

estudios y perspectivas

139

Institutional and policy
convergence with growth
divergence in Latin America

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Abstract

In the last decades Latin American countries, and very much related to the implementation of macroeconomic reforms, have seen a convergence in economic policy making, design, tool kits and objectives. This convergence has been rather generalized in the region with few exceptions. The paper explores the reasons why this convergence has not been reflected in a similar way on their economic performances. It pays special attention to the role played by institutional factors and by government policies in explaining the diversity in growth performance.

I. Policy and institutional convergence and divergent growth outcomes

A. Economic and political reforms since the debt crisis: Institutional and policy convergence

In the first decades of the postwar period, Latin America embraced a paradigm that placed the Developmental State at the center of the strategy, with industrialization, which was regarded at the time as critical to increase living standards, as the major objective. Over the past 30 years Latin America has experienced a major overhaul in economic policies and institutions as well as in political institutions. As a result, a “great transformation” has taken place, if we may appropriate Karl Polanyi’s expression for events of a different scale.

The major policy changes include far-reaching programs of economic reforms in different areas that gave a larger role to the private sector in the allocation of resources and greater scope to market forces and international competition, all this with the goal of entering a phase of strong export-led economic expansion. It is worth recalling what has happened. During and after the adjustment process to the debt crisis of

1982, monetary and fiscal policies were radically transformed. In 1980, in a group of 20 Latin American countries, ¹ none had an independent Central Bank. By 2012, a majority of countries (11) had an independent Central Bank. In addition in the largest countries (Brazil, Mexico, Chile, Colombia, and Peru) the central bank operated under an inflation targeting regime with a floating exchange rate and price stability as its sole mandate. ² Fiscal policy went through a similar overhaul. In 1980 no country had a balanced budget rule. By 2012, 8 countries had a balanced budget law, generally a strict commitment to balance the budget every year with the exception of Chile which had a structural budget rule which allowed for fiscal deficits during recessions provided that these were compensated by budget surpluses in boom periods (see table 1).

TABLE 1
LATIN AMERICAN COUNTRIES: CENTRAL BANK INDEPENDENCE AND FISCAL RULES, 2012

Country	Central Bank independence	Fiscal rule
Brazil	Yes, since 1988 ^a	B. B. since 2000
Chile	Yes, since 1989	Structural budget since 2000
El Salvador	Yes, since 1991	N. R.
Colombia	Yes, since 1992	B. B. since 1997
Honduras	Yes, since 1993	N. R.
Mexico	Yes, since 1993	B. B. since 2006
Peru	Yes, since 1993	B. B. since 1999
Paraguay	Yes, since 1995	N. R.
Uruguay	Yes, since 1995	N. R.
Ecuador	Yes, since 2002	B. B. since 2003
Guatemala	Yes, since 2002	N. R.
Argentina	Yes from 1992 to 2012	B. B. since 2000
Bolivia (Plurinational State of)	No	N. R.
Costa Rica	No	N. R.
Cuba	No	N. R.
Dominican Republic	No	N. R.
Haiti	No	N. R.
Nicaragua	No	N. R.
Venezuela (Bolivarian Republic of)	No	N. R.
Panama	No Central Bank	B. B. since 2002

Sources: IMF, Cottarelli (2009), Jácome and Vázquez (2005) and Central Bank websites.

^a Not formally independent but operates autonomously since 1988.

N. R. = No fiscal rule.

B. B. = Balanced budget.

Regarding structural reforms in other areas, the early and prominent components of the reform agenda were trade liberalization and deeper integration into the world economy based on comparative advantages, as well as a broad opening to foreign direct investment. As shown in table 2, tariffs were sharply reduced and the tariff structure radically simplified as non-tariff barriers were largely eliminated.

¹ This group of 20 countries includes those Latin American countries for which information is available in the Penn World Table. Table 1 shows these 20 countries.

² Inflation targeting regimes now prevail in major Latin American countries. Chile and Colombia were the pioneers having adopted inflation targets since 1990 and 1991 respectively. Peru introduced a floating exchange rate regime in 1994 and in 2002 the central bank replaced quantitative targets for monetary aggregates with inflation targets using the interest rate as the main instrument of monetary policy. After the 1994-1995 crisis, Mexico let the peso float and in 1999 moved to an inflation targeting regime eventually adopting a target interest rate as policy instrument. Brazil also joined this group of countries in 1999 after the exchange rate crisis of the beginning of that year.

The median average tariff which in 1985 was 42% fell to 5% in 2010 and the highest average tariff went down from 88% to 11%. These changes were so far-reaching that, as argued in Ocampo and Ros (2011), the objective of setting low tariffs was achieved to a much greater extent than in the classical period of primary export-led growth in the late 19th and early 20th centuries.

TABLE 2
OPENNESS TO INTERNATIONAL TRADE AND FOREIGN INVESTMENT, 1985-2010

Average tariff (%) ^a	1985	2010
Median average tariff	42	5
Highest average tariff	88 ^b (Dominican Republic)	11 Venezuela (Bolivarian Republic of)
Lowest average tariff	20 (Bolivia, Plurinational State of)	2 (C. Rica ^a and Nicaragua)
Foreign trade as % of GDP ^b	1980	2008
Median value	54.3	64.4
Highest value	177.9 (Panama)	156.5 (Panama)
Lowest value	11.5 (Argentina)	24.2 (Brasil)
FDI as % of total investment	1980	2009
Median value	4	13
Highest value	30 (Panama ^c)	37 (Chile)
Lowest value	0 (Cuba and Venezuela, Bolivarian Republic of)	-4 (Venezuela, Bolivarian Republic of)

Sources: For tariffs: Lora (2001), World Development Indicators. For Foreign trade: PWT.

For FDI: UNCTADSTAT.

^a Weighted mean to all products (%).

^b Openness at 2005 constant prices (%).

^c 2009 d: 1988 e: 1981.

A wave of FTAs or custom unions took place with NAFTA (1994) in the North and MERCOSUR (1991) in the South being the most important initiatives. Moreover, under the leadership of Mexico and Chile, a wave of bilateral or multilateral free trade agreements was launched. All this contributed to a sharp increase in the weight of international trade in the economy. As shown in table 2, the share of exports and imports in GDP increased for the median country from 54.3% to 64.4%. Some spectacular increases were recorded by Argentina (from 11.5% to 45.1%), Mexico (from 28.4% to 58.8%), Costa Rica (from 56.9% to 100.8%), and Paraguay (from 47.4% to 105.9%) (see table A.2 in Appendix). In turn, the relaxation of FDI regulations led to a sharp increase in the share of FDI in gross capital formation. The median country increased this share from 4% to 13% (see table 2) and for some countries this share rose to over 30% (table A.3 in Annex).

Trade and FDI liberalization were accompanied, in addition, by the elimination of exchange controls and domestic financial liberalization. The latter included the liberalization of interest rates, the elimination of most forms of directed credit, and the reduction and simplification of reserve requirements on bank deposits. Although it was also accepted that financial liberalization required regulation to avoid the accumulation of excessive risks in the financial system, the full acceptance of the need for regulation only came after a fair number of domestic financial crises (in particular the Tequila crisis of 1994-1995).

Another component in the agenda of structural reforms was the privatization of a large set of public enterprises together with the opening to private investment of public services and utilities sectors. The more general deregulation of private economic activities was also part of the agenda. The privatization process was more gradual than in the case of trade liberalization and a number of countries

kept public sector banks and a number of other firms, notably in oil and infrastructure services (water and sewage more than electricity and telecommunications).

There was, finally, an agenda of at least partial liberalization of labor markets, but here political factors limited the scope the reform proposals (Murillo and others, 2010). Even then, as many as 13 countries in our group of 20 undertook changes in labor market regulations with the aim of making the labor market more flexible (see table 3).

TABLE 3
LATIN AMERICAN COUNTRIES: LABOUR MARKET REFORMS, 1984-1999

Country	
Haiti	Yes (1984)
Brazil	Yes (1985)
Colombia	Yes (1990)
Guatemala	Yes (1990)
Argentina	Yes (1991)
Peru	Yes (1991)
Dominican Republic	Yes (1992)
Paraguay	Yes (1993)
El Salvador	Yes (1994)
Chile	Yes (1995)
Panama	Yes (1995)
Nicaragua	Yes (1996)
Ecuador	Yes (1997)
Venezuela ((Bolivarian Republic of)	Yes (1999)
Bolivia (Plurinational State of)	No
Costa Rica	No
Cuba	No
Honduras	No
Mexico	No
Uruguay	No

Source: Vega (2005); Lora y Pagés (1996) and NATLEX, International Labor Organization. Implementation year in parentheses.

Changes in political regimes went hand in hand with economic liberalization. Following Przeworski (2004) criteria to classify a political regime as authoritarian or democratic, table A.4 in the Annex shows that in 1980 there were only four countries (Colombia, Costa Rica, Ecuador, and Venezuela, Bolivarian Republic of) with democratic political regimes so that 85.1% of the population of the 20 Latin American countries lived under authoritarian regimes. In 2009, only one country (Cuba) continued to be authoritarian, representing 2% of the total population.

Moreover, perceptions about the rule of law in Latin America, available for 1996 to 2010 from Worldwide Government Indicators (WGI), show a steady improvement since 1996. The percentile rank of Latin American countries improved from 1996 to 2009 (see table 4), with only 6 exceptions (Argentina, Plurinational State of Bolivia, Ecuador Nicaragua, Paraguay and Venezuela, Bolivarian Republic of) plus a minor fall for highly ranked Costa Rica.

TABLE 4
LATIN AMERICAN COUNTRIES: PERCENTILE RANK FOR RUE OF
LAW INDICATOR, 1996 AND 2009

Country	1996	2009	Change
Chile	85	87	+2
Uruguay	65	70	+5
Costa Rica	68	65	-3
Panama	49	51	+2
Brazil	40	50	+10
Colombia	20	41	+21
Dominican Republic	41	48	+9
Mexico	30	35	+5
Cuba	18	35	+17
Argentina	55	30	-25
Peru	30	30	0
El Salvador	20	22	+2
Nicaragua	35	22	-13
Honduras	20	20	0
Paraguay	21	19	-2
Bolivia (Plurinational State of)	47	13	-34
Guatemala	12	13	+1
Ecuador	36	10	-26
Haiti	5	5	0
Venezuela (Bolivarian Republic of)	20	2	-18

Source: Worldwide Government Indicators (WGI). The WGI are produced by: Daniel Kaufmann, Brookings Institution, Aart Kraay, World Bank Development Research Group, Massimo Mastruzzi, World Bank Institute.

B. An initial comparison with the period of state led industrialization

The economic growth performance of Latin America since the 1980s is clearly weaker than that of the previous development phase. This is true even if we leave aside the “lost decade” of the 1980s. For the period 1990-2008, the average of Latin America’s per capita GDP growth rate has been 1.8% per year, well below the growth rate of the period 1950-1980 (2.7%) and less than the average growth rate of the world economy. The growth performance of GDP per worker, a gross measure of productivity, is even worse: 0.7% per year for 1990-2008 vs. 2.7% in 1950-1980. This means that most of the increase in GDP per capita since 1990 has been the result of the demograph bonus resulting from the slowdown of population growth (from 2.7% to 1.5%) in the face of a still relatively fast growth of the labor force (2.6% per year, a rate similar to the 2.8% of 1950-1980) (see Ros, 2009).

Table 5 indicates that only a few countries have experienced a dynamic growth of productivity at rates above 2% per year since 1990. Only 4 out of 19 countries (Dominican Republic, Peru, Chile and Uruguay), had a better growth performance than in the period 1950-1980 while at the same time having an equal or faster growth than the United States for 1990-2008. Most countries recorded growth rates below that of the US and a poorer growth performance in 1990-2008 than in 1950-1980. This poor overall productivity performance is not due to the absence of new dynamic and highly productive

activities; it is rather the reflection of the rising share of low-productivity informal activities, as the dynamic highly productive sectors were unable to absorb a larger share of the labor force (Ros, 2011).

TABLE 5
LATIN AMERICAN COUNTRIES: GROWTH PERFORMANCE, 1990-2008
(Relative to 1950-1980)

	Above	Below
Relative to USA	Dominican Republic (2.9)	<i>Panama</i> (2.8)
	Peru (2.9)	<i>El Salvador</i> (2.7)
	Above Chile (2.3)	<i>Nicaragua</i> (2.1)
	Uruguay (2.2)	
Average 1990-2008 (1.8%)		Argentina (1.7)
		<i>Honduras</i> (1.5)
		Costa Rica (1.1)
		Brazil (1.0)
	Below	Colombia (1.0)
		Guatemala (0.8)
		Bolivia (Plurinational State of) (0.6)
		Mexico (0.6)
		<i>Paraguay</i> (-0.1)
		Ecuador (-0.1)
		Venezuela (Bolivarian Republic of) (-0.2)
	<i>Haiti</i> (-1.1)	

Source: WDI and Maddison (2007, 2009).

In parentheses, growth rates (1990-2008) of GDP per person employed. Countries in italics show GDP per capita growth rate since for these countries GDP per person employed is not available.

It is worth noting that, when looking across countries, there is no apparent relationship between the degree and timing of market liberalization and growth performance. The countries in the northwest box with two of the best performances are Chile, an early reformer, and the Dominican Republic, a late reformer. Interestingly, these two countries have also two very different macroeconomic frameworks: while Chile has an independent central bank and a structural balanced budget rule, the Dominican Republic has none of this (see table 1). Interestingly, all of the fast growing economies under State-led industrialization, with thoroughly liberalized economies, have now underperformed in relation to the past and the United States, with the major exceptions of the Dominican Republic and Panama. It is also worth noting that this economic performance was affected not only by the poor results of the market reforms but also by worldwide macroeconomic turbulence. The collapse of growth during the lost decade of the 1980s was followed by a recovery in 1990-1997, although at a slower pace than during the years of State-led industrialization, and then by the “lost half decade” of 1998-2003. As a result, the relative position of Latin America in the world economy went back in 2003 to the levels of 1900! (see Ocampo and Ros, 2011). The combination of a new surge in external financing, the emergence of China as a new major purchaser of raw materials, and the increase in commodity prices, which had been absent since the 1970s, generated a new boom in 2004-2007, at a pace that was then more similar to that of the 1970s. The global crisis in 2008-2009 suddenly interrupted the recovery after 2003, bringing about a deep recession in 2009, second only to that of Central and Eastern Europe, among the emerging and developing countries.

C. Causes of slow growth: Bad governments or good governments with bad policies?

The factors explaining why some Latin American countries benefited more than others from the policy and institutional changes are to a large extent idiosyncratic. I will return below to this question. There were nevertheless some common factors behind the generalized failure to accelerate growth in the region, compared to the historical performance in 1950-1980. One such factor was a wrong diagnosis of the debt crisis. The reform overhaul was rooted in many policymakers' view that the 1982 debt crisis was the unavoidable consequence of the years of trade protectionism and heavy state intervention that had marked—and in their view distorted—Latin America's development during the postwar period. Thus, this crisis, which started with the Mexican moratorium of August 1982, was taken to be a crisis of the whole post war strategy of State-led industrialization. In fact, this was simply wrong. In countries with a large public external debt, such as Brazil and Mexico, the source of the problem was unsustainable macroeconomic policies, in particular fiscal policy, which led to a debt crisis (like today's European debt crisis) when the creditor banks realized that Mexico, facing a decline in oil prices since the beginning of 1981 and higher interest rates as a result of the tight monetary policy in the United States (the Volcker shock), would not be able to repay the debt. The same perceptions were then extended to the rest of Latin America. It is ironic that the diagnosis was most clearly contradicted by the problems of the Southern cone (Chile, Argentina and Uruguay) which had abandoned import substitution and embarked in a path of economic liberalization since the mid 1970s and suffered a crisis in the early 1980s, not as a result of large fiscal deficits, but rather of increasing problems in their banking sectors and a rapid expansion of private external debt very much like the one that preceded the Tequila crisis of 1994-1995.

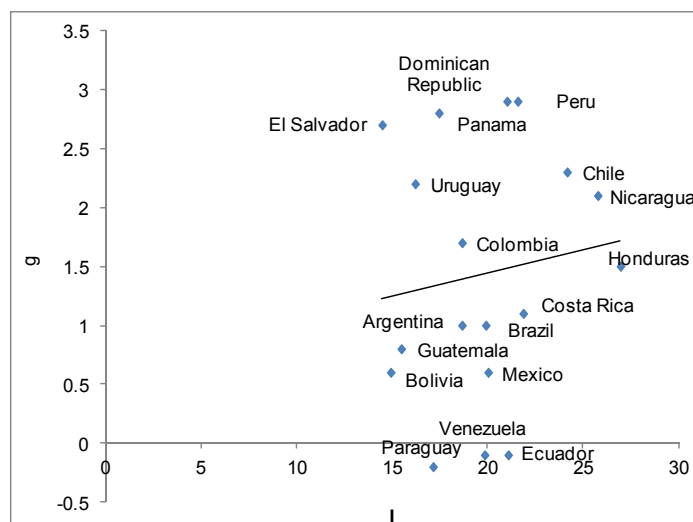
There were also problems of implementation coupled with an excessive optimistic view of the potential of structural reforms to trigger a resumption of growth. Trade liberalization, for example, was seen as a sufficient condition for export-led growth and was not accompanied by a depreciation of the real exchange rate as had been recommended by the advocates of export led growth such as Balassa and Baghwati, as well as, in fact, Williamson's Decalogue (where a competitive exchange rate was part of the 10 point program). Similarly, financial liberalization as it was undertaken proved a disaster leading eventually to the Tequila crisis. This was because the lessons from the Southern cone financial crisis of the early 1980s (that were analyzed by Diaz-Alejandro and Frenkel in the early 1980s) were simply not learnt.

The most important point to make here is that the slow down in growth took place in the midst of positive institutional changes, including, as already emphasized, changes in the direction of so called inclusive political and economic institutions (democracy, the rule of law, and economic liberalization, see Acemoglu and Robinson, 2012). The failure to accelerate growth cannot be blamed on bad governments. It has to be the result of bad policies undertaken by good governments.

What were the policy failures? There were several but let me focus on one. As graph 1 shows there is a correlation between growth of GDP per person employed and the investment rate (as a fraction of GDP). The correlation is not close due to idiosyncratic factors, but it is clearly positive. Countries that managed to invest more tended to grow faster than the rest. These investment rates fell in virtually all Latin American countries as a result of the fiscal adjustments that followed the debt crisis of 1982, adjustments that brought about a collapse of public investment almost everywhere (see graph 2). In some countries the low levels of public investment persisted after the recovery of the 1990s. In others, public investment recovered. As can be seen in figure 2, the key and striking difference between those in which GDP per person employed grew above 1.8% per year (the US rate), such as Panama, Peru and Uruguay, and those

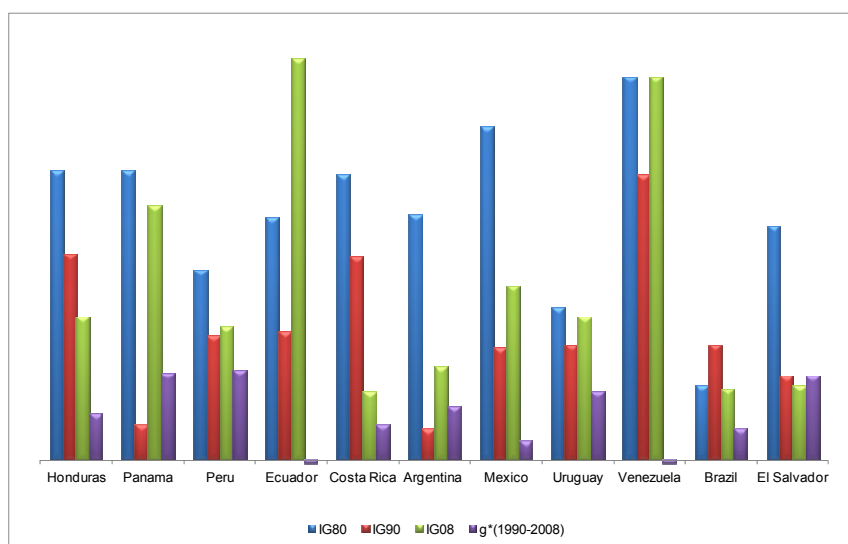
that failed to do so is that the first tended to recover the levels of public investment pre-debt crisis while most of the second did not.³ This is bad policy not a manifestation of bad institutions.

GRAPH 1
LATIN AMERICAN COUNTRIES: INVESTMENT (I) AND GROWTH (G)



Sources: The data on investment for Argentina and Venezuela (Bolivarian Republic of), the data is from CEPALSTAT, Economic Commission for Latin America and the Caribbean. For the rest of the countries the date is from World Development Indicators, World Bank. The GDP annual average growth rates are from the World Development Indicators.

GRAPH 2
LATIN AMERICAN COUNTRIES: PUBLIC INVESTMENT AS % OF GDP



Sources: IG. For Argentina and Venezuela (Bolivarian Republic of), the data is from CEPALSTAT, United Nations Economic Commission for Latin America and the Caribbean. For the rest of the countries the date is from World Development Indicators, World Bank.

g*: Labour productivity growth rate; IG: Public investment as % of GDP.

³ The recovery of public investment was not, however, a sufficient condition (see Ecuador, Bolivarian Republic of Venezuela, Brazil).

II. The role of industrial policy and macroeconomic reform

Trade liberalization was accompanied by the dismantling of state intervention in productive development that characterized the previous period, not only in the manufacturing sector but also in agricultural development. This vision was succinctly summarized by a lemma that was repeated in several contexts: “the best industrial policy is *not* to have an industrial policy”. In the application of this precept, technology policy, on which little progress had been made in the previous development phase (except, perhaps, in some agricultural research institutions), was also set aside, despite the fact that this is an element of intervention around which there is greater consensus. Trade liberalization and the dismantling of productive development policies was based on a number of arguments: the negative effects of protection on static efficiency (by moving the economy away from specialization according to comparative advantage and closing it off from external competition) as well as the encouragement of rent-seeking behavior as firms devoted resources to gaining advantages rather than increasing their efficiency.

A. Heterogeneous growth outcomes and the reversal of fortune

As shown in table 6 when we compare the rankings in the growth tables for the periods 1950-1980 and 1990-2008, a “reversal of fortune” is apparent: countries, such as Chile, Argentina, Uruguay, that were in the bottom half in the growth table in the period 1950-1980, call them the “losers from ISI”, tend to be in the upper half of the growth table in

1990-2008. And vice versa, countries such as Brazil, Mexico, Ecuador, Guatemala, the winners from ISI, tend to be in the bottom half of the table for the period 1990-2008. In fact there are only a few visible exceptions to this pattern, the Dominican Republic and Costa Rica which are in the upper half in both periods, and Venezuela (Bolivarian Republic of) and Haiti, which are in the bottom half in both periods. Excluding these 4 countries, the Spearman rank correlation coefficient is -0.11 .

TABLE 6
LATIN AMERICAN COUNTRIES: GDP AND GDP PER CAPITA GROWTH, 1950-1980 AND 1990-2008

1950-1980					1990-2008			
GDPpC Ranking		GDP	GDPpC	A	GDPpC Ranking		GDP	GDPpC
1	<i>Brazil</i>	6.6	3.8	16	1	Chile	4.8	3.6
2	Panama	6.2	3.5	5	2	Dominican Republic	5.2	3.6
3	Costa Rica	6.5	3.2	3	3	Costa Rica	4.7	2.9
4	<i>Mexico</i>	6.2	3.2	9	4	Peru	4.5	2.8
5	Dominican Republic	5.7	2.6	18	5	Cuba	3.0	2.6
6	<i>Ecuador</i>	5.5	2.6	11	6	Argentina	2.8	1.7
7	Guatemala	5.2	2.5	7	7	Guatemala	3.7	1.6
8	<i>Colombia</i>	5.1	2.2	2	8	Panama	3.4	1.6
9	Peru	4.9	2.1	12	9	El Salvador	3.4	1.6
10	<i>Paraguay</i>	4.7	2.1	13	10	Nicaragua	3.8	1.6
11	<i>Argentina</i>	3.7	2.1	4	11	Mexico	3.0	1.6
12	<i>El Salvador</i>	5.0	2.0	14	12	Bolivia (Plurinational State of)	3.5	1.4
13	<i>Nicaragua</i>	5.0	1.8	1	13	Brazil	2.8	1.4
14	Bolivia (Plurinational State of)	3.8	1.5	19	14	Uruguay	1.9	1.3
15	Honduras	4.4	1.5	8	15	Colombia	2.8	1.1
16	<i>Chile</i>	3.2	1.1	15	16	Honduras	3.6	1.0
17	Venezuela (Bolivarian Republic of)	4.7	1.1	17	17	Venezuela (Bolivarian Republic of)	1.9	0.3
18	<i>Cuba</i>	2.5	0.6	10	18	Paraguay	2.2	-0.4
19	Uruguay	1.4	0.4	6	19	Ecuador	1.0	-0.9
20	Haiti	1.9	0.1	20	20	Haiti	0.2	-1.7
	L. America*	5.3	2.6			L. America*	3.0	1.5
	USA	3.6	2.3			USA	3.0	1.9

Source: *Angus Maddison project's web page* (2012), Historical Statistics of the World Economy: 1-2008 AD, <http://www.ggd.c.net/MADDISON/oriindex.htm>. References: Currency Unit: 1990 Geary-Khamis dollars. A: GDPpC Ranking 1950-1980. *Also includes Puerto Rico, Trinidad y Tobago and Jamaica.

What accounts for differences in growth performance in that period and in the recent period? I will argue in this section that part of the explanation for this reversal of fortune has to do with the consequences of the abandonment of industrial policy. For that, we need to look at how industrial policy worked during the previous State-led industrialization period

A first factor accounting for differences in growth rates and the relative success of industrial policy in the period of state led industrialization has to do with the size of the economy. It can not be a coincidence that Brazil and Mexico, the two most populous countries, were those able to sustain the highest rates of industrialization during the second, more difficult phase of import substitution, in which industrialization expanded into heavy intermediates (steel and petrochemicals) and capital goods as well as capital intensive consumer durables.⁴ The size of their domestic markets is probably a major factor. For it allowed industrial sectors with high fixed costs (associated to their capital intensity), and as a

4 As shown in table 6, Mexico is second only to Brazil in the rate of expansion of GDP although it is tied in fourth place behind Panama and Ecuador in terms of growth of output per capita.

result strong economies of scale, to be established while it attracted the foreign investment required to set up these capital and technology intensive industries. In other countries, the opportunities for import substitution were concentrated in light consumer goods and intermediate goods with low capital and technology intensity and attempts to go into the “difficult phase” could result in highly inefficient industrial sectors. In the case of the Southern cone economies with a relatively high degree of industrialization in 1950, the opportunities for easy import substitution were non-existent or disappeared very soon (given, precisely, their relatively advanced industrial sectors).

A second factor affecting the efficiency of industrialization policies has to do with the nature of the domestic economy. Diaz Alejandro (1988) highlights this factor in his comparison of the economic histories of Argentina and Brazil. Brazil was a dualistic economy, a Lewis-type economy. In Arthur Lewis’ model of economic development there is a surplus of labor which generates an elastic supply of labor to the modern sector of the economy. This was important for the process of reallocation of labor in Brazil. The expansion of the industrial sector meant that the process of industrialization caused labor to move from low productivity sectors to high productivity sectors (from the “subsistence” to the industrial sector). These productivity gains were behind the rapid increases in GDP per worker and per capita. Argentina, by contrast, was a mature economy in which most sectors were modern and there was not a large subsistence sector. Productivity levels were similar across economic activities. This meant that the economy couldn’t benefit from the reallocation of labor from low to high productivity sectors. Rather, the expansion of the industrial sector caused labor to be taken away from the modern export sector. Because industrialization crowded out labor in the export sector, the anti-export bias was higher in Argentina.

A third factor refers to the role of export promotion policies and exchange rate policy and how successful was the transition to the “mixed model” of import substitution cum export promotion. It is worth noting that four of the fast growing economies are among the six that started experimenting with export promotion policies sometime in the 1960s or early 1970s (Bulmer-Thomas, 2003) and the two with crawling pegs (Colombia and Brazil). That is, all of the slow growing economies with only 2 exceptions were not early adopters of export-promotion policies. In the case of the countries with large domestic markets (Brazil, Mexico, and to a lesser extent Colombia) the success of export promotion policies was facilitated by the smaller anti-export bias generated by the protection of intermediate and capital goods (to the extent that required tariffs were smaller). All this suggests a role in growth outcomes for the type of industrialization policy adopted.

It is not a coincidence that Brazil and Mexico, the only two countries to share these three features (large size, labor surpluses and export promotion policy) are precisely the two countries at the top of the growth table (see table 6).⁵ It is these countries that benefited most from the productivity gains associated with the reallocation of labor towards the industrial sector and modern services. And I think this is the explanation for why the dismantling of industrial policy has harmed these two countries the most. In the period 1990-2008, they are clearly in the bottom half of the growth table.

This is part but not all the explanation for the “reversal of fortune” that characterizes the recent period since 1990 in comparison to the period 1950-1980. It turns out, as shown in table 7, that the most prosperous economies since 1990 are those that have specialized in natural resource intensive products taking advantage of their static comparative advantage given by their abundance of natural resources. Table 7 ranks countries according to net primary exports as a percentage of GDP, a frequently used indicator of abundance in natural resources (see for example Sachs and Warner, 2001). The association between abundance and natural resources and growth since 1990 is remarkable. These resource rich

5 Note that the rankings in table 6 differ from those in table 5 which uses the more appropriate concept for growth comparisons of GDP per person employed. Data for this is only available from 1980.

economies were the ones able to compensate the employment and output losses in manufacturing industries, an option that was not available to countries that were poorer in natural resources. There were, of course, exceptions such as the Dominican Republic a country whose comparative advantages are assembly of manufactures and tourism given by its location advantage.

TABLE 7
LATIN AMERICAN COUNTRIES: NATURAL RESOURCE ABUNDANCE
AND GROWTH, 1990-2008

Country	Net exports of primary goods 2009 ^a	Growth rate 1990-2008 ^b
Chile	29	2.3
Bolivia (Plurinational State of)	27	0.6
Ecuador	24	-0.1
Honduras	22	1.5
Nicaragua	20	2.1
Paraguay	20	-0.1
Peru	18	2.9
Venezuela (Bolivarian Republic of)	17	-0.2
Uruguay	13	2.2
Argentina	12	1.7
Guatemala	11	0.8
Colombia	10	1.0
Costa Rica	8	1.1
Mexico	6	0.6
Brazil	6	1.0
El Salvador	5	2.7
Panama	4	2.8
Dominican Republic.	3	2.9

^a Net exports of primary goods as % of GDP (WDI)

^b Growth rate of GDP per person employed (WDI)

The information for Cuba and Haiti was not available. GDP per capita italics.

The dismantlement of industrial policy was thus a big mistake. The best industrial policy, at least in the larger and poorer economies in natural resources, is not “not to have an industrial policy”.

B. Appreciating real exchange rates, falling industrial profitability and deindustrialization

Another big mistake has been to let real exchange rates appreciate rather than compensating trade liberalization and the dismantling of industrial policy with a relatively undervalued real exchange. This has meant that the region has been recurrently infected by the Dutch disease (appreciation caused by booms of natural resource intensive exports) and by the Mexican disease (appreciation caused by massive capital inflows).

Let us look at the Dutch disease in recent periods. The fast growing countries included in table 8 are either those rich in natural resources (Chile, Peru and Uruguay) or those which avoided a dramatic process of deindustrialization (Dominican Republic, Panama, and El Salvador).

In the case of the natural resource rich countries, the dynamism of the Chinese economy and of the world demand for raw materials have had so far favorable short term effects on economic growth (see Ros, 2012). The medium and longer-term developmental consequences of the raw materials export

boom will depend, however, on its effects on real exchange rates and the profitability of the non resource intensive tradable goods sectors, that is on whether a Dutch disease is developing in the region. As shown in graph 3, the raw materials export boom has been accompanied by a substantial appreciation of real exchange rates in Latin America sometime after the beginning of the past decade, only briefly interrupted by the temporary depreciations that took place in 2008 and early 2009 as a consequence of the international financial crisis, the “flight to quality”, and the increase in risk spreads in emerging markets.

TABLE 8
LATIN AMERICAN COUNTRIES: SHARE OF MANUFACTURING
IN GDP (%), 1990-2010 ^a

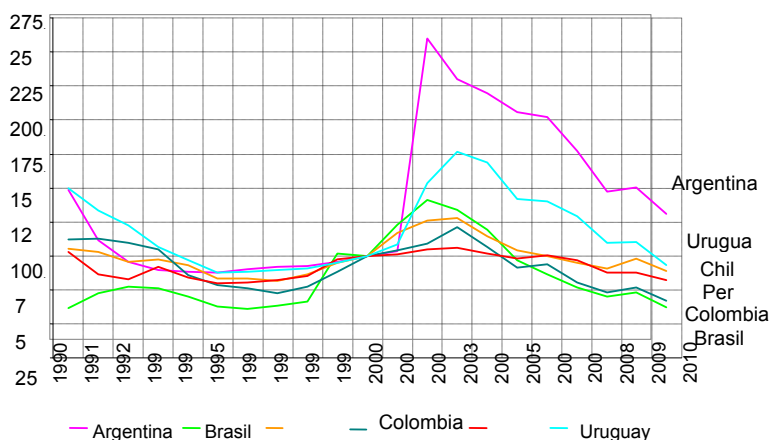
Country	1990	2010 ^b	Change
Uruguay	28.0	15.0	-13.0
Brazil ^c	27.4	15.8	-11.6
Chile	19.6	11.5	-8.1
Argentina	26.8	20.5	-6.3
Colombia	20.6	15.1	-5.5
Costa Rica	22.6	17.4	-5.2
Bolivia ((Plurinational State of)	18.5	13.9	-4.6
Paraguay	16.8	12.2	-4.6
Panama	9.7	6.1	-3.6
Mexico	20.8	18.1	-2.7
El Salvador	22.1	20.6	-1.5
Peru	17.8	16.6	-1.2
Venezuela (Bolivarian Republic of)	14.9	14.7	-0.2
Cuba	7.7	9.6	1.9
Honduras	16.3	18.4	2.1
Dominican Republic	18.0	24.1	6.1
Median	19.0	15.8	-3.2
Mean	19.2	15.7	-3.5

Source: WDI, World Bank.

^a Manufacturing value added as percentage of gross value added at factor cost.

^b 2010 or last available data. ^c Average of 1989 and 1991.

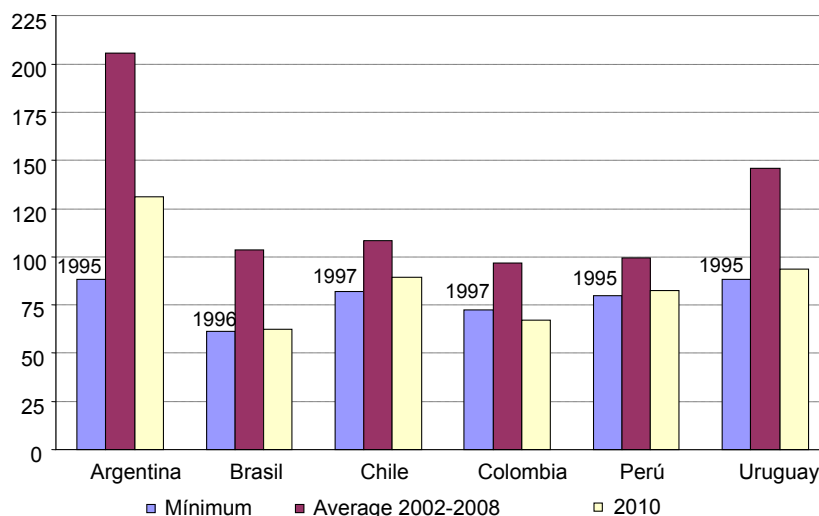
GRAPH 3
LATIN AMERICAN COUNTRIES: REAL EXCHANGE RATES IN SEVERAL
SOUTH AMERICAN COUNTRIES, 1990-2010



Source: Frenkel and Rapetti (2011). Bilateral rates vis a vis the United States (100 = 2000).

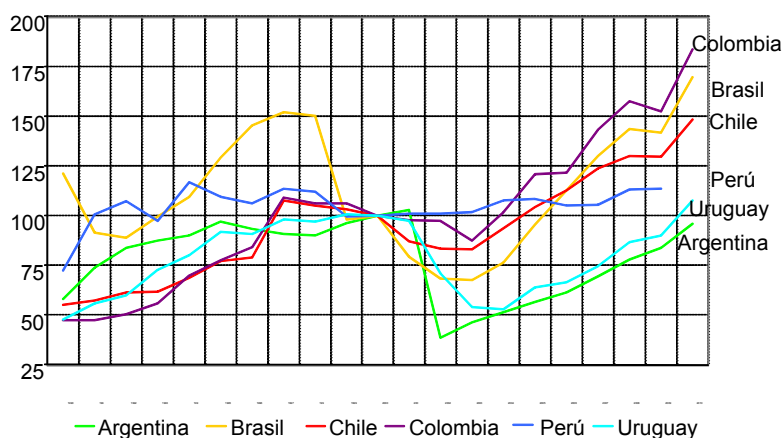
Graph 4 assesses the extent of appreciation by comparing the level of the real exchange rate in 2010 with its average level for the period 2002-2008 and the minimum level (i.e., the most appreciated level) in the 1990s. With the exception of Argentina, real exchange rates in 2010 were similar or lower than the minimum levels of the 1990s and well below (including Argentina) the average levels of 2002-2008. The primary exports boom has led to a decline the profitability of the industrial sector. As shown in figure 5, in several of South American countries, unit labor costs in dollars tended to increase after 2002-2003 in a substantial and sustained way suggesting that, at least for the labor intensive tradable goods sectors, there is an important problem of competitiveness and profitability.

GRAPH 4
LATIN AMERICAN COUNTRIES: REAL EXCHANGE RATES IN SOUTH AMERICAN COUNTRIES.
MINIMUM LEVEL OF THE 1990's, AVERAGE OF 2002-2008 AND 2010



Source: Frenkel and Rapetti (2011). Bilateral rates vis a vis the United States (100 = 2000).

GRAPH 5
LATIN AMERICAN COUNTRIES: UNIT LABOUR COSTS IN US DOLLARS
SOUTH AMERICAN COUNTRIES (2000 = 100)



Source: Frenkel and Rapetti (2011).

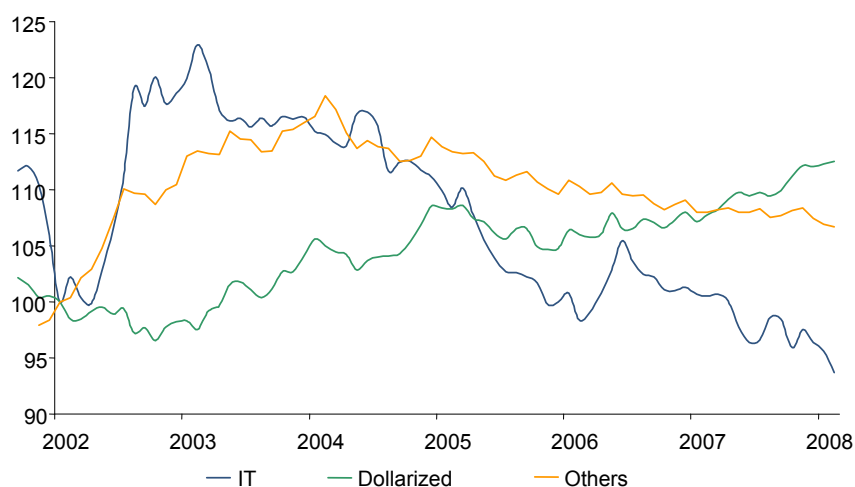
C. Can macroeconomic policy be a substitute for industrial policy?

The relationship between the real exchange rate and the rate of economic growth has been receiving a great deal of attention in recent times after the extraordinarily high growth rates achieved by countries that have deliberately undervalued their real exchange rates (this is the case of China) and the slow growth rates experienced by a large number of countries with overvalued exchange rates. In the absence of an industrial policy, and given the current institutional weakness to implement such a policy, can macroeconomic policy be a good substitute?

As noted by Kaldor and others, a high real exchange rate is equivalent to a tariff on imports and an export subsidy. Both of these, tariff and subsidy, benefit the tradable goods sectors, manufacturing being the largest of them in most countries. To counteract the adverse developmental effects of the Dutch and Mexican diseases and in this way act as a partial substitute for industrial policy, macroeconomic policy must fulfill certain requirements.

Since the adverse effects of those diseases arise mostly from the real exchange appreciation that accompanies the expansion of primary exports or the massive capital inflows and its crowding out effects on non resource based tradable sectors, exchange rate policy has a crucial role to play in neutralizing these effects. If this is so, the inflation targeting regimes currently fashionable in Latin America are not well prepared for the task of addressing those adverse developmental consequences. In fact, under this regime there seems to be a built in bias towards the appreciation of the exchange rate. Graph 6 shows the evolution of real exchange rates in Latin America in 3 groups of countries according to monetary policy regime (inflation targeting cum floating exchange rates, dollarized regimes, and others). As shown in the figure, the trend towards real appreciation in the period 2002-2008 was much more marked in countries with inflation targeting regimes than in the other two groups of countries.

GRAPH 6
REAL EXCHANGE RATES IN LATIN AMERICAN COUNTRIES
ACCORDING TO MONETARY POLICY REGIME, 2002-2008



Source: Ize (2008).

This built in bias towards appreciation may be due to various reasons. First, under inflation targeting (especially in its “strict form”) monetary policy focuses on achieving low inflation using the interest rate as the main policy instrument while ignoring other policy objectives such as employment and growth. Given the relatively large impact of the nominal exchange rate on the price level (relative to

that of the impact of the interest rate operating on interest sensitive components of aggregate demand, as argued below), it becomes in these conditions very tempting for central banks to subordinate the exchange rate to their inflation objectives or to respond in a non symmetrical way to appreciations and depreciations.⁶ Second, due to the shallowness of credit markets in developing countries the sensitivity of aggregate demand to interest movements is low and therefore central banks may need to raise interest rates excessively to achieve the inflation target. High interest rates then attract capital inflows which tend to appreciate the domestic currency.

Freeing monetary policy from the straight jacket of inflation targeting is thus a precondition for targeting the exchange rate. This may require the use of sterilized interventions in the foreign exchange market and the adoption of capital account regulations. However, these policies face limitations as sterilization may run into significant quasi-fiscal costs and capital inflows may find ways to circumvent regulations. Moreover, financial integration implies that when exchange rate policy is trying to pursue a real exchange rate target, monetary policy is no longer completely autonomous. In addition, while exchange rate management can affect closely the absolute price of tradable goods it faces more difficulties when it comes to affect the relative price of tradables vis a vis non-tradables and labor. If instead of generating a real depreciation, nominal devaluations led to rises in domestic prices, the devaluation-inflation spiral resulting from engaging in further devaluations can have deleterious effects on capital accumulation and growth.

All this means that the job of counteracting the Dutch and Mexican diseases requires not only giving monetary policy a greater room for maneuver in order to target the exchange rate but also policy coordination through the help, in particular, of fiscal policy and wage management policies. Indeed, fiscal policy may have to play a more preponderant role in managing domestic aggregate demand and in restraining, in particular, inflationary pressures in the non-tradable goods sectors (see, on the subject, Eichengreen, 2007; Frenkel, 2008; and Rapetti, 2011). Since part of the real appreciation associated to the Dutch disease arises from the spending out of natural resource rents on non tradable goods and services, or, in the case of the Mexican disease, from the expansion of credit resulting from massive capital inflows, counteracting this may require an increase in the fiscal surplus in order to moderate the pace of non-tradable demand growth. The required increase in the fiscal surplus can be generated through tariffs or taxes on the primary exports which are at the origin of the Dutch disease (see, on the subject, Bresser-Pereira, 2008 and 2011).

Wage management policies that coordinate the pace of real wage increases with the rate of productivity growth in the tradable goods sector can also help in restraining inflationary pressures in non-tradable goods prices and in containing the growth of unit labor costs, thus preventing the fall in profitability and capital accumulation in non resource intensive tradable goods sectors. As argued in Ros (2011), while a higher real exchange rate implies that in the short run real wages are lower than otherwise, it will nevertheless lead to higher real consumption wages in long run equilibrium as a result of the endogenous productivity growth effects of capital accumulation in the tradable goods sectors and of the absorption of employment from non tradable goods sectors. The mechanisms connecting an initially higher real exchange rate and a higher value of the real wage in the steady state are the presence of increasing returns to scale in the tradable goods sector and of diminishing returns to labor in the non tradable goods activities.

6 The so called “fear of floating” may also contribute to this non symmetrical response and to a pro-cyclical management of interest rates. For a critical discussion of the suitability of inflation targeting for developing countries, see Epstein and Yeldan (2009) and Rapetti (2011). On the non symmetrical response of monetary policy to exchange rate shocks in the Mexican case, see Galindo and Ros (2008), and in the case of Brazil, see Barbosa-Filho (2008).

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Annex

TABLE A-1
LATIN AMERICAN COUNTRIES: TRADE POLICY CHANGES:
AVERAGE TARIFF, 1985 AND 2010 (%)^a

Country	1985	2010
Argentina	28	6
Bolivia (Plurinational State of)	20	5
Brazil	80	8
Chile	36	4
Colombia	83	9
Costa Rica	53	2 ^a
Cuba		6
Dominican Republic	88 ^b	5 ^c
Ecuador	50	6
El Salvador	23 ^d	5
Guatemala	50	2
Haiti	11 ^e	9
Honduras	42 ^f	5 ^a
México	34	6
Nicaragua	54	2
Panama	101 ^g	8 ^a
Paraguay	71	4
Peru	64	3
Uruguay	32	4
Venezuela (Bolivarian Republic of)	30	11

Source: Lora (2001), World Development Indicators.

Notes: a/ Weighted mean to all products (%). a) 2009; b) 1988; c) 2008; d) 1986; e) 1993, f) 1989, and g) 1997.

TABLE A-2
LATIN AMERICAN COUNTRIES: FOREIGN TRADE
AS % OF GDP, 1980 AND 2008

Country	1980	2008
Argentina	11.5	45.1
Bolivia (Plurinational State of)	46.0	82.9
Brazil	15.9	24.2
Chile	49.3	85.7
Colombia	31.2	40.0
Costa Rica	56.9	100.8
Cuba	62.8	44.9
Dominican Republic	78.8	64.7
Ecuador	50.8	75.5
El Salvador	67.4	73.6
Guatemala	66.5	64.1
Haiti	78.8	54.8
Honduras	100.0	136.5
México	28.4	58.8
Nicaragua	61.2	104.7
Panama	177.9	156.5
Paraguay	47.4	105.9
Peru	56.4	53.4
Uruguay	36.7	62.7
Venezuela (Bolivarian Republic of)	52.2	51.8
Average	58.8	74.3

Source: PWT. Openness at 2005 constant prices (%).

TABLE A-3
LATIN AMERICAN COUNTRIES: FDI AS % OF GROSS FIXED CAPITAL
FORMATION, 1980 AND 2009

Country	1980	2009
Argentina	4	6
Bolivia (Plurinational State of)	12	15
Brazil	4	10
Chile	4	37
Colombia	2	13
Costa Rica	4	22
Cuba	0	0
Dominican Republic	6	32
Ecuador	3	3
El Salvador	4	13
Guatemala	8	12
Haiti	5	5
Honduras	1	15
Mexico	4	8
Nicaragua	6	22
Panama ^{a/}	30	30
Paraguay	3	8
Peru	1	19
Uruguay	12	26
Venezuela (Bolivarian Republic of)	0	-4

Source: UNCTADSTAT.

Note: a/ 1981.

TABLE A-4
LATIN AMERICAN COUNTRIES: TYPE OF POLITICAL REGIME AND POPULATION
BY COUNTRY 1980 AND 2009

Country	Authoritarian regime 1980	Population by 1980 (thousands)	Authoritarian regime 2009	Population by 2009 (thousands)
Mexico	Yes	68,347	No	111,212
Chile	Yes	11,094	No	16,602
Argentina	Yes	28,370	No	40,914
Cuba	Yes	9,653	Yes	11,110
Costa Rica	No	2,299	No	4,455
Uruguay	Yes	2,930	No	3,294
Panama	Yes	1,960	No	3,360
Venezuela (Bolivarian Republic of)	No	14,768	No	27,191
Colombia	No	26,631	No	43,677
Brazil	Yes	123,020	No	198,739
El Salvador	Yes	4,566	No	6,031
Peru	Yes	17,295	No	28,647
Guatemala	Yes	6,650	No	13,277
Ecuador	No	7,920	No	14,573
Honduras	Yes	3,402	No	7,834
Paraguay	Yes	3,196	No	6,291
Bolivia (Plurinational State of)	Yes	5,441	No	9,775
Nicaragua	Yes	2,806	No	5,541
Haiti	Yes	5,200	No	9,778
		Latin American population living under an	Latin American population living	
		85.1%	2.0%	

Source: Prepared by the author with information from Heston, Alan; Robert Summers and Bettina Aten, "Penn World Table Version 7.0," Center for International Comparisons of Production, Income and Prices at the University of Pennsylvania, May 2011.

Note: To determine if the political regime was a democratic or an authoritarian one the criteria of Przeworski (2004) was followed.

The sum of the population of the 19 countries was considered as the total population of Latin.



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