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Trade and economic growth:
A Latin American perspective on
rhetoric and reality

Juan Carlos Moreno Brid
Esteban Pérez Caldentey



ECLAC Subregional Office in Mexico

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This document was prepared by Juan Carlos Moreno Brid, Research Coordinator from ECLAC Subregional Headquarters in Mexico, and Esteban Pérez Caldentey, Economic Affairs Officer from ECLAC Headquarters in Santiago.

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Introduction

There is a longstanding tradition of analyzing trade and growth in economics, going back to the discipline's founders. But for Latin America, the debate on the significance of this relationship has had much more than academic relevance. It has been one of the central components of the different approaches to development that have shaped the region's economic history, the other (closely related) component being the roles of the State and of the market in economic development.

In Latin America, the dominant understanding of the relationship between trade and growth has evolved radically over time. Starting from the position that foreign trade should be managed with the objective of promoting industrialization and domestic development, around the mid 1980s it changed to an opposing view based on the notion that free trade and privatization are the fundamental guarantors of sustainable economic growth. In the last ten years, however, the consensus view has shifted again, to a more critical, skeptical view of the benefits of trade as an automatic and dynamic engine of economic growth.

More precisely, analysis of the trade-growth relationship in Latin America since World War II has passed through various stages. The first, which lasted until the early 1960s, was associated with the dominance of the Structuralist school of economic thought. It was marked by a rejection of free trade policies, an emphasis on primary commodity exports and inward, state-led industrialization. In the second stage, which lasted from 1960 to the mid-70's, the policies associated with 'structuralism' were called into question. But many professional economists remained committed to state led industrialization while also recognizing the role of manufacturing exports in promoting growth. The third and fourth stages were characterized by the dominance of orthodox economists and the

unconditional support within the economics profession for free trade and free market policies. Finally the fifth stage, associated with the erosion of the Washington Consensus, reflects the end of the region's fascination with free trade as an unequivocal and strong promoter of development. It has its roots, on the one hand, in Latin America's failed quest to enter a path of high and sustained economic expansion after the drastic elimination of trade protection implemented across the continent since the mid 1980s. On the other hand, it is also rooted in the fact that the resumption of high rates of economic expansion in many countries of the region in the last five years has resulted mainly from the worldwide commodity and mineral boom – a boom whose cause and effects have nothing to do with the adoption of the trade liberalization reforms in the region.

The approaches to the relationship between trade and growth described above were embedded in particular rhetorics meant to persuade and win converts to their causes¹. The terms 'center-periphery', "dependency", 'external strangulation' and 'secular decline in the terms-of-trade' were introduced and became integral parts of the development literature in the region during the inward industrialization stage. The expressions 'import-substitution industrialization' (ISI), 'export oriented industrialization' (EOI) and 'rent-seeking behavior' were widely used thereafter, especially in the third stage. As we will see, in spite of their theoretical difference, the rhetoric of the alternative approaches to trade and growth that have prevailed in Latin America shared a common feature. Each emphasized the allegedly dynamic, growth oriented character of their own interpretation of the determinants of growth and underscored their close correspondence to the Latin American reality. Opposing theoretical perspectives and their implicit economic policies were portrayed as flawed, based on an incorrect or unrealistic identification of the determinants of growth, and even as inapplicable to the Latin American case.

This paper analyses the different approaches to trade and growth in Latin America from the end of WWII to the present day. Specifically, it examines the underlying rhetoric of these alternative approaches and the extent to which their rhetorics matched their understanding of Latin American reality. It is shown that throughout the period under study, the relationship between trade and growth was far from robust. In other words, the region has been unable to make exports the lynchpin of rapid long-run growth. Addressing this failure is one of the most urgent tasks confronting Latin America, and one which has received insufficient attention.

¹ According to (McCloskey, 1986, 1987) rhetoric is the study and practice of persuasive expression. The rhetoric of economics examines how economists persuade. In his paper, *The Intellectual History of Laissez Faire*, Jacob Viner, one of the early and prominent critics of state led inward industrialization in Latin America, also gave his views on the rhetoric of economics and how economists persuade (Viner, 1960).

I. The Latin American rhetoric on trade and growth: part I

At the time of the initial formulation of development as an economic discipline following WWII, the prevailing theory of international commerce advocated unrestricted trade on the grounds that it is a mutually beneficial activity for both rich and poor nations. Using as its centre-piece the doctrine of comparative advantage developed by David Ricardo, the theory asserted that free trade enables trading countries to specialize in the production of the commodities they are able to produce at home at the lowest real cost, in accordance to their factor endowments. Free trade thus facilitates the optimal use of resources. These benefits were compounded by the freedom of choice in consumption allowed for by free trade².

The argument for free trade was very persuasive. It showed that any country -independently of its relative endowment of resources and its productive structure would benefit from free trade. The free trade doctrine was part of the general argument for laissez-faire which was lauded for its

² See Allen (1958) for an exposition and defence of free trade theory and policy. The properties of the standard mainstream free trade model based on comparative advantage the Hecksher-Ohlin (H-O) or Hecksher-Ohlin-Samualeson (H-O-S) model are found in four well-known theorems: (i) the Hecksher-Ohlin theorem; (ii) the Stolper-Samuelson theorem ;(iii) the Rybczynski theorem; and (iv) the factor-price equalisation theorem. The Hecksher-Ohlin theorem establishes a relationship between factor scarcity and factor embodiment in a commodity, such that countries export the commodity that intensively uses the abundant factor. It provides the basis for the gains from trade argument. These refer to the increase in output and real income for a given set of inputs or domestic resources that result from trade. The Stolper-Samuelson theorem complements the above theorem by stating that the intensive use of a factor of production for export (i.e., the abundant factor) raises its rate of return above all other prices. In turn, the consequent increase in the supply of that factor of production will lead to an increase in the output of the commodity intensive in that factor of production (the Rybczynski theorem). Finally, the factor price-equalisation theorem states that trade equalises commodity and factor prices across countries. Under conditions of perfect competition, trade in goods acts as a substitute for factor mobility. Under conditions of imperfect competition, free trade does not result in the full equalization of commodity and factor prices. However, free trade reduces commodity and factor price differentials among countries and thus acts as a force of convergence. See Evans (1989).

65 promotion of both economic efficiency and social equity. The latter was a crucial component of *laissez faire* and free trade rhetoric. As asserted by Viner (1960, p. 66; p. 68): “no modern people will have zeal for the free market unless it operates within a setting of ‘distributive justice’ with which they are tolerably content”³.

The analytical argument for free trade required very stringent assumptions. It assumed market clearing in the labor market (full employment), and that all trading nations have equal access to the same technology and to all markets⁴. The majority of development economists dealing with the Latin American case, including Raúl Prebisch (1901-1986), Ragnar Nurske (1907-1959), Arthur C. Lewis (1915-1991), Gunnar Myrdal (1898-1987) and Paul Rosenstein-Rodan (1902-1985), adopted an opposite view. They maintained that the expansion of trade hindered economic growth and development. Their arguments were prefaced on the fact that the assumptions required by the argument for free trade theory were not applicable to developing countries. For this opposing perspective, the fact that developed and developing countries did not have access to the same technology and that there were no mechanisms to ensure that all countries could equally share the fruits of technological progress constituted the basis on which to question the mainstream view of the trade-growth-development nexus.

The above-named economists identified several mechanisms through which trade generated and compounded international inequality. Such mechanisms included (among others) the combination of inelastic world demand for primary products, the existing mix of monopolistic markets for manufactures and competitive markets for primary products, and the enclave nature of primary commodity production.

The view that trade could be a fetter to economic growth justified the implementation of state led inward industrialization and development policies. From the mid-1940s until the 1960s, excluding trade as an automatic engine for growth meant that the problem of industrialization and development had to be understood as crucially dependent on achieving a sufficient rate of capital accumulation⁵. The process of capital accumulation would lead to development by the absorption of excess labor into the more productive sectors and by raising overall productivity (Lewis 1942, Rosenstein-Rodan, 1943). Also, a rapid process of capital accumulation would allow the populations of developing countries to break away from the ‘vicious circle of poverty’ or the ‘poverty trap’ (Nurske, 1952; Nelson, 1956).

This alternative theoretical framework implied on the one hand that development could not be attained unless a significant effort was made to accumulate capital. On the other hand this framework presupposed that the existing ‘automatic market forces’ would keep the economic system entrenched in a low level of development. Industrialization was not to be left to the market, but was rather to be the product of government intervention⁶. In fact, the state was called on to take a leading role in the inward industrialization process.

³ As put by Speigel (1987, p. 814) “The article in which Viner developed these ideas was ostensibly an exposition of the rhetoric of *laissez faire*, an early exercise in an approach that D.N. McCloskey was to apply on a wider scale more than a quarter century later.”

⁴ See Eatwell (1987), Robinson (1979, pp. 102-104).

⁵ The identification of development with economic growth and industrialization was entrenched in the thought of early development theorists. In this regard, it is interesting to note that Arthur Lewis’ *The Theory of Economic Growth* -first published in 1955- dealt with development issues and not with what economists currently understand as “growth theory.”

⁶ See Nurske, (1953), p. 10. Meier (2005), pp. 61-67 and Arndt (1987) p. 57.

In the specific case of Latin America, the case for inward state led industrialization found its most complete formulation in Prebisch (1949, 1951 and 1959)⁷. It rested mainly on a division between the structure and function of countries in the center (developed) and those in the periphery (developing). The former are self sustained in their technological progress which is the dynamic force in the growth process. The countries of the periphery supply food and raw materials to the countries of the center but do not manage to equally benefit from the fruits of the technological progress achieved at the center. In fact, the benefits of increased productivity in the periphery are transferred to the center. Countries in the periphery are thus caught in a poverty trap. The suggested solution was inward state-led industrialization. As Prebisch (1984, p. 179) argued:

“...import substitution stimulated by a moderate and selective protection policy was an economically sound way to achieve certain desirable effects. Such a policy would help correct the tendency toward a foreign constraint on development resulting from the low income elasticity of demand for imports of primary product by the centers, compared with the high income elasticity of demand at the periphery for manufactures from the centers. Import substitution by protection counteracts the tendency toward the deterioration in the terms of trade by avoiding the allocation of additional productive resources to primary export activities and diverting them instead to industrial production. Industrialization, in addition to assisting the overall penetration of technology and creating employment, promotes changes in the structure of production in response to this high demand elasticity for manufactures... industrialization and increased productivity in primary production are complementary. The more intense the latter, the greater the need for industrialization.”

The existing complementarities between primary production and industrialization meant that the manufacturing sector could not develop at the expense of agriculture. It also implied that state-led industrialization required the expansion of primary exports. Exports of primary products were to be encouraged as they provided the finance to buy imported capital goods –machinery and equipment- at this stage indispensable to sustain the industrialization effort⁸.

These arguments and theoretical constructs and their associated rhetoric did not in fact induce the adoption of import substitution policies by Latin America countries. Rather the opposite was the case. That is, the adoption of import substitution policies preceded the formulation of the approach associated with import substitution and its rhetoric. As stated by Prebisch (1984, p. 177):

“In reality my policy proposal provided a theoretical justification for the industrialization process which was already being followed (especially by the large countries of Latin America), to encourage others to follow it too, and to provide all of them with an orderly strategy for carrying this out.”

In short, state led industrialization was a fact before it became a policy and a policy before it became a theory⁹. Moreover, the political discourse that advocated this policy was dominated by the belief that industrialization, much more than a coherent set of economic measures with the aim of boosting growth and employment, was the way to overcome economic “backwardness”¹⁰. In short, inward state led industrialization policies were not derived from a theory and were not part of a standard economic strategy adopted by all or most Latin American economies. Rather they were a practical reality in the large economies of the region (Argentina, Brazil, Chile, Mexico and Venezuela).

⁷ In 1950, Raul Prebisch was appointed Executive Secretary of the Economic Commission for Latin America (ECLA, later renamed as ECLAC to officially include the Caribbean in its denomination). However, some of the main concepts that became associated with ECLAC, such as the ‘center-periphery’ dichotomy or the ‘secular decline in the terms-of-trade’, were developed in the mid-1940s. It is to be noted that ECLA was created in 1948 and the outcome of its first meeting was a resolution requesting a study of Latin America’s terms-of-trade. See Love (2005), pp. 162-163.

⁸ See, Prebisch (1949), 2 and Frankenhoff (1962), p. 192.

⁹ Love, 1994, p. 395 cited in J. A.Ocampo (2004).

¹⁰ See FitzGerald (2005), p. 107.

In the nations that adopted this development strategy the state used a variety of instruments to promote industrialization, including its legal authority to control the major natural resource based industries (i.e. the ‘crown jewels’). It undertook the promotion of new industries through fiscal, monetary and commercial means. Such instruments included a variety of subsidies ranging from fiscal transfers and tax exemptions, and also the use of selective tariff policy which aimed to increase effective protection. Most important, the state established national or development banks to channel credit under favorable circumstances -including below market and/or fixed nominal rates of interest- to targeted sectors¹¹.

¹¹ Brazil provides one of the best examples of formal, organized government intervention in the economy. It adopted the first formal government development plan in Latin America, the Target Plan of 1956-1960. Chile’s guided industrialization efforts by the *Corporación de Fomento* (CORFO) is another case in point. CORFO was created in 1939 to take a leading role in the establishment of several manufacturing industries and the diversification of the productive structure (Collier and Satin, 1996, pp. 235-37). This interventionist view was, in general, widespread in the region at the time, and also accepted internationally. Hence the General Agreement on Trade and Tariffs (GATT) included provisions allowing countries to impose tariff protection and import restrictions in order to safeguard their balance of payments position (articles 12 and 18) - see WTO (1999) and Meier (2005, pp. 74-75) – while not imposing specific trade rules on government procurement nor prohibiting subsidies of services.

II. The Latin American rhetoric on trade and growth: part II

The inward oriented development strategy evolved into one that recognized the role played by the external sector in promoting growth. This change in orientation was due in part to the perception that the strategy of inward industrialization did not provide the required foreign exchange, and that developing countries faced an impending foreign exchange gap. At the more general level, this change in orientation responded to the limitations of the inward industrialization process¹². The strategy gradually reached a point where it was unable to significantly develop the manufacturing industry and thus improve the growth prospects of Latin American economies (see tables 1 and 2 below).

Between 1941-1949 and 1950-1959, the average growth rate for Latin America declined from 2.7% to 1.7%. At the same time the composition of Latin American GDP did not alter greatly. The share of most industries in economic activity (mining, transportation and communication, electricity, gas and water, and services) remained essentially unchanged, although between 1950 and 1960 the share of manufacturing increased slightly from 19% to 22% of GDP while that of agriculture declined from 25% to 22%. In terms of the distribution of the labor force, manufacturing maintained its share between 1950 and 1960, while that of agriculture fell from 54% to 48%.

¹² See Arndt (1989), p. 76, who also states that the “Soviet efforts to neutralise the role of GATT, reinforced by the emerging political muscle of the Third World” was also a factor that influenced this change of orientation.

TABLE 1
LATIN AMERICAN REAL GDP PER CAPITA, AVERAGE
GROWTH RATES, 1941-1959
(Percentages)

Country	Time periods	
	1941-1949	1950-1959
Argentina	2.3	0.8
Bolivia	0.6	-1.7
Brazil	1.6	3.6
Chile	1.5	1.3
Colombia	1.6	1.8
Costa Rica	4.7	2.8
Dominican Republic	3.0	3.4
Ecuador	4.1	2.4
El Salvador	9.3	1.8
Guatemala	0.3	0.5
Honduras	1.5	-0.1
Mexico	3.7	3.1
Nicaragua	4.2	2.4
Panama	-2.2	1.8
Paraguay	0.6	-0.7
Peru	2.5	3.0
Uruguay	2.5	1
Venezuela	6.7	2.9
Average	2.7	1.7

Source: Authors' own elaboration based on official figures.

TABLE 2
PERCENTAGE DISTRIBUTION OF GROSS DOMESTIC PRODUCT AND LABOR
FORCE BY ECONOMIC SECTOR IN LATIN AMERICA, 1950-1964

Sector	Distribution of gross product				Distribution of labor force			
	1950	1955	1960	1964	1950	1955	1960	1962
Agriculture	24.7	23.9	21.8	20.8	53.5	50.4	47.7	46.5
Mining	4.0	4.4	4.9	5.0	1.1	1.1	1.0	0.4
Manufacturing	18.9	19.9	21.8	22.8	14.4	14.2	14.2	13.8
Construction	3.4	3.4	3.3	3.3	3.7	4.5	4.8	4.6
Electricity, gas and water	0.7	0.8	1.0	1.2	4.2	4.7	5.2	5.3
Transportation and communication	6.3	6.6	6.4	6.3	23.1	25.1	27.1	28.8
Services	42.0	41.1	40.8	40.6	23.1	25.1	27.1	28.8
Total	100	100	100	100	100	100	100	100

Source: United Nations (1966); Grunwald (1970).

The contribution of the inward industrialization process to growth and development during this period was hampered by several factors. Tax and investment incentives were provided to foreign firms, but these firms contributed little by way of value added and employment to the economies in which they operated and had rather regressive effects on the distribution of income. Moreover the strategy failed to create a robust domestic capital goods industry. As such, developing economies never really broke their dependency on imports of foreign machinery, equipment and intermediate goods. Finally, the repatriation of profits by foreign firms and the substantial import requirements of domestically-produced consumer goods compounded the balance of payments constraint¹³.

In Latin America, the limitations of this “closed economy” development strategy were soon recognized. In the late 1950s, the initial concern was the growing import requirement of capital and intermediate goods, which exceeded the capacity of exports thus creating a “foreign exchange gap”. ECLA economists understood that to avoid what they termed the ‘external strangulation’ of Latin American economies, the persistent rise in net-imports of capital goods had to be offset by large volumes of financial flows, be it foreign investment or external debt.

During the 1960’s, criticisms of the inward industrialization strategy became more general. It was argued that the strategy: i) was not conducive to the development of manufacturing (ECLA, 1964), ii) had failed to weaken the import requirements of capital and intermediate goods (Tavares, 1964), iii) had failed to generate sufficient employment and iv) had created inefficient industries incapable of competing in the international markets (Macario, 1964)¹⁴. Such recognition of the limits of the inward industrialization strategy opened the way for a shift towards a new “growth through trade” strategy. This shift was reinforced by the growing importance granted to trade by multilateral organizations, as reflected in the adoption in 1961 of resolution 1707, ‘International Trade as the Primary Instrument for Development’ by the UN General Assembly. In this regard, the creation of the United Nations Conference on Trade and Development (UNCTAD) and the nomination of Raúl Prebisch as its first Director General provided a unique opportunity to articulate the new development strategy.

Prebisch criticized the strategy of industrialization, arguing that it was bringing about the creation of inefficient industries, leading Latin America to adopt on average the highest tariffs in the world, preventing the generation of economies of scale and thus hindering overall growth prospects¹⁵. In his words, it had:

“generally insulated national markets from external competition, weakening and even destroying the incentive necessary for improving the quality of output and lowering costs under the private-enterprise system. It has thus tended to stifle the initiative of enterprises as regards both the internal and external market exports”¹⁶.

The revised strategy was formulated by UNCTAD for the developing world as a whole¹⁷. However, it reflected foremost the evolution of Latin American thinking on the relationship between trade and growth. As noted by Love (2005), p. 170-171: “The original UNCTAD programme... was that of ECLA mutatis mutandis at the global level. Prebisch’s reports to the organization in 1964 and 1968 if not fully “cepalismo”, were definitely international adaptations of the regional agency as it had evolved by the early 1960s”¹⁸. From this new perspective exports of primary commodities were seen as necessary to finance imports. It also stressed the need for developing countries to export manufactured products. In

¹³ The over valued currencies in many countries which adopted this strategy further stimulated imports and deterred exports, thus weakening their trade balance positions.

¹⁴ Prebisch (1986) pp. 212-213 asserts that the criticism of import substitution can be dated at least to 1959, but is careful to state that the first severe critique of the industrialization policy followed in Latin America was put forward in 1961 in his document “Economic Development, Planning and International Cooperation.”

¹⁵ Prebisch (1986) states: “In ECLAC we maintained from the very outset that protection was indispensable as a means of standing up to the centres’ technical and economic superiority. Unfortunately protection as a general rule has been greatly exaggerated if not abusive and has been kept in force for a very long time, affording industries no incentive to reduce their production costs....” See, Prebisch (1967) and Love (2005, pp. 170-173).

¹⁶ See, Prebisch (1984) and (1986).

¹⁷ See, UNCTAD (1964).

¹⁸ See also, Prebisch (1964 and 1967).

the case of Latin America, manufactured export products accounted for only 4% of total exports in 1961-62 (see table 3 below). Moreover, it also argued that non-reciprocal treatment should be granted by developed to developing countries to “promote specialization in industrial and primary commodities.” Such treatment was justified on the basis of the infant industry argument. Trade -and more specifically managed trade- was considered a ‘primary instrument for growth.’ Within this strategy the government had a key role to play in the management of trade, by implementing selected measures to monitor the evolution of imports and promoting exports.

TABLE 3
COMPOSITION OF EXPORTS OF LATIN AMERICA, 1934-1962
(Percentages)

	1934-1938	1946-1951	1955-1956	1961-1962
Agricultural products	66	70	52	53
Minerals and fuels	33	28	44	43
Total raw material exports ^a	99	98	96	96
Manufactured products	1	2	4	4
Total	100	100	100	100

Source: Grunwald (1970), p. 839.

^a Total raw materials = sum of agricultural products and minerals and fuels.

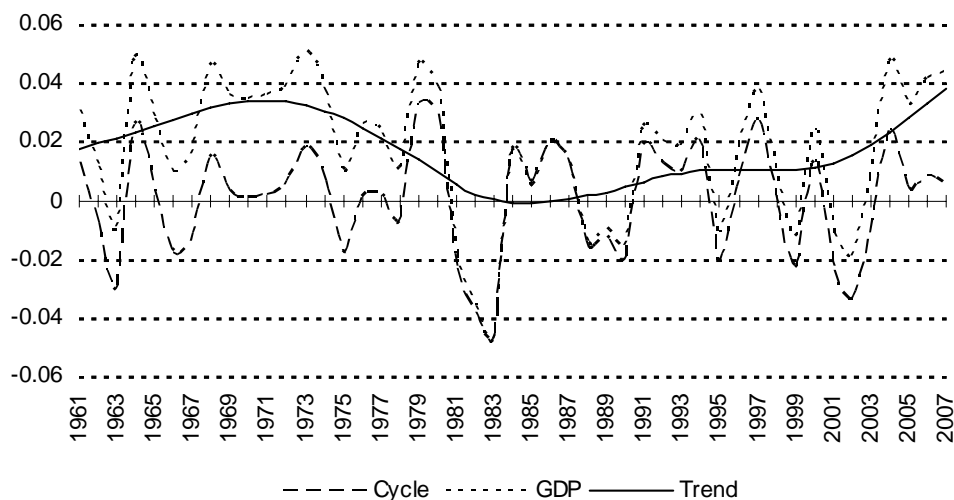
III. The Latin American rhetoric on trade and growth: part III

The Latin American rhetoric on trade changed remarkably from the 1980s onwards. The main event behind this shift was the international debt crisis that plunged the whole region into a deep financial collapse. Indeed, following the onset of the crisis in 1980, Latin American GDP per capita growth contracted in 1981, 1982 and 1983 by 1.8%, 3.6% and 4.7% respectively (see figure 1). The varying intensity of the debt crisis within Latin America produced large disparities of GDP per capita variation at the country level. In 1981, eight out of eighteen Latin American countries suffered contractions, including three of the largest economies of the region: Argentina, Brazil and Venezuela (where GDP fell 7.1%, 6.6% and 3.4% respectively). In 1982, all of Latin American economies, with the exception of Panama, experienced contraction. In 1983, the region contracted once again with the exceptions of Argentina and three Central American countries (Costa Rica, El Salvador and Nicaragua). In spite of the slow recovery process which began in 1984, these three consecutive years of massive downturns produced the worst decadal growth performance in Latin America and the 1980's were termed the 'Lost Decade' (see figure 1).

The 'Lost Decade' and the codification of free market oriented policies into the so called Washington Consensus became the main pillars on which to launch a devastating critique of the developmental policies

followed previously in Latin America. Countries were urged and pressured to follow the neoliberal mantra: “Stabilize, privatize and liberalize”¹⁹.

FIGURE 1
PER CAPITA GDP GROWTH IN LATIN AMERICA, DECOMPOSED INTO TREND
AND CYCLE (HODRICK-PRESCOTT METHOD), 1961-2007



Source: Authors' calculations based on data from World Bank Development Indicators (2009).

The policies followed prior to the 1980s were all classified under the label of import substitution industrialization (ISI). This label permeated the development vocabulary, and was interpreted (or caricatured) as an autarkic strategy seeking to substitute domestic goods for imports through a plethora of price distorting incentives, in particular in the area of trade policy. A recent textbook description is provided in Dunn and Mutti (2000, p. 264-265):

“During 1950-1970, the governments of many developing countries encouraged by a few academic economists, concluded that international trade was unlikely to benefit poor countries and that they should design policies to minimize their reliance on trade. Instead of stressing export growth, tariffs and other trade barriers were used to encourage the growth of local industries in order to produce substitutes for products that had previously been imported. This inward-looking, or autarkic, approach was designed to sharply reduce the role of trade in a nation's economy....the export sector could be ignored or even taxed, a strategy that promoted the shift of resources out of primary production”²⁰.

Mainstream economists and orthodox policy makers consider ISI as having had only detrimental consequences for growth. They argue that ISI is at the root of many of the ills of developing economies

¹⁹ See Rodrik (2006). The original Washington Consensus consisted of ten reform policies: (1) fiscal discipline; 2) reorientation of public expenditure; 3) tax reform; 4) liberalization of financial markets; 5) competitive exchange rate; 6) liberalization of trade policies; 7) openness to foreign direct investment; 8) privatization; 9) deregulation and 10) secure property rights. See Williamson (1990).

²⁰ A similar interpretation can be found in the case of Latin America in the study undertaken by *El Colegio de México*, the *Fundación Getulio Vargas* and the Washington Institute for International Economics published in the early 1980s. The study asserts: “The early post-war years saw a policy shift from export orientation to import substitution in Latin America. The intellectual underpinnings of this shift were provided by the United Commission for Latin America that saw scant possibilities for export growth through export expansion. The view was expressed that, due to a secular decline in their import coefficients, the developed industrial countries would not provide a sufficient stimulus for economic growth through primary exports; that Latin American countries were not in a favourable position to develop manufactured exports...”. Prebisch terms this view “a purely arbitrary assertion”. See, Prebisch (1986), p. 212.

including: the decline of primary sector output and exports; the excessive promotion of capital-intensive techniques coupled with low capacity utilization and high levels of unemployment and informality; unequal distribution of incomes and high poverty rates²¹.

The intellectual origins of such anti-ISI rhetoric can be traced back to a series of empirical studies aimed at measuring the effects of the distortions brought about by trade protection. Perhaps the most influential one in this regard was Little, Scitovsky, and Scott (1970). The book argued that countries that pursued import substitution policies beyond certain limits suffered adverse impacts. Import substitution led to an inefficient and high cost industrial sector incapable of facing foreign competition, and that could only survive by absorbing resources from other sectors, *inter alia* agriculture. They stressed that the administrative controls necessary to keep in place this ‘distorted’ incentive structure led firms to operate below potential capacity and thus to generate unemployment.

A key empirical measure of the distortion introduced by ISI policies presented by these and subsequent authors is the rate of effective protection²². This measures “the percentage by which the value added at a particular stage of processing in a domestic industry can exceed what it would be without protection”²³. The greater the effective rate of protection the greater the level of distortion introduced by a given tariff regime. Their empirical studies concluded that the rates of effective protection in Latin America were high and that they exhibited great variance by type of good, among economic sectors and even within countries (see tables 4 and 5 below). As an example, the average rate of effective protection in Brazil in the year 1966 ranged from 31% in capital goods industries to 230% in the consumption goods industries. But in Mexico, the rate of effective protection was much lower and the dispersion narrower, varying from 22% in the consumption goods industries to 55% in capital goods industries. Moreover, while Brazil afforded the highest rate of protection to consumption goods, Mexico provided it to its capital goods industries (see table 4).

TABLE 4
AVERAGE RATE OF EFFECTIVE PROTECTION FOR MANUFACTURING BY TYPE OF GOOD IN
SELECTED LATIN AMERICAN COUNTRIES
(Percentages)

Country	Year	Consumption	Intermediate	Capital	All manufactures
Argentina	1958	164	167	133	162
Brazil	1966	230	68	31	118
Mexico	1960	22	34	55	27

Source: Little, Scitovsky and Scott (1970), p. 174.

²¹ See for example, Griffin (1989) pp. 109-111 and Todaro (1989), pp. 438-444.

²² The studies by Little, Scitovsky and Scott, Ibid, and Balassa and Associates (1971) are the most cited computations of effective rates of protection. Others include, Cohen (1971); Anjaria (1987); World Bank (1987) and Greenway and Milnar (1987).

²³ The effective rate of protection is formally defined in the most simple terms as:

$$(1) ERP = \frac{t_j - \sum a_{ij} t_i}{1 - \sum a_{ij}}$$

where,

t_j = nominal tariff on an importable product j .

t_i = nominal tariff rate on importable i .

a_{ij} = share of i in the cost of j under no tariffs.

See Corden (1987), p. 103.

TABLE 5
ESTIMATES OF AVERAGE RATES OF EFFECTIVE PROTECTION IN SELECTED
LATIN AMERICAN COUNTRIES

Country	Little et. Al. (1970) ^{a b}	Cohen (1971) ^b	Anjaria (1979) ^b	Greenway and Milnar (1987)	World Bank (1987)
Argentina	162	55	27	...	...
Brazil	118	58	66	63	23
Chile	...	...	217	...	217
Colombia	...	...	29	19	55
Costa Rica	...	...	22	...	...
Dominican Republic	...	...	124	...	...
El Salvador	...	...	44	...	...
Guatemala	...	...	31	...	...
Honduras	...	...	59	...	...
Mexico	27	61	49	...	...
Nicaragua	...	...	53	...	...
Uruguay	...	...	384	384	...

Sources: Little et. al. (1970); Greenway and Milnar (1987) and World Bank (1987).

Notes: ... denotes not available.

^a The rates of effective protection in Little et al refer to the year 1958, 1966 and 1960 for Argentina, Brazil and Mexico. The rates of effective protection in Cohen are for the years 1953, 1966, and 1960 for Argentina, Brazil and Mexico respectively. The rates of effective protection for World Bank (1987) corresponds to the years 1980-1981, 1967 and 1879 for Brazil, Chile, Colombia.

^b Rates of effective protection on the manufacturing sector.

The argument based on the concept of effective protection turned out to be weak. First, as shown in Table 5, estimates of effective protection rates exhibited a wide range of variation. While Little et al. (1970) calculated a rate of 162% for Argentina for the manufacturing sector, Cohen (1971) computed a rate of just 55%. These computations also required stringent assumptions that call into question their veracity. Most important, empirical studies that followed the pioneering study by Little et. al (1970) showed that the role of the rate of effective protection in obstructing export development, industrialization and growth was in fact ambiguous. As explained by Brutton (1998) p. 912: “A particularly interesting point about the ERP [effective rate of protection] as it evolved is that a number of countries, later achieving outstanding success, showed the same sort of protection picture as did later failures. An obvious example is Taiwan....Taiwan’s ERP for consumer goods was higher than that of the Philippines and vastly higher than that of Mexico...Evidently the role of ERP is still ambiguous”

This initial ISI criticism based on empirical measures such as the rate of effective protection was surpassed by an argument that emphasized the inefficient and rent-seeking character of government and government officials. Rent-seeking was highlighted as a wasteful, inefficient and costly activity inherent to any regime based on strong intervention of the State in the economy. This criticism -based on the New Political Economy (NPE)- argued for a minimalist state as its proponents argued that governments were “almost universally prone to failure”²⁴.

The argument was potent because it stated that the most serious detrimental consequence of ISI for growth and development stemmed not from the distortion of resource allocation and its effects on output. Rather, the most important consequence was that it led to rent seeking, thus destroying the very foundations for growth and development. Indeed, ISI was seen as merely transforming the main agents

²⁴ The expression is from Stewart (2005).

of production and growth, namely firms and entrepreneurs, into rent-seeking entities. The argument was already present in Little et al: “The most serious results of these policies, however, is that the nascent industries have come to depend for their profits on government decisions, and so have formed the habit of devoting their efforts to obtaining privileges by pressure on the government rather than by cutting their costs”²⁵. Nonetheless, the NPE rent-seeking ISI argument was developed to its full extent during the 1980s drawing on the work of Buchanan and Tullock (1962)²⁶.

TABLE 6
YEAR OF ADHESION TO GATT AND WTO, AND PRE AND POST TRADE LIBERALIZATION
TARIFF RATES AND TARIFF DISPERSION IN LATIN AMERICA

Country	GATT	WTO	Year of trade liberalization	Pre trade liberalization		Post-trade liberalization	
				Tariff rate	Tariff dispersion	Tariff rate	Tariff dispersion
Argentina	1967	1995	1991	42.0	15-115	12.5	5-22
Bolivia	1990	1995	1985	12.0		10.3	5-10
Brazil	1948	1995	1991	51.0	0-105	17.32	0-65
Chile	1949	1995	1976	35.0	35	11.33	11
Colombia	1981	1995	1986	61.0	0-220	10.60	5-20
Costa Rica	1990	1995	1986	53	0-1,400	14.30	5-20
Dominican Republic	1948	1995	1992	...	....	16.70	...
Ecuador	-	1996	1991	37.0	0-338	11.29	2-25
El Salvador	1991	1995	1989	20.0		9.38	5-20
Guatemala	1991	1995	1988	50.0	5-90	10.27	5-20
Honduras	1994	1995	1991	41.0	5-90	8.90	5-20
Mexico	1966	1995	1986	24.0	0-100	12.53	0-20
Nicaragua	1950	1995	1991	15.9	...	9.90	0-20
Panama	-	1997	1996	....	...	10.67	...
Paraguay	1994	1995	1989	....	...	10.91	3-86
Peru	1951	1995	1991	37.6	0-120	16.80	5-25
Uruguay	1953	1995	1990	32.0	10-55	14.00	12-24
Venezuela	1990	1995	1996	37.0	0-135	14.31	0-50

Source: Wacziarg & Welch (2003); Henry (2007); World Bank (2003); WTO (2008b); Alam & Rajapatirana (1993); Cardoso & Helwedge (1992).

Note: ... denotes not available.

The pre-trade liberalization years are 1984 for Chile, 1985 for Bolivia, Costa Rica, Guatemala, Honduras and Mexico; 1987 for Brazil and Uruguay; 1986 for Argentina; 1988 for Paraguay and Peru; 1989 for Ecuador and Venezuela; 1978-1984 for Nicaragua, 1980 for El Salvador. The post-trade liberalization year is 1990 for Mexico, 1991 for Argentina, Bolivia, Chile, Paraguay and Venezuela and 1992 for the rest of the countries.

Either forced by necessity or convinced by the weight of argument, most Latin American economies adopted trade liberalization policies in the late 1980s and 1990s. In a sense, the free trade discourse and associated rhetoric represented a return to the arguments traditionally espoused in favor of such policies. First, that free trade improves resource allocation and stimulates employment and growth. Second, free trade is fair trade as it provides equal trading opportunity to all countries according to their respective capacities and endowments. Third, free trade helps countries to achieve development,

²⁵ Little et al. *ibid.*, p. xviii.

²⁶ Representatives of the New Political Economy include Lal (1982) and Bhagwati (1982).

rewarding economic agents and sectors with comparative advantage. Fourth, free trade benefits households and firms by widening the supply of products and lowering their costs. And finally, free trade prevents rent seeking behavior and promotes good government²⁷.

During this period Latin American countries completed their adhesion to the GATT and World Trade Organization (WTO), reduced their tariff rates and opened up their economies. Following trade liberalization and taking the 1980s as a reference point, the average regional tariff rate declined from 37% to 12% during the trade liberalization period²⁸. The openness coefficient, measured as the sum of export and imports over GDP, almost doubled, increasing from 23% to 40% between the periods 1970-1980 and 2002-2006 (see tables 6 and 7 above and below).

TABLE 7
TRADE OPENNESS IN SELECTED REGIONS, 1970-2006
(Percentages of GDP)

	1970-1980	1981-1991	1992-2006
Latin America & Caribbean	23.5	28.3	40.3
East Asia & Pacific	22.1	37.9	66.2
Europe & Central Asia	...	45.4	69.8
Euro area	46.2	54.6	64.5
Middle East & North Africa	60.4	51.1	57.2
South Asia	15.6	18.3	30.9
Sub-Saharan Africa	53.9	53.2	61.7
World	32.5	37.4	45.5

Source: World Bank Development Indicators (2008).

Note: Openness was measured as the sum of imports and exports divided by GDP.

The Latin American stance on free trade was enhanced by the region's active participation in promoting the Free Trade Area of the Americas²⁹, and more importantly in the region's involvement in the proliferation in bilateral free trade agreements (BFTA). The number of BFTAs – just four prior to the North American Free Trade Agreement signed by Mexico, the US and Canada in 1994 – increased thereafter to more than twenty (see table 8 below).

²⁷ See WTO (2008a). The mainstream literature argues that there is a wealth of empirical evidence showing that trade promotes growth and that the positive causal relationship between trade and growth has gained the status of a stylised fact in the literature. However, the transmission mechanisms between trade and growth have not received the required level of attention or study. As stated by Lewer et al. (2004) p. 163: "A serious weakness of the many statistical studies [of trade and growth] is that they have not yet shed much light on *why* the statistical relationship between trade growth holds so robust...studies have tried to distinguish the channels of influence through which trade enhances economic growth, but the results are so far merely suggestive." Ultimately the authors suggest that the main possible channel for trade to influence growth is through investment.

²⁸ It should be noted that the nominal tariff estimates presented in table 6 do not include para-tariffs. The inclusion of para-tariffs increases the rate of nominal protection. Edwards (1995, p. 200) reports for example that the pre-tariff rate of protection including para-tariffs was 92% for Costa Rica and 80% for Brazil, whereas in table 6, the nominal level of protection is 53% and 51%, respectively.

²⁹ The Free Trade Area of the Americas (FTAA, hereafter) negotiations which were expected to be completed in the year 2005 involved 34 countries including all Latin American and Caribbean countries, the United States and Canada – countries with important differences in size, population, economic structure, economic performance and, stability and welfare. The FTAA comprised nine negotiating groups. These are, market access, agriculture, government procurement, investment, competition policy, intellectual property rights, services, dispute settlement, subsidies, antidumping and countervailing duties. FTAA was negotiated on the belief that a free trade agreement will i) widen and solidify market access leading countries to maintain their preferential market access and act as a springboard for export development and promotion; ii) lead to greater foreign direct investment; iii) allow for technological transfer; and iv) improve labor mobility. See Roberts (2008) for a proposal to rethink and resuscitate the now-defunct FTAA.

TABLE 8
EXISTING TRADE AGREEMENTS IN THE AMERICAS

Agreement	Date of entry into force	Type of agreement
Central American Common Market	1961	Customs Union
Latin American Integration Association	1981	PS
Andean Community of Nations	1988	Customs Union
MERCOSUR	1991	Customs Union
NAFTA	1994	Free Trade Area
Costa Rica-Mexico	1995	Free Trade Area
Canada-Chile	1997	Free Trade Area
Mexico-Nicaragua	1998	Free Trade Area
Chile-Mexico	1999	Free Trade Area
EFTA-Mexico	2000	Free Trade Area
Israel-Mexico	2000	Free Trade Area
EC-Mexico	2000	Free Trade Area
Guatemala-Mexico	2001	Free Trade Area
El Salvador-Mexico	2001	Free Trade Area
Honduras-Mexico	2001	Free Trade Area
Chile-Costa Rica	2002	Free Trade Area
Chile-El Salvador	2002	Free Trade Area
Canada-Costa Rica	2002	Free Trade Area
EC-Chile	2003	Free Trade Area
Panama-El Salvador	2003	Free Trade Area
United States-Chile	2004	Free Trade Area
Korea-Chile	2004	Free Trade Area
EFTA-Chile	2004	Free Trade Area
Japan-Mexico	2005	Free Trade Area
CAFTA-DR	2006	Free Trade Area
Panama-Singapore	2006	Free Trade Area
Chile-China	2006	Free Trade Area
Chile-Japan	2007	Free Trade Area

Source: WTO (2008b).

IV. The Latin American rhetoric on trade and growth: part IV

The proliferation of BFTAs have without doubt deepened Latin America's free market orientation by significantly reducing the scope for public policy and government intervention, and by bringing under the sphere of the market other areas such as labor and the environment. This trend, present in NAFTA, is epitomized by the BFTA signed between the United States and Chile (2004). Both agreements have provided the structure and legal model for the majority of free trade agreements signed (or in the process of negotiation) by Latin American countries.

In these agreements, trade in goods is governed by the principle of non-discrimination and provides for the phasing out and elimination of tariffs between the signatory countries. While tariffs are for the most part programmed to be immediately eliminated, the text often contemplates their gradual phasing out for selected products over a specified period. Contrary to WTO legal texts, the services provisions require the granting of national and most favored nation treatment (i.e., non-discriminatory treatment) to service suppliers of contracting parties. The WTO General Agreement on Trade in Services (GATS) texts permits the imposition of 'discriminatory subsidies.' However, within the framework of the most perfected bilateral BFTA, these measures are not allowed once the agreement enters into force.

The more recent bilateral agreements include an investment chapter. Its provisions are without doubt one of the most important pillars of the BFTAs³⁰. It seeks to provide protection for foreign investors, or more specifically, ‘a secure, predictable, legal framework for foreign investors.’ This chapter is also one of the more controversial ones. First, the definition of investment is broad enough to cover tangible and intangible assets (property rights are considered an investment). Second, the investment chapter generally accords foreign investors national treatment and most-favored-nation treatment. Both national and most-favored nation provisions refer to the equality of treatment accorded to national and foreign investors in “like circumstances”³¹. The term ‘like circumstances’ is, however, broad and difficult to define and delimit.

Third, the level of generality of the investment chapter is enhanced by the call for minimum standards of treatment for foreign investors. The minimum standard of treatment means that investment should be treated according to the canons of customary international law. In turn, customary international law is defined as including ‘fair and equitable treatment’ and ‘full security and protection’³². Fourth the investment chapter explicitly decouples investment flows from performance requirements (such as requirements that activity involve a given level or percentage of domestic content, or generate a certain level of foreign exchange earnings).

The most controversial provisions of the investment chapter are those related to the issues of expropriation and compensation. The free trade agreements prohibit the direct or indirect expropriation (or nationalization). Direct expropriation is a well defined term which refers to the nationalization, transfer of title or seizure of private property by the host government³³. However, the term indirect expropriation (or nationalization) can be interpreted in different ways³⁴. The legal texts mention the phrase “indirect expropriation by measures equivalent (or tantamount) to expropriation or nationalization”³⁵. In order to determine whether an action constitutes “indirect expropriation” it needs to be assessed on a case-by-case basis. The evidence includes the economic impact of government action, the degree of interference of government action with investment-backed expectations³⁶.

All BFTAs are similar in their structure and content, with some chapters having identical provisions. It can be easily argued that the negotiations are in fact a gradual piecemeal approach to a single BFTA with the rest of the world, whereby countries are added on a gradual basis. In this view, the bilateral agreements will eventually converge to an overall encompassing multilateral agreement, giving credence to the consequent improvement in welfare and growth hypothesized by free trade advocates. In short, the BFTAs represent the last step towards the outright liberalization of the movement of goods and services and the full implementation of free trade policies. They also imply the quasi complete abandonment of domestic policies to stimulate growth.

³⁰ Bilateral Trade Agreements and the Investment chapters of the FTAs are meant to encourage investment flows in a context where foreign direct investment should fill the shortfall in official aid. This is particularly relevant for smaller economies. For an analysis of bilateral investment treaties and their impact on development policy, see, Petersen (2004).

³¹ See articles 10.2, 15.2 and 10.3 of the US-Chile, US –Singapore and US-CAFTA free trade agreements. See also, “U.S.-Chile Free Trade Agreement”, *The American Journal of International Law*, (July, 2003).

³² ‘Fair and equitable treatment’ includes the obligation not to deny justice in criminal, civil or administrative adjudicatory proceedings in accordance with the principle of due process embodied in the principal legal systems of the world. “Full protection and security” requires each party to provide the level of police protection required under customary international law. See articles 10.4, 15.5 and 10.5 of the US-Chile, US –Singapore and US-CAFTA free trade agreements. See also *The American Journal of International Law* (October 2001), pp. 881-885.

³³ See, Expropriation in International Law by Professor B.A. Wortley. Mimeo. July 1947.

³⁴ In some court cases the term ‘creeping expropriation’ as a form of indirect expropriation is also utilized.

³⁵ The issue of indirect expropriation was amply debated in the case of Metalcad Corporation vs. Mexico and Mexico vs. Metalcad Corporation in 2001 within the NAFTA framework. The tribunal that analyzed the case decided that the term expropriation meant “not only open, deliberate, and acknowledged takings of property...but also covert or incidental interference with the use of property which has the effect of depriving the owner of the actual or expected benefits of property...” See, Dodge, W.S. (2001) and *The American Journal of International Law*, (Oct., 2001), pp. 910-919.

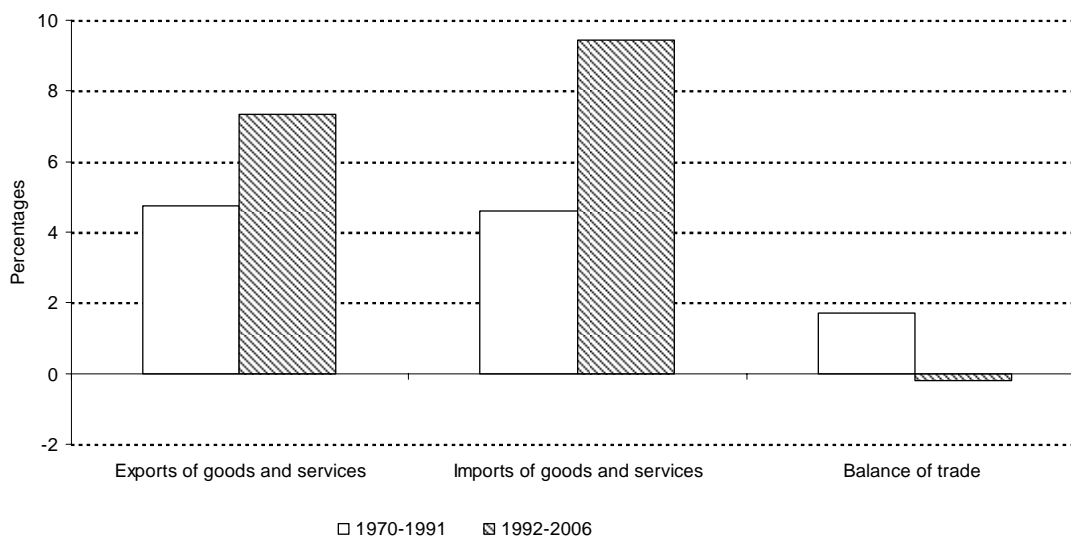
³⁶ Exceptions include cases where expropriation or nationalization are carried out, among other reasons, for a public purpose, in a non-discriminatory manner, or in accordance with due process of law.

The pattern of export development 1970-2006

Following the trade liberalization initiatives of the 1990s, Latin America did improve its export performance. The average annual rate of growth of exports of goods and services jumped from 4.8% in 1970-1991 to 7.3% in 1992-2006 (see figure 2). However, this dynamism of exports barely enhanced Latin America's participation in world trade.

As shown in Figure 3 below, Latin America increased, albeit modestly, its share in world exports of goods and services from 4.5% in 1990 to 5% in 2006. But its share in world trade in the post trade liberalization period (1990-2006) never managed to reach the levels attained during the pre-liberalization era (1960-1970). Moreover, the region has not improved its position in relation to other emerging economies in the East Asian bloc. It is worth noting that the economies of East Asia and the Pacific and Latin America had similar shares of world trade in the periods 1970-1980 and 1980-1990 (4.4% and 4.6%, and 4.9% and 4.6% respectively). However, during 1990-2006 (the period of trade liberalization), East Asia and the Pacific augmented their share in world trade to 8%, surpassing that attained by Latin America (5%).

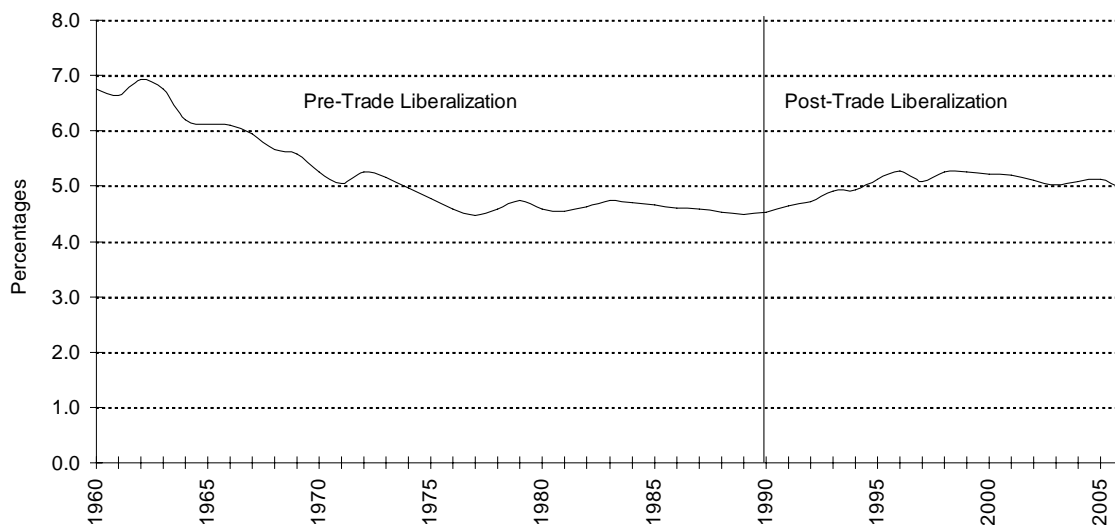
FIGURE 2
EXPORTS AND IMPORTS OF GOODS AND SERVICES (ANNUAL AVERAGE RATES OF GROWTH), 1970-2006



Source: World Development Indicators, World Bank (2008).

Latin America's export performance can be better explained by examining the composition of its exports. To this end, we compute the composition of exports of Latin America by factor intensity and compare it to that of world imports. If the Latin American factor intensity composition of exports differs substantially from that of world imports, then Latin America's pattern of specialization does not meet the conditions of external demand.

FIGURE 3
LATIN AMERICA'S SHARE IN WORLD EXPORTS, 1960-2006
 (Percentages)



Source: World Development Indicators, World Bank (2008).

Table 9 below shows the exports of Latin America to the rest of the world classified, by factor intensity into five categories using the SITC classification for the period 1980-2006. The categories are: i) primary commodities, ii) labor intensive and resource-based manufactures; iii) manufactures with low skill and technology intensity; iv) manufactures with medium skill and technology intensity and v) manufactures with high skill and technology intensity.

Table 9 shows a change in the composition of Latin American exports to the rest of the world, which has affected mainly primary commodities and manufactures with medium and high skill and technology intensity. Since 1980 the share of both manufactures with medium skill and technology intensity and manufactures with high skill and technology intensity has increased. Their respective export shares rose from 3.8% and 4.8% in 1980 to 25% and 20% of the total in 2006. During the same period the share of commodity exports declined from 79% to 37%. The shares of the two remaining categories, manufactures that are labor intensive and resource-based, and those with low skill and technology intensity have not changed significantly over time. But these changes in the composition of exports began prior to the trade liberalization period. As a result, trade liberalization per se did not produce any change with respect to the share of commodities in Latin America's export basket, but merely reinforced a previously existing trend. Furthermore, in spite of the decline in the commodity share of exports, the export structure remains predominantly commodity oriented. This characteristic is even more pronounced when the analysis is carried out at a more detailed and disaggregated level on a country-by-country basis.

TABLE 9
MERCHANDISE EXPORTS OF LATIN AMERICA TO THE REST OF THE WORLD AND WORLD MERCHANDISE IMPORTS CLASSIFIED
BY GROUP ACCORDING TO FACTOR INTENSITY, 1980-2006
(In percentage of the total)

Product group	1980	1985	1990	1995	2000	2002	2005	2006
Exports of Latin America to the rest of the world classified by group according to factor intensity								
Primary Commodities	78.9	64.7	55.2	40.6	28.4	29.3	34.8	37.4
Labor intensive and resource-based manufactures	8.8	9.8	10.9	12.2	12.1	11.8	10.0	8.4
Manufactures with low skill and technology intensity	2.4	9.0	8.7	6.9	5.6	6.0	7.1	6.2
Manufacture with medium skill and technology intensity	3.8	7.9	13.5	22.6	28.4	27.8	25.6	25.2
Manufactures with high skill and technology intensity	4.8	7.9	10.3	15.3	23.6	23.1	20.3	20.2
Not classified	1.2	0.8	1.4	2.4	1.9	2.1	2.3	2.5
World imports classified by group according to factor intensity								
Primary Commodities	26.1	22.1	18.6	16.9	13.4	13.5	13.6	14.3
Labor intensive and resource-based manufactures	18.2	17.9	20.1	19.4	18.6	18.7	17.1	16.4
Manufactures with low skill and technology intensity	8.8	7.2	6.6	6.5	5.8	5.7	6.9	7.0
Manufacture with medium skill and technology intensity	32.3	37.3	38.8	41.6	46.5	44.8	44.6	44.7
Manufactures with high skill and technology intensity	11.7	12.0	12.3	12.4	12.5	13.9	14.5	14.4
Not classified	2.9	3.5	3.6	3.2	3.2	3.4	3.3	3.1
Coefficient of adaptation of Latin America's exports to World import demand								
Primary Commodities	3.02	2.93	2.97	2.41	2.12	2.16	2.55	2.61
Labor intensive and resource-based manufactures	0.49	0.55	0.54	0.63	0.65	0.63	0.59	0.51
Manufactures with low skill and technology intensity	0.27	1.24	1.31	1.06	0.95	1.05	1.03	0.88
Manufacture with medium skill and technology intensity	0.12	0.21	0.35	0.54	0.61	0.62	0.57	0.56
Manufactures with high skill and technology intensity	0.41	0.65	0.84	1.23	1.89	1.66	1.40	1.40

Note: Authors' own computations based on the classification provided by UNCTAD (2002) and data obtained from WITS (2008).

Table 10 shows the ten leading traditional Latin American export products on a country-by-country basis for 1995 and 2005, classified by major categories. The categories include food and agriculture, beverages, oils and seeds, raw materials, mining and energy. The ten major commodity exports accounted on average for 56% of the total for Latin America.

At the country level, the data reveals that a subset of countries (Paraguay, Uruguay, Panama and Nicaragua) is highly specialized in the export of traditional commodities and has strengthened its pattern of specialization over time. For this group of countries, the ten major leading commodities represented 64% and 71% of total exports of goods in 1991 and 2006.

The exceptions to this pattern of specialization are mainly Central American countries (Costa Rica, El Salvador, Guatemala, Honduras) which have markedly decreased their degree of specialization in primary commodities (from 54% to 29% of the total). With the exception of Costa Rica, Central American countries have switched to the export of textiles. At the country level in 1990 textile exports represented 22.8%, 24.0%, and 22.9% of the total exports to the United States for El Salvador, Guatemala and Honduras, respectively. In 2006, textile exports represented 76%, 54%, and 68% for the same countries respectively (see table A-1 in the appendix).

Comparison of the composition of Latin America's exports to that of world imports shows that the region's specialization in manufactures with high skill and technological intensity and more importantly commodities is greater than that required by the rest of the world. In the case of commodities, the ratio of Latin America's share of commodities as a percentage of its total exports relative to the share of world commodity imports in total world imports is roughly 2.5% for the whole period. That is, Latin America's specialization in commodities exports is more than twice as great as that required by the composition of imports in the rest of the world.

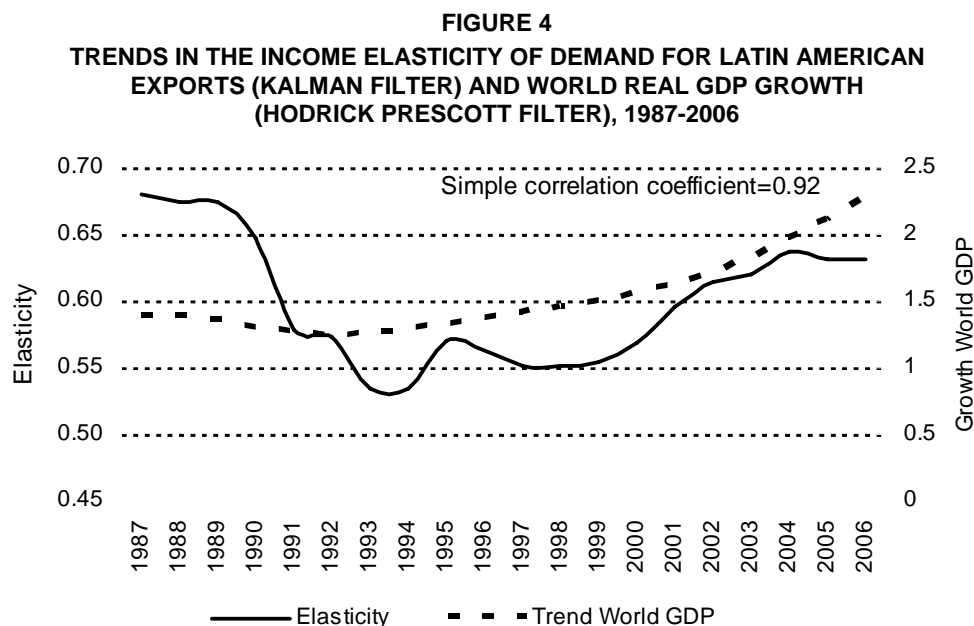
Meanwhile, Latin America's export specialization in labor intensive and resource-based manufactures and manufactures with medium skill and technology intensity falls below that required by world imports. The ratio of Latin America's exports of labor intensive and resource-based manufactures and manufactures with medium skill and technology intensity to that of imports of these goods by the rest of the world is on average 0.5. In short, trade liberalization has not managed to change the composition of Latin America's exports to adequately meet the conditions of demand from the rest of the world. As a result the region has not been able to boost exports on a sufficient scale to gain world market share. In this sense it is important to note that, contrary to free trade rhetoric, increasing exports is not equivalent to changing their composition towards products with a higher value added, but means rather changing their composition to meet external demand. Latin America's failure to adjust its export basket to world demand is reflected in the fact that the world income elasticity of demand for its exports is less than unity.

TABLE 10
EXPORT SHARE OF THE TEN LEADING PRODUCTS IN SELECTED LATIN AMERICAN COUNTRIES, 1995 AND 2006
(Percentages)

Country	Food and agriculture		Beverages		Oil and seeds		Raw materials		Mining		Energy		Total traditional		Other		Total	Total
	1995	2006	1995	2006	1995	2006	1995	2006	1995	2006	1995	2006	1995	2006	1995	2006	1995	2006
Argentina	18.0	9.5			17.4	21.0				2.9	7.6	16.2	43.0	49.6	0.0	0.0	43.0	49.6
Bolivia		2.6			7.3	11.5			38.3	16.7	11.9	46.3	57.5	77.1	13.0	2.4	70.5	79.5
Brazil	7.3		4.2	2.1	4.4	6.9	3.5		8.2	6.2		7.6	27.6	22.8	6.2	11.7	33.8	34.5
Chile	10.7	6.8					6.8	2.7	45.7	52.3		2.0	63.2	63.8	1.5	4.1	64.7	67.9
Colombia	22.2	9.4							7.4	14.5	21.4	26.1	51.0	50.0	13.5	13.0	64.5	63.0
Ecuador	39.8	21.3	6.2	1.2		1.2			2.2		35.1	56.9	83.3	80.6	1.8	4.7	85.1	85.3
Paraguay	40.7	33.9			29.8	44.7							70.5	78.6	7.9	2.1	78.4	80.7
Peru	13.3	7.1	5.3						38.0	49.3	5.0	7.2	61.6	63.6	0.0	5.8	61.6	69.4
Uruguay	36.3	42.8				3.0						4.4	36.3	50.2	15.4	5.6	51.7	55.8
Venezuela									3.9	2.3	76.3	87.2	80.2	89.5	4.9	3.5	85.1	93.0
Costa Rica	34.4	14.5	15.5	3.5									49.9	18.0	5.3	37.2	55.2	55.2
El Salvador	10.4	7.1	37.7	9.9								2.9	48.1	19.9	11.3	21.6	59.4	41.5
Guatemala	23.2	16.8	28.1	13.8		3.0					1.7	6.7	53.0	40.3	7.1	13.3	60.1	53.6
Honduras	34.8	17.2	28.6	17.5		3.0			2.2				65.6	37.7	8.5	19.4	74.1	57.1
Nicaragua	32.2	45.5	23.5	15.1						5.3			55.7	65.9	15.7		71.4	65.9
Panama	58.6	75.1	5.8						3.2				67.6	75.1	7.1	2.2	74.7	77.3
Mexico											9.3	13.2	9.3	13.2	33.5	35.2	42.8	48.4

Source: Own computations based on the Statistical Yearbook (ECLAC, 2007).

Figure 4 below shows the income elasticity of demand for Latin American exports and the trend of the rate growth of world GDP. The export elasticity was computed from a standard export equation using space-state econometric techniques. That is, exports (in real terms) are posited as a function of the terms-of-trade and world real GDP per capita. The trend in real world GDP growth was obtained using the Hodrick-Prescott method.



Source: Authors' elaboration based on data from World Development Indicators (2008).

Figure 4 shows that the income elasticity of Latin America's exports somewhat follows the trend of world GDP growth. The correlation coefficient between both series is 0.92 for the whole period considered and is statistically significant. However, the trajectory of the moving elasticity coefficient indicates that its final value is equal to 0.63, and that the maximum and minimum values are 0.68 and 0.63³⁷. Most important is the fact that the growth in exports of goods and services has not been able to keep pace with the rise in imports which accompanied trade liberalization. As indicated above, exports of goods and services expanded at a average annual rate of 4.8% and 7.3% in 1970-1991 and 1992-2006. But imports of goods and services expanded at rates of 4.6% and 9.4% respectively for the same periods.

³⁷ Formally, in the general case a state space model representation for an $n \times 1$ vector y_t , comprises two equations.

$$(2) y_t = Z_t \alpha_t + c_t + \varepsilon_t$$

$$(3) \alpha_t = d_t + T_t \alpha_{t-1} + v_t$$

Where Z_t is a conformable matrix, associated to the $(m \times 1)$ vector of unobserved state variables α_t . T_t is a matrix of parameters; d_t and c_t are vectors that include exogenous and observable variables. The error terms ε_t and v_t have the usual properties.

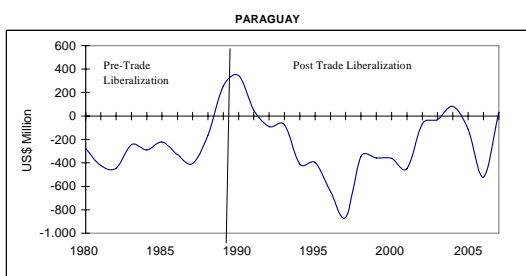
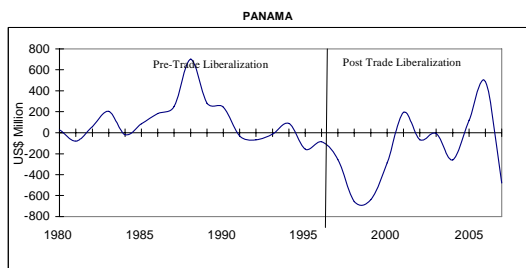
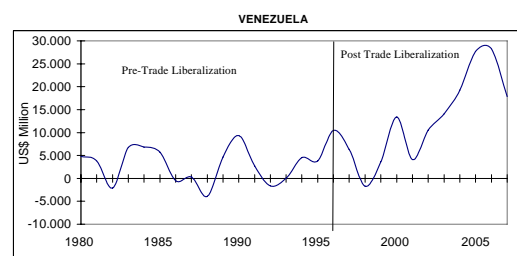
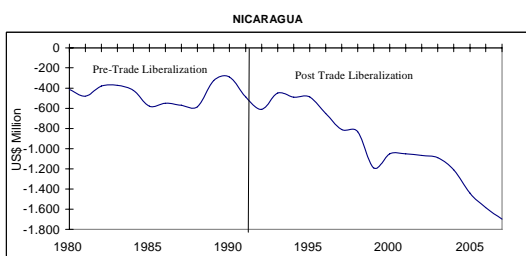
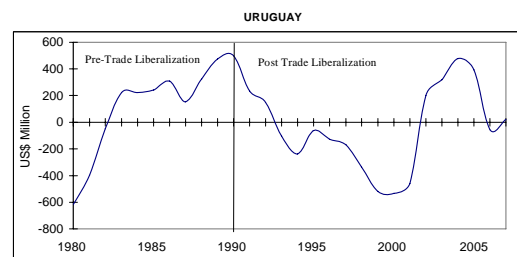
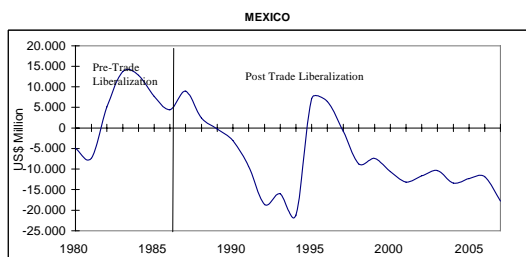
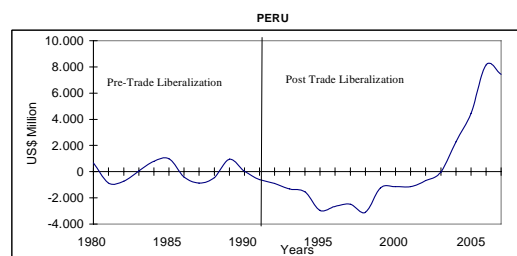
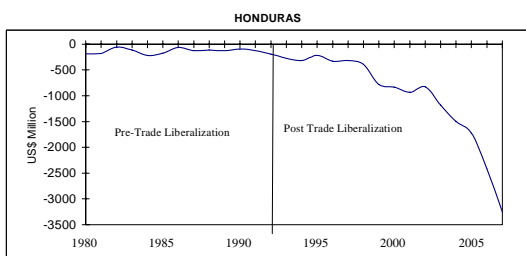
By construction the $(m \times 1)$ vector of unobserved state variables α_t follows a first order autoregressive process. The most widely used algorithm to estimate the parameters of Eqs. (2) and (3) is the Kalman filter. The statistical significance of the correlation

coefficient was determined on the basis of the formula: $\rho = \frac{r\sqrt{n-2}}{\sqrt{1-r^2}}$ where r is the simple correlation coefficient and n the

number of observations. ρ follows a student-t distribution. In this particular case the computed t value is equal to 9.31 above the critical 1.64 at a 95% level of confidence.

FIGURE 5
LATIN AMERICA. EVOLUTION OF THE TRADE BALANCE OF GOODS AND SERVICES IN PRE AND POST TRADE LIBERALIZATION PERIOD (ON A COUNTRY BASIS), 1980-2005





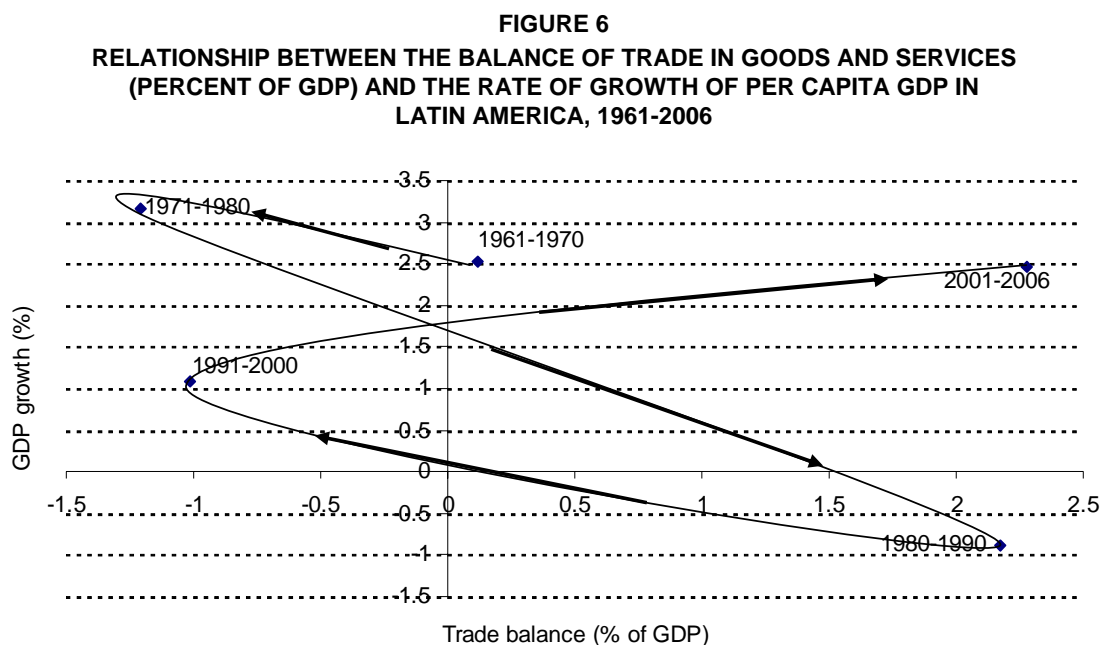
Source: ECLAC. Statistical Yearbook for Latin America and the Caribbean. Santiago: ECLAC. Several Issues.

Figure 5 shows that the balance of trade in goods and services thus deteriorated during the trade liberalization period. Indeed, the balance of trade was positive during the pre-trade liberalization period 1980-1990 (2.6% of GDP), but turned negative on average for the post-liberalization period 1991-2006 (-0.2% of GDP) (see table A-3 in the appendix). Country-by-country analysis for Latin American economies reveals, with very few exceptions, similar results.

An analysis of the relationship between trade and growth 1970-2006

The current pattern of trade in Latin America has two major implications for economic growth. It has limited the potential for growth and has imparted volatility to the growth trajectory. As a result and as shown above, the export elasticity for Latin American products from the rest of the world is less than unity. That is, export growth in Latin America is not commensurate to the growth of demand in the rest of the world.

Also, the negative trade balances that characterize the external positions of most Latin American countries imply that trade acts as a net-leakage from rather than an injection into the economy³⁸. The balance-of-payments constrained nature of these economies is illustrated in Figure 6. It shows that with the exception of the import substitution and recent commodity boom periods (1960-1970 and 2001-2006 respectively), Latin American economies have been forced to slow down growth in order to maintain their external balance³⁹.



Source: On the basis of World Development Indicators, World Bank (2008a/) and UNCTAD (1999).

The pattern of export specialization has also enhanced the volatility of Latin American growth. Indeed, the main export category, i.e. commodities, is acutely affected by not only foreign demand, but also the terms-of-trade. *Ceteris paribus*, the frequency and size of terms-of-trade fluctuations will affect the evolution of exports. Figure 7 below shows the evolution of the cyclical components of exports of

³⁸ Within the non-mainstream literature this point has been made by Kalecki (1969), Minsky (1986), McCombie and Thirlwall (1984).

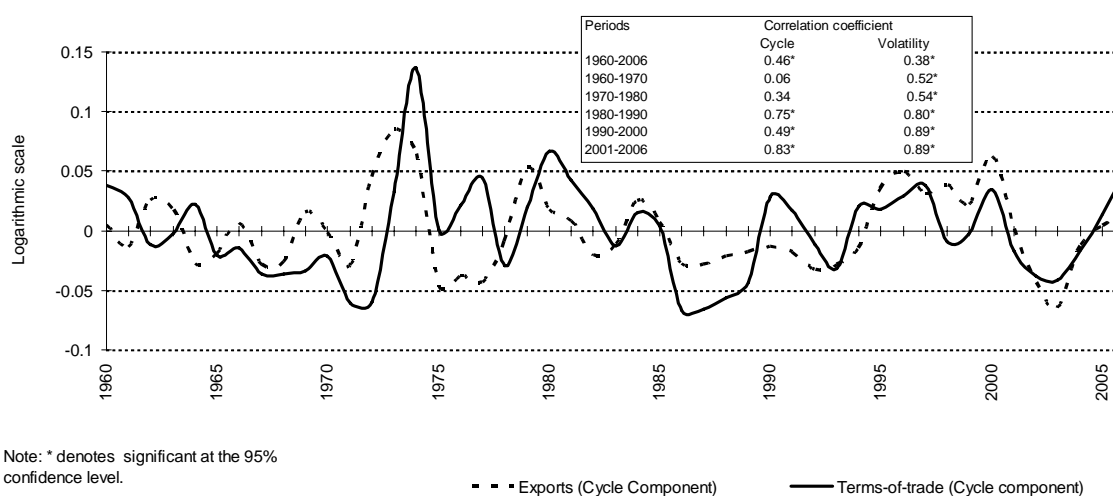
³⁹ Figure 5 appeared originally in UNCTAD (1999). Its potent message has been emphasized by, among others, Ocampo (2003 and 2004) and ECLAC.

goods and services and of the terms-of-trade for the period 1960-2006, together with correlation coefficients for the entire period and the sub-periods 1960-1970, 1970-1980, 1980-1990, 1990-2000 and 2001-2006.

The evidence shows that starting in 1980, the correlation coefficient between the cyclical components of the terms-of-trade and exports becomes significant and remains so throughout the trade liberalization period. For 1980-1990, the correlation coefficient is equal to 0.75; for 1990-2000 and 2001-2006, the coefficient is 0.49 and 0.83 respectively.

More to the point, the correlation coefficient between the volatility of the terms-of-trade and that of exports is positive and statistically significant for all periods under consideration. Thus the greater and/or more frequent are fluctuations in the terms-of-trade (that is, the more volatile they are) the greater and more frequent will be fluctuations in exports. In turn, the cyclical component of exports is significantly associated with the cyclical component of Latin America per capita GDP, both in levels and growth rates.

FIGURE 7
EVOLUTION OF THE CYCLICAL COMPONENT OF EXPORTS OF GOODS AND SERVICES
IN REAL TERMS AND TERMS-OF-TRADE IN LATIN AMERICA, 1960-2006
(HODRICK-PRESCOTT FILTER), AND CORRELATION
COEFFICIENTS FOR SELECTED PERIODS

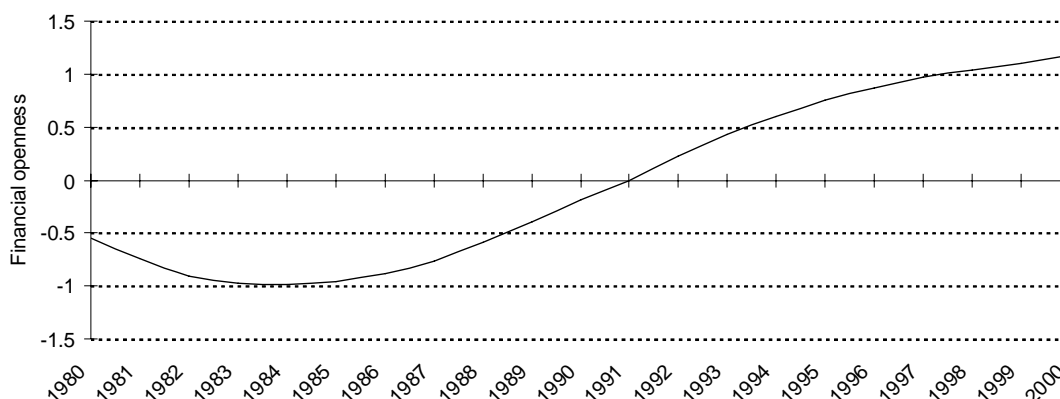


Source: On the basis of World Development Indicators, World Bank (2008).

The volatility imparted by terms-of-trade fluctuations on the growth trajectory of the Latin American economy is compounded by two factors. The first is financial volatility, which became prominent during the 1980's debt crisis and especially in the 1990's, due to the greater degree of financial openness of Latin American economies. The second is the policy reaction of Latin American governments and policy makers to real and financial volatility.

Figure 7 below shows an index of openness in capital account transactions developed by Chinn and Ito (2007). The higher is the value of the index the greater is the degree of openness of an economy to cross-border capital transactions. As Figure 8 shows, the level of financial openness rose above zero and systematically increased throughout the 1990s reflecting the fact that Latin American countries became on average more 'financially open' during this decade.

FIGURE 8
EVOLUTION OF FINANCIAL OPENNESS IN LATIN AMERICA, 1980-2000



Source: Based on Chinn & Ito (2007).

At the same time the region experienced various episodes when capital inflows come to a sudden stop ('sudden capital stops') Recent empirical evidence shows that Latin American countries experienced 25 episodes of sudden capital stops in the 1990's – double that of the 1980's. In addition, the evidence indicates that the average magnitude of financial shocks rose from 0.7% of regional GDP in the 1980's to 3.5% of GDP in the 1990's. In other words, financial shocks not only became more frequent in the 1990's but also more significant relative to GDP.

The response of Latin American governments to real and financial volatility (terms-of-trade and sudden capital stops) has been rather uniform. It consists of a contraction of internal demand as the main response to any significant terms-of-trade decline or sudden capital stop. Table 11 below shows that the average contraction in absorption due to both financial and terms-of-trade shocks for the period 1980-2006 was equivalent to roughly 10% of regional GDP.

TABLE 11
AVERAGE CONTRACTION IN DOMESTIC DEMAND DUE TO FINANCIAL AND
TERMS-OF-TRADE SHOCKS IN LATIN AMERICA, 1980-2006
(Percentages of regional Latin American GDP)

	Financial shocks	Terms-of-trade shocks (real shocks)
Latin America	6.99	2.64
South America	3.26	1.49
Central America	0.15	0.23
Mexico	3.58	0.92

Source: Titelman, Pérez Caldentey and Minzer (2008).

The terms-of-trade volatility and abrupt cessations in the inflow of foreign capital which have accompanied economic liberalization – together with the policy reactions that follow - have had important effects both on the trend and fluctuations of GDP growth in Latin America. In terms of its trend, GDP growth in the 1990s was on average half that registered in the protectionist cum ISI period. For 1960-1979, the average rate of growth of Latin American GDP was 2.8%. This pattern also holds with few exceptions at the country level where 13 of 18 countries experienced lower rates of growth of GDP per capita in the 1990s than in 1960-1980. Meanwhile, evidence shows that the volatility of GDP

growth -as measured by the coefficient of variation- increased in the 1990s. In 1960-1980, the coefficient of variation was 0.47, rising to 2.25 in the 1990s.

More precisely, during the 1990s Latin America witnessed more frequent periods of acceleration and deceleration in its growth of GDP per capita. In the period running from 1960 to 1980, it experienced an acceleration/deceleration in its rate of per capita GDP growth every four years. Thereafter, the region experienced such phenomenon every two years. Moreover, the amplitude of the GDP fluctuations became more pronounced during trade liberalization. The distance between peak and trough measured in percentage terms averaged 3.1% for the period 1960-1979, increasing to 3.4 % in 1991-2001 and 3.8% for 2002-06 (see table 12)⁴⁰.

TABLE 12
SELECTED MACROECONOMIC INDICATORS FOR LATIN AMERICA, 1960-2006

	1960-2006	1960-1979	1980-1990	1991-2001	2002-2006
Rate of growth of actual GDP per capita (percentages)	1.6	2.8	-0.4	1.4	2.2
Rate of growth of the trend component of GDP per capita (percentages) ^a	1.6	2.6	0.2	1.0	2.2
Frequency of GDP per capita cycles (number of years)	...	4	4	2	2
Coefficient of variation of GDP per capita growth					
Latin America	1.56	0.47	5.75	2.25	1.26
East Asia and the Pacific	0.50	0.88	0.26	0.36	0.08
Middle East and North Africa	1.77	1.10	8.47	0.78	0.59
South Asia	0.94	3.28	0.36	0.46	0.37
Amplitude of cycles ^b	3.14	3.08	2.93	3.41(4.42 ^c)	3.81

Source: Titelman, Pérez-Caldentey and Minzer (2008).

^a The trend and cycle components of the rate of growth of GDP per capita was obtained through the use of the Hodrick-Prescott filter.

^b The amplitude of the cycle was computed as the distance in percentage growth points between peak and trough.

^c Amplitude of cycle for the period 1995-2001.

⁴⁰ Note also that GDP growth is more volatile in Latin America than in other regions of the world including East Asia and the Pacific, the Middle East and North Africa and South Asia.

Conclusions

In Latin America the dominant understanding of the relationship between trade and growth, and its accompanying rhetoric, has radically evolved over time.

Initially the relationship was conceived as one of managed trade to promote industrialization and growth. This view was based on the belief that development could not be attained unless a significant effort was made to accumulate capital. At the same time it presupposed that the existing ‘automatic market forces’ would keep the economic system entrenched in a low level of development. Industrialization was not to be left to the market, but was rather to be the product of government intervention.

As a result, the state was called on to take a leading role in the inward industrialization process. This inward industrialization approach originally developed in the period 1940-1960 and framed in terms of concepts, among others, such as ‘center-periphery’, ‘dependency’ and ‘external strangulation’ came to recognize the role of the external sector and of trade policies in promoting the domestic industrialization efforts. The concepts of ‘infant industry,’ ‘managed trade’ and ‘special and differential treatment’ took center stage.

By the 1980’s, the debt crisis which caused the largest drop in output growth in the region’s history and affected most of Latin American countries, was used as the leitmotif to launch a devastating critique of earlier developmental policies and to recommend policies based on the mantra ‘stabilize, privatize and liberalize’. The pre-1980 policies were all labeled with the same rubric, Import Substitution Industrialization (ISI) strategies. ISI policies were then, through different arguments particularly its rent-seeking character, placed at the roots of the economic evils of

Latin America. Export outward oriented (EO) policies, responsible for the economic success of Asian countries according to the mainstream view, were then contra-posed to ISI policies. Free market beliefs and policies dominated the Latin American landscape during the 1990's and early 2000's.

Notwithstanding the implementation of free market policies, whose ultimate expression were bilateral free trade agreements, Latin America failed to overcome its external constraints, became highly vulnerable to the contagion effects of financial crisis, and became increasingly volatile. In short, a decade or more of free market policies did not lead Latin America to enter a path of high and sustained economic expansion. Moreover, the resumption of high rates of economic expansion in many countries of the region in the last five years has resulted mainly from the worldwide commodity and mineral boom –a boom whose cause and effects have nothing to do with the adoption of the trade liberalization reforms in the region.

The erosion of the Washington Consensus, reflecting the end of the region's fascination with free trade as an unequivocal and strong promoter of development, has led to a fifth stage in the understanding of the relationship between trade and growth. The characteristic feature of this stage is the skepticism that pure free market or state intervention policies will not by themselves ensure a sustainable growth path for Latin American economies. While there is a perceived need for a third way combining market and state intervention, the fifth stage has failed to produce clearly defined alternative viewpoints. This failure has been heightened by the unfolding of the global financial crisis which significantly limits, due to the strong expected contraction in external demand, Latin America, the role of trade as an engine of growth.

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Appendix

TABLE A-1
CENTRAL AMERICA: MAIN EXPORT PRODUCTS TO THE UNITED STATES AS A
PERCENTAGE OF THE TOTAL, 1990–2006

	1990	1995	2000	2006
Costa Rica				
Edible fruits and nuts	22.8	20.7	15.0	19.3
Optical photographic	0.7	2.0	5.3	15.4
Electrical machinery and equipment	4.7	6.4	35.5	22.0
Textile and apparel	37.5	40.9	23.3	12.1
Coffee and tea spices	4.6	4.6	3.5	3.6
Total	70.3	74.6	82.6	72.4
El Salvador				
Textile and apparel	22.8	71.7	82.9	75.8
Beverages	0.1	1.8	0.6	5.4
Coffee and tea spices	36.1	6.3	7.0	3.7
Sugars	4.0	3.1	0.9	2.1
Total	62.9	82.9	91.4	87.1
Guatemala				
Textile and apparel	24.0	44.8	57.1	53.8
Edible fruits and nuts	15.3	10.7	9.7	12.0
Coffee and tea spices	23.7	21.0	11.8	9.0
Mineral fuels	2.9	2.4	5.9	7.1
Sugars	9.8	3.8	1.5	3.9
Total	75.6	82.7	86.0	85.9
Honduras				
Textile and apparel	22.9	64.7	78.2	67.7
Machinery	0.0	0.5	2.3	10.2
Edible fruits and nuts	32.0	12.7	3.6	4.1
Fish and crustaceans	12.6	6.9	4.2	3.9
Total	67.4	84.8	88.2	86.0
Nicaragua				
Textile and apparel	0.0	57.2	51.7	57.6
Electrical machinery and equipment	0.0	0.0	0.0	8.3
Mineral fuels	4.1	0.0	0.0	7.2
Coffee and tea spices	0.1	10.0	1.5	5.8
Fish and crustaceans	36.1	18.1	20.0	5.7
Meat	0.0	3.7	3.7	3.7
Tobacco	2.3	1.8	0.5	2.2
Pearls	0.0	1.5	3.0	2.1
Sugars	47.9	2.4	3.0	1.8
Total	90.6	94.8	83.4	94.4

Source: MAGIC (2008).

TABLE A-2
RATE OF GROWTH OF GDP PER CAPITA (USING A FIVE YEAR ROLLING WINDOW) IN
LATIN AMERICA, 1960-2006

Country	1960-1970	1971-1980	1981-1990	1991-2001	2002-2006
Argentina	2,5	1,4	-2,8	2,6	3,9
Bolivia	0,5	1,5	-2	1,3	1,6
Brazil	3,3	6	-0,4	0,9	1,8
Chile	1,8	1,5	2,2	4,6	3,2
Colombia	2,3	3,1	1,5	0,7	2,9
Costa Rica	2,8	3	-0,1	2,4	3,6
Dominican Republic	2,9	4,5	0,4	3,9	3,3
Ecuador	1,3	4	-0,5	0,4	3,5
El Salvador	2,2	0	-1,4	2,2	0,8
Guatemala	2,7	3	-1,5	1,6	0,5
Honduras	1,6	2,2	-0,7	0,5	2
Mexico	3,4	3,7	-0,2	1,6	1,7
Nicaragua	3,5	-2,2	-3,7	1,2	2,2
Panama	4,8	1,5	-0,6	2,6	3,9
Paraguay	1,8	5,9	-0,2	-0,5	1
Peru	2,4	0,9	-2,7	1,9	4,2
Uruguay	0,4	2,7	-0,5	1,9	3,3
Venezuela, RB	1,5	-0,7	-1,8	0,2	2,7
Latin America	2,6	3,2	-0,4	1,4	2,2
South America	1,8	2,6	-0,7	1,4	2,8
Central America	2,9	1,2	-1,3	1,8	2,2

Source: Own computations on the basis of World Bank Development Indicators (2008a).

TABLE A-3
CURRENT ACCOUNT INDICATORS AS A PERCENTAGE OF GDP IN
LATIN AMERICA, 1980-1991-2006

	1980-1991	1992-2006
Current account balance	-1.88	-1.65
Exports of Goods	12.81	16.34
Imports of Goods	-10.09	-15.68
Balance of Trade	2.72	0.66
Balance of goods and services	1.70	-0.19
Income balance	-4.12	-2.67
Net unilateral transfers	0.54	1.22
Capital and financial account	0.05	2.36
Reserves	2.26	-0.43

Source: On the basis of ECLAC (2007) and World Bank Development Indicators (2008a).



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