A new look at productive development policies (PDPs) in Latin America

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1. LAC are long-term underperformers in the world economy

- Asian exporters of manufactures and services have grown considerably more rapidly
- Most LAC have either diverged from the levels of income of the advanced economies or have been treading water
- Few exceptions: Chile, Dominican Republic, and Panama, but only since 1990 and not very vigorously
- By contrast, all the Asian benchmarks have converged, some surpassing US income levels (Singapore)
- Compare Korea and Chile: in 1973, they had GDP pc that was 15-20% of US GDP pc; in 2014, Korea had 64% of US GDP pc, and Chile only 38%

LAC per capita GDP growth and some Asian benchmarks, 1950-2015

(average compound pc growth)

	1950-1973	1974-1980	1981-1990	1991-2010	2011-2015
Latin America and the Caribbean	**2.3**	**2.6**	**-1.2**	**2.2**	**2.2**
Argentina	1.9	1.0	-1.9	3.0	0.3
Bolivia	-0.1	1.1	-1.5	1.6	3.7
Brazil	4.9	4.5	-1.1	1.5	-0.1
Chile	1.4	2.5	1.4	4.2	2.7
Colombia	2.0	3.0	0.8	1.7	2.4
Ecuador	2.9	4.4	-1.4	1.8	2.7
Mexico	3.4	4.2	-0.7	1.3	1.4
Panama	3.3	4.9	0.7	3.5	6.1
Paraguay	1.2	7.1	0.3	0.6	3.3
Peru	3.0	0.4	-2.8	3.4	3.4
Uruguay	0.5	5.3	-1.1	3.4	3.2
Venezuela	2.7	0.3	-1.8	0.8	-1.5
Asian benchmarks					
China	3.3	4.9	7.7	9.5	7.3
Hong Kong SAR	8.0	6.7	5.0	2.9	2.3
India	1.9	2.0	3.3	4.6	5.1
Indonesia	3.9	4.8	3.8	3.2	4.2
Korea	4.3	6.4	8.4	4.3	2.4
Malaysia	4.6	5.5	3.3	3.8	3.7
Singapore	6.3	7.0	4.4	4.5	2.9
Thailand	2.6	4.8	6.2	3.2	2.3

Sources: Penn World Tables; IMF; WEO, Oct. 2016; World Bank, WDI.
Average for LAC is unweighted, includes Central America and Caribbean.

Convergence in GDP pc? Not in LAC, yes in Asia: GDP pc PPP as a % of US GDP

	1950	1973	1980	1990	2010	2014
Latin America and the Caribbean						
Chile	…	20	19	16	34	38
Uruguay	36	23	28	20	29	35
Argentina	41	35	35	21	31	32
Panama	15	19	19	15	25	31
Costa Rica	26	31	34	24	28	30
Mexico	28	33	42	30	29	30
Dominican Rep.	…	18	19	15	25	26
Venezuela	38	33	35	23	25	23
Colombia	20	17	20	17	19	22
Brazil	14	23	29	20	21	22
Peru	22	23	22	12	19	21
Jamaica	…	41	28	27	21	20
El Salvador	25	21	20	12	15	18
Ecuador	…	16	24	15	16	18
Guatemala	24	21	22	14	15	16
Paraguay	…	10	14	13	10	12
Bolivia	21	13	14	9	10	11
Honduras	17	11	14	10	8	8
Nicaragua	16	17	14	7	6	6
Haiti	…	5	7	4	3	3
Asian benchmarks						
Singapore	…	40	56	76	128	137
Hong Kong	…	38	55	76	90	92
Korea, Republic of	…	15	20	40	62	64
Malaysia	…	12	17	17	30	35
China	…	2	2	4	17	22
Thailand	8	9	11	15	20	21
Indonesia	…	4	6	7	9	12
India	5	4	4	5	9	10

Source: Penn World Tables and World Bank, WDI.

Even in good times (e.g., 2010-13), growth hasn’t been stellar

- When commodity prices were high (in 2010-13), LAC growth never exceeded Asian levels
- And since 2013, the end of the commodity super-cycle has had large negative effects on LAC growth
- Different LACs different constraints, but a shared problem is heavy dependence on one or a few commodity exports and output
- Chile is one of the most extreme: at the peak of the cycle in 2013, copper represented 20% of total GDP and 2/3 of goods exports; no developed country exhibits that level of concentration

Latin America and the Caribbean: Growth of GDP, 2011-2016

(average annual compound rates)

	2011-2016	2011-2013	2014-2016
Latin America and the Caribbean	**3.1**	**4.1**	**2.1**
Panama	7.4	9.2	5.7
Bolivia	5.2	5.7	4.7
Dominican Republic	5.1	3.4	6.7
Nicaragua	5.0	5.4	4.7
Paraguay	4.6	5.5	3.8
Peru	4.6	6.1	3.1
Guyana	4.4	5.1	3.7
Guatemala	3.8	3.6	3.9
Costa Rica	3.7	3.8	3.6
Chile	3.5	5.1	1.9
Honduras	3.5	3.6	3.4
Colombia	3.3	3.8	2.8
Ecuador	3.2	6.0	0.5
Haiti	3.0	4.2	1.8
Uruguay	2.9	4.4	1.4
Mexico	2.7	3.1	2.3
El Salvador	2.0	2.0	2.1
Argentina	0.9	2.4	-0.6
Jamaica	0.7	0.4	1.0
Brazil	0.3	2.9	-2.3
Trinidad &Tobago	-0.4	1.1	-1.9
Venezuela	-1.7	3.7	-6.7

Source: IMF; WEO, Oct. 2016. Average for LAC is unweighted. 2016 rates are estimated. Regional average growth rates are unweighted.

2. Where have we been?

A. Industrial Policy Mark 1.0: State-Led, Inward-Oriented (SLIO) industrialization (roughly 1950-80)
B. Washington Consensus: mid 1980s onwards

A. SLIO Industrialization (1950-1980)

- High nominal and effective protection
- Development banks and intervention in credit markets
- State-owned enterprises: they had their logic and were less of a waste than their detractors claim
- Suspicion of FDI, although many multinationals took advantage of high tariffs and non-tariff barriers
- Generally, less of failure than what the liberalizers have led us to believe; big countries did better than small countries; most countries did worse under liberalization
- Big problem: Failure at integration that would have created big markets and made industrialization possible with lower trade barriers

B. The Washington Consensus

- Emphasis on good governance and markets
- Role of the state:
  - balancing the fiscal books,
  - opening the economy to trade,
  - ending domestic financial repression,
  - deregulation,
  - privatization of SOE,
  - protecting property rights,
  - openness to FDI, without sector selectivity
  - maintaining a competitive exchange rate (some ambiguity here).

Counterfactual is not available

- But growth was even less satisfactory than during SLIO industrialization
- However, most countries were poor students of the WC
- Diversification the forgotten objective of policy, not back to SLIO policies but forward to creating new comparative advantages
  – In the framework of good macro policies

3. Toward an industrial policy Mark 2.0 (“PDPs”)?

- More openness to FDI, even competition for it
- New emphasis on exports as an engine of growth, although few have succeeded in diversifying them
- Many horizontal policies tried: training subsidies, subsidies for R&D, export promotion agencies, with varying degrees of success
- Some countries have even intervened in markets in favor of new production for export (subsidizing forestation and reforestation in Chile)
- Creation of business-government councils with the aim of solving coordination problems that impede diversification

Why would one need PDPs and what form should they take?

- Information externalities and coordination problems conspire against new outputs, especially in the tradable sector
  - Information externalities: innovators can't appropriate all the rents from innovation
  - Coordination problems: any new undertaking will require concurrent decisions between private agents and between private and public agents
- Ernesto Stein's policy matrix: Need to consider two dimensions:
  - horizontal – vertical policies (sector neutral – sector bias);
  - market interventions – public goods provision

Where do PDPs fit in the Stein policy matrix?

	Horizontal policies	Vertical policies
Public input	Rule of law Pro-investment business climate Sound macroeconomic framework Stability-oriented financial regulation Free trade agreements Macro policies, including exchange rate	Sanitary and phytosanitary measures Sector-specific education Sector-specific infrastructure Business-government councils Sector-specific regulation
Market intervention	General export subsidies Subsidies for entering foreign markets FDI subsidies and tax exemptions Innovation subsidies SME policies Financial market access policies	Sector-specific subsidies and tariffs Sector-specific FDI subsidies

PDPs are all but those in the NW quadrant. **I will argue that macro-exchange rate policies have powerful effects on the productive structure**.

Clearly, horizontal policies and public input provision are less dangerous than vertical policies cum market intervention

Add one policy dimension and don't forget the exchange rate regime

<table>
<tr><th></th><th>Horizontal policies</th><th>Vertical policies</th></tr>
<tr><td>Public input</td><td>EXCHANGE RATE REGIME</td><td></td></tr>
<tr><td>Market intervention</td><td colspan="2">STRADDLING-THE-FENCE POLICIES</td></tr>
</table>

The exchange rate issue

- Most countries have bought into flexible exchange rates cum inflation targeting
- This has rendered the real exchange rate very volatile and caused overvaluation for long periods of time
- Nothing is more inimical to diversification than currency overvaluation and volatility
- Need to look at the issue again, putting growth at the center of policy objectives

What are ***straddling-the-fence*** policies?

- Assume that policy makers want to diversify but that they don't know precisely ***into what***, and in fact neither does the market
- Market interventions that begin by choosing broad categories of sectors-activities that imply diversification and then let the market decide the uptake

Examples from Chilean experience

- Example I: Reintegro simplificado (import duty drawbacks) from 1985-2003:
  - exporters in a tariff line that totaled less than US$20 million received what in effect was an export subsidy estimated at about 6% of value of exports; the subsidy disappeared
  - when the tariff line had exports over $20 million
  - it was a subsidy on new exports that had a predetermined sunset clause

Example II: Invest Chile (2001-??)

- Upfront subsidy to multinationals investing in certain broad export-oriented sectors: information technology, biotechnology
- Subsidy dependent on the employment of skilled and unskilled labor
- Condition was to remain for at least ten years in Chile
- NO TAX BREAKS
- One-time subsidy

Bottom line

- Higher sustained growth needs policies to diversify production structure (and especially exports)
- While Asian countries may have found it appropriate to practice heavy-handed interventionism, it is unlikely that those policies would work in the LAC context
- Do all you can with horizontal policies that correct market failure, and all you can with the provision of public goods to new sectors
- Don’t shun intelligent straddling-the-fence market interventions that make the most use of the market to select the actual investments that will be made
- AND TAKE ANOTHER LOOK AT THE EXCHANGE RATE REGIME