

# CEPAL

## Review

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## Review

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## Options for Latin American reactivation in the 1990s

*Colin I. Bradford, Jr.\**

This article analyses the current internal and external situation of the various countries of Latin America and poses the question of whether this situation closes the door on the growth prospects of the region in the 1990s or, on the contrary, creates conditions and opportunities for the restoration of growth.

The recent economic literature on growth and development is also examined with regard to these issues and it is concluded that although external restrictions pose a major problem, they do not in themselves determine the future growth prospects of the region.

It is held that emphasis should be placed on improving various internal conditions in order to improve the productivity and growth of the national economy. Competitiveness is seen as the driving force which will facilitate and be facilitated by integration into the world economy. Exports, which must play a fundamental dynamic role, depend on a range of elements which activate the growth process, rather than on sectoral policies. The traditional dichotomies between import substitution and export promotion must be discarded in favour of approaches that combine the best of both aspects.

Emphasis is also placed on the need for compatibility between income distribution and growth, and it is concluded that there are a number of factors within the economic authorities' grasp, in contrast with the view that exogenous forces are determinant in the development process.

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## Introduction

The 1980s is now widely considered to have been a "lost decade" for Latin America. The heritage of that decade is the accumulated external debt which looms as a burden and potential constraint on Latin America's prospects for the next decade (Davrieux, 1990). Furthermore, the availability of new external financial resources is likely to be severely constrained in the 1990s from the supply side. The competition for external resources will be greater, with the United States, Eastern Europe, the Soviet Union and Southeast Asia (ASEAN) vying for funds, whereas Latin America was virtually alone in the 1970s as a willing and credible borrower. Social issues, poverty and equity are becoming more pressing priorities in economic policy in Latin America than previously.

These various pressures on Latin America raise the fundamental question of whether the countries of the region can restore economic growth in the 1990s.

The question briefly addressed in this article is to what extent the current conjuncture of external and internal pressures creates circumstances which close the door on growth prospects for Latin America for the 1990s, as many observers believe, and to what extent they create conditions which can be capitalized on by much of Latin America to initiate a restoration of growth over the coming decade. In particular, reference is made to some of the recent literature on economic growth and development against the background of the mixture of internal and external pressures in evaluating the possibilities for restored growth in the region.

## I

**Growth-led exports or export-led growth**

In recent years, there has been some re-examination in economics of our understanding of the growth process. Several of the issues taken up by this relatively new literature relate to each other and, more importantly for our purposes here, affect our thinking about how economic policies influence growth. One issue is the relative weight of the quantitative accumulation of factor inputs versus the qualitative improvement of such inputs. The importance of human capital *vis-à-vis* physical capital is one dimension of this issue. Another issue is the importance of technological change and how it should be treated analytically. Whether technology is exogenously or endogenously determined is one dimension of this issue. Still another issue is whether export growth is supply determined or demand driven. In essence, the question is whether cases of dynamic growth are cases of growth-led exports or export-led growth.

The recent literature on these issues sheds light on the fundamental conceptual perspective in the light of which development strategies are formulated: whether the process is one of structural reform of the national economy for domestic competitiveness which results in dynamic growth and an increased supply for export or whether it is one of trade policy reform for international competitiveness which allows the economy to respond to external demand. While many of the specific policy reforms would be the same under either formulation, the alternatives make quite a difference in how the development process is conceived and executed, as between achieving integration into the world economy through trade, on the one hand, or achieving national economic integration and dynamism through increased competitiveness, on the other.

Elhanan Helpman put the problem very well: "We need a theory that can address fundamental questions, such as: Does growth drive trade or is there a reverse link from trade to growth? Many authors have emphasized the role of free trade in promoting growth. Nevertheless, there also exist arguments that trade policy was central in the promotion of fast growth in Japan and some of the NICs. Current theory is not suitable to deal in a

satisfactory way with these alternative views" (Helpman, 1988, p. 6).

Conventional models with diminishing returns to capital led to the hypothesis of convergence among countries. The idea was that wage rates and capital-labour ratios would converge, since the rate of return on investment and the rate of per capita output growth are decreasing functions of the level of per capita capital stock. Since we have been witnessing a world of divergent growth in the 1980s, a re-examination seems appropriate.

In a frequently cited article in 1986 Paul Romer began with the point that if the assumption in conventional models of constant returns to scale in production held, then, of course, the output growth would be completely accounted for by the quantitative growth in factor inputs. The growth accounting work of Kendrick (1976), he noted, found the rate of growth of output to be between 1.06 and 1.30 times the rate of growth of inputs in the period from 1929 to 1969, and this was evidence that the rates of growth of human and non-human, tangible and intangible inputs were not sufficient to explain the growth of output (Romer, 1986, p. 1013).

This suggested to Romer the possibility of a new formulation involving three assumptions. First, knowledge is viewed as a capital good with an increasing marginal product. Capital stock is assumed to be a composite good where the knowledge component has increasing returns to scale which outweigh the decreasing returns of the physical capital stock component. Second, technological change becomes endogenously determined like any other input with a price and a marginal product which determine its economic role, rather than exogenously given as it is in most models. And third, the returns to new knowledge cannot be captured only by the firm generating it but constitute an externality that can be reaped by other economic agents. This creates a divergence between social and private return which must be addressed.

These assumptions represent major differences with regard to how the growth process is under-

stood and activated, and they have been taken as the basis for further work by others.

For example, Jaime de Melo and Sherman Robinson (1990) have formulated three types of knowledge externalities that help explain the dynamism of the growth process associated with high export-GDP and import-GDP shares. These are trade promotion externalities, import externalities and export externalities. Trade promotion externalities are those that are provided by governments through information services, market development advice, assistance in design and packaging, etc., which can be appropriated by firms with ambitions to export. Import externalities result from the learning opportunities made possible by importing capital goods and intermediate goods with embodied technologies. Export externalities are those that accrue from meeting international market standards, product quality specifications, quality criteria and distribution and marketing challenges, which, once achieved, can be generalized to other products and processes.

De Melo and Robinson find that when their model included measures of these externalities rather than relying solely on factor accumulation and exogenous technical change it improved the fit of export-GDP and import-GDP with patterns of structural change in output and trade in Korea and Taiwan.

These results and the theoretical ideas behind them lead to a different concept of the benefits of outward orientation and openness to the world economy. The benefits of trade derived from this line of work are the knowledge generation and spillover effects generated by export experience, importing embodied technologies, and trade promotion linkages. The knowledge generation effects of trade complement the already extant stock of knowledge from internal sources—education, previous economic growth, science and technological development, R&D promotion, etc. If knowledge is critical to growth, as Romer argues, the fact that much of the world's stock of knowledge is in industrial countries creates an imperative for open-

ness to trade as a means of capturing knowledge from abroad and internalizing it. Romer (1989), in another paper, using a regression of 90 countries, finds that openness as measured by the export-GDP share leads to increases in the rate of technological change and higher marginal productivity of capital, whereas exogenous increases in savings and investment are less potent in affecting these variables.

The conceptual innovation here is something more than putting the "A" term for the residual of the production function inside the parenthesis of the production function itself. It makes explicit the endogeneity of the knowledge generation process, the dynamic effects to be realized from it due to increasing returns, and the "public good" quality of knowledge which means that firms and institutions will have to devise strategies to capture the externalities. It is the endogeneity of the knowledge absorption process through openness that generates dynamic national economic growth which then yields rapid growth in the supply of exports. This is not the same as demand-driven export-led growth that results primarily from getting internal market conditions to reflect international prices. In the new formulation, it is the internalization of knowledge that spurs dynamic growth of the domestic economy, thus providing the surplus supply of exportable goods. These newer theories of growth fit rather well with patterns of investment-led, structural-change-driven, and supply-push exports derived from empirical research on the NICs in different regions in the 1980s (Bradford, 1987).

Helpman (1988, pp. 15-16) concludes: "The extremely fast growth of exports in some of the NICs gives the impression that international trade plays an important role in the process. It can nevertheless be argued that the co-movement of output and exports stems from internal sources that bring output growth, which induces in turn export growth ... Causality is from growth to trade rather than the other way around".

## II

**Industrialization, market size and the “big push” revisited**

Quite apart from the preoccupations with explaining rapid growth in trade, some recent literature has gone back to themes and ideas from an earlier period, which have been marginal to mainstream development discourse for thirty years, and re-examined them in the light of more recent thinking. These articles explore intersectoral linkages, market size and increasing yields from simultaneous investments, which had been first articulated in the balanced growth, big push industrialization literature from as long ago as the 1940s and 1950s.

These issues are explored in two articles by Kevin Murphy, Andre Shleifer and Robert Vishny (1989a and 1989b). The first incorporates the idea of increasing returns as a central element. Indeed, industrialization is defined as the “substitution of increasing returns technologies for constant returns technologies in the production of some goods” (1989a, p. 542). The intersectoral story that follows is in some ways quite familiar, with growth in agriculture being important to generating enough demand to make domestic manufacturing viable from an economic point of view.

The supply side complement to this idea is provided by the interesting finding by Jean-Claude Berthélemy and Christian Morrisson (1989, p. 9) that the supply of manufactured goods is a critical motivating factor for farmers to generate agricultural goods. Without manufactured goods to buy, farmers have no incentive to produce more, because there is nothing on which to spend their income. “It follows that a shortage of manufactured goods (consumer goods and inputs) can quickly cancel out agricultural development efforts and lead to a cumulative process in which the crises in both the agricultural and non-agricultural sectors fuel each other, the non-agricultural sector being gradually paralyzed by the drop in imports resulting from the decline in agricultural exports”.

From the demand side, however, Murphy, Shleifer and Vishny (1989a) argue that income distribution is not just compatible with industrialization but necessary for it, citing Chenery, Robinson and Syrquin’s figures that 80 to 90% of manufacturing output in developing countries is for the do-

mestic market. Industries with increasing returns technologies, which often require high fixed costs of R&D or capital equipment or both, are frequently hampered in their development by lack of sufficient demand.

The old argument that improving the distribution of income would erode domestic sources of savings by reducing the income shares of upper income earners with a higher propensity to save in favour of lower income earners with a lower propensity to save has been refuted by recent evidence and behaviour. Greater awareness of the importance of hidden savings in the informal sector, which constitutes over 30% of total non-agricultural employment in Latin America (Turnham *et al.*, 1990), and the evidence of capital flight and rentier behaviour among wealthy Latin Americans undermines the savings argument for the “growth-with-inequalities type of development pattern” (Armendáriz de Aghion, 1990).

Murphy, Shleifer and Vishny (1989a, p. 560) conclude by saying that “for both a closed economy and an economy with some open markets, our analysis stressed the role that composition of demand, as determined by the distribution of income, plays in industrialization. We identified the role of the leading sectors, such as agriculture or exports, in driving industrialization, but also showed that a boom in a leading sector might not suffice. For industrialization to take place, benefits from such a boom must be equally enough distributed to create large markets for domestic manufactures. Focusing on increasing returns and the size of domestic markets seems to offer insights that would be hard to obtain otherwise”.

In a second article (1989b), again focused less on trade than on the reasons for “stalled” industrialization, the same three authors address the issue of how an economy overcomes the circumstance of small internal market size inhibiting investment by firms whose profits would not be large enough, if they invest alone, to justify the lump sum investment required for increasing returns technologies. The issue then is one of pecuniary externalities as against the technological externalities stressed by Romer.

The solution is quite straightforward and quite familiar. Simultaneous investment by several firms increases incomes sufficiently to create a large enough market to render each firm's profit stream large enough to justify an investment that would not have been possible if each firm invested in isolation. The argument is extended to infrastructure, where the public good is amortized over the income stream of multiple simultaneous investments, thus making it feasible, whereas the incremental approach would yield a lower level equilibrium.

This line of reasoning leads to the conclusion that simultaneous, multiple-sector investments result in a profitable, economically viable and more dynamic growth path where increasing returns can be realized, and that in the same way it is

possible to execute economically viable shared infrastructure projects that would be otherwise impossible if investments were evaluated and executed separately. The pecuniary externalities that make this analysis a reality can be appropriated by an intersectoral approach which actively seeks to capture these externalities and the gains from increasing returns technologies. For the authors, "the bottom line is the overwhelming importance of domestic demand for most domestic industry" (Murphy *et al.*, 1989b, p. 1007). It is interesting to note that a National Institute of Statistics survey in Mexico found that among firms unwilling to invest in Mexico in 1988, 35% of the respondents mentioned exchange rate uncertainty and 45% mentioned "insufficient future demand".

### III

#### Conclusion: implications for Latin America in the 1990s

The articles referred to above provide interesting perspectives when considering the prospects for restoring economic growth in Latin America in the 1990s. Perhaps the most interesting general conclusion that can be drawn is the fact that, if the central elements in the theorizing in these articles are in fact powerful driving forces for growth in the future, then the external financial constraint does not appear to inevitably and unavoidably condition the region's growth prospects in the next decade. In other words, the fact that the outlook for significant financial flows to Latin America in the 1990s is bleak, does not necessarily doom the growth outlook for the region.

These perspectives place greater emphasis on getting the internal trajectory right as a means of improving the productivity and growth of the national economy and highlight the internal instruments and agents which can impact on the domestic economy. Competitiveness is conceived of as the centrepiece of a national economic project which generates a more dynamic domestic economy. This competitiveness cannot be achieved without reference to international prices and exposure to them through opening the economy, nor without access to technologies from abroad

through imports and export experience. National economic competitiveness would facilitate and be facilitated by integration into the world economy. But the *raison d'être* and driving force behind the development strategy is national economic competitiveness and dynamism which create their own imperatives for openness, competition, deregulation, privatization, macroeconomic stability and structural reform, rather than exports becoming the *sine qua non* of development.

The difference in emphasis is fundamental. Focusing on exports and the trade reforms that are necessary to achieve them is only part of the story. The export-led growth idea is based on the notion that if conditions are right, exports will occur, but the theory does not specify the agents of dynamic export growth beyond the efficiency gains from the static allocative effects of getting prices right. The growth-led export idea is based on a richer range of elements which activate the growth process. These focus on the knowledge generation process both domestically (through education, training, literacy, R&D support and the like) as well as in respect of the crucial absorption of technologies from abroad through open-economy policies. Learning by doing, investing in increas-

ing returns technologies in industry, obtaining embodied technologies through imports, gaining export experience, and reaping the externalities of trade promotion all provide elements for dynamic economic gain in this conceptualization of the process.

There is more for economic agents to do in the growth-led export framework. The emphasis on getting the domestic economy going for domestic reasons animates and roots the reform process within the national economic, institutional and political framework where it has more salience and power. The opening of the economy to international competition becomes part of and driven by a commitment to reinforcing domestic reforms to enhance national competitiveness. Export-led growth policy ideas are still vital, but they are now within a larger and more complex framework involving the whole society. We have for too long been involved in debates about dichotomous options rather than searching for "combinatoria" elements (Calvino, 1988, p. 20). A good example of the "combinatoria" approach is in the recent study led by Fernando Fajnzylber (ECLAC, 1990) on *Changing Production Patterns with Social Equity* (see especially but not exclusively pp. 83 and 98-100).

The second element that surfaces from this review of recent literature is the renewed confidence in the potential compatibility between income dis-

tribution and growth, which give greater weight to the size of the domestic market and inter-sectoral approaches in spurring growth. For the large and medium-sized economies in Latin America, these factors provide another set of positive elements for facing the policy dilemmas and challenges of the 1990s.

Taken together, these various lines of argument provide a more solid basis for a positive outlook for Latin America in the future. The common feature of these various elements is that they are fully within the region's grasp. National economic agents can act to realize the potential which exists within the national economy by internalizing technological knowledge and innovation from abroad and to exploit the advantages of a large internal market. The external trade and financial context remains important, of course, but is not necessarily determining. The view that dynamic export expansion is largely supply-determined and more the result of rapid economic growth than its cause places the responsibility and the prospect of restoring growth in the region more in the hands of Latin America itself, rather than making them subject to the fate of exogenously determined external economic forces. This can only be viewed as a good thing for a region that is more and more bent on getting its house in order for its own reasons as democracy returns to the region.

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