

Editor's Summary

The economies of Latin America and the Caribbean grew 6 percent in 2004, the highest rate since 1980. The United Nations Economic Commission for Latin America (ECLAC) estimates that the region's economies expanded by 4.3 percent in 2005. For 2006, ECLAC is forecasting 4 percent growth. If these predictions come true, the region will have completed four consecutive years of growth, accumulating a 10 percent increase in per capita income between 2003 and 2006.

That Latin America should be growing at a time of record-high commodity prices, record-low international interest rates, and robust global demand is not surprising. What is surprising is that the region is not growing more in this environment of the fastest world growth in thirty years. According to the International Monetary Fund (IMF), the region will post the slowest average growth in 2005–06 of any developing region.¹ Developing Asia will grow by 7.4 percent in 2005 and 7.1 percent in 2006, according to the IMF. Even Africa, at 5.1 and 5.4 percent, will amply outgrow Latin America.

The region's growth problem is anything but new. Since 1980, only Chile has registered sustained increases in income. Most other countries have stagnated or grown slightly. By contrast, India has averaged 6 percent economic growth annually for fifteen years, and China's economy has grown by 10 percent a year for twenty-five years.

Consequently, growth is back at the center of the research agenda in Latin America. Applying the standard prescription of "stabilize, liberalize, and open up" may well be necessary for long-term growth, but it certainly does not seem to have been sufficient. Economists and policymakers are casting about for something else to try. One popular alternative is variously known as competitiveness policy, industrial policy, or microeconomic interventions.

In the first paper in this volume, Andrés Rodríguez-Clare claims that such interventions have been commonplace in Latin America since the 1980s,

1. IMF (2005).

even in countries that generally advocate a hands-off approach to growth. Examples are policies to promote small and medium-sized enterprises, attract foreign direct investment (FDI), and, more recently, encourage technical innovation.

The problem with these policies, Rodríguez-Clare argues, is twofold. First, they have weak theoretical and empirical foundations. For example, it is hard to find the spillovers that would justify an emphasis on FDI. And why, conceptually, are small firms to be favored over large ones? Second, and more damningly, these policies seem to have had a negligible growth payoff.

According to Rodríguez-Clare, a more effective set of microeconomic interventions should specifically address the market failures that hinder accumulation and growth. One such problem arises when a coordination failure prevents firms from taking the necessary actions to increase sectorwide productivity, so that a cluster fails to develop. Rodríguez-Clare focuses on this type of agglomeration economy, and he proposes a set of microeconomic interventions that could be adopted as solutions.

His paper presents a model of a small economy with sector-specific coordination failures. The model suggests that, rather than trying to reallocate resources toward sectors that are seen as offering high clustering possibilities (as was the case with traditional import substitution), policy should aim at fostering cooperation in sectors in which the economy is already showing comparative advantage. A commonly cited example is from the Scandinavian countries, where clusters developed around the forestry industry. Chile seems to be following suit, with clusters now forming around natural-resource-intensive industries such as copper mining, vegetable and fruit farming, and forestry. Whether Chilean public policies in this area have been effective remains controversial, however, as discussant Ronald Fischer argues.

What are the policy implications? One conclusion stressed by Rodríguez-Clare is that general policies to increase innovation across the board are likely to be inferior to policies that take the more selective approach of trying to induce the development of innovation clusters in areas of comparative advantage. But that requires a policymaking apparatus that is able to identify these areas without political interference or corruption. Rodríguez-Clare acknowledges that not all Latin American countries have the strong states and institutions needed for this task. He cites Chile, Costa Rica, and Uruguay as promising examples.

El Salvador may be another source for optimism, Ricardo Hausmann and Dani Rodrik argue in the second paper in this volume. The country exemplifies the paradoxes of the postreform period in Latin America. On many

counts, El Salvador is a success story. It democratized its politics after the civil war of the 1980s. It also reduced its budget deficit, modernized its tax system, liberalized trade and banking, improved financial regulation and supervision, privatized energy and telecommunications, and reformed its social security system. A growth spurt followed, but El Salvador has mostly stagnated since the late 1990s.

According to Hausmann and Rodrik, the failure to grow stems from a failure to identify high-return investment projects. After the reforms, both agriculture and traditional industry declined. *Maquila* exports grew, yet they are not large enough to carry the economy forward. New export items are needed, but they have not appeared. In the terminology of Hausmann and Rodrik, El Salvador has failed at self-discovery—that is, at identifying new things to produce.

They arrive at this conclusion by applying to El Salvador the methodology of growth diagnostics earlier proposed by Hausmann, Rodrik, and Velasco.² Economic growth depends on the returns to accumulation (broadly construed), their private appropriability, and the cost of financing accumulation. The first task is to uncover which of these three factors poses the greatest impediment to higher growth. In some economies, the constraint may lie in low returns; in others it may be poor appropriability, and in yet others, too high a cost of finance. The next stage of the diagnostic analysis is to uncover the specific distortions that lie behind the most severe of these constraints. If the problem seems to be poor appropriability, is that due to high taxes, corruption, or macroeconomic instability? If the problem is with the high cost of finance, does that stem from fiscal deficits or poor intermediation?

Applying this framework, Hausmann and Rodrik discard other popular explanations for slow growth in El Salvador. For instance, the problem cannot be lack of human capital, since returns to education are low by Latin American standards; it does not seem to be expropriation risk, since the country has investment grade status; and it cannot be insufficient supply of capital, since real interest rates are also extraordinarily low. After eliminating these and other alternatives, Hausmann and Rodrik conclude that the problem lies with low demand for capital, due to a scarcity of privately profitable projects.

Much like Rodríguez-Clare, Hausmann and Rodrik argue that market failures (coordination failures and spillovers again figure prominently) can plausibly explain the scarcity of investment projects with high private returns. They then propose a very concrete policy approach to address the problem.

2. Hausmann, Rodrik, and Velasco (2005).

The gist of their proposal is the creation of a high-level Coordination Council whose main job would be to overcome these market failures. In their words, “the coordination council would seek out and gather information (from the private sector and elsewhere) on investment ideas; goad the different agencies involved into desirable promotion efforts; achieve coordination among these different governmental agencies when needed; push for changes in legislation and regulation to eliminate unnecessary transaction costs or other impediments; have the capacity to provide complementary public goods; generate subsidies and financial backing (either debt or equity) for new activities when needed; and credibly bundle these different elements of support with appropriate conditionalities.”

Hausmann and Rodrik provide a set of ten design principles to minimize the risk of capture of the council or the corruption of its activities. For instance, they argue that the council should only support new activities rather than established sectors, that the criteria for success and failure should be clearly established in advance, and that all support should have sunset clauses.

So far the arguments over microeconomic interventions in Latin America have generated more heat than light. Proponents have often failed to provide specifics, and opponents have often had a knee-jerk reaction against alleged “statism” and picking winners. Rodríguez-Clare and Hausmann and Rodrik provide detailed analyses and proposals, which are fully cognizant of the dangers of both market failure and government failure. May the serious discussion begin.

Relative price movements play a much larger role in developing than developed economies. In the former, large and sudden real devaluations, often linked to capital outflows, can wreak havoc with balance sheets and financial systems and hinder growth. At the same time, large and persistent revaluations, often linked to capital inflows, can reduce the competitiveness of exports and also hinder growth. This all raises the question of what accounts for these real exchange rate fluctuations—whether it is the relative prices of traded goods that move, or the price of nontradables relative to tradables. Answering this empirical question is crucial both for building relevant models and designing policies.

In the third paper in this volume, Enrique Mendoza tackles this issue and argues that the conventional wisdom is not necessarily applicable to Latin America. This conventional wisdom is that exchange-rate-adjusted relative prices of tradable goods account for most of the observed high variability of consumer-price-index-based real exchange rates. This view originates mostly

in the empirical analysis of real exchange rates for developed countries, but it has also been applied to Mexico by Charles Engel.³

Using monthly data for the 1969–2000 period (a sample larger than Engel's), Mendoza finds that the relative price of nontraded goods is far from irrelevant. In particular, in periods in which Mexico managed its exchange rate, including episodes with a fixed exchange rate or crawling pegs, movements in Mexico's relative nontradables prices can account for up to 70 percent of the variance of the real exchange rate. Interestingly, whenever Mexico managed its exchange rate, the country experienced high real exchange rate variability, but movements in the price of nontaxable goods contribute significantly to explaining it. This finding should cause a sigh of relief among many applied theorists, given that a vast collection of models emphasize the role of the relative price of nontraded goods in explaining costly inflation stabilizations, distortions caused by temporary policies, crises associated with reversals in capital flows, and other ills often found in emerging market economies.

Mendoza's finding also raises the theoretical question of why the relative price of nontraded goods moves so much under fixed or managed nominal exchange rates. One popular explanation involves rigidities in the domestic currency prices of nontraded goods. Mendoza prefers an alternative explanation, involving financial rigidities. In the second part of the paper, he builds a simple model of endogenous credit constraints with liability dollarization to illustrate how exogenous shocks can induce high variability in the nontaxable price and the real exchange rate. The model combines a standard balance sheet effect (because of the mismatch between the units in which debt is denominated and the units in which some of this debt is leveraged) and a debt-deflation process: an initial fall in the price of nontradables triggered by an exogenous shock tightens credit constraints further, leading to a downward spiral in access to debt and the price of nontradables. The upshot is that small shocks can induce sizable fluctuations in real quantities and prices, including the relative price of nontraded goods.

Since these fluctuations are excessive (they are magnified by the distortions in financial arrangements), the model and the empirical work provide a case for policies that would dampen relative price volatility. Conventional nominal exchange rate management does not seem to be much used, since Mexico's relative price fluctuations were large precisely under managed exchange rates. Mendoza suggests sectoral taxes as a potentially effective policy tool. An

3. Engel (2000).

alternative is debt denomination: if external debt were denominated in the price of nontradables, for example, instead of being denominated in dollars, much of the unwanted vulnerability and volatility would vanish. Accomplishing that through suitable debt management—and through the sound macroeconomic policies that generate the necessary credibility—should be a key objective for Latin American countries.

Weak bankruptcy legislation is yet another powerful explanation for low investment and growth. Firms take on debts to finance investments, and they generally intend to repay these debts with their future gains. There is always the possibility, however, that the borrowing firms will not fulfill the repayment promise. If the firm has many creditors, each creditor will try to be the first to recover its debts. This uncoordinated race may lead to a loss of value for everyone. It is in the collective interest of creditors, and of society at large, to dispose of the debtor's assets in an orderly way, via a centralized bankruptcy procedure. If the firm is not viable, then orderly liquidation is called for. If the firm is viable but financially distressed, then the answer is reorganization under a procedure that gives creditors some control, in order to avoid looting by management.

In the fourth paper in this volume, Aloisio Araujo and Bruno Funchal analyze the bankruptcy procedures in place in Latin America and find them lacking. They begin by sketching a simple model that identifies the pitfalls from incomplete private contracting and how bankruptcy law can overcome them. They then compare these abstract goals with the actual functioning of legislation in the region. Many Latin American countries, particularly in South America, reformed their bankruptcy procedures in the 1980s, aiming to provide a more attractive environment for business. The majority of these reforms focused on improving reorganization procedures to make it possible for viable businesses in financial distress to survive. Reducing the costs of the bankruptcy procedures was also an important goal: lower bureaucratic expenses means that more is left over for creditors.

Even after these reforms, Araujo and Funchal argue, Latin American bankruptcy arrangements fall short along two dimensions. The first is creditor protection. They use an index of such protection to show that the Organization for Economic Cooperation and Development (OECD) has the highest level of creditor protection, while the Latin American and Caribbean region has the lowest. Within the region, only the Chilean legal system provides protection on par with the average OECD country. This poor creditor protection in Latin America and the Caribbean increases the cost of capital and makes it difficult for firms to finance their investments with debt.

Second, Latin American bankruptcy procedures remain poorly designed. A good bankruptcy procedure should deliver an ex post efficient outcome that maximizes the firm's total value available to be divided among the debtor and creditors. It should also preserve the bonding role of debt by adequately penalizing managers and shareholders in bankruptcy states, and it should preserve the order of claims defined when the contracts were created. An index developed by the World Bank shows how close countries' bankruptcy procedures come to reaching these three goals. Again the OECD comes out on top, with Latin American and Caribbean countries near the bottom, slightly above sub-Saharan Africa and South Asia. Araujo and Funchal show that the index is a statistically significant determinant of the interest rate spread in each country, after controlling for GDP per capita. For every one point rise in the index (out of a possible 100), the interest rate spread decreases by 0.13 percent. The conclusion, again, is that an imperfect bankruptcy system increases the cost of capital and hinders the development of financial markets in Latin America.

The last two papers in this volume address one of the central issues of the early twenty-first century: migration. The most recent wave of globalization has made great strides in liberalizing the cross-border flows of goods and capital. Despite much liberal rhetoric, however, the deregulating push has not reached the cross-border flows of people. Much migration, especially between rich and poor countries, remains illegal. That does not mean the flows are small: economic and demographic realities dictate otherwise.

The Western Hemisphere is home to one of the biggest migratory flows, both legal and illegal, anywhere in the world: that between Mexico and the United States. Up to one-eighth of Mexico's labor force is currently employed in the United States. In 2003 remittances from these migrants totaled U.S.\$14.5 billion, or about 1.5 percent of Mexico's GDP. For Latin America as a whole, remittances exceeded U.S.\$45 billion in 2004, which is more than the combined flows of foreign direct investment and development assistance.

Until recently, research has centered on the effects of migration on the recipient country. The focus is now turning to the impact on the sending country. The paper by Ernesto López-Córdova studies the effects of remittances on development, focusing on schooling and health outcomes in Mexico, the second-largest remittance recipient in the world after India.

Studying the effects of remittances is tricky because remittances are obviously endogenous. The paper looks at a cross-section of Mexican municipalities. To address the issue of endogeneity, it uses two-stage least-squares with municipal rainfall patterns and the distance to Guadalajara as instrumental variables. The results of the estimation suggest that an increase in the fraction

of households receiving remittances reduces infant mortality and illiteracy among children aged six to fourteen years, while at the same time alleviating some dimensions of poverty and improving living conditions. Remittances seem to improve school attendance among young children—although, somewhat paradoxically, the opposite seems to be the case among teenagers.

Another tricky issue is isolating the impact of remittances from that of migration. The measured developmental improvements could be the effect of migration itself, which may, for instance, give households access to better healthcare information. To control for the separate impact of migration, López-Córdova uses state dummies that capture the existence of historical migration networks. The results on the independent and beneficial effects of remittances survive.

The last paper in the volume, by Nicole Hildebrandt and David J. McKenzie, also studies the impact of migration on human capital accumulation, focusing on child health outcomes in the sending country. As in the previous paper, the authors must contend with identification issues. Migrants are not randomly drawn from the general population. For example, the most prosperous and healthy rural Mexicans are not likely to find that the benefits of illegal migration outweigh their other options in Mexico. In addition, unobserved shocks, such as crop failures or natural disasters, may be both a reason for migration and a cause of worse health conditions.

To deal with these problems, Hildebrandt and McKenzie use historic migration networks formed as a result of U.S. demand conditions and the pattern of development of the railroad system in the early 1900s as instruments for current levels of migration. Their results show that migration results in lower infant mortality rates and higher birth weights. Hildebrandt and McKenzie also find, however, that children in migrant households receive less preventive health inputs such as breast feeding and vaccinations, which may have a detrimental impact on child health at older ages.

Given this positive overall effect of migration on child health, what are the channels through which migration improves health? The paper finds evidence that the higher income and wealth of the recipients of remittances is one factor, which allows households to spend additional resources on food and health services. But not everything has to do with money: migrants also seem to gain health knowledge through exposure to U.S. care, resulting in better health practices and higher health attainment. This last point suggests that the beneficial impact of migration goes beyond the direct effects of remittances. This should be taken into account, Hildebrandt and McKenzie argue, when designing migration policy.

All papers but one included in this issue were presented at the panel meeting held in Santiago, Chile, in May 2005. The meeting was hosted by the regional office of Harvard University's David Rockefeller Center for Latin American Studies. As usual, associate editors of *Economía*, members of the 2005 panel, and outside discussants and referees have done an outstanding job. Thanks are due to them all.

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