Growth and Economic Reforms in Latin America: What Do We Know? What Do We Need to Know?

November 17, 2006

Eduardo Lora

Thanks to Jeromin Zettelmeyer and the organizers of this conference for the kind invitation. I want to focus on the effects of microeconomic or structural reforms on growth, leaving aside macroeconomic reforms. I am in almost complete agreement with an excellent paper by Jeromin on Growth and Reforms that should have been presented at this conference. If you have read that paper, you will see a very close relation with my views.

Let me start with some of the main things we learned in the nineties:

1. We are pretty certain that trade, finance, education, and public infrastructure are important for growth. Most of the discussion of the last decade has been not about the importance of these things –which I will call outcomes-- but about the type of reforms, or policy actions, that can improve these outcomes, and therefore raise growth. More specifically, the discussion has concentrated on the set of reforms advocated by the international financial organizations, with all their emphasis on liberalization, privatization and some forms of regulation.
2. In assessing the effects of these reforms, there are several alternative approaches. The most common one is to assume that the outcomes you observe –say trade penetration—contain information about, or directly reflect, the intensity of policy actions, say trade liberalization. This is the approach by Loayza and his colleagues. An alternative approach is the one I have pursued in a couple of papers, which consists on measuring directly the effects of the reforms on growth. The results of both approaches are roughly consistent with each other. With the direct approach, the effects of structural reforms, such as trade and financial liberalization and privatization are most likely positive, but mild and transitory. That is, they raised income levels (10 to 15 percent), but apparently they did not raise growth rates permanently. With their approach, Loayza and colleagues have

found that growth rates in the nineties were increased by about 1 percent points per year. In their estimates, reforms have permanent effects on growth.

3. There is no much evidence that complementarities between microeconomic reforms are important, in the sense that growth effects would have been different with different combinations or sequences of these reforms. However, some studies that use industry-level data suggest that labor reform –which was very timid or inexistent in most countries—would have facilitated labor reallocation after trade liberalization and therefore could have increase its growth payoff. More important are the complementarities between micro and macro reforms. We have learned that a better sequencing between microeconomic and macroeconomic reforms would have saved some countries from major growth setbacks. Especially, financial regulation should have been better established before opening up the capital account. Also, fiscal policies should have been managed in a countercyclical way at the beginning of the reform process, when growth reform rebounded after trade liberalization and privatization. Fiscal policies contributed to the initial impetus only to aggravate the ulterior deceleration.
4. We have also learned that even those reforms that looked relatively simple to implement, like trade liberalization, require a modicum of institutional support to produce good effects. This conclusion comes both from econometric estimates and from country case studies. By institutional support I mean not only administrative capabilities to implement the decisions, but also leadership, commitment and political support to make the reforms credible and sustainable. Obviously, institutional requirements were much more complex in sectors such as finance or utilities, where regulation was central to the reform process. In these cases, technical capabilities, political independence and an effective judiciary were also necessary. In a way, we have come full circle in this respect. Many of the reforms were motivated by the presumption that reducing or eliminating the role of the state was at the essence of the reform, but now it is clear that virtually every reform requires the active involvement of the state, though probably with a different role.

5. There are a few other things that we suspect are important for the success of reforms, though we know with less certainty. We suspect that expectations and culture influence the effectiveness of the reforms. If credibility is lacking, investments may be postponed or based on short term return calculations. If the electorate at large does not believe in the benefits of the market economy, will eventually elect anti-market governments, and knowing this, investors will refrain from investing since the outset. There is some empirical evidence that indicates that Latin American voters do dislike pro-market policies, but we do not understand well how this influence the reform process and the investors´ perceptions and behavior.

So much for what we have learned. Let me now mention a few things we need to know:

6. We need better measurement of policy variables. When I developed my own indices of policy reform in the mid nineties I chose variables that were easy to observe and measure and which were representative of the policy reforms that I wanted to measure. For instance, I chose import tariffs and their dispersion as the only indicators of trade liberalization not because that was the only dimension of trade liberalization that mattered, but because we found that import tariff changes were very closely associated with other aspects of trade liberalization, such as the reduction of import quotas and licenses in the countries where we had this information. And similarly in the case of financial reform, we chose interest rate liberalization as one of the few indicators because in the countries that we had studied more carefully, it had taken place simultaneously with the elimination of other restrictions to the free allocation of credit. As a result, the indices were easy to calculate but had important measurement errors. Worse still, those measurement errors surely became bigger as the reform process got along, as new dimensions of the reform process were not captured by the variables originally selected. We do not know if the weaker growth effects that we found in our more recent estimates are partly due to this bigger attenuation bias. In one paper today, the authors combined structural reform indices with information on the quality of

structural policies by the Heritage Foundation. This is one possible way to go, but there is the snag that these indicators are based on opinions, not on objective measures of policies, and we know that perceptions of the quality of policies are very procyclical, which will bias the evaluation of the impacts of policy reforms.

7. Even though I am advocating for better measurement of the policy variables, I do not think we should use growth regressions to assess the effects of reforms directly, as I and others have done. There are several criticisms to this approach. I do not share Dani Rodrik´s conclusion that "we have learned nothing from regressing economic growth on policies". However, I do agree with his argument that policies are not random, but adopted by governments to pursue objectives that cannot be distinguished. If governments were always to adopt policies in order to maximize growth, then regressions could tell us something on the efficacy of those policies. But if they have other objectives, we cannot easily infer their effect on growth. Rodrik uses the example of import tariffs. If you find a negative correlation between growth and import tariffs it might be because trade protection is bad for growth, but it may as well be because tariffs are used to protect employment when growth is slow.
8. In this respect, the growth regressions by Loayza and colleagues are less problematic. The main criticism to their work is that they use policy outcomes, rather than policy variables as explanatory variables, as I have mentioned. But the advantage of their approach is precisely that it is agnostic with respect to the policy variables, while offering evidence about the importance of intermediate policy objectives. I find this agnostic approach fine because while private incentives, outward orientation or credit availability may all be necessary for growth, we have less certainty about the best strategy to achieve them, a point that has also been stressed by Rodrik. Therefore, the right approach, I think, is that of Loayza and his team, complemented with more detailed empirical or case studies to assess the effects of the policy actions on the immediate outcome variables that are intended to affect. For instance, it is surprising how little research has there been on the effects of trade liberalization on exports, on manufacturing production or even on microeconomic efficiency, in comparison to the amount of research on

the growth effects of trade. In the same way, we should do much more work on the effects of specific financial liberalization measures on the supply and the cost of credit, and on the different models of regulating infrastructure services on the supply of those services. However, although I sympathize with the type of growth analysis done by Loayza and his team, I have a serious difficulty in interpreting the results. The problem I see is that the coefficient of each policy outcome should be estimated using only the observations where the outcome is a binding constraint. For instance, if the binding constraint in a country is lack of skills, increasing the supply of credit cannot do much for growth and conversely, if there is no credit, or if starting a business is impossible for other reasons, the returns of education have to be much lower than otherwise. The growth diagnostic methodology proposed by Hausmann and his colleagues can help us identify the constraints. That information could be used to improve the coefficients of the growth regressions a la Loayza.

9. Let me say a couple of words about the growth diagnostics methodology proposed by Hausmann, Rodrik and Velasco. I find it intuitive and persuasive, and I am impressed at the speed at which it is taking hold among the international financial organizations. But I have a some concerns (in addition to the wise remarks by Sara Calvo this morning). One is that binding constraints may change fast. Lack of investment ideas may appear as the binding constraint today but after a couple of big investment projects get started we may realize that lack of infrastructure is kicking in, and little further down the road that what we may need is more finance. Since tackling each of there constraints may take long, we may go back to the conclusion that we should have worked on many potential –and not just current—constraints from the beginning. My second concern is that the maps are always much neater than reality. Suppose that, following the decision tree suggested by Hausmann and colleagues we find that interest rates are low, and from there we reach the conclusion, after discarding other alternatives, that the problem in country X must be lack of self-discovery. But on closer look we realize that some potential investors may have good ideas, but they have not pursued them, and have not applied for credit because they do not have collateral,

or they do but banks do not care to lend them anyway because the judiciary system is unreliable. And it is because of the combination of all these things that we observe low interest rates. In other words, when there are vicious circles or low level equilibria that prevent growth it may be deceiving to look for the most binding constraint. In that case, you may as well go back to the usual checking list.

10. Finally, I want to refer to the politics of reform. A lot of effort was put in the nineties in trying to explain the timing and mix of reforms with political economy models. Most of the work was theoretical, and the little empirical work that was done showed that their explanatory power was very small. As Andrés Velasco put it, all this effort was "much ado about little". The problem is that policy decisions are very messy things, that are not easy to explain with a few variables. Policy decisions are the results of complex negotiations, and one has to understand the mechanics and complexities of those negotiations to be able to say anything meaningful about what makes or breaks the decisions. Furthermore, one has to go beyond the "magic moment" of the policy decision to the implementation stage to understand how politics influence the reform process and its effectiveness. There is plenty of work to do here. A group of my colleagues at the IDB, led by Ernesto Stein and Mariano Tommasi, have done a very good work in a book called "The Politics of Policies", which all of you should read. They have opened an avenue for research that should be taken very seriously.

Let me thank again Jeromin and the organizers of this conference for the invitation.