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Discussion Paper

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on

Werner Baer's and Melissa Birch's EXPANSION OF THE ECONOMIC FRONTIER: PARAGUAYAN GROWTH IN THE 1970s

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In order to understand Paraguay's recent economic performance, let us first briefly explain about Paraguay's economic evolution. Since its independence from Spain, Paraguay's political and economic development is clearly differentiated in two periods. From 1811 to 1870, a unique model of development is established in Paraguay, in comparison to the rest of Latin America. This model consisted of re-structuring a mono-exporting economy through the implementation of an agrarian reform that created the conditions for an incipient process of industrialization at the end of the 1850's. In opposition to neighboring countries, Paraguay's sustained economic growth in that period did not lead to accumulation of external debt. Although foreign technicians were contracted by the State, every project was financed by national capital. This model of near authority is abruptly ended by a five years-war that devastated the country.

From 1870 Onward, Paraguay returned to its former condition of commodity export economy. Foreign enclaves and native latifundia established after the war, and devoted to exploitation of lumber and meat for external markets, did not encourage the creation of internal markets nor industrialization. Despite its characteristic of export-oriented economy, Paraguay remained semi-isolated from the international market because of its geographical position and its complete dependence on Argentina as principal intermediary, supplier and purchaser. From 1870 to 1970, Paraguay's economic performance could be defined in one word: stagnation.

The State's policy of <u>Outward Growth</u> inaugurated in the 1960's, would not attempt to divert the country from its agri-exporting course. It would simply attempt to provide more efficiency to the system opening the internal market, and to give the country full international exposure.

Taking the advice of American developmental agencies, the Paraguayan State set three important economic goals: a) creation of social overhead capital or basic infrastructure; b) agrarian reform, and c) encouragement of foreign investment. Industrialization through important substitution has been a secondary objective, but up to now it has never been seriously considered.

It in this context that we can understand the principal variables that shaped Paraguay's economic boom in the 1970's, and which constitute the core of this paper presented by Professor Baer and Ms. Birch: agriculture and construction. In the case of agriculture, external as well as internal factors contributed to its expansion, namely, favorable prices in the international market for commodities such as cotton and soybean, the closure of the European market for import of beef (a traditional Paraguayan product), the rural colonization inaugurated by the State in 1963, and the encouragement given by the State for foreign investment in agri-business. On the other hand, the construction boom responded almost exclusively to an external factor: the Itaipu binational hydroelectric project built to satisfy the industrial demand of Brazil's center-south regions.

In terms of the expansion of agriculture, this paper points out correctly the factors involved in it. The State's rural colonization program achieved a different effect from that in other Latin American countries that underwent an agrarian reform process during the same period. In Paraguay, population pressure on the Capital City as well as unemployment have been avoided for almost twenty years. This was achieved through distribution of public land in under-populated regions, and hence through a process of rural-rural migration instead of rural-urban migration. It could be added though that massive migration to Argentina helped to ease

the problem posed by a thin labor market. By 1973, 20 percent of Paraguayan population lived in Argentina.

As this paper points out, lack of credit and technology support as well as lack of social infrastructure, did not contribute to transform a peasant economy in the countryside. Nevertheless, the settlement of Paraguayan colonists in those new areas would create the conditions for more efficient forms of production in agriculture, and hence help the settlement of foreign medium farms and capital-intensive agriculture that ultimately halted the expansion of the agriculture frontier. Consequently, agriculture growth in the 70's was mostly concentrated in the production of Brazilian and Japanese farms as well as in modern latifundia. In the case of cotton production, (the most imp) the second most important export commodity over the last years, the peasant economy did relatively well, although in the long run it did not profit from favorable conditions in the international market.

Passing now to examine the other pole of growth during the & 70's, the construction sector, we can say that this "industry" greatly contributed to employ labor at the site of the Itaipu hydroelectric dam as well as in the Capital City. Itaipu alone employed a Paraguayan labor force larger than the one by the small industrial sector in several decades. However, this construction boom resulted in only housing for medium and upper income class, on the one hand. And, on the other hand, capital accumulation from this sector were diverted almost totally to a great number of savings and loans associations and local financial institutions that fluorished in this period. These financial institutions have mainly operated within the tertiary sector of the economy. Thus, the productive sec-

tor of the economy was practically absent of investment coming from Itaipu. This fact is clearly expressed in the paper, as well as the fact that capital inflow from Itaipu maintained an artificial exchange rate which overvalued the national currency. An increasing balance of trade deficit was financed from the capital generated by Itaipu, and substantial reserves were accumulated by the Central Bank.

At this point, I think it is important to examine the real nature of Paraguay's economic growth during the 70's which I believe this paper does not fully address. From my point of view, economic growth in Paraguay, during the 1970's, acquired a cuasi-artifical character. Although an important tant amount of investment within the productive sector clearly differentiates the 1970's economic growth from past decades, major accumulation of capital took place within non-productive sectors of the economy (commerce and finance). This accumulation of capital was channeled mainly through:

a) massive inflow of capital from Itaipu; b) illegal or non-registered traffic; c) operations of foreign banks and local financial institutions.

In terms of inflow of capital from Itaipu, we already stated that besides investment within the construction sector, this capital remained operating only for commercial purposes. At the same time, reserves accumulated by the Central Bank as a result of Itaipu's construction were not used by the public sector to allocate resources within industry or agriculture.

Illegal traffic has been more harmful to Paraguay's economic course over the last 10 years. A World Bank study shows that by 1977 and 1979 alone, illegal traffic constituted 50 percent and 75 percent of total trade respectively. From 1974 to 1979, the accumulated value of illegal trade represented 96% of GDP value in 1978, and 74% in 1979. In

1979 only, illegal trade amounted 38% of the GDP value for that specific year. Contraband represented huge capital losses for the country, and as this paper very well states, it meant less public revenues that could have been diverted in needed social infrastructure and productive investment.

Operation of foreign banks and local financial institutions constitutes the third and not less important factor in explaining this major capital accumulation within non-productive sectors of the economy. By 1970, only a couple of foreign banks were in operation in the country. A decade later, there were 16 of them plus 4 national banks. Foreign commercial banks managed to increase credits to the private sector by about 35% in 1977, and about 40% in 1978. Annual rate of increase of credits to the private sector was 25% in 1979, despite restrictive monetary measures adopted by the Central Bank to halt inflation, and 33% in 1980. Even during years of economic recession and financial crisis like 1981-82, commercial credits from private banks experienced an annual growth of 12% Yet, more than 70 percent of foreign banks operaions has been concentrated in the circulation sector of the economy rather than in the productive sectors: and the amount of lending operations of foreign banks in 1980 equals six years of cumulative foreign investment in productive sectors of the economy (afgriculture and forestry).

The model of development inaugurated in the 70's began however, to stagnate from the second half of 1981. Construction works within Itaipu started to reach the final stage, and these works in Yacyreta (hydroelectric plant to be built in conjunction with Argentina) was not being initiated. Prices of agro-exporting commodities depressed in the international market, and foreign capitals flows declined. In addition,

the government could not avoid a substantial budget deficit after more than ten years of public finance stability, and money supply decreased dramatically. GDP growth fell from 11.4% in 1980 to 8.5% in 1981, and to a dramatic -2.5% in 1982. Finally, this economic deceleration became critical at the moment the national currency depreciated more than 100% within the flexible exchange market.

The solution of the present crisis lies on many alternatives.

Devaluation of the domestic currency to a more real exchange rate is a fundamental imperative for Paraguay's exports. However, continuing reliance on an agro-exporting model as exclusive engine of development casts many doubts on the effectiveness of an economic growth without increasing bottlenecks.