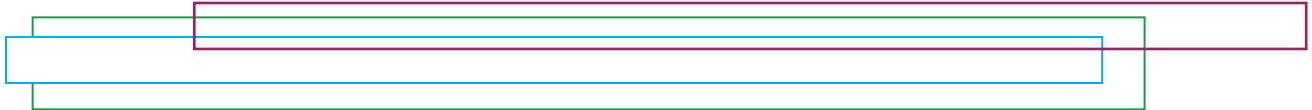




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PROGRAMA DE ESTUDIOS ASIÁTICOS

Documentos de Trabajo en Estudios Asiáticos No. 1



The Philippines and Latin America.
Similar challenges in the context of global crisis
Raimundo Soto

Documentos de Trabajo en Estudios Asiáticos

Pontificia Universidad Católica de Chile (UC)

Facultad de Historia, Geografía y Ciencia Política

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El Programa de Estudios Asiáticos de la Pontificia Universidad Católica de Chile (UC) entrega al público una serie de documentos de trabajo con el objeto de ampliar el conocimiento sobre Asia y promover la difusión de investigaciones sobre ese continente. Estos trabajos fortalecen el diálogo intercultural abarcando miradas desde América Latina hacia Asia, aumentando el conocimiento científico sobre la relación existente entre estos dos continentes. Lo anterior se complementa con un diálogo académico intercultural, intercambiando resultados y experiencias con investigadores de Asia, y otras zonas, razón por la cual se publican los trabajos en inglés y en castellano. Los ejes de investigación están orientados hacia los grandes desafíos del nuevo milenio junto a la necesidad de las sociedades latinoamericanas de generar un profundo conocimiento de nuestros interlocutores asiáticos y la de aumentar la competencia de los profesionales chilenos en una sociedad global.

Los “Documentos de Trabajo en Estudios Asiáticos” están organizados en base a tres ejes temáticos que representan las áreas de investigación de nuestro Programa, cada uno abierto a diversas disciplinas y al diálogo interdisciplinario.

1. Cooperación y Conflicto

En el contexto de una globalización acelerada y de una transformación de las estructuras mundiales, las relaciones económicas y políticas entre América Latina y Asia van profundizándose día a día, aumentando rápidamente su importancia. Estos procesos generan nuevos desafíos y requieren conocimientos específicos de política, economía y derecho, por nombrar sólo algunos, para así captar las oportunidades de cooperación, prevenir los posibles conflictos y resolver los problemas existentes.

2. Migración y Urbanización

El segundo eje se enfoca en un nivel nacional incluyendo algunos aspectos internacionales. La mayoría de los países de Asia están caracterizados todavía por una baja tasa de urbanización, aunque de rápido crecimiento. Por otro lado, en Asia se encuentra la mayor cantidad de megaciudades y grandes urbes que reciben sostenidos flujos de migración. Estos procesos presentan grandes desafíos en cuanto a la desigualdad y precariedad, requiriendo estrategias locales de adaptación a cambios globales.

3. Pensamiento y Cultura

Este eje dirige la mirada hacia el ser humano y su condición de vivir en comunidad buscando la comprensión de la base cultural, religiosa y ética de las sociedades de Asia. Tener conocimiento del contexto histórico del pensamiento, de la estética y la filosofía representa una condición necesaria para un diálogo intercultural. La identidad, las imágenes de lo “propio” y lo del “otro”, la percepción de la naturaleza y la construcción de la relación entre el ser humano y su entorno son otros aspectos centrales de esta área.

Documentos de Trabajo en Estudios Asiáticos No. 1

**The Philippines and Latin America.
Similar challenges in the context of global crisis ¹**

Raimundo Soto

¹ This paper was presented at the Conference "The First PACLAS International Conference on Philippine-Latin American Relations" held in Manila, The Philippines, December 15-17, 2008. Comments by the participants are gratefully acknowledged.

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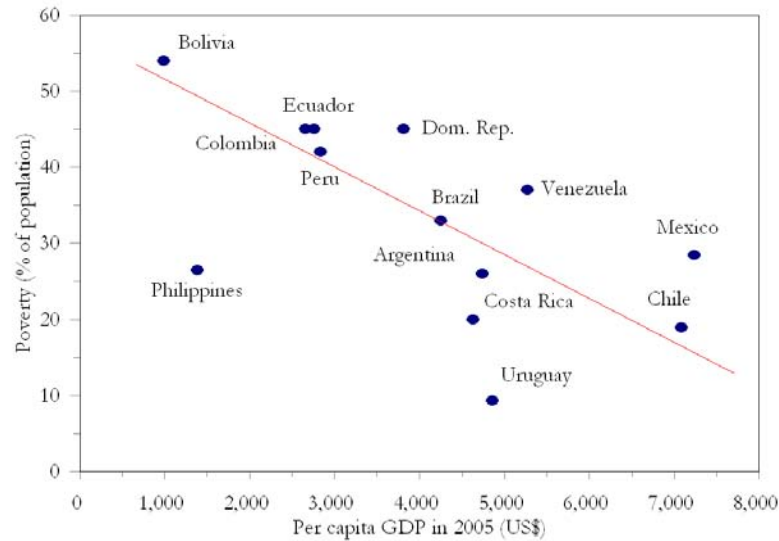
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I. Introduction

Despite geographical distance, the Philippines and Latin America share similar economic histories in the last 50 years. In the context of what appears to be the most severe financial crisis in almost a century, they face parallel challenges both in terms of weathering short-run difficulties and fostering long-run development.

Economic policies are, undoubtedly, at the heart of any long-run development strategy. The main goal of economic policy in developing economies ought to be the sustainable increase in the welfare of the population, considering not only current but also future generations. Measuring welfare gains is certainly very difficult. We do not know how to compare the welfare of different individuals, much less that of present versus future generations. Let me be very naive and, for the sake of comparison, use per-capita gross national income as a measure of welfare. Of course, welfare entails much more dimensions than mere income. Let me be also innocent when looking at poverty measures and use those developed by the United Nations. Again, poverty rates hide the complexities of being poor. Figure 1 shows the situation in the 12 largest Latin America countries and The Philippines as of 2005.

Two elements strike out immediately. First, there is a negative relationship between both variables, indicating that poverty levels are lower in richer economies. This, of course, is quite obvious. However, let us do the following simple exercise. Observe that all countries with poverty levels below 25% of the population have per-capita income levels above US\$ 4,500, with the only exception of The Philippines which I discuss below. Let us assume that this benchmark is a *necessary* condition to reduce poverty permanently. How long would it take low income countries such as Bolivia, Peru, or Ecuador to reach such benchmark and half their current poverty levels? That depends on their rate of economic growth. Take, as an example, the case of Bolivia, per-capita GDP has grown at a meager annual rate of 1% in the last 50 years, indicating that it would take around 160 years to achieve the US\$4,500 threshold. What annual rate of growth of per capita GDP would take Bolivia to the benchmark in, say, 50 years? A little above 3% per year, something that never occurred in the last 30 years. In a recent publication, the UN Economic Commission for Latin America (ECLAC 2006) has provided a far more sophisticated analysis for the region, reaching a strikingly similar conclusion: in order to halve poverty levels, Latin America would have to grow –on average– at around 2% in per capita terms for the next 25 years, something that has never happened.

Figure 1: Poverty and Income in 2006

Source: own elaboration based on Soto (2007)

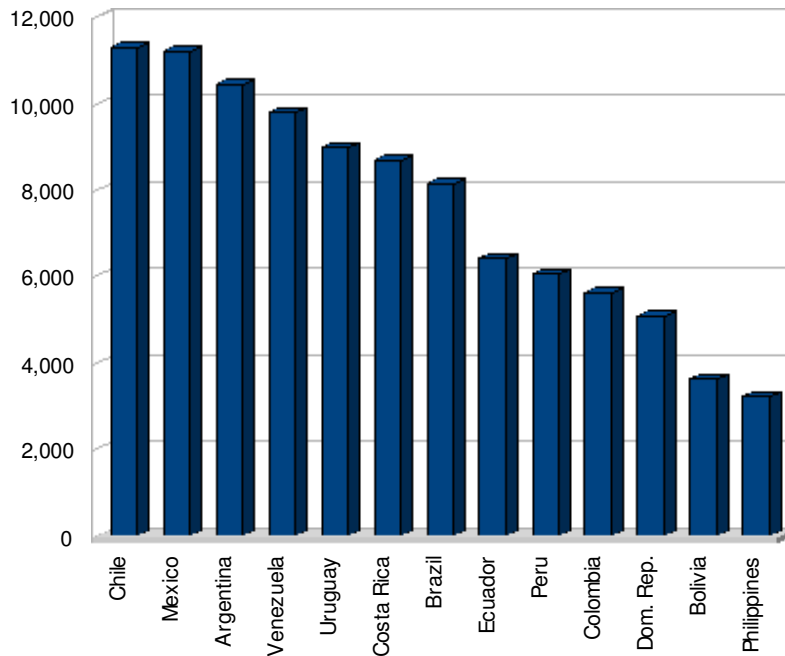
The second striking feature of Figure 1 is that the Philippines do not conform to the Latin American situation. Poverty levels are very low for Latin American standards, even without taking into account its comparatively low per-capita income level. This comes both as an interesting counterpoint and challenge from the Philippines. On one hand, it shows that the Latin American standard recipe for poverty alleviation –sustained economic growth— may not necessarily be the preferred or best answer. On the other, it challenges economists and policy makers in poor Latin American economies to study and learn from the case of Philippines.

Naturally, this is an extremely simplified exercise and it only serves as a motivating illustration. The links between economic growth and poverty are difficult to assess and there may be countless other elements that play a role in determining poverty levels. In fact, even within Latin America several countries do not perform as suggested by this naive experiment: for example, poverty levels in Uruguay are much lower than the level implied by per-capita income, while poverty in Venezuela is much higher than what it ought to be according to its income level.

However important, poverty is not the only dimension one should look at when discussing welfare. Average income levels are also important indicators of the welfare of the population. International comparisons are usually based on measuring per-capita income in a common currency and adjusting such measure to account for the differences in the cost of consumption goods and services in different countries. One such measure –

computed by The World Bank and dubbed PPP income levels — is depicted in Figure 2.² It can be seen that there are wide differences in average income among Latin American economies, with rich countries such as Chile or Mexico benefiting from welfare levels that double those in other countries such as Colombia or the Dominican Republic. The Philippines ranks very low in this comparison, suggesting Latin American economies could provide valuable lessons on how to improve current welfare levels in this Asian economy.

Figure 2: Per-capita income at PPP levels in US\$ of 2006



Source: own elaboration based on World Bank data.

This paper first identifies the main determinants of the unstable and slow economic growth in both Latin America and The Philippines in the second half of the 20th century, placing considerable attention to institutional aspects and the internal and external conditions that have shaped the evolution of these economies. In the second part of the paper I explore the role of productivity growth and innovation as a key component of the long-run growth strategy. The third part of the paper identifies the main challenges –financial and commercial— that both The Philippines and Latin America face in the current external situation, discussing their most likely short-run impact and the policies that our economies

² PPP stands for purchasing power parity. Data was obtained from *World Development Indicators 2007*.

should enact to reduce distress. I identify the opportunities for growth that stem from the current international conundrum, under the premise that periods of economic turbulence allow governments to gather support to enact reforms that are much needed for fostering long-run economic growth and, ultimately, increased welfare.

II. But why do countries grow so slow? ³

Let us examine the mechanics of long-run economic growth in Latin America and Philippines. Since economic growth deals with the ability of countries to produce and market goods and services, I focus on the fraction of the population available to work (i.e., those between 14 and 65). Using working-age population also takes care of the significant demographic changes that have taken place in the last decades. Let us look at economic growth in each Latin American country and the Philippines, measured by GDP per working-age person. I have also normalized all values to be 100 in 1960. In order to have a counterfactual comparator I used the same indicator in the developed economies, which have grown on average at 1.4% per year in the 20th century. Needless to say, choosing the developed economies as benchmark is not very challenging –emerging economies ought to perform better if they expect to catch up— but it suffices for our purposes. The dotted line in Figure 3 represents, then, how developed countries have grown in the last 50 years on average.

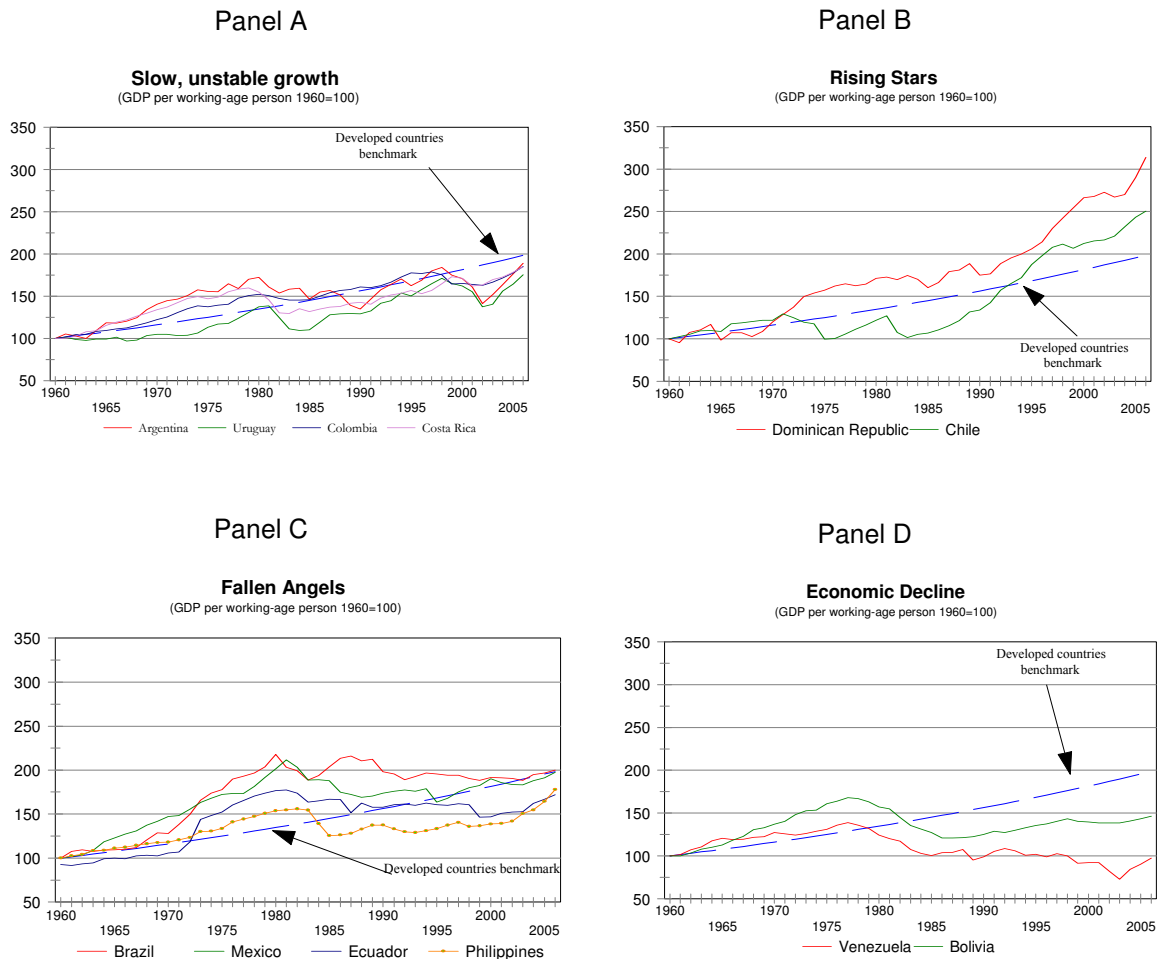
I have grouped the experiences of Latin American countries in order to synthesize the results. The two most striking results are: first, Latin American countries are comparatively more backwards today than 50 years ago and, second, economic instability is the rule rather than the exception. Most economies portray the case of *slow and unstable growth*, as depicted in panel A: Argentina, Uruguay, Colombia and Costa Rica exhibited growth rates comparable to the developed countries in the 1960-1980 period but afterwards growth have been much slower and with more marked fluctuations. Latin America's *rising stars* -Chile and the Dominican Republic in panel B- are the only two countries with vigorous, systematic growth in the last 20 years, although for Chile it initially meant just a return to trend after being about 40% below the benchmark in the 1980s. Three countries depict the inverse situation in panel C: after high and sustained growth in the 1960-1980 period, they have all but stagnated in the last 25 years. Brazil, Ecuador and Mexico have thus become fallen angels. Finally, two countries - Bolivia and Venezuela - have levels of GDP per-working age person that are *lower* in 2005 than they were 30 years ago (see

³ This section expands my article Risk, Uncertainty, and Macroeconomic Planning, published in *Proceedings of the Congreso Internacional sobre Desarrollo, Medio Ambiente y Recursos Naturales*, Jan Feyen (ed). 2007.

panel D). Actually, current levels of GDP per-working age person in Venezuela are lower than in 1960!

The Philippines performs very similar to the group of “fallen angels”. Economic growth was vigorous in the 1960s and 1970s and the country reduced the gap with developed economies. However, the strategy proved to be unsustainable; in the 1980s and early 1990s the economy fell into stagnation and there was virtually zero net growth. The current decade has witnessed a rebirth in economic growth and a substantial recovery towards long-run trends, yet the economy is still some 10% below the benchmark.

Figure 3: Growth in GDP per working-age person



Source: own elaboration

What are the reasons for the disappointing performance of most Latin American economies and the Philippines? Undoubtedly, explanations abound, ranging from poor economic policies to political and social unrest and from external adverse shocks to bad luck. The ultimate culprits are difficult to pinpoint but the following exercise provides insights as of where to look for answers. It has become customary to decompose economic growth according to its sources, namely the accumulation of physical capital, human capital, and knowledge of how to be efficient when producing goods and services. I will call this last element as “productivity”, which is clearly an overstatement. Below I will try to disentangle a little its components.

There are several methodologies to achieve such decomposition. I use the most popular to keep comparability with other studies.⁴ I follow Robert Solow’s approach of modeling production (GDP) as: $GDP_t = A_t PK_t^\alpha HK_t^{1-\alpha}$, where PK is physical capital, HK is human capital and A represents the productivity of a given level of physical and human capital. Parameter α indicates the relative importance of the two forms of productive capital. Accordingly, changes in GDP are the result of changes in human capital, changes in physical capital and/or changes in total factor productivity.

When computing the sources of growth I use a simple, aggregate Cobb-Douglas production function:

$$Y_t = A_t \mu_t K_t^\alpha e_t L_t^{1-\alpha} \quad (1)$$

where Y_t is output (value added), e_t is an indicator of the efficiency of hours worked, L_t , and μ_t is the occupation rate of capital, K_t . Parameter A_t is an indicator of the technical efficiency in the use of factors.

In this paper I define TFP to encompass not only technical efficiency but also the efficiency of labor and the degree of use of the capital stock. I thus compute TFP as a function of (A_t, μ_t, e_t) as follows:

$$TFP_t(A_t, \mu_t, e_t) = \frac{Y_t}{K_t^\alpha L_t^{1-\alpha}} \quad (2)$$

⁴ For a comprehensive description of this methodology see BERGOEING / KEHOE / KEHOE / SOTO 2002.

In this view, several elements could affect factor productivity beyond the technical ability to mix inputs and generate goods. For example, poor government regulation leading to lower use of capital and, thus, lower production is interpreted as declining TFP. On the other hand, an improvement in the education and training of the labor force is interpreted as increasing TFP. This interpretation of TFP links naturally with the analysis of long run economic growth presented in section 2 below, in which the determinants of TFP are explicitly considered. It also links to Chapter 5 where the determinants of TFP are studied at the microeconomic level for non-oil manufacturing firms.

To calculate TFP_t , given series for Y_t and L_t , I need to choose a value for α and generate series for K_t . In 1993, for example, according to the United Nations (DOWRICK / QUIGGIN 1994) this share –which corresponds to $1 - \alpha$ in the production function– was 0.39 in Ecuador. I chose a higher value of the labor share for growth accounting 0.65 – corresponding to $\alpha=0.35$ – for two reasons. First, measured labor compensation in developing countries fails to account for the income of most self-employed and family workers, who make up a large fraction of the labor force. GOLLIN (2002) shows that, for countries where there is sufficient data to adjust for this measurement problem, the resulting labor shares tend to be close to the value in the United States, 0.70. Based on household data for Mexico, GARCÍA-VERDÚ (2005) found that the labor share in national income is 0.60 and not 0.35 as reported by national accounts. Second, a high capital share implies implausibly high rates of return on capital. Using national accounts and my estimation of the capital stock described below, I estimated the cointegrating model of equation (1) and estimated $1-\alpha$ to be 0.50 (see Appendix B for the details of the estimation). Second, a high capital share implies implausibly high rates of return on capital.⁵

To calculate a capital stock series, I cumulate investment, I_t , using the perpetual inventory method, i.e.,:

$$K_{t+1} = K_t(1 - \delta) + I_t \quad (3)$$

⁵ With $\alpha=0.65$, as suggested by national accounts, and a capital/GDP ratio of 2.7 (the mean for the 1960-2004 period), the real interest rate (return on capital) should be above 25% per year in the steady state.

for some chosen depreciation rate δ and an initial condition on capital. Based on information by ECLAC (2004) and HOFMAN (2000) I use a depreciation rate of 4.6%,⁶ and, for the initial condition on capital, I assume the capital-output ratio to be 2 in 1950.⁷ This latter assumption is inconsequential since the initial value is mostly depreciated by 1970, the starting point of my analysis. Given the choice of α and generated series for K_t , I can calculate TFP series.

A convenient decomposition of the sources of growth obtains if taking natural logarithms of the production function and rearranging terms

$$\log\left(\frac{Y_t}{N_t}\right) = \frac{1}{1-\alpha} \log(A_t) + \frac{\alpha}{1-\alpha} \log\left(\frac{K_t}{Y_t}\right) + \log\left(\frac{L_t}{N_t}\right) \quad (4)$$

where N_t is the number of hours available for work by working-age persons. I use this expression to decompose the change in real GDP per working-age person over the period t to $t + s$ as

$$\frac{\log\left(\frac{Y_{t+s}}{N_{t+s}}\right) - \log\left(\frac{Y_t}{N_t}\right)}{s} = \frac{1}{1-\alpha} \left(\frac{\log(A_{t+s}) - \log(A_t)}{s} \right) + \frac{\alpha}{1-\alpha} \frac{\log\left(\frac{K_{t+s}}{Y_{t+s}}\right) - \log\left(\frac{K_t}{Y_t}\right)}{s} + \frac{\log\left(\frac{L_{t+s}}{N_{t+s}}\right) - \log\left(\frac{L_t}{N_t}\right)}{s} \quad (5)$$

The first term on the right-hand side of this equation is the contribution to growth of TFP changes, the second is the contribution of changes in the capital-output ratio, and the third is the contribution of changes in hours worked per working-age person.⁸ On a balanced growth path, output per worker and capital per worker grow at the same rate, and the capital-output ratio and hours worked per working-age person are constant. On such a path, the growth accounting would attribute all growth to changes in TFP. In the growth

⁶ Based on data from HOFMAN (2000) this value was estimated assuming that 35% of investment is in machinery and 65% in buildings. Average life periods were assumed at 25 and 50 years, respectively.

⁷ The average capital-labor ratio for the 1960-2004 period is 2.00 when using a starting point of 2 for the capital-GDP ratio in 1950. When using 2.5 as the starting value, this average ratio increases to 2.04, while it declines to 1.96 when using 1.5 as a starting value.

⁸ Since total hours worked are not available for the entire period, I used as an approximation the effective employment $(1-\mu)L_t$ where μ is the unemployment rate.

accounting, therefore, the second two terms measure the contributions of deviations from balanced-growth behavior: changes in the investment rate and changes in work effort.

In the subsequent set of graphs (see Figure 4) I have reproduced the same data on GDP per-working age person, along with total factor productivity. Total productivity is measured as changes in GDP per working-age person net of changes in employment, education levels, and net physical capital investment. Productivity, in this context, encompasses more than technology, as it takes into account the impact of elements such as institutions, regulation, and international competitiveness.

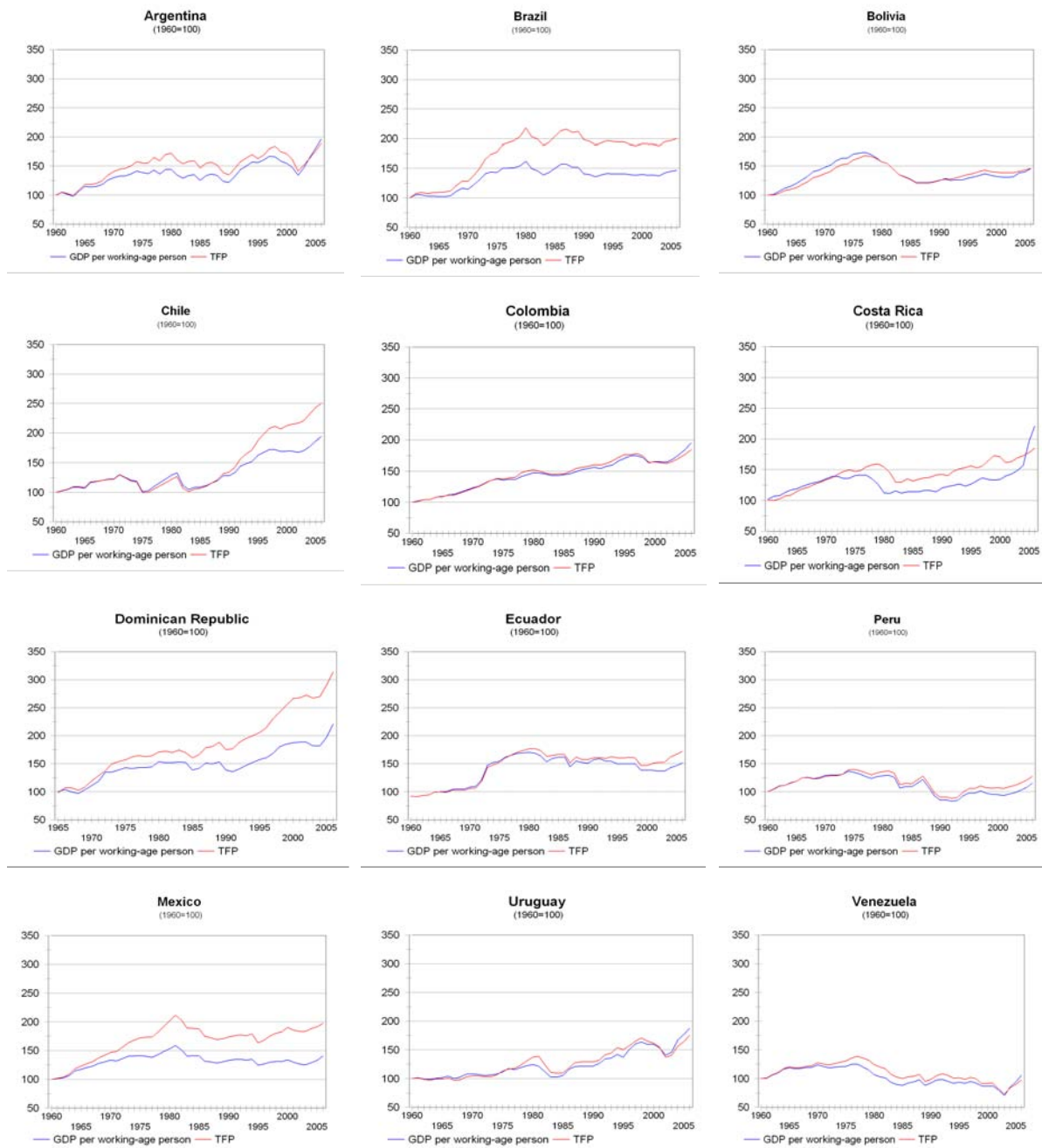
This simple computation provides a striking conclusion: long-run economic growth –and even most of its short-term fluctuations – is closely linked to changes in productivity levels. In all countries the evolution of economic activity closely follows that of factor productivity for most of the time period. This indicates that, while accumulating human and physical capital is important, it is the change in productivity that is crucial for sustained economic growth.

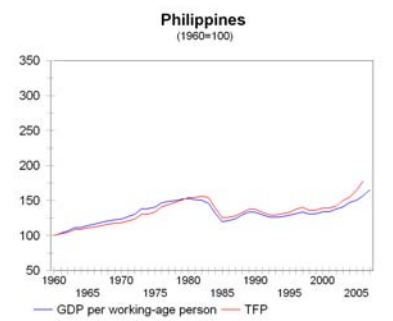
When looking at these graphs a second element becomes apparent: only two countries have managed to increase productivity in a significant manner in the last 25 years. In all other economies, productivity have been stagnant for long period of time –Bolivia, Brazil, Ecuador, Mexico or Venezuela – or it has increased at a very low pace (Argentina, Uruguay, Costa Rica, Peru). The Philippines follows along the same pattern, with productivity and production stagnant for most of the 1980s and 1990s, only to pick up in the 2000s in a significant manner. This performance is in marked contrast with that of other Asian economies. For example in countries such as Korea, Taiwan, or Thailand, Ireland total factor productivity has grown between 2% and 3% per year in the 1960-2004 period. In Latin America as well as in the Philippines, the average is a mere 1%.

Arguably, this is a highly simplified method of analysis and, certainly, it ignores the complex mechanics of adopting higher-productivity technologies, training the labor force, allowing investment to mature, developing infrastructure, and the like.

Yet it is a valid summary indicator of aggregate factor productivity in each country.

Figure 4 GDP per working-age person and Total factor productivity





Source: own elaboration

Among the results that are found in recent research (SOLIMANO / SOTO 2006), one that strikes as distinctive of Latin America is its proneness to economic crisis. A *growth crisis* is defined here as any year in which the rate of growth of GDP –not per-capita— is negative. The evidence indicates that there is an abnormally high frequency of ‘growth crisis’, particularly after 1980. On average, a Latin American economy has had 7 episodes of crisis in the 1960-2006, that is one crisis every six years. In contrast, the Philippines follows the pattern of its neighbors Korea, Thailand, and Malaysia that have had at most 3 episodes in the same period.

Crises are not only more frequent but also much deeper. All Latin American economies have had a crisis in which GDP dropped by 5% or more in a year. While most of these episodes concentrate around the early 1980s, during the so-called *debt crisis*, they also occur in a scattered manner in the 1990s and early 2000s. In the Philippines this phenomenon only happened in the early 1980s. These crises are not of a transitory nature; on the contrary they are deep, tend to have lasting effects, and are very costly. In particular, the negative effects of the 1981 crisis have been quite difficult to overcome. In six countries GDP per working-age person is lower in 2006 than it was in 1981. This includes the two largest economies: Brazil and Mexico. Recovery took over a decade in the Philippines and in Argentina and Uruguay, the richest economies in Latin America.

The Latin America growth experience –and to a lesser extent that of the Philippines— thus points at a very different type of macroeconomic instability than that in East Asia or Europe, one that is much closer to uncertainty than to diversifiable risk. Risk, as opposed to uncertainty, can be properly measured and anticipated, at least in probabilistic terms. Consequently, individuals can undertake measures to counterbalance its negative effects. Insurance and saving are well developed and efficient responses to economic risk. Risk diversification is a standard practice in finance and could be applied to most economic problems. Uncertainty, on the other hand, is usually impossible to measure and, hence, countervailing measures are harder to design and implement. Natural disasters, a

characteristic phenomenon in most Latin American economies, are uncertain in the sense that we know they will occur, but it is impossible to anticipate them—even in probabilistic terms—nor to diversify efficiently the risk they pose. Economic disasters, on the contrary, are easier to foretell and diversification measures are simple to implement.

In what follows I will argue that, as every other country in the world, the Philippines and Latin American economies face a relatively well known set of economic risks. However, the weaknesses of the institutional and political environment in which they operate turn what would otherwise be simple risks into high degrees of uncertainty. Negative shocks are much larger, last much longer, and are far more frequent than in other developing or developed economies.

III. What drives productivity, then?

When asked, a cautious high-school student would promptly answer that productivity and investment are intimately related. Evidence—for Latin America as well as for other regions of the world—on the causal links between the accumulation of human and physical capital and long-run economic growth is, surprisingly, elusive.

Historically, macroeconomic policies in Latin America operated under the premises that investment is a pre-requisite to economic growth. Rosenstein-Rodin argued in favor of significant and substantial public investment programs as a tool to launch sustained economic growth, a theory he baptized as “the big push” (ROSENSTEIN-RODAN 1943). Recently, this idea has flourished again in Argentina, Ecuador, and Venezuela where public investment has been called to become “the engine of growth”. MORCK AND NAKAMURA (2007) re-interpret the Japanese economic take-off following the Meiji Restoration of 1868 as a case of a “big push” engineered by the private sector (the *Zaibatsu*) instead of the government.

The majority of the available evidence, however, suggests that physical and human capital accumulation do not cause faster or sustainable economic growth, nor that public investment supports—nor can eventually replace—private capital accumulation. Empirical testing show that it is higher expected output growth (and the subsequent higher profitability of businesses) that drives investment and not otherwise. Injections of capital do not seem to be the driving force of future growth. Likewise, evidence on human capital accumulation tells a similar story. It is the expected wage increase that accompanies output growth that drives investment in higher education and training. Thus, in terms of

both physical and human capital, the data do not provide strong support for the contention that factor accumulation ignites faster growth in output per worker.

Evidence, collected by several authors, on the role of capital investment in Latin American countries supports three conclusions (see LOAYZA / SOTO 2002 and GUTIERREZ 2005). First, investment levels tend to be too low to be consistent with accelerated growth. A back of the envelope calculation suggests that the ratio of investment to GDP ought to be above 25% to sustain the above mentioned modest rate of growth of GDP per capita of 2% needed to reduce poverty in 25 years. The average ratio for all Latin American economies is slightly less than 20%. In a recent paper on the Philippines, MAGNOLI (2008) documents the same finding and notes that *The economy of the Philippines has grown rapidly since 2002. Over the last 10 years, however, domestic investment, while stagnant in real terms, has shrunk as a share of GDP* (MAGNOLI 2008). Likewise, in the Philippines domestic investment has declined from around 25% in the late 1990s to around 15% in the last five years. It is difficult to see how a sufficiently robust economic growth can be sustained at present levels of investment.

Second, there is evidence that capital formation in the public sector is either a limitation or a competitor to private investment, rather than a much welcomed complement. In some countries –notably in the Philippines, Bolivia and Ecuador—the public sector cannot keep public investment growing at GDP growth rates. This inability to secure adequate levels of public investment is due to a combination of weak tax-revenue performance, a weighty debt service, and a high cost of inputs. In other countries, competition between the public and private sector for investment funding hampers growth.

Certainly, public investment in infrastructure has a positive effect on economic growth, yet the evidence also suggests that, given appropriate regulatory frameworks, franchising infrastructure to be developed by the private sector is more efficient. Low public investment rates are not always associated with slow growth, while a high one does not signal for faster growth. In Chile, public investment declined by 2.5 percentage points of GDP after 1980, but was more than compensated by a substantial increase in private investment. On the other hand, in Colombia public investment expanded by almost two percentage points, yet the rate of growth in per capita GDP declined from 5.3 per cent in the 1960-80 period to less than 3 per cent in the 1981-2002 period.

Third, there is little evidence that investing in machinery and equipment is better for economic growth than other forms of investment.

Likewise, accumulating human capital is only loosely related to higher economic growth. Several studies have tried to measure the contribution of education, both in terms of quantity and quality, but tend to find that it has a minor effect in igniting faster growth. This does not imply that education cannot affect income levels (a higher and better educated

labor force undoubtedly reflects in higher GDP), it indicates that there is no connection to *GDP growth*. For example, achieving the education levels of a developed economy in Ecuador would imply less than one-half of a percentage point of additional growth (SOTO 2005).

IV. Why can't developing economies be as efficient as developed economies?

A very tough question to answer is why developing countries are not more productive if, after all, natural resources are abundant and capital and technology are readily available. There is little doubt of the abundance of natural resources, since the exporting strategy of all Latin American economies is based on primary sectors. In the increasingly globalized economy in which we live, technological advances are closer at hand than ever before. The Philippines, on the other hand, is not as richly endowed as Latin American economies, but it enjoys a strategic location in East Asia, benefits from the highly dynamic economies of its neighbors (China, India, Japan) and, contrary to the average Latin American economy, is relatively large in terms of population.

Among several explanations for low productivity levels, it has been claimed that the leading-edge technology is not actually available for poorer economies and, most likely, that is the case. However when one looks at the wide gap between efficiency in the developed world and that of Latin America, one has to conclude that this would unlikely provide a good explanation for our backwardness. In most sectors, productivity levels are significantly lower in Latin America than in the Asian tigers or European countries. Furthermore, productivity differences among Latin American economies are also very high and do not seem to be reducing on time; on the contrary, they seem to be slowly increasing as shown in Figure 4.

Human capital, on the other hand, is also increasingly mobile and can hardly be considered as a limitation to acquire more efficient production methods. This can be seen very clearly in the substantial migration between Latin America and the developed economies and, increasingly, in the internal migration in the region. The Philippines does not escape this norm as it is estimated that around 10% of the population live overseas. In a number of countries, remittances sent to their relatives from workers living abroad – typically in more developed economies— are one of the most significant sources of foreign currency. This suggests that these migrants have human capital that is valued in developed economies and that was poorly rewarded in their countries of origin. I will return below to this issue when discussing the current financial crisis.

If natural resources are abundant in our developing countries and factors of production can be acquired in the global markets, what is delaying faster growth? This complicated issue

has prompted several lines of analysis and they all give useful insights but not a causal link. First, some authors have justified productivity differentials on differences in human capital levels. Nobel Prize winner Robert Lucas has convincingly argued that education externalities are important and may lead to very different productivity and growth paths. Yet it remains to be explained why some countries would *choose* to have poor educational systems and a low-growth strategy. Other researchers –mostly at the World Bank— have highlighted the role of institutions as determining the ability of the countries to use efficiently their resources, an idea that goes back to Nobel Prize winner, Douglas North. Again, it remains to be explained why some countries would *choose* to have a weak institutions and settle for a low-growth path.

A deeper explanation for these low-growth strategies is provided by another Nobel Prize winner, Edward Prescott, who has also provided evidence that it is in the interest of groups within each economy to impede faster acquisition of technology and human capital accumulation (PRESCOTT / PARENTE 1997). Whenever groups benefit from market power in an economy and are able to extract economic rents, they take actions to maintain such rents in the long run at the cost of lower growth and less welfare in the rest of the society. Although one strategy for these groups could be to become an aggressive competitor in the market, it is usually more profitable to ask the government to intervene markets in their favor and grant them monopoly rents. When governments are weak to lobbying and can be captured by groups, the driving force of productivity changes is weakened and low growth is the result.

There are plenty of examples of this problem in Latin America. Lobbying for protection takes the most varied forms, ranging from openly nationalistic self-sufficiency arguments to the more subtle infant industry, import substitution proposals. Organized groups are surprisingly creative at the time of inventing reasons for acceding special status and the more educated their members, the higher the privileges they may enjoy.

In most Latin American countries protection is pervasive in areas such as the agricultural sector, infrastructure - in particular transportation and ports -, and publicly provided goods, such as education or health. In Chile, the paradigm of free-market policies in the region, labor immobility and wage increases were given to teachers and workers of the public health system for electionary reasons. Public resources to health and education doubled in a ten-year period. Since health and educational quantity and quality indices remained stagnant at best, one has to conclude that productivity in these sectors deteriorated (as detailed studies largely confirm).

Commenting on the case of Philippines some researchers have pointed out that to sustain growth the economy needs a competitive diversification. According to MAGNOLI (2008), in addition to pursuing a competitive real effective exchange rate to promote export and

increasing tax revenues to finance the needed boost in infrastructure and education, what is needed is to implement gradual reforms to tackle the rent-seeking conglomerate economy. In particular, the government should move to reduce *élite*-capture. Greater competition in ports and shipping, civil air transport, wholesale electricity and cement production markets would substantially reduce costs, spur investments, and create jobs. Reducing protection for agricultural products, particularly rice, will benefit the food processing and livestock industries.

Detailed analysis of protection tends to confirm that (1) efficiency losses are significant and (2) the protection enjoyed by some is largely paid by the unprotected poor segments of the society. This second aspect is, of course, a regressive transfer, hardly justifiable on any grounds. In several countries protection does not benefit industries but well organized groups of the population that enjoy preferential treatment in the labor market. For instance, the labor market in the Philippines is far from competitive relative to the other East Asian countries, due to a higher wage structure and unit labor costs that are much higher for broad ranges of manufacturing. As a result the country is finding it difficult to compete with lower wage economies particularly at the unskilled end of manufacturing.

Protection, even when it is mild, tends to have costs both in terms of static and dynamic efficiency. In the short run, protection allows low-productivity producers to remain in business and obtain a higher-than-normal return on their investment. Consumers and taxpayers inevitably bear the additional costs. Politicians in Latin America had based their fortunes on the tenet that protection is necessary for local producers to survive competition and avoid the costs of bankruptcy. While there is a short-run benefit of avoiding bankruptcies, the effect is devastating for the economy in the long term. Allowing inefficient producers to remain in business has two negative effects: low-productivity producers reduce total factor productivity and, more important, by remaining in business they inhibit market entry of producers with new, more productive technologies, thus curtailing productivity growth. Bankruptcies and “going out of business”, painful as they may be, are the mechanism through which a market economy signals for the relocation of resources that is necessary to improve productivity. Whenever protection cannot be obtained on legal grounds, these groups recourse to illegal practices, such as corruption, further increasing social costs.

What is then the role left to authorities to foster productivity gains? I think it is safe to say that experience shows centralized planning to be a chimera. If economies were static, measurable systems, perhaps there would be a chance for planning to solve efficiently economic problems. In highly dynamic systems, where risks and uncertainty abound, and decisions have to be made under incomplete information the chances of long-term planning to be successful are nil. Matters only complicate more when such decisions are to be made in environments of institutional weakness and corruption. Government policies,

then, can be summarily stated as *getting intelligently out of the way* (Soto / Saavedra 2006). We have discussed that it is the expectation of future benefits that drives human and physical capital accumulation as well as the adoption of new, more efficient technologies. In order to generate such expectations, the authorities must convince producers that if their investments are successful they will not be taxed away and if they fail the cost of going out of business and initiating a new enterprise will be reasonably low. Any other arrangement implies too high a risk.

This may look very naive. Consider, nevertheless, that most Latin American countries fail to convince producers on both accounts. For example, facing the current boom in commodity prices, the authorities in Bolivia, Chile, and Venezuela levied new, higher taxes to their main export products (gas, copper and oil, respectively). In several countries regulatory frameworks designed to attract private investment in telecommunications, energy, primary sectors or the financial sector, have been changed to reduce profitability once the private sector has made the investments. Nationalization of gas and oil companies in Argentina, Bolivia, Ecuador, and Venezuela are a token of this widespread phenomenon.

Even in economies where the respect for contracts and regulations is actively enforced, the cost of business failures could be a severed deterrent to investment and productivity gains. Consider the case of Mexico: during the debt crisis of 1982, there was a need to rapidly relocate resources from inefficient, subsidized firms in the non-traded sector towards more efficient, export-oriented enterprises that would flourish under the free-trade agreement signed with the US. One of the main limitations to a quick, efficient resource relocation was the absence of a bankruptcy law; lack of the protocols required to liquidate in an orderly manner a failed business, delayed adjustment. On the contrary, facing a similar shock Chile benefited from having enacted a modern bankruptcy law only months before the crisis.

V. Challenges for growth and poverty reduction at the onset of global crisis

During the last five years Latin America and Philippines have benefit from unusually high terms of trade as a result of sustained growth in developed economies as well as the demand from China and other East Asian economies. Based on historical evidence it is safe to say, however, that commodity booms do not last for long. One should expect a long run decline in the price of commodities as a result in the introduction of new, cost-reducing technologies.

According to ECLAC estimates (ECLAC 2008), the economies of Latin America and the Caribbean as a whole will grow by around 4.7% in 2008. The region's growth was based on an extremely favorable external situation resulting from the sustained expansion of the world economy and abundant liquidity in international capital markets. The region's terms of trade have been, on average, 33% higher than in the 1990s. Another stimulus was the rapid industrialization process under way in the developing countries of Asia, particularly China and India, which changed the structure of world demand. Latin America's export volumes soared at the same time as the terms of trade improved, which led to the region's accumulation of large trade surpluses. Another feature of the current international situation has been the growing influx of remittances from emigrant workers, especially in Central America, Mexico, Ecuador and Bolivia.

The Philippines conform quite closely to the Latin American case. A recent IMF report indicates that since 2005 the Philippines has experienced a surge in net foreign exchange inflows. These inflows were predominantly driven by the current account, particularly very strong inflows of transfers and remittances. Net foreign direct investment (FDI) flows, which had been very weak in previous years, turned strongly positive since 2005. Portfolio flows took an even more pronounced swing during the same time period. By contrast, net other investment (essentially loans) showed a large increase in outflows, reflecting stepped up debt prepayments by both the public and the corporate sector, as well as increased foreign lending by Philippine banks (IMF 2008).

The current international context is marked by extreme volatility in financial markets and greater uncertainty than the previous decade. Consequently, the developed economies are expected to experience a sharp economic slowdown. These changes in global conditions will have real and financial impacts on the emerging countries, in general, and in Latin America and the Philippines, in particular. Initially, these economies may be less affected than in previous crises, because they have reduced their external vulnerability in

recent years. Nevertheless, the situation clearly poses risks for the long run growth of these countries. First, exports of manufactures to the developed nations are expected to slacken. Second, migrant workers may send fewer remittances, which may sharply reduce disposable income in several Central American countries and also the Philippines. Lastly, future commodity prices, though difficult to predict, should tend to decrease as a result of the slowdown in demand and this, in turn, could affect exports, the current-account balance and growth, although it is highly likely that prices will remain above the levels observed in the first half of this decade. Similarly, the distributive impact of rising food prices will have a contractionary effect on consumption and on economic activity, since it affects the poorer sectors of the population most. It is also likely —though not always desirable— that central banks will raise monetary policy interest rates in order to contain the rising inflation, which will have further contractionary effects on regional GDP, although this will happen gradually. In the Philippines and other low-income countries in Latin America, the government faces the additional burden of mitigating the impact of higher food prices on the poor.

Due to past fiscal, monetary and trade reforms, the impact on the overall economy from the deteriorating external environment has so far been contained. Nevertheless, continued prudent macroeconomic policy management is needed to navigate through the challenging times ahead. Nevertheless, if the current bonanza is transitory the question is then whether Latin America and the Philippines are building up the capacity to face adverse shocks in the future. Or, as it has been customary, will a mild decline in world economic activity turn into an economic crisis?

Crises, either domestic or global, provide emerging countries the opportunities to improve macro and microeconomic policies to foster growth. Financial stress should lead the authorities to review regulations in the financial sector, in particular with regards to the quality of portfolios and of loans made to the productive sector. Foreign trade contraction should lead to an assessment of the competitive conditions of exporters and an identification of bottlenecks in infrastructure, price distortions that raise costs. Soaring unemployment should force the authorities to revise labor market regulations, aiming a efficiency and flexibility. Economic turbulence allow governments to gather support to enact reforms that are much needed for fostering long-run economic growth and, ultimately, increased welfare.

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