Do I have to take the final?

- The final is obligatory.
- If you miss it, you will get a zero.
- (If you are hospitalized, dealing with the emergency illness of a family member, etc., we will find a way of accommodating you.)
- As explained on the syllabus, if you missed the problem set, first midterm, or second midterm (but not two of these elements), we will scale up the remaining components so that they comprise 100 per cent of your grade.
April 24. Latin America: Crisis, Adjustment and Reform
iClicker question: which regional economy had the fastest GDP growth rate between 1950 and 1973?

- A. Latin America
- B. Asia
- C. Europe
- D. United States
iClicker question: which regional economy had the slowest GDP growth rate between 1900 and 1930?

- A. Latin America
- B. Asia
- C. Europe
- D. United States
- Latin America was the world’s fastest growing region in the first 3 decades of the 20th century.
  - The region attracted large capital inflows in the last 3 decades of the 19th century on the basis of its ample endowments of land and resources. 1900-13 then saw the largest capital inflows ever. Inflows continued in the 1920s.
  - Before 1913 and again after 1945, world trade was relatively free, which worked to the advantage of a material-exporting region. World Wars I and II were good for commodity prices and Latin export revenues.

<table>
<thead>
<tr>
<th>Period</th>
<th>LA</th>
<th>Asia</th>
<th>Eur</th>
<th>USA</th>
</tr>
</thead>
<tbody>
<tr>
<td>1900-13</td>
<td>2.2</td>
<td>0.6</td>
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<tr>
<td>1913-29</td>
<td>2.4</td>
<td>1.7</td>
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<td>1.7</td>
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<tr>
<td>1929-50</td>
<td>1.8</td>
<td>-1.1</td>
<td>0.4</td>
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<td>1980-89</td>
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<tr>
<td>1989-94</td>
<td>2.2</td>
<td>5.9</td>
<td>1.3</td>
<td>1.2</td>
</tr>
</tbody>
</table>

Source: Angus Maddison, Monitoring the World Economy.
The region also did well from 1930 to 1950, the first period of import substituting industrialization.

- In principle, there was considerable scope for convergence. Incomes in the big Latin American countries were only 50 per cent of US levels in the 1920s, 1930s and 1940s.
- There was scope for extensive growth, for importing known technologies and capital equipment from the US (something that Latin America did under the rubric of “import substituting industrialization”).

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<tr>
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<td>4.6</td>
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<td>1.5</td>
<td>2.2</td>
<td>1.0</td>
<td>2.0</td>
<td>1.2</td>
</tr>
</tbody>
</table>

Source: Angus Maddison.
But subsequently it underperformed.

- Latin America did the worst of any region considered here during the golden age (though still respectably by its own subsequent standards).
- In the 1970s it received a boost from foreign bank lending.
- The 1980s then saw the debt crisis and the “lost decade.”
- In the 1990s there were glimmering of a recovery as the first wave of reforms were put in place.
- But even now growth continues to disappoint, as we will see.

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<td>2.3</td>
<td>-0.5</td>
<td>2.2</td>
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<tr>
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<td>1.7</td>
<td>-1.1</td>
<td>5.7</td>
<td>5.7</td>
<td>6.6</td>
<td>5.9</td>
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<tr>
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<td>1.7</td>
<td>1.5</td>
<td>2.2</td>
<td>1.0</td>
<td>2.0</td>
<td>1.2</td>
</tr>
</tbody>
</table>

Source: Angus Maddison.
Import substitution, not central planning, was the LA response to the Great Depression

- The Great Depression was a disaster for Latin America.
  - Export revenues collapsed.
  - The terms of trade of commodity exporters collapsed.
  - The US and other importers slapped tariff on agricultural goods.
  - Foreign lending to Latin America was cut off.
  - Even servicing existing loans became impossible, and default followed.
  - Incomes declined and unemployment soared.

- It is no surprise in this context that Latin America became disenchanted with globalization and, for that matter, with the unfettered market.

- Latin countries applied on tariffs of its own.

- Latin countries promoted domestic industry as a substitute for imported manufactures rather than concentrating on exporting the primary commodities in which its land- and mineral-abundant economies had a comparative advantage.

- More generally, governments became more interventionist, micro-managing economic activity to a greater extent than before.
Import substitution worked well for a time

- There was low hanging fruit to be picked: Latin America could move into some industries relatively easily using imported technology.
- Thus, growth accelerated (from low levels) in the second half of the 1930s.
- In the 1940s, with stimulus from World War II, commodity prices recovered.
- Latin America maintained this momentum for a couple of decades after WWII.
- But this cossetted, highly interventionist approach to economic activity worked less well when the scope for extensive growth was played out a continued economic growth required innovation.
- High foreign borrowing, in the 1970s, put off the day of reckoning (as in Eastern Europe), but only temporarily.
  - [As we will see, 1970s was a decade of no TFP growth, but lots of growth by borrowing and brute force capital formation.]
Problems then became increasingly prevalent.
Cumulating over time, the effects on relative living standards were profound

- In 1950, real income per capita was three times as high in Latin America as in Asia ex Japan. (In 1950 many experts saw Latin America as the prospective growth success, not Asia.)
- But by 1994 real income per capita was fully 30% below developing Asia.
- Argentina is a poster child for this problem in the graph at the right.
We see here that disappointing growth largely reflects disappointing productivity performance (TFP accounts for a **declining** share of total growth, the opposite of what we would expect).
To what do economists point when “explaining” these problems?

- Narrow and inefficient tax systems incapable of adequately funding public programs.
- Inadequate spending on education and training (which falls behind the NIEs from the 1960s).
- Overborrowing, leading to repeated external debt crises.
- Monetary and fiscal instability, with its depressing effect on investment.
- Slow export growth (this was a part of the world where exports grew more slowly than output in the golden age).
- Political instability.

- But why?
- We will want to return to this question.
All this came to a head with the debt crisis of the 1980s

- Growth remained respectable through 1970s, reflecting scope for extensive growth.
- Ability to borrow abroad put off day of reckoning. (This is similar to what we saw when we discussed Eastern Europe.)
- But then capital inflows dried up.
- International resource transfer/exports swung from +20% of GDP (in 1975-77) to -40% of GDP (in 1982-87)
- The lost decade (of negative growth) followed.
- Counterexample of East Asian miracle became hard to ignore.
- The result was hesitant in the direction of market conforming reform (the so-called “Washington Consensus” reforms).
Elements of the Washington Consensus

- Macroeconomic stabilization (monetary austerity, balanced budgets). As a result, inflation rates came down.
- Trade liberalization: as a result, export/GDP ratios rose.
- Deregulation of industry. Supposed to encouraged efficiency, investment and inward FDI.
- Public enterprise was privatized. Ibid.
- Labor markets were reformed. (Or at least reforms were begun. In practice, costs of dismissal and other structural impediments remain considerable.)
Chile is an oft-cited success in this connection

- Completed stabilization, privatization and deep structural reform
- Succeeded in attracting considerable amounts of foreign investment.
- Growth has averaged 6% (“Asian-style”) since 1982.
  - [But inequality remains considerable.
  - Uninvestment in education holds back productivity growth.
  - And there are questions whether growth has been artificially supported by strong commodity prices and whether it might therefore be unsustainable.]
Parenthetical question: why has Chile succeeded where others have failed?

- Is reform easier in a small country?
- Is reform easier in a relatively ethnically homogenous country?
- Is reform more easily pushed through by an authoritarian government? (Then what makes it stick after democratization?)
In any case, no other country has been as successful over the last 20 years

- Growth across Latin America as a whole has been barely enough to keep up with population growth. Living standards have barely risen; poverty rates have barely fallen.
  - In the 20 years 1980-2000, p.c. incomes grew by only 11% (again, only about ½ % a year).
  - Even in 2001-2007, an exceptionally favorable period for growth, per capita incomes have grown by only 2.5 per cent per annum (compare China with 9 per cent and India with 6 per cent in per capita terms).

- And this despite the fact that countries have done virtually everything recommended by the Washington Consensus.
  - For example:
Inflation rates have come down
Fiscal policies are stronger
Public debt levels have declined sharply
Countries have developed domestic debt markets and borrowed in local currency.
External positions have strengthened as commodity prices have risen
Reserves have been accumulated
Net exports have grown
External debt to exports has declined sharply
(% of exports goods, services & income)
Investment recovery is being faster and stronger this time

Change in fixed capital investment over GDP ratio in Latin America* (percentage points variation from minimum)

Source: BBVA; *Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela
Credit ratings have improved
That is a long list of what seems like good news.

Who can ask for more?

And yet the payoff from reform has been limited.
Where in particular is the rebound in productivity growth?

<table>
<thead>
<tr>
<th>Contribution to the Potential Output</th>
<th>Potential Output</th>
<th>Productivity</th>
<th>Labor</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981-1985</td>
<td>1.9%</td>
<td>-1.8</td>
<td>2.2</td>
<td>1.5</td>
</tr>
<tr>
<td>1986-1990</td>
<td>2.1%</td>
<td>-0.9</td>
<td>2.0</td>
<td>1.0</td>
</tr>
<tr>
<td>1991-1995</td>
<td>3.0%</td>
<td>0.5</td>
<td>1.7</td>
<td>0.9</td>
</tr>
<tr>
<td>1996-2000</td>
<td>2.6%</td>
<td>0.2</td>
<td>1.5</td>
<td>1.0</td>
</tr>
<tr>
<td>2001-2005</td>
<td>2.4%</td>
<td>0.2</td>
<td>1.5</td>
<td>0.7</td>
</tr>
</tbody>
</table>

Source: BBVA
Bolivia as a case in point

- The country undertook far-reaching reforms starting in the mid-1980s, but the results have been disappointing.

- Incomes per capita are lower than 50 years ago.
  - In 2000 p.c. incomes were 1% lower than in 1950.
  - Even Argentina did better; there p.c. incomes rose by 75% over this period.
Reform in late 1980s and 1990s

- The mid 1980s saw successful inflation stabilization.
- In 1993 a new reform-minded government came to power. It sought to attract foreign investors by offering investors a controlling interest in exchange for new investments in electricity, telecom, hydrocarbons, water and transportation sectors. (Remaining ownership given to the workers.)
- Deep Washington Consensus reforms then led, encouragingly, to 4.5% p.a. growth in 1994-98.
- Foreign investment rose from 2% of GDP in 1994 to 12% in 1998, encouraged by privatization and centered on construction of natural gas pipeline.
- Unemployment in the cities fell from 10% in 1989 to 3% in 1997.
- Urban poverty rates declined from 52% in 1993 to 46% in 1999.
- But since then, the results have been disappointing. (See next slide…)
Since 1999, performance has disappointed

- Growth averaged only 2%, and that only with the help of strong commodity prices.
- Investment declined sharply, to 8% of GDP.

- Contrast China, with investment rates of 45% of GDP.
- Sustaining 5% growth would require private investment of 20% of GDP (assuming capital share of 0.25).

- As a result, growth has slowed and the reduction of unemployment and poverty rates has ground to a halt.
This failure to produce results has political consequences.

- Starting in 2003 there were violent protests against budget and tax proposals and natural gas exports.
  - Objections to “giving away half of natural gas” to foreign investors.
  - Complaints that austerity failed to deliver growth.
  - Increasing activism of indigenous peoples

- These led to 60 deaths, runs on banks, president’s resignation.
  - In response, government promised greater social dialog and a referendum on natural gas policies and exports.
  - But ethnic and region tensions, weak government and violent protests makes for an uncertain investment climate.
  - Election of new socialist president similarly deters foreign investment.
To be sure, a number of special factors have contributed to the subsequent slowdown

- You can build a gas pipeline and privatize public enterprise only once.
- Mid-1990s were unusually favorable from the point of view of international capital flows. Russian & Asian crises followed.
- El Nino in 1998 hit agricultural production
- Brazilian and Argentine downturns (1998-2001) depressed region
- Coca eradication from 1997, supported by US reduced corruption and organized crime but depressed incomes of poor farmers.
- Under these pressures, public spending rose sharply, and with it deficits. Led to further austerity measures.
And Bolivia suffers from a number of special handicaps

- Remoteness
- Conflicts between wealthy elites in lowlands and indigenous people in highlands making up half the population
Bolivia has lowest ranking in LA from World Economic Forum for quality of business environment.

- Regulations are arcane and burdensome (takes 2 months to register to set up a business).
- Property rights, rule of law, and enforcement of contracts are perceived by investors as uncertain.
- Public referendum regarding privatization of natural gas created uncertainty about whether it would be reversed.
- Protests against privatization of water supply in some cities, and rises in rates, led to abrogation of contracts.
- Illegal occupation of private lands by activist groups of indigenous people discouraged investment in agriculture and forestry.
- Political disputes over distribution between poor indigenous population in the west and wealthier urban population in the east.
Given all this, why has the payoff to reform been disappointing?
Given all this, why has the payoff to reform been disappointing?

- Washington Consensus answer would be that reforms remain incomplete.
  - Macroeconomic policy is still less than credible.
  - Structural reforms are still very partial.
  - Creditor rights, contract enforcement and rule of law still unreliable.
  - Tax systems remain inefficient and narrow.
    - Jeromin Zettelmeyer, in one of our readings, uses the following figures in support of this argument.
Comparison of high-income countries, Latin America, Asia and Sub-Saharan Africa
Comparison of high-income countries, Latin America, Asia and Sub-Saharan Africa
Comparison of transparency (2002 dip reflects events in Argentina)
So the implication follows:

- Washington Consensus I reforms are necessary but not sufficient for sustained economic growth at rates that significantly reduce unemployment and poverty.

- In addition, sustaining investment at the requisite rates also requires the political and social stability needed to boost domestic savings and attract investment from abroad.

- This leads to the “Washington Consensus II” agenda
  - Addressing problems of market underdevelopment,
  - Strengthening weak property rights
  - Strengthening rule of law
  - Rooting out corruption
But this begs the question of why LA has these institutional shortcomings

- It is tempting to apply Acemoglu, Johnson and Robinson’s story.
- A version of this was in fact developed independently by Kenneth Sokoloff and Stanley Engerman for Latin America.*
- In a nutshell, they argue that tropical climate (conducive to growing sugar and tobacco) was conducive to large landholdings, wealth inequality, plantation agriculture and (historically) forced labor. High levels of inequality then bred political institutions that gave arbitrary power to large, wealthy landholders. In contrast, the property rights of the masses were not protected. Once this way, always this way, they argue.

And the income inequality implied by this story is an incontrovertible fact

- Incomes of top decile as a multiple of bottom decile circa 1970 was 20 in Latin America, 10 in the OECD countries, and 7 in industrializing East Asia.

- This has a number of important implications for growth:
  - Difficulty of raising fiscal revenues.
  - Underinvestment in education
  - Political instability
But this story is problematic

- Large parts of LA (Argentina and Chile, for example) are far from tropical. Levels of income and institutional development vary enormously across the region. And there is no obvious mapping from climate and geography to institutional strength (strong in Chile, weak in Argentina).

- In Bolivia, Peru and Ecuador, large parts of the country (the Andean highlands) are and long have been occupied by indigenous smallholders. This would point to the development of strong democracy and effective checks and balances along North American lines, according to SE. But this has not been the case.
Coatsworth suggests an alternative

- What is it?
Coatsworth suggests an alternative

- What matters most is who colonized you.
- England had a Magna Carta and the Glorious Revolution in 1688, empowering the Parliament, constraining the Crown, and creating a system of checks and balances.
- Spain and Portugal had no similar political developments.
- Latin America, unlike North America, had the back luck of being colonized by the Iberians, who transferred their systems of arbitrary political power.
Problems with this version?

- Again, ignores the fact that strength of institutions seems to vary among Latin American countries, even though the identity of the colonizer does not (contrast Chile and Argentina).

- And strength of institutions also varies over time, contrary to the implications this very deterministic interpretation (contrast Chile under Pinochet and after).
Whether one buys the Acemoglu et al. version or the Coatsworth version, history casts a long shadow.

Historical legacies can pose an obstacle to building stronger political, legal and bureaucratic institutions.

Nonetheless, a historical legacy need not imply historical determinism, as Coatsworth emphasizes and we saw last time. Institutional arrangements can and do change. (Coatsworth recalls the Soviet example.) Small changes can cumulate and thereby have large effects.

But the question is where to target efforts to make those small changes.

- Consider three alternatives
Alternative 1 (following Pablo Spiller of our business school)

- Reform efforts should focus on political institutions that are overwhelmingly important in determining economic policy and the economic environment more generally.
  - In this view, constitutional, legal and process reforms can significantly alter policy outcomes.
  - The idea is that history delivers a political system that determines policy outcomes. One can most effectively cut into the problems bequeathed by history by reforming that political system.

- Thus, move from a proportional to a majoritarian representation electoral system to avoid congressional fragmentation, instability and deadlock.
- Or give the finance minister more agenda setting power over the budget as a way of avoiding free-riding behavior toward spending

- But are political systems really so easy to change when they grew have deeply-rooted historical legacies.
- And are the effects and effectiveness of different political systems really so predictable? (Proportional representation electoral systems seem to work well in, say, Europe, where they encourage coalition building and compromise.)
Alternative 2 (following Raghu Rajan and Luigi Zingales of University of Chicago)*

- Focus on creating *constituencies* for institutional reform
  - Farmers benefit from land reform. Use this as a way of creating a constituency for market friendly policies (as in Japan, Korea, etc. after World War II)
  - Workers in manufacturing benefit from export led growth. Thus, use export led growth as a way of spreading support for reform.

- But creating constituencies is easier said than done.
  - Competitive exchange rates and export led growth were item #5 on the original Washington Consensus. What is new here?
  - Mass privatization was seen as a way of creating a constituency for reform in Russia, and because of how it was done it ultimately created a backlash against reform.

Alternative 3 (following Hausmann, Rodrik and Veslasco of Harvard)

Avoid one-size-fits all advice.

- The problem with the Washington Consensus (and with WCII, WCIII and so forth) is the assumption that one set of reforms fit all.
- HRV observe, sensibly, that the binding constraint – inadequate savings, inadequate incentive to invest, or whatever – may differ across countries. The biggest bang for the buck and the way to avoid reform fatigue is to focus on the binding constraint.

- But is the binding constraint all that easy to identify?
- And, if reforms are complementary (recall our discussion of the Big Bang approach to transition), focusing on one alone may have a relatively low payoff.

Reforms work, but sometimes the payoff is disappointing in the short run, and the amount of time needed for results to appear proves challenging.

These facts can create reform fatigue and a backlash against reform efforts.

What to do?

- Stay the course? Easier said than done?
- Focus on binding constraints? Sure, if they can be identified and if complementarities are not important.
- Reform political institutions? Are we sufficiently good political engineers to be able to do this?
- Build constituencies for reform and liberalization? But the best way of doing so is time consuming (it takes a generation), so this doesn’t solve the problem in bullet point 1 above.

- We will return to all of this in subsequent lectures.
But now comes the credit crisis. (Can Latin America “decouple”?)