

Latin American structuralism and production development strategies

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1.1 Introduction

The recent international financial crisis has put macroeconomic analysis to a test. As in the Great Depression of the 1930s, the orthodox economic ideas about self-regulating markets that had prevailed in the years leading up to the crisis have been severely questioned. As a result, Keynesian thought, which had been born in the 1930s, has experienced an important revival – even if it has not always been followed in practice by policy-makers. In particular, Keynes' emphasis on the inherent instability of financial systems and the role played by aggregate demand in determining the levels of economic activity and employment have come back with significant force.

For the developing world and for Latin America in particular, crises have also spurred the development of new economic ideas and policies. The Great Depression of the 1930s planted the seed for the school of economic thought that was later developed at the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) under the intellectual leadership of Raúl Prebisch and that would eventually come to be known as Latin American structuralism.

Macroeconomic analysis arose out of the need to understand short-run macroeconomic dynamics, but later came to encompass the analysis of economic growth. The core ideas in this respect emerged in the 1940s and 1950s and were elaborated upon in the following decades. The idea that took centre stage had to do with the role of technological change, although also with the importance of physical and human capital formation. For developing countries, this analysis was mixed from

the start with three other concepts: (i) the role of surplus labour and the dualism in labour markets that it engenders; (ii) balance of payments constraints in both the short- and long-term macroeconomic dynamics; and (iii) the crucial role of industrialization as a mechanism for the transmission of technological progress. This last mechanism operates, in part, via investment in machinery and equipment, but also via production linkages and dynamic economies of scale generated by the learning processes associated with industrialization.

ECLAC and structuralist economic thinking have been in the past, and remain today, at the centre of this debate. This chapter deals with one particular aspect of Latin American structuralist thinking: the relation between economic growth and production structures. Section 1.2 summarizes the main contributions made by ECLAC and its main intellectual father, Raúl Prebisch, to this debate. Section 1.3 presents a detailed analysis of the relationship between economic growth and the production structure. Both sections make brief references to Latin America's experiences. Section 1.4 draws some brief conclusions.

1.2 ECLAC, macroeconomic analysis and structural change

At the risk of oversimplification, ECLAC's major contributions to macroeconomic thought revolve around two concepts. The first has to do with the crucial role of the balance of payments in shaping the business cycle in developing countries and, hence, the role that policies affecting the balance of payments have in managing the business cycle. The second is the link between long-term growth and the transformation of production structures, with industrialization as the most prominent feature of such transformation. Both of these ideas have implications for state intervention. They are also linked to a conceptualization of the international economic order as a system composed of a centre and a periphery, in which business cycles and technical progress originate in the centre and are then propagated to the periphery. At least two more ideas could be added: the need to develop appropriate financing mechanisms to facilitate the structural transformation, and what has come to be known as the structuralist theory of inflation. For the sake of brevity, however, this chapter will not deal with these issues.

Traditional macroeconomic analysis has developed the concept of "fiscal dominance" to refer to situations in which monetary policy and macroeconomic dynamics as a whole are determined by public finances. The concept developed by ECLAC might, by analogy, be referred to as "balance of payments dominance" in short-run macroeconomic dynamics (Ocampo, 2013). This implies that the basic

task of macroeconomic policy in developing countries is to devise ways of moderating external aggregate supply shocks generated through the balance of payments rather than managing aggregate demand. The former is determined largely by export earnings, the supply and cost of external finance and their impact on domestic interest rates, and the effects of both exports and external financing on the exchange rate.

It is not surprising that the management of balance of payments shocks became the focus of macroeconomic policy in Latin America. The types of measures used for this purpose in the past came to include, with some differences from country to country: foreign exchange and capital account management; import duties and quantitative import restrictions; taxes on traditional exports combined with incentives for non-traditional ones; multiple exchange rates; and, from the mid-1960s on, gradual devaluations (crawling exchange rate pegs). Starting in the 1970s, most of these policies were dismantled during the liberalization process, leaving a single tool – the exchange rate – to manage balance of payments. In several cases, this policy instrument was diverted to support anti-inflationary programmes, leading to situations in which no policy instrument was effectively assigned to manage external shocks.

As can be seen from the types of measures used, they were closely linked to the second component of macroeconomic policy, for which the focus was long-term growth: the industrialization strategy. The basic idea underlying this policy was that growth is a process of structural change in which primary sectors give way to modern industries and services and in which industrial activity is the main channel for the transmission of technical progress from the centre to the periphery – a process that Prebisch characterized as “slow and irregular”.

The complexities associated with this process were related to the management of economies whose static comparative advantages clearly lay in the production of primary commodities. In the classic ECLAC approach to the subject, industrialization strategies were also tied to the assumption that there was a secular downward trend of commodity prices. However, at least in the way it was framed at the time, this postulate has not been borne out by the facts. Indeed, the empirical evidence shows that, while real commodity prices fell through the twentieth century (but not in the nineteenth century), it was not a steady trend but rather the result of two sharp declines during the early 1920s and the 1980s (Ocampo and Parra, 2010). A much more solid line of reasoning is based on the fact that different sectors of the economy have very different capacities for transmitting technical progress and for generating new knowledge. Indeed, this classical justification for industrialization did not rely on the existence of a downward trend in commodity prices. Moreover, in the 1930s or immediately after the Second World

War, there was little need to champion domestic-based industrialization versus production for the international market since, in the wake of the collapse of the world economy, the only opportunities available were, by and large, those offered by domestic markets.

According to this approach, which was best expressed in the “Latin American manifest”, as Albert Hirschman dubbed the report issued by the Economic Commission in 1949 (Prebisch, 1973), the solution was not to isolate the region’s economies from the international economy, but rather to *redefine* the international division of labour so that Latin American countries could also reap the benefits of technological change, which they rightly saw as being closely associated with industrialization. In other words, this strategy sought to *create* new comparative advantages. Industrialization policies were modified as time passed in order to correct their own excesses and to take advantage of the new export opportunities that began to open up in the world economy in the 1960s. From that point on, ECLAC thinking began to evolve from an import-substitution strategy (with the institution becoming critical of the excesses associated with it) to a “mixed” model that combined import substitution with export diversification and regional integration.¹ This eventually led to the region’s widespread adoption of export promotion policies, a simplification of the complex system of tariffs and quantitative import restrictions, the streamlining or elimination of multiple exchange rate systems, and the introduction of crawling pegs in economies with a long history of inflation.²

An inherent problem in dealing with the intersection between factors influencing business cycles and long-term growth was that the changes in relative prices generated during the upward phase of external cycles make it difficult to hold to the industrialization strategy. Commodity price booms tend to generate incentives to return to a heavier reliance on primary production, both via rising international prices and through the effects that commodity price booms have on exchange rates.³ Both of these factors tend to exert downward pressure on the relative prices of manufactures. Capital account booms often coincide with upswings in commodity prices and have similar effects on the exchange rate. In the past, the policy tools devised to manage commodity price booms included

¹ For histories of the development of ECLAC thought, see Bielschowsky (1998), Rodríguez (2006) and Rosenthal (2004). In relation to the ideas on regional integration, see also Salazar-Xirinachs (1993). For a review of the first half-century of the *Economic Survey of Latin America and the Caribbean*, see ECLAC (1998b).

² See Ffrench-Davis, Muñoz and Palma (1998); Ocampo (2004); and Bértola and Ocampo (2012).

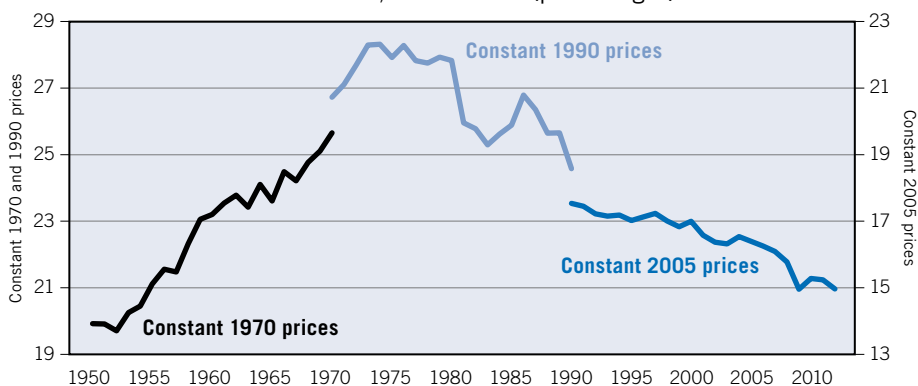
³ See analysis on Dutch disease effects in Altenburg and Melia, in this volume.

taxes on commodity exports, multiple exchange rate regimes that discriminated against those exports, and incentives for non-traditional exports, while capital controls were designed to deal with shifts in financing cycles. The dismantling of most of these policy instruments led to a situation in which, too often, governments came to reinforce the effects of external shocks with procyclical macroeconomic policies.

The industrialization strategy entailed a range of other elements, including the need to raise the rate of investment in manufacturing and physical infrastructure. This gave rise to a demand for multilateral external financing and to the development of domestic mechanisms, notably development banking and direct investment by the State in infrastructure and some industrial activities. In any case, the level of investment varied sharply across the region. For the sake of brevity, however, these topics will not be explored here.

Despite inefficiencies associated with high levels of protection, state-led industrialization was in many ways a very successful story. It led to the fastest rate of growth in Latin American history between 1945 and 1980, which was accompanied by rapid rates of human development and reduction in poverty levels (Bértola and Ocampo, 2012, Ch. 4). However, this process reached a plateau in the second half of the 1970s (figure 1.1), and was followed by a premature deindustrialization, in the sense that the share of manufacturing in GDP started to fall at lower levels of per capita income than had been typical of patterns in advanced countries. This process was set off by the joint effects of the debt crisis of the 1980s and the liberalization process that started in the mid-1970s in a few economies and spread throughout the region from the mid-1980s.

Figure 1.1 Latin America: Manufacturing value added as a share of GDP, 1950–2012 (percentages)



Source: Author's estimates, based on ECLAC data.

In the midst of the liberalization process, ECLAC produced its groundbreaking study *Changing production patterns with social equity* (ECLAC, 1990), which marked the beginning of a complete reworking of ECLAC thinking that has exhibited a remarkable degree of continuity over the past quarter century. In line with the proposals concerning economic growth that it put forward in its seminal 1990 study, ECLAC (1998a, 2000, 2007, 2008 and 2012) developed an agenda for production sector strategies in open economies. The point of departure for this agenda, as well as for the Commission's more classic contributions, was the idea that development is a process of structural change in which progress hinges on the economy's ability to develop technologically advanced production sectors. Accordingly, together with the promotion of more competitive production structures and "horizontal" policies to correct market failures in factor markets,⁴ ECLAC proposed a series of policies for developing more dynamic production structures by fostering innovative activities with higher technological contents (national innovation systems) and promoting exports (diversification of export products, domestic export linkages and the conquest of new markets). It also suggested ways of developing inter-sectoral synergies and complementarities in order to achieve "system-wide competitiveness", which was the seminal concept put forward in *Changing production patterns with social equity*.

The major constraint on the adoption of this policy was the institutional void created by the elimination of the mechanisms for supporting production sectors as the result of liberalization policies. ECLAC advocated the idea of forming public private partnerships (which each country should establish in line with its own characteristics and development history) to rebuild these institutional frameworks. The destruction of earlier institutions and the failure to build others to replace them were seen as the root causes of the fragility of the region's production structures. This strategy was also tied in with short-term macroeconomic policy because of the institution's obsession with maintaining competitive exchange rates, which were viewed as an essential ingredient of proactive policies to foster production sector diversification.

The recent return of attention in the region to industrial policies has validated ECLAC's approach. In particular, the widespread acceptance in the past few years of innovation strategies reaffirmed the validity of the approach that ECLAC advocated during Latin America's industrialization stages and which it continued to endorse and to adapt to changing circumstances generated by deeper integration into global markets.

⁴ These policies focused on providing credit to small and medium-sized enterprises (SMEs), long-term financing as well as technology, skilled human resources and land.

1.3 Economic growth and structural change

1.3.1 *Patterns of specialization and economic growth*

Economic growth is invariably accompanied by changes in production structures: changes in the composition of GDP and employment and in international specialization patterns. In addition, in developing countries, gains in productivity through the development process are linked to shifts in labour from low- to high-productivity sectors, as noted in classic development theory and discussed by Ros (2000). Most traditional studies portray changes in structures as simply a by-product of growth. In the structuralist view, on the other hand, these changes are neither mere by-products nor neutral in terms of their effects; quite to the contrary, they are the actual *engines* of economic growth. Seen from this perspective, development can be equated with an economy's capacity to generate new dynamic production activities (Ocampo, 2005). By the same token, the absence of growth is linked to an interruption of the process of structural change.

In industrialized countries the process of economic growth is driven by technological change. Since the generation of technology continues to be highly concentrated at the world level, it creates a world centre–periphery system. In developing countries, growth is driven by the capacity to absorb, with a lag, these technological changes and economic activities as they become mature and are gradually transferred to the periphery, or by the capacity to respond to the demand for commodities created by economic expansion at the centre. The transfer of technology and production activities is not a passive process: it entails an effort to develop new industries, including those attracted from industrial countries, as well as an active technological learning process (Katz, 1987). If efforts to narrow the technological gap succeed, these lags will be reduced and developing countries may become secondary sources of technology.

This emphasis on changing production structures is closely tied with the need to increase investment. Rapidly growing economies also have high investment rates, but this link is much less systematic than the one that exists between economic growth and structural change (Ocampo, Rada and Taylor, 2009, Ch. 3). This is because high investment rates are actually more of an effect than a cause of dynamic economic growth and associated structural change. This is why more attention will be devoted here to structural change than to investment. There can be, of course, other determinants of capital formation, in particular factors related to appropriate financing mechanisms.

There are a number of reasons why economic growth and changes in production structures are interrelated. The first explanation, which has the longest history in development thought, is that different branches of production create very

different opportunities for generating and transmitting technical progress and, hence, for boosting the economy's productivity. The classic defence of industrialization made the argument that industrial activities were the best channel for transferring technology and spurring other innovations. Some primary-sector activities, such as agriculture and mining, may also experience steep increases in productivity, but they have been less effective in transmitting those increases to other sectors of production.

This leads us to the second explanation, which has to do with different sectors' production linkages. The more traditional sorts of linkages, which are the type focused on by Hirschman (1958), are created by the demand that a new activity generates for others (backward linkages) and the opportunities that it offers for the development of other activities (forward linkages). The key feature to notice in this connection, as well as in the case of the transmission of technical progress, is that these effects are confined to a single geographical area (a country or a region within a country) and do not radiate out to the rest of the world, as tends to occur in an increasingly integrated world economy.

A type of linkage identified more recently has to do with what Hidalgo et al. (2007) call the "product space". In these authors' view, the factors and inputs used in a given branch of production are invariably specific in nature, such as particular kinds of production plants or facilities, workers with certain types of skills and specific intermediate inputs. Consequently, they cannot be directly shifted over to other economic activities except at the cost of lower levels of productivity. They can, however, be used or adapted for use in activities that are in the nearby "product space". In this view, a production activity's capacity to innovate and diversify will depend on what activities are "nearby". Thus, depending on the "density" of nearby production activities (the authors use the metaphor of a forest which is more dense in some areas and sparser in others), they will generate very different opportunities for the diversification of production.

These two phenomena, which, in a broad sense, can be referred to as *innovations* and *complementarities*, should be the essential focus of any production

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