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CHAPTER 1

SHIFTING PARADIGMS IN LATIN AMERICA'S ECONOMIC DEVELOPMENT

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1.1 Introduction

Latin America has experienced in recent decades a major shift in the paradigms that oriented its development patterns. In the first decades after World War II ("postwar period", for short), the region had embraced a paradigm that placed the developmental state at the center of the strategy, with industrialization as the major objective, which was regarded at the time as critical to increase living standards. We will characterize this paradigm as state-led industrialization, a concept that—following Cárdenas, Ocampo, and Thorp (2000)—expands upon the more traditional concept of Import Substitution Industrialization (ISI), because import substitution was only one of its features and not the central feature in all countries during all time periods. This strategy had taken root in the postwar years, but it had precedents in the long protectionist past of many Latin American countries (Coatsworth and Williamson 2003) and in the responses to the external shocks experienced during World War I and, particularly, the Great Depression of the 1930s, which will be the point of departure for our analysis. This paradigm was replaced during the 1970s in a few countries and the mid-1980s in the rest of the region by another which placed markets and integration into the world economy at the center.

This chapter analyzes the central features of both paradigms and presents an overall evaluation of its development outcomes. The economic literature is full of caricatures of both paradigms—of state-led industrialization in the more orthodox literature, and of market-led development in the more critical literature in recent years. Caricatures have the advantage that they are easy to demolish, and the obvious disadvantage that they do not reflect what was actually thought or done in economic policy. We provide here a

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more balanced view of both paradigms. Following terminology that was common in Latin American structuralism in the past but has actually become quite fashionable in other schools of thought in recent years, we will refer to the industrial countries as the "center" and developing countries as the "periphery" of the world economy.

1.2 State-led industrialization

The collapse of Latin America's terms of trade and export revenues in the 1930s, together with increased protectionism in the center of the world economy, suggested to many that excessive reliance on foreign trade and primary exports as engines of growth could be detrimental to economic development, and thus had a major role in the paradigm shift that took place in those years. While the break with the previous phase of economic development—the classic period of primary export-led growth—may have been less clear-cut than implied by much writing on the subject, both because industrialization was not new in the region and because the primary export sectors continued to have an important role in the development process, the collapse of the primary export-led growth process led to the emergence of a new development strategy that combined industrialization and enhanced state intervention.

The collapse of the primary export-led growth process was not, however, the only "big fact" that contributed to a paradigm shift. The collapse of the world financial system was another, as the financing boom that many Latin American countries experienced in the 1920s was followed by a bust and default in the early 1930s. Furthermore, this collapse had long-term implications, since an alternative world financial system would not emerge until the 1960s. Also, as noted by Lindauer and Pritchett (2002), the Great Depression of the 1930s had shown that an activist government was needed to bring stability to the economy, whereas the world war effort and the rapid industrialization of the Soviet Union had suggested that governments could plan and direct successfully rapid expansions of economic activity and radical transformations of the economic structure. The successful reconstruction of Europe under the Marshall Plan showed, finally, that large inflows of aid could greatly contribute to development.

What were the main components of the new development strategy that emerged in Latin America? Following Fishlow (1985), we can say that there were three elements which manifested themselves very clearly in the new conceptions: macroeconomic policies centered on the management of the balance of payments, industrialization as the engine of growth, and a strong state intervention in various areas of the economy.

1.2.1 Macroeconomic policies in the periphery

The previous phase of export-led growth had been characterized by recurrent balance of payments crises, as cyclical collapses in commodity prices were generally accompanied by sharp reversals of capital flows. In response to these crises, an important group of

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Latin American countries had shown a tendency to abandon the gold or silver standard for more or less prolonged periods of time. However, this proclivity was always accompanied by the aspiration to restore those standards, implying that there was never an attempt to permanently abandon macroeconomic orthodoxy. All this changed radically with the crisis of the 1930s, as the foundations of orthodoxy were undermined by the collapse of the gold standard in the central countries themselves. The abandonment of the gold standard by its architect, Great Britain, in September 1931 was a landmark which was followed (and in some cases anticipated) by pragmatic attempts in various industrialized countries to face the crisis through public spending and expansionary monetary policies.

Economic theory itself experienced a radical change with the publication of John Maynard Keynes' *The General Theory of Employment, Interest and Money*, which led to an unprecedented macroeconomic activism aimed at stabilizing the business cycle. Counter-cyclical macroeconomic policies also emerged in Latin America as a result of the crisis of the 1930s, but their major features were different from those in industrialized countries, reflecting the different nature of the determinants of the business cycle in the periphery of the world economy. Indeed, while Keynesian thinking focused on the stabilization of aggregate demand through active fiscal and monetary policies, the predominance of external shocks—on raw material prices as well as volatile capital flows—explains why the focus of macroeconomic management in Latin America leant towards the management of balance of payments shocks, both negative and positive.

With time, government intervention in this area became more complex, and included (with a variety of national experiences) exchange controls, tariffs and direct import controls, taxes on traditional exports, and multiple exchange rates—which were often used as instruments of trade policy rather than exchange rate policy and, later in the process, incentives for new exports. Many of these instruments had parallels in industrialized countries, particularly Western Europe, where multiple exchange rates were common in several countries and exchange controls were only fully dismantled as late as 1990. The management of these instruments responded to aggregate supply shocks of external origin and, by trying to shift demand towards domestic goods, had a more important counter-cyclical role than aggregate demand management as such.

1.2.2 The industrialization strategy

Balance of payments interventions were intimately linked, in turn, to the second component of the development strategy, industrialization, whose focus was nonetheless on long-term growth. The industrialization strategy did not emerge suddenly, in practice or in theory, but arose rather gradually as the mistrust in the possibility of a return to primary export-led growth took hold. Fundamental landmarks in this process were the collapse of raw material prices after World War I and again in the 1930s. Moreover, as noted by Diaz-Alejandro (2000), the emergence of protectionist policies in the industrialized countries multiplied these direct negative impacts. The passage of the Smoot–Hawley tariff in the US in 1930, the British Commonwealth preferences of 1932, the

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reinforced protectionism by France, Germany, and Japan—and discriminatory trade arrangements for areas under their political hegemony—contributed to the feeling in Latin America that the era of export-led growth had come to an end. As a result, even if prosperity returned in the industrialized economies, the outlook for Latin America's exports that competed with production in industrial countries or their colonies and commonwealths was pessimistic.

The idea of industrialization also gained strength in world economic thinking, and in the 1940s became the basis of the new economic development theories. Industrialization and development became synonymous for several decades. Nonetheless, just as in the case of macroeconomic management centered on the balance of payments, it was facts that forced the shift to industrialization policies and, at least in the initial stages, more as a result of experimentation than an articulated theory. As brilliantly expressed by Love (1994): "Industrialization in Latin America was fact before it was policy, and policy before it was theory" (p. 395).

The idea of industrialization emerged from the facts to the point that it was adopted in Latin America at a time when—with a few exceptions such as Mexico—the interests of commodity exporters continued to be dominant. Moreover, those interests continued to play an important role during the whole industrial development phase, among other reasons because industrialization continued to depend on the foreign exchange generated by commodity exports. Indeed, in Hirschman's (1971) interpretation, a distinctive characteristic of Latin America's industrialization, in contrast to the experience of "late industrialization" in Europe examined by Gerschenkron (1962), was precisely the weakness of industrial interests in relation to those of primary product exporters.

The theory, which in the Latin American case was provided by the United Nations Economic Commission for Latin America (CEPAL being its Spanish acronym),[1] arrived in an advanced stage to rationalize a process that was proceeding at full strength almost everywhere. It is worth noting that in this vision, embodied above all in CEPAL's 1949 report, which Hirschman baptized as the "Latin American Manifesto," the solution to Latin America's development problems was not to isolate itself from the international economy but to redefine its insertion into the international division of labor. This was essential, in CEPAL's view, for the Latin American countries to benefit from technological change which was viewed as intimately linked to industrialization. Moreover, industrialization policies varied through time in order to correct their own excesses, to respond to new opportunities that the world economy started to offer in the 1960s, and to adapt to the opportunities open to countries of different sizes. As emphasized in various histories of CEPAL's thinking (Bielschowsky 1998; ECLAC 1998; Rosenthal 2004), from the 1960s CEPAL became persistently critical of the excesses of import substitution, and advocated a "mixed model" that combined import substitution with export diversification and regional integration. This strategy helped rationalize import substi-

[1] United Nations Economic Commission for Latin America and the Caribbean, after the Caribbean joined.

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tution and exploit the opportunities that were increasingly available to developing countries in world markets. It also helped adapt the strategy to the possibilities for small countries. Such mixed model became the dominant pattern in the region during the mid-1960s, and was reflected in the generalization of export promotion policies, the partial rationalization of the complex structure of tariff and non-tariff protection, the elimination and simplification of multiple exchange rate regimes, and the adoption of gradual devaluation policies in countries with an inflationary tradition (Ffrench-Davis, Muñoz, and Palma 1998; Ocampo 2004a).

In particular, the small economies returned early in the postwar period to reliance on primary exports, which they mixed with the promotion of light manufacturing and, in the case of Central America, with the launch of its common market in 1960. Even in some larger economies, like Peru and Venezuela, primary exports continued to be central to the development strategy. In those larger economies where industrialization was the core of the development strategy (i.e. Argentina, Brazil, Chile, Colombia, and Mexico), export promotion policies, geared to the development of new export sectors, became common in the mid-1960s. These policies included export subsidies (tax rebates and subsidized export credit), import duty drawbacks for exporting firms, and export processing zones.[2] As already mentioned, gradual devaluation ("crawling pegs"), to compensate for the inflation differential between the domestic economy and its main trading partners, also became an important export promotion instrument in several major South American countries, notably Argentina, Brazil, Chile, and Colombia, from the mid-1960s onwards.

1.2.3 State intervention

The first two components of the development strategy produced an unprecedented degree of state intervention in the economy. But state intervention also involved a wider array of policy instruments in addition to interventions in the management of the balance of payments and the use of protection as a development policy instrument. The state intervened actively in providing fiscal incentives to new industries and in financing productive activities through state development banks such as BNDES in Brazil, CORFO in Chile, IFI in Colombia, and NAFINSA in Mexico, and the establishment of directed credit to strategic sectors. It also developed a complex intervention apparatus in the agricultural sector (technological development centers, price regulations, distribution of agricultural products, irrigation, and in some cases agrarian reform). The process was also accompanied by an expansion of public expenditures, with priority

[2] The first and major example is the maquiladora plants in Mexico's northern border, which in 1965 began processing textiles and later assembling electronic components for export to the US. Similar free trade zones were later introduced in many other countries, notably in Central American and Caribbean countries (Dominican Republic and Haiti being the first) to exploit locational advantages (low transport costs due to proximity to the US market) and labor cost advantages.

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given to economic development spending on infrastructure and social services, financed by the development of a new tax base that relied much more on incomes and indirect taxes on domestic economic activities than on import tariffs. The development of infrastructure services (water and sewage, electricity and telecommunications) as well as, in several countries, financial services, also relied heavily on state-owned banks.

The development strategy also led to greater activism in social policy. Some developments were common to the region in the postwar period, in particular the establishment of public education and health systems. The more developed schemes followed a tendency to create social security systems based on wage employment and to actively regulate the labor market. In the more developed countries of the region, these systems had started to be developed in the last phases of the primary export-led phase. To the extent that access to wage employment in the modern sectors was limited—particularly in the less developed countries—the results were "segmented welfare states," in which wage earners in the formal sector had a wide array of benefits to which the urban informal sector and most of the rural population did not have access. The poorer sectors of the population remained subject to the laws of economies which worked with an "unlimited labor supply" *à la* W. Arthur Lewis. On the other hand, under the initial leadership of Mexico and in a wider set of countries from the 1960s, different agrarian reform models were applied. In general their results were limited, except in the case of Cuba, and thus only partially changed the extremely high concentration of rural property inherited from the past. In most cases, therefore, the weight of dominant agrarian interests continued to prevail.

State intervention and industrialization thus became distinctive features of a whole era. It is worth noting, however, that among the different models of state intervention that were typical in the immediate postwar period, Latin America opted for a *lesser* rather than a greater degree of state intervention—that is, for a model of economic organization in which private enterprise continued to have a major role. Indeed, in the early postwar years, and with very few exceptions (the US being the most important one), the real choice was not between state vs. free market economies but rather among different variants of state intervention and economic planning. In this spectrum, Latin America opted for a mixed economy model, which resembled more that of Western Europe than the different variants of socialist systems that proliferated at the time, including in Asia and Africa. In Latin America, only Cuba adopted a socialist model at a later stage (in the 1960s); there were also failed attempts in that direction by Chile and Nicaragua in the 1970s and 1980s respectively. It is also worth noting that foreign investment was welcome to the extent that it contributed to the industrialization process. While in many countries its access was certainly restricted in some sectors—natural resources, infrastructure, and financial services, in particular—it is also true that overall, these restrictions were less stringent than in the "Japanese model" followed at the time in Japan and some East Asian tigers (notably in South Korea).

The preference for a mixed economy, with a large presence of domestic and foreign private-sector firms, is likely to have its historical roots in the fact that Latin America had experienced, unlike other regions, a relatively fast process of economic growth in the period preceding state-led industrialization. Indeed, from 1913 to 1950 Latin America

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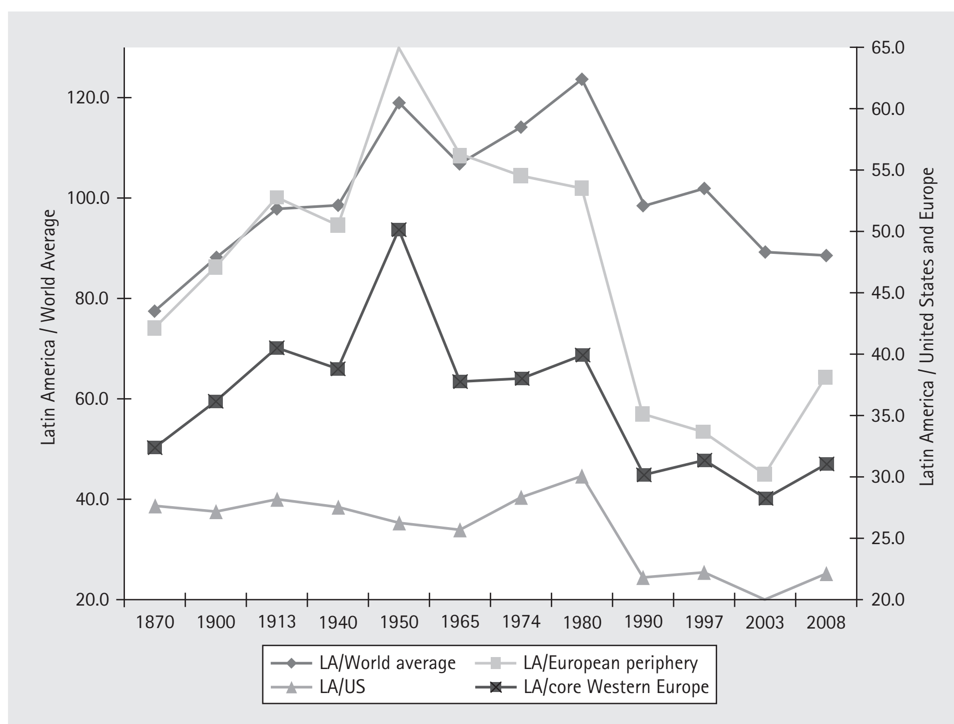

FIGURE 1.1 Latin America's relative per capita GDP

Source: Maddison (2006) and online updates of his series. Core Western Europe refers to Maddison's Europe 12, and European periphery to Maddison's 14 small Western European countries.

had been, together with the United States, the region of fastest growth in the world (Figure 1.1). Relative success thus contributed to curtailing the "statist excesses" in the subsequent phase of development.

1.2.4 The development performance of the region under state-led industrialization

Latin America's development performance during the period of state-led industrialization has been a controversial issue. For some, the postwar period should be seen as a golden age of unprecedented prosperity and increase in living standards. For others, the postwar period witnessed a dismal performance in which Latin America squandered opportunities for rapid growth and catching up.

A first reason for the disagreement has to do with the perspective adopted. The 1950–80 period was one of unprecedented prosperity for the world economy as a whole. In this context, Latin America's average comparative performance was not particularly

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impressive. Its 2.7% annual growth rate of GDP per capita was somewhat above the world average and that of the US but lower than that of the core Western European countries. In the latter case, however, the war collapse and later reconstruction are the basic explanation, as the relative position of Latin America in 1980 was slightly better than in 1940 (see again Figure 1.1). The region's average performance did fall short of the best performances in Southern Europe, Japan and the East Asia tigers. But, again, if we compare this with the European periphery, Latin America's relative position in 1980 was again slightly better than in 1940. Furthermore, if we leave out the early post-war period and focus on 1965-1980, Latin America grew faster than the average for the world and for the leading industrial countries.

Therefore, a positive view of economic performance is a more appropriate perspective. This was indeed a period of acceleration of growth with respect to a successful past and, particularly, a period of major economic and social transformations which compare favorably with what happened in Latin America before 1950 and after 1980. Hirschman (1987) calls the 1950–80 period "les trente glorieuses" precisely because of the substantial increase in living standards. Performance is particularly remarkable given the rapid acceleration in population growth and urbanization that took place during these years. Indeed, total GDP growth in Latin America (rather than GDP per capita) exceeded that of the industrial countries and the world (see Table 1.1). Progress started to permeate a broader segment of society. Based on Bértola, Hernández, and Siniscalchi (2010), Table 1.2 indicates that advance in human development accelerated in the 1940s and was rapid until 1980 (see also the analysis in Astorga, Bergés, and FitzGerald 2003). Prados de la Escosura (2007) also estimates that the bulk of the reduction in poverty achieved during the 20th century took place between 1950 and 1980. Nonetheless, income inequality remained very high by world standards, and increased in several countries over different time periods.

An additional reason for the disagreement concerning the growth record during the period of state-led industrialization is the high heterogeneity of performances across the region. Take, for example, the richest economies in 1950, Venezuela and, particularly, the Southern Cone countries (Chile, Argentina, and Uruguay). These countries had an income per capita well above that of southern Europe or Japan in 1950. Compared to the performance of these countries after 1950, the growth performance of the Latin American richer economies looks dismal indeed (Table 1.3). By 1980, Greece, Portugal, and Spain had caught up with Argentina and surpassed Uruguay and Chile, while Italy and Japan had incomes per capita that were more than twice those of Chile and Uruguay and well above those of Argentina.

Yet now look at Brazil and Mexico and other fast-growing countries in Latin America (which also include Costa Rica, Ecuador and Panama with growth rates of over 3% per capita; Colombia, the Dominican Republic, Guatemala, and Paraguay can be added to that list since the mid-1960s). Although not as good as the best performers in East Asia, these economies' rates of growth of GDP implied a process of catching up with several developed economies, certainly including the United States (see Table 1.1). Brazil was the star performer with GDP per capita growth of 4.1% per year from 1950 to 1980, while Mexico also had a rather high growth rate of 3.4%—in both cases despite rapid

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Table 1.1 Weighted average growth rates (%)

	GDP		GDP per worker		GDP per capita	
	1950–80	1990–2008	1950–80	1990–2008	1950–80	1990–2008
Argentina	3.3	4.2	2.0	1.8	1.6	3.0
Bolivia	3.2	3.8	2.4	0.4	0.9	1.5
Brazil	7.0	3.0	3.4	0.6	4.1	1.5
Chile	3.5	5.4	1.9	3.7	1.4	4.0
Colombia	5.1	3.5	2.3	0.5	2.3	1.9
Costa Rica	6.3	5.1	2.9	1.5	3.2	2.8
Dominican Republic	5.8	5.7	2.6	3.0	2.7	3.9
Ecuador	6.1	3.2	4.1	–0.3	3.2	1.5
El Salvador	4.1	3.8	1.4	1.5	1.2	1.8
Guatemala	5.0	4.0	2.7	1.5	2.2	1.5
Honduras	4.3	4.1	1.9	–0.4	1.3	1.8
Mexico	6.6	3.0	3.4	0.5	3.4	1.6
Nicaragua	4.1	3.3	0.7	0.1	1.0	1.5
Panama	6.1	5.6	3.6	2.5	3.2	3.6
Paraguay	5.5	2.6	3.0	–1.1	2.8	0.5
Peru	4.9	4.9	2.4	1.8	2.1	3.4
Uruguay	2.2	3.2	1.2	1.6	1.3	2.8
Venezuela	6.0	3.2	2.4	–0.7	2.2	1.2
Latin America	5.5	3.4	2.7	0.7	2.7	1.8
United States	3.6	2.8			2.2	1.7
Core Western Europe	4.1	1.9			3.5	1.6
European periphery	4.3	2.2			3.4	1.3
World	4.5	3.7			2.6	2.4

Source: Latin America according to ECLAC database. Non-Latin America according to Maddison (2003) and online updates of his series.

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Table 1.2 Indicators of human development

	Education Index[a]		Life Expectancy Index[b]		Human Development[c]	
	LA20	LA7[d]	LA20[e]	LA7	LA20	LA7
A. Latin American index						
1900		0.101		0.141		0.074
1910		0.113		0.185		0.092
1920		0.129		0.233		0.106
1930		0.150		0.265		0.123
1940		0.175		0.321		0.142
1950		0.206	0.420	0.435		0.183
1960	0.227	0.236	0.555	0.576	0.214	0.227
1970	0.275	0.286	0.618	0.633	0.257	0.271
1980	0.327	0.334	0.689	0.702	0.311	0.326
1990	0.401	0.414	0.743	0.751	0.334	0.354
2000	0.446	0.461	0.770	0.780	0.367	0.390
B. Relative to industrial economies						
1900		0.255		0.343		0.305
1910		0.264		0.382		0.335
1920		0.283		0.425		0.356
1930		0.310		0.437		0.364
1940		0.343		0.505		0.388
1950		0.380		0.591		0.439
1960	0.393	0.410	0.717	0.744	0.452	0.479
1970	0.424	0.441	0.783	0.802	0.466	0.492
1980	0.462	0.472	0.828	0.844	0.499	0.524
1990	0.532	0.549	0.866	0.876	0.485	0.513
2000	0.570	0.589	0.869	0.880	0.486	0.516

[a] The Education Index refers to years of schooling, with a ceiling of 16 years.
[b] The Life Expectancy Index has a minimum standard of 20 years and a maximum of 85 years.
[c] The Human Development Index is a geometric average of the first two and per capita GDP.
[d] LA7 includes Argentina, Brazil, Chile, Colombia, Mexico, Uruguay, and Venezuela.
[e] LA20 includes also Bolivia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Nicaragua, Panama, Paraguay, and Peru.

Source: Bértola, Hernández, and Siniscalchi (2010).

population growth, which implied that GDP growth was very fast (7.0 and 6.6% respectively).

What factors explain these differences in growth performance? The first one has to do with the size of the economy. It cannot be a coincidence that Brazil and Mexico, the two

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Table 1.3 GDP per capita in richest Latin American countries vs. southern Europe and Japan

	1950	1980
Venezuela	7,462	10,139
Argentina	4,987	8,206
Uruguay	4,659	6,577
Chile	3,670	5,680
Italy	3,502	13,149
Spain	2,189	9,203
Portugal	2,086	8,044
Japan	1,921	13,428
Greece	1,915	8,971

Source: Maddison (2006).

most populous countries, were those able to sustain the highest rates of growth during the second, more difficult phase of industrialization, in which manufacturing expanded into heavy intermediates (steel and petrochemicals), consumer durables, and some capital goods. The size of their domestic markets is probably a major factor here, since it allowed industrial sectors with high fixed costs (associated with their capital intensity), and, as a result, strong economies of scale, to be established while it attracted the foreign investment required to set up these capital and technologically intensive industries. For these reasons, it also facilitated the transition to the "mixed model" in which non-traditional exports played an increasing role in the expansion of manufacturing industries. In other countries, the opportunities for industrialization were concentrated in light consumer goods and intermediate goods with low capital and technology intensity, and attempts to enter the "difficult phase" could have resulted in highly inefficient manufacturing sectors.

A second factor has to do with the structural features of the domestic economy—a fact that differentiates the Southern Cone countries from the rest of Latin America. Díaz-Alejandro (1988: ch. 12) highlights this factor in his comparison of the economic histories of Argentina and Brazil. Brazil had a Lewis-type economy with a surplus of labor that generated an elastic supply of labor to the modern sector of the economy. The expansion of the industrial sector meant that the process of industrialization caused labor to move from low- to high-productivity sectors (from the "subsistence" to the industrial sector). These productivity gains were behind the rapid increases in GDP per capita. Argentina, by contrast, was a mature economy in which more sectors were modern, and there was not a large subsistence sector. This meant that the economy would benefit less from the reallocation of labor from low- to high-productivity sectors. Rather, the expansion of the industrial sector caused labor to be taken away from the modern export sector. Because industrialization crowded out labor in the export sector, the

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anti-export bias was higher in Argentina. It was implied that formal labor markets were more developed and unionization was more important (see below).

A third factor relates to the role of export promotion policies and exchange rate policy, and the degree of success of the transition to the "mixed model" of import substitution-cum-export promotion. It is worth noting that most of the fast-growing economies are among those that started experimenting with export promotion policies some time in the 1960s or early 1970s; two of them (Brazil and Colombia) also adopted crawling pegs. By contrast, the slow-growing economies, with few exceptions such as Argentina and Chile, were not early adopters of export-promotion policies. In the case of the countries with large domestic markets (Brazil, Mexico, and to a lesser extent Colombia), the success of export promotion policies was facilitated by the smaller anti-export bias generated by more moderate protection of intermediate and capital goods. All this suggests some role in growth outcomes for the type of industrialization policy adopted.

In relation to economic performance, it must be pointed out, finally, that despite Latin America's reputation for high inflation, this was not a general feature of the region before the 1970s. Indeed, as noted by Sheahan (1987), in the 1950s and 1960s only four countries (Argentina, Brazil, Chile, and Uruguay) could be characterized as having had high rates of inflation relative to the rest of the world. In the 1960s the other 14 countries had rates of inflation lower than the average inflation rate in Asia (which has a reputation for low inflation), and ten countries (in Central America and the Caribbean plus Mexico, Paraguay, and Venezuela) had lower inflation than the average for the world economy (4.0%). One factor behind the inflationary trends of the Southern Cone countries was the strength of the labor unions. With indexation systems (of the exchange rate, in particular), Brazil and Colombia were able, from the mid-1960s, to avoid the overvaluation and unstable real exchange rates affecting their export competitiveness, and the uncertainty and stimulus to speculative activity with its discouraging effects on long-term investments. This can also be said of Chile after its 1970s traumas (high inflation under the Allende years, followed by massive macroeconomic imbalances during the first phase of the Pinochet regime).

1.3 The era of market reforms

State-led industrialization started to be criticized in the 1960s both by the political left and by economic orthodoxy.[3] From the left, the criticism focused on the inability to overcome external dependency and, above all, to transform the dependent and unequal social structures inherited from the past. In particular, as already pointed out, the industrialization experience had done little to eliminate the very unequal income distribution and, in some cases, was thought to have led to growing social marginalization. Moreover,

[3] See e.g. the reviews of the debate at different points in time by Hirschman (1971), Fishlow (1985), and Love (1994).

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the initial dependence on primary exports had been compounded with new forms of dependence on foreign capital and technology. Without necessarily sharing the point of view of the political left, Hirschman (1971) expressed brilliantly the underlying idea: "Industrialization was expected to change the social order and all it did was to supply manufactures" (p. 123).

The criticism from economic orthodoxy, located at the time in some US universities and the International Monetary Fund—though not yet at the World Bank[4]—centered on high inflation and associated lack of macroeconomic discipline—which, as discussed above, was relevant only for a few countries—and on the allocative inefficiencies that were generated in particular by trade protection and resulting anti-export bias (negative effective rates of protection for exporting sectors), as well as by anti-agricultural (net taxing of the agricultural sectors, largely through price regulation) and anti-employment biases (on the assumption that Latin America's comparative advantages were in labor-intensive sectors). Major texts in this line of criticism included Little, Scitovsky, and Scott (1970), based on a comparative study of seven developing countries in Asia and Latin America, and the major NBER research project led by Krueger (1978), which emphasized the superior growth and productivity performance of "outward oriented" industrialization vis-à-vis import substitution strategies.

Eventually, the viewpoint of economic orthodoxy, extended to encompass the criticism of a wider range of state interventions, became the dominant paradigm. According to Lindauer and Pritchett (2002), a number of "big facts" contributed to this new paradigm shift in Latin America and elsewhere in the developing world. The rapid growth of East Asia, based on manufacturing exports and outward orientation, led to a reassessment of the role of trade as well as of the role of government, given the mainstream (incorrect) interpretation of the East Asian development experience in the 1970s and 1980s as supposedly less state-led. The shortcomings of central planning were by the early 1980s also becoming clear, both in its strong form (the Soviet Union and Eastern Europe in general, as well as China, which would adopt a major shift in the late 1970s) and in its soft form (India with its disappointing growth performance). In the late 1980s, the fall of the Soviet Union and the end of communism in Central and Eastern Europe did much to further undermine the support for state-led development.

For Latin America, however, the debt crisis of the 1980s was by far the most important "big fact" determining the shift in the paradigm. The critics of state-led industrialization saw this event as the crisis of the whole development model followed until then. Independently of the problems that that model was facing in several countries, this is an incorrect interpretation. More than structural problems, the debt crisis was the result of the risky macroeconomic policies of the 1970s and, particularly, the second half of that decade: high external indebtedness, in the context of low real interest rates at the international level, and high commodity prices, combined with a huge external shock

[4] The Bank was, at least until the 1970s, part of the industrialist consensus, and contributed with its projects to the industrialization process and to building modern apparatus of state intervention, notably in the areas of infrastructure.

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generated by the strong and unexpected increase of interest rates in the US in 1979–80 and the collapse, also largely unexpected, of commodity prices (Díaz-Alejandro 1988: ch. 15; Ocampo 2004a). The predominance of these macroeconomic factors over structural factors is reflected in the fact that the crisis hit large debtors, such as Brazil and Mexico, that continued to pursue state-led industrialization, but also affected with equal or even greater severity those countries that had engaged in the 1970s in market liberalization experiments (Argentina, Chile, and Uruguay). In contrast, the country that better managed the boom of the second half of the 1970s (Colombia) was hit by the contagion generated by the debt crisis, but did relatively well.

In any case, this event led to a reversal of the previous consensus on the development strategy and to a new conventional wisdom which viewed government as an obstacle to development, the private sector as the leading actor, trade as the engine of growth, and foreign direct investment as a priority.

1.3.1 The new paradigm

An essential difference between the rise of the new and the old paradigms lies in the relationship between ideas and practice. As we have seen, the old paradigm, articulated by CEPAL, arrived at an advanced stage in order to rationalize a process that was already in place. In the new paradigm shift, ideas came first as an intellectual and even openly ideological attack that acquired full force in the 1970s. The most paradigmatic case was, of course, the Chicago school offensive in Chile, which started in the 1950s and whose main results arrived with the Pinochet regime, giving a distinctive feature to a regime that initially lacked an economic model (Valdés 1995). Some texts, especially Balassa et al. (1986), had an important role in this process.

The World Bank and the IMF also had an important role in the diffusion of the reform agenda, through their policy conditionality. This gave the shift an appearance of an external imposition. This is in contrast with the previous paradigm, which, although conditioned by external influences, clearly emerged from within. Thus, while the document that best synthesized the vision of the previous period was CEPAL's "Latin American Manifesto," the one that more clearly articulates the new paradigm is the ten policy recommendations of the "Washington Consensus" formulated by Williamson (1990) to summarize what he perceived to be the reform agenda being pushed by the Washington institutions. The center of gravity had clearly shifted towards the economic thought generated in industrial economies and especially in the United States. To use CEPAL's terminology, the "center–periphery" model now dominated the realm of economic ideas prevailing in Latin America. Although these external influences were important, the view of the reform agenda as a mere external imposition is incorrect, as we will see below.

If industrialization and state intervention had been at the core of the previous development phase, the liberalization of market forces took that role under the new paradigm. In the area of macroeconomics, the idea that became popular in the 1970s, and

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especially in the 1980s, was that of "getting the prices right"—an expression that made reference to achieving an equilibrium exchange rate and letting interest rates be determined by market forces. The expression was also used to highlight the need for eliminating the discrimination against agricultural goods that resulted from price regulation by the state, as well as the need to set the price of public utilities in such a way as to cover costs. Later, the emphasis shifted in the macroeconomic area to low inflation rates guaranteed by autonomous central banks. In more than a few cases, however, inflation targets were achieved through the overvaluation of the exchange rate, thus contradicting the objective of "getting the prices right."

Low inflation in turn entailed the need to maintain healthy public-sector finances—an objective that proved harder to achieve. In the 1980s, the task was synonymous with reducing public spending, and thus rearranging government priorities, as well as changing the tax structure by increasing value added tax and reducing direct tax rates. Towards the end of the 1990s, public finance restructuring involved in addition the formulation of explicit fiscal targets of different kinds (primary surplus or budget balance, but also restrictions on the growth of government spending), as part of a broader set of fiscal responsibility rules which also affected the regional or local fiscal authorities in federal or decentralized systems.

With respect to changes in the economic structure, the early and prominent components of the reform agenda were trade liberalization and deeper integration into the world economy based on comparative advantages, as well as a broad opening up to foreign direct investment. Although only a few countries imitated the Chilean model, adopted in the 1970s, of establishing a uniform tariff, tariffs were sharply reduced and the tariff structure radically simplified as non-tariff barriers were largely eliminated. The objective of setting low tariffs was thus achieved to a much greater extent than in the classical period of primary export-led growth. Moreover, under the leadership of Mexico and Chile, a wave of free trade agreements was launched.

Trade liberalization was accompanied also by the dismantling of state intervention in productive development that characterized the previous period, not only in the manufacturing sector but also in agricultural development. This vision was succinctly summarized by a lemma that was repeated in several contexts: "the best industrial policy is *not* to have an industrial policy." In the application of this precept, technology policy, on which little progress had been made in the previous development phase (except, perhaps, in some agricultural research institutions), was also set aside, despite the fact that this is an element of intervention around which there is greater consensus. Trade liberalization and the dismantling of productive development policies was based on a number of arguments: the negative effects of protection on static efficiency (by moving the economy away from specialization according to comparative advantage and closing it off from external competition) as well as the encouragement of rent-seeking behavior as firms devoted resources to gaining advantages rather than increasing their efficiency.

Trade liberalization was accompanied, in addition, by the elimination of exchange controls and domestic financial liberalization. The latter included the liberalization of interest rates, the elimination of most forms of directed credit, and the reduction and

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simplification of reserve requirements on bank deposits. In this case, advocates of reform argued that the previous system of "financial repression" discouraged savings, as deposits frequently received negative real interest rates on their funds. This led, in their view, to limited access to credit, especially for small and medium-size enterprises, and in several instances to lending based on political connections rather than the profitability of the projects.

Another element in this agenda of structural reforms was the privatization of a large set of public enterprises together with the opening up to private investment of public services and utilities sectors. In this case, however, the process was more gradual, and a number of countries kept public-sector banks and a number of other firms, notably in oil and infrastructure services (water and sewage more than electricity and telecommunications). The more general deregulation of private economic activities was also part of the agenda, although it was recognized from the beginning that there should be some regulation of monopolistic practices and unfair competition, including those that could present themselves in privatized utilities. It was also accepted that financial liberalization required regulation to avoid the accumulation of excessive risks in the financial system, though the full acceptance of the need for regulation only came after a fair number of domestic financial crises.

Social development was not prominent in the initial market reform agenda. In Williamson's original decalogue, for example, spending on education and health was only mentioned as a priority in the task of reducing and restructuring public sector expenditures. However, in the reform proposals that the World Bank promoted, there were three ideas amply disseminated: decentralization, targeting of public social spending towards the poor, and the introduction of private-sector participation in the provision of social services. There was, in any case, recognition of the essential role of the state in this area. A topic where there was an overlap between this agenda and fiscal retrenchment was the pensions regime. The introduction of a new individual savings scheme, adopted by Chile in the 1980s to replace the old pay-as-you-go system, was disseminated as a panacea in the region and beyond, especially in post-communist Central Europe, even though not all reformers followed this trend. There was, finally, an agenda of at least partial liberalization of labor markets, but here political factors largely blocked the reform proposals (Chapter 31 in this volume, by Murillo, Ronconi, and Schrank).

1.3.2 Policy diversity

As the implementation of the new paradigm made major strides, alternative policy proposals were advanced from other quarters. CEPAL's *Changing Production Patterns with Social Equity* (ECLAC 1990) was an important contribution in this regard, to which other contributions from this institution were added in subsequent years. Outside CEPAL, the alternative paradigm took the form of "neo-structuralism"

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(Sunkel 1993; Bielschowsky 2009). These alternative proposals focused on four predominant themes:

(i) the adoption of more active and counter-cyclical macroeconomic policies in order to avoid, in particular, the disequilibria generated by boom-bust cycles in external financing;
(ii) the combination of trade liberalization with open regionalism;
(iii) the promotion of innovation through active technology and productive development policies adjusted to the new open economies; and
(iv) the adoption of equity at the center of development policy (see esp. Ocampo 2004b; Ffrench-Davis 2005).

Over time, this last objective would eventually obtain an important place in the agenda of those institutions that promoted reforms, in particular the World Bank, and the first would be brought into the agenda during the 2008–9 global financial crisis.

Reflecting these and other alternative views, the map of structural reforms shows a diversity of national responses, even during the years of greater activism (see e.g. Stallings and Peres 2000). This diversity indicates, furthermore, that the transformation cannot be simply understood as an external imposition: it was really the outcome of national decisions adopted since the mid-1980s by democratic political regimes, in sharp contrast with the initial neo-liberal experiments in the 1970s in the Southern Cone. Diversity was evident both in the models of macroeconomic management and in the speed and scope of some structural reforms—trade opening, financial liberalization, and the privatization process. There were, in addition, relatively common elements that were not part of the initial reform agenda and that responded more to domestic political pressures. Chief among them is the generalized increase in social spending that took off in the 1990s (ECLAC 2009). Greater social activism, together with the very limited scope for labor market deregulation, are probably the most important contributions to the revision of the reform agenda that came with the democratic wave that simultaneously swept the region. Another element that emerged from the political realm was support for regional economic integration, which was in opposition to the more orthodox visions that promoted unilateral trade liberalization.

Diversity became broader over time as a reflection of the poor results of reforms in several countries, as well as of the open political rejection of market reforms in some countries. The "lost half-decade" that followed the Asian crisis of 1997 and the Russian crisis of 1998 was a turning point in this regard. From then on, a greater pragmatism was accompanied by the incorporation of new issues into the agenda, especially those relating to equity and institutional development. The excessively positive assessments of the reforms, which curiously were drafted as the new crisis hit the region (IDB 1997; World Bank 1997), were followed by much more subtle views that emphasized the need to make progress in overcoming the severe problems of poverty and inequality in the region, as well as on institutional development (see esp. Kuczynski and Williamson 2003; World Bank 2006).

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1.3.3 Economic and social performance

The economic and social performance of Latin America since the 1980s has been weaker than that of the previous development phase. This is true even if we leave aside the "lost decade" of the 1980s. For the period 1990–2008, the average of Latin America's per capita GDP growth rate has been 1.8% per year, well below the growth rate of the period 1950–80 (2.7%) and less than the average growth rate of the world economy (see again Table 1.1). The growth performance of GDP per worker, a gross measure of productivity, is even worse: 0.7% per year for 1990–2008 vs. 2.7% in 1950–80. This means that most of the increase in GDP per capita since 1990 has been the result of the demographic bonus resulting from the slowdown of population growth (from 2.7% to 1.5%) in the face of a still relatively fast growth of the labor force (2.6% per year, a rate similar to the 2.8% of 1950–80) (see Ros 2009).

Table 1.1 indicates that only two countries have experienced a dynamic growth of productivity since 1990 (Chile and the Dominican Republic); two countries show fairly similar though relatively low productivity growth in both periods (El Salvador and Uruguay); the rest show a much poorer performance in 1990–2008 than in 1950–80. This poor overall productivity performance is not due to the absence of new dynamic and highly productive activities; rather, it reflects the rising share of low-productivity informal activities, as the dynamic highly productive sectors were unable to absorb a larger share of the labor force.

Despite the significant demographic bonus, the mixed growth performance during the reform period is illustrated in Table 1.4. There are seven countries that have grown since 1990 at a per capita rate above the world average, six of which have improved in this respect relative to their own past performance, while eleven countries have experienced performance below the world average, and seven of them also with respect to their past record. Across countries there is no apparent relationship between the degree and timing of market liberalization and growth performance. The countries in the upper left corner of the table include Chile, an early reformer, the Dominican Republic, a late reformer, turbulent Argentina, with a heterodox exchange rate policy since 2002, and relatively more orthodox Peru. Interestingly, all the fast-growing economies under state-led industrialization, most of which have thoroughly liberalized their economies, have now underperformed in relation to past and world trends, with the major exceptions of the Dominican Republic and Panama. In contrast, the poor performers under state-led industrialization have done better under the new paradigm.

This economic performance was affected not only by the poor results of the market reforms but also by worldwide macroeconomic turbulence. The collapse of growth during the lost decade of the 1980s was followed by a recovery in 1990–97, although at a slower pace than during the years of state-led industrialization, and then by the "lost half decade" of 1998–2003. As a result, the relative position of Latin America in the world economy went back in 2003 to the levels of 1900 (Figure 1.1)! The combination of a new surge in external financing and the increase in commodity prices, which had been absent since the 1970s, generated a new boom in 2004–7, at a pace that was then more similar to

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Table 1.4 Relative growth performance, 1990–2008

		Relative to 1950–80	
		Above	**Below**
	Above	Chile (4.0%) Dominican Rep. (3.9%) Panama (3.6%) Peru (3.4%) Argentina (3.0%) Uruguay (2.8%)	Costa Rica (2.8%)
Relative to world average	**Below**	El Salvador (1.8%) Honduras (1.8%) Bolivia (1.5%) Nicaragua (1.5%)	Colombia (1.9%) Mexico (1.6%) Brazil (1.5%) Ecuador (1.5%) Guatemala (1.5%) Venezuela (1.2%) Paraguay (0.5%)

Source: See Table 1.1 (average per capita GDP growth in 1990–2008 in parentheses).

that of the 1970s. But if the slow pace of economic growth since 1990 cannot solely be attributed to market reforms, neither can reformers claim for themselves the success of the recent period, which had also been remarkable in countries now embracing more heterodox views. In any case, the global crisis in 2008–9 suddenly interrupted the recovery after 2003, bringing about a deep recession in 2009 which was second only, among emerging and developing countries, to that of Central and Eastern Europe.

In the social development area there was really no "lost decade," as revealed by the continuous progress made in education and health in the 1980s (see Table 1.2), though with a slowdown in the 1990s that, together with the fall in relative per capita income, led to a lag in human development vis-à-vis the industrial countries. The lost decade led to a significant increase in income poverty, but this was followed by progress in this area during the two periods of economic expansion in the 1990s and the new century, with a partial reversal during the "lost half-decade." However, it was only in 2005 that poverty rates returned to their 1980 levels, so that in this area Latin America lost a quarter of a century rather than a decade (Figure 1.2)! Reduction in poverty rates was significantly helped—and in countries with young populations in 1980 greatly so—by the near-completion of the demographic transition since, as already mentioned, most of the increase in average per capita incomes for the region was the result of the demographic bonus—i.e. the increase in the labor force rather than the increase in GDP per worker (Ros 2009).

The significant reduction in poverty levels during the first decade of the 21st century also reflects the effects of an improvement in income distribution in several countries,

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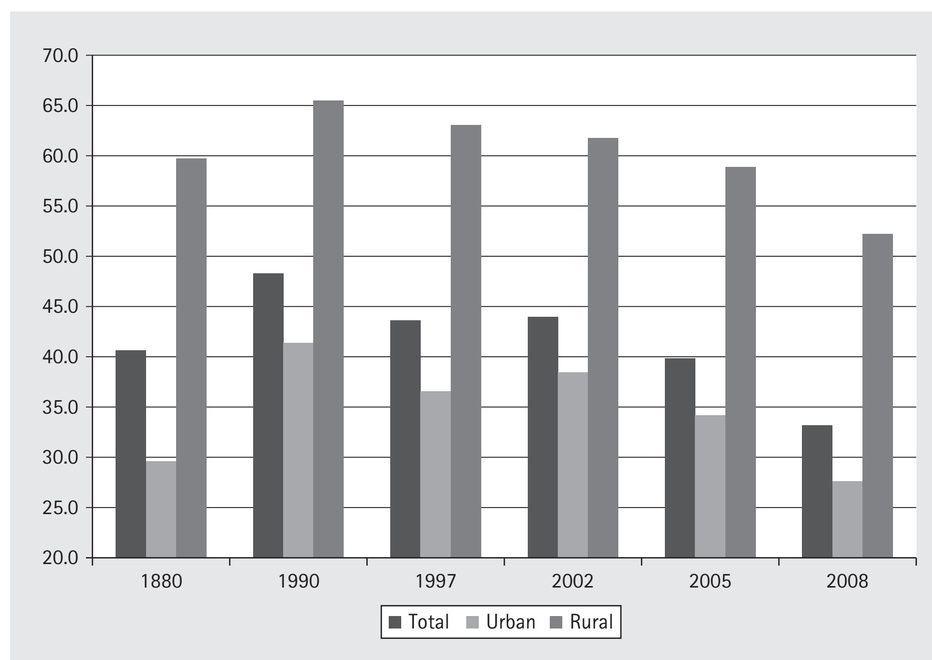

FIGURE 1.2 Latin America's poverty

Source: ECLAC (2009).

which reversed the moderate deterioration that had taken place on average from the early 1990s to the early 2000s (and in some cases, in the 1970s or 1980s). The factors behind the recent improvement in income distribution are still subject to debate. Rising social spending has played an important role, both transfers to poor households and, even more so, improved educational opportunities, which is a major factor behind the reduction in the skill premia, in sharp contrast to the opposite trend that was experienced in most Latin American countries during the 1990s. Improved distribution was facilitated by more conjunctural factors, such as the reduction in the rural–urban gap, thanks to booming agricultural prices, and increased formal employment during the 2003–8 boom, in the context of a significant reduction in the growth of the labor force. In any case, these improvements have only made a small dent in the large inequalities that still characterize the region (Gasparini et al. 2009; Cornia 2010).

1.4 Looking forward

The mixed outcomes of market reforms led to a heated debate and the reopening of many issues in the development agenda (Birdsall, de la Torre, and Valencia Caicedo, Chapter 4 below). If we look back at the neo-structuralist views set out by CEPAL

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since the 1990s, counter-cyclical macroeconomic policies and more active social policies are now clearly on the regional agenda. As we have seen, economic integration was introduced by politics rather than economics, though its success has been mixed. There is also broader agreement on the need for active technology policies, accompanied now by growing interest in production sector policies, under the leadership of Brazil, but action is still marginal in both areas in most countries. As in the past, regional differences in responses are already evident, in some cases backed by strong ideologies.

Major external shocks have always led to significant changes in Latin America. The 2008–9 world financial crisis was a shock of this type, and one which has already led to broader state activism throughout the world. An equally significant event is the collapse of international trade that took place during the recent crisis, and its still insufficient recovery as this chapter is written. Whatever happens in this area will be crucial, given the emphasis of market reforms on integration into the world economy. The crisis will also speed up the shift away from Western hegemony in economic affairs. These processes may lead to new changes, which could be major or even epochal ones. The immediate future will thus be full of news about global development patterns.

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