

# ECLAC REVIEW

ECONOMIC  
COMMISSION FOR  
LATIN AMERICA AND  
THE CARIBBEAN



UNITED NATIONS

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# CEPAL REVIEW

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THE CARIBBEAN

ECLAC



# CEPAL

REVIEW

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COMMISSION FOR  
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**Explanatory notes**

The following symbols are used in tables in the *Review*:

... Three dots indicate that data are not available or are not separately reported.

(–) A dash indicates that the amount is nil or negligible.

A blank space in a table means that the item in question is not applicable.

(-) A minus sign indicates a deficit or decrease, unless otherwise specified.

(.) A point is used to indicate decimals.

(/) A slash indicates a crop year or fiscal year; e.g., 2006/2007.

(-) Use of a hyphen between years (e.g., 2006-2007) indicates reference to the complete period considered, including the beginning and end years.

The word “tons” means metric tons and the word “dollars” means United States dollars, unless otherwise stated. References to annual rates of growth or variation signify compound annual rates. Individual figures and percentages in tables do not necessarily add up to the corresponding totals because of rounding.

## Editorial note

This ninety-seventh issue of *CEPAL Review* (whose Spanish edition has been retitled *Revista CEPAL*) marks the beginning of a new stage that includes the formation of an Editorial Board, a broadening of the publication's editorial line and a redesigned cover, all inspired by the need to reflect the shifting realities of today's world. It is a world in which the cumulative effects of successive socio-economic, institutional, political, environmental, cultural and conceptual transformations everywhere have combined to bring about nothing less than a change of era.

The financial crisis unleashed in late 2008 is threatening to have economic repercussions similar in scale to those of the Great Depression of the 1930s, whose aftermath was transformational in every way. It is taking place in a context of growing problems of environmental sustainability, including the escalation of global warming and the energy and food crises, all amidst rapid innovations in science and technology and ever-greater interactions between them. Other developments have included the growing activism of the most disadvantaged sections of society, the resurgence of domestic and international conflicts, and changes in the global situation facing countries and regions, all of which has led to far-reaching reviews of doctrinaire positions concerning the best way of achieving socio-economic and political development in our countries.

The result is that we need to review, modify, extend and diversify our cognitive maps and develop a more comprehensive and realistic (and less ideological and dogmatic) outlook that enables us to grasp the complexity of today's changes and contribute as far as possible, without sacrificing disciplinary focus, to the renewal of public policies, strategies and approaches so that they match the new realities.

*CEPAL Review* has set itself the task of contributing, from a regional and institutional perspective, to a better

understanding of the nature of the processes described and their consequences in the different countries of the region. An Editorial Board has been created to this end and its varied membership comprises some of the foremost academic authorities on the different aspects of development, both in Latin America and the Caribbean and elsewhere in the world, the aim being to represent as far as possible the diversity of our region and other relevant experiences. The Board's membership also includes some of the personalities formerly employed by ECLAC together with current staff from the Santiago headquarters and the various subregional headquarters and national offices.

To ensure that the contents of *CEPAL Review* reflected the profound changes now in progress, a number of leading specialists were invited to contribute an article to this issue on the different aspects and possible outcomes of the global economic and financial crisis and thereby contribute to the debate on its origins and on the approaches and policies that would need to be adopted to resolve it and advance towards a more inclusive and sustainable form of development. We would like to express our gratitude to the authors who, agreeing to abide by the usual editorial requirements of this publication, made a special effort to comply with them despite the limited time available.

Firm in its commitment to academic rigour and editorial independence, *CEPAL Review* wishes to extend this invitation to all researchers in the region and elsewhere who desire to contribute to our understanding of the nature of the many challenges in today's world and to the formulation of the policies needed to address them.

*Oswaldo Sunkel*  
Chairman of the Editorial Board  
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Editor  
*CEPAL Review*





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Latin America

# The impact of the global financial crisis on Latin America

*José Antonio Ocampo*

**T**his essay argues that while the complete lack of liquidity characterizing the most severe phase of the financial crisis unleashed in September 2008 is now a thing of the past, lending and production activity in the industrialized countries are both contracting rapidly and the financial system is still undercapitalized. Of all the external channels through which the crisis has been transmitted to Latin America, the drop in remittances is the least important. The most widespread negative effects will come from the decline in the volume of international trade and the sharp deterioration in the terms of trade for commodities. In addition, a period of very restricted external private-sector financing lies ahead. The region's economies have entered this crisis in a stronger position than in the past, mainly because public debt is lower and international reserves are large, but this will only partially mitigate the repercussions of the worst global economic crisis since the Great Depression of the 1930s.

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# I

## Introduction

The global economy is widely acknowledged to be going through the worst financial crisis since the Great Depression of the 1930s. Although the industrialized world may be spared a contraction in production activity as sharp as the one experienced then, it is clear that it is also passing through the deepest recession since the Second World War (the point at which a “recession” becomes a “depression” has never yet been completely clarified). The crisis is reaching every corner of the planet. Given the role of China as a mainstay of global economic dynamism in recent decades, the contraction of its exports in November and December 2008 and the virtual stagnation of its economy during the fourth quarter of that year are the clearest evidence for the depth of the global crisis.

In the case of Latin America, the markedly favourable conditions of the 2003-2007 period, resulting from an unusual combination of a financial boom, exceptionally high commodity prices and strong remittances from migrant workers, have also come to an end. A number of the region’s economies were already experiencing a substantial slowdown over the course of 2008, among them Colombia, Mexico, the Bolivarian Republic of Venezuela and almost all the smaller economies of Central America and the Caribbean. As will be seen, financing became scarcer from the third quarter of 2007, coinciding with the first phase of the financial crisis in the United States. Then in mid-2008, the fall in commodity prices began. But it was the global financial collapse of mid-September 2008 that unleashed the most profound changes by causing credit to dry up, substantially raising risk spreads, turning the fall in commodity prices into a rout and triggering a deep recession in the industrialized world. Even those Latin American economies that were still highly —not to say increasingly— dynamic

up to the third quarter of 2008, such as Brazil and Peru, ran into a wall.

With hindsight, the peculiarity of the developing world was its ability to insulate itself to some extent from the first phase of the crisis thanks to the renewed commodity price boom, the relative security its very high levels of international reserves represented for external capital and the continuing dynamism of the major Asian economies. This gave rise to a theory, propounded by the International Monetary Fund (IMF) among others, that the developing world would “decouple” from adverse trends in the industrialized countries. To use the terminology employed by Calvo (2008), however, that “Indian summer” was followed by a “storm” triggered by the global financial crisis of September 2008, whereupon it became obvious that the decoupling theory was sheer fantasy.

This essay will analyse the effects of the international crisis on Latin America. Following this introduction, the second section considers the financial crisis in the United States. The third section looks at the three external channels through which the crisis has been transmitted as the mechanisms that produced the earlier boom have been inverted. The fourth contains some considerations on the vulnerability of the region’s countries and is followed by a short section of conclusions.

As will become clear in the second section, the international situation was still very fluid at the time this essay was being completed (January 2009). Having become so severely undercapitalized, the global financial sector had not found its poise and lending was continuing to contract, while economic activity and international trade were declining rapidly. What this indicates is that the intensity and duration of the crisis were still unknown. At the same time, new macroeconomic packages were being implemented, among them the second phase of the United States financial rescue plan, the fiscal programme announced by the Obama administration and the new financial rescue package announced by the British Government. Consequently, many of the observations made in this essay are subject to future contingencies.

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□ The author is grateful for the assistance provided by María Paula Carvajal in preparing this document. This essay was written for the United Nations Development Programme (UNDP) project “Estado, democracia y mercado: informe regional sobre la democracia en América Latina”.

## II

### The global financial crisis

By January 2009, a year and a half had elapsed since the subprime mortgage securitization crisis erupted in the United States, and four months since the fateful week that began on Sunday 14 September 2008 with the bankruptcy of Lehman Brothers, one of the big five investment banks in the United States, and the rescue of another, Merrill Lynch, which became a subsidiary of Bank of America; Bear Stearns, having been bailed out in March, began the process of merging with J.P. Morgan Chase. The week continued with the rescue of the country's leading insurance firm, American Insurance Group (AIG), and the compulsory sale of the leading savings and loan bank (Washington Mutual) and one of the largest commercial banks, Wachovia. Many smaller institutions had already gone under and more have done so since. Furthermore, some investment banks that were still independent, such as Goldman Sachs and Morgan Stanley (in October the Japanese financial group Mitsubishi UFJ would acquire a 20% stake in the latter), became bank holding companies, thereby coming under the supervision of the Federal Reserve. On Wednesday 17 and Thursday 18 September, the United States financial system was on the verge of total breakdown and the period that came to be known as the "credit crunch" began; at its most critical stage, interbank lending and issues of commercial paper were paralysed. A series of bankruptcies also began among European banks that week, and still continues. Some British banks were already in difficulties beforehand.

As the great economic historian Charles Kindleberger has pointed out (Kindleberger and Aliber, 2005), frequent financial crises are an embedded feature of capitalism's history. Since the 1960s, furthermore, there has been a greater tendency towards financial crises of various kinds, coinciding with different global economic liberalization processes (Bordo and others, 2001). In the case of the United States, this is the third banking crisis of recent decades. The first was the Latin American debt crisis, which was skilfully managed so that its cost would be paid for by Latin America and it would not be seen for what it also was, the bankruptcy of the leading United States financial institutions. The second was the crisis in the United States savings and loan system in the late 1980s, and the third is the one being experienced now. To these

might be added the major stock market collapses, including "Black Monday" in October 1987 and the bursting of the bubble in technology stocks at the beginning of the present decade, plus three episodes of acute dollar weakness, the latest of which was already in evidence before the September crisis temporarily reversed the phenomenon.

The frequency of crises is essentially due to the incapacity of financial systems to self-regulate, one corollary of which is that financial liberalization measures sow the seeds for them. The fundamental problem, as Minsky (1982) pointed out a quarter of a century ago, is that confidence tends to rise as financial booms proceed, leading financial agents to take positions that become riskier and riskier as financial liabilities outstrip current revenues or, viewed from a balance sheet perspective, as borrowing rises relative to capital (greater leverage). The logic of this mode of operating in booms is clear, as asset-price inflation allows returns to be obtained with limited capital. Booms thus end with overborrowing by all agents and undercapitalization of financial institutions, sowing the seeds of bankruptcies among both borrowers and financial intermediaries. Although this logic is recurrent, the current crisis must be the "acid test" showing that financial markets, even the most sophisticated ones, are incapable of self-regulation.

Faced with the collapse experienced by many developing countries as a result of the successive Asian, Russian and Latin American crises at the end of the last century, economic orthodoxy ended up by accepting that financial liberalization had to be accompanied by better prudential regulation and supervision (something that had already happened in a number of Latin American countries after the 1980s debt crisis). But this recommendation was not applied in the heart of global financial capitalism, where deregulation continued. Among other consequences, this led to the final removal, in 1999, of the boundaries between investment banking and commercial banking that had been established in the 1930s and, in 2004, of capital requirements for investment banks, allowing these to double their leverage levels over the following years. Furthermore, there was no regulation whatsoever of "financial innovations" such as subprime mortgages, the securitization of these or the proliferation of financial

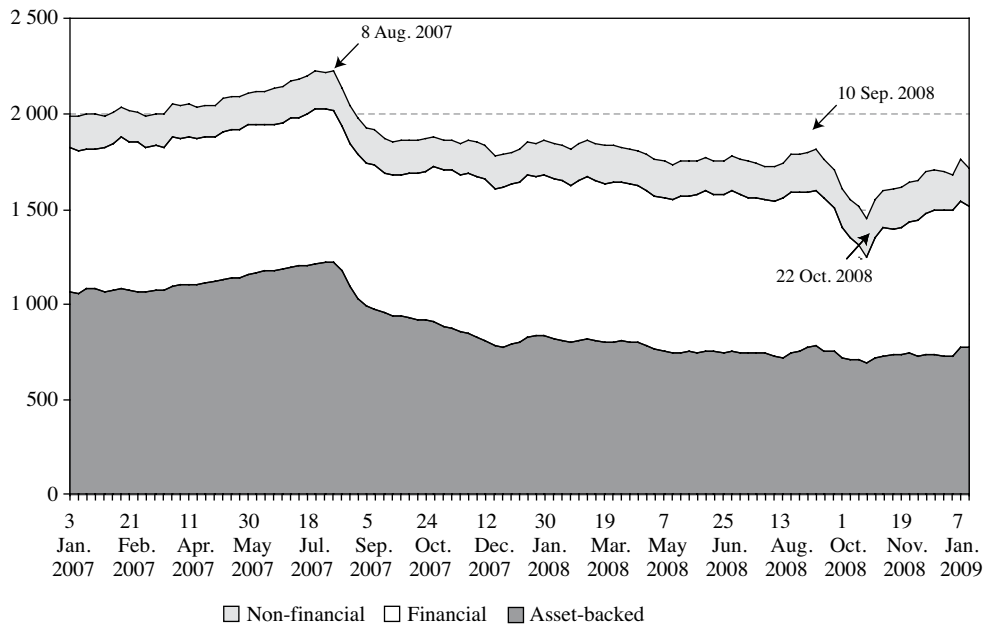
derivatives, particularly the new type of credit insurance that became known as credit default swaps. Nor was there any attempt at controlling the ever-greater array of off-balance sheet financial assets in the hands of even the most heavily regulated institutions (banks), while new intermediaries such as hedge funds were completely unregulated.

On top of all this, many non-bank agents began to specialize in maturity transformation, i.e., issuing bonds to raise short-term funds and then using these to make long-term loans or investments, thus creating a kind of “shadow banking system”. This is a function that has traditionally been assigned to commercial banks and that becomes very problematic during crises. Bank runs are one of its most disastrous manifestations, but while this problem has not been wholly absent during the recent crisis, it has tended to disappear as deposit insurance has become widespread. However, since non-bank agents do not have access to this insurance, which in any case is limited in its coverage, the problem has now been manifested in massive withdrawals from mutual funds, hedge funds and the like.

The initial responses of the economic authorities centred on improving liquidity provision facilities and lowering central bank intervention rates, i.e., on effectively discharging their function as lenders of last resort. Measures to provide access to Federal Reserve discount window loans were first announced in mid-August 2007, shortly after the market in mortgage-backed financial securities began to collapse (figure 1 shows one aspect of this collapse, in the market for securitized commercial paper). In September 2007, the Federal Reserve cut interest rates for the first time. Of the world’s major central banks, the Federal Reserve has been aggressive on both fronts, as has the Bank of England, while the European Central Bank has taken a much more conservative line. Over time, credit facilities proliferated and could be used by a range of intermediaries who had never had access to them before. The first step in this direction was taken in the United States in March 2008 as a result of the bankruptcy of Bear Stearns, when investment banks were allowed to access specific Federal Reserve lending facilities.

FIGURE 1

**United States: commercial paper in circulation**  
(Billions of dollars)



Source: Federal Reserve System, Washington, D.C.

In the first phase of the crisis, which lasted from mid-August 2007 until the Bear Stearns bankruptcy in March 2008, the mortgage-backed securities market deteriorated sharply. The fact that many of these securities were held by financial intermediaries, and did not necessarily appear on their balance sheets, contributed to an atmosphere of mutual distrust regarding the quality of their portfolios which in time was to become the most troublesome factor in the crisis. The use of credit lines created by the Federal Reserve was moderate to begin with but began to pick up in March 2008, a month that may thus be seen as marking the start of a second phase in the crisis. At the same time, the amount of government securities held by the Federal Reserve and not lent out to private agents declined, allowing it to maintain the total size of its portfolio (see table 1). Interest rates were cut very sharply up to March 2008 (by between three and four percentage points), and these cuts fed through to short-term Treasury securities, the interbank market and deposit and lending rates in the banking system, but rates in the capital markets (corporate bonds

and those of state and local governments) and those for mortgages remained practically unchanged (see table 2).

The scale of the collapse in mid-September 2008, when the third phase of the crisis began, took the authorities and the market itself by surprise. As lending seized up, the central bank took some completely unexpected measures, including the decision to purchase commercial paper through a limited liability company (actually a fund administered by the Federal Reserve Bank of New York) whose assets are backed by the Federal Government. This was the mechanism that had been designed since March to manage the Bear Stearns portfolio and that was to be used to manage that of AIG. With these measures, the policy focus switched from shoring up liquidity in the system to reactivating lending. This goal gradually came to include lower interest rates on commercial credits (for vehicle purchases, education and credit cards) and mortgages.

One consequence of this was the large-scale creation of new credit facilities increasingly oriented

TABLE 1

**Portfolio of the Federal Reserve**  
(Billions of dollars)

Week ending	8 Aug. 2007	2 Jan. 2008	12 March 2008	10 Sept. 2008	12 Nov. 2008	28 Jan. 2009
Total credit	850.6	891.7	869.2	888.3	2 198.2	1 989.9
Holdings of non-borrowed federal securities	787.3	724.1	697.5	361.7	271.2	376.2
Credit and portfolio holdings acquired from private sector	22.3	102.0	130.5	428.1	1 313.4	1 105.4
Traditional credit <sup>a</sup>	22.3	62.0	70.5	132.9	193.8	89.5
Term auction credit		40.0	60.0	150.0	415.3	415.9
Federal securities term facility				115.9	200.0	125.1
Facilities for investment banks					64.9	32.1
Asset-backed commercial paper					80.2	14.6
Credit to AIG						38.3
Other					82.3	0.0
Net commercial paper portfolio holdings in limited liability companies					249.9	316.2
Net portfolio of Maiden Lane <sup>b</sup>				29.3	26.9	27.0
Net portfolio of Maiden Lane II and III <sup>c</sup>						46.7
Assets denominated in foreign currencies and others (Central bank liquidity swaps)	41.8	66.6	42.4	99.6	615.0	510.3
Float	-0.9	-1.0	-1.2	-1.0	-1.5	-2.0

Source: Federal Reserve System, *Federal Reserve Statistical Release*, H.4.1, Washington, D.C., 2009.

<sup>a</sup> Operations with repurchase agreements, primary, secondary and seasonal credit and overnight lending of Treasury securities.

<sup>b</sup> Limited liability company created to administer the Bear Stearns portfolio.

<sup>c</sup> Limited liability company created to administer the AIG portfolio.

TABLE 2

## United States: selected interest rates

Week ending	10 Aug. 2007	28 March 2008	12 Sept. 2008	31 Oct. 2008	16 Jan. 2009	23 Jan. 2009
Intervention rates						
Federal Funds	5.25	2.18	1.99	0.82	0.10	0.20
Discount	6.25	2.50	2.25	1.68	0.50	0.50
Interbank (Libor)	5.43	2.67	2.82	4.70 <sup>a</sup>	1.11	1.14
Treasury securities						
1 month	4.82	1.22	1.53	0.28	0.04	0.03
10 years	4.79	3.52	3.66	3.92	2.30	2.56
3-m. certificates of deposit (secondary market)	5.43	2.74	2.79	3.45	0.85	1.05
Preferential loans	8.25	5.25	5.00	4.43	3.25	3.25
Corporate bonds						
AAA	5.78	5.51	5.46	6.42	4.89	5.10
BAA	6.66	6.93	7.05	9.49	7.97	8.15
State and local government bonds	4.59	4.96	4.54	5.35	4.80	5.13
Conventional mortgages	6.59	5.85	5.93	6.46	4.96	5.12

Source: Federal Reserve System, *Federal Reserve Statistical Release*, H.15, Washington, D.C., 1997.

<sup>a</sup> Week ending 15 September 2008.

towards all agents in the market: commercial and investment banks were now joined by mortgage intermediaries, mutual funds and even hedge funds. Federal Reserve lending to the private sector and acquisitions of private-sector assets increased by almost US\$ 900 billion between the week ending 10 September and the week ending 12 November, when the latter peaked. On top of this were the credit swaps granted to other central banks around the world. In this period of two months and a few days, the total Federal Reserve portfolio increased by US\$ 1.3 trillion (just over 9% of GDP). These assets were financed out of government deposits held in the Federal Reserve and surplus bank reserves deposited there (one of the manifestations of the hoarding of liquidity throughout the world), which had now become interest-bearing. Given that bank reserves form part of the monetary base, the latter grew by 70% between August and November. Much the same happened, albeit on a smaller scale, at other central banks in the industrialized countries.

These central bank measures were supplemented by bank rescue programmes led by various governments. Initially, there was a lack of coordination among authorities. In the United States, the ruling party

opposed the US\$ 700 billion rescue package presented by the Bush administration, which was ultimately passed by Congress in early October thanks to opposition support. In Europe, governments announced a series of competing initiatives, particularly where deposit insurance was concerned. Generally speaking, the measures introduced by the United Kingdom on 7 October set the agenda for the rescue plans. The primary focus was on using public money to capitalize financial institutions, which in some cases has meant complete nationalization (including that of the mortgage giants Fannie Mae and Freddie Mac and the AIG group in the United States). The second measure was the expansion of deposit insurance and State guarantees for certain credit lines, particularly interbank ones, while the third consisted in creating funds to purchase "toxic assets". Although this was at the heart of the package originally approved in the United States, it was subsequently abandoned as an instrument owing to the difficulties of implementing the purchase of complex and heterogeneous securities. The Citibank rescue announced in late November 2008 and the new British package of January 2009 represent a middle way between the second and third type of measures described above, with governments extending a public

guarantee to excess losses deriving from toxic assets still held by financial institutions (or a portion of them in the case of Citibank). Oddly enough, until January 2009 the rescue packages did not include relief for borrowers (particularly poor mortgage holders) and nor, despite pressure from some members of the United States Democratic Party, had there been any changes to the bankruptcy law to allow at least smaller mortgages to be renegotiated.

The measures applied have served to correct some of the most glaring distortions generated by the financial collapse of mid-September. After rising by almost two percentage points in the month following the crisis, the interbank interest rate tended to normalize from mid-October onward (see table 2). Issues of commercial paper recovered from the low point of 22 October (see figure 1), while pressure on Federal Reserve lending facilities eased from mid-November (see table 1). The rate of monetary base creation declined but remained high, so that between August 2008 and January 2009 a total of US\$ 855 billion was issued, equivalent to just under 6% of United States GDP.<sup>1</sup>

Meanwhile, contrary to the policy objective, there was a flight to quality originally manifested in lower interest rates on very short-term Treasury bills, which became a proxy for money, but this process coincided with a rise in market rates (or, what comes to the same thing, a significant increase in all risk spreads). From November, however, all interest rates began to fall, although those on long-term Treasury securities fell by far the most. Taken all together, while Federal Reserve rates have fallen by 5 to 6 percentage points since mid-August 2007, some are still higher than they were then (lower-rated corporate bonds and state and local government bonds) and others have fallen only modestly (highly rated corporate bonds).

This means that, although United States policy did enough to overcome the complete lack of liquidity that characterized the third phase of the crisis, as of January 2009 it had not succeeded in reactivating lending, which instead began to contract across the board in the closing months of 2008, when bank lending also began to be affected. Injecting public capital into banks has been a vital means of restoring some stability to the system, but as of early 2009 it was obvious that this process was not over and could

end in the complete nationalization of a very large number of institutions, especially in Great Britain but also in the United States and some countries of continental Europe. At the same time, it is not clear that this capitalization is sufficient to ensure more dynamic lending in the absence of a recovery in economic output.

Economic activity, meanwhile, has plummeted, with the industrialized countries seeing a 5% to 6% annualized rate of decline in the last quarter of 2008 and the first quarter of 2009.<sup>2</sup> There is a consensus among analysts that the effectiveness of monetary policy in the United States is very limited and that the country is actually in a “liquidity trap”, manifested most particularly in the hoarding of the most liquid securities (including the depositing of commercial banks’ excess reserves with the Federal Reserve) and in the strong demand for short-term Treasury securities. For this reason, attention has turned to the unconventional monetary measures mentioned earlier, whose focus is squarely on reactivating and reducing the cost of lending, and on fiscal packages. The United States has announced the largest of these, worth US\$ 800 billion (just under 6% of GDP). In other countries, central banks have continued with the task—still incomplete in Europe—of lowering interest rates.

One way of summing up recent events is to say that the third phase of the crisis, characterized by a total liquidity freeze in the financial system, has been followed since November by a fourth in which this problem has disappeared but financial institutions remain severely undercapitalized and credit is still very restricted, and whose dominant feature is the collapse of production activity in the industrialized countries, which have dragged the rest of the world down with them.

The situation in 2009 will depend on how these issues evolve. Most projections in late 2008 saw the economies of the industrialized countries, led by the United States, taking a turn for the better in the second half of this year. This is an optimistic scenario. The experience of the past in the developing world, like the Great Depression in the United States and Japan’s “lost decade” of the late twentieth century, indicate that in crises like the present one that involve deleveraging and radical balance sheet adjustments,

<sup>1</sup> According to the Federal Reserve H.3 series, the monetary base was US\$ 1,698 billion in the last two weeks of January 2009, or a little over double the August 2008 figure of US\$ 843 billion.

<sup>2</sup> Figures announced on 30 January showed United States GDP falling at a rate of 3.8% in the last quarter, but analysts expect this to be revised down yet further.



the recessionary effect tends to be powerful and long-lasting. The only forecast for 2008 that proved accurate was the pessimistic scenario published by the United Nations, according to which the recession would last throughout 2009, with a fall of 1.5% of GDP in the industrialized countries and 0.4% in the world as a whole (United Nations, 2009, table I.1). Given recent economic activity data (including those showing a marked slowdown in the Chinese economy in the fourth quarter of 2008), even this scenario now looks optimistic. Even the IMF (2009), usually among the most optimistic of institutional forecasters, stated in late January that global GDP would fall by 0.6% at market prices, a cut of almost two percentage points from the estimates it had given out just two months earlier. Private-sector forecasters are even more pessimistic.

It should be stressed that one of the main problems throughout the crisis has been the lack of coordination between the international authorities, with the striking exception of the measures applied by central banks to improve liquidity provision. One of the most recent

illustrations of this failure of coordination has been the lack of consensus in Europe concerning the need to implement a more expansionary fiscal policy. In any event, it must be remembered that Europe has better automatic stabilizers than the United States (more generous unemployment insurance in particular) and that the onus is therefore on the latter to adopt ambitious discretionary fiscal measures. There has also been a great deal of discussion as to whether or not fiscal packages should focus on higher spending, with its guaranteed effects on aggregate demand, or include tax measures whose effects on aggregate demand are more uncertain.

Again, it has never been clearer that institutional improvements are needed to coordinate global macroeconomic policies and manage financial globalization. In fact, the crisis has also revealed a need to create new regulatory institutions in Europe and even the United States, given the institutional complexity of the latter's prudential regulatory and oversight system, involving as it does a whole host of federal and state agencies.

### III

## The external channels of crisis transmission

As was noted in the introduction to this essay, the strong growth experienced by Latin America in 2003-2007 resulted from the unusual combination of a financial boom, rising commodity prices and a high level of remittances from migrant workers. It was thus the reversal of these positive trends that turned these factors into external channels transmitting the crisis to the region.

#### 1. Remittances

Of the three channels referred to, information on migrant workers' remittances is the most fragmented. Nonetheless, a review of Latin American balance-of-payments statistics makes it clear that the period of rapid remittance growth ended in 2006. Remittances have increased more slowly (by an average of 3%) over the past two years, with a moderate contraction in Mexico in 2008. In this case, the fall-off in United States construction activity was the most important crisis transmission channel for migrant workers, since a

substantial proportion of workers in the home-building sector are Mexican migrants (13.8%, or almost three times the 5.1% share of Mexican workers in the United States labour force) (J.P. Morgan, 2008). The decline of construction in Spain, a very important destination for Colombian and Ecuadorian migrants, may have had a similar effect.

However, it seems unlikely that there will be a large decline in remittances overall. World Bank forecasts for 2009 see them stagnating instead (Ratha, Mohopatra and Xu, 2008). Furthermore, the purchasing power of remittances will tend to increase if the currencies of the recipient countries depreciate. Thus, curiously enough, continuity of remittances could have a stabilizing effect on household consumption.

#### 2. International trade

The volume of world trade increased by 9.3% a year during the recent 2003-2006 boom, more than twice as fast as world GDP at market prices (3.8%) (United

Nations, 2009, table I.1). However, the growth rate of trade volumes has been very sensitive to the business cycle, and thus more volatile than that of world GDP. Accordingly, international trade has acted as an amplifier of both upturns and downturns in production activity. Trade growth fell substantially in 2007 and 2008, so that by September 2008 it stood at just 2% (United Nations, 2009, figure I.9). In fact, the partial data available indicate that world trade contracted in the fourth quarter of 2008. Forecasts from the World Bank (2009, table I.1) are for a 2.1% drop in 2009, while the pessimistic scenario from the United Nations (2009, table I.1) shows a 3.1% decline.

The contraction in trade volumes will be the main crisis transmission mechanism for the countries of Latin America and the Caribbean as a whole, but it will particularly affect those whose export structure is dominated by manufactures and services, i.e., Mexico, Central America and the Caribbean. In turn, commodity price trends will be the determining factor for South American exports.

In recent years, the world economy has experienced the most spectacular commodity price boom in over a century, whether measured by duration (five years) or intensity and breadth (World Bank, 2009, chapter 2). As table 3 shows, however, the boom was much stronger for mining products, including energy commodities, than for agricultural products. This is manifested in the fact that at their peak, generally in

the second quarter of 2008, real mineral prices were far higher than in the 1970s (this was even truer of energy commodities than of metals). Agricultural commodities, on the other hand, barely reached the levels of that period.

One consequence of this was that, in the developing world as a whole, mining commodity exporters saw by far the largest terms-of-trade improvements, while the terms of trade of agricultural exporters held more or less steady and those of manufactured goods exporters worsened (United Nations, 2009, figure II.6). In Latin America, the most marked improvements in the terms of trade were recorded in the Andean countries, from the Bolivarian Republic of Venezuela to Chile, all major exporters of mining products,<sup>3</sup> while Argentina, Brazil and Paraguay, which are exporters of agricultural commodities, saw only small improvements, even in 2008. Meanwhile, all the Central American countries plus Uruguay, which are heavily reliant on oil imports, saw their terms of trade worsen, while in Mexico, which combines mainly manufacturing exports with external sales of oil, they improved slightly (see figure 2).

<sup>3</sup> Some commentators do not include Colombia in this pattern, but two fifths of that country's export basket are in fact energy commodities (oil and coal) and metals (nickel and gold).

TABLE 3

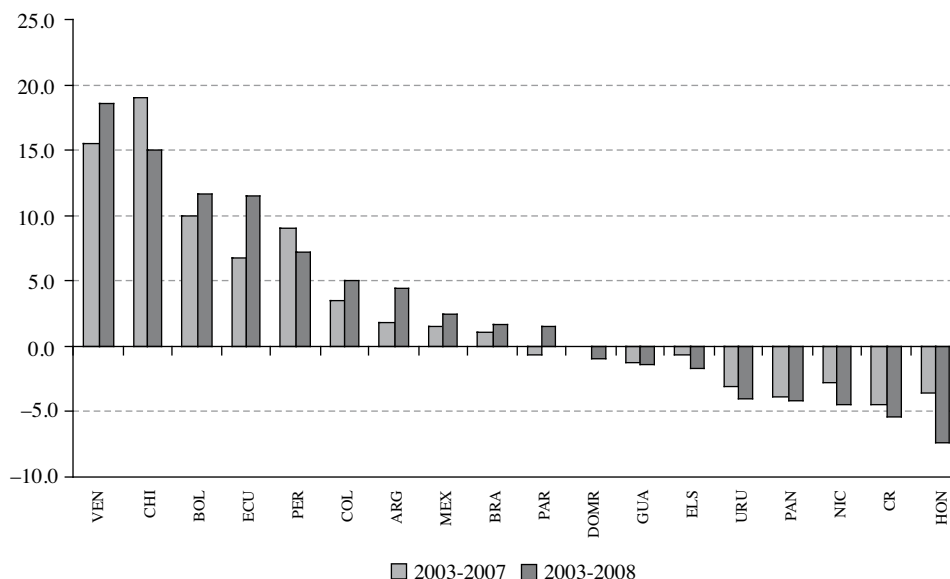
**Real commodity prices***(Deflated by manufacturing price index, 1945-1980 = 100)*

	Total non-oil	Agriculture total	Tropical agriculture	Other agriculture	Metals	Oil
1945-1970	98.4	98.9	100.1	97.5	96.4	64.6
1971-1980	104.1	103.0	99.6	106.4	109.4	192.1
1981-1990	81.1	75.5	63.1	88.2	106.6	246.3
1991-1997	75.3	73.7	57.9	89.9	82.4	139.5
1998-2003	69.4	67.0	50.7	83.6	80.4	193.7
2004	75.1	69.1	52.8	85.7	102.8	290.7
2005	80.3	72.1	59.5	84.9	118.3	410.7
2006	96.0	76.1	63.8	88.5	187.8	487.0
2007	102.4	80.7	69.7	91.9	202.3	518.7
2008-I	121.0	100.8	94.2	107.5	214.0	687.3
2008-II	123.3	102.1	99.1	105.0	221.5	860.7
2008-III	112.7	94.2	88.5	100.0	198.1	810.0
2008-Oct.	87.9	77.3	66.6	88.2	137.0	503.4
2008-Nov.	80.3	72.6	58.3	87.0	116.3	374.2

Source: José Antonio Ocampo and María Ángela Parra, "The terms of trade for commodities in the twentieth century", *CEPAL Review*, No. 79 (LC/G.2200-P), Santiago, Chile, April 2003, updated by the author from the same sources.

FIGURE 2

**Latin America and the Caribbean (selected countries):  
terms-of-trade gains and losses**  
*(Percentages of GDP)*



Source: prepared by the author on the basis of data from the Economic Commission for Latin America and the Caribbean (ECLAC).

This difference between mining and agricultural commodities indicates that the factors determining prices in the two groups of products are very different. In the case of energy and mining products, the key factor has been the low rate of investment resulting from weak market prices for commodities of this type between the mid-1980s and the early 2000s. Prices then rose sharply because of the high demand generated by rapid growth in developing countries over the past five years, including strong Chinese demand for metals. Investment responded positively, but in all mining projects there is a significant time lag between investment decisions and higher output. In the case of agriculture, and despite the alarm bells rung by the food crisis in the first half of 2008, the imbalance between supply and demand was much more moderate. One important transmission channel in this case was the fact that high energy prices translated into strong prices for agricultural commodities that are used, or that replace those used, to produce biofuels (Von Braun, 2007).

Commodity prices boomed in the second half of 2007 and the first half of 2008, and dollar depreciation and financial speculation drove them still higher. Prices peaked and began to retreat around mid-2008, i.e.,

before the financial collapse of September that year. As the credit system crumbled, the prices of commodities, and particularly energy and mining commodities, went into freefall. Even so, by November they were still higher in real terms than they had been in the 1970s. Tropical agriculture commodities, conversely, had fallen back to their low levels of the 1990s. Price declines for temperate-zone commodities were more moderate.

The outlook for commodity prices is negative. By November they had fallen below the most recent projections of the World Bank (2009, table I.4), which were for a price drop of 25% for energy commodities and 23% for non-energy commodities in 2009. To the cumulative decline up to November, furthermore, must be added the fresh drop in commodity prices in December.

The decline in international trade will be perhaps the most important of the channels whereby the global crisis is transmitted to Latin America. It could not be otherwise, given how much more open the Latin American economies are to trade now than in the past. The process will bring benefits, the greatest of which will come from the reversal of the terms-of-trade deterioration for oil-importing countries. The lesson of history is that opportunities also arise during crises

because of the positive effects of a more competitive exchange rate in diversifying the production structure, but more active production development policies of the type espoused by the Economic Commission for Latin America and the Caribbean (ECLAC) (most recently in ECLAC, 2008a) will be needed if advantage is to be taken of these opportunities.

### 3. Capital flows

One of the most striking characteristics of the financial flows to the developing world over the past four decades has been the change in the factors driving booms: whereas in the 1970s it was syndicated bank lending to the public sector, this role was played in the 1990s by international bond issues and during the recent boom by portfolio capital.

The nature of financial flows during the recent upsurge can best be appreciated by reviewing the external balance sheets of the leading Latin American economies (see table 4).<sup>4</sup> They show two striking changes. The first is an increase in assets, particularly international reserves but also direct and portfolio investments abroad, in all cases exceeding the rapid GDP growth in current dollar terms of the seven countries analysed (this almost doubled between 2003 and 2007). The second is the pronounced shift in the composition of liabilities, characterized essentially by lower borrowing and increased portfolio liabilities. The latter include investments in the region's countries by international investment funds, which also participate in local bond markets. The corollary of this process was the boom in both stock and bond markets in the countries, which in the latter case expanded by 15 percentage points of GDP from 2001 to 2007.<sup>5</sup> Stock market valuations will be examined later on.

Two further aspects of these external balance sheets are worth highlighting. First, the combined effect of rising assets and falling liabilities meant that net external financial liabilities declined sharply, by 10 points of GDP between 2003 and 2007. This was furthermore a feature shared by all the region's seven largest economies. By late 2007, the net financial position was positive in three of them (Argentina,

Chile and the Bolivarian Republic of Venezuela) and close to balance in another two (Colombia and Peru). Second, the build-up of reserves looks extremely solid when compared with debt liabilities, but much less so if reference is made to all portfolio liabilities. This indicates that the reserves build-up may be seen as offsetting the accumulation of this class of liabilities. In the region's two largest countries, indeed, reserves only covered a relatively small proportion of portfolio liabilities in late 2007, while in four (Mexico and, albeit from a stronger position, Chile, Peru and the Bolivarian Republic of Venezuela) they have increased more slowly than these liabilities over recent years.

This external balance sheet improvement is unquestionably the region's greatest strength as it faces less favourable international conditions. In particular, it means that the spectre of high external public borrowing will be less of a factor in future or, to be more precise, that it will be a factor in a smaller number of countries. However, it should be emphasized that in recent years portfolio flows, the most dynamic component of external financing, have proved very volatile once again. Furthermore, as will be seen, borrowing by some private-sector firms has become a new source of vulnerability.

Throughout the boom period, the relative importance of external financing as a source of the region's balance-of-payments surpluses tended to increase. Capital-account balances, which were virtually nil between mid-2002 and mid-2004, recovered thereafter and began to outstrip current-account balances as a source of balance-of-payments surpluses. From mid-2006 to mid-2007, capital inflows become a veritable flood. In six of the region's seven largest countries (the exception being the Bolivarian Republic of Venezuela), the balance-of-payments surplus in the fourth quarter of 2006 and the first half of 2007 was close to US\$ 113 billion, some US\$ 100 billion of which was on the capital account (about two thirds was accounted for by Brazil and the rest by the other five economies) (Ocampo, 2007).

Figure 3, which tracks monthly Latin American bond issues on international markets, confirms that financing peaked between mid-2006 and mid-2007, a period when issuances were rising but unstable and the predominance of private firms increased (about 70% of all issues). In general, corporate issues are higher-cost and have shorter average maturities than government bonds and thus require more frequent debt rollovers. For these reasons, they are more vulnerable to fluctuations in capital availability.

<sup>4</sup> See Jara and Tovar (2008) and Ocampo (2007) for a more detailed analysis of external financing flows entering Latin America in recent years.

<sup>5</sup> Ocampo and Tovar (2008) provide a more detailed analysis of developments in the bond markets of the Latin American countries over the current decade.

TABLE 4

**Latin America (seven countries): external balance sheet**  
(Percentages of GDP at current prices)

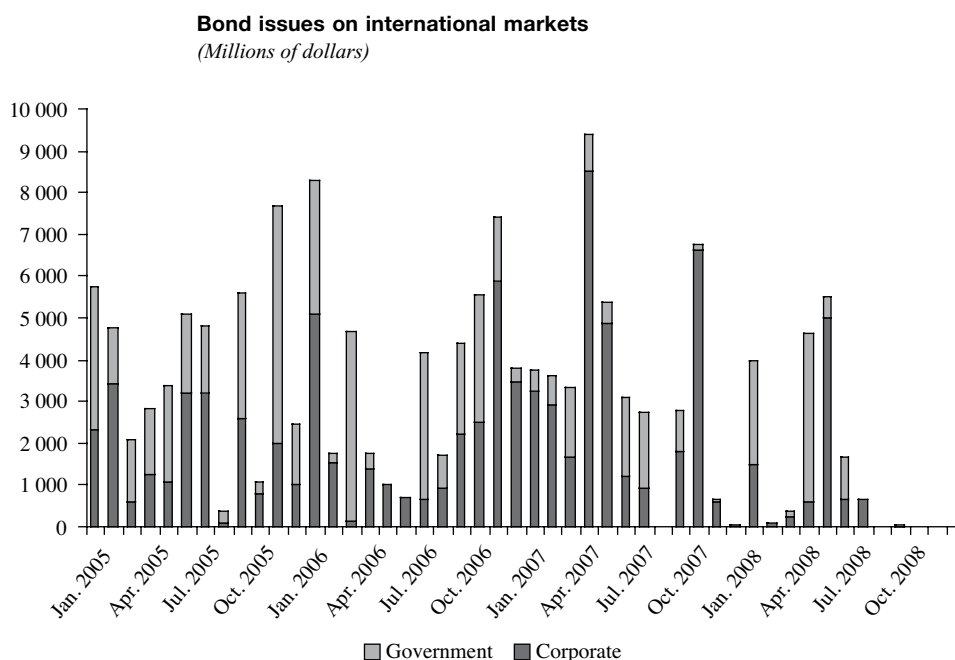
	2001	2002	2003	2004	2005	2006	2007
<b>Assets</b>							
Total <sup>a</sup>	26.5	29.7	31.9	31.5	31.4	32.4	37.5
Foreign direct investment	5.8	6.9	7.0	7.2	7.0	7.5	7.9
Portfolio assets	2.1	2.4	3.2	3.2	3.5	3.9	4.8
Derivatives	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Other investments	12.1	13.3	13.4	12.6	11.4	10.8	12.5
International reserves <sup>a</sup>	6.6	7.1	8.3	8.5	9.5	10.0	12.3
<b>Liabilities</b>							
Total <sup>a</sup>	62.4	65.4	70.4	66.4	61.5	60.3	65.6
Foreign direct investment	24.5	25.5	28.6	28.1	26.7	25.6	27.2
Portfolio liabilities	19.8	20.1	23.1	22.9	22.8	23.8	28.0
Shares	5.5	4.9	7.2	8.4	10.4	13.0	16.9
Debt	14.3	15.2	15.9	14.5	12.3	10.9	11.1
Derivatives	0.0	0.0	0.0	0.1	0.1	0.2	0.3
Other investments <sup>a</sup>	18.0	19.8	18.6	15.4	11.9	10.7	10.2
<b>Assets - liabilities</b>							
Direct investment	-18.8	-18.6	-21.6	-20.9	-19.7	-18.0	-19.2
Financial	-17.1	-17.1	-16.8	-14.0	-10.4	-9.9	-8.9
Reserves as percentage of debt	20.3	20.4	24.0	28.3	39.1	46.5	57.9
Reserves as percentage of portfolio liabilities	33.1	35.5	35.9	37.0	41.6	42.1	44.0
Domestic capital market as percentage of GDP	34.2	32.1	38.7	39.8	43.8	44.5	49.1
<b>Financial assets - liabilities</b>							
Argentina	-0.3	19.8	20.1	22.0	29.5	26.2	29.0
Brazil	-34.9	-36.4	-35.2	-31.0	-24.1	-23.8	-28.9
Chile	-3.2	-1.5	3.9	13.5	17.3	27.6	42.7
Colombia	-13.8	-13.6	-14.5	-10.2	-5.2	-3.1	-0.9
Mexico	-17.6	-16.7	-18.6	-18.4	-19.3	-21.1	-16.7
Peru	-29.4	-27.9	-26.4	-21.3	-14.4	-7.6	-6.8
Venezuela, Bol. Rep. of	23.9	35.9	48.7	44.6	49.3	50.8	51.3
<b>Reserves as percentage of portfolio liabilities</b>							
Argentina	2.2	-14.2	1.7	19.6	67.6	72.8	93.4
Brazil	18.1	13.1	13.6	15.7	23.1	28.6	35.4
Chile	142.4	145.8	108.3	98.9	93.3	98.3	83.6
Colombia	78.8	88.1	84.2	91.8	102.7	96.8	114.6
Mexico	30.8	41.6	42.7	39.0	35.8	30.0	29.0
Peru	131.1	125.4	105.2	114.4	91.7	98.2	97.5
Venezuela, Bol. Rep. of	131.1	125.4	105.2	114.4	91.7	98.2	97.5

Source: prepared by the author on the basis of data from the International Monetary Fund (IMF), *International Financial Statistics* [online].

N.B.: current-dollar GDP data from the Economic Commission for Latin America and the Caribbean (ECLAC); domestic capital market data from the Bank for International Settlements. The data are for the seven largest economies (Argentina, Brazil, Chile, Colombia, Mexico, Peru and the Bolivarian Republic of Venezuela).

<sup>a</sup> The value of liabilities with the International Monetary Fund has been deducted from these accounts.

FIGURE 3



Source: Economic Commission for Latin America and the Caribbean (ECLAC) on the basis of data from J.P. Morgan.

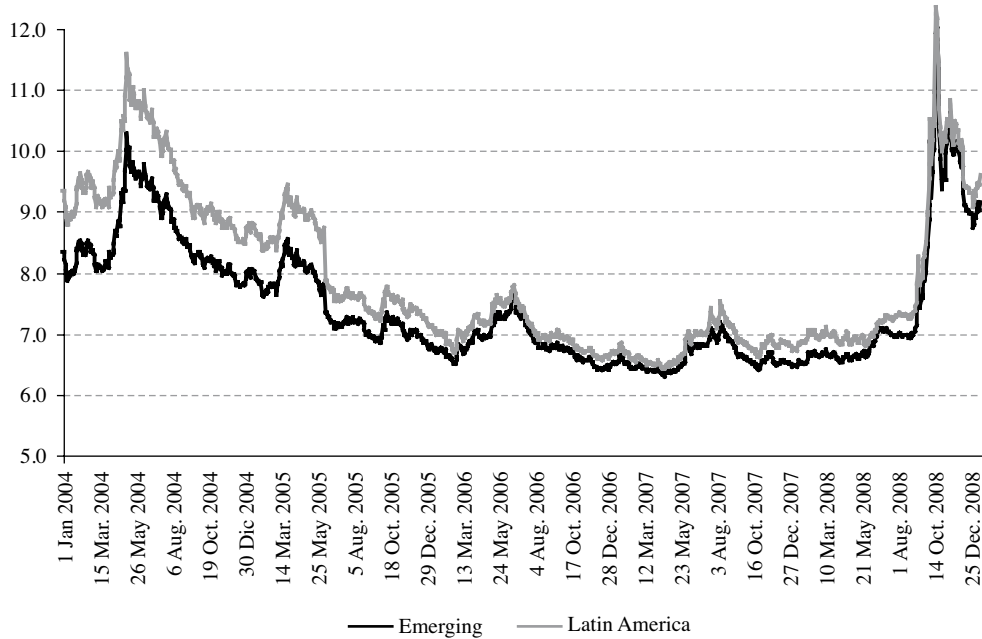
Figure 4 shows another striking feature of the boom period: the large reduction in external financing costs. From mid-2004 onward, country risk spreads on Latin American bonds, like those of emerging markets generally, were systematically lower than they had been before the Asian crisis. Furthermore, having initially been wider than the emerging market average, these spreads tended to approach that average. Meanwhile, although Federal Reserve interest rates also rose over the period (from September 2004 onward), the rates on long-term Treasury securities, which provide a benchmark for price-setting in international bond markets, were not greatly affected. The result was that falling spreads translated into a sharp decline in external financing costs, from 10% in the first half of 2004 to just under 7% at their lowest point in April and May 2007. This trend altered on two occasions: in March 2005, because of rising interest rates in all markets, and in the second quarter of 2006, reflecting a more specific emerging-market shock whose epicentre was Shanghai. It should be added that the reduction in financing costs was experienced right across the region, although it was moderate in the two countries already considered low-risk before the boom (Chile and Mexico).

This financial market “exuberance” was transmitted to the Latin American economies via three different channels. In the first place, there was the downward pressure on domestic interest rates generated by the reduction in external financing costs. A second and sometimes complementary factor was that this pressure was reflected in exchange rates. Lastly, strong risk appetite was manifested in stock market inflation. The great boom in Latin American stock markets began in mid-2004, i.e., when the country risk spreads of the region’s countries began to fall rapidly. On average, stock prices in the region’s seven largest economies quadrupled in dollar terms between mid-2004 and mid-2007 (see figure 5).

The international financial crisis has spread in complex ways over time and had different effects on the different countries of the region. The initial impact, during the third quarter of 2007, consisted of a large decline in capital flows and bond issues (see figure 3), a moderate increase in financing costs (see figure 4) and a likewise moderate decline in stock markets, which was quickly reversed (see figure 5). Compared to the previous market shock of May to July 2006, spreads were more volatile between July and September 2007, but the effects were diverse. Displaying a pattern that

FIGURE 4

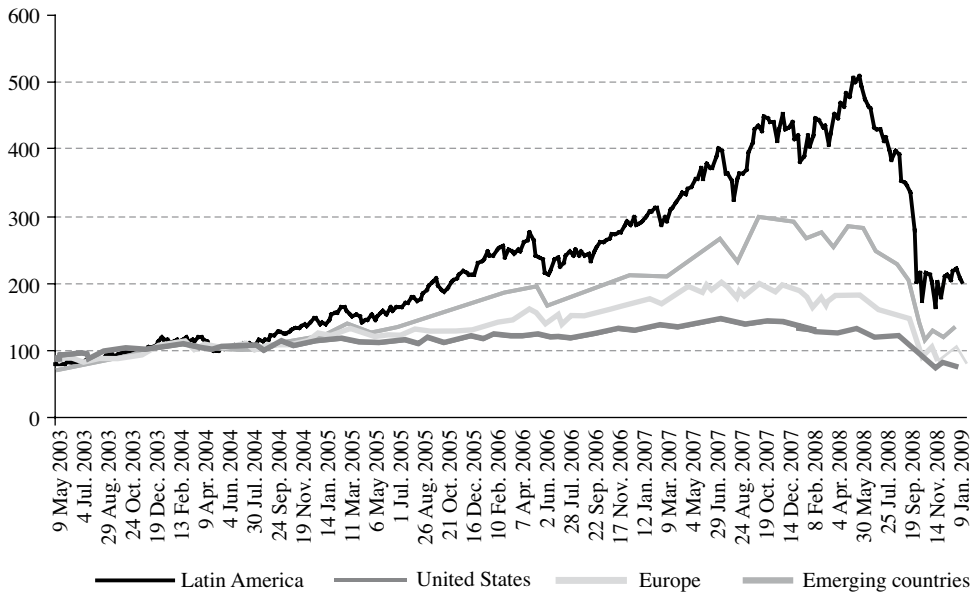
Latin America and emerging countries: sovereign bond yields



Source: Prepared by the author on the basis of data from J.P. Morgan.

FIGURE 5

Stock markets  
(July 2003-June 2004 = 100)



Source: Prepared by the author on the basis of data from Morgan Stanley.

would subsequently be heightened and that reflects an element of so-called “political risk”, the increase in and volatility of spreads were greatest in Argentina and the Bolivarian Republic of Venezuela. In Brazil and Colombia, meanwhile, just as in May to July 2006, exchange rates were particularly sensitive to short-term movements in spreads; there was also a strong correlation between the two variables in Mexico, but with much lower levels of volatility. Chile and Peru were the economies least affected (see table 5).

This turbulent situation was followed, however, by an “Indian summer” in which financing costs fell back again and financing flows were renewed. The latter, however, did not rise back to their earlier levels and became more irregular, as can be seen from monthly bond issues. By contrast with the global pattern (a brief recovery in October 2007 followed by a downward trend), Latin American stock prices, measured in dollars, resumed their upward trend and actually peaked in May 2008, although this largely reflected the strong appreciation of the Brazilian real.

The new upset in the market occurred in June 2008, and thus clearly predated the financial collapse of September. In fact, it coincided with the reversal of the upward trend in commodity prices. This relationship is explained by the fact that many emerging multinationals in Latin America are producers of industrial commodities such as steel and cement. Bond emissions plummeted in June and July and disappeared from the market from August onward. Financing costs had already risen by half a percentage point by the time of the September 2008 collapse. The volatility of spreads was much the same as it had been during the shock in the third quarter of 2007. Argentina and the Bolivarian Republic of Venezuela moved further away from the other large countries, while in Brazil and Colombia exchange rates once again proved particularly unstable. Stock markets fell sharply, but prior to the September upheaval still averaged levels three and a half times as high as in mid-2004.

The collapse of mid-September 2008 dramatically heightened these tendencies.<sup>6</sup> Lending of every kind dried up and capital departed the region via some rather unexpected channels: worldwide securities sell-offs as mutual and hedge fund deposits were redeemed in the United States, and the dismantling of carry trade operations conducted out of Japan, one of whose

beneficiaries had been Brazil. This caused all the Latin American currencies to depreciate sharply, while the dollar and yen appreciated on international markets. Furthermore, exchange-rate fluctuations resulted in large losses on futures markets, especially in Brazil and Mexico. The sum total of net capital outflows from Latin America during the fourth quarter of 2008 is unknown, but the loss of reserves in most of the countries is a manifestation of the phenomenon. The other effects are known with accuracy: financing costs rose substantially (see figure 4) and stock markets fell by much more than those in the industrialized countries (see figure 5); spreads became very volatile and their correlation with exchange-rate movements increased in all the countries (see table 5); Brazil, Chile and Mexico were now the countries with the most unstable exchange rates, while Colombia proved more stable than in earlier episodes, perhaps because its legal reserve requirement for incoming capital had reduced the volume of more volatile capital; and the gap between spreads in Argentina and the Bolivarian Republic of Venezuela and those in the other large economies of Latin America widened significantly, to 10 or more percentage points.

In line with interest rate movements in the United States (see table 2), financing costs peaked in late October (12.35% on 23 October) before declining and tending to stabilize at between 9% and 10% from mid-December, a level not far removed from those prevailing before the boom which began in 2004 and two to three percentage points higher than those considered normal before the United States financial crisis. The greatest pressure on currency markets also arose between mid-September and late October; although currencies have depreciated less since then, markets have remained very volatile. Stock markets have also tended to stabilize, and indeed in Latin America they have done so at levels higher than those of mid-2004, by contrast with what has happened in other markets (see figure 5).

Although there appears to have been a recovery from the worst symptoms of the financial collapse associated with the complete illiquidity characterizing the third phase of the United States financial crisis, its more permanent effects persist. All current projections indicate that private capital flows will remain at low levels for the immediate future. Projections by the Institute of International Finance (2009), for example, indicate that in 2009 private lending flows into all emerging economies will be negative, by comparison with net inflows of over US\$ 600 billion in 2007, but

<sup>6</sup> A recent essay by Bustillo and Velloso (2009) provides a detailed analysis of the effects of the international financial crisis on the Latin American economies.



TABLE 5

**Latin America (selected countries): exchange-rate and risk spread volatility in periods of turbulence**

	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Ven., B.R. of	EMBI +
<b>Risk spread volatility<sup>a</sup></b>								
May 2006-Jul. 2006	26.2	19.6	3.6	27.7	14.7	10.1	20.9	16.4
Jul. 2007-Sep. 2007	60.6	21.9	14.5	31.6	15.0	23.5	64.6	25.0
Jun. 2008-12 Sep. 2008	58.5	24.2	7.0	24.3	22.1	24.0	48.0	24.5
15 Sep. 2008-Jan. 2009	352.4	79.4	61.4	104.7	82.4	92.6	306.6	126.5
<b>Average spreads</b>								
May 2006-Jul. 2006	362.8	249.3	81.0	215.4	134.3	167.5	207.6	
Jul. 2007-Sep. 2007	414.2	187.3	105.6	167.3	111.9	151.3	389.2	
Jun. 2008-12 Sep. 2008	632.5	226.5	173.0	211.5	168.5	190.1	623.4	
15 Sep. 2008-Jan. 2009	1 572.6	450.7	323.5	502.6	384.0	470.1	1 492.2	
<b>Exchange-rate volatility<sup>b</sup></b>								
May 2006-Jul. 2006	0.56	3.24	2.11	3.12	1.81	0.57	2.24	
Jul. 2007-Sep. 2007	0.78	2.95	0.91	4.51	1.21	0.57	0.00	
Jun. 2008-12 Sep. 2008	0.59	3.16	2.74	5.99	1.55	2.17	0.00	
15 Sep. 2008-Jan. 2009	3.63	8.20	6.28	3.64	7.70	1.86	0.00	
<b>Average exchange rate</b>								
May 2006-Jul. 2006	3.07	2.20	535	2494	11.16	3.26	2.59	
Jul. 2007-Sep. 2007	3.14	1.92	520	2041	10.96	3.15	2.15	
Jun. 2008-12 Sep. 2008	3.03	1.62	507	1818	10.26	2.89	2.15	
15 Sep. 2008-Jan. 2009	3.32	2.23	628	2260	12.87	3.09	2.15	
<b>Ratio between exchange rate and EMBI +</b>								
May 2006-Jul. 2006	0.789	0.832	0.796	0.885	0.755	-0.388	0.477	
Jul. 2007-Sep. 2007	0.818	0.658	0.364	0.789	0.930	0.059	0.000	
Jun. 2008-12 Sep. 2008	-0.145	0.440	0.752	0.788	0.177	0.375	0.000	
15 Sep. 2008-Jan. 2009	0.751	0.876	0.901	0.678	0.901	0.808	0.000	

Source: prepared by the author on the basis of data from J.P. Morgan Chase.

N.B.: EMBI = Emerging Markets Bond Index.

<sup>a</sup> Standard deviation.

<sup>b</sup> Coefficient of variation.

that the large outflows of portfolio capital seen in 2008 will be stemmed. All studies suggest that the most critical problems will arise when the region's major private firms seek to roll over their debt (see, for example, J.P. Morgan, 2009). Consequently, the heavy reliance of these firms on industrial commodities and the drastic shortening of financing maturities will be the main weaknesses of the capital account.

These problems, plus the major uncertainties deriving from the still partially unresolved financial crisis in the industrialized world, suggest that the

weakness of private-sector external financing will persist for some time. However, it is possible that the capital-account crisis in Latin America will be less acute than on earlier occasions because of the better starting conditions this time around in terms of reserve levels and external debt. Furthermore, one favourable side-effect of the new context has been the easing of the powerful pressures causing currencies to appreciate in a number of the region's countries during the boom. These subjects will be the main focus of the following section.

## IV

### The vulnerability of the Latin American countries

The history of Latin America since the 1970s has been marked not only by major external shocks, both positive and negative, but also by macroeconomic policies that have tended to heighten rather than mitigate the effects of these upheavals on domestic economic activity, i.e., procyclical macroeconomic policies. The fundamental problem with this behaviour is that a number of vulnerabilities arise during the favourable phases of the business cycle, essentially in the form of public- or private-sector deficits which lead to high levels of borrowing and corresponding balance-of-payments current-account deficits, further exacerbated by overvalued national currencies. These vulnerabilities are exposed when the exceptional external conditions come to an end and severe macroeconomic adjustments have to be made in the form of fiscal tightening (involving differing combinations of spending cuts and tax increases), restrictive monetary and credit policies and large exchange-rate adjustments.

Compared with this historical pattern, it has been argued that the recent economic boom led to an important change in macroeconomic policy, reflected in the higher priority given to macroeconomic equilibria (see ECLAC, 2008c, among others). As evidence for this, the proponents of this view point to the healthier public accounts and current-account surpluses that characterized the region during the boom period.

This interpretation of recent economic history in Latin America needs to be qualified, however, in a number of ways. A far more realistic reading is the one presented by the Inter-American Development Bank (IDB, 2008), largely based on the work of Izquierdo, Romero and Talvi (2008) and agreeing with my own position in an earlier paper (Ocampo, 2007). According to this alternative view, the cause of the recent good performance was the strength of the external factors that drove the boom, since economic policy generally remained procyclical. The most important and common differences from the past were lower external borrowing by the public sector and the build-up of international reserves.

Table 6 presents a summary of developments in fiscal indicators. As can be seen, in 2008 just three countries ran a central government deficit of more

than 2%: Brazil, Colombia and the Dominican Republic. In almost all the countries, furthermore, central government debt as a proportion of GDP was substantially lower than at the beginning of the previous crisis, with the exceptions of Brazil and Colombia once again, plus Argentina and Uruguay. However, these positive fiscal results were primarily due to exceptional public-sector revenues and not spending policies, which generally remained procyclical, with some exceptions.<sup>7</sup> The most notable of these is Chile, a country that has followed structural balance rules for its fiscal accounts for almost a decade, reinforced during the economic boom by means of two stabilization funds designed to save the fiscal surpluses generated by high copper prices: the Economic and Social Stabilization Fund and the Pensions Reserve Fund.

As table 6 shows, the GDP-elasticity of primary spending was over 1 in almost all the region's economies. According to countercyclical rules, however, spending ought to increase by significantly less than GDP during economic upturns, i.e., the GDP-elasticity should be less than 1. The exceptions, besides Chile, were El Salvador and Guatemala. Although there are other countries where elasticity was less than 1, real primary spending growth during the boom exceeded the long-term growth rate of the economies concerned.

This procyclical behaviour of fiscal policy stands in contrast to the complex institutional apparatus introduced since the late 1990s in the form of numerous fiscal responsibility laws and newly created stabilization funds. Rule changes and the practice of earmarking resources in advance indicate that hitherto the effects of these fiscal institutions have been limited (Jiménez and Tromben, 2006).

Developments in the external accounts also reveal a pattern that is far from suggesting a policy approach designed to generate balance-of-payments current-account surpluses. Once again, the determining external factor was the sharp improvement in the

<sup>7</sup> See, in particular, IDB (2008, chapter 3). A study by ECLAC (2008b, chapter IV) also contains some important reflections on the subject.

TABLE 6

**Latin America: fiscal indicators**  
(Percentages)

	Central government surplus or deficit (percentages of GDP)		Central government debt (percentages of GDP)			Real primary spending growth 2003-2007
	2007	2008	2007	2008	Change 1998-2008	
Argentina	0.6	1.0	55.7	48.0	10.4	11.9
Bolivia (Plurinational State of)	2.3	3.0	37.1	30.7	-24.4	5.0
Brazil	-2.0	-2.6	32.7	30.1	5.9	9.0
Chile	8.8	6.9	4.1	3.5	-8.6	2.5
Colombia	-3.0	-2.7	35.2	33.2	11.1	7.9
Costa Rica	0.6	-0.5	27.7	23.5	-19.4	5.1
Ecuador	-0.1	-0.1	27.5	22.6	-34.4	10.3
El Salvador	-0.2	-0.6	34.5	31.2	-2.1	0.4
Guatemala	-1.5	-1.2	21.7	19.3	2.9	2.9
Honduras	-2.9	-1.9	17.4	17.4	-57.6	7.4
Mexico	0.0	0.0	21.1	20.4	-7.4	5.9
Nicaragua	0.6	0.8	42.2	34.6	-89.6	6.4
Panama	1.2	-1.0	53.2	46.6	-15.4	8.2
Paraguay	1.0	0.5	17.3	12.1	-8.4	4.4
Peru	1.8	2.3	27.2	22.8	-14.4	7.4
Dominican Republic	0.6	-3.2	19.0	16.7	-1.5	10.2
Uruguay	-1.7	-1.0	50.7	39.9	15.9	6.4
Venezuela (Bol. Rep. of)	3.0	-1.8	19.3	14.0	-15.4	13.4

Source: prepared by the author on the basis of data from the Economic Commission for Latin America and the Caribbean (ECLAC).

terms of trade. Figure 6 shows an estimate for the current-account balance of the region as a whole, with and without terms-of-trade adjustments. In the former case, the base year taken is the one preceding the economic boom, i.e., 2003. As can be seen, the current-account surplus was entirely due to the terms-of-trade improvement. Adjusted for this variable, the current account registered a growing deficit throughout the boom period. This reached the equivalent of 5% of GDP in 2008, a much higher figure than that for the Latin American economies before the crisis of the late twentieth century.

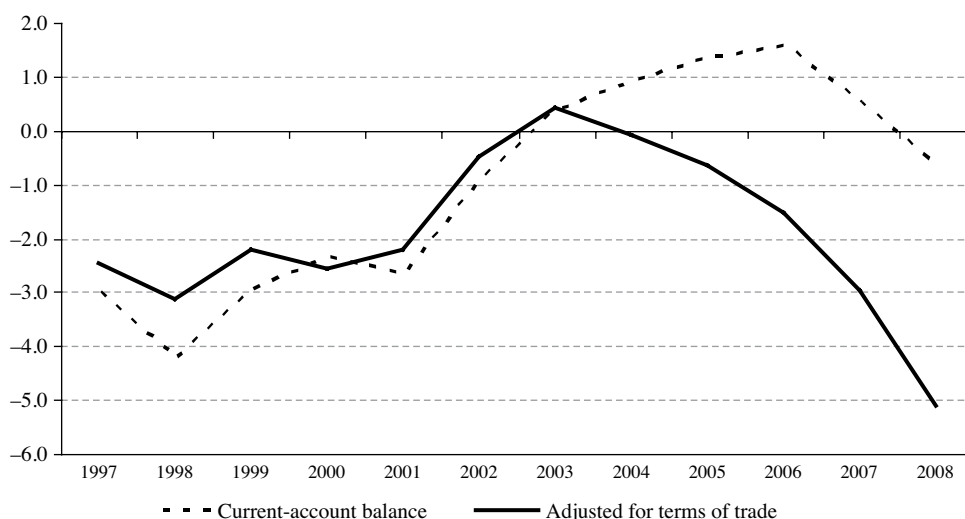
Table 7 gives a more detailed overview. As it shows, the only economies to record a current-account surplus up to 2008 were three hydrocarbon exporters (Plurinational State of Bolivia, Ecuador and the Bolivarian Republic of Venezuela) and Argentina. Another two whose exports are based on mining commodities (Chile and Peru) ran surpluses up to 2007, but these declined sharply in 2008. As table 7 reveals, both countries were already running substantial current-account deficits in 2007 if the adjustment is made for changes in the terms of trade. Brazil followed a similar path, albeit the country's initial

surplus was more modest. The only economies to show a small current-account surplus in 2008, when adjusted for the terms of trade, were Plurinational State of Bolivia and Uruguay. In the latter, the current deficit was therefore due to high prices for imported hydrocarbons. Otherwise, what this indicates is that given the collapse of mining and energy commodity prices, countries with an export base of this type will need to undergo a major adjustment process over the coming years.

One of the basic explanations for the current-account deterioration over the period of strong economic growth was, as formerly, the tendency towards real currency appreciation. As table 7 shows, this was particularly strong in Brazil, Colombia and the Bolivarian Republic of Venezuela, but also in a number of smaller economies (Guatemala, the Dominican Republic and Uruguay). Chile also experienced peso appreciation in real terms, although this was more moderate. The most notable exceptions here were Plurinational State of Bolivia and Peru; Argentina was also an exception until 2006, but the real-term devaluation shown in table 7 owes more to official underestimates of the inflation rate in recent

FIGURE 6

**Latin America: current account with and without terms-of-trade adjustment**  
(Percentages, base year 2003)



Source: prepared by the author on the basis of data from the Economic Commission for Latin America and the Caribbean (ECLAC).

years. The real-term devaluation undergone by the United States currency during the boom favoured the three dollarized economies (Ecuador, El Salvador and Panama).

Figure 7, meanwhile, reveals that the only aspects in which the Latin American economies have shown a systematic and consistent improvement in relation to the past are external public borrowing and the build-up of international reserves. To correct the effects of real exchange-rate variations on GDP, the estimates used 2000 purchasing power parity exchange rates. As can be seen, there was a substantial improvement in net external debt levels, thanks to lower borrowing up until 2006 and the build-up of international reserves since then. The reduction in public borrowing was due both to explicit fiscal policy decisions (less external financing and greater use of growing domestic capital markets) and to programmes favouring heavily indebted poor countries and the renegotiation of the Argentine debt.

The reserves build-up, meanwhile, resulted from explicit decisions to accumulate both current-account surpluses (usually generated, as we have seen, by exceptional commodity prices) and the flood of external financing. The latter is reflected in figure 8, which calculates the build-up of reserves as a proportion of GDP in six of the seven largest Latin American

economies during the three phases of plentiful external financing. As can be seen, Argentina was among the first to bring in a policy of building up reserves (the reserves deriving in this case from the current-account surplus rather than from the capital account). Other than Mexico, all the countries in the chart intervened actively in the market to accumulate some of the funds entering in the flood of external financing between mid-2006 and 2007.<sup>8</sup> Chile and Peru did the same during the first half of 2008, as did other countries to a lesser degree. This “fear of floating” when confronted with that surge of external capital was thus one of the great virtues of Latin American macroeconomic management during the recent economic boom (as it was, indeed, in the developing world generally), although in some cases it did not serve to prevent real currency appreciation.

As a result both of lower public-sector external borrowing and of the reserves build-up, virtually all the countries are well placed in this respect (see table 7). The main exceptions are certain Central American countries (El Salvador, Nicaragua and Panama) and, to

<sup>8</sup> In the case of Chile, the calculations include the transfer of resources to stabilization funds. The balances of these funds were also added to the international reserves total to calculate the country's external borrowing ratios.

TABLE 7  
Latin America: external indicators  
(Percentages)

	Current-account balance (percentages of GDP)		Current account adjusted for terms of trade <sup>a</sup> (percentages of GDP)		External debt (percentages of GDP)		External debt net of international reserves (percentages of GDP)		Change in terms of trade		Change in exchange rate <sup>c</sup>	
	2007	2008	2007	2008	2007	2008	2007	2008	2003-2008	2003-2008	2003-2008	2003-2008
Argentina	2.7	3.5	0.9	-0.9	47.2	42.8	29.6	27.5	21.9	13.3		
Bolivia (Plurinational State of)	13.4	12.0	3.5	0.3	41.3	13.5	0.7	-30.9	49.6	5.3		
Brazil	0.1	-1.9	-1.0	-3.6	14.9	14.2	1.0	-0.1	13.7	-42.3		
Chile <sup>b</sup>	4.4	-3.0	-14.6	-18.1	34.1	33.4	14.3	13.0	72.2	-14.2		
Colombia	-2.8	-2.7	-6.3	-7.8	21.7	19.0	11.5	9.4	47.8	-32.8		
Costa Rica	-5.7	-7.0	-1.3	-1.6	32.0	29.4	16.3	16.9	-14.5	-3.3		
Ecuador	3.6	3.0	-3.1	-8.5	38.1	31.8	30.4	21.1	45.4	15.8		
El Salvador	-5.5	-5.9	-4.8	-4.2	44.5	40.8	33.7	30.1	-7.7	4.5		
Guatemala	-5.1	-4.6	-3.8	-3.2	12.6	12.0	-0.3	0.0	-6.3	-16.6		
Honduras	-9.9	-14.9	-6.4	-7.4	24.6	22.5	2.4	4.9	-9.8	-4.9		
Mexico	-0.6	-1.4	-2.1	-3.8	12.2	11.8	3.7	3.7	9.2	0.4		
Nicaragua	-18.3	-25.8	-15.5	-21.4	59.1	51.2	39.9	34.7	-9.9	-2.0		
Panama	-7.3	-7.3	-3.5	-3.2	42.5	36.4	32.5	28.9	-8.4	9.9		
Paraguay	0.4	-2.1	1.0	-3.7	25.8	19.5	5.2	0.6	3.3	-26.1		
Peru	1.4	-3.8	-7.7	-11.1	30.4	27.1	4.5	3.9	42.6	1.9		
Dominican R.	-5.4	-12.7	-5.5	-11.8	18.4	17.3	11.3	11.9	-5.4	-25.1		
Uruguay	-1.0	-3.5	2.1	0.5	52.9	40.7	35.1	21.6	-16.5	-23.6		
Venezuela (Bol. R. of)	8.8	12.6	-6.7	-6.0	23.2	17.9	8.5	5.9	163.8	-30.3		

Source: Prepared by the author on the basis of data from the Economic Commission for Latin America and the Caribbean (ECLAC).

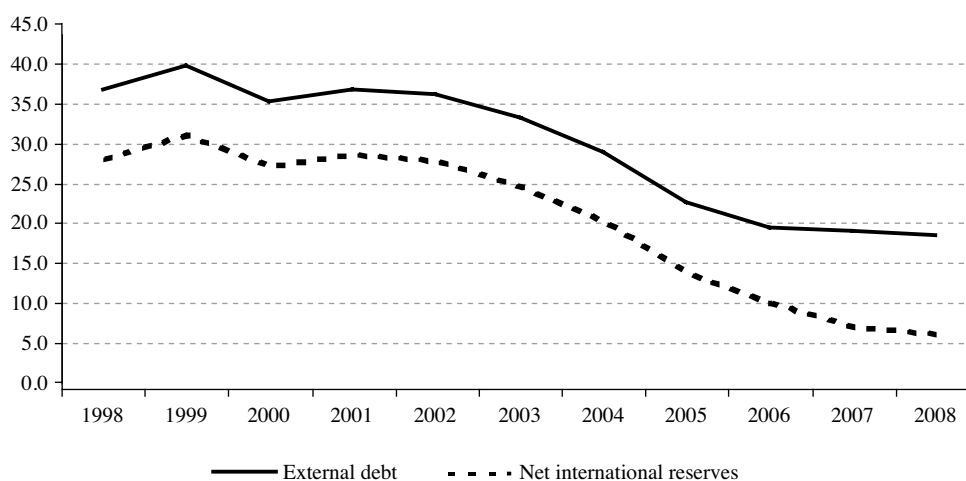
<sup>a</sup> Reference year = 2003.

<sup>b</sup> The net external debt calculations include assets accumulated in sovereign wealth funds.

<sup>c</sup> A positive sign indicates depreciation.

FIGURE 7

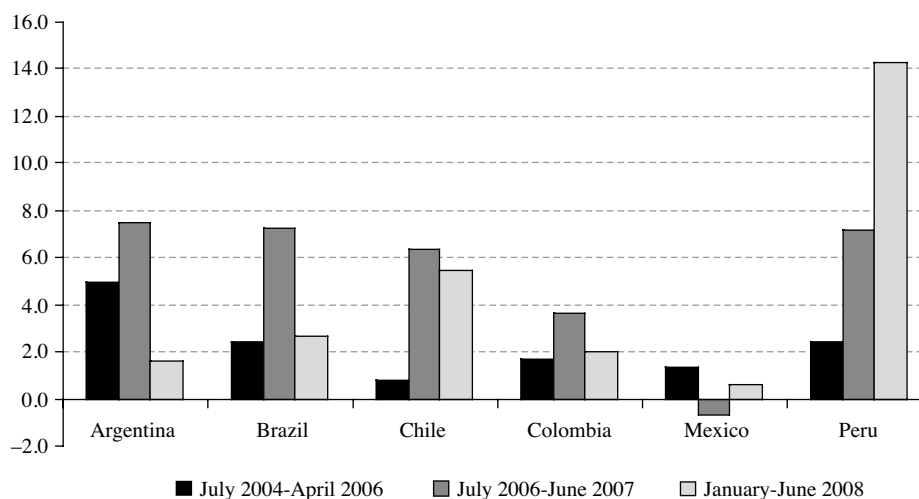
**Latin America: external debt, gross and net of international reserves**  
(2000 exchange rate)



Source: prepared by the author on the basis of data from the Economic Commission for Latin America and the Caribbean (ECLAC). N.B.: In the case of Chile, includes resources in sovereign wealth funds.

FIGURE 8

**Latin America (selected countries): reserves accumulated in periods of plentiful external financing**  
(Percentages of GDP)



Source: prepared by the author on the basis of data from the International Monetary Fund (IMF), *International Financial Statistics* [online].

N.B.: In the case of Chile, includes resources transferred to sovereign wealth funds.

a lesser extent, South American countries that inherited a heavy external debt burden from the previous crisis (Argentina, Ecuador and Uruguay). Plurinational State of Bolivia is running large surpluses and in 2008 Brazil was in a position of virtual equilibrium.

This favourable situation as regards public and external borrowing is the region's main asset in the current crisis. Where public borrowing is concerned, with some exceptions (Brazil and Colombia being the most obvious ones) there is greater scope than in the past to adopt countercyclical fiscal policies. Chile of course has particular room for manoeuvre because it saved a substantial volume of fiscal revenues during the economic boom. In a number of economies, high levels of international reserves have been used to

mitigate the effects of the crisis on export sectors and private-sector firms without access to financing. During the most critical months of the crisis, they also meant that some liquidity provision policies could be applied. Central banks subsequently began to cut interest rates, a tendency that has been spreading widely as of early 2009. Exchange rates came under pressure more rapidly than in the past, allowing the overvaluation that was a feature of several economies (Brazil, Chile, Colombia and Mexico chief among them) to be quickly corrected. These measures were supplemented by a wide range of fiscal, sectoral and social policies (ECLAC, 2009). Other than the rapid depreciation of a few currencies, however, the macroeconomic repercussions of these initiatives have so far been moderate.

## V

### Conclusions

The international crisis has had the anticipated effects on Latin America. Having been underpinned by an exceptional combination of favourable external conditions, the economic boom came to an end and all the factors that nurtured it are now working in the opposite direction. Of these, the possible decline in remittances is the least important and will be offset in several countries by real currency depreciation, which will positively affect the domestic consumption capacity of the households receiving these resources.

The greatest and most widespread repercussions of the crisis will be felt in the sphere of trade. All the countries, but especially Mexico, Central America and the Caribbean, are being affected by the contraction in real trade volumes, while the South American economies, particularly those exporting mining and energy commodities, have experienced a sharp decline in their terms of trade. The fall in energy prices will partially offset the adverse effects of lower international trade in a number of small economies.

From an external financing point of view, it is possible that the most acute problems associated with the illiquidity characterizing the severest stage of the crisis (between mid-September and late October 2008) may be behind us. However, a phase of very restricted private-sector external financing, of unknown duration and intensity, still lies ahead. Multilateral financing

can only partly compensate for the dearth of private funding, unless it is accompanied by measures such as an exceptional large-scale issue of special drawing rights by the IMF. The benefits of this financing will also depend on the conditions attached to the use of Fund resources, an issue on which some progress has been made, although more remains to be done. The lack of private-sector financing will particularly affect certain large private-sector firms with an obvious need to roll over debt.

The Latin American economies went into the crisis with greater strengths than in the past, but these are more modest than has been claimed in some optimistic studies on the handling of the recent economic boom. With some striking exceptions, Chile chief among them, fiscal policies have remained procyclical. In most of the countries, furthermore, there has been a tendency for the current account to deteriorate, a process exacerbated in many cases by currency appreciation. Lower external borrowing by the public sector and the decision to absorb the flood of external financing by building up reserves are the two key elements of this new-found strength and are a departure from the way economic upturns were handled in the past. We do not yet know how much scope they really offer for adopting countercyclical macroeconomic policies during the crisis that is beginning. Hitherto,

the only really definite development has been the rapid correction of the acute overvaluation of certain currencies in the region.

The crises of the past indicate that real currency depreciation is an opportunity to diversify the production structure. It may in fact be the most important of the opportunities offered by the current situation, and it should thus be actively pursued by applying production development policies.

Regional markets also offer an opportunity for diversification, a kind of “import substitution” in the region as a whole rather than in individual countries. However, opportunities of this kind will depend on other factors. In recent decades, intraregional trade has in fact been highly procyclical and integration efforts are going through a period of weakness or even crisis. Furthermore, major differences in respect of

exchange-rate adjustments within current integration agreements could, in combination with individual protection measures, actually exacerbate the difficulties these efforts are currently facing.

There is now greater scope than in the past to apply countercyclical fiscal and monetary policies, and sparing use has begun to be made of these, but this scope is still limited. It will undoubtedly relieve countries of the need to adopt overly restrictive policies, with the exception of some whose handling of the economic boom was markedly procyclical. In summary, Latin America is better prepared than on other occasions, but this will serve to mitigate only some of the effects of the worst crisis the world economy has experienced since the Great Depression.

(Original: Spanish)

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**KEYWORDS**

Financial crisis  
International finance  
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Credit  
Balance of payments  
Economic indicators  
Developed countries  
Latin America

# The international financial crisis: its nature and the economic policy challenges

*José Luis Machinea*

**T**his article discusses the origins of the international financial crisis, emphasizing the instability of the financial system as a leading cause. Although monetary policy in the early part of this decade may have helped to inflate the property bubble, it is far from having been the decisive factor. This article also argues that the function of controlling excessive asset price rises is one for regulatory policy rather than interest rates. What is proposed, accordingly, is the creation of institutional arrangements that facilitate the implementation of countercyclical financial policies during periods of strong economic growth. After considering the characteristics that economic policies in developed countries should adopt, the article then analyses the effects of the international crisis on the current accounts of the region's countries and the difficulty of applying countercyclical policies in the absence of a global lender.

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*"A sound banker, alas, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional way along with his fellows, so that no one can really blame him."*

John M. Keynes (1931)

*"Most astonishingly, these now-doubtful techniques had previously been hailed as the cornerstones of modern risk management. Moreover, the turbulence proved greatest in countries whose supervision of credit risk had been thought to be the best in the world. Indeed, the regulatory standards and protocols of these countries were in the process of being emulated worldwide."*

Caprio, Demirgüç-Kunt and Kane (2008)

# I

## Introduction

As this article was being written, the world was still caught up in one of the worst economic crises of the past century. The epicentre was the financial collapse in the United States, but the shockwaves had spread to financial systems in parts of Europe. While the history of financial crises dates back several centuries (and the world has experienced some 300 of them, of differing sizes and characteristics, in the last 200 years), none has been as profound and far-reaching as the present one, with the sole exception of the crisis that began in the early 1930s.<sup>1</sup> Furthermore, economic policy responses being equal, this crisis is very likely to be far graver than that one. There are three factors suggesting this: the sheer size of the financial market, broadly defined, as it is several times the size of developed countries' combined output (see table 1), the profound interconnectedness of financial institutions around the world, and the historically unprecedented opacity of the financial system.

These factors at least partially explain how an initial loss estimated at between US\$ 300 billion and US\$ 400 billion on the United States subprime mortgage market can have led to a crisis of this magnitude. As of early 2008, losses on assets originating in lending by the United States financial system appeared to be in excess of US\$ 2.2 trillion,

although the final figure will depend on the scale and duration of the recession.

Meanwhile, the crisis has generated losses on asset values, particularly share and house prices, equivalent to some 25% of global wealth. Figure 1 shows the scale of losses on the New York stock market in comparison with other crises of the last 80 years. As of late December, the stock markets of the world's leading economies had lost some 40% to 45% of their value, while in China the figure was over 60%. This drop in wealth is, along with uncertainty, one of the main factors behind the worsening recession.

The current financial crisis raises a variety of issues encompassing everything from its origins, its peculiarities and the factors compounding it to the question of what can be done to prevent it from worsening and how similar crises can be avoided in future. Some of these issues are discussed in this article which, following this introduction, devotes a second section to analysing the concurrent and determining factors in financial crises, particularly the present one. As there is no consensus about what causes crises, we thought it helpful to present (third section) some alternative explanations, many of which are complementary. The fourth section examines some factors that have exacerbated the crisis and that are familiar from the long-standing debate about moral hazard and systemic risk. The fifth section considers what could be done in the way of countercyclical policies to reduce the scale and duration of the current international recession, with particular emphasis on bank capitalization and fiscal policy. The sixth section offers a very stylized account of the effects of the crisis on Latin America, the difficulty of implementing countercyclical policies and the importance of having a global lender of last resort. The closing section contains some final reflections.

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<sup>1</sup> Reinhart and Rogoff (2008) record over 300 financial crises from 1800 to the present day. The frequency of crises has increased in recent decades (Bordo and Eichengreen, 2001); Laeven and Valencia (2008) list 125 crises between 1970 and 2007.

TABLE 1

**Size of the capital market: selected indicators, 2007**

(Billions of dollars, except where other units are specified)

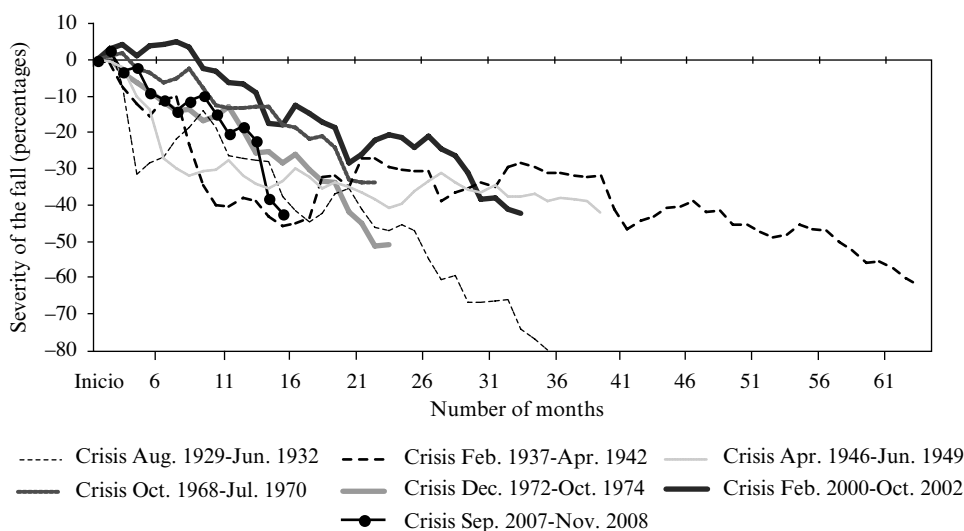
	GDP	Stock market capitalization	Debt securities			Bank assets	Bonds, shares and bank assets	Bonds, shares and bank assets (% of GDP)
			Public	Private	Total			
World	54.5	65.1	28.6	51.2	79.8	84.8	229.7	421.1
European Union	15.7	14.7	8.8	19.4	28.2	43.1	86.1	548.8
Euro area	12.2	10.0	7.6	15.4	23.0	30.1	63.5	520.1
North America	15.2	22.1	7.4	24.0	31.5	13.8	67.4	441.8
Canada	1.4	2.2	0.8	0.8	1.6	2.6	6.4	442.5
United States	13.8	19.9	6.6	23.3	29.2	11.2	61.0	441.8
Japan	4.4	4.7	7.1	2.1	9.2	7.8	21.7	495.7

Source: International Monetary Fund (IMF), *Global Financial Stability Report. Financial Stress and Deleveraging. Macro-financial Implications and Policy*, Washington, D.C., 2008.

FIGURE 1

**United States share prices during the financial crises of the last 80 years**

(Percentage drop in the Standard & Poor's 500 index, adjusted for inflation)



Source: prepared by the author on the basis of *Financial Times*, Standard & Poor's and Shiller, R.J. (2000), *Irrational Exuberance*, Princeton, Princeton University Press.

## II

### Concurrent and determining factors in financial crises

#### 1. Concurrent factors

Two elements have characterized all financial crises: the existence of a system, which means there is a network through which problems interconnect and affect many actors, and opacity of information, which means that different actors have different levels of information about the quality of financial intermediaries' assets and the characteristics of their liabilities (asymmetrical information).

Both elements have been particularly important in the present crisis. There has never been a financial system more complex and interconnected than the one developed during this phase of financial globalization. One manifestation of this is that in mid-2008 the derivatives market was worth US\$ 500 trillion, or nine times global output.<sup>2</sup> Furthermore, there is no precedent for the opacity characterizing the financial system in recent years. It became more and more difficult to understand the different "vehicles" and derivatives; the vocabulary used became more and more impenetrable as it turned into a specialist jargon. Operations became less and less transparent as a result.<sup>3</sup>

With regard to the first point, the outstanding example was the bailout of the world's leading insurance company, American International Group (AIG), in October and November 2008. This forestalled solvency problems at a number of financial institutions whose loans were guaranteed by AIG via credit default swaps. Considering the number of operations insured and the amounts involved (about US\$ 450 billion, including 55,000 subprime mortgages) and the amount of assistance (US\$ 150 billion to December 2008), it can hardly be doubted that AIG was insolvent.

The reason for providing an insolvent institution with this assistance was to ward off a systemic crisis, since the collapse of AIG could have dragged down a number of financial institutions and created a panic.

Practices like these undoubtedly increase moral hazard, an issue we shall return to later.

Regarding the second point, it is no surprise that information asymmetries should have been a determining factor in the sharp contraction of lending during the early stages of the crisis, both between financial institutions and in the commercial paper market. The first large increase in the cost of interbank credit came in mid-August, following months of house price falls in the United States and a fortnight in which a number of hedge funds went bankrupt; this happened despite huge funding injections by central banks (see figure 2). Nobody could be better placed than financial institutions to understand the characteristics of widely used instruments, realize that they were under growing strain and at the same time be aware of how hard it was to value the portfolios of other institutions.

In just a few weeks, information asymmetries gave way to total uncertainty: when events occur that radically alter a situation and destroy what agents thought they knew, the problem is not just that some are informed and others uninformed, but that nobody has the information they need.<sup>4</sup>

#### 2. The determining factors in the crisis: boom, euphoria and procyclical lending

While it is safe to say that interconnectedness, information asymmetry and, finally, a large dose of uncertainty are all necessary for financial crises to come about, we need to ask why they are recurrent. There is no simple answer, so it is hardly surprising that interpretations differ.

One important distinction between the different explanations is the role each assigns to the market and public policies. For some, financial crises are the result of errors connected with State intervention, whether at the microeconomic or the macroeconomic level;

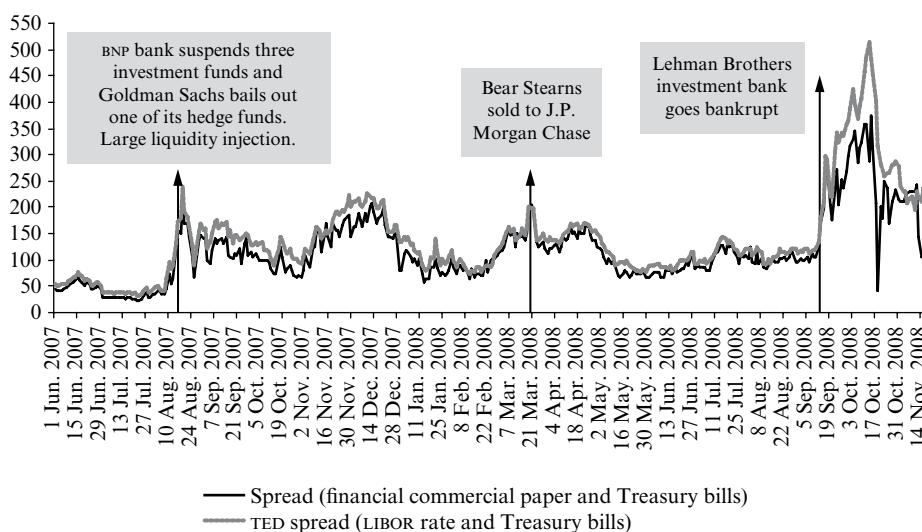
<sup>2</sup> US\$ 55 billion of this was accounted for by credit default swaps.

<sup>3</sup> See Mizen (2008) for a detailed description and analysis of the different instruments and vehicles.

<sup>4</sup> Bagehot wrote: "In England, after a great calamity, everybody is suspicious of everybody; as soon as that calamity is forgotten, everybody again confides in everybody" (Bagehot, 1920, pp. 124 and 125).

FIGURE 2

**Three-month interest rate spread: LIBOR, Treasury bills  
and financial commercial paper, 2007-2008**  
(Basis points)



Source: prepared by the author on the basis of Federal Reserve data.

N.B.: LIBOR = London interbank offered rate, TED spread = spread between the interest rate paid by banks and the yield on Treasury bills.

for others, they follow naturally from the workings of the financial system. While the former believe that the market ought to play a leading role, both in crisis prevention and in the search for solutions, the latter insist on the need to improve (and in some cases completely alter) the nature of regulations in order to prevent, or at least restrain, the procyclical behaviour of the system. In these cases a number of concurrent factors tend to be involved, and the present crisis is no exception. However, we believe that certain elements predominate, and it is these that will now be discussed.

(a) *Boom, euphoria and procyclical lending*

One well-known explanation for cycles of economic boom and bust concerns the behaviour of the financial system and is associated with the thinking of Minsky and Kindleberger.<sup>5</sup> The argument is that as the expansionary phase of the cycle proceeds, financed by burgeoning credit, there is growing confidence that the boom will continue and this increases the demand for

and supply of credit. Euphoria and the expansion of financing generate a bubble in some or all asset prices, creating a feeling that buying these assets on credit is a very profitable activity. In an increasing number of cases as the boom continues, credits can actually be paid down only if prices keep rising. As Minsky put it, “a regime in which capital gains are being earned and are expected is a favorable environment for engaging in speculative and Ponzi finance”.<sup>6</sup>

Credit growth, which often occurs in a context of loose monetary policy, is boosted during the expansion phase by increased leverage in the financial system, i.e., by a rising ratio between assets and equity.<sup>7</sup> Historically, this has been the result of innovations that demand less capital, including the emergence of new intermediaries, which has reduced the participation of traditional deposit banks in the financial sector. The extreme case is the United States, where financial

<sup>5</sup> See Minsky (1972, 1975 and 1986) and Kindleberger and Aliber (2005). Bordo (2008) reminds us that this explanation is rooted in the tradition of nineteenth-century monetary economics and was further developed by Irving Fisher (1933).

<sup>6</sup> Minsky (1986, p. 210). Financing is described as speculative when revenues are sufficient to pay off only the interest and not the capital; Ponzi financing is when revenues are not sufficient to pay capital or interest. In both cases, capital gains are essential to “survival”.

<sup>7</sup> This increased leverage observed by Minsky in the expansionary phase of the cycle has been corroborated by Reinhart and Rogoff (2008).

assets held by traditional deposit banks account for less than 25% of all financial institutions' assets (see figure 3).<sup>8</sup>

Higher leverage weakens the financial system, as capital is left more and more exposed to small asset losses. Since changes in leverage are procyclical, it peaks just when asset prices are starting to fall. The effects of price falls, and borrowers' diminished ability to pay in consequence, are thus amplified at this stage; in this way, the impact on system solvency is greatly heightened.

Solvency problems are intensified by another characteristic of the expansionary period. Considering that short-term interest rates are usually lower than

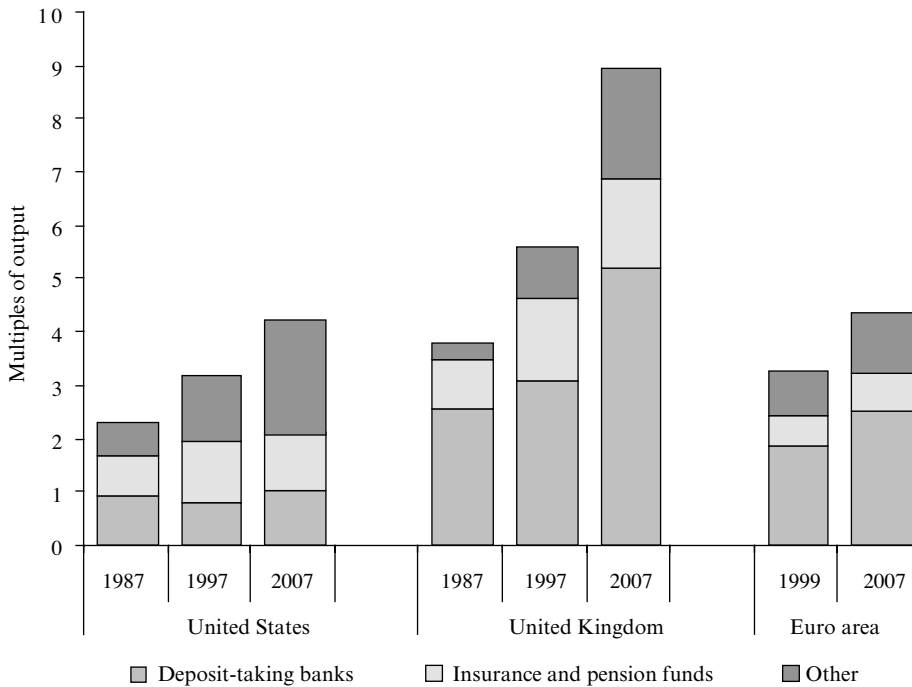
long-term rates, financial institutions usually finance the optimism of the boom by increasing their short-term liabilities. Too large a mismatch makes them more vulnerable to changes in market sentiment, as investors tend to reduce their financing once they start to observe difficulties with asset quality. The growing shortage of liquidity affects system solvency as institutions have to liquidate assets at "fire sale" prices to meet their obligations. The scale of the impact on solvency depends on a variety of factors, including the size of the bubble and the existence or otherwise of a lender of last resort which can resolve liquidity issues and prevent asset prices from falling too far.

In Minsky's view, instability is a characteristic of modern financial capitalism and arises because expectations are based on the past, leading to speculative and Ponzi behaviour. Why, then, do boom periods not always end in crises, as the logic of the model would appear to require? There are a number of answers, ranging from the size of the bubble to the triggers

<sup>8</sup> Although the size attained by other financial institutions is unprecedented, their existence and the importance of their role are not. A hundred years ago, the difficulties of trust funds and stock market agents were a crucial part of the explanation for the most critical developments in the 1907 financial crisis and its favourable resolution (Bruner and Carr, 2007).

FIGURE 3

**Size and distribution of financial assets**  
(Multiples of output)



Source: International Monetary Fund (IMF), *Global Financial Stability Report. Financial Stress and Deleveraging. Macro-financial Implications and Policy*, Washington, D.C., 2008.

for crises, but one particularly important factor is the existence in recessions of countercyclical policies that are manifested in higher fiscal deficits (partly because of automatic stabilizers) and financing for the financial system, whose role usually goes beyond that of lender of last resort. These are the policies that prevent recessions getting out of hand and situations of panic arising. Minsky warns that this capacity of countercyclical policies would be imperilled if the tendency towards excessive financial system liberalization and growing participation by other financial intermediaries were to continue.<sup>9</sup>

This view, which is predicated on the formation of expectations based on the recent past, has few points of contact with a view that assumes rational expectations; and indeed, if the latter were at work, it would be hard to imagine the behaviour of economic agents switching as rapidly as it does in crises, particularly when this change in expectations is not due to any significant shift in the behaviour expected from the public sector.

<sup>9</sup> See Minsky (1986, chapters 2, 3 and 4) and Papadimitriou and Wray's excellent introduction to the 2008 edition of Minsky.

#### (b) *The 2007-2008 crisis*

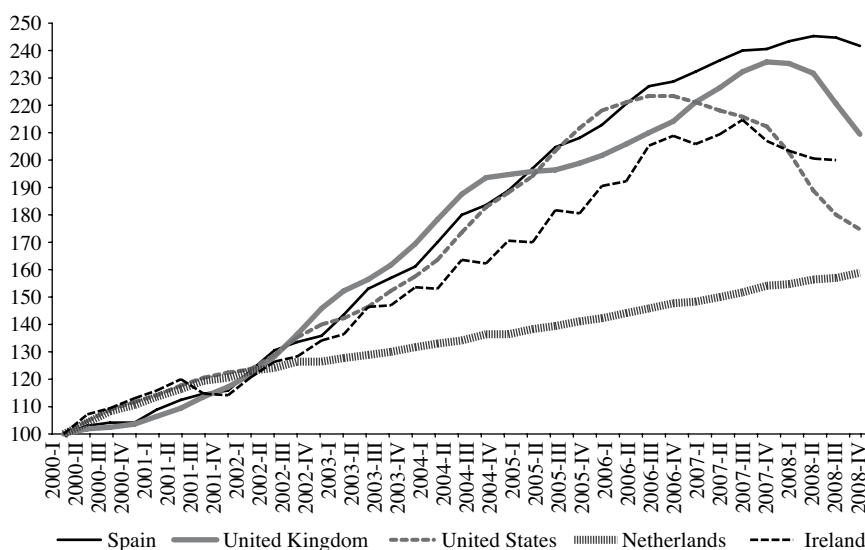
The theory analysed in the previous section provides a fairly good explanation for the behaviour of the financial market in recent years, and particularly the sharp rise in house prices in the United States and a number of European countries (see figure 4). Falling property prices were the trigger for the crisis, as they exposed the poor quality of subprime lending, which was running at US\$ 600 billion a year in the United States in 2006 and represented 20% of all mortgage lending in the country. As prices dropped, this began to affect the “non-subprime” segment of the mortgage market.

To complicate the situation, the euphoria that usually goes with booms was compounded by the risk rating models used. These had two shortcomings. One was that in a number of countries, particularly the United States, they were based on information from the last five years, which is too short a time as it may reflect just one phase of the cycle; the other was the assumption in these models that actions undertaken on the basis of them would not, as in physics, influence the variables they were trying to predict. In this way, “herd” movements are accentuated and it is not possible to distinguish between one-off changes and systemic

FIGURE 4

#### Selected countries: house prices, 2000-2008

(Quarterly data: 2000-I = 100)



Source: prepared by the author on the basis of data from the Spanish Ministry of Housing, Bank of England, Standard and Poor's, Statistics Netherlands and the Department of the Environment, Heritage and Local Government in Ireland.



shifts. In other words, crises cannot be explained by risk models that assume the world is stationary: at times of crisis, the parameters defined by stochastic processes are not stable, and therefore models based on these processes cannot be used to calculate risks (Fanelli, 2008 and Heymann, 2007).<sup>10</sup>

Supervision was obviously deficient, not only because market participants were not required to apply models based on more reasonable assumptions, but also because they were allowed to use different ploys to take excessive risks and increase leverage.<sup>11</sup> The inadequacy of supervision seems to have been due to a number of factors, ranging from low pay and capacity constraints at regulators to efforts to give local financial institutions an edge in the global marketplace. The most important factor, however, was an approach that had the effect of increasing self-regulation by placing the main onus on financial institutions themselves, which in this case chose the models that best served their growth strategies.

In mid-2007, when falling house prices began to affect the asset base of financial intermediaries and unsettle the market, the other factor mentioned above came to the fore: the volatility of bank financing as the role of deposits was taken over by placements in the capital markets and, much more seriously, by short-term commercial paper.<sup>12</sup> Deposits as a share of bank liabilities have been diminishing for several decades, from 70% in 1980 to just 40% in 2008 (IMF, 2008b).

Raising finance in the money markets and capital markets is a trend of recent years that is accounted for by the convenience of borrowing large amounts without having to incur administrative costs (for branches, salaries and advertising, for example). When this trend was supplemented by the aforementioned mortgage securitization, the picture was complete: the “deposit problem” was circumvented, leverage was enhanced and responsibility for lending quality was avoided.<sup>13</sup>

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<sup>10</sup> See Sotelsek and Pavón (2008) for a description and evaluation of the use of risk models.

<sup>11</sup> Special investment vehicles (SIVs) were the most notorious instance of this.

<sup>12</sup> A paradigmatic instance of this trend was Northern Rock, a bank that was nationalized in September 2007. See Milne and Wood (2008).

<sup>13</sup> In operations involving SIVs, banks generally undertook to supply liquidity or take back the loan in the event of solvency problems, so that those initiating the operation were left with a liability that would later affect them. Some investments of this type, furthermore, ended in the purchase of the bonds originally sold by the bank owning them (Mizen, 2008).

A final comment is needed on the distortion of lending incentives caused by asset securitization. The switch from bank to market as the central element in risk diversification has clear advantages in terms of liquidity and also allows risk to be diversified outside of a particular geographical area, including the borders of a given country. This assumes that information is transparent enough for investors to be aware of the risks of the “package” they are buying, a condition that was far from being met. Furthermore, replacing banks with markets raises some questions, since if all these were “pre-packaged” products, what would be the advantage in knowing the client, which was one of the main factors behind the rise of banks? Again, if knowing the client does not affect the profitability of a financial institution, where is the incentive for good lending?

The feeling that something was amiss with the assets of certain financial institutions, particularly those backed by low-quality mortgages, arose in full force between May and August 2007, when a number of hedge funds were faced with major losses and rating agencies reduced the ratings of bonds backed by mortgages of different qualities. The uncertainty was manifested in the market for short-term asset-backed commercial paper, which fell by half in just a few months (see figure 5). The consequence was a sharp reduction in the liquidity of all the banks that had turned to that market, irrespective of individual portfolio quality. Just as the solvency problems of certain financial institutions affected the liquidity of the system, initially because of information asymmetry and then increasingly because of the general uncertainty, the lack of liquidity fed back into these solvency problems.

To sum up, excessive leverage, the rise in short-term assets and the growing importance of under-regulated financial institutions became a dangerous mix that was hard to handle.

Lastly, a word about the remuneration of senior bank management, particularly in the developed world.<sup>14</sup> Over recent years, this remuneration has been linked to short-term profits and, in many cases, the number of operations completed. The different “vehicles” and increasing leverage contributed to higher profits in the short term, and thus to higher pay, irrespective of the medium- and long-term repercussions. Furthermore, the revenues of the rating agencies depended on

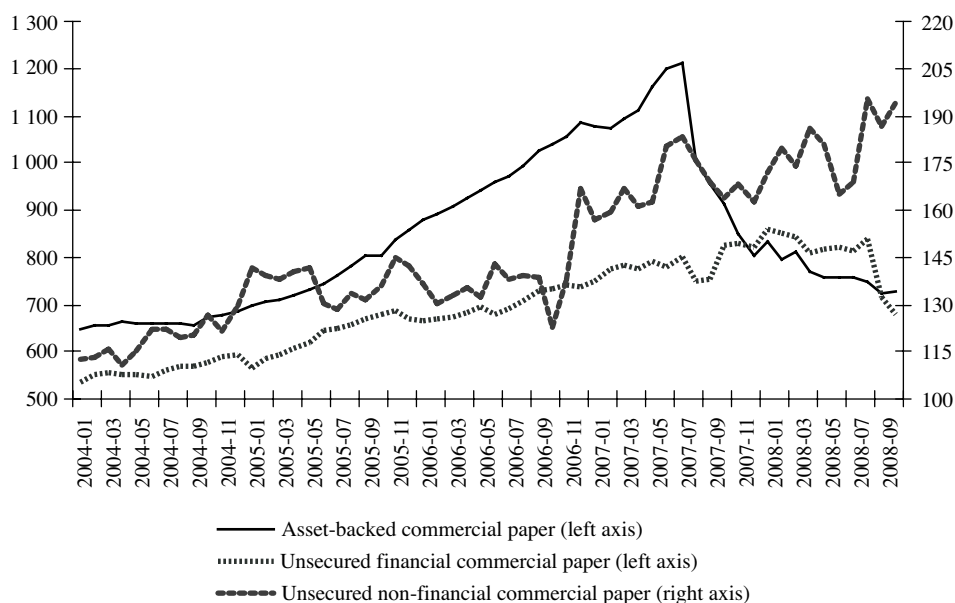
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<sup>14</sup> Forty years ago, Galbraith (1967) warned of the growing importance of managers, whose goals were different from shareholders’.

FIGURE 5

**Asset-backed commercial paper and unsecured financial and non-financial commercial paper**

(Billions of dollars, seasonally adjusted monthly data)



Source: prepared by the author on the basis of Federal Reserve data.

intermediaries applying for assessment so that they could place their instruments in the market. They were thus both judge and party to the case. Considering the outcome, it seems they were more party than judge.

Executive pay and the role of the rating agencies contributed enormously to a model based on excessive risk-taking. Although they cannot be said to have caused the bubble and financial crisis, they undoubtedly propelled it to unknown heights.

As is usually the case, there is no one factor that explains the current financial crisis. Who could maintain that the policy of holding down interest rates for too long between 2001 and 2004 did not affect the subsequent situation? Before reviewing this and other arguments about the responsibility of economic policies for the crisis, some brief remarks should be made about the lack of incentives for implementing countercyclical economic policies during the boom.

(c) *The economics of the “never-ending” boom*

In an economic boom, procyclical lending, above-trend output growth and asset-market bubbles, particularly for property prices, are “good news”. The process is therefore hard to criticize. Not only are the

banks happy, but so too are businesses that see demand growing and can borrow more cheaply, not to mention people who are newly able to afford a first or second home and of course the owners of assets, who look on with pleasure as their wealth steadily expands. In this environment, the government can hardly feel anything but euphoric: the economic situation means that a majority of the population approve of the way it is running the country, and it can therefore win elections. In these circumstances, who would have the heart to spoil the party?

There will probably be analysts who cavil, but there will be many others writing clever articles to show that the above-trend growth in economic activity is because technological change has raised productivity on a more or less permanent basis; that property prices are still low considering changes in demand now that families aspire to own two homes; or, as has repeatedly been argued in several developing countries, that properties are still much cheaper than in... Paris or Rome! Furthermore, there will be those who justify large current-account deficits, either because they are “the result” of strong investment demand (even if this investment is going into non-tradable goods) or

because they are due to higher saving in the rest of the world, which someone “has” to absorb to maintain the global balance.

In short, economic policy during boom periods is highly conducive to excess. It is no coincidence that the clamour for countercyclical policies is heard loudly at times of recession but very rarely in the

expansionary phases of the cycle. This is why there are reasons to doubt the ability of the authorities to regulate cycles.<sup>15</sup> The most advisable course would seem to be to reduce their room for manoeuvre by introducing some countercyclical rules. Although such measures will certainly be difficult to impose, now is the time to do it.

### III

## An alternative explanation: monetary and financial policy errors

There are two lines of argument that emphasize economic policy errors as explanatory factors in financial crises. The first stresses the conduct of monetary policy; the second has microeconomic foundations and centres on the financial system safety net, be it implicit or explicit, which reduces the cost of the crisis for the different actors involved (banks and investors).

#### 1. Monetary policy

According to this viewpoint, the current crisis is due to an overly expansionary monetary policy run by the Federal Reserve from late 2001 to December 2004, manifested in Federal Funds rates of less than 2%. Although the European Union and the United Kingdom applied a similar policy, rates were cut by less and the period of low rates was less prolonged (see figure 6).

From a more structural point of view, it may be argued that the low interest-rate policy was driven by an excess of “lendable” funds in the international market, produced by: (i) the Chinese policy of maximizing exports and building up international reserves, (ii) the policy of building up reserves for self-insurance purposes in Brazil, China, the Russian Federation, the Republic of Korea and various developing countries and (iii) the policy in oil-exporting countries of accumulating resources in sovereign funds. This increase in saving in the “rest of the world”, it is argued, offset the low saving rate in the United States and accounted for the current-account deficit in that country, which was thus surprisingly able to combine lower saving with lower interest rates (Roubini, 2005 and Eichengreen,

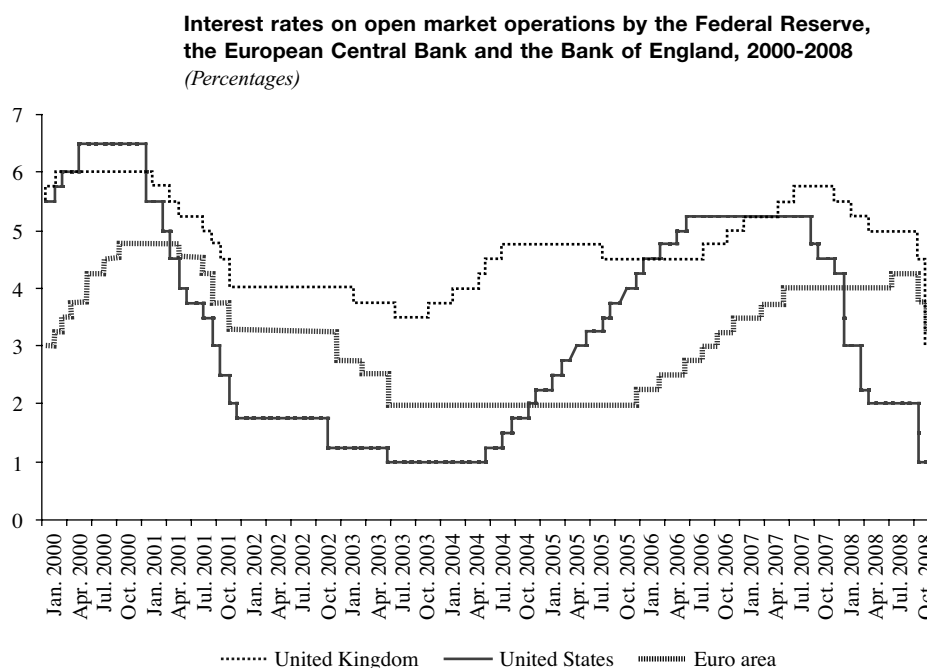
2005). Although this interpretation holds true where the abundance of “lendable” funds in international markets is concerned, it needs to be qualified by the observation that, even leaving the United States out of the equation, there was no increase in the global saving rate, as the rise in the countries mentioned was offset by lower saving in the rest of the world, particularly Japan and Europe. Furthermore, what has been seen in recent years in the rest of Asia, with the exception of China, is that “excess saving” has basically been due to lower investment.<sup>16</sup>

Whether they were due to structural causes, monetary policy or both, low interest rates were conducive to excessive lending growth. However, the emphasis in this argument needs to be weighed carefully. In the first place, as figure 6 shows, central bank interest rates in Europe and the United Kingdom were reduced by less than the Federal Reserve rate, yet there was also a house price bubble in a number of European countries. Furthermore, while there were fewer subprime mortgages in Europe than in the United States, this could have been due to more appropriate regulation or, probably, to the greater depth of the mortgage market in the United States resulting in “prime” mortgage lending opportunities running out earlier than in other countries.

<sup>15</sup> See, for example, Gerchunoff (2008, p. 1), who has argued that “examining these failures can provide lessons for the future, but crises are inevitable in a capitalist world sustained by ‘animal spirits’ and in a democratic world sustained by the hope of social progress”.

<sup>16</sup> See Eichengreen (2005).

FIGURE 6



Source: prepared by the author on the basis of data from the Bank of England, the Federal Reserve and the European Central Bank.

Secondly, the current crisis cannot be attributed to a constriction of the money supply as discussed by Friedman and Schwartz (1963) in relation to the 1929-1932 period. While there was a marked reduction in the bank multiplier this time around, as then, the increase in the monetary base more than made up for it.<sup>17</sup>

Lastly, it needs to be asked whether holding down short-term interest rates over a fairly long period may have caused the house price bubble and subsequent crisis. It must certainly have had an effect, particularly as it may have created expectations that monetary policy would not “permit” a recession and that, consequently, the prices of certain assets would carry on rising. However, medium- and long-term interest rates fell by considerably less (see figure 7), making it difficult to justify the rationality of a financial institution deciding to grant a 30-year mortgage because the short-term interest rate was very low. It may have provided a way

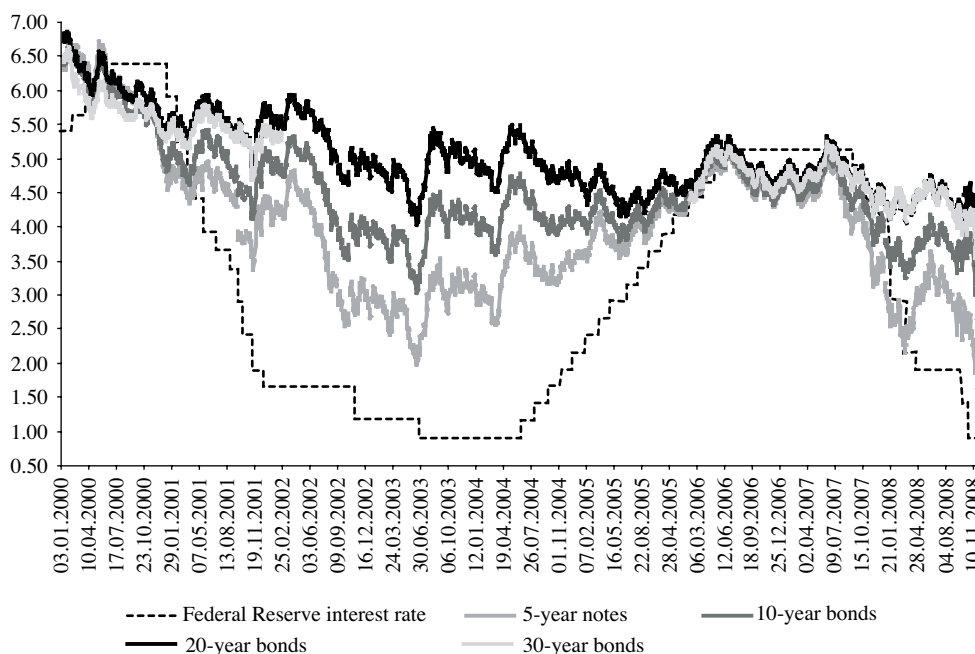
of offering three years of low introductory mortgage rates to tempt buyers with little financial knowledge, but it cannot be supposed that financial institutions extrapolated this situation to the medium and long term. Or did someone think that low interest rates were not among the instruments of countercyclical policy and therefore would not rise in the expansionary phase of the cycle? Again, why did credit continue to expand in 2005 and much of 2006, at a time when the Federal Reserve was rapidly raising interest rates, sending a clear signal that the period of low rates was over? The answer lies not so much in monetary policy as in the fact that the incentive to increase lending was not the long-term profitability of the financial institution but the year-end bonus or payment per operation concluded.

To sum up, it is possible that keeping interest rates low over a long period of time may have influenced the behaviour of the different actors, but this can hardly be claimed as the underlying cause of the housing market bubble in the United States and several European countries. The economic policy mistake of this period was certainly the failure to come to grips with the “irrational exuberance” of the markets, but it is not clear that this ought to have been a job for monetary policy. If interest rates are already called

<sup>17</sup> In the 1930s, the reduction in the multiplier was due to the increase in demand for cash over bank deposits (Bernanke, 2000), while in the current crisis it was a consequence of the extraordinary rise in bank reserves. In the United States, reserves represented 5.4% of the cash held by the public in July 2008, but by November 2008 that figure had risen to 79.3%.

FIGURE 7

**United States: interest rate on Federal Reserve open market operations and yield on Treasury securities**  
(Percentages)



Source: prepared by the author on the basis of Federal Reserve data.

upon to control inflation and, at least in the United States, regulate the level of economic activity, it seems excessive to burden them with an additional task like that of bringing an asset price bubble under control. The reasonable thing would have been to use some other instrument, the most obvious choice being measures to regulate the system, particularly higher capital requirements during the boom.

## 2. The safety net

A second explanation pointing to faulty public policies is the one traditionally maintained by the International Monetary Fund (IMF) and World Bank. The central idea is that the “excessive” presence of public safety nets prevents the discipline of the market from operating and thus encourages excessive risk-taking. In relation to the present crisis, this view is put forward in an article by three World Bank analysts (Caprio, Demirgüç-Kunt and Kane, 2008) who argue that the problems of the crisis have included inadequate regulation and oversight that failed to keep pace with financial innovation. In the tradition of World Bank

documents, however, the emphasis is placed on the existence of explicit or implicit subsidies provided via the different countries’ safety nets.

The argument is, then, that crises derive from an incentive structure which encourages the idea that the authorities will have to bail out shareholders and investors in financial institutions if they get into trouble. In other words, excessive risks are taken during booms because actors do not believe the market will ever punish them, given the “providential” presence of the public sector. This is what is known as moral hazard.<sup>18</sup> One example of it, according to the authors, was the rescue of Bear Stearns during the latest crisis, when the problems were those of insolvency; according to

<sup>18</sup> In a world of rational expectations and Ricardian equivalence, if a public-sector bailout is expected then the different economic agents ought to reduce their outlays by an amount similar to the cost of the State intervention, i.e., to the increase in debt and thus in future taxes. In other words, moral hazard will create an incentive for greater risk-taking, but at the same time will lead to a reduction in demand, two effects that could ultimately offset each other, at least where their effects on the cycle are concerned.

the authors' logic, the liquidation of Lehman Brothers was the right step to take.<sup>19</sup> Following this approach, the aim should not be for risk-taking to be reduced through regulation but for the market to penalize those who get it wrong. This would mean reducing the size of the safety net, whether explicit or implicit.

This discussion revolves around two concepts: systemic risk and moral hazard. Generally speaking, what generates systemic risk is the lack of perfect information on the solvency and liquidity of financial institutions, although it can also arise when such perfect information is available, as it "may be rational behaviour to withdraw deposits from a solvent financial institution if one thinks it may cease to be solvent as a result of a run on its deposits by other depositors. In this case there are rational expectations that are conditional on the behaviour of other agents, whose level of information is unknown" (Machinea, 2002, p. 14).

History shows us that, following the 1930 crisis, it is hard to find situations of acute financial crisis that have not led to significant intervention by the economic authorities.<sup>20</sup> In other words, priority has been given to systemic risk over moral hazard (Goodhart, 1999). The reason is obvious: a systemic crisis can generate high costs in terms of lower output and higher unemployment, while the costs associated with moral hazard do not look so considerable, or at least seem to be remote in time. Furthermore, two strategies have generally been used to reduce the moral hazard of public intervention: (i) "constructive discretion" and (ii) the policy of not bailing out bank shareholders. The former means that the central bank is not explicit

about the policy it intends to follow towards financial institutions in difficulties.

However, the problem with the strategy of reducing moral hazard by punishing shareholders is that the management of a number of major financial institutions tends to be quite independent. In particular, executives who receive extraordinary bonuses linked to short-term profits are usually unaffected by any action aimed at punishing shareholders.

In summary, if the two principles set out above are adhered to, it seems unlikely that bankers and investors will take on so many risks when the probability of a bailout is substantially less than 1 and profits have to be weighed against a prospective loss of 100% of capital.

It has been argued in this connection that if systemic risk is the result of information asymmetry, the best way to resolve it is through greater transparency, so that runs on particular financial institutions are the result of the purging effects of the market rather than confusion among savers about their solvency.<sup>21</sup> Considering the costs of obtaining and interpreting individual information, the solution would be for advice to be provided by specialists who would benefit from clear economies of scale. This is the role that ought to be played, for example, by the rating agencies. The role they actually have played in several of the most recent crises, but particularly the present one, obviates the need for any further discussion of the subject.

It may be mentioned here that a number of the region's countries substantially reduced their safety nets in the 1990s, while the flow of information in the market increased. Safety nets continued to be removed for as long as it took the crisis to appear.<sup>22</sup>

<sup>19</sup> A similar argument is made by Bordo (2008). However, it is difficult to understand how moral hazard could have been an issue in the case of shareholders, whose shares lost just over 90% of their value compared to a year earlier.

<sup>20</sup> By "significant interventions" are meant those that exceed the deposit guarantee designed to protect uninformed small depositors. At present, runs on financial institutions are usually led by large depositors.

<sup>21</sup> See Calomiris and Gorton (1990) and Calomiris and Powell (2000).

<sup>22</sup> See Machinea (1996) and Rozenwurcel and Bleger (1997) for a critical review of these reforms in Argentina.

## IV

### How the crisis spread: prioritizing moral hazard

In early September 2008 there was a major credit crunch and interbank credits were difficult to obtain, even though the premium over United States Treasury bills in the commercial paper and interbank markets was below the average of the previous 12 months (see figure 2). The disappearance of Bear Stearns via its takeover by J.P. Morgan had confirmed the perception that some financial institutions were too big to fail, including the investment banks. Creditors got their money back and the only ones to be penalized were shareholders, who recovered less than 10% of what their shares had been worth a year earlier. Thus, a worsening of systemic risk was avoided without creating moral hazard for shareholders.

The situation changed radically on 15 September following the liquidation of Lehman Brothers; losses for the financial system as a whole as a result of that event are put at US\$ 500 billion. The reading of the markets was that any intermediary could be liquidated, regardless of size, with all the effects on the system this implied. At this signal, panic spread and the credit markets seized up. In the interbank market, the interest rate rose by 175 points over Treasury bill yields in 10 days and 350 in a month (see figure 2); much

the same happened in the commercial paper market. Everything suggests that the financial markets were just hours away from a complete meltdown.

The lesson, which is not a new one, is that disciplining the market in the middle of a crisis is not so much mistaken as outright foolish. The Lehman Brothers bankruptcy may have brought some order to other actors, as is shown by the fact that the sales operation of Merrill Lynch was shut down the same day, but in the days that followed it became clear that while the medicine had been effective in disciplining some investment banks, it had exacted an extraordinarily high cost for the stability of the system. If there was any doubt as to which needed to be given priority in a crisis, systemic risk or moral hazard, the Lehman Brothers bankruptcy will probably go down in history as the episode that ended the debate... at least for a while.

The problem of moral hazard is still there, of course, but it cannot be eliminated at the cost of imperilling the world economy. While it may be argued that the collapse was due to underlying structural causes that went beyond Lehman Brothers, there can be no doubt that its liquidation made the crisis more likely to worsen.

## V

### From bailing out financial institutions to bailing out the economy

The search for an answer to the question of what is needed to end the crisis has occupied many economists and politicians over recent months, and this search has yielded different proposals. Leaving aside the need to rethink the way the international financial system operates, however, the answers have been converging upon two elements on which action ought, in our view, to be taken in the short term: restoring

a “certain level” of lending and using fiscal policy to boost demand.

#### 1. Credit and the financial system

To restore a certain level of lending, one necessary step is to reduce the uncertainty surrounding financial institutions. Accordingly, the measures taken since

mid-September have aimed to restore the liquidity and solvency of these institutions. This has required huge public-sector intervention involving sums so large that they would have been unimaginable just months before.

Specifically, to improve liquidity the public sector decided, with some variations between countries, to guarantee the liabilities of financial institutions by raising deposit guarantee limits (or removing them in extreme cases) and guaranteeing interbank credits and placements on the capital markets. Thanks to these measures, the costs of financial institutions' liabilities fell and much of their liquidity was restored.

However, the increase in liquidity has not translated into a rise in lending to the private sector, for three reasons. Firstly, financial institutions still feel a degree of uncertainty about renewing their liabilities, even though the situation is starting to normalize. This is forcing them to maintain a higher level of liquidity than usual, something that has been manifested in the increase in bank reserves already referred to. This is a variant on the liquidity trap, as it prevents monetary policy from being effective in reducing interest rates on loans to the private sector.<sup>23</sup>

The second reason is the loss of bank capital and thus the need to re-establish the ratio between capital and assets. The third is uncertainty about the solvency of potential customers in the context of a deepening recession.

To resolve or at least palliate the problem of solvency among financial institutions, public-sector measures were initially aimed at purchasing toxic assets and, increasingly, at using State funds to capitalize these institutions. The problem with this measure is the difficulty of estimating portfolio quality in the midst of a recession, and thus of calculating how much fresh capital is needed. Given the news items appearing daily in the media about different banks requiring further capital injections after already receiving assistance, the time has come to take some final decision that can significantly reduce uncertainty. One alternative, which worked in the Nordic countries in the early 1990s, is temporary nationalization of banks. The second would be for the public sector to buy toxic assets from financial institutions and set up a "bad bank", but the difficulty here would be in setting the price: paying the market price would

not solve the problem, but paying nominal values would be tantamount to making a gift of taxpayers' money to the banks.<sup>24</sup> A halfway solution would be to acquire assets at an above-market price but with the stipulation that the bank thus benefited is obliged to repay out of future profits the difference between that value and the amount ultimately recovered.<sup>25</sup> In this case and for the duration of the emergency, the debt would have to be excluded from calculations of the institution's net worth given that it would be set against profits.<sup>26</sup> Another alternative is to create a new "good bank" from the sound assets of existing banks. Creditors (other than guaranteed deposit-holders) and shareholders in the rump banks would only get back whatever they could recover from the "bad" assets plus the difference (if positive) between the "good" assets and the guaranteed deposits transferred to the new bank (Butler, 2009). Although this option entails the smallest fiscal cost in the short run, it is also the one that would generate the greatest uncertainty because of the large losses that would affect unsecured creditors. However, if a decision is not taken soon, rising losses will mean that the final option is the only viable one.

Partly because of undercapitalization, but also due to the other two factors mentioned earlier, particularly the uncertainty associated with the recession, the Federal Reserve took a step that would have been unthinkable a few months ago, although it is not without precedent in financial history: it decided to lend directly to the private sector by purchasing commercial paper.<sup>27</sup> In early 2009, for its part, the Bank of England announced that it would guarantee some lending to small and medium-sized enterprises.

<sup>23</sup> See Krugman (2008) for an ingenious demonstration of the importance of fiscal policies in this context.

<sup>24</sup> This alternative is akin to guaranteeing part of banks' existing assets.

<sup>25</sup> The bank itself could be given the portfolio to administer. The incentive is obvious: the more it recovers, the less it will have to pay back.

<sup>26</sup> This obviously cannot become normal practice, but it could be applied for the duration of the emergency.

<sup>27</sup> Although it is unusual, history does record similar episodes. For example, Bagehot quotes the words of a Bank of England director in the 1825 crisis: "We lent it on behalf of the Bank of England by every possible means and in modes we had never adopted before; we took in stock on security, we purchased Exchequer bills, we made advances on Exchequer bills, we not only discounted outright, but we made advances on the deposit of bills of exchange to an immense amount, in short, by every possible means consistent with the safety of the Bank..." (Bagehot, 1920, p. 52). In 1970, furthermore, after the collapse of the Penn Central railway company, the Federal Reserve provided credits to non-financial firms, taking commercial paper as security.



From being lenders of last resort, in other words, central banks have become the only lenders.

Unfortunately, the current hyperactivity does not make up for the lack of earlier action to control the financial system and the property bubble. Beyond the extraordinary costs of the assistance package, financial measures are unlikely to re-establish growth. Their central aim is to prevent a depression occurring because of bank closures and the disappearance of credit. It is one thing to prevent credit from “disappearing”, but quite another to restore it to normal levels. Further pressure needs to be brought to bear on financial institutions assisted by the public sector so that they start lending again, and although there is scope for the State to guarantee some new credits, everything suggests that the process of restoring lending to normal levels will take a great deal of time. This is not only because of the supply factors referred to, but also because solvent potential borrowers will hardly be in a mood to take out loans for durable goods purchases or investment in this climate of uncertainty. This is a further obstacle for monetary policy, since the liquidity trap is being compounded by another of the factors emphasized by Keynes: the low interest-rate elasticity of spending in a climate of depression.<sup>28</sup>

## 2. The need for a fiscal stimulus

Based on the arguments in the previous paragraph, there is a need to increase the fiscal deficit as a mechanism for stimulating demand. This does not mean neglecting the important role of monetary policy, including further cuts in interest rates; otherwise credit and confidence would collapse and no fiscal measures would be sufficient to ward off a major depression.

It should be said that before the present crisis there was a degree of consensus, at least in the United States, that the best way of conducting countercyclical policy was by means of automatic fiscal stabilizers and monetary policy.<sup>29</sup> In other words, discretionary fiscal policy was ruled out on the basis of some historical evidence and of arguments that were central in the

debate between monetarists and Keynesians in the 1960s and 1970s, such as the time it took to put fiscal policies into effect once they became necessary given the process involved (diagnosis, preparation, support from Congress, tendering), the “crowding out” of the private sector as a consequence of higher interest rates, and the lower fiscal multiplier posited by theories of permanent or life cycle income.<sup>30</sup>

However, the scale and likely duration of the current crisis and, particularly, the limited or negligible effectiveness of monetary policy in a situation like the present one have silenced a number of these objections (Taylor, 2008b; Blinder, 2008). Discussion seems to have centred now on the type of fiscal stimulus; the “monetarists” recommend tax cuts (designed to reach as many people as possible) or subsidies, both on a permanent basis (Taylor, 2008b). We believe that to settle on solutions of this type would be a mistake, because it is not the moment to adopt permanent measures that merit more thorough discussion and because resources need to be targeted, for reasons of equity and efficiency, on the sectors most affected by the crisis. We say “efficiency” and not just “equity” because these are the sectors for which liquidity constraints are critical to spending decisions. The developed countries have established a system that acts as an automatic stabilizer: unemployment insurance. The idea is to increase, exceptionally, the amount of the subsidy or the time it is paid so that it becomes something more than an automatic stabilizer. Supplementary measures could include subsidizing the mortgage payments of certain borrowers (unemployed and lower-income) and financing local public works, which tend to be relatively small-scale and quick to execute. To these might be added fiscal measures to favour present consumption over future consumption. What needs to be clear is that in this case efficiency is to be gauged not by the “quality” of spending but by its effects on overall demand and the speed with which it can be implemented (IMF, 2008a).

The measures referred to should not include tax cuts, since in an atmosphere of crisis and uncertainty a lower tax burden will probably not translate into substantially higher spending, particularly given the difficulty of targeting tax cuts on lower-income sectors or those most affected by the crisis. Unfortunately,

<sup>28</sup> The fact that interest rates have less effect on demand does not mean that reducing them does not cause disposable income to rise. The most obvious case is the relationship between European Central Bank rates and EURIBOR, the rate to which most mortgages are indexed.

<sup>29</sup> The United States was one of the few countries where monetary policy played this role on different occasions; elsewhere, an “extreme” version of inflation targeting sometimes prevented monetary policy from playing a countercyclical role.

<sup>30</sup> See, for example, Feldstein (2002), Auerbach (2002), Taylor (2000 and 2008a) and Blinder (2004), although this last does say that fiscal policy would be necessary in “extreme situations”.

political negotiations are increasingly tending in this direction. It would be a grave mistake to increase debt in these circumstances without being sure what the effect on demand will be.

In summary, what is needed is a large-scale fiscal incentive that has substantial repercussions on demand and can be brought in as quickly as possible. Although it may sometimes seem doubtful that any fiscal stimulus can offset the sharp fall in private-sector investment and consumption, the idea is not to reverse the short-term trend but to find a floor for the recession that might help to change expectations.

To increase overall demand significantly, there needs to be a coordinated effort involving both developed and developing countries. It is worth remembering here that developing countries were key actors in the recovery from the 2001 recession, as they have accounted for over 60% of global growth in recent years. China and India have obviously been the main actors in this new situation. With a few exceptions, however, developing countries have far

less scope to implement countercyclical policies than developed ones.

Two concluding remarks are called for. First, the prospects of success will be lessened if some of the major developed and developing countries do not cooperate, and there will also be a problem of inequity: in a globalized world of more open economies, those that do not participate will benefit from the efforts of those that do. Second, it is important not just to increase spending, but to ensure that fiscal policy does not include more or less covert “national procurement” clauses. While these do make fiscal packages easier to pass, there are two problems with them. The first is the risk of triggering protectionist policies; the world experienced the consequences of these once before in the 1930s, but they would be far greater today. The second is that developing countries would be the worst affected, both by protectionism and by the fact that countercyclical policies, as analysed in the next section, will be applied on a greater scale in the developed countries.

## VI

### Developing countries: the needs and limitations of Latin America

#### 1. Overview of the situation

As must inevitably be the case in a globalized world, developing countries have begun to experience the effects of the financial crisis. In Latin America these effects have been felt through two channels: a real channel and a financial one.<sup>31</sup>

Through the “real” channel, Mexico and the Central American countries are being affected by the drop in industrial exports and remittances and by the fall-off in tourism and foreign direct investment (FDI). Lower commodity prices are having a major impact in South America and, to a lesser extent, Mexico; lower oil prices will favour Central America, however (ECLAC, 2008a and 2008b).

Table 2 summarizes a number of the effects of the crisis on the current accounts of the region’s countries. The table was prepared using 2008 current accounts, with the adjustments consequent upon the international financial crisis (“exogenous factors”). In other words, it does not take into account the internal adjustments (exchange rates and level of activity) that would be necessary if higher current-account deficits could not be financed. It is assumed that total imports remain unchanged, which is compatible with a growth rate of 3% if investment declines substantially because of negative expectations and the lack of financing.<sup>32</sup> Exogenous variations reflect changes expected in: (i) export and import prices, (ii) industrial export volumes, (iii) remittances, (iv) tourism revenues and

<sup>31</sup> Considering that there is an article in this edition of *CEPAL Review* specifically discussing the impact of the crisis on Latin America, here we shall offer a stylized account of certain developments.

<sup>32</sup> If capital goods imports (which represent about 25% of all imports) declined by 15%, this would leave room for imports of other products to increase by 5%, which is compatible with 3% growth.

TABLE 2

## Latin America: current-account balance and financing requirements

	Percentages of GDP				Millions of dollars	
	2008	2009 scenario 1 <sup>a</sup>	2009 scenario 2 <sup>a</sup>	Average 1997-1998	2009 scenario 1: adjusted current-account balance	2009 scenario 1: financing needs net of FDI
Argentina	3.7	-1.4	-2.4	-4.5	-4 027	-352
Bolivia (Plurinational State of)	14.8	6.8	5.6	-7.4	942	0
Brazil	-2.0	-3.4	-3.7	-3.7	-45 450	-30 450
Chile	-3.3	-9.7	-9.6	-4.7	-16 507	-8 130
Colombia	-3.0	-4.6	-5.8	-4.6	-9 794	-3 311
Costa Rica	-9.0	-9.6	-10.9	-3.7	-2 606	-1 205
Dominican Rep.	-13.6	-14.4	-15.4	-1.3	-6 191	-4 316
Ecuador	3.2	-7.3	-10.8	-5.4	-3 558	-3 033
El Salvador	-6.4	-7.8	-9.4	-0.8	-1 636	-1 308
Guatemala	-5.3	-7.1	-8.3	-5.0	-2 449	-1 872
Haiti	-2.7	-3.9	-5.3	-1.2	-245	-222
Honduras	-13.2	-14.7	-15.2	-3.5	-1 878	-1 204
Mexico	-1.5	-4.0	-5.2	-2.9	-41252	-31 433
Nicaragua	-29.7	-28.5	-28.3	-22.0	-1 684	-1 384
Panama	-10.0	-9.2	-10.5	-7.2	-1 949	-599
Paraguay	-2.6	-14.7	-14.5	-4.8	-1 882	-1 725
Peru	-4.8	-8.6	-9.1	-5.8	-10 108	-5 233
Uruguay	-4.3	-4.0	-4.3	-1.7	-1 026	0
Venezuela (Bol. Rep. of)	16.6	1.3	-3.2	-0.4	3 213	0
Latin America	-0.7	-4.0	-5.1	-3.7	-148 087	-91 306

Source: prepared by the author (see annex).

<sup>a</sup> Current-account balances in 2009 are expressed in terms of 2008 GDP. See annex for the assumptions involved in the two scenarios.

(v) in some countries, a drop in rents from natural resource exploitation being sent abroad. All these variables are calculated for two alternative scenarios, presented in the annex. The results show the scale of the problem: in the least pessimistic scenario, the current-account deficit increases by an average of 3.3 points of national output to 4%, exceeding the 1997-1998 figure (see table 2). In the rather more pessimistic scenario it reaches 5.1% of GDP. To complicate the situation, foreign direct investment is expected to fall sharply, reducing one of the least unstable sources of financing for the current account. On the less pessimistic hypothesis (25% drop), net FDI would be equivalent to 1.6% of output in the region as a whole. This implies a financing shortfall of US\$ 91 billion (US\$ 138 billion in the more pessimistic scenario), 68% of it in two countries, Brazil and Mexico (see table 2).

To this must be added the maturity of external debts, which different estimates put at US\$ 120 billion, giving a total of US\$ 210 billion. Financing this imbalance will not be easy, as the repercussions of the crisis are being manifested via the “financial” channel in higher country risk (see figure 8). In fact,

a number of countries (Argentina, Ecuador and the Bolivarian Republic of Venezuela) have no access to international credit. Furthermore, private-sector debt is going to be difficult to roll over, as this would require a normalization of the financial market in relation to the fourth quarter of 2008, when outflows of private capital led to sharp devaluations. These have affected the liability situation of private-sector firms, although the most significant effect has been the “disappearance” of credit, which has left many of them on the verge of default and operating with very short-term credits.<sup>33 34</sup>

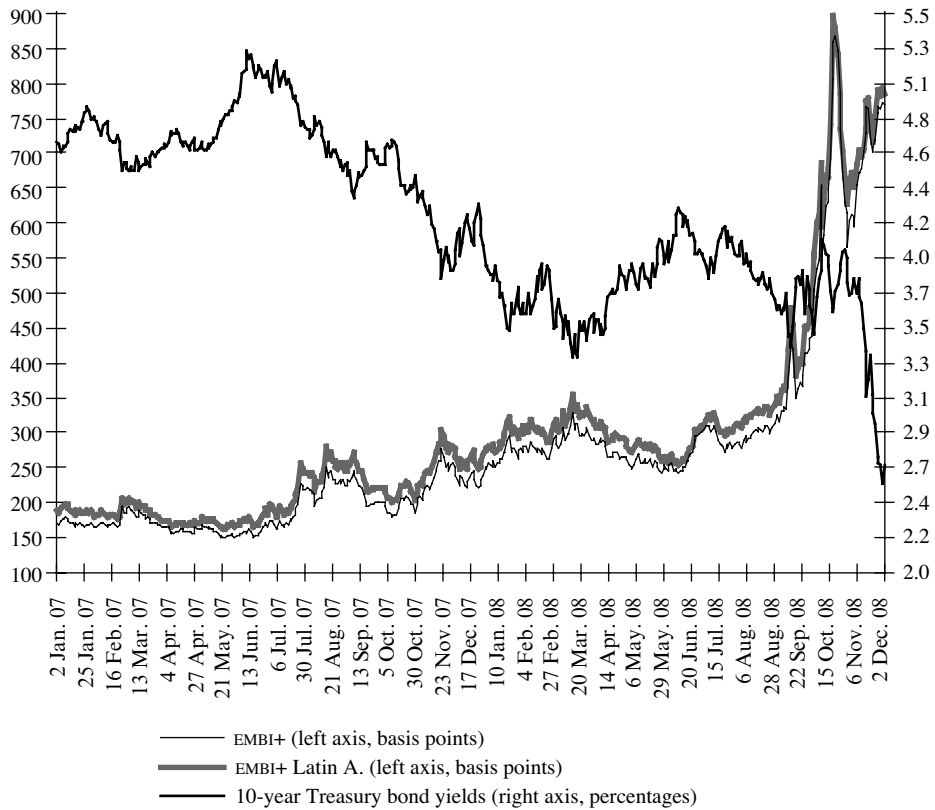
Depending on the characteristics of each country and the economic policy measures adopted, the lack of new international financing will affect international reserves, the real exchange rate and the level of economic

<sup>33</sup> The situation is even more critical in a number of eastern European and Asian countries, particularly the Russian Federation. See J.P. Morgan (2008).

<sup>34</sup> A number of corporations, particularly in Brazil and Mexico, had made bets in the derivatives market against a devaluation of the local currency. This led a number of them into substantial losses and even bankruptcy.

FIGURE 8

EMBI+ and 10-year United States Treasury bond yields, 2007-2008



Source: prepared by the author on the basis of Federal Reserve data and J.P. Morgan.  
 N.B.: EMBI+ = Emerging Markets Bond Index Plus.

activity. In other words, the lack of financing can be offset, at least in part and for a limited time, by running down international reserves. If this proves insufficient, the other two instruments for adjusting the external imbalance will be devaluation of the real exchange rate and a lower rate of economic activity. In the fourth quarter of 2008, a combination of simultaneous changes in these three variables could be observed.

Although no exercise has been carried out to show the effects of the crisis on the public accounts, the close relationship between export commodity prices and fiscal revenues means that the latter are expected to fall substantially (Jiménez and Tromben, 2006). By way of compensation, sizeable energy subsidies, which in 2008 stood at over one point of output in several countries, will be reduced. According to the Economic Commission for Latin America and the Caribbean (ECLAC, 2008b), fiscal deficits will increase by about 1.5% of output in 2009. While this estimate

may be on the optimistic side, the difference between this and other crises in terms of fiscal solvency is, thankfully, staggering.

To cope with the crisis, then, it will be necessary to implement countercyclical policies designed to offset the drop in demand (both external and internal) and finance the external and fiscal imbalances. Unsurprisingly, the two issues are clearly intertwined.

**2. Countercyclical policies**

Given the current global economic situation, we need to ask what developing countries, and Latin America in particular, can do to implement countercyclical policies. The short answer is: considerably less than the developed world.<sup>35</sup>

<sup>35</sup> There are exceptions: the most striking is China, whose extraordinary level of savings and international reserves is allowing it to implement expansionary policies.

First of all, the channels through which assistance to the sectors worst affected by the crisis might be increased are not obvious, partly because most developing countries do not have unemployment insurance, or at least none that works effectively and has adequate coverage. Beyond channelling more resources into anti-poverty programmes and implementing public works in local areas, therefore, there is an urgent need to find other ways of reaching the middle-income sectors being affected by the crisis (such as funding existing health-care coverage for a certain period of time and paying a larger allowance per child).

Secondly, and most importantly, at times of crisis there is a clear macroeconomic asymmetry between developed and developing countries. This is manifested in the behaviour of interest rates, as investors seek refuge in the assets of developed countries and “flee” the currencies of developing countries. The consequence is that whereas interest rates fall in the former, they rise in the developing world. The current crisis offers the most extreme example of this. Whereas the average country risk of emerging countries increased by some 445 basis points between early June and late December 2008, yields on United States Treasury bills fell by 145 basis points over the same period (see figure 8). Similarly, while the currencies of developing countries are depreciating, those of developed countries are tending to appreciate.

The effects of these developments are fairly obvious. Capital flight, arising in consequence of greater uncertainty, makes it harder to implement countercyclical monetary policies. This does not mean there is no scope for reducing interest rates, given the easing of inflationary pressures and the often excessive increases in these rates during the first nine months of 2008. Meanwhile, the increase in borrowing costs, or the virtual “disappearance” of credit in certain circumstances, is making it far more difficult to apply countercyclical fiscal policies. The situation is quite heterogeneous, however, partly because of policies from the recent past that are unlikely to change under current circumstances.<sup>36</sup> At one extreme is Chile, which is in a position to implement countercyclical fiscal policies thanks to the resources it saved during the period of strong fiscal surpluses, although the country’s current-account deficit ought to be a cause for concern. At the other are Argentina, Ecuador and the Bolivarian Republic of Venezuela

<sup>36</sup> See Gerchunoff (2008).

with a country risk spread of over 1,500 points, which is tantamount to not having access to credit. While other countries are in a position to borrow, they will be doing so at considerably higher rates than in recent years.<sup>37</sup> Opportunities to implement countercyclical fiscal policies will thus be compromised, although the situation will vary from country to country.<sup>38</sup>

### 3. Financing from lending organizations

The absence of an international lender of last resort is more serious than ever in the circumstances described. This being so, the announcement by the Federal Reserve of a liquidity swap line for Brazil and Mexico is a step in the right direction; the real problems will come, however, for countries whose macroeconomic behaviour has been responsible but which will not qualify for special financing because they are not “strategic” for the United States. This is why there is a need for a lender of last resort that can generate incentives to reduce major imbalances and protect the level of economic activity. This will surely be a renewed IMF, which will disburse significant amounts of resources promptly and, in the event of sudden changes in the capital markets, unconditionally, at least in the case of countries that can demonstrate responsible macroeconomic behaviour.<sup>39</sup> Failure to do so promptly would mean that resources which ought to be helping to stem the run on the currency market, preventing sharp devaluations and underpinning demand, i.e., serving as a countercyclical mechanism, could instead end up financing capital flight.

Multilateral support needs to be supplemented by the regional networks that are playing an increasingly important role throughout the world.<sup>40</sup> They are complementary because, while regional networks are much more efficient at providing assistance as and when needed, at least in Latin America, they are unlikely to have the resources they need to finance larger countries at a time of major upheaval.<sup>41</sup>

<sup>37</sup> Brazil and Mexico will also be in a position to take up the US\$ 30 billion liquidity swap facility announced by the Federal Reserve.

<sup>38</sup> A number of countries have already announced countercyclical measures, however. See ECLAC (2009) for a good summary. Their ability to implement what has been announced will be put to the test over the coming months.

<sup>39</sup> Concessional interest rates would be required for middle- to low-income countries. See Griffith-Jones and Ocampo (2008).

<sup>40</sup> See Ocampo (2006).

<sup>41</sup> Machinea and Titelman (2007) discuss ways of boosting regional institutions in Latin America.

Notwithstanding the differences between developing countries in their capacity to implement countercyclical policies, there is something they all have in common with one another and with “recently developed” countries such as the Republic of Korea: since the Asian crisis, these countries have followed a policy of self-insurance involving larger international reserves and the creation of sovereign funds. In line with this, a number of these countries have been running current-account surpluses, which has contributed to the global supply of “lendable” funds. If what is needed now is higher demand to support economic recovery, it is reasonable to think that these countries’ current accounts will weaken, a process that will be accelerated in some of them due

to falling prices for their export products. Thus, not only for structural reasons but also to meet immediate needs, the incentive for self-insurance deriving from the defective workings of the international financial system needs to be removed.<sup>42</sup>

Lastly, returning to the financial needs of 2009 and doubtless 2010 as well, the lack of international financing may condemn the region and particularly its smaller countries to a disproportionate adjustment. Assuming that private lending normalizes to some degree, there is an urgent need for net financing of at least US\$ 70 billion a year (or about US\$ 90 billion gross) from lending organizations or developed countries.<sup>43</sup> The harder credit is to come by, the larger this figure will obviously be.

## VII

### Final reflections

In the years leading up to the crisis that began in 2007 and worsened in 2008, the world economy grew at a rapid rate. It was a period when the financial sector grew on the back of globalization and innovations that helped to expand capital markets, accelerate the creation of new intermediaries and instruments and, crucially, reduce relative capital levels in the finance industry as a whole. It was also a time when the profits of financial intermediaries grew exponentially, swelling from 5% of all profits of firms listed on the New York Stock Exchange in 1980 to 40% in 2007.

This “explosion” in the finance business favoured the growth of certain sectors, particularly durable goods purchases and construction, but it did so—particularly in the last 10 years—at the cost of growing structural weakness. This is not a new phenomenon, as it has happened on many occasions over the last two centuries and especially the last 40 years. In this document we have discussed the main factors behind the crisis, stressing the instability inherent in the financial system, which has intensified in recent years owing to policies of excessive deregulation. We have also argued that the right instrument for correcting the exuberance of the system and its effects on asset markets is not the interest rate, but financial regulations.

We have also considered what might be done to reduce the scale of the recession and ward off the combination of depression and deflation that is threatening the global economy. Developed

countries have a particular responsibility here, not only because they caused the crisis, but also because the problem banks are located within their territories and because they have greater scope for implementing countercyclical policies. As well as speeding up implementation of these measures, there is a need to act as decisively as possible both in applying the fiscal stimulus package and in recapitalizing banks. Delays and “shortfalls” may mean years of recession, compounding future public-sector debt problems. In other words, it would be better to borrow somewhat more now to prevent a prolonged recession that would perpetuate the rising trend in the public debt, as has happened in Japan in recent years.

Where banks are concerned, the options are narrowing in some countries. Unless a permanent solution is found involving temporary nationalization or the purchase of “bad assets”, with all the problems this entails, the option of creating new institutions on the basis of existing banks’ “good assets” and guaranteed deposits is the one that will begin to prevail, with “toxic assets” and unguaranteed liabilities remaining behind

<sup>42</sup> This mechanism will obviously not alter the incentive for China and the Russian Federation to build up international reserves, as these countries’ strategy is guided by other considerations.

<sup>43</sup> The Institute of International Finance expects these organizations to disburse no more than a net US\$ 8 billion in Latin America in 2009.

in the old banks. While the latter alternative has a lower fiscal cost, it would increase the level of uncertainty about banks (or countries) that had not opted for one of the other solutions, so that its overall effects would be difficult to predict.

A few comments apart, this document has not examined the changes needed on the international stage and in national financial systems. With regard to these challenges: aside from altering the incentive system for bank executives, reorganizing the way rating agencies operate to ensure they are truly independent, preventing liabilities other than deposits from exceeding a set amount and increasing the transparency of traded assets, there is a vital need to create countercyclical financial regulation, i.e., to increase capital requirements during upturns and reduce them in recessions. Furthermore, given the enormous capacity of the financial sector for innovation, there is a need to supplement particular capital requirements by risk type with a blanket limit covering all the different varieties of assets.<sup>44</sup> In any event, whatever regulations are put forward in the international sphere will require more input from developing countries, since they cannot be identical for countries with different levels of macro volatility and financial depth and instability.<sup>45</sup>

The economics of countercyclical measures is not simple, since nobody likes to “stop the party”, especially considering that almost all sectors benefit during booms. As the effects of the current crisis are showing, however, when the party does stop, i.e., when boom turns to bust, the costs are not shared in the same way as they were during the years of strong

growth. Lower growth, unemployment and higher taxes particularly affect middle-income and poorer sections of the population. In the face of all these pressures, it is important to construct institutions that can help to implement countercyclical financial policies during booms. Difficult as it may be, now is the time to do it.

The other aspect to stress, once again, is the need to have global and regional safety nets so that developing countries have better prospects of implementing countercyclical policies. This will mean restructuring everything about the IMF from its governance (with a greater presence for developing countries on the board) to credit access (which needs to become more flexible, particularly at times like the present).

The existence of global safety nets would also spare countries the need to self-insure by increasing their international reserves, which limits their willingness to run moderate current-account deficits. Thus, global and regional safety nets will not only make it easier for developing countries to moderate the adjustments required in times of difficulty, but will also help to forestall the kinds of structural imbalances seen in recent years.

Lastly, given that proper regulation of the financial system involves reducing its procyclical tendencies and generally increasing risk capital requirements, it is possible that credit growth may be less in the short term, a small price to pay when set against a less procyclical and more stable financial system and thus stronger credit growth in the medium and long run. Future changes in financial regulation will have to reckon with pressure groups that will soon be inclined to downplay the effects of the crisis or put the blame on other actors. It is also important that these regulations should not hinder financial innovation and, in particular, that efforts to reduce risk do not obstruct the financing of developing countries.

<sup>44</sup> A proposal that meets both requirements is that of Goodhart and Persaud (2008).

<sup>45</sup> See Fanelli (2008).

## ANNEX

### Assumptions used to construct the scenarios

The effects of the global economic recession on the current accounts of the Latin American countries were estimated following the assumptions detailed below, which in a number of cases were constructed using information from the fourth quarter of 2008. For example, remittances fell by about 5% in the fourth quarter of 2008, prior to the large increase in unemployment in the United States, so that two alternatives

were analysed: an 8% and a 15% drop. Where the terms of trade were concerned, eclac assumptions for 2009 were used. For manufacturing exports, the percentage of manufacturing exports under the maquila system was taken, and only value added was imputed to them. In all cases other than the terms of trade, it was assumed that the percentage change relative to 2008 would be the same in all the countries.

**1. Terms of trade:**

Alternative 1: reduction of 12.8% (with a 40% drop in the oil price).

Alternative 2: reduction of 14.2% (50% drop in the oil price).

**2. Manufacturing exports:**

Alternative 1: reduction of 5% by volume.

Alternative 2: reduction of 10% by volume.

**3. Tourism:**

Alternative 1: 10% decline in net revenues.

Alternative 2: 20% decline.

**4. Remittances:**

Alternative 1: 8% reduction.

Alternative 2: 15% reduction.

**5. Investment revenues:**

Considering the drop in returns on mining operations, rents sent abroad were reduced to their level of 2005, a year when export prices for minerals were similar to those forecast for 2009. The exercise was carried out for three countries where this item had seen an extraordinary increase in recent years. The reduction implies a fall of about US\$ 10 billion, US\$ 4 billion and US\$ 3 billion in Chile, Colombia and Peru, respectively.

Regarding financing, the assumptions made for net foreign direct investment were:

a. Alternative 1: 25% decline from 2008.

b. Alternative 2: 35% decline.

(Original: Spanish)

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**KEYWORDS**

Financial market liberalization

Globalization

Financial crisis

Economic development

United Nations

Development financing

Hunger

Poverty mitigation

Evaluation

Latin America

# The global crisis, speculative capital and innovative financing for development

*Ricardo Ffrench-Davis*

One of the characteristics of globalization has been the marked volatility of financial flows. The realization that this was affecting growth and equity induced the International Conference on Financing for Development, held in Monterrey in 2002, to adopt a global commitment to deal with the issue of development financing. Since then there has been a mixture of progress, backsliding and inaction. This article conducts a brief review of financial globalization and the current global crisis. It then examines the Monterrey Consensus, the evaluations by the United Nations Secretariat of compliance with the commitments accepted, and the financial system reforms needed to make globalization more equitable. It then proceeds to a stocktaking of the progress made under a North-South collaboration initiative, Action against Hunger and Poverty, in applying “innovative financing mechanisms” that can contribute to attainment of the Millennium Development Goals and help developing countries cope with critical situations like the current global recession. It concludes with proposals for dealing with the challenges that remain.

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# I

## Introduction

Of all the remarkable features of the current globalization process, one of the most striking has been the huge boom in international financial flows, of which volatility is a marked characteristic. These are not harmless fluctuations but great swings that translate into powerful economic cycles, extending over long periods of time and qualitatively affecting resource allocation and equity, thereby sowing the seeds of growing imbalances until they trigger costly recessions in the real economy. Time and again, Latin America has been among the first to fall victim to shocks of this kind. The epicentre of today's crisis in the international financial markets was to be found, however, in the world's leading economy, a promoter of liberalized markets. Today, most of the world has been dragged down into a situation that originated in the globalization of financial volatility. Its severe worldwide consequences ought, at long last, to spur an urgently needed correction in the international financial architecture.

Following this introduction, section II offers a brief review of financial globalization and the current global crisis. Section III examines the main international effort made in recent decades to correct

the severe shortcomings of financial markets and reorient them towards development financing, namely the International Conference on Financing for Development held in Monterrey in March 2002. It then goes on to evaluate the increasingly urgent warnings of the United Nations Secretariat about the need to step up compliance with the Monterrey Consensus commitments that came out of the Conference and to make further corrections to bring about the kind of development financing needed if globalization is to benefit developing countries. Section IV summarizes the activities and advances of the Action against Hunger and Poverty Initiative, led by the heads of government of Brazil, Chile and France and the United Nations Secretary-General; particularly, the proposals for "innovative financing mechanisms" that can contribute to more equitable development and help combat financial volatility, while supporting developing countries in their efforts to deal with critical situations such as the current global recession. Lastly, section V describes the challenges that need to be met during this crisis if the foundations for sustained development are to be strengthened.

# II

## The globalization of financial volatility and the present crisis

The seeds of the current global crisis were sown gradually over the years and decades that preceded it. The main trigger were developments in the financial markets, with their strongly short-termist and speculative bias. Following the disastrous collapse of the 1930s, the international capital markets began to expand significantly in the mid-1960s (Díaz-

Alejandro, 1985; Devlin, 1989; Eichengreen, 2003). The process has gathered pace in recent years as rapid diversification has led to the introduction of a growing number of opaque and speculation-prone segments.

In part, the increase in financial flows undoubtedly reflects the growth of the world economy, rising international trade and the globalization of production. However, it is also due to factors of a financial nature whose influence has been increasing far more rapidly, particularly since the 1990s. The ever-growing presence of offshore international financial centres, combined with light or non-existent

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regulation, stimulated capital movements by making it possible to circumvent national financial regulations and capital controls and taxes. This phenomenon, together with revolutionary innovations in information and communication technologies, and the use of increasingly sophisticated financial techniques (many of them employing off-balance sheet operations to create excessive leverage), contributed structurally to the remarkable boom in international capital flows. Procyclical macroeconomic policies were the other factor that set the scene for imbalances which were to become increasingly explosive, given the scale of the resources involved and the volatility characterizing them.

Using information from the Bank for International Settlements, the Organisation for Economic Co-operation and Development (OECD) and the World Bank, it can be estimated that about US\$ 40 are traded in the currency markets for every dollar of international trade in goods and services. This uneven proportion indicates that the same funds are traded several times a day, usually without connection to any actual international trade. This may benefit those who wish to operate in a market where prices are quoted daily and where it is always easy to buy and sell, but it represents a problem for the macroeconomic environment in the rest of the economy, which is where the overwhelming majority of firms and workers operate. The fast-expanding financial markets are subject to frequent “mood swings” that affect expectations of the price of the dollar, for example, so that funds which were flowing into a particular geographical market may suddenly emigrate to another.<sup>1</sup> Decisions of this type in the financial and currency markets have very powerful effects on the real economy, i.e., on output, employment, profits and tax revenues.

Generally speaking, the financial boom took place in a context of flexible or fragmented regulation and oversight and was characterized by a procyclical bias (Ocampo, 2007; United Nations, 1999). The lack

of regulation was not uniform. Banking systems, for example, continued to be closely regulated, especially in the developed economies.<sup>2</sup> Nonetheless, as already mentioned, supervision had a procyclical bias, and this was heightened after the second agreement of the Basel Committee on Banking Supervision (Basel II) (Griffith-Jones and Persaud, 2005; Stallings and Studart, 2006).

In any event, the main difficulties arose because of three very marked features of financial activities. First, regulation of expanding segments (such as stock markets) or new ones (international investment funds, hedge funds and derivatives markets), which had come to make up the bulk of financial markets, was weak or non-existent. Consequently, these financial “innovations” meant a profound lack of transparency. In a context where these markets were constantly expanding, it became more and more difficult to grasp the risks involved, including the frauds that would be detected subsequently. Secondly, agents in markets of this sort usually take a short-termist approach when allocating the funds they manage, a bias heightened by prevailing incentive systems (Williamson, 2003a). They also operate with liquid resources and internationally, creating huge macroeconomic volatility in individual countries. A third characteristic is the predominance of a markedly procyclical neoliberal macroeconomic approach (Ffrench-Davis, 2005, chapter V; Ocampo, 2007), with sharp currency and monetary cycles. Two manifestations of this were the giant external deficit of the United States and the real exchange-rate appreciation experienced in Latin America from 2004.

The costs of the “financieristic” approach have been seen repeatedly in emerging economies, as demonstrated by the so-called tequila crisis, the subsequent crisis in East Asia and the 1998-2003 recession in Latin America. The current crisis, which originated in the United States before spreading to much of the planet and which has also centred on the financial markets, has some specific ingredients in common with our own recent experiences.

It is hard to predict exactly when crises will break out, but what is increasingly feasible is to identify when the ground is being prepared for them. We have often seen massive capital inflows pushing emerging

<sup>1</sup> Greenfield (production-oriented) foreign direct investment (FDI) is usually channelled into fixed assets that are “irreversible” in the short run, meaning that funds cannot be pulled out from one day to the next. Conversely, resources of a financial nature can depart in a matter of seconds. This is why financial investment and greenfield FDI are treated differently in economic research and in the policy approaches of a number of countries that have behaved more responsibly. This was what happened in Chile during the first half of the 1990s, for example, when a reserve requirement was introduced to prevent excessive financial inflows without discouraging FDI (see Ffrench-Davis, 2008, chapter IX).

<sup>2</sup> In the Latin American economies, on the other hand, bank privatization was accompanied by loose regulations, giving rise to a series of banking crises that were very costly for national States.

economies into situations of vulnerability, including the following: (i) substantial current-account deficits, (ii) large external liabilities that exceed international reserves and have a significant liquid component, (iii) real exchange-rate appreciation and currency misalignment, (iv) high prices for local assets (shares, bonds, real estate), (v) high levels of household borrowing relative to wages and profits and (vi) falling interest rates with substantial increases in the money supply. The longer the run-up and the deeper the economy goes into these areas of vulnerability, the more severe will be the potential “financieristic” trap for the authorities and the less the chances of escaping from it without experiencing an economically and socially ruinous shock.

Different combinations of the variables referred to were present in the Latin American crises of 1982, 1995 and 1999. In emerging economies, external shocks associated with capital flows or the terms of trade have tended to be long drawn-out processes characterized by gradually mounting vulnerabilities. Since these processes have gone with steadily rising asset prices, however, financial operators have reaped growing profits despite burgeoning macroeconomic imbalances.

The current crisis, originating in the United States, shares a number of these sources of vulnerability with emerging economies, such as excessively low interest rates, property price bubbles, risky incentives to lending because of the high level of liquidity, high levels of leverage and procyclical risk ratings. However, there are substantial differences in that the United States is the issuer of the leading international currency and it was its markets that first created the channels of expansion, involving a profusion of financial engineering mechanisms, which were then exported. These channels, we repeat, were characterized by a great lack of risk transparency and by very high levels of leverage.

Subprime mortgage lending was the trigger for the crisis but not the main source of vulnerability, since otherwise its effects would have been confined to that segment of the United States economy. The sector clearly underwent an unsustainable boom based on the faulty perception that high prices would continue to rise indefinitely (a feature reminiscent of many of the situations that have led to shocks in Latin America and the Caribbean), but at the same time many other imbalances of financial origin were in the making in the United States in particular and the Anglo-Saxon world in general.

- (i) First, mortgage market bubbles spread around the globe,<sup>3</sup> although always with essentially “micro” implications, as they were not sufficient in themselves to unleash a crisis in a world whose GDP was in excess of US\$ 60 trillion.
- (ii) Financial innovation had gone worldwide; it paved the way for massive frauds with repercussions in the real economy, but it also had very procyclical effects on expectations.
- (iii) Many investors were operating with extremely high levels of leverage. This might be justifiable in the case of legitimate producers and users of products who have the backing of real activities, but not in that of speculators operating with minimal capital.
- (iv) Stock markets surged to heights incompatible with real growth in net profits, which are what ultimately underpin share prices.

At the macroeconomic level, the United States economy ran a growing current-account deficit from the early 1990s onward (see figure 1). In an initial stage lasting until 2000, the increase in the external deficit was due to private-sector activities. Although this deficit adjusted after the 2001 recession, the government began a process of increasing the fiscal deficit which lasted until 2003, peaking at almost 5% of GDP. Between 2003 and 2006, the public sector began to adjust again, but private-sector exuberance caused the already large current-account deficit to widen, and by 2006 it stood at 6% of GDP.

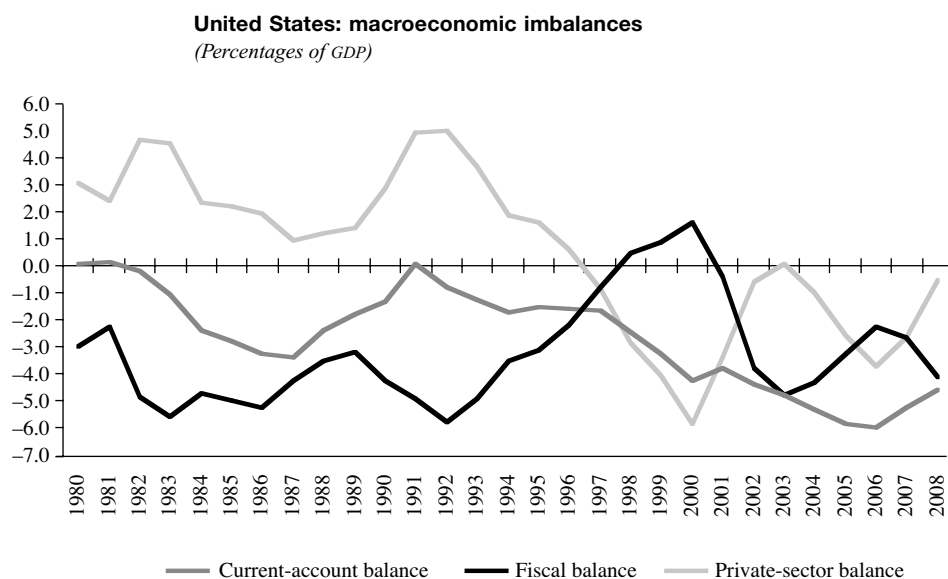
In parallel, long-term interest rates in the United States fell for several years until they reached historic lows (which have been shown to be even lower than the equilibrium rate), a trend that intensified from 2002 as demand for United States Treasury securities rose strongly (see figure 2).

A similar trend was followed by real estate assets, whose prices almost trebled (191% increase) between 1996 and the peak of mid-2006 (see figure 3); housing prices grew at double-digit annual rates for 80 consecutive months, from late 1999 to mid-2006 (see table 1).

As already noted, stock markets were central to the bubble in many countries, as they also displayed an unsustainable upward trend (see figure 4). Natural resource prices, meanwhile, rose exorbitantly; with time it became clear that speculators had progressively been dominating the derivatives markets for these

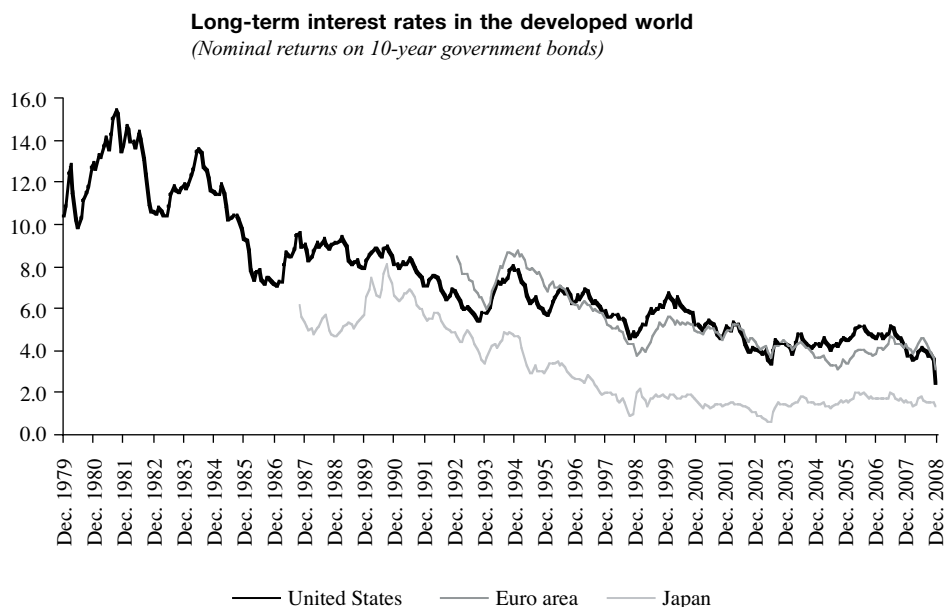
<sup>3</sup> There were also real-estate price booms in many countries.

FIGURE 1



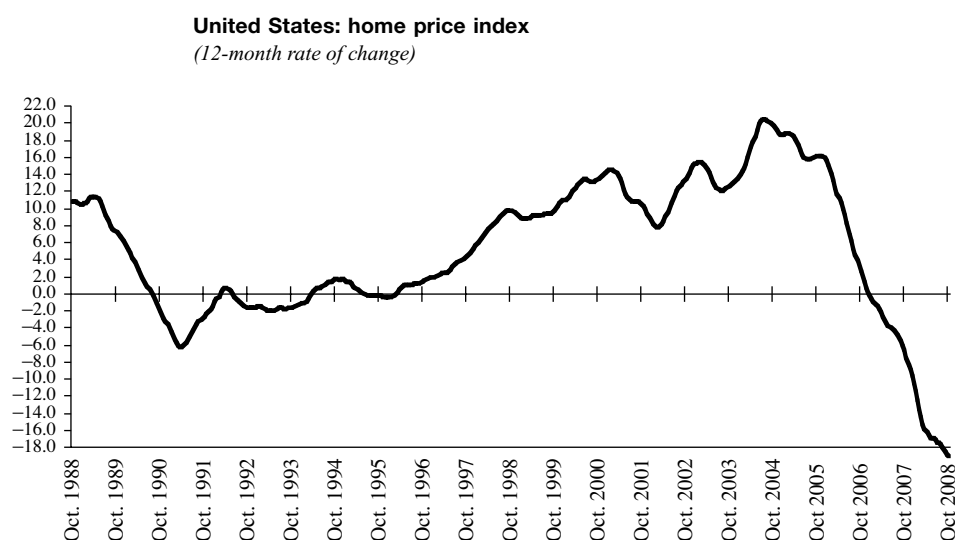
Source: prepared by the author on the basis of International Monetary Fund data.

FIGURE 2



Source: prepared by the author on the basis of data from the Federal Reserve Bank of New York, the European Central Bank, the Bank of Japan and the Bloomberg financial information channel.

FIGURE 3



Source: prepared by the author on the basis of data from the S&P/Case-Shiller index.

commodities, and this was borne out by the rapid fall in prices when the cycle turned downward (see figure 5 and table 2).<sup>4</sup> There were obvious symptoms of bubble behaviour, not only in the United States real estate sector but in a range of activities around the world. Furthermore, the procyclical behaviour of the risk rating agencies worsened the imbalances by inflating financial agents' expectations.

It is striking that, in general, evaluations by the risk rating agencies, which ought to be contributing to the sustainability and transparency of agents and markets, actually made the imbalances worse. They continued to be highly procyclical, just as they were in the run-up to the Asian crisis (Reisen, 2003).

The world is now faced with the urgent need to resolve the greatest crisis since the 1930s, whose effects on the real economy were only beginning to be discerned in late 2008. Looking beyond the corrections already made and the numerous downward revisions to economic growth forecasts that will be seen in the different countries, this is an opportunity for reforms to change the speculative and untransparent bias of financial activities. Without question, the globalization process as it

now stands is characterized by a severe deficiency of macroeconomic and financial regulation and a striking imbalance between the voices, opinions and interests that are taken into account in designing and implementing public policies.

TABLE 1

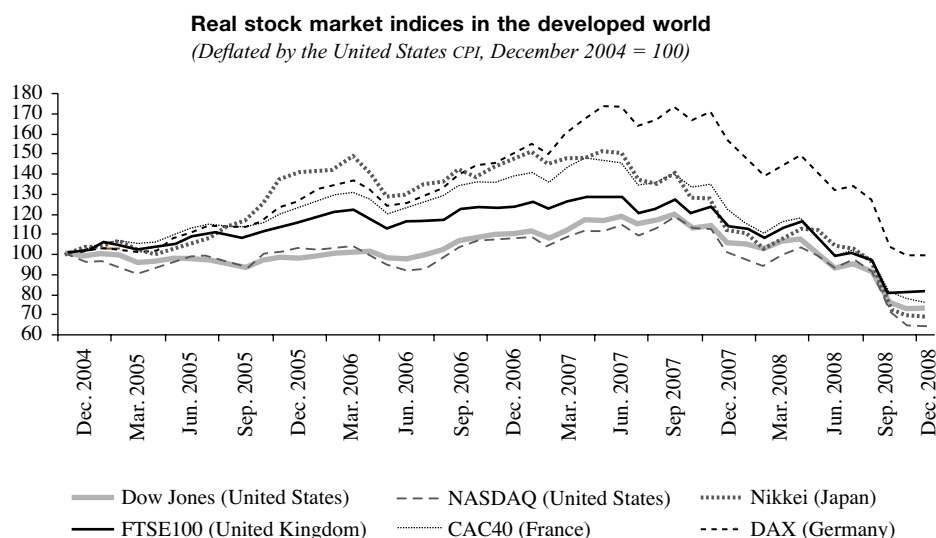
**United States: home price index**

	Level (Jan. 2000=100)	Dec.-Dec. change (%)	Annual average change (%)
1989	81	6.1	0.0
1990	82	-3.6	0.8
1991	78	-1.8	-4.2
1992	78	-1.7	-0.7
1993	76	-1.3	-1.7
1994	77	1.7	0.7
1995	77	-0.4	0.2
1996	78	1.9	0.9
1997	80	5.4	3.4
1998	87	9.1	8.4
1999	95	10.8	9.4
2000	107	14.1	12.9
2001	120	8.9	11.8
2002	133	15.0	11.1
2003	151	13.4	13.5
2004	179	18.7	18.3
2005	209	15.9	16.9
2006	225	0.2	7.4
2007	215	-9.7	-4.4
2008	182	-19.1	-15.4

Source: prepared by the author on the basis of data from the S&P/Case-Shiller index.

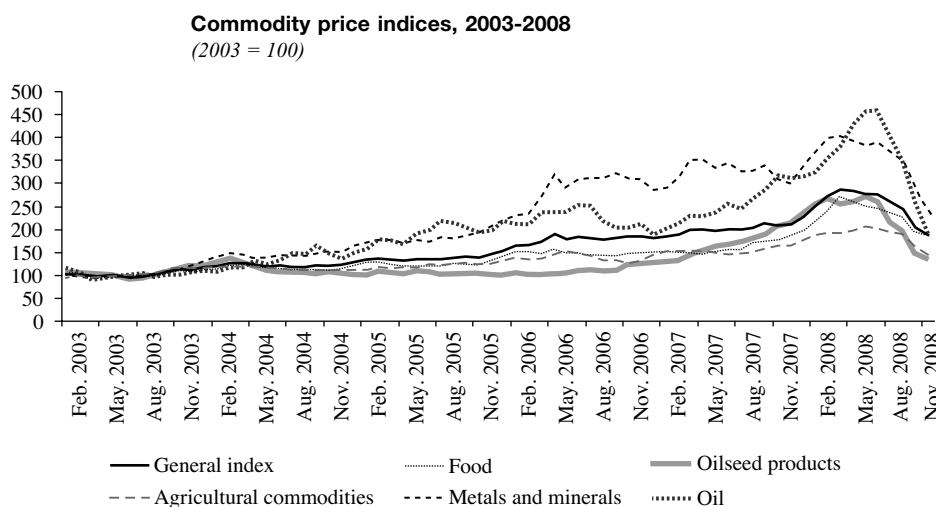
<sup>4</sup> As a top executive in a mining company put it, the expansion of the copper derivatives market was increasingly driven by operators who had no connection or familiarity with the product. Thus, the price rose from 60 cents in 2002 to 400 cents in 2008, before falling back to 130 cents in the latter part of that year.

FIGURE 4



Source: prepared by the author on the basis of financial information from Bloomberg.

FIGURE 5



Source: prepared by the author on the basis of data from the United Nations Conference on Trade and Development (UNCTAD).

TABLE 2

**Commodity price indices**  
(2003 = 100)

	2003	2004	2005	2006	2007	2008
General index	100	120	134	175	197	250
Food	100	114	122	145	158	228
Oilseed products	100	113	102	108	165	225
Agricultural commodities	100	113	118	136	151	185
Metals and minerals	100	141	178	285	321	352
Oil	100	131	185	222	246	353

Source: prepared by the author on the basis of data from the United Nations Conference on Trade and Development (UNCTAD).



As President Obama rightly said, it is time to hear the voices of Main Street instead of the voices of Wall Street. As we have repeatedly argued in relation to economic policy, “productivism” has

to replace “financierism” (Ffrench-Davis, 2006) if the market is to serve the needs of development financing and growth with equity, an issue that is examined in section III.

### III

## Development financing and the Monterrey Consensus

In 2002, the international community held a summit whose purpose was to agree on the measures needed to correct the path of financial globalization. Critics of that path had argued that what was occurring was the globalization of volatility and that the large increase in financial flows had contributed little and poorly to the financing of development (Ffrench-Davis and Ocampo, 2001). Trends at the time indicated that the world was moving too slowly to attain the Millennium Development Goals (MDGs).

The Monterrey Consensus of the United Nations International Conference on Financing for Development represented a major step forward, as it recognized the biases and failures in the international financial system that were obstructing or discouraging development (growth and equity alike) and drew up a set of relevant and sensible proposals which the representatives of the signatory countries undertook to implement gradually. Since then there have been some excellent evaluations of progress and setbacks in their application, particularly those prepared by the United Nations Secretariat.

This section will first review some of the aspects encompassed by the Monterrey Consensus and the progress made since the agreement was signed, including certain issues that arose after the development financing summit, and will then briefly examine the amended Declaration of the Follow-up International Conference on Financing for Development held in Doha, Qatar, in late 2008 to review application of the Monterrey Consensus.<sup>5</sup>

<sup>5</sup> The principal documents considered were: (i) Monterrey Consensus of the International Conference on Financing for Development (United Nations, 2002), (ii) Follow-up to and Implementation of the Outcome of the International Conference on Financing for Development: Report of the Secretary-General (United Nations, 2007a), (iii) Summary by the President of the General Assembly of

#### 1. The Monterrey Consensus: evaluation and follow-up

##### (a) *A selective evaluation*

The Monterrey Consensus represented a substantive step forward in the international development agenda. It complemented the international agreements on the subject, including the Millennium Development Goals, since the attainment of these goals is closely bound up not only with official development assistance and domestic social policies but also with the economic performance of developing countries.

The Monterrey Consensus recognized the crucial role of investment and its financing for economic growth, at a time when there was a strong fashion in economics for across-the-board liberalization, including more liquid financial flows. The fashion had taken as given that physical capital did not count for much in development and that financial flows, then being increasingly liberalized, contributed to macroeconomic stability and development.

The agreement signed at Monterrey marked a shift towards a pragmatic approach. It stressed the need to maintain “adequate” levels of productive investment, which actually needed to become much higher in most developing economies for their living standards to converge with those of richer countries. Increased productive investment required comprehensive financial development, including

the High-Level Dialogue on Financing for Development (United Nations, 2007b), (iv) Report on the Tenth Session of the Committee for Development Policy of the United Nations (United Nations, 2008a) and (v) Doha Declaration on Financing for Development (United Nations, 2008b). Use has also been made of material prepared by the author for the Financing for Development Office of the United Nations Department of Economic and Social Affairs, in preparation for the 2008 Doha Conference.

a significant strengthening of long-term segments of capital markets and the creation or completion in domestic capital markets of segments geared towards small and medium-sized firms (SMES) and other excluded sectors. In fact, in its concern for equity (and fulfilment of the MDGs), in several paragraphs the Monterrey Consensus repeatedly underlines the essential role belonging to the creation or completion of SME financing mechanisms (paragraphs 17, 18 and 24, for instance). This point represents a crucial link between economic growth and equity, since middle- and low-income agents are major providers of productive employment and such mechanisms are needed to give them more effective market access.

This comprehensive pro-development approach includes the issue of migrant remittances. Besides the traditional proposal of reducing remittance costs, the Monterrey Consensus (paragraph 18) advances the innovative view that remittances could serve to “securitize” loans for development-oriented investments by recipient families. This is one of the measures that would permit a significant expansion of microcredit.

Consequently, the countries signing the Monterrey Consensus “invite banks and other financial institutions, in developing countries as well as developed countries, to foster innovative development financing approaches” (paragraph 23). Similarly, they undertake to “support new public/private sector financing mechanisms” (paragraph 24).

The document, with laudable foresight, recognizes the importance of “sound macroeconomic policies”, but again with a pragmatic approach (paragraph 14). Along with due concern for price stability and fiscal balances, it stresses that their goals should also include full employment, poverty eradication and sustainable external balances, the latter requiring “an appropriate exchange rate regime”. When it comes to maintaining “adequate levels of productive investment” (paragraph 10), the Monterrey Consensus identifies a need for consistent macroeconomic policies. Evidently, “consistency and soundness” must be understood in the sense highlighted in this paragraph.

Several paragraphs are devoted to discussing financial crises. The Monterrey Consensus gives “priority to the identification and prevention of potential crises (...) with particular attention to short-term capital flows and their impact” (paragraph 55). It is recognized that domestic macroeconomic

balances can be destroyed by depressed export revenues (paragraph 37) and by contagion from financial crises. It then “underlines the need to ensure that the international financial institutions, including the International Monetary Fund, have a suitable array of financial facilities and resources to respond in a timely and appropriate way” (paragraph 59) to situations of this type, before adding that “the need for special drawing rights allocations should be kept under review”.

The document recognizes the International Monetary Fund (IMF) Compensatory Financing Facility and Contingent Credit Line as renewed and valid safeguards, but adds that the signatory nations mean to “continue to assess its effectiveness” (paragraph 37). It is further stated that even if burden-sharing can be made fair and unsustainable debts restructured in a timely and efficient manner, “such a mechanism should not preclude emergency financing in times of crisis” (paragraph 60). More precisely, it is argued that there is a need for compensatory financing to prevent crises from worsening or at least to mitigate the deterioration.

Lastly, mention should be made of another innovative source of financing, which is the agreement to strengthen international tax cooperation and efforts to combat tax evasion, money laundering, flows of illicit funds, terrorism financing and corruption (paragraphs 64 and 65). The implication is that transparency and cooperation contribute to enhanced public expenditure efficiency in developing nations and to increased tax revenues that can be used to finance domestic development and meet the Millennium Development Goals.

#### (b) *Follow-up and implementation*

There have been substantive annual follow-up reports by the Secretary-General of the United Nations, covering each of the six chapters of this global agreement on financing for development. In addition, the General Assembly has held High-level Dialogues on Financing for Development culminating in the Follow-up International Conference on Financing for Development tasked with reviewing the application of the Monterrey Consensus, which was held in Doha in late 2008, in the midst of the global financial crisis. Here we examine some aspects that merit particular attention in the Report of the Secretary-General of the United Nations on Follow-up to and Implementation of the Outcome of the International Conference on Financing for Development (United Nations, 2007a)

and in the Summary of the High-level Dialogue on Financing for Development presented by the President of the General Assembly (United Nations, 2007b). A selective review will be undertaken as an input for the discussion of innovative financing sources which will be the focus of section IV.

The follow-up report by the Secretary-General notes “considerable advances in some areas and modest progress, stagnation or retrogression in others”, in a general context of “widespread concerns that the fruits of development and growth are not fairly distributed and (...) a growing trend towards a higher concentration of income and wealth” (United Nations, 2007a).

The Report makes use of new financial market research and knowledge that has become available since 2002 on the issues covered by the Monterrey Consensus. In particular, it expands on many aspects of that document, complementing it with a proposal for a consistent approach to the development of policies oriented towards the goals laid down by the signatory countries. The progress made on the understanding of macroeconomic matters in this sixth follow-up report is of great importance, as it moves decisively in the direction of a macroeconomic approach aimed at stimulating both local and foreign productive investment in developing countries (paragraphs 17-20).<sup>6</sup> It stresses the necessity of “employment-oriented macroeconomic policy” in relation to both labour and capital, i.e., the effort to narrow the gap between actual output and potential GDP, following a development macroeconomics approach.

In a notably clear statement, the document argues: “Countries should seek to expand their tools for sound macroeconomic policy, including effective capital flow management (...) and macroprudential mechanisms, the establishment of countercyclical funds (...) and the enhanced use of their tax systems to manage booms and busts.” This paragraph (number 18) represents outstandingly pragmatic, down-to-earth progress towards a policy-oriented approach informed by the most recent research on the procyclical evolution of international financial

markets and the shortcomings of the macroeconomic approaches more in fashion (Ocampo, 2007).

The Report of the Secretary-General stresses the need “to provide stronger oversight of financial market activities”, arguing that “perhaps most urgently, international and national authorities should collaborate to strengthen the transparency and regulation of hedge funds and derivative instruments” (paragraph 56). The stress laid on this in the report long predates the eruption of the subprime crisis and the intensification of the speculative component in the climbing price trend of several commodities.

Mention is also made of “countries internationally perceived as successful globalizers”, for which “managing the boom periods of capital flows is critical. In this respect, countercyclical regulations and instruments should be given utmost consideration” (paragraph 54). The document considers several issues related to the international financial architecture and the slow progress or setbacks in this area by comparison with other forces of globalization.<sup>7</sup> One of them is the fact that “the international community has not yet succeeded in developing some broadly acceptable form of contingent liquidity (...) to provide financial support to countries with market access that may face potential capital account crises” (paragraph 119). Just a few lines before (paragraph 118), mention had been made of the need for “a comprehensive reform of the international monetary system”, particularly with respect to international reserve currencies.

A sharp distinction is made in the report between short-term financial flows and long-term investments, since it has become increasingly evident that the latter tend to be more closely associated with productive activity than the former. It is emphasized that the effects of capital inflows on economic growth also depend on the quality of domestic intermediation and exchange-rate policy. These two factors are mentioned several times (in paragraph 104, for instance). This reiteration is welcome, since the currently fashionable approaches have failed dramatically: intermediaries have not channelled the increased financial funds into investment projects but into consumption and existing assets, which became

<sup>6</sup> These proposals converge with the arguments we have repeatedly put forward about the need to correct the macroeconomic approach prevailing in Latin America. This is characterized by a neoliberal or “financieristic” bias, as compared to a macroeconomy geared towards sustained development. See Ffrench-Davis (2006, chapter III) for an analysis of “financieristic” and “productivistic” macroeconomic approaches.

<sup>7</sup> The report underlines several other issues, such as environmental taxes that could help mitigate the destruction of the environment and provide financing for research and adaptation, and resource-use taxes or royalties.

overpriced as a result, while at the same time capital inflows in general have tended to lead to outlier exchange-rates. Consequently, developing economies ought to implement active exchange-rate policies that are consistent with the evolution of domestic productivity, while focusing financial reforms on the development of long-term and non-traditional segments of domestic capital markets.

As already mentioned, the Monterrey Consensus introduced the issue of illicit flows and tax evasion. The Secretary-General's report goes further with a discussion on "expanding fiscal space" and fighting tax evasion. In fact, a fairly standard characteristic of developing countries is a strikingly low tax burden. As a consequence, they exhibit a limited capacity to finance infrastructure and human capital investment and to ensure the efficiency of public expenditure. Several well-argued paragraphs are devoted to tax and budgetary matters (paragraphs 26-36) and this issue is returned to at the end of the report, which features substantive proposals (paragraphs 124-126) focused on the role that could be played by the new (or reformed) United Nations Committee of Experts on International Cooperation in Tax Matters.

It should be stressed that the report explicitly mentions "innovative sources of finance [that have been] largely brought into the mainstream" (paragraphs 93-96). It will be recalled below that at the 2005 High-level Plenary Meeting of the sixtieth session of the General Assembly, or World Summit,

79 heads of State and government subscribed to a Declaration acknowledging the value of promoting innovative development financing.

Approval of the Doha Declaration on Financing for Development was beset by great difficulties because of opposition to the Secretariat proposal that was led by the delegation of the outgoing United States government. For all that, the final text, even after being watered down in intensive negotiations, did reiterate the positions of the Monterrey Consensus and the determination to step up compliance with the commitments entered into when that document was signed.

The following steps forward may be mentioned. First, the agreement to convene a conference at the highest level in 2009 on the world financial and economic crisis and its effects on development. This implies acceptance that the United Nations and its Member States are entitled to a say on an issue that some countries want confined within the exclusive remit of the IMF and World Bank. Second, the recognition that the architecture of the international economic system also requires corrections if it is to meet the needs of middle-income countries. Third, the explicit reference, following protracted debate between the delegations, to the importance of "innovative financing sources", with special recognition for the Action against Hunger and Poverty Initiative. Section IV briefly details some of the progress made in this field.

## IV

### Review of progress and emerging issues

Several innovative forms of financing have been proposed to help countries implement equitable social and economic policies in the effort to bring about "globalization with a human face". There is a growing determination to move from words to fulfilment of commitments and effective action, particularly as regards attainment of the Millennium Development Goals. For this to happen, it will be essential to thoroughly overhaul the workings of the financial markets. This is far more obvious now, given the deep crisis the world is going through, than in 2002 when the Monterrey Consensus was approved. In recent years, concrete measures have been adopted in an

encouraging number of cases, while in others there are now solid technical foundations that will eventually help to generate political support for future action. In particular, we wish to highlight the progress made in the field of what is known as innovative financing.

The developing world needs more resources for productive and social development, plus international commitments to ensure that people gain from the potential benefits of globalization rather than being mere passive victims of its negative features. Efforts are needed to ensure that a growing number of people become "winners" in terms of social and economic well-being.

## 1. Action against Hunger and Poverty

In 2004, determined to contribute to the fulfilment of the internationally agreed Millennium Development Goals and the Monterrey Consensus, the representatives of a group of countries from North and South launched a partnership for development and solidarity geared towards identifying innovative sources of funding to help promote public goods, boost economic development and combat public “bads” such as hunger and poverty.

Action against Hunger and Poverty was created by the presidents of Brazil, Chile and France, with the support of the Secretary-General of the United Nations; the group was subsequently joined by the heads of State of Spain, Germany, Algeria and South Africa. Funding raised by means of innovative financing mechanisms would be used to set up projects to facilitate the attainment of the Millennium Development Goals. As part of this North-South partnership, which was strongly supported by the United Nations, the heads of State of the member countries of the initiative appointed a technical working group to study possible mechanisms for financing the fight against hunger and poverty. Its proposals are summarized in box 1.

BOX 1

### **Innovative sources of financing for action against hunger and poverty**

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Solidarity levies on air travel  
 Reduction of tax evasion, particularly via tax havens  
 Increasing the benefits of migrant remittances (linking with microcredit)  
 Currency transaction tax (CTT)  
 Taxation of arms trade  
 Creation of International Financial Facility (IFF)  
 Issuance of special drawing rights (SDRs) for countercyclical financing of development  
 Voluntary contributions through credit cards  
 Socially responsible investing or “ethical funds”  
 Solidarity lotteries

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*Source:* Action against Hunger and Poverty proposals, presented to the United Nations General Assembly in New York in September 2004 and 2005.

These proposals were presented at the United Nations in September 2004 and were supported by the representatives of numerous countries. They called for work to continue and for the results of the activities carried out to be presented at the World Summit of September 2005 in which progress

towards the 2015 Millennium Development Goals was to be reviewed. The 2005 New York Declaration on Innovative Sources of Financing for Development was prepared by Action against Hunger and Poverty with the idea of steering globalization away from its more dehumanizing and procyclical aspects, raising awareness of the issues and ensuring that speeches made at international summits were followed up with tangible action. Prepared by the technical working group, the Declaration was endorsed by 79 heads of State. Concrete action was also announced during the Summit, as summarized further on.

As part of the Action against Hunger and Poverty Initiative, the Pilot Group on Solidarity Contributions for Development was set up in 2006. Including the seven countries named above, this group comprises 55 countries from both North and South with very different levels of development. The representatives of all these countries have expressed a willingness to identify and apply pro-development levies and to contribute by generating specific funding to the struggle against “public bads” such as tax evasion and financial crises.<sup>8</sup>

These two groups of nations share a comprehensive approach that pursues the globalization of solidarity, i.e., globalization with a human face that brings the benefits of development to all countries and all their middle- and low-income inhabitants. The approach is pro-growth and pro-equity as regards both sources of funding and the uses it is put to.

The group has made tangible progress, and this was reflected in the proposals presented at the World Summit of September 2005, which included a levy on airline tickets. The pilot project for the international air-ticket solidarity contribution was officially started in 2006, with proceeds to go to the fight against hiv/aids, tuberculosis and malaria. Chile and France (since March and July 2006, respectively) were the first countries to introduce airport fees earmarked for this solidarity initiative.

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<sup>8</sup> The Pilot Group on Solidarity Contributions for Development has addressed several issues besides those covered by the Action against Hunger and Poverty Initiative. They include reviewing the solidarity levy on air travel, issuing special drawing rights as a countercyclical financing mechanism to deal with financial and trade instability in developing countries, introducing a modest tax on financial or currency transactions, repatriating illicit capital outflows, enhancing the potential role of the carbon market, linking migrant workers’ remittances to microcredit in recipient households, stepping up efforts to combat tax fraud and tax evasion, implementing a digital solidarity contribution and promoting the Digital Solidarity Fund.

The project designed to deal with the three pandemics mentioned, the International Drug Purchase Facility (UNITAID), was set up by the governments of Brazil, Chile, France, Norway and the United Kingdom and is supported by the Clinton Foundation and the Bill & Melinda Gates Foundation. Thirty-four countries are currently members of UNITAID and are contributing to the financing of its activities, while several others are considering applying such a levy or using other sources of sustainable financing for this purpose.

To avoid bureaucracy and duplication in administrative costs, UNITAID operates through the World Health Organization. This is a key feature of the Facility and one that ought to be foremost in the design and identification of sources and uses of financing, given how many funds and institutions experience a shortage of financing.

HIV/AIDS, tuberculosis and malaria are major causes of hunger and poverty in the households they affect. All three are critical factors in the progress and setbacks of the development process. In addition to fighting these diseases directly, UNITAID also aims to improve the functioning of markets for therapeutic drugs in order to lower their cost and raise their quality, not only for the direct beneficiaries but also for the health systems of developing countries in general. From this perspective, it benefits poor and middle-income countries alike.

This innovative source of financing has the following advantages: (i) air passenger transport is an activity that has benefited greatly from globalization; (ii) generally speaking, air travel is a comparatively undertaxed sector (in respect of fuel and VAT, for instance); (iii) the air transport levy is progressive, as air travellers usually belong to the upper-income brackets and are thus quite well placed to share the benefits of their position with the rest of the world; (iv) it is an easy-to-collect national levy, involving negligible bureaucracy in cases where airport fees or ticket taxes are already in force.

The International Finance Facility (IFF) proposed by the United Kingdom opened the way to another pilot programme. In November 2006, the International Finance Facility for Immunisation (IFFIm) was founded under the leadership of the United Kingdom with financial backing from eight countries (Brazil, France, Italy, Norway, South Africa, Spain, Sweden, United Kingdom). IFFIm is to fund child immunization programmes and strengthen health systems in the world's 70 poorest

countries. Future legally binding grants from participating donor countries constitute the financial basis for an IFFIm bond issuance programme that will take place over 10 years.

In February 2007, a pilot advance market commitment (AMC) for pneumococcal vaccines was launched at the instigation of Italy and with financial backing from five countries (Canada, Italy, Norway, Russian Federation and United Kingdom) and the Bill & Melinda Gates Foundation. This AMC aims to accelerate the development of new pneumococcal vaccines, specifically for developing countries, by guaranteeing to subsidize their future purchase, if they are successfully developed.

Several concrete initiatives have been undertaken to develop more accurate data on migrant remittances and promote the sharing of information and best practices to reduce transfer costs. They also aim to "securitize" such remittances, in an effort to foster development by promoting recipient families' access to local financial and banking institutions. Cooperative efforts are being made by migrant communities, local and central governments in origin and destination countries, banks, transfer operators and civil society.<sup>9</sup>

## 2. Two ongoing initiatives

We shall now turn our attention to two specific issues. Progress has been made on both of them in technical design, and both have pro-development attributes, while recent events have given them a renewed urgency.

### (a) *Fighting tax evasion internationally*

Hunger and poverty are also associated with weak tax systems, not least because of tax evasion by means of tax havens. Consequently, efforts to combat tax evasion could become a major source of innovative financing for development. The issue has aroused renewed interest now that a number of emblematic cases have come to light in developed economies. Although evasion and flows of illegally acquired funds are a global concern, they affect developing countries with particular severity because they deprive them of essential resources that could be used to finance public services and investment.

<sup>9</sup> For many developing countries, migrants' remittances became the main source of capital from abroad. Unlike loans, furthermore, which flow out of the recipient country upon repayment, these funds are irreversible once they have been transferred. These financial flows fell substantially, however, when the current crisis began.

The Pilot Group on Solidarity Contributions for Development has established a task force, led by Norway, to develop proposals and plans of action for combating flows of illicit funds. In the more specific field of tax evasion, the Follow-up International Conference on Financing for Development held in Doha to review implementation of the Monterrey Consensus was used as an opportunity to launch an initiative, orchestrated by the Government of Germany with support from Chile, Norway and Uganda, to develop concrete projects in this area and coordinate their work with international organizations and civil society.

It is a matter of serious concern that a large share of the profits from the financial flows and capital gains of globalization are untaxed or undertaxed because of tax avoidance or evasion. Tax havens are one of the means by which this inequity is perpetuated. Tax evasion, furthermore, is bound up with money laundering, corruption and terrorism financing: three pervasive “public bads”.

Tax evasion has an ethical dimension, as it penalizes legitimate, transparent, unsecretive investors who duly pay their taxes, while benefiting those who engage in tax avoidance and other activities funded with money from illegal practices or allowed by tax loopholes or policy failures. Furthermore, tax evasion is very unfair to honest taxpayers. Permissive policies in the face of booming financial flows, together with weak or non-existent oversight, have allowed this flaw in globalization to develop further. It is well known that a substantial portion of the resources which leak out of the tax systems of countries in both North and South are sheltered in tax havens.

Given the weaknesses of tax systems in developing countries, it is essential to strengthen their ability to raise public revenue by adopting measures to prevent evasion perpetrated through tax havens. The United Nations Committee of Experts on International Cooperation in Tax Matters can play an important role here. The Organisation for Economic Co-operation and Development has also been working on the issue of tax evasion and tax havens, though any progress achieved would be limited to its member countries. Collaboration between the two institutions could help in concrete decision-making to combat international tax evasion and improve the tax systems of developing countries.

Effective solutions to this problem require collective measures. There are several initiatives that could be explored, such as a mandate for the United

Nations Committee of Experts on International Cooperation in Tax Matters to address international tax evasion and the preparation of a code of conduct on this issue. A strengthened Committee secretariat would be required, with full political support and the resources needed to develop its technical proposals.

(b) *Countercyclical mechanisms in the world economic slowdown*

The volume of financial flows has grown with remarkable speed in the past couple of decades. The magnitude of purely financial flows overshadows all other international transactions, including official development assistance, greenfield foreign direct investment, trade credit and migrant remittances.

The financial markets are currently experiencing frequent “mood swings” affecting, for example, stock market price expectations and exchange rates, so that funds flowing towards a particular geographical market can suddenly be switched to another. Consequently, a developing economy can move overnight from a situation in which there is an oversupply of foreign currency to one of a severe drought. Such “mood swings” in financial and currency markets are felt very strongly in the real economy, i.e., in output, employment, profits and tax revenues. In fact, recessive macroeconomic disequilibria in emerging economies can strongly affect developing countries, as happened with the East Asian crisis.

Crises triggered by external shocks affect the situation of businesses, which experience sudden falls in the demand for their products. This in turn affects employment: as a result of contagion from the East Asian crisis, for example, the average unemployment rate in Latin America rose by 3 to 4 percentage points from 1997 to 1999-2003. Thus, crises weaken the producers of wealth – businesses and workers – and depress the economy. An output gap usually opens up between potential GDP and actual GDP, implying a drop in actual total factor productivity, permanently foregone GDP and a recessionary dynamic that deters investment in physical and human capital. In other words, the present situation and future prospects deteriorate while development is undermined and, with it, the prospects of attaining the Millennium Development Goals.

The Asian crisis and its far-reaching contagion effects spurred fruitful analytical and empirical work, whose results are reflected in the contents of the documents referred to. In the particular case of

Latin America, it led to recessionary effects lasting all of six years. Between 1998 and 2003, the region's GDP increased by just 1.4% a year, which was less than the rate of population increase. Forfeiting growth in jobs, wages and profits for six years exacted an enormous cost. There could hardly be a more wasteful use of resources than to allocate them to unemployment. To rectify the situation, national macroeconomic policy design and the international architecture need a thorough overhaul.

Action against Hunger and Poverty and the Pilot Group on Solidarity Contributions for Development have developed proposals for strengthening countercyclical mechanisms and financing them through issues of special drawing rights (SDRs) by the International Monetary Fund. The United Nations Committee for Development Policy made convergent proposals in its Report on the Tenth Session (United Nations, 2008a). The analysis that follows is based mainly on the latter.

External shocks, transmitted through the trade and capital accounts, usually have large negative economic and social effects on developing economies. The initial effects on key macroeconomic and social variables can spread to the entire economy in the form of reduced government spending and private investment, lower wages, higher unemployment and thus greater poverty. Installed economic capacity is underused and some resources are foregone for ever. Therefore, economic shocks can impede or delay progress towards the Millennium Development Goals.

There is consequently a need for a development-friendly international financial architecture, including deeply reformed countercyclical official credit facilities for low- and middle-income economies when they are adversely affected by external shocks such as trade and financial crises or by worsening natural disasters associated with climate change.

As studies by the International Monetary Fund and its Independent Evaluation Office report, there is an urgent need to improve existing compensatory financing mechanisms and design new ones where gaps exist. This urgency arises, first, because the global economic outlook for 2008-2009 has turned gloomy and developing countries are likely to be highly vulnerable to a slowdown in developed economies. Second, the need for action has been made even more pressing by large increases in oil and food prices, which have severely affected countries that are net importers of these

commodities and provoked a great deal of social discontent in several countries.

In recent years, some countries have built up large cushions of reserves and fiscal resources as a buffer or "self-insurance" against external shocks. However, high levels of reserves entail large costs, mainly in terms of the opportunity costs of productive investment foregone and direct financial losses stemming from relatively low interest earnings on reserve assets. The depreciation of the United States dollar has further added to the financial costs of holding reserves, as many countries hold them in dollar-denominated assets.

Official compensatory flows can play a crucial role in sparing developing countries the unnecessary costs entailed by holding such high levels of international reserves and, most importantly, in helping them to avoid contractions in economic activity and productive investment that go beyond what is required to restore real macroeconomic equilibria.<sup>10</sup> Economic contractions have been quite frequent and have resulted in underutilization of present potential GDP and the loss of prospective growth. In this regard, improved compensatory flows can potentially be a very effective mechanism for protecting economic growth and the incomes of poorer people in the affected countries, both now and in the near future.

There are currently a number of major compensatory financing mechanisms, but either they are limited in coverage and volume or too narrowly defined, or funding is released too late or is subject to conditionality that is inappropriate given the nature of external shocks.

In view of the worsening global economic outlook, its implications for developing countries and the inadequacy of existing compensatory finance instruments, there is an urgent need for a reformed compensatory financing architecture so that official liquidity and assistance can be provided to developing countries suffering the negative impact

<sup>10</sup> A crucial condition of macroeconomic equilibrium is for potential or installed GDP to be actually used; for this to be sustainable, the "right macro-prices" are needed. It must be stressed that these remarks apply to real economies that are "well-behaved" or have already corrected their main imbalances. Evidently, economies with extremely appreciated exchange rates and large external and fiscal deficits (after duly counting international solidarity revenues) will need to engineer significant drops in aggregate demand and large devaluations. We recall that, recently, for five or six years, several Latin American countries recorded large output gaps (with actual GDP well below potential GDP) and experienced major imbalances in the real macroeconomy during that prolonged period.



of external shocks. To be effective, liquidity must be adequate and have the attributes of “speedy disbursement, scale proportionate to the shock and low conditionality” (United Nations, 2008a).

To finance a significant improvement in the volume and quality of compensatory financing, bearing in mind the arguments in favour of a gradual move towards a global reserve currency, issuance of special drawing rights (SDRs) should be reinstated. A new reform would allow the IMF to use them to finance a significant increase in the availability of compensatory financing. The current prospect of downward adjustments in economic activity and financial turmoil represents an appropriate context for a new allocation of SDRs with a countercyclical

role, with a view to progressing cautiously and gradually towards a true international reserve currency. Furthermore, the allocation of 22 billion SDRs approved by IMF member countries in 1997 and since ratified by 133 of them (but still awaiting ratification by other countries to reach the requisite threshold of 85% of Fund quotas) should be completed without delay.

The existing compensatory financing mechanisms of the IMF should be significantly simplified, as current schemes are too numerous and complex. All compensatory facilities should have the attributes referred to of speedy disbursement, scale fully proportionate to the external shock and low conditionality to maximize the beneficial impact on recipient countries.<sup>11</sup>

## V

### Conclusions

Capital flows have great potential to contribute to economic development. However, the transitory nature of financial transactions and the incomplete state of existing instruments and institutions have helped make financial markets some of the worse-functioning in the whole market economy system. Financial flows tend to exhibit wild swings, spells of excessive optimism or pessimism and prolonged periods of outlying domestic prices and ratios (Rodrik, 1998; Stiglitz, 2000); these have been characteristics of exchange rates, stock and real-estate prices, and interest rates. Consequently, better information, regulation of the financial sector and comprehensive but prudent macroeconomic management of financial flows are desirable public goods. This is why governments have a responsibility for the behaviour of supply (in the case of industrialized countries) and demand (in the case of developing countries), both coordinated where necessary by international organizations. Inaction can carry a heavy cost, as was demonstrated during the debt crisis, the 1994 Mexico crisis, the Asian crisis of 1997 and the prolonged stagnation of the countries of Latin America in 1998-2003 (Ffrench-Davis, 2006, chapter VIII).

Given the growing imbalances produced by globalization, there is a pressing need to restructure the international financial architecture in response to profound shifts in the global economy. As the Report

of the Secretary-General of the United Nations on Follow-up to and Implementation of the Outcome of the International Conference on Financing for Development (United Nations, 2007a) emphasizes, and as the Summary of the High-level Dialogue on Financing for Development presented by the President of the General Assembly (United Nations, 2007b) reaffirms, instability is a pernicious feature of today's system. The voices of developing countries must be heard and serious measures taken to prevent and respond to financial crises (including the proposal for reformed countercyclical mechanisms).

A tougher challenge is actually to generate the right conditions for redirecting potential savings towards development. The following observations need to be made. First, international finance has generally become undertaxed at the expense of the real economy, which is forced to cover the revenue shortfall or lack of public investment for productive development. This is particularly prejudicial to less mobile factors of production (small businesses

<sup>11</sup> In late 2008 the IMF approved a new mechanism similar to the one proposed in detail by Action against Hunger and Poverty at least since January 2007. This is the Short-Term Liquidity Facility (SLF). The arrival of the new Managing Director, Dominique Strauss-Kahn, has brought a welcome shift towards pragmatism and away from the extreme neoliberalism of earlier years.

and low-skilled labour). The currency transaction tax could improve financial equity and generate substantial resources to stimulate growth with equity (Williamson, 2006). Second, the fashionable approaches favouring across-the-board opening of the capital accounts exhibit a strong bias towards high-income producers, but also towards short-termist speculative agents. The latter are the new rent-seeking actors. As the Report of the Secretary-General quoted earlier points out, there is a need to reform rules and institutions so that financing can be redirected to sectors that are usually excluded, such as small and medium-sized enterprises and micro producers. Third, there is growing evidence that

greenfield foreign direct investment flows contribute to productive investment and foster development while, conversely, short-term financial flows exhibit a weak link with capital formation during booms, are a common source of busts and act as a deterrent to productive investment. In the present financial turmoil, the call by the Monterrey Consensus and the Report of the United Nations Secretary-General for greater stability in financial flows is more relevant than ever.

A development-friendly reform of the financial system is unquestionably needed, as today's architecture is far from meeting that description.

(Original: Spanish)

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**KEYWORDS**

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# Globalization and the new international trade environment

*Oswaldo Rosales V.*

**T**he combination of profound technological change and the emergence of powerful competitors such as China and the other BRIC countries has led to dramatic shifts in competitiveness and a tendency for production to be structured around global value chains. Against this background, traditional protectionist threats have reappeared and others have arisen in connection with new security requirements, private-sector quality standards, good practices and climate change. These issues are integral to the new competitive environment but could turn into protectionist barriers in the absence of the right multilateral approach. In view of this and of the current global crisis, the present paper offers some policy proposals oriented towards the adoption of an internationalization strategy in the region's countries, emphasizing the importance of innovation and on issues that can be addressed from a regional cooperation standpoint.

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# I

## Introduction

Over the past three decades, the international economy has been undergoing a rapid transition characterized by the advance of globalization, intense technological change and the rise of major new competitors such as China, India and the Asia-Pacific region in general. The implications of these three developments are manifold and complex. They include, for example, dramatic changes in the global map of trade and competitive advantage and the emergence of new winners and losers among economic areas, countries, production sectors and firms. The scale of these changes could even lead to some adjustments in the “centre-periphery” view of the world since, at least in its less refined versions, this does not accommodate the growing presence of competitive developing countries that are increasingly making their presence felt in dynamic segments of the global economy and acting as drivers of technological change.

The slowdown in global economic growth observed so far would have been worse had it not been for the dynamism of major emerging markets such as those in the so-called BRIC group comprising Brazil, the Russian Federation, India and China, at least up to the first half of 2008. These countries and emerging economies generally are now accounting for the bulk of world gross domestic product (GDP) growth and a substantial share of international trade. The BRIC countries are also gaining importance in the financial sphere, as they are playing an increasingly important role in sustaining global economic equilibria. Any hint as to what they (and particularly China) might do with their enormous reserves has immediate repercussions on global financial markets. Again, to be sustainable in the long run, any solution to the crisis would have to attribute a greater role to the BRIC countries and emerging economies in the system of international financial governance.

One of the most striking features of globalization is that financial flows are far larger and moving faster than real flows in the economy. This marked disparity, however, distracts attention from the equally spectacular changes taking place in global production and trade, which are critical to growth prospects in the coming years. It is on these changes that this article will focus. The severe repercussions of the

current global financial crisis do not invalidate these issues. The greatest damage to Latin America and the Caribbean from this crisis would come if the region were to repeat the mistakes of adjustment policies in the 1980s by unnecessarily undermining growth and employment and, most critically, by sacrificing investment in infrastructure, education and innovation. These costs explain the widening of the gap between the region and the Asia-Pacific economies.

Despite the scale of the changes in the global economy, which have coincided with a strong expansion (2003-2007), the dangers of traditional protectionism—export subsidies and direct domestic support in agriculture, and antidumping arrangements, to name some of the most important—have yet to be avoided, while the uncertainty associated with the new international situation is hindering progress with multilateral trade negotiations and creating scope for the application of new types of protectionist measures. If the global economy contracts in 2009 and 2010, it is not only the Doha Round that will be affected. In the context of an economic slowdown and credit crunch in the industrialized economies, the competitive challenges posed by emerging economies may trigger pressures for renewed forms of protectionism. There are new issues on the global agenda such as trade security, the links between trade, climate change and the environment and some competitiveness-related aspects such as certification of quality or good production practices which, if wrongly handled, could deepen these tendencies, particularly affecting exports of natural resources and natural resource-based manufactures.

The growing importance of innovation and the expectation of a less dynamic international environment highlight the need to apply internationalization policies which focus on increasing the knowledge incorporated into exports and encouraging international alliances, the creation of international trade networks, a greater presence in global value chains, investment abroad, support for small and medium-sized enterprises (SMEs) that emphasizes access to the intangible aspects of the new competitiveness and, in short, a more determined effort to train human resources that is commensurate with the intensity of the technological change we are experiencing.

## II

### Uncertainty in the multilateral trade environment

To address the new global challenges, there is a pressing need to modify the institutional structure and mode of action of the World Trade Organization (WTO). First, though, the Doha Round needs to be completed, not least because there would be less scope for significant WTO reform if it were to fail.

#### 1. The need to complete the Doha Round

Given the seriousness of the international situation resulting from the subprime crisis, there have been suggestions that the Doha Development Round should be postponed until a more propitious time. This would be the worst possible course of action. On the contrary, precisely because the crisis is so severe, negotiations need to be concluded as soon as possible, ensuring that the results are balanced and meet the declared goal of contributing to development. The need to complete the Doha Round becomes more urgent as the outlook for the world economy and trade in 2009 and 2010 deteriorates.

Awaiting better times before resuming the Doha Round negotiations would be particularly ill-advised for at least two reasons. First, because the process has coincided with the most favourable cycle in the world economy for the past 40 years (2003-2007), and yet no significant progress has been made in that period. Second, because the message sent out by suspending negotiations specifically with a view to resuming them only under better economic conditions would worsen the prospects for the world economy yet further by opening the way not only to measures that directly blocked trade but also to others that, under the pretext of supporting the sectors affected by the crisis, would lead to new sectoral disputes that would overload the WTO dispute resolution system without allowing it to make progress with trade negotiations. This would be undesirable for the Organization, distracting it from the agreements process and forcing it to focus on conflicts.

The current international economic crisis, the worst in almost 80 years, poses a serious challenge to recent progress on trade liberalization, particularly because the two driving forces of globalization — trade and

capital flows— will be depressed in 2009 and part of 2010. The threat of protectionism is a challenge for the immediate future. In a scenario of simultaneous economic contraction in the United States, the European Union (EU) and Japan, with rising unemployment and tightening credit, the political authorities will find the pressure for subsidies and trade barriers difficult to resist. The debate on the enormous bailout for the United States automobile industry illustrates these dangers. If other trading partners went down the same route, competitiveness would no longer be about quality and low costs but about the budgetary capacity of governments. Sectoral bailouts of this kind could damage international trade, since the entire global manufacturing sector is suffering from a drastic downturn in demand but special financial support programmes favour only certain segments of it. In a context of continuing weakness in global demand, support programmes could give rise to artificial competitive advantages derived exclusively from various forms of fiscal support.

The protectionist danger does not lie only in measures that could infringe WTO commitments. After two decades of unilateral cuts, applied tariffs are well below consolidated ceilings agreed at the WTO. Indeed, countries could double tariffs without violating those commitments, which would lead to an 8% decline in international trade (*The Economist*, 2008a). This is precisely what it would take for the current crisis to turn into a depression of historic proportions. If we have learnt anything from the depression of the 1930s it is that procyclical policies and protectionism served to make the problem worse and more protracted. The debate seems to have been going the right way so far, as was demonstrated at the Group of Twenty (G-20) meeting held in Washington, D.C. in November 2008. However, if we examine the extent to which the three main commitments have been complied with so far, there is little room for optimism.<sup>1</sup>

<sup>1</sup> Up until now, none of the 20 economies has met the commitment to apply a countercyclical fiscal policy and a programme of extra spending equivalent to up to 2% of GDP; the commitment to complete the Doha Round in 2008 failed, while the agreement

## 2. Reforming the World Trade Organization

The main WTO reforms discussed are the following:

(i) dealing with the erosion of basic non-discrimination principles (most-favoured-nation treatment and national treatment) that has resulted from the proliferation of preferential trade pacts and free-trade agreements, (ii) improving special and differential treatment for developing countries, particularly the least developed, (iii) improving coordination between the WTO and multilateral financing agencies so that trade reforms are accompanied by financial assistance to developing countries, (iv) creating institutional mechanisms that allow decisions to be taken more quickly and efficiently and (v) strengthening the ties between the WTO and civil society organizations (WTO, 2004).

### (a) *Preserving non-discrimination*

One of the most striking features of today's international economy is the proliferation of bilateral or plurilateral free-trade agreements whose benefits, by definition, are confined to their signatories. They run counter to the principles of non-discrimination established by virtue of both most-favoured-nation treatment, which obliges WTO members to give similar treatment to all trading partners, and national treatment, which requires them to give these partners the same treatment as local economic actors in certain respects. Agreements of this type have been made possible by article XXIV of the General Agreement on Tariffs and Trade (GATT), which permitted customs unions and free-trade agreements to exist subject to certain conditions.<sup>2</sup> Hitherto, these conditions have been interpreted vaguely and countries have not shown any particular enthusiasm for defining them more precisely to ascertain how far the web of preferential agreements is compatible with GATT (now WTO) requirements.

Because of this proliferation of free-trade agreements, the world is moving towards a situation in which most-favoured-nation treatment, from being the norm two decades ago, is now becoming the exception.

If this comes about, the World Trade Organization will be severely weakened, as the bulk of trade flows will be governed by disciplines that, while similar to those of the WTO, do not come under its authority. Countries signing agreements of this type must notify them to the WTO, but this is a formality and the Organization does not have effective mechanisms for evaluating their internal effects and their repercussions on other partners.<sup>3</sup> From this point of view, the more attractive option could be to start examining the possibility of improving links between the different agreements so that they become building blocks for free trade and not stumbling blocks, i.e., using preferential agreements to move towards the multilateralization of commitments and prevent them from turning into fortresses that block trade with non-members.

### (b) *Improving special and differential treatment provisions*

Traditional mechanisms have consisted, first, in giving the least-developed developing countries more time to meet their commitments and, second, in allowing a significant range of their products to enter the markets of the main countries or groupings completely or partially tariff-free. The analysis by the group of experts convened by the WTO concluded that these provisions were inadequate and, in some cases, actually counterproductive. It was judged that the Generalized System of Preferences (GSP) applied, for example, by the United States and EU to exports from developing countries is ultimately ineffective for the following reasons: (i) because the benefits are concessionary and not binding, they are unstable and do not provide a basis for long-term investment planning, (ii) preferences are sometimes tied to obligations unrelated to trade, (iii) most benefits tend to go to the provider of the concessions, something that can be deduced from the number of products included and the margins of preference granted, (iv) benefits tend to have a low ceiling, with preferences being altered arbitrarily as the product involved becomes more competitive, and (v) there is a tendency

to refrain from imposing new trade barriers for 12 months has already been broken by several of the governments participating in the summit.

<sup>2</sup> The conditions are basically as follows: (i) that the creation of these groupings does not result in more restrictive tariff barriers or trade regulations either between the members of a particular customs union or free-trade area or between them and non-member countries and (ii) that the trade agreements deriving from these customs unions or free-trade areas serve to remove the main obstacles to trade between the signatory countries.

<sup>3</sup> It has been suggested that this aspect should be incorporated into the Trade Policy Review Mechanism to give the WTO greater powers to evaluate the real contribution of free-trade agreements to the liberalization of trade flows. However, this would mean screening the entire trade agenda, old issues as well as new, as this would be the only way to reduce the incentive to sign agreements of this type. But this is highly unlikely and everything suggests that the trend towards free-trade agreements will continue over the coming years.

for beneficiary countries to become over-reliant on these preferences and slacken their efforts to diversify exports (WTO, 2004).

There is scope, then, to recast the concept of special and differential treatment by linking it more closely to the issues of trade assistance and facilitation and by providing developing countries with the resources they need to improve and expand their infrastructure, their exportable product baskets, their education systems and their worker training, as well as groupings of SMEs and their access to credit and new technology. This requires a closer and more functional relationship between the WTO and multilateral financing agencies such as the World Bank and regional banks so that resources can be made available to buttress trade reforms with the infrastructure, human resources and technology needed to complement them. Trade agreements, discriminatory or not, only generate opportunities for higher demand if the necessary exporting capacity is available. This need to expand and diversify the range of exportable products is even greater in the least-developed developing countries. In the renewal of special and differential treatment, in short, the emphasis should be shifted from export demand to export supply.

(c) *Improving the workings of the WTO*

Another subject for debate is the decision-making procedure of the World Trade Organization, as decisions are taken by consensus and not by vote. Each of these methods has pros and cons,<sup>4</sup> but what is being discussed now is the need to make mechanisms more responsive and ministerial meetings more efficient, and to strengthen high-level political participation. Consideration has been given to forms of “variable geometry” that would allow commitments to apply only to those who originally supported them, but with room for multilateralization as new partners sign up.

Other concerns include making progress with transparency rules and improving links with civil society organizations by publicizing WTO functions and activities more vigorously and providing training and technical assistance on trade rules to governments, academia, employers’ organizations and the media. The dispute resolution mechanism—one of the Organization’s most highly regarded—is among the few multilateral forums in which the complaints of developing countries have not only been heard, but in many cases have led to changes in the industrialized-country policies they challenged.<sup>5</sup>

The main contribution of the WTO to a stronger world economy consists in a set of trade disciplines ensuring that predictable ground rules are applied and preventing backsliding at times of crisis or economic contraction or slowdown like the present. In the absence of initiatives to restart the Doha Round, greater efforts should be made to identify and publicize the trade implications of the financial crisis by recording the protectionist measures being taken by the Organization’s members, irrespective of whether they comply with current rules. These efforts should also document the amount of resources involved and the costs the measures represent for developing countries. Much the same could be done for the cost of protectionist measures applied by these same countries and their distributive effects, whose main victims are usually lower-income groups. This awareness-raising effort would alert the international community to trade developments and help WTO members appreciate the need to resume the Doha Round negotiations.

<sup>4</sup> See WTO (2004) for a more detailed discussion.

<sup>5</sup> An overview of WTO disputes can be obtained by consulting the Integrated Database of Trade Disputes for Latin America and the Caribbean (IDATD) prepared by the ECLAC Division of International Trade and Integration [online] <http://badicc.eclac.cl> or <http://www.cepal.org/comercio>, both of which contain links to English versions.



### III

## The new protectionist threats in the twenty-first century

The acceleration of technological change and its repercussions for the competitive hierarchy of firms, conglomerates and nations is tending to manifest itself in the appearance of new trade issues affecting competitiveness, although many of them have yet to be addressed in multilateral trade rules.

The rules on trade security brought in unilaterally by certain countries, or recommended by multilateral organizations such as the World Customs Organization (WCO), have created strong pressures for institutional and operational improvements throughout the chain of trade activities. In this context, private-sector rules have been developed whose application is voluntary but which can affect countries' competitiveness. They include good practices in agriculture, safety certification, the rules of the International Organization for Standardization (ISO) and quality certification. The influence of environmentalist and consumer movements has also grown, particularly in Europe, and this has had indirect consequences for international trade by increasing requirements for the safety and "traceability" of food products in industrialized-country markets. Lastly, mention should be made of the environmental and climatic effects of economic and international trade growth.

The multilateral trading system has by no means kept up with the speed of technological change or with unilateral initiatives backed largely by the new system of business actors from the private sector whose influence on trade issues is often greater than that of industrialized-country governments themselves. This interaction of technological and business developments with new trade issues and institutions is complex, combining requirements arising from technological progress, such as quality certification, and business models based on technological change that set out to limit competition and protect private-sector activities, such as certification requirements associated with specific laboratories and firms.

The boundaries between technological progress, new issues, the creation of new agencies and institutions and protectionism are blurred and can easily be overstepped, particularly if developing countries do

not have the technical capacity to distinguish changes inherent in technological change or new modalities of trade (like global value chains), to which they need to adjust, from what are merely novel ways of transacting private-sector business that may hinder competition or encourage protectionism.

#### 1. Security in international trade

Following the attacks of 11 September 2001, security rules gained importance in international relations and began to affect trade regulations owing, in particular, to the need to prevent the global supply chain from being used for terrorist purposes. This led to the creation of the Customs-Trade Partnership Against Terrorism (C-TPAT) in the United States (2002), the Authorized Economic Operator (AEO) programme of the World Customs Organization (2005) and the Partners in Protection programme of Canada, all designed to secure supply channels.<sup>6</sup> The new trade security programmes take in not just products themselves but also the proper handling and traceability of cargo right along the supply chain, on the basis that "the security of a transport chain depends upon its weakest link" (Commission of the European Communities, 2003).

Complying with the new requirements brings new costs; furthermore, they depend on the situation of the firm and the level of certification demanded.<sup>7</sup> These measures may adversely affect small and medium-sized producers, since if they are not able to comply with the requirements of these programmes they risk losing markets as they cease to be competitive relative to firms which do comply, whose goods enter not only more rapidly but with stronger security guarantees. Thus, products no longer compete just

<sup>6</sup> See ECLAC (2008a, chapter III) for a more detailed account of these initiatives.

<sup>7</sup> This encompasses, for example, physical security measures at the firm, cargo protection, staff security procedures, staff identification and monitoring systems and electronic communication and database systems.

on quality and price but also on security, a variable whose importance for access to more sophisticated markets could increase further.

## 2. Private-sector rules on food quality and safety

There is growing concern about food safety and the possibility of accidental contamination. One consequence of the globalization of agrifood chains is that they have started to include production links which operate under different national institutional standards, including the quality of sanitary and phytosanitary regulation, cross-border protection and even the efficiency and honesty of officials. Although food safety has improved greatly in recent decades, progress at the individual country level has been uneven, so that there are still major outbreaks of disease transmitted by foods which have been contaminated with micro-organisms, chemicals or toxins. Thus, the cross-border trade in contaminated foods may be contributing to the spread of such outbreaks (WHO, 2007).

Voluntary quality standards have increased both in quantity and in strictness, with a view to ensuring product safety and corporate commitment to protection of the environment and employment rights, among other things. Several public and private institutions that oversee safety and sustainability are promoting concepts and programmes of good practice in agriculture and manufacturing, together with different actors in the agrifood chain.<sup>8</sup>

In addition, in recent years multiple organizations have emerged to promote the concept of “fair trade” and private certification, i.e., the granting of labels guaranteeing that a particular product has been produced in accordance with their standards. There are currently 20 certified fair trade initiatives, most of them in Europe and North America, whose objective is to regulate the use of product certification labelling.<sup>9</sup>

<sup>8</sup> “Good agricultural practices” are the measures applied in the production, processing and transportation of agricultural products to ensure product safety and protection for the environment and workers.

<sup>9</sup> These initiatives are members of Fairtrade Labelling Organizations International (FLO), an association that provides direct support to certified producers by defining the parameters of what is deemed “fair trade”. Working on the basis of ISO standards for certification bodies, FLO inspects and certifies some 500 producers’ organizations in over 50 countries of Africa, Asia and Latin America.

To participate in global value chains, it is of course necessary to meet international quality standards. Complying with the relevant voluntary private standards can facilitate access to the more profitable segments of these chains. Sometimes, however, the concept of “fair trade” may turn into protectionism, particularly when the aim is to impose specific business practices from industrialized economies, even though they may be no better than those in developing countries. Another unfair trading practice, which is not emphasized enough, is the agricultural protectionism in industrialized economies. In other cases, quality certification itself can become an attractive business and relax its original focus on upholding quality standards throughout the value chain. The proliferation of private standards and the growing market demand for them, particularly in the food sector, is forcing exporters to turn to a quality certification market that is lacking in transparency, has considerable barriers to entry and suffers from certain conflicts of interest between these agencies and the leading producers in the central economies. This being so, it is worrisome that what were originally private, voluntary standards originating in major global consortia are tending to become predominant in international markets, whether because of gradual de facto multilateralization, their great influence in key markets or the oligopolistic nature of certification agencies.

In some cases, governments wholly or partly adopt private-sector quality requirements and pursue standardization, which means that, in practice, these requirements can become compulsory. In this way, the agricultural sector, and exporters in particular, are forced to adapt to many requirements of both a public and a private character (Salles de Almeida, 2008).<sup>10</sup>

## 3. The trade effects of private standards

The adoption of private standards (in addition to compulsory official norms) is both a challenge and an opportunity for the region’s countries, as compliance with these may become a de facto prerequisite for exporting agricultural products to markets that are more environmentally aware and increasingly demanding about quality. Even though compliance with rules may create greater opportunities to access stringent

<sup>10</sup> Among the most important are ISO rules on organic production, safety, good practice, denomination of origin and geographical descriptions.

markets, they may also act as trade barriers because of the costs they represent, especially for developing-country suppliers. They could also be protectionist if their requirements exceed those established in the WTO Agreement on the Application of Sanitary and Phytosanitary Measures (SPS Agreement). By and large, agricultural exporters in developing countries are uncomfortable with the proliferation of private standards. In this area, the WTO distinguishes between concerns about content and concerns about compliance (see table 1).

The main concerns raised at the WTO relate to the relationship between private-sector organizations and international standards organizations (private standards are generally stricter than international ones), certain unnecessary trade restrictions imposed by private-sector norms (especially for small farmers), the measures governments could adopt to ensure that private-sector organizations comply with the SPS Agreement, and their relationship with other areas of WTO work, such as technical barriers to trade. Another concern is the lack of transparency of private standards, as they are not notified to the WTO.

With regard to good agricultural practices, developing countries face three major challenges: (i) ensuring that the interests of small producers are considered in standards relating to both product safety and the sustainability of domestic production, since excessively strict requirements could drive out small producers, (ii) ensuring that producers are not overloaded with practices and norms which, while not legally binding, in practice condition market access, and (iii) monitoring their effects on production,

certification and marketing costs, particularly for smaller producers.

#### 4. The implications of climate change for the trading system

Climate change will be one of the main challenges facing the international community over the coming years. The trading system is a source of tension, given potential conflicts between climate change and the basic principles of international trade: non-discrimination, removal of quantitative restrictions, and non-arbitrary discrimination. Governments have begun to draw up specific legislation to comply with international obligations in this area, particularly those deriving from the Kyoto Protocol. If this legislation fails to take basic WTO principles into account, members will probably try to settle their differences through the dispute settlement mechanism, which will increase the cost of cooperation and intensify opposition to the workings of the multilateral system based on WTO rules (Hufbauer, 2008).

Different initiatives have arisen in the developed countries to deal with the link between climate change and trade by implementing “offsetting border measures” (Brewer, 2007). In 2007 and 2008, different legislative proposals were discussed in the European Union and the United States to address these issues. The initiatives range from the possible application of tariff surcharges varying by the contribution of each product’s entire supply chain to the “greenhouse effect” (or its equivalent, the requirement to purchase international emissions permits) to new areas for “green”

TABLE 1

**Concerns about the application of private sanitary and phytosanitary standards**

Content-related	Compliance-related
Multiplication of private standards systems within and between markets.	Cost of third-party certification, particularly for small and medium-sized enterprises and farmers in developing countries.
Unclear boundary between official and private sanitary and phytosanitary standards.	Requirement of some private systems that only designated certification bodies be used.
Relationship between private systems and the international standardization institutions mentioned in the Agreement on the Application of Sanitary and Phytosanitary Measures.	Lack of equivalence between systems, so that certification audits have to be repeated.
Scientific justification for certain prescriptions relating to production processes and methods.	Non-recognition of certificates issued or lack of accredited certification bodies in developing countries.

Source: World Trade Organization (WTO), *Private Standards and the SPS Agreement* (G/SPS/GEN/746), Committee on Sanitary and Phytosanitary Measures, Geneva, 24 January 2007.

subsidies, trade defence mechanisms (safeguards and antidumping) or even a “level playing field” for emissions requirements. If they lead to measures to keep local industries competitive with imports, these proposals could severely affect international trade.<sup>11</sup>

A review of the initiatives mentioned reveals an interesting paradox. The proposals of the United States, a country that has not signed up to the Kyoto Protocol, are not only unilateral but tend to be considerably stricter than those of the European Union, which focus mainly on environmental subsidies and adaptation of the WTO regulatory framework to the challenges of climate change. If the region is not adequately prepared for this debate and any negotiations that ensue, it could find once again that it has arrived too late and that after a few years it is having to adjust to global standards that take no account of its interests, involving energy and environmental standards that may constrain its competitiveness.

##### **5. A space for regional cooperation**

The international agenda requires greater cooperation between countries in Latin America and the Caribbean to improve their position in the global economy. This not only means agreeing on regional mechanisms to mitigate the effects of the international financial crisis, but also requires them to address the challenges of competitiveness and innovation, which will certainly have a greater medium- and long-term impact on the living conditions of most people in Latin America and the Caribbean (ECLAC, 2008b).

The issues considered above, namely security, best practices, private quality standards and climate change may be diverted into protectionist channels. This is why Latin America and the Caribbean should address these aspects in regional forums and take steps to increase technical and institutional preparedness so

that countries can adopt common positions on matters of growing importance to international trade.

Trade security is a good area in which to coordinate the region's trade facilitation and assistance efforts by establishing synergies between governments and employers' organizations in the region and by sharing information both on outside markets and on the steps being taken in each country, so that positions can be coordinated. For example, mutual recognition agreements with leading trade partners could be approached in a more coordinated fashion, since if the region succeeded in reaching common standards and finalizing a set of internal agreements on the matter it could improve its negotiating position vis-à-vis its main partners while at the same time boosting intraregional trade.

The region's governments could also share information on the main restrictions facing their products in industrialized markets owing to the application of private standards that ultimately affect competitiveness. This could facilitate joint negotiations with governments or private-sector groupings in those countries or to subregional trade facilitation projects making it possible to adapt to the main trends in the international scene.

In this context, regional integration is urgently needed. In addition to the traditional arguments for it, the requirements imposed by the current phase of globalization have created new needs for strategic international partnerships in the fields of production planning, logistics, marketing, innovation and technology. The standards of competitiveness and technological innovation are rising, while the rapid development of China, India and other Asian countries is radically redrawing the global trade map both for goods and services and for capital and comparative advantage. Larger markets, legal certainty, compatible standards and connectivity are now indispensable for growth with equity. In short, convergence between integration schemes is crucial to a renewed open regionalism in Latin America and the Caribbean (ECLAC, 1992, 1994, 2006a, 2006b and 2008a).

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<sup>11</sup> See ECLAC (2008a, chapter III) for a review of these proposals.

## IV

### The emergence of new competitors: the BRICS

One of the most striking features of the global economy in the first decade of the twenty-first century is the consolidated presence of a number of developing economies among the leading players on the international stage. The most interesting phenomenon has undoubtedly been the emergence of China as a global actor and of Asia as the continent that has attained the highest growth rate in human history. The situation is best described by Larry Summers in the introduction to Mahbubani's excellent book charting the shift of power towards Asia.<sup>12</sup>

#### 1. The importance of China in the global economy

The economic expansion of China has been spectacular: in 1980-2008 the country grew at an average annual rate of 9.9%, much higher than the 2.8% achieved by Latin America and the Caribbean. In consequence, China ranks second behind the United States in total GDP measured at purchasing power parity and third behind the United States and Japan in nominal dollar terms. Every important international indicator captures the growing presence of China in global

aggregates. This has created a new configuration in which the production chains of the Asia-Pacific region are organized around China. The country is actively strengthening its trade links with Africa and Latin America and the Caribbean. The Asian economies hold 60% of the world's international reserves and 53% of United States Treasury securities, and their large current-account surpluses contribute to the stability of the global economy. They are at the heart of a prospering South-South trading system that accounts for 41% of all developing-country trade (ECLAC, 2008c).

Changes in global export rankings reveal the extraordinary competitive leap made by China, which rose from eleventh place in 1995 to second in 2007 (and first in 2008, according to unconfirmed figures). Exports of manufactures and services rose at similar rates (see table 2).

The emergence of China as a global player has been boosted by its ability to forge alliances with other emerging economies in the areas both of trade (the G-20 group of agricultural developing countries organized by Brazil at the Doha Round) and of finance (it has been invited to the other G-20, which should create the template for reform of the international financial system). All this was made more widely known by a Goldman Sachs (2003) study that introduced the concept of the BRIC countries.<sup>13</sup>

<sup>12</sup> The Industrial Revolution was so called because, for the first time in human history, living standards improved fast enough for the change – amounting perhaps to 50% – to be observable in the span of a single lifetime. At current growth rates, Asian living standards could rise 100-fold, or 10,000%, in a lifetime. The emergence of Asia and everything that is coming will feature prominently in the history books written in 300 years' time, pushing the cold war and the rise of Islam into the background (Mahbubani, 2008, p. 10).

<sup>13</sup> These countries account for 43% of the global population, 27% of global GDP, 11% of world goods and services exports and 16% of global foreign direct investment flows (Fitzgerald, 2007).

TABLE 2

**Selected countries: changes in global export rankings**  
(Positions in the ranking)

	Goods and services		Goods		Manufactures		Services	
	1995	2007	1995	2007	1995	2006	1995	2007
United States	1	1	1	3	1	3	1	1
China	11	3	9	2	9	2	8	5
Germany	2	2	2	1	2	1	3	3
Japan	3	4	3	4	3	4	5	6

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official World Trade Organization (WTO) figures.

The remarkable expansion of China is well known, but what is interesting about the study is the information it provides on developments in the other BRICs, forecasting not only that by 2043 the GDP of China would surpass that of the United States, but also that by 2040 the countries of the European Union would have dropped out of the group of the world's leading industrialized economies (G-8), being displaced by China, India and Brazil (see table 3).

TABLE 3

**Ranking of the world's leading economies, 2000-2040**

(Ranked by GDP)

	2000	2020	2030	2040
1	U. States	U. States	U. States	U. States
2	Japan	China	China	China
3	Germany	Japan	Japan	India
4	U. Kingdom	Germany	India	Japan
5	France	U. Kingdom	Russian Fed.	Russian Fed.
6	Italy	India	Germany	Brazil

Source: prepared by the author on the basis of information from Goldman Sachs (2003), "Dreaming with BRICs: the path to 2050", *Global Economics Paper*, No. 99, New York, October 2003.

Over 40% of the strong expansion of the global economy in the 2003-2007 cycle was due to growth in the BRICs, a figure that could rise to 70% in 2009 given the recession in the central economies. Indeed, it was due to the dynamism of the emerging economies —of which the BRICs are leading members— that the world economy was not in recession in 2008. The BRIC economies were responsible for the greatest investment boom in history<sup>14</sup> and thus for the rise in energy and commodity prices experienced up to September 2008, before Lehman Brothers went bankrupt and the subprime crisis unfolded into a global financial crisis.

The export presence of the BRICs rose from 7% of global goods exports and 3% of services exports a decade ago to 13% and 8%, respectively, in 2006 (see

figures 1 and 2). In 2007, the BRIC countries held 38% of all international reserves (see figure 3), while China (21.3%), the Russian Federation, Saudi Arabia, Kuwait, the United Arab Emirates and Singapore generated almost 40% of global savings (see figure 4), half of which were used to finance dissaving in the United States. These figures indicate not only the scale of the issues that need to be addressed when reforming the international financial system but also the fact that, to be sustainable in the long run, any solution will have to give a greater say on global financial governance to the BRICs and emerging economies (Rosales, 2008).

## 2. The BRICs and the centre-periphery concept in the early twenty-first century

According to this widely accepted concept, the global economy is made up of two great groupings that interact with each other: the centre and the periphery. Their production structures are dissimilar, being heterogeneous and specialized in the periphery and homogeneous and diversified in the centre. These differences determine the nature of trade and technology transfers in the global economy. In the long run, the argument goes, the economic evolution of each system causes the periphery to fall further behind in terms of production and technology, while its terms of trade deteriorate (Rodríguez, 1980).<sup>15</sup>

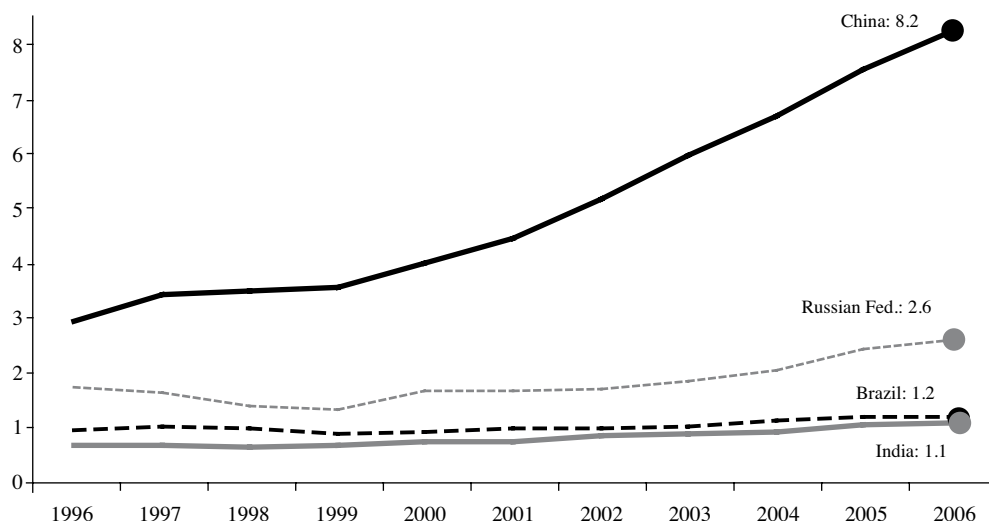
However compelling this may be as a holistic interpretation, it is clear that the "centre-periphery" concept does not capture the realities of international trade today. For one thing, the experience of China and a number of Asian economies has shown that convergence with the income levels of the central economies, while slow, is possible. However, it could be argued that this convergence has been possible precisely because these economies challenged the primary-export pattern, venturing into the export of manufactures and

<sup>14</sup> In the last three years, about half the world's infrastructure investment is estimated to have taken place in emerging economies, which have allocated 6% of GDP to investments in roads, electricity, railways and telecommunications. This rate of investment relative to output is more than double that of the industrialized nations. It is calculated that, in real terms, China has invested more in five years than it did in the whole of the twentieth century (*The Economist*, 2008b).

<sup>15</sup> The argument is that the large capital goods-producing sectors in the central countries give them access to technological progress, and the advantages of this spread throughout their economies thanks to their more integrated societies and more powerful unions. In the periphery, on the other hand, new technologies are basically imported because capital goods production is marginal if not non-existent and is confined to the export sector, which in turn is restricted to the primary sector. Thus, excess labour keeps wages low, preventing the periphery from retaining the fruits of its limited technical progress. In this way, higher productivity in the primary-export sector ends up being transferred to the centre because of the worsening terms of trade.

FIGURE 1

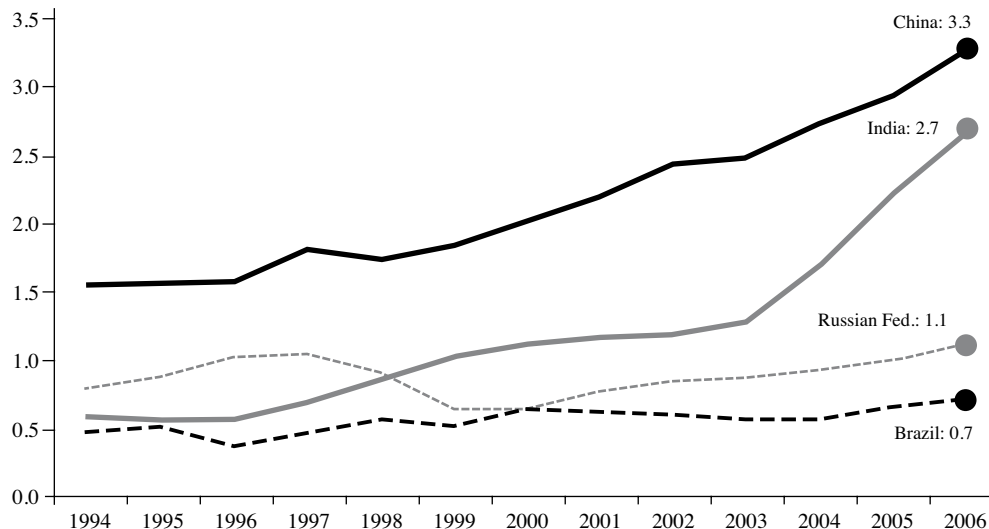
**BRIC countries: share of world goods exports**  
(Percentages)



Source: Commodity Trade Database (COMTRADE).

FIGURE 2

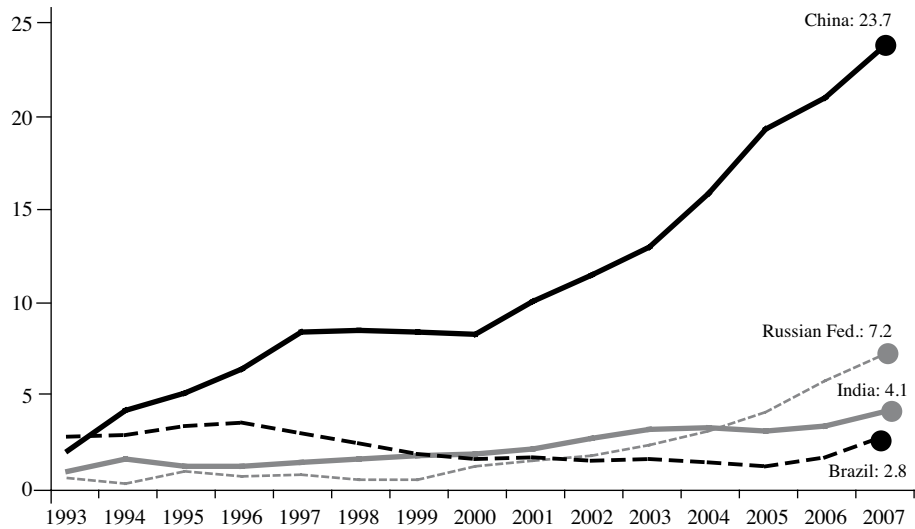
**BRIC countries: share of world services exports**  
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of data from the Organisation for Economic Co-operation and Development (OECD).

FIGURE 3

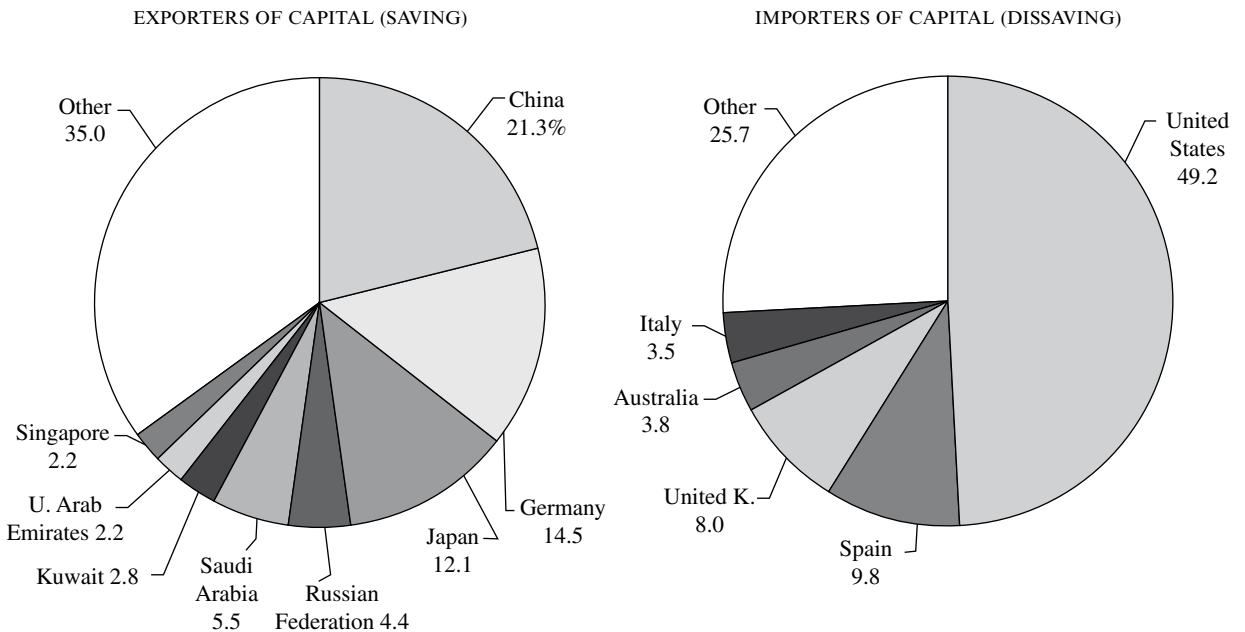
**BRIC countries: international reserves**  
(Percentages of the world total)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of data from the International Monetary Fund (IMF).

FIGURE 4

**Structure of global saving, 2007**  
(Percentages of the total<sup>a</sup>)



Source: International Monetary Fund (imf), World Economic Outlook Database, October 2008.

<sup>a</sup> Measured by the countries' balance-of-payments current-account balance.



gradually increasing their technology content. Indeed, the “peripheral” economies have shown themselves able to draw closer to the technology frontier in a variety of areas as they have come to play an important role in the global economy as exporters of manufactures, services or particular technologies.

If the above argument is accepted, then a first step would be to incorporate into the analysis the fact that there are two subgroups in the periphery, a traditional one and an innovative one, capable of competing successfully in the global arena of the knowledge economy. The next thing would be to

consider what forms the links between the two periphery subgroups might take, i.e., whether it is possible that intra-periphery relations might also be marginalizing for economies on the periphery that have not yet migrated away from natural resource exports. This theoretical concern is of great importance at a time when economic and trade ties between China and Latin America are intensifying (Rosales and Kuwayama, 2007), when South-South trade has become the engine of the global economy and when the growth prospects of the Chinese economy are increasingly important for many Latin American economies.<sup>16</sup>

## V

### Towards an internationalization strategy

The global economic context at the end of the first decade of the twenty-first century is characterized by rapid technological change, the emergence of aggressive new global competitors and the marked changes in competitiveness and protectionist threats that have ensued. The sectors most reliant on natural resources or low-skilled labour will be increasingly exposed to traditional and renewed forms of protectionism, and this will have a significant effect on production and external trade activities. The countries that are quickest to grasp this situation and apply the right policies to adapt will be better placed to participate successfully in the international economy.<sup>17</sup>

#### 1. The global context

Over the coming years, we shall see an acceleration of scientific innovation and technological change, driven by progress in computing, information and communication technologies, biotechnology, nanotechnologies and neurosciences or cognitive sciences (Kelly, 2005). The conjunction of increased computer processing capacity, faster and more efficient broadband, the

development of satellite technologies and the Global Positioning System (GPS), wireless technologies, better heat, torsion, vibration and tension sensors in the field of robotics, new materials and brain sciences has actually led to the emergence of new fields of knowledge.<sup>18</sup> These changes are radical enough in themselves, but the greatest novelty is the increasing speed with which the new knowledge is being applied to production and exports, shortening product and corporate strategy cycles.

This technological convergence will be more profound than the digital convergence we have experienced over the past 25 years, radically altering the outlook for civilization and, of course, considerably affecting production and international trade. The explosiveness of this conjunction of technological innovations is well captured by the expression “technological big bang”.<sup>19</sup>

A review of the effects of this innovation synergy on the production structure shows, naturally enough, the importance of innovation as the hub of policies to improve productivity. In the sphere of production, leading innovations include process digitalization,

<sup>16</sup> See ECLAC (2008c) for a full account of economic and trade relations between Latin America and China (an electronic version is available at [www.cepal.org/comercio](http://www.cepal.org/comercio)).

<sup>17</sup> As the Prime Minister of Singapore put it: “As a small country with no natural resources, Singapore has long known that we have no choice but to make the mastery of knowledge our competitive advantage” (Lee, 2008).

<sup>18</sup> They include biocomputing (application of biological principles and processes to the development of new technologies such as biological computer programs and DNA computing), proteomics (study of how proteins can be combined to cure diseases) and biomimicry (technologies that replicate biological activity) (Kelly, 2005).

<sup>19</sup> The word *bang* is an acronym for **bits** (information technologies), **atoms** (nanotechnologies), **neurones** (cognitive sciences) and **genes** (biotechnologies).

barcodes, outsourcing, insourcing, offshoring, online connection, the sharing of information with suppliers and distributors and online innovation, processes that in turn require a permanent connection or connectivity infrastructure, the organization of global networks and rapid and appropriate responses (Friedman, 2005). The processes described affect not only production but also the fields of goods logistics, transport, security and traceability and thence international trade.

Technological change has combined with the liberalization of financial flows and the gradual opening up of markets to trade and investment to speed up the dynamic of innovation, the convergence of international standards and corporate strategies and the tendency for production to be organized around global value chains (OECD, 2005 and 2008). The latter have resulted in the geographical fragmentation of production processes, made possible by the growing digitalization of many activities, greater internationalization and commercialization of services and the reduction of transport and logistics costs. This has also stimulated specialization, innovation in selected activities and the creation of new firms and capabilities. The internationalization of services and the explosive growth of service-sector outsourcing have helped create a global supply of skilled activities in the fields of design, consultancy and the manufacture of specific inputs. This has made possible the emergence of new firms that are internationally competitive in the provision of strategic services and obviates the need to invest heavily in global infrastructure to penetrate global markets, or in the learning of complex business techniques (Hamel, 2007).

Global value chains encompass everything from research and development to product recycling, taking in production, support services, distribution, marketing, finance and after-sales services along the way. The objective of these chains is to increase the knowledge content at every stage, since this determines the value per unit produced. Consequently, the current debate on competitiveness is giving greater importance to the “intangible” aspects that contribute most to the knowledge-intensity of each segment of the global value chain, namely quality, timeliness, connectivity, patentability and trademark registration, traceability, safety, environmental conservation and energy efficiency. All these attributes are what provide the basis for product differentiation and thence access to the most lucrative sectors of demand and a more functional link with trends in technological change and international demand.

## 2. Some policy orientations

It is suggested here that the objectives of policies to improve the position of the Latin America and Caribbean countries in the international economy cannot be measured solely by the level of exports as a share of GDP. Attention also needs to be paid to their composition (and particularly their knowledge content), the way they are integrated with the rest of the production system and their contribution to the progressive homogenization of productivity levels in the economy. The opportunity now exists to reverse the region’s well-known “structural heterogeneity”, always provided that public policies set out decisively to use access to new technologies to narrow the productivity gaps between firms and sectors. Without substantive efforts in this direction, the level of technological heterogeneity will tend to increase, making it less and less viable to reconcile growth with progress on equity. Furthermore, policies to improve the international position of the region’s economies need to give more room to measures favouring the internationalization of firms and their contacts, since this is where the opportunities for higher growth and better access to innovation sources lie.

### (a) *From trade liberalization and export orientation to internationalization strategies*

International trade and investment policies have evolved from market opening in the 1980s to an export-oriented approach. However, the emergence of global value chains and the growing importance of innovation in production and foreign trade activities now require a further step: the application of policies oriented explicitly towards internationalization, including training of skilled human resources, efforts to stimulate production clusters, innovation programmes and measures to attract foreign direct investment (FDI), which brings technology and know-how to specific sectors or activities. Only then will it be possible to capture significant shares of the major international markets and keep up the pace of innovation needed to preserve the competitive positions that have been won.

Internationalization strategies need to favour the creation of international partnerships and networks in different areas so that local production activities which participate in global value chains can move up the hierarchy to the most profitable links via a range of investments that raise their knowledge content. This means, for example, strengthening the links between goods and services trade and investment,

placing innovation at the heart of competitiveness policies and using public-private alliances to stimulate it. These would improve the prospects of progress with the adoption of production methods that serve to strengthen the linkages between primary, manufacturing and service activities, diversify the production and export base and increase the direct or indirect presence of SMEs in that export dynamic, always with an eye to a more balanced distribution of productivity growth.

(b) *From participation in international trade to participation in global value chains*

While the earlier goal of internationally oriented economic policies might have been to boost trade, the importance of technological innovation now means there is a need to stimulate the introduction of new technologies and participation in global value chains. This means, for example, that trade policy (centring in this first decade of the twenty-first century on trade negotiations and the signing of free-trade agreements) should now be oriented towards administering these agreements from a strategic perspective. To this end, they should be treated as a form of alliance with major partners in the spheres of investment and technological progress, facilitating the creation of joint programmes in the areas concerned and the possibility of making joint investments in neighbouring markets. The idea is to use trade agreements as a platform for attracting FDI into technology-intensive sectors and, at the same time, for increasing the presence of the country's firms in international innovation networks, technology businesses and global value chains. In summary, trade policy needs to be a tool at the service of the strategy of international participation in innovation networks and technology businesses.

(i) *From research and development to a flow of innovation, investment and marketing (from R&D to I&I&M)*. This means that instead of the traditional concept of research and development (R&D), what needs to be adopted is an approach based on a continuous flow of innovation, investment and marketing (I&I&M), i.e., of knowledge that quickly feeds through to investment and production and is introduced into the international market via new products, processes or strategies.<sup>20</sup> This means taking

a more proactive approach to trademarks and patents by encouraging economic actors to obtain and export patents and, through them, knowledge. The incentive structure ought to reflect this orientation, so that the scientific community perceives that a patent brings greater rewards than an academic study. Furthermore, a closer relationship between firms, universities and technology centres would make it possible to develop the idea of a “technology business” benefiting all participants in the alliance, as compared with the current concept of the “research project” financed out of public funds and tied only somewhat tenuously—if at all—to the realm of production.

(ii) *Prioritizing innovation and putting it on the business agenda*. Innovation has become the cornerstone of successful international strategies. It is a broader concept than that of traditional research and development. It includes everything from technology copying and adaptation to product and process research, new business models and marketing, finance and logistics activities leading to the creation of new realizable value—ideally in the international market—via different forms of brand differentiation, i.e., the “decommodification” of products or services.

In the region's case, priority should be given to innovation in natural resource processing firms, without neglecting new industries, particularly those related to biotechnology and information and communication technologies. There is no “Chinese wall” between activities of this type. On the contrary, biotechnology is the basis of the new knowledge, accounts for much of the value added to natural resources and makes it possible to commercialize new products in the agribusiness, forestry, aquaculture and mining sectors.

Again, the subject of innovation should be higher up the business agenda. To achieve this, there should be public policies to support SME organizations (e.g., by financing hours of work by professionals specializing in the topic) with a view to encouraging collaboration by SMEs on different innovation measures. It would also be helpful for the leading employers' organizations to appoint innovation, investment and marketing representatives and develop work programmes and schemes to connect their members to technology centres and universities in the country and abroad. A wide range of grants, reports, placements and research projects are needed to strengthen relationships between academia and the sphere of production and foreign trade.

(iii) *Strengthening the links between goods, services and investments*. As they have been increasingly

<sup>20</sup> I am indebted for the term I&I&M to Ángel Flisfisch, a former Chilean ambassador to Singapore, who used it in some notes to the Office of International Economic Affairs of the Ministry of Foreign Affairs in 2002 or thereabouts.

incorporated into value chains, services have become the main component of product value added. This is particularly true of consultancy, advertising and marketing, legal assistance, accounting and finance, information and communication technologies and quality engineering and control services, among others. Owing to the spread of the new technologies, competitive advantages now tend to be expressed in “international value networks”. At the top of these chains are “knowledge”-intensive aspects such as trademarks, patents, quality and copyright, while further down are activities that are more natural resource-intensive, involve less processing and employ less skilled labour. Widespread access to modern services for firms, particularly SMEs, is a crucial driver of productivity.

It is not realistic, therefore, to separate the competitiveness of goods from the availability on demand of competitively-priced services of international quality or access to modern product, process or management technologies, which are usually incorporated into foreign direct investment. Public policies should facilitate access to these services at something close to international cost and quality standards, while promoting exports of business services in which the country has or can acquire competitive advantages (engineering, architecture, consulting, construction, communications, design, audio-visual techniques, health care, etc.).<sup>21</sup>

(iv) *Making investment abroad a public policy goal.* Investments abroad follow firms’ own internationalization cycle, once they have ventured into international markets with some degree of success. Successful goods and services exporters quickly find that the returns on the different elements in the value chain associated with a particular product (production, logistics, transport, distribution, marketing) vary with the knowledge-intensity of each segment in that chain. Consequently, the next step in the natural evolution of export activities, particularly natural resource-intensive ones, is to build up a direct or indirect presence in value chains through alliances with importers and distributors in destination markets. For example, the consolidation of Brazilian manufacturing exports in the region has led to considerable growth in exports of Brazilian services to different external markets in the wake of

domestic customers. This has been found to be the case with financial, legal and construction services, among others (CNI, 2007).

The purpose of investing abroad, then, is to establish a greater presence in the global value networks associated with the main export products concerned. Since the region is still basically an exporter of natural resources, this means following the backward and forward linkages of the natural resource being exported and developing competitive advantages in the fields of engineering, biotechnology and related business services. This will allow exporters to participate in other new business networks, to pick up on technological and corporate innovation in the main markets and, lastly, to provide a corporate learning platform from which to launch more ambitious global operations. Thus, for example, the entry of developing-country suppliers, distributors and processing firms into global value chains depends not only on the strategy of transnational enterprises but also on the proactive internationalization policies applied by the former. The experience of the “trans-Latins” would repay study in this respect, both to modernize public-sector support policies for international trade and investment and to evaluate regional integration efforts.<sup>22</sup> It would be desirable for integration mechanisms to be compatible with the experience of the trans-Latins and other successful cases of business development.

(v) *Making human resources training the cornerstone of changing production patterns.* Attaining competitiveness in sectors producing something more than a natural resource with a low level of processing requires the formation of a critical mass of skilled human resources which, in conjunction with natural comparative advantages and certain minimum facilities in terms of infrastructure and connectivity, can attract local and foreign talent to participate in projects of global interest. While it is true that the countries of Latin America and the Caribbean are not in a position to form that critical mass for most products, they can do it for some. This would involve, for example, promoting the development of local suppliers of specialized inputs, parts and services (design, quality control, logistics, distribution) in segments of the value chain associated with the natural resource being exported. This would require the application

<sup>21</sup> There are several interesting examples of service exports of this type in the region. See, for example, ECLAC (2007).

<sup>22</sup> If there is one major integration goal that has not been achieved it is precisely that of building regional production chains to help firms compete in international markets.

of public policies to ensure that domestic producers are able to comply with the relevant international standards. On this basis, it is possible to train skilled human resources in fields where the country has or can acquire competitive advantages, supplementing them with specific central or regional government support in education and training activities, as well as infrastructure and logistics. This approach has proved its worth in several Latin American countries, enabling them to attract foreign direct investment into technology-intensive sectors and acquire a presence in exports of high-quality products and services (information technology and pharmaceuticals in the case of Costa Rica, biotechnology and information technology in Argentina and information technology and logistics in Uruguay).

This means not only considering the creation of massive programmes of doctoral study grants, which form part of the right strategy, but also a reform of secondary and university education, special programmes to develop talent, national educational support programmes in mathematics, English and basic science and public initiatives reflecting governments' strong commitment to improving education quality.<sup>23</sup>

(vi) *Prioritizing the intangible aspects of competitiveness.* Production development and export promotion policies designed to improve SME competitiveness ought to give priority to improving their technological and managerial capabilities, staff training, compliance with international quality standards, collaboration with one another and presence in global value networks. This last item includes the possibility of treating firms of this type as indirect exporters in local value chains associated with goods and services exports.

<sup>23</sup> A few years ago, the decision was taken in Malaysia to teach mathematics and basic science in English, the thinking being that this would be an educational asset in the global knowledge society (Lee, 2008).

(vii) *Enhancing inter-agency coordination and the integrated policy approach.* Progress with this orientation requires greater coordination between the different public institutions associated with internationalization support policies, i.e., between the agencies responsible for export promotion and diversification, inward FDI, technological innovation and dissemination, production and business development and human resources training, including secondary and university education.

While there is always some degree of coordination between government agencies, what is meant here is the need for them to operate on the basis of shared planning encapsulating the different territorial interests and with well-defined responsibilities for financing, coordination and performance. This is what we find in countries that have successfully conquered a place for themselves in the international economy, invariably with a strong commitment from the main political authorities.

(viii) *From public policies to public-private alliances.* Last but not least, the policy criteria suggested require a public-private alliance as a vital institutional framework for progress with the work of innovation, competitiveness and internationalization. It is an alliance of this type that can provide the basis for a vision for the country over the next 10 or 20 years, its strengths and weaknesses and the tasks to be performed by government and by private, employers' and labour organizations, respectively, if they are to jointly address the challenges of innovation and competitiveness. Such a shared diagnosis of the future, with a medium-term outlook transcending political cycles, makes it easier to determine the commitments, programmes and financing needs that will have to be met by public and private actors and to develop an integrated policy approach that makes inter-agency coordination a vital force rather than a mere formality.

(Original: Spanish)

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**KEYWORDS**

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# Public-private alliances for long-term national development strategies

*Robert Devlin and Graciela Moguillansky*

**F**ew developing countries have succeeded in consistently closing the income gap with the world's richest nations without proactive government action in pursuit of economic transformation and a dynamic role in the global economy. Two factors are crucial here: the development and implementation of a medium- and long-term strategy to achieve rapid economic transformation, and the support provided to this strategy by a public-private alliance forged by means of a social process suited to local conditions. This article analyses the way alliances of this kind operate in 10 countries outside the region deemed to be successful because they have achieved a process of convergence with the developed countries or performed better than those of Latin America and the Caribbean, despite having similar resource endowments. One element that is lacking in the region, or at best is only incipient, is public-private collaboration. Thus, the aim of the analysis is to prompt reflection about the kind of alliances we ourselves could form to underpin strategies aimed at creating "Latin American tigers".

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# I

## Introduction

The six-year period from 2003 to 2008 was a relatively prosperous one for Latin America and the Caribbean following the lost decade of the 1980s and the region's recovery from successive cyclical shocks in the late 1990s and early 2000s. In this expansionary phase, the region's economy grew by an average of 5% a year and per capita income by 3%, while employment and poverty indicators also improved (ECLAC, 2008a). This was an unprecedentedly good economic performance, at least by the standards of the past 40 years (ECLAC, 2008b).

However, this performance needs to be taken in a broader context. First of all, about a third of the growth was due to external factors (IDB, 2008). Secondly, it was hardly spectacular compared to that

of other developing regions (see table 1). A study by ECLAC (2008c) singles out the factors behind the relative underperformance of Latin America and the Caribbean, pointing to shortcomings with productivity, investment and economic transformation and to a lacklustre external trade performance.

Future developments in the global economy, furthermore, are expected to be less favourable to growth in the region. For one thing, it is going to have to cope with a deep recession, the worst since the Second World War, and while some are forecasting a recovery in 2010, this will be modest and hesitant (IMF, 2009). For another, even assuming recovery does take place, there are organizations such as the World Bank that do not expect global growth

TABLE 1

**Growth rates in developing countries**  
(Percentage variation in constant 2000 dollars)

	2006 (ranking)	2007 (ranking)	2008 (ranking)	2009 (ranking)	2010 (ranking)
<i>East Asia</i>	10.1 (1)	10.5 (1)	8.5 (1)	6.7 (1)	7.8 (1)
China	11.6	11.9	9.4	7.5	8.5
Indonesia	5.5	6.3	6.0	4.4	6.0
Thailand	5.1	4.8	4.6	3.6	5.0
<i>Europe and Central Asia</i>	7.5 (3)	7.1 (3)	5.3 (5)	2.7 (5)	5.0 (5)
Poland	6.2	6.6	5.4	4.0	4.7
Russian Federation	7.4	8.1	6.0	3.0	5.0
Turkey	6.9	4.6	3.0	1.7	4.9
<i>Latin America and the Caribbean</i>	5.6 (5)	5.7 (6)	4.4 (6)	2.1 (6)	4.0 (6)
Argentina	8.5	8.7	6.6	1.5	4.0
Brazil	3.8	5.4	5.2	2.8	4.6
Mexico	4.9	3.2	2.0	1.1	3.1
<i>Middle East and North Africa</i>	5.3 (6)	5.8 (5)	5.8 (3)	3.9 (4)	5.2 (4)
Algeria	1.8	3.1	4.9	3.8	5.4
Egypt	6.8	7.1	7.2	4.5	6.0
Islamic Republic of Iran	5.9	7.8	5.6	3.5	4.2
<i>South Asia</i>	9.0 (2)	8.4 (2)	6.3 (2)	5.4 (2)	7.2 (2)
Bangladesh	6.6	6.4	6.2	5.7	6.2
India	9.7	9.0	6.3	5.8	7.7
Pakistan	6.2	6.0	6.0	3.0	4.5
<i>Sub-Saharan Africa</i>	5.9 (4)	6.3 (4)	5.4 (4)	4.6 (3)	5.8 (3)

Source: World Bank, *Global Economic Prospects*, Washington, D.C., 2008.

□ The authors appreciate the valuable collaboration of Raúl Holz in this research.

to be as strong as in recent years (World Bank, 2008). Lastly, the same source indicates that, for a variety of reasons, there are no grounds for expecting a medium- and long-term commodity price boom as beneficial as the one that recently took place.

Thus, for all its progress in consolidating democracy, implementing structural reforms and restoring economic growth, the region has fallen behind in other aspects of development, while the external factors contributing to its “satisfactory” performance may soon be a thing of the past.

It is urgent for the region to find a path to consistently high growth rates that enable it to converge with the wealthier countries of the world and dramatically reduce poverty. The history of development indicates that this is a very difficult task, but not impossible. Indeed, a significant number of economies have caught up to a great degree, with some even joining the club of developed countries. This obviously stands in marked contrast to the experience of Latin America and the Caribbean (see figure 1).

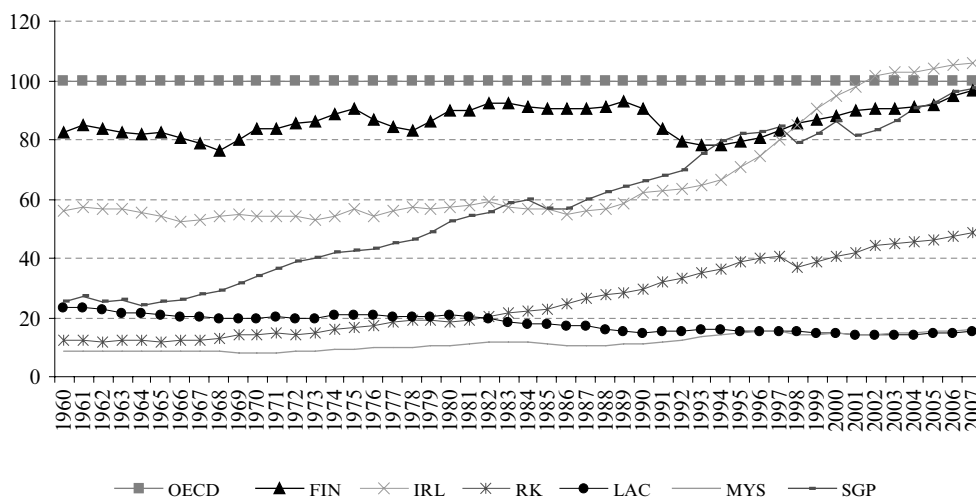
Those countries succeeded because of a combination of domestic and external factors, most of which reflected the particular situation

of each. Nonetheless, there was one common factor: the proactive attitude of government, which fostered development by effectively implementing an internationally oriented medium- and long-term national economic transformation strategy. These strategies were organized within the framework of a public-private alliance. Since this is a missing or only very incipient element in the economies of Latin America and the Caribbean, the present article will examine it in greater detail with the aim of prompting reflection about the development of a similar economic policy for the region.<sup>1</sup> The current crisis makes this process of reflection even more necessary. Short-term adjustments will be inevitable in the coming months, but they should be made as part of a more comprehensive approach, i.e., in the context of a medium- and long-term strategy. Otherwise, there is the risk of creating inconsistencies and even contradictions between adjustment policies and the conditions needed for productive transformation and upgrading of economies, as happened in the 1980s.

<sup>1</sup> The analysis is based on a forthcoming book by Devlin and Moguillansky (2009).

FIGURE 1

**Per capita income in selected countries and regions**  
(Percentages, high per capita income countries = 100)



Source: prepared by the author on the basis of World Bank data.

N.B.: OECD = rich countries of the Organisation for Economic Co-operation and Development, FIN = Finland, IRL = Ireland, RK = Republic of Korea, LAC = Latin America and the Caribbean, MYS = Malaysia, SGP = Singapore.

The article is organized as follows. After this introduction, it first analyses the character of development strategies and the way these have evolved in certain successful countries outside the region studied by the authors as part of a research project. It then

goes on to review the nature of the different public-private alliances on which these countries' approaches to development have been based. Lastly, it examines an example of a long-term public-private alliance, that of Ireland, leaving the final section for conclusions.

## II

### Strategies to promote economic transformation and internationalization

#### 1. The character of development strategies

Overtly or tacitly, governments usually have a development strategy. A strategy is a template for action or simply a plan to attain particular goals. Development strategies can have very different characteristics, however. To simplify, strategies may be said to be differentiated chiefly by the amount of public intervention in pursuit of the goals set, and by the emphasis put on accelerating the market's pace of economic transformation.

On the one hand, there are strategies that focus on public-sector interventions to strengthen the autonomous action of market forces, examples being monetary and fiscal policies compatible with macroeconomic stability, protection for property rights and the legal institutions underpinning them, external trade and investment liberalization and certain basic public goods such as education and infrastructure. This approach bespeaks confidence that the free play of market forces will solve economic problems and that a "sound" macroeconomic policy generates sufficient incentives for businesses themselves to lead a process of economic transformation based on the country's international comparative advantages. In consequence, the scope and goals of public interventions are relatively limited and they are kept at arm's length from the workings of the market. To act otherwise would only create distortions that interfered with growth and development.

At the other extreme are strategies that are mistrustful of certain market signals and question whether static comparative advantages by themselves can drive economic transformation rapidly enough to bring about convergence with developed countries. This approach recognizes that short-term signals can be very unreliable guides to the optimum allocation

of resources, so that transformation opportunities in turn cannot be exploited to the fullest.<sup>2</sup> Public-sector intervention should thus aim directly at rectifying them. The most common problems include externalities, uncertainty, non-availability of information and lack of coordination between different actors in the market.

From this second standpoint, the goal of public-sector actions and initiatives is to "distort" some short-term market signals—particularly microeconomic ones—and thereby encourage firms to take measures aimed at the medium- and long-term creation of new comparative advantages based on production processes with greater value added and technology content. In other words, some efficiency in the allocation of resources in certain activities or sectors is sacrificed to stimulate economic transformation (UNCTAD, 2006). As Evans (1995) argues, an approach of this kind reveals a magnified concern with a country's ranking in the global economic hierarchy, on the assumption that this is not irremediably fixed by the existing structure of static comparative advantages but that there is scope for public interventions to begin upgrading the economy or accelerate the process of transformation. Furthermore, this perspective is more relevant than ever now that production processes are globalized and services are being traded on a massive scale.

In point of fact, countries' strategies have not strictly followed either of the approaches described, but contain elements of both (Evans, 1995; Ul Haque, 2007). What is at issue, rather, are

<sup>2</sup> As Rodrik (2008a) notes, the new growth theory recognizes the existence of multiple market failures, as does the new trade theory. See also Lall (2000).

the mechanisms used and the dominant approach in the orientation of public policies. Nonetheless, there is an ongoing debate between proponents of the first alternative, known as “monetarist” in the 1960s and “neoliberal” at present, and of the second, which was formerly called “structuralist” and now goes under the name of “neoliberalism” or “industrial policy”.<sup>3</sup> It should be said that while the contemporary debate originated with the famous disagreement between monetarists and structuralists in the import substitution industrialization period, the proponents of neoliberalism and industrial policies have brought a great deal of “value added” to the discussion. In any event, the academic debate about which of these approaches would be best for economic growth remains unresolved, since there are serious methodological obstacles to obtaining the formal evidence needed to support one position or the other (Rodrik, 2008a).<sup>4</sup>

Given the lack of conclusive empirical evidence, in the present study we have opted simply to “bet” that the second approach in its modern version is far more relevant to Latin America and the Caribbean. First, because few countries have industrialized without an active strategy of public policy intervention (Chang, 2003). Second, because among the few countries that have succeeded in significantly closing the income gap with the rich world over the past 50 years, a large number did so by proactively working towards industrial transformation, including dynamic internationalization of the economy. Many case studies also suggest that a proactive medium- and long-term strategy can help to bring about this transformation.<sup>5</sup> Lastly, Latin America and the Caribbean has been among the regions that have most closely followed the neoliberal prescriptions of the Washington Consensus but, as we saw earlier, without distinguishing itself in terms of the growth of developing countries.

## 2. Development strategies in practice

Table 2 presents the 10 countries included in our research into the factors determining the success

of strategies and the effectiveness of policies. Five of them (Finland, Ireland, the Republic of Korea, Singapore and Spain) are members of a group of 10 countries (out of a universe of 206) which closed the income gap with the United States by more than 10 points between 1960 and 2005. The other five were Hong Kong Special Administrative Region, Luxembourg, Malta, Norway and Portugal.<sup>6</sup> In addition, two countries in our project, the Czech Republic and Malaysia, closed the gap to a lesser degree. Australia and particularly New Zealand have lost ground in the convergence process, but they have fared better than Latin American countries that are similarly reliant on natural resources. All the countries in table 2 other than Australia, New Zealand and Sweden were relatively or very poor after the Second World War.

To illustrate the different orientations, table 3 summarizes the evolving export development strategies of four of the 10 countries in the study.<sup>7</sup> Those of Finland and Singapore can be characterized by their structural nature, i.e., they have explicit targets for economic transformation where what is pursued is a dynamic of internationalization underpinned by direct, proactive public policy action. Also included were Australia and New Zealand, whose strategies shifted towards a neoliberal approach in the 1980s, although in the present decade the latter country has striven, with considerable difficulty, to apply economic transformation measures.<sup>8</sup>

A good number of these countries have actively pursued economic transformation strategies by developing formal multi-year plans of national scope (see table 4). These plans are important because they help to ensure that the strategy is integrated into the official and public domains, facilitating accountability and orienting the implementation and allocation of resources in accordance with the priorities laid down.

<sup>6</sup> Taiwan Province of China does not appear in the World Bank database of 206 countries.

<sup>7</sup> In the interests of a focused analysis, the research concentrated on export development strategies (a cornerstone of all the strategies), which encompass four main aspects: efforts to attract foreign direct investment (FDI), the internationalization of small and medium-sized enterprises (SMEs), innovation and export promotion.

<sup>8</sup> The Czech Republic (from 2000 onward), Ireland, Malaysia, the Republic of Korea and Sweden all took an economic transformation approach. Spain is an intermediate case: while a quite liberal strategy is applied at the national level, the autonomous communities have implemented what are clearly economic transformation strategies.

<sup>3</sup> Rodrik (2008a) gives an overview of the debate.

<sup>4</sup> The same problem exists with regard to the effects of trade liberalization and even of exports on productivity and growth (Rodríguez and Rodrik, 2000; WTO, 2008).

<sup>5</sup> Most such studies evaluate the successful experience of East Asia. See, for example, Wade (1990), Evans (1995) and Amsden (1989).

TABLE 2

**Per capita income in selected countries as a proportion of per capita income in the United States<sup>a</sup>**

(Percentages, United States per capita income = 100)

	1960s	1970s	1980s	1990s	2000s (first half)
Australia	63.7	64.4	61.4	60.2	62.1
Finland	54.1	64.4	69.9	65.0	70.6
Ireland	36.6	41.3	43.8	57.0	78.7
Rep. of Korea	8.3	12.4	18.0	28.5	34.4
Malaysia	5.7	6.9	8.4	10.8	11.5
New Zealand	56.9	52.4	46.4	40.8	40.8
Czech Rep.				16.7	17.2
Singapore	17.8	31.4	44.5	60.6	67.4
Spain	32.1	40.0	38.0	40.5	42.5
Sweden	83.7	87.3	84.5	78.2	80.6

Source: prepared by the author on the basis of World Bank data.

<sup>a</sup> Constant 2000 dollars.

TABLE 3

**Selected countries: milestones in national development strategies**

	First period	Second period	Third period	Fourth period
Australia	1920 Import substitution	1983 Washington Consensus-style policy and trade liberalization	2000 Efforts to spur innovation and attract FDI	
Finland	1970 Natural resource-intensive industrialization. Protectionism and subsidies for fledgling industries. Constant emphasis on education	1993 Entry into the European Union. Liberalization of trade and external capital, including FDI, and greater attention to long-term microeconomic trends. Strengthening and coordination of industry and the innovation system to move towards an innovation society. Research and development approach oriented by the dynamism of industry	2006 Strengthening of the renewal of the innovation system. Increase in the knowledge base. Improvements in science and technology research quality and goals. Increased commercialization of innovations	
New Zealand	1960 Import substitution industrialization	1984 Washington Consensus-style economic liberalization	2006 Economic transformation agenda centred on globally competitive firms, world quality infrastructure, support for innovation and productivity, environmental sustainability and promotion of Auckland as a globally competitive city.	
Singapore	1965 Import substitution industrialization. Exports of light manufactures and efforts to attract FDI.	1979 Policy of orientation towards medium- and high-technology industry and services. Wage increases in labour-intensive sectors as an incentive to achieve the above goal.	1990 Internationalization of manufacturing into neighbouring countries, followed by expansion into China, India and the Middle East. Begins to develop industrial and services clusters, including partially State-owned local firms. Development of a financial and business services platform.	2000 Development of existing industrial clusters and identification and development of new sectors by attracting investment, supporting innovative firms and developing technology in old sectors and a selected number of non-traditional sectors with development potential. Internationalization of SMEs. Creation of new geographical spaces for investment and export.

Source: Robert Devlin and Graciela Moguillansky, "Fomentando tigres latinoamericanos: principios para una visión estratégica nacional en el marco de alianzas públicas-privadas", Santiago, Chile, 2009, unpublished.

TABLE 4

**National plans in selected countries**

Republic of Korea (up to 1993)	Five-year plans
Republic of Korea (1997 onward)	National plans discontinued, but indicative planning takes place within each ministry
Finland	Three-year plans
Ireland	Six- to seven-year plans
Malaysia	Complementary and interactive indicative plans including a 30-year vision, a 10-year framework plan and a five-year plan
Czech Republic (before 1990)	Central planning
Czech Republic (since 1990)	Three-year plans

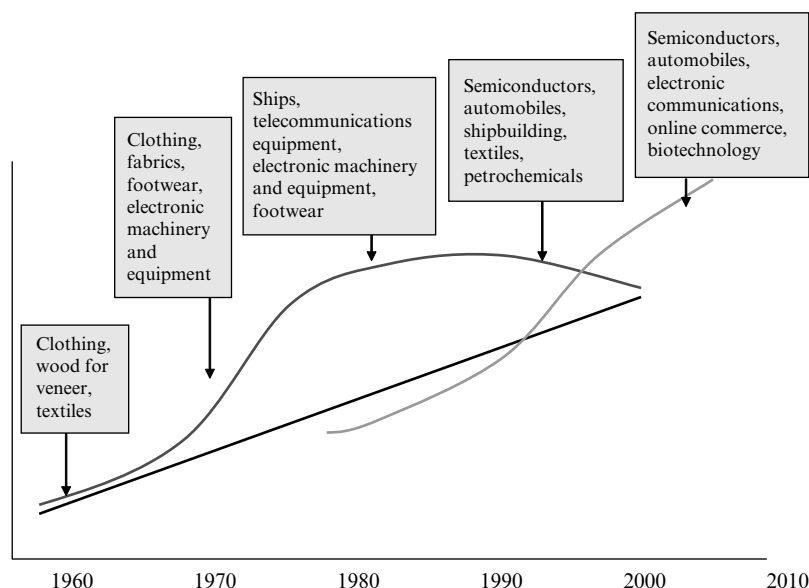
Source: Robert Devlin and Graciela Moguillansky, “Fomentando tigres latinoamericanos: principios para una visión estratégica nacional en el marco de alianzas públicas-privadas”, Santiago, Chile, 2009, unpublished.

The strategies of countries where public policies actively promote economic transformation have certain features in common. For example, the highest importance is given to macroeconomic stability, fiscal soundness, consistently high investment rates and dynamic internationalization of the economy. Given the growing importance of innovation, all the countries have given priority to human development, including education, with ever-increasing efforts to expand

higher education coverage. Although the exploitation of static comparative advantages is a starting point for export development, they have all made determined efforts to create new advantages over time so that external sales can be continually upgraded. Diagram 1 shows the paradigmatic case of the Republic of Korea. Furthermore, the upgrading strategy is dynamic and adapted to local and external conditions. Where public policies are concerned, a “neutral” horizontal

DIAGRAM 1

**Republic of Korea: development of principal industries**



Source: Yoo Soo Hong, “Public and private sector alliances for innovation and economic development: the Korean case”, document presented at the seminar “Public-private partnerships for innovation and export development” (Seville, 13 and 14 September 2008) held by the Economic Commission for Latin America and the Caribbean (ECLAC) and the Ibero-American Secretariat (SEGIB), 2008.

approach is combined with selective interventions to stimulate strategic sectors and activities.<sup>9</sup>

Lastly, a characteristic that can be observed in the evolution of strategies in all the countries, albeit much more clearly in some like the Czech Republic and New Zealand, is the tendency for past practices

to be maintained even when better alternatives are available (path dependency). This has been made manifest by the difficulty experienced in switching from the relatively neoliberal strategy promoted from 1984 and 1990, respectively, to a more structuralist one in the 2000s.<sup>10</sup>

### III

## Proactive economic transformation strategies: the role of public-private alliances

Development strategies with a proactive economic transformation approach start with a diagnosis and evaluation of key opportunities for improving the country's positioning in the global market, involving a medium- and long-term projection and the identification of primary constraints needing to be overcome, mitigated or removed if these opportunities are to be capitalized upon (Stiglitz, 1998). Obviously, this evaluation and the goals set need to be based on empirical evidence about the capabilities of the economy and short-, medium- and long-term trends in the external environment. As for public policies and programmes to deal with these primary constraints, they need to take account of the real situation of the country, the capabilities of the public and private sectors and the measures that will most encourage the private sector to take decisions compatible with the goals of the strategy concerned. Macroeconomic goals and programmes also need to be aligned with those aimed at specific activities or sectors so that market signals and government incentives can be combined in a consistent way.

How can this task be undertaken? Today, by contrast with the decades immediately following the Second World War, the production apparatus in most countries is in private-sector hands. Consequently, it is private firms that must provide market information which, however incomplete,

can serve to identify trade opportunities and the obstacles (including public policy-related ones) to economic transformation.<sup>11</sup> However, firms can be short-sighted when it comes to taking decisions and measures that might yield better performance. This is because of the externalities and "market failures" mentioned above, which are especially important in a fast-changing globalized world: first mover advantages, optimum coordination of the business world, appropriation of the benefits of innovation and technological development, etc.<sup>12</sup>

Although governments also have shortcomings and do not necessarily have better information than the private sector, their political leadership can stimulate proactive and forward-looking strategic thinking about the country's needs and coordinate collective actions in pursuit of the public good. Thus, when both sides are working together it is possible to enhance their separate potential for supporting mechanisms and programmes that can identify and deal with primary market failures, as well as failures deriving from public regulation and planning policies themselves. In short, collective thinking is usually more intelligent than isolated individual approaches.

The neostructuralist approach adds some important requirements, however. First and foremost,

<sup>9</sup> Hausmann and Rodrik (2006) showed that upgrading export activity while continually adding value was vital to rising incomes and convergence. Owing to market failures, however, this does not come about spontaneously. Furthermore, some export development paths are more propitious than others. Because of this, and because governments have limited resources for promoting development, public policies are "doomed" to be selective.

<sup>10</sup> See Haworth (2008) and Benáček (2008).

<sup>11</sup> Depending on the development level of the country's economy and its position in the cycle, the primary constraints on sustained growth may be concentrated in the macro-, meso- or microeconomic spheres. Hausmann, Rodrik and Velasco (2005) have come up with some ideas for diagnosing the subject systematically and setting priorities.

<sup>12</sup> Fajnzylber (1990) points out that economic transformation failures can be particularly damaging in natural resource-based economies.

public-private alliances can only be an effective tool of development strategy if the State collaborates closely with the private sector but retains a degree of autonomy in relation to the public good, or what Evans (1995) calls “embedded autonomy”. Only then can it be a full partner for the private sector, but avoiding “capture” by special interests. The second point is that both attaining this autonomy and developing an effective economic transformation strategy depend on the institutional design of a social process of public-private collaboration that yields the information needed to identify socially beneficial opportunities and deal with the primary constraints of new production activities, but without capture of the State.

It should also be pointed out that some of the information needed to produce diagnoses and

create intelligent strategies is in the hands of other non-commercial agents such as academia (including researchers) and unions.

If strategies and financial support for them<sup>13</sup> are to put down deep political roots that endure over the medium and long term, it will be necessary to develop consensus or something approaching it, or at least forge a public understanding. This is why alliances often have to include groups from outside the business sector.<sup>14</sup> In any event, the mere fact of “working together” within an institutional framework designed in the light of the considerations discussed here is itself a social process that can lead to the creation of consensus providing the basis for a development strategy which transcends political cycles (Stiglitz, 1998).

## IV

### The field of action of public-private alliances

#### 1. A framework of analysis

Diagram 2 provides a stylized description of the field of action of public-private alliances. The left-hand column offers a schematic representation of how their members work together to build a development strategy. It should be stressed that the development of alliances of this type, and the role they play in formulating and implementing the strategies concerned, depend greatly on the particular political, historical and cultural context of the country concerned.<sup>15</sup> There are countries

where something like a true public consensus can be reached because this context combines favourably with propitious economic conditions and effective institutions capable of processing the interaction of participants within the alliance. In other cases, the nature of the political context may mean that the alliance is viewed merely as the expression of a public understanding or passive acceptance of the development strategy. One way or another, though, the degree of agreement among the participants in the alliance will condition the extent to which a particular strategy is developed and applied.

When it comes to forging consensus and understandings, interaction between the parties in a public-private alliance can vary in both form and scope. The left-hand vertical axis of diagram 2 shows that the discussion between the public and private sectors may vary along a non-discrete scale reflecting different characteristics of the interaction between the two, ranging from a true dialogue that yields consensus to government consultation of the private sector that helps produce a public understanding or to what is basically imposition of the strategy without much public consultation or dialogue, but with some degree of understanding between the parties. The scope of social participation in the alliance also varies. The horizontal axis of diagram 2 shows that this may range from a trilateral relationship

<sup>13</sup> If public acceptance of a strategy is too low, allocating resources to implement it causes strains. For example, public spending on research and development and innovation may be unpopular compared to other alternatives like poverty reduction programmes. Thus, it may be necessary to build up an explicit public consensus or understanding to ensure that the former is consistently provided for in the budget.

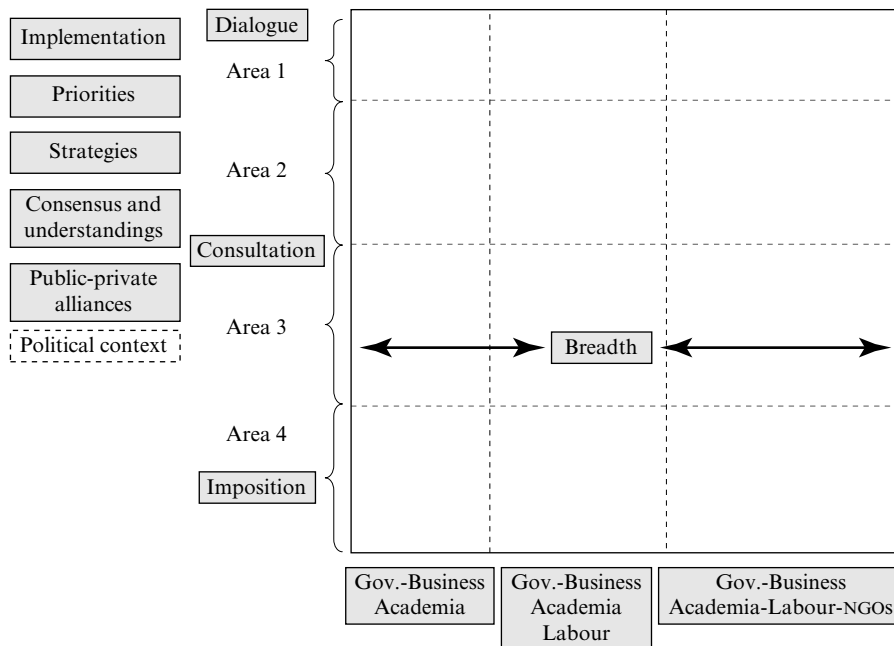
<sup>14</sup> As Prats i Català (2005) points out, however, weaker sectors may need support if they are to participate effectively in the dialogue.

<sup>15</sup> In the words of a joint study by the World Bank, the International Institute for Democracy and Electoral Assistance and the Economic Commission for Latin America and the Caribbean (World Bank/IDEA/ECLAC, 2005, p. 11): “The process of building a national Vision does not have a unique format but must be adapted to the country situation and to the particularities of the participating stakeholders.”



DIAGRAM 2

Scope of public-private alliances



Source: Robert Devlin and Graciela Mogueillansky, “Fomentando tigres latinoamericanos: principios para una visión estratégica nacional en el marco de alianzas públicas-privadas”, Santiago, Chile, 2009, unpublished.

between government, firms and academia to a very broad alliance encompassing practically all major representative groups in society.

Lastly, account needs to be taken of a third aspect not included in diagram 2: the operating structure of public-private alliances. Here, the following stylized variants can be identified: (i) those functioning through formal, explicit structures, (ii) those that have a formal structure but emerge ad hoc and (iii) alliances operating through informal networks or tacit agreements. In practice, all three structures must be present, or coexist, in any public-private alliance. However, one or two may be expected to predominate.

2. Alliances in practice

In the countries studied, we found the following dominant structures:

Structured formal: Finland, Ireland and Singapore.

Ad hoc formal: Australia (e.g., committees and councils focused on specific tasks).

Tacit/informal: Spain and Sweden.

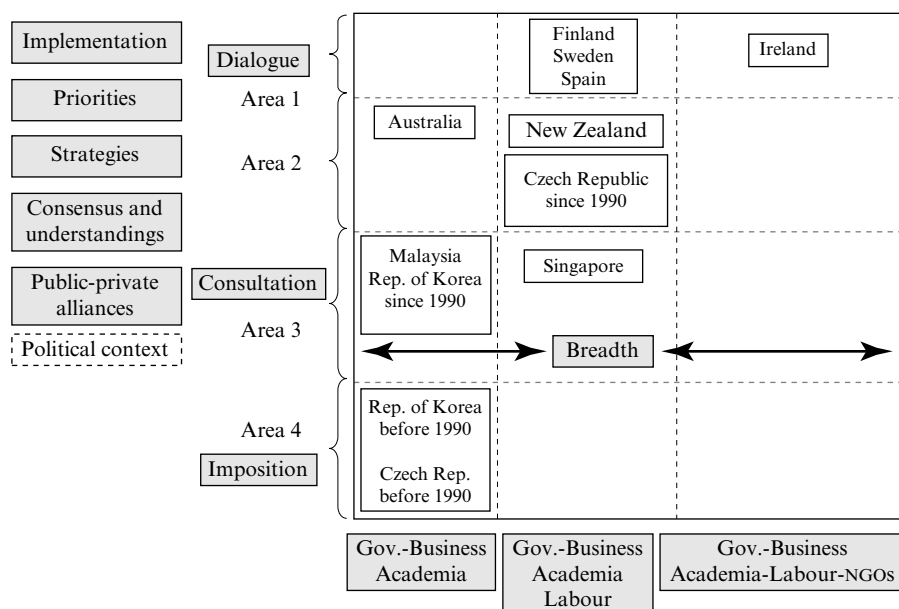
Hybrid (two or more of the above): Czech Republic, Malaysia, New Zealand and Republic of Korea.

Using this classification of countries by the structure of their public-private alliance and the real scope of interaction as indicated in diagram 3, the nature of national alliances in the countries studied can be described. In Ireland and Finland, for example, they are characterized by their breadth and formal structuring. They are a real force in strategy development and implementation throughout much of the public-sector hierarchy, they give rise to a genuine social dialogue, and the agreements reached are close to being consensus transcending political cycles. Accordingly, these countries belong to Area 1 of diagram 3, with alliances encompassing government, firms, unions, academia and, in the case of Ireland, non-governmental organizations (NGOs).<sup>16</sup>

<sup>16</sup> NGOs were incorporated only recently.

DIAGRAM 3

**Public-private alliances: positioning of countries**



Source: Robert Devlin and Graciela Mogueillansky, “Fomentando tigres latinoamericanos: principios para una visión estratégica nacional en el marco de alianzas públicas-privadas”, Santiago, Chile, 2009, unpublished.

Singapore also has a fairly broad and well-structured public-private alliance that is involved in formulating and implementing the development strategy at different levels of the public-sector hierarchy. That of Malaysia has similar characteristics, although without union involvement.<sup>17</sup> In both countries, however, the government undertakes extensive consultations (rather than dialogues) with its partners, after which it takes decisions and announces strategies, so that what emerges is a public understanding rather than a consensus as such. The characteristics of their alliances place the two countries in Area 3 of diagram 3.

One aspect that should be highlighted in the four countries mentioned, particularly Ireland and Singapore, is how deep the public-private alliance goes in terms of penetrating the government hierarchy. This improves information sharing and process coordination and makes it easier to forge

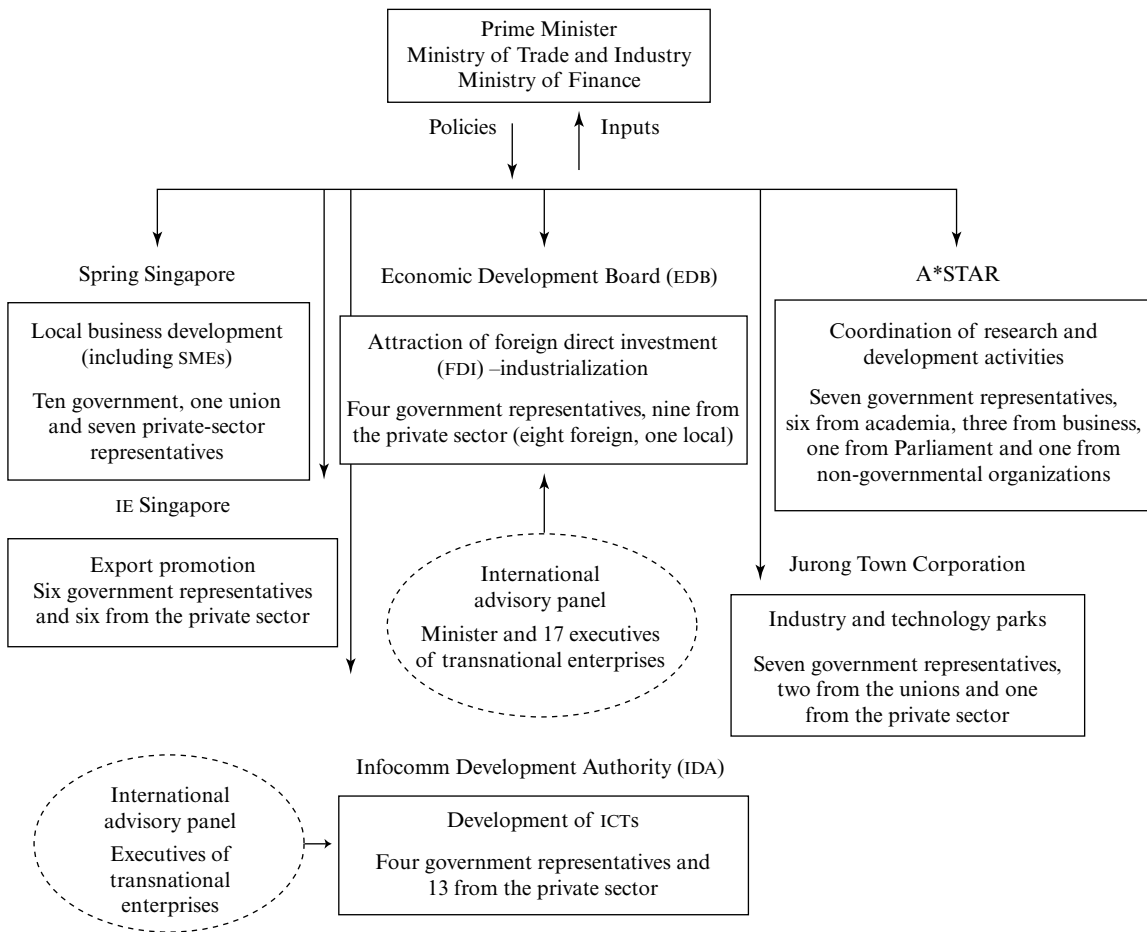
consensus or understandings. Diagram 4 shows the system of institutions created in Singapore for these purposes. Interaction with the private sector is very wide-ranging and representatives from firms even sit on the boards of organizations such as the Economic Development Board (EDB), where the country’s development strategies have traditionally been produced. Furthermore, locally-based multinationals operating in the country are part of the private participation, which reflects the importance of firms of this type in the production system and the priority given by the government to garnering international knowledge relevant to its strategy. In the case of the Agency for Science, Technology and Research (A\*STAR), not only are some locally-based multinationals incorporated, but so are some foreign academics. Although Ireland has a very similar profile, the members of the different boards have operational responsibilities, whereas in Singapore they only comment on and periodically evaluate policies and programmes.

In Singapore, and to a lesser extent in Ireland and Malaysia, there is another form of public-private

<sup>17</sup> The unions in Singapore have an institutional relationship of sorts with the government.

DIAGRAM 4

**Singapore: public-private boards of institutions supporting international trade and investment**



Source: Robert Devlin and Graciela Moguillansky, “Fomentando tigres latinoamericanos: principios para una visión estratégica nacional en el marco de alianzas públicas-privadas”, Santiago, Chile, 2009, unpublished.

alliance: international panels of advisers like those for the Economic Development Board and the Infocomm Development Authority (IDA) (see diagram 4). In addition, the Development Board, which traditionally spearheaded both the formulation and the implementation of development strategies,<sup>18</sup> organizes a private meeting of the highest political level every year, whose conclusions are announced in a press release. This is attended by invited CEOs of major multinationals and local

government representatives who analyse trends in globalization and in the South-East Asia region as well as changes in technology and trade patterns. This is not just a forum for sharing information applicable to national strategies; it also serves to create a network of contacts in the international market whereby concrete opportunities for the country can be identified.<sup>19</sup> The same procedure,

<sup>18</sup> Innovation agencies have since taken over this role.

<sup>19</sup> Another attraction of this meeting from the point of view of general managers of multinationals can be the opportunity it provides to learn about issues relating to East Asia.

but in the academic realm, is followed by A\*STAR, which has included a number of Nobel laureates and operates in the context of the National Research Foundation (NRF), a body that leads innovation strategy and implementation.<sup>20</sup> In 2005, Malaysia also formed an international group of advisers to support formulation of its latest national plan. With similar characteristics to that of Singapore, it drew in leading personalities from academia and the private sector.

The public-private alliance of Ireland is embodied in a special council, chaired by the Taoiseach (prime minister), which regularly convenes representatives of the major social groups and, with technical support, engages in discussions to reach consensus on the future socio-economic direction of the country (see section V). This council is believed to have been critical to the success of the Irish alliance and economic model. Finland has its Science and Technology Policy Council (STPC), which serves the same purpose.

Australia and New Zealand can be seen as intermediate cases in the diagram 3 classification. Rather than consensus, the character of their respective public-private alliances depends on coalitions based on the political platforms of governments. In Australia, the alliance is mainly between the government, firms and academia, although changes are likely following the recent election of a government with ties to labour. New Zealand had an alliance with firms and academia until 1999, when a new government brought in labour representatives and paid them greater attention. The structure predominating in both alliances is “fluid”, which partly reflects a degree of hostility to corporatism, albeit for different reasons. In Australia, the government until recently maintained a highly orthodox position; in New Zealand, following a long period of very liberal economic policies, the government had great difficulty establishing a social consensus that would allow it to enlist the business sector and political opposition in the construction of an Irish-style model of alliances, collaboration and proactive economic transformation (Haworth, 2008). The hybrid structure of the country’s public-private alliance was not stable or well-coordinated enough to generate lasting national consensus on a

comprehensive structural strategy transcending the electoral cycle. This partly explains why progress has been slow and incomplete in New Zealand despite the launching of two complementary medium- and long-term strategic economic transformation initiatives, leading to great uncertainty.<sup>21</sup> The fact is that the alliances of these two countries, both of them situated in Area 2 of diagram 3, are not clearly consolidated, which explains the lack of consensus or more solid public understandings.<sup>22</sup>

The Czech Republic is also in Area 2 of diagram 3. The country has formal, structured forums with broad participation and vigorous interaction between the public and private sectors in both the design and implementation of national strategies. However, their input into decision-making has depended greatly on the ideology of the different governing coalitions that have held power during the democratization period.<sup>23</sup>

In Spain it proved possible to build a consensus around the country’s national development strategy during the process of democratization and integration into the European Union by means of forums, committees and working groups, among other things. At present, the dominant form of interaction in the alliance between central government and specialized organizations is informal in nature and takes place mainly with unions and business groupings, some of the latter with support from the public sector, which also provides part of their financing.<sup>24</sup> From this it can be deduced that Spain probably belongs in Area 1 of diagram 3. In Sweden, a country where there is consensus, it is not very easy to describe how the public-private alliance works, given its markedly informal and tacit character.<sup>25</sup>

<sup>20</sup> The private-sector representatives on the boards of the NRF and the Research, Innovation and Enterprise Council (RIEC), to which it reports, are all Singaporean.

<sup>21</sup> See Office of the Prime Minister (2002) and Ministry of Economic Development (2005). An election in late 2008 was won by the conservative opposition. It remains to be seen whether there will be continuity in the economic transformation strategy.

<sup>22</sup> There is a fairly solid public-private alliance in the area of innovation, but the relevant government agencies are not well articulated with a global scheme for the overall direction of the economy.

<sup>23</sup> The insistence of the European Union on conducting a broad social dialogue on the use of cooperation funding has been a positive factor for public-private alliances.

<sup>24</sup> In Andalusia the alliance is structured and formal and is mostly a three-way affair; the private sector is not so proactive, however.

<sup>25</sup> In Sweden there was a tacit alliance between government and major Swedish multinationals, and until recently there were also formal wage agreements between the government and unions.

At the other extreme are the Republic of Korea and the Czech Republic before the 1990s. Both countries belong in the bottom left-hand corner of diagram 3 (Area 4), with strategies being formulated and implemented almost exclusively by government and its specialists. Naturally, the Czech Republic did not really have a private sector at that time. In the case of the Republic of Korea, prior to democratization the practice was to design specific plans regulating the activities of the major industrial conglomerates (*chaebols*), based on a close relationship between the public and private sectors and a wide range of incentives and penalties applied unilaterally to firms.<sup>26</sup> Because it now has a quite sophisticated economy, however, the country has abandoned national planning and the *chaebols* have a great deal of commercial independence. Since the advent of democracy, the government has increasingly come to appreciate the valuable role the alliance between the public and private sectors can play in supporting strategies; nonetheless, dialogue is only incipient. As for the Czech Republic, although it now has appropriate structures in place, the relevance and strength of its public-private alliance depends, as already mentioned, on political coalitions. An economic transformation project arose in the first half of the 2000s but weakened in 2007 following the election of a conservative government.

Lastly, the public-private alliances that are most complete and most effective at supporting medium- and long-term development strategies with enough public consensus or understanding to prevent pendulum swings are to be found in Finland, Ireland, Malaysia, Singapore, Spain and Sweden. The least solid or effective are those of Australia, the Czech Republic and New Zealand. The Republic of Korea, meanwhile, is still in transition from a bureaucratic development model to a more open social model.

### 3. Consensus-building

Long-term strategies based on a high degree of consensus between the public and private sectors can give better results, not least because consensus helps ensure the survival and stability of strategies across electoral cycles, encourages stakeholders to participate in their development and provides an

implicit public verdict on their effectiveness and on the public policies associated with them. More important still is the fact that processes oriented towards building consensus around a particular strategy can mobilize and incorporate the best information, perspectives and capabilities available in the country, while also making it more likely that stable funding commitments will be secured for the priorities agreed on.

Unfortunately, consensus-building is not easy. It depends on factors as diverse as cultural inclinations, political structures and configurations, the power of different social groups, the leadership, vision, representativeness and public standing of social partners, the successes achieved and the degree of urgency perceived.<sup>27</sup> Nonetheless, institutional frameworks that are properly structured to reflect the country's socio-political characteristics can also help to create consensus over time.

Ireland is an interesting case study. The country was one of the poorest in Europe, but from the late 1980s onward it succeeded in building a consensus about its development and its place in the international economy, triggering one of the most remarkable economic transformations anywhere in the world since the post-war period. One particular body, the National Economic and Social Council (NESC) has played a vital role in concerting economic policy agreements over a number of decades. The Council was originally a public-private forum where representatives of the main social groups met to exchange views, but its role has gradually changed to one of facilitating consensus on the general orientation of the economy. As it has evolved, it has also developed a methodology for processing this dialogue so that it yields consensus-based policies (see section V). It should be noted that the formulation of medium- and long-term strategies, embodied in Irish national plans, predated by over two decades the fuller national consensus achieved in the late 1980s following a period of economic crisis. The fact that there was already an effective forum where problems could be discussed constructively made it easier to reach agreement on an economic transformation strategy.

<sup>26</sup> See Evans (1995), Amsden (1989) and Wade (1990).

<sup>27</sup> A fairly common factor in the countries selected is that a consensus or understanding has often emerged in a situation of crisis. One obstacle to New Zealand adopting a more structuralist strategy was satisfaction at the country's "respectable" rates of natural resource-based growth, even though they were not enough for convergence.

Consensus arrived at through collective action has the advantages already discussed, but can also entail risks that manifest themselves as rigidity in the application of strategies and programmes.<sup>28</sup> However, certain characteristics of the National Economic and Social Council come close to the ideal, especially as regards the way its strategic evaluations of the country's environment avoid "lock-in". As an Australian expert has pointed out (Marsh, 2006) in a more general analysis dealing with the subject of consensus, these characteristics are as follows: (i) the ability to make existing understandings more stable, (ii) the application of mechanisms to reconcile different viewpoints, (iii) an institutional framework that consistently facilitates the study and resolution of problems, (iv) an environment in which the boundaries between political disciplines and the expectations of different social stakeholders can be transcended and (v) the ability to build new political coalitions and networks.

## V

### An example of a far-reaching public-private alliance: the case of Ireland<sup>29</sup>

#### 1. Structure and operations

The National Economic and Social Council of Ireland came into being in the early 1960s as a talking shop for employers' associations, unions, farmers' organizations and very high-level public-sector officials (it now includes non-governmental organizations). Its original purpose was to provide a forum where groupings and organizations with different interests could exchange views on the country's economic and social development. In the 1970s and 1980s the NESC served as a non-confrontational discussion forum, but after the crisis of the second half of the 1980s and the macroeconomic disequilibrium, recession and unemployment that ensued, it evolved into a place

In the construction of what prove to be more durable strategy-forming consensus, like those of Ireland and Finland, and likewise in the case of understandings such as those of Malaysia and Singapore, there is an explicit concern to make social cohesion part of the process, as this is an important factor for the full incorporation of civil society. In addition, public-private alliances are presided over by the country's highest authorities, such as the president or prime minister.

Although consensus is undoubtedly difficult to attain, high-level forums and meetings that are attended by the public and private sectors, are geared towards solving problems and reaching agreements, are isolated to some extent from day-to-day political confrontation and are grounded in analyses based on real facts can be a good mechanism for achieving social consensus on a national economic transformation and internationalization strategy that is sustainable in the medium and long run.

where social understandings and agreements could be reached within the framework of an economic policy focused on high and sustained economic growth with social equity.

The Council now analyses strategic medium- and long-term economic issues and advises the Taoiseach (prime minister) on policy and programme guidelines. It is chaired by the Secretary-General of the Department of the Taoiseach and its members include the secretaries-general of certain ministries and five representatives from each of the following groups: employers' associations, unions, farmers' organizations, non-governmental organizations and independent representatives (usually specialists or academics). The government invites nominations for representatives of the social groups and itself appoints the independent participants, who share

<sup>28</sup> Another risk is the "capture" of the State already referred to. This can be mitigated by ensuring that the forum is representative and by means of codes of conduct, evaluations and transparency (O'Donovan, 2008).

<sup>29</sup> This section is based on the study carried out by O'Donovan (2008).

its outlook to some degree. Appointments are for three-year terms.

The NESC receives technical and administrative advice from a semi-autonomous secretariat with nine members (most of them specialists with master's degrees or doctorates) responsible for preparing studies to support its deliberations. Its director is a politically impartial and widely respected economist and its staff are selected by competitive examination and appointed by the State on a temporary basis. In 2007, the secretariat had a budget of 1.1 million euros.

The Council meets once a month and decisions are taken by consensus. It prepares a triennial report which is used as a strategic input for negotiations on the social agreement between the government, firms and unions, and as a guide for the government's national plan. The activities of the NESC began to be consolidated in 1986, when it was able to lay the groundwork for conversations between the government and different social stakeholders that resulted in a three-year agreement on wages, taxes and social spending as part of a programme of growth, employment and fiscal equilibrium. Once the situation of macroeconomic imbalance had been dealt with, subsequent reports focused on other strategic issues such as competitiveness, the supply of industrial goods and services and the knowledge economy, all on the basis of social cohesion policies.<sup>30</sup>

## 2. The consensus-building methodology

The discussions of the National Economic and Social Council of Ireland do not focus on short-term issues. Instead, it formulates recommendations based on the broad principles framing the government's medium- and long-term socio-economic policies and programmes. The goal is to attain consensus within an analytical framework that makes it possible to forge a social agreement, orient a national strategy and incorporate government programmes into the national plan. The type of public-private alliance associated with the Council consists mainly of a process of consultation and agreement between partners united by functional interdependence and a sense of solidarity, social cohesion and participation.

Both facets are indispensable to the process, since depending exclusively on the former would give too much importance to the relative power of the partners, while relying solely on the latter would reduce the concept of inclusion to nothing more than a consultation exercise in which the interested parties merely made known their views and needs.

There is a third important aspect, however: negotiation. Consensus-building implies that the partners do not come to the table with hard-and-fast positions or a determination to maximize the benefits to themselves, but rather are willing to follow a process of deliberation that provides an opportunity to formulate and reformulate agreement on particular problems and their solutions as well as on the identities and preferences of the participants, the end result being the creation of something akin to a public good. Thus, the alliance-building process depends on the ability to work towards understanding and enter into deliberations with a view to solving a concrete problem in a way that yields consensus.

The key to the NESC process may be the method of deliberation. The first step is to accept that the essential mandate of the participants is to solve problems, while the second key point is that the deliberation mechanism is designed to do so through dialogue based on inputs from neutral experts and working groups that help to create common positions. The characteristic of this mode of operating is that the debate among the participants does not turn on a definitive point of view; instead, following consideration of the empirical evidence presented by a neutral technical secretary, and in compliance with the problem-solving mandate, a sort of "joint decision" can emerge. The participants are obliged to explain, justify and accept responsibility for their proposals vis-à-vis the evidence, their partners in the alliance, their own members and the general public. Thus, understanding and consensus are not a precondition for the alliance, but an outcome of it.

Another important element in consensus-building is social cohesion, a permanent goal of deliberations on the direction and content of future strategies. The experience of the National Economic and Social Council reveals that a pragmatic discussion aimed at solving a concrete problem can produce consensus, even when there are underlying conflicts of interest and no initial understanding. It should be noted that consensuses achieved at the NESC

<sup>30</sup> For more detailed information, see the web page of the Government of Ireland [online] <http://www.irlgov.ie/> and the nesc web page [online] <http://www.nesc.ie>.

are always temporary, i.e., they serve to formulate practical recommendations for action, but goals, methods and analyses can always be revisited.

The deliberations of the Council are private and are supported by the Taoiseach. The actors involved vary depending on the issues at stake, which makes consensus easier to achieve. Something else that contributes to this is a forward-looking approach, which makes government representatives less defensive. As we have said, the NESC only makes recommendations based on the main thrust of medium- and long-term government socio-economic policies and programmes, and they are not binding. Nonetheless, the strategic reports of the Council have provided the basic input for negotiations on the socio-economic programmes of the social agreement that are held in the Taoiseach's cabinet, and have been very influential in the preparation of the national plan.

Lastly, it must be remembered that the good results achieved by the NESC and its methodology are the outcome of a long process of trial and error beginning several decades ago, thanks to the decision by the public sector to offer interested social groups the chance to participate in a neutral high-level three-way forum backed by the Taoiseach and supported by high-quality technical inputs, so that different viewpoints on the country's development could be analysed in private.

One concrete example of the NESC methodology are the deliberations on the national recovery strategy

applied in 1986, when there was an urgent need to stabilize the economy. The problem was analysed intensively at the monthly meetings of the Council under the guidance of its chairman and on the basis of studies prepared by the secretariat. A vital element in reaching an understanding was the switch of focus from the annual fiscal deficit to the debt-to-GDP ratio, which opened the way for a more constructive exchange of views. First of all, it was observed that despite public spending cuts the fiscal situation was continuing to worsen, while the historically high global interest rates of the time were making debt service expensive; accordingly, it was concluded that the multi-year build-up of debt was more important than the fiscal deficit in a given year. Secondly, it was established that the crisis in Ireland went deeper than the fiscal deterioration and originated in the impaired growth rate of the economy. It was also concluded that this mediocre performance was due not just to the macroeconomic problem, but to the country's development style as well. In addition to formulating macroeconomic recommendations, the Council emphasized the challenge of development and economic transformation, i.e., the need to create comparative advantages in areas other than agriculture. To implement policies in this sector, primary constraints were also analysed and industrial policies recommended to deal with them. Following the return to a situation of macroeconomic balance, this latter aspect of the NESC approach was given even greater prominence in the reports.<sup>31</sup>

## VI

### Conclusions

The current financial crisis represents a new challenge for Latin America and the Caribbean that will need to be confronted by means of short-term adjustments, but also within the framework of a proactive strategy for productive transformation and insertion into the international economy in the medium and long terms. In this way the region will improve its positioning in the global market and will be able to take advantage of the renewal of growth in the world economy, avoiding the contradictions observed in the adjustments of the 1980s.

The study on which this article is based showed how some successful countries from outside the region

had managed to substantially increase and sustain their growth rates, thereby closing or significantly narrowing the per capita income gap with the rich countries over the long run, and identified a set of common characteristics that influenced this process. The present article focuses on two of these: the importance of a strategic forward-looking vision

<sup>31</sup> See Caillaud and Tirole (2007) for an analysis of the dynamic of different consensus-building strategies. See Prats i Català (2005) for information on leadership, dialogue, consensus and representative groups.



and public-private collaboration or alliances to deal with problems consensually and decide on strategies for solving them.<sup>32</sup>

It was observed that the key is to organize a representative social process within a framework of alliances that facilitate an intelligent national effort to identify opportunities for accelerating the country's economic transformation and dynamizing the mode of its international insertion, coupled with identification of short-, medium- and long-term constraints and the capacity of the private and public sectors to remove or alleviate them so that the goals set can be achieved. The design of the social process is crucial here: it needs to be socially inclusive and representative and supported at the highest political level, and it must not result in the capture of the State by special interests. Its mode of operation should be conducive to objective, empirically grounded diagnostic work, as this will make it easier to reach consensus on where the economy ought to be internationally in five, 10 or 15 years' time and on the measures needed to attain goals that are realistic but also ambitious.

The study shows how the different countries were able to fulfil these requirements each in their own way, given that there is no universal formula. Nonetheless, the most successful were those with more stable public-private alliances that provided a basis for consensus or public understandings to underpin economic transformation strategies oriented towards successful internationalization of the economy.

<sup>32</sup> The third, effective institutional organization of the public sector to implement the strategy agreed on, was not addressed in this article, but it is a central pillar of the study by Devlin and Moguillansky (2009).

There is a growing interest in developing economic transformation strategies in Latin America and the Caribbean, and the seeds of public-private alliances to sustain them already exist in several countries. However, according to the results of the authors' research published originally in ECLAC (2008c) and of a forthcoming study by them (Devlin and Moguillansky, 2009), there is still a long way to go in terms of designing and implementing strategies and developing effective alliances to support them.

As regards strategies, a significant number have been documented whose contents largely consist of a set of fairly general aspirations for the development of a modern, competitive economy, but which are not complete enough to express effective and properly financed plans of action. Recognizing that strategy and actions plus financing and public-sector organizing ability are the four indispensable elements for achieving these aspirations, the efforts made often fail to yield the desired results. This is because strategies have a very wide range of broad goals, giving rise in turn to a proliferation of unquantifiable targets and actions for which no deadlines or accountability exist. At best, they represent conceptual frameworks rather than strategies as such.

What we consider true alliances are those which give rise to a consensual vision transcending political cycles and where the public sector has the ability to be a credible partner of the private sector, i.e., can effectively implement the actions needed to carry forward a strategy that provides the basis for rapid economic transformation. Inevitably, all this has to be achieved through a social and political process of trial and error. But the goal is clear: to begin constructing an effective strategic approach to public policymaking that can contribute to the development of Latin American "tigers".

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**KEYWORDS**

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# Export diversification and growth in emerging economies

*Manuel R. Agosin*

**T**his paper develops and tests a model of growth that emphasizes the introduction of new exports as the main source of growth in countries that are well within the global technology frontier and depend for growth on adapting existing products to their economic environment. It seeks to capture the stylized facts behind growth in countries as different as the Republic of Korea, Taiwan Province of China, Mauritius, Finland, China and Chile, all of which have relied on export diversification. The widening of comparative advantage is thus seen as the main driver of economic growth. The export diversification hypothesis is tested using an empirical growth model. Controlling for other variables that affect growth, export diversification —both alone and in interaction with growth in per capita export volumes— is found to be highly significant in explaining per capita GDP growth over the 1980-2003 period.

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# I

## Introduction

This paper explores the connection between rising exports and GDP growth, with reference to the divergent growth experience of East Asian and Latin American and Caribbean countries. We are interested in the issue of whether export growth is associated with overall economic growth. In a statistical sense the relationship must hold, since exports are a part of GDP, but the focus here will be on whether there is a particular kind of export growth that can result in sustained growth both in exports and in GDP. We posit that countries with diversified export structures are able to record consistently higher export growth than countries whose exports are largely confined to just a few products.

Section II presents some analytical considerations on the question of why output and export diversification should be positive for growth. In section III, a model is developed to capture the stylized facts of

an economy where growth is based on adaptation of foreign goods rather than on genuine innovation. After looking at the export and growth experience of Latin America and the Caribbean and Asia (section IV), we show the plausibility of a negative association between export concentration and growth owing to the effects of concentration on export and output volatility (section V). Then, in section VI, we show that an export diversification index and export growth interacting with this index (a sort of diversification-weighted export growth rate) are strong explanatory variables in a simple empirical growth model estimated with cross-section data for 1980-2003. In section VII, the coefficients yielded by the empirical model are used to estimate the average contribution of export diversification, investment and the rule of law to growth in Latin American and Asian countries. Section VIII recapitulates.

# II

## Analytical considerations

Why might export diversification be beneficial to growth? There are potentially two different types of effects. The first is what we call the portfolio effect, which takes its name from the financial literature. The greater the degree of diversification, the less volatile export earnings will be. Less volatile exports are associated with lower variance of GDP growth. This in itself is a positive aspect of diversification, since countries with imperfect (or no) access to world financial markets

will not be able to smooth consumption in the face of large fluctuations in exports and output.

In addition, the variance and mean of the growth rate may be negatively correlated for other reasons. This adverse effect of volatility on average growth could result from hysteresis. Periods of contraction lead to the destruction of installed capacity and to deskilling of the labour force, neither of which can easily be undone during the next boom. Also, countries

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whose exports are highly dependent on one or a few products tend to have more volatile real exchange rates than countries with diversified export structures, and real exchange-rate volatility discourages investment in tradable goods and services.

Second, there is the dynamic effect of export diversification. Long-run growth is associated with learning to produce an expanding range of goods. This view sees growth as resulting from the addition of new products to the export and production basket. In countries that have few indigenous sources of productivity growth, most productivity advances come from the investment process itself, as new capital goods embody changes in production methods and open up new sectors that have higher factor productivity than existing ones. These sectors are not new to the world, but they are new to the economy where they are being introduced and represent technical change.

One of the single most important characteristics of countries with low per capita income is that they have a comparative advantage in a very limited range of goods. In other words, paucity of skills or a lack of complementary inputs (some non-traded) mean that these countries are unable to apply production knowledge that exists elsewhere in the world. As a country develops, it becomes increasingly able to produce an ever wider range of goods and can begin to compete in international markets for them. Consequently, there is a line of causation that runs from per capita income to diversification of production and exports. While not the only one, the ability to export can certainly be judged a good indicator of international competitiveness.

But there may also be a causal relationship running from efforts to diversify exports to growth itself. The acquisition of new comparative advantages may be a powerful spur to more rapid economic growth. In other words, countries whose comparative advantages remain confined to a narrow range of low-technology goods grow slowly, and countries that are able to broaden their comparative advantages grow more rapidly. That is the major hypothesis of this paper.

Production of goods that represent a step up the technological ladder for a country requires trained labour, but the introduction of such goods also speeds up the training of workers, as those employed in the new ventures tend to train others. In addition, the introduction of a new type of production increases the likelihood that other new sectors will arise, as human capital employed in the new sector may well come up with new production ideas.

In some recent literature, it has been convincingly argued that producers do not have complete knowledge of the comparative advantages of their economies. There are elements of comparative advantage that are, so to speak, discovered in the process of producing a new good. On this view, introducing a new good to the export basket has an externality, because it reveals to other producers the underlying cost structure of the economy. However, in a developing-country context, the introduction of a new good or the application of a new technology is easily copied, because such technological innovations cannot be patented in the economy where they are introduced. Therefore, the leader will not reap all the benefits of his investment (Hausmann and Rodrik, 2003).

A similar strand of argument emphasizes the discovery of foreign demand (Vettas, 2000). Making a new product for export markets may reveal to domestic producers that there is demand in international markets for products that can be (or already are being) produced domestically.<sup>1</sup> In fact, the introduction of a new good may create demand abroad for that good by making consumers aware of its existence and characteristics. Like cost discoveries, demand discoveries represent non-patentable innovations and, as such, can be easily copied. Again, there is an important externality here that can lead to a sustained spurt of growth.

A further development in the literature is the demonstration that producing a new export can have additional growth-enhancing effects. Export discoveries are not random, but follow some kind of sequence. Countries that become good at producing a particular export are likely to develop comparative advantages in related sectors. It has been observed that new exports cluster together or follow a pattern in time, examples being television sets, digital versatile discs (DVDs) and mobile phones in China, different varieties of fruit in Chile and different kinds of wearing apparel in East Asia and Central America. This phenomenon can be explained by the observation that clusters of goods tend to utilize the same or similar public goods (specific public institutions) and non-tradable inputs (roads, logistical services). Hence, an export discovery may facilitate the emergence of other new exports in the same or closely related sectors. This being

<sup>1</sup> A case in point is wine in Chile. While wine has been produced there since the seventeenth century, it was not until the mid-1980s that exports took off, mainly because a few entrepreneurs discovered that, with some modifications to production techniques, Chilean wine could be sold very profitably in Europe (Agosin and Bravo-Ortega, 2007).

the case, an export discovery has not only positive intra-industry growth effects but also inter-industry spillovers (Hausmann and Klinger, 2007; Hausmann and Rodrik, 2006).

### III

## A model linking output and export diversification to growth

The purpose of this model is to attempt to capture these stylized facts. In a sense, it seeks to flesh out the classic view of development as resulting from the “advantages of backwardness” (Gerschenkron, 1962). In other words, technologically backward economies can grow at fast rates simply by copying what already exists elsewhere and do not have to grow by pushing out the technology frontier.<sup>2</sup> Some countries are able to reap the advantages of being inside the technology frontier, either because of the policies they apply or because institutional arrangements are favourable; others are not. However, introducing goods that exist elsewhere is an innovation that can easily be copied. Indeed, it is precisely this that provides the impetus for rapid economic growth. The inability to reap discovery benefits is also the key market failure that needs to be dealt with if an economy with these characteristics is to grow.

There is no aggregate production function and no technical change other than those embodied in the introduction of newer and more sophisticated goods. Aggregate output is the sum of the production value of all goods produced in the economy. Let us begin with an economy that produces one traditional good (say, sugar) using land and labour. Sugar is the numeraire of our economy (its price is unity). The introduction of any new good is the product of an idea, in the sense of “self-discovery” as the term is used by Hausmann and Rodrik (2003); in order to be profitable, any new idea requires the existence of sector-specific public goods (“infrastructure” for short). Thus, economic growth in a developing-country setting is hampered by an informational externality (since those who introduce a new idea are unable to reap all its benefits) and by

These hypotheses suggest that export diversification should indeed be associated with economic growth, with export diversification the cause and economic growth the effect.

a coordination problem (since without the requisite infrastructure new ideas cannot be profitable).

Following Romer (1993), aggregate production is the sum of all goods produced. Let us assume that factor endowment consists of land ( $T$ ), unskilled labour ( $L$ ) and initial human capital ( $H_0$ ). Sugar production uses land and labour but not human capital; all modern goods use labour and human capital but not land. There is an unlimited supply of unskilled labour, in the sense of Lewis (1954), so that we do not have to worry about running up against a labour shortage, and the wage is fixed at its subsistence level ( $\bar{w}$ ).

$$Y = F(T, L_T) + \sum_j \sum_i p_{ij} G_{ij}(L_{ij}, H_{ij}; A_{ij}, B_j) \quad (1)$$

$$\begin{aligned} & B_j = 0, A_j = 0 \\ & B_j = 1, A_j = 0, 1 \\ \text{where } & j = 1, \dots, n \\ & i = 1, \dots, m \end{aligned}$$

For a product  $G_{ij}$  to be generating output, the economy must have the supporting infrastructure ( $B_j = 1$ ). This is a necessary but not sufficient condition. The sufficient condition is that an entrepreneur must be using the idea ( $A_{ij} = 1$ ). If the sector-specific infrastructure is not in place, there cannot be any production ( $A_{ij} = 0$ ). Investment in infrastructure in this model is a public-sector decision. Growth takes place through the introduction of new goods or through investment in existing non-traditional goods. We assume that sugar production does not increase.<sup>3</sup>

<sup>2</sup> This is why calculating total factor productivity in developing economies makes so little sense.

<sup>3</sup> An alternative assumption is that sugar production grows at the rate of world demand, i.e., at the rate of growth of world output multiplied by the income elasticity of demand, which is usually much lower than unity.

This model captures the essentials of the experience of countries as different as the Republic of Korea (Amsden, 1989), Taiwan Province of China (Wade, 1990), Mauritius (Wellisz and Lam Shin Saw, 1993), Finland (Jäntti, Saari and Vartiainen, 2005) and Chile (Agosin, 1999; Agosin and Bravo-Ortega, 2007).

Human capital (other than the initial endowment) is on-the-job training. There is no firm-specific human capital. In other words, trained workers can migrate without any retraining costs to other modern sectors of the economy. Existing trained workers train others. Hence, the increase in human capital in any given period is proportional to the initial endowment plus the human capital that is employed in the modern sector of the economy. The economy may also import human capital through foreign direct investment.<sup>4</sup> Formally, some of the products ( $G_{ij}$ ) may bring with them the human capital ( $H_{ij}$ ) needed for their production.

$$\dot{H} = \mu \left( H_0 + \sum_j \sum_i H_{ij} \right) \quad (2)$$

New ideas are the key to growth in this economy. Because many new ideas are variations on existing ones, new ideas (and new production sectors) are a function of the number of ideas being exploited in the economy ( $A_{nm}$ ) and of the stock of human capital.

$$\dot{A} = J \left( A_{nm}; H_0 + \sum_j \sum_i H_{ij} \right) \quad (3)$$

The public sector builds sector-specific infrastructure that enables the introduction of new ideas. We make the following assumptions: (i) the public sector balances its budget, (ii) all revenues come from taxing profits generated both in the modern sectors and in sugar production, (iii) government expenditures are either on investments in new infrastructure projects or in consumption ( $C_G$ ) and (iv) the cost of each infrastructure project is the same (and equal to  $\lambda$ ). From the condition of public-sector budget balance, we can obtain the number of new infrastructure projects undertaken:

$$\dot{B} = (\tau / \lambda) \left( \pi_s + \sum_j \sum_i \pi_{ij} \right) - C_G / \lambda \quad (4)$$

<sup>4</sup> This is one of the roles assigned by Romer (1993) to foreign direct investment in his original formulation of the model.

In this model, new infrastructure projects generate growth. However, since they must be financed out of tax revenue and the tax rate decreases the net profits of enterprises in the modern sector, there is a trade-off between new infrastructure projects and investment by existing firms in the modern sector, since investment is financed from retained earnings.<sup>5</sup> We assume that in the modern sector, aftertax profits are fully reinvested in existing ventures. Aftertax profits in sugar are consumed.

When will a new product be introduced into the economy? Assume that a prospective entrepreneur borrows  $C_0$  in period 0 to gather information about introducing a new idea into the economy. The entrepreneur also knows that capital of  $C_1$  is needed to make the project operational and will borrow this in period 1 if and only if the project indeed turns out to be profitable after the requisite information has been obtained. The project yields a profit of  $\pi_{ij}$  in period 2, but in period 1 the information needed to ensure the project is profitable becomes known to all potential entrepreneurs.<sup>6</sup>

Formally, and assuming risk neutrality, the entrepreneur will decide to gather information about the project if expected aftertax profits in period 2 exceed the search costs in period 0 and the capital investment costs in period 1:

$$(1 - \tau)E(\pi_{ij}) \geq C_0(1 + r + \varphi)^2 + C_1(1 + r + \varphi) \quad (5)$$

where  $r$  is the international interest rate and  $\varphi$  the country risk premium. Alternatively,  $r$  can be interpreted as the bank deposit rate and  $\varphi$  as the spread between borrowing and lending rates.

If expected profits are normally distributed, with a sufficiently large number of draws, average realized profits will be equal to expected profits. All entrepreneurs draw their information from the same pool. Some will wind up with profits that satisfy (5) and some will not.

<sup>5</sup> As will be seen below, we have made the simplifying assumption that there is no capital in this economy and that new production requires an advance (say, to hire skilled and unskilled workers) which is repaid in the following period. For pioneers, there is an additional investment in information-gathering.

<sup>6</sup> This is a somewhat different setup from the one used by Hausmann and Rodrik (2003). Their model requires a period of monopoly so that the innovator can reap a rent. We require only that the prospective profits of the project be sufficient to at least cover the costs of searching and setting up production.



The situation of a copycat investor is much more favourable, since he or she can wait to observe which projects are profitable. For a copycat investor, the condition for making an investment in a sector  $A_{ij}$  which turns out to be profitable is:

$$(1 - \tau)\bar{\pi}_{ij} \geq C_1(1 + r + \phi) \quad (6)$$

This implies that it pays to wait for others to make the self-discovery, which means that there will be suboptimal investment in discoveries.

Discoveries can be of two types. One has already been highlighted by Hausmann and Rodrik (2003): the discovery of costs, which is related to information on input-output coefficients in the sector. For simplicity, we assume that these coefficients are fixed. Formally, a cost-discovery problem tells us that the entrepreneur must form an expectation with regard to these coefficients which ex post may or may not take their ex ante expected values. Simplifying the notation by eliminating subscripts and making  $C = C_0(1 + r + \phi)^2 + C_1(1 + r + \phi)$ :

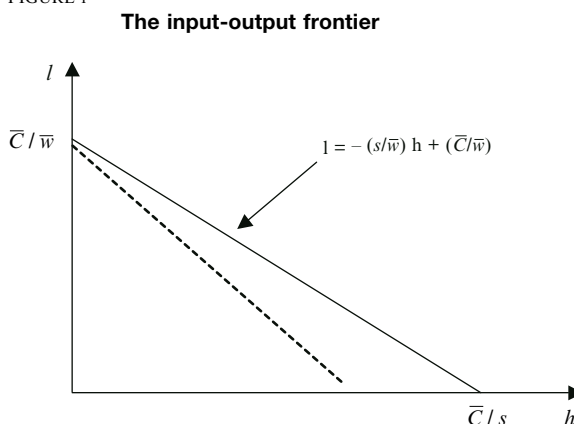
$$(1 - \tau)E(\pi) = (1 - \tau)[p - \bar{w}E(l) - sE(h)]G \geq C \quad (7)$$

The maximum levels of  $l, h$  that yield a positive profit higher than the value of the investment  $C$  can be mapped by converting (9) into an equality. An investment will be made if the combined values of  $l$  and  $h$  are such that they are within the triangle in figure 1, where  $\bar{c} = p - C / [G(1 - \tau)]$ .<sup>7</sup>

If the entrepreneur draws input-output coefficients which do not fall within the triangle, the investment will not be profitable. In addition, since each entrepreneur is small, she does not take into account the effect of her investment on the skilled labour wage rate. However, one of the effects of cost discovery will be that investments by copycats push up this wage, reducing ex post the return on capital for the pioneer investor. An increase in the skilled labour wage will result in an inward movement within the input-output frontier, but only on the  $h$  axis, as described by the dotted line in figure 1.

In addition, under certain circumstances, if the country's producers as a group face a downward-

FIGURE 1



Source: author's calculations.

sloping demand curve, the product price may fall.<sup>8</sup> In this case the entire input-output frontier will move inward towards the origin. If the tax rate increases, the input-output frontier will also move inward, making investment in discovery less likely.

But, as noted above, there is another kind of discovery: demand discovery. Entrepreneurs may know the cost structure of a particular good but be uncertain as to whether they can sell it abroad. Once a market for the product has been created abroad, other producers can take advantage of the discovery without incurring the costs of opening up the market. In this case, the investment decision will look like this:

$$(1 - \tau)E(\pi) = (1 - \tau)[E(p) - \bar{w}l - sh]G \geq C \quad (8)$$

In this case, there is a minimum price that makes the venture profitable, and that happens when the equality in (8) holds. As copycats enter the market for the discovered product, the skilled labour wage will be bid up and the product price may fall. In equilibrium, this will reduce the profits of pioneer and copycats alike and discourage discoveries.

We have thus seen that the actions of followers erode the profits of the pioneer, either by raising factor rewards or by reducing the product price. However, the source of the market failure remains the same:

<sup>7</sup> For the problem to have a sensible solution, must be positive  $\bar{c}/\bar{w}, \bar{c}/s$ .

<sup>8</sup> This is a far from hypothetical case. In Chile, the discovery of kiwis as an export product in the 1970s led in a few years to a collapse in the international price from which domestic producers did not recover until the late 1980s.

the pioneer takes risks that, if successful, result in easier profits for others. Therefore, it pays to wait for others to make the discoveries, and the supply of self-discovery will be suboptimal.

This model has interesting properties. When only sugar production exists, the potential for opening up new sectors is restricted to the resources the government can extract from taxing sugar profits, which are anyway not reinvested. Therefore, there might be a good argument for squeezing profits in the traditional sector, which (in the model) would have the result of lowering consumption and raising investment in infrastructure specific to other (new) sectors of the economy. At any rate, the potential for the introduction of new products into the economy is limited by the narrow tax base. As the tax base widens with the opening up of new sectors, the government is able to finance new infrastructure projects, thus accelerating growth. There is, nonetheless, a trade-off between building new infrastructure and opening up new sectors and investment by the private sector in the existing modern sectors.

Human capital formation is the consequence of new ideas being introduced and existing skilled workers training unskilled workers. A high rate of investment in human capital (with the effect of raising  $\mu$ , in our model) can ease the pressure on the skilled labour wage that is a consequence of investment in the modern sector and of the discovery of new products. In addition, the higher the rate of human capital accumulation, the higher will be the rate of new discoveries.

In this model, government has three roles: investing in infrastructure specific to sectors that do not yet exist, which makes discovery possible; subsidizing the cost of discovery, in light of the informational market failure involved; and raising the rate of skill formation (presumably by raising the value of  $\mu$ ).<sup>9</sup> As already noted, it should balance the need for public investment with

<sup>9</sup> The costs of the last two have not been factored into the model.

the drag of taxes on modern-sector investment, which is financed largely out of retained earnings.<sup>10</sup>

The model can account for several of the constraints on growth discussed in the literature and can be used to illustrate the decision-tree approach to the issue employed by Hausmann, Rodrik and Velasco (2005). For example, growth can be constrained by a high cost of finance. This would be reflected in an interest-rate spread ( $\phi$ ) that would raise the threshold for the expected profits required for self-discovery activities.<sup>11</sup> The economy may not be generating enough growth through discovery because of low appropriability of returns to discovery. This could be the case if the tax rate is too high, as this would reduce the rate of return to investments in new products.<sup>12</sup> While taxes finance infrastructure investment, they can also finance consumption. The rate of new skill formation may be too low to prevent the wages of skilled labour from rising to levels where they choke off investment. This would be reflected in a low  $\mu$  in equation (2).

These considerations may explain why successful countries are able to grow faster than others: they may subsidize discovery activities in various ways; they may keep borrowing costs low, either through policies that deepen financial markets or by directing credits to winners (see Amsden, 1989, for the Korean experience); they may use government revenue for investment rather than consumption; they may keep tax rates reasonable; or they may invest in human capital accumulation. Most of the successful countries of Asia have done some or all of these things, but Latin American countries have failed to do enough of them to ensure an adequate rate of self-discovery.

<sup>10</sup> We are assuming that investment in existing modern sectors is financed out of retained earnings, but that the funds required to set up a new sector are borrowed.

<sup>11</sup> If non-availability of credit for new projects is the problem, then  $\phi$  is in effect infinite.

<sup>12</sup> Remember that taxes on sugar profits do not matter because these are consumed, but if taxes were high they would affect profits on both traditional and new products. Taxation on the latter discourages investment by reducing the appropriability of returns.

## IV

### Trade and growth in Latin America and the Caribbean and Asia, 1980-2003<sup>13</sup>

In this section, we show the plausibility of the hypothesis linking export diversification and growth by looking at the recent experience of East Asia and Latin America and the Caribbean. As shown in table 1, Asian exporters of manufactures grew much faster during 1981-2003 than Latin America and the Caribbean. Asian output and exports grew more than twice as fast as those of Latin America and the Caribbean. Even if one excludes the 1980s, the “lost decade” in the latter region, these differences also apply to the period since 1990, although average Asian output and export growth rates are not quite double those of Latin America and the Caribbean. Figure 2 shows that these averages are not a statistical fluke, since the same pattern repeats itself at the country level: all Asian countries exhibit higher rates of growth in both GDP and exports. Even during the

1991-2003 period, the country with the highest rate of GDP growth in Latin America and the Caribbean (Chile) was surpassed by five of the ten Asian countries included in the sample.

What is interesting about these figures is that both GDP and exports consistently grew faster in the Asian countries than in Latin America and the Caribbean. In fact, the ratio of GDP growth to export growth is practically identical in the two regions for the two periods analysed but, as argued below, Asian countries’ exports not only grew faster but were also of higher “quality”; that is, they were considerably more diversified.

Of course, this does not mean that faster export growth is the key to the success of the Asian countries relative to their Latin American counterparts, since there are many other differences between them, but

TABLE 1

#### Latin America and the Caribbean and Asia (selected countries): GDP and export growth, 1981-2003

(Percentage annual change in GDP and real exports of goods and services)

	1981-2003		1991-2003	
	GDP	Exports	GDP	Exports
Growth rates				
Latin America and the Caribbean	2.4	5.3	3.0	6.2
Asia	5.9	11.1	5.5	11.7
Ratio of GDP to export elasticity				
Latin America and the Caribbean	0.49		0.45	
Asia	0.47		0.53	

Source: author’s calculations based on World Bank, *World Development Indicators* [online database] <http://devdata.worldbank.org/dataonline/>.

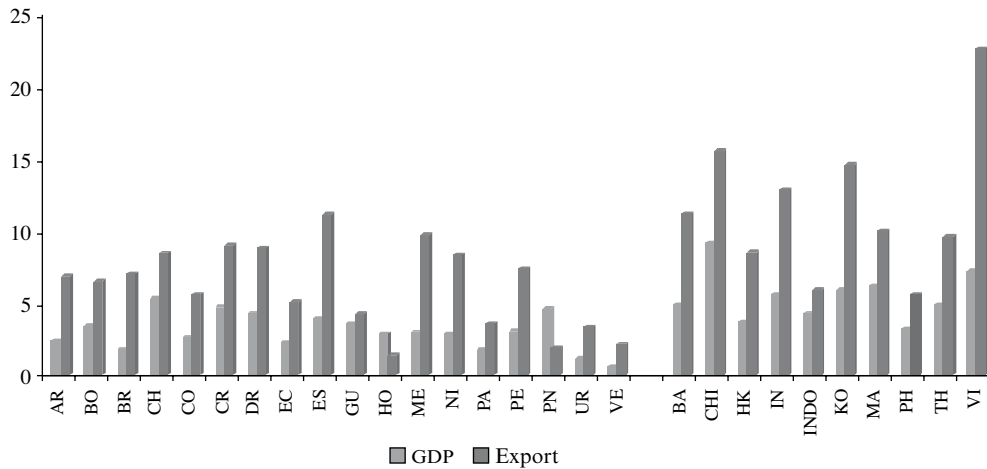
N.B.: Exports refer to real exports of goods and services (nominal values deflated by the relevant GDP deflator). Countries included are: in Latin America and the Caribbean, Argentina, Bolivarian Republic of Venezuela, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Plurinational State of Bolivia and Uruguay; in Asia, Bangladesh, China, Hong Kong (SAR), India, Indonesia, Malaysia, Philippines, Republic of Korea, Thailand and Vietnam.

<sup>13</sup> The 2004-2007 period was affected by the unprecedented rise in primary commodity prices, which undoubtedly raised the Herfindahl-

Hirschmann coefficients of Latin America to levels considerably higher than those considered “normal” for the region.

FIGURE 2

**Latin America and the Caribbean and Asia (selected countries): growth of GDP and of goods and services exports, 1991-2003**  
*(Percentage average annual rates of growth)*



Source: author's calculations based on World Bank, *World Development Indicators* [online database] <http://devdata.worldbank.org/dataonline/>.

N.B.: Country abbreviations are as follows: in Latin America and the Caribbean, Argentina (AR), Plurinational State of Bolivia (BO), Brazil (BR), Chile (CH), Colombia (CO), Costa Rica (CR), Dominican Republic (DR), Ecuador (EC), El Salvador (ES), Guatemala (GU), Honduras (HO), Mexico (ME), Nicaragua (NI), Paraguay (PA), Peru (PE), Panama (PN), Uruguay (UR) and Bolivarian Republic of Venezuela (VE); in Asia, Bangladesh (BA), China (CHI), Hong Kong Special Administrative Region (HK), India (IN), Indonesia (INDO), Republic of Korea (KO), Malaysia (MA), Philippines (PH), Thailand (TH) and Vietnam (VI).

faster export growth, more diversified exports and the factors that underlie these phenomena do appear to have played a role.

There is evidence that output and export diversification has been a trait in the development pattern of Asia. The proxy for output and export diversification that we use here is the Herfindahl-Hirschmann Index (HHI),<sup>14</sup> taken from the *Handbook of Trade and Development Statistics* of the United Nations Conference for Trade and Development (UNCTAD) and measured at the three-digit Standard International Trade Classification (SITC) level. However imperfectly, this indicator captures both vertical and horizontal diversification. By vertical diversification is meant the shift from exporting, say, primary commodities to exporting manufactures. Horizontal diversification means broadening the

export basket by diversifying into goods within the same broad category; for example, from grapes with seeds to seedless grapes, or from coffee for the mass market to gourmet coffee.

As can be seen from table 2, in 1980 Asian countries had a much lower HHI on average than Latin America and the Caribbean; during the period up to 2002 the index declined consistently in all Asian countries, with the exceptions of Taiwan Province of China and the Republic of Korea, where the HHI bottomed out in 1992.<sup>15</sup> However, in 2002 these two latter economies had a lower HHI than most of Latin America and the Caribbean. Indonesia, a country whose exports were dominated by oil in 1980, saw a dramatic fall in its HHI over the 1980-2002 period, from 0.53 to 0.12. China too, even after starting out

<sup>14</sup> The HHI for country *j* is defined in the following manner:

$$HHI_j = \sum_i \left( \frac{x_{ij}}{x_j} \right)^2$$

where  $x_{ij}$  is the value of exports of good *i* by country *j* and  $x_j$  represents the total value of exports from country *j*.

<sup>15</sup> These two economies have the highest per capita incomes in the entire sample of middle-income countries, Asian or Latin American. In fact, the International Monetary Fund classifies them as developed economies. Perhaps the rise in the HHI is evidence of the U-shaped relationship between industrial concentration and income levels found by Imbs and Wacziarg (2003).

TABLE 2

**Latin America (selected countries) and Asian exporters of manufactures:  
Herfindahl-Hirschmann export concentration index, 1980-2002**

	1980	1986	1992	1998	2002
<i>Latin America<sup>a</sup></i>	0.36	0.40	0.30	0.26	0.25
Argentina	0.15	0.17	0.15	0.13	0.14
Bolivia (Plurinational State of)	0.39	0.52	0.32	0.20	0.25
Brazil	0.15	0.12	0.09	0.09	0.09
Chile	0.41	0.37	0.31	0.28	0.27
Colombia	0.58	0.58	0.24	0.25	0.22
Costa Rica	0.32	0.39	0.30	0.19	0.21
Ecuador	0.55	0.45	0.47	0.35	0.39
El Salvador	0.38	0.71	0.24	0.24	0.13
Guatemala	0.31	0.47	0.22	0.24	0.19
Honduras	0.37	0.50	0.46	0.44	0.20
Mexico	0.48	0.27	0.15	0.11	0.13
Nicaragua	0.37	0.52	0.29	0.32	0.18
Panama	0.26	0.37	0.45	0.30	0.31
Paraguay	0.28	0.40	0.36	0.43	0.38
Peru	0.26	0.25	0.27	0.22	0.25
Uruguay	0.24	0.20	0.18	0.17	0.19
Venezuela (Bol. Rep. of)	0.67	0.57	0.56	0.49	0.75
<i>Asian exporters of manufactures<sup>a</sup></i>	0.22	0.17	0.13	0.14	0.14
China	...	0.17	0.08	0.07	0.09
Hong Kong (SAR)	0.16	0.16	0.15	0.18	0.12
Taiwan Province of China	0.12	0.10	0.09	0.14	0.15
India	0.11	0.16	0.14	0.14	0.13
Indonesia	0.53	0.34	0.19	0.16	0.12
Republic of Korea	0.09	0.10	0.11	0.15	0.15
Malaysia	0.30	0.23	0.16	0.20	0.22
Thailand	0.20	0.14	0.09	0.11	...

Source: United Nations Conference on Trade and Development (UNCTAD), *Handbook of Trade and Development Statistics*, Geneva.

<sup>a</sup> Unweighted average of countries shown.

with a relatively low HHI in 1986, experienced a large decline to less than 0.10, the kind of level observed in most developed countries. Most Asian exporters of manufactures are rapidly approaching HHI levels very similar to those of developed countries.

Several Latin American and Caribbean countries have been diversifying their exports. Particularly impressive has been the decline in the HHI of Mexico, Colombia and, to a lesser extent, Chile. Argentina maintained a low HHI for the entire 1980-2002 period, but its exports remain more concentrated than those of Asian manufacturing exporters.

Practically the same picture emerges if one looks at the number of goods exported, also at the SITC

three-digit level (see table 3). The maximum number of positions in the three-digit SITC is 239 and practically all Asian countries are fast approaching that number. While an increase in the number of goods exported can also be seen in Latin America and the Caribbean, it has been more modest, so that the average remains at about half the maximum.<sup>16</sup>

<sup>16</sup> A curiosity of the data is that the number of products exported by most Latin American countries actually declined during the first half of the 1980s. This could have been another effect of the debt crisis.

TABLE 3

**Latin America (selected countries) and Asian exporters of manufactures:  
number of goods exported, 1980-2002**

*(At the three-digit level of the Standard International Trade Classification)*

	1980	1986	1992	1998	2002
<i>Latin America<sup>a</sup></i>	141	112	142	163	169
Argentina	198	201	211	221	220
Bolivia (Plurinational State of)	47	42	82	119	130
Brazil	225	213	219	222	225
Chile	181	147	195	209	201
Colombia	162	149	189	197	201
Costa Rica	144	113	142	179	175
Ecuador	80	53	116	148	151
El Salvador	116	86	113	149	164
Guatemala	168	121	137	167	168
Honduras	99	56	90	120	131
Mexico	201	208	221	229	229
Nicaragua	97	41	63	86	137
Panama	136	64	75	88	120
Paraguay	63	24	61	90	94
Peru	176	135	162	187	190
Uruguay	156	130	149	166	150
Venezuela (Bol. Rep. of)	153	128	193	196	194
<i>Asian exporters of manufactures<sup>a</sup></i>	189	182	212	217	225
China	...	90	233	232	233
Hong Kong (sar)	164	165	175	179	227
Taiwan Province of China	210	214	219	221	219
India	211	205	214	222	227
Indonesia	144	154	208	216	227
Republic of Korea	207	212	215	220	217
Malaysia	214	217	222	227	224
Thailand	176	197	211	222	...

Source: United Nations Conference on Trade and Development (UNCTAD), *Handbook of Trade and Development Statistics*, Geneva.

<sup>a</sup> Unweighted average of countries shown.

## V

### Evidence for the portfolio effect

The portfolio effect of output and export diversification on growth should mean that export diversification is associated with faster growth. If the portfolio effect were indeed at work, the causal relationships would be those summarized in figure 3. Export diversification is related positively to growth because of its effect in reducing the variance of export and GDP growth. As already stated, a reduction in the volatility of GDP growth should have a positive effect on growth itself.

These hypotheses are not falsified by the data available for the 1980-2003 period. Figure 3 would

lead one to expect a negative correlation between export diversification and the variance of export growth, a positive correlation between the variance of export growth and the variance of GDP growth, and a negative correlation between the variance of GDP growth and the rate of GDP growth.<sup>17</sup>

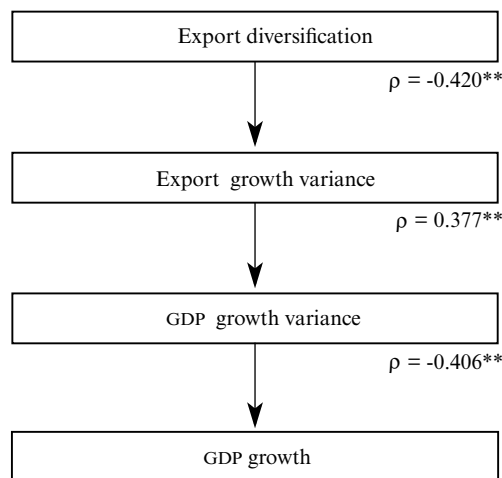
<sup>17</sup> Part of the effect of high GDP volatility on the GDP growth rate could be due to the impact of volatility on investment. High GDP volatility can be expected to lead to low rates of investment, with low investment being the cause of slow growth.

This is precisely what the data show (see figure 3). All correlation coefficients are of the expected sign and are significantly different from zero at the 1% level. Export diversification is measured as  $DIV = 1 - HHI$ . Increases in  $DIV$  are highly correlated with declines in the variance of export growth. In turn, a lower variance of export

growth is highly correlated with a lower variance of GDP growth. Lastly, a lower variance of GDP growth is strongly associated with higher GDP growth.

These simple correlations do not amount to proof of the portfolio effect, but they do suggest that something like it may indeed be at work.

FIGURE 3

The portfolio effect of export diversification on growth, 1980-2003<sup>a</sup>

Source: World Bank, *World Development Indicators* [online database] <http://devdata.worldbank.org/dataonline/>, and United Nations Conference on Trade and Development (UNCTAD), *Handbook of Trade and Development Statistics*, Geneva.

<sup>a</sup> The values of  $\rho$  represent the correlation coefficients between the variables in the two adjacent boxes. All are significant at the 1% level. The data used are for 106 countries over the 1980-2003 period. Export growth refers to goods and services in 2000 dollars. GDP growth data are in 2000 dollars.

## VI

### Growth empirics: does export diversification add anything?

In this section, we explore whether export diversification has any explanatory power in a parsimonious empirical model of growth. Two different variables, proxies for output and export diversification, were tested. One was  $DIV$  by itself, while the other was diversification-weighted per capita export growth; in other words,  $DIV$  interacting with per capita export growth ( $RX * DIV$ ). As will be noted below, while  $DIV$  has the correct sign and is highly significant, it is the interactive variable that has the most explanatory power. The intuition behind the inclusion of this interactive variable is

that diversification is more powerful when a country's exports are growing rapidly than just by itself. Note the difference between Colombia and Malaysia: both wind up in 2002 with a  $DIV$  of 0.78 ( $HHI$  of 0.22), but Malaysia's exports grew at a rate of 10.7% in the 1980-2003 period, while Colombia's grew only at an average rate of 5.7%. Diversification-weighted per capita exports in Malaysia grew at an annual rate of 5.9%, while those of Colombia grew by only 2.5% a year. GDP growth averaged 6.4% in Malaysia but only 3.1% in Colombia.

The estimation strategy is to add *DIV* and *RX\*DIV* to an otherwise standard empirical model of per capita growth. The variables considered were initial GDP per capita, initial openness (trade as a percentage of GDP), average fixed capital formation during the period, and the rule of law index from the database developed by Kaufmann, Kraay and Mastruzzi (2003).<sup>18</sup> The model is estimated by ordinary least

squares (OLS) and by instrumental variables (IV). This latter technique is used to correct possible simultaneity biases stemming from the endogeneity of the growth rate, export diversification and the investment rate. The instruments used for the investment rate and for *DIV* and *RX\*DIV* were manufactures as a share of exports, population size and the rule of law index.

The most suggestive results of the exercise are shown in table 4. In equations (1) and (2), we control only for initial GDP per capita and openness. *DIV* and *RX\*DIV* are of the correct sign and highly significant when entered individually into the regression. The inclusion of both *DIV* and *RX\*DIV* in an equation (not

<sup>18</sup> A host of different controls were also used, including the average years of schooling in the population aged 15 to 64, but they were not found to add anything to the equation.

TABLE 4

**An empirical model of growth***(Dependent variable: average annual rate of per capita gdp growth, 1980-2003)*

Explanatory variable	(1)		(2)		(3)		(4)	
	OLS	IV	OLS	IV	OLS	IV	OLS	IV
log YPC80	-0.102 (-0.87)	-0.366 (-2.57)*	-0.014 (-0.16)	-0.080 (-0.72)	-0.800 (-6.99)**	-0.717 (-5.41)**	-0.683 (-5.94)**	-0.581 (-3.92)**
TRADE80	0.006 (1.51)	0.014	0.005 (1.62)	0.006 (1.68)+	-0.001 (-0.44)	0.000 (0.01)	-0.000 (-0.01)	0.003 (0.83)
I/Y					0.192 (9.12)**	0.249 (4.88)**	0.159 (6.49)**	0.119 (3.09)**
RL					1.345 (7.30)**	0.949 (3.48)**	1.198 (6.41)**	0.911 (3.53)**
DIV	4.646 (5.12)**	12.147 (4.71)**			2.309 (3.59)**	5.05 (2.92)**		
RX*DIV			0.326 (9.37)**	0.465 (9.26)**			0.176 (5.43)**	0.312 (5.65)**
Adj. R2	0.165	-	0.427	0.365	0.655	0.608	0.677	0.640
No. of observations	124	118	118	117	113	112	109	108

Source: World Bank, *World Development Indicators* [online database] <http://devdata.worldbank.org/dataonline/>, except for the Herfindahl-Hirschmann Index data, which are from United Nations Conference on Trade and Development (UNCTAD), *Handbook of Trade and Development Statistics*, Geneva.

N.B.: Underlying GDP and export data are in constant 2000 dollars. Exports refer to goods and services. The rule of law index is from Kaufman, Kraay and Mastruzzi (2005) and was measured in 1996. Constant not shown; *t* ratios in parentheses; IV estimations with robust standard errors.

\* Significantly different from zero at the 10% level.

\*\* Significantly different from zero at the 5% level.

\*\*\* Significantly different from zero at the 1% level.

Definition of variables:

YPC80 = GDP per capita in 1980.

TRADE80 = exports plus imports divided by GDP in 1980.

I/Y = gross fixed capital formation (average for the period) as a share of GDP.

RL = rule of law index (1996).

DIV = export diversification index (1- HHI), average for the period (data end in 2002).

RX\*DIV = diversification-weighted rate of per capita export growth.

Instrumental variables used for DIV, RX\*DIV and I/Y: share of manufactures in GDP, population size and rule of law.



shown) renders *DIV* not significantly different from zero, while the coefficient associated with  $RX^*DIV$  remains almost unchanged and is still highly significant. Interestingly, the share of trade in initial GDP plays no role in explaining cross-country variations in per capita GDP growth rates. Neither is initial income per capita a robust explanatory variable, as the significance of the coefficient attached to this variable fluctuates quite sharply between model specifications and estimation techniques. As we shall see, this result is overturned when we add control variables to the model.

Next, we introduce *DIV* and  $RX^*DIV$  into a more completely specified model, one that includes gross fixed investment and the rule of law index. This is done in equations (3) and (4). It can be seen that this parsimonious model is statistically quite powerful. Initial GDP per capita becomes highly significant, the openness variable continues to have no role in the explanation of cross-country growth differences, and investment and the rule of law are both of the correct sign and also highly significant. These results confirm the finding in the literature that growth is positively related to investment, a hypothesis that goes back to the Harrod-Domar model and is also compatible with some of the more recent endogenous growth literature.<sup>19</sup> The results also lend credence to the more recent emphasis on institutions as important determinants of growth.

The rule of law (*RL*) is only as good as the capacity of governments to enforce it, and such capacity is likely to depend on a basic social pact. Other things being equal, countries where the government is perceived as working for the good of society as a whole are better able to enforce the rule of law, and this may explain the result that higher levels in *RL* are positively correlated with growth, and that the coefficient associated with *RL* is highly significant.

Both the variables that attempt to capture output and export diversification (*DIV* and  $RX^*DIV$ ) are highly significant, the interactive variable more so than *DIV*. Note that the model explains between 60% and two thirds of the cross-country variation in per capita gdp growth rates. Instrumental variable estimations raise the value of the coefficients attached to diversification and diversification-weighted per capita export growth. In equation (3), the coefficient of *DIV* doubles. In equation (4), the coefficient of  $RX^*DIV$  rises just shy of 100%. At the same time, the coefficients of the other variables remain more or less stable when we go from OLS to IV estimations. This would seem to support the notion that export diversification, in either of its two formulations, has indeed been an important contributor to the differences in growth performance between Asia and Latin America and the Caribbean.

## VII

### Growth differentials: how much does output and export diversification explain?

Even if the coefficients attached to our proxies of output and export diversification are statistically significant, they may not add much to the explanation of growth differentials. Through a simple exercise using the regional average values of *DIV*,  $RX^*DIV$ , *I/Y* and *RL*, we can show that our two output and export

diversification variables do explain a quantitatively important share of the difference in growth performance between exporters of manufactures in Asia and Latin America and the Caribbean.

First let us look at what the data for our main variables tell us about these variables that purportedly explain differences in growth performance. As can be seen in table 5, the rate of per capita gdp growth was quite robust in the Asian high performers, but very modest in Latin America and the Caribbean. Asia has done better than Latin America and the Caribbean in all explanatory factors, but two stand out: investment rates are almost 9 percentage points of gdp higher in Asia, and average diversification-weighted per capita export growth is 6.7 percentage

<sup>19</sup> Ironically, the profession rediscovered Harrod-Domar in the guise of the AK model. Since economists do not have much historical memory, however, nobody has remarked that the ak model is nothing other than the Harrod-Domar model in a new guise. Since much of the growth in productivity in developing countries comes embodied in imported machinery, the importance of investment is likely to be even greater for this group of countries than for developed economies.

TABLE 5

**Latin America and the Caribbean (selected countries) and fast-growing Asian countries:  
per capita GDP growth and some key factors explaining the difference, 1980-2003**  
(Percentages, except for RL and DIV indices)

Countries	Per capita GDP growth rate	I/Y	RL	DIV	RX*DIV
<i>Latin America</i>	0.4	20.2	-0.27	0.71	1.9
Argentina	0.3	18.1	0.28	0.86	3.4
Bolivia (Plurinational State of)	-0.2	16.0	-0.66	0.73	1.3
Brazil	0.8	20.8	-0.26	0.90	5.2
Chile	3.5	21.7	1.26	0.69	4.3
Colombia	1.1	19.0	-1.04	0.70	2.5
Costa Rica	1.2	22.2	0.64	0.71	3.2
Ecuador	0.3	21.1	-0.39	0.58	2.0
El Salvador	0.0	15.3	-0.48	0.69	1.5
Guatemala	0.0	15.0	-0.64	0.75	-0.5
Honduras	-0.1	25.1	-0.85	0.62	-1.2
Mexico	1.0	22.4	-0.12	0.82	6.5
Nicaragua	-1.3	23.9	-0.68	0.71	0.1
Panama	1.4	21.0	-0.68	0.66	-0.1
Paraguay	0.1	24.0	-0.50	0.62	1.5
Peru	0.1	22.6	-0.35	0.75	1.7
Uruguay	0.1	14.7	0.53	0.81	3.0
Venezuela (Bol. Rep. of)	-1.1	21.2	-0.66	0.41	-0.1
<i>Asian exporters of manufactures</i>	4.8	29.0	0.32	0.85	8.6
China	8.2	36.0	-0.45	0.92	18.1
Hong Kong (SAR)	4.0	28.3	1.71	0.84	8.2
India	3.8	22.6	-0.01	0.86	6.6
Indonesia	3.7	26.8	-0.36	0.80	2.3
Republic of Korea	5.6	32.4	0.81	0.87	10.0
Malaysia	3.6	30.7	0.85	0.80	5.9
Thailand	4.7	31.4	0.49	0.89	3.0
Vietnam	4.7	23.6	-0.50	0.78	15.0

Source: World Bank, *World Development Indicators* [online database] <http://devdata.worldbank.org/dataonline/>, except for the Herfindahl-Hirschmann Index data, which are from United Nations Conference on Trade and Development (UNCTAD), *Handbook of Trade and Development Statistics*, Geneva.

N.B.: Underlying GDP and export data are in constant 2000 dollars. Exports refer to goods and services. The rule of law index is from Kaufman, Kraay and Mastruzzi (2005) and was measured in 1996.

Definition of variables:

I/Y = gross fixed capital formation (average for the period) as a share of GDP.

RL = rule of law index (1996).

DIV = export diversification index (1-HHI), average for the period (data end in 2002).

RX\*DIV = diversification-weighted rate of per capita export growth.

points higher. This latter difference arises out of the fact that exports are considerably more diversified in Asia than in Latin America and the Caribbean and, moreover, have grown faster.

Armed with these data, we undertook a simple calculation of the extent to which each of the three factors identified above (investment, the rule of law and export diversification) help to explain growth differentials between Latin America and the Caribbean and the fast growers of Asia. The results are shown in table 6. About 80% of the difference in growth rates is explained by differences in investment rates, the rule of law and export diversification. Using the coefficients of

equation (3) in table 4 (IV estimation), the main factor explaining growth differences turns out to be investment, with export diversification adding a not insignificant 0.7 percentage points to the superior Asian growth performance. When we use the coefficients of equation (4), diversification-weighted per capita export growth becomes the most important factor explaining growth differences. This factor by itself explains almost 50% of the difference in growth rates between fast-growing Asian exporters of manufactures and Latin America and the Caribbean. We take this to be evidence that export growth, in the context of diversification, is the variable pulling GDP growth and investment.

TABLE 6

**Latin America and Asian exporters of manufactures:  
explaining the difference in growth rates<sup>a</sup>**  
(Percentages)

	Calculation I	Calculation II
<i>Growth differential</i>	4.4	4.4
Contribution of:		
Investment	2.2	1.0
Rule of law	0.6	0.5
Export diversification	0.7	
Diversification-weighted per capita export growth		2.1
<i>Total of above factors</i>	3.5	3.6

Source: results in table 4 and data in table 5.

<sup>a</sup> In calculation I, the coefficients of equation (3, IV) were used; calculation II is based on the coefficients of equation (4, IV).

## VIII

### Conclusions

This paper has developed a theoretical model that attempts to capture the stylized facts of growth in economies that do not themselves innovate but catch up with the technological frontier by adding new activities to their production and export structures. The model suggests that export diversification, insofar as it is symptomatic of broadening comparative advantage, is the key to economic growth.

The empirical sections of the paper show that export diversification is indeed associated with higher economic growth. We speculate that there are two channels through which diversified export growth stimulates output growth. One of them we have called the portfolio effect. Diversification of exports leads to less export volatility, which in turn results in lowered output volatility. Countries with highly unstable economies grow more slowly than countries that exhibit more dampened cyclical fluctuations. The data do not contradict this chain of reasoning.

The second effect concerns the dynamic benefits associated with successful efforts to diversify comparative advantages, with learning and information externalities paramount among them. Our results are complementary to the recent findings of Hausmann and Klinger (2007) that a country's export pattern is a good predictor of future growth. Countries that

export products associated with the export profile of high-income countries tend to converge rapidly towards those higher levels of income and, hence, to grow more rapidly. We would add that low-income countries generally have comparative advantages in few goods or, not unusually, just one. Efforts to diversify away from their traditional comparative advantage are likely to get the growth process started. It is only through output and export diversification that the spillovers of new exports can begin. These spillovers can be horizontal or vertical. Any new export produces information that is useful to other potential entrants into the industry. The emergence of a new sector facilitates the appearance of other sectors that utilize the same non-tradable inputs or public goods.

The empirical results are congruent with this model. In a cross-country econometric model of growth, the proxies for output and export diversification used (both the degree of export diversification and the interaction between per capita export growth and export diversification) are highly significant and make an important contribution to explaining variations in growth rates across countries.

The empirical model shows that variables other than export diversification also play a role in explaining

differences in economic growth between countries. Investment certainly takes pride of place. It has already been noted that the dynamic Asian economies have investment rates considerably higher than those of the Latin American and Caribbean countries. The strength of investment could well be associated with export growth and diversification: the more diversified an economy is, the greater the likelihood that there will be profitable investment opportunities. In addition, where there is vigorous self-discovery there will also be vigorous investment. Finally, the more diversified exports are, the stronger will be the linkages between some exporting activities and the

rest of the economy.<sup>20</sup> In our empirical model, when diversification-weighted export growth is introduced as an explanatory variable, the quantitative importance of investment declines sharply. This may very well be an indication that rapid export growth cum diversification is a powerful incentive to investment.

(Original: English)

<sup>20</sup> However, investment and export diversification are not so highly correlated that their joint inclusion in the econometric model renders one of them not significant. In fact, the coefficient of the diversification variable is quite robust to the introduction of investment.

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# Chile: towards inclusive development

*Ricardo Infante B. and Osvaldo Sunkel*

**T**his paper suggests that Chile needs to adopt a renewed long-term development strategy tending towards inclusive development with increasing equity in order to supersede the undesirable effects of the current economic growth pattern, namely the persistence of unacceptable inequality in incomes, living standards and quality of life and a growing feeling of social exclusion. To address these issues, it first charts the development of inequality over the past two decades. It then goes on to analyse the characteristics of the production structure in the Chilean economy, as these are believed to be a determinant of inequality. Drawing on this analysis, it outlines a renewed strategy designed specifically to include the different production and social strata involved in the growth process. Lastly, it identifies the policy areas critical to inclusive development.

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# I

## Introduction

In the past 20 years, Chile has enjoyed solid economic growth that has resulted in a doubling of per capita income and a large reduction in absolute poverty. However, there is still an unacceptable level of inequality in incomes, living standards and quality of life, while the perception of social exclusion is increasing. This paper will attempt to show that these outcomes will probably persist in the future unless we undertake an examination of today's style of economic growth and adopt a renewed long-term development strategy conducive to inclusive development with increasing equity.

In what follows, selected indicators will be used to show the evolution of inequality since the early 1990s. This will be followed by an in-depth analysis of the characteristics of the production structure in the Chilean economy, which we consider to be a much overlooked determinant of inequality. Setting out from this analysis, we outline a renewed strategy designed specifically to include the different production and social strata involved in the growth process. Lastly, we identify the policy areas that we consider critical to inclusive development.

# II

## Growth with inequality

Thanks to exceptional economic growth averaging 5.5% a year, per capita incomes in Chile rose by 96% between 1990 and 2007. This was combined with decisive and effective social policies, so that absolute poverty fell by almost two thirds over the period, from 38.6% to 13.7% (MIDEPLAN, 2007). Not only this but, among other advances, the country became a dynamic participant in globalization and achieved an extraordinary expansion of infrastructure and public services as well as education coverage, housing, health care and social security.

However, there is a considerable social deficit. The unemployment rate has remained high (8%), as has the level of informality (38% of the employed population). Occupational insecurity increased in 1990-2006 as the proportion of wage earners without labour contracts rose from 14.3% to 17.3% of the total, the proportion of those not contributing to the social security system held steady at about 33% and

short-term contracts became more prevalent and job turnover remained high.

Furthermore, the share of labour in output diminished, as annual growth in real wages, at 2.9% a year, was lower than the increase in gross domestic product (GDP) per person employed (3.3%). The result of all this is that the highly unequal distribution of personal income characterizing the Chilean economy has remained practically unchanged: the autonomous income of the wealthiest 20% of the population is 13 times as great as that of the poorest 20%. This ratio falls to 11.2 if monetary income is the yardstick and to 6.8 if the overall effect of social policy on the autonomous income of households is considered (MIDEPLAN, 2006a).

In these circumstances, we believe it is indispensable to introduce the concept of relative poverty, as this still affects almost a third of the population. Unlike the concept of absolute poverty, that of relative poverty establishes social norms and standards of consumption that alter as average family incomes rise. Those living in relative poverty are defined as the group of people or families whose incomes are less than 0.6 times the average, and who thus represent the relatively disadvantaged sector of society. According to figures from the National Socio-economic Survey

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(CASEN) (2006), this sector encompasses 25.6% of the population, or about 4.3 million people.<sup>1</sup>

In summary, the prevailing social market economy model, as modified by the “growth with equity” strategy adopted in 1990 (Muñoz, 2007; Sunkel, 2006a), has worked very well for most Chileans but has not succeeded in reducing equality, and poverty levels remain high. Compensatory action by the State has been able to reduce them substantially, but a large irreducible rump remains (Contreras, 1998; Bravo and Contreras, 1999; Sunkel, 2006b).

According to the economic thinking now prevalent, the way to supersede this failing in the workings of the current model would be to increase the economic growth rate and improve social policies. Although something could be done in this way, the present paper argues that a different development strategy needs to be designed. The basic problem is not so much the speed of growth as its composition, meaning the enormous productivity and quality differences that characterize the production structure in both goods- and services-producing sectors.

As will be shown in detail in the following section, the (minority) social groups linked to the country’s competitive and highly productive modern segment (such as industries oriented towards external trade) and the geographical areas associated with it are expanding far more dynamically than the average, but levels of job creation are low.

Medium- and low-productivity segments (which include the bulk of informal and insecure employment), the (majority) social groups involved with them and the geographical areas in which they are located are associated with slow-growing activities that have few points of contact with the most advanced sectors. They participate only tangentially in growth, so that however rapid this is it fails to produce the desired results for micro, small and medium-sized enterprises and for the medium- and low-income social sectors they support.

This is a divergent dynamic with contradictory sociocultural and political effects. Those who participate in globalization are fully able to satisfy the sociocultural and consumption expectations this generates; they are the winners. Those left behind are swept along by globalization on a virtual level in the form of a television and advertising bombardment that generates wild expectations of consumption paid for “in handy monthly instalments”. An acute contradiction is thus generated between expectations and reality, heightened by the burden of rising debt caused not just by the overstimulation of consumption but also by the privatization of social services, which has hit middle-income sectors particularly hard. This may be one of the causes of rising social disaffection and dissatisfaction with democracy and even anti-establishment behaviour such as repeated violent protests, crime and drug addiction, which do not seem to correlate with the country’s successful economic growth (Calderón, 2008; Sunkel, 2008).

In this context, State action has centred on implementing public policies to benefit the excluded, especially the poorest. This has eased the plight of these social groups, but has not resolved the problems of relative poverty and equity. In other words, there has been no narrowing of the huge gaps between excluded social groups and those with higher income levels.

As recent experience shows, the social effects of this divisive and divergent dynamic can at best be mitigated by higher growth and greater and more effective social spending. To deal decisively with the problem, therefore, it is necessary to contemplate a radical shift in the focus of public policies with the adoption of an inclusive development strategy that can gradually diminish the structural heterogeneity prevailing in the different strata, sectors and regions of the country’s economy and society since, as this paper tries to show, this diversity, together with the concentration of wealth and a dysfunctional labour market,<sup>2</sup> is among the main obstacles to growth with equity and thus to greater civic harmony and democracy.

<sup>1</sup> The yardstick used to measure relative poverty is based on the methodology established in EUROSTAT (1998) to define the concept of exclusion. The study takes the following determinants into account: low incomes, labour market status and situation indicators associated with exclusion.

<sup>2</sup> On these topics, see Solimano and Pollak (2006).



### III

## The ECLAC concept of structural heterogeneity

The analysis of the economic structure of Chile presented later in this paper draws on the concept of structural heterogeneity originally formulated by the Economic Commission for Latin America and the Caribbean (ECLAC) in the 1960s (ECLAC, 1964) and subsequently developed by a number of authors (Pinto, 1970; Sunkel, 1971; Pinto and Di Filippo, 1974 and 1982; Sunkel, 1978; Souza and Tokman, 1979; Infante, 1981; Tokman, 1982). A similar approach was developed in the same period for heterogeneity in the manufacturing sector of developed countries (Salter, 1966).

ECLAC (1964) contended that the structural heterogeneity of Latin America manifested itself at that time in the differing productivity levels of workers in the various production strata, a characteristic of the region's economy that also lay at the root of its unequal income distribution. Thus, the economic structure was formed of three strata that had different levels of access to technology and markets and, in the 1960s, possessed the following characteristics:

(i) A traditional stratum with very low productivity and income levels. This segment included 36.4% of all workers and generated just 5.1% of the region's GDP (see table 1).

(ii) A modern stratum consisting of export activities and large industrial and services firms which operated on a large scale and had a decisive share of the local market, and whose productivity per worker was similar to the developed-country average. It absorbed just 13.1% of the employed workforce but produced 53.3% of GDP.

(iii) An intermediate stratum made up of sectors where worker productivity was close to the average for the countries. This accounted for the bulk of employment (50.6%) and generated a substantial share of GDP (41.6%).

The heterogeneity of the production system was manifested in the fact that output per worker in the modern stratum was four times the average, 29 times that of the traditional stratum and about five times that of the intermediate stratum. These productivity differences fed through into worker earnings and were thus a determining factor in the poor distribution of income in Latin America.<sup>3</sup>

<sup>3</sup> See Cimoli, Primi and Pugno (2006). On the relationship between productivity and structural heterogeneity, see Cimoli (2005) and Rupfer and Rocha (2005).

TABLE 1

**Latin America: output, employment and productivity by production stratum, 1960s**  
(Absolute values and percentages)

Production stratum	GDP		Employment		GDP per person employed		
	Level <sup>a</sup>	Percentage	Level <sup>b</sup>	Percentage	Level <sup>c</sup>	Index	
						Traditional = 1	Latin America total = 1
Modern	61.1	53.3	10.3	13.0	5.9	29.5	3.9
Intermediate	47.7	41.6	39.9	50.6	1.2	6.0	0.8
Traditional	5.8	5.1	28.7	36.4	0.2	1.0	0.1
<i>Total</i>	<i>114.6</i>	<i>100.0</i>	<i>78.9</i>	<i>100.0</i>	<i>1.5</i>	<i>7.5</i>	<i>1.0</i>

Source: authors' calculations based on Z. Slavinsky, "Anexo estadístico", *La mano de obra y el desarrollo económico de América Latina en los últimos años* (E/CN.12/L.1), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), 1964.

<sup>a</sup> Billions of 1960 dollars.

<sup>b</sup> Millions of workers.

<sup>c</sup> Thousands of 1960 dollars.

## IV

### The economic structure of Chile

We shall now present an analysis based on the empirical findings of a recent study on the relationships between output and employment by production stratum (Lagos M., 2008), prepared using data from the latest input-output matrix of the Central Bank (dating from 2003) and 2007 data from the Chilean Internal Revenue Service.

The heterogeneity of the Chilean economy is clearly revealed when we examine the different productivity levels of the various production strata, the type of intersectoral relationships, the value added generated and primary income distribution, together with the contribution of each production stratum to the dynamic of the economic structure. Lastly, we show how the inequality generated by the heterogeneity of the production system has been partly reversed by a targeted policy of social spending.

#### 1. Productivity differences by sector and by establishment size

To illustrate the heterogeneous character of the Chilean economy, we use 2003 output and employment data broken down by sector and by the size of establishments.<sup>4</sup>

The sectors (branches of economic activity) have been organized into three representative groups with three markedly different levels of productivity: low, medium and high (see table 2). Also included are productivity data for establishments by size, i.e. small, medium and large, by sector.<sup>5</sup> Lastly, productivity indices are given for firms in each sector by size, revealing the intrasectoral (within each sector) and intersectoral (between sectors) heterogeneity of the economy.

Comparing productivity levels by sector reveals that mining is 15 times as productive on average as agriculture, while construction and industry are twice and four times as productive, respectively. Turning to intrasectoral differences, we find, for example,

that large agricultural producers are seven times as productive as small ones, a ratio that rises to 12 in the case of construction and to as much as 40 in that of mining. In short, the data show that intrasectoral productivity differences are substantially greater than intersectoral ones.

Meanwhile, the employment figures show that the sectors where small businesses have the greatest labour retention capacity<sup>6</sup> (including informal activities and microenterprises) are the least productive of all (see table 2a). This is the case in the agriculture, community services and commerce sectors, which contain between 47% and 59% of all those employed in small businesses and low-productivity activities.

TABLE 2

**Chile: output per worker by sector<sup>a</sup>  
and by establishment size, 2003**  
(Small business index, agriculture = 100)

Sector	Establishment size			National total
	Small	Medium	Large	
<i>Low productivity</i>				
Agriculture	100.0	114.8	718.2	100.0
Community services	100.0	146.6	408.4	103.5
Commerce	100.0	102.5	914.8	139.7
<i>Medium productivity</i>				
Construction	100.0	246.7	1 270.5	217.7
Transport/commerce	100.0	435.0	1 761.1	356.8
Manufacturing	100.0	262.1	2 458.9	426.2
<i>High productivity</i>				
Financial services	–	–	–	636.0
Electricity, gas, water	–	–	–	1 503.3
Mining	100.0	427.6	3 976.3	1 509.7
<i>National total</i>	<i>100.0</i>	<i>189.2</i>	<i>1 383.8</i>	<i>238.5</i>

Source: International Labour Organization (ILO) and C. Lagos M., "Desarrollo inclusivo. Matriz de insumo-producto sectorial en una economía heterogénea: Chile 2003", *Proyecto Chile 21. Desarrollo incluyente*, Santiago, Chile, Fundación Chile 21, 2008.

<sup>a</sup> Gross output value per worker.

<sup>4</sup> To carry out this estimate, use was made of a 2003 input-output matrix covering nine sectors, by establishment size. See Lagos M. (2008).

<sup>5</sup> This comes close to the original concept of traditional, intermediate and modern strata.

<sup>6</sup> In small businesses, most employment is in informal activities. From here on, these businesses will be treated as part of the informal sector.

Conversely, the greater a sector's ability to absorb formal employment in medium-sized and large establishments, the higher its productivity (see table 2a). Thus, in the medium-productivity stratum, including the construction, transport and industry sectors, the share of formal workers in total employment,<sup>7</sup> or formality rate, is between 53.2% and 59.5%; in the high-productivity segment, to which the electricity, finance and mining sectors belong, this rate is 89%. This tells us that the greater the average productivity of these sectors, the more formal employment they will absorb.

## 2. Intersectoral relationships under conditions of heterogeneity

Economic linkages by productivity level are identified on the basis of information from the input-output matrices published by the Central Bank of Chile (2003).<sup>8</sup>

TABLE 2A

**Chile: distribution of workers by sector and by establishment size, 2003**  
(Percentages)

Sector	Establishment size			Total
	Small	Medium	Large	
<i>Low productivity</i>				
Agriculture	51.8	34.3	13.9	100.0
Community services	46.7	25.7	27.6	100.0
Commerce	59.1	21.2	19.7	100.0
<i>Medium productivity</i>				
Construction	46.8	36.4	16.8	100.0
Transport/commerce	45.4	30.7	24.1	100.0
Manufacturing	40.5	34.0	25.5	100.0
<i>High productivity</i>				
Financial services	–	69.5	30.5	100.0
Electricity, gas, water	–	–	100.0	100.0
Mining	10.6	19.6	69.8	100.0
<i>Total</i>	<i>45.1</i>	<i>31.0</i>	<i>23.9</i>	<i>100.0</i>

Source: International Labour Organization (ILO) and C. Lagos M., "Desarrollo inclusivo. Matriz de insumo-producto sectorial en una economía heterogénea: Chile 2003", *Proyecto Chile 21. Desarrollo incluyente*, Santiago, Chile, Fundación Chile 21, 2008.

<sup>7</sup> Employees in medium-sized and large firms as a percentage of each sector's total.

<sup>8</sup> See its 2003 *Compilación de referencia*, hereinafter "CdR" (Central Bank of Chile, 2003).

The findings were arrived at using a sectoral matrix of the Chilean economy which covers nine sectors disaggregated by three levels of productivity (low, medium and high), the distribution of value added and final demand for these activities or sectors. Regarding final demand, domestic consumption includes consumption of locally produced goods and services by households and government. Household consumption, meanwhile, is broken down by per capita income into high, medium and low strata.<sup>9</sup>

### (a) *The matrix of intersectoral relationships by establishment size*

The methodology indicated was used to obtain a summary matrix for 2003 that includes the economic relationships between the three strata defined by establishment size, i.e., by productivity level.

While the analysis of productivity differences by economic sector reveals the heterogeneity within and between sectors, only productivity differences by establishment size will be examined in what follows.

The data show that in 2003 the Chilean economy generated output of 97.4 trillion pesos (see table 3). In terms of destination, 38 trillion pesos of this output was accounted for by intermediate production, 25.7 trillion by household consumption, 6.1 trillion by government consumption, 8.2 trillion by gross investment and 17.5 trillion by exports.

Regarding the origin of output (97.4 trillion pesos), we find that value added accounted for 48.8 trillion (including 2.1 trillion in taxes, 21.1 trillion in wages and 25.6 trillion in return on capital) and intermediate consumption for 48.7 trillion (38.2 trillion in local inputs and 10.5 trillion in imported inputs). As the data indicate (see table 3), the bulk of total output (97.4 trillion) was generated by the large enterprise sector or stratum (77.9 trillion). The situation is similar for intermediate output. Meanwhile, the bulk of household consumption was by high-income strata,

<sup>9</sup> The low stratum (income below 60% of the median) includes 26.4% of the population, the middle stratum (income between 60% of the median and the average) 48.3% and the high stratum (above-average income) 25.3%. Aggregate household consumption is given by the 2003 CdR. However, to disaggregate it into deciles (a necessity of the grouping used), and in the absence of more up-to-date information, use was made of National Institute of Statistics (INE, 1998) data on family budgets. Since this survey is known to have an underestimation bias for household incomes, consumption by decile was adjusted by the distribution of autonomous income for that decile as given by the National Socio-economic Survey (CASEN, 2003).

with the small and medium-sized enterprise strata producing a significant portion of this.

Although output and consumption were concentrated in the high-productivity and high-income sectors, respectively, most jobs (4.3 million out of total employment of 5.6 million) were in the low and medium-productivity strata. The data thus show marked disparities in intersectoral productivity (see table 3).

(b) *Intermediate production: the lack of integration in the production system*

The structural matrix (see table 3a) shows the high degree of heterogeneity characterizing the Chilean economy. In the case of intermediate relationships, we find that the high-productivity sectors produce 83.3% of intermediate goods and services, while the figure is just 8.6% for low-productivity firms and 8.1% for medium-productivity ones.

Meanwhile, spending on inputs by low- and medium-productivity firms goes mainly to high-productivity firms, since 71% and 77%, respectively, of their locally sourced intermediate consumption is supplied by these (see table 3d).

In summary, almost all intermediate output is generated by large firms, with the share of small and medium-sized firms being very small. Furthermore, the demand for intermediate goods and services is mainly supplied by high-productivity firms, revealing the limited capacity of small and medium-sized firms to supply inputs competitively.

This explains the differing shares of intermediate consumption in gross output value, with a figure of about 40% for low- and medium-productivity sectors and 52% for high-productivity firms (see table 3b).

These data reveal the lack of integration in the economy, something that particularly affects low- and medium-productivity firms. The low density of the production fabric manifests itself in intersectoral relationships that are characterized by very incomplete intermediate production linkages.

(c) *Consumption: output and income concentration*

Two different aspects are considered here. First, we examine the shares of the different productivity strata in output of consumer goods and services and, second, we rate the importance of households with different income levels (low, medium and high) for total consumption and thus for production levels at the different sizes of firm.

The data show that a large proportion of household consumption (73.4%) is of goods supplied by large enterprises. This is because, irrespective of household income level (low, medium or high), most household spending goes on goods and services produced by high-productivity sectors (see table 3d). The share of small and medium-sized firms in total household consumption is just 18.1% and 8.5%, respectively.

At the same time, and in consequence of the concentration of high wages and part of the gross surplus in high-productivity sectors, spending by high-income households represents 58.4% of total consumption, while the figure is 30.4% for middle-income households and 11.2% for low-income households<sup>10</sup> (see table 3c).

The data also show that government consumption is even more concentrated than household consumption, since 98.7% of the goods and services consumed by public-sector bodies, i.e., almost the entirety, is produced by the high-productivity firms segment (see table 3b).

(d) *Investment and exports: a dynamic of concentration*

Investment and export heterogeneity is also extremely pronounced: 86.4% of capital goods production takes place in large firms, with small and medium-sized firms accounting for shares of just 7% and 6.6%, respectively.

Again, high-productivity firms generate 85% of all exports, with a figure of 6.5% for small firms and 8.5% for medium-sized ones (see table 3b).

Setting out from this information, it is possible to understand why the trade liberalization achieved by the country has not translated into direct benefits for small and medium-sized firms: (i) the group of non-large (i.e., small and medium-sized) firms accounts for only a small share of the export total (15%); (ii) if exports from these sectors were to increase, the weakness of the production fabric would mean that only 26% of intermediate consumption by small and medium-sized firms would be supplied by other firms of the same size, with the remaining 74% coming from large firms, and (iii) when the output of high-productivity firms increases (to supply the external

<sup>10</sup> The low stratum (incomes below 60% of the median) includes 26.4% of the population, the middle stratum (incomes between 60% of the median and the average) 48.3% and the high stratum (above-average incomes) 25.3%.

TABLE 3

**Chile: intersectoral transaction matrix by establishment size, 2003**  
(Billions of current pesos and thousands of workers)

GOV component	Sector/size	Intermediate demand				Final demand						Total	GOV		
		S	M	L	Total	Households (low)	Households (medium)	Households (high)	Government	Gross Investment	Flow of stock			Exports	FISIM <sup>a</sup>
Intermediate consumption	Small (S)	428	336	3 124	3 888	519	1 377	2 739	59	542	25	1 133	0	6 394	10 282
	Medium (M)	572	391	3 935	4 898	193	534	1 469	22	510	117	1 490	0	4 335	9 233
	Large (L)	2 465	2 440	24 534	29 439	2 170	5 912	10 794	6 041	6 690	330	14 926	1 558	48 421	77 860
	National total	3 465	3 167	31 593	38 225	2 882	7 823	15 002	6 122	7 742	472	17 549	1 558	59 150	97 375
	Imports	693	786	9 039	10 518										
	Grand total	4 158	3 953	40 452	48 563										
Value added	Wages	4 361	3 222	13 518	21 101										
	Capital	1 657	1 854	22 122	25 633										
	Taxes	106	204	1 768	2 078										
	Value added	6 124	5 280	37 408	48 812										
Output	Gross output value (GOV)	10 282	9 233	77 860	97 375										
Workers (thousands)		2 683	1 623	1 332	5 638										
GOV/worker (millions of pesos)		3.8	5.7	58.5	17.3										

Source: C. Lagos M., "Desarrollo inclusivo. Matriz de insumo-producto sectorial en una economía heterogénea: Chile 2003", *Proyecto Chile 21. Desarrollo incluyente*, Santiago, Chile, Fundación Chile 21, 2008.

<sup>a</sup> Financial intermediation services indirectly measured (imputed banking charges).

TABLE 3A

**Chile: intersectoral relationship matrix by establishment size, 2003**  
(Horizontal percentages)

GOV component	Intermediate demand				Final demand					Total	GOV			
	S	M	L	Total	Households (low)	Households (medium)	Households (high)	Government	Investment			Flow of stock	Exports	FISIM <sup>a</sup>
Small (S)	4.2	3.3	30.4	37.8	5.0	13.4	26.6	0.6	5.3	0.2	11.0	0.0	62.2	100.0
Medium (M)	6.2	4.2	42.6	53.0	2.1	5.8	15.9	0.2	5.5	1.3	16.1	0.0	47.0	100.0
Large (L)	3.2	3.1	31.5	37.8	2.8	7.6	13.9	7.8	8.6	0.4	19.2	2.0	62.2	100.0
National total	3.6	3.3	32.4	39.3	3.0	8.0	15.4	6.3	8.0	0.5	18.0	1.6	60.7	100.0
Imports	6.6	7.5	85.9	100.0										
Grand total	8.6	8.1	83.3	100.0										
Wages	20.7	15.3	64.1	100.0										
Capital	6.5	7.2	86.3	100.0										
Taxes	5.1	9.8	85.1	100.0										
Value added	12.5	10.8	76.6	100.0										
Gross output value (GOV)	10.5	9.5	80.0	100.0										

Source: C. Lagos M., "Desarrollo inclusivo. Matriz de insumo-producto sectorial en una economía heterogénea: Chile 2003", *Proyecto Chile 21. Desarrollo incluyente*, Santiago, Chile, Fundación Chile 21, 2008.

<sup>a</sup> Financial intermediation services indirectly measured (imputed banking charges).

TABLE 3B

**Chile: intersectoral relationship matrix by establishment size, 2003**  
(Vertical percentages)

GOV component	Intermediate demand				Final demand					Total	GOV			
	S	M	L	Total	Households (low)	Households (medium)	Households (high)	Government	Gross Investment			Flow of stock	Exports	FISIM <sup>a</sup>
Small (S)	4.2	3.6	4.0	4.0	18.0	17.6	18.3	1.0	7.0	5.3	6.5	0.0	10.8	10.5
Medium (M)	5.6	4.2	5.1	5.0	6.7	6.8	9.8	0.4	6.6	24.8	8.5	0.0	7.3	9.5
Large (L)	24.0	26.4	31.5	30.2	75.3	75.6	72.0	98.7	86.4	69.9	85.0	100.0	81.9	80.0
National total	33.7	34.3	40.6	39.3	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Imports	6.7	8.5	11.6	10.8										
Grand total	40.4	42.8	52.0	49.9										
Wages	42.4	34.9	17.4	21.7										
Capital	16.1	20.1	28.4	26.3										
Taxes	1.0	2.2	2.3	2.1										
Value added	59.6	57.2	48.0	50.1										
Gross output value (GOV)	100.0	100.0	100.0	100.0										

Source: C. Lagos M., "Desarrollo inclusivo. Matriz de insumo-producto sectorial en una economía heterogénea: Chile 2003", *Proyecto Chile 21. Desarrollo incluyente*, Santiago, Chile, Fundación Chile 21, 2008.

<sup>a</sup> Financial intermediation services indirectly measured (imputed banking charges).

TABLE 3C

**Chile: intersectoral relationship and consumption matrix by establishment size, 2003**  
(Horizontal percentage composition of intermediate demand and household consumption)

GOV <sup>a</sup> component	Sector/ size	Intermediate demand				Household consumption			
		S	M	L	Total	Low	Medium	High	Total
Intermediate consumption	Small (S)	11.1	8.6	80.3	100.0	11.2	29.7	59.1	100.0
	Medium (M)	11.6	8.0	80.4	100.0	8.8	24.3	66.9	100.0
	Large (L)	8.2	8.0	83.8	100.0	11.5	31.3	57.2	100.0
	<i>Total</i>	<i>9.1</i>	<i>8.3</i>	<i>82.6</i>	<i>100.0</i>	<i>11.2</i>	<i>30.4</i>	<i>58.4</i>	<i>100.0</i>

Source: C. Lagos M., "Desarrollo inclusivo. Matriz de insumo-producto sectorial en una economía heterogénea: Chile 2003", *Proyecto Chile 21. Desarrollo incluyente*, Santiago, Chile, Fundación Chile 21, 2008.

<sup>a</sup> GOV = Gross output value.

TABLE 3D

**Chile: intersectoral relationship and consumption matrix by establishment size, 2003**  
(Vertical percentage composition of intermediate demand and household consumption)

GOV <sup>a</sup> component	Sector/ size	Intermediate demand				Household consumption			
		S	M	L	Total	Low	Medium	High	Total
Intermediate consumption	Small (S)	12.4	10.6	9.9	10.2	18.0	17.6	18.3	18.1
	Medium (M)	16.5	12.3	12.0	12.9	6.7	6.8	9.7	8.5
	Large (L)	71.1	77.1	78.1	76.9	75.3	75.6	72.0	73.4
	<i>Total</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>

Source: C. Lagos M., "Desarrollo inclusivo. Matriz de insumo-producto sectorial en una economía heterogénea: Chile 2003", *Proyecto Chile 21. Desarrollo incluyente*, Santiago, Chile, Fundación Chile 21, 2008.

<sup>a</sup> GOV = Gross output value.

market, for instance), the inputs they require come preponderantly (78.1%) from other large firms.

Under these circumstances, if the aim is to turn small and medium-sized firms into suppliers of large firms oriented towards the external market, it will be necessary to invest heavily in substantial improvements to the integration of the production system. Given the heterogeneity of the production structure, a strategy of export-led growth, even when very successful as in this case, has proved clearly inadequate to bring about balanced, equitable development.

### 3. Value added and primary income distribution

The heterogeneity that can be seen to characterize intermediate relationships and final demand is also manifested in the sphere of work, i.e., in jobs and wages.

A large proportion of the aftertax value added in low-productivity sectors is accounted for by the remuneration of labour, which represents 72.5% of value added in small firms and 63.5% in medium-sized ones (see table 3b). However, remunerations in these two types of firms represent just 20.7% and 15.3%, respectively, of total wages in the economy. Furthermore, low-productivity activities (small and medium-sized firms) absorb 47.6% and 28.8%, respectively, of total employment in the economy.<sup>11</sup>

In high-productivity firms, conversely, remuneration of labour constitutes 37.9% of aftertax value added

<sup>11</sup> This is because of differences in average wages in the various sectors reflecting, first, the marked productivity differences between small and medium-sized firms and large ones (see table 3) and, second, the fact that workers in the latter are more highly organized.

and represents 64.1% of all wages in the economy, while their share of total employment is only 23.6% (see table 3).

Wage differences are largely explained by the unequal productivity of labour in the different strata of the economy. In aggregate terms, while labour output in low-productivity sectors is 3.8 million pesos, in high-productivity ones it is 58 million. In other words, output per worker is almost 15 times as great in high-productivity sectors as in low-productivity ones. This productivity difference means that gross remuneration per worker in small and medium-sized firms is between a fifth and a sixth of that earned by workers in high-productivity firms, and largely explains the inequity of distribution in the Chilean economy and its persistence over time.

The share of the gross surplus in value added, meanwhile, is 63.1%. The bulk of returns on capital go to high-productivity firms, which account for about 86.3% of the gross surplus in the economy. The high proportion of wages and of the gross surplus accounted for by large businesses means that they generate the bulk (76.6%) of value added in the economy.

In short, wages and the gross surplus are highly concentrated in large firms, while people employed in small and medium-sized firms, who are the great majority (76.4%), receive a very small portion of value added (23.3%).

#### **4. The dynamic of the economic structure: the dominance of large firms**

One of the advantages of input-output matrices is that they can be used to simulate the reaction of the economy to different scenarios. The economic coefficients of one of these matrices allow us to identify the contribution made by each of the factors of production (inputs, capital and labour) to the production of a final good supplied in the economy.

If output increases, the demand for factors of production will increase proportionately.<sup>12</sup> This process is iterative for each economic sector, since it is at once a source of supply and demand for goods, services or both. Thus, inverse input-output matrix mechanisms can be used to simulate the static effects of different changes in aggregate demand in the economy and ascertain how total production varies in a heterogeneous economy like that of Chile.

<sup>12</sup> On the assumption that technology is fixed (which is reasonable in the short term).

We shall now measure the effect a 10% rise in final demand, for example, would have on output in the different production strata of the economy. It is interesting to determine how much the economy would grow if: (i) aggregate demand from small and medium-sized firms increased at the rate indicated and (ii) aggregate demand from high-productivity firms increased by the same amount.

The estimates show that if final demand from all small firms increased by 10%, the output of the economy would rise by only 1%. This is because low-productivity sectors have such a small impact on intermediate relationships and final demand.

Again, if demand from high-productivity firms rose by 10%, this would induce higher production in the other sectors (via demand for inputs), but primarily in those with the same level of productivity,<sup>13</sup> whose output would grow by 9.4%.

Lastly, the estimates highlight how little impact medium-productivity sectors have on the results. It must be remembered that the medium- and low-productivity sectors account between them for 17% of intermediate consumption and 23% of gross output value. If demand for goods and services in these sectors grew by 10% (as the result of an investment plan, export promotion or higher private spending, for example), total output in the economy would rise by only 1.7%.<sup>14</sup>

In summary, the Chilean economy, and thus Chilean society, are divided into differentiated and largely unconnected worlds. The first, the world of high-productivity firms, is the one that drives the economy and pays good wages, while the others, the worlds of medium- and low-productivity firms, do not greatly influence growth, even though they absorb the bulk of the workforce. Consequently, as postulated, heterogeneity is reproduced even under conditions of rapid economic growth.

#### **5. Redistributive and distributive policies: the limitations of social spending**

The poor distribution of income generated in the labour market because of the heterogeneity characterizing the workings of the economy has been systematically corrected by the policy of social spending.

<sup>13</sup> High-productivity firms generate 64% of all intermediate transactions.

<sup>14</sup> Under the same conditions, the output of low-productivity (small) firms taken by themselves would increase by 1%.



Social policy is one of the redistributive mechanisms that have been applied to improve people's living standards, particularly in more disadvantaged social groups, by supplementing income from households' employment with subsidies for such things as health care, education and housing, and with cash transfers. This kind of policy entails a number of risks, however. The first is that the ability to expand redistributive policies of this kind depends on the fiscal situation, particularly the tax burden. Secondly, the high proportion of income now provided by social spending in the poorest households means that earnings count for little there and so families' and individuals' living standards are increasingly dependent on public resources rather than work (Infante, 2007a).

The data show that in households in the first quintile, only 28.8% of total income is from work (see table 4). This figure rises to 52.3% for households in the second quintile. When both quintiles are considered (40% of the population), it transpires that only part (40.5%) of these households' total income derives from work, while the bulk (59.5%) is from social spending.

Under these conditions, many people are enabled to participate in society basically because they are provided with a level of income that makes an acceptable minimum standard of consumption possible, but are not linked to society through work, which is the main factor in social integration and citizenship.

Low per capita household incomes are due, in turn, to the poor labour-market positioning of people

TABLE 4

**Chile: origin of total household income by quintile, 2006**  
(Percentages)

Income and subsidies	Autonomous income quintile					Total
	I	II	III	IV	V	
Household earnings	28.8	52.3	66.0	77.2	86.4	78.5
<i>Average autonomous income (a)</i>	<i>35.0</i>	<i>61.6</i>	<i>78.2</i>	<i>90.2</i>	<i>99.2</i>	<i>91.2</i>
Welfare pensions (PASIS)	7.3	2.5	1.2	0.5	0.1	0.7
Household subsidy (SUF)	1.8	0.5	0.2	0.1	0.0	0.2
Chile Solidario voucher (CHS)	0.5	0.2	0.1	0.0	0.0	0.0
<i>Drinking water subsidy (SAP)</i>	<i>0.6</i>	<i>0.4</i>	<i>0.3</i>	<i>0.1</i>	<i>0.0</i>	<i>0.1</i>
<i>Targeted subsidies</i>	<i>10.2</i>	<i>3.6</i>	<i>1.8</i>	<i>0.7</i>	<i>0.1</i>	<i>1.0</i>
Family allowance	1.5	1.5	0.9	0.4	0.1	0.3
Unemployment subsidy	0.1	0.1	0.1	0.0	0.0	0.0
<i>Non-targeted subsidies</i>	<i>1.6</i>	<i>1.6</i>	<i>1.0</i>	<i>0.4</i>	<i>0.1</i>	<i>0.3</i>
<i>Total subsidies (b)</i>	<i>11.8</i>	<i>5.2</i>	<i>2.8</i>	<i>1.1</i>	<i>0.2</i>	<i>1.3</i>
<i>Monetary income (a+b)</i>	<i>46.7</i>	<i>66.9</i>	<i>80.9</i>	<i>91.3</i>	<i>99.3</i>	<i>92.5</i>
Imputed rent	5.1	5.1	5.4	5.0	3.2	4.6
Nursery education	3.7	2.5	1.7	0.9	0.2	0.6
Basic education	20.0	12.2	7.6	4.3	0.9	3.1
Intermediate education	7.8	6.3	3.9	2.2	0.4	1.4
Adult education	0.4	0.4	0.2	0.1	0.0	0.1
<i>Total education (c)</i>	<i>31.9</i>	<i>21.4</i>	<i>13.4</i>	<i>7.5</i>	<i>1.5</i>	<i>5.2</i>
Health-care subsidy	20.6	11.3	5.3	1.0	-0.9	2.1
Supplementary food programme	0.6	0.4	0.2	0.1	0.0	0.1
Older adult food programme	0.2	0.1	0.1	0.1	0.0	0.0
<i>Total health care (d)</i>	<i>21.4</i>	<i>11.8</i>	<i>5.6</i>	<i>1.2</i>	<i>-0.9</i>	<i>2.2</i>
<i>Total income (a+b+c+d)</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>

Source: Ministry of Planning (MIDEPLAN), "Distribución del ingreso e impacto distributivo del gasto social", *Análisis de resultados de la Encuesta CASEN* series, No. 2, Santiago, Chile, 2006; and "Metodología de valorización de los subsidios en salud, educación y monetarios", *Casen 2006*, Santiago, Chile, 2006.

with the capacity to work. The data show that 48.3% of workers in quintile I households are employed in low-productivity activities and 14.5% in sectors with a medium-low level of productivity (see table 5). In other words, 62.8% are in lower-productivity strata, while in quintile II households the figure is 56.7%. In sum, about 60% of workers from the country's most disadvantaged households are not in decently paid, productive jobs. Unless this situation changes, a large and growing volume of resources will have to be devoted on a permanent basis (via social spending) to income transfers so that less well-off sectors can

attain an acceptable standard of living. However, policies of this type could depend on the availability of fiscal resources, with the tax burden being one limiting factor.

Consequently, it seems vital for redistributive policies to be progressively supplemented with distributive ones to narrow productivity divides and thus improve the autonomous incomes of the most disadvantaged sectors. Distributive policies could thus bring about a real reduction in inequality both of incomes and of access to opportunities between the different groups in the social structure, as indicated below.

TABLE 5

**Chile: workers by establishment size and income quintile, 2006**  
(Percentages)

Productivity/establishment size	Autonomous income quintile					Total
	I	II	III	IV	V	
<i>High productivity</i>	17.2	21.3	26.9	27.7	35.8	27.2
Manual and clerical workers (firms of 200 people and over)	16.6	20.7	25.7	26.1	29.2	24.7
Employers (firms of 200 people and over)	0.0	0.0	0.0	0.0	0.3	0.1
Own-account workers (professional and technical)	0.6	0.6	1.2	1.6	6.3	2.4
<i>Medium productivity</i>	34.6	37.1	33.6	32.3	29.4	33.0
Medium-low	20.1	21.9	19.1	18.0	16.3	18.8
Medium-high	14.5	15.2	14.5	14.3	13.1	14.2
<i>Low productivity</i>	48.2	41.5	39.5	39.9	34.9	39.8
Manual and clerical workers (firms of 6 to 9 people)	7.8	6.1	6.3	4.4	3.2	5.2
Employers (firms of 6 to 9 people)	0.1	0.1	0.2	0.3	1.8	0.6
Informal	40.3	35.3	33.0	35.2	29.9	34.0
Employers (firms of 5 people or less)	0.3	0.5	1.0	1.8	5.0	2.0
Manual and clerical workers (firms of 5 people or less)	15.3	13.0	10.5	7.2	4.7	9.3
Own-account (not prof. or technical) and unpaid family workers	24.7	21.8	21.6	26.2	20.1	22.7
<i>Total</i>	100.0	100.0	100.0	100.0	100.0	100.0

Source: authors' calculations based on data from the Ministry of Planning (MIDEPLAN) and the 2006 National Socio-Economic Survey (CASEN).

## V

### Socially inclusive development

As already noted, the current economic model relies on the *a posteriori* redistribution of a (small) share of the revenues generated by growth. If progress is to be accompanied by increasing equity, it is necessary to devise a renewed development strategy whose central goal is productive employment and satisfactory social participation in the production process and in the

actual structure and workings of the socio-economic system, thereby ensuring better primary distribution of income at source (Sunkel and Infante, 2006).

This means viewing the dynamic of development in terms not only of modern export sectors but also, and categorically, of less productive sectors. Today's strategy is working quite well for the former, although

it needs reinvigorating with products that incorporate increasing value added and technological density. Underlying this strategy, however, is the erroneous belief that the country has a fairly homogeneous production system, and this has blinded us to the exceptional priority and importance that ought to be attached to the second group of sectors. What is required, then, is a renewed strategy built essentially upon efforts, first, to enhance the current export process by dynamizing it through diversification and, second, to reduce heterogeneity by narrowing productivity differences by establishment size, sector and region.

Consideration should therefore be given to implementing an ambitious programme of long-term (15 to 20 years) structural transformation that would enable less advanced sectors to gradually raise the

productivity and earnings of those working there and to improve the quality of life of relatively disadvantaged families (Infante, Molina and Sunkel, 2007).

In summary, the development strategy proposed would include new forms of reciprocal action between the State and market, on the basis of a long-term strategic vision, and between the State and citizens, civil society, solidarity and grass-roots organizations and regions and localities; a greater emphasis on effectiveness, flexibility and decentralization; and an overriding concern with technological, institutional and organizational issues (Sunkel, 2006c). What is proposed, in short, is that social participation should be expressed in the first place through productive activities that provide a basis for and are eventually transformed into greater social and political participation by relatively disadvantaged groups in society.

## VI

### The strategic areas of inclusive development

As indicated, the divisive and divergent dynamic characterizing today's development will not be solved by higher growth rates or greater and better applied social spending. What is required is a change of approach: public policies that gradually diminish the structural heterogeneity of the different sectors and regions of the country's economy and society, since this is the main obstacle to growth with equity (Sunkel and Infante, 2006). These policies would have to gradually level out the asymmetries in productivity between advanced activities and unproductive ones such as informal micro and small enterprises, thereby reducing wage differentials as well. This would have a real impact on inequality, both in access to opportunities for the different groups in society and in income distribution.

At the same time, the recent financial crisis, having originated in the United States and quickly spread to all other industrialized and emerging economies, is bound to have a negative effect on Chile in the short term. The effects have already shown up in substantial downward revisions to growth forecasts and in rising unemployment.

Given the marked heterogeneity of the production structure, the fall-off in activity can be expected to have the greatest effects on the lower-productivity strata (small and medium-sized firms), which account

for the bulk of employment. As a result, the labour market is highly likely to deteriorate as informal working and unemployment rise and real wages fall. If this happens, the costs of the current crisis will fall mainly on the low- and medium-income sectors of the population, reinforcing the tendency towards income concentration already discussed.

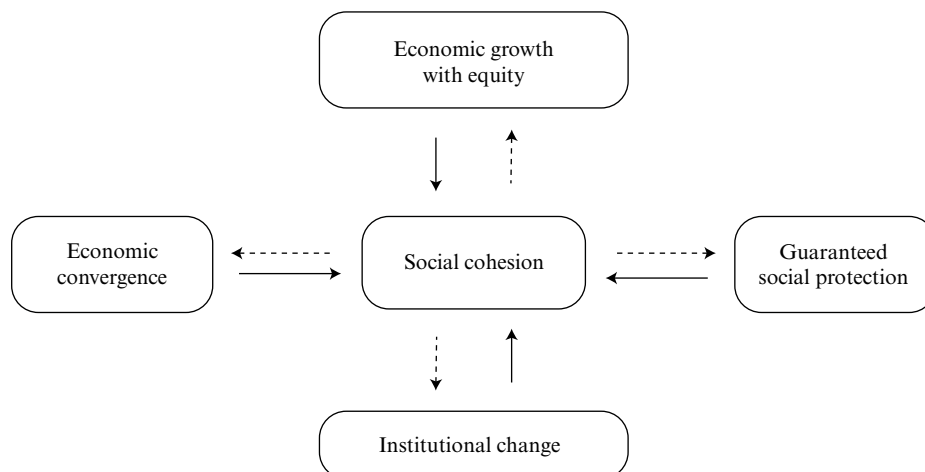
A preliminary (and highly provisional) version of the proposed inclusive development strategy takes account of at least four closely interrelated elements: economic convergence, guaranteed social protection, the institutional changes required and sustained economic growth with equity. If these pillars functioned properly, they would strengthen social cohesion by ensuring the well-being of a growing proportion of the population and minimizing disparities by preventing polarization (see diagram 1).

#### 1. Convergence

The success of a strategy to integrate people better into society depends crucially on measures to deal with the marked heterogeneity of the economic system.<sup>15</sup>

<sup>15</sup> This is one of the main lines of ECLAC work, and the most recent results can be consulted in ECLAC (2008).

DIAGRAM 1

**Inclusive development**

Source: prepared by the authors.

In the effort to achieve economic convergence or the gradual homogenization of productivity in the different production strata, smaller firms (micro, small and medium-sized) have an important role to play in dynamizing growth, creating jobs and reducing informality.

It is well worth studying the extraordinary experience of the European Union, where the goal of industrial convergence was achieved by putting in place conditions and factors that improved growth and very substantially narrowed the gaps between member States and less developed regions within them. The priority was to raise productivity and there was special emphasis on improving the environment for small and medium-sized enterprises.<sup>16</sup> We shall now discuss some issues of critical importance if productive convergence is to be attained in Chile.

First, gradual homogenization of the economic structure will be viable only if the “business model” followed by large firms in their dealings with smaller ones includes powerful incentives for business development in medium-sized and small enterprises.

The idea is to create a more competitive environment in which small businesses can expand. This would be done by applying a set of pro-competition rules designed

to encourage the proliferation of such firms in the long run. Another aim is to carry out programmes of investment in new social sectors, i.e., to develop a “social economy” that generates employment specifically for workers in informal sectors and is oriented primarily towards meeting the social needs of lower-income strata, an issue that has already been mentioned as one of the criteria of action for a forward-looking approach to the crisis. A strong and sustained effort will be needed here, as will State coordination, and all this will have to be reflected in the commitment of a large volume of resources over a long period. Decisions about the amount and destination of these resources would have to be arrived at through social dialogue (Infante, 2006).

Another proposal is for the creation of regional production clusters with a local structure underpinned by solid institutions capable of enhancing innovation capacities, reducing risk aversion, disseminating market information, technology and know-how, fostering workforce training and providing a pool of shared experience. It is local institutions that make it possible to develop synergies and sustain cluster economies. Local actors would thus be taking responsibility for their own development (Guardia, 2007; Muñoz, 2008).

The State has a central role to play in redistributing public resources, but on the basis of a strategy in which the regions take the main responsibility for their own development. There is a vital aspect here that needs spelling out: regions, or rather territories, acquire

<sup>16</sup> See European Union (1997) and Commission of the European Communities (1993). See Infante (2008) on industrial homogenization policies in the European Union.

economic and social significance to the extent that they are recognized as constituting both geographical and social entities.

## 2. Institutional change

Institutional changes in the economy, the labour market and social dialogue are required when formulating a new conception of national development with a comprehensive medium- and long-term approach involving the State, citizens' organizations, workers and businesses.

Where economic institutions are concerned, the current business model needs to be amended to overcome one of the basic obstacles to the effective application of an economic convergence policy. The effect of this model has ultimately been to weaken larger and larger segments of the medium-sized and small business segments,<sup>17</sup> creating bottlenecks which the State has then had to step in and resolve.

Public policies need to change and give priority to raising productivity, with a special effort to improve the environment for small and medium-sized businesses, as these create the bulk of productive employment.

One requirement of institutional change is that the new business model applied by large firms in their dealings with small ones should include, among other things, powerful incentives for micro, small and medium-sized enterprises to develop and integrate into production clusters. This means creating a more competitive environment in which smaller firms can grow their businesses by developing a set of pro-competition rules designed to favour the proliferation of smaller business units over the long term (Román, 2008).

Another important challenge for an inclusive, socially just development strategy is to construct solid institutions in the labour market. The new regulatory framework for collective negotiations should have a flexible structure that encompasses both the new paradigm of the globalized firm (outsourcing) and contractual asymmetry between large and small firms, particularly where production chains are concerned (Feres and Infante, 2007).

The new ground rules should lead to a more equitable distribution of the costs and benefits

associated with the commercialization of final products. In particular, paying low wages and flouting employment rights should no longer be seen as legitimate factors of competitiveness.<sup>18</sup>

To be effective at the different levels of civic participation, the new social dialogue will require institutional renewal. To this end, a participatory structure should be created through a network of grass-roots social institutions. This is perhaps the most important task facing the State and society if they are to lay the groundwork for inclusive development with higher-quality jobs and equity (Sunkel and Infante, 2006).

An initiative of this kind should involve broadly based participation by the private sector and civil society organizations in each region and locality, which is where productivity differences and the specific characteristics that need remedying are manifested in practice. A task of this magnitude would require a new social contract in which decisions about the quantity and allocation of resources were taken at the appropriate levels by means of social dialogue between workers, businesses, government and civil society representatives to provide the best possible response to the expectations and actual needs of citizens.

## 3. Guaranteed social protection

This is about constructing a society capable of providing everyone with equitable access to opportunities for progress and social protection.

Broadly speaking, the idea is that there should be combined action by the State, the market and society to improve opportunities of access to the social capital needed for material and moral progress and the best possible social protection that can be achieved given a country's income and development levels. The guarantee concept encompasses all the opportunities and basic protections a society is in a position to provide to everyone through public policies (Lagos E., 2008).

The State has prime responsibility for developing consensual policies that use public and private instruments to guarantee the protection of citizens' rights and make available the resources necessary for this, to the extent that the state of the economy allows. The idea is that the scope of guaranteed and enforceable rights should expand along with the resources yielded by economic growth. Thus,

<sup>17</sup> By business model is meant the whole system of regulations and business practices, whether based on common sense or on legal provisions, that allow particular market structures and their operating methods to exist.

<sup>18</sup> On these subjects, see Infante (2007b).

guaranteed social protection coverage is constrained by the degree of development that is sustainable. A guaranteed social policy should include health care, education quality and economic and social rights, among other aspects.

Although substantial and consistently applied high-quality redistributive policies in the fields of education and health care, for example, could lead to changes in the factors underlying inequality and thereby help to bring about a more equitable society, social spending cannot be relied upon exclusively to counteract the tendency towards income concentration that arises when those with more resources of every kind compete with those who have been denied access to even a minimum of opportunities. In the quest for more equitable income distribution, redistributive policies and measures need to be combined with others of a distributive type like the economic convergence policies and institutional changes proposed, as these act upon incomes at source and thus have permanent effects (Assael, 1998).

Another consideration is the kind of citizen that guaranteed social protection might tend to produce. The idea is for society to create citizens through work, which is the main factor in social integration, and not through welfarism financed by social spending, as happens now.

#### 4. Economic growth with equity

Rapid and sustained growth in output of consumer goods and services is a direct and essential condition for better living standards in the population. Having hitherto been non-inclusive and benefited mainly a minority of the population, this growth must meet a number of special requirements if development is to be inclusive.

The growth rate needs to be fairly high, of course—well above the rate of population increase, so that society clearly perceives it and feels encouraged to work for and cooperate in pursuit of social cohesion. Historical experience around the world suggests it is reasonable to expect growth rates to range between 5% and 6% a year (Ffrench-Davis, 2003). Higher rates could hardly be sustained for long periods without generating inflationary pressures and other disequilibria, while lower rates would be almost imperceptible to the population and insufficient to meet its aspirations and expectations. Growth within the range indicated is also needed to achieve reasonably high levels of employment.

One essential condition for growth is the expansion of production capacity, i.e., investment. History shows, once again, that investment has to be in excess of 25% of GDP for the rates of consumption growth indicated above to be attained. Furthermore, strong investment is also needed to sustain a high level of employment, which is the main source of income for most of the population, and to incorporate technological progress, which is an essential prerequisite for improved productivity and competitiveness. Again, achieving convergence in the production system will mean investing heavily in modernization and productivity improvements in the less advanced segments of the country's production structure.

In countries like Chile where science and technology are not well developed, technological progress comes essentially from the outside, incorporated into imported capital goods and services. Consequently, another essential requirement for inclusive growth is to foster a strong export dynamic that generates financing not only for these imports but also for those of consumer goods and services which the country does not produce, or does so only very inefficiently, and of high-technology products which the local economy is unable to produce and for which demand is very dynamic. In other words, the export sector has to be the equivalent of the sectors producing capital goods and technological progress in the developed countries, whence the critical strategic importance of developing more dynamic, diversified and stable exports.

The export pattern of Chile and the Latin American countries in general is notoriously dominated, however, by raw materials or commodities deriving from mining, agriculture, forestry and fisheries. These have traditionally been undynamic and very unstable in international markets and the trend of their terms of trade has been a deteriorating one, although this has been reversed in recent years because of the arrival of new actors on the international stage.

The critical importance of developments in the export sector has meant that its average growth rate has decisively influenced the medium-term growth rate of the economy, so that the frequent sharp fluctuations which are a feature of global commodity markets have translated into a succession of booms and busts. The latter have become severer in recent decades because of the unbridled expansion of the international financial system, which has been a very major contributor to instability in the international economy and lies behind today's deep crisis. This global instability has led in

turn to sharp oscillations in wage and employment levels, with all the negative effects these have had on living conditions for most of the population, and especially lower-income strata —another key factor in poverty and inequality in Chile.

Lastly, the new macroeconomic policy should not only give priority to reasonably high and sustained growth, but should also guide incentives and basic prices towards the goal of convergence in the production system. The policy applied should concentrate not just on basic equilibria and growth as such, but also on addressing the vulnerability of growth to changes in the international economy. This would make it possible to avoid the underutilization of production capacity and the negative productivity effects of fluctuations in economic activity, with all their various consequences for the different production strata and the employment and income levels of those who work in them.

## 5. Social cohesion

The problems of inequality, community integration, family life, environmental protection, security and quality of life are receiving greater and greater attention (Machinea and Uthoff, 2004). When it comes to addressing these new demands, the shortcomings of the current model are obvious. Here we should cite the example of the European Union, where social cohesion is essentially rooted in a State that guarantees its citizens equal access to certain fundamental rights and does

not naively trust that the market will automatically yield the desired results.

Applying the inclusive development strategy proposed should strengthen social cohesion as the different aspects composing it (economic convergence, institutional change and growth with equity) interact with one another.

It is generally recognized that employment is one of the main routes towards social inclusion in any country. The quality of work in the different sectors of society will determine their level of inclusion and whether this inclusion is of a more or less beneficial type. This is why job creation policies aimed at lower-productivity sectors, particularly the unemployed and the poor, are the main instrument in social inclusion strategies, which are an essential underpinning of democracy.

In short, even at the risk of repeating ourselves, we must stress that a social integration strategy relying on high-quality job creation requires a strong and sustained commitment of resources to promote economic convergence over a prolonged period, and decisions about the level and allocation of these resources should be taken through a process of social dialogue. An approach of this kind calls for a social covenant encompassing agreements to increase fiscal revenues and use accumulated national savings so that the inclusive development strategy has the financial sustainability it needs to ensure social cohesion in the medium and long term.

(Original: Spanish)

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# Institutions and public policies for rural development in Guatemala

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**T**his article reviews the formal institutional framework for implementing rural development policies in Guatemala, which originated in the State modernization process promoted through the Peace Accords. The main thesis is that rural development policies will be more efficient if they are based on the institutional framework that the Peace Accords provided, which distinguishes between three levels of government: central, deconcentrated and decentralized. While the two sub-national levels execute 43% of total public investment, central government needs to target the budget on poor zones, cut subsidies to the private sector and increase the supply of public goods. At the deconcentrated and decentralized levels, the territorial approach has proven effective in generating policies, but land-use planning needs to be based on political-social covenants between local stakeholders.

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# I

## Introduction

Recent discussion of poverty-reduction policies in Guatemala has focused on the need to implement specific measures for rural development. This approach reflects the fact that most of the poor and indigent live in rural areas (INE, 2007), and that social policies and trade liberalization have thus far done little to reduce the country's poverty indices (World Bank, 2003 and 2004).

Rural development policies in Guatemala have originated from both domestic and external sources. The former included the Peace Accords signed in 1996, which led to specific actions targeting rural areas. Agreements on rural development included the Agreement on Social and Economic Aspects and Agrarian Situation, the Agreement on Resettlement of the Population Groups Uprooted by the Armed Conflict and the Agreement on Identity and Rights of Indigenous People, which called for the creation of new public institutions to promote policies addressing agrarian, agricultural and rural issues.

In the case of external sources, structural adjustment and trade liberalization policies initially dominated, with the aim of promoting growth in rural areas. Nonetheless, discussion has recently embraced the farm system, in its updated sustainable-livelihood version (Ellis, 2000), and the territorial approach, the latter drawing on European experience on rural development (Sepúlveda and others, 2003).

Although domestic and external debate on rural development has helped to define *what* policies need to be adopted in this domain, there is still a conceptual vacuum in terms *how* to organize public, social and

private agents to promote the development of rural areas; and, as a result, institutional arrangements have gained an important place in the current debate. Public policies for rural development require dynamic institutions with capacity to implement the relevant measures and view the problem multi-sectorally with a local, decentralized and citizen-participation approach. In other words, what is needed is modern State that can put policy guidelines into practice.

This article reviews the formal institutional framework for modernizing the Guatemalan State that arose from the Peace Accords; and it discusses relevant aspects of rural development policies. The main thesis is that the existing institutions provide a framework for effectively promoting rural development policies, by affording greater sustainability to actions and strengthening State entities. Rural development policies can thus serve as a tool for consolidating Guatemalan State institutions.

The first section of the article analyses policy guidelines in Guatemala since the signing of the Peace Accords. It reviews rural public spending by central, deconcentrated and decentralized government, and the achievements and repercussions of relevant policies in the period 1996-2007. It then outlines local debates on rural development, before describing the current formal institutional structure—i.e. that supported by a specific legal framework—for promoting development in rural areas. The fifth section identifies the key aspects of this institutional framework that require strengthening; and the final section sets out the main conclusions.

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## II

### Rural development policies in Guatemala in the period 1996-2007

#### 1. Policy orientations

The Agreement on a Firm and Lasting Peace, signed in 1996, changed the direction of rural development policies in Guatemala. Firstly, it recognized the need to overcome the poverty, inequality and social and political exclusion that had been the main obstacles to the country's comprehensive development and a source of political-military conflict. Secondly, it was argued that this objective could not be attained without strengthening real, functional and participatory democracy, while the economic and social development process meant forging public-policy consensuses between social actors and the Government (Government of Guatemala/Guatemalan National Revolutionary Unity, 1996).

The rural programme set out in the Peace Accords contains social, economic and agrarian components. The social programme included measures relating to health care, education and other basic services for the rural population. The economic programme focused on fostering rural competitiveness, including aspects of foreign trade, access to productive assets and increased public investment in rural areas. The agrarian programme, recognized the need to tackle this through market mechanisms, with policy instruments such as: (i) providing legal certainty on land property rights; (ii) avoiding the concentration of land-holding by imposing a land tax on large agricultural estates (*latifundios*) and on idle land; (iii) putting a legal framework in place for the discussion and settlement of agrarian disputes; and (iv) creating favourable conditions to enable campesino groups to gain access to land ownership.

While the peace agenda was being promoted, State deregulation, structural adjustment and trade liberalization policies were also actively promoted from 1996 onwards. Among other measures, State-owned assets were privatized and the fiscal burden of the Ministry of Agriculture, Cattle and Food was reduced, which meant fewer interventionist tools and a reduction in the number of civil servants. International trade was also promoted through trade

agreements, which opened up new markets but also meant greater domestic competition.

#### 2. Rural public spending

The Guatemalan State has implemented these policies with different degrees of progress over three government terms.<sup>1</sup> From 1996 onwards, for example, social public spending was expanded in rural areas, and public infrastructure investment increased substantially. In the agriculture sector, the general property register was modernized, and the cadastral information register was created to improve legal certainty over land ownership; the Agrarian Affairs Secretariat was set up to provide dispute-settlement services; and the Land Fund was created as a temporary mechanism to facilitate access to land.<sup>2</sup> In the productive domain, government investments were expanded in rural areas; the Rural Development Bank was turned into a mixed-ownership joint-stock company; and free trade agreements were promoted.

An analysis of public expenditure in rural areas gives an idea of the development policies implemented in this sector. Table 1 shows that, following the signing of the Peace Accords in 1996, expenditure increased at an annual average real rate of 11%. From then on, greater attention was paid to rural infrastructure, which in the 1996-1999 presidential term accounted for 60% of total public expenditure by central government. In the most recent period analysed (2004-2006), infrastructure investment averaged 40% of the total, while social policy spending absorbed 50%. Expenditure on productive development has maintained a constant share of total public expenditure in the rural sector of about 11%. The targets set by the Peace Accords

<sup>1</sup> For a review of the fulfilment of the Peace Accords see, for example, MINUGUA (2004) and Government of Guatemala/Secretaría de la Paz (2007).

<sup>2</sup> Items that are still pending include the land tax and creation of agrarian courts, which are seen as crucial for revitalizing land markets.

TABLE 1

**Composition of rural public spending by central government, 1985-2006**  
(Millions of quetzales at 2000 prices)

Year	Social spending	Infrastructure	Productive development	Total
1985	604	827	256	1 687
1986	545	509	477	1 531
1987	620	1 174	441	2 235
1988	738	718	627	2 083
1989	761	626	569	1 957
1990	573	565	333	1 472
1991	633	727	319	1 679
1992	268	535	348	1 151
1993	736	1 040	301	2 078
1994	736	707	296	1 739
1995	723	1 375	259	2 356
1996	1 262	1 717	188	3 167
1997	999	2 439	294	3 731
1998	1 616	2 446	439	4 500
1999	1 040	3 854	683	5 577
2000	1 496	1 803	432	3 731
2001	1 455	1 677	837	3 969
2002	1 466	2 946	691	5 103
2003	1 479	2 094	555	4 127
2004	2 590	2 210	517	5 317
2005	3 095	2 130	794	6 019
2006	3 532	2 832	790	7 155

Sources: For data corresponding to the period 1985-2001: Kerrigan, G., *Gasto Público hacia el Sector Agrícola y Desarrollo de las Áreas Rurales: ALC, tendencias y desafíos*, Santiago, Chile, Food and Agriculture Organization of the United Nations (FAO), 2001; for 2002-2004: Inter-American Institute for Cooperation on Agriculture/United States Agency for International Development (IICA/USAID), *Actualización de la base de datos del gasto público rural del período 2002-2006*, consultancy report, IICA-Guatemala, 2007; for 2004-2006: Secretariat of Planning and Programming (SEGEPLAN), *Actualización de la base de datos del gasto público rural del período 2006-2007*, Consultancy Report, Guatemala City, 2008.

for social public spending and infrastructure investment have been surpassed by at least 50% in the various budgets in the period 1996-2007 (SEGEPLAN, 2008a).

The time series of the composition of rural public expenditure was estimated using the FAO methodology (Kerrigan, 2001), which divides expenditure into 25 categories. Nonetheless, over the last 10 years (1996-2006), 91% of rural expenditure in Guatemala has been in six specific areas: roads (33%), rural education (28%), agricultural productive development (10%), social infrastructure (10%), health and rural nutrition (6%)<sup>3</sup> and the issuance of land purchase vouchers (4%).

The structure of rural expenditure in Guatemala since 1996 has matched the overall Latin American

pattern (Fan and Rao, 2003), with social spending serving as the main tool for reducing poverty, while infrastructure investments and productive development have targeted export promotion, mainly in sectors with competitive advantages.

Rural development has also been assisted by government decentralization policies, since departmental and municipal government budgetary funding is a major source of financing. Public investment at the departmental and municipal levels accounted for 43% of total investment nationwide in 2007 (see table 2), when investments executed by the three government levels amounted to US\$1.428 billion.

Table 3 shows rural sector investments undertaken by departmental governments in the period 2004-2007, financed by transfers from central government to the rural development councils (CODEDES). During those four years, rural investment at the departmental level totalled 2.714 billion quetzales (roughly US\$362 million) and accounted for 74% of total resources received by the governments in question.

<sup>3</sup> The share of expenditure on health and nutrition grew by 11% over the last four years and explains the rise in social spending shown in table 1.

TABLE 2

**Public investment implemented at the three levels of government, 2007**  
(Millions of quetzales and dollars<sup>a</sup>)

Type of Government	Quetzales	Dollars	Percentages
Central government	5 838	761	53
Autonomous bodies	461	60	4
Deconcentrated government <sup>b</sup> (departmental)	1 067	139	10
Decentralized government (municipal)	3 587	468	33
Total	10 953	1 428	100

Source: Secretariat of Planning and Programming (SEGEPLAN), *Avances y desafíos de las políticas públicas en la administración Berger: ejercicio de transición*, Guatemala City, 2008.

<sup>a</sup> At the average annual exchange rate of 7.67 quetzales per dollar (see Bank of Guatemala, *Indicadores económicos de Guatemala* [online] <http://www.banguat.gob.gt/>).

<sup>b</sup> Corresponds to central government transfers to departmental development councils; does not include investments made by the ministries on a deconcentrated basis or social investment funds.

TABLE 3

**Composition of investments made in rural areas through the transfer to departmental development councils, 2004-2007**  
(Quetzales at current prices)

Type of investment	Projects approved			
	Quetzales	Percentage	Number	Percentage
<i>Infrastructure</i>				
Roads and highways	920 365 226	43	2 500	47
Water and sanitation	741 770 584	35	1 702	32
Urban development	401 777 511	19	950	18
Energy	27 443 119	1	67	1
Housing	15 437 009	1	44	1
Other infrastructure	24 915 924	1	84	2
<i>Total infrastructure</i>	<i>2 131 709 373</i>	<i>79<sup>a</sup></i>	<i>5 347</i>	<i>72.5<sup>a</sup></i>
<i>Social investment</i>				
Education	470 073 731	89	1 702	90
Health and social assistance	41 083 590	8	136	7
Culture and sport	8 549 874	2	27	1
Other social spending	5 739 234	1	16	1
<i>Total social investment</i>	<i>525 446 428</i>	<i>19<sup>a</sup></i>	<i>1 881</i>	<i>25.5<sup>a</sup></i>
<i>Productive development</i>				
Crop farming and livestock breeding	47 203 009	83	128	86
Industry and trade	5 427 217	10	8	5
Productive organization	2 333 541	4	4	3
Science and technology	1 486 154	3	4	3
Other productive development	506 224	1	4	3
<i>Total productive development</i>	<i>56 956 145</i>	<i>2<sup>a</sup></i>	<i>149</i>	<i>2<sup>a</sup></i>
<i>Grand total</i>	<i>2 714 111 946</i>	<i>100</i>	<i>7 377</i>	<i>100</i>

Source: Prepared by the author on the basis of Secretariat of Planning and Programming (SEGEPLAN), *Análisis del comportamiento del aporte a los consejos departamentales de desarrollo en el marco de las orientaciones de política período 2004-2007*, Dirección de Inversión Pública, Guatemala City, 2007, unpublished.

<sup>a</sup> Figures are percentages of the grand total.

The structure of departmental investment remained heavily biased towards infrastructure (79% of the total), with roads—construction, maintenance and widening—absorbing 43% of the total. While the social investment category at this government level does include social projects, it mainly involves infrastructure works, such as school building and remodelling (89%), the building and remodelling of health centres (8%), and the construction of sports facilities (2%).

Specific examples of projects undertaken by departmental councils include street paving; remodelling of parks, markets or public buildings, and the construction of community sports halls and facilities. This not only demonstrates the lack of coordination with central government policies, but also raises serious doubts as to the efficiency and effectiveness of public investment undertaken by this government level in terms of poverty reduction.

Departmental governments channelled just 2% of their total resources into productive development (56 million quetzales in 2004-2007), where the agricultural sector absorbed over 83%. Projects in this sector include forestry, irrigation, and various production-oriented initiatives.

The public budget at the municipal level accounts for 33% of total national investment. In 2006, rural municipalities administered 70% of these resources, worth to 2.945 billion quetzales (roughly US\$ 328 million). Table 4 shows investments made in 45 poor municipalities located in rural areas, where—as at the departmental level—infrastructure investments predominate. The “Other activities” category includes administrative expenses, which absorb a high percentage of the funding received.

Considering the expenditure of all three levels of government (centralized, deconcentrated and

decentralized), rural public spending amounted to US\$ 272 per person in 2006. This figure surpassed the US\$90 recorded in Guatemala in 2003 and US\$140 per capita Latin American average reported by FAO (Kerrigan, 2001), whose estimates only included central government outlays. This means that Guatemalan rural development policies must consider the budgets of deconcentrated and decentralized government as a major funding source.

### 3. International cooperation for rural development

Although grants from international cooperation, both bilateral and multilateral, represent roughly 2% of total annual rural expenditure, their importance stems from the fact that they provide technical assistance which will later be reflected in public policies.

In 2007, international development agencies had committed a total of US\$282 million in grant projects for Guatemala (to be executed over five years), of which 78% corresponded to rural development initiatives (IICA/USAID, 2007a). The main investment categories of bilateral cooperation are productive development (41% of total commitments), followed by support for infrastructure (35%) and health and human resources (24%).

Non-reimbursable multilateral cooperation, part of which targets the country's emerging needs and the rest is channelled into pre-investment in promising loan projects, totalled US\$251 million in 2007, of which US\$140 million (56%) corresponded to rural development projects to be implemented over a five-year period. The funding thus obtained was destined for social programmes (81% of the total), productive development (16%) and infrastructure (3%).

TABLE 4

**Composition of expenditure in 45 poor rural municipalities, 2005**  
(Quetzales and dollars at current prices)

	Quetzales	Dollars	Percentages
Infrastructure	239 389	31 499	43.0
Social spending	139 851	18 401	25.0
Productive development	636	84	0.1
Other activities	176 309	23 199	32.0
<i>Total</i>	<i>556 185</i>	<i>73 182</i>	<i>100.0</i>

Source: Inter-American Institute for Cooperation on Agriculture/United States Agency for International Development (IICA/USAID), *Actualización de la base de datos del gasto público rural del periodo 2002-2006*, Informe de consultoría, IICA-Guatemala, 2007.

#### 4. Achievements and outcomes of rural policies in Guatemala

Table 5 shows the main indicators of the progress achieved by rural development policies. In the social domain, the proportion of households with access to drinking water, sanitation, electricity, healthcare and education expanded, with the corresponding indicators growing at rates above 30% in the period 1994-2006. For example, in 2006, 86% of Guatemalan households had access to drinking water, sanitation and electrification, and the proportion exceeded 75% in the rural area. In terms of productive

infrastructure, the road network has expanded by 25% over the last 12 years, and the number of telephone lines has increased by over 1,200%. Traditional agricultural exports, such as sugar, coffee, cardamom and bananas, grew by 68% in the period 1994-2006, while non-traditional agricultural exports—fruit, vegetables and others—expanded by 255%.

Rural development policy outcomes can be measured through progress in reducing poverty in the country. Table 6 displays the main poverty indicators, which shows that total poverty shrank from 61% to 51% between 1990 and 2006, while extreme poverty decreased from 20% to 15%.

TABLE 5

**Guatemala: Main indicators of the progress of rural development policies, 1994, 1998, 2002 and 2006**

Indicators	1994	1998	2002	2006	Gross growth rate 1994-2006 (percentages)
Access to drinking water (thousand families)	1 701	n.a.	2 052	2 239	32.0
Access to sanitation (thousand families)	1 447	n.a.	1 651	2 239	55.0
Coverage of electric power system (thousand families)	1 095	1 414	1 934	2 213	102.0
Coverage of basic health services (million people)	0.5	2.2	3.1	4.1	720.0
Net primary school enrolment rates (percentages)	69.0	78.0	88.0	96.0	39.0
Road network (km of highways)	12 162	13 856	14 044	15 188	25.0
Access to telephone services (lines per 100 inhabitants)	n.a.	5	14	66	1 220.0 <sup>a</sup>
Traditional agricultural exports (in millions of dollars)	633	1 229	798	1,061	68.0
Non-traditional agricultural exports (in millions of dollars)	204	290	424	723	255.0

Source: Prepared by the author on the basis of Bank of Guatemala, *Indicadores económicos de Guatemala* [online] <http://www.banguat.gob.gt/>; National Institute of Statistics/Secretariat of Planning and Programming (INE/SEGEPLAN), *Necesidades básicas insatisfechas al 2002*, Vol. 2, Guatemala City, 2006; INE, *Encuesta Nacional de Condiciones de Vida (ENCOVI) 2006* [online] <http://www.ine.gob.gt/y/segeplan>, *Avances y desafíos de las políticas públicas en la administración Berger: ejercicio de transición*, Guatemala City, 2008.

<sup>a</sup> Represents the growth rate for the period 1998-2006.

TABLE 6

**Guatemala: Total and extreme poverty, 1990, 2000 and 2006<sup>a</sup>**  
(Percentages and thousand people)

Year	Total poverty			Extreme poverty		
	Urban	Rural	Total poor (percentage)	Urban	Rural	Total poor (percentage)
1990	n.a.	n.a.	5 443 (61)	n.a.	n.a.	1 782 (20)
2000	19	81	6 398 (56)	7	93	1 787 (16)
2006	28	72	6 626 (51)	17	83	1 977 (15)

Source: For 1990 Secretariat of Planning and Programming (segeplan), *Hacia el cumplimiento de los objetivos de desarrollo del Milenio en Guatemala. II Informe de avances*, Guatemala City, 2006; For 2000 and 2006; National Institute of Statistics (INE), *Encuesta Nacional de Condiciones de Vida (ENCOVI) 2002* and *ENCOVI 2006* [online] <http://www.ine.gob.gt/>.

<sup>a</sup> The data for 1990 measure poverty using income indicators, whereas in 2000 and 2006 poverty was estimated on the basis of consumption.



Although total poverty increased in absolute terms, it decreased relatively by five percentage points between 2000 and 2006.

A comparison of data between the rural and urban zones shows that urban poverty increased from 19% to 28% in 2000-2006 while rural poverty retreated from 81% to 72%. This reflects the fact that poverty has migrated from rural areas towards urban zones, particularly in the extreme poverty category.

If the current pace of poverty reduction is maintained, under an optimistic scenario Guatemala would have an extreme poverty rate of 13% in 2015, which would exceed the first Millennium Development Goal (MDG) by three percentage points. It was precisely this modest progress reducing poverty that led the country to embark on a debate on rural development policies, which is analysed in the following section.

### III

## The national debate on rural development policies

Given the progress made in terms of poverty reduction and the existence of a number of outstanding issues in relation to the Peace Accords, a process of dialogue and debate on the orientation of rural development policy was inaugurated in 2002. In that year, the Government of Alfonso Portillo set up an inter-sector roundtable to formulate a national policy on this issue;<sup>4</sup> and this initiative was taken up again in 2004 by the Óscar Berger administration. The discussions and agreements reached in the various dialogue mechanisms clarified the vision and general objectives of rural development,<sup>5</sup> the main elements of which are commented on below.

#### 1. Policy orientations

The roundtable mainly discussed the following issues: (i) the population to be targeted by the policies; (ii) the importance of the productive focus to complement the social agenda; and (iii)

unresolved aspects of the agrarian dispute. It was agreed that the target of the policies would be the poorest groups in rural areas —those that have suffered exclusion and marginalization ever since the colonial period. Accordingly, the final beneficiary was identified as the small scale rural economy, which in Guatemala is indigenous and campesino. From the standpoint of agricultural social organizations, this meant the chance to strengthen campesinos as a social class; and for government mechanisms, it represented a chance to target policies on the country's poorest municipalities.

The focus on the campesino economy also required policies targeted on promoting rural production; while social policies must continue, priority needs to be given to productive investments in the rural sector. As discussed in the roundtable, the objective is to energize the campesino economies. Stimulating production requires strategic public investments, so the various government mechanisms must cease to be observers of processes and become proactive agents of rural development. Likewise, productive development needs to take account of local advantages and conditions, which means formulating differentiated policies.

The roundtable failed to reach a general consensus on the agrarian issue, because conversations were interrupted by disagreements between business groups and the campesino sector. Campesino organizations argued that targeting policies on the poorest groups meant providing them with productive assets, among which land is a fundamental element.

<sup>4</sup> Participants in the roundtable included government delegates, representatives from the academic sector, political parties, the campesino and indigenous sector, small-scale rural producer organizations, rural women, business associations and the environment.

<sup>5</sup> The closing statement of the Comprehensive Rural Development Dialogue and Participation Roundtable, which concluded in September 2006, claims significant progress, including agreements reached on the main variables that determine rural development, a vision of the rural area in 25 years' time, the principles and approach that should guide comprehensive rural development policy, and its main lines of action (Government of Guatemala/Gabinete de Desarrollo Rural, 2006, p. 43).

At the same time, access to land meant an increase in the campesino population, the aim of which would be to strengthen campesinos as a social class. Given that one of the quickest ways to make land available is to redistribute it, social organizations proposed the expropriation of improperly used farms (e.g. for drug trafficking) and idle land as the main policy tool. Nonetheless, the business sector saw expropriation as a threat, since it would set a precedent for a confiscatory agrarian policy. The rural business sector is in favour of agrarian policies aimed at revitalizing land markets, and the creation of rural development instruments based on non-agricultural sectors such as handicrafts and ecotourism.

While these differences are being resolved, identification of the campesino economy as a policy target would help reactivate the land market. Rural development based on the campesino economy has significant effects on factor markets. For example, greater agricultural productivity translates into greater demand for land and, given that production is based on labour-intensive crop growing, medium- and large-scale farms tend to become fragmented while small ones expand, thus favouring changes in the agrarian structure.

As the agrarian issue is the key issue in the ideological and social class struggle in rural zones, it looks set to remain a feature on the critical path of rural development (IICA/USAID, 2008). Discussions on this subject need to be based on consensus; and progress in defining policy targets and the role to be played in rural development by the Government are points of convergence that would make it possible to unblock the debate on agrarian policy in Guatemala.

## 2. Policy instruments

Although the roundtable did not define suitable policy instruments for revitalizing the campesino economy, several national studies have been undertaken on this technical issue (Barrios and Mellor, 2006; IICA/USAID, 2008). Firstly, identification of the indigenous and campesino economy as a subject of policy is consistent with academic arguments on poverty reduction. The recent literature contains wide-ranging discussions on the potential of small-scale agriculture as a poverty reduction tool (World Bank, 2007; Mellor, 2007; Christiaensen, Demery and Kühn, 2006; Haggblade, Hazell and Reardon, 2005). The main argument is that agriculture generates a demand effect, in that

agricultural growth based on small-scale production generates income for a larger number of farmers and wage-earning farm workers, who in turn demand agricultural and non-agricultural goods and services on domestic markets. This fosters urban employment and activity in local non-agricultural sectors, thereby provoking multiplier effects and virtuous circles for poverty reduction (Christiaensen, Demery and Kühn, 2006; Mellor, 2007).

Nonetheless, if agriculture is to become a successful tool of poverty reduction, certain minimum conditions need to be satisfied (Haggblade, Hazell and Reardon, 2005; Mellor, 2007), such as a significant increase in the production of tradable agricultural goods. Moreover, the greater productivity of an exportable good should generate a substantial increase in local incomes, and thus a massive and equitable distribution of corresponding profits. This can be achieved if production is in the hands of small-scale producers and if labour markets socialize incomes; and in Guatemala this involves the campesino economy. Non-agricultural sectors also need to emerge and consolidate, which, among other factors, requires an efficient and strengthened framework of public institutions that can adapt to the dynamic of local markets.

In the case of Guatemala, Barrios and Mellor (2006) and IICA/USAID (2008) identified the main tools for promoting economic growth based on campesino economies; and these are compatible with those highlighted by Allcott, Lederman and López (2006), López (2005) and Fan and Rao (2003), in terms of their emphasis on the public-good nature of development policies. The instruments in question are as follows: (i) promotion of agricultural research and extension; (ii) creation of productive infrastructure, mainly roads and irrigation systems; (iii) improvement of productive organization; and (iv) access to financial markets.

## 3. The territorial approach to rural development

The territorial approach, for which the theoretical underpinning is provided by the new economic geography (Fujita, Krugman and Venables, 1999), has gained popularity in Guatemala despite being exogenous to the national debate on rural development. Its key argument is that regional characteristics are what determine a region's economic development, rather than the characteristics of people

themselves (de Ferranti and others, 2005, pp.103-124). Economic agents “agglomerate” in specific localities for the purpose of generating suitable conditions for economic growth (Fujita, Krugman and Venables, 1999). Moreover, some regions offer positive externalities that can promote development; but this also means that the economic backwardness of a region reflects a lack of institutions that agglomerate economic agents for the purpose of exploiting its natural advantages.

Regionally differentiated policies thus need to be formulated to improve equity between the various regions of a given country and optimize resource use (e.g. create jobs). Such policies originate from regional planning in which local agents jointly

identify policies and, at the same time, are able to attract local funding to implement the actions prioritized in the social consensus.

National policy objectives can also be achieved, since the territorial approach makes it possible to identify the productive potential of campesino economies, and convene local productive sectors to pool resources and pursue common development goals. Here, the approach encounters an appropriate institutional framework in the State decentralization and modernization policies being promoted in Guatemala through the Peace Accords, which were set out in the Law on Development Councils, the Law on Decentralization and the new Municipal Code, as discussed in the next section.

## IV

### The formal public institutional framework for rural development

Guidelines for State modernization in Guatemala are based mainly on two sources (Sojo, 2000) and in practice have been promoted with varying degrees of intensity. Firstly, there are initiatives driven by the economic ideology of structural adjustment and trade liberalization, which aim to downsize the government apparatus and enhance the effectiveness of fiscal policy (expenditure and tax revenue). The key mechanisms proposed in this area are the concessions system, the dis-incorporation of State enterprises and privatization (Méndez, Gálvez and Vásquez, 2008), along with decentralization, less State intervention and incentives for citizen participation.

Secondly, the peace process in Guatemala has also generated proactive measures to create a more equitable, inclusive and participatory society, with the Peace Accords being used to attempt to move from an authoritarian counter-insurgency State towards a democratic and inclusive one with a stronger civil society. From this perspective, decentralization and citizen participation can be seen as ways of enabling the population to take ownership of its development process (SEGEPLAN, 2008a).

As both schools of thought have influenced national policies, it can be concluded that modernization of the State in Guatemala pursues two

major objectives: improving efficiency in the provision of public goods and services by the State, and reducing exclusion and social discrimination (Sojo, 2000; SEGEPLAN, 2008a). The main instruments deployed to achieve these objectives are decentralization —i.e. the strengthening of local power— and creation of the dialogue and consensus mechanism between the State and society.<sup>6</sup>

Guatemala has created a legal framework to achieve the goals of State modernization, represented mainly by the so-called participation and decentralization laws: the General Law on Decentralization (Decree 14-2002), the Law on Urban and Rural Development Councils (Decree 11-2002) and the Municipal Code (Decree 12-2002).<sup>7</sup>

This legislation sets up a formal structure for formulating, implementing and evaluating public

<sup>6</sup> Recently, there has been discussion of reform of the political system as another essential element for modernizing the Guatemalan State (segeplan, 2008a).

<sup>7</sup> Although concessions, dis-incorporations and privatizations have been relatively successful in terms of rural development and the administration of natural resources in Guatemala (Méndez, Gálvez and Vásquez, 2008), this article focuses on the formal institution of decentralization and participation arising from the Peace Accords.

policies; and it also provides for resources to be devolved the deconcentrated and decentralized government levels. Broadly speaking, these laws define three levels of government (i.e. its vertical organization); and they also identify formal mechanisms for reaching consensus and agreement (the urban and rural development councils system) and the agencies that implement public policies (see diagram 1).

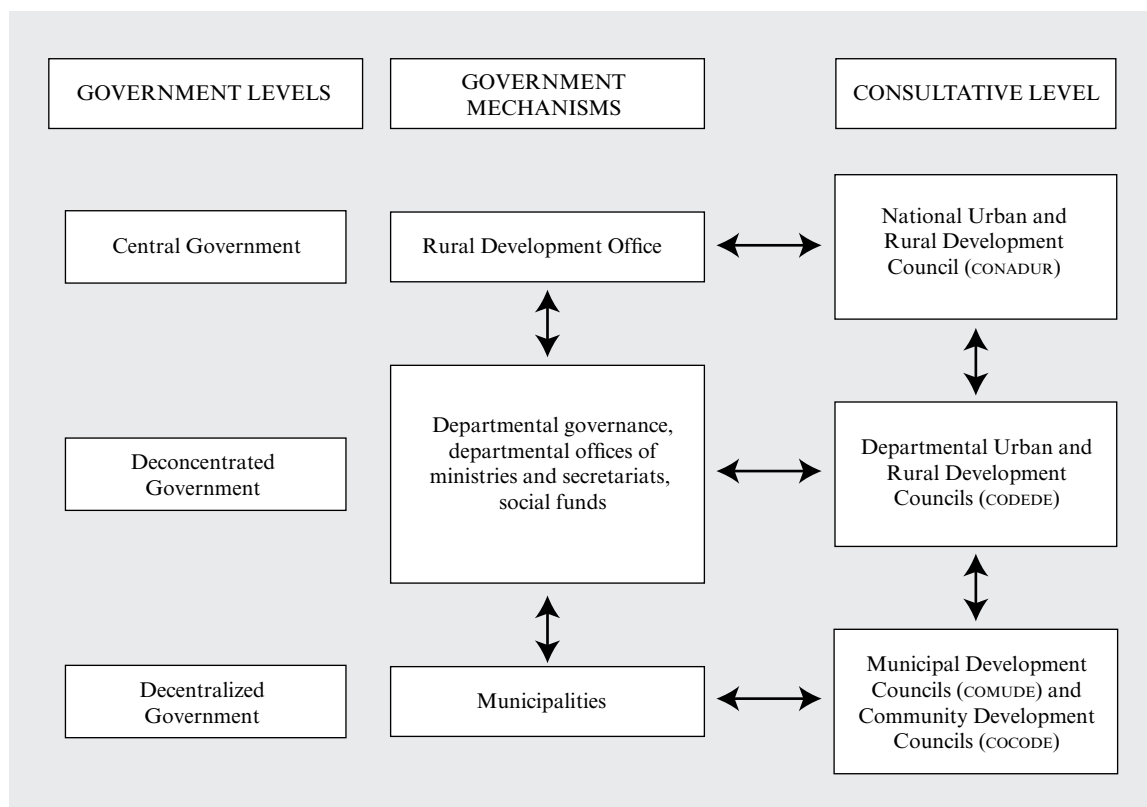
In terms of public policy implementation, the highest level in the hierarchy is the Central Government, consisting of the President, Vice President and Cabinet of Ministers. In the case of rural development policies, the Government is represented by the specific Rural Development Office (GDR) created in 2006 (Government Agreement 471-2006). This entity, consisting of seven ministers and five secretaries, coordinates the rural development policies and programmes implemented by the Government. Also at this level of government, the Social Cabinet is responsible for coordinating

national policy on social issues. The GDR thus has a microeconomic promotion approach, while the Social Cabinet focuses on education, health and nutrition. The fact that Central Government is represented in a specific office means that the sectoral vision of development has been abandoned in favour of a functionally operational and politically oriented scheme (Méndez, Gálvez and Vásquez, 2008).

The role of the deconcentrated government level is mainly to plan and coordinate actions in the departmental and local domains, where government bodies reach public policy consensus with social and private stakeholders. The deconcentrated government is headed by departmental governors, who are appointed by the President of the Republic and report to the Minister of Governance. In the case of rural development, this government level also includes departmental offices of the ministries and secretariats comprising the respective cabinet, as well as social investment funds.

DIAGRAM 1

Diagram of the formal institutional framework for rural development



Source: Prepared by the author on the basis of participation and decentralization laws.

Decentralized government is represented by the municipalities, which have autonomy to elect their own officials. Stronger municipal government is the key objective of State decentralization policies both in Guatemala and throughout Latin America. Municipalities have been assigned various productive and social coordination and promotion functions, financed out of their own funds and transfers from Central Government.

Each government level has its own formal mechanisms for forging consensus and agreement on public policies, known as Development Councils.<sup>8</sup> The Central Government has the National Urban and Rural Development Council (CONADUR), which consists of representatives from indigenous groups, campesinos, women, rural and urban entrepreneurs, academia, development and sector non-governmental organizations (NGOs), departmental governors, mayors and the ministerial cabinet. The Planning and Programming Secretariat of the Office of the President (SEGEPLAN) fulfils technical secretariat functions for the Rural Development Office and CONADUR, for which it serves as interface in articulating the debate between the two mechanisms.

At the deconcentrated or departmental government level, policies are decided upon in departmental development councils, consisting of representatives of indigenous peoples, women's groups, urban and rural entrepreneurs, universities with presence in the relevant department and deconcentrated offices of the ministries, together with the mayors of each department and the departmental governor, who chairs and coordinates

the mechanism. The SEGEPLAN departmental office serves as technical secretariat.

Similarly, the decentralized or municipal government level coordinates policies in the municipal development councils (COMUDES), which consist of syndics and councillors from the municipal corporation in question, up to 20 representatives from community development councils (COCODES), together with representatives from society and the ministries that maintain a presence in the municipality in question. In this case, the relevant municipal planning office serves as COMUDE technical secretariat.

The legal framework described above regulates the financial resources allocated to deconcentrated and decentralized governments. In the first case, the State transfers to departmental development councils the equivalent of one percentage point of the revenue collected from value added tax (VAT) levied at a flat rate of 12%. Under the Constitution of the Republic, municipal governments receive 10% of the general State income budget, 1.5 percentage points of VAT, and various percentages of the taxes on oil distribution, vehicle circulation, and central collection of the single tax on real estate property. As shown in table 2, the municipalities execute 33% of the public investment budget, while departmental councils undertake another 10%.

The State modernization policies promoted through the Peace Accords have made it possible to develop a formal institutional framework for designing and implementing public policies. Nonetheless, this has not enabled public or private stakeholders or civil society to formulate or agree upon specific policies, because, despite being appropriate, the mechanism is not yet fully operational. The next section analyses the fundamental aspects that need to be improved to consolidate the institutional framework for formulating and implementing public policies in Guatemala, with the emphasis on rural development.

<sup>8</sup> The Law on Development Councils also created the Regional Urban and Rural Development Council (COREDUR), but this will not be discussed in this article since, in practice, it is not operating.

# V

## Strengthening of the formal institutional framework for rural development

At the present time, the scope of policies at the three government levels is not clearly defined; and the existing legal framework does not specify the type of public policies to be applied at each level, except for the specific functions of municipal government. Definition of the scope of policies at each level will provide a frame of reference for identifying institutional strengthening needs.

An initial claim might be that Central Government is responsible for providing national public goods and services; foreign trade and macroeconomic policies, and those for adapting to and mitigating climate change, are formulated at this level, for example. The recent literature argues that central governments should refrain from implementing policies that subsidize private goods, since this generates political rent-seeking (de Ferranti and others, 2005; López, 2005; Allcott, Lederman and López, 2006) and interferes with the proper workings of deconcentrated and decentralized governments. In the case of rural development, the Specific Rural Development Office should focus on agricultural research and extension policies, creation of infrastructure (mainly roads and irrigation systems), improvement of productive organization and facilitation of financial markets.

Deconcentrated or departmental governments should focus on policies that make the most of local competitive advantages. Examples would be the building of roads to connect departmental capitals or storage centres in strategic localities. The investments to be undertaken should be identified collectively by the various local stakeholders, for which reason there is no *a priori* definition of local rural development policies. But even in this case, one can apply the principle of giving preference to those oriented towards the provision of public goods and services rather than subsidizing specific sectors (López, 2005; Allcott, Lederman and López, 2006; Schejtman and Berdegú, 2003).

State decentralization has made municipal governments responsible for providing public services locally. The Municipal Code identifies 15 specific municipal competencies, including health,

education and security. The resources they receive under the Constitution have to be invested in projects relating to education, preventive health, infrastructure works and public utility services, while transfers obtained from VAT are channelled into infrastructure, education and health projects.

### 1. Central Government

Central Government needs strengthening basically in two areas. Firstly, it is necessary to improve the efficiency and effectiveness of public policy instruments; and, secondly, public policies can be strengthened if political actors use the mechanisms provided by CONADUR to reach agreement on policies, find strategic partners, and reduce the costs of public dialogue.

Public policy efficiency and effectiveness at the central level can be improved by prioritizing public expenditure in the poorest localities of rural areas and by targeting campesino economies. Policy effectiveness also involves cutting expenditure on private subsidies and increasing instruments to boost the supply of public goods and services. This requires coordination at the highest political level.

Several recent studies (World Bank, 2003; Vergara and Lavarreda, 2006) have addressed the issue of social spending efficiency in Guatemala. The World Bank (2003) claimed that public expenditure on social protection programmes was regressive, since the wealthiest quintile absorbed 46% of social investment while the poorest quintile received just 8%. This study concluded that none of the country's social protection programmes was well targeted, as there was little focus on the poorest sectors.

As rural poverty in Guatemala is geographically biased (most of the poor live in the national *altiplano*), the policy choice is to target social programmes on those parts of the country (World Bank, 2003). In this regard, although some programmes have been implemented already such as *Guate Solidaria Rural* and the strategy to reduce chronic malnutrition that started in 2005, and more recently the programme of conditional transfers that began in the second

half of 2008, it is essential to continue targeting resources on poor localities and population groups, to make rural social spending more effective in reducing poverty.

Priority also needs to be given to policy instruments that aim to stimulate the supply of public goods. Expenditure on productive agricultural development, for example, consists essentially of fertilizer programmes and the *Bosques y Agua para la Concordia* programme (the latter serving as a mechanism for compensating civil self-defence patrols for their participation in the armed conflict), which are clearly private subsidies. If this type of subsidy were reduced and investment in public goods expanded, it would be possible to increase agricultural growth (López, 2005; Allcott, Lederman and López, 2006).

Policy targeting on poor population groups and localities and on the supply of public goods requires institutional coordination at the highest political level. Various methods have been used for this in Guatemala, such as presidential appointment of Governmental Commissioners to coordinate government ministers; inter-agency councils or commissions, in which a collegiate board of involving the government and private entities performs the coordination; and specific government offices consisting of a few ministries and secretariats, chaired by the Vice President. As the latter represent the only mechanism recognized in the institutional structure (SEGEPLAN, 2008a, p. 211), it is recommended to continue strengthening them to increase government capacity for coordination, supervision and evaluation of public policies.

Central Government has an interest in CONADUR for two reasons: firstly, the system of urban and rural development councils is a suitable structure for seeking consistency and correspondence between national and decentralized policies. Secondly, CONADUR makes it possible to streamline policy consensus and negotiation, reducing the transaction costs of the respective dialogue and also generating partners to implement the measures involved. It is better to have a single formal interlocutor than numerous roundtables.

A recent example of attempts to relate local policies to national ones was the Regulation for Administering the CODEDE Contribution (IICA/USAID, 2008), approved by CONADUR in December 2007. This legal mechanism created economic incentives for departmental councils whose investments were

aligned with public policies; and regulatory criteria were introduced for fulfilment in the projects undertaken by the various departments. As a political consensus mechanism, CONADUR played a major role in the approval of this regulation.

Civil society, for its part, can channel its demands and influence decision-making through institutionally created spaces. For example, it can play a major role in reducing private subsidies, taking advantage of the possibility offered by development to supervise public policies. Nonetheless, the use of the space provided to them by CONADUR is a political decision that social stakeholders have under-valued.

## 2. Deconcentrated government

The main weakness at the deconcentrated government level has been identified by SEGEPLAN, which argues that processes to nurture participation, enforce decentralization and strengthen local power have been implemented haphazardly, prioritizing financial decentralization without clear rules. As a result, municipal actions and those undertaken by development councils —financed by central government transfers— have lost touch with public policies (SEGEPLAN, 2008a, p.219). The deconcentrated level of government is the interface between local policies and national ones; and it is also where rural development policies are planned and implemented.

The territorial approach to rural development makes sense at the departmental level, as shown by over 22 local planning exercises undertaken in Guatemala, which proved to be effective tools of public governance in guiding processes of participation, decentralization and strengthening of local power (SEGEPLAN, 2008a). For that reason, strategies to strengthen the deconcentrated level of government focus on the local planning process.

An evaluation of local planning made by IICA and USAID (2007b) found that the main challenge for the CODEDES was not to improve the technical aspects of planning, which will always be improvable, but to take advantage of its different stages —i.e. dialogue, consensus building and negotiation— to mobilize public and private resources to achieve common development goals. This means firstly a phase of negotiation and forging agreements on the objectives and territorial vision held by key local stakeholders; and, secondly, channelling financial resources from civil society, the private sector and

the Government into actions and projects that are negotiated and agreed upon in the planning process. In other words, strategic planning must become a political-social covenant between local stakeholders to transform the local area in question.

Turning local planning into a political-social covenant requires greater participation from local stakeholders —mainly civil society and the private sector— because government mechanisms predominate when defining actions. As a political consensus-building process, local planning needs to define practical measures, responsibilities and deadlines, and use them to exert social and political pressure to ensure that the relevant actors fulfil their respective commitments. For that purpose, *iica/usaid* (2007b) has recommended creating legal instruments such as local contracts which indicate the penalties to which actors would be liable failure to comply.

The greatest challenge facing local planning at the departmental level is to shake off the informal institutional framework inherited from 36 years of civil war, in which local stakeholders have generally been reluctant to participate in development processes. This can be achieved by making sure that what is agreed upon in planning processes is reflected in investment projects. Hence the importance of linking local planning to the process of preparing the State budget, which has not yet happened: most of the projects identified in local planning processes are not reflected in the department's investment budget. Departmental governments need to be capable of reaching the political agreements needed to channel resources into local actions.<sup>9</sup>

In short, the main functions of deconcentrated government are to coordinate and plan public policies

at the departmental level. While the territorial approach is a proven tool for identifying and ranking public investment priorities, its scope needs expanding to encompass a larger number of social and private stakeholders, and to turn local planning into a political-social covenant with mechanisms to give incentives for implementing actions. This would make it possible to ensure the sustainability of the territorial approach to rural development and, at the same time, strengthen the formal institutional framework for citizen participation. The challenge is to overcome the reluctance that prevails in this regard, which will be achieved if the political covenants are really applied locally. Land-use planning at the departmental level is seen as a suitable tool of rural development that also contributes to modernization of the State at its deconcentrated level.

### 3. Decentralized government and international cooperation

Various studies on municipal governance (e.g. Letelier, 2007) have identified the following substantive issues in “municipalism”: linking municipal expenditure to public policies, increasing municipal revenue and improving the type of investments they undertake. It is also essential to expand municipal planning capacities; and the strengthening of citizen participation in political consensus-building and negotiation would help improve national democratic processes. As the link between national policy and local interests materializes at the departmental level, it would be important to strengthen this government mechanism to enhance the effectiveness of municipal policies.

International cooperation could play an active role in consolidating the formal institutional framework for rural development. Its most important contribution, whether productive, participatory or circumstantial, would be to provide technical assistance to ensure that public policy formulation and consensus-building includes what is planned at the local level and strengthens civil organization.

<sup>9</sup> The real chance of departmental governors being able to reach political agreements locally is a matter for concern. For example, the Governor of the Department of Huehuetenango, appointed by the President, has little political support for negotiating with the 31 mayors and 10 district deputies who are elected democratically.



# VI

## Conclusions

The behaviour of rural development policies in Guatemala is like an out-of-tune and dis-coordinated orchestra: there are considerable financial resources available—more than the Latin American average—but effects in terms of reducing poverty have been few. This statement applies to the central, deconcentrated and decentralized government levels alike. Recent debate on rural development policies suggests that an initial measure would be to strengthen the institutional framework for formulating, reaching consensus on and implementing public policies.

The Peace Accords proposed an institutional structure that would adapt to the new rural development guidelines by creating a logical institutional framework to promote citizen participation and build consensus around public policies. Nonetheless, although the legal framework is in place, political and social actors in practice “do not play on that field”. This article identifies a number of measures to strengthen the institutional framework for peace and rural development, for application at the three government levels, which could be promoted by public, private or social stakeholders.

At the central level, citizens would be more likely to have their proposals made binding if they really participated in CONADUR, rather than doing so in “dialogue roundtables”, the conclusions of which are not subsequently reflected in public policies. Through participation in CONADUR, citizens would need to retarget investment in public goods—which have been identified in the national debate—and eliminate rent-seeking mechanisms that favour specific pressure groups. Central government, meanwhile, could streamline the process of reaching policy consensus if it dealt with a single interlocutor

(CONADUR), thereby reducing the cost of negotiating and reaching agreements while also generating partners for policy implementation.

The departmental level of government is perhaps what most needs strengthening and where the territorial development approach has the greatest repercussions. Here it is crucial to ensure that what is agreed on at the departmental level is reflected in public policies, which means that all stakeholders need to have clearly established commitments and targets in local development plans. The public-social contracts that have been implemented in several Latin American countries might be a suitable mechanism for achieving this goal and for increasing financing for local investments in public goods.

Municipal governments (decentralized level) still need to improve the technical capacity of their planning offices. It is also important to continue encouraging citizen participation in the supervision and formulation of public policies. The territorial development approach has proven an effective way to generate policies and pool efforts among the various social actors at the local level.

The promotion of local policies within the existing formal framework would help to make rural development policies more sustainable. At the same time, it would strengthen the formal institutional framework for participation and inclusion, since it would have clear objectives justifying its existence: i.e. prioritizing public and private investments. This will also contribute to modernization of the Guatemalan State, which is essential for achieving genuine development and successful participation by Guatemala in the economy of the twenty-first century.

*(Original: Spanish)*

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# Sixty years of ECLAC: structuralism and neo-structuralism

*Ricardo Bielschowsky*

**T**his article analyses the thinking and key ideas generated by ECLAC throughout its six decades of life, by reviewing the work published since its creation in 1948, in both the structuralist stage (1950s, 1960s, 1970s and 1980s) and the neo-structuralist phase (since 1990). It then reviews the most important contributions made between 1998 and 2008, which address the effects of the structural reforms of the 1990s; the agenda for the global era; approaches to rights, citizenship and social cohesion; the Schumpeterian-structuralist convergence and countercyclical macroeconomic policies under conditions of financial volatility. The article discusses the similarities and differences between the two phases and concludes that neo-structuralism has remained analytically very close to structuralism.

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# I

## Introduction

This article summarizes the evolution of thinking at the Economic Commission for Latin America and the Caribbean (ECLAC) during its 60 years of existence, through a systematic review of the extensive bibliographic material published by the institution, focusing particularly on its sixth decade.

The texts published in the first 30 years studied in this article were mostly authored by the leading ECLAC intellectuals of that period, while those chosen to represent the institution's thinking over the three most recent decades tend to be its official documents.

This article reproduces and duly extends the five-period classification used in an earlier review of the first five decades (Bielschowsky, 1998), organized around the “messages” that motivated the institution's intellectual output and reflected the historical circumstances at each point in time.<sup>1</sup>

The key ideas of the first three decades were industrialization (the 1950s); the need to implement fiscal, financial, agrarian, administrative and other reforms to intensify the industrialization process and reduce inequalities (the 1960s), and the reorientation of development “styles” (the 1970s).

In the 1980s, the debt crisis inevitably caused a change in ECLAC priorities, which shifted from the production-distribution focus prevailing until then to concentrate more on macroeconomic issues.

Since 1990, however, long-term reforms have taken centre stage once more, but without neglecting the need to attain and preserve macroeconomic stability. The message that has come to dominate the ECLAC research and discussion agenda, encapsulated

as “changing production patterns with social equity”, embraced the two main objectives that have traditionally been promoted by the institution: to develop a productive base combining continuous productivity increase with competitive engagement in the international economy, while building a more equal and fairer society.

In the 1990s, ECLAC updated its thinking to reflect the new reality of open trading arrangements, international capital mobility, privatization and deregulation, against a backdrop of closer relations with the rest of the world and greater regional integration. It achieved this while conserving the key elements of its original structuralist approach and formulating alternative strategies and policies that were largely at odds with the neoliberal agenda. The expression “neo-structuralism” aptly characterizes this new stage.

Between 1998 and 2008, the neo-structuralist analyses and proposals were enhanced, matured and improved to form a policy agenda encompassing the institution's four basic analytical domains of macroeconomics and finance, productive development and international trade, social development and environmental sustainability. This recent programme—heterodox in macroeconomics, development-oriented in terms of resource allocation and State intervention, universalist in the social field and conservationist on the environment—is embedded in the main official ECLAC documents that will be referred to in this article, and in numerous papers authored by its research fellows.

A reading of those documents shows how the institution's thinking has blended continuity and change. Throughout its history, ECLAC has maintained the same methodological and analytical approach, conserving the unity and coherence of its intellectual output, while keeping its analyses permanently up to date. As noted in the 50th anniversary volume *Cincuenta años del pensamiento de la CEPAL: textos seleccionados*, what changes is the real history under analysis and the ideological background against which it unfolds; and this calls for emphases to be continually fine-tuned and interpretations renewed, to adapt to new historical contexts (CEPAL, 1998a).

□ Abbreviated and slightly amended version of the introduction to the volume commemorating the 60th anniversary of ECLAC (forthcoming), which contains a selection of the articles published between 1998 and 2008. The author is grateful to the many colleagues who have collaborated in the research and made valuable comments on the original text, particularly Miguel Torres for his outstanding contribution to this article. Naturally, the interpretation and any errors or omissions are the author's responsibility.

<sup>1</sup> On the evolution of ECLAC ideas, see Hirschman (1963), Cardoso (1977), ECLAC (1969), Rodríguez (1981, 2006), Gurrieri (1982), Pazos (1983), Hodara (1987), Fitzgerald (1994), Hettne (1995) Bielschowsky (1998), Rosenthal (2004) and Love (2005), among others.

This can be seen in the transition towards neo-structuralism, which reflected historical changes, both domestic and international, i.e. the macroeconomic instability that took root in the 1970s following the breakdown of the Bretton Woods system, and the reorientation of the region's economies towards deregulation and globalization since the late 1980s. This caused ECLAC to rethink its analytical and propositional stance and adapt it to new times. Nonetheless, this review preserved the accumulated analytical tool box, putting it at the service of a “positive agenda” for the economic and

social development of the region, which was both alternative and contrary to orthodox macroeconomic and neoliberal thinking on resource allocation.

The present article contains three sections in addition to this introduction and conclusion. The second section summarizes the main ideas generated by the institution in the structuralist phase — the first 40 years— while the third sets out the thinking of the neo-structuralist phase that has prevailed since 1990. The fourth section highlights the similarity of the analyses made in the two stages.<sup>2</sup>

## II

### The structuralist stage (1948-1990)

The ECLAC analytical system is based on the “historical-structural” method. This studies the specific productive, social and institutional characteristics, and international engagement of Latin American and Caribbean countries, which are seen as peripheral, in contrast to those of the “central” economies, viewed mainly from the standpoint of medium- and long-term change. The approach originated in the three basic texts through which Prebisch gave theoretical and ideological orientation to the institution (ECLAC, 1951a and 1951b; Prebisch, 1973), and was developed further over the two ensuing decades by the same author and some of his followers.<sup>3</sup>

The inaugural trilogy sees the central countries as producers of industrialized goods, whereas the region's socioeconomic structure had the following characteristics:<sup>4</sup> (i) specialization on primary goods and lack of productive diversity (low levels of inter-sector complementarity and vertical integration); (ii) highly varied levels of sector productivity<sup>5</sup> and an unlimited supply of labour with incomes close to subsistence level; and (iii) an institutional structure (State, agriculture sector and business fabric, among others) that was poorly oriented towards investment and technical progress.

Industrialization, which had been strengthened in the wake of the recession of the 1930s and the Second World War and was progressing spontaneously without the support of development policies, was seen as the way to overcome poverty and close the widening gap that existed between the periphery and centre. Nonetheless, serious problems were emerging because of the characteristics of the socioeconomic structure noted above.

Diversifying the region's meagre productive base required simultaneous investment in many sectors; and this called for a major additional effort to generate foreign exchange and saving, in circumstances where

<sup>2</sup> The structuralist approach has close ties with the output of “developmentism”, associated with names such as Rosenstein Rodan, Singer, Nurkse, Lewis Myrdal, Hirschmann and other pioneers of this school of thought. Recently, following the initial contribution by Fajnzylber, ECLAC intellectuals have been among those seeking alternatives to neoliberal interpretations and policies, such as Taylor and Shapiro (1990), Amsden (1989) and Wade (1990), among others. Nonetheless, this paper does not discuss the divergences and convergences between the institution's thinking and that contained in the specialist literature of the rest of the world.

<sup>3</sup> The historical-structural method allows for a fertile interaction between the deductive and historical-interpretive approaches, focusing on the path pursued by economic agents and institutions and the permanent interplay between theoretical formulations and historical changes. The volume by Furtado (1959) on the economic formation of Brazil is perhaps the key reference for the use of this method in historical studies. For discussion on this, see for example Sunkel and Paz (1970), chapter 5.

<sup>4</sup> Octavio Rodríguez (1981) provides a detailed and precise view of the formulations made by Prebisch, based on a recapitulation of the key elements of Prebischian thought.

<sup>5</sup> Later, in the 1960s, Pinto (1965, 1970) would use the expression “structural heterogeneity” to refer to this diversity.

specialization on primary goods was producing a very small supply of foreign exchange compared to the demand for it. Moreover, the coexistence of a small high-productivity sector with a larger and less dynamic one produced a type of structural heterogeneity with a very low surplus-income ratio. In addition, poorly developed institutions meant inadequate fiscal capacity, the wasting of part of the surplus on unproductive investments and superfluous consumption, and scant stimulus from investment and technological progress.

These three features of underdevelopment, and the “peripheral status” of Latin America, are the key aspects around which the intellectual work and levels of analysis traditionally explored by ECLAC have been structured: technical progress, growth, employment, income distribution and poverty; international engagement in the context of “centre-periphery” relations, and planning and design of the economic policy implications.<sup>6</sup> Later, when reviewing more recent thinking, we will see that these elements are still present in ECLAC analysis.

The leading intellectuals in the institution’s early years (Prebisch, Furtado, Medina Echavarría, Noyola-Vázquez, Ahumada, Pinto, Sunkel and others) believed that overcoming “peripheral status” required specific modalities for introducing technical progress, distributing income and relating with the rest of the world. Accordingly, these authors called for an autonomous theory to be formulated to capture the nature of the region’s underdevelopment and the vicissitudes of its socioeconomic evolution. Many analytical contributions were produced by ECLAC researchers inspired by structuralism; and that intellectual output boldly and independently contributed to the formation of an ideological identity for the region as a whole.

During the institution’s first decade, devoted to the message of industrialization, the key contribution was perhaps the Prebischian idea that there was a basic asymmetry between the sluggish growth of world demand for commodities produced at the periphery, and burgeoning peripheral demand for industrial products made at the centre. This asymmetry would have potentially fatal consequences

for development in the countries of the region, since it would tend to cause a structural deficit in the balance of payments, with negative repercussions for inflation and the continuity of growth. It was also claimed that the difficulties were aggravated by the fact that the terms of trade were turning against undeveloped countries, contrary to the benefits promised by the apologists of free trade.

The attention paid to external vulnerability and the shortage of foreign exchange, which, in conjunction with the lack of saving and investment, were seen as the main obstacles to growth, would lead to an analysis of the determinants of the industrialization process, i.e. the dynamic of import substitution.<sup>7</sup> It would also have a decisive influence on the structuralist interpretation of Latin American inflation made by Noyola Vázquez (1957) and Osvaldo Sunkel (1958), whose basic contribution was to draw attention to a theoretical possibility, namely that under special circumstances the primary cause of inflation was not monetary expansion, but balance of payments deficits and other problems inherent to Latin America’s undeveloped structure.

At the same time, the issue of external vulnerability was a key aspect of the analyses undertaken in the 1950s to establish a regional market —firstly in Central America and then in Latin America as a whole— which at that time was seen as a mechanism for expanding industrialization and compensating for the shortage of foreign exchange (ECLAC, 1959).<sup>8</sup> Years later, following the creation of United Nations Conference on Trade and Development (UNCTAD), led by Prebisch, it would also be a key element in proposals relating to the need to regulate international commodity reserves and to create preferential schemes of access to the central markets for the commodities and industrial goods produced by developing countries.

In the 1960s an additional component was added to the pro-industrialization message: the proposal to implement institutional reforms —in the agrarian, fiscal and financial domains, among others— that were considered crucial for the continuity and deepening of industrial development. At the same time, in an ECLAC that was less optimistic than in

<sup>6</sup> The belief that the process was highly problematic spawned a major effort to formulate programming techniques, inaugurated in 1952 (ECLAC, 1955) and, later, the creation of the Latin American and Caribbean Institute for Economic and Social Planning (ILPES).

<sup>7</sup> The analysis was performed by Prebisch in the inaugural texts and more fully by Tavares (1964) in the 1960s.

<sup>8</sup> On participation by ECLAC in the creation of the Central American market, see the report produced by one of its major inspirations, Victor Urquidí (1998).

the previous decade, and as a reaction to the fact that the relative success of industrialization had been insufficient to prevent a substantial increase in urban poverty, initial analyses of its effects on employment plans and income distribution started to emerge. Henceforth, the institution's agenda would link the issue of equity with that of productive development—a major step forward from the work of the previous decade, when this issue had virtually been ignored.

Furtado (1961) formulated the hypothesis of the persistence of under-employment—and hence under-development—throughout the industrialization process. Earlier ECLAC interpretations concerning the propensity towards structural deficit in the balance of payments and inflation, were now joined by evidence of a new form of poverty and social imbalance that was increasingly urban and occurring alongside the modernization being promoted by industrialization.

It was at this point that the analysis relating poverty and unequal income distribution to widening disparities in productivity and income between individuals, sectors and regions emerged in ECLAC. This gave rise to the concept of structural heterogeneity, seen as the outcome of inherited historical conditions and the natural evolution of the labour market. Its core argument is that, to the detriment of the worker, the abundant supply of labour is accompanied by slow growth in the demand owing to the slow rate of growth of investment and the prevalence of a high level of capital intensity.

These years saw an outpouring of ideas on the relation between the dynamic of the income distribution and growth under the new socioeconomic heterogeneity conditions, e.g. Pinto (1965, 1970), Furtado (1969) and Tavares and Serra (1971). At the same time, as a consequence of the growing inflow of foreign capital into the region, there was also a fertile debate on the dependent nature of the Latin American modernization process, represented, for example, by Sunkel (1971) on the economic interpretation and Cardoso and Faletto (1969) on the political interpretation.

In the 1970s, ECLAC thinking continued to move forward along its two basic tracks, namely the nature and difficulties of economic growth and industrial development and the income distribution.

On the first of these issues, the debate on the inadequacies of the industrialization process carried

over from the previous decade, when questions had been raised concerning the constraints imposed by excessive protection and the lack of an institutional framework to promote investment and technical progress. Nonetheless, in response to the wave of liberalization introduced into the Southern Cone countries in the 1970s, ECLAC adopted a cautious attitude towards rethinking the regulatory framework for economic activity, even though many of its intellectuals since the early 1960s had acknowledged this to be overly protectionist (e.g. Prebisch, 1961 and 1982; Macario, 1964). Instead, the proposal was to provide export incentives targeting regional and global markets. Simultaneous expansion of the domestic market and industrial exports—a combination that was taking its initial steps in countries such as Brazil at that time—was seen as the way to tackle the problem of external vulnerability; and from the early 1970s it was put forward as an alternative to borrowing abroad, which was eliciting serious warnings over the risks of excessive debt (ECLAC, 1971).

On the distribution of income, the debate over development styles or modalities gained maturity by analysing the relationship between the structure of demand (income distribution) and supply (capital accumulation and technical progress), and the finding that the predominant model perpetuated inequality and did not make it possible to deal adequately with poverty. The message posited the need for income redistribution—understood to imply restoring democracy, which was absent from much of the region at that time—as a way to make a fairer style of growth politically viable.

In the 1980s, known as the “lost decade” owing to the fall in regional per capita income caused by the debt crisis, work by ECLAC reflected the backdrop of the recessionary adjustments implemented in most countries across the region. This diminished the relative importance of the two issues that had predominated until then—productive development and equality—as priorities turned towards a field in which the institution had done little work in the previous decade, namely the analysis of macroeconomic stability and particularly the debt-inflation-adjustment *troika*.

The ECLAC discourse included renegotiation of the external debt to allow adjustment with growth. In the 1980s there was less-than-full consensus among the institution's technical teams and leaders on how to address the problem, i.e. between approaching



or diverging from the views of the International Monetary Fund (IMF) and the banks, and between greater or lesser heterodoxy in combating the inflationary process.<sup>9</sup> In general, the heterodox approach prevailed, which called for control of inflation combined with debt renegotiation to enable growth and investment to recover. This formula was proposed to avoid the major short-term sacrifices that creditors were imposing on the region's countries, and to achieve export competitiveness in the medium and long terms. This message was in keeping with the ECLAC tradition, since it claimed that beyond tackling short-term difficulties, the structural solution to external problems required expansion and diversification of both output and exports.

The relative supremacy of macroeconomic issues in the 1980s did not prevent continued interest in economic development in its productive and distributive spheres; and the high point here was perhaps the thesis formulated by Fernando Fajnzylber (1983, 1990). On joining ECLAC in 1983, Fajnzylber had just completed the volume *La industrialización trunca de América Latina*. This study, along with *Industrialización en América Latina: de la caja negra al casillero vacío*, published at the

end of the decade, were the main reference texts for the review of structuralism and implanting of the neo-structuralist phase that began in 1990.<sup>10</sup>

Fajnzylber was against the emerging neoliberalism, believing that development involved an important role for the State; but he was also highly critical of the development model adopted at that time and of the institutional framework that embraced it. Naturally, Fajnzylber's opposition to neoliberalism in the 1980s is no different from the numerous ideological discrepancies that were being expressed in the development literature worldwide in that period. Nonetheless, his arguments were particularly important for ECLAC, because, from the analytical standpoint, it was he who led the institution towards the neo-structuralist stage, which would evaluate the opportunities and development challenges facing open economies with active but less interventionist States. Moreover, his emphasis on technical progress based on knowledge accumulation—which stemmed partly from neo-Schumpeterian studies of the revolution represented by information technologies and biotechnology, and the creation of national innovation systems—would establish a new analytical benchmark in ECLAC thinking.

### III

## The neo-structuralist stage (1990-2008)

### 1. A brief outline of its evolution

In the late 1980s, nearly all Latin American and Caribbean countries were moving rapidly towards trade and financial liberalization, privatization and reduced State intervention. As is well known, the international political and ideological setting at that time was highly unfavourable for heterodoxy and hostile to the classical eclac formulations, given the institution's scepticism and cautious attitude towards trade liberalization and other forms of deregulation. Given the sensation that such reforms were historically irreversible, and the need to open dialogue with the organization's member countries,

Gert Rosenthal—who took over from Norberto González as Executive Secretary in 1988 and led the institution's intellectual output until late 1997—embraced and promoted Fajnzylber's ideas to position them in the ideological debate of the time, acknowledging the institutional reforms but opposing several key elements of the liberalization guided by the Washington Consensus. During Rosenthal's mandate, eclac adopted Fajnzylber's ideas as the basis for designing a new strategy for productive and social development and participation in the international economy.

Research on the workings of Latin American and Caribbean economies in the new historical

<sup>9</sup> For a discussion of the divergences, see Marinho (1991) for example.

<sup>10</sup> Sunkel (1991) also contributed at the start of this new phase.

circumstances came to occupy a fundamental place in the institution, alongside the formulation of strategies and policies for the region's development that were alternatives to the orthodox reformist agenda. The analyses and policy implications were based on a selective and transforming review of the reforms recommended by orthodoxy, stressing the goal of growth with distributive equity.

In fact, as noted in the introduction, the work published from 1990 onwards contains forceful arguments for reconsidering financial liberalization and macroeconomic management in a context of financial capital volatility; the implementation of new industrial, technological and trade policies; the retargeting of pension reforms and the design of social policies in various areas, together with public interventions in the area of environmental sustainability.

The neo-structuralist formulation made it possible to build bridges with those Latin American and Caribbean governments that had persevered with the reforms, without abandoning the original structuralist analytical edifice, while insisting on the urgent need to implement policies for radical social and economic change to overcome underdevelopment, going beyond the functioning of the free market. For some, this meant surrendering to neoliberalism, but for others it was an alternative that would make it possible to continue influencing the region's destinies from ECLAC's traditional theoretical and methodological perspective. A reading of the key texts published in the decades of 1990 and 2000 strengthen the latter interpretation.

From 1990 onwards, the institution gave more flexibility to the development policy concept that had accompanied classical structuralism over the previous four decades. Nonetheless, while acknowledging the changes to the regulatory framework, it made a critical analysis of the reforms, highlighting both their merits and their mistakes and inadequacies. The need to review State participation in economic life and the tools and mechanisms of intervention was recognized, but they continued to be seen as having a key role to play in the socioeconomic development agenda in the financial, productive, social and environmental domains.

The document entitled *Changing production patterns with equity* (ECLAC, 1990) presented at the twenty-third session and coordinated by Rosenthal and Fajnzylber, sets forth the main arguments of this new phase. It proposes greater trade openness, to be implemented gradually and selectively and to

be strengthened by a high and stable real exchange rate, as part of a project to achieve "authentic" competitiveness, i.e. competitiveness founded on the strengthening of productive capacity and innovation. It highlights the systemic nature of competitiveness, prioritizing the creation of physical infrastructure, human resource formation and policies towards innovation and technical progress, together with others aimed at achieving faster and sustained growth and successful international engagement.

With this proposal, ECLAC brought its topics of permanent concern—long-term growth and social justice—back to the debate. Faynzylber contributed several forceful ideas to the message of changing production patterns with social equity, thereby renewing the ECLAC view of development. He argued that both social equity and technical progress were fundamental for raising productivity and competitiveness, and drew a distinction between authentic and spurious competitiveness. The former stems from constant and increasing implementation of new technologies, human capital skill development and social equity, whereas the latter is based on advantages obtained from exchange rates, wages and natural resources. He also underscored the importance of industry as the sector with the greatest potential for content and dissemination of technical progress, but argued that this needed to be articulated with the other sectors to promote *spillover* effects and productive chains. He also proposed a broad social pact centred on innovation and technical change; and he saw the role of institutions as crucial, placing a high value on democracy, which would make it possible to materialize the productive and social change (Torres, 2006).

From then on, these ideas were further developed in a series of texts, particularly in the documents of the subsequent sessions. Here it is important to note the proposals on the requirement for simultaneity between social equity and changing production patterns, and on the analysis of their complementarities (ECLAC, 1992), as well as the proposal emphasizing education and knowledge as key pillars of changing production patterns with social equity (ECLAC/UNESCO, 1992).

This is also true of policies aimed at improving engagement with the international economy, which include control of short-term capital flows and strict regulation of finances (ECLAC, 1995), faster growth to achieve significant changes in production patterns along with greater productivity and equity (ECLAC,

1996), and an “open regionalism” orientation (ECLAC, 1994).<sup>11</sup>

The review also encompassed recommendations in the fiscal domain, symbolized by the concept of the fiscal covenant (ECLAC, 1998b), using a method that sought to reconcile social demands with the consolidation of public finances and macroeconomic balance, under increasingly mature democratic practices. The document addresses the consolidation of fiscal adjustment, an increase in the productivity of public governance and transparency, promotion of equity and the strengthening of democratic institutions.<sup>12</sup>

In its sixth decade ECLAC continued with the work of the previous 50 years, in particular with a view to enhancing and maturing the neo-structuralist arguments of the 1990s. In doing so it was able to evaluate the results of the liberalizing reforms in the light of the region’s economic and social performance, following nearly a decade of intensive discussion on the subject. The institution’s thinking evolved in the midst of a significant slackening of the ideological debate, as the predominant neoliberalism in the region was weakened by successive cyclical disturbances in the late 1990s and early years of the new century.

Two different settings prevailed during the institution’s sixth decade: the first five years (1998-2003) were characterized by slow global and regional economic growth following the wave of financial crises (Asian, Russian, Argentine); and the second half (2003-2008) featured vigorous economic growth both worldwide and in most of the region’s countries. Despite a favourable economic climate in the second five-year period, this did not disturb the greater ideological equilibrium between neoliberalism and contrary points of view that had developed internationally since the late 1990s. The same is true of the regional ideological context, in which several governments emerged with discourses

<sup>11</sup> The document on open regionalism was written by Gert Rosenthal. The other studies mentioned were supervised by Rosenthal, and coordinated by Fajnzylber and Ramos, Fajnzylber and Ottone, Ffrench-Davis and Altimir, respectively. Rosales participated in all of them.

<sup>12</sup> The article in question was written during the period of transition between the term of office of Executive Secretary Gert Rosenthal and that of his successor José Antonio Ocampo, between 1997 and 1998. It consolidated reflections on the fiscal problem facing Latin America and the Caribbean undertaken in ECLAC for over a decade, coordinated by Juan Carlos Lerda (2008).

and programmes that departed from the previously hegemonic ideology.

In the first five years of the decade, ECLAC was led by José Antonio Ocampo, and in the second, by José Luis Machinea. The work done in the two periods was analytically consistent, albeit with slight changes of emphasis associated with changes in the setting.

In keeping with what the institution had been propounding since the 1990s in terms of macroeconomic outcomes and policies under financial capital volatility (ECLAC, 1995; Ffrench Davis, 2005), in the first five-year period the earlier analysis was deepened to evaluate the effects of international capital flows on the region’s economies in periods of boom and cyclical downswing. This stressed the importance of creating a global and regional financial architecture and adopting autonomous national policies with strong countercyclical components, to mitigate or offset the effects of such flows (Ocampo, 1999a and 1999b; ECLAC, 2000a, 2001a and 2002). At the same time, and in different ways, the structuralist foundations for ECLAC thinking were recovered and brought up to date. From the analytical standpoint, if Fajnzylber was the protagonist of the inauguration of neo-structuralism, Ocampo began its consolidation and enhancement.<sup>13</sup>

In the second half of the decade, the earlier work was continued, with a number of additions arising from the expansionary phase the region was passing through.<sup>14</sup> Under Machinea there was, for example, an insistence on the need to develop countercyclical macroeconomic mechanisms to prepare for the potential reversal of favourable situations and view the challenges facing the region from a standpoint that looked far beyond the immediate or short-term

<sup>13</sup> For example, he reclaimed Prebisch’s notion of global asymmetries (Ocampo, 2001; ECLAC, 2002), deepened the analysis of socioeconomic conditions and the region’s international engagement in the globalization era (ECLAC, 2002), coordinated the detailed critical analysis made of the performance of the different countries in the framework of the reforms (ECLAC, 2001b), and insisted on the importance of establishing a link between macroeconomic studies and microeconomic analyses of the process of producing goods and services, in line with what Jorge Katz had been writing (ECLAC, 1996; Katz, 2000a). This period also saw a strengthening of analyses of the social aspects of the regional reality, and the issue of citizenship was stressed, recovering the old sociological tradition that was started 40 years earlier by Medina Echavarría (ECLAC, 2002). Additional space was also provided to make further progress in understanding the problem of environmental conservation, to which Alicia Bárcena, among others, contributed.

<sup>14</sup> See Machinea (2007).

setting (ECLAC, 2007a). Progress also continued to be made in analysing the topics of productive development and international trade (ECLAC, 2004a and 2008b), and social issues. This included a study on social protection networks in Latin America and the Caribbean (ECLAC, 2006a),<sup>15</sup> possibly the broadest and most far-reaching work done on this subject in the region.<sup>16</sup>

## 2. The sixth decade and new formulations

The institution's work over the last decade has included five key analytical innovations: a wide-ranging assessment of countries' economic and social performance following the liberalizing reforms; an agenda for the global era; sociopolitical concepts of citizenship and social cohesion; a merging of the structuralist and Schumpeterian approaches; and the emphasis placed on countercyclical macroeconomic policies in situations of financial volatility.

It should be noted that these are not global theoretical or conceptual innovations, but merely involve the inclusion of innovative analytical concepts and schemes in the institution's thinking, or, at least, their use with a new emphasis. Nonetheless, the fact that they have been included shows that, without losing its traditional analytical bearings (i.e. the historical-structural orientation), ECLAC thinking continued to move forward in its sixth decade driven by intellectual restlessness and a permanent attitude of renewal.

### (a) *Evaluation of the effects of the reforms based on the performance of the 1990s*

The first contribution made by ECLAC over the last decade, based on the neo-structuralist approach, involved a monitoring and critical evaluation of the results of the reforms. The poor performance of the region's countries in the 1990s was analysed through research and debate between the mid-1990s and early 2000s that gave rise to numerous publications.

One of the documents synthesizing this work is *A decade of light and shadow: Latin America and the*

*Caribbean in the 1990s* (CEPAL, 2001b).<sup>17</sup> On the "light" side, the document mentions the control of inflation and reduction of fiscal deficits, export dynamism, greater attraction of foreign direct investment (FDI), productivity growth in enterprises and leading sectors, higher social spending, greater emphasis on the problems of environmentally sustainable development and progress on democracy and respect for human rights. In terms of "shadow", the document notes disappointing and unstable economic growth; insufficient export diversification; the predominance of defensive strategies in domestic enterprises; the restructuring of industrial sectors, with very poor results in terms of productive and innovation capacity; large external deficits and persistent external vulnerability, exacerbated by highly unstable capital flows. The shadows also include mediocre saving and investment levels, higher unemployment, informality and structural heterogeneity, and persistent inequity in the income distribution.

### (b) *The agenda for the global era*

The second innovation concerns expanding the "changing production patterns with social equity" paradigm to embrace the concept of an agenda for the globalization era, which included a set of proposals for relations between countries and peoples worldwide, together with the crucial role of the regional space and national strategies. This was an idea created by Ocampo to organize recommendations on strategies, institutions and other policy instruments in these three areas (ECLAC, 2002).

The concept reaffirms the principles to be found in the debates taking place in international organizations, namely: (i) supplying global public goods, such as democracy, peace, security, macroeconomic and financial stability, and environmental sustainability; (ii) using heterodox mechanisms to rectify global asymmetries in three basic areas (production-trade, macroeconomics-finance and capital and labour mobility); and (iii) the incorporation of a rights-based international social agenda. In the domain of national strategies, topics for reflection include the challenges of globalization in ECLAC's four domains of concern:

<sup>15</sup> The key participants in this work were Andras Uthoff and Daniel Titelman.

<sup>16</sup> During this period, the need to create a regional institutional and coordination framework between nations to deal with economic problems was also highlighted (see, for example, Machinea and Rosenwurz (2005), and Machinea and Titelman (2007)), continuing with a reflection promoted as a regional project on this issue.

<sup>17</sup> The volume was coordinated by Ocampo, Bajraj and Martín. See also the other "assessments", such as those made by Stallings and Peres (2000); Núñez del Prado (ECLAC/ILPES, 1998) and Ocampo, Franco and Sainz (ECLAC, 2004b).

macroeconomics and finance, changing production patterns, social development and environmental sustainability. It also introduces an intermediate facet between the global and national spheres with recommendations for institutions and policies that could be promoted regionally, to support macroeconomic stability and financial, productive and trade integration.

(c) *The approach on rights, citizenship and social cohesion*

The third innovation involves the approach in terms of rights, citizenship and social cohesion. The sociological aspect of development is not a new topic in ECLAC's work, having been represented in the past by major intellectuals in that field, such as Medina Echavarría, Cardoso, Faletto, Graciarena, Woolfe and Gurrieri. Recently this perspective has regained its importance in the institution's thinking.

In earlier studies, the issue of conflicts between the social classes inevitably took pride of place, whereas more recent analyses focus on the difficulties of fully exercising citizenship rights. This is consistent with the United Nations tradition of defending human rights, which, as is well known, began by guaranteeing the exercise of civil and political rights before gradually incorporating the concept of economic, social and cultural rights.

This topic is addressed in several texts,<sup>18</sup> but gained importance in two of them: the 2000 session document, entitled *Equity, Development and Citizenship: a global view* (ECLAC, 2000a); and the volume entitled *Social cohesion: Inclusion and a sense of belonging in Latin America and the Caribbean* (ECLAC, 2007b).<sup>19</sup>

The conceptual design of the message on rights, citizenship and social cohesion is founded on four complementary pillars. The first consists of analysing the region's social problems —poverty, exclusion, inequality of income and wealth, insufficient and inadequate social protection, unequal access to existing protection mechanisms, racial, ethnic and

cultural discrimination— in terms of an ethical framework on human rights seen as universal, indivisible and interdependent. The second pillar calls for social policies and poverty reduction to be governed by principles of universality, solidarity and efficiency. The third shows that these policies must be treated holistically, both in terms of the necessary integration with economic policies —since both are crucial for social development— and in recognizing the virtuous relation that exists between the different social benefits (education, health and housing, among others). The fourth pillar consists of developing an institutional framework and democratic practice which, essentially, encourages citizens to become involved in political life and to organize for participation in decision-making processes and the implementation of social policies that enable them to uphold their rights and strengthen their sense of belonging.

(d) *The merging of the structuralist and Schumpeterian approaches*

The assessment of the 1990s raises a fourth aspect of progress in the form of an interesting analytical refinement to ECLAC neo-structuralism in the domain of productive development and international engagement: the merging of the structuralist and Schumpeterian approaches. This originated in the writings of Fajnzylber in the 1980s, and has been analytically upgraded more recently by several authors, such as Katz, Ocampo and Cimoli.

Three complementary formulations can be identified in this merger. The first, in keeping with the approach taken by Katz, is set out in a group of papers critically evaluating the effects of the reforms on the productive performance of the countries of the region and the growth rate of their economies, and also in discussions on the relevant transformation strategies and development policies (Katz, 2000a and 2000b).

The second is a contribution to the analysis of the relationship between the dynamic of the productive structure and economic growth in developing countries (Ocampo, 2002 and 2005). This study shares the view of those who, like ECLAC since its inception, believe that per capita GDP growth is related to changes in the composition of output and forms of specialization for international trade. The review of innovation processes goes hand in hand with the idea of forming productive chains based on

<sup>18</sup> For example *Education and knowledge: basic pillars of changing production patterns with social equity* (ECLAC/UNESCO, 1992), which highlights the importance of education for making progress on citizenship. Artigas (2003) reviews the use of the concept of rights by ECLAC.

<sup>19</sup> Ernesto Ottone, Martín Hopenhayn and Ana Sojo participated in conceptualizing social cohesion in both documents. Among other ECLAC texts on this subject, see the volume organized by Sojo and Uthoff (2007).

stimuli with potential to promote innovations based on “complementary aspects, linkages and networks”, with capacity to generate an “integrated productive fabric”. In other words, it addresses innovation in the broad Schumpeterian sense, as the capacity to create new activities and undertake existing activities in new ways.

The third approach stresses the importance of foreign trade as a decisive factor in growth potential that is sustainable over the medium and long terms. This has been gradually improved, and its most finished version to date can be found in the document *Progreso técnico y cambio estructural en América Latina* (ECLAC, 2007c).<sup>20</sup>

Thus, the main constraint on convergence is the behaviour of international trade, measured in terms of the elasticity of exports and imports, which reflects country’s competitiveness.<sup>21</sup> This in turn depends on increasing productivity in developing countries relative to developed ones, measured by the technological gap between their productive structures—which, among other things, reflects the degree of diversification and complexity of productive chains— together with non-technological features that affect competitiveness, such as financing, institutions, and tariff systems.

The study concludes that Latin America and the Caribbean need to retarget their productive and export basket on goods of higher technological content and, at the same time, add value through larger sector chains. This would make it possible to strengthen growth, overcoming the fact that the region’s technical progress has been limited to enclaves that have few effects on the economy at large, which has fostered structural heterogeneity, informal labour activity, low wages, poverty, and a concentration of income and wealth.

The merger of the Schumpeterian and structuralist approaches is not surprising, given the priority both assign to the analysis of historical trends in the productive domain. The neo-Schumpeterian accent on knowledge formation and accumulation through the enterprise learning process, the effect

of past decisions on the present (*path-dependency*), and changes in techno-economic paradigms enhance the historical-structural approach used by ECLAC in its attempt to understand changes in productive structures under conditions of underdevelopment and structural heterogeneity.

In the 2008 session document, the interpretation elicited another analytical innovation in ECLAC, namely the idea that the new technologies allow for opportunities to become less concentrated in industry and more intensively incorporated into other sectors of the economy (ECLAC, 2008).<sup>22</sup>

(e) *Countercyclical macroeconomic policies under financial volatility*

In the 1990s, the instability of growth and its obvious link to financial capital volatility became a major issue on the ECLAC programme. Concern about this problem had first been raised in a number of documents published in the first half of that decade (ECLAC, 1995); and at that time, there were calls for mechanisms to be created to restrain the inflow of speculative capital and mitigate its undesired effects. Following the crisis of the second half of the decade, the emphasis shifted towards building an international and regional institutional financial framework (ECLAC, 1999 and 2002), and formulating suitable countercyclical policies to maintain macroeconomic stability in Latin America and the Caribbean (see ECLAC, 2000a, 2001a, 2002).<sup>23</sup>

On the latter, it is stressed that, without giving up achievements on monetary and fiscal issues and on price stability, macroeconomic policy should target real objectives such as the pace and stability of economic growth and full employment. At the same time, the pro-cyclical management of economic activity was sharply criticized, arguing that fiscal policy tends to overheat the economy and prevent reserves being built up to deal with cyclical downturns; while, in the monetary and credit domains, capital inflows were seen as generating highly expansionary effects by fuelling a “contagion of optimism” among economic agents leading to

<sup>20</sup> See also Cimoli and Correa (2005); Cimoli and others (2005); Cimoli, Primi and Pugno (2006).

<sup>21</sup> The main precursor of this model is the foreign-trade multiplier introduced by Harrod (1933), reformulated by Kaldor (1966, 1975) and Thirwall (1979), and modified to include the concept of technological gap by Cimoli, Dosi and Soete (1993). The most recent version can be found in Cimoli and Correa (2005).

<sup>22</sup> The emphasis on this point is due to Machinea, the document’s coordinator.

<sup>23</sup> This topic was promoted in the 1990s mainly by Ricardo Ffrench-Davis, Gunther Held, Andras Uthoff and Daniel Titelman, and received decisive collaboration from Ocampo from 1998 onwards.

over-borrowing and excessive risk exposure. The reversal of external flows is thought to lead to a credit crunch, loss of asset liquidity, a negative wealth effect, economic contraction and fiscal constraints that make it difficult to counteract the cycles.

It is also claimed that problems are magnified because of their effects on the exchange rate, where frequently excessive appreciation discourages investment in tradable goods and undermines competitiveness in periods of cyclical boom, while also generating balance of payments deficits. In contrast, its often violent depreciation during cyclical downswings tends to have a negative effect on domestic prices and the balance sheets of private and public agents that hold foreign currency debts. This helps to provoke domestic financial disturbances and deepen the recession, having particularly perverse

effects on employment, wages, public spending in the social sectors, poverty and income distribution. The recurrence of cyclical upheavals makes it very important to put effective social protection networks in place that can support the most vulnerable sectors during this type of situation.<sup>24</sup>

It also offers a programme of policies to tackle the volatility of financial capital, consisting of the following three components: consistent and flexible management of countercyclical policies in the fiscal, monetary and credit domains; active prudential regulation and supervision of the financial system, with a countercyclical content; and implementation of a liabilities policy that ensures appropriate characteristics for external and domestic debt. It also underscores the role played by exchange-rate regimes that are compatible with increasing competitiveness.

## IV

### The similarity between the structuralist and neo-structuralist analyses

As mentioned above, despite the major changes introduced since 1990 to adapt to the new historical conditions, neo-structuralist thinking is very similar to that of its structuralist forerunner. The prefix “neo” signifies adaptation to times of openness and deregulation, but the analytical basis of the new phase remains structuralist. This point is examined, in two sections, devoted respectively to the key analytical elements of the two periods and to analysis in the four major fields on which the institution has traditionally focused.

It should be noted that this similarity reflected highly unfavourable historical trends. Despite the major progress made by Latin America in terms of productive, social and institutional development, many of the structural factors of underdevelopment that worried Prebisch and the other pioneers of Latin American structuralism still persist. Similarly, many of the initial conclusions on the perverse trends that gave rise to phenomena of underdevelopment are still valid, such as macroeconomic stability; lack of investment, technical progress and growth; underemployment or informality; bad distribution of income and poverty.

#### 1. The key analytical elements of the two periods

There are many links between the classical formulations of structuralism and neo-structuralism. First of all, the contrast between the productive and social structure of Latin American and Caribbean countries and that of developed nations has fostered the basic theses underlying ECLAC’s analytical output in both stages. In the structuralist period, attention was drawn, among other things, to unfavourable “centre-periphery” relations, deterioration of the terms of trade, external imbalance and structural inflation, the import-substitution dynamic, regional integration and dependency. In contrast, the neo-structuralist stage highlights ideas relating to unfavourable international engagement and

<sup>24</sup> This subject was addressed, for example, through an analysis of the procyclical behaviour of social public spending. On this topic, see *Social panorama of Latin America 2000-2001*, Chapter IV (ECLAC, 2001c) and *Social panorama of Latin America 2005*, Chapter II (ECLAC, 2006b).

asymmetries in the era of globalization, external vulnerability and business cycles, open regionalism and the global, regional and national agendas.

Secondly, the core message of the two periods is that the State's contribution and social mobilization are necessary to tackle those problems and promote development. In the structuralist stage industrialization was seen as essential to attain "convergence", although it was considered hard to achieve. In the neo-structuralist stage it was argued that development through "changing production patterns with equity" is essential to achieve that convergence, but it is also hard to attain.

Lastly, in both stages the difficulties of achieving development are seen as stemming from the characteristics of Latin American and Caribbean underdevelopment, defined basically through three key elements that do not differ greatly one from another. These were specified in the foregoing pages in the case of structuralism and are used again in what follows to show their similarity with the neo-structuralist phase.

- (i) The first element that characterizes regional underdevelopment in the structuralist phase is poorly diversified production and a specialization on primary goods. This requires greater effort in terms of saving and foreign exchange (the two "gaps") and imposes constraints on growth through external vulnerability and inflation, among other factors. The neo-structuralist view also argues that the lack of productive and export diversity translates into low technological density and poor sector linkages, which impairs growth owing to a lack of multiplier effects, external vulnerability, macroeconomic stability, and other factors.
- (ii) The second key element of structuralism is productive heterogeneity with an unlimited supply of labour, combined with low average productivity, average incomes close to subsistence levels, concentration of property ownership and unequal distribution of income linked to superfluous consumption and poverty, all of which curtails investment and restrict growth. The analysis is very similar in the neo-structuralist phase: productive heterogeneity with an abundant supply of labour, informality, low average productivity and poverty, concentration of property and income, insufficient allocation of income to capital accumulation and, hence, constraints on investment and growth.

- (iii) The third key factor of the structuralist stage consists of the fact that the institutional fabric has a low propensity for capital accumulation and technical progress, which strengthens the trend of underinvestment. Similarly, neo-structuralism explains slow growth by the fact that the existing institutional framework—defined, among other things, by incipient national innovation systems, States that do not perform development tasks and a lack of "global player" enterprises—results in low levels of investment in both physical capital and knowledge.

Two other similarities are also relevant. Firstly, in both stages, macroeconomic interpretations have been heterodox, and studies of price instability and activity levels have focused on the external imbalance generated by productive specialization and, since the 1980s, also on the new design of the international financial system. Secondly, since the late 1970s, emphasis has been placed on the tension that exists between the conditions needed for sustainable development and universal patterns of consumption and production that have adverse effects on the natural environment.

## 2. Continuity and change in the four major thematic areas of analysis

The study of the evolution of ideas on the four basic issues that ECLAC has focused on, reveals both continuity and changes of approach through time. These are now briefly reviewed.

### (a) *Macroeconomics and finance*

While the debt crisis of the 1980s forced ECLAC to pay more attention to macroeconomic and financial issues, this does not mean it had previously ignored these topics. Proof of this is the systematic monitoring of the economic situation of the region's countries, produced in the annual *Economic Survey of Latin America and the Caribbean*, of which the 60th edition was published in 2008.<sup>25</sup>

It could be said that up to 1980, ECLAC intellectual output covered three analytical approaches in the macroeconomic domain. In the early texts,

<sup>25</sup> In relation to the first 50 years of this publication, see the article in the 1997-1998 edition (ECLAC, 1998c), which was coordinated by José Miguel Benavente.



Prebisch claimed that external vulnerability, which he attributed mainly to issues of production and trade, needed to be addressed with countercyclical macroeconomic policies based on foreign exchange management, rather than fiscal and monetary policies, as would later be stressed by the institution. Secondly, in the 1950s, it was argued that inflation in Latin America was not necessarily the result of monetary expansion, but imbalances in which external constraints played a key role. This analysis was referred to as “structural inflation”. Lastly, as noted above, throughout the 1970s ECLAC warned of the dangers of excessive external borrowing. These warnings were premonitions of the debt crisis and anticipated the subsequent worry about the effects on macroeconomic stability caused by a sudden stop in international capital flows, a topic that gained importance in the institution in the 1990s and 2000s. Following the debt crisis, a phase involving more sustained and detailed analysis of macroeconomic and fiscal imbalances began, with priority being given to the external debt and international financial movements, and their repercussions in terms of domestic financial solvency and macroeconomic stability.<sup>26</sup>

From the 1980s onwards, ECLAC would repeatedly state its conviction that it was essential to combat inflation and pursue fiscal balance. As mentioned above, at the outset opinions differed on how to address this topic. Nonetheless, in the 1990s, a heterodox interpretation was chosen with respect to several core elements of macroeconomic and financial management, as is shown in at least three aspects of the debate on the subject.

The first is the importance accorded to the combination of price stability and the pace of growth, i.e. the Keynesian principle that monetary, exchange-rate and fiscal policies should simultaneously target price stability and a sustained expansion of the level of economic activity.<sup>27</sup>

Secondly, and in a complementary way, heterodoxy is revealed in the analysis of the potentially perverse effects caused by the free circulation of speculative capital on the macroeconomic health of

the region’s countries and incentives for investment and competitiveness, and also in recommendations to make monetary and exchange-rate policies more flexible in managing those capital flows. In keeping with this idea, priority has been given to controlling these elements increasingly through domestic mechanisms and articulating a new global and regional financial architecture—an emblematic key idea of the 2000s. Underlying this position is the proposal that the set of policies should be countercyclical, i.e. they should give greater stability to long-term economic growth and above all avoid exchange-rate appreciation given its negative effects on competitiveness and the balance of payments, which accentuate external vulnerability.

Lastly, heterodoxy is seen in the emphasis on rigorous regulation and supervision of financial institutions and capital markets, and on the importance of their stability. Theoretically, orthodox economists do not disagree with regulation—they could hardly disagree with the Basle I Agreement—but this has not always been matched by their enthusiasm, possibly because of the controversies that the topic generates in the financial community, which is often reluctant to accept intervention of any kind.

(b) *Changing production patterns and international trade*

Based on the founding texts authored by Prebisch, ECLAC has been motivated by the theoretical possibility of convergence between the region’s per capita income and that of developed countries, in an interpretation of how to overcome underdevelopment that draws on the notion of increasing returns to scale. Already in the initial studies, and also in the version published a few years later by Lewis (1954), the idea was linked to the fact that the industrialization process would increase the amount of capital per worker by absorbing workers from backward sectors, in conditions of abundant labour supply at near-subsistence productivity levels. In these circumstances, the region’s economies would have an ample period of time in which average productivity would increase significantly. The assumption was that, in the event of success, and depending on the rate of capital accumulation, industrialization could allow income levels at the periphery and centre to converge.

In recent formulations, ECLAC has considered the possibility of convergence between the region’s

<sup>26</sup> In this period, there was wide-ranging discussion of the topic of external debt renegotiation with a view to regaining space for economic growth and development. See Devlin (1984 and 1985), for example.

<sup>27</sup> This has repeatedly been highlighted by Ricardo Ffrench-Davis (2005), for example, in his writings on “reforming the reforms.”

countries and developed nations, thus concurring with modern growth theories—both those stemming from the Schumpeterian camp and the new neoclassical approaches—as a result of non-decreasing returns to capital and knowledge per worker. The institution's current view is that convergence depends on the relative speed with which technical progress is introduced and disseminated in the region's productive structures through fixed capital and knowledge, compared to what is happening in the rest of the world. This speed is thought to depend on changes in the sector composition of output and the intensity of the innovation process in each sector of the economy.<sup>28</sup>

The main analytical concepts used in the two periods are, as noted, insufficient production- and export-diversity and structural heterogeneity. The structuralist stage identified insufficient diversity in the productive structure and specialization on primary goods in which international trade grows slowly, resulting in trade that was unfavourable to growth and in limited dynamism. The neo-structuralist diagnosis was that systemic competitiveness was low, productive and export specialization focused on goods of low levels of knowledge intensity, with little international dynamism, few domestic productive linkages, and insufficient capacity to generate externalities. From this it was concluded, as in the first period, that international engagement tends to be unfavourable, balance of payments problems recurrent, and growth both limited and unstable.

Similarly, the concepts of structural heterogeneity and under-employment (informality, to use recent language) are inherent to both stages, which has two consequences. Firstly, the difficulties caused by the potential constraints on economic growth. In the first phase, the argument was that there was a relative shortage of saving and investment as a result of low average productivity and lack of business capacity. More recently it has been argued that labour absorption is insufficient in sectors where productivity is growing fastest, whereas the opposite is the case in the informal sector, which helps to strengthen heterogeneity and weaken the increase in productivity, and hence restrain growth. As will be seen below, the second consequence is social, because

in both periods heterogeneity is seen as a key factor in the reproduction of poverty and inequality.

Lastly, the first phase highlighted the low propensity among productive agents towards investment and technical progress, and the need to tackle this insufficiency with vigorous State intervention. The recent phase retains the concept of “rent-seeking” business tendencies, but it is combined with the notions of a low propensity to invest—especially in infrastructure—fragility of the national innovation system, and insufficient innovation and research and development. To address these problems, the recommendation is to selectively promote investment in public goods and public-private partnerships to replace generalized State support for this process.

It is also easy to discern similarities between the central messages of the two periods. In the structuralist stage, it was argued that, except in the case of total success of industrialization, international engagement would continue to be unsatisfactory and external constraints would remain, along with slow and unstable growth, unemployment, underemployment and poverty, and a widening gap in income and wealth levels between the centre and periphery.

The current message is similar; but instead of almost exclusively highlighting industrialization, the new structural change strategy is conceptually articulated around the notion of diversified production and exports, adding value through innovation while expanding and strengthening the productive fabric (ECLAC, 2000a, 2002, 2004a, 2008b). The most recent document on the subject (ECLAC, 2008b) renews this idea by raising the possibility of opportunities opening along many sector paths, rather than just manufacturing, in which it is potentially feasible to generate and exploit technical progress. Failure to implement the structural change strategy perpetuates the region's inadequate international engagement, problems competing with Asian countries, external constraints that hamper growth, insufficient quality-job creation, difficulties in overcoming poverty and inequality, and a widening gap with respect to developed nations.

### (c) *Social development*

As noted above, in the 1960s, the social issue moved to the core of ECLAC studies. The contemporary diagnostic showed that poverty and unequal income distribution reflected concentrated ownership, structural heterogeneity and underemployment, low wages resulting from low average productivity

<sup>28</sup> On this issue, see, for example, Hounie and others (1999) and Cimoli and others (2005).

and abundant labour supply, compounded by a lack of suitable social policies. It was argued that labour absorption was being hampered by the low investment rate and the technological profile of the production of goods and services that were typical of wealthy countries—destined for a minority of the population—based on technologies that were imported from those countries requiring a lot of capital and little labour. As an aggravating factor, surplus labour could not emigrate owing to international restrictions on the free movement of workers. The productive and social structures were thus related the various interpretations of growth modalities or styles, which form an important chapter in the institution's analytical development.

In the neo-structuralist phase, the ideas conceived were similar to those of the first period. The current interpretation is that poverty and the income distribution are structural phenomena, reflecting an unequal distribution of, and access to, productive and social assets—credit, technology, information, education and health systems, among others—compounded by structural heterogeneity, abundant labour supply and labour informality. This situation is made worse by the absence of freedom of movement for international migratory flows in response to the excess supply of local labour, compared to that enjoyed by goods and services and capital (ECLAC, 2002). Emphasis is placed on the fragility of mechanisms for accessing wealth-creating opportunities, such as education, technology and credit (ECLAC/UNESCO, 1992 and ECLAC, 2000a), and on the insufficiency, precarious nature and inequity of social safety nets (ECLAC, 2006a).<sup>29</sup>

Recent ECLAC thinking features two long-standing analytical concepts: citizenship and social cohesion, and structural heterogeneity, which is the most original and permanent element in the history of ECLAC ideas on poverty and the income distribution. Prebisch had addressed the phenomenon of productive heterogeneity in the founding texts; and, as noted above, it was seen as potentially permanent by Furtado (1961) and Pinto (1965 and 1970). The idea expressed by these authors was

that despite the spread of modernity, backwardness and wide differences in labour productivity between economic sectors and subsectors, and between regions and segments of the population, tended to be maintained and sometimes expanded.

Since the 1960s at least, ECLAC has defended the need for widespread social and political mobilization to implement development strategies, which aim firstly to increase and standardize productivity throughout the economy, and secondly to reduce social disparities through a wide range of social policies. These are the strategies which, since 1990, have been referred to by the felicitous expression “changing production patterns with social equity”.

It would clearly be an exaggeration to claim that structural heterogeneity has been the concept around which the ECLAC programme of discussion and research has recently been organized. Nonetheless, a systematic reading of the relevant texts reveals its presence as a conceptual backdrop in many of the studies on the region's economic and social reality.

#### (d) *Environmental sustainability*

The first documents on development and the environment prepared in ECLAC date back to the first half of the 1970s, which, as is well known, were years of major effervescence in thinking on the subject around the world. The times of greatest impact and international visibility possibly coincided with documents disseminated by the Club of Rome regarding the material limits to global output growth, produced from the developed country standpoint, and the United Nations response expressed in the United Nations Conference on the Human Environment held in Stockholm in 1972, and the creation of the United Nations Environment Programme (UNEP) in the same year.

The key guiding principle of the second initiative involved reconciling the universal need to conserve the natural world with overcoming poverty in developing countries. The “tension” between global socioeconomic development and environmental conservation at that time would acquire the basic features that the institutions and specialists around the world who discuss the environmental problem use to this day.

It was against that backdrop that ECLAC gradually assimilated the topic into its research programme, with the integrating approach of environmental sustainability and social inclusion. A more definitive incorporation based on systematic

<sup>29</sup> The main dissemination mechanism in the ECLAC social area is the annual publication entitled *Social panorama of Latin America*. Its main contributors throughout the 1990s and 2000s have been Rolando Franco, Pedro Sainz, Ernesto Espindola, Juan Carlos Feres and Arturo León.

studies would occur a few years later through a project directed by Osvaldo Sunkel between 1978 and 1980 (Sunkel and Gligo, 1981). It is no coincidence that the orientation adopted in that initial stage focused on development styles and the environment in Latin America.<sup>30</sup> By using that approach, Sunkel was able to organize discussion in the historical-structural format, in keeping with the analytical tradition he had helped create in the institution.

The novelty compared to the Stockholm resolutions was that the ECLAC approach aimed at a more radical proposal, inspired by the idea of altering the development mode of each country in the region through strategies to combat poverty and inequality and at the same time conserve the environment. According to Sunkel (1971), Latin America was being submitted to the logic of the development style that was emerging across the world, namely transnational capitalism. This was becoming predominant owing to its rapid penetration in countries in terms of sector widening, and the depth with which its productive techniques were being applied in each sector (deepening) (Sunkel and Fuenzalida, 1979). Yet adoption of this style in Latin America would mean replicating production processes that were energy-intensive, unsuited to the region's resource endowment and aimed at a consumption modality that is restricted to élites and based on cultural absorption of the way of life prevailing in rich countries.

In the ensuing years, the proposal to promote environmental sustainability through a radical change of development style gradually lost pre-eminence in ECLAC work. During the 1990s and 2000s, work proceeded in closer harmony with the principles of the Rio Declaration on Environment and Development, and that determined by the various multilateral agreements promoted by the United Nations since 1992 and reaffirmed at the World Summit on Sustainable Development held in 2002.<sup>31</sup> The main analytical benchmark became

the concept of sustainable development, defined as development with the capacity to meet the needs of the current generation without compromising satisfaction of the needs of future generations, organized around principles of natural resource management and protection, poverty eradication and changing production and consumption patterns.<sup>32</sup>

To understand the position expressed in ECLAC documents in that context, it is useful to refer to three hypothetical scenarios specified by UNEP (2003) for achieving the Millennium Development Goals (MDGs) in 2015, particularly in relation to environmental sustainability. The first would involve passive subordination to a growth pattern associated with global characteristics of production and consumption that would represent a continuation of environmental deterioration, with serious long-term consequences for humanity. The second hypothetical framework would also reflect the maintenance of economic growth in the same modalities, but with substantial intervention on behalf of environmental conservation and poverty reduction, with results that were significant yet possibly insufficient in terms of both objectives. The third, referred to as the "great transition", would be based on radical reforms and policies, capable by 2015 of effectively reversing the direction of the prevailing effects thus far on global patterns of consumption and production, the environment and poverty.

The latter scenario, albeit under another name, is consistent with a change of "style" in the sense indicated by Sunkel (1981). It might be suggested that, as in the author's initial work, ECLAC dreams of the third scenario, while in practice endeavouring first and foremost to contribute to discussion and analysis of the second. In any event, understanding the difficulties involved in achieving this second scenario means participating in a mission that the institution considers both arduous and monumental, i.e. inserting basic characteristics of environmental sustainability into the predominant style and, at the same time, enabling it to promote increasing social inclusion.

For eclac, the agenda has inevitably involved struggling against the fearsome set of trends

<sup>30</sup> See, for example, Pinto (1970 and 1976), Graciarena (1976), Wolfe (1976), Sunkel (1971) and Sunkel and Fuenzalida (1979). Villamil (1981) contains a brief review of these publications, prepared in the framework of the aforementioned 1978-1980 project.

<sup>31</sup> Such is the case, for example, of the United Nations Framework Convention on Climate Change (UNFCCC), the Convention on biological diversity, the United Nations Convention to Combat Desertification in those Countries Experiencing Serious Drought and/or Desertification, particularly in Africa, and the Kyoto

Protocol to the United Nations Framework Convention on Climate Change.

<sup>32</sup> Gligo (2006) recently made an interesting interpretation of the inaugural reflection on the occasion of the 25th anniversary of intellectual production on the subject.

caused by human activity across the world that are perverse for environmental conservation: particularly climate change and global warming, desertification and drought, depletion of the ozone layer in the stratosphere, loss of biodiversity and the destruction of ecosystems, and cross-border movement of toxic waste. On issues relating to poverty, environment and patterns of consumption and production, the

programme consists of the elements singled out at the various world conferences as priority action areas, i.e. water and sanitation, energy, health and agriculture, and so forth. This general orientation has been visible particularly since the late 1990s, when the institution started to seek closer interaction with the sustainable development initiatives promoted by the other United Nations bodies.<sup>33</sup>

## V

### Conclusion

This article has presented a summary of the most important ideas generated by ECLAC in its 60 years of life. It has also reviewed the contributions made by the institution in its sixth decade and has established an analytical parallel between the structuralist stage, which occupied the first four decades, and the neo-structuralist phase that has prevailed since 1990.

A broad review of the studies undertaken by the institution during its six decades leads to two major conclusions. Firstly, the thinking generated since 1990 remains analytically very close to the work done in the first four decades. Despite adapting to times of openness and globalization, the foundations of the structuralist analysis of underdevelopment in Latin America and the Caribbean have remained intact.

The second conclusion is that neo-structuralism has matured and improved over the last decade. A reading of the voluminous intellectual output of the period shows that ECLAC has absorbed no less than five new conceptual approaches, thereby demonstrating its capacity for rethinking: light and shadow in terms of the region's performance under the effects of the institutional reforms; an agenda for the global era; rights, citizenship and social cohesion; merger between the structural and Schumpeterian analyses, and improvement of studies on countercyclical macroeconomic policies at times of financial capital volatility, linked to the implementation of a new international financial architecture.

ECLAC will have many analytical and empirical challenges to address in the future, including the fact that the institution's studies encompass a large number of countries with widely differing macroeconomic configurations and productive,

social and environmental characteristics. At the same time, consideration will also need to be given to the pace and intensity of changes in all the major areas it focuses on; and studying them means facing major uncertainty. For example, the repercussions of the current international financial crisis and fluctuations in world trade on the macroeconomic health of the region's countries; the (imprecise) effects of the intensive worldwide technological revolution on productivity, competitiveness and trade, together with the consequences of the relative scarcity of natural resources in several countries. Consideration must also be given to the numerous sources of unpredictability in social trends and the threat that environmental destruction represents for humanity, which are susceptible to the widest range of hypotheses.

Although the work done by ECLAC could certainly be improved, an analysis of possible improvements is beyond the scope of this concluding note. Nonetheless, it is worth noting the need for greater interaction between the various domains of study and deeper knowledge of the region by systemizing the differences between the countries and their specific patterns of real and potential development. The latter remains a pending task for the institution and an obligation towards the region.

<sup>33</sup> The current ECLAC Executive Secretary, Alicia Bárcena, was mainly responsible for the renewal that occurred when she joined the institution as Director of the Sustainable Development and Human Settlements Division. See, for example, Bárcena and others (2002), Bárcena and de Miguel (2003) and Bárcena and others (2004).

The analytical capacity and databases available to ECLAC are sufficient to address these and other bold endeavours. Moreover, as argued throughout this article, the institution has demonstrated its capacity to adapt to new realities and new challenges. The historian

called upon to systemize the thinking underlying the institution's seventh decade of activities in 10 years time will probably have a rich stock of intellectual output to draw upon, as did the current author when reviewing the sixth decade.

(Original: Spanish)

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### Flagship publications

**Preliminary Overview of the Economies of Latin America and the Caribbean**, LC/G.2401-P. United Nations Publication, Sales Number: E.08.II.G.2, ECLAC, Santiago, Chile, December 2008, 143 p.

With annual economic growth for Latin America and the Caribbean projected at 4.6%, 2008 will mark the sixth consecutive year of growth and, at the same time, the end of a period which has very few precedents in the economic history of the region. Between 2003 and 2008, regional GDP growth averaged nearly 5% per year, with per capita GDP increasing by over 3% per annum, coupled with improving labour-market indicators and falling poverty in the region. Another noteworthy feature of the period was the fact that policymakers in most of the countries focused on maintaining macroeconomic balances, leading to surpluses in both external and fiscal accounts. The highly favourable external economic environment of the last few years has been another contributing factor.

These results will not be repeated in the coming year, however. Growth projections for 2009 are much lower than for 2008, and the governments of the region will need to make every effort to apply anticyclical policies in order to ward off an even sharper economic decline. The growth rate for Latin America and the Caribbean is projected to be 1.9% in 2009, and that is based on relatively optimistic assumptions regarding the crisis.

Again in contrast to the period 2003-2008, growth projections suggest that the regional unemployment rate will rise from an estimated 7.5% in 2008 to between 7.8% and 8.1% in 2009, depending on the trend in the labour force participation rate, and the informal sector will expand. The behaviour of international food and fuel prices, on the other hand, indicates that inflation will subside from 8.5% in 2008 to around 6% in 2009.

In just over a year, what had begun as a problem in the United States subprime mortgage market in mid-2007 turned

into a systemic crisis that crippled credit markets in the developed countries. This will undoubtedly hit the real economy very hard but, as of the end of 2008, it is still too soon to accurately gauge the full impact.

The depth and duration of the recession will depend on the effectiveness of measures to stimulate demand and offset the slump in private spending, as well as on the normalization of credit markets. It is to be hoped that the array of measures implemented by the United States Federal Reserve and other central banks will succeed in containing systemic risk and that, in conjunction with the recovery of their financial systems as well as fiscal policy measures, the developed economies will begin to emerge from the worst of the crisis in the second half of 2009. This is the fairly optimistic scenario on which growth projections for the region for 2009 are based.

Although the region is now better equipped to cope with an economic crisis, there are a number of channels through which its effects are likely to be transmitted to the economies of Latin America and the Caribbean. First, the global slowdown will drive down export volumes and prices, remittances, foreign direct investment and the demand for tourism services. In addition, external financing will be more expensive and will be more difficult to obtain.

Growth in 2009 is projected to stand at 1.9%. This estimate is built on the assumption that the global economy in general, and the economy of the region in particular, will gradually begin to recover during the second half of the year. The projection is based on a comparison of average levels for 2008 and 2009, which points to a sharp slowdown, and the growth forecast largely reflects a statistical effect. Nonetheless, a more pessimistic scenario of continuing and even deepening recession and credit conditions remaining tight cannot be ruled out. In this case, obviously, the aforementioned problems would worsen and the growth rate would be lower than the current projection.

Deteriorating labour-market indicators and falling remittances will have a negative impact on income distribution in the region. Under current circumstances, this means that public policymakers will face the double challenge of implementing anticyclical measures to stabilize economic growth and of developing instruments to shield the most vulnerable sectors of the population from the effects of the crisis. The fiscal resources available to each country for use in financing such policy actions differ considerably, although public finances in general will come under increased pressure owing to the expected decrease in fiscal revenues.



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*A partir del estudio de tres países, se concluye aquí que la economía mundial ha mostrado un patrón global de crecimiento, tanto estructural como coyunturalmente, en los últimos 140 años.*

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