Why did Latin America fall behind East Asia

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The middle income trap

- Since 2007 World Bank economists are referring to the "middle income trap": the growth of many middle income countries that were growing fast saw their growth stall as they reached around US$ 10 thousands in PPP.
- The data seems to confirm this, but there are three problems:

Three problems with the m-i trap

- First, the researches that were made on the subject used a quite large income interval to define the middle-income countries.

- Second, the authors were unable to detect the new historical facts that changed the sort of the developing countries.

- Third, the East Asian countries didn't fall in the trap.

1. Large bands of income levels

- Michael Spence (2011) – Book Farrar Straus Giroux. Between $5,000 and $10,000.
- Jesus Felipe (2012) – Working Paper Series No. 306, Asian Development Bank, Washington DC. Two bands: i) $2,000 to $7,500 and ii) $7,500 to $11,500 (1990 PPPs).
- Eichengreen, Barry, Donghyun Park and Kwanho Shin (2013) – NBER Working Paper No. 18673. Two bands: i)$10,000 and $11,000 and ii) $15,000 and $16,000.
- Ayiar, Shekhar, Romain Duval, Damien Puy D, Yiqun Wu and Longmei Zhang (2013) –IMF Working Paper WP/13/71. Between $1,000 and $12,000

2. Such “causes” are not new historical facts

- To explain a new historical fact (the outcome) we need other new historical facts (the cause).
- The causes usually offered are not new facts:
- To explain a new historical fact (the outcome) we need other new historical facts (the cause).
- The causes usually offered are not new facts:

1. Inadequate institutions
2. Insufficient education
3. Lack of innovation and domestic patent
4. Insufficient investment in infrastructure
5. Demography and aging;
6. Macroeconomic policies and environment.

3. The East Asian countries continued to grow

- South Korea, Taiwan and Singapore, which were middle-income countries in 1990, today are rich countries.

- China, which was in a much lower level of income per capita in 1990, continued to grow fast. Since 2010, growth has slowdown, but growth remains highly satisfying.

Middle income or 1980s trap?

- An alternative to the concept of a middle-income trap that is worth to consider is the "1990s' developing trap".
- Countries stopped growing fast and making the catching up, not because they reached a given income per person and turned middle-income,
- but because one relevant historical new fact happened in the 1980s:

THE WEST'S POLICY REGIME CHANGED

1980s'
trade and financial liberalization

- The Washington Consensus or "the reforms" (a kind of magical catch-word) changed the policy regime of developing countries (except East Asia) from
- Developmental policy regime

  to a
- Liberal policy regime
- Such change, defined by the US in 1985 (the Baker Plan), + the growth with foreign savings policy aimed to restore growth that had stopped in 1980 due to a major foreign debt crisis.
- But had the opposite outcome.

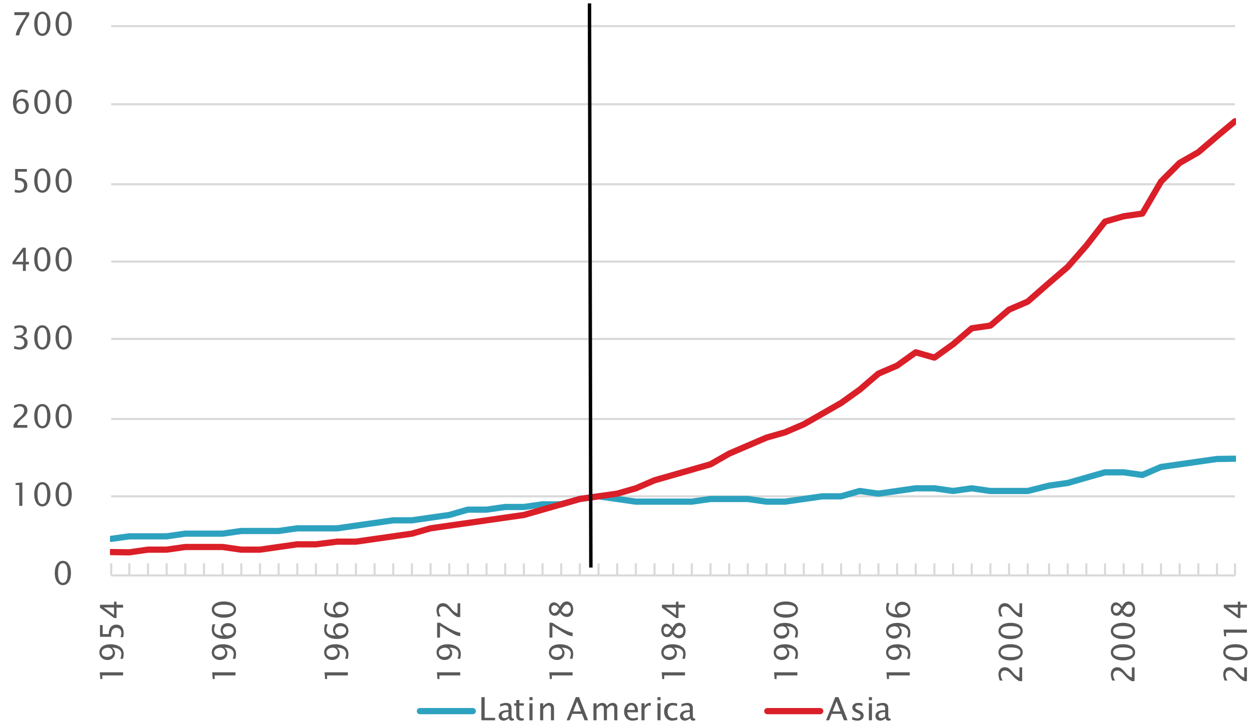
First, were, really, the 1980s a turning point?

Average income per person growth rates

	1960 –1980	1991–2014
Latin-America	3.0	1.2
East Asia	4.7	5.3

Source: Pen World Tables. Latin America: Brazil, Mexico, Argentina and Colombia
East Asia: China, South Korea, Taiwan, Singapore (1954-60 not included).

A self-telling figure



Per person income of Brazil, Mexico, Colombia, Argentina and East Asia. Index 100 for 1980.

Per capita GDP (average growth rate, %)

	1954–1980	1981–2014
Argentina	1,7	1,1
Brasil	4,7	1,0
Colombia	2,1	1,9
Mexico	3,6	0,7
China	2,0	6,5
Korea	4,9	5,7
Singapore *	5,2	4,0
Taiwan	6,0	5,1

Source: Penn World Table: * Average for the period 1960–1980

Second, why did the reforms have the opposite consequences?

- Not because they caused the increase of inequality, as the left uses to argue.

- Nor because the reforms were not accompanied by fiscal adjustment, as the liberal right defends.

- But because it throwed the Latin American countries in the "new-developmental macroeconomic trap".

New-developmental trap

- The new-developmental macroeconomic trap is
1. the long-term increase of the interest rate above the international interest rate, and,
2. mainly, the long-term overvaluation of the exchange rate.
- These two things were caused, respectively,
1. The use and abuse of the interest rate;
2. The dismantling of the intuitive mechanism of neutralizing the Dutch disease, which was embodied in the country's trade system.

To invest and grow a country needs the 5 macroeconomic prices right

- (1) profit rate, (2) interest rate, (3) exchange rate, (4) wage rate and (5) inflation.

1. The level of the interest rate around which the Central Bank makes its monetary policy, should be low;
2. the exchange rate should make competitive the competent tradable non-commodity companies;
3. and the wage rate should grow with productivity;
4. so that the profit rate is satisfying to the companies to invest.

Investment depends on the exchange rate

(besides the profit rate and the interest rate)

- If the exchange rate is not just volatile, but overvalued in the long-term, cyclically. (What is true in Latin America, not in East Asia.)

- Because, in this case, companies will make their calculus considering the overvalued currency, realize that the investment is not competitive notwithstanding using the best technology in the world, and will not invest.

Interest rate

- Latin America: high

1. To attract capitals
2. To control inflation
3. To favor rentier capitalists and financiers

- East Asia: low

-because East Asian countries wisely didn't give to the interest rates such uses.

- High interest rates

1. Discourage investment,
2. appreciates the national currency,
3. appreciate the national currency and
4. enrich unnecessarily rentier capitalists and financiers;

Dutch disease defined

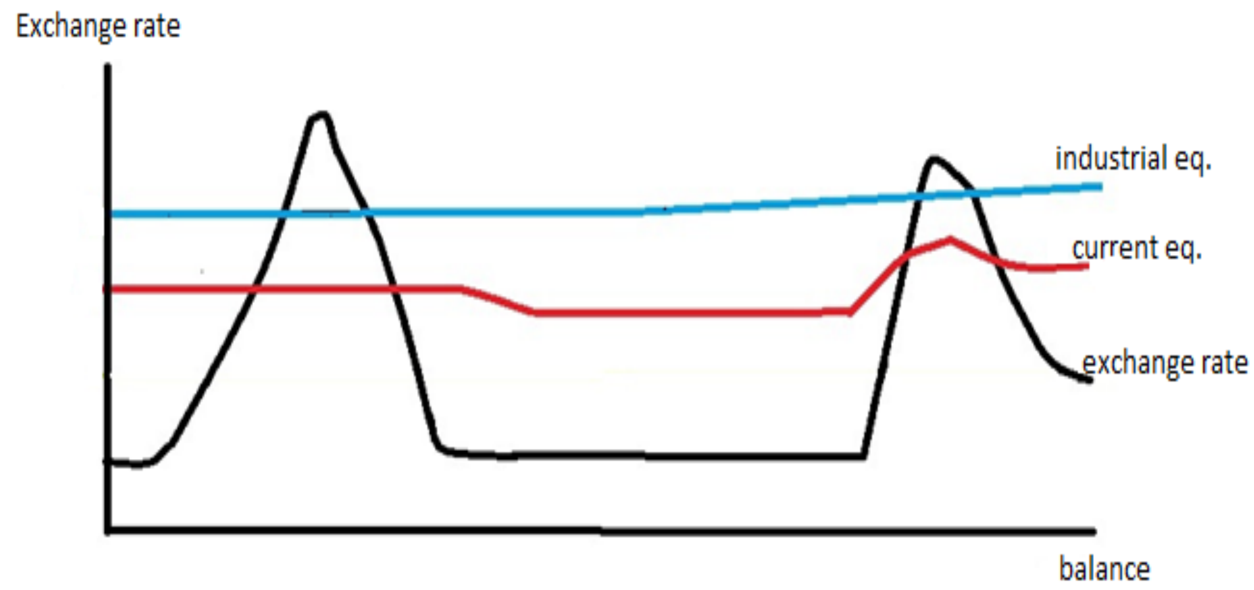
- It is a long-term overvaluation of the exchange rate in countries exporting commodities that benefit from Ricardian rents and/or price booms, and, so, may be exported at an exchange rate substantially more appreciated than the one required by the manufacturing companies utilizing technology in the world state-of-the-art.
- It is a competitive disadvantage existing in Latin America and most developing countries, not in East Asia.

Exchange rate: if it is not managed, tends to be appreciated

- The country engages in current account deficits ("growth" with foreign savings);
- It fall into a financial crisis;
- The Dutch disease (if existing) pulls the exchange rate up to the current equilibrium;
- High interest rates pulls the exchange rate to a current-account deficit.

- Low growth, deindustrialization, and falling behind turn inevitable.

Tendency to the chronic and cyclical overvaluation



The difference between the industrial equilibrium curve and the current equilibrium is the Dutch disease.
The area between the current equilibrium and the exchange rate is the accumulated current account deficit in the cycle.

How the Latin America countries fall in the new-dev macro trap

- They adopted very low if not negative interest rates, but it increased because

1. They financed budget deficits with public debt;
2. They bowed to the "financial repression theory"

- The exchange rate appreciated in the bottom of the cycle because

1. of the hither interest rates and because
2. They stop neutralizing partially the Dutch disease with import taxes.

- The ensuing competitive disadvantage meant fall in investment and deindustrialization.