ANDRÉS VELASCO

Editor's Summary

More than a decade after promarket economic reforms became widespread in Latin America, the growth picture is not encouraging. True, per capita output increases in the 1990s reached almost 2 percent a year, which is a far cry from the negative 0.7 percent during the lost decade of the 1980s. But hopes have been dashed nonetheless. Only Chile has managed to achieve Asian growth rates over a relatively long period of time. In other reforming countries—Argentina and Mexico are good examples—vigorous growth spurts have been followed by periods of stagnation. Even in once-mighty Chile, increases in output of more than 7 percent per year in 1985–97 have since slowed to less than 3 percent, on average. Worse, the return of macroeconomic and financial instability since 1999 has brought output collapses in a couple of countries and recessions almost everywhere else. The first decade of the twenty-first century could turn out to be yet another lost decade for economic growth.

It was only natural, then, that *Economía* should devote its entire fifth issue to the question of growth. David Lindauer and Lant Pritchett fire the opening salvos by asking how *big ideas* for attaining sustained growth have evolved over the past half-century. Their conclusions are dispiriting: today's magic formula becomes yesterday's stale fad, again and again. After World War II, sages from developed nations advised developing countries to focus on capital accumulation. If, for some reason, the private sector failed to accumulate enough, government could and should fill the gap by coordinating expectations, supporting leading sectors, and giving the economy the big push necessary to attain sustained growth. Central planning did achieve a few decades of fast accumulation in Stalin's Russia, and import substitution—its milder Latin American cousin—did cause Brazil, Mexico, Peru, and others to grow quickly, at least for a while. However, the limitations of this approach soon became evident: some countries in which it was tried (such as India) never grew much; in Latin America, once the easy phase of import substitution was over, so was the period of fast growth; and, of course, there is the small fact that the Soviet Union and its satellites collapsed and were revealed to have been much poorer than anyone in the West had guessed.

More recent big ideas on how to promote growth have not fared much better. The 1980s saw the rise of adjustment lending and promarket reforms. High tariffs, financial repression, and capital account restrictions were out; trade and financial liberalization, foreign direct investment, and the magic of the market were in. If the transition from one to the other was costly, then the World Bank, the Inter-American Development Bank (IDB), and the International Monetary Fund (IMF) would foot the bill. But again, hard facts get in the way of big ideas. Lindauer and Pritchett list four unpleasant realities. Two of them I already mentioned: the disappointing growth performance of Latin America and the multitude of financial crises, both in the region and elsewhere. The third is the "collapse of sub-Saharan Africa, which has by now become so complete as to force itself into world consciousness." The fourth is the realization that the transition from socialism to capitalism in Eastern Europe and the former Soviet Union "has gone horrifically worse than anyone would have dared predict." Overall, this is not a happy set of results for the big ideas of the 1980s and 1990s.

What is to be done? Lindauer and Pritchett argue that the first step is to discard the very idea of a big idea. This does not mean that anything goes. Some universal economic principles ought to be reflected in sound economic policies. As discussant Dani Rodrik points out, however, these principles can underlie a host of different policies, applied through an array of different institutions. For example, allowing interest rates to clear credit markets is an inevitable conclusion of sound economic analysis, whereas choosing the American over the German model for organizing the banking industry is not.

Lindauer and Pritchett also warn against that recently popular source of big ideas, the cross-country growth regression. They are very critical of the econometrics underlying such regressions, and their criticism is sure to prove controversial. They are even more critical of the policy advice derived from that econometric work: if the partial correlation between right-hand variable *X* and growth is positive, then advocate more *X*. Such an approach is misleading, claim Lindauer and Pritchett: "The basic flaw in growth regressions is that they confuse partial correlations with (stable) parameters and confuse empirical variables (that might be associated with policies) with feasible actions to promote growth."

One possible way out, they conclude, is to leave aside abstract discussions about what countries ought to be doing and go back to studying what countries actually did. That is precisely the task that Stanley Engerman and Kenneth Sokoloff undertake in their paper on the role of factor endowments and inequality in Latin American growth over the very long run. They begin with a basic and often-asked question: why did Canada and the United States do well while the rest of the New World lagged? The standard answer is that Anglo-Saxon institutions (such as parliamentary democracy and political decentralization) and culture (most notably, Protestantism and its work ethic) were good for capitalist growth, while those of Spain and Portugal were not. But if this is right, Engerman and Sokoloff argue, the English Caribbean should have done as well as English North America—and plainly it has not, despite great sugar wealth in colonial times.

Instead of culture, Engerman and Sokoloff focus on natural endowments. Some colonies, including Brazil, the Caribbean, parts of Mexico, and what is today the southern United States, featured soil and climate conditions that made it profitable to grow crops with great economies of scale, such as sugar and cotton. For this and other (political) reasons, land ended up in the hands of a few European settlers, giving rise to highly unequal societies. Much of North America, by contrast, was best suited for the cultivation of grains, which can be produced efficiently on a small scale. The result was an egalitarian distribution of land, wealth, and political power.

That was four hundred years ago. What about now? The question is pertinent given that the divergence in incomes between the United States and Canada and the rest of the region did not start in colonial times, but rather in the first half of the nineteenth century. In the Engerman-Sokoloff scheme, initial inequality is self-perpetuating: bad distribution breeds bad institutions, which, in turn, worsen inequality and impede capital accumulation and technological innovation. History matters, big time: the effects of initial endowments, which spread across time through colonial institutions, explain diverging trajectories stretching all the way to today.

This line of argument, as discussants Daron Acemoglu and Miguel Urquiola agree, is breathtakingly ambitious, but it is very successful in ordering a motley assortment of facts into a persuasive whole. It also fits neatly with related work by Acemoglu and coauthors Simon Johnson and James Robinson on the role of political inequality (again arising from colonial origins) in generating bad policies that retard growth.

As with any big idea, however historically grounded it might be, this one raises many questions. One has to address that ever-present puzzle called Argentina. The *pampas* are also suitable for grain. Why were they carved up into relatively few huge estates instead of many Jeffersonian family farms? Another issue has to do with the precise link between economic inequality and the quality of institutions. Chile is highly unequal, but it is recognized as having the best institutions in Latin America. How did this come to pass? Yet another question is why inequality should necessarily generate institutions that are bad for growth. One might conjecture that powerful landowners and capitalists crafted rules that made the world safe for land and capital accumulation, though perhaps unsafe for other growth-enhancing activities, such as innovation. These are all huge questions which, as the authors point out, clamor for more research.

Detailed empirical research on precisely one of these questions—namely, the mutual feedback between the quality of institutions and income growth—is provided by Daniel Kaufmann and Aart Kraay in the third paper in this issue. They draw on a rich new set of data on institutions and governance collected by the World Bank. Their starting point is that the data show that countries in Latin America typically have weak institutions and a low quality of government, even after controlling for their per capita income levels.

Analyzing how this matters for growth is statistically hard because of simultaneity and mutual causation: do good institutions cause growth, or are they simply a luxury sufficiently rich countries can afford? Kaufmann and Kraay develop a clever strategy for dealing with the issue, and they arrive at two conclusions. The first is not novel, but it is nonetheless important to see the finding reaffirmed with new data and techniques: there is a strong positive causal effect running from better governance to higher per capita incomes.

Their second conclusion proved controversial with the discussants, and it is likely to be controversial elsewhere: there is a weak and even negative causal effect running from per capita income to governance. This negates the existence of virtuous cycles, in which as countries get richer, they build better institutions, which, in turn, foster even faster growth, and so on. Kaufmann and Kraay explore one reason why increased wealth may worsen the quality of governance: state capture: "If the fruits of income growth largely accrue to an elite that benefits from misgovernance, then any possible positive impact of income growth on governance could be offset by the effect of the elite's negative influence." This is plausible, though again it raises questions that call out for further research. What determines the extent to which elites benefit from misgovernance? Or, in the terminology of the late Mancur Olson, why are some elites more encompassing than others, internalizing a larger share of the possibly deleterious effects of their rent seeking? After all, not all elites are kleptocratic, and not all rulers are like Zaire's Mobutu.

Invention and technology adoption, rather than crude factor accumulation, are key to prosperity. That, at least, is what growth accounting increasingly seems to suggest. Why the region has been so bad at both is the central issue in William Maloney's paper. Again, the focus is historical, contrasting Latin American performance with that of countries (namely, Australia, New Zealand, and the nations of Scandinavia) whose rich natural resource endowments make them a revealing control group. There is no natural resource curse, Maloney argues, but a curse associated with not knowing how to use such natural resources properly. The divergence in per capita incomes between the Latin American countries and the rest, in his view, results from two factors.

The first is the weakness in Latin America of the institutions and networks that make technology adoption possible. Learning about what to make and how to make it does not happen in a vacuum: it happens through universities, technical institutes, trade associations, and think tanks. The countries of Scandinavia and Oceania excelled at producing such institutions to foster the sectors in which they enjoyed abundant natural resources. Sweden had an Ironmasters' Association by 1747, and Australia had world-class engineering schools by the middle of the nineteenth century. In Chile, another mining country, the University of Chile began teaching engineering in 1847, but until the 1950s there was no training of engineers or technicians specializing in copper (the country's biggest resource).

The second factor is that in Latin America, artificially created monopoly power put up barriers to technology adoption. Examples include concentrated credit markets that only lend to insiders, and barriers to trade and foreign direct investment that impede knowledge spillovers. As demonstrated in much recent work on growth theory, these policies create not just the small Harberger triangles of static analysis, but also distortions that accumulate through time and have large dynamic effects.

Again, the question is, what can be done? Maloney argues that government can help in creating the institutions and networks necessary for innovation and technology adoption. He cites Chile's state development corporation (CORFO), founded in 1939, as a successful example. By founding technical institutes, contracting technical assistance abroad, and providing credit here and there, CORFO laid the foundations for Chile's successful export drives in fruit, wine, fish, and forestry products. Other Latin American nations founded similar development agencies, but they met with much less success.

All of which raises the issue of state capacity. Maloney's second prescription is to curtail monopoly power through appropriate regulation. This must surely be right, but it is easier said than done. Doing away with market power artificially created by the state may be readily accomplished. Reducing the market power of large quasi-monopoly firms is much harder, however, as Latin American governments that have tried to introduce flat phone rates (to ease Internet access) can readily attest. Technical complexity is one issue; possible state capture by the regulated firm is another—an important issue addressed by Kaufmann and Kraay in the previous paper.

Regulation may be appropriate in some sectors, but deregulation is called for in others. So argue Arturo Galindo, Alejandro Micco, and Guillermo Ordoñez, who revisit the classic question of whether financial liberalization promotes growth. Theory offers no clear-cut answers: liberalization may enhance efficiency while increasing the likelihood of financial crises, for instance. Empirical work is made difficult by the fact that financial deregulation often takes place alongside trade liberalization and privatization, such that it is hard to disentangle the effects of each.

The three authors tackle the question by studying whether sectors that rely more on external finance (that is, on borrowing as opposed to retained earnings) grow more quickly after liberalization. Their answer is affirmative, suggesting that deregulation boosts growth. They identify two transmission channels: deeper credit markets and increased allocative efficiency.

These results come with two important, policy-relevant caveats. First, not all kinds of financial liberalization are created equal. Deregulating domestic markets seems to matter a great deal for growth; opening up the capital account seems to matter hardly at all. Second, liberalization works only if accompanied by strong institutions and rule of law. If property and creditor rights, among others, are not protected, then liberalization can do more harm than good.

I conclude, as usual, with some acknowledgments. This fifth issue of *Economía* contains papers presented at the Panel Meeting held on 27 April 2002, in Cambridge, Massachusetts. The Center for International Development and the David Rockefeller Center for Latin American Studies at Harvard University cosponsored the meeting. I am grateful to both organizations for generous financial and logistical support. Thanks are also due close to home: to the Associate Editors of *Economía*, to Managing Editor Magdalena Balcells, and to Administrative Assistant Caroline Paquette. This issue of the journal would not have been possible without their hard work.