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AND THE GLOBAL FINANCIAL CRISIS

WORKING PAPER 5  
THE INTER-AMERICAN DEVELOPMENT BANK AND THE  
GLOBAL FINANCIAL CRISIS:  
PROMOTING PRODUCTIVE DEVELOPMENT

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## Abstract

This paper reviews the response of the Inter-American Development Bank (IDB) to the ‘global financial crisis’, against the background of its analysis of regional development priorities prior to the crisis. Between 2003 and 2009 the Bank developed a focus on ‘productive development’: ‘industrial’ policies for open national economies in an integrated world economy, with an emphasis on productivity-enhancing social and labour-market reforms. Its response to the crisis reflected the fact that as far as Latin America and the Caribbean (LAC) was concerned, it was short-lived, and gave way to a phase of global rebalancing in which conditions for renewed growth were largely benign (with easy access to capital and strong demand for commodities), but at the same time variable in their impact, and fraught with risk. The period between 2008 and 2013 was as much one of opportunity as crisis; production and trade were as significant as finance, though there were financial risks that needed to be managed; and intra-regional variation was as important as ‘global’ impact. The Bank consistently stressed the need to be ready to restore and maintain the momentum of productive development once the world economy as a whole emerged from the crisis period. In 2013, as the crisis drew to a close, the Bank again highlighted long-running problems of low productivity and domestic savings, and identified the prevalence of informal labour and inefficient firms as the principal obstacles to sustained growth. It argued, therefore, that policy should focus on the reallocation of resources, the elimination of perverse incentives, and the promotion of productivity-enhancing structural reform.

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## THE INTER-AMERICAN DEVELOPMENT BANK AND THE GLOBAL FINANCIAL CRISIS: PROMOTING PRODUCTIVE DEVELOPMENT

### INTRODUCTION

The key to understanding the impact of the ‘global financial crisis’ in Latin America and the Caribbean as well as the response of the IDB is to grasp that the crisis phase quickly gave way to a short and exceptional period characterized by relatively benign conditions in terms of easy access to low cost capital, and sustained demand from other emerging economies for primary commodities, that one group of countries (primary exporters in South America and Trinidad and Tobago) was seen as better placed to take advantage of these conditions than another (Mexico, Central America and the rest of the Caribbean), and that the commodity export boom was not seen as a basis for long term growth. The Bank predicted that this period of transition (which it described as a ‘two-speed’ world economy in which growth in emerging economies far outstripped that in the advanced economies) would give way in the medium-term to a more balanced global economy marked by a permanent shift in the global distribution of production and income, an accompanying shift from exports to domestic demand in emerging economies, and a greater level of integration and competitiveness in the global economy as a whole. The key to successful navigation of the period of ‘global crisis’ was therefore to ensure that short-term policy responses did not work against the over-riding need to position one’s economy for the new circumstances that would prevail once the crisis was over. This meant that its focus would remain on an agenda of structural reform already in place, intended to promote ‘productive development’. Overall, the analysis offered the period 2003-2013 is striking in its consistency and its attentiveness to original, sophisticated and detailed empirical analysis, and highly coherent, *within* the Bank’s unwavering commitment to global liberal capitalism.

Given the rich and varied output of the IDB itself, and the equally substantial policy analysis produced by ECLAC, the World Bank, and other international organizations, sometimes in partnership with the IDB, my approach is necessarily selective. I touch only briefly or not at all on some key contributions to the ‘political economy of reform’ (IDB, 2006, 2010b; Lora, 2007), I leave for another time the Bank’s substantial work on China, and I offer a descriptive synthesis, not a critique (for which see Cammack, 2006, 2009; Charnock, 2009). As regards the structure of the paper, a substantial policy review conducted by the Bank in 2003 is taken as a baseline. I then turn to the response to the crisis, taking two complementary policy papers from 2009 as a focus. The final section tracks the theme of productive development through successive annual macroeconomic reports through to *Rethinking Reforms* (IDB, 2013).

### BASELINE 2003: A PUZZLE AND A SOLUTION

In 2003 the IDB's Office of Evaluation and Oversight (OVE) conducted a comprehensive review of the Bank's 1997 poverty reduction strategy, and the Bank itself concurrently produced a set of strategy documents to guide its future activity. The OVE report noted the policy review in progress, but declared it 'beyond the scope of this evaluation' (IDB, 2003a, ft. 2, p. 1). It picked out as the core of the Bank's approach its statement in the 1997 document that 'the basic strategy of poverty elimination is to help the poor earn their way out of poverty. To do that the economy must generate an expansion in the number of jobs available to the poor and an increase in the productivity or earning power of the poor in these jobs' (IDB, 1997: 2, cited in IDB, 2003a: 6). The IDB proposed to achieve its goal of poverty reduction 'through a set of core policies and actions built upon two major themes: the improvement of the human capital of the poor, and, most importantly, the increase of their employment and income generating opportunities' (ibid: 9). This echoed directly the agenda launched by the World Bank in 1990 (World Bank, 1990; Cammack, 2002), and it featured, as the OVE report noted, two 'guiding principles' 'pro-market reform to increase opportunities through economic growth and creation of jobs,' and 'targeting, rather than universality as an approach to building capacities' (ibid: 28).

In its evaluation, the OVE noted the following 'puzzle': 'the reforms undertaken with the encouragement of the IDB and other multilateral agencies have not yet resulted in a sustained acceleration of economic growth relative to the sixties and seventies,' despite 'the implementation of structural reform measures,' 'a better policy environment', and improvements in most of a 'host of variables identified as contributing to growth'. Rather than a strong pro-poor bias emerging in recent growth, 'the poorest 25% of the poor had generally a negative change in their real household per capita income during the nineties'; the region's sensitivity to external shocks and hence its volatility may have increased; unemployment rates had risen; informality and self-employment had increased; and while real labour income had begun to recover if only 'glacially' from its declines in the 1980s, 'there is a sharp increase in net participation rates, particularly of female participation rates in the lowest quintile,' and the number of hours worked by household shows a strong increase in the lower quintiles, with the lowest quintile showing the largest increase' (ibid: 30-32). In short

These results indicate that the marginal gains in real labour income obtained by the poor were mainly due to increases in participation rates and "efforts" rather than increases in the average remuneration received by the poor. ... Thus the 1997 strategy goal of helping the poor earn their way out of poverty through the expansion of the number of jobs available to the poor and increase the earning power of those jobs (sic) does not appear to have been achieved. Furthermore,

even though the region's poor have always been excluded and vulnerable, the reform has increased that vulnerability to covariate shocks, thus increasing risk for workers and households. The ensuing "transitory" poverty thus is an increasing challenge faced by the region and the Bank (ibid: 32-3).

Concluding this section, the report questioned 'the assertion that improved governance should result in a shift towards redistribution of income and assets – including land towards the poorer members of society,' offering the hypothesis that 'the main factor accounting for inequality is not personal or household characteristics, but the economic and political environment surrounding them,' and suggesting that perhaps 'inequality and poverty are entrenched in the economic and the political system (ibid: 33). Despite investment in health and education, it went on, 'the promise of increased capability raising productivity, does not seem to be occurring', possibly because specific attention to 'an economic and institutional environment conducive to poverty growth' would be needed to bring this about (ibid: 37). 'Furthermore',

the relative progress obtained during the decade in terms of improved capabilities (even if not consistently pro-poor) were (sic), at least partially, offset by a failure to increase the "number of jobs available to the poor and increase the productivity or earning power of the poor in those jobs" as envisaged by the strategy (p.1) (ibid: 38).

As a result, the impact on poverty was moderate – a drop in the incidence of extreme poverty from 19 per cent to 13 per cent in the 1990s, and a 14 per cent reduction in the absolute number of extremely poor, to 77 million, with some evidence of subsequent worsening of these indicators (ibid; 38-9). In response to all this, the report concluded that 'a serious decline in the Region's poverty will require the countries and the Bank to follow a different path from that of the nineties' (ibid: 43).

Even so, the report did not reject the strategy out of hand. It recommended that more attention should be paid to local circumstances, and that the Bank should establish 'comparative information-databases relating to indicators and benchmarks for measuring performance,' which would enable it to 'work with borrowing countries to establish clear and measurable goals,' and offer critical evaluations of past interventions. 'Perhaps,' it suggested, quoting from a paper by Rodrik (mis-named as Roderick) (1999),

a greater emphasis on income and asset inequality, as well as the problems of market and governance failures needs to be raised. Then the Bank may rise to the challenge of developing a de facto poverty strategy that has a "vision of how social cohesion can be maintained in the face of large inequalities and volatile incomes, both of which are being aggravated by the growing reliance on market forces." If the Bank is to be relevant to the Region it needs to help countries "develop an alternative vision that articulates how tensions between market forces and the yearning for economic security can be eased" (ibid: 44).

After all this, the specific recommendations made were modest: more resources should be allocated to the poverty reduction effort within the overall budget; ‘Management should develop information on targeted social expenditure programmes as part of the country programming process’; and, concluding the report:

Management should formally raise the issue of *poor labour market performance* in its annual country updates. Over the past decade, there has been significantly more progress on improving the capabilities of the poor than on improving their opportunities for productive engagement in the economy ... . This imbalance warrants additional attention from the Bank. Annual country strategy updates should contain a country specific diagnosis of the situation regarding unemployment and wages, along with an action plan for future Bank intervention to improve the situation if the diagnostic reveals significant problems with respect to the labour market performance of the poor (ibid: 45, emphasis mine).

So although the report cast doubt on the adequacy of some elements of the existing strategy, and drew attention to the need to address income and asset inequality and the ways in which they were entrenched in the economic and political system, it essentially called for a better co-ordination of targeted social expenditure and labour market reform again, an approach that was in line with concurrent World Bank policy review in the area of social protection (Cammack, 2012). This approach, most recently reiterated in the 2013 *World Development Report* (World Bank, 2013), reflected the view that while success had been achieved in increasing labour force participation, increased *participation* had not fed into ‘good jobs’ and increased productivity. In short, ‘good’ or productive jobs remained the focus, and the issue was to find a better way of creating them. So while the broad policy approach was correct, structural and institutional shortcomings of various kinds, including prevailing patterns of risks and incentives, were blocking the path to the generation of much-needed step changes in productivity.

The integrated strategy adopted concurrently by the Bank showed clear evidence of engagement with the OVE review, in that its structure (with sections on diagnosis and lessons learned, and emphasis upon country-specific dialogues and strategy papers, for example) reflected the critique and advice offered. At the same time the Bank defined a comprehensive agenda structured around two overarching goals, sustainable economic growth, and poverty reduction and promotion of social equity, and four priority areas of comparative advantage for Bank activity: Modernization of the State, Competitiveness, Social Development, and Regional Integration. It also considered the Environment as crosscutting and addressed it in each of the four core areas. As formulated in its totality:

This strategy has a multidimensional focus and establishes the relationships between the Bank’s priority areas and the general goal of sustainable economic growth. Proposed Bank actions to foster growth include the following lines of

activity: strengthen the institutional foundations for *macroeconomic stability*; improve the *competitiveness* of productive activities, with special emphasis on the institutional and economic environment for the strengthening of financial systems and the infrastructure sector; increase the quality and coverage of education and health, to promote human capital and *social development*; strengthen public institutions and improve democratic governance, in the context of the *modernization of the State*; and promote *regional integration* and improve the relative position of the countries of the region in the world economy. Activities in all of these areas will pay particular attention to the environmental dimension, in order to ensure the sustainability of economic growth (IDB, 2003b: np)

The strategy document on sustainable economic growth recognized the challenge posed by a decade of low per capita growth and identified increased productivity, rather than the simple accumulation of factors of production, as the key. It highlighted the need for macroeconomic stability; public institutions capable of securing the latter, ensuring the efficient operation of markets and carrying out structural reforms to make them more flexible; deeper financial sector reforms; and the improved infrastructure services that were ‘an essential determinant of national and foreign private investment’; and it noted the need to ensure environmental sustainability. Within this framework, it outlined a comprehensive strategy for *greater integration into world markets on the basis of system-wide improvements in human and social capital, and labour productivity*, focused on

the importance of increasing the region’s participation in world markets through regional integration, since a dynamic export sector that takes full benefit of the region’s comparative advantage is a key element to improve the possibilities of economic growth; the need to promote social development and enhance human and social capital, since they provide the foundations to improve labour productivity and to provide a favourable environment for productive activities; the need to include actions to improve productivity and the income of the poorest and excluded populations, since actions that directly benefit marginalized populations and those to promote sustainable economic development are complementary in most cases; and the need to ensure environmental sustainability, since it is key for the consolidation of the comparative advantages of the region, the promotion of long term productivity, and to ensure sustainable economic growth (ibid: ii).

The core objective, then, was to promote productivity and competitiveness, in order to ‘improve the relative position of the countries of the region in the world economy’ (ibid). This gave the Bank a clear guiding framework that remains in place ten years on:

The proposed framework for action is based on the recognition that macro-economic stability helps to improve the private investment climate and provides budgetary certainty for public investment. Similarly, the quality of institutions,

stable financial systems with broad coverage, infrastructure, and the quality of human capital contribute to investment processes and the productivity of existing assets, both public and private. In turn, regional integration and a good economic positioning in the context of globalization strengthen investment and create new opportunities for growth. For this reason, the actions that the Bank is proposing to develop address the following priorities: (i) strengthen the foundations for macroeconomic stability; (ii) improve the conditions for competitiveness for the development of productive activities, with special emphasis on the institutional and economic environment for the strengthening and stability of the financial systems and public infrastructure service sectors; (iii) increase the quality and coverage of education and health to promote human capital and social development; (iv) strengthen public institutions and improve the political climate in the context of modernization of the State; (v) promote regional integration and the countries' international positioning. Likewise, all these actions will be undertaken within an environmental perspective to ensure the sustainability of economic growth (ibid: 11).

The need for a 'democratic, modern and efficient state' with active citizen participation reflected the need 'to guarantee an adequate relationship between the State and the market, which in turn assures the economic incentives on which sustainable growth rests' (ibid: 15). Protection from risk would allow workers to risk more in the market, and social development policy would promote productivity by changing the incentives facing potential workers – protection from risks associated with integration into reformed labour markets, and positive incentives for productive activity and investment through 'reduction of social exclusion, social conflicts and anti-social behaviour' (ibid: 16-17).

The parallel document on poverty reduction and social equity highlighted the continuing incidence of poverty and inequality, and set the objective of poverty reduction squarely in the context of incorporation into the productive process:

At the end of the decade, the richest 20 per cent of the population accounted for around 60 per cent of the region's income, while the poorest 20 per cent received around 3 per cent. In most countries, inequality is greater than what would be expected given per capita income levels. This is due mainly to great disparities in assets and, in particular, to the level and quality of human capital and its returns. The persistent inequality in the region not only hinders efforts to reduce poverty with growth, but also is limiting the countries' growth rates (IDB, 2003c: i).

This 'diagnosis' led straight to the comprehensive approach reflected in the parallel document reviewed above:

To reduce poverty, in addition to sustainable economic growth, macroeconomic stability and democratic governance, targeted activities are also required, such as: creating productive opportunities for the poor and excluded populations; providing better access to physical and social infrastructure; addressing

structural inequities in the distribution of assets (particularly in the area of education); establishing comprehensive social protection systems and dealing with social ills that disproportionately affect the quality of life of the poor; eliminating the social barriers that leave ethnic groups and women at a disadvantage; and promoting a more efficient and effective State, that is more inclusive and sensitive to the needs of the poor, more accountable, and better recognizes the human rights of the poor (ibid: i-ii).

Essentially, then, the document set out to bridge the gap identified by the OVE report between growth policies on the one hand, and social protection on the other: ‘Specific actions to improve the living conditions of the poor and the policies to increase per capita income and productivity are not necessarily inconsistent, instead, in many cases they are complementary’ (ibid: ii). Within this context, the Bank would ‘favour financial support for actions that contribute directly to strengthening the productivity and income generation potential of the poor and excluded groups, including the expansion of physical and social infrastructure and the development of their human capital,’ which in turn required ‘a strategy that combines improvements in the overall *Competitiveness* climate with targeted measures to tackle constraints on the productivity of the poorest workers and small producing units’ (ibid: iii). Among the objectives contemplated were greater integration into international markets, by means of ‘measures to improve regulatory systems, particularly at the micro level and in the (sic) labour markets’, including ‘removing barriers to the formalization and growth of micro enterprises and small businesses, and promoting competitive pricing of basic utility services like power and water’ (ibid: 8). Additionally,

Although the insufficiency of incomes to emerge from poverty relates fundamentally to human capital insufficiency (an issue examined in the section on human development) and the lack of complementary assets (particularly capital and infrastructure), recent studies show that labour regulations are also keeping workers, especially the less educated, out of higher productivity jobs. To improve the access of these workers to better jobs, countries need policies that simultaneously lower recruitment and termination costs and help create more jobs. Necessary adjuncts to such policies are improvements in instruments for social protection and intermediation and employment training programs to help displaced workers find new jobs in dynamic sectors of the economy (ibid; cf. 17).

Sections on education, health and productive work focused on reasons and means to encourage the poor to invest in human capital, with particular emphasis given to ‘women’s development and empowerment,’ unsurprisingly glossed as the education of the mother, the involvement of women in the workforce, and a preponderant role in the implementation of programmes to fight poverty (as in control over cash transfers) (ibid: 8-10; cf. 18-19). The document then turned to social protection, developing the theme

that the poor's excessive exposure to risk was a major obstacle to poverty reduction, and spelling out the logic also advanced in its account of sustainable growth:

The region needs to redouble efforts to develop sound institutional responses to cushion the impact of adverse shocks on the poor. Social-protection policy interventions can improve the welfare of poor people faced with sharp drops in income or consumption and possible erosion of human capital investment. Apart from these equity improvements, *social protection for the poor can spur growth in so far they can afford to take riskier, but with higher returns, activities in the production sphere and labour market*. Lastly, if the poor are shielded from income fluctuations associated with the lowering of trade barriers and flexible labour markets they will be more likely to back liberalization programs and pro-growth reforms (ibid: 11; cf. 23; emphasis mine).

Each of the forewords to the policy documents contained the concise statement that 'This renewed strategic framework proposes actions to improve the well being of the region's people, placing special emphasis on the poorest. It does so within the framework of democratic governance, global competitiveness, social inclusion and cohesion, the new regionalism, and mainstreamed environmental sustainability' (IDB, 2003b: np). As noted, the emphasis throughout was on the existing structural and institutional impediments to the translation of improved macroeconomic policy making into more productive jobs and successful engagement in the global economy. Overall, the framework and the detailed proposals that stemmed from it were neither surprising, nor original. Rather, they added up to a comprehensive approach that fully reflected and linked with current thinking in official development circles, from the OECD, with its strong focus on product and labour market reform, to the World Bank, with Poverty Reduction Strategy Papers (PRSP) and related initiatives, along with concurrent work that would be reflected in the 2004 and 2005 *World Development Reports*, on the themes of 'making services work for poor people', and creating 'a better investment climate for everyone' (Cammack, 2002b; World Bank, 2003, 2004). The puzzle here, if there is one, is that ten years on, after two periods that in different ways offered surprisingly benign conditions for growth in the region, little progress had been made in relation to the reform of labour markets, and low productivity remained a key issue. It is not surprising, then, that the issue of productive development looms large.

### PRODUCTIVE DEVELOPMENT

The notion of 'productive development' has been a principal component of the analysis developed by the IDB for a decade. It was essentially a rethinking of industrial policy in the wake of the critique of earlier policies of import-substituting industrialization (ISI), and in the new context of global competitiveness. Underpinning it, both at the Economic Commission for Latin America and the Caribbean (ECLAC/CEPAL) and at the IDB, was

the conclusion that ‘the late 1980s and the entire decade of the 1990s represented a transition from the industrial policies of the import substitution model to industrial policies suitable for open national economies in a more integrated world economy’ (Melo, 2001: 3; see also Peres, 1997, and ECLAC 2002, 2004). Melo identified a turn in industrial policies in the region to ‘explicit industrial policies congruent with the new, market-oriented, development strategy adopted by most countries in the region’ (ibid: 5).<sup>1</sup> These new policies, pursued in various ways in Brazil, Colombia and Mexico in particular, aimed to ‘improve the competitiveness of domestic producers in a new, increasingly integrated and open world economy’ (ibid: 7), through policies to promote exports, output growth and investment, and higher productivity and competitiveness, the latter through the integration of production chains, and measures to protect and promote competition, and promote technological modernization and SME development (ibid:14-48).

The character of ‘productive development’ was spelled out further in a later paper (Melo and Rodríguez-Clare, 2006). It defined productive development policies as ‘policies that aim to strengthen the productive structure of a particular national economy’, in order to ‘raise growth and improve the competitiveness of the overall economy while maintaining a rising trend in living standards’ (ibid: 5), ran through a stylized contrast between the import-substitution and liberalization periods, and identified the defining feature of current policies as ‘encapsulated in the key idea that *the new industrial policies are aimed at improving the competitiveness of domestic producers in the new, more integrated and open world economy*’ (ibid:12, emphasis original). In summary:

A key generic feature of the new approaches to productive development policies in the region is that they attempt to address a core set of issues (such as productivity, efficiency, product quality, etc.) revolving around the central question of how to raise countries’ competitiveness. The obvious underlying assumptions are that trade liberalization was necessary and is here to stay; that it is not only desirable but possible to change the prevailing world distribution of comparative advantages so as to increase the region’s exports of manufactured goods (and even high-technology goods and services) and decrease dependence on primary-sector exports; and, lastly, that the government has a role to play in this task (ibid: 13).

Their survey of productive development policies in Latin America was set in the context

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<sup>1</sup> He noted three key features of industrial policy: ‘First, the adoption of the new industrial policies was almost simultaneous in a significant number of countries and can roughly be dated to the three-year period 1994-1996. Second, in most leading countries this took the form of explicit, medium-to-long-term plans, programs, and/or strategies for the industrial sector. Third, the policy turn was generally the outcome of (or, at the very least, was broadly related to) a public debate about the effects of the structural reforms and the need to improve the domestic industry’s competitiveness in the new context of a more open national economy’ (ibid: 5).

of a ‘two-paradigm hypothesis’, contrasting *demand-driven* and *strategy-driven* approaches typified by Colombia and Brazil respectively. The first responds to the ‘needs of existing sectors in the private economy, with the main aim of raising their international competitiveness’, while the second is ‘characterized by its emphasis on crisp definitions of the desired medium- and long-term changes in the vector of goods and services produced by the economy and the use of selective policies to promote a small number of industries’ (ibid: 13-14). An alternative framework, prefacing analysis of specific policies, contrasts creating incentives for producers to “do more of the same” (increase output and investment while leaving their production functions unchanged) with those that aim to encourage them “to change their ways” (or alter their production functions). Neither of these alternatives approximates to the ‘strategy-driven’ approach, which is intended to create *new* branches of activity, rather than to build upon or transform existing ones.

Melo and Rodríguez-Clare concluded that ‘Latin America’s incursions into activist development policies have been timid and inconsistent,’ noting as a ‘particular weakness in the intellectual climate of industrial policy formulation in a number countries (sic) in the region – but by no means all – that, judging by the existing policies, the lessons from other regions of the world have not really been learned’ (ibid: 54, 56), singling out the need for subsidies to be both temporary and contingent upon performance (ibid: 56-7). Still, they identified as ‘genuine contributions to the arsenal of economic development thinking and practice’ the ‘idea of a public-private partnership working towards key development objectives (such as improving competitiveness and raising productivity), together with systematic, organized public-private dialogues to discuss problem diagnoses, policy measures, and action commitments’, and the ‘sheer amount of experimentation currently taking place in the region’, as a necessary learning process on the way to ‘new more consistent and less timid policy frameworks where productive development policies can develop their potential to effectively contribute to the goals of economic growth and modernization’ (ibid: 57).

#### **BEFORE THE CRISIS: FIVE YEARS OF ‘EXCEPTIONALLY GOOD TIMES’**

In sum, as we have seen, the 2003 policy review led to an integrated strategy grounded in macroeconomic stability and focused on improved productivity and competitiveness as keys to lasting gains in growth and poverty reduction, with social policy and social protection aligned with these goals. Over the period to 2008, general progress was made, in the context of what the Bank’s 2008 Macroeconomic Report called five years of ‘exceptionally good times’ (IDB, 2008: 1). But as it would report three years later, while ‘the fraction of people living on less than US \$ 2.5 per capita per day in the Region fell from 27 per cent to 18 per cent,’ and income inequality (Gini coefficient), improved in 13 out of 16 countries for which data was available, and long-term gains in education and

infant mortality were sustained and improved, two serious problems remained:

Despite this progress, two striking features of Latin American and Caribbean economies are the *continuing and very high levels of inequality*, and the *low levels of productivity*. Latin America and the Caribbean is the most unequal region in the world, bar none. Inequality has very serious social and economic costs – it results in higher levels of crime, lower levels of growth, and less poverty reduction. The Region also has very low levels of Total Factor Productivity (TFP) – between 1960 and 2005 TFP grew by approximately twice as much in the typical East Asian country as it did in the typical country in Latin America and the Caribbean. *Productivity is a social issue because it is the key to long-term increases in real wages, as well as to increases in incomes for households outside the wage-earning sector* (IDB, 2011a: 1; emphasis mine).

As GDP growth averaged 2.3 per cent per year between 1995 and 2002, and improved to 4.8 per cent per year between 2003 and 2008 (ibid: 10), the response was not to repudiate the previous strategy, but to reinforce its central logic:

To meet the twin challenges of high inequality and low productivity, the focus is on interventions that are meant to build human capital throughout the life cycle; facilitate the insertion of workers in the labour market; and help households manage risk, including the risk of ill health, old age, loss of employment, and destitution; and ensure that all households can attain acceptable levels of consumption, education, health, and nutrition (ibid: 1).

The IDB's response to the global crisis was shaped by the diagnosis and orientation set out prior to its onset, and by its long-term objectives related to 'productive development'. Seven strategic priorities were identified: investing in early childhood development; improving school quality; addressing 'youth-at-risk'; improving the functioning of labour markets and the coverage of social security; addressing the 'double burden' of health transition (chronic lifestyle related conditions along with 'a backlog of reproductive and communicable diseases, child malnutrition and anaemia which continue to disproportionately affect the poor'); addressing structural poverty (through conditional cash transfers); and fostering social inclusion (ibid: 2). Among these, the most significant was the focus on labour markets, and on the drawbacks of the high incidence of informal employment. These stemmed from a range of factors – high registration and transaction costs, low access to finance, high taxes on firms, and rigid labour regulations – and were exacerbated by distorted incentives arising from the way that social insurance was funded. In particular, the provision of free health insurance and non-contributory pensions reduced the incentives to participate in contributory schemes:

In sum, the low valuation of social insurance by workers in the formal sector creates a tax on formal work, while the creation of non-contributory pension and health care programmes for those in the informal sector is a subsidy to informal

work. This can distort the choices made by firms and workers – and the costs of these distortions may be far from trivial. .. In addition, most workers are not well covered against risks. The implications of this situation for pension systems are that low contribution rates and high mobility between formal and informal jobs result in low contribution densities, defined as the fraction of time that workers contribute towards a pension during their active work lives. For a large proportion of workers, particularly for the least skilled, contribution densities are below the threshold needed to qualify for a retirement pension in defined benefit models, or will result in very low pensions in individual capitalization systems. ... In terms of unemployment protection, workers in the Region are ill-equipped to face the risk of job loss. Most countries mandate firms to pay severance in case of dismissal, and 12 countries in the Region have either unemployment insurance or unemployment saving accounts. But severance pay and unemployment insurance cover formal workers only, and even in the formal sector coverage is low. Severance pay may also have potentially large cost in terms of employment creation. Moreover, because poor workers are over-represented among informal workers, they are less protected than others against the risk of employment loss (ibid: 22).

In other words, the present situation reflected the worst of all possible worlds.

In broad terms, then, the implications were the same, whether the world market was in a state of boom or bust – the proposed policy set could be advanced as the best means to take advantage of the former, or to minimize the negative consequences of the latter. So it is not surprising that it did not change as the depth of the crisis was revealed. At its core was the advice to push forward with structural reforms, and particularly to promote greater productivity and exposure to world market completion, with reforms to social protection integral to the realignment of individual risk in relation to both the domestic labour market and international competition.

### **BASELINE 2009: MACROECONOMIC STABILITY AND SOCIAL REFORM**

The initial response of the Bank to the crisis came in the (April) 2008 Macroeconomic Report, *All That Glitters May Not Be Gold*. As the title suggests, it sounded a note of caution. Completed as the crisis was breaking, it questioned whether the major Latin American economies were sound enough to withstand the adverse external shock that it represented, arguing that ‘growth performance and fundamentals are weaker than meets the eye’ (IDB, 2008: 2). The positive evidence to which it called attention – growth rates close to 6 per cent per year, low inflation, fiscal prudence, sound financial policy, falling public debt, rising international reserves, improved credit ratings and untroubled bond markets – were no cause for complacency. If the effects of ‘favourable winds’ were stripped out, the growth rate was ‘less than exceptional’, and if proof were needed, LA stood last (‘behind every other emerging region, including Africa’) in growth in real GDP

over the period 2003-2007 (ibid: 8, 9). Private investment was no higher than in the last upturn, and productivity growth was poor; the small fiscal surplus concealed a structural deficit if the cyclical nature of activity was taken into account; public investment as a share of primary spending was 'currently at its lowest level in thirty years and only half that of emerging Asia', public debt had not fallen as much as it should have, given the favourable context, too many private firms were putting cash on deposit abroad, and the build-up of international reserves was matched by monetary liabilities and beset by exchange rate risk (ibid: 11-23). The emerging 'sub-prime' crisis in the US and the 'real fear of a recession in the US economy' (ibid: 25) were addressed against this background, with the relative immunity of Latin American bonds to the crisis attributed not to strong fundamentals but to the specific (domestic) source of the crisis and the extent of Federal Reserve intervention. The conclusion was that Latin American countries should take advantage of the bonanza to strengthen macroeconomic fundamentals: tighter fiscal rules along Chilean lines, reduced structural public debt, increased public investment, tougher bank regulation, risk-proofed international reserves, and the creation of 'conditions conducive to increasing investment and raising productivity' (ibid: 29-32).

A year later, with the crisis at its peak, a considered and comprehensive response took shape with the publication of twin reports (IDB 2009a, 2009b) on macroeconomic policy and social and labour market policy respectively. The first, the annual Macroeconomic Report prepared for the March 2009 Annual meeting of the Board of Governors of the Bank, predicted a return to growth in 2010, and expected the region to 'withstand the global storm better than in the past, and than other emerging economies' (IDB, 2009a: 1-2). At the same time it warned that recovery in the United States might not be either early or strong, and proposed to address the manner in which potential problems might be anticipated in advance, and risks identified and mitigated. Although the Bank, in common with other international economic organisations, still rather underestimated just how severe the crisis would be, its analysis focused on the possibility of an L-shaped recovery, with pre-crisis levels of US GDP and G-7 industrial production reached only in December 2013. 'To the extent that the likelihood of a protracted crisis increases,' it warned, 'only short-term policy responses that offer a high degree of social protection, are fiscally sustainable and are aligned with, or at least do not undermine, long-term productivity and medium-term growth should be deployed' (ibid: 31). In the short term, it predicted serious negative consequences for GDP growth, fiscal balance, bank loan portfolios, and international liquidity ratios (the relationship between international reserves and short-term under one year maturity obligations). In short, 'the challenge [was] to anticipate gathering problems early on to act in a timely fashion, and to design a set of policies that will prevent countries from entering into financially fragile territory that might expose them to a liquidity crisis and a major economic collapse' (ibid: 36).

The ensuing analysis of policy options centred on the risk of a liquidity crisis: ‘Countries will inevitably face trade-offs between the potential benefits of pursuing expansionary macro policies, on the one hand; and the costs of these policies in terms of their liquidity positions – and, thus, the likelihood of a liquidity crisis – on the other’ (ibid: 38). In effect, the potential for a liquidity crisis was seen as requiring a degree of restraint in counter-cyclical measures, for fear of precipitating counter-productive falls in private investment and in consumption. This in turn led to a differentiated approach:

A few countries in the region may be strong enough both from a fiscal sustainability and international liquidity perspective to pursue expansionary fiscal policies without risking a loss of credibility. However, even countries with sustainable fiscal policies might still face a relevant trade-off between expansionary policies and liquidity considerations. ... Other countries in the region may not afford the luxury to consider these trade-offs, or only do so at substantially higher downside risks” (ibid).

Similar considerations applied to debt management policy (buy-back of outstanding public debt), expansionary monetary policy, and liquidity assistance to corporates. The IDB saw the disparity between emerging market and developed countries in this respect as placing responsibility on the multilateral banks to ‘step in and play for EMs the role that fully credible governments, such as the US government, play domestically’ (ibid: 41). Such support should focus on the medium and long term, not on emergency short-term financing, and should be ‘complemented by incentive-compatible conditionality, ensuring a gradual convergence to sustainable structural fiscal positions’ (ibid: 42). *Both* macroeconomic stability and key social indicators had to be protected, and this in turn required a partnership between the IMF, and the Multilateral Development Banks:

While setting targets to achieve a consistent macroeconomic framework should be primarily the role of the IMF, MDBs should work on the design of optimal expenditure composition policies – or expenditure increasing policies when feasible – that maximize the impact on long-term development and poverty alleviation (ibid: 44). Following these general policy principles would bring about large beneficial effects to LAC, allowing the region to simultaneously pursue prudent countercyclical fiscal policies that may contribute to minimize the impact on growth of the global crisis without risking a traumatic liquidity crisis (and thus avoiding large associated social costs and economic collapse), and at the same time insulating households, particularly low income ones, from the negative effects of what may turn out to be a prolonged downturn (ibid: 44).

A footnote at this point refers across to the companion policy analysis on social and labour market policies, noting the simultaneous need to consider ‘the impact of social measures on the incentives of households, workers and firms, as some measures may have negative impacts on fundamental determinants of productivity and medium term

growth' (ibid: ft. 45). The same statement appeared in the foreword to the second study itself, adding that 'the social challenge generated by the crisis is .. not only to protect the vulnerable population, but to do so in a fiscally sustainable manner and with programs that contribute to, rather than retard, the resumption of growth' (IDB, 2009b: np). This is clear evidence of the close coordination of macro-structural and micro-structural policy. The social and labour market study sets out the connection between macroeconomic and social and labour market policies, addressed in general terms as follows:

Of course, social and labour market policies are not implemented in a vacuum. Their viability and effectiveness hinge upon countries being able to respond to this crisis with sound macroeconomic policies that prevent countries from entering financially fragile territory, as discussed in the already mentioned companion report. In turn, strengthening social and labour market policies to protect the most vulnerable within a context of fiscal scarcity could contribute to the sustainability of prudent macroeconomic policies. If a protracted period of low or negative growth materializes, the countries best poised for a recovery will be those that have responded to the crisis with social and labour market measures that offer a high degree of social protection (e.g., policies that effectively prevent irreversible impacts among the most vulnerable), are fiscally sustainable, and are aligned with, or at least do not undermine, the necessary changes required to adapt to the new environment which will emerge from the crisis. The latter will most likely be characterized by higher competition among emerging economies for scarcer capital and foreign direct investment. This new environment will reward those countries which have adopted social and labour policy measures in response to the current crisis which, while expanding coverage of a bundle of essential social entitlements, are also aligned with the medium to long-term objectives of removing bottlenecks for growth in aggregate labour productivity and output (ibid: 2-3).

Of particular note here are the recognition that sound macroeconomic policies form an essential element but not the whole policy framework, the glossing of social protection policies as 'effectively prevent(ing) irreversible impacts among the most vulnerable', the principal focus on the advent of a more competitive global economy, the resulting emphasis on the need for 'social protection' to induce greater aggregate labour productivity and output, and the analytical focus on individual national trajectories in 'world economy' time. In short, what the strategy seeks to protect is the potential for increased productivity and output in the future, via the enhanced availability and exploitability of the labour force, including its more marginal cohorts.

Within this framework, the report distinguishes between short-term and systemic (or structural) measures, in relation to health and nutrition, education, and labour markets. It identifies an 'effective social safety net' as one that 'provides a minimum level of welfare in light of the diverse risks faced by families, including individual shocks such as

health and labour disruptions, and aggregate shocks such as natural disasters or financial crises,’ adding that measures that ‘also nurture investment in human capital and promote future potential productivity gains’ should especially be supported and expanded during the crisis (ibid: 9). Conditional cash transfer (CCT) programmes are seen as exemplary in this regard, as they combine short-term flexibility (as the scale or frequency of payments can be increased and reduced as impact of crisis hits and subsides), while at the same time they address long-term investment in health and education of the future workforce (ibid: 9-10).

Its principal focus is on the impact of crisis on labour markets. Here the rejection of short-term measures to absorb large pools of labour on a temporary basis is emphatic:

Absorbing large pools of labour temporarily will not be the way out of this crisis for the region. *Compared to other regions of the world, Latin America and the Caribbean has not made the systematic changes in the way its labour markets operate—its systems of training, employment generation, human capital formation, labour and social security regulations—to enable it to exit from this crisis in a stronger competitive position.* The global nature of this crisis means that the region may not be able to “muddle through” waiting for export growth or wage declines to diminish the need for more fundamental reforms. As a result, while LAC governments may feel the pressure to initiate programs to stave off key short-term effects, the most critical element will be to simultaneously initiate key systemic labour market policy and program changes to lay the foundation for the region to emerge from the crisis not leagues behind its international competitors and with the foundation of stabilizing policies to react to future crises on a more immediate basis (ibid: 11, emphasis mine).

Facing a medium-term scenario (‘not a pretty one’) of ‘increasing levels of already high informality, lower labour force participation, falling real wages, pressures on pension systems and, most importantly, little to no new growth in formal employment’ the IDB urges that ‘it will be those countries which initiate key structural changes, both social and labour-market related, that will emerge best from the crisis and positioned for the future’ (ibid: 12). Here, these changes cluster around the theme of active labour market policies: perhaps short-term training in the workplace for specific job-related skills, which must be ‘particularly well targeted to those jobs in risk of layoff during the crisis but competitive over the medium term;’ perhaps temporary employment in public works or extensions of worker benefits, though many caveats apply (ibid: 13-16), but preferably systemic measures inducing longer-term structural change in underlying labour market conditions, which divide into three:

- (i) helping firms (and their workers) be more productive, (ii) changing the fundamentals about how human capital is protected, allocated (fitting the right people into the right job), and formed, and (iii) changing the relative costs and benefits

of formal vs. informal employment for firms and workers, taking structural steps to lower labour costs in the formal sector to improve both productivity and growth, while expanding the scope of social security (ibid: 16-17).

In other words, the IDB took reference of the crisis to advocate fundamental structural change in Latin American labour markets, with the principal objective of increasing the size of the formal sector. Policies advocated included ‘firm-based human resource development models that can become an essential element in the “infrastructure” of competitive labour markets in the future’, along the lines of the Mexican CIMO (*Calidad Integral y Modernización*), wholesale reform and modernization of technical education, and, crucially, the restructuring of labour benefit systems to ‘serve future crises’ through the reform of severance and unemployment insurance regulations, and introduction of OECD-style labour intermediation (job finding) systems, (ibid: 17-19). In the same spirit, it called for the ‘pursuit of reforms to achieve universal health insurance coverage while creating incentives to boost formal job creation, labour productivity and output growth’ (ibid: 24), and complementary measures in relation to education, principally concerning protection of education spending, exploitation of the flexibility of CCT systems, and, on a systemic level, ‘significant reform .. in the national systems that educate teachers as well as in the institutional mechanisms that attract and maintain (sic) effective teachers’ (ibid: 28-9). Hence:

To advance the productive skills of the generation that will be entering the labour market to a changed world, educational systems in LAC must realign institutional and student incentives toward performance rather than attendance. A medium-term investment to improve the region’s human capital base should include simultaneous efforts to: (i) reform and modernization of technical education, create community colleges or technical colleges linked to local industries and services and (ii) better align curriculum at the secondary level with core competencies demanded across labour markets (e.g., communication, critical thinking, problem-solving, and group work) (ibid: 29).

The analysis reviewed above reflected strategies that were advocated as much in Europe, Africa and Asia as in Latin America, and which had been developing over two decades. At the same time, they were calibrated to what were seen as the specific characteristics of the region within the global political economy: (i) high income and asset inequality; (ii) lower productivity growth; (iii) low savings rates; (iv) high levels of labour informality; and (v) poor educational quality (IDB 2009b: 7). As the next section demonstrates, these were constant points of reference throughout the sequence of annual macroeconomic from 2010 onwards, and they shaped the policy orientation of the Bank as the end of the ‘global financial crisis’ approached in 2013.

### BASELINE 2013    LOOKING BEYOND THE CRISIS

In March 2010 *The Aftermath of the Crisis* dwelt on policy lessons learned and challenges ahead, expressing the latter as ‘consolidating macroeconomic policy credibility’ and ‘unleashing productivity’ (IDB 2010a: 17-22). It grudgingly accepted that stronger fundamentals had ‘played a very important role’ in withstanding the crisis (ibid: 1, 5-7)), but argued that ‘the *key innovation* in this episode of global financial turbulence was the readiness of the international community to act as international lender of last resort by providing timely, unconditional, preventive and sizeable assistance to emerging markets at the height of the financial crisis, and preventing otherwise sound economies from entering into financial distress’ (ibid: 1-2). Its policy advice reflected this, dwelling at length on the need for the further strengthening of the IMF, seconded by the MDBs, as the lead lender of last resort (ibid: 7-17), and calling for the reinforcement of work in progress on fundamentals (17-19). With this out of the way, it turned its attention to the need to address the region’s unsatisfactory growth performance, drawing on the full-length study issued as the IDB’s annual flagship report in the same year, *The Age of Productivity* (IDB, 2010b). It set the 2009 policy statements in historical context, noting that ‘average income per capita in the region was one quarter that of the United States in 1960 and is now only one sixth. Rather than catching up to the developed world, Latin America and the Caribbean have distanced themselves even farther’ (IDB, 2010a: 20). It then attributed this poor performance to lagging relative TFP (total factor productivity), commenting that ‘while East Asia has more than doubled TFP levels relative to those prevailing in 1960, Latin America has remained stagnant (ibid: 21).

There followed a succinct summary of the position taken by the Bank (and all other relevant international organizations in this period):

For a region starved for growth, diagnosing the causes of this poor productivity and attacking their roots is a high development priority. IDB (2010[b]) identifies several characteristics of the Latin American productive landscape that serve as a departure point for policy analysis, and it highlights the complexity of effectively attaining aggregate efficiency gains, indeed an intricate problem that goes well beyond technological growth. This process requires incentives to be aligned, fair competition for resources, and the opportunity for firms with good ideas to thrive and grow. *Low productivity is often the unintended result of a myriad of market failures and poor economic policies that distort incentives for innovation, prevent efficient companies from expanding, and promote the survival and growth of inefficient firms.*

Raising productivity also requires substantial coordination to identify appropriate policies, understand the conflicts between different objectives, secure the resources to implement the policies, deal with those who would prefer the status quo or other policies, and maintain sustained efforts in

complementary areas until they bear fruit. Such an effort depends on the capacity of the State and the political system to maintain stable and credible policies that enable the private sector to invest and innovate with a long-term horizon, adapt policies to changes in economic circumstances, and coordinate the policies of different areas – economic, social and institutional – taking into account their effects on each other (ibid: 21; emphasis mine).

On this issue, the Bank proposed a division of labour: ‘just as much as macroeconomic concerns should be fundamentally addressed by the IMF, enhancing productivity growth is the task of MDBs’ (ibid: 21-22). Here, though, it looked ahead only to the end of the crisis, and the inevitable unwinding ‘at some point’ of Quantitative Easing in the US, taking short-term macroeconomic challenges into account.<sup>2</sup> If capital flows to emerging markets continued, at relatively low interest rates, growth rates near 5 per cent per annum might be expected in Latin America for the period 2011-2014. If they did not (due for example to continued fiscal deficits in the advanced economies), growth might peak at around 3 per cent and drop below 2 per cent per annum by 2014. In the short term, ‘capital controls, quantitative restrictions on credit growth and tighter fiscal policies’ were recommended in order to manage exchange rates (ibid: 34).

In the following three years, three successive macroeconomic reports (IDB 2011b, 2012b, 2013) took the ‘productive development’ agenda forward. The first two assessed the structural changes taking place in the global economy under the impact of the crisis, but focused mainly on macroeconomic policy, while the third, *Rethinking Reforms*, set out a post-crisis agenda for structural reform. A brief review of these reports, concentrating mainly on the third, demonstrates the continuity with policy development in the pre-crisis period, and the explicit focus on the imperatives arising from the reshaping of the global economy and the ‘rise of China’. In essence, these successive annual reports apply the analysis set out previously to the specific structural challenges, both international and domestic, resulting not from the ‘global financial crisis’ but from its effect in accelerating ‘rebalancing’ and structural change in the global economy.

The first report followed that of the previous year (see ft. 2 below), in that it identified two ‘quite different regional clusters’ in Latin America and the Caribbean (hereafter LAC), noted that the substantial changes in trade and capital flow patterns taking place affected these clusters in different ways, and argued that economic policy design would have to accommodate these differences in order to ensure widespread and stable growth

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<sup>2</sup> The principal emphasis throughout was on the LAC-7 (Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela). A brief parallel analysis for the ‘CA-7’ and the ‘CAR-4’ (Box 1, pp. 39-43). Weaker fundamentals and different short-term macroeconomic challenges were identified for these groups, arising from greater trade openness, greater dependence on remittances, heavy reliance on tourist revenues, and the negative correlation between commodity prices and terms of trade. These differences pointed towards much lower growth expectations, exacerbated by direct competition with China.

(IDB, 2011b: v). The broad context was the emergence of a ‘two-speed world’ characterized by sluggish growth in the advanced economies and robust growth in emerging markets; and the two contrasting clusters were a rapidly growing ‘Brazilian cluster’ of net commodity exporters, benefiting from high levels of demand in Asia and in China particularly, and a ‘Mexican’ cluster with much stronger commercial ties to the advanced economies, and struggling to deal with the new global environment.<sup>3</sup> The Bank identified

four key characteristics of the new global economic order: i) the reallocation of world output and demand from industrial countries to emerging markets that have a high propensity to consume primary commodities and have become the engine of the world economy; ii) a substantial shift in Latin America and the Caribbean’s trade towards emerging markets; iii) a reallocation of world saving towards emerging markets – Latin America and the Caribbean being one of the main beneficiaries – providing ample availability of inexpensive international capital and credit; and iv) a new international financial architecture characterized by a set of innovations to provide timely and sizeable liquidity assistance in times of crisis for emerging markets (ibid: vii).

These developments raised concerns for the Bank, in view of its misgivings with regard to development on the basis of export of primary commodities. It responded by setting the challenge facing each cluster in the context of its overall commitment to productive development, for which the commodity bonanza offered no long-term solution.

Brazilian-cluster countries would have to ‘make good use of the external bonanza with sound macroeconomic and financial management – avoiding overheating, and keeping in check any build-up of vulnerabilities that may put countries at risk – while investing in raising productivity;’ in contrast, Mexican-cluster countries would need to ‘successfully meet the challenges of macroeconomic stability – ensuring fiscal sustainability and stable financing of current account deficits – productive restructuring and the implementation of innovative trade policies that enhance chances of faster growth;’ and all the countries in the region would have to ‘take advantage of this opportunity to tackle long-standing challenges that are common to all: raising the quality of education, reducing informality, and increasing productivity’ (ibid: xi). In other words, the focus on productivity now came to the fore.

The report then reprised its now established view of the boom in commodity prices and availability of ‘vast and relatively inexpensive financial resources’ (ibid: 5) as a double-

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<sup>3</sup> As the Report noted, Brazil (grouped with the other South American countries, and Trinidad and Tobago) saw its exports to Brazil, China and Russia rise from 9 per cent of its total exports in 2006 to 17 per cent in 2009, while Mexico (grouped with Central America and the rest of the Caribbean) sent only 3 per cent of its exports to the same countries in the latter year (ibid: viii). For further discussion of the model from which clusters were derived, see Ch. 1, 8-13, and Appendices 1 and 2, 53-57.

edged sword, and set out at length the model on which its analysis was based, before turning to ‘Latin America and the Caribbean’s insertion into the post-Financial Crisis new global economic order’ (ibid: 15-29). Here, it looked forward to ‘gradual global rebalancing,’ new trade patterns attendant on the ‘reallocation of world output and world demand from industrial countries to emerging markets that have a high propensity to consume primary commodities,’ and new capital flow patterns (ibid: 16, 17). Assuming a relatively benign outcome to this process, policy imperatives differed between the two groups, as outlined above. But still, on broad trade policy ‘all groups should pursue two common objectives: i) increase market access to Asian, United States and European markets by reducing both tariffs and non-tariff barriers as well as transport costs and other trade facilitation issues; and ii) unify markets at home’ (ibid: 43). There were common challenges too in relation to factor allocation and productivity, and the Bank drew again on *The Age of Productivity* to warn that the ‘demands posed by the new global economic order on market efficiency and productivity in Latin America and the Caribbean will be major’ (ibid: 44). Beyond the differences touched on above (p. 20), a common challenge arose from the size of the non-trade sectors and the ‘abysmal’ relative decline in service productivity, which stood at less than 15 per cent of that of the United States:

The sheer size of non-trading sectors in most Latin America and the Caribbean economies implies that they hold the key to increasing overall productivity and growth. The service sectors occupy 60% of the labour force, compared to about 20% each in the primary and the manufacturing sector. Unlike in tradable sectors, there is considerable room for productivity increases in the service sector: while labour productivity in agriculture has increased at the respectable rate of 3.5% since 1990, and at over 2% in manufacturing, productivity in services has been virtually stagnant over the last two decades (see Figure 20[below]). The picture is even grimmer in some categories of services, particularly for retail and wholesale trade; finance; community and personal services; and transportation. Productivity growth is also low in construction, a large and fast-growing sector in many economies (ibid:45, and Figure 20, below).

Here, again, low productivity levels were linked directly to the incidence of informality:

The service sectors show very low productivity levels because they have become the last refuge for the productive resources not used elsewhere and a large source of informality. The problem is especially acute among the smallest firms, which absorb much of the redundant work force. Although small firms are the majority of all firms in any economy (in the United States, for example, 54% of firms have 10 or fewer workers), in Latin American countries the excess of small firms is overwhelming: in Argentina 84% of firms have 10 or fewer workers, while in Mexico and Bolivia over 90% do not even have 10. Needless to say, most of these small firms operate in the service sectors (ibid: 46).



In these circumstances, it would be necessary but not sufficient to favour policies such as wider and cheaper supply of credit, improved transport costs, lower taxes and the encouragement of innovation, because ‘a host of other policies *promote the survival of unproductive firms*’ (emphasis mine):

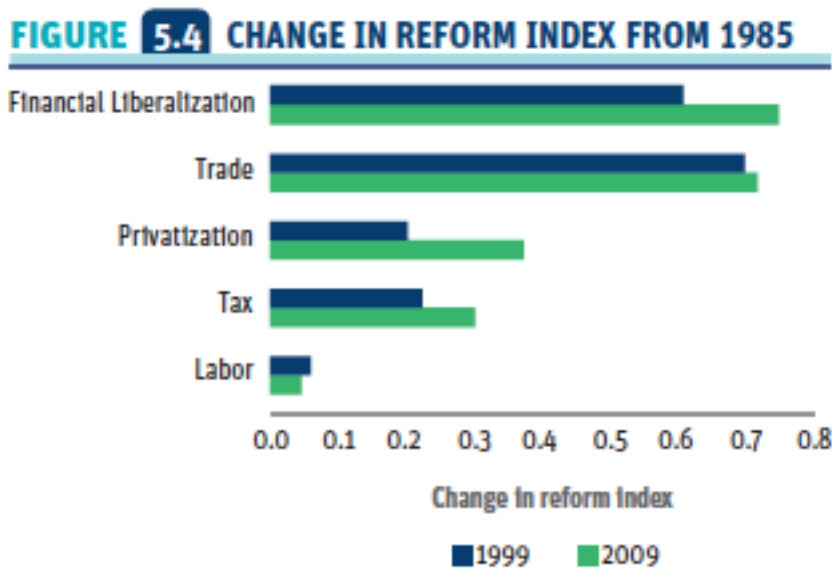
Among those policies stand out tax regimes that discriminate in favour of small and informal firms, social programs that subsidize informal employment at the expense of formal jobs, and a variety of interventions aimed at supporting micro- and small firms that face productivity problems that are beyond remedy. These low-productivity firms crowd out some other firms that are somewhat more efficient, which helps explain the relative scarcity of medium-sized firms (ibid).

All countries in the region, therefore, faced the challenge of ‘productive restructuring’ (ibid: 47).

The 2012 Macroeconomic Report, *The World of Forking Paths* (IDB 2012b) dwelt on the complex short-term challenges arising from uncertainty in the global economy as China faltered and another European recession threatened. It gave the region fair marks for financial supervision, and fiscal, exchange rate and international reserve policies, but noted again the extent of commodity dependency, the limited fiscal space, and the need for any stimulus packages to be easily reversible, and, in general, for constant vigilance. The 2013 Report, *Rethinking Reforms*, notes the continuing frailty of global recovery, and suggests that ‘the moment has come to reignite the reform agenda’ (IDB, 2013: 9). Its premise is that macroeconomic policy space has contracted further, prospects for global growth are poor. It argues that structural reforms are timely (ibid: 11-27), and that domestic savings should be mobilized for investment in infrastructure (ibid: 45-59). Its

broad focus is on the achievement of higher productivity through the reallocation of ‘misallocated’ resources, and the case is most forcefully made with regard to pensions, social security, tax and especially labour market reform, the latter being an area where ‘a strategy that seeks to reduce informality could potentially have a large payoff’:

Much work must be done to improve education, support healthy product market competition, ensure equitable tax systems that promote development, develop labour markets that function well, and establish regulatory frameworks and institutions that favour sufficient investment while encouraging ample savings to finance that investment in a safe manner. ... In the area of labour market reform, there appears to be considerable space for further reforms and a clear association between economic misallocation, including labour and firm informality, and lower productivity. ... Informality tends to go hand in hand with a higher proportion of smaller, less-efficient firms, high worker turnover, a less-educated and less-trained workforce, the likelihood of illegal practices, and reduced access to credit. (ibid: 2).



Source: Lora (2012).

Drawing on work by Guillermo Lora, the report argues that most feasible reforms in the areas of financial liberalization, trade and (though to a lesser extent) privatization have already been made in the region, while tax reform and particularly labour reform have lagged behind (ibid: Table 5.4, p. 32, reproduced above). The case for labour market reform opens with an overview of the negative characteristics of informal labour markets (defined here as workers not covered by contributory social insurance): ‘a smaller firm size frequently implies little labour training, limited adoption of new technologies or innovation, and, in general, unexploited economies of scale or scope;’ ‘high job turnover and occupational choices concentrated in low-skilled, frequently self-employed jobs

imply that human capital accumulation is discouraged;’ and ‘relatively high degrees of illegal activity combined with small firm size imply that access to credit markets is limited’. As informality is ‘a distinctive and persistent feature of labour markets in Latin America and the Caribbean,’ the potential gains from reform are significant (ibid: 35-7 and Figure 6.2, p. 38).

Here again the argument is made that ‘well-meaning reforms may generate incentives for firms to operate at an inefficient scale, hampering growth and productivity’ (ibid: 42). Such reforms include special tax regimes with exemptions for small firms (such as *Repeco* in Mexico), and non-contributory health and social insurance programmes, which constitute ‘an effective subsidy to the informal sector,’ and as a result have ‘the unintended consequence of incentivizing informality’ (ibid: 44).<sup>4</sup>

The conclusion to the chapter is an important point of reference, and is cited in full:

Labor market reforms have the potential to unleash growth in the region thanks to the impact on productivity and resource allocation. There is considerable room for reforms in the labor market area, but designing effective labor market reforms is no easy matter.

The following recommendations flow from the analysis:

- Institutional features, distortions, and misallocations in labor markets vary greatly across countries; reforms should therefore be tailored to particular country characteristics and should also take into account implementation capacities.
- In countries where informality rates are high, reducing informality may be among the key reform objectives, as a reduction in informality may significantly increase productivity and, hence, long-term growth.
- Labor market reforms to tackle informality are necessarily complex and may also require the reform of social protection programs, which may then require alternative forms of financing.
- As a result, reform design may need to take into account the following:
  - a comprehensive diagnosis, to identify which institutional features are creating the most distortionary incentives;
  - an integrated design to balance economic and social objectives;
  - appropriate incentives for both the supply side (workers) and the demand side (firms) to operate in the formal economy (ibid: 44).

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<sup>4</sup> In the following chapter, it is further argued that ‘large informal sectors can hinder household savings. This is because informal workers do not contribute to mandatory pension plans. Moreover, to the extent that these workers save voluntarily, their informality status limits access to financial services. This means that their savings are not intermediated by local financial systems and therefore are less likely to flow to productive investments. In addition, in order to mitigate the social costs of informality, governments oftentimes implement programs that, as was argued before, may further hamper domestic savings. Therefore, policies aimed at reducing informality – rather than those designed to mitigate its consequences – are also likely to have positive effects on private savings’ (ibid: 58).

## CONCLUSION

The principal purpose of this paper has been to document the policy advice offered by the IDB over the last decade, and to situate its response to the global financial crisis in its broader policy stance. What emerges is that the focus on productivity and productive development is constant throughout the period, and that it revolves primarily around the need for the reform of labour markets and social protection. The extent of informal labour is highlighted as a particular problem, and linked to perverse incentives on the one hand, and low levels of domestic savings on the other. In turn, as noted at the outset, this links back to the focus on productive labour (rather than narrowly on macro-economic reform) at the World Bank around 1989-90 – or in other words, precisely at the moment when policy debate in Latin America is said to have focused narrowly on the Washington Consensus agenda of liberalization, privatization and deregulation. A more balanced view of the policy environment then and since would give more prominence to issues relating to productivity and competitiveness.

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