GROWTH, INSTITUTIONS AND CRISES:
LATIN AMERICA FROM A HISTORICAL PERSPECTIVE

Edited

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INTRODUCTION
to
GROWTH, INSTITUTIONS AND CRISES: LATIN AMERICA FROM A HISTORIC PERSPECTIVE

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For a long time Latin America's economic performance has puzzled economists and historians. How con we explain that a region 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 19th 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 the *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 the 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 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 had taken place in the region in the last two centuries. At the same time, Latin America's growth record has been insufficient to close the income gap with North-Atlantic economies. Initial studies on international comparisons of long run growth revealed that, relative to the U.S., Latin America fell behind between 1700 and 1900.[2]

The study of colonial institutions and the 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 differed radically not only from the U.S. 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 understand 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, the 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, which was characterized by an increased integration of commodity and factor markets worldwide. The expansionary cycle of the world economy increased the demand of raw materials and foodstuffs, benefiting export sectors throughout the region. However, only in Argentina the export sector truly became the "engine of growth" for the three decades before the First World War.[3] The resumption of sustained per capita 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 the Latin American countries became recipients of international capital inflows in the form of foreign direct investment and foreign loans. Virtually every governments borrowed in international capital markets, mostly in gold denominated debt.[4] While in many instances external debt financed the

construction of railroad networks, port facilities and public works, it also exposed the 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 U.S.) 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. Since Latin America was still highly vulnerable to external shocks, 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 non-export 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 eruption 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 the industrialization through import substitution. Thus, the larger economies in the region followed an inward looking-strategy based upon 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, México, Peru and Venezuela)

averaged only a 2.4 percent in GDP per capita growth in the period 1950-1973. Growth rates masked problems associated with trade and capital controls and protectionism: 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, México, Peru and Venezuela grew, on average, at rate of 2.4 percent, whereas smaller and less diversified economies had a much lower growth.[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 U.S.). 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 as means to remedy some of the pitfalls of the inward-looking strategy, particularly the growing external imbalances. Yet, the lack of harmonization of 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, but also 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 postwar 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 towards outward orientation. Integrating to global markets allowed East Asia to maintain a fast-growing development until the 1990s, a trajectory that

contrasted sharply with the dismal economic growth record of Latin American in the last quarter of the 20th century.

A key conclusion from the study of the Latin American economic past is that history matters. Despite its simplicity, this conclusion points out at the complexities involved in understanding the fundamental connections 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 in three parts: Part 1 deals with economic growth, taxation and institutions, and has three papers. The second part includes five papers and focuses on financial crises, lending and inflation. And finally, 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.

I. 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 the 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? 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 inter-country 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 OECD countries and for the 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 deepening gap between the OECD and Latin America. The author argues that, contrary to popular believes, 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 America remained largely unchanged.

In "*Before the Golden Age: Economic Growth in Mexico and Portugal, 1910-1950*" Pedro Lains provides a comparison of Mexico and Portugal's economic growth during the first half of the 20th 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 stagnated or experiencing economic retrogression. Economic expansion in these two countries was the result of structural changes at the aggregate level, as well as at the of 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 counties later experiences -- Portugal after 1973 and Mexico after 1982 --, when import tariffs and quantitative restrictions were used as the main source of protection. Lains also argues that his results call into question the traditional interpretation of Mexico and Portugal's industrialization. According to traditional views this process took off after World War II; the data discussed by the author suggests 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 demographical 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. In it the authors analyze the role played by institutions in shaping the 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 across the countries of the Americas. They argue that there are striking contrasts the tax systems of developed and developing countries; while advanced nations rely heavily on income and broad-based consumption taxes, emerging counties rely on taxes on international trade, value added taxes and turn-over 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 governments. Departing from traditional works that have asked how taxation affects inequality, Sokoloff and Zolt analyze the way 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 the tax structures in North America is *not* that one region is rich and the other poor. Even when income 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. Sokoloff and Zolt 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 within the each of these regions and their respective countries.

II. Financial Crises, Lending and Inflation

The first chapter in Part II of the volume is "*Financial Crises, 1880-1913: The Role of Foreign Currency Debt*," by Michael D. Bordo and Christopher D. Meissner. In this contribution 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 of the "liabilities dollarization" 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 30 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 suggesting 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 very different historical backgrounds, and strong institutions such as Australia, Canada, New Zealand, Norway, and the US 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 found that a strong international reserve position seems to be correlated with a lower likelihood of a debt crisis, currency crisis or a banking crisis. According to them, "this strengthens the evidence for the hypothesis that foreign currency debt is dangerous when miss-managed." 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 Paollera and Martin Grandes use Argentine data from the late 19th 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 Paollera and Grandes main 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 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 allows policy makers and investors about the "true" country risk in federal countries where sub-sovereigns entities are fiscally interdependent and potential time inconsistencies and sovereign moral hazards are present. della Paollera and Grandes show that their "true" measure of country risk departs from the traditional typical sovereign risk spread by 200 to 350 basis as the 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 policy-makers 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 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 bases of their empirical analysis using Mexican data fro 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 100% of deposits.

In "*Sudden Stops and Currency Drops: A Historical Look,*" Luis A.V. Catao uses a data set for 1870 through 1913 to analyze the main salient characteristics of sudden stops of capital inflows to both "core" and "periphery" countries. Catao argues that the behavior of capital markets during the period preceding World War I was remarkably similar from what we have observed during the last two decades. The analysis focuses on four issues: First, Catao 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 Catao'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 on the existence of "contagion" during the late 19th and early 20th centuries. Fourth, Catao 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 which 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 f Foreign Advisors in Chile's 1955-58 Stabilization Program,*" Sebastian Edwards analyzes Chile's experience with anti-inflationary policies in the mid 1950s. In 1955-58 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%. The policies adopted contradicted the newly dominant orthodoxy in Latin America that associated inflation to *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% in 1956, and was further reduced to 17% 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, non-partisan, technocratic arbiters. It was precisely because they were foreigners that they could raise 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 always) 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 in 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.

III. 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 the Mexican economy in the mid-twentieth century 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 20th 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 20th 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 micro data 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 and Great Britain. 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 analysis, in 1911 CIVSA was quite efficient, and its levels of productivity compared favorably with those in the U.S. and in the U.K. 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 rather the consequence of a complex confluence of policies and circumstances. At the time of the Great Depression the different actors of 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.

ENDNOTES

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[1] "Mexico is the country of inequality. Nowhere does there exists such a fearful difference in the distribution of fortune, civilization, cultivation of the soil, and population." Alexander von Humboldt, *Political Essay on the Kingdom of New Spain*, trans. John Black, London, Brown, 1811, vol. 1, p. 134.

[2] This conclusion is best presented by John Coatsworth "Economic and institutional Trajectories in Nineteenth-Century Latin America" in John H. Coasworth and Alan M. Taylor (eds.), *Latin America and the World Economy 1800,* Cambridge, Mass., Harvard University Press, 1998.

[3] For an examination of the export-led growth see Victor Bulmer-Thomas, *The economic history of Latin America since Independence*, New York, Cambridge University Press, 1994, chapter 3.

[4] The pioneering study of the history of foreign debt in Latin America from a long-run perspective is Carlos Marichal, *A century of debt crisis in Latin America: from Independence to the Great Depression, 1820-1930*, Princeton, New Jersey, Princeton University Press, 1989.

[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 (ed.) Latin *America in the 1930s: the role of the periphery in the world crisis*, (New York, St. Martin's Press, 1984.

[7] For an evaluation of price distortions of inward-looking development see Sebastian Edwards, "Trade orientation, distortions and growth in developing countries," *Journal of*

Developing Economics 39, 1992. For a recent treatment see Alan Taylor "On the costs of inward-looking development: price distortions, growth and divergence in Latin America," *Journal of Economic History* (58), March 1998.

[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, *Monitoring the World Economy, 1820-1992*, Paris, OCDE, 1995.