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Commission on Growth and Development

WORKING PAPER NO.51

Growth Challenges for Latin America: What Has Happened, Why, and How to Reform the Reforms

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1 2 3 4 5 12 11 10 09

This working paper is a product of the Commission on Growth and Development, which is sponsored by the following organizations:

Australian Agency for International Development (AusAID)
Dutch Ministry of Foreign Affairs
Swedish International Development Cooperation Agency (SIDA)
U.K. Department of International Development (DFID)
The William and Flora Hewlett Foundation
The World Bank Group

Cover design: Naylor Design

About the Series

The Commission on Growth and Development led by Nobel Laureate Mike Spence was established in April 2006 as a response to two insights. First, poverty cannot be reduced in isolation from economic growth—an observation that has been overlooked in the thinking and strategies of many practitioners. Second, there is growing awareness that knowledge about economic growth is much less definitive than commonly thought. Consequently, the Commission's mandate is to "take stock of the state of theoretical and empirical knowledge on economic growth with a view to drawing implications for policy for the current and next generation of policy makers."

To help explore the state of knowledge, the Commission invited leading academics and policy makers from developing and industrialized countries to explore and discuss economic issues it thought relevant for growth and development, including controversial ideas. Thematic papers assessed knowledge and highlighted ongoing debates in areas such as monetary and fiscal policies, climate change, and equity and growth. Additionally, 25 country case studies were commissioned to explore the dynamics of growth and change in the context of specific countries.

Working papers in this series were presented and reviewed at Commission workshops, which were held in 2007–08 in Washington, D.C., New York City, and New Haven, Connecticut. Each paper benefited from comments by workshop participants, including academics, policy makers, development practitioners, representatives of bilateral and multilateral institutions, and Commission members.

The working papers, and all thematic papers and case studies written as contributions to the work of the Commission, were made possible by support from the Australian Agency for International Development (AusAID), the Dutch Ministry of Foreign Affairs, the Swedish International Development Cooperation Agency (SIDA), the U.K. Department of International Development (DFID), the William and Flora Hewlett Foundation, and the World Bank Group.

The working paper series was produced under the general guidance of Mike Spence and Danny Leipziger, Chair and Vice Chair of the Commission, and the Commission's Secretariat, which is based in the Poverty Reduction and Economic Management Network of the World Bank. Papers in this series represent the independent view of the authors.

Acknowledgments

These issues are discussed in further detail in *Reforming Latin America's Economies after Market Fundamentalism*, Palgrave Macmillan, New York, 2006—cited here as Ffrench-Davis (2006). I appreciate the research support of Rodrigo Heresi and the very useful comments of Roberto Zagha.

Abstract

Latin America faces the twin challenges of achieving economic growth and reducing extreme inequality. Notwithstanding the heterogeneity among Latin American countries (LACs), most of them exhibit both (i) low average GDP growth and (ii) increased inequality during the 1980s. This long period includes the "lost decade," when outcomes in both variables were evidently negative. These negative trends have persisted since the early 1990s, in the period of intense reforms under the Washington Consensus. The development gap (difference in GDP per capita or per worker between rich countries and LACs) and the equity gap (difference between GINI coefficients of each group) have broadened in this period.

We seek to identify which are the main failures and main missing ingredients required to produce equitable growth.

We work with average figures for the standard 19 LACs, as well as research into some country cases such as Argentina, Brazil, Chile, and Mexico. We examine in general the performance since 1990, but we conduct a brief comparative analysis of the structural reforms in the paradigmatic case of Chile in the 1970s and those of other LACs in the 1990s, stressing strategic similarities in trade, financial, and macroeconomic reforms. The similarities in reform approaches explain a significant share of similar economic outcomes: unequal, unstable, and low average GDP growth. In fact, GDP growth averaged 2.9 percent in Chile in the 16-year period 1974–89 (the period of the Pinochet dictatorship and neo-liberal reforms) and 3.1 percent in Latin America in the 19-year period 1990–2008.

We focus on the behavior of gross capital formation (GKF) and total factor productivity (TFP). GKF has exhibited notably low averages compared to East Asian economies; interestingly, reforms were able to increase significantly "financial savings" but failed to increase "national" savings that finance domestic capital formation, a variable that is a crucial determinant of potential GDP growth.

We evaluate (i) the macroeconomic environment in which agents make their decisions (usually in LACs, under an economic activity operating significantly below potential GDP, with outlier macro-prices, and fluctuating aggregate demand); (ii) features of financial reforms (usually intensive in short-term segments and weak financing of risk and long-term financing), and their implications for capital formation and the distribution of opportunities in the domestic economy; (iii) features of trade reforms (intensive in resource-based exports but low total output of tradables); and (iv) the distribution of productivities (whose average determines the evolution of average TFP), which is closely linked to the narrow space granted for the development of small and medium enterprises (SMEs).

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Growth Challenges for Latin America: What Has Happened, Why, and How to Reform the Reforms

Ricardo Ffrench-Davis[1]

Introduction

Latin American countries were in need of deep economic reforms by the late 1980s. Inflation was rampant, imports were excessively repressed under inconsistent protectionism, and governments exhibited large deficits financed with money printing. The rather good growth performance of 1950–80 had come to an end.

During the 1990s, Latin America implemented deep economic reforms, framed by the so-called Washington Consensus. Dramatic changes affected the relative importance of the state, which saw its sphere of action diminished amidst financial and trade deregulation, massive privatization, and the reduction of public investment, offering broader space for the working of private economic agents. One of the crucial objectives of reforms has been to improve the environment for productive activities and to achieve a sustainable higher GDP growth. In that respect, two purposes commonly stated by neoliberals have been the achievement of a "market friendly" environment and "right prices" (two purposes that we share, obviously). It was assumed that across-the-board liberalization would also allow markets of factors to develop rather spontaneously (to become complete).

We intend to explain why neo-liberal reforms have failed in these aspirations: productive activities—firms, entrepreneurs, labor—have faced, frequently, an *unfriendly* domestic scenario, with *wrong* macro-prices such as outlier exchange and interest rates, and factor markets remaining quite incomplete.

Nearly two decades of intensive and profound reforms have produced a mix of successes and failures. It is evident that there are clearly positive results in several areas. Outstanding are the eradication of hyperinflation, more balanced public budgets, a rise in the share of exports in GDP, reduced room for

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bureaucratism, diminished capital gains and rent-seeking associated with trade protectionism and financial repression, and fewer microeconomic decisions taken centrally. Notwithstanding, the net balance, in terms of growth and equity, has been notoriously poor. Overall the net outcome is "disappointing," using an expression summarizing an evaluation made by John Williamson (2003b), the outstanding economist who coined the expression "Washington Consensus" in his well-known publication of 1990.[2]

Per capita GDP hardly rose 1.5 percent per year between 1990 and 2007, while in the United States it increased 1.7 percent. Eighteen years since 1990, the number of poor people in LAC is still close to 200 million, and investment ratios have been lower than in the 1970s; development divergence has prevailed. Accountability has been absent, in the sense that there are impressive flaws in the design of reforms and in the capacity to recognize failures and correct them quickly.

In this paper we examine the evolution of reforms, policies, and results and conclude on the need to reform them, starting from the current situation. That is why we label our proposal a "reform of the reforms." We focus on the most outstanding features of four areas of reforms that are at the core of neoliberal approaches: macroeconomic policy making, and liberalization of trade, of the capital account, and of domestic financial markets. These specific reforms help explain why growth performance and equity have been poor on average for the region.

In section 1 we summarize the reforms and the results achieved. In section 2 we examine some common features that underlie the poor outcomes of the Washington Consensus reforms. In section 3, we highlight three analytical issues and policy implications of an alternative approach. Section 4 presents some policy conclusions.

1. Reforms since the 1990s and Their Outcome[3]

LACs exhibit broad heterogeneity. However, there are significant similarities in terms of the features of the main economic reforms and the main results achieved, particularly among the medium and large LACs. The more outstanding successful outlier in the 1990s—Chile—actually implemented most

[2] It must be stressed that what John Williamson called the Washington Consensus explicitly (i) advised against premature and across-the-board opening of the capital account, and (ii) recommended maintaining competitive exchange rates. See Williamson (1990).

[3] Descriptions, assessments and measurements of reforms appear in ECLAC (1998; 2000); Easterly, Loayza, and Montiel (1997); Edwards (1995); Ffrench-Davis (2006); Ganuza et al. (2001); IADB (1997); Kuczynski and Williamson (2003); Lora (2001); Morley, Machado, and Pettinato (1999); Ocampo (2004); Rodrik (2006); Stallings and Peres (2000); and World Bank (1997; 2005). See Gelb (2006) for a related analysis of the case of South Africa.

of the neoliberal reforms in 1974–81 (see box 1), period in which its average GDP growth was, interestingly, as low as that of Latin America since 1990.[4]

Box 1: One Third of a Century of Chilean Economic Reforms and Outcomes

The extended conviction that the "Chilean model" is one unique and uniform paradigm of economic reform is misleading. Since 1973, Chile has experienced a series, not a unique model, of diverse approaches to build a market economy. Actually, the Pinochet regime includes two rather divergent subperiods (1973–82 and 1982–89). Since 1990, a new stage was started, where significant *reforms to the reforms* were introduced to macroeconomic and social policies.

Several of the tougher neoliberal reforms, such as drastic import and financial liberalization, were implemented by the Pinochet dictatorship in the 1970s; that first half of the regime ended with a huge economic crisis in 1982. This experience implied enormous economic costs whose procyclical and regressive effects were long-lasting. The evidence proves that gross mistakes, based on market fundamentalism, were made in social and economic policy, which artificially increased the duration and magnitude of recessive adjustment and the associated welfare costs, after the crises of 1975 and 1982.

In the second half of the dictatorship, there was a more pragmatic macroeconomic management that concluded in 1998–99 with a fast recovery based on the idle capacity existing after the 1982 crisis. Nonetheless, in the whole 16 years of dictatorship GDP growth averaged merely 2.9 percent with very low capital formation, increased poverty, and worsening income distribution.

The democratic administrations, in power since 1990, emphasized a medium-term development strategy of growth with equity. The program of the new regime stressed (i) rising "investment in people"; (ii) redressing of exports toward diversification and value-added; and (iii) achieving a sustainable macroeconomic balance (built on active fiscal, foreign exchange, and capital account policies).

The outcome of the set of reforms of the reforms was that during 1990–98 there was a vigorous expansion of the productive capacity, averaging 7.1 percent per year in 1990–98, along with significant poverty reduction (from 45 percent to 21 percent of population) and some improvement in income distribution. Nevertheless, a recessive output gap in 1999–2003 reflects policy inconsistencies and lack of deeper reforms to the neo-liberal reforms. The recessive situation after 1999, in response to contagion of the Asian financial crisis, and the subsequent stagnation of economic activity, was concentrated in non-exported GDP, which represented around 70 percent of the economy; that stagnation involved a negative impact, mainly in SMEs and employment. The Asian crisis contagion was multiplied toward the rest of the economy through a reversal of the capital account, monetary, and exchange rate policies in the late 1990s. That recessive impact prevailed until 2003, constituting a substantive pitfall of Chilean macroeconomic policy. The recessive quinquennium was the consequence of a policy option of not facing the negative external shock with a positive domestic reactivating shock, after having corrected both the real exchange rate overvaluation and the excessive current account deficit. After the recessive gap of 1999–2003, a significant recovery was recorded in 2004–07, led by a sharp improvement of the terms of trade.

In all, in the 19 years between 1990 and 2008, GDP growth averaged 5.3 percent, in contrast to 2.9 percent in 1974–89. That remarkable difference was due to the improvement in the quality of macroeconomic policies in the first years of democracy, the increase in social investment, and some efforts (still quite insufficient) in correcting micro- and meso-economic flaws by progressing toward "completing" long-term capital markets, and enhancing labor training and technological innovation.

Source: Based on Ffrench-Davis (2002) and updates.

[4] In the 1970s and 1980s, like Argentina since 1990, Chile recorded years with very high and years with very negative rates of GDP growth. Both nations share low averages in the respective periods.

Deep Trade and Financial Reforms

Economic reforms proceeded at a fast pace across LACs along the 1990s. It is interesting to underline that the reforms resemble those implemented in the 1970s in the Southern Cone, particularly the trade and financial reforms in Chile (see Ffrench-Davis, 2002). Main features of trade, domestic capital markets, and capital account reforms made by LACs since the late 1980s are summarized here.

Trade reforms

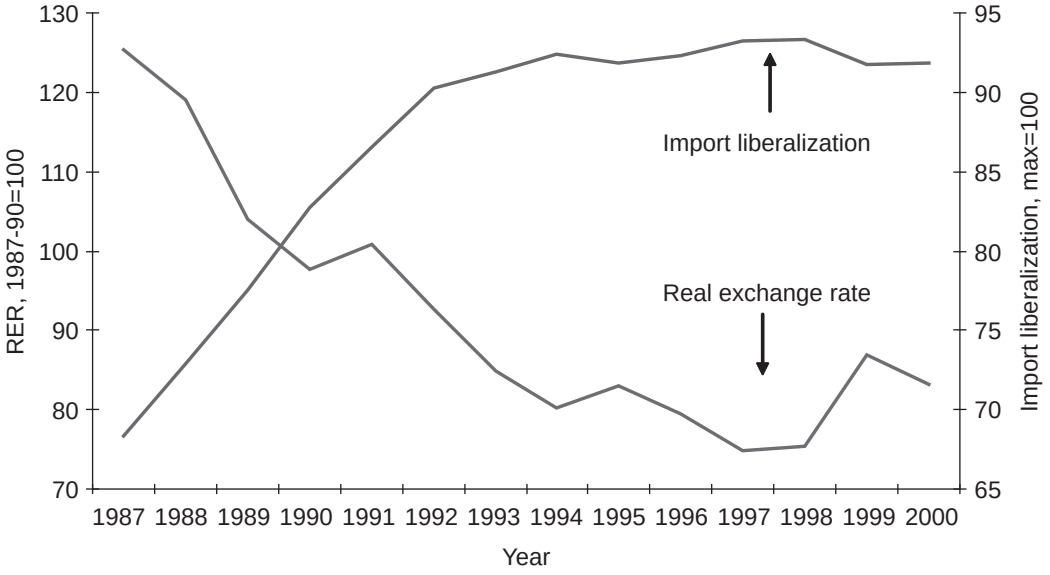
Many countries in the region have undertaken deep import liberalization since the debt crisis (Bouzas and Keifman, 2003). Generally, import liberalization was carried out within a short period (1989–90 to 1992–93). Argentina implemented the bulk of its liberalization program in April 1991. In Chile—with an extremely protectionist starting point in 1973—the process ended by mid-1979. Mexico launched in mid-1985 a drastic import liberalization program and a gradual dismantling of its traditional industrial policy.[5] Brazil started its program in 1988 with an average tariff of 51 percent ending in 1993 with 14 percent. Even Colombia, a country with a traditional gradualist approach, suddenly accelerated its program of gradual trade openness and reduced its tariffs drastically in 1990–92.

Consequently, generally for LACs, there was rejection of a gradual approach that would have allowed the reconversion of existing industries rather than destroying a large percentage of a country's installed capacity, as inevitably occurs during a rapidly implemented import liberalization, particularly if the exchange rate appreciates during the process.

In most LACs, after the initial impulse from the late 1980s to the mid-1990s, trade openness tended to stabilize. In fact, countries such as Argentina, Costa Rica, Ecuador, Mexico, Paraguay, and Uruguay adjusted somewhat their policies in the opposite direction in order to face the balance of payments problems derived from the Asian crisis and its effects in Latin America from 1998 on; particularly, some non-tariff restrictions were reintroduced. But overall, LACs today have trade regimes notably more liberalized than in the late 1980s. Figure 1 shows the rapid evolution of import liberalization in the region as a whole between 1987 and 1994, the slower advance up to 1998 and the subsequent slight reversal in the general trade regimes. In all cases, albeit to varying extents, quantitative restrictions were dismantled, tariffs lowered significantly, and the range of effective tariff rates has diminished substantially.

[5] It is important to note that, in contrast with the Chilean experiment of the 1970s, Mexico's liberalization drive was implemented in parallel with a steep real depreciation of the currency (in 1982–83 and in 1986–87), which gave the manufacturing sector a large cushion for its adjustment.

Figure 1: Latin America (16): Import Liberalization and Real Exchange Rate, 1987–2000 (indices)



Source: Calculations for 16 countries, based on ECLAC figures; Morley, Machado, and Pettinato (1999); and database of Economic Development Division, ECLAC. Real exchange rate is an index of the weighted average amount of real local currencies per one real U.S. dollar.

These regional trends in trade policy have been complemented by bilateral or multilateral free trade agreements covering a wide spectrum of items. In fact, the reciprocated trade openness became highly significant in recent years, thus enhancing liberalization (not reflected in figure 1).

Capital account liberalization and foreign exchange policy

In a number of countries, trade liberalization was accompanied by a broad opening of the capital account. Under the capital surges prevailing from the early 1990s up to 1998, the liberalization of the capital account prompted considerable exchange rate appreciation (see figure 1) just when trade reforms urgently required the opposite—a compensatory real depreciation.

The mix of import liberalization and RER appreciation implied a sharp destruction of import-substituting sectors, including both inefficient firms that were overprotected and producers that would be efficient under "normal" (not outlier) relative prices and a more gradual movement to a new equilibrium. This was one of the causes of the increase in the rate of labor unemployment during the 1990s (Weller, 2001). Imports, in turn, expanded much faster than exports, weakening the external accounts and accommodating increasing capital inflows. The net balance was a mix of stronger negative pulls on the production of importables than positive pulls on exportables (see Bouzas and Keifman, 2003; Santos-Paulino and Thirwall, 2004).

The exchange rate has a strong impact on the allocation of resources between tradables and nontradables. This role was strengthened by the sharp reduction of protectionism in LACs. On the other hand, in a framework of open capital

accounts, the short-term segment of capital markets captures a heavy weight in the foreign exchange rate dynamics. Foreign currency lends itself to speculative operations and bubbles more than other items, because it serves as an instrument for arbitrage, capital flight, money laundering, medium of exchange, and hoarding. Consequently, the working of the foreign exchange market (implying both access to foreign exchange and exchange rate adjustments) has significant macroeconomic effects, unlike many other goods or assets with purely micro implications.

The set of conditions reflecting the reality of most LACs in recent years—that is, fluctuating terms of trade, inflexible and heterogeneous productive structures, and need of structural transformation—and abrupt changes in external supply of financing and its terms, render the two traditional extreme formulas of free and fixed nominal exchange rates inconvenient.[6] The alternative in relation to the problems that arise from these two corner options consists of the broad family of "intermediate regimes" (see Williamson, 2000).

Exchange rate instability tends to reduce the capacity to identify comparative advantages, a trend that undermines capital formation. It often has a negative and stronger impact on new exports, on those undertaken by companies with less diversified markets, and on those with more limited access to capital markets. Consequently, exchange rate instability, although affecting all exports, is biased against nontraditional products (see Agosin, 2007; Caballero and Corbo, 1990; ECLAC, 1998, chapter IV). That bias also tends to affect nationally owned enterprises as compared to diversified transnational corporations. Naturally, this is especially relevant in economies with exports concentrated in few commodities that are seeking to diversify and upgrade their export basket.

The existence of instability, given imperfect capital markets and binding external restrictions, also has implications for the relation between foreign exchange policy and the average level of effective demand. Instability usually reduces the average rate of use of resources and biases the market toward the short-term and financial *neo-rent-seeking*.[7] This is a strong reason for avoiding an exchange rate policy that closely follows fluctuations of international prices and capital flows. A policy that avoids extreme ups and downs of the real exchange

[6] The mainstream vision has changed over time. A free exchange rate was advocated by closed economy monetarism. Open economy monetarism (the monetary approach to the balance of payments) advocated a fixed exchange rate, as was applied in 1979–82 in the monetarist experiment in Chile and in Argentina in 1991–2001. After the Argentinean crisis (in 2002), the approach in fashion became a fully floating exchange rate regime but with an ambiguous tolerance to interventions under "exceptional" circumstances.

[7] In speculative markets, a considerable part of the efforts of economic agents focuses on acquiring information for personal benefit and leads to a zero-sum game, where gains of some are losses of someone else, or even a negative sum redistribution, owing to the use of real resources for these purposes. At a distributive level, indiscriminate deregulation concentrates opportunities in favor of sectors with greater access to the financial system.

rate allows for a sustainable higher average level of effective demand and economic activity.[8] Therefore, it tends to encourage a greater utilization of capacity and to encourage productive investment.

In short, exchange rate stability and competitiveness is extremely important in a developing economy undergoing structural transformation, exhibiting sharp heterogeneity, and with crucial "incomplete" factors markets. In such developing economies, and in contrast with the case of more homogeneous and diversified developed economies, redeployment of resources across sectors is hard and costly. Hence, it is essential for the exchange rate to be guided by the trend shown by the current account of the balance of payments projections (at full employment), seeking to attenuate the transmission of outlier short-term fluctuations of the terms of trade or capital flows into the domestic economy. Regulation of the capital account and of access to the foreign exchange market is crucial to moderate destabilizing capital flows.

Financial reforms

The liberalization of the domestic financial market and the capital account opening were core components of reforms. Proposals for financial liberalization were encouraged by the previous unsatisfactory experience with increasingly interventionist policies and heavily repressed interest rates. The latter occurred particularly in countries with high inflation. In response to this, countries such as Brazil and Colombia, successful in increasing investment ratios during the 1970s, undertook heterodox financial reforms. Capital movements and domestic loans were regulated, orienting them toward productive investment agents; positive and active but moderate real interest rates were established by the respective central banks; and long-term financing channels were created.

During the 1990s there was an upsurge of financial reforms of a quite different sort, relating both to domestic capital markets and the capital account. The predominant pattern followed the more naive orthodoxy, repeating to a large degree the 1970s inefficient reform experience of the Southern Cone. The reform consisted of the extensive and abrupt liberalization of interest rates, of maturity terms and credit allocation, and the relaxation of prudential regulations and supervision on financial institutions. There was widespread disregard for the high risk of generating speculative bubbles, adverse selection, and moral hazard—repeating Chile's missteps in the 1970s. It is interesting to note that a "financieristic" bias assigned a strategic role to the sector's sharp liberalization,

[8] Naturally, near full employment tends to have a greater inflationary impact, which can be compensated for by policies that favor social concertation related to the level of prices and income, thus seeking to guide expectations. In its absence, economic policy is forced to overly depend on restricting aggregate demand below the production frontier.

without considering in the reform design the characteristics of the "product" in question (see Díaz-Alejandro, 1985; Stiglitz, 2000).[9]

The general outcome of domestic financial liberalization was a large rise in financial savings in the short-run segment of the capital market, and a weakened long-term segment, without an increase in the ratio of national savings; actually, in some praised reformers such as Argentina and Mexico, there was a drop in domestic savings in 1990–94.[10] That is, the combination of reforms implied that the new credit facilities in a liberalized financial market intermediated funds from savings toward consumption or investment in financial and real estate assets. Additionally, freer imports with exchange rate appreciation generated strong market incentives toward intermediating savings to imported consumption goods.

In brief, owing to the financial reforms implemented during the 1970s in the Southern Cone, and later in the 1990s in the rest of Latin America, financial markets tapped a markedly greater proportion of total savings, but national savings that finance capital formation remained generally depressed.

In parallel, high real interest rates have tended to prevail. For example, the lending real interest rate averaged 38 percent in Chile in 1975–82, and many LACs exhibited also "outlier" rates during the 1990s and the present decade (see ECLAC, 1998, chap. IX; ECLAC, 2004, chap. III). Investors seem to have been notably more sensitive to those high interest rates than consumers. In brief, for rather long periods, the markets exhibited high real interest rates, increased spreads, and weak prudential supervision. As a consequence, Latin America suffered several banking crises during the 1990s replicating that of Chile in 1983 (ECLAC, 1998, chapter XII; Stallings and Studart, 2005).

The Overall Outcome

Significant progress was attained on several fronts. There has been a generalized recognition by regional authorities of the need of preserving macroeconomic balances. As proof of the effectiveness of this recognition, hyperinflation has disappeared, and many countries have experienced single-digit inflation rates; the 1,600 percent annual average inflation of 1990 (led by Argentinean and Brazilian hyperinflations) had converged to a 6 percent plateau in the 2005–07

[9] In a brilliant analysis of financial reforms implemented in the Southern Cone in the 1970s, Carlos Díaz-Alejandro concludes that "financial reforms … yielded by 1983 domestic financial sectors characterized by widespread bankruptcies, massive government interventions to rescue private institutions, and low domestic savings. The clearest example of this is Chile." This poor outcome is identical to several cases of similar reforms, and similar shocking failures in LACs in the 1990s.

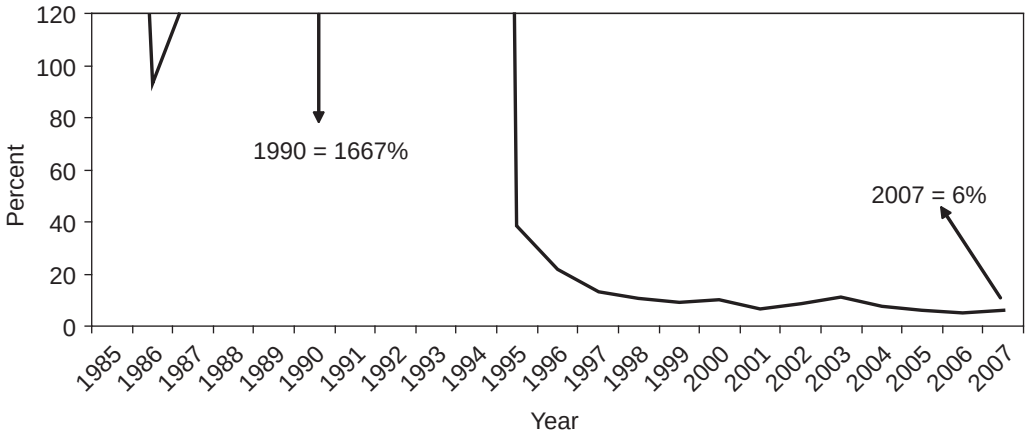
[10] Argentina reduced its saving rate from 18.5 percent of GDP (current prices) in 1990 to 15.6 percent in 1994, and Mexico from 20.3 percent to 14.7 percent in the same period, in clear processes of crowding-out of domestic savings induced by excessive capital inflows, poor absorption capacity, and weak intermediation of domestic financial systems.

(see figure 2).[11] Also, budget balances and fiscal savings have improved considerably. Actually, in the quinquenium before the contagion of the East Asian crisis, the average fiscal deficit was 1.5 percent of GDP; a significant improvement compared to the 1980s performance and quite a positive figure compared to several developed economies. Monetary expansion to finance public deficits has nearly ceased. On another front, the quantum of exports has expanded rapidly—generally faster than world trade—and has diversified in terms of items exported and markets of destination. Many countries have accumulated significant international reserves. Another crucial ingredient of neoliberal reforms also has been implemented: a long wave of massive privatizations of public firms.

By early 1998, an optimistic mood prevailed among public and private leaders in LACs, and in financial and official institutions abroad. Optimism was related to both the recent performance and the future prospects for the region. The predominant view was that reforms were working well (see IMF, 1997, pp. 175–6).

Frequently, it could be heard that this first generation of reforms was already accomplished, and that it was time for implementation of the second generation. This second set includes areas such as education and the judicial system reforms (Camdessus, 1997; IADB, 1997; World Bank, 1997). Then, the predominant view was that growth had picked up. Actually, GDP rose 5.2 percent in 1997. However, actual growth had been similar in 1994, just before the explosion of the tequila crisis. In practice, high instability of GDP was an outstanding fact, while growth had averaged merely 3.3 percent in 1990–97 (see table 1).

Figure 2: Latin America (19): Inflation Rate, 1985–2007 (weighted averages)



Source: Based on ECLAC figures for 19 Latin American countries. Weighted averages.

[11] Inflation started to rise by 2007, led by sharp increases in the international prices of food and minerals. It was mainly an imported inflation, even though in some countries inflation responded, also, to economic activity becoming closer to potential GDP.

Table1: Latin America: GDP Growth, 1971–2008 (annual growth rates, %)

	1971–80	1981–89	1990–97	1998–2003	2004–08	1990–2008
Argentina	2.8	−1.0	5.0	−1.3	8.4	4.0
Brazil	8.6	2.3	2.0	1.5	4.8	3.9
Chile	2.2	3.1	7.6	2.7	4.8	5.3
Colombia	5.4	3.7	3.9	1.1	5.6	3.6
Mexico	6.5	1.4	3.1	2.9	3.4	3.2
Peru	3.9	−0.7	3.9	2.0	7.5	4.3
Uruguay	2.7	0.4	3.9	−2.1	8.9	3.4
Venezuela	1.8	−0.3	3.8	−2.7	10.4	3.6
Latin America (19)						
Total	5.6	1.3	3.3	1.4	5.6	3.1
Per capita	3.0	−0.8	1.5	−0.2	4.1	1.6
Per member of EAP	1.7	−1.5	0.6	−1.1	3.3	0.6

USA = 1.8%

ASIA (6) = 3.5%

WORLD = 1.7%

Source: Based on ECLAC figures. LF= labor force. Preliminary figures for 2008.

The "overshooting" of optimism is a signal and cause of real macroeconomic instability, associated with changes in the mood of risk rating agents, political authorities, international financial institutions, and influential mediatic economic observers. The short present influences excessively expectations about the future. There is an overwhelming short-termism that leads to procyclical performance, which we discuss in the companion working paper "From Financieristic to Real Macroeconomics" (French-Davis 2009).

When a new prolonged period of binding external constraint started during 1998, the economic performance worsened sharply. In the sexennium 1998–2003, GDP growth collapsed to 1.4 percent, implying an annual per capita drop of 0.2 percent. In general, during this period optimism disappeared and it became fashionable to hold the contradictory view that reforms had been insufficient and weak (Krueger, 2004). A sharp GDP recovery up to 5.6 percent in 2004–08, especially led by a very positive terms of trade shock, once again improved the mood of observers and authorities (IMF, 2005).

In all, annual average GDP rose scarcely 3 percent during the 19 years between 1990 and 2008; most countries exhibited rates around that meager figure (see table 1). Additionally, active population (the labor force, comprising all workers and entrepreneurs) increased 2.5 percent annually after 1990; consequently, the mediocre output growth hardly matched the yearly additions to the labor force. This fact, plus a regressive bias in economic reforms and policies, helps explain the poor performance of employment and wages: 2007 recorded a somewhat higher unemployment and an average wage similar to that in 1980 (see table 2). However, wages refer to the formal segment of labor markets. Actually, labor markets expelled workers from the formal toward the informal segments, with more instability of jobs and income of non-wage workers (IADB, 2004; Tokman, 2004).

Table 2: Latin America: Social Indicators, 1980–2007

Year	GDP per capita (PPP US$)	Poverty		Real wage index (1995=100)	Unemployment (% of labor force)	Population (millions)
		(millions)	(% of pop.)			
1980	7,277	139	40.5	102.7	7.7	343
1990	6,601	209	48.3	96.2	7.2	434
2005	9,313	197	35.1	104.3	8.0	561

Source: GDP per capita, poverty, and population based on ECLAC data for 19 countries. Real wage regional index is based on real indices provided by ECLAC for 12 countries, weighted by labor force in each year. Unemployment is calculated by ECLAC with information for 24 Latin American and Caribbean countries.

The deficient labor situation contributed strongly to a worsening of the *macrosocial* balance (as can be labeled the set of general social conditions like poverty levels, employment, social programs, and the distribution of income, voices and opportunities). In terms of poverty, after the sharp rise in the number of poor recorded in the 1980s, an additional worsening took place during the neoliberal reforms, with the absolute number of poor people peaking at 221 million in 2002, after the Asian crisis. Economic recovery began in 2004, but as of 2007 there were nearly as many poor people as in 1990[12] (see table 2) and income distribution remained notably regressive (Bourguignon and Walton, 2007; ECLAC, 2007; World Bank, 2003). This is partly associated to the slackness of labor markets, higher open unemployment, the low physical investment ratio (that is, productive investment or GKF as a share of GDP) and the underrated role granted to reducing the equity gaps in education, labor training, and access to capital markets. The hard fact is that the distribution of opportunities and of productivity has become even more skewed than before these sorts of reforms (Altimir, 2004).[13] This is especially grave in the region that traditionally has been the most unequal in the world (Bourguignon and Morrison, 2002).

As a consequence, there was a double development divergence in LACs: like in the 1980s, per capita GDP did not converge to that of the developed world. In addition, within LACs, the regressive gaps between high-income brackets and low-income brackets remained high. Presently, Latin America has a GDP per capita (in PPP equivalent) of merely one fourth of that of the richer countries. Additionally, the average LAC records an equity gap between the income of the richer quintile and poorer quintile of households that is over twice as large as

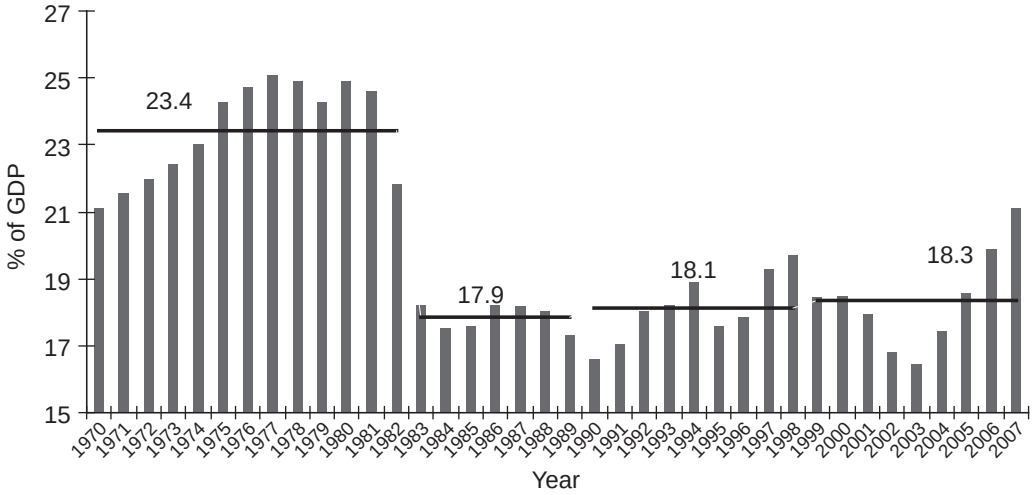
[12] It must be stressed that the number of poor is measured with a poverty line constant in real terms. Thus, given income distribution, even a very low economic growth per capita reduces the number of poor. As well, notwithstanding minimal economic growth, some policies focused on the poor can reduce the headcount index, as the cases of Brazil and Mexico do prove.

[13] That was clearly the case of Chile, during the 1970s and 1980s, when most neoliberal reforms were implemented. Some significant correction, *with reforms to the reforms*, took place with the return to democratic rule in the 1990s (see Ffrench-Davis, 2002, ch. 9).

that within the richer countries of the world.[14] These much larger equity gaps are inconsistent with the consolidation and deepening of democracy and social peace (a requirement for sustained economic development).

The meager GDP growth was associated, to a significant degree, with a low ratio of productive investment. As discussed below, it is known that innovation is partly associated to investment in equipment and machinery, so that low GKF tends to be correlated with low TFP.[15] Productive investment is one of the areas where the reforms have performed more poorly. In fact, in the 1990s, Latin America invested, on average, five percentage points of GDP less than it did in the 1970s, and roughly the same level as in the 1980s "lost decade" (see figure 3). Under the effects of the 1999 recession, investment fell again, recouping only in 2006 the investment ratio of 1998;[16] with the significant recovery of economic activity that took place in most LACs since 2004, the investment ratio kept rising up to a peak in 2008. The rise in the ratio is associated with the gradual drop in

Figure 3: Latin America (19): Gross Fixed Capital Formation, 1970–2007 (% of GDP, scaled to 2000 prices)



Source: Based on ECLAC data for 19 countries. Preliminary figures for 2007.

[14] According to the World Bank's World Development Indicators, the G-7 exhibits a ratio of 7 times between the fifth and first quintiles of income, while the average ratio for LACs jumps to 19 times. In both cases, figures do not include the distribution of goods and services by the public sector.

[15] In Ffrench-Davis (2006, ch. III), we stress the relevance of the interrelation between GKF and TFP. We show that, frequently, econometric work has tended to underestimate the role of GKF because of the difficulty in measuring changes in its rate of use. The investment ratio remains a crucial variable for employment of human capital, for innovation and TFP, and for the growth of potential GDP.

[16] The investment ratio has been increasing since 2003, principally related to a persistent drop in the output gap between actual and potential GDP. Nevertheless, the peak investment ratios since 1983—located in 1997–98 and 2006–08—still are notably lower than the average ratio recorded in the period 1970–82 (see figure 3). The investment performance of the Washington Consensus reforms has been shockingly negative.

the recessive output gap since 2003 and improved expectations. The positive investment trend was already being reversed during 2008, with the arrival of the contagion of the global financial crisis.

Swings in the investment ratio are closely related with cyclical adjustments in economic activity, as several country cases show. In fact, a notorious effect of recessive situations has usually been a sharp reduction in investment ratios. For instance, in the 1995 Tequila crisis, a drop of GKF can be observed of 13 percent in Argentina and 30 percent in Mexico; in 1999 it fell 18 percent in Chile and, between 1998 and 2002, decreased 56 percent in Argentina, and 11 percent in all Latin America.[17]

Nevertheless, not all sectors exhibited low GKF. In general, it appears that it was rather vigorous in the production of exportable goods and services. That helps explain why export volume grew 7–8 percent per year in 1990–2007, a rather good comparative performance with respect to that of the global economy. But the rest of GDP—that is, about 6/7 of the value-added output—was stagnant and presumably with notably low GKF. Evidently, for vigorous overall growth, there is a need for the rest of the economy (non-exports) to expand fast. Actually, that has happened in several really successful exporting emerging economies (EEs): for instance, in Korea and Taiwan, China for several decades, and in Chile in 1990–97, the output of non-exports expanded annually around 6 percent; in Latin America, it scarcely rose 2.5 percent in 1990–2007 (see table 3).[18]

Table 3: Latin America (19): Growth of Exports and Non-Exported GDP, 1990–2007 (annual average growth rates, %)

Year	GDP	Exports	Non-exports
1990–1997	3.3	8.4	2.6
		(0.9)	(2.4)
1998–2003	1.4	5.1	0.7
		(0.8)	(0.6)
2004–2007	5.5	8.2	4.9
		(1.4)	(4.1)
1990–2007	3.1	7.2	2.5
		(1.0)	(2.1)

Source: Based on ECLAC figures for 19 countries. Preliminary figures for 2007. Figures into brackets are estimates of points of GDP growth contributed by exports and non-exports (rest of GDP), respectively. The direct contribution of exports to GDP is the domestic value-added component of gross exports of goods and services. Export value-added was calculated by discounting from gross exports an estimate of their imported content. The imported content was assumed to be equal to the share of non-consumer imports in total GDP; for the Mexican maquila, actual figures of value-added were used.

[17] Naturally, drops in net investment are much larger. For instance, the net decline was 30 percent in Chile in 1999, rather than the 18 percent gross drop.

[18] It is relevant to recall that Chile, during the neo-liberal experiment in 1974–89, achieved a vigorous 10.7 percent growth in the quantum of exports, but the rest of GDP rose a meager 1.6 percent, explaining the modest 2.9 percent average GDP growth.

Consequently, for development convergence of LACs, a dynamic, leading role of the production of exportables (intensive in technology, innovation, externalities, and scale), must be associated with vigorous expansion of investment and output in the rest of the economy. As documented in the companion macro paper (Ffrench-Davis, 2009), the move from a two-pillar to a three-pillar macroeconomic policy approach is crucial for achieving that goal. That three-pillar macroeconomics must be complemented with reforms and policies geared to complete factor markets, in the search for systemic competitivity.

2. Market Fundamentalism and Reform Pitfalls

There are a wide variety of paths and timings chosen by LACs in the design of their structural reforms and economic policies. However, there are some distinctive features that reflect common external influences or common domestic approaches, which are at the core of significant shortcomings of the first generation of reforms implemented across Latin America (Rodrik, 2006). Most reforms were performed under the umbrella of the so-called Washington Consensus. The neoliberal fashion tackles several real problems, of great significance, that had been emerging or developed in recent decades, particularly in the 1970s and early 1980s. In the case of LACs, those economic pitfalls generated costly disequilibria, such as the huge fiscal deficits, high and variable inflation, a worsening accountability of public firms, negative real interest rates, the arbitrariness of effective protection, and too many microeconomic decisions centralized by national authorities. Naturally, I share this critical view. However, the right changes can be made in a right or in a wrong way.[19] That is what happened, frequently, with several of the neoliberal reforms. Usually, they have been too loaded with ideology, depicting a poor understanding of how markets actually do work and their limited degree of maturity and *completeness*.

It is a significant feature that neoliberalism has an extreme faith in the efficiency of the traditional private sector and mistrust for the public sector and nontraditional forms of private organization. There is a tendency to implement reforms abruptly and to the extreme, assuming that when markets are liberalized they become *complete* rather spontaneously. This view regularly disregards crucial dynamic interrelationships among variables, the implications of structural heterogeneity of agents, or factor market segmentation, and it is too short-termist.

[19] The reform approach to trade, finance and macroeconomic management has been sharply different, for instance, in East Asia and in Latin America (see Ffrench-Davis, 2006, ch. IV, and Rodrik, 2001, on trade reforms). Also, it is relevant that there is not only one *right* way, as the diversity among successful cases reveals: the variety among China, Korea, India, Malaysia, and Chile (in the 1990s), for instance.

The predominant approach or "conventional wisdom" assumes that free market signals flow transparently and fluidly among sectors, factors, and generations. In doing so, structural imbalances are assumed away, except those generated by state intervention. These naive assumptions lead to an underestimation of the negative effects on (i) capital formation, (ii) the utilization rate of potential GDP, and (iii) the distribution of productivity and opportunities among people.

The view still in fashion, which is built on microeconomic theory and *optimization*, paradoxically jumps to policy recommendations based on the *maximization* of liberalization. It usually disregards gradualism and intermediate positions beyond the extremes of indiscriminate liberalization and arbitrary interventionism; it also underrates the deep implications of the absence of complementary reforms.

Typical failures, to diverse degrees and combinations across Latin America, have included the following: (i) the liberalization of the capital account, together with large capital inflows, which usually has given way to cases of crowding-out of domestic savings and increased external vulnerability; (ii) trade liberalization has proceeded *pari passu* with exchange rate appreciation, contradicting all reasonable recommendations; (iii) bank privatization without prudential regulation and supervision (PRS) has brought in moral hazard and related nontransparent loans, which have produced banking crises and rescues at government expense of up to one-half of annual GDP, according to figures published by the World Bank; (iv) the absence of effective prudential regulations of public services, parallel to their liberalization or privatization. Subsequently, some of these pitfalls have been corrected, particularly related to PRS, although partially; some other have been aggravated with the adoption of policies such as a freely fluctuating exchange rate.

The predominant approach has involved repeating costly mistakes, particularly in macroeconomic management, design of trade and financial reforms, and with respect to the weakness of efforts to *complete* factors markets. For example, it is impressive that the policy errors carried out in the financial reforms of Argentina and Chile during the 1970s were replicated, to a significant degree, in many other countries of the region since the mid 1980s. They share the weakness of prudential supervision, but also the booms in short-term segments, the crowding out of domestic savings, and financial crises highly expensive for the treasury. Comprehensive *accountability* seems to be rather absent, judging from the frequent applause by international financial institutions (IFIs) and financial agents for many ill-designed reforms whose objectives have not been accomplished or that have ended up in critical scenarios (recall the exuberant praises for Argentinean reforms by 1997).

In all these cases there has been responsibility for reformers, resulting from the lack of pragmatism in the design and sequencing of reforms. They should be extremely disappointed and revising radically their recipes. However, learning

and pragmatism have been quite limited among the influential IFIs and the main political and economic leaders, in this strong wave of transformation of Latin American economies.[20]

In fact, the Washington Consensus reforms have been, generally, conducted under the belief that there is a *unique* (one-size-fits-all) policy recipe for liberalizing all markets, abruptly if possible, and until the extreme (more of the same is always good). In Rodrik's (2006) words, commenting on the World Bank (2005) publication, *Economic Growth in the 1990s: Learning from a Decade of Reform*:

> It warns us to be skeptical of top-down, comprehensive, universal solutions—no matter how well intentioned they may be. And it reminds us that the requisite economic analysis—hard as it is, in the absence of specific blueprints—has to be done case by case. These should be music to any economist's ears. After all, what distinguishes professional economists from ideologues is that the former are trained to make contingent statements: policy A is to be recommended only if conditions x, y, and z obtain. Sensible advice consists of a well-articulated mapping from observed conditions onto its policy implications. This simple but fundamental principle seems to have gotten lost in much of the thinking on economic reform in the developing world, which has often taken an a priori and mechanical form….

There was no significant consideration of the fact that the selection of policies should depend (i) on the objectives democratically chosen by society; (ii) on the degree of development or completeness of domestic markets; (iii) on the degree of homogeneity of these markets; (iv) on the particular domestic macroeconomic situation; and (v) on the nature of international institutions and markets.[21] Some progressive revisionism has been in progress, as well depicted in the report analyzed by Dani Rodrik (2006), recognizing failures and shortcomings of the Washington Consensus reforms.

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[20] A recent IMF report (see Singh et al., 2005) apparently refers to a definition of macroeconomic balances that moves somewhat in the direction of the approach that we develop in the companion paper, but their policy proposals do not reveal significant pragmatic changes. Furthermore, Singh and Cerisola (2006) seem to step back to the cruder neoliberal approach to macroeconomics. He asserts, "it would appear that the macroeconomic instability witnessed in Latin America has mainly reflected policy instability. At the root of this instability have been unsustainable fiscal and monetary policies that have interacted with weak financial systems and given rise to frequent reversals of market-oriented reforms.… However, the primary driver of macroeconomic instability in the region appears to have been fiscal policy, with large fiscal deficits and high levels of debt creating an inflationary bias and sowing the seeds for periodic debt crises.… The volatility of Latin American exchange rates has been high … fixed-type arrangements were typically undermined by unsustainable fiscal policies and ended in crises." Evidence since the Washington Consensus reforms, as shown in this paper, do not support that view.

[21] It is evident that well-developed standard neoclassical analysis can be used to show the dangerous pitfalls of naive market fundamentalism. See, for instance, Krugman, 1990; Rodrik, 2003 and 2006; Sachs, 1987; Solow, 2001; Stiglitz, 1998 and 2001; Williamson, 2003b.

An *unfriendly* domestic environment appears to be a crucial factor explaining the insufficiency of economic growth. The unfriendliness is a consequence of (i) the persistent boom-and-bust evolution of aggregate demand, associated to the strongly cyclical behavior of net capital flows and, to a lesser degree, unstable terms of trade; (ii) *wrong* macro-prices (like outlier exchange and interest rates, which entrepreneurs and workers have to face in their allocative decisions; (iii) the weaknesses of policies directed to *complete* markets of productive factors (labor training, technology, and long-term segments of capital markets); and (iv) insufficient investment in infrastructure and public goods.

It is evident that *market friendly* reforms and *right prices* are inputs for growth. However, actual poor performance indicates that *friendship* has not been effective and prices have diverged from *rightness*. For instance, it is common to observe in neoliberal reforms notably high real interest rates; as well, pro-cyclical fluctuations of real exchange rates are a known fact. Evidently, these outlier macro-prices pose obstacles to accurate project evaluation for the allocation of resources, do promote speculative rather than productive investment creating larger capacity, and contribute to the deterioration of the portfolio of financial institutions.

Real macroeconomic instability is one strong force behind the poor achievement of investment ratios in the 1990s. Low GKF makes it harder to incorporate technical change; increases in productivity are closely associated with diverse forms of higher levels of investment (De Long and Summers, 1991). A significant, well-documented variable underlining the drop recorded in productive investment is the output gap between actual and potential GDP. The gap reflects the underutilized installed capacity in firms and other components of the stock of physical capital, unemployment of labor, and reduced actual total factor productivity (TFP). Profits tend to decrease while the mood of lenders becomes somber.

The other relevant explanatory variable for growth is the scarcity of the ingredients required by a productive investor. There is need for long-term financing, access to technology and capacity to absorb it, availability of well-trained labor, and infrastructure complementary to productive investment.[22] Neoliberalism still assumes that liberalization and privatization bring along, spontaneously, a rising supply of these ingredients of potential GDP. Usually, its supply does not emerge (i) spontaneously and (ii) in the right time; hence, it is a challenge for reforms and economic policy to take account of it. The challenge is *completing* factors markets, since incomplete, underdeveloped, or inexistent markets cannot work well: they imply missing factors in the aggregate production function. This *incompleteness* is an intrinsic feature of underdevelopment and reveals a lack of enhanced systemic productive capacity or systemic competitivity.

[22] As documented by Easterly and Servén (2003), most LACs also "witnessed a retrenchment of the public sector from infrastructure provision," a space that was not fully replaced by private participation.

Those sources of discouragement for domestic private investment have been reinforced by a change in the relative composition of FDI, from greenfield investment to acquisitions. Greenfield investment has been discouraged by the "unfriendly" environment for GKF, and acquisitions have been stimulated by privatization, depressed prices of domestic assets, and over-depreciated currencies during crises. Acquisitions covered over one half of FDI inflows in the recessive period 1998–2003.

The spread of neoliberal reforms has been reinforced by the phenomenon (mistakenly evolved into an ideology) of economic globalization. It is beyond discussion that globalization, and especially the ability to move money rapidly from one place to another, has limited the room for discretionary policy from governments and has discouraged some policy issues from the research agenda; for instance, newer research on intermediate exchange rate regimes and regulation on capital flows. Financial crises and the "financierization" of globalization have brought into the forefront the economic agents linked to the financial sphere, in public and private enterprises as well as in ministries and other governmental departments, and in mass media. This situation imposed the predominance of a short-termist bias (*financierism*) over concerns for productivity and additions to productive capacity (*productivism*). A considerable part of the efforts of economic agents focuses on acquiring information leading to capture benefits at the expense of the rest of the economy (capital gains and the associated *neo rent-seeking*), and tends to lead to a negative sum redistribution, given that real resources are used in the process; the rent-seeking bias is reinforced by intensive lobbying pressing for further capital account liberalization and elimination of taxes on returns to financial flows and fees.[23]

At a distributive level, indiscriminate deregulation also concentrates opportunities in favor of sectors with greater access to the financial system and more short-termist approach; in fact, usually the long-term segments of capital markets and SMEs have tended to loose shares in the financial markets. Macroeconomic policy making has become excessively influenced, probably not purposely, by well-trained specialists in short-term and liquid finance (see companion paper, Ffrench-Davis, 2009).

The extent of the loss of room for exerting policy discretion has been exaggerated, as revealed by the effective macroeconomic activism exhibited by some EEs; particularly, at present, by market interventions in China and India. In fact, still there is significant room to *make* globalization, according to domestic requirements for achieving growth with equity, notwithstanding the new context of increasingly integrated markets. In Ffrench-Davis (2009), we illustrate the room for maneuver in macroeconomic management-cum-capital account

[23] The traditional "rent-seeking," associated with economic rents resulting from excessive protection to import substituters, has been replaced by economic rents resulting from capital gains associated to speculation with financial assets, to windfalls from mergers and acquisitions, and tax privileges. Consequently, rent-seeking did not disappear with import liberalization, but changed its source.

controls, and the high efficiency in the use of resources it may imply, with the cases of Chile in 1990–95, and the Republic of Korea and Malaysia in 1998–99 (see Mahani, Shin, and Wang, 2006; Kaplan and Rodrik, 2001).

It is evident that we are not condemned to an extreme, a unique option of no room for active policies. Understanding the real working of markets, strong personality, political will for giving priority to the common good, and transparency, are crucial ingredients. It is true that they are very demanding requirements. That explains why few countries have reached development—but, indeed, it is possible.

3. Toward a Progressive Policy-Oriented Pragmatism

Criticism of neoliberalism, frequently, lacks concrete policy proposals. Here we adopt a policy-oriented approach, that is pragmatic (or realistic) in the sense of considering the actual working of markets and the response capacity of different economic agents; we search for pragmatism with a progressive bias, in the sense of being efficient in achieving growth with equity. In this search for more appropriate policies we have benefited from work of diverse authors concerned about the disappointing record (see, for example, Bourguignon and Walton, 2007; Rodrik, 2006; Ocampo, 2004; Williamson, 2003b; Solow, 2001; Stiglitz, 2000; Krugman, 1990). The *disappointing* market record can be improved significantly by *reforming the reforms*.

Reforms should not become a goal themselves, but an input for progress. An identification of the results being sought should be made; then accountability should be demanded. For instance, it turns out to be necessary to reform or correct the reforms (i) if success in reducing inflation and imposing fiscal discipline are unable to provide stable aggregate demand and *right* macro-prices to domestic producers; or (ii) if a domestic financial reform, implemented in order to increase domestic savings and enhance the volume and quality of investment, leads to a financial savings increase while national savings decrease, and investment remains low;[24] or (iii) if a vigorous export expansion does not generate a dynamic GDP growth.[25] We have already documented that failures have predominated in these three issues. What are the analytical pitfalls underlying these failures?

Here we present some of the analytical pieces, policy-oriented, that contribute to explain the failures of the neoliberal implementation of reforms

[24] A common situation with the Washington Consensus financial reforms has been that financial institutions captured a much larger volume of savings (called here *financial savings*) from the public (firms and natural persons) and borrowed from abroad, but intermediated a significant share of both toward consumption. Chile in the 1970s and Argentina and Mexico in the 1990s exhibit a large rise in financial savings, with a drop in national savings ratios.

[25] For further detailed analysis, see Ffrench-Davis, 2009; and Ffrench-Davis, 2006, chs. II, VII, and V on issues (i), (ii) and (iii), respectively.

under the Washington Consensus, and offer a robust alternative. We stress three most relevant features of emerging economies, which should have a determinant bearing on the design of specific policies. They relate to (i) the structural heterogeneity of factors and markets; (ii) the incompleteness of factors markets; and (iii) the implications of asymmetries in instability.

Factor Structural Heterogeneity

Factor heterogeneity or market segmentation is one of the most typical features of developing countries. This naturally affects the transparency and flow of information, and the diverse capacity of different agents to respond efficiently to a given policy change. Various dimensions of structural heterogeneity play a crucial role: among others, heterogeneity within each factor market; heterogeneity in the openness and stability of various external markets; heterogeneity between stages of the business cycle (expansive and contractionary); variety in the elasticity of response to incentives among regions and among market segments (large and small businesses, rural and urban enterprises, infant and mature firms, consumers and producers, productive and speculative investors); heterogeneity in the time horizons and variables maximized by productive as compared to purely financial agents; and heterogeneity in the degree of mobility of factors (financial funds highly mobile, while most producers of GDP tend to be immobile in the short term).[26] All these forms of heterogeneity have significant implications for the effects of the adjustment path, its gradualism, and the feasibility of attaining different combinations of objectives (hysteresis), which implies that there is no single equilibrium but rather multiple ones.

In periods of surges (as opposed to a stable trend), liquidity constraints for consumers tend to be released faster than for productive investors, given the weaknesses of long-term segments of capital markets. As well, consumers can react faster than productive investors since the latter need to identify, design, and develop new projects, which is a time-consuming process. Given the irreversibility of investment, optimistic expectations adopted at a particular time by long-term investors must be taken as sustainable for a longer horizon.

Among producers there is also structural heterogeneity. For SMEs, usually, cyclical swings are more costly. Their potential larger flexibility is overwhelmed by their lack of diversification and their limited access to capital markets; as a matter of fact, financial markets use to be more cyclical for SMEs and informal producers than for large, diversified firms.

In brief, the particular features of the transition to a new equilibria make a crucial difference, and naive reforms may have an extremely long and costly

[26] The issue of structural heterogeneity and its implications for economic development has been widely studied at ECLAC and by associated researchers. See, for example, Fernando Henrique Cardoso (1977); Fajnzylber (1990); Machinea and Kacef (2007); Ocampo and Parra (2007); Ocampo (2002); Pinto (1970); Sunkel (1993).

adjustment period, given the presence of imperfect and *incomplete* markets. What happens during the process (hysteresis effects on the flows of human and physical capital), together with the time involved, can have significant implications for the well-being of people. We must always take into account that the sustained achievement of growth with comprehensive equity is the ultimate objective of economics.

Completion or Creation of Factor Markets

Hence there arises the recommendation of contributing to improve the working of markets by enhancing the role of longer-term horizons and productivistic factors. The target is an endogenous development process guided by reforms and policies designed within the national economy and accommodated to its markets' features and objectives. A crucial space corresponds to the implementation of a productive development policy. This includes systematically developing and *completing* factor markets; the criteria for guiding the priorities and timing of completing markets should be (i) the allocation of resources towards investment in physical and human capital, (ii) deliberately *improving the distribution of productivity and opportunities across society* (particularly removing obstacles faced by SMEs), and (iii) promoting the acquisition of comparative advantages via productive clusters, incentives to innovation, and effective labor training.

Reforms and policies should strive to actively contribute to complete and integrate factor markets rather than increase segmentation, as it has often tended to occur in labor and capital markets with the neoliberal style of reforms. In fact, the combination of trade and financial reforms, real macroeconomic instability, and low GKF implied an increase for demand of qualified workers and entrepreneurs, and weakened that for unqualified workers and small entrepreneurs. As a consequence, most jobs created are informal.

Meso policies, such as labor training, dissemination of technical knowledge, and removing obstacles faced by SMEs in incomplete and noncompetitive markets, are at the core of spreading productivity through society. That is the most sustainable road to endogenous dynamic growth with equity. This is the constructive option, in contrast to inward-looking development based on the more naive old Import Substitution Industrialization (ISI) approaches, or outward-looking approaches based on integration into world markets via abrupt and indiscriminate import and financial liberalization, and the fading-out of the sense of nation.

For success, any approach requires a dynamic and modern private sector, together with active linkages with global markets and an efficient state. Given a framework of structural heterogeneity, achieving an efficient state—central and local governments, regulatory agencies, and public enterprises—is not easy. Furthermore, it is necessary to be selective also in the sense of dealing only with that quantity and quality of actions that the state is capable of designing and

implementing with social efficiency, and focusing efforts where they will have the greatest impact. These principles help to minimize "state failures." However, the performing capacity of the state is not immutable. Fortunately, capacity to design, implement, monitor, and correct can be built with a suitable mix of consistent political will and technical support. Development needs a strong and efficient state.[27]

Growth and Allocative Implications of Instability

Financial and terms of trade instability has become an outstanding feature of EEs. We distinguish two sorts of instability. One is the very short term, which can be faced by the producers of GDP with derivatives or waiting a short while before closing dealings in the market. But the strong globalization of financial volatility is a more damaging instability. Capital surges have been not one-shot events but a process of several continued flows that have taken place in medium-term cycles generated by successive waves of optimism, then followed by contagion of pessimism in international financial markets. Indeed, an essential feature of financial flows to developing countries has been strong medium-term cycles. There was abundant financing in the 1970s, followed by drought in flows in the 1980s, a new period of large inflows in 1990–97, and negative financial flows after the Asian crisis. Although the presence of short-term lending has made the cycle more severe, fluctuations in liquid inflows into stock markets, and longer-term flows such as midterm bank lending and bond financing, have been equally important in generating these cycles. The extended terms of these cycles—thus affecting expectations about macro-prices, among other variables—have generated significant misallocative effects. Given irreversibility of resource allocation, sudden stops in inflows have been a common source of costly crises—for all LACs in the 1980s; Argentina, Mexico, and Uruguay in 1995; East Asia in 1998; and most recently Latin America in 1998–2003.

Instability of the real economy is asymmetrical; inevitably, any instability implies, on average, underutilized potential productivity and lower actual output. In fact, subsequent economic recovery may increase the flow of output in the present up to the full use of existing capacity, but it cannot recover output not generated yesterday. Obviously, this has significant implications for average actual TFP and GDP.

Instability also tends to be asymmetrical with regard to income distribution, since high-income sectors—which used to be more diversified and have better access to financial markets—can take better advantage of the opportunities emerging during economic booms, and then adjust more easily during recessive periods. The available data indicates that distribution has a tendency to deteriorate (rather sharply) during recessions and to improve (rather gradually)

[27] Fukuyama (2004) recognizes and emphasizes the crucial role of the state's strength in development. Actually, developed economies have reached that situation with strong and effective states.

with recoveries, but with a weaker strength on the latter than the former (Morley, 2001; Rodrik, 2001). The labor market is negatively affected via the depressive incidence of instability on the output gap and then on the investment ratio. The more *incomplete* the financial markets and the smaller the capital formation ratio, the larger will be the probability that regressive effects predominate, particularly via worsened labor markets and social expenditure.

Frequent conjunctures with significant underutilization of productive capacity result from external shocks and unsustainable domestic macroeconomic policies and outlier macro-prices, as illustrated by the cases of Argentina and Mexico in 1995. The actual productivity of the total stock of factors evidently decreased in these two nations in 1995, given that this stock kept growing (although at a slower pace) while actual output decreased. Output recovered in 1996–97, giving way to widespread assertions that the crisis had been superseded fast and efficiently. The contagion of the Asian crisis in 1998 sent the region into a six-year recession; as noted earlier, in 1998–2003, GDP growth averaged a shocking 1.4 percent (see table 1), below the rise of population.

Always, the present value of recoveries, as well as of drops in output and welfare, should be considered in assessing the performance of a reform, a policy, or an adjustment process.[28] There is a worrisome tendency to underrate the significance of real instability and underutilization of capacity.

4. A Guide to Reforming the Reforms

A Macroeconomics for Development[29]

A *financieristic* or neoliberal approach emphasizes macroeconomic balances of two pillars: (i) low inflation and fiscal balances, together with (ii) full opening of the capital account. The financieristic approach assumes either that these pillars are enough for achieving productive development in a liberalized economy, or that the two pillars will be enough with the addition of some microeconomic reforms. As shown, several LACs were successful after 1990 in reducing inflation to one-digit figures, and balancing their fiscal budgets. However, economic activity was notably unstable; in the period covered, overall changes in GDP were led by ups and downs in aggregate demand and outlier exchange rates, and these responded to shifts in net capital flows and terms of trade fluctuations. Similarly, in the 1990s, East Asia continued to fulfill the two conventional pillars—low inflation and fiscal surpluses—but several countries lost the third pillar, of sustainable macrobalances for the real economy. Therefore, most EEs were implementing financieristic or two-pillar macroeconomics at the outset of

[28] Several varieties of reforms might work in the sense of generating growth and welfare increase sometime in the future, but after a costly adjustment process is finished.

[29] The macroeconomic issue is the focus of the companion paper for the Commission on Growth and Development (Ffrench-Davis 2009). Here we just present some concluding remarks.

the Asian crises, with the euphoric support of specialists in microfinance. A financieristic rather than productivistic approach had become binding for macroeconomic policies.

An alternative, appropriate definition of macroeconomic balances should include a comprehensive set of fundamentals. That is, alongside low inflation and fiscal responsibility, which are indeed crucial variables, it should include a balanced real economy, including an aggregate demand consistent with the productive capacity of the economy and a "sustainable external balance."

This implies, first, a high rate of use of productive factors (capital and labor), since a low rate of utilization discourages investment in human and physical capital, hampering future growth and macrosocial balances. Second, a balanced real economy must avoid vulnerability to costly external crises by keeping sustainable external deficits and net debt, low net liquid and short-term liabilities, and non-outlier real exchange rates and price-earnings ratios in stock markets.

Naturally, broader macroeconomic goals require more and better policy instruments. A review of complementary domestic macro policies to achieve a sound real macroeconomics covers several key areas including monetary, exchange rate, and fiscal policies; the regulation of capital flows; and effective prudential regulation and supervision of financial institutions. An outstanding feature in all these areas is the need for a strong countercyclical nature in a framework of globalized markets.

The need for effective measures to ensure that capital inflows crowd in productive investment and are consistent with a sustainable macroeconomic environment is emphasized: the composition, the level, and deviations from sustainable levels of the volume of flows are crucial. As discussed, the explanation rests on the diverse capacity of different markets and agents to react, and on the asymmetries intrinsic to instability already discussed.

In the last two decades, capital formation has been comparatively very low. It is a well-established empirical fact that there is a strong correlation between physical investment and growth, resulting from the interrelation of capital accumulation, productive employment, and the absorption of technical progress. Hence, careful attention should be devoted to the effects of given reforms or policies on investment ratios and productivity growth.

In order to move toward a macroeconomics for growth, we need to have a systematic clear differentiation between economic recovery and the generation of additional capacity. This has been a common misleading factor for both leftist and rightist governments in Latin America, and has been present again since 2004. That pitfall leads not only to neglect the relevance of overall investment from the point of view of public policies, but also stimulates the private sector to run a *destabilizing intertemporal adjustment.* Indeed, interpreting mere recovery as sustainable growth of potential GDP—and widely advertised as supported by a supposedly high actual TFP—leads authorities to believe and the population to

feel they are richer and to start consuming the future, while not being really richer. Sharply distinguishing between creating capacity and using existing capacity should be guiding our macroeconomic policy.

Trade Reforms for Development

Deep trade reforms, principally import liberalization, have been implemented in LACs in the past two decades, drastically reducing the dispersion of effective protection; the reformers had foreseen that this would result in more competitive firms, higher productivity, and rising export-oriented production of tradables. All this has happened, to some degree, throughout the region. However, one of the main achievements of economic reforms—the significant dynamism of export quantum (still concentrated on natural resources)—has not been accompanied by overall GDP growth. We stress that, in order for trade reforms to be successful, it is necessary that the present value-added by the creation of new activities (mostly exportables) exceed the present value-subtracted by the destruction of existing activities (mostly importables). This implies an increase in the share of the value-added by tradables in GDP. Additionally, it is expected that export activity will have positive spillover effects on the rest of the economy, which will depend upon the degree of diversification and the quality of value-added in goods and services exported. International competitiveness must be attained through a continuing increase in productivity rather than by low wages and rising subsidies or tax exemptions (Agosin, 2007; Rodrik and Rodríguez, 2001; Sachs, Larraín, and Warner, 1999).

The analysis of trade reforms shows that several LACs adopted abrupt import liberalization together with a weaker export promotion (or non-existent export promotion, beyond the significant direct impact of tariff reductions on imported components of exportables); this is in sharp contrast with successful East Asian export-led growth experiences. Indeed, significant inconsistencies have prevailed in LACs, particularly the coexistence of import liberalization and exchange rate appreciation; usually, real interest rates also have been extremely high, discouraging investment and the restructuring of output toward a rising value-added. In addition, a lack of comprehensiveness has characterized policy sets, with weak or negligible efforts to improve factor markets such as labor training, technology, infrastructure, and long-term segments of capital markets. The shortcomings or *incompleteness* of these markets, plus procyclical features of the macroeconomic environment during the transition from ISI to import liberalization, have been a significant deterrent for private investment and systemic competitiveness. Overall, negative pulls appear to have been stronger than positive pulls on investment and value-added during the transition to post-reform equilibria.

Since exported GDP still represents only about one seventh of total GDP in Latin America, the challenge is to get export dynamism-cum-growth of non-exported GDP.[30]

In LACs, exports are still highly intensive in primary or semi-manufactured natural resource–based goods; that is, LACs are still commodity exporters. Exports that are apparently intensive in manufacturing are actually maquila activities with low value-added. Commodities have had unstable prices (we know with certainty) and (presumably) they have weak linkages with the rest of the economy (non-exported GDP). For export upgrading, there is a role for (i) the level and stability of the real exchange rate (we know that RER instability deters nontraditional exports, and, hence, diversification); (ii) a sustainable macro for development; and (iii) factor market completion in enhancing productive linkages.

One relevant component of Latin American exports that has contributed to their upgrading is associated with reciprocal trade liberalization. Intraregional exports tripled in 1991–97, covering in 1997 one quarter of total exports of goods; but subsequently such exports were greatly affected by swings in regional output in the recessive sexennium. If attention is focused on shares of nontraditional products (which are more intensive in value-added), they are significantly higher in intraregional trade than in total exports of the region. These goods and services face distortions and incomplete domestic markets, which preferential regional trade agreements (PRAs), in an environment of *open regionalism*, can contribute to removing progressively and efficiently. PRAs are significant for these products rather than for traditional exports, for which extra-regional markets will remain the main destination. In this sense, regional trade contributes to a more dynamic and productive transformation of domestic economies, and can complement policies directed to enhance systemic productivity. However, intraregional trade is notably lower than gravity models predict. There is broad room for efficient overall export growth, with a rising share of intraregional trade.

Financial Reforms-for-Development

Financial reforms, including the broad liberalization of domestic capital markets and opening of the capital account, were other outstanding components of the actual implementation of the Washington Consensus package.

The standard outcome for the domestic financial markets has been intensive short-term activity together with weak long-term segments. What is needed is an institutionality that encompasses a vigorous long-term segment of the financial market, in order to finance a rising productive investment ratio, with notably more equitable access. Greater access to this enhanced segment is needed,

[30] The relevant figure is that of net exports; that is, gross exports (the standard published figures) net of imported components. In Ffrench-Davis (2006, ch. VII) we have made rough estimates of net exports. We use those figures in estimating non-exported GDP.

particularly by SMEs and people with low and medium income levels, who typically suffer the social segmentation of capital markets. They need this market to deal with contingencies, to invest in education and labor training, and to promote the development of productive activities and their modernization. Specialized credit entities and guarantee mechanisms are required in order to do what the market has been unable to do spontaneously. The priority in this field should be to favor access to financing at "normal" rates, as well as access to the resources that low- and medium-income sectors do not possess: technology, some inputs and services, marketing channels, long-term financing, and better infrastructure.

International finance has played a leading role in defining business cycles in Latin America. Indeed, from the debt crises of the 1980s, external crises and subsequent recoveries have shaped the pattern of economic instability of most LACs. For the average LAC, generalized booms and recessions were led by sharp changes in aggregate demand; with the exception of 2004–07, those changes were led by sharp shifts in the supply of external financing.

The high costs generated by business cycles in EEs are thus, evidently, related to the strong and growing connections between domestic and international capital markets. This implies that an essential objective of public policies must be to reap the benefits from external savings, but reduce the intensity of capital account cycles and their negative effects on domestic economic and social variables.

In this sense, our approach challenges the common assertion in the mainstream economic literature that efficiency requires an open capital account. It is relevant to review the analytical foundations of the role of capital flows in development and the issue of capital account opening, discussing the contribution it can make to capital formation and macroeconomic stability through different channels. We stress that the conventional arguments are based on assumptions that are often unrealistic regarding the functioning of international capital markets and their interaction with EEs. Therefore, across-the-board capital account liberalization, intensive in financial capital (loosely linked to GKF) rather than in long-term capital and greenfield FDI (directly linked to GKF), can be a destabilizing source of shocks.

The experience with volatile capital flows in recent decades has left behind a track of instability and crises in EEs and particularly in Latin America. But critical episodes have also given origin to valuable lessons that can help us to understand better the process of financial globalization and to improve the future macroeconomic management.

From an analytical point of view, recent crises have shed light over a number of wrong hypotheses that became part of the conventional wisdom of the financial world and part of academia. We summarize five wrong assumptions: (i) recovery from crises is rapid, (ii) open capital accounts discourage macroeconomic disequilibria, (iii) corner exchange rate regimes are

the only viable today, (iv) financial inflows complement domestic savings, and (v) prudential regulation of banks suffices for deterring financial crises. These beliefs have misleadingly prescribed a passive approach in the management of macroeconomic policies.

As an alternative approach, in Ffrench-Davis (2009) we have grouped a set of active macro-policies for open economies. In all of them, the underlying principle is that usually crises are the consequence of badly managed booms; consequently, the main aim of macroeconomic policies should be of prudential nature, by controlling booms before they become unsustainable. In particular, since international capital markets give rise to frequent cycles of abundance and scarcity of funding and systemic crises, policy makers should exercise active capital account and exchange rate management, in order to ensure that capital inflows are persistently consistent with real macroeconomic stability, investment, and growth based on systemic competitiveness. Indeed, in the last decades we have learnt that in spite of the new challenges imposed by globalization of financial volatility, still there is significant room for successful domestic policies. There is no unbeatable reason why LACs cannot improve the balance between positive and negative effects of external shocks.

It is interesting to compare the long experience of Chile with reforms with that of most reforms in LACs one or two decades later. In box 1 we summarized reforms and economic policies in Chile since 1973. There we explain why average growth was short of 3 percent during the dictatorship (1973–89), and examine the policy variables underlying the jump to 5.3 percent since the return to democracy (1990–2008). The more significant positive change took place in the first half of the 1990s with the return to democracy and the successful implementation during this quinquenium of what we call a macroeconomics for development. This experience is especially relevant for three reasons: (i) the Chilean economy is the only LAC that has grown at such satisfactory rates since 1990, averaging 5.3 percent; (ii) Chile led the way in neoliberal reforms, carried out under the prolonged umbrella of the dictatorship of Pinochet, in the long period 1973–89, with a poor average outcome; and (iii) the Chilean case is usually, mistakenly, shown as a uniform-across-time paradigmatic example, which grants great relevance to understanding the process, its ingredients, and the evolution through time of reforms and outcomes. *Reforms to the reforms*, in the early 1990s, represented a sharp move toward a macroeconomics for development.

It is evident that there is need to be *market friendly* and to have *right prices* for a market economy to achieve development. The crucial point is that, consequently, priority must be granted to productive activities and employment; it is impossible to have, in general, good consumers that are bad producers. In contrast, frequently, priority to purely financial activities has resulted in outlier exchange and interest rates and volatile aggregate demand, all providing a most *unfriendly* environment for productive activities. *Productivism* must take the place captured by *financierism* under neoliberal reforms.

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Latin America faces the twin challenges of achieving economic growth and reducing extreme inequality. Notwithstanding their heterogeneity, most Latin American countries (LACs) have exhibited both (i) low average GDP growth and (ii) increased inequality since the early 1990s. The long period of intense reforms under the Washington Consensus approach has been negative on both grounds for most LACs, and the development and equity gaps with rich countries have broadened.

We seek to identify the main failures and missing ingredients for producing equitable growth. We examine the region's general performance since 1990, but in the paradigmatic case of Chile we analyze the country's structural reforms in the 1970s and compare them with reforms of other LACs in the 1990s, stressing some strategic similarities in trade, financial, and macroeconomic reforms.

We evaluate (i) the macroeconomic environment in which agents make their decisions, (ii) features of financial reforms and their implications for capital formation and the distribution of opportunities in the domestic economy, (iii) features of trade reforms, and (iv) unequal distribution of productivities.

Ricardo Ffrench-Davis, *Professor, University of Chile*

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The Commission's audience is the leaders of developing countries. The Commission is supported by the governments of Australia, Sweden, the Netherlands, and United Kingdom, The William and Flora Hewlett Foundation, and The World Bank Group.

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