Why, from the 1980s, did East Asia continue to grow while Latin America fall behind?

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Since 2007 economists are referring to the "middle income trap"; the fact that middle income countries, which were growing fast, quasi-stagnated from the 1980s. Several studies searched to confirm the trap, but the intervals used to check the middle-income trap were diverse and large, varying from US$ 2,000 to $ 16.000 dollars in PPP.[1] Intervals so large make the trap relative, but let us assume that is reasonable to identify a middle-income trap – that around 1980s the growth rates of the middle-income countries, except the East Asian countries, have fall. Starting from this assumption two questions follow: why did Latin American and other middle-income countries quasi-stagnate, while the East Asian countries continue to grow?

The table below compares Latin America and East Asia before and after the 1980 decade. It confirms the quasi-stagnation of Latin America and the continuation of the fast growth of East Asia. The figure below also shows that East Asia and Latin America were growing at a similar rates up to the 1980s and, after that, Latin America stalled while East Asia continued to grow fast.

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

Rates of growth of Latin America and East Asia before and after the 1980s. Sources: Pen World Tables. Latin America: Brazil, Mexico, Argentina and Colombia; East Asia: China, South Korea, Taiwan, Singapore (1954-60 not included).

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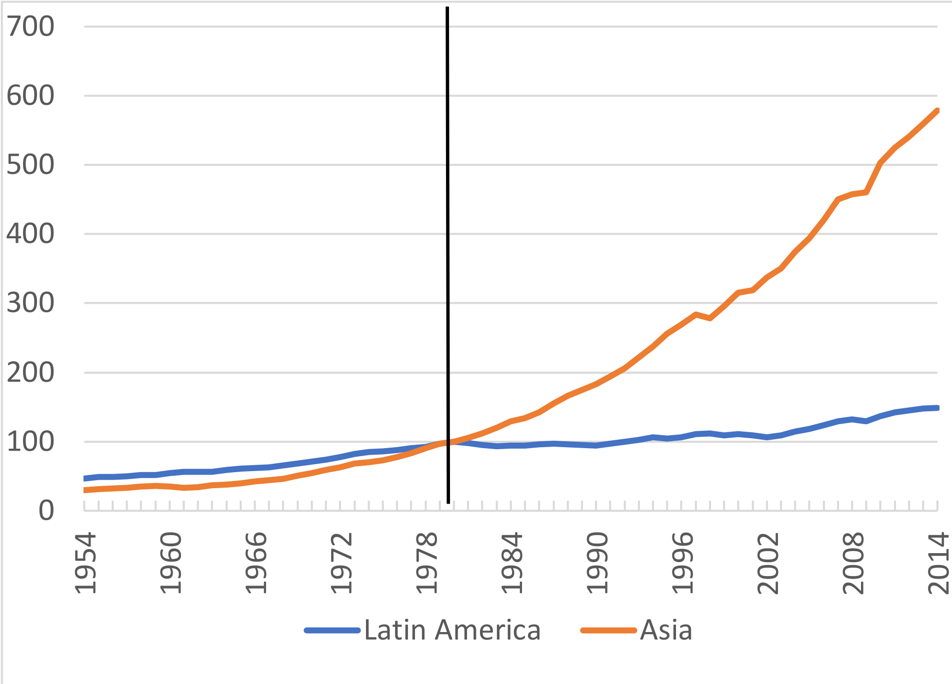

Comparing the growth per capita of Latin America and East Asia from the 1960s to 2014. Latin America: Brazil, Mexico, Colombia and Argentina.

The causes for the middle-income trap presented in this literature emphasize the quality of the institutions, problems related to demography, the lack of economic infrastructure; poor education, the lack of stimulus to technological learning, research and development. Yet, these explanations do not represent the new historical facts which manifested when the country turned middle-income. Those problems already existed before, and, nevertheless, had not stopped growth.

My argument is that the new historical fact was the 1980s' trade and financial *liberalization*. That, instead of speaking of a middle-income trap we should speak of "the 1980s' liberalization trap", or, more completely, "the 1980s trade and financial liberalization trap". Countries stopped growing fast and making the catch up not because they reached a given income per person but because one relevant historical new fact happened in the 1980s. On the pressure of the West, developing countries adopted the neoliberal reforms, specifically trade and financial liberalization.

Both regions were engaged in trade and financial liberalization. Why outcomes have been so different? Why in the 1980s did East Asian countries detach themselves from Latin American countries and continue to grow? New developmentalism's[2] response to this question is simple: because import taxes in East Asian countries were just necessary for the short period their manufacturing industry could be called infant, while in Latin America they were used additionally to neutralize the Dutch disease.

The infant industry argument legitimizes tariff protection for some time, while tariffs adopted to neutralize the Dutch disease on the domestic market will be legitimate as long as the country exports commodities. The East Asian countries don't face the Dutch disease problem. Thus, once the infant industry factor ceased to be relevant, they successfully opened their economies in the 1980s. Instead, when the Latin American countries had overcome the infant condition, the import tariffs continued to be necessary to neutralize the Dutch disease.

Import tariffs on manufactured goods are not protectionist but just assure the companies of a given country equal conditions of competition. The Dutch disease is a long-term overvaluation of the exchange rate in countries which, due to Ricardian rents, or price booms, may export commodities at an exchange rate substantially more appreciated than those that the manufacturing companies utilizing the best technology available in the world require to be competitive. A non-neutralized Dutch disease is a major obstacle to industrialization and growth.

The correct way of neutralizing the disease is to impose a variable tax on the exports of commodities – variable according to the international prices of the commodities.[3] During the fast industrialization period (1950 to 1980), Latin American policymakers did not know the Dutch disease, but they had learned with the classical development economics that growth is "structural change", i.e., is industrialization. Thus, they adopted pragmatically whatever policy led to industrialization, the more obvious being the import tariffs.

The Dutch disease is a major competitive disadvantage. It is difficult to say how large is such disadvantage. It depends essentially on the severity of the Dutch disease and on its variation in the commodity boom cycles and the corresponding exchange rate cycles. The severity of the Dutch disease is equal to the percental difference between the industrial equilibrium (the exchange rate that competent manufacturing companies require) and the current equilibrium (the exchange rate that balances intertemporally the current-account of the country). For example, if the industrial equilibrium of a country is #$ 4.00 per US dollars, and the current equilibrium, #$3.30 per US dollars, the Dutch disease will be #$0.70 per US dollars and its severity, 17.5%.

Oil is the main origin of Dutch disease, and, given the international price constant (reflecting the marginal cost of the less efficient exporter admitted in the market), its severity will depend on the cost of production of oil. For instance, the Dutch disease is very severe in Saudi Arabia, which faces the disease since it became an exporter of oil. Other countries, for instance, Brazil, whose competitive disadvantage originated in coffee, or meat, or soybeans, the Dutch disease is less severe and may even disappear when the prices of these commodities fall.

Thus, when, in the 1980s, the West imposed to Latin America trade liberalization (with the consent of the local dependent elites), the East Asians opened also their economies, but they were ready for it because the infant industry argument had lost validity, and they already counted with a competitive manufacturing industry. Differently, the competent manufacturing companies in Latin American countries immediately faced a major competitive disadvantage.

The 1980s liberalization trap reached the Latin American countries also on its financial side because they tried insistently to grow with "foreign savings", i.e., with foreign indebtedness, while the East Asian countries' policy was to grow with domestic savings. Since 1980 China experienced current-account deficits only in three years. South Korea only used foreign indebtedness in the 1970s, when it was growing very fast and, for that reason, the rate of substitution of foreign for domestic savings was low.

This is a mistaken policy associated usually to a high rate of substitution of foreign for domestic savings. It is mistaken not only because the country risks cyclical financial crises. Even if the country reaches to limit its foreign indebtedness to avoid its foreign debt ratios (to GDP and to exports) to grow and the ensuing currency crisis, this policy will continue to be a mistake because it will keep discouraging investment and encouraging consumption. Only in special conditions, when the country is growing *very* fast, this will not happen, because increased profit opportunities has reduced the marginal propensity to consume.

To reject that capital-poor countries should receive capitals from capital-rich countries is counterintuitive, but simple to explain. A current-account deficit corresponds a more appreciated currency than a balanced current-account. Current-account deficits and the respective foreign finance means an additional and constant increase in the capital inflows in the country which will necessarily appreciate its currency for the time the deficit is maintained. In the new-developmental model, a long-term appreciated currency will discourage investment and growth. Thus, given the appreciation of the currency, the foreign money will finance rather the increase of consumption than of investment. The acquisitive power of wages, salaries, and the revenues of rentier capitalists increase, while the private investments stalls, because the long-term appreciation of the national currency *disconnects* the competent manufacturing companies not only from the foreign but also from the domestic demand. Financial liberalization enters the game, because to implement the growth with foreign savings policy the country must increase its interest rate to attract capitals and leave their entry fully free.

Summing up, the East Asian countries continued to grow, while the 1980s liberalization caught the Latin American countries. For a few interconnected reasons: because, with trade and financial liberalization, the Latin American countries stopped neutralizing the Dutch disease, while the East Asian countries had no disease to cope with; because the Latin American countries adopted the growth with foreign savings policy while the East Asian countries adopted the growth with domestic savings policy; because, either due to the dismantling of the mechanism that neutralized the Dutch disease, or due to current-account deficits, the Latin American manufacturing companies face a long-term competitive disadvantage, while the East Asian companies compete in equal conditions with the industrialized countries.

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[1] For Spence (2011), between US$ 5,000 and 10,000; for Felipe et al. (2012), two bands, between $2,000 to $7,500 and between $7,500 to $11,500; and for Eichengreen et al. (20l2), also two bands, between $10,000 and $11,000 and between $15,000 and $16,000.

[2] New developmentalism is a new school of thought that emerged in Latin America in the 2000s. It evolved from classical development economics (of Rosenstein-Rodan, Lewis, and Prebisch). See Bresser-Pereira, Marconi and Oreiro (2014), Bresser-Pereira (2016).

[3] Bresser-Pereira (2008).