**Does the liberal policy regime condemn Latin America to quasi-stagnation?**

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## Introduction

Latin American countries are quasi-stagnant since 1980. Recently a director of the Council of the Americas asked "how will the 'lost second decade' continue to translate into political instability? At the root of the regional turmoil is economic failure. According to the Economic Commission for Latin America and the Caribbean - ECLAC, the period 2014-2020 will be the slowest growth in Latin America in 70 years. Indeed, Latin America is deindustrializing, experiencing quasi-stagnation, and falling behind for 40 years, while the East Asian countries that began to grow after the Second World War (South Korea, Taiwan and Singapore) are today rich countries.

There are many causes on the supply side why Latin-America have been quasi-stagnant (here represented by Brazil, Mexico, Argentina, Chile and Uruguay) from the 1980s while East Asian tigers, although undergoing some reduction in their growth rates, have continued to grow fast. Among these causes the priority given to education and the substantially higher degree of inequality in Latin America than in East Asia are the more mentioned. These are real problems; they explain while from 1950 to 1980 East Asian tigers were already growing faster than the Latin-American countries, but they do not explain why from the 1980s Latin America became quasi-stagnant compared to the East Asian . Besides the micro we must also look for the new macroeconomic facts that explain this change. In a recent paper, Bresser-Pereira, Araújo and Peres compared the two group of countries and argued that the "liberalization trap" (not the "middle-income country trap") was this historical new fact. Did the trade and financial liberalization play a major role in explaining the Latin American quasi-stagnation?[1]

Policy regimes may be developmental or liberal.[2] The policy regime is developmental or Keynesian when it involves a moderate intervention of the state in the economy; it is liberal when such intervention is limited to the minimum.[3] In the two regions there was a major change of the policy regime from a developmental to a liberal one, but the adoption of a liberal policy regime represented a radical change in Latin America, while it was milder in East Asia. Before 1980 they did not had the Dutch disease problem and were already open economies exporting manufactured goods, while the most successful countries in Latin America, like Brazil and

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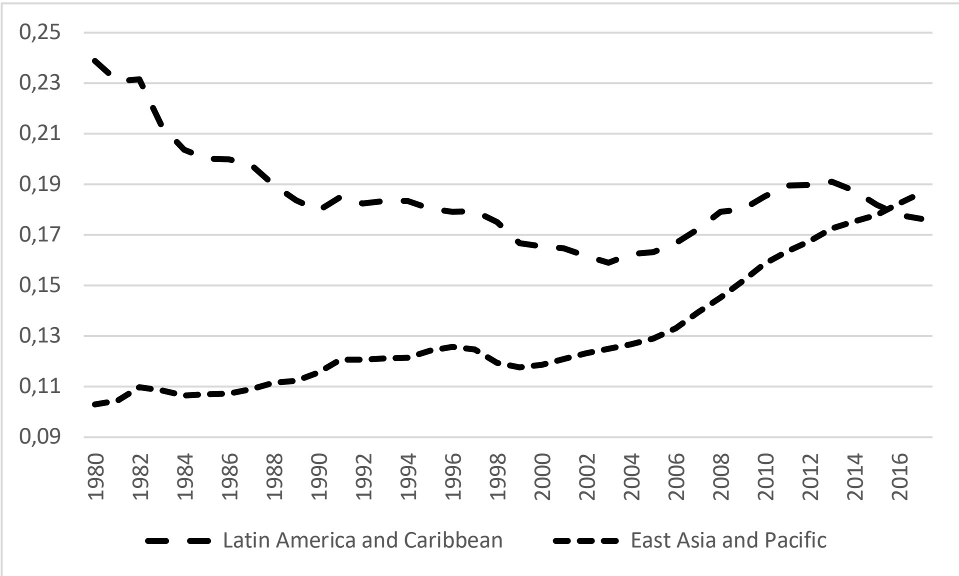
Mexico, were only able to export manufactured goods because they neutralized their Dutch disease with import tariffs.

The relative stagnation of Latin America may be shown by comparing the growth of the GDP per capita from 1980 to 2018 in the region with the growth in the rich countries, and in the East Asian countries. In a catching up figure (Figure 1), where the GDP per capita of the United States in these 40 years are 100% and the lines show the evolution of the average GDP per capita in this period in the East Asian and Pacif countries and in Latin America and Caribbean we see graphically this falling behind.

Figure 1: GDP per capita of Latin America and Caribbean and East Asia and Pacific in relation to the GDP per capita USA (constant 2010 US$): 1980-2017




Source: World Development Indicators.

Considering the last 40 years of quasi-stagnation, in the first ten years the cause was obviously a major foreign debt crisis. What about the other 30 years? Since the end of the 1980s, the Latin American countries engaged in liberal reforms, one after the other, in consonance with the Washington Consensus: trade liberalization, financial liberalization, privatization not only of competitive but also of the monopolist sectors of the economy, generalized deregulation. Reforms that are supposed to make the countries return to fast growth, but one after the other they fail to achieve what was promised. The liberal reformers have always a ready explanation: the reforms have not liberalized as much as it was necessary; more reforms would be required. In this paper, our hypothesis is that in the Latin American countries, given the stage of their economic growth and the fact that they are commodity exporters that suffer from the Dutch disease, economic liberalism is unable to assure economic growth and catching up. While, between 1930 and 1980, they adopted a developmental policy regime and were successful in industrializing and growing, in the 1980s they have fallen in the grips of a major financial crisis, which opened room to economic liberalism. Turned dominant from around 1990, the liberal policy regime condemned Latin America to quasi-stagnation.

We know that this is a bold hypothesis, but we believe that we have strong arguments in its favor. Before coming to them, however, we must make some simple assumptions. First, according to the new-developmental approach, when the exchange rate tends to be overvalued for several years within an exchange rate cycle between two currency crises, it is determinant of investment. The explanation for this is simple. In their decision to invest the companies take into consideration such exchange rate, realize that its planned investment although technically competitive is economically non-competitive (the exchange rate disconnected the company from its demand), and don't invest or reduce their investment to the minimum.[4]

Second, we understand that heterodox policymakers as well as the orthodox policymakers behind either the developmental or the liberal policy regime, are reasonably competent economists. If they are liberal, they believe that the state should limit itself to guarantee property rights and contracts and keep the fiscal account balanced; if heterodox, that the state should additionally intervene moderately in the economy keeping the five macroeconomic prices right (interest rate, exchange rate, wage rate, inflation rate, and profit rate), maintaining balanced the fiscal account except when countercyclical fiscal policy is required, maintaining firmly balanced, if not showing a surplus, the current account, investing in the infrastructure, and making selective industrial policy.

Given these assumptions and what we understand by either liberal or new-developmental policy regimes, in the following section we will present the reasons why economic liberalism is unable to lead the Latin American countries to growth and catch up. We will discuss, first, the fact that Latin American countries interrupted their industrialization before it was consolidated, second, the growth with foreign savings policy, third, the use of an exchange rate anchor to control inflation, fourth, the high level of the interest rate around which Latin American central banks manage their monetary policy, fifth, the problems involved with the Dutch disease, and sixth, the rejection of capital controls, seventh, the rejection of industrial policy, and eighth, public savings. In the conclusion we say a few words about the political economy involved.

## First, non consolidated industrial development

All countries that formed their nation-state and industrialized, beginning with England in the second half of the eighteenth century did that in the framework of a developmental policy regime.[5] Nevertheless from the 1980s, in the framework of the Washington Consensus, the rich countries pressed the Latin American countries to change from a developmental to a liberal policy regime before they had arrived to a strong level of economic development or of productive sophistication to resist to trade liberalization.

Classical Developmental emerged as a new discipline in the post-war period, when ECLAC prominent economists, such as Prebisch and Furtado, to name a few, put forward a theoretical interpretation for the unequal development among the nations. Efforts to understand the economic development process of less developed countries led to the policy recommendation in favour of the industrialization of non-industrialized countries, aiming at improving their economies' participation in trade flows. Industrialization policy would follow a developmental strategy known as import substitution. In Latin America, this strategy had been observed since the II World War until late 1970s, and this is the period of the highest growth rate in the continent.

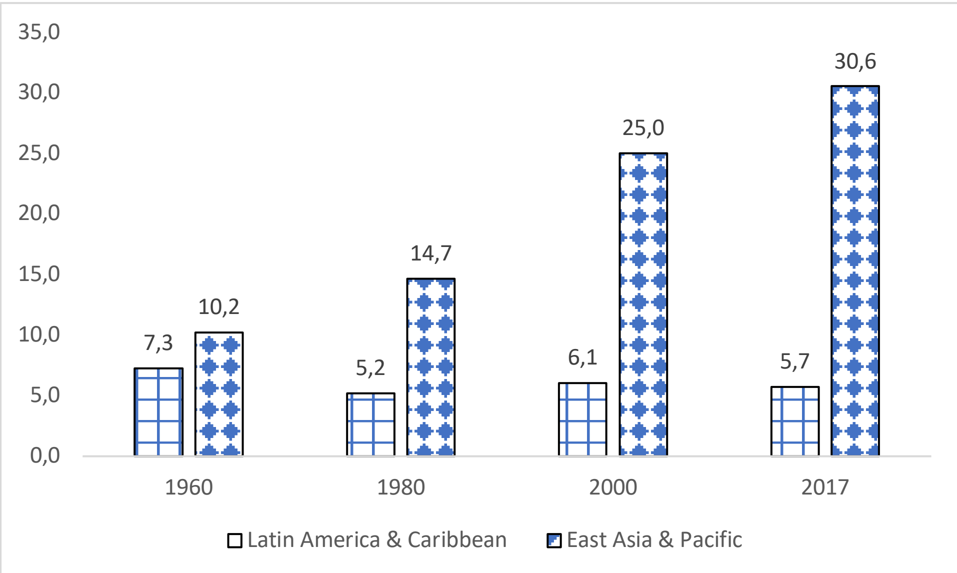
In practice, late industrialization gave periphery countries highly heterogeneous and less diversified productive structures, in contrast to the more homogeneous and highly diversified structure of the central economies. Their productive structure would be characterized as 'immature' and to attain a maturity phase, as conceived by Kaldor (1966), industrialization should be completed. Kaldor suggests four development phases in the industrialization process,[6] and argues, in the wake of the Keynesian tradition, that the maturing of an "immature" economy is based on the growth of aggregate demand. From this perspective, the capital accumulation generated by the industrialization process is the key variable of economic development, since it speeds up technological change to the benefit of the entire economy — as reflected in lower unit costs and higher-quality export products, enabling domestic producers to compete on foreign markets.

The industrialization process, based on import-substitution and state intervention in the Latin American economies, faced a chronic balance of payment problem associated with a high preference for immediate consumption before industrialization had been fully completed. In this sense, from a structuralist theoretical perspective, the economic history of Latin American economies is marked by adjustments in the growth rate caused by external constraints. This restriction is generally present because most countries have failed to overcome a pattern of productive specialization based on the exploitation of natural resources. Although developed economies such as the United States, Canada, and Australia, are examples of countries that have begun their development trajectory based on the exploitation of natural resources and raised the highest and most sustainable levels of development, their growth was not suddenly interrupted by trade liberalization as happened in the Latin American economies from the 1980s.

The industrialization strategy based on import substitution and state intervention in Latin America was abandoned after the external debt crisis of the 1980s, and the process of overcoming it spanned roughly the whole decade. The severity of the liquidity crisis that hit the highly indebted Latin American economies, following the sharp increase in the international interest rates and the default of the Mexican economy in 1981, left them with little room for manoeuver and the "reorientation to the market" phase started.[7] The way out of the long economic recession that followed the debt crisis (known as the 'lost decade') is associated with the economic opening implying trade and capital liberalization, privatization, and financial deregulation, which became the main economic policy recommendation of the Washington Consensus. The management of monetary and fiscal policies, on their turn, became chiefly subordinated to the views of the international financial markets. This subordination implied narrowing policy space for implementing developmental policies aiming at completing the industrialization process. In a word, the process of trade and financial integration of the Latin American economies from the 1980s onwards caught these economies in the process of catching up and implied the loss of autonomy for economic authorities to implement 'effective countercyclical macroeconomic policies consistent with longer-term development objectives and developmental policies'(Ocampo and Vos, 2008: 29). The management of countercyclical fiscal policy, a low and stable long-term inflation rate, low real interest rates, and a competitive real exchange rate along the time proved to be difficult targets to be accomplished for most of the Latin American economies.

Figure 2 compares the share of the exports in the trade flow of both Latin America and Caribbean and East Asian and Pacific economies to illustrate the point about the difference in the evolution of the productive structures of both regions. While in 1960 the share of exports of goods and services of the Latin America and Caribbean was a little lower (7.3%) than the East Asian and Pacific region (10.2%), but not very distant, in the following decades the difference increases steadily. This is a clear indication that the East Asian and Pacific countries have well succeeded in the process of catching up, and the Latin American and Caribbean countries are falling behind and becoming less industrialized, relatively.[8]

Figure 2: Share of exports of goods and services (current US$) of Latin America and Caribbean and East Asia and Pacific regions in world exports: selected years (%)




Source: World Development Indicators.

**Second, growth with foreign savings**

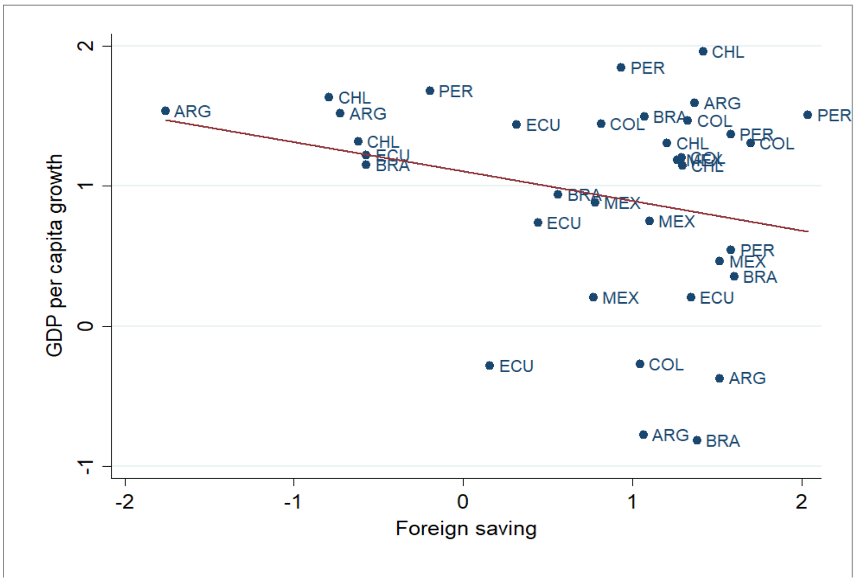
The liberal theories and the corresponding liberal orthodoxy argue that the total savings rate can be increased by resorting to foreign savings. According to this thesis, the absorption of foreign savings complements domestic ones, increasing the economy's total savings. Actually, this view is an expression of exchange rate populism. It ignores that foreign savings rather replace than add to domestic savings. It does not consider that the capital inflows that are required to finance the current account deficits (the "foreign savings") appreciate the national currency and make the local companies not competitive, thus discouraging investment, while increases the acquisitive power of salaried people and rentiers, thus stimulating consumption.

Our assumption in this paper is that, under normal circumstances, the rate of substitution of foreign for domestic savings tends to be high,[9] and this is what has been happening in Latin

America since the 1990s. According to ECLAC, based on the consolidation of national accounts figures, from 1990 until 2018, the correlation between domestic and external savings is negative (-0.6). During this period, the share of domestic saving as a percentage of GDP was 19.7%, with little oscillation, and the average share of external savings was 1.9%.

To illustrate how the strategy to grow with foreign savings in Latin America has implied less economic growth, Figure 3 illustrates with the trend line that when the economies show positive foreign saving, their GDP per capita growth rate is lower than when the opposite is observed. Therefore, the Figure shows that the GDP per capita growth has been negatively correlated with foreign savings in the Latin American economies since the 1990s.

Figure 3: Latin America: Foreign Savings and GDP per capita growth: 1990-2018




Source: IMF database.

According to the arguments of new developmentalist theory, especially those of Bresser-Pereira (2014; 2016) and Bresser-Pereira, Oreiro and Marconi (2014), the strategy of growth with current account deficits, besides leading countries to a balance-of-payment crisis, is associated with the long-term appreciation of the domestic currency. A consequence of the overvaluation is that it makes uncompetitive the companies that produce tradable non-commodity goods and services adopting the best available technology, thus discouraging investment and stimulating consumption. The deficits correspond to a long-term appreciated exchange rate because countries engaged in this strategy require an *additional* foreign currency inflow to finance them, which appreciates the country's currency.

Historical evidence of the dynamic Asian countries shows a very different growth performance. The Asian countries, in general, show current account surpluses, a correspondingly competitive exchange rate, and high rates of investment and domestic savings. Therefore, their growth strategy is based on "foreign dissavings", despite the common wisdom saying that capital-poor countries should receive savings from capital-rich ones. China, Malaysia and Taiwan illustrate the case, as do Indonesia, South Korea, Malaysia and Thailand, which endured the 1997 balance-of-payments crisis when they abandoned this policy and resorted to foreign savings. A clear relation, therefore, exists between the exchange rate and growth, as well as between trade surpluses and accelerated growth.

**Third, anchor to control inflation**

Liberal orthodoxy views as legitimate to control inflation through the use of an exchange rate anchor, i.e., the appreciation of the national currency. They are critical of the populist politicians that uses the prices of the state-owned enterprises, but feel comfortable in using "the price of the country" (the exchange rate) to control inflation. The majority of Latin American economies experienced high inflation and monetary instability during the 1980s, as Table 1 shows. Because of that, inflation control was crucial for Latin American economies to resume growth in the 1990s. Often, exchange rate-based anchors were the means used to achieve price stability in the region.

Although inflation came down quickly in countries that adopted exchange rate-based stabilisation, it led to imbalances over the longer-term that increased countries' vulnerability to financial crises. The appreciation of the exchange rate proved harmful to the manufacturing sector, and it discouraged exports of manufacturing goods and generated deficits in the trade balance and the current account balances. The result was an increase in the fragility of the Latin American economies which left the countries susceptibles to exchange rate crises.

Table 1 – Latin America and selected countries: inflation rate (consumer prices)

| Period | LA and Caribbean | Argentina | Brazil | Chile | Colombia | Ecuador | Mexico | Peru |
|---|---|---|---|---|---|---|---|---|
| 1980-89 | 170.7 | | 328.1 | 21.4 | 23.4 | 34.0 | 69.0 | 481.3 |
| 1990-99 | 130.2 | | 843.2 | 11.8 | 22.1 | 39.0 | 20.4 | 807.9 |
| 2000-09 | 6.0 | 8.6 | 6.9 | 3.5 | 6.3 | 17.8 | 5.2 | 2.6 |
| 2010-18 | 5.3 | 11.2 | 6.1 | 3.0 | 3.8 | 2.8 | 4.0 | 2.9 |

Source: IMF - World Economic Outlook Database, October 2019

Unlike in Latin America where there was a recurring trend of currency overvaluation cycles in the 1980s and 1990s, the Asian countries concentrated on their export-led growth strategy with permanent stimulus to the export sector, avoiding exchange rate appreciation. While the former used the exchange rate as a stabilization tool, the latter used the exchange rate as a stimulus to the export sector.

**Fourth, high level interest rate**

The use of an exchange rate anchor to control inflation and the growth with foreign savings policy are made operational by increasing the level of the interest rate around which the central bank conducts its monetary policy. Monetary authorities search to legitimizing such high interest rates with the need to cool off aggregate demand, ignoring or not realizing that such usually interest rate level is not really required to control inflation but to attract foreign capitals which cause exchange rate appreciation. Indeed, to increase the interest rate is an obvious and legitimate policy to keep the prices right; but why move the interest rate down from, for instance, 7% percent level, instead of 3% level - a legitimate level considering, for instance, a 1% international interest rate and a 2% country risk?.

During the 1980s and early 1990s, liberal policymakers adopted high real interest rates in Latin America which were  a main cause for the overvalued exchange rate in the long term. A direct impact of exchange rate appreciation is on the price of tradable goods, discouraging exports. An indirect effect is on the domestic prices, through the relative decrease in the prices of imported goods, mainly raw materials and inputs. Also, if the appreciation trend persists, it induces the substitution of domestic products for similar imports.

According to the new developmentalism, the tendency to the overvaluation of the exchange rate is built over a succession of appreciation and depreciation cycles. The cycle starts with an exchange rate crisis that leads to depreciation. Because interest rates are historically higher in Latin American countries, the exchange rate appreciates again, and it stabilizes for some years in an overvalued bottom level, corresponding to a current account deficit and increasing foreign debt. Only a financial bubble explains why the creditors take time to react. But they eventually lose confidence, suspend the roll-over of the debt, and another currency crisis closes the cycle.

For the new developmentalism theory, following the Keynesian tradition, interest rates, around which the Central Bank makes its monetary policies, should be kept at a low level, while the exchange rate should be competitive. If this virtuous combination between the interest rate and the exchange rate is achieved and sustained, then it is expected that the competent non-commodity producers should be made competitive using the best technology available in the world. On its turn, the wage rate should grow with productivity, not more than that, so that the profit rate would be satisfactory for competitive enterprises, especially those in the manufacturing sector.

**Fifth, neutralization of the Dutch disease**

The trade liberalization adopted by the Latin American countries in the framework of the Washington Consensus involved the abandonment of the mechanism that neutralized the Dutch disease on the domestic market (high import tariffs, which all countries adopted) and on the foreign markets (export subsidies, which only Brazil adopted). Import tariffs are usually understood as protectionism except in the case of the infant industry; the new-developmental approach adds a second condition: import tariffs on manufactured goods are not protectionist when they neutralize the Dutch disease and, thus, assure to the manufacturing industry equal conditions of competition in relation to the manufacturing industries of other countries.

One of the main contributions of New Developmentalism on growth theory is to identify that most developing countries face a major economic disadvantage that may impair their catching up process: the Dutch disease. According to Bresser-Pereira (2008: 48), “the Dutch disease is the chronic overvaluation of the exchange rate caused by the abundance of cheap natural and human resources whose exports are compatible with an exchange rate lower than the one that would pave the way for the non-commodity tradables industries.”  To measure the Dutch disease, the new developmentalism defines two equilibrium exchange rates - current and industrial - that when they diverge, the economy would be facing the disease. According to Bresser-Pereira (2018: 6):

> The current equilibrium is dependent on the value of the foreign money and on the international price of the commodities exported. The industrial equilibrium is the exchange rate that the companies producing manufacturing goods (or, more generally, tradable non-commodity goods and services) utilizing state-of-the-art technology require to be competitive. The Dutch disease can be defined as the difference between the two equilibriums.

This definition of Dutch disease has interesting implications. First, it indicates that the ‘disease’ imposes restrictions on the manufacturing sector to attain the stage of maturity to boost long-term growth. Second, it brings to the forehand of the explanation for the unequal development of nations the management of the macroeconomic policies, in particular, the role of the exchange rate in the catching-up process of developing economies. Therefore, for the new developmentalism, the Dutch disease is the result of short-term commodities booms and long-term Ricardian rents that make viable exports of such commodities at an exchange rate more appreciated than the one required by the country’s existing or potential companies producing tradable non-commodity goods and services.

Before the 1980s debt crisis, the policymakers in Latin America didn’t know the Dutch disease but knew that growth involved industrialization. Thus, intuitivelly or pragmatically adopted high import tariffs that neutralized it. This mechanism is not the ideal way of neutralizing the disease, because it just neutralizes it on the domestic market, but it is politically more feasible, particulary when the exported commodity is agricultural and involves a large number of producers.

On the other hand, the import tariffs should not be seen as protectionist, as are not protectionists the tariffs deriving from the infant industry argument. They just create equal conditions of competition for the local companies. The difference is that in the case of the infant industry, the tariffs are necessarily temporary, while in the case of the Dutch disease, they will be required while the disease is in action.

Given the new developmentalism approach, import tariffs play an essential role in fostering structural change to increase long-term growth rates. Therefore, import tariffs are instruments to neutralize the Dutch disease, and not only a way to protect the infant industry, as usually pointed out in the economic literature. If adequately administered, they would work to protect domestic markets and, therefore, contribute to sustaining demand for local producers.

The Latin America and Caribbean region is traditionally exporter of commodities, and therefore a region prone to Dutch disease. In 1990, according to ECLAC database, 66.8% of the total exports of goods from the region were of primary goods. Although this share is being reduced, reaching 48.2% in 2018, the deindustrialization process has been advancing in the continent: the manufacturing sector share in total value added decreased from 20.3% in 1990 to 14.3% in 2018.

**Sixth, capital controls**

The liberal orthodoxy rejects the capital controls which are often strongly required, not so much to avoid capital flight (because the competently heterodox policy will reject current account deficits and will not engage in net foreign debt), but to limit the capital inflows that unduly appreciate the national currency.

Capital controls are one of the most controversial issues in the macroeconomic debate since Keynes's publication of the *General Theory*, in 1936, in the sense that it reflects the contemporaneous debate on the efficiency of the markets as opposed to governmental regulation to better coordinate the functioning of modern economies (Carvalho and Sicsú, 2004). More recently, since the neoliberal wave of the 1990s, the core of the debate is around the degree of autonomy that monetary authorities in developing countries have when capital flows are loosely regulated.[10]

Rey (2015:1), in an influential paper based on empirical evidence, concluded that developing economies, financially integrated and without currency convertibility, are more sensitive to the global cycle, because 'whenever capital is freely mobile, the global financial cycle constrains national monetary policies regardless of the exchange rate regime'.[11] This is so because capital flows tend to have a pro-cyclical nature. In practical terms, in the absence of capital controls, when international liquidity is plentiful, excessive international flows tend to appreciate the currencies of these economies. Otherwise, when the international cycle is reversed, the currencies of these economies tend to suffer sharp depreciation.

Free capital movement has at least two consequences for developing economies that have limited capacity to issue liabilities in their own currency, both negative. A first negative externality is to exacerbate exchange rate volatility. Several consequences follow from this. Given the importance of the exchange rate as a signal to the general operating conditions of the economy, its volatility induces a significant deterioration in public expectations, that is to say, the variation in the exchange rate may fuel adverse expectations among residents and nonresidents about the soundness of the economy. Moreover, as observed by Carvalho and Sicsú (op. cit: 178), even minor fluctuations in the exchange rate reduce the predictability of firms' financial operating costs, increasing uncertainty and lowering investment incentives. As a result, the cost of capital in these economies tends to rise with increased volatility. Also, the imbalances created by the free movement of capital are not transitory, because the pricing system is not flexible enough to adjust the productive structure, once relative prices change due to exchange rate fluctuation.

To increase policy autonomy and reduce exchange rate volatility, most developing countries, including Latin America, after the currency crises that occurred in the second half of the 1990s have adopted a strategy of accumulating international reserves for precautionary purposes. Carvalho (2009) shows that the accumulation of reserves works as a 'liquidity cushion' to protect economies against adverse short-term changes in the balance of payments and allows for the accommodation of sudden demands for foreign currency. According to the author, the accumulated reserves can give some 'breath' for economic authorities to try to avoid the worst consequences of a sudden stop.

However, regardless the strategic importance of the accumulation of large volumes of foreign reserves for developing economies, in most cases, the accumulation of reserves is not a choice, but a consequence of the capital inflows that are beyond the control of the economic authorities. In some other cases, reserve growth may be the result of the expansion of net exports, resulted from a boom in commodities.[12] In short, the accumulation of high levels of reserves in a volatile environment of capital flows is an important instrument, though far from a sufficient one, to counterbalance the uncertainty surrounding the behaviour of the capital account in developing economies financially integrated.

The new developmentalism identifies a second negative externality of free capital movement in developing economies: the long-term overvaluation trend of the exchange rate. This externality might be considered the most damaging effect of the free capital movement on developing economies because if, on the one hand, the increased volatility of the exchange rate turns long-term decisions more uncertain as mentioned, on the other, when the exchange rate is overvalued in the long-term, decisions will be indefinitely postponed. As put in Bresser-Pereira (2018:2): “The exchange rate acts as a *switch* that grants or withholds *access* to existing demand, be it international or domestic.” (italics in the original).

The trend towards the overvaluation of the exchange rate in developing countries financially integrated occurs because the exchange rate does not just oscillate around the equilibrium. As claimed by Bresser-Pereira (op. cit), after a balance of payment crisis, the exchange rate depreciates sharply. However, because interest rates are higher in developing economies, international capital ends up returning, setting up a valuation trajectory. This trajectory will reach a floor, and due to the Dutch disease, the level of the exchange rate will be the lowest that the more efficient commodity exporters can tolerate. For how long can the overvaluation cycle last? According to the new developmentalism, the exchange rate can remain substantially overvalued for several years, affecting resources allocation in the long run. Growth rates will be reduced.

Given this perspective, capital controls,[13] together with the accumulation of reserves, are essential instruments to widening policy space, and increase growth potential of developing economies. [14] Carvalho (2009) registers three groups of measures of capital controls. The first group should apply to inflows by non-residents. This would inhibit the inflow of short-term financial capital, searching for interest rate arbitrage opportunities. A second group of capital account regulations should control outflows by residents. As noticed by Carvalho, based on the empirical observation of the balance of payment crisis in the late 1990s, residents are the first group of investors to promote capital flight. A last group of regulations should limit the possibility of domestic firms that sell to local markets to issue liabilities in foreign currencies. This would avoid the problem of exchange rate mismatches between assets and liabilities.

**Seventh, industrial policy**

The liberal orthodoxy rejects industrial policy which is much required if a country is really involved into a national project of growth. New Developmentalism’s microeconomics involves a clear distinction between the competitive and the non-competitive sectors of the economy. In the non-competitive sector, which includes the infrastructure and basic inputs companies and the large commercial banks “to big to fail”, there is no market and the state is supposed to coordinate with the use of planning and strong regulation. In the competitive sector, the coordination by market is much superior to the one by state, but in some industries, for some time, industrial policy is necessary if the country is really committed to growth.

New developmentalism advocates industrial policy as an instrument to enhance long-term growth rates. Therefore, to improve aggregate productivity, industrial policy should focus on all activities that produce dynamic effects on the economy as a whole. Latin American economies are latecomers among the industrialised economies, and therefore industrial policies are necessary to promote the diversification and to reduce heterogeneity in their productive structure.

Also, new developmentalist approach advocates that industrial policies should be well-coordinated with macroeconomic policies. In this sense, industrial policy should be seen as an essential complement to the macroeconomic policy regime, which should aim at keeping the five main macroeconomic prices ‘right.’[15] Following these orientations, the economy should be able to induce capital accumulation and simultaneously allow policy space for the implementation of appropriate industrial and technological policies to accelerate the catching-up process.

The advancement of the deindustrialization process in Latin America since the 1990s strongly suggests that industrial policies are relevant to restore a higher growth trajectory. According to Nassif et al (2018), in the structuralist and new developmentalism approach, industrial policy is defined as the combination of governmental incentives at the sectoral level, with horizontal policies.[16] In the first case, it is included tariff protection on imports, subsidies within limits imposed by the World Trade Organization - WTO, and, most important, long-term public credit for investment projects and innovation. As well remarked by Ocampo et al (2009:153), public funding should be considered a significant instrument of industrial policy, as international agreements have not yet limited development banking.[17] In the second case, horizontal industrial policies should target investment in infrastructure and research and development - R&D.

Among all instruments of industrial policy, tariffs are wrongly the most polemic. New Developmentalism rejects protectionism, but, as we saw when we discussed the Dutch disease, it advocates in favour of tariffs when they are a means to neutralize the disease in relation to the domestic market. Thus, it is not only the infant industry argument, but also the neutalization of the Dutch disease argument that legitimize industrial policies based on tariffs on the imports of manufactured goods.

A different orientation for the industrial policy should be applied to non-competitive sectors, including the basic infrastructure inputs and the financial industry. In these cases, the coordination by the market is much inferior to the one by the state, which should step in with strong and transparent regulation.

**Eighth, public savings**

Liberal orthodoxy disregards the importance of public investment. It believes legitimate to transfer to the private sector the monopolist infrastructure public services, using the argument that "private are more efficient than public companies". This is false. To privatize the infrastructure is to lose control of the investments required for growth. The investor in the privatized monopolies are not really business entrepreneurs. When they get hold of a company, they are usually made responsible of making investment. They do the minimum possible, they delay the investments, and they increase the prices in the first opportunity while the quality of the services deteriorate.

There are two main approaches in the economic literature that address the role of fiscal policy and analyse its impact on the determination of private investment: the neoclassical approach and the Keynesian approach. The first is opposed to activist fiscal policy, assuming that exits a crowding-out effect between public and private investment. It also stresses the inflationary consequences of fiscal expansion and the problems related to the expansion of public debt. The second approach, based on the principle of effective demand of John Maynard Keynes (1936) and Michal Kalecki (1954), is in favour of contra-cyclical fiscal policy, and control on public debt.

Concerning the crowding-out effect, the idea is that a rise in investment by the public sector can inhibit private investment, assuming that the use of physical inputs and financial savings by the public sector will limit the availability of these resources to the private sector. Also, public investment would pressure up the price of inputs and, above all, interest rates. Interest rates should rise because it is assumed that public expending is to be financed through increased compensation for public bonds. If so, credit would be reduced to the private sector that would then reduce investments. This is how the crowding-out effect would work. Besides, expansionary fiscal policies bring up inflationary risks, as well exposed in the neoclassical synthesis model set up by Hicks (1937), as well as in the monetarists and new-classical models.

Differently, public spending increases the level of activity, what leads to higher aggregate savings – instead of reducing the loanable funds available to private agents (Camara Neto; Vernengo, 2004–5). According to Keynes's investment theory, the private decision to invest in capital goods depends on long-term expectations of profits which are driven by the 'animal spirits'. Short-term interest rates or cost-of-capital variables play no role on decisions that involve the 'animal spirits'. On this, Fazzari (1994/1995: 232) based on a detailed examination of the behaviour of US individual firms on investment, concludes: "…. there is little if any loss to investment from possible deficit induced increases in interest rates, while there may be substantial gains for investment caused by the economic stimulus resulting from deficit."

Gavin and Perotti (1997) analysed the fiscal policy in Latin American countries from 1970-95 and found that it had been procyclical, and particularly so in periods of low growth. Alberola et al. (2016) investigated the relationship between fiscal policy and the cycle in Latin America and also concluded that fiscal policy is procyclical. According to the authors, the main explanation for that is financing conditions "Worsening financing conditions, which tend to coincide with difficult economic times, constrain fiscal policy. Favourable financing conditions, more prominent in good times, favour fiscal profligacy" (Alberola op. cit: 24)

Table 2 shows for selected regions and years that public investment-to-GDP ratios have remained relatively stable. Latin America and the Caribbean is the region with the second-lowest public investment-to-GDP ratio. Also, the share of private investment-to-GDP increased throughout the period, from 10% in 1990 to 15% by 2015, confirming that private investment drove the increase in total investment in the region, while public investment remained stable.

Table 2 – Public and private Investment-to-GDP ratio(%), selected regions
1990, 2000, 2010, 2015

| **Public Investment** | | | | |
|---|---|---|---|---|
| Region | 1990 | 2000 | 2010 | 2015 |
| East Asia & Pacific | 9 | 14 | 14 | 11 |
| Eastern Europe & Central Africa | 3 | 2 | 3 | 3 |
| Latin America & Caribean | 4 | 3 | 4 | 4 |
| Middle-East & North Africa | 5 | 4 | 8 | 7 |
| South Asia | 6 | 5 | 6 | 4 |
| Sub-Saharan Africa | 4 | 4 | 5 | 5 |
| **Private Investment** | | | | |
| Region | 1990 | 2000 | 2010 | 2015 |
| Eaest Asia & Pacific | 13 | 12 | 22 | 26 |
| Eastern Europe & Central Africa | 19 | 10 | 11 | 12 |
| Latin America & Caribean | 10 | 14 | 15 | 15 |
| Middle-East & North Africa | 8 | 9 | 11 | 11 |
| South Asia | 10 | 12 | 18 | 18 |
| Sub-Saharan Africa | 9 | 9 | 12 | 13 |

Source: Castellani et al. (2019).

Note: East Asia and Pacific (EAP), Middle East and North Africa (MNA), Eastern Europe and Central Asia (ECA), Latin America and Caribbean (LAC), South Asia (SAS) and sub-Saharan Africa (SSA).

## Conclusion

In this paper we offered eight arguments why liberal policy regimes, which became dominant in Latin America from the 1990s, are incapable of making the region to grow and catch up. On the contrary, what we are seeing is quasi-stagnation. We didn't include in our discussion the political economy involved. We say now, in this conclusion, a few words on this subject. In contemporary capitalism, the orthodox policymakers represent mainly the interest of rentier capitalists (who live out of interests, dividends and real estate) and financiers, who manage the wealth of rentiers and act as their organic intellectuals, while the heterodox hope to represent the interest of the working or salaried classes. The policies defended by liberal policymakers reflect such political economy. The ideal would be that they were "neutral" policymakers above the class interests, but we know that this is impossible.

The class commitments cause major distortions in the policymaking process. The commonsense distinction between right and left policymaking is between the state expending more or less than it should, between fiscal populism and austerity. Actually, fiscal discipline is a condition for long-term growth. Fiscal populism is contradictory to the idea of the state achieving public savings to finance its required investments. When a developing country faces a macroeconomic disadjustment, the effective policy is a combination of fiscal adjustment with currency depreciation. The fiscal adjustment hits more the poor than the rich; the depreciation, more the rich, less the poor. Austerity is a way of doing excess fiscal adjustment and no currency depreciation; it is to recover the competitiveness of the country by reducing just the wages of workers instead of also the profit and wealth of the rentier capitalists by depreciating the currency.

Differently from fiscal populism, exchange rate populism is not a problem of choice, but a question of destiny for liberal orthodoxy. Since the liberal economist believes that the market coordinates well the exchange rate, he rejects exchange rate policy. Besides, he believes that to try to grow with foreign indebtedness is the right thing to do. Thus, when the current account deficits show up, he sees them as natural. It is not. Current account deficits are the main cause of loss of economic competitiveness and of cyclical financial crises. Together with high interest rates, they are in the core of the financialization process.

Summing up, a liberal policy regime is incompatible with growth in the Latin American countries. Economic liberalism is bad also for rich countries and for countries that don't suffer from the Dutch disease. Policy regimes are either liberal or developmental. A Keynesian policy regime is a developmental regime to the extent that it defends a moderate state intervention. The fact that the regime is developmental does not mean that it will work well. It depends on the capability of the policymakers. This, however, is not the case of the liberal policy regimes. They count too much with the coordinative capability of markets, ignoring that they are unable to coordinate the non-competitive sectors of the economy and to keep right the five macroeconomic prices. In consequence, they adopt the policies that we discussed in this paper, which are enimical of growth and catching up.

When we compare the developmental and the liberal phases of the economic history of the rich countries, considering, for instance, England and France, we see that growth was faster in the two developmental phases (the Mercantilist 1700-1830 phase and the 1945-1975 Golden or Keynesian phase, than the two liberal phases: the 1830-1929 phase and the 1980-2018 neoliberal phase). If this is true to rich countries, is truer to developing countries and still truer to Latin American countries.

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[1] Bresser-Pereira, Araújo and Peres (2020).

[2] We define developmentalism as the alternative form of organizing capitalism to economic liberalism. When the economic policy regime is liberal the role of the state is reduced to the minimum; when it is developmental, it is assumed a moderate state intervention and a national perspective (Bresser-Pereia, 2017).

[3] Note that we are using the word "liberal" in its original or academic meaning, not in the American or colloquial meaning.

[4] Bresser-Pereira (2012; 2014), Bresser-Pereira, Oreiro and Marconi (2014).

[5] The Industrial Revolution happened in the context of Mercantilism, the first historical developmentalism.

[6] See Feijó and Lamônica (2012).

[7] In the words of Bresser-Pereira(2002:6):"After 1982, when the debt crisis broke, macroeconomic instability emerged as the central economic problem. Latin American countries had no alternative but to adjust and reform."

[8] According to UNIDO (https://stat.unido.org/database/MVA%202019,%20Manufacturing;jsessionid=D1874726E6DDCE4AAA6D159E27056F2C) in 1990 the share of manufacturing value added in total GDP in Asia was 18.1% and 16.5% in Latin America. In 2018 these shares were 22.5% and 12.8%, respectively, which illustrates how deep deindustrialization has advanced in Latin America since the 1990s. For a discussion on Latin America deindustrialization, see, among others, Palma (2005).

[9] See Bresser-Pereira et al (2014a) for an empirical study on Brazil.

[10] See, also, Kregel (2008); Ocampo and Stiglitz (2008) and Arestis (2016).

[11] On this, Carvalho (2008: 273) states: "It is consensual among economists that opening the capital account of the balance of payments reduces the domestic autonomy in the choice of goals and instruments for monetary policy. In fact, it is practically a tautology, since opening the capital account increases international financial integration and this means precisely that the national economy becomes part of some bigger economic unit".

[12] Besides, the management of foreign reserves as a policy instrument imposes restrictions on domestic policies, since the impact of capital flows should be sterilised. If economies work with relatively high rates of interest, consequently the cost of sterilisation will be higher, and this cost is reflected in an increase in the burden of public debt.

[13] Chile is a well succeded example of capital controls established in the late 1980s.

[14] It should be added that new developmentalism also proposes the creation of a sovereign fund (following the Norway example) to be built with the revenue of an export tax imposed on export of commodities. The creation of this fund would prevent capital inflow and therefore contribute to fighting the appreciation trend of the exchange rate. On the other hand, the tax on export of commodities would be the instrument to neutralise the Dutch disease. This tax would increase the cost of production of commodities and, in this sense, it would make the current equilibrium exchange rate to converge to the industrial equilibrium.

[15] See Bresser-Pereira (2019:46-47) for an explanation for the 'right' levels of the macroeconomic prices.

[16] Ocampo (2005) also advocates in favour of horizontal and sectorial industrial policies, as the dynamic of productive structures results from the interaction between activities, firms, **sectors** and institutions.

[17] It should also be mentioned that Hausmann and Rodrik (2003) argue in favour of public credit as a better instrument to support innovative firms in comparison to the use of tariff protection. Tariff protection, according to the authors, would not be so efficient, because, in practice, it is difficult to separate true innovators from imitators.