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Latin America

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John Williamson's contributions to economics and economic policymaking are outstanding in at least two major and interlinked fields of study: analysis of the international monetary system and macroeconomic analysis. In the latter field, his analysis is particularly notable on exchange rate regimes and capital account regulations. His work on these two macroeconomic issues has been full of rich references to several Latin American experiences, a region that has been on his radar throughout his professional life. His specific contributions to Latin American debates are intrinsically linked to his drafting of the now classic "Decalogue" of the Washington Consensus (Williamson 1990), as well as his later review of Latin America's reforms and how to improve their results in the edited volume with Pedro-Pablo Kuczynski, *After the Washington Consensus: Restarting Growth and Reform in Latin America* (Kuczynski and Williamson 2003).

This chapter reviews some of the debates on the structural reforms and macroeconomic dynamics of Latin America, with a specific reference to Williamson's contributions to those debates. It first looks back at the initial Decalogue and how much it was implemented in Latin America, then examines the relevance for the region of Williamson's contributions to the analysis of exchange rates and capital account regulations, and finally the success and frustrations with market reforms in Latin America.[1]

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1. The discussion of the Latin American experience with market reforms borrows from Bértola and Ocampo (2012, chapter 5).

The Washington Consensus

John Williamson coined the term "Washington Consensus" in 1989 for a project for the Institute for International Economics. The Decalogue that he then drafted was neither his own agenda nor what he regarded as the neoliberal doctrine. In the first case, he aimed at setting out "what would be regarded in Washington as constituting a desirable set of economic policy reforms" (Williamson 1990, 7). In the second case, he did not include the strict neoliberal agenda, which he understood as the mix of monetarism, supply-side economics, and minimal government, none of which were part of any "consensus," even in Washington circles (Williamson 2008). Furthermore, although his own ideas were broadly in line with the Decalogue, which he conceived as a mix of "prudent macroeconomic policies, outward orientation, and free-market capitalism" (Williamson 1990, 18), he adopted rather nuanced views on several of the issues involved. Be that as it may, the term became the center of a fierce ideological debate, with critics of market reforms identifying it with market fundamentalism. To use the term of Nancy Birdsall, Augusto de la Torre, and Felipe Valencia Caicedo (2011), the consensus became a "damaged brand," which was certainly not Williamson's fault.

Half of the Decalogue was on what Williamson called "prudent macroeconomic policies": fiscal discipline and public sector spending priorities (particularly health, education, and infrastructure), and the need for tax reform, market-determined and positive real interest rates, and competitive and relatively stable real exchange rates. In the first of these areas, Williamson's view was that "a balanced budget (or at least a nonincreasing debt-to-GNP ratio) should be a minimal medium-run norm, but that short-run deficits and surpluses around that norm should be welcomed insofar as they contribute to macroeconomic stabilization," a view that, as he pointed out, was considered at the time to be too Keynesian in Washington circles to be part of any consensus (Williamson 1990, 9). In relation to interest rate policies, his view was that "interest rates should be positive but moderate, so as to promote productive investment and avoid the threat of an explosion in government debt" (Williamson 1990, 13), even hinting at the desirability of some state regulation in certain cases. He would add later that he should have made a stronger case for prudential regulation as an essential part of domestic financial liberalization. In the area of exchange rates, he showed his clear preference for intermediate exchange rate regimes. He would later regard this as wishful thinking, as he put it, as the dominant views in Washington were already leaning toward the perception that only extreme exchange rate regimes (either total flexibility or hard pegs) were desirable (Williamson 2008).

The second component of the consensus was outward orientation, which was embodied in trade policies aimed at expanding exports (particularly nontraditional exports) and import liberalization, and opening the doors for foreign direct investment. In the second area, consistent with his views on macroeconomic management, Williamson explicitly excluded capital account liberalization, a view that he would later recognize as also being his own preference rather than the dominant Washington perspective, which was moving into fuller capital account convertibility at the time. In the case of trade policy, his policy recommendations were more mainstream, but again with several caveats: acceptance of "substantial but strictly temporary protection" for infant industries, and "a moderate general tariff (in the range of 10 percent to 20 percent, with little dispersion)...as a mechanism to provide a bias toward diversifying the industrial base without threatening serious costs" (Williamson 1990, 15). Based on his evaluation of what he considered the successful European trade liberalization of the 1950s, he also expressed his preference for a "speed of liberalization [that] should vary endogenously, depending on how much the state of the balance of payments can tolerate" (Williamson 1990, 15).

The last component, free market capitalism, was embodied in the last three elements of the policy package: privatization, deregulation, and protection of property rights. Only in the first of these did Williamson express explicit caveats, particularly his perception that there are cases of public utilities (e.g., water) and services (public transportation) that should continue to be provided by the government.

Interestingly, Williamson explicitly excluded equity concerns, which only showed up in his Decalogue as public sector spending priorities. He would later assert that the reason for such an omission was not his own views but the fact that "I could not convince myself that the Washington of 1989 (or 2004, for that matter) agreed that equity was of any consequence" (Williamson 2008, 23, footnote 8). The issue would figure prominently in his post–Washington Consensus proposals. Given the enormous inequalities in Latin America, Williamson endorsed policies that would enhance equity, even at the cost of some loss in efficiency, specifically in terms of direct taxes, property taxes, elimination of tax loopholes, and better tax collection. Along with that he endorsed policies aimed at asset accumulation by the poor such as education, titling, land reform, and microcredit programs (Williamson 2003, 2008). He would also come to recognize his disregard for institutional issues in the original Decalogue.

Latin America and the Washington Consensus

Considering that the Decalogue was, after all, aimed at the Latin American governments, to what extent did they adopt the reforms? Reform indices estimated by Eduardo Lora (2001), indicate that the reforms were rapid and widespread between the mid-1980s and the mid-1990s. There were, however, significant differences in the liberalization process across the region.

Barbara Stallings and Wilson Peres (2000) divided eight Latin American countries they analyzed into two groups according to the strength and velocity of the reform process. The "aggressive" reformers (Argentina, Bolivia, Chile, and Peru) introduced rapid and fairly comprehensive reforms within a very short period of time, in fact generally as part of major macroeconomic adjustment processes (that of Chile in the mid-1970s). The "cautious" countries (Brazil, Costa Rica, Colombia, and Mexico) introduced reforms much more gradually and at differing speeds in different areas. Most of the Latin American countries probably fall into the second group.

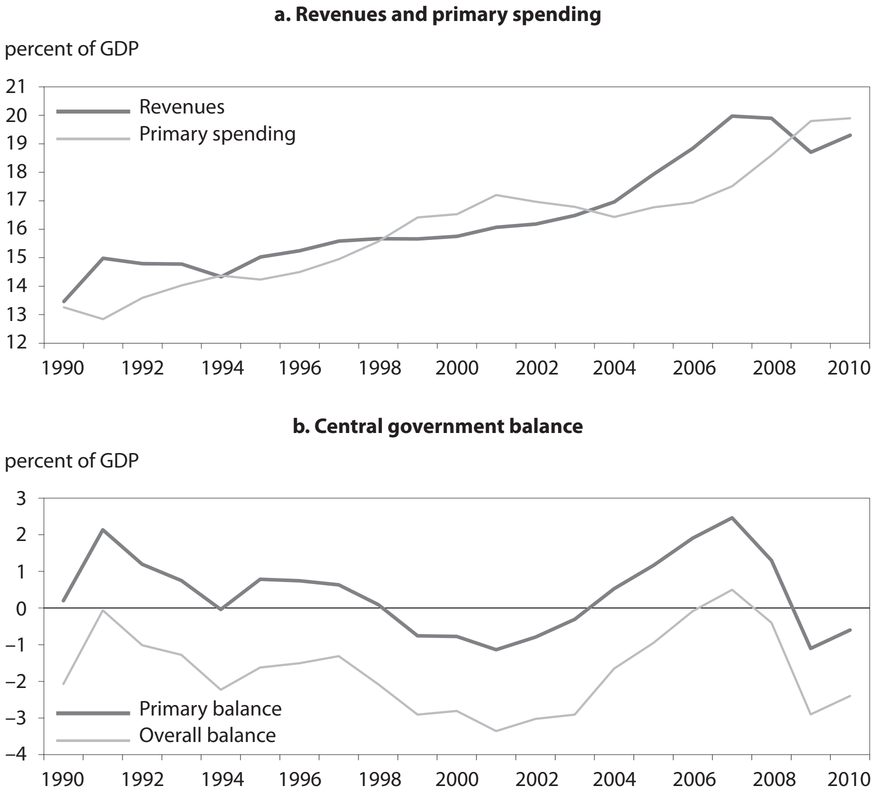
For those elements of the Decalogue that can be measured, the most widespread reforms took place in trade and finance. There was also a high level of convergence in terms of fiscal discipline and tax structures. However, in both areas there were distinct ingredients introduced by Latin American politics, particularly regional trade integration, a significant expansion of social spending, and opposition to privatizations in several countries (as well as opposition to labor market reforms, an issue not addressed in this chapter).

In the area of fiscal discipline, the task had actually started in earnest in the 1980s, when governments undertook massive reductions in the public sector—the equivalent on average to slightly over 5 percentage points of GDP throughout the decade, or over one-fourth of central government expenditures. Since 1990, however, central government spending has started rising again (figure 10.1, graph A), reaching in recent years average levels comparable with those prior to the debt crisis. This is a reflection of increased social spending, which has risen by about 6 percentage points of GDP over the last two decades. This persistent and widespread trend can be understood as the result of democratization.

Rising spending since the 1990s was matched by rising revenues, so as to maintain moderate fiscal imbalances (between 1 and 3 percent on average; see figure 10.1, graph B). This was achieved mainly by raising value-added taxes, but direct tax revenues also started to increase over the past decade. In any case, comparisons with Organization for Economic Cooperation and Development countries show that Latin America's tax structures are still biased toward indirect taxes and nontax natural resource revenues. Starting in the late 1990s, there was also the spread of explicit fiscal targets of various types (e.g., targets for the primary surplus, and balanced budgets or caps on increases in public spending) as part of broader packages of fiscal responsibility rules, which included norms for regional or local fiscal authorities in federal or strongly decentralized systems. Chile was the only country that adopted a countercyclical fiscal rule at the time (Williamson's clear preference), a practice that has been followed more recently by Colombia. All of this can be read as being consistent with the first three elements of the Decalogue.

These reforms were accompanied by the elimination of most foreign exchange controls and by the liberalization of domestic financial markets. With a few exceptions, the first did not follow Williamson's recommendation to be cautious with capital account liberalization. Action in the domestic financial sector included the liberalization of interest rates, elimination of most forms of directed credit, and reduction and simplification of bank reserve requirements. Financial liberalization generally unfolded with a glaring lack of prudential regulation, and thus led to frequent domestic financial crises. In fact, two-thirds of the countries of the region (12 of 18, excluding Cuba)

Figure 10.1 Central government finances, 1990–2010 (percent of GDP, simple averages)



Note: Figure excludes Brazil and Dominican Republic until 1996.

Source: Author's estimates based on data from the UN Economic Commission for Latin America and the Caribbean (ECLAC).

endured national financial crises in the 1990s or early 2000s (Laeven and Valencia 2008). Prudential regulation and supervision were generally strengthened after these collapses.

With regard to the second component of the Decalogue, outward orientation, Latin America had already evolved prior to the debt crisis from a strict import-substitution model to a mixed model that combined export promotion (including a layer of export subsidies on the interventionist trade structures typical of the past) and regional integration (Bértola and Ocampo 2012, chapter 4). This process started earlier in the smaller economies, but most mid-size and large economies went in the same direction starting in the mid-1960s when a Latin American invention, the crawling peg (in the line of Williamson's intermediate exchange rate regime), was introduced by several countries. The result was a turnaround of the downward trend in the export coefficient and the beginning of diversification of the export basket, both of which clearly predated market reforms. This was mixed in the 1970s with a rationalization of the tariff and nontariff structure, which nonetheless remained complex, with the exception of Chile.

The generalized reform process that took off in the mid-1980s led to a sharp reduction in the level and dispersion of tariffs, the virtual elimination of quantitative import restrictions, and the reduction of export subsidies. These reforms were undertaken rapidly (over one to three years). All Latin American countries also became members of the World Trade Organization when it was created in 1993. With very few exceptions (notably Mexico's oil industry), steps were also taken to open up the economies to foreign direct investment.

There were also two elements in this process, however, that violated the orthodox call for nondiscriminatory trade liberalization. The first again had political origins: regional integration. The landmarks were the creation of the Southern Common Market (Mercosur) in 1991 and the simultaneous revitalization of the Andean Community and the Central American Common Market. The second, which was led by Mexico and Chile, was the subscription of a myriad of free trade agreements that ushered in a "neo-orthodox" approach to trade liberalization by signing free trade treaties with industrialized countries as well. The first such accord, the North American Free Trade Agreement, was signed in 1993, but many were added in later years and they included an increasing number of Latin American countries.

In the third area of the Washington consensus policies, free markets, several countries privatized a wide array of state-owned enterprises and opened up public utilities to private investment. However, in Costa Rica and Uruguay, there was open and successful opposition to privatization, and in many other countries various enterprises, especially public utilities and oil and mining firms, remained in state hands. In the financial sector, many development banks and state-run first-tier banks survived as well. Even Chile, the country that championed these reforms early on, held on to its state-owned copper and oil enterprises, as well as its development bank and a government-run first-tier bank. In fact, only three countries took a truly radical approach to privatization: Argentina, Bolivia, and Peru. Deregulation included eliminating price controls, reducing red tape, and lowering entry barriers. There was recognition of the need to adopt regulatory schemes for privatized public utilities and stronger antitrust legislation. However, this new regulatory agenda was put into practice at a slow and irregular pace.

The Decalogue has thus been broadly followed by Latin American countries. However, there were significant variations in the strength and speed of reforms, along with several ingredients introduced by democratic politics. Needless to say, the diversity in approaches became even greater in the early years of the 21st century, largely because of the victory of leftist political movements opposed to market reforms. The positions they most had in common were rejection of free trade treaties with industrial countries and support for regional integration. Again, however, diversity was also the rule among the left-wing governments, an issue that cannot be explored here.[2] Washington itself also became more nuanced, as reflected in Kuczynski and Williamson (2003) and Birdsall, de la Torre, and Valencia Caicedo (2011), among others. There have been all along proposals for an alternative agenda, notably by the United Nations Economic Commission for Latin America and the Caribbean.[3]

Macroeconomic Policy: Exchange Rate Regimes and Capital Account Management

There is probably no area where Latin America owes more to John Williamson than in his proposals for macroeconomic policy management. His work on this topic is dominated by what can be regarded as his two well-grounded obsessions: how to avoid exchange rate misalignment and how to mitigate the effects of boom-bust cycles in external financing. Decisions about these policies have serious implications for the design of the international monetary system, which, in his view, should include both a system of reference exchange rates (Williamson 1983, 2007) and some form of capital account regulations for emerging economies (Jeanne, Subramanian, and Williamson 2012). In relation to economic policy in emerging economies, Williamson has advocated consistently throughout his professional life for both intermediate exchange rate regimes (Williamson 2000) and capital account regulations (Williamson 2005), a term that I prefer to that of capital controls. Needless to say, exchange rate misalignment and boom-bust cycles in external financing have left a legacy of crises and poor macroeconomic performance in Latin America.

These proposals are, of course, part of a broader conception of how to manage stabilization (countercyclical) policies in open economies, and particularly how to make them crisis-proof. The full set of Williamson's recommended policies—as spelled out, for example, in Williamson (2003, 2008)—includes countercyclical fiscal policies; hard budget constraints for subnational governments; countercyclical monetary policies; intermediate exchange rate regimes focused on maintaining competitive real exchange rates; accumulation of foreign exchange reserves or stabilization funds when exports are strong; prudential regulation and supervision; minimization of domestic use of the dollar; and explicit policies aimed at curbing foreign currency indebtedness, such as a widespread use of domestic financing by governments, regulation of bank borrowing and lending in foreign exchange to avoid currency mismatches in domestic portfolios, and prudential capital account regulations.

Interestingly, while Williamson correctly recognized that this package was not mainstream Washington thinking, and that exchange rate competitiveness and capital account regulations should not have figured in his initial

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2. See, in this regard, Levitsky and Roberts (2011).

3. Among the several reports from this institution, see ECLAC (2000).

Decalogue, his views very much align with those of economists who have been characterized as Latin American "neo-structuralists." These include Ricardo Ffrench-Davis (2006), Roberto Frenkel (2008) and myself (Ocampo 2003; Ocampo, Rada, and Taylor 2009). In turn, his skepticism about capital account liberalization, well argued in Williamson (2005) and Jeanne, Subramanian, and Williamson (2012) among many of his writings, is now part of a broad-based trend in economic thinking.[4] His views of financial markets as subject to boom-bust dynamics follows an even larger tradition, which includes the pioneering work by Charles Kindleberger (Kindleberger and Aliber 2005) and the most recent account by Carmen Reinhart and Kenneth Rogoff (2009). A recent diagnosis by the IMF (2011, chapter 4) indicates that the volatility of capital flows has increased over time and is more pronounced for emerging than for advanced economies, that bank lending is more volatile (followed by portfolio debt flows), and that, interestingly, foreign direct investment volatility has increased and is now similar to that for portfolio debt flows.

Williamson's views on the exchange rate system are intrinsically tied to his perception that a competitive exchange rate is essential for growth in open economies to encourage dynamic export growth and diversification, and to avoid balance of payments crises. In Williamson (1990, 14), he asserted: "In the case of a developing country, the real exchange rate needs to be sufficiently competitive to promote a rate of export growth that will allow the economy to grow at the maximum rate permitted by its supply-side potential, while keeping the current account deficit to a size that can be financed on a sustainable basis." He went immediately on to argue that the *stability* of the real exchange rate around the competitive level was equally important, particularly to guarantee an adequate response of nontraditional exports: "Growth of nontraditional exports is dependent not just on a competitive exchange rate at a particular point in time, but also on private-sector confidence that the rate will remain sufficiently competitive in the future to justify investment in potential export industries.... Thus, it is important to assess the stability of the real exchange rate as well as its level" (Williamson 1990, 14).

Although Williamson's proposals have always emphasized the need for competitive real exchange rates—or "fundamental equilibrium exchange rates," as he called them in Williamson (1983)—he has held a sort of asymmetric view on this issue that shows a stronger obsession with overvaluation generated by excessive capital inflows. In his 2008 paper, he thus pointed out that "overvalued exchange rates are worse than undervalued rates, but a rate that is neither overvalued nor undervalued is better still" (Williamson 2008, 17, footnote 3). In any case, in his view, undervaluation should be equally avoided, both for domestic reasons (it can have domestic inflationary effects and can limit investment, as domestic savings will have to be partly used to finance the current account surplus) and because it contributes to global imbalances

4. See, for example, the contributions to Ocampo and Stiglitz (2008).

if practiced by large economies—a point that is of course forcefully made in Jeanne, Subramanian, and Williamson (2012). This distances Williamson from the authors that see undervaluation as a policy instrument, in a sense as a substitute for industrial policy (see below).

Competitive exchange rates can only be guaranteed by active policy decisions, which are best guaranteed in intermediate exchange rate regimes. Williamson (2000) provides a full critique of the doctrine of polar exchange rate regimes as well as Williamson's defense of intermediate regimes. He argues that even hard pegs are subject to the risks of overvaluation and speculative pressures typical of fixed exchange rate regimes in general. But he equally argues that totally flexible exchange rates are not a good solution either, as "markets displayed at best only a weak tendency to pull exchange rates back to any plausible medium-term equilibrium rate" (Williamson 2000, 6). Hence, his case for intermediate regimes "is motivated not by an irrational fear of floating, but by legitimate concerns that floating will generate misalignments" (Williamson 2000, 63).

The typology of intermediate regimes includes crawling pegs, crawling bands or target zones, reference rates, and (somewhat against Williamson's preference) managed floating. He agrees that none of these regimes is free from misalignment and speculative pressures. The first risk arises if authorities try to use the crawl as a nominal anchor for the price level. The second arises because interventions may attract further inflows and speculative movements that may generate self-fulfilling expectations. To avoid these problems, Williamson suggests several alternatives, including reference rates and soft margins, that imply no short-run commitment to intervene, and monitoring bands that would only call for interventions beyond a certain deviation from what is believed to be the equilibrium rate. In any case, the essential point is to provide markets with information as to what authorities believe is an equilibrium rate. If confirmed by specific policy actions (market interventions but also monetary or fiscal policies) aimed at not deviating substantially from that equilibrium rate, such information can actually generate stabilizing speculation. Williamson's lack of or lukewarm support for managed floating is based on the view that this regime does not provide such information to market agents and, since it lacks well-defined rules, is not a transparent form of intervention either.

Williamson's defense of capital account regulations is closely tied to his views both that international capital markets are subject to boom-bust cycles, and that booms may lead to substantial exchange rate misalignment. In his 1990 paper, he argued that, aside from liberalization of foreign direct investment, "there is relatively little support for the notion that liberalization of international capital flows is a priority objective for a country that should be a capital importer and ought to be retaining its own savings for domestic investment" (Williamson 1990, 14). Although he accepted in later writings that this view was not a source of consensus in Washington circles, he held to his views

Table 10.1 GDP growth: Dynamics and volatility

Period	Average growth (percent)	Standard deviation (percent)	Coefficient of variation
Weighted average			
1950–1980	5.5	1.7	0.31
1990–2011	3.4	2.4	0.71
Simple average			
1950–1980	5.0	1.1	0.21
1990–2011	4.0	2.0	0.51

Note: Data exclude Cuba and Haiti.

Source: Author's estimates based on GDP data from the UN Economic Commission for Latin America and the Caribbean (ECLAC).

and continued to expound upon them, particularly in Williamson (2005) and Jeanne, Subramanian, and Williamson (2012).[5]

Latin America's experience has always figured in Williamson's work on boom-bust cycles, exchange rate regimes, and capital account regulations. This includes, early on, his contributions to one of the most lucid collections on the financing boom that led to the Latin American debt crisis, the volume edited by Ricardo Ffrench-Davis (1983). In Williamson's later writings, some regional policy practices figure prominently, particularly the experience of several Latin American countries with crawling pegs and later with crawling bands, as well as the prudential capital account regulations (unremunerated reserve requirements) put in place by Chile in 1991 and Colombia in 1993.

To what extent can we say that Latin America followed the policies recommended by John Williamson? No doubt, the region shows significant achievements in macroeconomic policies over the past quarter century. They include the aforementioned advances in fiscal discipline as well as significant reductions in inflation rates, with single-digit inflation having become the rule in the region since 2001 (with two major exceptions, Argentina and Venezuela). However, these advances have not been matched by equivalent progress in reducing Latin America's traditional vulnerability to external shocks from both boom-bust cycles in external financing and commodity price cycles. Thus, if we compare the recent decades to 1950–80, Latin America has experienced since 1990 much sharper business cycles (table 10.1). Furthermore, macroeconomic policy has continued to be procyclical in a number of ways. In particular, although fiscal balances tend to vary in a countercyclical way, tending to fall during booms and increase during crises (figure 10.1, graph B), government spending has continued to be procyclical through the recent business cycle in

5. As some of the proposals to manage financial instability are dealt with in other parts of this volume—particularly prudential capital account regulations and GDP-linked bonds—I will not deal with them here.

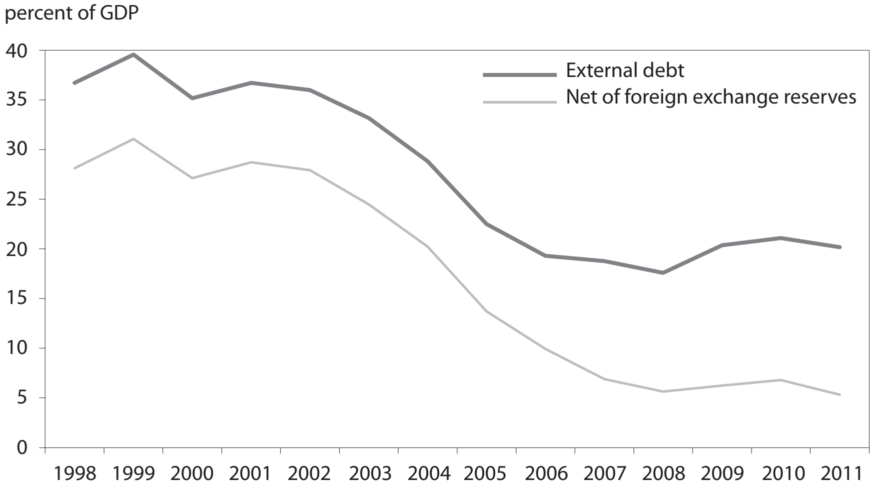
a large number of countries (IDB 2008, IMF 2009, Ocampo 2012). Thus, the countercyclical pattern of the overall deficit is more a reflection of the procyclical behavior of government revenues (both taxes and revenues from natural resources). As indicated, Chile is the only country that has followed for some time a countercyclical fiscal rule.

Credit, and particularly private credit, has also continued to exhibit strong procyclical patterns, largely associated with external financing cycles. Monetary policy continued to be relatively procyclical in most countries during the 2004–08 boom as, with the exception of Colombia, interest rate hikes came rather late in the process, that is, only when the food price shock hit in 2008. This may be associated with biases introduced by focusing primarily on inflation, as exchange rate appreciation during booms helps achieve low inflation rates despite booming domestic demand, with the current account of the balance of payments deteriorating to absorb excess domestic demand. There were, nonetheless, major achievements in countercyclical monetary policy during the recent crisis, when countries were able to avoid the initial increase in interest rates that was characteristic of previous crises (García and Marfán 2011). Also, and quite aside from orthodox recommendations, countercyclical credit policies during the recent crisis included the active use of public sector banks to increase domestic lending.

Three policies were essential to increase the room to maneuver for countercyclical monetary policies during the recent crisis, all of which vindicate Williamson's views. The first was the decrease in external borrowing and an increase in foreign exchange reserves relative to GDP during the 2004–08 boom, both of which led to a sharp reduction in the external debt net of reserves (figure 10.2). The second was the broader use of domestic bond markets to finance governments and increasingly, though less so, the corporate sector. This, together with foreign exchange reserve accumulation, led to the improvement in external balance sheets, which was the single major advance in terms of macroeconomic policy during the boom years. Third, thanks to the reinforcement of prudential regulation following past crises, the 2008–09 recession was the first in recent decades that was not accompanied by any domestic financial crisis.

From this perspective, however, there are two remarkable failures in macroeconomic policy in the region. The first is that, despite more active interventions in foreign exchange markets, real exchange rates have tended to be very volatile in countries using more flexible exchange rate regimes, a fact that frequently leads to overvaluation at the end of external financing booms. This reflects the strong tendency of several countries to appreciate the exchange rate during booms and depreciate it during crises. This is seen in figure 10.3, which shows the instability of the monthly real exchange rate over 2004–11 in Latin American countries classified according to the IMF's "de facto" exchange rate regime, with countries with more exchange rate flexibility on top and those with dollarized regimes at the bottom. In any case, none of the economies in the first group have followed a clean flexible exchange rate policy but rather a managed floating policy that mixes variables of exchange rate flexibility and

Figure 10.2 External debt as percent of GDP at 2000 exchange rates, 1998–2011



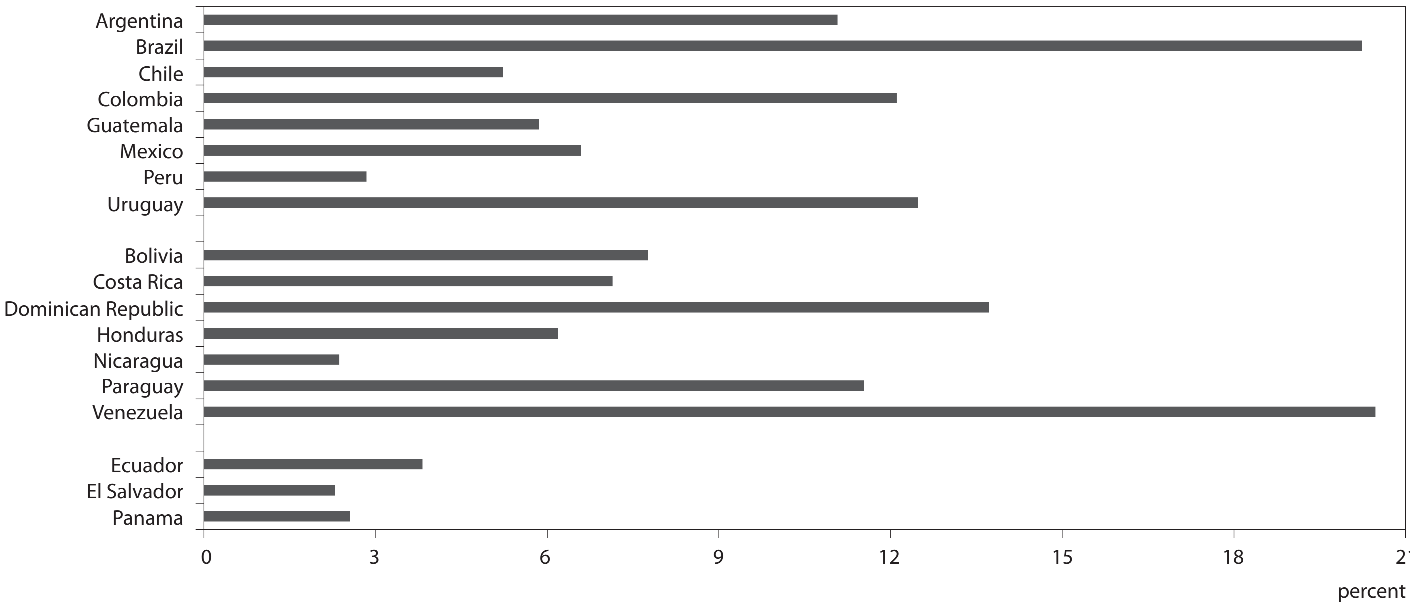
Source: Author's estimates based on data from the UN Economic Commission for Latin America and the Caribbean (ECLAC).

active foreign exchange interventions and, more generally, reserve management (and in the case of Chile, fiscal stabilization funds).

Only one country, Peru, stands out in the first group in terms of its capacity to reduce exchange rate volatility. It heavily intervenes in the foreign exchange market and regulates the dollar assets and liabilities of its domestic financial system in a comprehensive countercyclical way. In contrast, the two countries using prudential capital account regulations, Colombia at the end of the previous boom and Brazil in recent years, are among the countries with the most unstable real exchange rates. In fact, Brazil, together with Venezuela, which uses an old-fashioned exchange rate system (multiple exchange rates and strong exchange controls), are the countries with the most unstable real exchange rate. The high volatility of real exchange rates in the first group is perhaps a demonstration of Williamson's view that managed floating is not the best intermediate regime, as it does not provide adequate information to markets to encourage stabilizing speculation.

The second failure is the incapacity to smooth aggregate demand management, as reflected in the strong tendency of the current account of the balance of payments to deteriorate during booms. This was hidden during both the 2004–08 and 2010–11 upswings by booming terms of trade. As figure 10.4 indicates, when the effects of terms of trade are netted out, there was a sharp deterioration of the current account to deficits that since 2008 have been significantly higher than prior to the 1997–98 crisis. This shows that Latin America has essentially spent its booming terms of trade and, indeed, in 2008 started to overspend its exceptional commodity revenues.

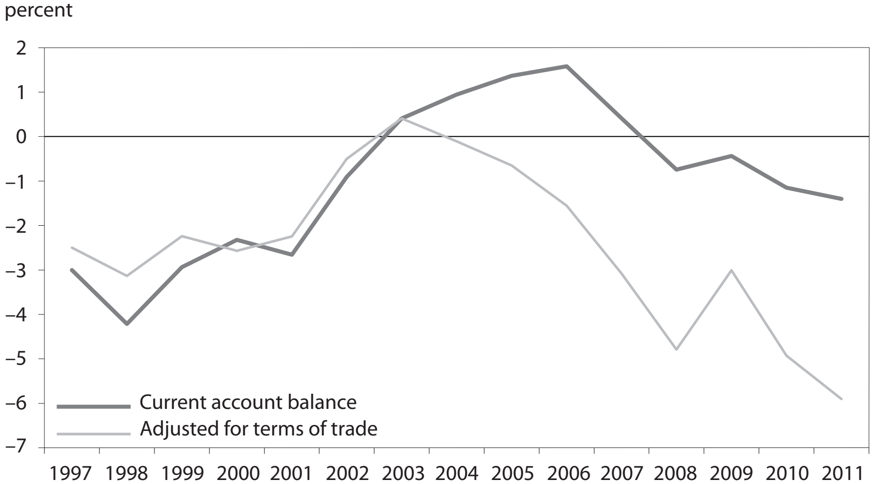
Figure 10.3 Coefficient of variation of the real exchange rate, 2004–11



Note: Countries are classified according to the International Monetary Fund's "de facto" exchange rate regime, with countries with more exchange rate flexibility on top and those with dollarized regimes at the bottom.

Source: Author's estimates based on monthly series of the real exchange rate from the UN Economic Commission for Latin America and the Caribbean (ECLAC).

Figure 10.4 Current account balance with and without adjustment for terms of trade, 1997–2011 (terms of trade of 2003 = 1)



Source: Author's estimates based on data from the UN Economic Commission for Latin America and the Caribbean (ECLAC).

The Light and Shadow of Outward Orientation

In many ways, the trade and foreign direct investment liberalization components of John Williamson's Decalogue have been success stories in Latin America. Exports have grown rapidly and the region's economies are more open today than at any time in their history. Transnational corporations have a much greater presence than in the past, and the more successful Latin American firms (the "translatinas") have expanded within the region and some have become world-class players.

At the aggregate level, the coefficients used to measure the degree of openness began to climb in the mid-1960s, thanks to what I referred to above as the mixed model. However, although this trend predated the reform process, it was certainly accelerated by that process. Indeed, at the turn of the 21st century, the export coefficient reached levels comparable to those of 1928–29, and has consistently surpassed those levels since then (Bértola and Ocampo 2012, figure 4.2). This was accompanied by a significant transformation of Latin America's export structure. Up to the turn of the century, the structure of exports followed the trend that had held since the 1960s, which implied an increasing share of manufacturing exports and a reduction in the share of natural resources and natural-resource-based manufactures. Since then, just the opposite has occurred: a "re-commoditization" of the region's export structure.

This process has followed different paths in different parts of the region, generating two basic patterns of specialization that broadly follow a regional "North-South" division. The northern pattern, typical of Mexico and Central

America, is one of diversification toward exports of manufactures with a large component of imported inputs (in its most extreme form, *maquila*) that are primarily destined for the US market. The southern pattern, typical of South America, is made up of a combination of extraregional exports of commodities and natural-resource-based manufactures and a diversified range of goods that are traded within the region. Intraregional trade has thus made a significant contribution to the growth of exports of manufactures but has exhibited strong procyclical patterns, particularly in South America.

The recent re-commoditization of the export structure is closely associated with growing trade with China. These trade flows show significant imbalances: Latin America exports to the Asian giant a limited set of commodities (oil, soybeans, copper, iron ore and scrap iron, and pulp) and imports an increasing array of manufactures. Demand from China is also one of the major sources of the commodity price boom that has benefited the region since 2004 (with a brief interruption in 2008–09), particularly South America.

Foreign direct investment also rose sharply in the 1990s and peaked at the end of that decade. Although inflows remained high (2.8 percent of Latin America's GDP in 2004–08 versus 3.3 percent of GDP in 1997–2003), mounting outflows in the form of profit remittances and rising foreign direct investment outflows by the translatinas have cut deeply into the net transfer of resources generated by foreign direct investment (0.1 percent of GDP in 2004–08 versus 2.2 percent in 1997–2003). The nature of foreign direct investment flows has been closely interlinked with those of trade. So, the northern pattern of specialization has attracted transnational corporations that are active players in internationally integrated production networks, whereas in South America, investment has been concentrated in services and natural resources.

However, contrary to the expectations of reformers, the relative success of Latin America in terms of increasing exports and foreign direct investment has not been reflected in rapid GDP or productivity growth. Table 10.1 compares average GDP growth rates in 1990–2011 with the average for 1950–80. The results are striking. Even when we take into account the 2004–08 boom and the rapid recovery after the recent global financial crisis, growth has not only been slower by more than 2 percentage points but, as already pointed out, has also been more volatile. The comparison is less striking if we refer to per capita GDP. In this case, however, the rising demographic dependency ratio tended to depress that indicator in 1950–80, whereas the "demographic dividend" (the decline of such a ratio) buoyed per capita GDP growth during the reform period.

The most telling disappointment is productivity growth. A comparison of trends in labor productivity (GDP per worker) shows a much poorer performance during the period of reforms compared to 1950–80 (0.6 percent in 1990–2010 versus 2.7 percent in 1950–80), except for Chile, the Dominican Republic, and Uruguay—though in the latter case with poor performance in both periods (Bértola and Ocampo 2012, figure 5.10). This is also what total factor productivity trends show. For example, an IDB (2010) study indicates that, after climbing until the mid-1970s, total productivity fell sharply during the debt crisis, and its growth was sluggish or even slightly negative between 1990 and 2005 (the last year for which the study provides estimates).

The reasons for the poor performance of economic and productivity growth during the reform period continue to be subject to debates. An essential feature that has characterized this process is the large asymmetry between the productivity gains achieved by successful firms and sectors, on the one hand, and overall productivity trends, on the other. The poor performance of the latter should be understood, therefore, as a reflection of an increasing underutilization of production resources, particularly labor. So while productivity rose in leading firms and sectors, no doubt supported by growing integration into the world economy, the large or even growing share of informal labor dragged down overall productivity trends. The idea that an increase in productivity in internationalized sectors would spread to the rest of the economy and boost economic growth has therefore not been borne out.

To overcome the shortcomings in terms of growth and equity that have characterized market reforms, Kuczynski and Williamson (2003) proposed a comprehensive agenda made up of four major elements: (1) further crisis-proofing, along the lines mentioned in the previous section; (2) completion of first-generation reforms, particularly with more flexible labor markets to expand formal employment, and enhanced access to markets of developed countries; (3) second-generation reforms to create the institutional infrastructure of a market economy to provide public goods, build national innovation systems, and develop deeper financial sectors that operate in local currency (but, as explicitly stated, *not* industrial policies); and (4) reforms to improve income distribution and accelerate social development.

One of the most controversial issues in this policy diagnosis is whether poor growth and productivity during the reform period are associated with structural trade and production patterns and, therefore, if active productive sector policies are necessary to overcome them. In this regard, Williamson's view is that the basic reason for poor growth was macroeconomic rather than structural in character, and was related therefore to the issues discussed in the previous section. In his own words: "The results have not been comparably encouraging in...Latin America. But the blame for this seems to lie in the misguided macroeconomic policies—like allowing exchange rates to become overvalued and making no attempt to stabilize the cycle—that accompanied the microeconomic reforms, rather than in the latter themselves" (Williamson 2008, 26).

Notwithstanding the agreement on the role played by short-term macroeconomic policies in enhancing volatile growth, other schools of thought have emphasized the problems generated by Latin America's patterns of specialization in inducing poor growth and productivity performance. Thus, if Williamson and Latin American neo-structuralists stand in the same camp on short-term macroeconomics, they stand in opposite camps in the interpretation of frustrations with growth. The associated problems include premature de-industrialization, as the shares of manufacturing production and employment started to fall at lower levels of per capita GDP than those typical of patterns that have been previously experienced by industrialized countries (Bértola and Ocampo 2012, figure 4.4). To this one could add the fact that the region tended to increase its share in world markets in sectors that have tended to reduce their weight in world trade, in sharp contrast to the patterns of East Asia (Palma 2011), and in activities that offer fewer opportunities for diversification and for making improvements in product quality (Hausmann 2011). To use Ricardo Hausmann's terminology, the region tended to specialize in a part of the "product space" that offers fewer opportunities for technological change.

The region's manufacturing sectors also lagged behind the world technological frontier, and this was true not only of labor-intensive and engineering-intensive sectors but even of natural-resource-intensive sectors. Moreover, the technological gap has been widening, in relation not only to the more diversified industrialized and dynamic Asian economies, but also to the more developed natural-resource-intensive economies. This is reflected in a lower share of engineering-intensive industries, meager resources directed toward research and development, and a near absence of patenting of technological innovations in relation to all these groups of economies (ECLAC 2007, Cimoli and Porcile 2011).

These alternative interpretations are part of a broader debate on the relationship between growth and economic structure. One significant part of this debate relates to the clues to the success of East Asia. In this regard, Williamson (2003, 2008) stands on the side of those who consider that selective industrial policies were not the clue to the success of East Asia, and he quotes Marcus Noland and Howard Pack (2003) to support this view. This is in contrast to the views of Alice Amsden (1989) and Robert Wade (2003), among others, who emphasize the interventionist nature of East Asian policies and their focus on structural change and technological upgrading of exports as critical factors behind their success.

In broader terms, the structuralist interpretations of the success stories in the developing world have emphasized the capacity of a given development strategy to facilitate the technological upgrading of exports and domestic production generally (Ocampo, Rada, and Taylor 2009). In this line of thought, Ricardo Hausmann, Jason Hwang, and Dani Rodrik (2007) have argued that the "quality" of exports—which could be understood as their technological content—is the factor that has been associated with faster economic growth in developing countries, not trade openness per se. Therefore, active policies focused on increasing the technological content of production may be a necessary ingredient in a successful export-led strategy. It is probably better to argue today for broader production sector policies, as they may involve not only industrial sectors but also the technological upgrading of natural resource production and the development of modern services, particularly those with high technological and human capital content.

The mainstream view in relation to this issue is that there is no role for industrial policies. Williamson belongs to a more nuanced camp, where there is a positive view of "horizontal" production sector policies—that is, those that have no sectorial bias and are thus "neutral" in their sectorial effects. The view is particularly positive toward those policies aimed at building national innovation systems to diffuse technological innovation, fund and create tax incentives for research and development, and encourage venture capital and industrial clusters (Williamson 2003, 2008). As noted above, even in his 1990 paper, Williamson favored gradual import liberalization, a moderate tariff, and infant industry protection. But this nuanced view that he still holds remains opposed to selective (or "vertical") policies, as they involve picking winners, a rather risky strategy and one that creates opportunities for rent seeking.

The basic argument against "neutral" policies is that different sectors have different capacities to induce technological change and growth. These policies do involve risks of failure, but such risks are often at the center of success stories of individual private sector firms, which must constantly search for opportunities for new activities in order to grow. Furthermore, developing such new activities is a learning process in which winners are in a sense created rather than chosen a priori. In this view, the new activities that are promoted depend on domestic capacities, must be carried out in close partnership with the private sector, and should have technological upgrading as the central criterion for selection. In any case, active production sector strategies do have additional institutional requirements, and involve risk of rent seeking that must be avoided. Because of these special institutional requirements, some economists, such as Dani Rodrik (2008), visualize exchange rate undervaluation as a substitute for industrial policies, as it also generates a bias in favor of tradable sectors. However, it is an imperfect substitute, as it is not a selective strategy and, if practiced by large economies, generates global imbalances. As already mentioned, Williamson is also against undervaluation as a development strategy.

This remains, therefore, an open debate. In any case, Latin America's actions in this area have remained limited. Since the turn of the century there has been a partial return to more active production sector policies, but it was not until the 2008 launch of Brazil's production development policy that it can be said that there was a return to an ambitious production sector development strategy. In the rest of the countries, policies in this area remain limited. The incentives the countries provide to businesses are weak and complex, and they are a far cry from the protectionist measures and other incentives provided during the previous phase of development. So even in this area it can be argued that the Decalogue still rules in Latin America.

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