

## Assessing the New Economic Model in Latin America

by Albert Berry

I am very appreciative of the study by Augusto de la Torre and Nancy Birdsall, whose *raison de etre* and general contents.

Augusto has summarized here. I think it is very opportune that we, the interested parties, begin to reconsider the so-called "Washington Consensus". A decade after the reform process has reached all of the major countries of Latin America, it is clear that the outcomes have been disappointing, both relative to the high hopes held out for them and in absolute terms. This should probably not come as a surprise. Too many elements of that consensus lacked solid foundations in the combination of theoretical understanding and empirical support that is essential to provide confidence that one has found a good policy direction. As the 1990s moved along we saw, and still see at many different levels, a sharp level of debate and disagreement on globalization, liberalization and what comes with these developments. Typically, however, both the proponents of the new model and its detractors have utilized weak arguments. The latter have more often been characterized by basic lack of understanding of economics and of the principles of international trade theory, the former more often by unprofessional analysis and argument, sometimes rather transparently tied to powerful vested interests. Neither side deserves many gold stars for either balance (not surprising) or for depth. Now, with a decade of experience whose effect has been to burst the bubble of the unfettered optimists, it is surely time for us to get serious in the way we address these crucial issues.

It is well to remember that Latin America's economic performance under the old import substituting industrialization (ISI) model was rather impressive. GDP grew at an average of about 5.5% in each of the 1950s, 1960s, and 1970s. Income distribution was very unequal and, as moderately reliable data on the level of inequality became available in the 1960s and 1970s, there was a wave of concern that inequality was becoming more severe. This was easy for economists to believe since they saw the ISI model's connection to crony capitalism, monopoly profits and a division between a favoured labour elite and the rest (unfavoured) part of the workforce. Concerns with the high level of urban unemployment contributed also to the critique. When a retrospective on the performance of this model became easier to achieve, from the depths of the 1980s crisis, that performance began to look better. The evidence on distribution, rather than pointing to a worsening, suggested stability, with one or two cases of worsening (e.g. Brazil in the 1960s) and a couple of cases of improvement (e.g. urban Colombia over the late 1970s and 1980s). Overall there was very little movement--inequality remained dauntingly high but at least did not get worse. Stop-go cycles were another defect of this model in some countries over certain periods.

In retrospect it may seem surprising that this model was dropped in favour of the new one given the latter's weaker performance on both the growth and the distribution fronts (see below). The full political economy of this process has no doubt yet to be written, but some elements of it are clear enough. For one thing, there was a general shift in favour of the market as the main mechanism for resource allocation. The central planning experiments were in difficulty; it was easy to point to inefficiencies built into the various interventionist models, and the economics

profession, for reasons at least partly independent of the real world, was shifting increasingly to a position favouring the market. This was associated, *inter alia*, with the declining popularity of Keynesian economics, both for theoretical reasons and because fears of severe recessions or depressions in the developed countries had waned. In the context of Latin America another factor which became relevant was the demonstration by the East Asian countries of just how fast growth could be; 6% was not the real ceiling, as one might have thought on the basis of previous Latin experience, but rather 9% or so. And these countries achieved their dramatic economic growth on the basis of rapid export growth; they also (especially Taiwan) achieved impressive equality along with the growth. An optimist might then have said to himself: "if Latin America could grow by 5.5% under the old model which we know had some serious flaws, it should be able to do at least somewhat better under the new one, perhaps 7%, still not quite up to the best achieved in East Asia but very good indeed.

It is now commonplace to note that those East Asian countries were not, at the time of their main growth bursts, free traders. Rather, they pushed exports with great vigour, but also protected their own markets firmly, albeit selectively. In the most egregious cases of intellectual dishonesty these were characterized as free traders by the supporters of that policy preference. It is now also commonly observed that these countries had undergone important agrarian reforms which laid the groundwork for equitable growth. What the East Asian cases did point to was the capacity of countries (in their case relatively small ones) to grow dramatically on the back of strong export growth, selective import protection, and very high investment rates.

The expectations of the new model were fast growth and (in the view of quite a few though not all supporters) an improvement in income distribution. The latter expectation was based in part on the trade theory which predicts that as trade increases the price of a country's abundant factor of production will rise; in this case the factor was presumed to be labour. Such indeed was the East Asian experience, as exports of labour intensive manufactures--especially garments--fuelled rapid increases in the demand for labour and ultimately in wages as well. In the Latin American case it was also expected that freeing trade would be especially beneficial to agricultural workers (peasant farmers and proletariat) on the grounds that the ISI regime had discriminated against this sector. Freer trade should thus have been in a position to help the poorest segment of most of these societies.

None of these expectations were unreasonable but all have turned out, thus far, to be wrong. One of the big questions now is whether the poor showing of the new model will be temporary or permanent. Even if one assumed that the performance will improve with time, it is important to understand why it has been weak thus far, i.e. why the optimists' predictions were so far off the mark. One way to look at this issue is to ask first, why growth has been slower under the new model than under the old one, and secondly, what about the new model or about other things happening simultaneously with its introduction might have contributed to increasing inequality rather than the expected decline therein.

## **Disaggregating the 2.5% growth gap between the old and new models (old: 5.5%, new, 3.0).**

A bit of this difference is probably due to the decline in the rate of population growth between the ISI period and the 1990s, leading to a slowdown in labour force growth. But the latter has been modest and is unlikely to account for much of the gap.

Another obvious factor has been the greater instability under the new model, due mainly to the instability of international capital flows. This is probably the most obvious and least forgivable of the flaws in the modus operandi of the new model. The similarities between international hot money movements and stock market behaviour are too obvious to miss; in retrospect it seems hard to believe that this problem was not better anticipated and prepared for. There is no doubt that it has caused a measurable loss of growth for the region, as countries take several years to get back on track after suffering a crisis of capital outflows. Also pernicious has been the currency-appreciating effect of capital inflows; appreciation makes investment look less attractive in the tradables sector so, paradoxically, when the foreign capital is there to be invested, the incentive to invest may be weak. Whether the best way to address these problems is a Tobin-type tax on short-term capital flows and whether such an imposition can be so easily evaded that it will not be effective are matters of serious professional debate. But as to whether such short term capital flows give few benefits relative to the headaches they create (or have created so far) there can be little question. If the damage wrought cannot be alleviated by refinements to the system, this will suggest a lower growth potential within the new model than would otherwise have been attainable, not to mention the costs of the greater instability.

Most predictions of benefits from freer trade are based on static economic theory which suggests that such trade will lead to a more efficient allocation of resources. This theory has its strong points and its weak ones; one of the latter is that it does not allow for the "learning by doing" phenomenon which constitutes the main argument for temporary or "infant industry" protection of the type which the East Asians seemed to use effectively. But even if we were to disbelieve the merits of such protection (and there is no doubt that it has all too frequently been misapplied), it is noteworthy that most quantitative estimates of the potential gains from such trade are of very modest proportions. Unless one assumes economies of scale are quite important, it is rare for these estimates of one-shot benefits to exceed 2-3% of a country's GDP, i.e. the equivalent of six months of good rapid growth. In short, unless these estimates are wrong the static benefits from freer trade, even if positive as generally predicted, will be of quite modest proportions. They could not begin to explain, say, a 2% better growth performance on a continuing basis. Naturally such benefits would vary from country to country, in particular being greater in a country which has constrained its trade severely so that it is well below optimal levels.

What is the optimal level? Few people would now argue that it is low, i.e. most economists agree that most countries can reap major benefits from international trade. But this does not mean that the optimal level is the maximum level. Free traders, and the simplest of trade theory, say that the optimal level is the level corresponding to a total absence of barriers. More complicated trade theory (e.g. the "new trade theory" which allows for market imperfections) does not come up with any such simple predictions. Presumably the acid test comes from the empirical data. Helliwell's recent observation around that fact that, while Canada's free trade

treaty with the U.S. has certainly produced a large increase in trade between these two countries, from an already high absolute level, it does not appear to have spurred Canada's growth. The 1990s was the first decade in which Canada grew less rapidly than the U.S.A. Such an outcome may suggest that the additional benefits to moving from a high level to a maximal (free level) may be small or nil.

In any case, it does appear that claims to the effect that significant increases in trade would contribute to large increases in growth must be based not on static resource allocation arguments but on dynamic arguments, i.e. those related to the level of investment and to the rate of technological change. These effects, however, are much less understood than the static ones.

Another factor in the growth differential, but less obviously attributable to the shift of models, is the lower investment rate, one of these two 'dynamic' determinants of output levels. Here the competing hypothesis is simply that the region is still suffering the aftereffects of the 1980s crisis and that investor confidence or capacity to find good opportunities has not yet recovered from that debacle. The presence of FDI should normally have a positive effect. Freer trade could in principle affect willingness to invest in either direction. The chance to sell in larger than home-country markets would be expected to remove a constraint that sometimes limits the desire to invest. On the other hand, it is possible that risk appears higher when firms do not have the relative certainty of protected status in their home market. Since aggregate investment is one of the economic variables whose determinants are least understood, this is clearly an open question. The Hirschmanian hypothesis that risk-taking is the scarcest of resources in many developing countries might argue for the latter interpretation, and the prediction that investment would be weaker in more open systems would have some credibility. It should be noted that there exists a literature arguing, on the basis of cross-country studies, that savings and hence investment is empirically greater in more open economies (more precisely, economies whose exports are higher or growing faster) but its persuasiveness is less than total due to a variety of methodological complications which make the results hard to interpret.

The impact of openness on the rate and type of technological change is also hard to get at clearly. It is generally accepted that openness promotes faster change, though also often argued that it brings in inappropriate technology. One of the big uncertainties here revolves around the possibility that openness may mainly bring in technology a bit sooner, i.e. the issue is more one of timing than of yes vs. no. Since, however, the general presumption is that the effect of greater openness would be positive, this factor could not be a part of the explanation for the low growth under the new model.

### **Why Has income Distribution Gone the Wrong Way?**

Although there are exceptions, it is the case that most countries of Latin America have suffered increases in income inequality very shortly after the reform package was introduced (or began to be introduced). In those countries which shifted towards openness in the 1970s (those of the Southern Cone) inequality rose in the 1970s. And so on for those adopting the new approach in the 1980s and the 1990s. In no case has there been a significant improvement in distribution, while in a good share of those suffering a worsening this has been quite significant. In short, the income distribution experience associated with the new model has generally been of increases to

an already extreme level of inequality. Why this outcome instead of the predicted improvement. Undoubtedly there are a number of factors at work. One which helps to shift the presumption from improvement to worsening is the fact, now generally recognized, that Latin America is not a low wage region by world standards. (This notoriety belongs to the low wage countries of Asian and Africa). Accordingly, Latin America could not expect the distributional boon that the East Asian countries got when they had the lowest wages of the major trading nations. Instead, increased trade in Latin America may have helped to widen the gap between more and less skilled workers. A second feature which may have been at work relates to the fact that larger firms tend to dominate international trade and also tend to be more capital intensive than smaller ones. Thus, as a country's trading ratios raise this factor can work against job creation. In the East Asian cases of growth with equity (through the labour intensity of the exports, in part) the fact that small and medium enterprise was effectively tied into the export process constitutes a major contrast with Latin America, where the growth of exports, quite substantial during the 1990s, appears to have done nothing for employment creation.

The distributional impact of more open trade and more generally of a more market-friendly set of economic policies is much more complicated than the themselves complicated links to growth. Yet, for Latin America at least, it may be the distributional effects which prove the main Achilles heel of this strategy of development. So they need to be looked at carefully, leaving aside the ideology-based arguments which have played too large a role so far. We do know that heavy participation in international markets is not *per se* inconsistent with equality. When the exports are labour intensive they can promote equality, although when this route is taken the "sweat-shop" charge is likely to come up frequently. We also know, especially from the Scandinavian experience, that social networks can be built which help to achieve equality and stability in spite of the inevitable shocks which are a feature of dependency on many world markets. The former route to growth with equity will probably not be open to Latin America unless small and medium enterprises (SMEs) can be tied into the export process much more than they have been in the past, thereby raising the labour content of exports, again following the East Asian examples, especially those of Japan and Taiwan. The latter route is made difficult by the currently weak social safety nets in many Latin American countries (weak especially in coverage of poorer people), and by the fact that the new macroeconomic stringencies which came first with the debt crisis and then with the attempt to keep inflation low, have curtailed social expenditures in a way which makes it very hard to follow this particular route.

It would be useful to be able to distinguish between (i) basic flaws in the open, liberalized economy as a way to manage an economic system, (ii) correctable flaws and (iii) other reasons for its weak performance which have had nothing to do with the new model as such. To the extent that the main explanations lie in the last category, they are likely to have no policy implications for the reforms which have been undertaken; if they fall in the second category, they will suggest the reforms that need to be undertaken, and if in the first they will suggest a reconsideration of the choice of the new model and possible reversal or other changes away from it.

Whether the Free trade area of the americas will proceed or not remains an open question. Its direct impact on Canada will presumably be marginal. If, as Helliwell and others have concluded, the net effects of our free trade area with the U.S.A are not easily detectable, it is hard to believe that those of the FTAA would be. What happens in this area matters mainly for the

non-NAFTA countries, South and Central America and the Caribbean. Here the risk is that, through continued actions as ill-thought through as those of the last 15 years will lead to further losses and to the general failure of freer trade to bring such benefits as it may be capable of. The worst possible outcome might be the adoption of the FTAA without due consideration of the problems which have arisen thus far with the new market-friendly model, and the possibly great difficulty in reversing those steps in future, should its defects continue to be evident. Latin America might find itself locked into a trading system not constructed on the basis of a professional analysis of how to satisfy its needs and very costly to modify. The best decision at this time might be a delay of 5-10 years during which a better understanding of the nature of the problems is achieved; then further advances might inspire some confidence. Plunging ahead at this time is very much a gamble undertaken without much feel for the odds of success. At the same time there is no good reason to believe that waiting would have severe costs. If major benefits to an FTAA are in fact possible this is not evident to date; more likely the potential benefits are modest for most countries in any case.

Two excellent tests of whether the policy thinking is becoming more competent will be provided by the evolution of thinking and actions in the areas of capital flows and of employment. As long as there is serious defense of unfettered international financial flows, one can safely conclude that seriousness has not set in. On the employment front, the presence of a serious challenge is clear from the 1990s record in Latin America, in which the bulk of job creation was in the microenterprise sector, even though GDP growth was occurring at 3% per year. Employment cannot simply be assumed to take care of itself as long a growth is adequate. Reaching 5% growth, perhaps not an easy target in the light of the 3% for the 1990s, would probably not be enough to tighten the relevant labour markets, as long as it (the growth) continues to be accompanied by rapid technological upgrading. The role of SMEs appears to be pivotal here, and the Latin American countries have not yet seriously addressed the probable complexity of designing and implementing an effective policy package for this sector.

Both sides of the debates have been guilty of gross errors and oversimplifications. The argument that freer trade will create jobs is wrong, as trade economists routinely point out, unless one has evidence that the increased imports will not displace as many workers as the new exports create. That more trade is necessary for competitiveness is also, as a first approximation, wrong although it might be valid under very special circumstances. Criticisms of MNCs and other large firms because of the low wages they pay or the hard work conditions are equally suspect. These are indeed concerns, but the main worry about an increasing role for such firms-- the main way in which large firms sabotage the possibility of generally rising wages, is by not creating enough jobs, not by underpaying the workers. Both defenders and critics are thus all too often debating at the wrong level; as long as the discussion is at that level there is little chance of dealing successfully with the complex issues which confront us.