

This PDF is a selection from a published volume from the National Bureau of Economic Research

Volume Title: The Decline of Latin American Economies: Growth, Institutions, and Crises

Volume Author/Editor: Sebastian Edwards, Gerardo Esquivel and Graciela Márquez, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-18500-1

Volume URL: <http://www.nber.org/books/edwa04-1>

Conference Date: December 2-4, 2004

Publication Date: July 2007

Title: Introduction to "The Decline of Latin American Economies: Growth, Institutions, and Crises"

Author: Sebastian Edwards, Gerardo Esquivel, Graciela Márquez

URL: <http://www.nber.org/chapters/c10651>

Introduction

Sebastian Edwards, Gerardo Esquivel, and
Graciela Márquez

For a long time Latin America's economic performance has puzzled economists and historians. How can we explain that a region so rich in natural resources has had such a mediocre economic performance? Why has Latin America lagged behind, while its neighbors to the north—the United States and Canada—have developed and flourished? Why is it that after being one of the wealthiest nations in the world in the late nineteenth century, Argentina has joined the ranks of the crisis-prone countries? The papers collected in this volume deal with these issues from a historical perspective. In December 2004 the authors met at El Colegio de Mexico in Mexico City and spent two days discussing why Latin America's history has been characterized by mediocre growth, rampant protectionism, very high inflation, low productivity growth, and successive crises. Two themes run through these papers: (a) institutions have played an important role in shaping the Latin American economies; and (b) political considerations—including, in particular, distributional struggles—have been crucial in determining economic outcomes in the region.

Inequality and backwardness have been two central features of Latin American economies during the last two centuries. The region's skewed income distribution was already apparent to European travelers journeying in the Spanish colonies at the beginning of the nineteenth century. Many of

The papers collected in this volume were presented at the National Bureau of Economic Research's (NBER) Inter-American Seminar on Economics (IASE), held on December 6–8, 2004, at El Colegio de Mexico, Mexico City.

Sebastian Edwards is the Henry Ford II Professor of International Economics at UCLA's Anderson Graduate School of Management and a research associate at the National Bureau of Economic Research. Gerardo Esquivel is a professor of economics at El Colegio de Mexico, and Graciela Márquez is a professor of history at El Colegio de Mexico.

them pointed out the enormous gap that existed between the rich and the poor in the region.¹ Inequality has remained a salient feature of Latin America despite the profound economic transformations that have taken place in the region in the last two centuries. At the same time, Latin America's growth record has been insufficient to close its income gap with north Atlantic economies. Initial studies on international comparisons of long-run growth reveal that, relative to the United States, Latin America fell behind between 1700 and 1900.²

The study of colonial institutions and economic performance in the half century after Independence remains crucial for understanding how Latin America fell behind. Inequality inherited from the colonial past (and reproduced in the nineteenth century) shaped Latin American structures of taxation in ways that not only differed radically from the United States and Canada, but also from other developing economies. Differences prevailed well into the twentieth century. Lessons learned from the study of fragmented markets, political instability, and weak institutional structures—salient characteristics of nineteenth-century Latin America—illuminate not only our knowledge of the past, but also provide important elements to understanding present-day problems of this and other developing regions of the world.

At the end of the nineteenth century, and after decades of virtual stagnation, Latin American economies began to experience a slow but sustained recovery. This resumption of growth coincided with a process of globalization in the world economy that was characterized by an increased worldwide integration of commodity and factor markets. The expansionary cycle of the world economy increased the demand for raw materials and foodstuffs, benefiting export sectors throughout the region. However, only in Argentina did the export sector truly become the engine of growth for the three decades before the First World War.³ The resumption of sustained per capita gross domestic product (GDP) growth elsewhere faltered due to a number of factors, including weak institutions, poor infrastructure, and misguided economic policies.

Throughout 1870–1913 the vast majority of Latin American countries became recipients of international capital inflows in the form of foreign direct investment and foreign loans. Virtually every government borrowed in international capital markets, mostly in gold-denominated debt.⁴ While in many instances external debt financed the construction of railroad net-

1. "Mexico is the country of inequality. Nowhere does there exist such a fearful difference in the distribution of fortune, civilization, cultivation of the soil, and population" (von Humboldt, 1811, p. 134).

2. This conclusion is best presented by John Coatsworth's "Economic and Institutional Trajectories in Nineteenth-Century Latin America" (1998).

3. For an examination of the export-led growth see Victor Bulmer-Thomas (1994).

4. The pioneering study of the history of foreign debt in Latin America from a long-run perspective is Carlos Marichal (1989).

works, port facilities, and public works, it also exposed Latin American economies to banking and currency crises. Indeed, the accumulation of external debt denominated in foreign currency precipitated financial crises in countries like Brazil and Argentina, where foreign debt and fiscal mismanagement led to economic catastrophes.⁵ Interestingly, in other then-emerging and peripheral economies, including British offshoots (Australia, Canada, New Zealand, and the United States) and small European countries (Norway and Finland), stronger fiscal and financial systems helped reduce the frequency and virulence of financial crises.

The disruption of trade and capital flows brought about by World War I and its aftermath resulted in the expansion of the manufacturing sector in more diversified economies; at the same time, export sectors suffered from cyclical movements in commodities markets. Latin America was still highly vulnerable to external shocks, and the Great Depression reduced income per capita throughout the region. Individual outcomes, however, varied, depending on the degree of openness, the behavior of export prices, and the degree of diversification of the nonexport sector. The recovery from the slump of the early 1930s was in part helped by unorthodox policy measures, including very large real devaluations and increases in government spending, which facilitated import substitution and appeased social protests.⁶ The outbreak of World War II resulted in renewed external restrictions in commodity and capital markets, further reducing export earnings and foreign borrowing for the region as a whole. In the late 1940s, economic policy deliberately promoted domestic manufacturing in countries such as Brazil, Mexico, Colombia, Argentina, Chile, and Peru. In these countries a diversified industrial base and a sizeable domestic market gave credence to theories supporting industrialization through import substitution. Thus, the larger economies in the region followed an inward-looking strategy based on the rise of protection levels, capital controls, exchange controls, multiple exchange rate schemes, and public intervention in labor markets.⁷

In the period 1950–1960, average GDP growth rate for the twenty largest Latin American economies was 5.3 percent. Yet, the variance across the region was significant, and the acceleration of population growth lowered GDP per capita rates. For instance, the larger economies (Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela) averaged only 2.4 percent in GDP per capita growth in the period 1950–1973. Growth rates masked problems associated with trade and capital controls and protec-

5. See, for example, the paper by Bordo and Meissner in this volume, as well as the references cited therein.

6. Latin American responses to the 1930s Depression were systematically analyzed in Rosemary Thorp (1984).

7. For an evaluation of price distortions of inward-looking development see Sebastian Edwards (1992). For a recent treatment see Alan Taylor (1998).

tionism: inefficient allocation of resources, inflationary pressures, monopolistic industrial structures, and growing current account and public deficits. Concerns about macroeconomic behavior appeared at different junctures in different countries, and stabilization programs attempted solutions that had varying degrees of success. By the 1960s, under the auspices of the United Nations Economic Commission for Latin America, the model of inward-looking development was present in virtually every country in the region. In the period 1950–1973, the economies of Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela grew, on average, at a rate of 2.4 percent, whereas smaller and less diversified economies had a much lower growth rate.⁸ Even if we consider the first group of countries as representative of Latin America, GDP per capita growth rate was only higher than that of African countries, and was similar to that of the western offshoots (Australia, Canada, New Zealand, and the United States). During this period, other regions in the world expanded at a more rapid pace: Asia (2.6 percent), Eastern Europe (4.0 percent), Southern Europe (4.8 percent), and western Europe (3.8 percent).⁹

In the 1960s, most Latin American governments considered regional integration to be the means to remedy some of the pitfalls of the inward-looking strategy, in particular growing external imbalances. Yet, the lack of harmonization between exchange rate, fiscal and monetary policies produced poor results. More importantly, the dominant autarkic orientation remained unchanged, as did the price distortions associated with it. Not implementing a policy shift at that time (the 1960s) was a lost opportunity for Latin America; price distortions became more severe in the 1970s and 1980s, and distortive policies had long-run effects on accumulation and growth.

In other latitudes, developing economies also industrialized, following similar inward-looking strategies. In particular, the economies of East Asia promoted import substitution industrialization in the early post-World War II period, with policies and instruments similar to those implemented in Latin America. In the 1960s and 1970s, however, the policy menu in East Asia shifted away from inward-looking development and increasingly moved toward outward orientation. Integrating with global markets allowed East Asia to maintain a fast-growing development until the 1990s, a trajectory that contrasts sharply with the dismal economic growth record of Latin America in the last quarter of the twentieth century.

A key conclusion from the study of the Latin American economic past is that history matters. Despite its simplicity, this observation points out the complexities involved in understanding the fundamental connections

8. For figures on average and individual GDP growth rates see Bulmer-Thomas, *op. cit.*, table 9.4, 309.

9. Growth estimates correspond to estimates by Angus Madison (1995).

between growth trajectories and institutional paths. The essays in this volume show important dimensions of the historical interaction of economic performance and institutions in Latin America. This book also offers analytical insights into today's debates on the implications that political and institutional changes may have on economic development.

The volume is divided into three parts: part one deals with economic growth, taxation, and institutions, and has three papers. Part two includes five papers and focuses on financial crises, lending, and inflation. The third part has two papers on protectionism and economic performance. In the rest of this introduction I provide a reader's guide to the volume.

Economic Growth, Taxation, and Institutions

The volume opens with a paper by Leandro Prados de la Escosura titled "When Did Latin America Fall Behind?" In this piece Prados de la Escosura asks one of the fundamental questions in Latin America's economic history: has the income gap between Latin American countries and the core of advanced nations widened over time? And if so, when did this widening begin? Was there an era when Latin America grew at a rate comparable to that of the core nations? And, perhaps more important, why did Latin America fall behind? In an effort to address these issues Prados de la Escosura uses some tools of the inequality literature. He addresses long-run intercountry inequality in terms of real GDP per head (purchasing power adjusted). He also uses an improved human development index as an indicator of welfare for present-day Organization for Economic Cooperation and Development (OECD) countries and for Latin American nations. Prados de la Escosura's analysis shows that there has been a long-term rise in income inequality for this sample of countries. The main determinant of this increased cross-country inequality is the widening gap between the OECD and Latin America. The author argues that contrary to popular belief, Latin America fell behind, in terms of income, in the late twentieth century—not in the nineteenth century. Furthermore, the author argues that "the decline that probably took place in the decades after independence seems hardly comparable to the dramatic fall that took place in Latin America's relative position to the OECD in the late twentieth century." Prados de la Escosura also shows that, although cross-country inequality in terms of human development declined over time, the gap between OECD and Latin American countries remained largely unchanged.

In "Before the Golden Age: Economic Growth in Mexico and Portugal, 1910–1950," Pedro Lains provides a comparison of Mexico's and Portugal's economic growth during the first half of the twentieth century. He argues that what makes these countries particularly interesting is that they experienced solid growth in the interwar years, a period when most of the world was either stagnant or experiencing economic retrogression. Eco-

conomic expansion in these two countries was the result of structural changes at the aggregate level as well as at the industrial sector level. These reforms favored those sectors with above-average total factor productivity and, thus, contributed to faster growth. Perhaps more importantly, during the interwar period the exchange rate was used as the most important tool for protecting local industries. This contrasts sharply with both countries' later experiences—Portugal after 1973 and Mexico after 1982—when import tariffs and quantitative restrictions were used as the main sources of protection. Lains also argues that his results call into question the traditional interpretation of Mexico's and Portugal's industrialization. According to traditional views, this process took off after World War II; the data discussed by the author suggest that strong industrialization forces were already gathering momentum during the interwar years. The author also discusses some of the most important differences between Mexico and Portugal, including political differences, differences in external policy, and demographic differences.

The next chapter, "Inequality and the Evolution of Institutions of Taxation: Evidence from the Economic History of the Americas," is by Kenneth L. Sokoloff and Eric M. Zolt. The authors analyze the role played by institutions in shaping Latin American countries' ability to raise revenues through taxation. Sokoloff and Zolt argue that the way in which nations organize their tax systems has widespread economic and social effects. It affects economic performance, productivity, inequality, and the degree of decentralization. The main interest of Sokoloff and Zolt is to analyze the relationship between inequality and taxes. They ask how and why tax institutions have differed and evolved throughout the countries of the Americas. They argue that there are striking contrasts in the tax systems of developed and developing countries; while advanced nations rely heavily on income and broad-based consumption taxes, emerging countries rely on taxes on international trade, value-added taxes, and turnover taxes. Sokoloff and Zolt also argue that developing countries are more likely to raise taxes at the national level rather than at the state and local level. Departing from traditional works that have asked how taxation affects inequality, Sokoloff and Zolt analyze the ways in which inequality may influence the design and implementation of tax systems. They argue that one of the most important reasons why tax structures in Latin America look so different from tax structures in North America is *not* that one region is rich and the other poor. Even when incomes across the North and the South were relatively equal, the tax structures were very different. Sokoloff and Zolt ask whether these differences in taxes (and spending) might play a role in explaining the divergent paths of long-run development. Their thesis, that inequality plays an important independent role in influencing the structure of taxation, is supported by comparisons between Latin America and

North America, as well as by comparisons between the respective countries within each of these regions.

Financial Crises, Lending, and Inflation

The first chapter in part two of the volume is “Financial Crises, 1880–1913: The Role of Foreign Currency Debt,” by Michael D. Bordo and Christopher D. Meissner. In this paper, Bordo and Meissner inquire what has been the role of foreign currency debt in precipitating financial crises in Latin America. This question, which has recently been discussed in the context of modern crises, has received the name *liabilities dollarization*, as the cause of financial crises. According to this literature, countries that have a high proportion of their debt in foreign currency are more prone to having a financial crisis. Moreover, in countries with a high degree of liabilities dollarization, crises will tend to be profound and costly. In their paper, Bordo and Meissner put together a data set for nearly thirty countries between 1880 and 1913, and examine debt crises, currency crises, banking crises, and twin crises. Bordo and Meissner pay special attention to the role of foreign currency and gold clause debt, currency mismatches, and debt intolerance. They argue that there is strong evidence that suggests that a larger proportion of foreign currency debt leads to a higher chance of having a debt crisis or a banking crisis. An important finding, however, is that countries with strong institutions, with very different historical backgrounds, such as Australia, Canada, New Zealand, Norway, and the United States, were able to manage their exposure to hard currency debt, and were able to avoid having recurrent crises. Furthermore, these countries never had severe financial meltdowns. Bordo and Meissner also find that a strong international reserve position seems to be correlated with a lower likelihood of a debt crisis, currency crisis, or banking crisis. According to them, “this strengthens the evidence for the hypothesis that foreign currency debt is dangerous when mismanaged.” An important finding is that a history of defaults matters: countries with previous default histories seem prone to debt crises, even when they have low debt ratios.

In “The True Measure of Country Risk: A Primer on the Interrelations between Solvency and the Polity Structure of Emerging Markets: Argentina 1886–1892,” Gerardo della Paolera and Martin Grandes use Argentine data from the late nineteenth century to analyze the behavior of a true measure of country risk. What makes this period particularly interesting is that in 1890 the world suffered the first widespread emerging market capital and debt crisis—the so-called *Barings* crisis. Della Paolera and Grandes’ most important contribution is constructing a measure of country risk that takes into account the evolution of both national, provincial, and local debt. This measure acknowledges the importance of the political

structure of an emerging nation, such as Argentina, in determining its degree of participation and its strategies in international debt markets. The authors argue that the rationale for constructing this index of the true degree of risk premium is that the polity structure of a country matters for the conduct and outcome of the public debt phenomenon. This is particularly the case if the country has—as in Argentina—a federal structure with a significant struggle between the provinces and the federal government. The authors argue that this index informs policymakers and investors about the true country risk in federal countries where subsovereign entities are fiscally interdependent and potential time inconsistencies and sovereign moral hazards are present. Della Paolera and Grandes show that their true measure of country risk departs from the traditional typical sovereign risk spread by 200 to 350 basis points as Argentina approached its 1890 financial crisis.

In “Related Lending: Manifest Looting or Good Governance? Lessons from the Economic History of Mexico,” Noel Maurer and Stephen Haber use Mexican historical data to analyze the extent to which banks lent to related firms during the 1884–1910 period. This has become an important question in modern economics, as scholars have tried to determine whether managers channel bank resources to related firms. Maurer and Haber argue that the dominant view among academics and policymakers is that related lending, a widespread practice in most emerging nations, should be discouraged, because it provides a mechanism through which bankers can loot their own banks at the expense of minority shareholders and depositors. The authors, however, take a different view, and argue that neither looting nor credit misallocation are necessary outcomes of related lending. According to them, related lending is the natural outcome of economic, financial, and institutional structures that result in very high information costs and contract enforcement costs. Maurer and Haber argue that whether related lending encourages looting depends on the other institutions that support the banking system. According to them, a particularly important factor is whether existing institutions give depositors and minority shareholders incentives and mechanisms to monitor directors, as well as incentives for directors to monitor other directors. On the basis of their empirical analysis using Mexican data from the Porfiriato period, the authors conclude that related lending does not need to be economically inefficient. They identify four conditions that would prevent related lending from becoming a form of organized looting. First, banks must be well capitalized. Second, bank directors must have a substantial equity position in their own banks. This gives them incentives to monitor one another. Third, minority and outside shareholders must have their own money at risk. And fourth, there should not be deposit insurance that covers one hundred percent of deposits.

In “Sudden Stops and Currency Drops: A Historical Look,” Luis A. V.

Catão uses a data set for 1870 through 1913 to analyze the salient characteristics of sudden stops of capital inflows to both core and periphery countries. Catão argues that the behavior of capital markets during the period preceding World War I was remarkably similar to what we have observed during the last two decades. The analysis focuses on four issues: first, Catão shows that during the period under study all main capital-importing countries sporadically faced capital flow reversals. During these reversal episodes the volume of capital flowing out amounted to approximately 4.5 percent of GDP, on average. Second, the analysis shows that these sudden stop episodes affected both fixed and floating exchange rate countries. Moreover, according to Catão's results, there were no significant differences in sudden stops under the two regimes. Third, the results discussed in this paper show that most sudden stop episodes displayed significant cross-country synchronization. Moreover, they were all immediately preceded by an increase in international interest rates. This important result provides some evidence for the existence of contagion during the late nineteenth and early twentieth centuries. Fourth, Catão shows that not all sudden stop episodes resulted in currency collapses: while some countries did experience dramatic currency depreciations, others managed to preserve exchange rate stability. According to the author, "these distinct responses are related to domestic factors that heightened the pro-cyclicality of capital inflows and domestic absorption in some countries—notably in Latin America and Southern Europe—relative to others."

In "Establishing Credibility: The Role of Foreign Advisors in Chile's 1955–1958 Stabilization Program," Sebastian Edwards analyzes Chile's experience with anti-inflationary policies in the mid-1950s. In 1955–1958 Chile implemented a stabilization package with the advice of the U.S. consulting firm of Klein-Saks. At the time the program was put in place inflation had reached the extremely high annual level (for that time) of 85 percent. The policies adopted contradicted the newly dominant orthodoxy in Latin America that associated inflation with *structural* problems. The Klein-Saks program took place in a period of acute political confrontation. After what was considered to be an initial success—inflation declined to 38 percent in 1956, and was further reduced to 17 percent in 1957—the program failed to achieve durable price stability. Edwards argues that the foreign advisors of the Klein-Saks Mission gave *initial* credibility to the stabilization program launched in 1955. According to him, these foreign advisors played the role of independent, nonpartisan, technocratic arbiters. It was precisely because they were foreigners that they could rise above the political fray and suggest a specific program, whose main components were rapidly approved by a highly divided Congress. The fact that the program was very similar to one proposed earlier by the government—and that was rejected by Congress—underscores the view that, while locals are suspect of being excessively partisan, foreigners are often (but not al-

ways) seen as independent policy brokers. But providing *initial credibility* was not enough to ensure success. In spite of supporting trade reform, foreign exchange rate reform, and the de-indexation of wages, Congress failed to act decisively on the fiscal front. Consequently, the fiscal imbalances that had plagued Chile for a long time were reduced but not eliminated. In 1957, a sharp drop in the international price of copper—the country’s main export—resulted in a major decline in fiscal revenue and an increase in the fiscal deficit. The Mission recommended a series of belt-tightening measures, but politicians had had enough of orthodoxy. No adjustment was made, and inflationary expectations once again shifted for the worse. Edwards presents empirical results on the evolution of inflation, exchange rates, and interest rates that support his analysis.

Protectionism and Economic Performance

The last two chapters in the volume deal with protectionism and economic performance, an issue that has been of great interest to Latin American scholars for a long time. Indeed, a number of analysts have argued that Latin America’s mediocre growth and its historically unequal income distribution have been, at least in part, the result of pervasive protectionist policies. In “Some Economic Effects of Closing the Economy: The Mexican Experience in the Mid-Twentieth Century,” Gerardo Esquivel and Graciela Márquez investigate the closing of the Mexican economy in the mid-twentieth century and how it affected the Mexican economy. They are particularly interested in understanding how protectionism affected the economic structure, as well as conventionally defined economic performance. In the first part of the chapter the authors describe the type of commercial policies implemented in Mexico during the first part of the twentieth century. The authors then use data from the Industrial Census for 1945–1965 to investigate the way in which these policies affected employment, wages, and the regional location of economic activity. Their results provide support for the wage and employment implications of standard international trade theory. An important finding, however, is that commercial policy in Mexico during the mid-twentieth century does not appear to have affected the geographical pattern of production. Esquivel and Márquez reach this conclusion after having analyzed the evolution of a “location index” and a “regionalization index.”

The final paper in the volume is “The Political Economy of Protectionism: The Mexican Textile Industry, 1900–1950,” by Aurora Gómez-Galvarriato. In this paper Gómez-Galvarriato uses microdata from a textile mill in Mexico to analyze the evolution of prices, costs, and productivity during a period of increasing protectionism. In order to have a benchmark for comparison, Gómez-Galvarriato also analyzes the behavior of key data in textile mills in the United States, Great Britain, and

Japan. What makes this analysis particularly interesting is that the data come from the archives of one of the oldest textile firms in Mexico: the Compañía Industrial Veracruzana S.A. (CIVSA). According to Gómez-Galvarriato's analysis, in 1911 CIVSA was quite efficient, and its levels of productivity compared favorably with those in the United States and in the United Kingdom. CIVSA's productivity levels, however, did not increase during the rest of the twentieth century. According to the author, this dismal performance was not the result of a single factor; it was the consequence of a complex confluence of policies and circumstances. At the time of the Great Depression the different actors in this saga—unions, stock owners, management, and the government—decided that maintaining the status quo was the best way of dealing with the crisis. Subsequently, however, every effort to improve technology was opposed by unions and, to some extent, by industrialists, who could do well as long as import tariffs were sufficiently high. According to Gómez-Galvarriato the government also benefited from this arrangement, as it could maintain a relatively peaceful labor-relations regime in a sector that was considered to be politically very important.

References

- Bulmer-Thomas, V. 1994. *The economic history of Latin America since independence*. New York: Cambridge University Press.
- Coatsworth, J. H., and A. M. Taylor, eds. 1998. *Latin America and the world economy since 1800*. Cambridge, MA: Harvard University Press.
- Edwards, S. 1992. Trade orientation, distortions and growth in developing countries. *Journal of Developing Economics* 39:31–57.
- Madison, A. 1995. *Monitoring the world economy*. Paris: OECD.
- Marichal, C. 1989. *A century of debt crisis in Latin America: From independence to the Great Depression, 1820–1930*. Princeton, NJ: Princeton University Press.
- Taylor, A. M. 1998. On the costs of inward-looking development: Price distortions, growth and divergence in Latin America. *Journal of Economic History* 58:1–28.
- Thorp, R., ed. 1984. *Latin America in the 1930s: The role of the periphery in the world crisis*. New York: St. Martin's.
- Von Humboldt, A. 1811. *Political essay on the kingdom of New Spain*. Trans. John Black. London: Brown.

I

Economic Growth, Taxation, and Institutions

