

Effective Policymaking: The Latin American Experience

Carlos Valencia

April, 2003

Abstract

This paper presents a view of economic development policy anchored in practices that have worked in successful countries. By returning to the basic environment that induces private investment in an open economy, attention is drawn to the attributes that determine the risk perceived by individual investors in achieving their expected returns. The concept of *completeness* is explained as the guiding principle in structuring a national process of reforms tailored to specific distortions and market imperfections of sectors and industries. This facilitates the understanding of why the Washington Consensus has been useful in stabilizing the economies but has shown weak results in inducing savings and fostering investment capable of accelerating growth.

The Challenge

1. At the start of the twenty first century Latin America finds itself engaged in a never-ending battle to procure a better standard of living for its citizens. A region approaching half a billion people continues to struggle with the task of extending the benefits of the economic system to a vast number of its citizens. Indeed, after many years of economic experimentation, close to half of its population remains below the poverty line. Moreover, to aggravate the situation, the region exhibits the worst income and wealth distribution in the world, revealing a continent with great potential for social instability in the long run. There are two main reasons for the disappointing rate of poverty reduction in the region: too little economic growth in many of the poorest countries, and persistent inequalities that inhibited the poor from participating in the growth that did occur.
2. In contrast to Asia where rates of economic growth in the order of 7% and above have been the norm in the last decades, Latin America remains stagnant and unable to reach the 6-7% rates of GDP growth experienced in the late seventies and early eighties. More important, productivity growth has not increased, losing ground to other regions of the world in terms of competitiveness and export growth. This is of utmost importance since manufacturing for export has become the preferred tool to increase opportunities, employment and to capture the savings of the industrialized consumer societies.
3. With a population approaching half a billion people, the greatest challenge for economic governance is the inclusion of half of these citizens into the mainstream of economic activity with sustainable income gains. This requires growth with opportunity creation.
4. Economic growth with opportunity creation is a deeper concept than economic growth. The presence of an expanding economic system that increases output and generates an expanding opportunity set requires a well thought out regulatory and policy framework. This framework would deepen property and individual rights and seek to enable the conditions for full market growth. Access and the capability to take advantage of the expanding opportunity set require a predetermined policy direction and priority.

The Options for the Region

5. To generate the level of inclusion mentioned above, Latin America requires sustained robust growth for the foreseeable future. A limited outlook characterized by poor real sector performance and low domestic savings suggests that the potential for bootstrapping the economies on the basis of production for domestic markets is limited. At the current stage, disposable incomes are not large enough to support the level of consumption needed to create sustainable employment on the scale required. This leaves no other option than to assume that the growth in production has to be geared toward world markets. Producing for global markets brings competitiveness into the analysis. Country cost and in particular factor cost is no longer determined locally or regionally but by prices set somewhere else in the world.

6. If the main objective is to drive the economic system toward exports, a substantial increase in public and private investment is needed. A brief survey of countries that have reached high levels of economic growth in the past shows that total investment on an annual basis should be in excess of 25% of GDP. Moreover, several of the fastest growing economies have reached periods of more than 35% of GDP. It is important to note that in these cases, public investment has been relatively steady at roughly 12%-15% of GDP, showing an important contribution from the public sector to key catalytic investments.

7. Given that a broad sector strategy to promote exports requires many products, many firms and many players, the presence of an expanding and vibrant private sector is a key component of a successful strategy. This implies that the creation of an environment that seeks and retains the private investor is a top priority for all countries willing to go this route. To succeed countries must recognize that private investment grows in a given location when the expected return/risk is competitive with other world destinations.

8. Countries have to examine all the attributes taken into account by the investor, making the necessary adjustments to satisfy investor decision-making requirements. These are voluntary reforms that countries have to enact to create an environment that is competitive and friendly to business. Partial or incomplete attention to the full requirements of the private investor will not produce the desired outcome.

Trade and Integration: a Framework Based on Success

9. The most successful countries in Asia and Latin America from a growth perspective are those that have adopted a diversified export base. Taking advantage of the emerging competitive global costs and low transaction costs, these countries have introduced new products diversifying their export base and increasing employment and opportunities. By emphasizing market needs delivered with low price and high quality, exporters managed to bypass barriers to their traditional products as well as to displace local production.

10. In the end, what matters to these successful countries is how many new products can be introduced on a regular basis to maintain export growth. Much remains to be done but

the experience is indeed quite good with this approach. If special trade and integration agreements are added to a well-structured competitive base, the benefits offered by economies of scale and specialization can further improve export prospects.

11. Globalization and free trade alone are not sufficient to create inclusion. Recent work on the subject favors solutions that account for institutional and equity issues as the best way to benefit from globalization with equitable growth.¹ In the end, however, inclusion can only take place when economic governance accepts two objectives, economic growth and opportunity creation with access to work, ownership and commerce.

12. Competitive labor rates are often the subject of international disputes with exporting countries singled out for labor markets that clear at substantially lower prices. In a global economy an individual is in competition not with his/her compatriot but with a worker somewhere else in the world. In this context, the best edge for the individual is to increase productivity through a higher level of human capital. In the presence of massive unemployment, however, economic policy should favor employment for persons with limited human capital by targeting markets for different products.

13. Several countries have succeeded by adopting a multi-pronged strategy based on the available resource endowments including their labor pool. This suggests several tiers of export complexity and sophistication requiring different levels of technology, labor skills and raw materials. In the end costs, quality and prices determine success.

The Role of the Public

14. For most of the last decade, Washington based organizations have promoted a series of structural reforms based on the principles stated in the Washington Consensus². Since a major component of these reforms focused on the reduction of fiscal deficits through smaller governments and privatization of state enterprises, many programs in support of the population were either cancelled or reduced in scope. The introduction of these changes created a perception in the public that structural reforms are a heavy burden to society and in particular to citizens groups dependent on government programs. The lagging successes have eroded public support for the reform agenda creating the imminent danger of falling back into the failed populist agendas of the past. To avoid this trap, a reform agenda has to be based not on preconceived formulas but on a pragmatic envelope based on results that can induce the support of the population and hence assure the continuity and sustainability of the required change.

Desired Conditions for Growth and Prosperity in a Global Economy

15. The reforms required by the Washington institutions often exhibit a weak linkage to the necessary conditions that move an economy toward the ideal general equilibrium. By endorsing a standard policy formula, the reforms ignore that economic efficiency can only be reached when all necessary conditions for market functioning are met and that a

¹ Rodrik D. (1997)

² It should be noted that Kuczynski and Williamson (2003) have compiled a new set of ideas to overcome the failures of the original formula. Their work fails to recognize the relevance of an expanding opportunity set.

less than complete set of conditions will not achieve the desired result. It is a fact that without broad and deep competitive markets the emphasis on a few macro policy variables is not sufficient to stimulate investment and growth. Another conceptual problem that arises is that all reforms must be viewed in light of a dynamic economic system. Acceptance of this condition suggests that three determining concepts have been missing: the timing of individual reforms; the sequencing of interrelated reforms; and the selection of the ones deemed binding in each country case³.

16. A review of the nature and scope of the reforms reveals a quilt of patches here and there often without completeness. What do we imply by completeness in the context of structural reforms? A reform package is complete when all distortions and market imperfections that are binding on the success of a given sector are addressed. Many distortions and market imperfections due to inappropriate policies are complementary and reinforcing. A comprehensive assessment at the country specific level of all the necessary conditions needed to restore confidence, investment and economic growth is required. Diligence in ensuring that all the necessary conditions become effective is the only way to reach completeness.

17. Countries that have succeeded in maintaining sustainable growth have done so with a variety of measures and dynamic policy stands, rather than with a dogmatic and rigid policy set. One common characteristic is that they have concentrated on the conditions that determine the efficient functioning of markets. It is also noted that policies that generate results are kept, while those that fail are immediately replaced. This implies that decision-makers have a constant focus on results. Given the different stages of the reform processes in the countries of the Latin American region, it is considered unwise to make specific recommendations about policy priorities as well as to classify reforms by vintage. There are no compelling reasons to state that some reforms are first or second generation if any of them is not generating economic growth.

18. The approach to follow should be based on a pragmatic view of the multiple attributes required to restore economic growth and opportunity creation for improved social conditions. From another angle, the approach aligns all necessary factors to set in motion the engine of trade and commerce that in turns captures savings and investment both locally and abroad. To the quantitatively minded, the issue is one of dynamic optimization based on a real problem in which variables relate only to the problem at hand and not to a problem somewhere else. Which policy is a part of the solution depends on where the system is at any given time. Hence the relevance of selecting the proper instrument variables and analyzing the timing and sequencing.

19. At the outset, it is important to recognize that economic growth based on trade and commerce in the global economy requires increases in the activity of many sectors, and that these activities at the micro-level all contribute to its competitive stand. Improving

³ Stiglitz (2002) has raised timing and sequencing, but has excluded selection. To aid in visualizing the critical relevance of these arguments, the reader is referred to the theory of optimal economic growth and dynamic general equilibrium.

competitiveness requires a variety of initiatives including policies, regulation, legal framework, and investment linked to production.

20. Investments to bring installed capacity to technological levels capable of producing the quality and productivity that permits placing the country's products on the markets of the world are a private activity in most countries that succeed. It is noted that in several Asian countries, strategic public support is also prevalent. Creating the proper environment and investing in strategic supportive areas is also seen in some cases as a public sector task. No specific guideline is given here. If public infrastructure development is the preferred way, the successful experience of many countries across the world should be sufficient to endorse this approach.

21. Although productivity gains and better efficiency contributes substantially to lower the FOB price of a manufactured good, high transactional costs can undermine factor cost savings, hence eroding competitiveness. Poor governance can increase the risk of having a stable and predictable platform for entrepreneurial activity. Each country has different endowments and conditions, reasons for which a country specific approach should be preferred over a standard solution.

22. To promote an outward-strategy, countries must get involved in sectors and industries with good potential for competitive production deploying incentives for robust private sector participation. Successful countries set targets for export and job creation growth, and move swiftly to enact measures to meet the targets. In this task, individual policies and programs remain in the solution depending on how well they perform. All actions and policies are results-driven. This is a dynamic process, with great agility and responsiveness to performance indicators broadly shared. The main task of public policy should be to identify and determine the timing and sequence of individual actions.

23. Recognizing that the individual decision to invest in a given activity or industry involves an assessment of a multitude of negative and positive attributes, the analysis and action should focus on shifting the negatives to positives through reforms. This includes a wide range of policies ranging from macro to national to sector to industry specific. The more general or macro the attribute is, the greater the significance in a wider number of activities or industries. For example, an efficient external sector with a competitive exchange rate is a necessary condition in practically all investment decisions. Having a sanitary service with international standing would be an essential factor for food production but not for metal mechanic manufacturing where metallurgic standards are relevant.

24. It is assumed that each investor views its own rate of return as a dependent variable of the relevant attributes to the activity or industry in question. Each investment decision is specific, and each has a unique signature. This signature can be visualized as a growth chain. Each attribute is a link in the chain. In order for the rate of return conditions to be favorable, and thus entice the investor, all links must be in place. Similar to the anchor chain of a ship, if one link fails, the chain fails to perform. Having all links in place has

been termed the "*completeness*" of the reform process. Notice that this micro-decision for each individual determines success at the aggregate level.

25. To create the environment supportive of an export drive the first task is for the public sector to create the conditions that swing investors to invest in the country. Good institutions as well as an appropriate policy set are necessary conditions. Private investors, both domestic and foreign, will invest in long term ventures only when this enabling environment is in place. These enabling conditions address the financial return expectations, preferences and risk bearing capacity of investors. Reviews of the countries that are successful at capturing investment from the global pool suggest attention to the attributes outlined below.

26. *National resolve.* The decision to create an export driven economy is not exclusively a decision of a few leaders or entrepreneurs. Experience indicates that the best practice model requires a national effort that includes a broad spectrum of society. Nations as a societal group seize the opportunity before them with the understanding that all members of society should be winners. In these cases, the public has a perception that the endeavor they commit themselves to is a win-win proposition for all, rather than for benefit of a few powerful groups. It is also understood that not all benefit at the same level. What is implied is that all benefit from the national commitment.

27. *Macroeconomic governance.* Fiscal policy seeking a national deficit below 2% of GDP continues to be an important factor in keeping inflation under control. This discipline should be a permanent feature of economic governance. A strong complementary policy instrument has to be devoted to increase domestic savings. As stated above, the high level of investment needed to get the economy growing comes from a combination of domestic savings and foreign investment. While public savings are paramount in providing ancillary investments such as economic infrastructure, the corpus of the resources originates in private sector resources. As a general rule, scarce public savings should be allocated to fund programs that are complementary and that increase the returns of private capital.

28. The development economics lessons learned suggest that good institutions and good policy matter. A state focused on being a regulator of economic activity setting the rules of the game for prolific and robust private sector activity is a key component of the successful model herein envisioned. Transaction costs throughout the economy should be low especially in the affairs requiring public involvement. A key factor in this model of development is the presence of a financial sector that will allocate resources throughout the economy. In practice, a deep financial system with a large number of players brings saving vehicles to a broader public while granting access to businesses and individuals that are not part of power groups or financial cartels. Financial regulation and close surveillance of the banking system are critical attributes.

29. Strong equity markets are also part of the overall effort to increase vehicles for directing savings and more importantly to provide the vehicles for the small investor to participate in the benefits of growth. Spreading ownership is a key factor in the creation

of a middle class, an objective that is not only economic but that increases the stability of societies and the way they go about choosing their leaders.

30. External sector liberalization addresses the need to migrate into an outward looking economy. The elimination of trade barriers both for importers and exporters facilitates inter-border transactions getting local producers much closer to the markets of the world. Country cost, a key indicator of the competitiveness of an economy includes not only the factor cost but also all the transactions costs levied by the national and local governments on the exporter or producer.

31. There are many areas in which actions can be taken to lower these costs, ranging from export tariffs to customs fees to the time merchandise is kept in processing when arriving or leaving the country. All these areas must be considered as possible targets for improvement in order to make transactions more efficient and to lower country cost. It should be noted that distortions in the international system due to the preferences and particular interests of industrialized nations will continue. Furthermore, their efforts to grant priority to their interests will continue in the international arena regardless of the consequences for emerging economies. This implies that internal pressure on those countries to continue to protect traditional industries like textiles, garments and agricultural products will continue. Hence the need to establish an export drive that is not based on the products with difficult market permeability.

32. The most critical macro variable in terms of competitiveness is the management of the exchange rate. Whatever countries have done in the past, the most disastrous consequences have been observed when there is reluctance to free the exchange rate. An overvalued exchange rate tends to erode the competitiveness of local producers and results in production being sold domestically on a small scale. The lack of incentives to modernize and expand also limits economies of scale and in the end firms become unprofitable. Damage to the productive capacity brings along widespread unemployment aggravating social conditions and increasing poverty. The model that is envisioned here calls for constant vigilance of the exchange rate. Several models have been tried in order to promote the competitiveness of non-traditional exports, a goal of the expanding model proposed here. The successes indicate that the system has to be responsive and in close linkage to capital inflows which tend to put upward pressure on exchange rates.

33. Institutional arrangements that act independently of the political cycles of the country are also an imperative need. These start with the central bank. Several countries in Latin America have enacted laws granting independence and autonomy to these institutions to manage fiscal monetary policy introducing a stabilizing and comfort generating factor in macro economic governance. The more public institutions follow national objectives rather than the needs of particular governments, the better the system is in creating the sense of predictable rule and stability needed to attract the private investor. Both institutions and policies are critical.

34. The last element in the attributes required in terms of macroeconomic policies relates to the tax system and its impact on the allocation of capital to production and job

creation. Taxation policy in the region has often been unbalanced with marginal tax rates that are higher for those in the middle than those in the upper tiers. While there are sufficient arguments to utilize taxation as a tool to correct inequalities, it has also been established that excessive progressive taxation can stifle investment and drive capital away rather than attract it. This is pertinent because the rate of private investment determines to a large extent the rate of job and opportunity creation, engines to solve the inequality problem.

35. ***Governance and the rules of the game.*** The need to create an environment that enables a robust increase in private activity in the countries of the region has already been mentioned. This enabling environment starts with a rule of law that is reliable and that has processes that are perceived by the public in the country and abroad as just and fair to all. Dispute resolution for the exercise of a broad class of individual and corporate rights is also a desirable feature of the legal system. Secure property rights actively extended to the informal sector providing the entry point for the expansion of economic opportunities must be part of a low cost unbiased and fair legal system.

36. Regulatory functions and rules and procedures that are based on analysis and logical justifiable basis, with transparent and clear purpose, are part of the rules of the game. Independence from political powers and day to day pressure is a must to create these conditions. When the rules change from government to government, as is often the case in the region, country risk increases and long term decisions regarding investment are deferred. This is the crucial linkage between national policy and the policy of the current government. Through their elected representatives societies must understand that they have to make long term contracts with those who have savings to invest. Their decision is a micro-economic decision based on trust and reciprocity. Failure of this social capital equation to materialize through good long-term governance severely hinders the chances of making the best practice model herein discussed possible.

37. Whatever the form of government in practice in the country, priority must be granted to maintaining the rules in all sectors of the economy. Integrity and rectitude of public servants driven by incentives of merit and fairness rather than by political favoritism and special interest retribution should be the norm. Corruption, a prevailing and pervasive characteristic of governments in the region, should be fought aggressively since its prevalence erodes the values of society and in the end destroys the confidence for the industrious pursuit that is at the core of the best practice model.

Social Needs and Sustainable Interventions

38. As previously stated, the primary objective development interventions should be driven by a desire to increase the inclusion of the poor. This calls for a massive program of opportunity creation to provide the insertion points for the common citizen. Opportunities alone without the capabilities of the public, as well as the enabling environment to access them, is not sufficient to reach a sustainable solution. Surveillance of the match between the opportunities created and the capabilities of the public to seize them must be carried out in a continued basis. These analyses must guide the deployment of public programs to increase the capabilities and the access of the population.

39. While the needs for social expenditures in most countries will continue to be large, realignment and refocusing of priorities to enhance the programs that provide these capabilities is highly advisable at the initial stages of the recovery of economic growth. Once economic activity takes off, additional revenues will materialize expanding coverage and quality of services. Regarding social expenditures, current efforts to streamline and to increase the efficiency of public programs should be granted priority. It should be remembered that the desired model is based on substantial allocations to the development of technology and innovation, which in turn requires sustained contributions to human capital formation and to basic social services.

40. A popular view suggests that investing in education is the correct approach to become competitive and to restore growth. This is not totally true. The issue is not if education investments are warranted or not. Timing and sequencing is the issue. Traditional education might be appropriate for the youngest segment of the population but inappropriate to optimize the potential contribution of older workers already in the labor pool. Given the vintage of human capital, the optimal rule must be based on the marginal contribution of each labor vintage to national welfare through production. This indicates that alternate methods of education such as on the job training are valuable instruments to consider.

41. There is no question that education should be supported. The issue is how to use the scarce resources available to the economy at the initial stages to optimize the expenditure keeping in perspective the time delay of educational investments. In this context, it is worth noting that the region's demographic window of opportunity impacts this optimal solution. Indeed, it suggests that the highest return in terms of public programs is in improving the capabilities of the active population since they are the ones that in the short run can participate in the economic expansion.

42. Poverty reduction therefore should be given priority with a clear understanding that real poverty reduction requires sustainable income gains at the household level. Programs that generate a temporary improvement or that have to be funded on a permanent basis by public transfers are merely poverty alleviation. In view of the fiscal requirements of these types of programs, careful targeting is advisable. Overburdening the economy with higher marginal tax rates to fund alleviation programs deter capital accumulation, a key component of the desired economic expansion.

Passive or Active Public Sector

43. The roles of the public and private sectors have been in turmoil in the last ten years in the region, with Washington institutions insisting on rigid rules encompassing limited participation of the public sector in the economy while enforcing a strong privatization rule. It is likely, however, that the best approach should rely in a flexible role for the public sector focusing on a progressive transfer to the private sector of functions best suited for private management. In reality, the best practice model shows a mixed application of these principles. In several Asian countries, specific actions of the government have gone beyond compensation for market imperfections and distortions.

Often public programs have supported, among others, the entrance of new players into the economy, credit and services to improve the competitiveness of the small entrepreneur, technology and innovation, export promotion, curtailed by regulatory and investment decisions that increase the power and control of large groups, and to provide economic infrastructure.

44. Several countries in the region have applied this pragmatic model recognizing that there are sectors in the economy that require this public presence. In any case, the best practice model shows no unique trends in this area. The only characteristic of note is that when there is an active public presence, it is strategic and has a purpose determined by how well the activity performs through time. Constant review of the effectiveness of these programs is required. Incentives to drive the systems toward efficiency must be in place in order to facilitate goal seeking and adaptability. Some of the government interventions seen in the best practice model include export promotions, entrepreneur formation, competitive credit access, technological transfer and innovation, trading company formation, and tax regimes for cooperative production schemes.

A Reform Process to Induce Exports Investment and Job Creation

45. As defined by The Global Competitiveness Report 2000⁴, the level of competitiveness of a country is a complex condition linked to factor costs and to many non-economic/financial attributes. These factors and non-economic/financial attributes determine the inherent risk of the country, and in turn the expected financial rate of return of investment. To succeed in transforming an economy into an export machine, multiple changes in diverse sectors and industries need resolution. Incomplete reforms not linked to specific results at the industry and sector levels do not generate new investment and economic growth.

46. It is helpful to visualize the reforms needed in a two dimensional matrix with rows that include the attributes or links of a chain, ("*growth chains*") with columns including each individual sector or industry. At the bottom, a row contains a Boolean expression representing the logic intersection of all the attributes in the column. The expression indicating outcomes is "true" when all attributes have been resolved; it is "null" when as few as one of the attributes fails.

47. To enrich the analysis, think of the matrix described above as composed of independent probability density functions defining the relative risk of investing in each industry, with the vector corresponding to the Boolean expression at the bottom as the dependent probability density function depicting the success for the investor. In other words, the matrix defines the inherent risk of investing in a particular industry in the country. In a global economy, the investor's decision to make a specific investment in a given location is regulated by the relative choice of alternative expected rates of return.

48. It should be seen from this simple analysis that to succeed the Boolean expression has to be a union and not an intersection. By insisting in incomplete reforms, policymakers have ignored the most basic conditions of sufficiency, hence the failure of many reform

⁴ "The Global Competitiveness Report 2000", World Economic Forum, Geneva, Switzerland 2000.

programs to restore economic growth and to induce private investment at the individual level.

49. The promotion of private sector investment for export production and job creation is a complex and interrelated problem covering many sectors and many industries. To generate results, a process of organizing public action with rigor and method is needed.

50. To start, public action should include the national policy and commitment to identify and enact the enabling environment for private sector investment. The centerpiece of this task includes the identification of the growth chains by sector, industry and activity. Next, the list of the actions and reforms needed to enable the "*completeness*" of the growth chains must be defined. All links to the chain as well as the corresponding laws and procedures must be set in motion to procure approval by the pertinent entities or authorities.

51. Once reforms are launched and results begin to appear, a monitoring function is deployed to support decision-making and program guidance. Attention is given to identify factors that assure continuity ("*anchors of continuity*"). For example, periodical reports to all partners in the public are provided demonstrating results as well as who benefits from the reforms. Real benefits to the population grant incentives for continuing support and sacrifice.

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