

# Economic and Social Challenges in Latin America: Developing an Agenda for the 2010s

---

The Latin America and Caribbean Economic Association (LACEA), in partnership with the Latin America Initiative at the Brookings Institution and the Inter-American Development Bank, hosted a workshop in Washington D.C. on February 5<sup>th</sup>, 2010, to discuss the economic issues that will be relevant for Latin America and the Caribbean during the next decade.

One of the goals of the session was to identify some research areas that should be more actively promoted by LACEA (networks, journal and annual meetings), as well as GDN, during the coming years.

The roundtable consisted of three sessions and a keynote luncheon. In each session, two members of the group provide some inputs for the discussion of the group. Below you will find a short document summarizing the main conclusions of the workshop.

## *Macroeconomic issues*

Despite having weathered the recent crisis relatively well, Latin America has many macroeconomic challenges. In part, Latin America was less affected by the crisis because the region is not fully integrated with the rest of the world financially. More than complacency, this should invite countries to reflect on how to deepen their financial sectors, while at the same time preserving sound financial regulation and supervision practices. Another issue is the lack of regional trade in Latin America. For example, Asian countries benefited highly from successful regional trade relationships to offset the contraction in other markets. Latin American countries need to learn from the experiences of the Asian countries in terms of regional trade.

In addition, relative to Asia, investment and saving rates are low. Private and public investment should be promoted. There are no simple formulas to increase savings, but for this and other

reasons that have to do with equity considerations as well, the tax base needs to be expanded. Only with greater fiscal capacity the region will be able to provide universal access to social protection and widen the provision of public goods. The type of taxation is a matter of debate but the preference is not to focus on taxes that greatly distort investment or employment decisions, calling for greater emphasis on personal income and value added taxation instead.

Another macro area that deserves attention is the high demand for inefficient accumulation of international reserves. In addition to the “fear of floating” countries face uncertainty about the ability to access an international lender of last resort during systemic crises. More work needs to be done in terms of designing the architecture that would reduce the demand for reserves (ex-ante issues) while at the same time effectible dealing with liquidity shortfalls during systemic crises (ex-post issues).

In terms of the future agenda, a key point is the adoption of countercyclical policies, which is still at an early stage of development in the region. More analysis is necessary on topics such as the size of fiscal multipliers in the region. Even though LAC has established inflation targeting models, they are not immune to procyclical outcomes. For example, given inflationary expectations led by increases in world food prices many central banks had to raise interest rates during 2008, when the U.S. was already in a recession. Improving the design of monetary policy is another important subject for future research.

### *Rethinking the Development Strategy*

Latin America’s long-run growth performance suggests the need to re-think the development strategy. GDP per worker has been declining relative to the U.S., Europe, and Asia at least since the 1960s. Simple growth accounting shows that capital per worker and TFP have also lagged relative to the rest of the world, with the exception of Africa. This leads to the inevitable question of why Latin America has an investment and productivity problem, and how to tackle it. Low productivity is a symptom, not a syndrome. Latin American countries need to focus on asset and product specificity instead of TFP if they want to understand why GDP growth is low.

At the same time, Latin America has shown relatively high levels of commodity export dependence. It is tempting—but not necessarily correct—to associate that dependence to the productivity problem as there are good examples of countries where commodity dependence and high productivity coexist. Commodities can be transformed into a wide range of products. Abilities used in the production of commodities can be used to move to other related sectors with greater value added. Thus, commodity-dependence per se is not the problem.

Perhaps more worrisome than the commodity dependence, is the speed of Latin America's deindustrialization. Compared to other world regions, Latin America has shown a decreasing trend in the GDP share of manufacturing output since the 1960s. Furthermore, the share of industries with intensive use of engineering in manufacture's product with respect to world average in 2000-2003 was lower (for almost all Latin American countries) than it was for the 1970-1973 period. This means that, except for Mexico, Latin American countries had a share of industries with intensive use of engineering in the 1970s higher than they did in the 2000s. Policymakers in Latin American countries should pay attention to the market structure. Lack of competition leads to low innovation.

In response to these concerns, some countries have decided to revamp productive development policies, meaning interventions that set goals in terms of investment, private expenditure in R&D, exports, and the development of micro and small exporting firms. In the case of Brazil, for example, BNDES has played an important role in this matter, as it holds either debt or equity in almost all Brazilian biggest multinationals. Latin American countries need solid development strategies, which not only focus on the "industrial" component, but also on the "development" aspect. Brazil seems to be a good example in this regard.

China and India are expected to remain as the most important dynamic forces of the world trade in the coming years. Europe and the U.S. faced massive declines in import volumes in the post crisis period. Given that Central American countries are important trading partners with the U.S., they are very likely to be affected by these changes in the U.S. share in global trade. Latin American countries' trade share will be affected by three major forces:

- i. Competitiveness effect (captures whether the country has gained or lost market share in the products/markets where it already was positioned at an initial time).
- ii. Initial specialization effect (captures whether the products/markets where the country was positioned initially have grown more or less than world export demand. It captures whether a country's exports were "at the right place at the right time").
- iii. Adaptation effect (captures whether the country has shifted its exports from products/markets that are growing less to others that are growing more, or vice versa).

Latin American countries have been performing well in (i) and (ii); however not in adaptation (countries seem to be "putting more eggs in the same basket").

Productive Development Policies or PDPs can be either horizontal (transversal) or vertical (to support a specific sector), and can either take the form of inputs (as public goods) or market interventions (subsidies, etc.). The way PDPs are designed poses important policy and institutional questions. It is important to think about how to structure an organization that is independent from the specific sectors (and therefore "interest-free") and that is in charge of implementing the industrial policy. Given the institutional legacy, and the associated rent-seeking behavior, productive development policies can be easily captured when the emphasis is placed on vertical interventions. Development banks have a role to play but given excesses of the past special attention needs to be paid to their corporate governance structure, as well as their assessment of risk. The funding of these banks is another issue, as in many cases it is based on workers contributions (e.g., Brazil and Mexico) so there are some distributional issues that cannot be ignored.

Part of the problem associated with designing interventions is the lack of information. Governments do not have the correct information on the externalities. This information asymmetry problem needs to be resolved and the accurate information needs to be revealed by public or private institutions.

The political economy of how countries will choose their ‘winner and loser’ sectors, is very relevant. There is evidence that countries are focusing on the wrong sectors. A key intellectual issue is how the “picking” process will be designed in order for policy-makers to implement it. Some countries rely on the advice of consulting groups to choose the “right” sectors (which somehow can ameliorate the rent-seeking problem). But the political economy considerations have to be brought into the analysis, mainly because industrial policy interventions have a high risk of capture. The specific design of trade and tax policies can make low productivity sectors and firms experience high profits, which is not desirable.

Overall, Latin America needs to increase production and efficiency. Countries need to focus on their actual capabilities. Finding entirely new sectors is not easy, and may not be even desirable. Countries have to start with what they have now.

### *Informality and unemployment*

There has been a change in the size distribution of firms in Latin America. The share of small firms and self-employed individuals has increased, aggravating the long-standing problem of informality. There are complex issues associated with this trend. First, informality is costly since moving from formality to informality comes with a large productivity loss. Due to the change in the size distribution of firms, more resources are allocated to the low productivity sector with negative effects on aggregate growth. Therefore, the black box part of TFP can be partially explained by informality. Secondly, policymakers need to address the equity implications of the informality problem. Social interventions, including Conditional Cash Transfer (CCT) programs, have been successful in some ways, but may be generating problems in the area of economic efficiency. Future research needs to focus on these often ignored side-effects in order to influence their design and implementation. Problems get worse if these programs are funded with taxes on formal labor, generating a strong vicious circle of high informality and increasing demands for social protection, which lead to larger social programs and higher taxation. These are some of the unintended consequences of programs that seem to have good motivations. But the problem of informality will not go away fast, so government need to think hard on how to provide social protection to people in the informal sector.

Some of the problems are micro in nature but macro in magnitude. Latin America may have left behind the worst macro problems; however, at the micro level there is still much to do. Most of the Latin American firms are too small to thrive, but too large given their productivity. The main problems are that there is limited investment in technology and training, and the capital markets, from which the firms can borrow from, are underdeveloped. There is also the “fear of growing” due to the huge asymmetry in enforcement based on size. In other words, the Latin American state “bites disproportionately” when the firm is large. Similar conclusion can be reached with the special tax regimes, which are simplified when the firm is small, but full-blown when it is large. All these give an incentive to the firms to stay small.

Another longstanding important problem is the high transportation costs due to poor infrastructure in the region. Internal transportation costs make movement of goods within the country more difficult. This also leads to increases in the cost for exports to reach ports and airports which ultimately reduce productivity. This is also evidence that LAC service sectors face productivity problems as well. Given the fact that services are a significant share of GDP for most LAC countries, improving productivity for this specific sector would have a large effect for overall productivity growth.

High unemployment and low productivity are two intertwined problems. Self-employment, high worker rotation, and temporary employment, are all related to low TFP. This is also related to low human capital accumulation due to distortions in the labor markets. Unfortunately, the skills that are provided are the ones with low returns to scale. There is need to invest in the quality of education, and policy should be targeted to achieve this goal.

It is true that the margin firms may stay smaller because of tax incentives/tax distortions. However, this does not mean that lowering taxes will solve the problem of informality. Tax enforcement needs to be strengthened. With less tax evasion at the top, tax rates could be lowered so that there are less incentives for informality. One good example is social security contributions, which many individuals treat as a tax which they try to evade, especially if social policy provides some form of protection. Therefore, social policy needs to be designed to avoid evasion from those that can afford to make contributions.

### *Conveners*

Mauricio Cárdenas, Senior Fellow & Director, Latin America Initiative, Brookings

Ricardo Hausmann, Director, Center for International Development, Harvard University

Santiago Levy, Vice President, Sectors and Knowledge, Inter-American Development Bank

### *List of Participants*

Andrea Repetto, Professor, School of Government, Universidad Adolfo Ibañez, Santiago de Chile

Arturo Galindo, Senior Research Economist, Research Department, Inter-American Development Bank

Carmen Pages, Principal Research Economist, Research Department, Inter-American Development Bank

Caroline Atkinson, Director, External Relations Department, International Monetary Fund

Ernesto Stein, Regional Economic Advisor, Country Department Central America, Mexico, Panama, and Dominican Republic, Inter-American Development Bank

Felipe Barrera, Senior Education Economist, The World Bank

Gerardo della Paolera, President, Global Development Network

Graciela L. Kaminsky, Professor of Economics and International Affairs, George Washington University

Marcela Eslava, Associate Professor of Economics, Universidad de Los Andes, Colombia

Nicolás Eyzaguirre, Director, Western Hemisphere Department, International Monetary Fund

Pablo Sanguinetti, Research Director, Public Policies and Competitiveness Office, Andean Development Corporation (CAF)

Ugo Panizza, Debt and Finance Analysis Unit, Division on Globalization and Development Strategies UNCTAD, Switzerland