

**UNCTAD**

**THE RISE OF THE SOUTH AND NEW PATHS OF  
DEVELOPMENT IN THE 21ST CENTURY**

**BACKGROUND PAPER**

**BRAZIL'S RECENT GROWTH**

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**BACKGROUND PAPER NO. 3**

**This study was prepared for UNCTAD as a background paper for to the ECIDC Report 2012. The views in this paper are those of the author and not necessarily those of UNCTAD or its member states. The designations, terminology and format employed are also those of the author.**

**IS BRAZIL'S RECENT GROWTH  
ACCELERATION THE WORLD'S MOST  
OVERRATED BOOM?**

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**MARCH 2012**

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## **IS BRAZIL'S RECENT GROWTH ACCELERATION THE WORLD'S MOST OVERRATED BOOM?**

### Introduction

Except for several commodities and a small number of other activities (such as finance), Brazil's — and Latin America's — economic performance since the beginning of neo-liberal reforms (c. 1990) has been poor; this not only contrasts with its own performance pre-1980, but also with what has happened in Asia during this period. I shall argue that the weakness of the region's new paradigm is rooted as much in its intrinsic flaws as in the particular way it has been implemented. Keynes once said (discussing Say's Law) that Ricardo conquered England as completely as the Holy Inquisition conquered Spain; the same could be said for neo-liberalism in Latin America (LA): it has conquered the region, including many in its left-wing intelligentsia, as completely (and fiercely) as the Inquisition conquered Spain. This process has been so successful that it has actually had the effect of 'closing the imagination' to conceptualising alternatives.

In Brazil (and LA in general) the genesis of the new development strategy can be located in a series of negative external and domestic shocks c.1980, when the region was particularly vulnerable. As had happened in the 1930s, these laid the foundations for a radical ideological transformation that led to a new paradigm, this time along the lines of Anglo-Saxon neo-liberalism and US neo-conservatism. This was quite distinct from what was happening in Asia, where reforms were implemented in a much more pragmatic way.

Perhaps the key difference between LA and Asia is that in the latter most actors in favour of the reforms (including local capitalist élites, the administrative classes, and most intellectuals — even many in the 'new' left) did not have to be convinced that in the real world there are so many distortions, market failures, coordination failures (especially in investment) and financial fragilities that when it came to policy-making the Washington Consensus's set of 'first-best' policies belonged to a fantasy world. And maybe they were also just cynical enough not to get too excited about an ideology (neo-liberalism) that is based mostly on recycled

19<sup>th</sup>-century ideas wrapped in an ‘end of history’ aura (Frangie and Palma, 2010). So, in Asia one often finds the parallel existence of a seemingly fundamentalistic neo-liberal discourse (to appease the gods of the markets), with a more pragmatic, targeted and sometimes imaginative implementation of reforms. And an ‘irreverent’ pro-growth macro is never far away. In LA, instead, the aim of policy makers (including — and so far especially — those in the ‘new’ left) regarding the neo-liberal orthodoxy is not just the ‘talking the talk’, but the ‘walking the walk’ of that orthodoxy.

In fact, I sometimes wonder whether the unique brand of neo-liberalism bought by so many Latin Americans is just shorthand for ‘nothing left to decide’ — and in the case of the ‘new’ left, of course, ‘nothing left to think about *critically*’ (Palma, 2009a). Indeed, in most of the region the attitude today towards neo-liberal economics, and in particular when it comes to policy-making, resembles Lord Kelvin’s attitude towards physics at the end of the 19<sup>th</sup> century (Kelvin, 1900). Then, he famously declared that in physics “there is nothing new to be discovered now. All that remains is more and more precise measurement.”

What characterises Brazil’s (and the rest of Latin America’s) economic reforms most is that they were undertaken primarily as a result of the perceived economic weaknesses of the region — i.e., there was an attitude of ‘throwing in the towel’ vis-à-vis the previous state-led import substituting industrialisation strategy (ISI). Basically, most politicians and economists interpreted the 1982 debt crisis as conclusive evidence that ISI had led the region into a cul-de-sac. As Hirschman has argued (1982), policy-making has a strong component of ‘path-dependency’. As a result, people often stick with policies well after they have achieved their aims, and those policies have even become counterproductive. This leads to such frustration and disappointment with existing policies and institutions that is not uncommon to experience a ‘rebound effect’. An extreme example of this ‘backlash’ (or ‘reverse shift’) phenomenon is post-1982 LA, where economic reform ended up being mostly about the reversal of the previous development strategy — which, in many aspects, had overstayed its welcome.

From this perspective, what most differentiated LA from Asia was not just the strength with which the new neo-liberal ideology was adopted, but also the form in which the previous one (ISI) was given up. Hirschman called this “LA’s tendency to fracasomania” (1982). So, perhaps it should not be surprising that the discourse of the reforms ended up resembling a compass whose ‘magnetic north’ was simply the reversal of as many aspects of the previous development strategy as possible — as Gustavo Franco (when President of Brazil’s Central Bank) explained, the main task of economic reform in Cardoso’s first government was “...to undo forty years of stupidity [besteira]...” (Veja, 15/11/1996). With this ‘reverse-gear’ attitude, this experiment in economic reform almost inevitably ended up as an exercise in ‘not-very-creative-destruction’. The mere idea that alternatives to neo-liberal reforms could exist increasingly met with a mixture of amusement and contempt. Franco again: “[The alternative now] is to be neo-liberal or neo-idiotic [neo-burros].” (Ibid.) And, of course, “burros” belong in (intellectual) Gulags.

In this respect, I would argue that perhaps one reason why ‘pure’ ideology is so important in LA (past and present) is that there is little else in the form of social cohesion. This helps to explain the peculiar set of priorities and the rigidity with which the reforms were implemented in LA, as well as their poor outcome, as distinct from many Asian countries — where economic reforms were implemented not as a messianic endeavour but (rightly or wrongly) as a more targeted and pragmatic mechanism to help lift specific pressing economic and financial constraints in order to continue and *strengthen* their existing ambitious industrialisation strategies.

1.— The collapse of Brazil’s (and Latin America’s) growth rate post-1980 is unique in the Third World

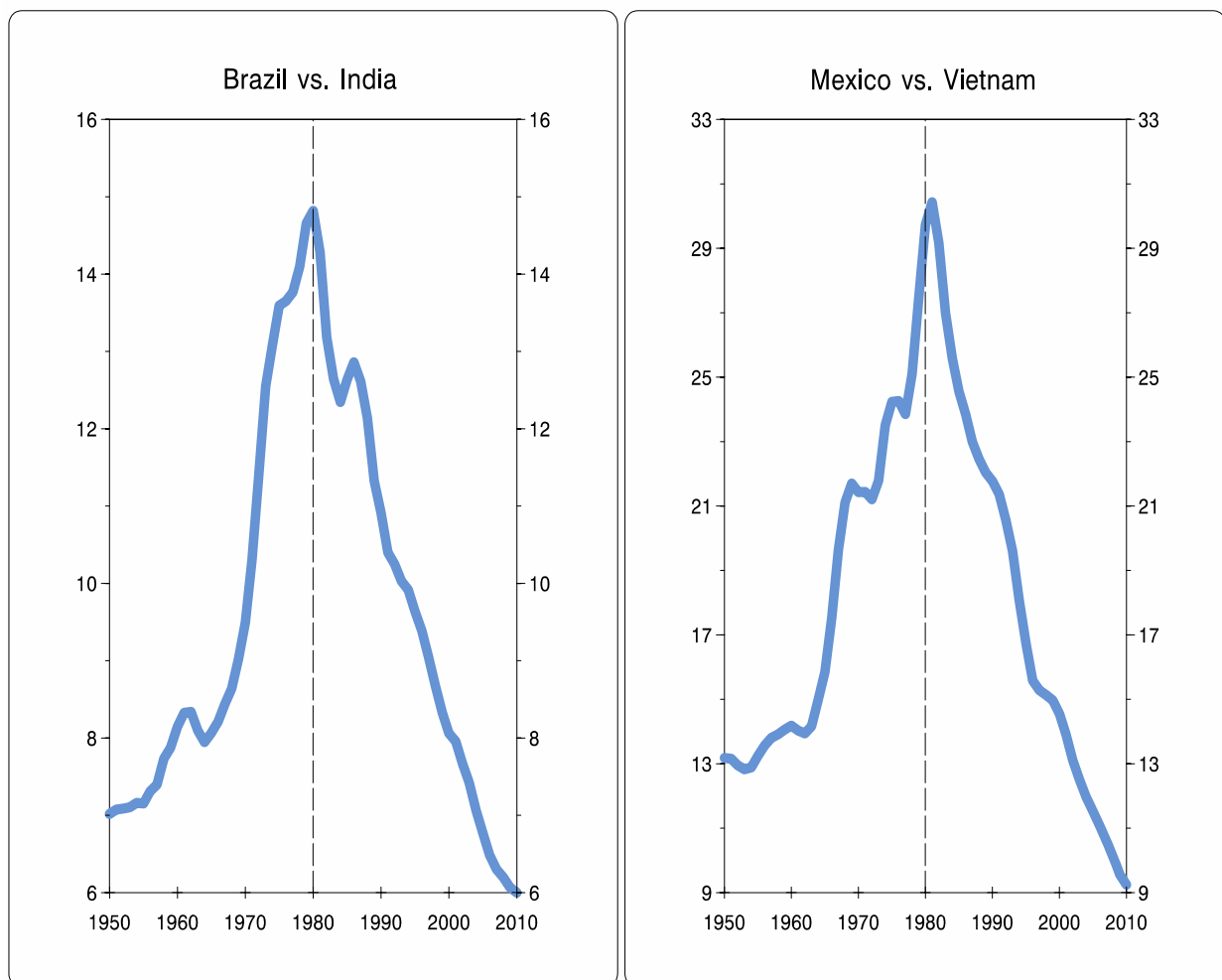
As is well known, the beginning of neo-liberal reforms instituted by Reagan and Thatcher was followed by a slowdown of the world economy. This was also associated with the complex transition from the ‘mass-production-for-mass-consumption’ techno-economic paradigm to the age of information and telecommunications, with its more knowledge-intensive and flexible production techniques (Pérez, 2002). The average annual growth rate of the world economy fell

from 4.9% (1950-1980) to 3.3% (1980-2011; GGDC, 2012). However, Brazil's growth-rate collapse was extreme, even in this context (from 6.8% to 2.6%, respectively). The fall in the rest of LA's was nearly as remarkable — excluding Brazil, the average regional rate fell by half (from 5% to 2.6%).

The exception to the general slowdown in the world economy was the 'third-tier' NICs (China, India, and Vietnam). Elsewhere in the developing world, the 'second-tier' NICs (Malaysia, Thailand, Indonesia) managed (on average) to keep their growth-rate stable despite the 1997 financial crisis, while in the 'first-tier' NICs (Korea, Hong-Kong, Singapore, Taiwan), and in North Africa and Sub-Saharan Africa growth-rates declined, but by a relatively small margin. Brazil's rate, instead, fell by nearly two-thirds, while (as mentioned above), non-Brazil LA saw its growth rate nearly halved. For example, if one ranks all countries of the database (excluding oil-exporting Middle Eastern countries) by GDP growth-rate (94 countries), Brazil's growth-ranking collapses from 10 (1950-1980) to 58 (1980-2011 — or to 53 if the 1980s is not taken into account). In turn, Mexico's falls from 13 to 65 (or to 59 for 1990-2011). What a contrast with China (41 to 1), India (69 to 5), and Vietnam (80 to 2)! Their divergent fortunes become evident in Figure 1.

FIGURE 1

Brazil's GDP per capita as a multiple of India's GDP per capita, and Mexico's as a multiple of Vietnam's, 1950-2010

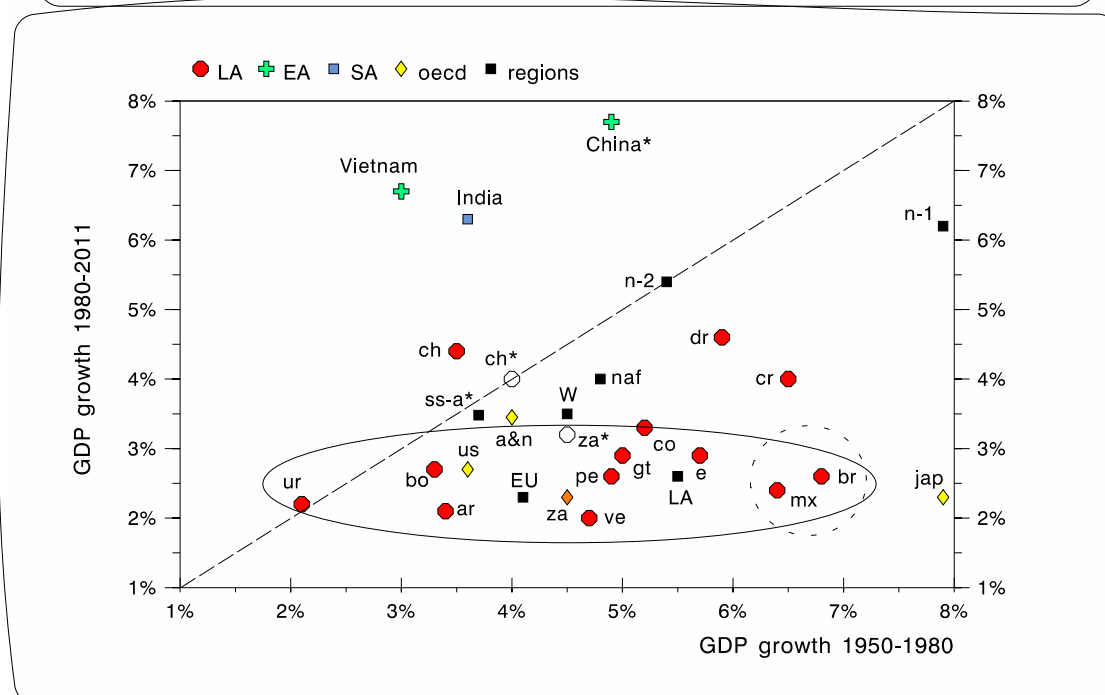


● **Source:** WDI (2012, data in constant 2000-US\$). The series were brought back to 1950 using GGDC (2012). 3-year moving averages.

Although from a Gerschenkronian (or Kuznetsian) perspective, one would have expected some catching-up by lower-income Asian countries, the extent of the post-1980 gains is truly remarkable — and China's catching-up is of course faster still. Figure 1 also confirms that (as opposed to what is usually assumed) Brazil's relative growth weakness is *not* confined to the 1980s. Moreover, LA's disappointing post-1980 performance is fairly homogenous — see Figure 2.

FIGURE 2

Latin America and other regions: GDP growth, 1950-1980 and 1980-2011



- **Regions:** LA = Latin America; EA = East and South East Asia; EU = European Union (excluding Germany because of unification); n-2 = second-tier NICs; naf = North Africa; SA = South Asia; ss-a\* = Sub-Saharan Africa (excluding South Africa); and W = 'world' (weighted average for the 97 countries of the source).

- **Countries:** a&n = Australia and New Zealand; ar = Argentina; bo = Bolivia; br = Brazil; ch = Chile (ch\* = Chile 1950-72 and 1972-2008; 1972 is chosen as a cutting year to avoid the distorting effect of 1973, the year of the military coup); China\*, rate of growth 1980-2011 = 8.7%; co = Colombia; cr = Costa Rica; dr = Dominican Republic; e = Ecuador; gt = Guatemala; mx = Mexico; pe = Peru; us = United States; ur = Uruguay; ve = Venezuela; and za = South Africa (za\* = South Africa 1994-2011 — the ANC period). Unless otherwise stated, these acronyms will be used throughout the paper.

- **Source:** GGDC (2012; data in constant 2011-US\$, EKS PPPs). The GGDC dataset only provides information for 13 Latin American countries (all included in the graph). Unless otherwise stated, this will be the source of all data on GDP, employment and labour productivity in this paper.

While between 1950 and 1980 the range of growth in LA was rather wide (from 2.1% [Uruguay] to 6.8% [Brazil]), in the latter period (1980-2011) 9 of the 13 countries of the database appear within a very narrow range — between 2% (Venezuela) and 2.9% (Peru and Ecuador). Furthermore, Colombia emerged only slightly from this narrow range after 2003 (3% in 1980-2003; 3.4% overall), leaving only Costa Rica,



Chile and the Dominican Republic properly outside this remarkably narrow (and disappointing) band — with growth-rates for 1980-2011 of 4%, 4.4% and 4.6%, respectively.

Moreover, in LA only Chile managed to grow faster in the second period (3.5% and 4.4%, respectively), with Uruguay growing practically at the same pace (2.1% and 2.2%). In Chile, however, economic reforms began in 1973, so a more meaningful comparison would be between pre-1973-ISI (1950-1972) and post-1973-reform periods. In this case, the growth rate is actually the same in both periods (4%; see 'ch\*' in Figure 2). This Figure also confirms the remarkable growth-collapse of Brazil and Mexico — only Japan does worse.

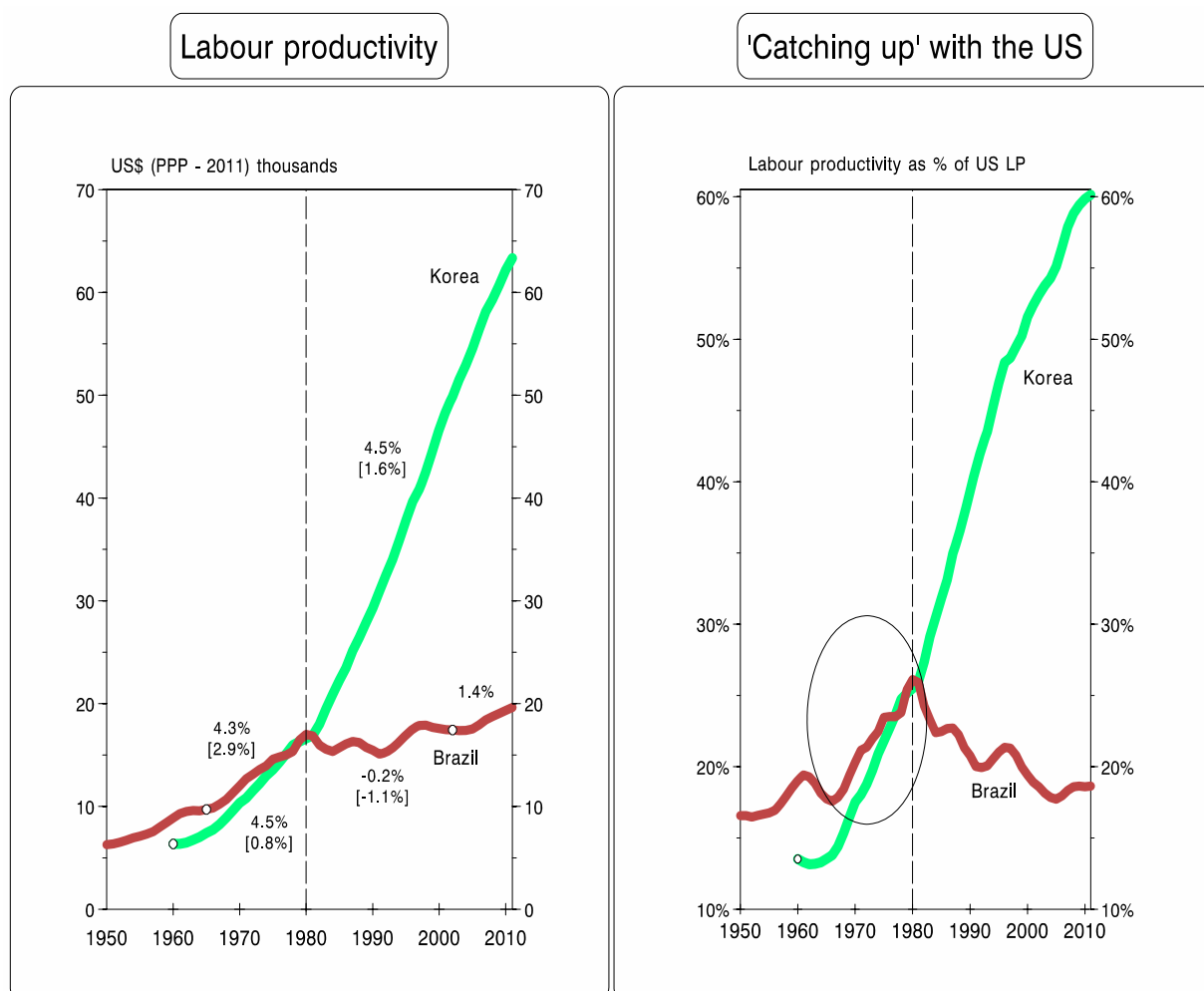
2.- Why is it so difficult for Latin America to sustain productivity growth (and TFP growth) for any significant length of time?

Perhaps the most significant stylised fact that emerges from LA's economic performance since the end of the Second World War is that while Latin American countries are perfectly capable of generating periods of dynamic economic growth (as evident in Brazil and Mexico before 1980, and in a few Latin American countries for short periods since then — e.g., Chile, Argentina and Peru), they seem totally unable to *sustain* this growth over time. This is particularly the case for productivity growth. Meanwhile, many in Asia mastered this 'growth-sustainability' technique quite nicely.

A comparison between Brazil and Korea helps illustrate this phenomenon (see Figure 3).

FIGURE 3

Brazil vs. Korea: labour productivity and 'catching up', 1950-2011



- **LP** = labour productivity. Percentages on top are average annual real rates of productivity-growth during respective cycles (Brazil, 1965-1980, 1980-2002, and 2002-2011; Korea, 1960-1980, and 1980-2011). Those below in brackets indicate TFP growth rates in the same periods (although starting in 1960, and finishing in 2004, as (at the time of building the series) data necessary to construct TFP series were only available during these years). 3-year moving averages.

- **Sources:** productivity, GGDC (2012; for Korea, and other Asian countries, the GGDC database only provides data on employment since 1960). TFP, calculations made by Anish Acharya and author, using the Hall and Jones (1999) methodology for decomposing output per worker; see Acharya (2009), and Palma (2010).

In terms of productivity, Brazil (like Mexico) was just about keeping up with Korea (and other dynamic Asian countries) before 1980. In fact, by 1980 Brazil's overall productivity level was still higher than Korea's (US\$18,045 and 16,240, respectively

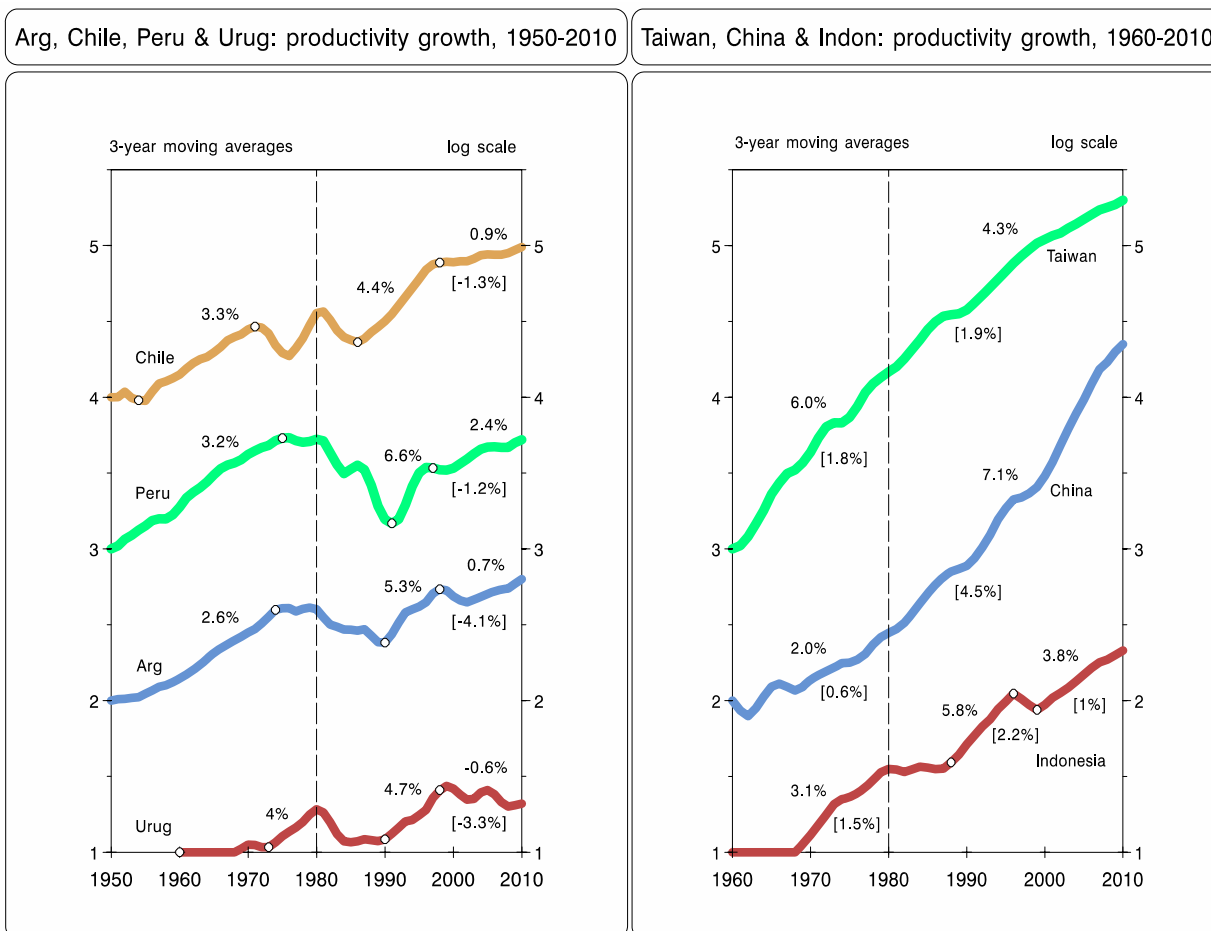
— data in constant 2011-US\$, EKS PPPs). Furthermore, in terms of TFP (keeping in mind the problems associated with both its concept, and its measurement) before 1980 Brazil had a rate three times higher than Korea. However, after 1980 the fortunes of these two countries moved in opposite directions: while Korea (despite 1997) kept its productivity growth intact (4.5% p.a.) — and managed to double its TFP growth-rate — Brazil's productivity and TFP growth-rates collapsed to the point of becoming *negative* for over two decades after 1980 (the latter one highly negative). As a result, (and despite the post-2002 recovery in Brazil) by 2011 Korea's average productivity levels were more than *3 times* those of Brazil's (US\$64,000 and 19,700, respectively; constant 2011-US\$, EKS PPPs). So, while Korea was closing its productivity gap with the US very rapidly — up from 25% (1980) to 60% (2011) — Brazil was falling behind (in a cyclical fashion) equally fast — down from 28% to 19% of US's productivity levels, respectively.

As has been widely reported (and is evident in Figure 3), the Brazilian economy has moved into a more dynamic growth-cycle since 2002 (led mostly by a boom in commodities, finance and real estate), which was quickly resumed in 2010 after the 2009 slowdown (in part due to a pre-presidential election expenditure boom). As a result, productivity growth reached an average annual rate of 1.4% between the starting point of the cycle (2002 — the year of the election of President Lula da Silva) and 2011 — with a rate of growth of 5% in 2007 and one of 4% in 2010. However, and despite a growing collective optimism (reaching recently levels of euphoria) in both Brazil and the financial press, there is so far little evidence that Brazil's productivity-acceleration could be sustained — in fact, the fast 2010-rate was already reversed in 2011 (down to 0.7%) despite the continuation of the highly beneficial boom in commodity-prices and the abundance of inflows (including FDI).

The difficulty in sustaining periods of productivity growth is also evident in the four Latin American countries of Figure 4, which are included in this graph because they are the only ones in the region that experienced at least some years of rapid productivity growth after 1980. However, in them all productivity growth stopped abruptly after a relatively short period of time — and TFP growth became negative after that point.

FIGURE 4

Latin America (4) and Asia (3): productivity growth, 1950-2010



- Percentages above the lines are average annual real rates of productivity-growth during respective cycles; those in brackets below the lines indicate TFP growth rates between the end of the respective post-economic reform growth period and 2004 (last year for which TFP-data are availability). **Arg** = Argentina; and **Urug** = Uruguay.
- **Source:** productivity, GGDC (2012); TFP, Acharya (2009), and Palma (2010).

As it is evident in Figure 4, as far as productivity growth is concerned, if pre-1980 some LA countries were at least good middle-distance (productivity)-runners (Brazil and Mexico), post-1980 countries in the region became at best good sprinters... Meanwhile many Asian tigers became top marathon-runners (a skill that crucially includes the ability to hold one's nerve more effectively in both sides of the economic cycle) — see Figure 4, right-hand panel.

The Chilean case is probably the most notable, in that its high productivity-growth period stopped abruptly in 1998 without having experienced a financial crisis (as in Argentina) or political crisis (Peru). Chile needed only two relatively minor

aftershocks (or contagion) from the Asian financial crisis (1997) and the Russia default (1998) — and (this being LA) an amplification of these shocks via an over-reaction by its Central Bank (following the region's 'tough' monetarist neo-liberal tradition). Subsequently productivity growth practically vanished (0.9% between then and 2010), becoming actually stagnant in 'per-hour-worked' terms for the next decade — and even negative in TFP terms until 2004 (-1.3%).<sup>2</sup> How different from the three Asian countries of Figure 4 (each representing one of the three NIC groups — with China reaching 7.1% and Taiwan 4.3%), or from other Asian countries that also managed rapid productivity growth during the three decades between 1980 and 2010, such as Korea (4.5%), Vietnam (4.1%), India (4%), Thailand (3.7%), Hong-Kong (3.3%), Sri Lanka (3.2%), Malaysia (3%), Singapore (3%), Cambodia (3%), Bangladesh (2.4%), or Pakistan (2.4%), among others. LA's average for this period (0.3%) seems to belong to a different world — one that also includes the Philippines (0.5%), LA's honorary country in Asia. Even if the 1980s are excluded (due to LA's debt crisis and its aftermath — the misleadingly called 'lost decade'), and the period is restricted to the post-reform 1990-2010 one, LA's average productivity growth (1.3%) is just a fraction of that of most Asian countries (China 8.5%, Vietnam 4.7%, India 4.5%, Cambodia 4%, Taiwan 3.8%, Korea 3.8%, Malaysia 3.2%, Thailand 3.1%, Bangladesh 3%, and so on).

In fact, in Figure 4 Indonesia is included (even though it is the least dynamic of the 'second-tier' NICs) because its experience is particularly relevant for a comparison with LA. Not only was it the hardest hit by the 1997 financial crisis, but also its whole post-independence history has been turbulent, plagued by natural disasters, separatism, poverty, genocide and corruption (the latter two especially during Suharto's three-decade-long presidency). Also, since the end of its oil-boom, Indonesia largely abandoned its (somewhat megalomaniac) industrial policy, and soon acquired a Latin-American-style proclivity for premature financialisation and

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<sup>2</sup> Referring to these two contrasting periods, Michael Porter once said that Chile was like a two-act play; by then Chile was well into the second act, but most Chileans were still giving the first a standing ovation...

monetarist-macro.<sup>3</sup> Yet, even then, no Latin American country has managed Indonesia's productivity growth-rate since 1990.

For those who consider TFP growth a more telling indicator of economic success (despite the major problems associated with its concept and its measurement), the contrasting picture between the two periods is even more striking (see Palma, 2010). With the exception of Chile, all LA posted negative TFP-rates during the 1980s, and in half of them TFP growth remained negative after 1990 and economic reform (and in four others was stagnant). As a result, both during the 1980s *and* the post-1990 reform-period LA's average is negative and well below everybody else's. That was clearly not the case between 1960 and 1980 — when only a few countries in the Mediterranean EU, Japan and Taiwan posted higher TFP growth rates than LA (and practically none higher than Brazil). So, for those who follow the Washington Consensus, the most challenging question must be how was it that in most of LA TFP growth became negative (or at best stagnant) well *after* full-blown economic reform? And the well-rehearsed answer that what is needed is yet more of the same neo-liberal reforms by now sounds increasingly hollow.

However, the most challenging question emerging from the above is why is it that Latin American countries, although perfectly capable of generating periods of dynamic productivity growth, are totally unable to *sustain* economic growth in time — as so many countries in Asia are capable of doing? This is particularly true for Brazil, a country that grew Asian style for 15 years before 1980, and has struggled ever since — with its recent partial recovery already running out of steam.

### 3.- Sectoral diversities and the “one-thing-at-a-time” process of catching-up

Figure 5 measures the relative productivity gaps of four Latin American countries vis-à-vis the US. In Panel A, Brazil's productivity gaps throughout the whole 1950-2007 period show very clearly LA's 'one-thing-at-a-time' style of catching-up.<sup>4</sup> While pre-1980 ISI succeeded in significantly closing the manufacturing productivity gap, this

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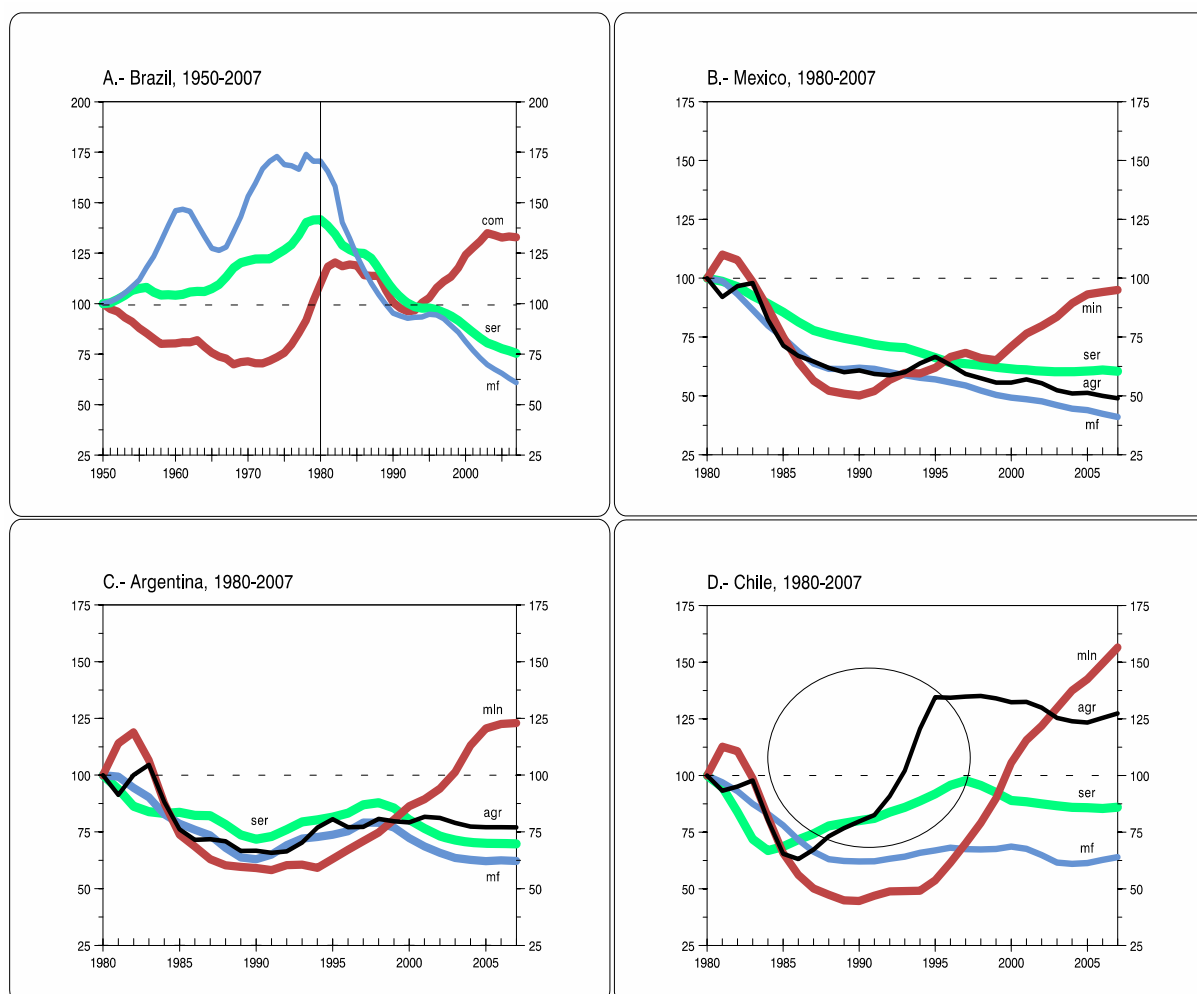
<sup>3</sup> 'Financialisation' is the rise in size and dominance of the financial sector relative to the non-financial sector, as well as the diversification towards financial activities in non-financial corporations.

<sup>4</sup> Unfortunately, the source (GGDC, 2009) has not updated this sectoral databank after 2007.

happened at the expense of commodities; the opposite was the case afterwards. One big difference, however, is that (as in East Asia) the pre-1980 manufacturing catching-up also managed to pull services *à-la*-Hirschman. This goes a long way to explaining the differences in the aggregate productivity growth rates between the two periods. Another one, of course, is the superior growth-enhancing characteristic of manufacturing due to its dynamic economies of scale, spill-over effects, and so on. And yet another is the fact that the post-1980 commodities' catching-up (as evident in Mexico and Argentina, but not in Chile) was really only a narrow mining phenomenon (see Figure 5).

FIGURE 5

Brazil, Mexico, Colombia and Chile: relative productivity gaps with the US



- **com** = commodities (primary sector); **agr** = agriculture, forestry and fishing; **min** = mining and quarrying; **mf** = manufacturing; and **serv** = services. To simplify Panel A, agriculture and mining are shown together as commodities.

- Each line is an index number (1950 = 100 for Brazil, 1980 = 100 for the rest) of the ratio of labour productivities between the respective country and the US (each in real terms and domestic currencies). An increase implies 'catching up' with the respective labour productivity in the US, and a decline a falling behind. 3-year moving averages.

- **Source:** GGDC (2009).

The relative increase in productivity differentials with the US in Mexico and Argentina does not mean that in many Latin American countries agriculture has not also gone through a major transformation. In fact, in some countries a technological revolution has been unfolding, which has altered the organisation of production and the social relations in the rural sector (see, for example, Katz, 2004). In many cases,



'sowing pools' and 'zero tillage' production arrangements have replaced the traditional farmer. And this technological and organisational change has not come about only because of the influence of multinationals; it has also been the result of domestic technological efforts involving R&D carried out both by public institutes (such as Fiocruz or Embrapa in Brazil, INTA and Instituto Malbran in Argentina, INIA in Chile), and local companies (see Katz, 2004). However, as these transformations in agriculture have also taken place in the US, even in Argentina (and despite the remarkable boom in soya) the overall agriculture productivity gap with the US widened vis-à-vis 1980. The same happened in Brazil.

The primary commodities revitalization has also had the added advantage of benefiting from the post 9/11 surge in commodity prices. Yet, as this phenomenon has been fuelled by massive speculation, it may well prove to be no more than a short term bubble; although it is possible that it could last for longer, as long as China and India continue to surge ahead, and (over-liquid and extremely uncertain) financial markets continue to be attracted by commodities. However, the key question here, as well as with the mining, timber and fisheries' revolution is why they have had such little capacity to pull the rest of the economy with them. Basically, what is happening is that while a few activities in the primary sector have succeed in forging ahead in their efforts to 'catch-up' with their counterparts in rich nations, the bulk of the economy (especially, as Figure 5 shows, most of manufacturing) is being left behind. "Convergence", therefore, seems to be a far more complex phenomenon than it is implicit in neo-classical models. This is a remarkable fact that (with few exceptions; see Katz, 2004) finds little emphasis in the literature.

Panel D synthesises Chile's better 1986-1998 GDP performance. What took place was mostly an investment-led burst of productivity growth in agriculture, forestry and fishing (10% p.a.), and increased productivity in services (3.3%, backed up by infrastructural investment and business construction — see Palma, 2010). The growth of productivity in mining only started in the mid-1990s (oddly enough, when other sectors began to falter), reaching 11% p.a. in 1994-2003. In addition, after falling behind in the 1980s, the productivity gap in manufacturing stabilised

(although, in part, this was due to a particularly rapid decline in manufacturing employment and de-industrialisation in Chile; see below).

One phenomenon apparent from Panel B is Mexico's particularly poor performance. For reasons of space, I cannot analyse this here in detail (see Palma, 2005a) but, basically, an economy with FDI levels and access to the US markets that policy-makers in other developing countries can only (day)dream of, has performed particularly disappointingly in terms of productivity growth — falling behind the US in *all* sectors.

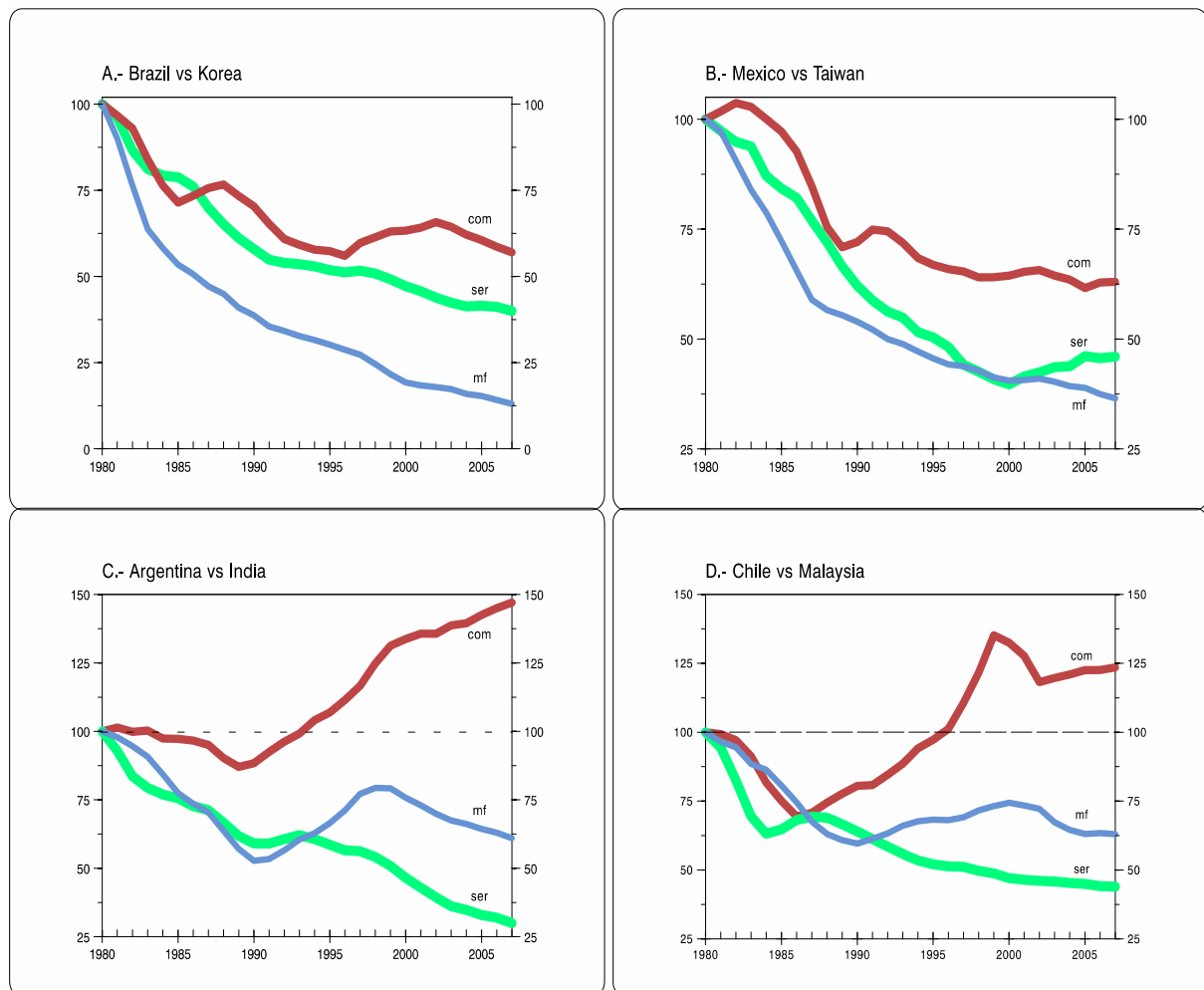
Regarding the remarkable neglect of manufacturing, as argued elsewhere (Palma, 2005b, and 2008; see also below), there is plenty of evidence to suggest that as one gets closer to the productivity frontier, the need for industrial policy increases exponentially.<sup>5</sup> From this perspective, the sad irony is that LA abandoned industrial policy at the very moment it needed it most! So, for example, since 1980 manufacturing productivity in the US has forged ahead of Brazil's by a factor of 3.5 (Panel A); by a factor of 2.3 vis-à-vis Mexico's (Panel B); by a factor of 1.7 vis-à-vis Argentina's (Panel C); by a factor of 1.6 vis-à-vis Chile's (Panel D); and by one of 2.4 vis-à-vis Colombia's (not included in Figure 5). Moreover, as in manufacturing most of Asia was catching up with the US, LA was falling behind Asia by an even larger *relative* margin (see Figure 6).

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<sup>5</sup> See also, Khan and Blankenburg (2009).

FIGURE 6

Brazil, Mexico, Argentina and Chile: relative productivity gaps with four Asian countries



● As Figure 5.

The collapse of Brazil's productivity in manufacturing relative to Korea's is truly remarkable: since 1980, manufacturing productivity in Korea has already forged ahead of Brazil's by a factor of 7.5 (Panel A). In turn, Mexico fell behind Taiwan by a factor of 2.8 (Panel B); Argentina vis-à-vis India (in a cyclical fashion) by a factor of 1.6, and in services by one of 3.4 (Panel C); and Chile vis-à-vis Malaysia (during the 1980s) by a factor of 1.6, and in services by one of 2.4 (Panel D).

At the beginning of September, *The Economist* joined the prevailing regional economic euphoria — based exclusively on the fact that after a soft landing from the global financial crisis, a few countries of the region are experiencing an acceleration of their growth rate led entirely by a boom in commodity-prices, finance and real estate — and predicted that what is coming may well be a “Latin American decade”,

with Brazil as its powerhouse. If the subject was football, music, literature, or exotic tourism that may well be the case; it is also plausible to happen in the rôle played by the region, especially Brazil, in certain aspects of international politics. But it looks rather unlikely in terms of economic performance — other than in commodities and finance. But who knows? The 2010s might indeed surprise us, the sceptics, and end up as the Latin American decade (in fact, even more implausible events have occurred before), but so far the hard evidence is clearly on the side of yet another ‘Asian decade’.

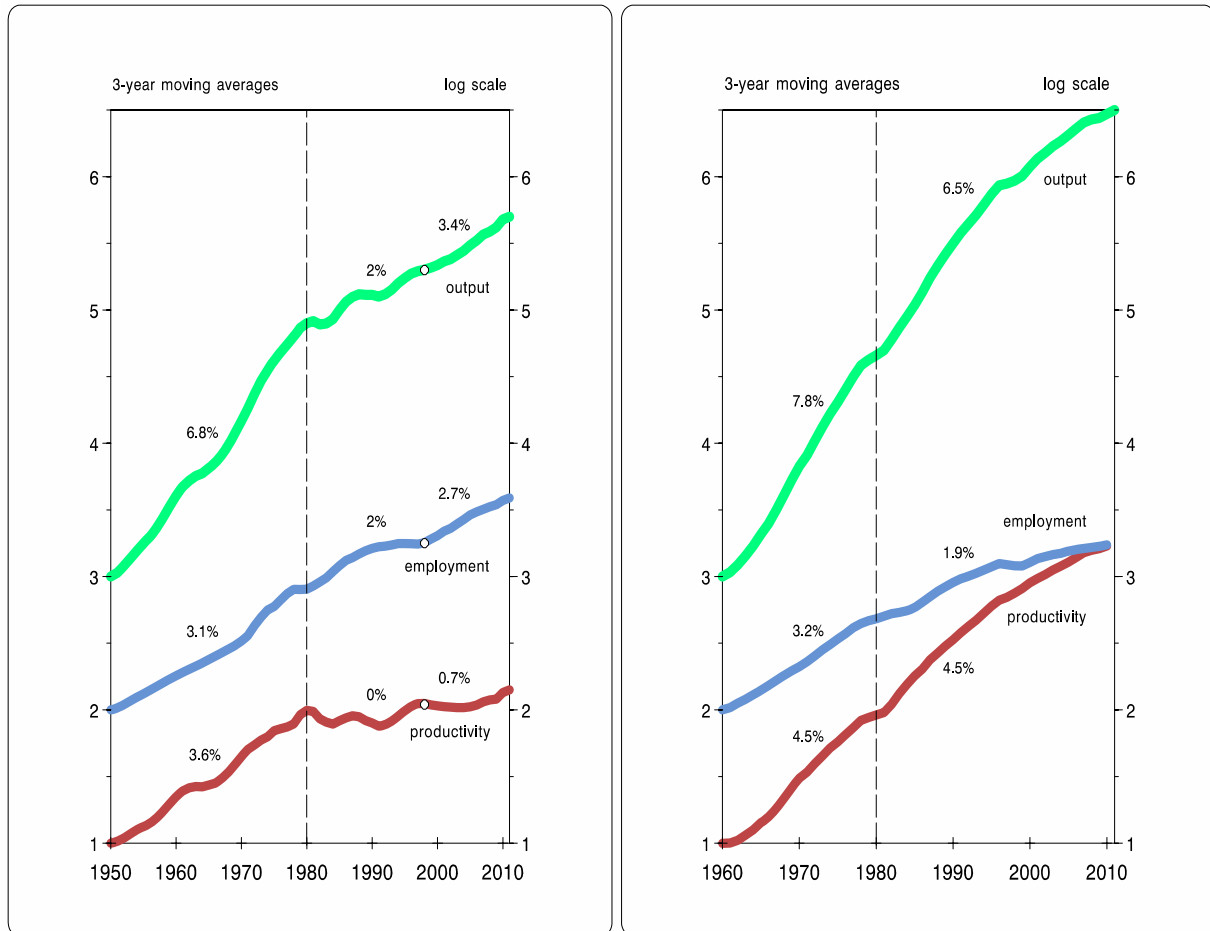
4.— In Latin America after 1980, the decline in GDP growth was absorbed mostly by productivity, leaving the growth of employment practically unaffected

The only positive side of LA’s poor productivity-growth record is that it is not only associated with low levels of investment, technological change (except for a few commodities), de-industrialisation, and so on, but it is also associated with rapid employment creation. A new comparison between Brazil and Korea helps explain this additional contrast between LA and Asia — now in terms of how a rapid decline in GDP growth after 1980 is absorbed in Brazil mostly by labour productivity, while a (small) decline in Korea’s GDP-growth is entirely absorbed by employment (Figure 7).

FIGURE 7

BRAZIL: output, employment and productivity, 1950-2011

KOREA: output, employment and productivity, 1960-2011



- Log scales and 3-year moving averages. Percentages are annual real growth-rates for respective periods (1950-1980, 1980-1998, and 1998-2011 for Brazil; and 1960-1980, and 1980-2011 for Korea; the source only provides data for Korea since 1960).
- **Source:** GGDC (2012).

If in Brazil one divides these five decades into three periods (1950-1980, 1980 until its 1998 financial crisis, and the post-1998 recovery), during the first a rapid rate of GDP-growth (6.8% p.a.) was generated by employment creation and productivity growth in relatively similar proportions (3.1% and 3.6%, respectively). In Korea, meanwhile, the extra one percent GDP-growth (7.8% overall) had its origin in additional productivity growth (3,2% and 4,5%). However, when in Brazil GDP-growth collapsed after 1980, this was absorbed mostly by productivity (which fell from 3.6% to 0%), while in Korea the small growth-deceleration after 1980 was absorbed entirely by employment (leaving productivity growth unaffected).

Therefore, an despite the huge divergence between the two countries in terms of GDP-growth after 1980, Brazil had the same capacity as Korea to generate employment during the near four decades between 1960 and their respective financial crises (1960-1997 and 1960-1998). Basically, both countries nearly trebled their levels of employment during this near 40-year period (Brazil adding 46 million workers, and Korea 13 million).<sup>6</sup> However, as in Brazil labour productivity absorbed most of the deceleration in GDP-growth during the second period (1980-1998), having a relatively minor acceleration afterwards, by 2011 Korea's average labour productivity was 3.2 times higher than Brazil's — having been almost identical in 1980.

The uniqueness of LA's 'GDP-shock-absorber' becomes even more evident when Brazil is compared with South Africa during their 'reform period' (1994-2011; see Figure 8).

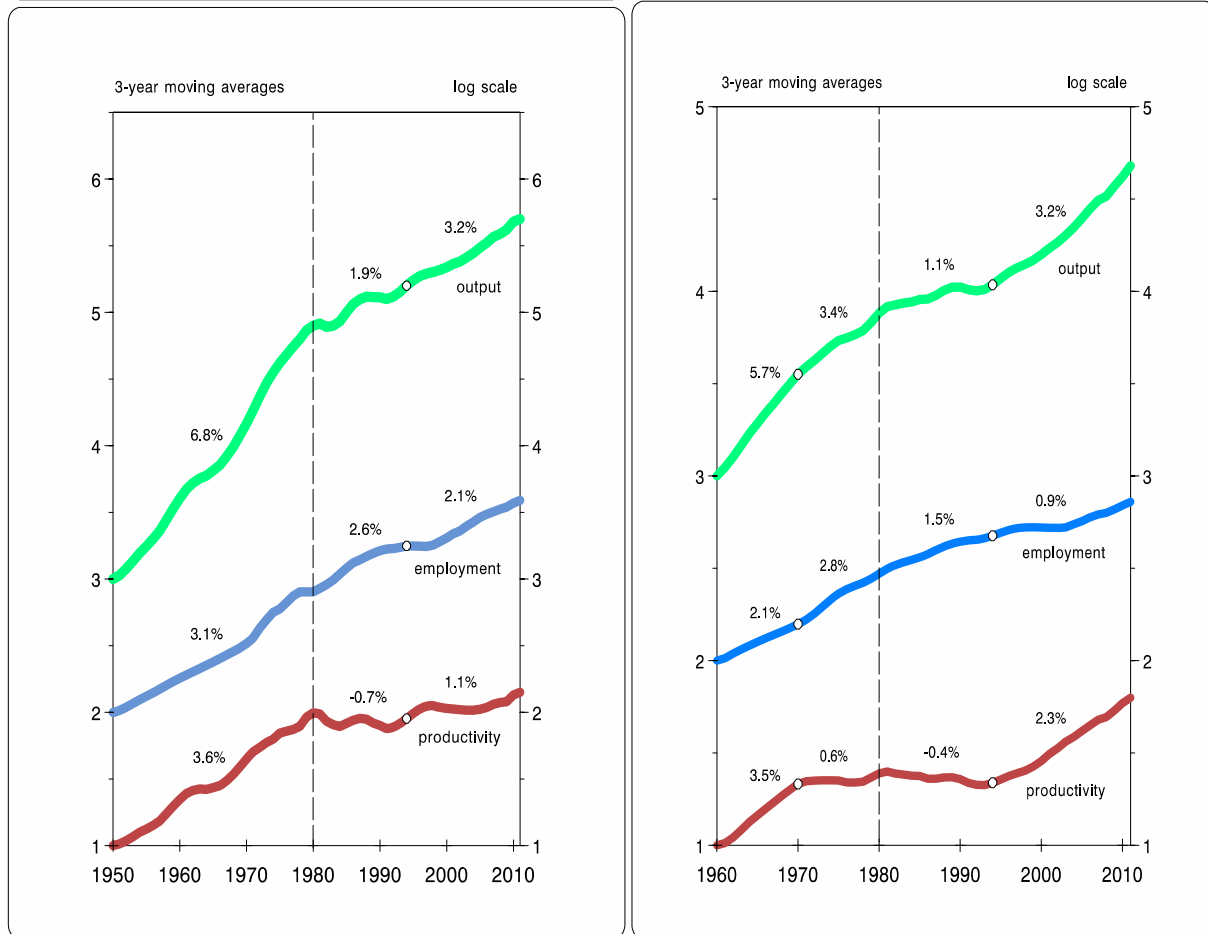
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<sup>6</sup> There are well-known problems with employment data, especially in services (information on formal jobs is normally available, but those in the informal sector are often estimates). However, there is no reason to believe LA's statistics are different from Asia's.

FIGURE 8

BRAZIL: output, employment and productivity, 1950-2011

SOUTH AFRICA: output, employment and productivity, 1960-2011



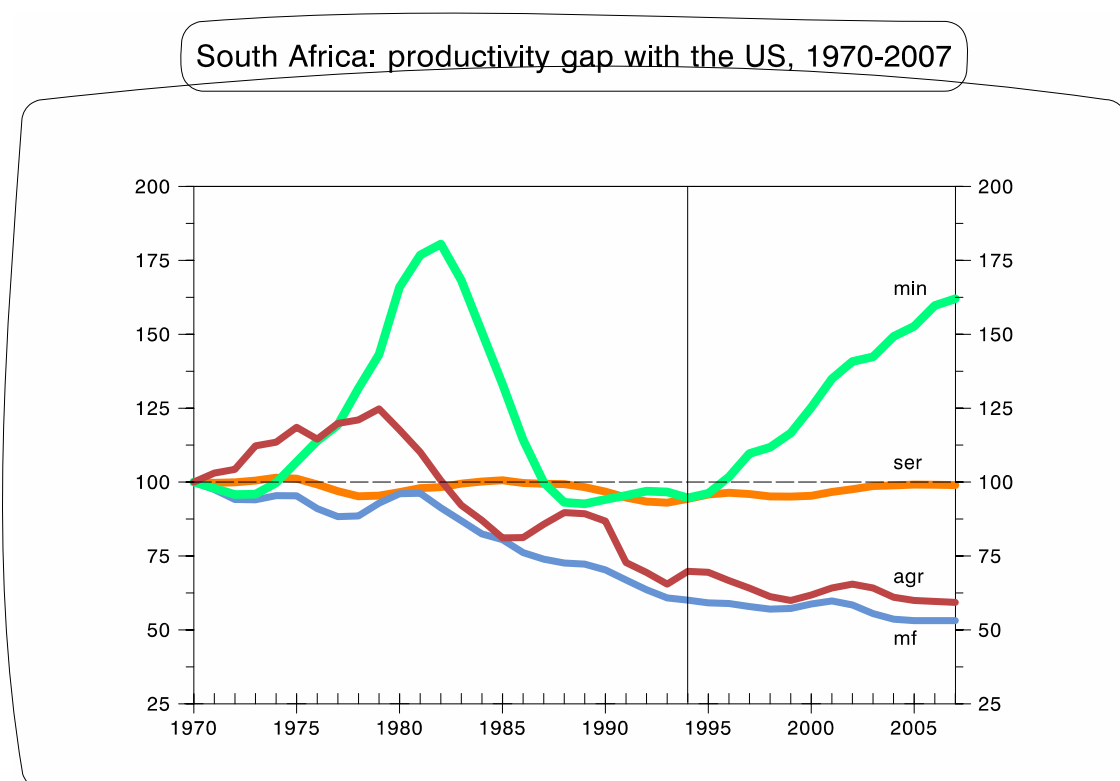
- Log scales and 3-year moving averages. Percentages are average annual real rates of growth for respective periods (1950/1960-1980, 1980-1994, and 1994-2011).
- **Source:** GGDC (2012); this source does not provide employment data for South Africa, so, the source for this is Quantec (2009 and 2012).

This comparison between Brazil and South Africa is telling. Both countries started economic reforms simultaneously in 1994 (i.e., since the beginning of the ANC period, and the first election of Cardoso and the 'Real Plan'), and both have had an identical GDP-growth rate since (3.2% p.a.). However, South Africa's GDP growth is explained mostly by productivity growth, while Brazil's mainly by employment. There are, of course, many differences between the two countries, but the fact that in Brazil the Workers' Party (PT) became the capitalist elite's best friend (particularly after the election of Lula), while in South Africa COSATU, one of the ANC dominant forces — and despite the growing neo-liberal orientation in the ANC government's

core policy-making — remained a militant organisation, undoubtedly had a lot to do with this.

So, for example, while Brazil increased its service employment by more than one half during this period (1994-2011), South Africa did so by only one third. From this perspective, South Africa's main problem during the ANC period is that it ended up with East Asian levels of employment elasticities (0.3), but Latin American levels of GDP growth (3.2%). The end result was a quarter of its labour force unemployed (see Figure 9).

FIGURE 9



- **agr** = agriculture, forestry and fishing; **min** = mining and quarrying; **mf** = manufacturing; and **serv** = services.
- Each line is an index number (1970 = 100) of the ratio of South Africa's labour productivities and the US (each in real terms and domestic currencies). An increase implies 'catching up', and a decline a falling behind. 3-year moving averages.
- **Source:** GGDC (2009; the source has not updated this sectoral databank after 2007).

This is a very similar picture than those of Latin American countries in Figure 5 — except that South Africa has a much better relative productivity performance in



services, and a worse in agriculture; however, the former is mostly due to low employment creation in this sector.

The main lesson from the contrast between South Africa and Brazil is that even in this (so-called) globalised world there are still significant degrees of freedom regarding the labour-intensity of output. And if LA has chosen a labour-intensive growth-path and South Africa the opposite, this has been mostly for *endogenous* political economy reasons.

Table 1 shows that this contrast in terms of GDP ‘shock-absorbers’ (productivity in Latin America; employment in Asia and South Africa) also applies to the other countries of each region.

TABLE 1

Growth of GDP, Employment and Labour Productivity, and Gross Employment Elasticities, 1950-2011

	GDP		Employment		Labour Productivity		Emp 'Elasticities'	
	1950-1980	1980-2011	1950-1980	1980-2011	1950-1980	1980-2011	1950-1980	1980-2011
China*	4.9	8.7	2.2	1.7	1.2	<b>7.2</b>	0.4	0.2
N-1*	8.1	6.2	3.7	2.0	5.0	<b>4.2</b>	0.5	0.3
Viet Nam*	3.0	6.7	1.4	2.4	1.1	<b>4.1</b>	0.5	0.4
India*	3.6	6.3	1.5	2.3	1.5	<b>4.0</b>	0.4	0.4
N-2*	5.4	5.4	2.4	2.3	3.5	<b>3.0</b>	0.4	0.4
South Africa*	4.5	3.2	1.9	0.9	1.9	<b>2.4</b>	0.4	0.3
"World"	4.4	3.7	2.0	1.6	2.4	<b>2.1</b>	0.5	0.4
USA	3.6	2.7	1.7	1.3	1.6	<b>1.6</b>	0.5	0.5
EU	4.1	2.3	0.5	0.8	3.6	<b>1.5</b>	0.1	0.3
Latin America	5.5	2.6	2.8	2.5	2.8	<b>0.3</b>	0.5	<b>1.0</b>
Dom. Rep.*	5.9	4.6	3.8	2.8	2.1	<b>1.8</b>	0.6	0.6
Chile	3.5	4.4	1.4	2.8	2.1	<b>1.6</b>	0.4	0.6
Colombia	5.2	3.4	3.1	2.2	2.0	<b>1.2</b>	0.6	0.6
Costa Rica	6.5	4.0	3.6	3.1	2.8	<b>0.8</b>	0.6	0.8
Argentina	3.4	2.1	1.2	1.4	2.1	<b>0.7</b>	0.4	0.7
Uruguay*	2.1	2.2	0.6	1.7	1.6	<b>0.5</b>	0.3	0.8
Peru	4.9	2.9	2.3	2.5	2.6	<b>0.4</b>	0.5	0.9
Brazil	6.8	2.6	3.1	2.3	3.6	<b>0.3</b>	0.5	0.9
Mexico	6.4	2.4	3.2	2.5	3.1	<b>0.0</b>	0.5	1.0
Bolivia	3.3	2.7	0.8	2.8	2.5	<b>-0.1</b>	0.2	1.0
Guatemala	5.0	2.8	2.7	3.0	2.2	<b>-0.2</b>	0.5	1.1
Ecuador	5.7	2.9	2.7	3.2	2.9	<b>-0.3</b>	0.5	1.1
Venezuela	4.7	2.0	3.7	2.4	1.0	<b>-0.4</b>	0.8	1.2

- Countries and regions are ranked according to their 1980-2011 growth rates of labour productivity. For those with ‘\*’, for employment and productivity the first period rates are restricted to 1960-1980; for South Africa the second period is also restricted to 1994-2011 (the ANC period). **L Productivity** = labour productivity; **Emp “Elast”** = gross employment elasticities (understood simply as the ratio between employment growth and GDP growth). ‘World’ excludes African countries as the source does not provide information on employment (and ILO, 2012 only provides information on African employment for a small number of years; furthermore, as for

many African countries no real data exist, ILO estimates are based on econometric predictions).

- **Sources:** GGDC (2012). Employment for South Africa, Quantec (2009 and 2012).

Among the many issues arising from Table 1, four stand out vis-à-vis the first period (1950/1960-80). First, pre-1980 only the 'first-tier' NICs (N-1) was doing better than LA in terms of GDP and employment. Second, LA's pre-1980 productivity growth was also relatively energetic (2.8%); i.e., productivity doubling every 25 years, with Brazil and Mexico needing less than 20. Third, pre-1980 there was nothing special about LA's employment elasticities. And fourth, there was diversity within Latin America countries.

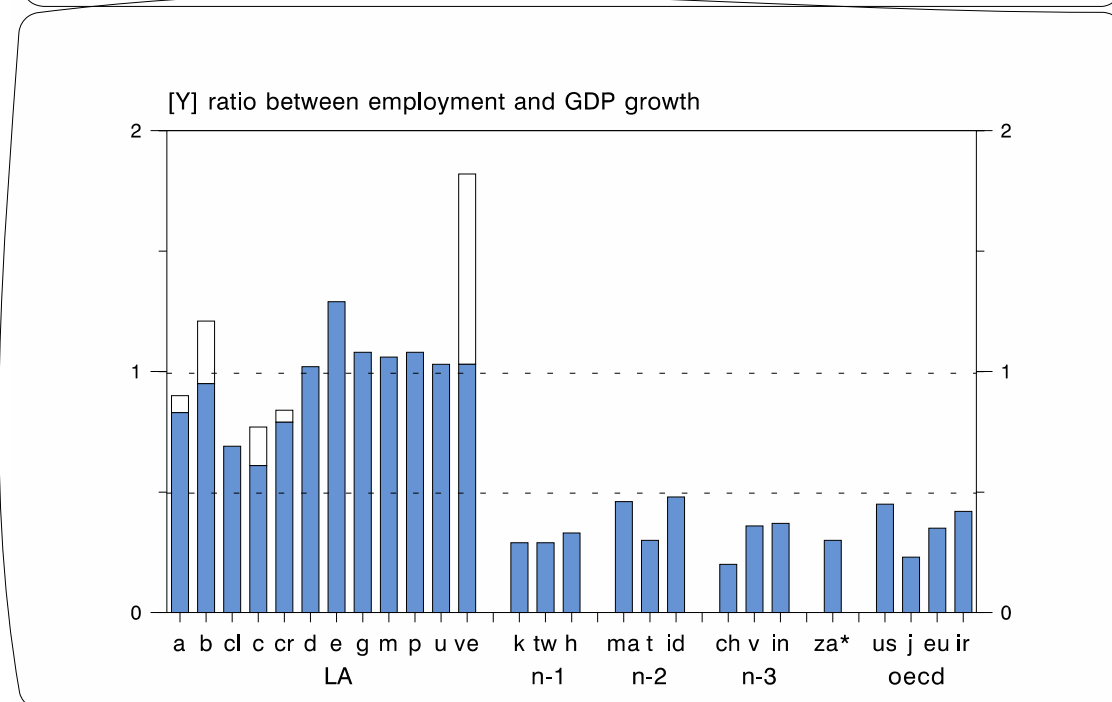
However, post-1980 things changed sharply: while LA's GDP growth rate fell by half (becoming one among the worst), its employment creation remained relatively stable. Consequently, its employment elasticity nearly doubles (from 0.5 to 1, a level at least twice as high as other countries). And its labour productivity (growing at just 0.3% p.a.) sinks — by far — to the bottom.

##### 5.- Latin America's unique post-reform combination of high employment elasticities and low productivity growth

As already evident in Table 1, as far as employment elasticities are concerned, post-1980 LA seems to live in a world of its own. In fact, Latin American countries' post-1980 employment elasticities are about twice as high as anybody else's — see Figure 10.

FIGURE 10

Latin America, Asia, South Africa & OECD: gross employment elasticities, 1980-2010



- **a** = Argentina; **b** = Brazil; **cl** = Chile; **c** = Colombia; **ch** = China; **cr** = Costa Rica; **d** = Dominican Republic; **e** = Ecuador; **eu** = European Union; **g** = Guatemala; **h** = Hong Kong; **id** = Indonesia; **in** = India; **ir** = Ireland; **j** = Japan; **k** = Korea; **m** = Mexico; **ma** = Malaysia; **p** = Peru; **t** = Thailand; **u** = Uruguay; **v** = Vietnam; **ve** = Venezuela; and **za\*** = South Africa (since 1994). Employment elasticities as in Table 1 (African countries are excluded because the GGDC dataset does not provide data on employment for this region, and the ILO database only provides econometric estimate; for South African employment, see Quantec, 2009, and 2012). White bars on top of blue ones are additional employment elasticity when ratio is calculated using GDP in domestic currencies.

- **Sources:** for GDP, WDI (2012, constant 2000-US\$); for Taiwan (2012). For GDP in domestic currencies, GGDC (2012), and UN (2012). For employment GGDC (2012), and ILO (2012).

However, a sectoral analysis indicates that LA's high elasticities are entirely due to services. For example, between 1980 and 2011 net-job creation in Brazil reached about 35 million, of which 32 million were in services — 11 in trade/hotels/restaurants; 2 in transport/storage/ communication; 3 in finance/insurance/real estate; and 15 in community/ social/personal/government services. That is, while in Brazil overall output in services was growing at an average rate of just 2%,

employment did so at 4.1%. Furthermore, whatever the ‘populist’ literature may suggest, there is no evidence that in the latter category these are mainly government jobs — in Brazil, for example, the overall employment elasticities of services reached 2.2, while excluding the latter sub-sector this increases to 3.5 (4.1% employment-growth vs. 1.2% output-growth).

At the same time, and going against the expectations of those in the Washington Consensus, other than in the ‘maquila’ industry (an industry that exists mostly due to artificially-created trade restrictions in the US, which gave Mexico and some Central American countries preferential access to its markets) there is little evidence that increased employment creation relates (in a Heckscher–Ohlin–Samuelson ‘market-led’ fashion) to trade liberalisation. This is especially true in commodities. In fact, not only did employment in the primary sector decline in most countries (Brazil lost 2 million jobs), but also, with a few exceptions, there is no evidence that the jobs created in services are associated with the commodity boom in any significant way.

There are, of course, many political economy issues that emerge from LA’s high employment elasticities, and the role played in it by the informal sector, that cannot be analysed here.<sup>7</sup> However, I would like to mention at least one: the historical legacy of the ‘new’ left. Whatever one’s views on the ‘new’ left, its emergence certainly helped reduce the traditional ‘workers-paranoia’ of the region’s capitalist élites. Basically, when the ‘new’ left in LA became convinced that it could not get the political power to implement its own agenda, it decided to gain power to implement someone else’s agenda.<sup>8</sup> In fact, Mrs. Thatcher was right when she proudly proclaimed in one of her last interviews that ‘New Labour’ was her greatest political achievement. Likewise, perhaps the greatest political achievement of Pinochet (and similar military dictators) is the Latin American ‘new’ left. So, as far as employment was concerned, there was not much point in the region’s capitalist

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<sup>7</sup> One is the remarkable idealisation of the informal sector by some neo-liberal aficionados, which led De Soto (1989), for example — following Milton Friedman’s glowing remarks on the Italian black market — to proclaim that it was the only real ‘market economy’, the future of humanity!

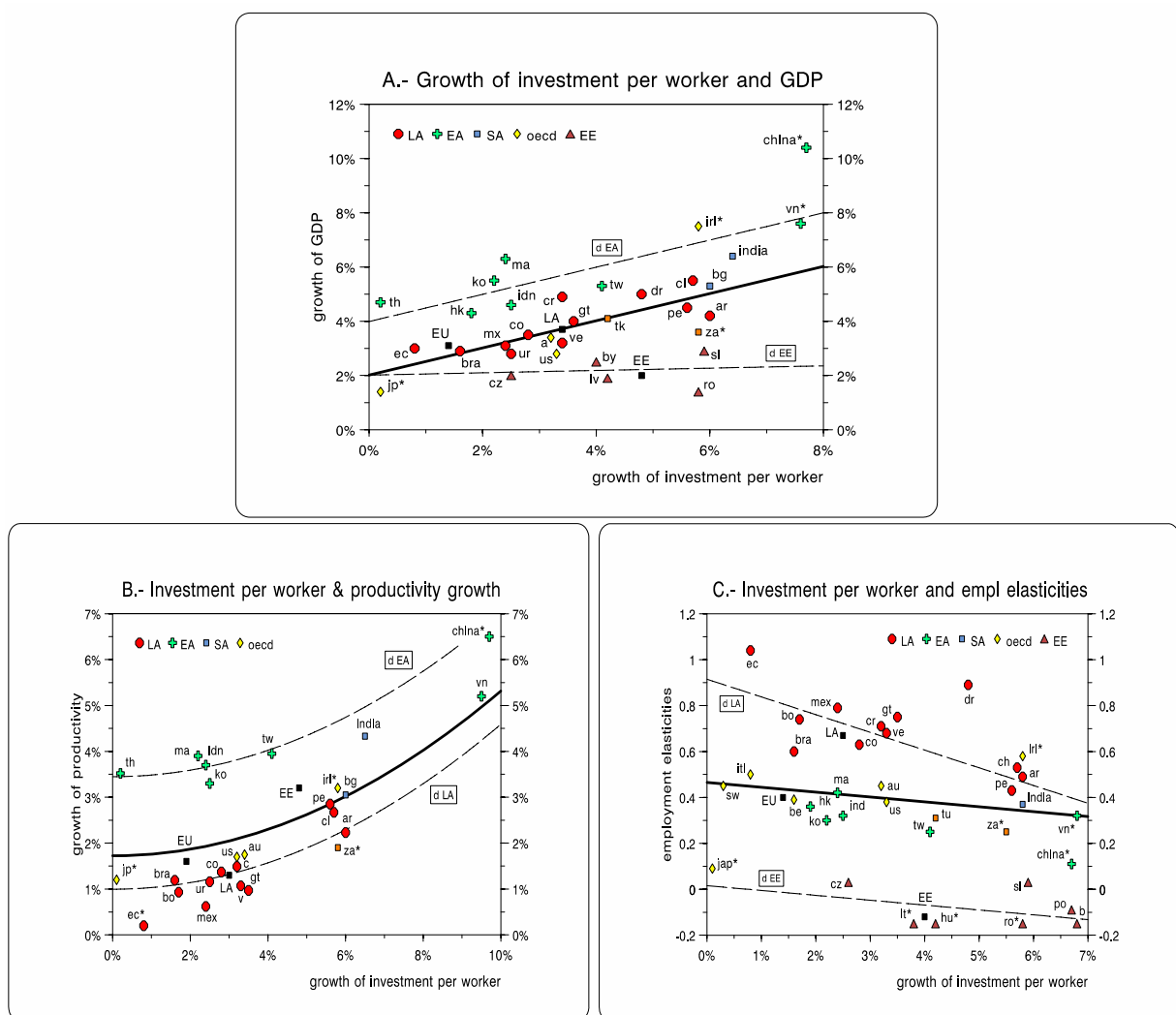
<sup>8</sup> See, for example, Arantes, 2007; Oliveira, 2006; and Palma 2009a.

élites continuing with their traditional anti-labour bias. Here the above comparison between Brazil and South Africa is telling.

Figure 11, in turn, indicates that in LA during the post-1990 reform period there is a contrasting relationship between investment and productivity growth, on the one hand, and between investment and employment growth, on the other.

FIGURE 11

Latin America: the contrasting fortunes of labour productivity and employment in the post-reform period, 1990-2010



● Full titles: **Panel A**, Growth of investment per worker and of GDP, 1990-2010; **Panel B**, Growth of Investment per worker and of labour productivity, 1990-2010; and **Panel C**, Growth of investment per worker and employment elasticities, 1990-2010.

● Acronyms as in Figure 2, and **au** = Australia; **bg** = Bangladesh; **by** = Belarus; **cz** = Czech Republic; **EE** = Eastern Europe; **hk** = Hong Kong; **idn** = Indonesia; **irl\*** = Ireland

(1993-2007, to reflect the high growth period); **lv** = Latvia; **ro** = Romania; **si** = Slovenia; **tk** = Turkey; **tw** = Taiwan; **v** = Venezuela; and **za\*** = South Africa (1994-2008). **china\***, investment growth = 12.2%; **ec\***, productivity growth = -0.1; for **jp\*** = -0.6%. '**d LA**' = dummies for LA (intercept in **Panel C**, and intercept and slop in **Panel D**); '**d EA**' = dummy intercept for EA (Panels A and C); '**d EE**' = dummy slop for EE (Panel A), and intercepts for Panels C and D).

- For regression statistics, see Palma (2010);  $R^2$  in Panel A = 77%; in Panel B = 86%; and in Panel C = 82%; all variables are significant at the 1% level. In these and following regressions, 't' statistics are calculated using White's heteroscedasticity adjusted standard errors.<sup>9</sup>

- **Sources:** for GDP and investment, WDI (2012, constant 2000-US\$); for Taiwan (2012). For employment GGDC (2009), and ILO (2012).

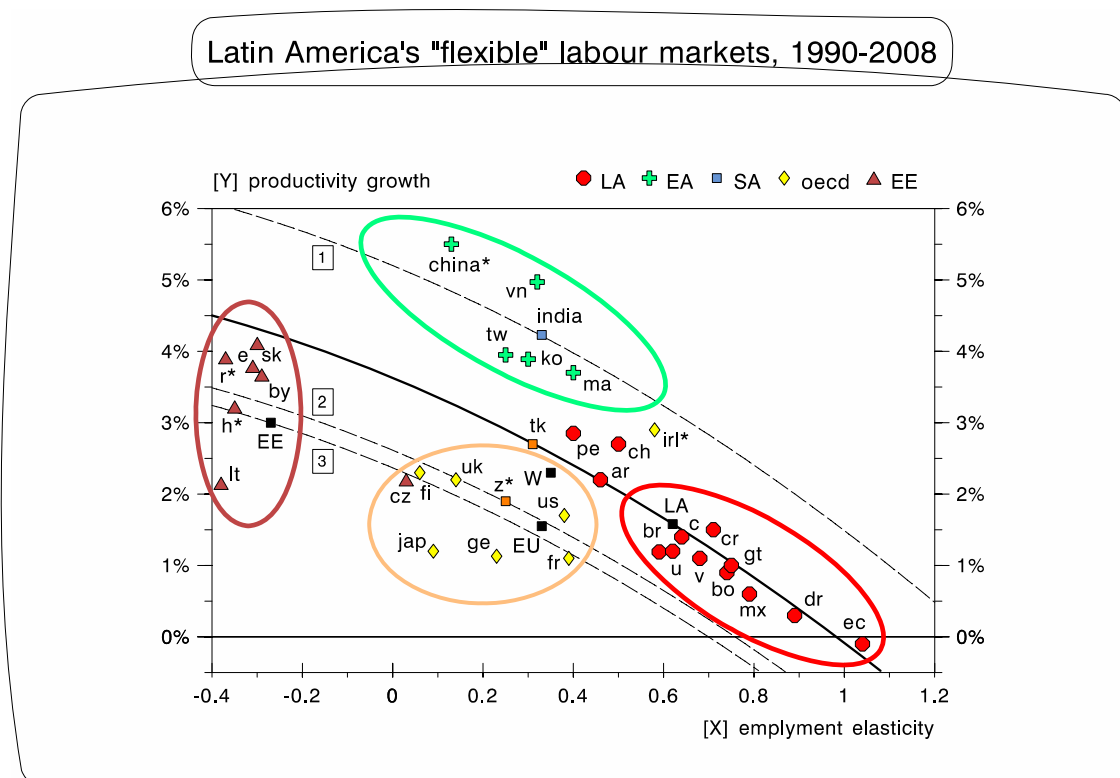
While in panel B, LA is best represented by a highly significant *negative* (productivity) dummy, in Panel C LA generates a highly significant *positive* (employment) one. However, both dummies cancel each other out, and LA's relationship between investment and GDP growth (Panel A) ends up best represented by the base regression.

The fundamental point here is whether LA's ability to generate high employment elasticities may well affect investment and GDP growth *negatively*. More specifically, the two critical questions are: what is the nature of the relationship between LA's high employment elasticities and low productivity growth? And (crucially), if there is a fundamental relationship between the two, which is the direction of causality? See Figure 12.

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<sup>9</sup> For a discussion of the important econometric issues raised by cross-section regressions like these, see Pesaran, et. al. (2000). In particular, one has to understand that these regressions are simply a cross-sectional *description* of cross-country differences, categorised by the explanatory variable. That is, they should *not* be interpreted in a 'predicting' way, because there are a number of difficulties with a curve estimated from a single cross-section — especially regarding the homogeneity restrictions that are required to hold.

FIGURE 12



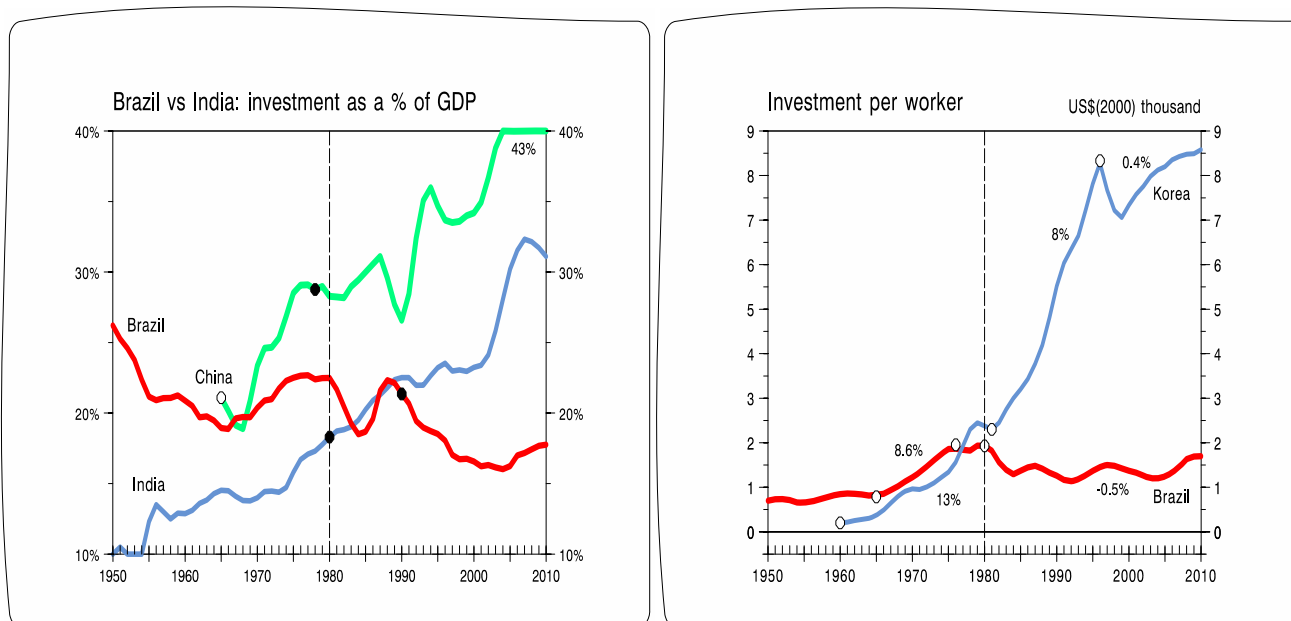
- [Y] = vertical axis; and [X] = horizontal axis. Countries and regions as Figure 2 and 10, fi = Finland; sk = Slovak Republic; uk = United Kingdom; v = Venezuela; and vn = Vietnam. Employment elasticity for h\* (Hungary) = -1.2; and for r\* (Romania) = -2. china\*, productivity growth = 8%. [1] = dummy intercept for EA; [2] = dummy intercept for OECD countries; and [3] = dummy intercept for EE.
- $R^2 = 85\%$ ; all variables are significant at the 1% level (Palma (2010)).

Even though this is a difficult relationship to interpret as both variables (employment elasticities and productivity growth) have crucial components in common, Figure 12 complements what we already know — this time for the shorter post-reform period 1990-2011. That is, after economic reform most Latin American countries are uniquely positioned within the geography of this relationship due to their remarkable labour market ‘flexibility’ — flexibility in the sense that they are able to generate single-digit unemployment rates despite such poor GDP growth. Figure 12 also indicates that in the rest of the world there are also specific regional patterns.

6.— Latin America’s remarkably poor investment effort and its political economy  
 There is little doubt that the core of LA’s inability to sustain productivity growth after 1980 is its low rate of accumulation — poor even from the perspective of its relatively inadequate historical record (Figure 13).

FIGURE 13

Investment patterns in Latin America and Asia, 1950-2010



- In the left-hand panel, black circles indicate the beginning of economic reform (1978 for China — Deng Xiaoping’s speech to the Third Plenary Session of the Party’s Eleventh Central Committee; 1980 for India; and 1990 for Brazil — Collor’s ‘New Brazil’ Plan). In the right-hand panel, percentages shown in the graph are growth rates in the respective periods (for Brazil, 1965-1976 and 1980-2010; and for Korea, 1960-80, 1981-97 and 1997-2008. 3-year moving averages).
- **Sources:** for investment, WDI (2012; China’s data available only from 1965); for investment in LA before 1960, CEPAL (2012); for India (<http://mospi.gov.in/>). For employment, GGDC (2012).

In the left-hand Panel, while investment-rates in China and India are stationary around a positive trend (the same is the case for the average of East Asia and South Asia), Brazil rate is stationary around a slightly declining trend (while LA’s average is stationary around a low intercept — see Figure 14).<sup>10</sup> It is fairly obvious that LA’s capitalist élite has a preference for both sumptuous consumption, and for

<sup>10</sup> Due to space constraints, these and some other statistics below are not reported here; see Palma (2010a). In the case of India (and South Asia), the investment-rate is stationary around a positive trend only until 2003 (due to India’s investment surge after that date).



accumulation via mobile assets (financial ones and capital flight) rather than via 'fixed' capital formation.<sup>11</sup> And neo-liberal reforms — despite all their efforts towards defining and enforcing property rights, and so many other 'market-friendly' policies aimed at incentivising investment — have had little impact on that. Even the slight increase in investment in Brazil during the surprisingly positive environment after 9/11 (particularly in terms of access to finance and terms of trade) is unremarkable vis-à-vis those of Asia. Basically, in LA between 2002 and 2007 while the ratio of the stock of financial assets to GDP jumped from 106% to 182%, the average investment rate only improved from 17.2% to 20.4% (see IMF, 2012a, and WDI, 2012). Not much evidence here of the supposed revitalising effects of 'financial-deepening' promised by McKinnon and Shaw.

In essence, no theory of investment seems to be able to explain LA's stationarity-around-a-low-intercept behaviour, especially taking place during such a *long* period, such *diverse* domestic and international scenarios, and through such *divergent* development strategies (see Figure 14). In turn, Figure 13 shows that in Brazil economic reform seems to have unleashed more powerfully the predatory and rentier instincts of the region's capitalist élites (the former especially during the privatisation period, and the latter during their financialisation one) rather than their Schumpeterian ones.<sup>12</sup> In India, as in many other Asian countries, meanwhile, reforms, especially partial financial liberalisation, may have brought complex challenges to the macro and the inevitable financial fragilities (as well as 'flexible' labour markets, increased inequalities, and so on), but at least in these Asian countries the rate of accumulation increased *after* their implementation.<sup>13</sup> In LA, meanwhile, the cloud did not even have that silver lining.

Furthermore, in the very few cases in LA where investment actually increased after reforms, as in Chile (see Palma, 2012), it is not obvious why it took so long for it to happen (over ten years after the beginning of reforms), let alone why it ran out of

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<sup>11</sup> At least easy access to mobile assets helps oligarchies become more democratic... (See specially Boix, 2003).

<sup>12</sup> For the Russian-style predatory process of privatisation in LA, see, for example, Mönckeberg (2001); Wolf (2007); and Winter (2007).

<sup>13</sup> The same is true, among others, for Malaysia and Thailand.

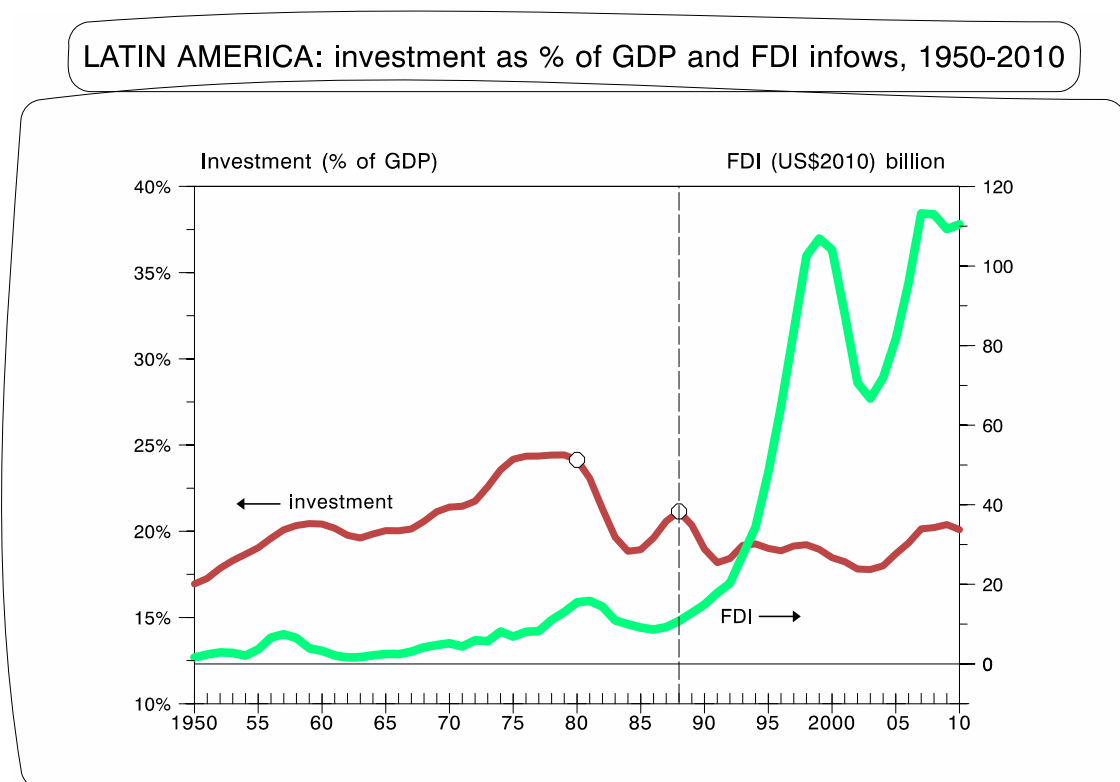
steam so easily afterwards (post-1998). However, in Chile, at least for a time, investment per worker showed dynamic growth; in Brazil, instead, (and despite the post-2003 recovery) by 2010 investment per worker was still *below* its 1980 level. On average, the rest of LA follows on average a pattern similar to Brazil's, with its 2010 level still below that of 1980. An extreme example is post-1980 Mexico: despite the highest level of FDI per worker in the world, by 2008 its investment per worker still had not recovered its 1980/1981 level. By then, and despite 1997, Korea had a level 3.7 times higher, and Malaysia and Thailand 2.4 times higher. In turn, China's 2008 level was 12 times higher; India's 4.7; and Vietnam had more than trebled this statistic since 1994 (first year that data are available for this country).

Perhaps from this perspective the contrasting productivity growth performance of LA and many in Asia — and the inability of LA *to sustain* productivity growth — are not that difficult to explain after all... In Brazil, for example, when between 1965 and 1980 investment per worker grew at an annual rate of 6.8%, productivity grew at East Asian levels (4.3%). Then, when investment per worker subsequently collapsed, productivity stagnated. Finally, when investment per worker began to increase again (6% between 2004 and 2010), productivity growth improved again (see Figures 7 and 8 above).

As the Mexican case already indicated, one of the most remarkable stylised facts of LA's investment behaviour during the 'liberalised' period is the mixed impact of inflows — including FDI. Before 1980, when in LA overall inflows (FDI, portfolio and 'others') averaged less than US\$ 20 billion per year (in 2010-US\$), productivity growth reached 2.6% p.a. (3.6% for Brazil). But when they increased by more than three times (1988-2010), productivity growth only reached half the pre-1980 rate (1.2% p.a.; 1.3% for Brazil). Of course the disappointing post-1990 performance in 'liberalised' LA has many roots (see Palma, 2012), but there is little doubt that the negative effects of the massive surge of (volatile) inflows is part of that narrative. For example, huge inflows led to a chronic deficiency of effective demand for non-commodity tradable activities, especially manufacturing; this was the outcome of the 'deadly triad' of over-valued exchange rates (that switched aggregate demand towards foreign markets); high interest rates (due to 'tough' monetary policies to

deal with these inflows); and remarkably low levels of public investment by ‘sterilised’ governments (of about 3% of GDP; these were necessary to balance public finances in a context of low taxation, as part of the ‘sound fundamentals’ shop-window part of the open capital account story).<sup>14</sup> Added to this, there was a hugely increased uncertainty (especially due to the volatile nature of inflows) affecting especially private investment. However, the aspect of inflows that is most truly remarkable is shown in Figure 14.

FIGURE 14



- White circles show the 1980 peak before the 1982 debt crisis, and the year before the ‘Brady-bonds’ agreement (that helped convert unwanted US bank loans to Latin American countries into a variety of new bonds; at the same time this mark the beginning of economic reform in many countries in the region). 3-year moving averages.

- **Sources:** ECLAC (2012; investment in current prices).

<sup>14</sup> While in OECD countries personal income tax collection reaches on average 9% of GDP, in LA it amasses less than 1% — with income tax evasion fluctuating around 50%, equivalent on average to 4.5% of GDP (ECLAC, 2010). From this perspective, there is little doubt that LA confirms Schumpeter’s hypothesis that: “[t]he fiscal history of a people is above all an essential part of its general history” (1918).

Basically, a huge surge of inflows of FDI after the ‘Brady-bonds’ agreement and the beginning of economic reform — reaching an average of US\$ 75 billion a year between 1988 and 2010 (in 2010-US\$; ECLAC, 2012) — has been associated with a remarkably poor rate of investment (as a share of GDP). In fact, despite the growth-acceleration in many countries after the post-2003 commodity-price boom and the new surge in inflows, as well as the rapid recovery after the 2008 crisis, by 2010 the average investment-share of the region was still in its (already disappointing) ‘Brady-bonds’ starting point (1988) — with Brazil and Venezuela, although for different reasons, lagging behind. In other words, as Figure 14 clearly indicates, in LA inflows of FDI equivalent to *US\$1.8 trillions* (1988-2010; 2010-US\$) has been associated with a rate of accumulation that is poor even from the perspective of its inadequate historical record — on average 19% of GDP (ECLAC, 2012; see also Palma, 2012).<sup>15</sup>

So, again, not much support here for the mainstream proposition that DCs are full of investment opportunities, just waiting for the availability of finance (which, supposedly, can only come from rich countries and not from the high proportion of the national income appropriated by their élites). And significant support for the Keynesian proposition that the mere availability of finance does not lead by itself to higher levels of investment.

So the usual argument that one of the main reasons why LA needs capital inflows is because its many investment opportunities are constrained by finance is rather hollow. It is not that LA lacks investment opportunities (e.g., those associated with forward and backward linkages of commodity production); the issue that still needs a more elaborate answer is why is it that neither domestic nor foreign capital shows much interest in taking advantage of them? And, again, post-reform LA has shown little support for the mainstream argument that says that all that is required for the happy union between these investment opportunities and foreign finance are ‘prices right’ and ‘institutions right’. The experience of East Asia shows

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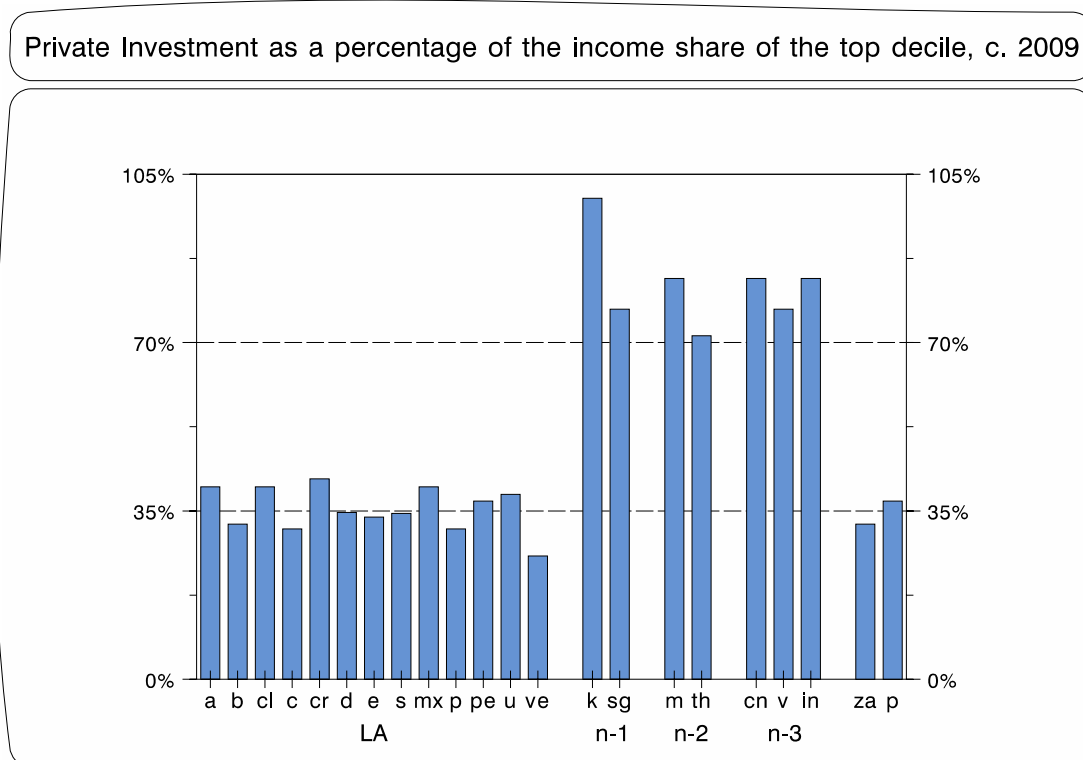
<sup>15</sup> Part of this phenomenon is the fairly unimpressive rôle of mostly rentier Spanish multinationals, only able to operate in (protected) non-tradable activities (including domestic finance and utilities). To paraphrase Oscar Wilde, for LA to have been conquered by Spain once may be regarded as a misfortune; twice looks like carelessness.

that effective trade and industrial policies, pro-growth macros, and so on are probably more relevant.

Keith Griffin once wrote that foreign aid may well end up simply *substituting* domestic savings (Griffin, 1970); well, post-reform LA seems to indicate that in DCs FDI also could have a strong substituting effect on national private investment — except, of course, in Asia.

However, what is still unclear is why (despite the huge share of national income appropriated by the top earners, well-defined and enforced property-rights, ‘pro-market’ reforms, and a tsunami of FDI) every time private investment in LA manages to rise much above 15% of GDP its capitalist élite starts experiencing feelings of vertigo. From this perspective, the most striking political-economy difference between LA and Asia is found in their contrasting relationships between investment and income distribution (Figure 15).

FIGURE 15



● **n-1** = first tier NICs; **n-2** = second-tier NICs; **n-3** = third-tier NICs, and **a** = Argentina; **b** = Brazil; **cl** = Chile; **c** = Colombia; **cr** = Costa Rica; **d** = Dominican Republic; **e** = Ecuador; **s** = El Salvador; **mx** = Mexico; **p** = Paraguay; **pe** = Peru; **u** = Uruguay; **ve** = Venezuela; **k** = Korea; **sg** = Singapore; **m** = Malaysia; **th** = Thailand; **cn** = China; **v** = Vietnam; **in** = India; **za** = South Africa; and **P** = Philippines.

● **Sources:** for income distribution, WDI (2012); for private investment IMF (2012b). See also TDR (2006).

It is often acknowledged that the only historical legitimacy of capitalism — i.e., the legitimacy of a small *élite* to appropriate such a large proportion of the social product — rests on the capacity of this *élite* to develop society's productive forces. And they can do so mainly by reinvesting most of that huge share. So, no other statistic seems to reflect so neatly the difference in the nature of capitalism in LA and most of Asia than that of Figure 15 — while in LA this ratio hovers around 35%, in most of Asia it has a value of at least double that level, with Korea's above 1! That is, while in LA private investment (which usually hovers around 15% of GDP) accounts for only one-third of the income-share of the top decile (about 45% of national income), in most of Asia this ratio jumps to more than twice that level. In other words, while LA's top deciles appropriates *twice* as much as those of Korea and Taiwan, LA's share of private investment in GDP reaches *half* the East Asian levels. From my own perspective, this is *the* most crucial characteristic of the (sub-prime) nature of LA's capitalism: what I like to call the "two-times-half-style capitalism" — i.e., how to create an institutional environment in which one can get twice as much, with half the effort.<sup>16</sup> And FDI, instead of making a positive impact on that asymmetry, has been happy to accommodate.<sup>17</sup>

Figure 15 also shows that in South Africa (in this respect, LA's honorary middle-income country in Africa), and in The Philippines (the honorary one in Asia) similar low ratios as those of LA for private investment as a proportion of the income share of the top decile indicate that their capitalist *élites* have the same Latin preference for having their cake and eating it... Also, as discussed in detail in Palma (2009c), it seems that now with globalisation there is some 'Latin-contagion' going around, as LA is now exporting some crucial features of its political settlement and distributional outcome to the US (see Palma, 2009c). In the latter country, private investment as a percentage of the income share of the top decile has fallen from about half (before 1980s' Reagan) to a more relaxed Latin level of about only a third. Also, what happened in Florida during the 2000 presidential election and in Ohio in

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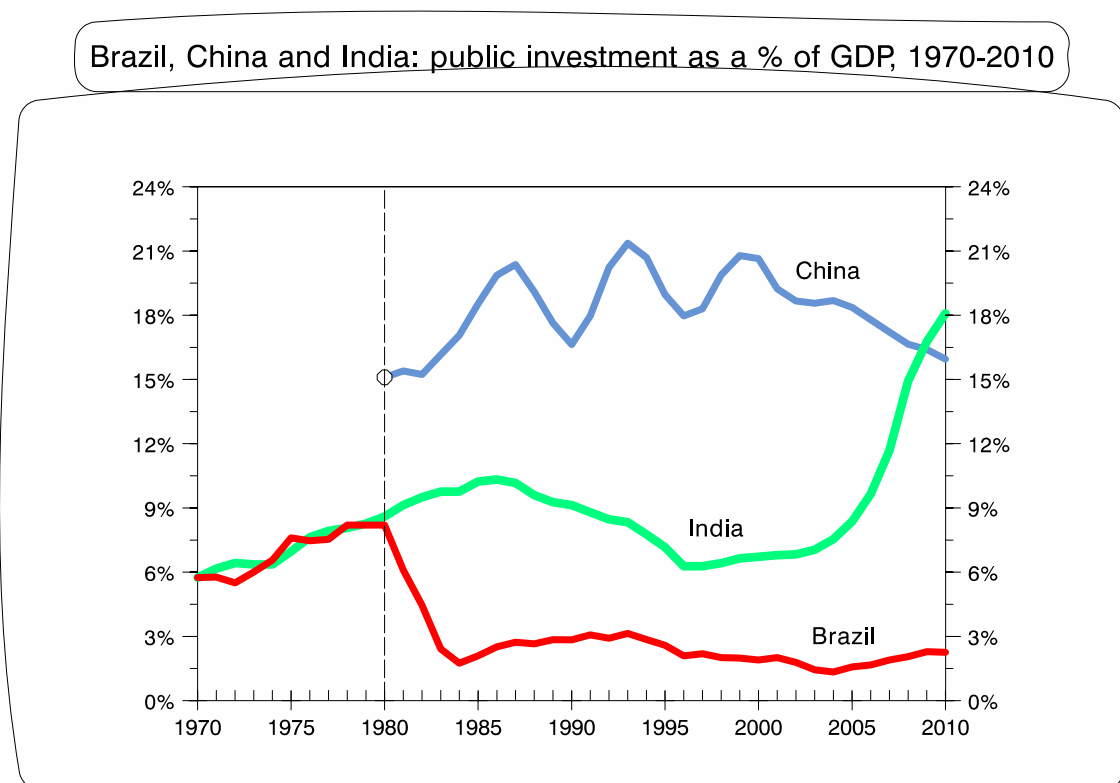
<sup>16</sup> TFP aficionados, however, may well argue that there is a positive twist in this.

<sup>17</sup> For example, the share of LA in Banco Santander's worldwide profits is twice that of its assets, while in its European operations it is exactly the other way round.

that of 2004, and all the corruption uncovered in Wall Street after the 2008 global financial crisis maybe are just the sign of things to come in the US — as the electoral fraud engineered there could have come straight from the PRI's toolbox across the Rio Grande, and the corruption in financial markets straight from LA's privatisation extravaganza. In other words, and as opposed to Marx's prediction, now it is the less developed countries that seem to be showing the more industrialized ones the image of their own future.

Figure 16 shows one of the key components of the poor investment effort in LA after neo-liberal reforms — the collapse of public investment.

FIGURE 16



- **Sources:** IMF (2012b; data for China available only from 1980).

One of the stated aims of neo-liberal reform in LA (but certainly not in Asia) is to tie the hands of governments in terms of their capacity to create (what the mainstream

likes to call) ‘artificial’ rents. In LA, however, neo-liberal reforms have only succeeded in tying government hands in terms of public investment. Basically, in a context of low public revenues, the squeeze of public investment becomes the only mechanism to square public finances. Meanwhile, all sorts of ‘growth-hindering’ rents (such as those resulting from lack of proper competition policy) and corruption continued unabated. In essence, a low (and remarkably regressive) tax intake — on average less than half the OECD level in terms of share of GDP — and an emphasis on balanced budgets left little room for public investment.<sup>18</sup> And in the case of Brazil, the only Latin American country with a level of public revenues close to that of OECD countries, higher a tax-intake has been neutralised by the servicing a huge public debt — a debt acquired mostly as a result of the mismanagement of financial reforms and political corruption (especially the huge amounts paid by the Cardoso government to get the constitutional reforms that were necessary to allow for the re-election of the President; see Palma, 2006). So, in essence, there is no difference between Brazil and the rest of the region in terms of what one could call the low ‘net’ tax-intake (i.e., excluding what is used for the service of public debt). Therefore, and not surprisingly given the level of its public debt, the collapse of Brazil’s public investment after 1980 is similar to the one found in other Latin American countries after 1980 — with most public sectors in the region investing only around 3% of GDP (see IMF, 2012b, and Palma, 2110). In other words, this collapse took place as much in economies with relatively high tax intake (Brazil) as in those where this was particularly low (Mexico, with just 12% of GDP for non-oil taxes). Unsurprisingly, crumbling infrastructure and shortages of complementary capital have become major constraints for growth. Chile at least invested in infrastructure via ‘private concessions’.

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<sup>18</sup> In some Latin American countries, taxation is not just low, but it is so regressive that income distribution ends up being even more unequal *after* taxes. In the European Union, meanwhile, the GINI index improves by a range between 18 to 22 percentage points when taxes and all forms of government transfers are taken into account. In LA, instead, the GINI index improves at best by 2 percentage points; see Goñi, et. al. (2009). See also Di John (2007 and 2009).

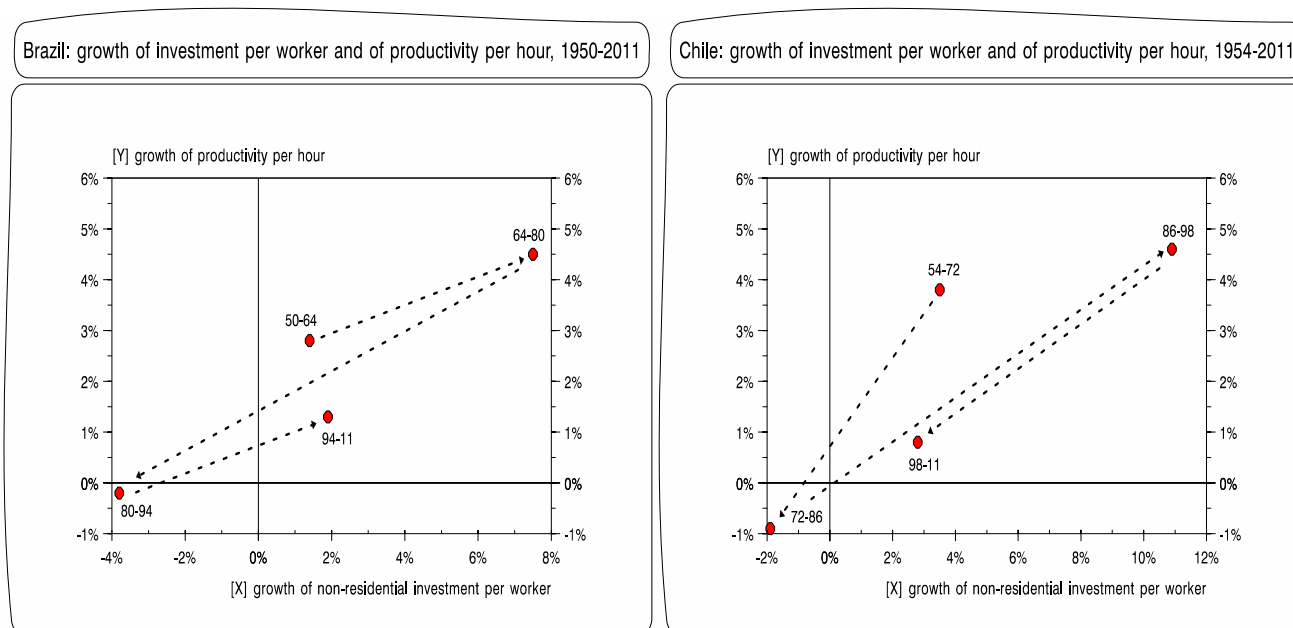


## 7.— The crucial relationship between investment and productivity growth: the economy’s engine-room

The most robust statistical relationship between the growth of investment and productivity is found between *non-residential* investment per worker and productivity *per hour worked*. Not only is there a strong correlation between the two (stationary) series, but also (via an autoregressive distributed lag model that allows for more complex dynamics in the data) investment is found to have a large — and highly significant — impact multiplier. In Brazil, for example, during the period 1960-2010 the  $R^2$  is 68%, and the impact multiplier is 0.4 (with a ‘t’ statistic of 9).

Figure 17 summarises the related growth cycle in two economies with at least one period of (Asian-pace) dynamic growth: Brazil (1964-1980), and Chile (1986-1998).<sup>19</sup>

FIGURE 17



- **[Y]** = vertical axis; and **[X]** = horizontal axis. Each observation indicates the average rate of growth for both variables during the respective period.
- **Sources:** for productivity and employment, GGDC (2012); for investment, WDI (2012). To obtain the non-residential component of investment, I have multiplied

<sup>19</sup> In Chile, I have chosen 1986 as the starting date of the high growth period because after the 1982 crisis the economy only recovered its pre-1982 level of GDP in 1987.

the WDI data on total investment by the share of non-residential investment in Hofman (2000; this author provided the necessary updates).

Of the many intriguing issues arising from Figure 17, three are revealing: first, unsurprisingly, the periods of rapid productivity growth are associated with high (non-residential) investment growth.<sup>20</sup> Second, when (for different reasons) investment declined, productivity growth did not just decline, but actually *collapsed*. Finally, although in both countries the growth of investment per worker in the last period resembles that in the first, productivity growth per hour worked is significantly lower.

So, in most of the region today investment per worker is below, or at best similar to 30 years ago, and the unintended consequence of ‘tight’ monetary policy (making sure that labour markets never even begin to get tight) is to preserve this ‘market failure’. Unless governments get serious in achieving East Asian levels of public investment, and in implementing East Asian-style trade and industrial policies, more growth-enhancing macros, more effective market compulsions and other forms of ‘disciplining’ the capitalist élite, it is difficult to envisage a breakthrough. Unique specific circumstances may have helped some countries to break temporarily with this dynamic (like the rather unusual transition to democracy in Chile), but perhaps it is unsurprising that after a relatively short period they have returned to the fold, their burst of investment and of productivity growth having fizzled out. In the case of Brazil, for example, and despite the current growing euphoria (and what Ortega y Gasset would have probably called an abundance of “self-satisfied individuals”), there is so far little concrete evidence that Brazil’s current (and well-publicised) growth-acceleration could prove to be the exception to this rule. In fact, even at the peak of Brazil’s short-lived recovery, mixed with the good news, there were already indications that its three main economic problems continued unabated: investment was already losing momentum; imports were growing significantly faster than exports; and manufacturing continued to fall behind other activities — as a share of GDP, in 2010 (the year of the greatest euphoria)

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<sup>20</sup> For Kaleckian growth-dynamics, see Taylor (2010); and Ocampo, Rada and Taylor (2009).

manufacturing had one of the lowest share in GDP since the end of the Second World War (15.7%; a share that was less than half the level of the late 1970s and 1980s) — and by 2011 this share fell again to 14.5%, a level similar to that in 1956 (i.e., at the time of the election of ‘JK’ as president, and the beginning of the emphasis on large scale industrialisation (<http://www.ipeadata.gov.br/>)).<sup>21</sup> But at times of economic jubilation, minor ‘inconveniences’ like these don’t really take the sparkle out of the congratulatory champagne...

#### 8.- The analytics of economic growth in Latin America

As far as LA is concerned, there are at least two ways of understanding the intriguing relationship between employment, productivity, investment and growth. One is the (neo)structuralist view, postulating that in the absence of a binding foreign exchange constraint, output growth is largely driven by effective demand. The emphasis here is that the starting point for understanding low productivity growth is deficient effective demand. The resulting sluggish output growth leads to modest labour absorption in the ‘modern’ (higher-productivity) sector, and to the necessity of high labour absorption in (low-productivity) services — mostly via the informal sector. The inevitable end result is low *overall* productivity growth (see Ocampo, 2004; and Ocampo, Rada and Taylor, 2009). So, slow aggregate productivity growth is understood mostly as a low-effective-demand/low-GDP-growth problem leading to increased informality, rather than as a Kaleckian-low-investment phenomenon. On such ‘Pasinetti grounds’, a high employment elasticity is a *derived* measure.

However, among other things, those working from this perspective still need to explain why is it that in other parts of the world (South Africa is just one obvious example) low effective demand/low GDP growth leads to relatively fast productivity growth and high unemployment, rather than to LA’s relative stagnant productivity and low unemployment (and the resulting high-employment elasticities)? Also, if their analysis is right, and in the absence of a foreign exchange constraint lack of

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<sup>21</sup> Juscelino Kubitschek, often known as ‘JK’, was the Brazilian President (of Czech Roma origin) that in 1956 launched the ‘Plan of National Development’, with its emphasis on rapid industrialisation.

sufficient effective demand is where the productivity problems start, in their work it is not really clear why is it that LA (but not Asia) has been saddled with sluggish effective demand since economic reform. Can it really all be due to just a fundamentalist macro?

There is an alternative perspective on the ‘causality question’, which is the one suggested in this paper. Even though some of the above (neo-structuralist) mechanisms may well also be at play, my view emphasises a converse logic: there are analytical and statistical reasons for arguing that the starting-point is not deficient effective demand — somehow *exogenously* determined somewhere else in the economy — leading to low GDP growth/low employment creation in the ‘modern’ sector, but *the political economy of the labour market* (reinforced by that of public finance). High employment elasticities are not the end result but *the starting point* of the analysis. Here the dynamics run mostly from high employment elasticities to low productivity growth via an alternative ‘Cambridge-connection’ — especially those of Marshall, Kalecki, Joan Robinson and Salter. In essence, I shall argue that what could be called ‘excessive-labour-market-flexibility’ is a key foundation for both LA’s poor productivity, *and* low GDP growth performances — mostly via its negative impact on investment per worker, and efficiency wages. The (non-linear) relationship of Figure 12 is also more significant when employment elasticity is the explanatory variable.

From this perspective, two different dynamics (leading to structural heterogeneity) are at work. On the one hand, in many commodities and in a few industrial and service activities openness and international competition have launched more interesting effective demand-investment-productivity growth dynamics.<sup>22</sup> However, in the (more protected) bulk of the economy there is a very different reality. In LA, unemployment rates may be relatively low, but this does not

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<sup>22</sup> Within this context of ‘structural heterogeneity’, LA has developed two types of successful ‘modern’-sector regional oligopolies: those involved in large-scale capital-intensive commodity production for exports, and those that have mastered the technique of organising low-value-added labour-intensive production chains — sometimes for exports (mostly agricultural products), and sometimes in services (eg. retail). Their success has made the entry by foreign firms into the latter markets difficult; it is only when these regional oligopolies need new technologies that they get a foreign partner (rather than making the creative effort themselves) — see Robinson (2008).

mean that labour markets are tight: the labour force still grows fast by new entrants; in most countries the primary sector and often also manufacturing keep shedding labour; and there is a large 'reserve army' in the informal sector. Consequently, this dominant part of the economy (typically more than two-thirds) can operate with a remarkably elastic supply of labour and little pressure on wages, investment per worker and productivity growth. In other words, this bulk of the economy can operate with few *compulsions* for investment and productivity growth thanks to 'flexible' labour markets, natural protection, and a (typically) high degree of oligopolistic concentration.<sup>23</sup> In other words, if in the bulk of the economy there is the option to increase output mostly by adding employment, what would be the incentive — let alone the *compulsion* — to invest, particularly in terms of investment *per worker*? Moreover, as there is little upward pressure on wages what would give a Marshallian efficiency-wage dynamic a chance? As Joan Robinson analysed long ago in her criticism of the supposed 'exogeneity' of the variables making up the Harrod–Domar model, the incentives for investment and productivity growth would only really kick in when the labour market gets tight.

Furthermore, as labour-intensive techniques in manufacturing have been mastered in low-income Asia — where wages are even lower and labour is in abundance — LA cannot compete in low-wage labour-intensive manufacturing anymore (except when its geographical location and US's trade treaties favour 'maquila' activities). In LA, therefore, services, both formal and informal (and construction) are the only employment-answer. At the same time (and very importantly), in relatively high middle-income countries there is also an insatiable (and often highly income-elastic) demand for low-cost low-productivity services.<sup>24</sup> In low-income Asia, meanwhile, more growth-enhancing labour-intensive manufacturing provides the higher employment-GDP-growth-outlet. Bangladesh is a

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<sup>23</sup> As the head of Chile's largest holding company and former President of the Confederation of Chilean Industry explains, "in Chile [...] there are usually not more than three firms per sector. One can see this in pharmacies, supermarkets and most other activities. [...] Today we have the paradox that the world is moving towards democracy, but in Chile the movement in the economic sphere is towards the opposite direction ..." ([http://www. Atinachile.cl/node/4629](http://www.Atinachile.cl/node/4629); my translation. See also below).

<sup>24</sup> Although sometimes these activities are 'low-productivity' due to the peculiar way in which output in services is measured in national accounts.

good example of this, with its labour market more ‘flexible’ than India’s, and an official minimum wages of less than US\$2 a day.<sup>25</sup> So, Bangladesh follows a typical Lewis-model (2 million workers have been absorbed by the export-garment industry alone in recent years), but LA (in the bulk of the economy) follows an atypical one: there is high labour-absorption, but labour is being transferred to little or no productivity-growth-potential services — sometimes even *from* manufacturing (due to rapid de-industrialisation; see Palma, 2005b and Section 10 below).

LA’s abysmal rates of productivity growth in services since 1980 — on average, either zero (Chile and Colombia) or negative (rest of the region) — are clearly not shared by the Asian countries discussed so far (India 4%, Taiwan 3.7%, Singapore 3.6%, Malaysia 3.5%, Indonesia 2.4%, Hong Kong 2.3%, Korea and Thailand 1%). In the latter countries, (among other factors) a rapid growth in manufacturing helps by pulling productivity growth in services *à la* Hirschman — as was the case in LA before 1980 — and high public investment in infrastructure has the same effect.<sup>26</sup> These two factors goes a long way to explaining the differences in the *overall* productivity growth rates between both regions.

In sum, from my perspective, one piece of the puzzle that the structuralist analysis clearly underestimates is that in LA low productivity growth is not just a low-effective-demand/low-GDP-growth phenomenon limiting the capacity of the ‘modern’ sector to absorb additional labour — with high-employment-absorption-‘informality’ coming to the rescue, like the cavalry in every good old Western (the structuralist model). It is mainly the result of the political economy of LA’s labour markets, low levels of private investment (despite huge inequalities and abundant finance — but low ‘compulsions’), and (a mostly low tax collection related) low public investment, all *endogenising* sluggish output growth.<sup>27</sup> The resulting

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<sup>25</sup> After months of violent protests over poor pay and conditions, in July 2010 the official minimum wage was increased to 3,000 takas a month (US\$45), up from 1,662 takas (US\$25) — the first raise since 2006. Many international clothing companies, such as Wal-Mart, Tesco, H&M, Zara, Carrefour, Gap, Metro, JCPenney, Marks & Spencer, Kohl’s, Levi Strauss and Tommy Hilfiger, import in bulk from Bangladesh.

<sup>26</sup> For the case of Brazil before 1980, see Figure 5, Panel A above. China’s unreliable sectoral employment data makes it difficult to have a firm estimate of the rate of growth of productivity in services, but all indications are that its rate is at least as high as that of India.

<sup>27</sup> In *net*-terms, in most of LA investment in infrastructure and business construction was remarkably

productivity growth rates may be poor, but there is a relatively stable low-intensity dynamic that the ‘invisible hand’ finds it difficult to break.<sup>28</sup> This, together with peculiar politics (particularly when the ‘new’ left is involved), has led to political settlements characterised by ‘low-intensity’ Nash equilibria (Palma, 2009c, and Palma, 2010). And where something different has been attempted, as in Venezuela, the results have been rather disastrous.

Ultimately, in Brazil — as in most of LA — the commodity boom (helped by unprecedented favourable prices) has provided the foreign exchange; services have generated the precarious, low-productivity and low-wage employment (both formal and informal); while financial markets have provided all the fun.<sup>29</sup>

So, what is really wrong in post-reform LA is that neither the really ‘modern’ sector (usually associated with large-scale commodity production, although in Mexico also with its *non*-maquila manufacturing exports, and in Brazil with many of its ‘BNDES-encouraged’ manufacturing), nor the rest of the formal economy (mostly oriented towards the domestic market, although lately more regionally oriented), or (unsurprisingly) the informal sector are able to generate much of what really matters for the complexities of economic growth — i.e., the externalities and the spill-over effects that may help set in motion processes of cumulative causation that take advantage of dynamic economies of scale, increasing returns, etc.<sup>30</sup> That is, those issues which are central to the ‘how-one-thing-leads-to-another’ Hirschmanian growth-philosophy when dealing with such intricate market structures as those that characterise developing countries — complexities that get even more intricate as developing countries move to middle and high-middle income levels.

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poor (sometimes even negative), not just during the 1980s, but also after reforms; see Hofman (2000).

<sup>28</sup> Nelson was already trying to address this issue of ‘low level equilibrium traps’ in the 1950s (Nelson, 1956).

<sup>29</sup> In the five years preceding the global financial crisis (2002-2007), in LA the capitalization of the stock exchanges increased annually by 45% in real terms, bank assets by 21%, and private and public bonds by 22% and 25% (see IMF, 2012a).

<sup>30</sup> These are the kind of (difficult-to-model) issues that were usually ignored by traditional (constant-returns-cum-perfect-competition) mainstream economics, and are now tackled (but so far not very successfully) by the ‘new’ traditions in mainstream thought. In ‘new-growth’ theory, for example, growth is now normally modelled as a function of market imperfections that somehow create increasing returns in the process of technical change—but this process is still *explicitly* modelled as not-sector-specific (see, for example, Aghion and Howitt, 1998; for a critique, see Palma, 2005b).

Although neo-liberals were just about the only political group who really understood Kalecki's hypothesis that capitalism cannot endure the political consequences of sustained periods of full employment, Latin American neo-liberals have overshot in the opposite direction: capitalism with clearly insufficient labour market compulsions seems not to work very effectively either. That is, as capitalists practically need not compete with each other in the labour market, there are few market pressures coming from this direction either forcing productivity growth, or the investment levels necessary to back this up.

To perpetuate this, in most countries there is no collective bargaining, strike-breakers are legal, and sub-contracting labour (as a mechanism to bypass even timid labour legislation) is widespread — even in the public sector. At the same time, minimum wages in most countries are set at remarkably low levels (in Mexico, for example, in 2010 the value of the minimum wage was worth just one-third of its 1976 level).<sup>31</sup> In fact, the only Latin American neo-liberals that have paid some attention to Churchill's views that low wages only subsidise inefficient producers are found in the 'new' left in Chile and Brazil (as well as in Argentina after the 2001 crisis).<sup>32</sup> These countries have followed a policy of rising minimum wages and subsidies for the poor, which have not only foster effective demand, but have had a significant impact on poverty alleviation.<sup>33</sup> However, in these countries there are still activities in which workers do not have the right to a legal minimum wage, or some other basic right — domestic servants in Chile, for example, an occupation that accounts for 12% of female employment, still do not have a minimum wage, and

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<sup>31</sup> This is the value when its nominal level is deflated by the index of consumer prices; see <http://www.inegi.org.mx>; see also Palma (2005b).

<sup>32</sup> In his speech to the House of Commons proposing the legislation to create 'Trade Boards' to regulate workers' remuneration in industries with low wages (28 April 1909), for example, Churchill explained that the Boards were necessary in industries where the bargaining strength of employers greatly outweighed that of workers. According to him, "... where you have what we call sweated trades, you have no organisation, no parity of bargaining, the good employer is undercut by the bad, and the bad employer is undercut by the worst." For an analysis of the minimum wage in Britain, see <http://www.iatge.de/aktuell/veroeff/2005/gr2005-01.pdf>.

<sup>33</sup> In Chile, for example, the amount necessary to cover a 'basket of basic needs' for an average-sized family (i.e., the poverty line for the average family) fell from 4.3 minimum wages to 2.4 during the 1990s (reaching the landmark of 2 in 2005). See Palma (2011).



their legal working hours are 12 per day.<sup>34</sup> Moreover, in those activities where minimum wages do apply, they are often ignored; and even in the formal sector many workers do not have a labour contract.<sup>35</sup> And so on. Also, at the first sign of labour markets getting tight, not just 'independent' Central Banks, but also governments are quick to react. In Chile, for example, in the early 2000s when the market for domestic servants became slightly tight, and meagre wages began to increase, the government (presided over by a member of the Socialist Party) immediately opened up immigration from Peru — many things are possible in LA, but middle classes unable to afford domestic servants is not one of them.

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<sup>34</sup> According to the main household survey, in 2006 their average working week actually reached 75 hours; see <http://www.mideplan.cl/casen/>.

<sup>35</sup> In Chile, in 2000, half of the workers in non-agricultural firms that earned the minimum wage or less did not have a labour contract; see Infante, Marinakis and Velasco, (2003).

## 9.– Exports as a faltering engine of growth: the ‘middle-income export-trap’

As far as exports are concerned, LA moved from a situation in which pre-1980 exports and GDP were growing at the same pace (5.4% per annum between 1950 and 1980; ECLAC, 2012, data in US\$-2000), to one where exports grew two and a half times faster than GDP (6.8% and 2.7%) — even more in Mexico (8% and 2.6%). As in the pre-1980 ISI period income elasticities for imports were certainly higher than one, a unitary GDP-elasticity for exports created an inevitable foreign exchange constraint on growth (and a resulting accumulation of foreign debt). Therefore, a pro-exports policy re-engineering was surely inevitable. However, the one chosen has not been the most effective: while the rate of growth of exports has increased on average by half, that of GDP *fell* by two-fifth (8.1% and 3.4% for the post-1990 economic reform period, respectively — even more disproportional in Mexico; *Ibid*).<sup>36</sup> In this pro-exports policy re-engineering, the East Asian strategy of simultaneously insulating domestic markets and outwardly orienting manufacturing production was never even considered as an option.

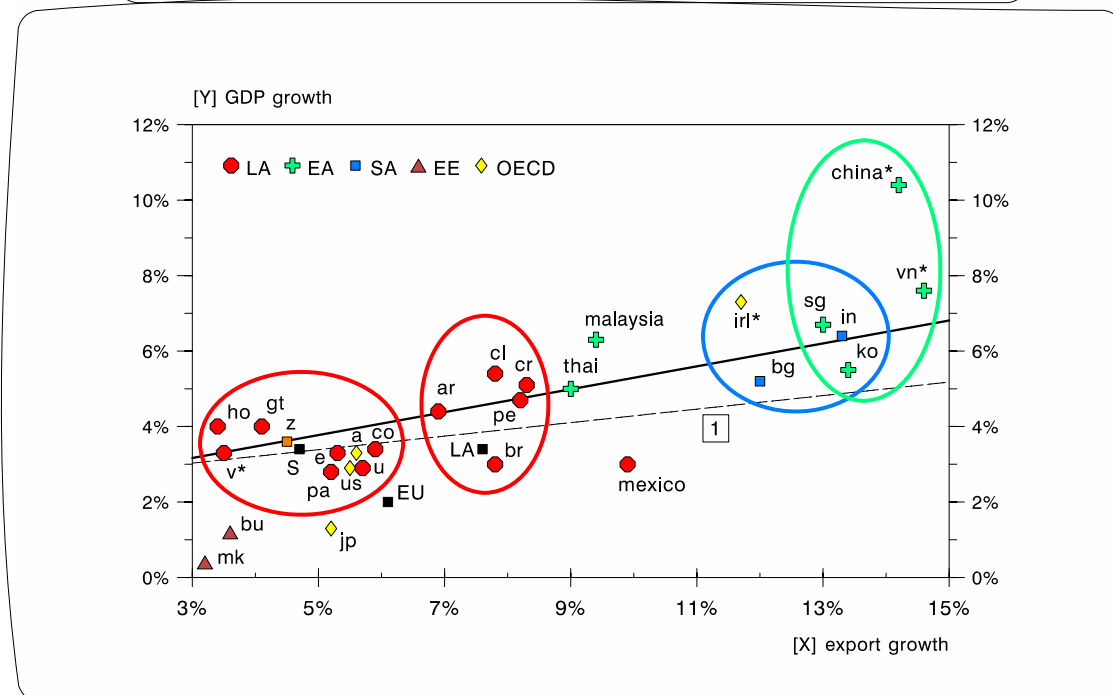
So, unsurprisingly, when comparing LA with the rest of the world the region generates a significant *negative* export-GDP dummy (highly influenced by the disappointing performance of Brazil and Mexico; see Figure 18).

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<sup>36</sup> Data in this section (and next) includes only until 2008, to avoid distortionary effect of the global financial crisis. The Latin American averages also exclude the special case of oil-rich and politically distinctive Venezuela; if included, the regional averages for 1980-2008 are 6.3% and 2.7%, respectively for the period 1980-2008 (and 7% and 3.4% for 1990-2008).

FIGURE 18

Export and GDP growth in four developing regions, 1990-2008



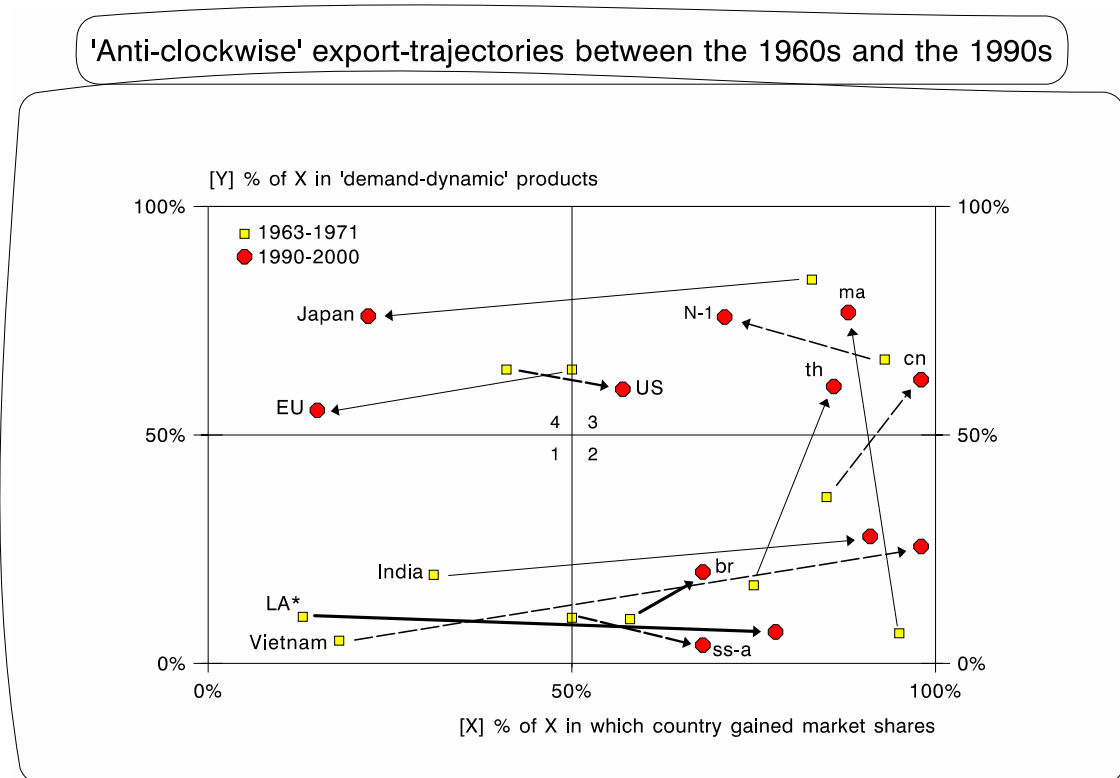
- [Y] = vertical axis; and [X] = horizontal axis. As Figure 2 and 12, and a = Australia; bu = Bulgaria; china\*, export growth = 17.1%; lt = Lithuania; mk = Macedonia; S = Sub-Saharan Africa excluding South Africa; v\* = Venezuela (exports growth = 0.2%); vn\* = Vietnam (exports growth = 19.8%); and z = South Africa (1994-2008). [1] = negative intercept dummy for LA; there are also a negative intercept dummy for the OECD and for the EE (not included in Figure). LA's average excludes Venezuela.
- $R^2 = 79\%$ , and all variables (including dummies) are significant at the 1% level (Palma, 2010).
- **Source:** WDI (2012).

There is little doubt that one of the foundations of LA's negative export-GDP-dummy is the fact that in an export-led model what matters is not only how much, but *what* one exports — and, of course, *how* does one make those exports (i.e., the question of the value added content of exports — in the Latin American context, this refers especially to the 'maquila' issue). In addition, having a non-monetarist growth-enhancing macro-policy (able to deliver both a competitive exchange rate and a sensible and stable interest rate, as in most of fast-growing Asia) also helps. The comparison between Mexico and Malaysia (or Thailand) is the most telling (see

middle of the graph) — with similar rate of growth of exports, Malaysia manages to grow twice as fast as Mexico (and Thailand half as much).

Figure 18 also indicates that in this relationship there are two different clusters in LA, with the more dynamic export group composed of Argentina, Chile, Costa Rica and Peru (followed by Brazil and Mexico, with dynamic exports but sluggish GDP growth — while their exports grew at 7.4% and 9.4%, both their GDPs grew at only 3%). Also, with the exception of the latter two countries, this small, livelier group is best represented by the base relationship (rather than the Latin American negative dummy). Figure 19 looks at the ‘quality’ of exports issue.

FIGURE 19



- **[Y]** = vertical axis = percentage of exports in *products* that were ‘demand-dynamic’ in OECD imports (i.e., products that increased their share in OECD imports during respective periods due, for example, to their higher income elasticity); and **[X]** = horizontal axis = percentage of exports in which the respective *country* or region gained market shares in OECD imports during the relevant period. That is, the vertical axis refers to product ‘quality’, and the horizontal one to countries/regions’ ‘competitiveness’. Excludes oil. **LA\*** = Argentina, Bolivia, Chile, Colombia, Ecuador, Paraguay, Peru and Uruguay (i.e., Latin America excluding Brazil, oil-exporting Venezuela, and Mexico and Central America due to maquila exports); **N-1** excludes Hong Kong. Data for Taiwan correspond to those reported in the second edition of the Trade-CAN software. Regarding Vietnam, the first observation corresponds to

the period 1973-1984 (i.e., from the date when US combat troops left Vietnam until the beginning of economic reform; Trần Văn Thọ, et al. 2000).

- **First observation:** export profile of a country or region between 1963 and 1971.
- **Second observation:** that between 1990 and 2000. If an observation is in **Quadrant 1** this indicates an ‘uncompetitive’ country (i.e., less than half its exports have gained market shares) exporting ‘non-demand-dynamic’ products (i.e., less than half its exports are ‘demand-dynamic’ products); if it is in **quadrant 2**, it shows a ‘competitive’ country exporting ‘non-demand-dynamic’ products; if in **quadrant 3**, a ‘competitive’ country exporting ‘demand-dynamic’ products; and in **quadrant 4**, an ‘uncompetitive’ country exporting ‘demand-dynamic’ products — see Appendix 3 in Palma (2009) for a more formal definition of the four quadrants.

- **Source:** Trade-CAN (2009).

This Figure shows that LA’s remarkable improvement in market shares in world trade (i.e., increased export-competitiveness) — the successful movement from quadrants 1 to 2 — was not accompanied by an improvement in the ‘quality’ of its exports (an upward movement from ‘2 to 3’).<sup>37</sup> It is well known that LA’s improved export-competitiveness did not include many ‘high-tech’ products, with their high-positive-externalities and spill-over-effects (see Palma, 2009b). Figure 19 indicates that it did not include demand-dynamic products in general. Meanwhile in EA the swift movement of the N-2 countries and China from quadrants 2 to 3 is so fast that it even eats away some degree of export-competitiveness of the N-1. This process is much more acute vis-à-vis Japan (and the EU). With the exception of the US (mostly due to the Clinton years), the overall pattern that emerges is an anti-clockwise trajectory.

For LA and other countries moving into quadrant 2, the crucial strategic trade and industrial policy issue is whether there are *endogenous* market forces that would lead them afterwards in an upward ‘2-to-3’ trajectory. Or whether there are crucial (Ricardian) market failures that would (at best) trap them into being increasingly competitive in products that tend to be marginalised (in value terms) from world markets — except for temporary cycles such as those benefiting many commodities after 9/11, and after the 2008 global financial crisis. Furthermore, especially in

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<sup>37</sup> In Palma (2009b), I show that the statistic used in Figure 19 to measure ‘demand-dynamics’ could also be considered a proxy for a product’s technological content.

commodity-markets, excessive competitive struggle for market shares often leads to a self-defeating fallacy of composition problems.

So far, there is little evidence of endogenous upward forces from '2-to-3'. Countries in quadrant 2 seem to need an East Asian-style 'exogenous push'. For these policies to be effective, however, what is also needed is an underlying power structure and institutional arrangements that would allow them to be successful (as was the case in most of Asia). These include a professional bureaucracy capable of devising a competent educational and training system that encourages the acquisition of productive capability,<sup>38</sup> as well as able to implement intelligent trade and industrial policies that generate rents as incentives for the transfer of resources towards more growth-enhancing activities (such as those with more long-term productivity growth potentials); and a state strong enough to be capable of imposing performance-related conditionalities to 'discipline' the capitalist élite to use these rents effectively. That is, a state capable of threatening non-performing companies credibly with withdrawal of subsidies.

If these policies — and the institutional arrangements necessary for their success — are not implemented in LA, the potential GDP-growth-enhancing effect of further increases in export-competitiveness would continue to be restricted by the generally low productivity growth *long-term* potential of its current export pattern, its modest positive externalities and spill-over effects, and (crucially) its low capacity to induce productivity growth elsewhere in the economy (including services).<sup>39</sup> In other words, as has become evident so far, without these policies LA's current export pattern has little capacity to generate growth-sustaining processes of *cumulative causation*. Furthermore, lack of an upward movement from '2-to-3' could seriously affect the welfare gains from trade specialization in terms of the purchasing power of exports.

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<sup>38</sup> In terms of education, LA tends to score well on quantities indicators (such as enrolment, gender, etc.), but rather badly in terms of quality. For a recent study of the weakness of the Chilean educational system, see Carnoy, at [www.stanford.edu/dept/SUSE/ICE/pdfs/Chilepaper.pdf](http://www.stanford.edu/dept/SUSE/ICE/pdfs/Chilepaper.pdf); and Waissbluth (2010).

<sup>39</sup> On the distinction between "allocative", "Schumpeterian" and "growth" efficiencies, see Dosi, Pavitt and Soete (1990), and Cimoli, Dosi, Nelson and Stiglitz (2009).

Existing evidence for LA indicates that the (not-so-)invisible hand of globalised markets are only creating incentives leading towards further penetration into quadrant 2. This ‘quadrant-2 stickiness’ is what I like to call the middle-income ‘exporter trap.’ This ‘trap’ seems to be equally relevant to those who export commodities (in terms of their capacity to increase the share of manufacturing value added in their exports, via the up and downstream manufacturing activities associated with commodity extraction and processing, as in the ‘Nordic model’), as to those who export ‘maquila-manufacturing’ (in terms of their capacity to augment the share of value added in the gross value of output, especially via an increased domestic production of inputs).<sup>40</sup> In fact, current Ricardian international comparative advantages, as Cimoli, Dosi and Stiglitz (2010) state, “are a luxury that only technological and market leaders can afford (indeed a major asset that they can exploit)”. One case in point is Chile, whose Ricardian comparative advantages led to a horizontal export trajectory (in fact, slightly downward) from quadrant 1 to 2. Its copper industry is a good example; while rapidly gaining market share, Chile has actually been *reducing* the share of manufacturing value-added in its copper exports, with the proportion of refined copper in total exports being drastically reduced in favour of the far more primitive copper ‘concentrates’ (Palma, 2009b).<sup>41</sup> Not much evidence of a Hamilton-List-Akamatsu-style logic here. There is ample evidence, however, that the sharp slowdown in Chile’s growth since the late 1990s is partly due to this under-investment in upward productive diversification (Moguillansky, 1999). Finally, the nature of regional trade agreements with the US is likely to make

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<sup>40</sup> Unfortunately, as exports are only measured in terms of gross value of output, the lack of ‘deepening’ of maquila exports cannot be shown in Figure 19. In Mexico, for example, the share of imported inputs in the gross value of production by maquila-export activities has remained constant at about 75% of the total. In fact, in this ‘end-of-value-chain-assembly-activities’ the gross value added is not only a small proportion of the value of exports, but its relative size has actually declined (see <http://www.inegi.org.mx>; and Palma (2005a).

<sup>41</sup> In Chile, the proportion of refined and ‘blister’ copper (i.e., copper that is 96 to 99% pure) has fallen from 97% of total copper exports in 1972 (i.e., before economic reforms) to about 60% in the mid-2000s — in favour of the far less processed form of copper ‘concentrates’ (with just over one third metal content). See, <http://www.cochilco.cl/english/productos/anuario.asp>; Caputo (2000); Lagos (2000); and Debrott (2001).

the '2-to-3' transition even more intricate — as opposed to Asia's Japanese and Chinese 'upward pulling' powers.<sup>42</sup>

Table 2 shows that in Brazil (and Russia) there is a similar 'regression' towards an export structure dominated by unprocessed primary products.

TABLE 2

Brazil, China, India and Russia			2000	2009
Structure of Exports				
Brazil	Primary products		24%	42%
Brazil	Manufacturing based on natural resources		24%	22%
Brazil	Manufacturing - low tech		12%	7%
Brazil	Manufacturing - medium tech		25%	19%
Brazil	Manufacturing - high tech		12%	7%
Brazil	others		3%	4%
Brazil	Total		<b>100%</b>	<b>100%</b>
China	Primary products		6%	2%
China	Manufacturing based on natural resources		10%	9%
China	Manufacturing - low tech		41%	30%
China	Manufacturing - medium tech		20%	24%
China	Manufacturing - high tech		22%	35%
China	others		1%	1%
China	Total		<b>100%</b>	<b>100%</b>
India	Primary products		14%	12%
India	Manufacturing based on natural resources		28%	32%
India	Manufacturing - low tech		39%	25%
India	Manufacturing - medium tech		11%	17%
India	Manufacturing - high tech		5%	9%
India	others		2%	5%
India	Total		<b>100%</b>	<b>100%</b>
Russian Federation	Primary products		41%	50%
Russian Federation	Manufacturing based on natural resources		26%	26%
Russian Federation	Manufacturing - low tech		5%	2%
Russian Federation	Manufacturing - medium tech		12%	9%
Russian Federation	Manufacturing - high tech		4%	2%
Russian Federation	others		12%	10%
Russian Federation	Total		<b>100%</b>	<b>100%</b>

Source: UN-COMTRADE database

In sum, export-led growth when based on relatively unprocessed primary commodities or 'thin' maquila exports has proved to be a poor engine of growth. The main lesson from post-reform LA is that if the region wants to insist on this export orientation, it should think about this model only as an export-'enabling' growth-strategy, not as an export-'led' one. That is, one in which dynamic (but not much growth-enhancing) exports can only be expected to provide the necessary foreign exchange *to enable* a fast rate of growth that is not balance-of-payments

<sup>42</sup> In the case of the N-2 countries, for example, the ('non-maquila') production of manufacturing components for export to China has had a significant effect in this direction.



constrained. However, for this growth actually to take place there is still the need for a proper 'engine' to be found elsewhere in the economy. That is, other sectors or activities that would play the role of 'production frontier shifters', able to set in motion processes of cumulative causation — characterized by their positive feedback loops into the system, and capable of generating a momentum of change which is self-perpetuating (e.g., in the Veblen/Myrdal or the Smith/Young/Kaldor manner). There is not much evidence from LA that unprocessed primary commodities or 'maquila' exports can play that role — nor that the countries of this region have made much effort toward export-upgrading or looking elsewhere for an effective engine of growth; furthermore, their 'monetarist' macro and open capital accounts have contributed to a deficient effective demand by switching a disproportionate amount of the aggregate demand towards foreign markets due to overvalued exchange rates.

As Stiglitz always insists, even from the narrow perspective of mainstream economics, in a world full of distortions the lifting of one (e.g., a trade barrier or a capital control) does not necessarily lead to a superior (let alone optimal) equilibrium. Or, as Lipsey and Lancaster demonstrated half a century ago, "if one of the Paretian optimum conditions cannot be fulfilled, a second best optimum situation is achieved only by departing from *all* other optimum conditions" (1956, p. 12, emphasis added). For example, if policy makers in LA ignore crucial distortions simply because they are out of bounds (such as Asian competitors with 'distorting' trade and industrial policies, and 'distorting' pro-growth macros) and design what they — from their mainstream perspective — consider to be 'first-best' policies (and apply, for example, flexible exchange rates, a low and flat import tariff, or abandon trade and industrial policies), then the likely outcome will not even be a 'second-best'. Additionally, if policy makers in LA keep assuming that they live in a world in which the 'efficient capital market theory' rules, and continue to implement sweeping financial deregulation and full opening of capital accounts (as if all that mattered in financial markets were market discipline and self-regulation), the likely outcome would be even more financialisation, overvalued exchange rates, and so

on. That is, rather than an outcome that is a ‘first-best’ scenario, it is more likely that there will be one visited by ‘first-class’ financial crises.<sup>43</sup>

Surely it is time to realize that free trade, Ricardian comparative advantages, fully open capital accounts, ‘flexible’ exchange rates, ‘independent’ monetary policy, regressive taxation, liberalized finance, economies on automatic pilot and policy ‘neutrality’, and so on may well be (from a logical point of view) internally coherent in mainstream power-point models, but in the real world these policies do not lead to sustainable growth. Although there is little doubt that the alternative scenario of pro-growth macros, strategic trade and industrial policies, coordination of investment, capital controls, progressive taxation, a competent educational and training system that encourages the acquisition of productive capability, and so forth are challenges as big as they come, why should it be that only low- and middle-income Asian countries are capable of mastering this complex course of action effectively? Perhaps LA’s ‘purity of belief’ is just an excuse for not even trying...

To summarize, from the perspective of their own mainstream economic thinking, perhaps the main problem with LA’s neo-liberal economists (of all political denominations) is how a rigid ideology seems to constrain their core policy-making from moving beyond a virtual world of ‘first bests’. As a famous Chicago-trained economist said in a recent interview in Chile, the main problem with Latin American market fundamentalists is “...that [their] ideology ... is blind to the common sense.”<sup>44</sup>

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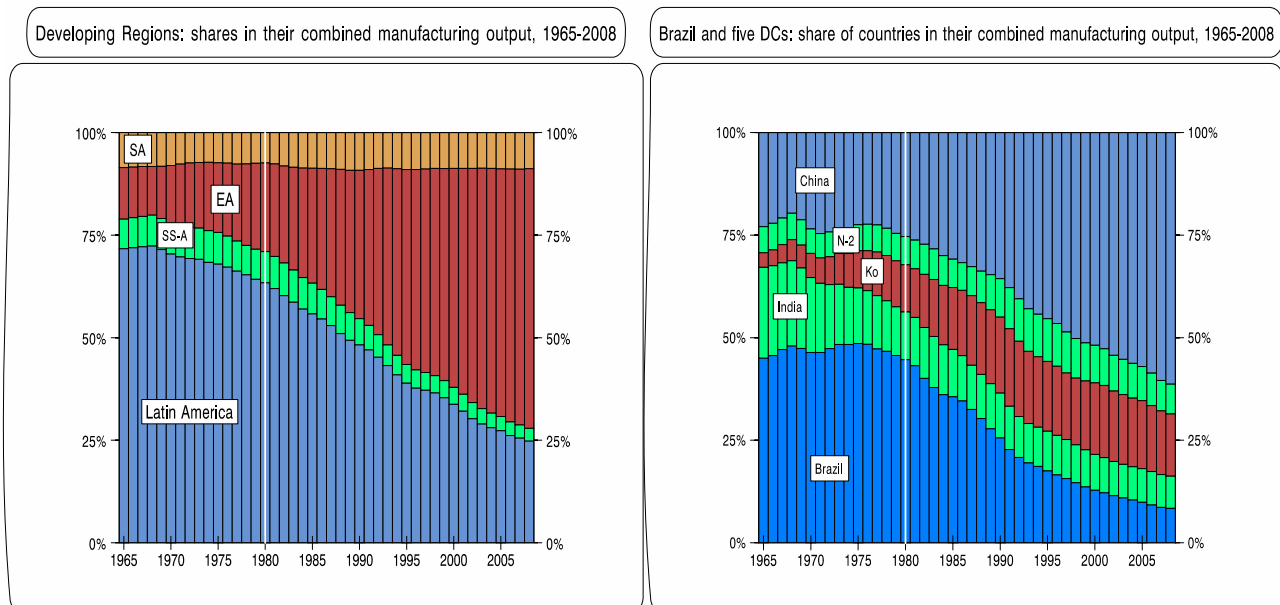
<sup>43</sup> It is quite remarkable how in LA financial policy is still inspired by the ‘efficient capital markets hypothesis’; i.e., it is still devised assuming that in financial markets prices at all times “fully reflect” all available information, so that there cannot be an *endogenous* gap between market prices and fundamentals, let alone a bubble. And that stock markets would always ‘self-correct’, because stock prices are supposed to be a ‘random walk’ — i.e., in stock markets there is no scope for profitable speculation (especially under risk neutrality) because smart market players would simply force stock prices to become rational (by taking the other side of trades if prices begin to develop a pattern, as this is bound to have no substance). In other words, for the efficient market theology a ‘rational surfer’ is not one who has fun riding waves, but one who gets drowned trying to create undertows!

<sup>44</sup> See interview with Martin Carnoy, Professor of Economics and Education at Stanford University, June 2010, in <http://www.elmostrador.cl/noticias/pais/2010/06/24/%E2%80%99Cla-competencia-en-educacion-es-una-locura-de-la-derecha%E2%80%9D/>. For his paper on Chile, see [www.stanford.edu/dept/SUSE/ICE/pdfs/Chilepaper.pdf](http://www.stanford.edu/dept/SUSE/ICE/pdfs/Chilepaper.pdf).

## 10.- Manufacturing as a faltering engine of growth due to Latin America's premature de-industrialisation

It's hard to believe today that during the 1960s and 1970s LA was the undisputed manufacturing powerhouse of the South, responsible for nearly three of every four dollars of manufacturing value-added generated there (Figure 20, left-hand panel). Although its share began to fall in the 1970s due to some inevitable catching-up from late-starters, this process accelerated after 1980 in such a way that by 2008 LA's share represented just one-fourth of the total — and adding Taiwan to East Asia (not included in the WDI database), just one-fifth. As South Asia has kept its share almost intact, and as Sub-Saharan Africa represents a small (and declining) proportion of the total, what was really going on was a switching of position between LA and East Asia. That is, when the inevitable catching-up from Asian late-starters began to take place properly, LA — especially Brazil — instead of putting up a fight, threw in the towel...

FIGURE 20



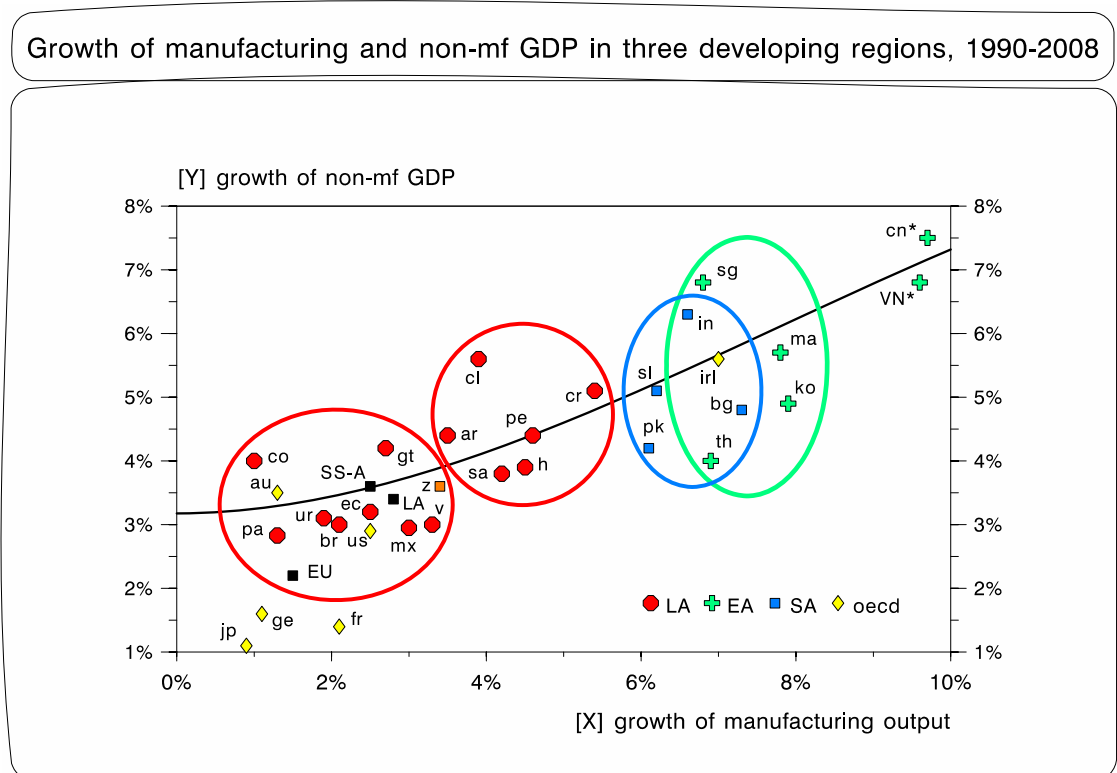
- Regions according to WDI definitions; **DCs** = developing countries; **EA** = East Asia; **ko** = Korea; **N-2** = Malaysia and Thailand; **SA** = South Asia; and **SS-A** = Sub-Saharan Africa.

- **Source:** WDI (2012; data are only available from 1965 for most countries and regions).

LA's relative decline is particularly acute in the case of Brazil (right-hand panel). By the mid-1970s Brazil's manufacturing output (US\$ 56 billion) was almost identical to the combined output of China, India, Korea, Malaysia and Thailand (US\$ 57.8 billion). By 2008 its manufacturing output (US\$ 121 billion) was equivalent to less than 10% the combined output of the other 5 Asian countries (US\$ 1.4 trillion; WDI, 2010; data in constant 2000-US\$). This turnaround took place because while Brazil's manufacturing output grew at roughly the same pace as the combined output of these Asian countries between 1965 and 1980 (9.5% and 9.2%, respectively), between 1980 and 2008 it did so at just one fifth the Asian rate (1.9% and 9.8%, respectively — 2.1% and 10.1% for the post-1990 economic reform period). In other words, while the combined manufacturing output of the five Asian countries continued to grow at roughly the same pace after 1980 as it had done previously (9.2% and 9.8%, respectively), Brazil's rate collapsed by four fifths (from 9.5% to just 1.9%). Perhaps this remarkable process of de-industrialisation is what the President of the Brazilian Central Bank wanted to unleash when he declared in 1996 (see introduction) that the main aim of the economic reforms in his country was 'to undo forty years of stupidity'...

In turn, Figure 21 shows the relationship between the growth of manufacturing and that of non-manufacturing GDP since 1990.

FIGURE 21



- [Y] = vertical axis; and [X] = horizontal axis. **mf** = manufacturing.
- Regions: as Figure 20; and **SS-A** = Sub-Saharan Africa excluding South Africa.
- Countries: acronyms as Figure 2 and 12; and **cn\*** = manufacturing growth of China = 12.3%; **h** = Honduras; **fr** = France; **ge** = Germany; **pk** = Pakistan; **v** = Venezuela; **VN\*** = manufacturing growth of Vietnam = 11.2%; and **z** = South Africa (1994-2008). There are negative intercept and slope dummies for the EU, Eastern Europe, and Sub-Saharan Africa not shown in the graph.
- $R^2 = 71\%$ ; all variables are significant at the 1% level (see Palma, 2010).
- **Source:** WDI (2010; some Eastern European countries only have data available from 1995). For Ireland, UN (2010), and for Taiwan, Taiwan (2010).

In manufacturing (unlike in exports) LA is best represented by the base regression (i.e., there is no significant Latin American dummy) — i.e., generally poor performance in manufacturing is linked to similarly poor performance in GDP — as opposed to the EU, Eastern Europe and Sub-Saharan Africa, where their even poorer performance in manufacturing generate three different negative regional dummies. As in exports, there is a slightly better cluster — but this time it does not include Brazil! This is made up of Argentina, Chile, Costa Rica and Peru (this time followed by the ‘maquila’ countries of Honduras and El Salvador). In addition, the most robust

specification for this relationship tends to confirm ‘Kaldorian’ dynamic increasing returns in manufacturing; that was not the case for the (linear) export regression.

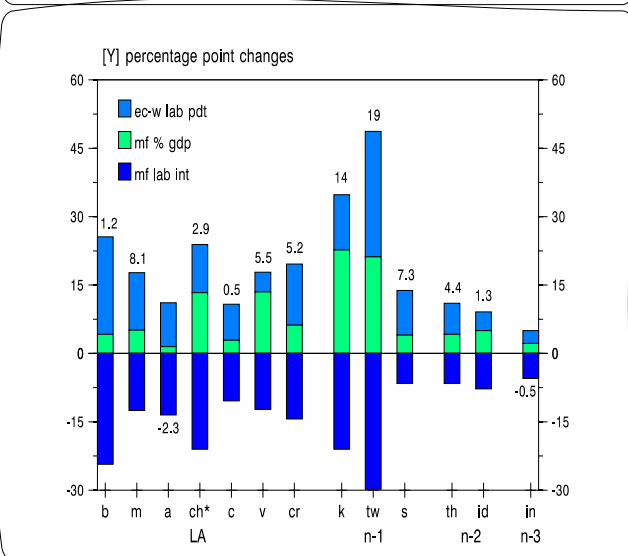
Together with low rates of investment (including in services and infrastructure) and lack of upward export capacity diversification, there is little doubt that the remarkable neglect of manufacturing since economic reforms lies at the heart of LA’s productivity problem, especially its long-term *sustainability*.

Finally, Figure 22 builds on my previous work on de-industrialisation (Palma, 2005b, and 2008), this time using an imaginative de-composition methodology, which disaggregates the changes in the share of manufacturing employment into its three main components — the economy-wide labour productivity, the share of manufacturing in GDP, and the labour intensity in manufacturing (i.e., the inverse of labour productivity; see Tregenna, 2009).

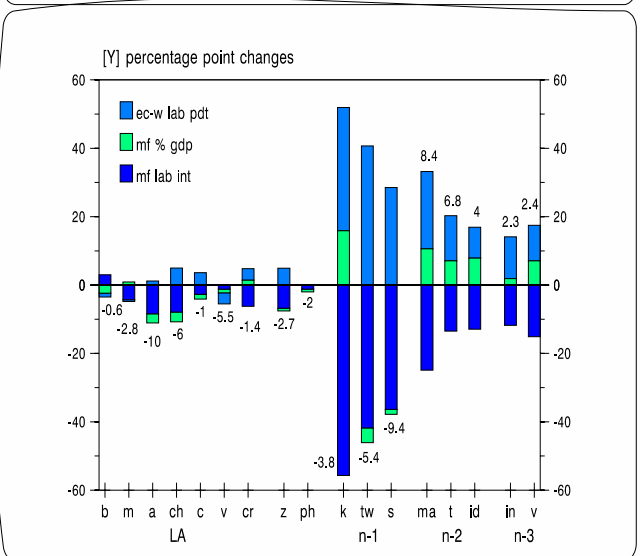
FIGURE 22

Latin America: the neglect of manufacturing and the post-1980 process of de-industrialization

Changes in the share of mf employment: a three-way decomposition analysis, 1950-80



Changes in the share of mf employment: a three-way decomposition analysis, 1980-2007



● [Y] = vertical axis; and [X] = horizontal axis. **mf** = manufacturing. **ec-w lab pdt** = economy-wide labour productivity; **mf % gdp** = the share of manufacturing in GDP; **mf lab int** = labour intensity in manufacturing (the inverse of labour productivity). Percentages shown above each bar are the overall percentage change in the share of manufacturing in total employment (the net effect of the three processes at work); when the figure is negative, the percentage is shown below the bar.

- Countries: acronyms as Figure 2, 8 and 12, and **ch\*** = Chile (1950-73); Malaysia and Vietnam are excluded from the left-hand panel due to lack of data on manufacturing employment.
- **Sources:** for manufacturing output, WDI (2010). For Taiwan, Taiwan (2010). For manufacturing employment, GGDC (2007) and ILO (2010). Tregenna (2009) was used for the methodology in the ‘three-way decomposition’ analysis.

The main findings in Figure 22 are: first, with the exception of Argentina, in LA between 1950 and 1980 changes in the share of employment in manufacturing were all positive, and were the outcome of large changes in its three components. These changes were not as large as those of Korea and Taiwan, but were larger than those of Singapore, Thailand, Indonesia and India (see left-hand panel). Second, that LA’s *overall* post-1980 decline in the share of manufacturing employment is similar to those of much more advanced, much higher income per capita, N-1 economies (as opposed to the positive changes that took place in Asian countries with more similar levels of income per capita — the N-2; see negative figures below the bars in the right-hand panel). Third, LA’s post-1980 decline in the share of employment in manufacturing, although similar in size to those in the N-1 countries, was the result of forces of a *very* different nature. The remarkably small change in the three components of manufacturing employment after trade liberalisation and neo-liberal reforms suggests that LA adopted a type of ‘standing still’ defensive strategy in this respect. And fourth, as the evidence of the right-hand panel particularly suggests, that rather than referring just to the 1980s as the ‘lost decade’, as far as manufacturing is concerned (and with few exceptions, as EMBRAER) in LA the three post-1980 decades might well deserve that label.<sup>45</sup>

Part of the post-reform problem with LA’s manufacturing, of course, was due to the nature of the ISI’s legacy. ISI’s rigid system of protection (in highly-income-unequal domestic markets) resulted in many distortions, as incentives inevitably led to horizontal diversification because there were more rewards for developing new products than for productivity ‘deepening’. In this sense, despite its discourse, ISI

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<sup>45</sup> According to a senior manager of one of the major retail outlets in Chile, nearly 90% of manufacturing products currently sold in his department store are imports (see [http://diario.elmercurio.com/2010/06/23/economia\\_y\\_negocios/economia\\_y\\_negocios/noticias/35E59938-CA53-43F2-8571-088B44D979E5.htm?id={35E59938-CA53-43F2-8571-088B44D979E5}](http://diario.elmercurio.com/2010/06/23/economia_y_negocios/economia_y_negocios/noticias/35E59938-CA53-43F2-8571-088B44D979E5.htm?id={35E59938-CA53-43F2-8571-088B44D979E5})}).

did not really have a proper ‘infant industry’ agenda because its logic was not one of temporary protection to help — and push — firms to get to the frontier and become internationally competitive (Pérez, 2008; Díaz-Alejandro, 1989; and Fajnzylber, 1990). Rather, often supposedly ‘infant’ corporations (eg. General Motors, ITT, General Electric, Bayer or Nestlé) ended up protected with effective rates that sometimes reached four-digits. In fact, there was actually a ‘double play’: with big exceptions (as the already mentioned case of EMBRAER indicates), the manufacturing industry that emerged from ISI found it particularly difficult to adjust to the new open paradigm and the surge of Asia. This was made worse by the *speed* taken by trade liberalisation, and the unnecessary difficulties and distortions created by *monetarist-macros*. But what developed around ISI (including institutions, suppliers and skills) was considerable.<sup>46</sup>

After trade liberalisation LA’s (relatively fragile) manufacturing not only had to adapt hastily to a new tough internationally competitive scenario, but it had to face two further problems. On the supply side, it had to struggle against an Asian “double-squeeze”. On the one hand (and as mentioned above), as labour-intensive techniques in manufacturing had been mastered in low-income Asia — where wages are even lower, labour is in abundance, and exchange rates and interest rates are kept “artificially” at levels which are both stable and competitive — LA found it particularly difficult to compete in low-wage, labour-intensive, small-profit-margins manufacturing (except when its geographical location and US’s trade treaties created distortions that favoured ‘maquila’ activities). On the other, LA’s manufacturing also found it difficult to compete with technologically-complex, rapid-product-evolving manufacturing production from high-middle income Asian countries, with their huge investment rates, effective trade and industrial policies, ‘pro-growth’ macros, and outstanding technological-absorbing capabilities.<sup>47</sup> From this perspective, what is particularly difficult to understand is what little effort was made by Latin American countries to develop the obvious manufacturing niche available to them: the up and

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<sup>46</sup> Unfortunately, ISI was not allowed to transform the region’s political configuration either (as a normal process of industrialisation would have done) — military regimes put a stop to that.

<sup>47</sup> For three views on the rise of Asia, see Amsden (2001), Chang (2006), and Khan (2001). See also Cimoli, Dosi and Stiglitz (2009). See also Ferguson (2011).



downstream manufacturing activities associated with commodity extraction and processing.<sup>48</sup>

To summarise, LA's post-economic reform 'policy neutrality' attitude regarding manufacturing (despite the huge distortions in world trade in manufacturing) happened because supposedly 'the markets-always-know-best'; this led to a process of premature de-industrialisation without an end in sight. In other words, the naïve attitude of "let's assume that all the Paretian optimum conditions are fulfilled" (including a level playing field in international trade in manufacturing) has led to the supposed 'first-best' policies in this respect. LA's 'manufacturing-catching-up-in-reverse' (Figures 5 and 6), LA's huge relative decline in its share of manufacturing output in the South (Figure 20), and the remarkably small change in the three components of manufacturing employment after neo-liberal reforms (Figure 22) should then not come as a surprise; nor should the lack of a *sustainable* engine of growth, or the productivity slowdown. In Brazil not even an institution such as BNDS has been able to do much about it.

Added to this, on the demand side, Latin American-style neo-liberal capitalism has been characterised by a chronic deficiency of effective demand for its non-commodities tradable sector, especially manufacturing. This has been the direct outcome of the 'deadly triad' of undervalued labour, overvalued exchange rates (backed up by high interest rates), and 'sterilised' governments. These are, respectively, the direct outcome of 'flexible' labour markets, open capital accounts with 'tough' monetarist macros, and governments with their hands (institutionally) tied in terms of implementing effective counter-cyclical action and pro-active public investment.<sup>49</sup>

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<sup>48</sup> See Walker and Jourdan (2003), and Palma (2009b).

<sup>49</sup> According to a Goldman Sachs analyst, Brazil's real is currently the world's most overvalued major currency (see <http://www.bbc.co.uk/news/business-11424864>). In the same spirit, perhaps Brazil's recent (but already disappearing) growth acceleration may well be the world's most overrated boom! In turn, in the October 'Economist's Big Mac index' the real comes second (after the Swiss Franc) in terms of degree of overvaluation — 42% vis-à-vis its 'Big Mac PPP level' (or the exchange rate that would mean hamburgers cost the same in the US as in Brazil); see [http://www.economist.com/node/17257797?story\\_id=17257797](http://www.economist.com/node/17257797?story_id=17257797).

In other words, in post-reform LA there is not much evidence in manufacturing of the characteristics that have been associated in the mainstream literature with ‘high-imagination-enabling-countries’ (Friedman, 2007). Rather, evidence (particularly that in the right-hand Panel of Figure 22) points towards countries whose manufacturing sectors have been (defensively) in ‘hibernation’.

## Conclusions

In the economic literature there are three different analytics of growth, but only in one is growth analysed as a ‘sector-specific’ phenomenon (the structuralist/ Post Keynesian/heterodox tradition; see Palma, 2005b, and 2008). From this perspective, LA’s abysmal TFP-record well after economic reform should make those who believe otherwise think again. In particular, how can those in the Washington Consensus — with their emphasis on ‘getting the prices right’ and ‘getting the institutions right’ — explain that after two decades of putting into practice open capital accounts, free trade, balanced public accounts, well defined and enforced property rights, independent central banks and so on (i.e., well after having set the Latin American economies on automatic pilot and policy neutrality), LA’s TFP record can still only be described as appalling?<sup>50</sup> And the well-rehearsed argument that what is needed is yet more of the same sounds increasingly hollow.

Perhaps the main lesson from LA’s experiment with neo-liberal reforms is that the Washington Consensus is just one of the many heaps of ideological recipes still waiting for a theory relevant to the real world (or a bonfire...). How can it explain why so many in Asia do things ‘wrong’ (sometimes *very* ‘wrong’) but develop fast, while LA does almost everything ‘right’ (and with so much ‘credibility’, and scoring so high in the usual indices, such as those of ‘economic freedom’, ‘competitiveness’, and so on) but can only achieve a low-intensity growth dynamic — with all its difficulties in creating, let alone sustaining productivity growth? And why is it that the ‘invisible hand’ does not know how to break this low-intensity growth

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<sup>50</sup> Not much evidence in LA, though, of even an attempt at ‘getting the social capital right’. But this was never really part of the neo-liberal blueprint. As Mrs. Thatcher famously made it clear, from a neo-liberal perspective “there is no such a thing as society, just individuals.”

dynamic? When Keynes said that people usually prefer to fail through conventional means rather than to succeed through unconventional ones, he could not have guessed just how accurately his remarks would define LA today.

So, most of Asia gets a capitalism that is pretty unsavoury (with all its contradictions, unfairness and excuses), but one that at least is capable of developing many of the productive forces of society (despite the fact that financial markets, and sometimes also policy makers, often insist in forging ahead in the wrong direction).<sup>51</sup> LA, meanwhile, gets a neo-liberal brand of 'sub-prime' capitalism which is not even able to offer much productivity growth — i.e., as mentioned above, LA gets the cloud without the silver lining. This is mostly due to an elite that does not want to know what capitalism is really about, and a bunch of highly-trained economists who still believe that when it comes to policy making the first commandment is that one has to stick to the 'first-best'.

From the latter perspective, perhaps the key difference between LA and many countries in Asia is that policy-makers in the former still believe that the Washington Consensus is a set of ingenious tricks devised by Dumbledore, while the latter instinctively know that they actually are the work of Voldemort...

Apparently, in LA market capitalism is a system in which only workers and small firms continuously have to struggle to improve their performance just to survive; for big capital the rules of the game are more agreeable. What the new neo-liberal paradigm seems not to grasp is that it is one thing to implement reforms in

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<sup>51</sup> India, for example, is an extreme example of this. It has had 30 years of remarkably rapid GDP-growth, leading to a near six-fold increase in output. However, on the one hand, financial markets and policy makers are increasingly leading the economy into a rapid process of financialisation (with the inevitable bubbles and growing financial fragilities); and on the other, nowhere is more evident the failure of capitalist economic growth to improve the well-being of the majority of the population. In fact, according to the Multidimensional Poverty Index (an index that measures the 'deprivations' in households — from education and health to assets and services — just eight Indian states still account for more poor people than the 26 poorest African countries combined (421 million). Furthermore, the 'intensity' of the poverty in many parts of India is still today (after 30 years of rapid growth) much worse than that in Sub-Saharan Africa (see <http://www.ophi.org.uk/policy/multidimensional-poverty-index/>). The latter phenomenon has made the study of India's rapid economic growth much more difficult because many analysts (at home and abroad) have tended to confuse a well-founded *socialist critique* of India's capitalist development with the concrete analysis of how capitalism has been able to develop many of India's productive forces (on its *own terms*, 'warts and all') — for example, the average labour productivity has increased more than three-fold since 1980 — what a difference with LA! (Or by factors of 3.4 for India, and 1.1 for Brazil and the rest of LA; see GGDC, 2012).

order to create market *opportunities*, but quite another to ensure that there are sufficient market *compulsions* to guarantee that these opportunities are taken up.<sup>52</sup> As a result, LA's brand of capitalism is characterised as much by its capacity to generate market opportunities as by its ability to waste them. What LA urgently needs today is new institutions to help create both the required capabilities and the necessary compulsions for productivity growth, especially those that would help to 'discipline' the capitalist elite *à la* EA. It also needs a new structure of property rights — including well-defined and enforced rights on *skills à la* Japan or Germany.<sup>53</sup> And, of course, the ideology to back this up would also help — as Gramsci said, more often than not battles are won or lost on the field of ideology.

Added to this is the already mentioned phenomenon that Latin American-style capitalism has also been characterized by a chronic deficiency of effective demand from the 'deadly triad' of undervalued labour (due to 'flexible' labour markets), overvalued exchange rates with high interest rates (due to open capital accounts and monetarist macros), and 'sterilized' governments.

In summary, the region's growth performance since economic reform may be rather disappointing (particularly in terms of productivity-growth), but Latin American-style neo-liberal capitalism became unrivalled when it came to offering world-class commodities, an abundance of (precarious, low-productivity and low-wage) jobs, stylish retail, lucrative finance, and the 'purity of belief'. So, clearly today Brazil is no emerging 'tiger' — but the processes of 're-commoditisation' and financialisation are certainly able to create a most remarkable degree of euphoria. Paraphrasing Churchill (see sub-title), 'never in the field of economics has so much euphoria been generated by so few accomplishments'.

By now it should be obvious that 'flexible' labour markets do not transform an oligarchy into a proper capitalist class; even from a neo-liberal perspective surely one can have too much of a good thing. The same happens with the opening of capital accounts excessively reinforcing the domestic élite's 'high-appropriation-cum-little-accumulation' distributive strategies, and its long-standing biases for mobile

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<sup>52</sup> Wood (2002) and Khan (2005).

<sup>53</sup> On the necessity of adequate property rights on skills, see especially Pagano (1991).

assets. In Brazil, for example, the ‘coefficient of financialisation’ — the ratio of the stock of non-monetary financial assets to the stock of productive capital — increased from 7% at the beginning of economic reform (1991) to 40% in 2009 (See Bruno, 2010).

Some economists, like Rodrik (2007), have argued that in LA the contrast between the two periods (pre- and post-economic reform) is based on the fact that during ISI there were incentives to invest (industrial policies), but little market discipline due to lack of competition. In turn, during the reform period there was little incentive to invest, but a lot of market discipline. However, on the latter issue, I think the region is still waiting for the real thing — as the head of Chile’s largest holding company and former President of the Confederation of Chilean Industry explains, “[t]his is a market economy in name only. Competition has disappeared; mergers and acquisitions have led to a huge degree of oligopolistic concentration.” ([http:// www.atinachile.cl/node/4629](http://www.atinachile.cl/node/4629)).<sup>54</sup> Moreover, one should never forget that in many countries in EA the ‘market discipline’ part of the story has had an added ‘state discipline’ component; i.e., the ability of the state to threaten non-performing companies *credibly* with withdrawal of subsidies.

Those in heterodox circles who like to look at the Anglophone periphery as models (i.e., Ireland and New Zealand rather than Korea or Malaysia), and argue that what LA needs to be able to replicate their pattern is an industrial policy that attracts FDI to fill the more challenging technological gaps, create ‘clusters’, and so on, have something to explain: how will middle-income LA ever become a dynamic capitalist endeavour without a proper domestic capitalist class (like those found in some Asian countries)? In this respect, the weakness of post-reform FDI-intensive Mexico is particularly telling — and the little overall impact of FDI on the region’s investment (see Figure 14 above). And oddly enough, many pre-1980 structuralist thinkers made the same mistake, expecting (in vain) that FDI would be the force that would transform ISI into a more export-oriented endeavour. Despite its many

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<sup>54</sup> According to a recent study, four family-groups (including that of the current Chilean President) control 47% of the assets traded in the Chilean Stock Exchange; see <http://www.emol.com/noticias/economia/detalle/detallenoticias.asp?idnoticia=430194>.

contributions, FDI was actually part of ISI's main problem: its anti-learning bias (Pérez, 2008). In addition, even when it was the Latin American domestic firms that had contracts with foreign companies, they normally had to import the technology and use it rigidly as it came; whenever possible, they also had to import the machinery and parts. In the early 1970s Brazil may have produced more cars than the whole of developing Asia put together, but there was no *Hyundai* in sight...

Surely it is time to acknowledge that Latin American economies, some of them already well above the ten thousand dollar mark in per-capita terms, should be perfectly capable of relying on their own resources and capabilities when dealing with their main current economic challenges. But for this to happen, two obstacles need to be overcome. The first is the one facing LA's neo-liberal economists of all political persuasions: when it comes to policy making, how to abandon their 'first best' fantasy world, and stop *de facto* assuming 'complete markets', 'automatic stabilisers', 'efficient market hypotheses' and so on (i.e., how to give up their self-imposed rôle of 'keepers of the neo-liberal holly grail' — the only true believers).<sup>55</sup> The second is the one facing LA's capitalist élites: how to overcome their long-standing addiction to 'low-intensity' economic life (currently so well nourished by the discreet charm of a narcissistic ideology, and financial- and commodity-euphorias), and acquire the Schumpeterian ambitions of some of their Asian counterparts — with their Canon-style motto: 'if anybody can, we can'.

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<sup>55</sup> Otherwise, they should hardly complain if their zombie policy-making is sometimes described as being inspired by 'voodoo economics' (see, for example, Krugman, 2010). It is quite remarkable that in LA as well not only New Classical, but also New Keynesian economists still work within a 'complete markets paradigm', and with the strongest version of the 'efficient markets hypothesis' (for a critique, see Buiter, 2009).

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