, until the capital account was liberated in 2001 (Ffrench-Davis, 2008a, Chapter. IX; Le Fort and Lehman, 2003). That is how it was caught up in the contagion of the Asian crisis in 1999.

Regulation of the capital account as explained here, aims to attain sustainable equilibrium of the real macroeconomy; that is, the opposite of attempting to perpetuate disequilibriums. In the direction of such equilibriums, the region has recently made

interesting attempts at regulation, especially to avoid excessive exchange rate appreciation. Of these, it is worth mentioning Argentina, Brazil, Colombia, and Peru (ECLAC, 2009c).

In some countries of the region, with pension-fund reforms moving in the direction of private capitalization funds, long-term sources of increasing and highly significant volumes have been set up, based on the result of increasing institutional savings. The neo-Liberal approach has pressed for liberalizing fund management and free movement of funds to and from abroad. Of course, if margins for action are very broad, they can become sources of macroeconomic instability. The significant volume of these funds, which originate in workers' wages, and their character as very long-term savings, grants them a crucial role in a *reform of reforms* that will make them (i) a factor of real macroeconomic stability (Zahler, 2005), and (ii) a key player in gradual restructuring of the capital markets towards productive development. Workers' funds should undoubtedly be aimed at strengthening productive investment and, as a result, creating increasingly decent jobs.

There are many positive experiences in other regions of capital account regulation. Economies such as that of the Republic of Korea maintained strict control of capital during their remarkable economic growth for one-third of a century. Following liberalizations of capital inflows performed in the early nineties, which resulted in the crisis of 1998, maintained control of fund outflows from residents. On the other hand, the most traditional controls, as applied in China and India (e.g., the bans on short-term financial debt, quotas on stock investment, and controls on capital outflows), have proved highly effective in drastically reducing the connection of the domestic economy to the volatility of international markets (Ocampo, 2008). Both countries have most successfully resisted the current crisis and made it possible to materialize the remarkable reactivation programme currently in operation.

In short, the urgent *reform of reforms* of the Washington Consensus should prioritize linking the financial system – of both the domestic financial market and the capital account- to the domestic investment process and the domestic economy rather than to short-term and speculative external financial markets. It is essential to contribute to the stability of domestic demand and of macro-prices, such as the exchange rate, and attempt to deconcentrate economic power, privileging preferential treatment for SMES.

5. Conclusions

The instability of the real macroeconomy is usually asymmetric in terms of distribution, for sectors of higher income and better access to markets make the most of the opportunities arising in boom periods and adjust more speedily to periods of recession, with the resulting growth of the gaps between large enterprises and SMES, between skilled and low-skilled workers, in addition to expansion of informal sectors in recessive situations. Income distribution tends to deteriorate in recessions and improve in recoveries, but with less force in the latter than in the former. In addition, efforts weaken in economic reforms that require continuity and a long-term perspective.

Finally, in the dynamic dimension, the labour market is negatively affected through the recessive effect of instability on investment. Expansion of capital stock is restricted, while the potential labour force, inexorably, continues to rise as time passes. Accordingly, the usual discrimination of less-skilled workers resulting from growing unemployment

and of smaller-sized businesses is intensified. As pointed out earlier, instability tends to increase informality in the business and labour market.

The high costs caused by economic cycles in the countries of Latin America are related to the strong connections set up among domestic financial markets and pro-cyclical segments of international financial markets. In the same way that liberalization took place, a major boom has occurred in financial activity with no increase in national savings, with a very low rate of fixed-capital investment, and intense fluctuation in economic activity and employment; what in this paper is known as *financierism* versus *productivism*. The main cause is a financial market dominated by agents specializing in the short-term rather than in productive investment, who have played a key macroeconomic role. In turn, as they have fluctuated widely, a small proportion has financed productive investment; this deficiency is aggravated by the fact that their volatility has given rise to financial and exchange crises, the recessive effects of which have discouraged capital formation among nationals and employment.

These ideas are put forward at a time when the world appears to have escaped from a depression that many analysts in 2007-2008 feared could have been comparable to the crisis of the 1930's. This was avoided thanks to energetic public action, aimed at correcting the world macroeconomic environment. The correction involved operating against the prevailing paradigm of a passive State and neutral economic policies; fiscal policy in particular was used with counter-cyclical decision. Having avoided collapse, this does not imply the end of recession, but rather the beginning of recovery of economic activity in the world and in the region. It is a major challenge to complete recovery in a way that is sustainable, providing an environment for labour and productive capital stimulating dynamic development.

This article has documented how the type of macroeconomic approach adopted decisively affects the degree of stability, and how this impinges on the path of growth and influences the degree of equity or inequity structured in domestic markets. Sustainability of development requires public policies consistent with social inclusion, enabling countries to join the international economy, increasingly integrated domestically, and not socially disintegrated. How the reform of national capital markets is addressed and the connection with international markets raises a crucial challenge for sustained achievement of a macroeconomy conducive to economic and social development, with decent work as the strategic variable.

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