

Nota para Coloquio sobre Crecimiento en América Latina

(Perdón, me equivoqué y lo escribí en inglés!)

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- The main objective of this venture is nothing less than to understand why growth is so low in Latin America, and what policies would be appropriate to change this.
- There are, of course, several explanations one could offer for slow growth, but an explanation would be more satisfactory and convincing if it could also explain or at least be consistent with other characteristics of LA: high volatility, high income inequality, and weak states.¹ There are other LA stylized facts one would like to explain: low savings, low scale of firms, high informality, etc. Often, what we do is to try to explain these individual facts separately, but perhaps it is time to try to think of them together as LA stylized facts, and tackle the difficult challenge of putting together a theory that would be consistent with all of them.
- One problem with this strategy, of course, is that there are significant differences across Latin American countries. We have cases of successful development, such as Chile, with an income per capita level that is almost an order of magnitude higher than Nicaragua's. Clearly, we can learn as much about development from considering differences within Latin America, as we can learn by considering differences between some imaginary LA model versus other regions. But it seems nevertheless useful to think of such a model, and this is precisely what I will discuss below.
- One way of motivating this discussion is by asking why Latin America suffers from these problems, whereas East Asian countries manage to perform much better. Clearly, low growth is not a problem that all LDCs face. But it could also be argued that Latin America's bad performance is not the exception but the rule for LDCs... perhaps East Asia's miracle is the exception, not Latin America! If this were true, then it is not so much that we need to explain LA's bad performance, but rather that we have to explain

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¹ A recent paper by Aghion and company argues that credit constraints lead to both higher volatility and lower growth, and perhaps also higher income inequality, but this just leads to the next question: why does Latin America suffer from more binding credit constraints? (Aghion, P. G. Angeletos, A. Banerjee and K. Manova Volatility and Growth: Financial Development and the Cyclical Composition of Investment, Harvard University).

the East-Asian Miracle. The approach I take below is to explain LA's bad performance as if it was the exception that needs explanation.

- Two deep theories come to mind that could explain LA's bad economic performance: one postulates that LA's problems come from historically determined "institutions" and the other is that the main problem arises from LA's endowment structure (i.e., abundance of natural resources).
- Another possibility has to do with bad policies. If policies are exogenous, determined by "ideas," then it could be that LA just happened to choose policies that led to high volatility, increasing inequality, and low growth. Things like import substitution, and open capital accounts with weak financial systems, could be examples of such bad policies.
 - One example that shows that policies cannot be seen as completely endogenous is China. Clearly, a change in policies over the last three decades explains the current miracle there, and it is impossible to argue that history or endowments explain such policy shift.
- To state the obvious, I think that Latin America's bad performance is due to a combination of the three factors: endowments, institutions and policies. In particular, natural-resource abundance makes it more difficult to develop good institutions, and makes bad institutions particularly problematic; moreover, bad institutions makes it more likely to have bad policies, both in terms of content and in terms of their "outer features," such as stability, flexibility, implementation and enforcement.²
- The idea that an abundance of natural resources is a hindrance to development has been intensely debated, without reaching anything close to a consensus. The simple hypothesis that natural-resource intensive industries lack growth potential is clearly rejected by considering the experience of countries such as Canada, Australia, the Scandinavian countries, and – of course – Chile. But it may be the combination of weak states (perhaps arising from income inequality) and natural-resource abundance that generates the problems.
- Let me elaborate on this point. With a strong state (by this I mean a "developmental state," one that is interested in development, and can formulate and execute long-term

² Tomassi, Stein and Spiller, "Political Institutions, Policymaking Processes, and Political Outcomes: An Intertemporal Approach," IADB, 2003.

policies to bring it about), then NR abundance is not a hindrance to development, as the cases of Canada, Australia and the Scandinavian countries show. But with a weak state, then NR abundant countries remain specialized in a few commodities, which brings about low growth, high inequality, and high volatility.³

- Consider a model where each industry may have low or high productivity according to whether it solves its industry-specific coordination problems. Let Z be the improvement in productivity that a sector realizes if it achieves “coordination.” This Z may differ across sectors. The productivity increase arising from coordination (i.e., $Z > 1$) may come from coordination to get appropriate regulation, or sector-specific public goods, or industrial agglomeration, etc. If a country has a comparative advantage in an industry with a higher Z , then its income gap with respect to rich countries (assumed to have mastered coordination in all their sectors) will be higher if they fail to achieve coordination. Thus, if Z is higher in natural resource-intensive industries (this is just an assumption, and I have nothing to support this assumption for now), then a weak state leads to lower relative income levels than for countries with strong state or with a different endowment structure. In sum, having an abundance of natural resources is not itself a curse, but it does place higher demands on the political system.
- Note: rich countries that have an abundance of natural resources don’t suffer from high volatility, but this may be because when they achieve coordination, they move out of simple commodities, upgrading to more sophisticated goods and higher diversification.
- Why is it that Latin America appears to be plagued by weak states? First of all, there are some important exceptions: Chile is the most obvious case of a country with a strong state, whereas Brazil, Uruguay and Costa Rica offer more moderate examples of strong states. But the norm in the region appears to be that of weak states. The most common explanation is that this is due to history. In particular, the existence of indigenous societies that lagged European societies in terms of weaponry and other aspects, together with the abundance of natural resources led to extractive institutions, inequality, racism,

³ Here I implicitly assume that a strong state is also a developmental state, but this is not necessarily the case. One could imagine a strong state that is not developmental, in that it could design and carry out elaborate policies, but it could have an objective that is not economic development, but military power, or enrichment of the ruler and the elite, etc.

fragmentation, etc. In turn, inertia explains that even today, countries are affected by the institutions that arose hundreds of years ago.

- Two comments about this last point:
 - First, institutions are not set in stone. Ideas, individual leaders, and external shocks all affect history and institutional evolution. Perhaps the priority now is to think about policies and reforms that would allow an improvement of institutions and stronger states in the region.
 - Second, one could argue that the evolution of political institutions in the region first led to dictatorship by the elites, and later on to highly fragmented democracies. One way to think about this transition from dictatorships to fragmented democracies is in terms of the classic trade-off between governance and representation. In societies that are more fragmented, or polarized, this trade-off is particularly steep, as it is difficult to establish both representation and governance. Perhaps what we have experienced over the last decades is the transition from one extreme with low representation and high governance, to another extreme with high representation and low governance. In this case, the challenge now would be to tinker with electoral systems and democratic institutions so as to achieve a better combination of governance and representation.
- According to the previous points, the main challenge for LA is to implement political and institutional reforms that would lead to stronger states and then pursue appropriate development policies. Of course, this doesn't mean that in the meantime there should be no effort to improve the current set of policies, but it does suggest that the priority in most countries should be to improve institutions. Moreover, it implies that countries with weak states should be less ambitious in the type of development policies adopted.
- Two examples are worth discussing related to this last point.
 - The first example is the implementation of Export Processing Zones. In Mexico, Central America and some Caribbean countries, EPZs have been a key component of recent efforts to open the economies and increase exports and FDI. I have argued elsewhere that export promotion and attraction of FDI are not the best development policies, but I also noted that EPZs are easy to implement and may be particularly effective for countries with weak states that are just adopting

outward-oriented development strategies (“Microeconomic Interventions After the Washington Consensus”). Thus, EPZs may be appropriate for Nicaragua, but not for Costa Rica.

- The second example is related to policies to support Small and Medium-Sized Enterprises (SMEs). The conceptual case for this is very weak, but even putting this aside, one must note that almost all firms in LDCs (and even DCs) are small. Thus, pursuing a policy to improve productivity in SMEs implicitly assumes that the State will be able to implement programs to improve productivity for most firms in the economy. This is clearly overly-ambitious for a weak state.
- As the topics chosen for this Coloquio show, there are many issues that must be addressed in order to improve economic performance in the region. I have been thinking lately about one such issue, namely the set of “microeconomic interventions” that should be pursued to increase growth. I believe that even with the current institutions we have in Latin America, we can do much better in this area. Currently, the standard set of microeconomic interventions (MI) entail export promotion, FDI attraction, promotion of SMEs, and innovation policy. Unfortunately, these interventions either lack strong theoretical and empirical basis, or are implemented in ways that are likely to prove ineffective. A more appropriate set of MIs should depart from an analysis of the market failures that most significantly retard development. I believe such market failures are information spillovers that prevent discovery of new profitable investment opportunities, and coordination failures that prevent actions that would improve productivity in areas of comparative advantage.
- Following the discussion above and the recent paper by Hausmann, Rodrik and Velasco named “Growth Diagnostics,” one could think of a matrix where one classifies countries according to whether they have a weak or strong state, and according to whether the binding constraint to growth is lack of finance, excessive taxation (explicit and implicit) or low returns to investment. For countries with strong states and low returns to investment, an aggressive set of MIs may be appropriate. For countries with weaker states, one would have to think about MIs both in terms of economic principles (i.e., choosing first best policies to deal with market failures) and institutional constraints, which limit the set of interventions the State can undertake effectively.