



Why Doesn't Latin America Grow Faster?

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Section 1

by: Benjamin Jiang

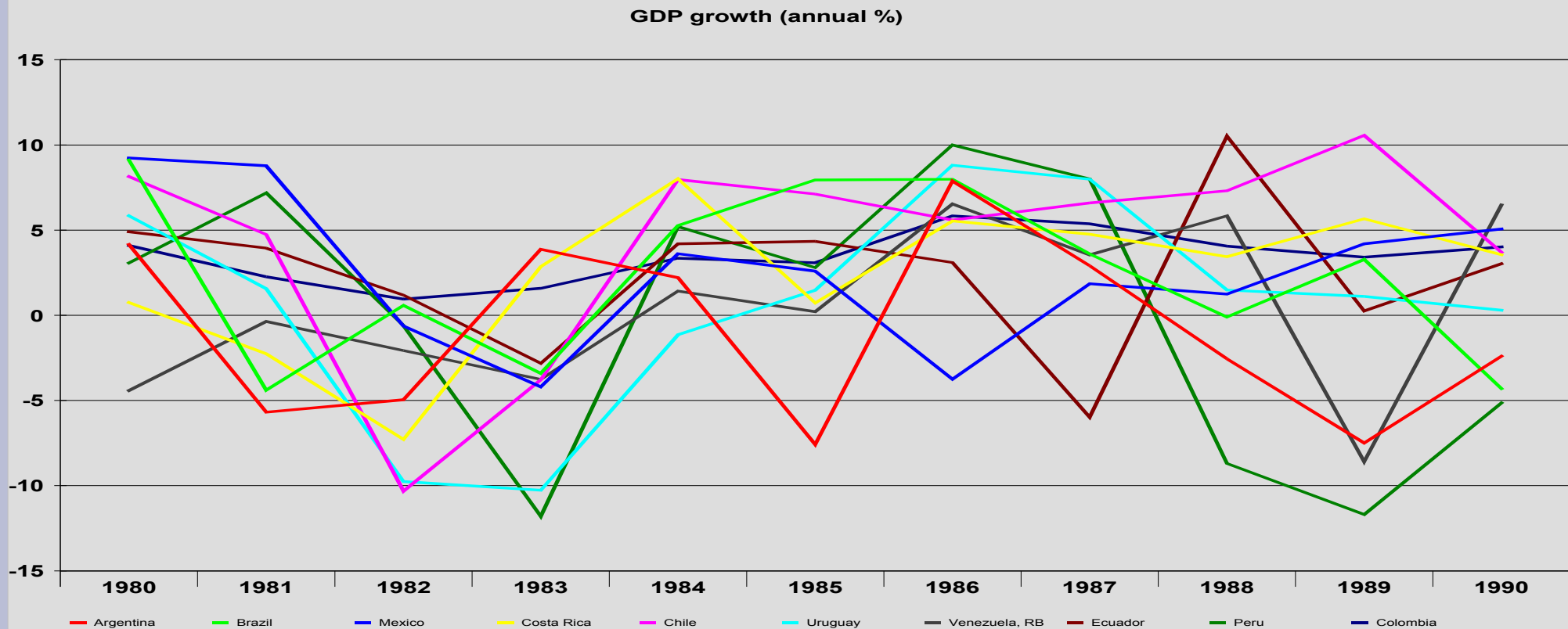
- I. The “Lost Decade” of the 80’s
- II. The 90’s - Driven by Expectation
- III. Critique of Latin American Growth

I. The “Lost Decade” of the 80’s

Key Points:

- ◇ Stagnancy
- ◇ Debt Crisis of the 1980’s
- ◇ The Washington Consensus

Stagnancy (1980-1990) GDP Growth (annual %)

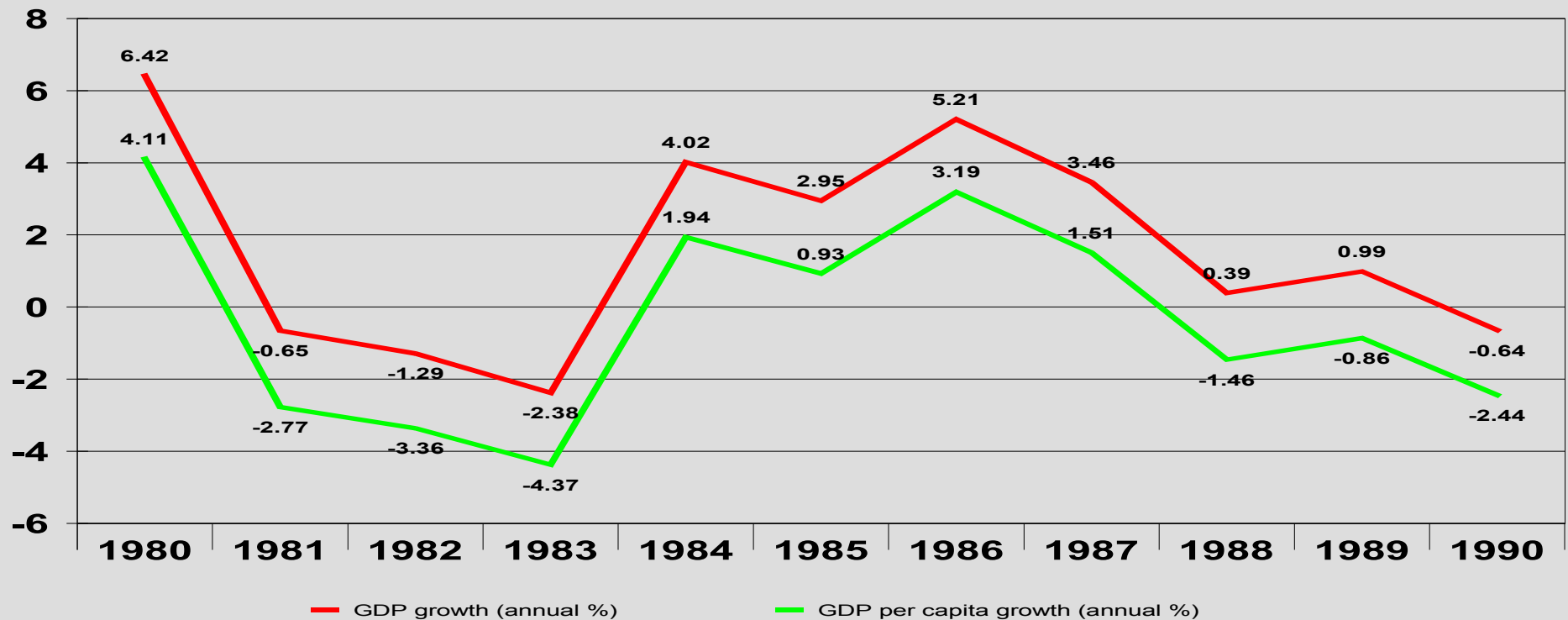


*The imaginary least squares regression line highlights the level of inactivity in terms of Total GDP growth in the 80's

Stagnancy

GDP Growth (%) vs. GDP / Capita Growth (%)

Latin America & Caribbean



*This chart not only shows instability of the economy, it also identifies that the income per worker is directly correlated to the regions GDP.

The Debt Crisis of the 1980's

- Latin America has historically relied heavily on foreign investment to finance their development
- This is okay during times of economic expansion, however, in times of stagnancy, Latin America has always had trouble fulfilling their debt obligations
- Thus creating a “boom and bust cycle”
- On major bust occurred during the early 80's following a 25-year expansionary period.
- The debt crisis followed four interrelated shocks
 - 1) A steep plunge in commodity prices
 - 2) Instability in the financial markets of the first world
 - 3) Recession abroad
 - 4) Unstable exchange rates

From:

“The Latin American Debt Crisis from the 1980's”

-Alexander Theberge

The Washington Consensus

The **Washington Consensus** is a phrase initially coined in 1987-88 by John Williamson to describe a relatively specific set of ten economic policy prescriptions that he considered to constitute a 'standard' reform package promoted for crisis-wracked countries by Washington based institutions such as the IMF, US Treasury and World Bank.

The Washington Consensus: The Proposed Solution

Consisted of 10 Components:

- i) Fiscal discipline*
- ii) Redirecting public expenditure*
- iii) Tax reform*
- iv) Interest rate liberalization*
- v) Exchange rate competitiveness*
- vi) Trade liberalization*
- vii) Allow for FDI*
- viii) Privatization of state enterprises*
- ix) Deregulation/Allow market entry*
- x) Enforce/Establish property rights*

From:

“Did the Washington Consensus Fail?”

-John Williamson

The Washington Consensus

i) Fiscal discipline

The ability of the government to maintain a balanced budget in times of expansion and recession.

ii) Redirecting public expenditure

A redirection of public expenditure priorities toward fields offering both high economic returns and the potential to improve income distribution, such as primary health care, primary education, and infrastructure

iii) Tax reform

Constructing a tax system that would combine a broad tax base with moderate marginal tax rates

iv) Liberalizing Interest Rates

Involves the ultimate objective of market determined interest rates

v) Exchange rate competitiveness

The attempt to create a unified exchange rate at a level sufficiently competitive to induce growth in exports.

The Washington Consensus

vi) Trade liberalization

The argument that quantitative restrictions should be rapidly replaced by tariffs, and these should be progressively reduced until a uniform low rate is achieved.

vii) Liberalization of Inward Foreign Direct Investment

A reform that eliminated all barriers impeding the entry of foreign direct investment

viii) Privatization of state-owned enterprises

ix) Deregulation/Allow Market Entry

The abolishment of regulations that impede the entry of new firms or restrict competition; thus promoting liberalism

x) Enforce/Establish Property Rights

The process of securing the legal system in guaranteeing individuals property right enforcement

From:

“The Washington Consensus as Policy Prescription for Development”

-John Williamson

The Washington Consensus

The Washington Consensus is awesome!

In fact, it's better than TV.



The Washington Consensus was the right thing to do; the place to begin.

What do you think?

The Washington Consensus Criticism & Critique

The Washington Consensus has been the subject of criticism for many contemporary political economists. Perhaps one of the more notable critiques is offered by Joseph Stiglitz which contends that “there is no single ‘best’ strategy for development, that different policies impose different costs and confer different benefits on different groups, and that the choices of alternatives should be made through a democratic process. As a replacement for the Washington Consensus, he offers what he calls a new Democratic Consensus, built around ‘democratic, equitable, and sustainable development.’”

From:

“Nobel sentiment : Joseph Stiglitz and the Washington Consensus”

-Robert A. Senser

The 90's – Driven By Expectations

Key Points:

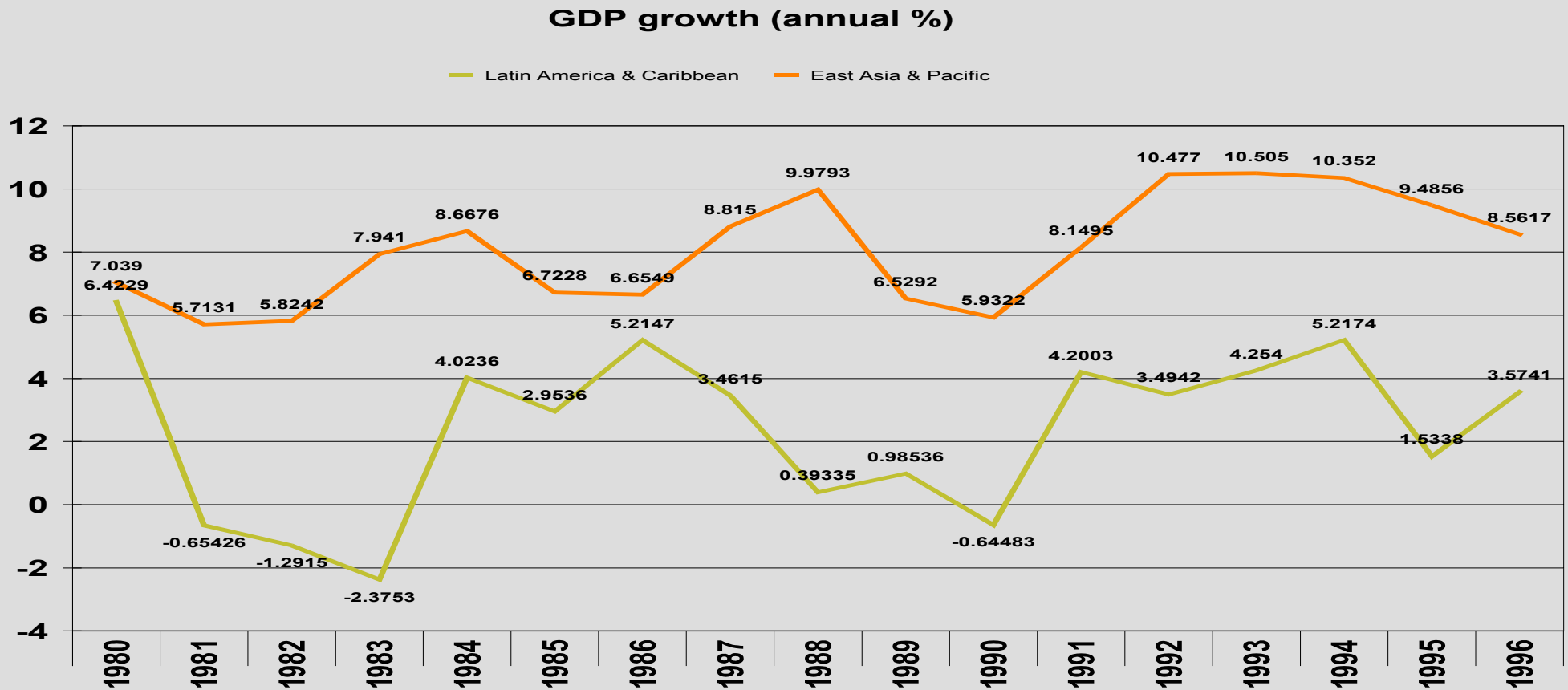
- ◇ The Aftermath of the Washington Consensus
- ◇ Relative International Growth Comparisons
- ◇ Performance Evaluation is Subjective

The 90's – Driven By Expectations

- The implementation of The Washington Consensus reforms led to hopes for high-growth in the region.
- The materialization of said expectations was, however, a different matter.
- And when compared to East Asian economies, realized growth in Latin America seems minute.

The 90's – Driven By Expectations

GDP Comparison to East Asia (1980-1996)

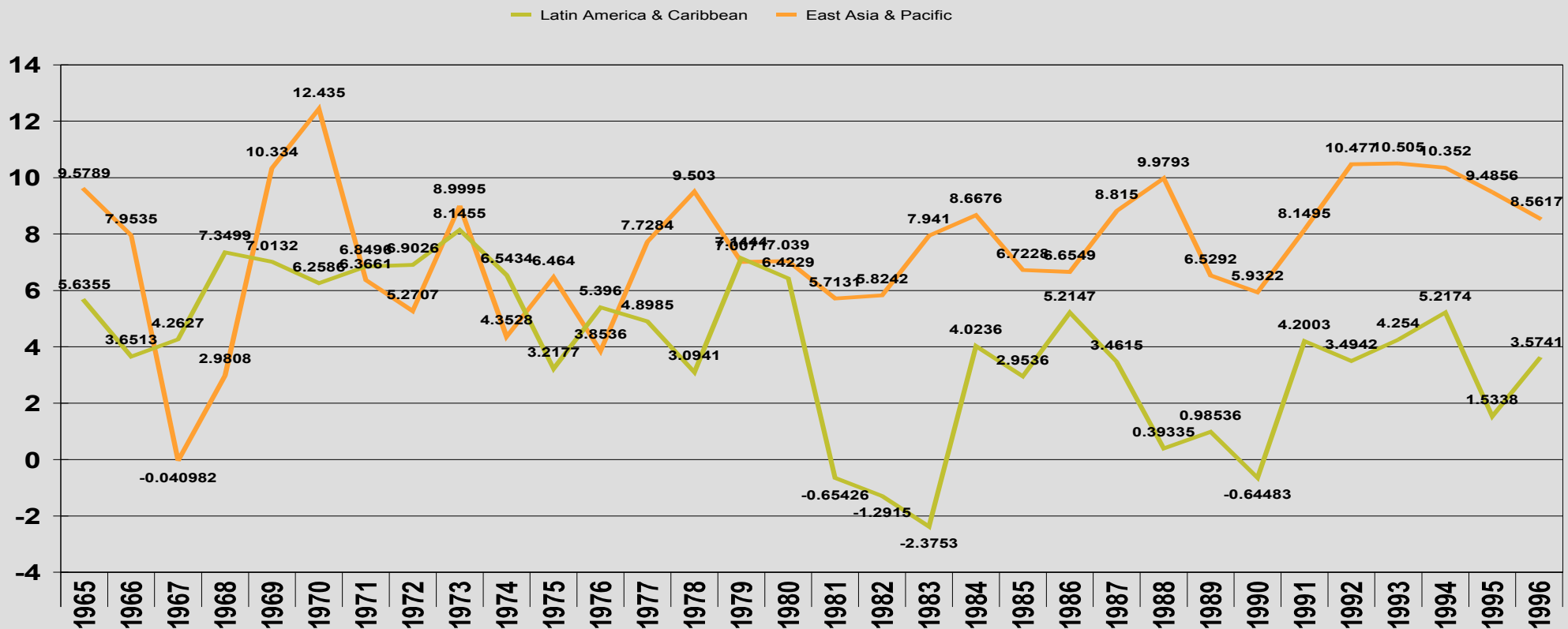


***So, why compare Latin America and East Asia?**

The 90's – Driven By Expectations

A Further Look Back (1965-1996)

GDP growth (annual %)



*Up until 1980, they had comparable growth patterns, but took a steep dive after the 80's and early 90's.

The 90's – Driven By Expectations

What's with the disparity?

“If Latin America attained East Asian values for the reform variables and they remained constant, the per capita growth gap would shrink in the long run by 2.5 percent.”
(F & M)

There is room for increased depth in reforms and there's plenty of scope too, along the lines of structural reform.

Table 6. Decomposition of Per Capita Growth Gaps
(Latin America compared to other regions, 1991-95)

	East Asia “Miracle”		OECD	
Stabilization and Structural Reform		2.52		1.92
Current Reform	3.14		2.24	
Past Reform	-0.62		-0.32	
Control Variables		0.19		-5.62
Income	-0.32		-6.65	
Education	0.52		0.95	
Terms of Trade	0.01		0.08	
Other Factors		2.03		3.15
Structural	0.56		3.71	
Transitory	1.60		-0.42	
Aggregation	-0.13		-0.14	
Growth Rate Shortfall		4.74		-0.55

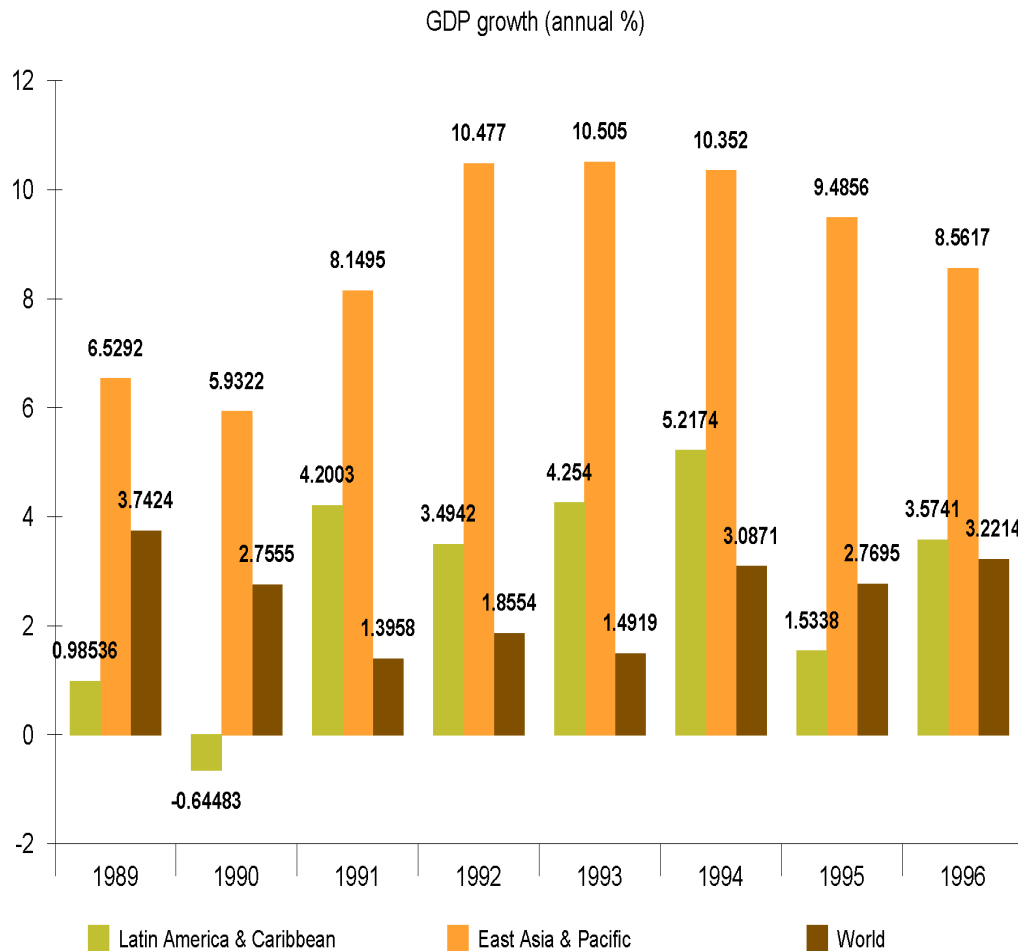
The 90's – Driven By Expectations

Country	Growth Contributions in the Period			Growth Shortfall (1991-95 relative to 1976-80)
	Reforms	External Factors	Other Factors	
Argentina	1.00	-1.60	3.76	-3.16
Bolivia	1.58	-2.81	2.85	-1.62
Brazil	-1.93	-1.58	1.93	1.58
Chile	1.67	-1.69	0.06	-0.04
Colombia	-0.04	-2.21	1.42	0.83
Costa Rica	0.91	-1.92	0.96	0.05
Ecuador	2.45	-2.44	-2.26	2.25
Guatemala	1.46	-2.00	-2.02	2.57
Honduras	0.90	-2.01	-1.83	2.94
Haiti	-1.41	-2.04	-7.45	10.90
Jamaica	3.51	-1.62	3.79	-5.68
Mexico	0.83	-1.86	-3.61	4.64
Peru	1.32	-2.06	4.49	-3.75
Paraguay	0.24	-1.67	-5.61	7.05
El Salvador	2.86	-2.23	4.63	-5.26
Uruguay	0.91	-1.60	0.16	0.53
Venezuela	0.54	-2.79	4.01	-1.76
Typical Country (Simple Average)	0.99	-2.01	0.31	0.71

The external environment was very unfavorable for Latin America during this period, contributing a *negative two percent to the average country's growth when compared to the bloomy '76-'80 period.*

*This directly refutes the absolute effectiveness of the Washington Consensus

The 90's – Driven By Expectations



Disappointment with Latin American growth was itself a reflection of overall slow growth according to ELM.

The 90's – Driven By Expectations

Conclusions for the 90's

- Had people based their expectations on cross-country historical data, there would've been no disappointment.
- The slow growth in the early nineties is a reflection of slow growth in all countries.

Critique of Latin American Growth

Why was Latin America so disappointing?

Critique of Latin American Growth

- Eduardo Fernandez-Arias discusses the dissatisfaction with growth performance using international and historical standards.
- He deduces that growth has not been higher in the post-reform period not because of a failure of reforms, but because of 1) an unfavorable external environment and 2) insufficient dept and breadth of reform.

Critique of Latin American Growth

Table 2: Explaining annual per capita GDP growth (percent)

Explanatory Variables	Including Structural Policy Index	
	(3): Assumption A (Lags underneath)	(4): Assumption B (Lags underneath)
<u>Stabilization and Structural Reform</u>		
Lower Public Consumption	3.4 (0.8) -1.1 (0.8)	3.2 (0.8) -1.0 (0.8)
Lower Inflation	1.5 (0.6) -0.2 (0.6)	1.5 (0.6) 0.1 (0.7)
Financial Deepening	1.5 (0.6) -0.2 (0.7)	1.4 (0.6) -0.1 (0.7)
Exchange Rate Unification	2.3 (0.5) -0.4 (0.6)	2.2 (0.5) -0.4 (0.6)
Structural Policy Index (Residual)	15.8 (9.0)	----- 5.9 (2.9)
Structural Policy Index (Change)		
<u>Control Variables</u>		
Initial GDP	-3.0 (0.7)	-2.8 (0.7)
Education	0.56 (0.39)	0.59 (0.39)
Terms of Trade	6.2 (2.5)	6.4 (2.5)
<u>Worldwide Cycle</u>		
1966-70	0	0
1971-75	0.49 (0.4)	0.45 (0.4)
1976-80	0.19 (0.4)	0.13 (0.4)
1981-85	-1.52 (0.5)	-1.60 (0.5)
1986-90	-0.53 (0.6)	-0.73 (0.6)
1991-95	-1.62 (0.7)	-1.90 (0.7)
<u>Number of Observations</u>	376	376
Adjusted R ²	0.60	0.60
DW Statistic	1.99	1.98
Latin America 1991-95 Average Residual Dummy	0.28 0.59 (0.62)	-0.06 -0.17 (0.86)

The results of Fernandez's study is that despite the unsatisfactory growth gained from policy reforms thus far, the reforms that have been put in place have indeed delivered a boost in growth, as shown in table 2.

Critique of Latin American Growth

- ◇ Fernandez identifies his assertion that the eventual goal of long-term sustained growth rates in Latin America will require both an intensification of reform along the dimensions already implemented and broadening of reform to incorporate changes in the structural characteristics of Latin American economies. However, he does not offer a viable plan of action for which Latin America's growth deficiency problem can be alleviated. To explore this, we move to section 2 of our presentation:

From:

"Reform and Growth in Latin America: All Pain, No Gain?"

-Eduardo Fernandez-Arias

How Can Latin America Grow Faster?

What can be done?

Hausmann and Velasco

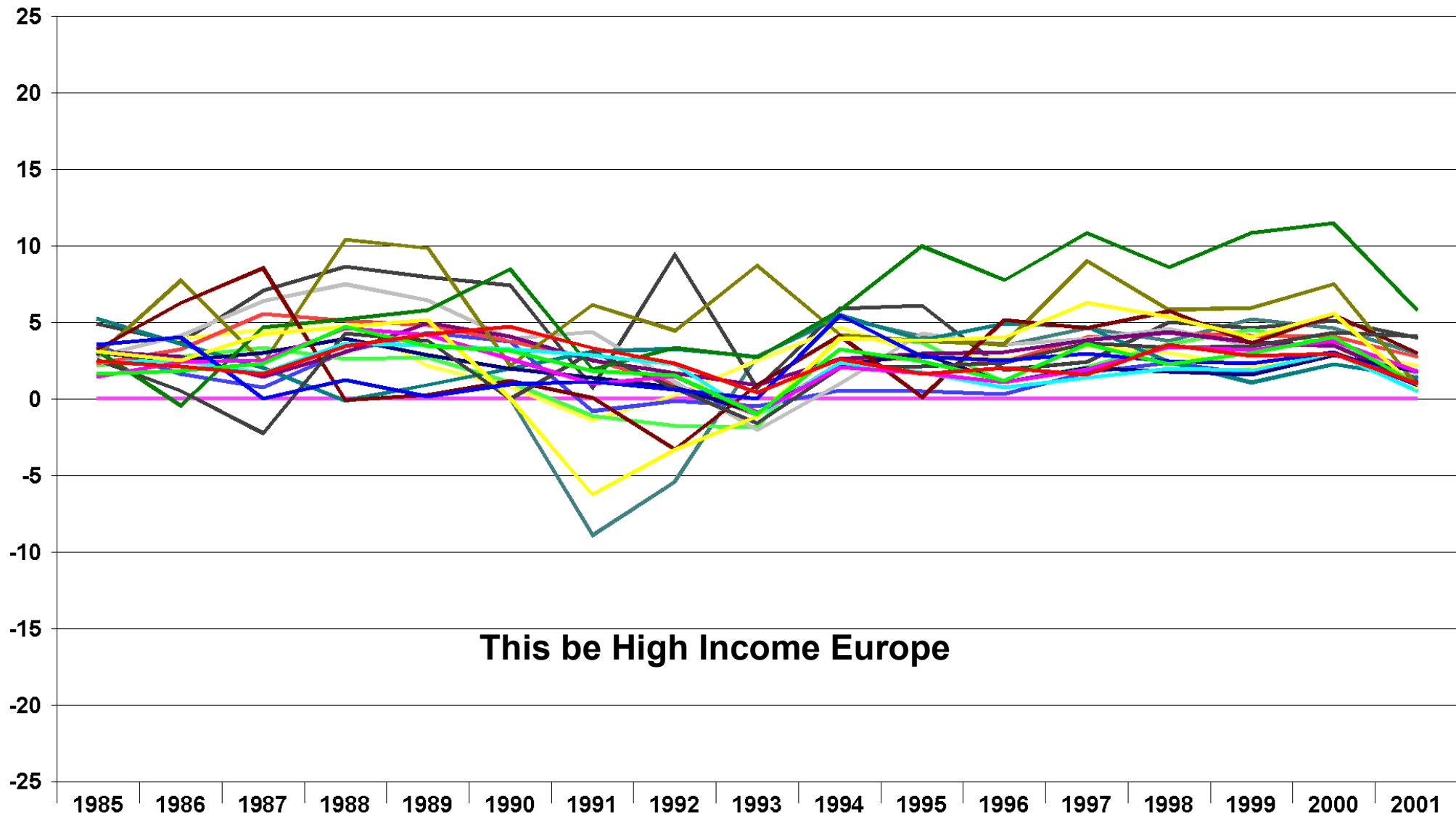
“Perhaps the pitfall is in looking for a single common cause.”

“Different growth problems across Latin America. [...] We need a framework for carrying out growth diagnostics and identifying different obstacles to growth in different countries.”

Do we agree that problems within Latin American countries are sufficiently different to require a case-by-case approach? Or, should we continue to pursue a “reform package” approach?

What can be done?

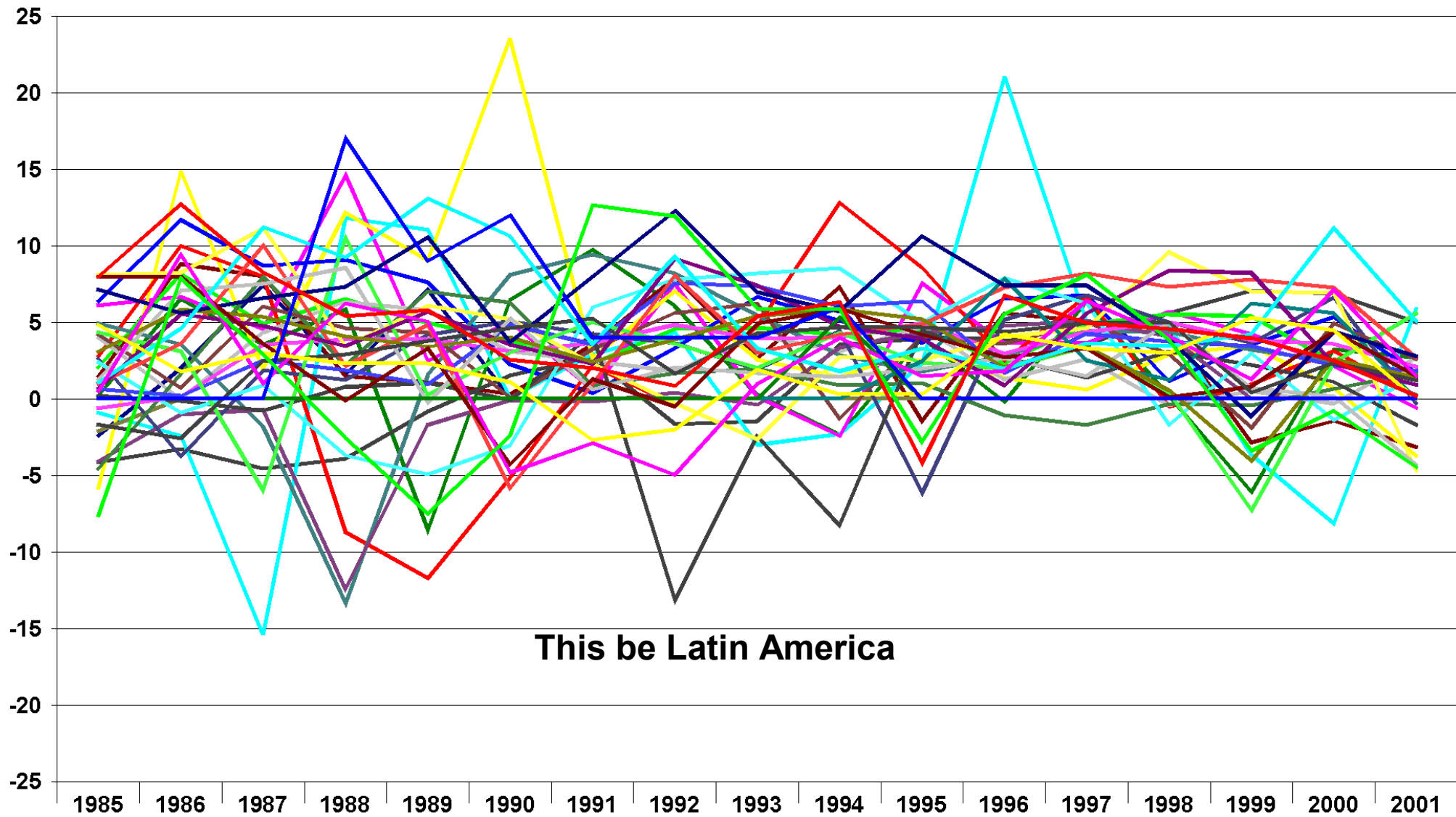
GDP growth (annual %)



This be High Income Europe

What can be done?

GDP growth (annual %)



What can be done?

The basics of growth. Suppose,

Growth is increasing the expected returns to accumulating human or physical assets.

The expected return for a private agent in turn depends on the amount of assets s/he has, the assets' productivity and the appropriability of the generated output.

What can be done?

Expected returns =
(savings/investment effort)(appropriability)(productivity)

This implies that there should be no expected return if:

- i) There are no initial assets
- ii) Output is not appropriable
- iii) The assets are not productive

For private agents! A government can appropriate and sustain non-productive endeavours while still expecting returns.

What can be done?

Expected returns =
(savings/investment effort)(appropriability)(productivity)

Each factor in turn depends upon fundamentals (preferences and technology) and government and market distortions.

In this context, it follows, that a reform is but the removal of a distortion.

What can be done?

Expected returns =
(savings/investment effort)(appropriability)(productivity)

Linearity shouldn't be expected. Changing any one determinant of a factor may result in a vastly different return outcome. That is, initial levels matter to the effect of a reform on growth.

What can be done?

From all this, it is reasonable to conclude that a given reform is likely to produce different growth outcomes depending upon the overall conditions of the country in which it's implemented.

And so the need to prioritize. “To go for the reforms that alleviate the most binding constraints on growth, and hence produce *the biggest growth bang for the reform buck.*”

What can be done?

This approach takes into consideration the fact that it is not possible to go about reforming more broadly and deeply—a fact overlooked in the first two papers.

Not everything can be done at once.

Reasonable enough? What about the Washington Consensus? Lots of reforms were implemented at once—relatively speaking. Why did countries embrace it?

What can be done?

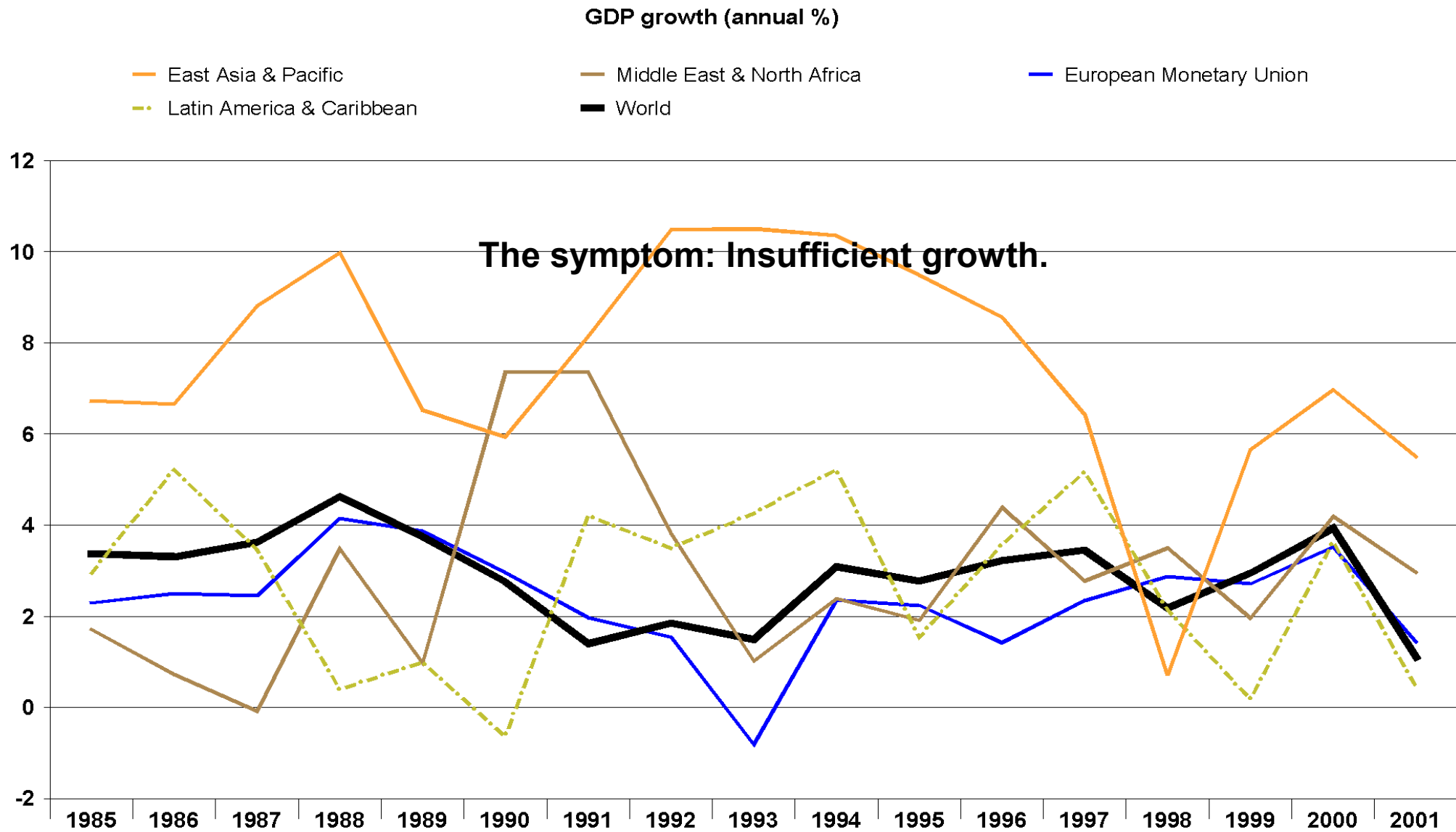
That's not the point. Washington Consensus reforms were not the best reforms for *every* Latin American country.

“[While] Wholesale reform is guaranteed to improve welfare, [for] the best possible economic growth rate is achieved by eliminating all obstacles that stand in its way.”

This requires absolute knowledge of all constraints, an absurd requirement in its own right but not as absurd as believing its feasibility.

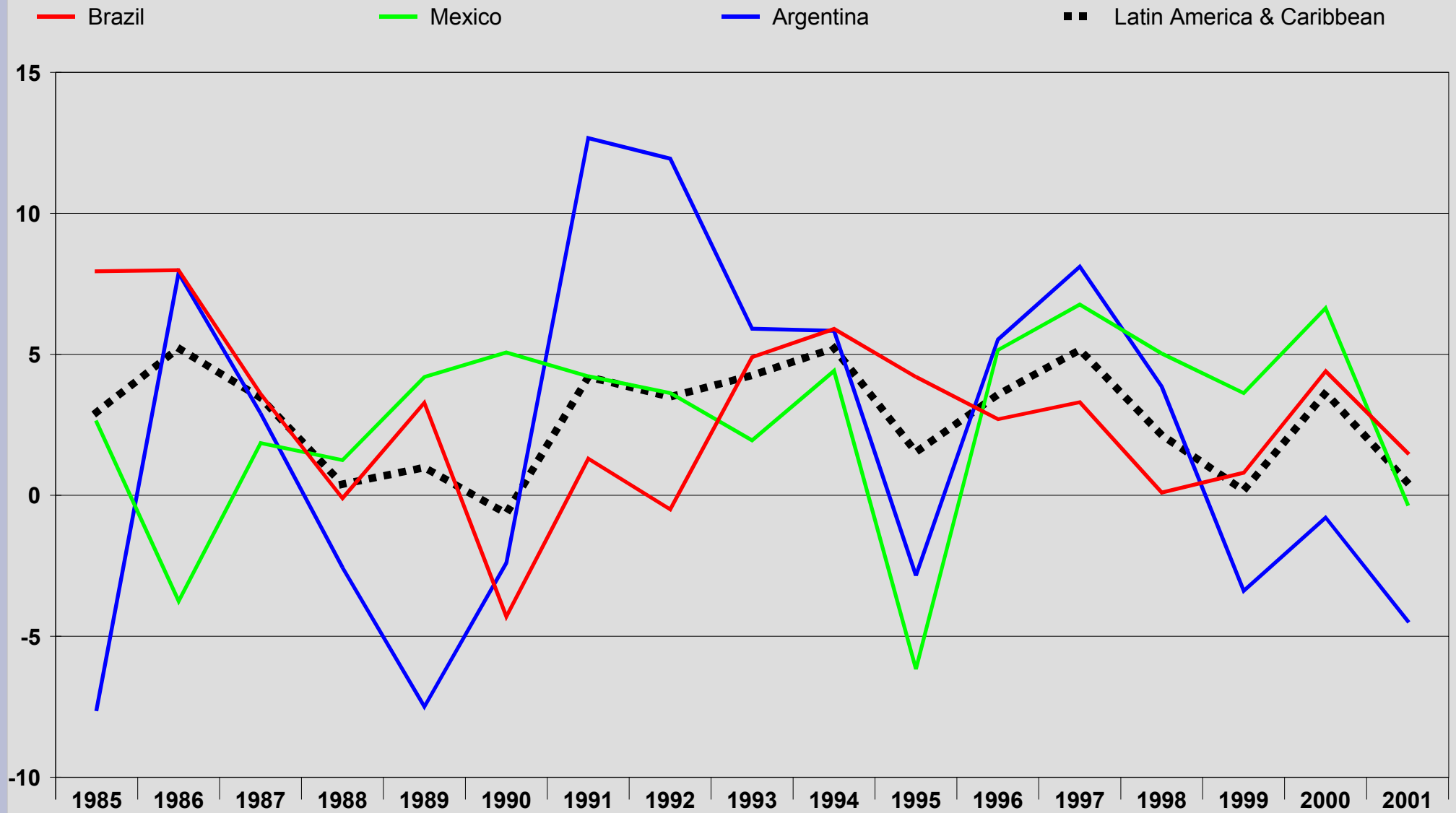
“Technically correct, but practically impossible.”

Diagnostics



Diagnostics

GDP growth (annual %)



Diagnostics

Different diseases

The predatory state:

- The failing state; Lack of property rights or enforcement thereof
- Crises prone state; The not-so-trustworthy state (e.g. Argentina)
- The red-tape state; Barriers to entry and state control enterprises

The over-committed state.

- Over-taxing state; High taxes. Expected after-tax returns are low, which depresses investment demand and leaves low interest rates.
- Under-investing state; Insufficient infrastructure, social returns on investment are low also producing low interest rates.
- Over-borrowing state; Government borrows so much that it depletes all after-tax private sector savings, producing high interest rates.

Diagnostics

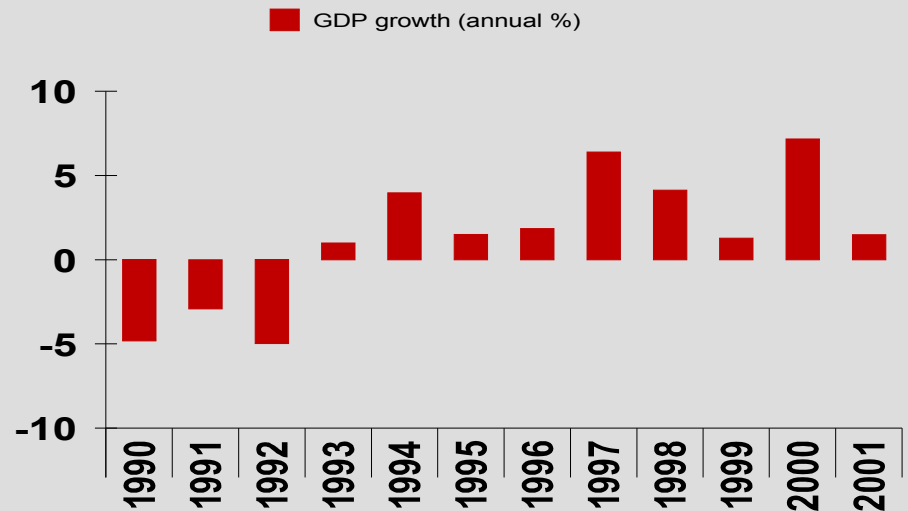
Barbados

- Interest rate avg = 8% ('88-03)
- Investment avg = 15.7%
(more than 4% lower than Brazil)
- GDP growth rate avg = 1%
- Government revenues = 38.2%

Barbados



Barbados



Diagnostics

Killer Applications

“Political order, macroeconomic stability and an adequate business environment constitute the backbone for economic activity”

However, it may not suffice.

Encourage innovation as well as adoption of foreign processes.

Because of competition, too little innovation is bound to occur. Thus, in equilibrium it remains low. Lack of

Diagnostics

Any strong feelings?

Should we be skeptical about this approach?

Is the state all that important?

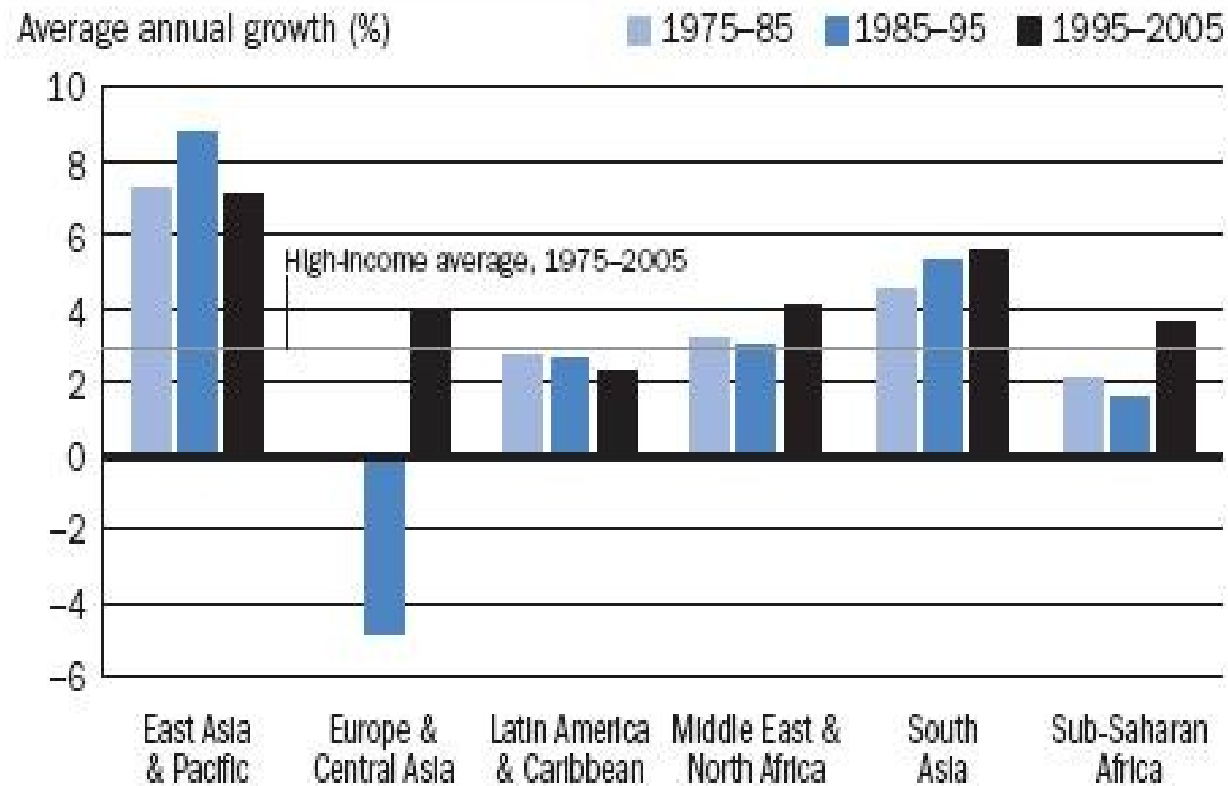
Do they overlook the importance of the external environment?

Could this make flexibility reforms high-priority—the unseen binding constraint?

Outlook

Patterns of regional growth vary widely

4c



Still bad growth performance.

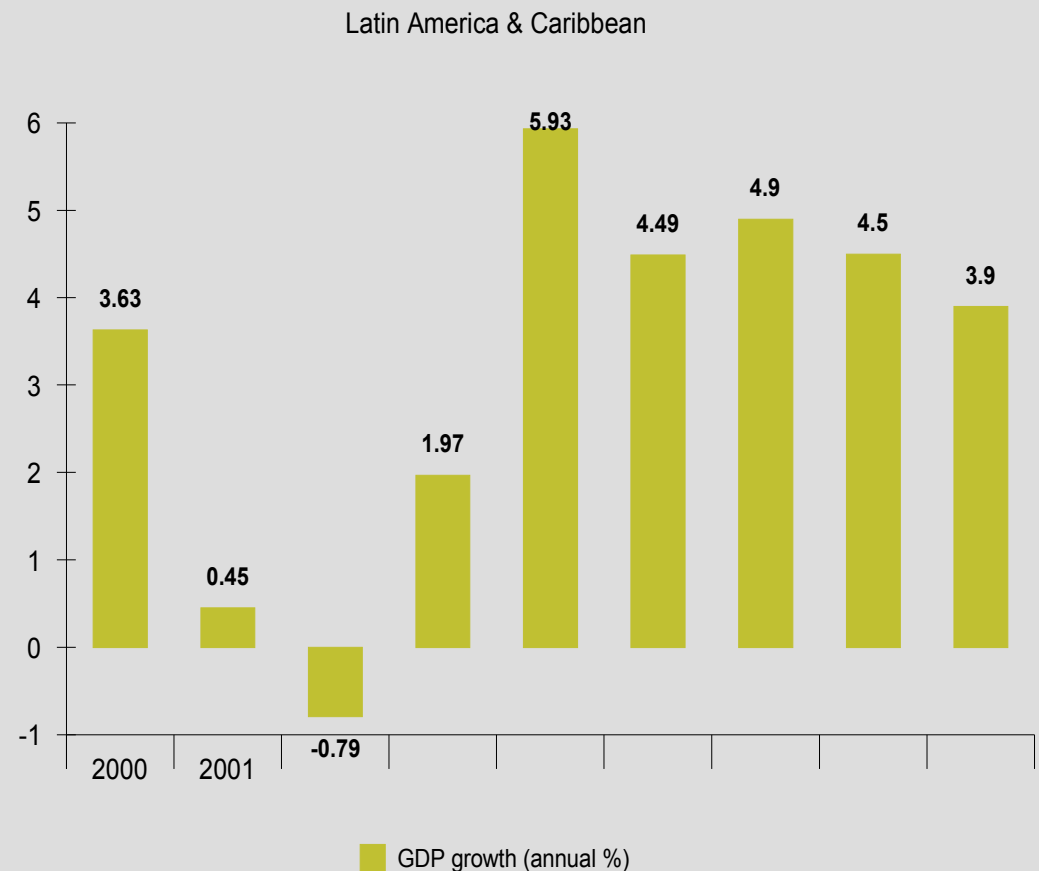
The worst performer in the '95-'05 period.

Is there any hope?

Source: World Bank data files.

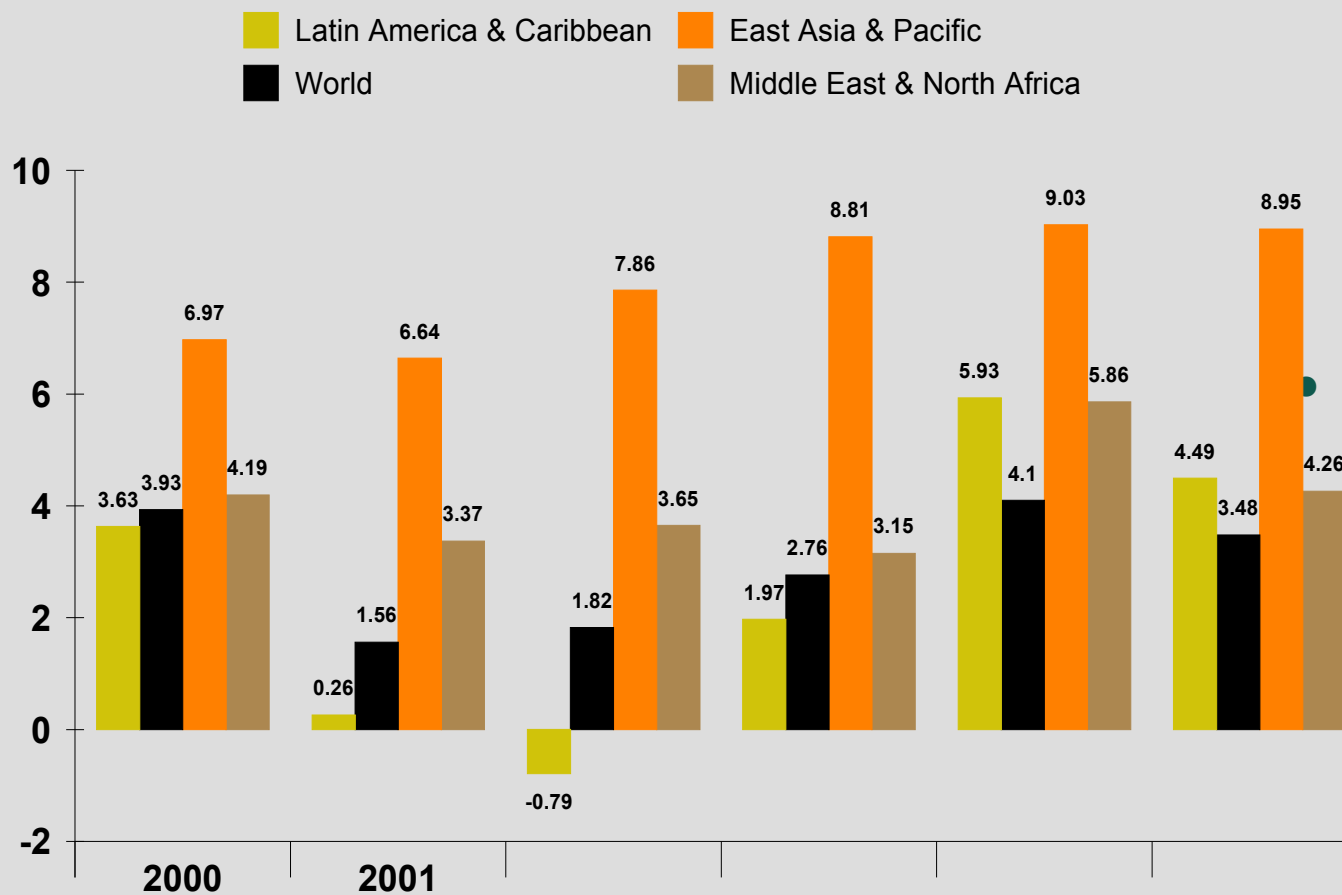
Outlook

- Growth for the period 2000-2008 should turn out to be more than 2%!
- Keep in mind the extremely favorable external environment.
- It is a time of low spreads, “high liquidity” and risk hunger.



Outlook

GDP growth (annual %)



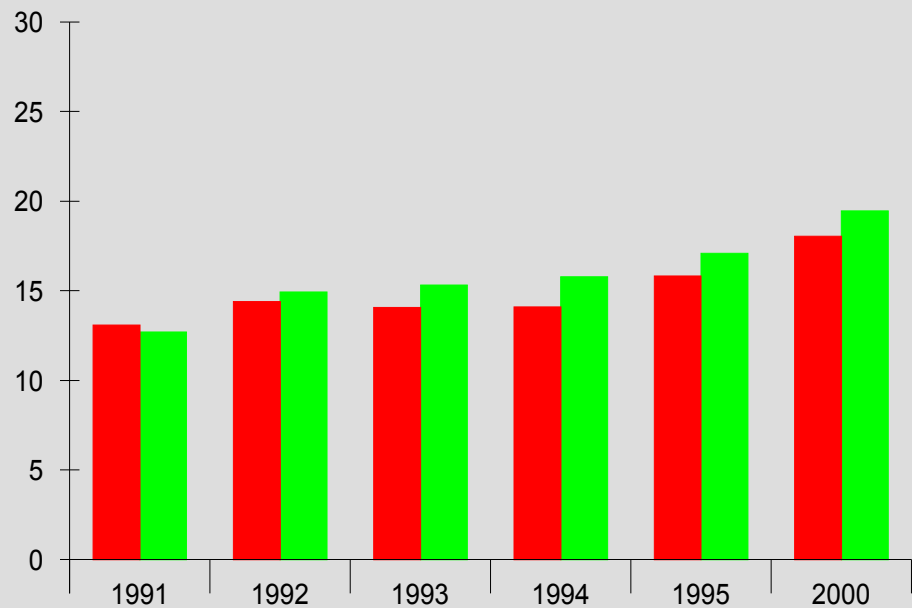
- Latin America only outperforms world growth in the last two years.

- It still lags far behind East Asia

The Middle East and North Africa outperform Latin America.

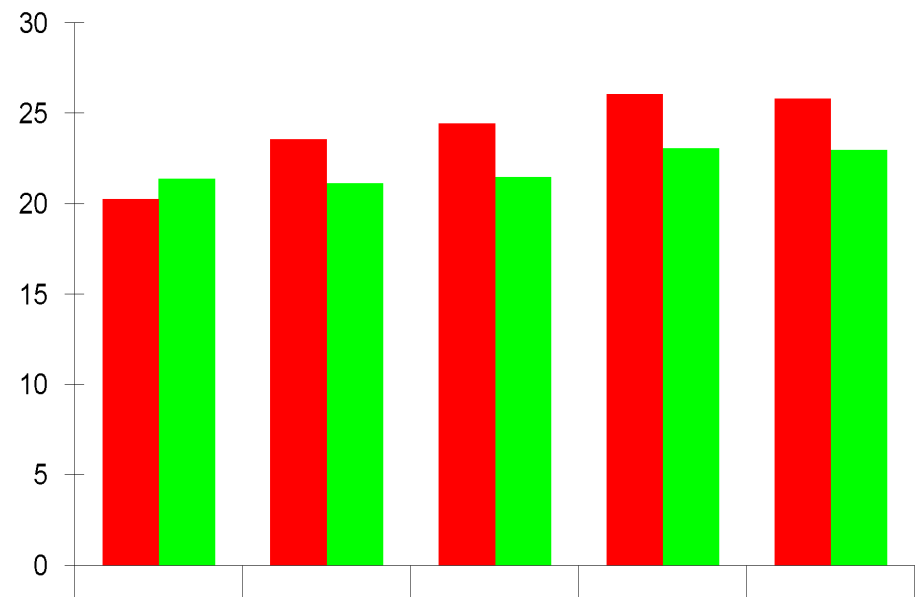
Outlook

Latin America & Caribbean



■ Exports of goods and services (% of GDP) ■ Imports of goods and services (% of GDP)

Latin America & Caribbean



■ Exports of goods and services (% of GDP) ■ Imports of goods and services (% of GDP)

2001-2005

Trade balances across the region have improved. Could this be enough to avoid another series of crises?

Conclusion

- Pimping and state-building ain't easy.
- As with any problem, if an earnest attempt is to be made at a solution, all available information must be taken into consideration.
- It is not radical to look at a country within a region or a region within a country.

Conclusion

- To say one should not have expected what one *did* expect overlooks the reasons and motives behind those expectations.
(Namely, people are poor and the situation is not improving. We want to improve the situation)
- The conditions in most Latin American countries have improved, but again, this is partly due to the external environment.
- Something worth seeing...