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“The Future of Latin America Depends on its Ability to Discover How to Evolve its Comparative Advantage”

An Interview with Ricardo Hausmann, Director of the Center for International Development at Harvard University

Professor Hausmann sat down for a conversation with LAPJ lead editors, Manuel González and Patricia Goldstein, on 6 March 2018. What follows is a lightly edited transcript.

LAPJ Staff: Professor Hausmann, thanks for accepting our invitation. We would like to start with a general economic assessment. What has happened in Latin America in the last two decades?

Ricardo Hausmann: The period 2004-2014, 2012 depending on the country, was a period of relative rapid growth in Latin America, typically associated with positive terms of trade, shocks, and ample access to international finance. In general, the countries of Latin America fared relatively well during the 2008-2009 international crisis, but they got into trouble when the terms of trade deteriorated afterwards. Right now, the question is how can Latin America grow in the context of relatively stable terms of trade? And that implies they have to be able to expand their exports, typically not necessarily by expanding quantities in their existing industries but by being able to expand into newer industries. Evolving the comparative advantage of the countries is at the core of what might signal future success.

LAPJ: What are the most recurrent binding constraints for growth that you observe in the region?

RH: The glass is half empty and half full. First of all, countries are very different from each other. In some of them, you see interesting things; in others, you see enormous policy efforts that were targeting constraints that were not really important.

For example, countries like Chile (2004) and Colombia (2012) invested an enormous effort in signing Free Trade Agreements with the United States (the US), but we did not see any impact of that in terms of greater export dynamism to the US or much US investment. In a country like Mexico, on the other hand, when they signed the Free Trade Agreement with the US in 1993 (i.e. NAFTA), exports doubled in the following six years, they doubled again in the subsequent ten years, so you saw an enormous explosion of trade associated with the agreement. Thus you might have thought that they removed the constraint that was really important. But Chile and Colombia copying other people's reforms did not imply copying the outcomes of the reforms, because those reforms were not targeting things that were as important in those countries.

Take a country like Argentina: it is obvious to me that in a country where 40 percent of the population live in the capital city, you don't expect the capital city to be producing agriculture or much manufacturing, you would expect that capital city to be producing internationally traded services, and especially if these services can be provided in a way in which geography matters less (last time I checked, Argentina was not located at the center of the globe.). So the ability of countries to move into new industries will depend on their ability to adapt their productive ecosystems to support those industries.

We just finished a study on Panama, which is a country that has had remarkable growth for the last 25 years, and it has been led by high-skill export services. They did a lot of very unconventional policies to attract those industries to Panama. Ex post, we found enormous synergies between different efforts. Obviously, you have the Canal, but you did not have ports before the Americans left in 1999, so now, with ports you can have logistics. They already had a financial center, but then they developed an airport hub and were lucky enough to get a successful regional carrier. Then they passed a law to attract the regional headquarters of multilateral corporations. And then they had to adapt their immigration policies, to let people in, so that multinational corporations could move in, and they created a couple of special economic zones, which also forced them to relax immigration restrictions, and this relaxation allowed them to attract enough foreign talent to complement whatever skill shortages were at home. That policy reform is radically different from others that have been inspired by copycatting OECD countries.

The future of Latin America depends on its ability to discover how to evolve its comparative advantage, and that may not involve just copying “best practices.”

LAPJ: At Harvard you teach a class on economic development named “Why Are So Many Countries Poor, Volatile, and Unequal?” Have you found already the answer to that question?

RH: The short answer is that countries are poor because technology did not diffuse into them. The reason why they have less technology is because technology is really defined by three things: tools, codes, and know-how. Tools and codes are relatively easy to move. Know-how is hard to move, because know-how exists only in brains,

and moves with enormous difficulty from brain to brain throughout a long process of imitation and repetition. Know-how is not objective knowledge that can be written down; it is an ability of the brain to recognize patterns, to move the body and to react to situations. It takes forever to train a violinist, it takes us at the Kennedy School forever to graduate a PhD, and the reason is that we don’t know how to teach it, because it is just imitation and repetition until people get it. Modern technology requires not only individuals with know-how, but teams with different bits of complementary know-how that have to be brought together to implement the technology, and that is what slows the process down.

Why are countries poor? Because technology did not diffuse into the country, because collective know-how did not diffuse into the country. Why are they unequal? Typically, because the technology that has diffused into one part of the country is hard to move to the rest of the country, so there are enormous technological differences within the country. Why are they volatile? They are volatile because their economies are highly undiversified, and there are many missing markets, so any shock to one part of the system is hard to absorb, as there is not enough capacity to move resources to other parts of the economy.

LAPJ: More recently, you have been working on a new research subject called “The Sense of Us.” What can you tell us about it?

RH: There is a tension between how anthropologists see humans and how economists see humans. Economists see humans as these very selfish individuals that have very personal preferences and do whatever they like the most, given the constraints they have. Anthropologists look at humans and think that we are the most cooperative species on

Earth. An economist would say that the reason we cooperate is because we have incentive-compatible contracts, such as stock options, but actually we evolved for hundreds of thousands of years before people invented stock options. How did we do that? An anthropologist would say that we evolved moral sentiments. We don't procreate because we are taught in school that it is important to procreate to maintain the species. We procreate because evolution developed a sexual sentiment, and we cooperate because evolution developed a moral sentiment. Thus, we know that we have to cooperate. With whom? With "us."

The problem of sustaining cooperation is the "free rider problem." The solution to the "free rider problem" is that when you feel that you are supposed to cooperate, and you did not, you feel guilty. When other people find out, you feel ashamed. When you find out that other people did not cooperate or cheated, you feel outraged. In order to punish the other people in a way that is safe for you, you gossip and you derive pleasure from gossiping, and you derive pain if you are the object of gossiping. All of these moral sentiments support cooperation. Different cultures feel guilt and shame for different reasons, but the ability to feel guilt and shame is in some neurotransmitters that are coded for in our genes. We are a highly cooperative species, we are "parochially" cooperative, we cooperate with people we call "us" and not with people we call "them." We evolved that in order to defend "us" from "them," so we cooperate in fighting "them."

All of this is important because in order to maintain the coherence of an organization, say the Center for International Development, or the Harvard Kennedy School, or Harvard University, or the State of Massachusetts, or the US, you must have some sense that you must cooperate with

"us." Governments act on behalf of "us." They act legitimately if they can articulate why what they are doing is on behalf of "us."

The question is what do we mean by "us," and that is a historical construct, because in our evolutionary past we used to interact with very small groups, with people who spoke, believed, and looked like "us," but economies of scale – maybe associated with technology – have made us cooperate with ever larger groups. As groups become larger, they become inherently more heterogeneous. Latin America in this respect is a very unique place, because you have 18 countries speaking the same language, but what is typical in the world is to have one country speaking many languages. For example, in South Africa there are 11 official languages, in India the census recognizes over 1,600 languages, and 700 languages in Indonesia. Societies are racially and religiously different, and on top of that heterogeneity you have to construct a "sense of us," and most countries stumble in the process of defining a "sense of us." For example, in Kenya politics tend to be tribal based, so you vote your tribe; in India, as the saying goes, you don't cast your vote, you vote your caste. In Pakistan, they don't have a common language, but they have tried to create a "sense of us" based on a common religion. In Albania, they don't have a common religion, so they have tried to create a "sense of us" based on a common language. Every country has a very different way of defining "us," and the definition of "us" also involves the definition of "not us."

In the US, there is a debate between two "senses of us": one that is in some sense narrower, which says that "us" are the descendants of the European settlers, and another "sense of us" that is more encompassing, which includes African Americans, Latinos, Muslims, etc. The problem is

that if you have a broader “sense of us,” in order to work it has to be deep enough to make shared decisions on what kind of public goods you want – What should be taught in schools? Should there be prayer (or no prayer) in schools? How much redistribution should you have? If the poor don’t look like the majority, are they really part of “us” and should we tax ourselves to help them? – These tensions are important determinants of the nature of the problem states face, and consequently are determinants of the challenge to generate a capable state.

LAPJ: Currently, we count at least seven regional integration processes in Latin America (i.e. ALBA, CAN, CARICOM, MERCOSUR, SICA, PACIFIC ALLIANCE and UNASUR), which make the continent look quite fragmented. Are countries failing in their will to cooperate?

RH: When Latin America became independent, the country I am from [Venezuela] was a political unit that also included Colombia, Ecuador, and Panama. For some reason, history has fragmented the space and created borders. For instance, Guatemala became five countries. It happened very quickly in the 19th century, but it has been sustained over this period.

In the 1860s there were very strong nationalist movements in Europe, such as German and Italian nationalism, which created not smaller states – like Catalonia – but larger states of all German-speaking people or all Italian-speaking people. Interestingly enough, in those places there were many sovereign states (different jurisdictions), but there was the aspiration of joining all these small states into a bigger one. One of the common public goods that they focused on was a common national language, because there were really many German and Italian languages, but not

a common one. So the creation of a national language like *Hochdeutsch*, or the creation of modern Italian, based mostly on Tuscan, was part of the national aspiration of creating a broader political unit. The question is why were the Europeans focused on a broader political union, and we were more focused on “I would rather be a big fish in a small pond?” My answer to that question is economies of scale.

The Industrial Revolution created enormous incentives to have larger markets, so the Germans in 1815 started with a customs union, the *Zollverein*. The *Zollverein* wanted to standardize things to have access to a larger market, and there were industries such as books, culture, newspapers, etc., that needed to standardize language. Union meant that all of these products could have bigger markets. So there was a strong political force behind lowering the barriers caused by different borders and jurisdictions. For some reason, those incentives in Latin America were subdued because we really had very few cash crops and mineral products to sell, and we were not selling them to each other but to distant places. So in some sense, our kind of economic development did not create enough incentives for us to sell to each other and consequently to try to eliminate the transactions costs associated with changing jurisdictions. To this day, the trade of Latin America with Latin America is astonishingly small.

LAPJ: In 2018 there will be elections in Mexico, Brazil, Colombia, Venezuela, Paraguay, and Costa Rica, countries that count for almost 80 percent of Latin America’s population. How do you see the current political landscape in the region?

RH: Well, when most people will read this interview, the answers to these questions

will have been resolved by history. So, I am not going to guess what is going to happen, but I will rather talk about the issues that are going to be decided.

I think that Latin America moved left in the context of high commodity prices, or at least the left was very successful and long-lived during the period of high commodity prices. Then the left got into trouble when commodity prices came down. So, for example, Lula was fairly successful in his two presidential terms, Dilma was somewhat successful at the beginning of her first presidency, but things really deteriorated when the terms of trade became less supportive, and when they had to pay for other economic sins that they had committed.

In Argentina the economic and political dynamics were quite dramatic. The right lost power in the context of the 2001-2002 economic crisis. This was followed by a spectacular recovery aided by high soy-bean prices and volumes. The left seemed to be super-entrenched and were able to change many things. Then, the external environment became a little harder and they mismanaged it big time. As a consequence, they lost political power.

On the other hand, Mexico has been ruled mainly by the center right, and now there is a bit of disappointment there. They have had sort of mediocre but not catastrophic performance, in spite of the fact that they had to face very significant shocks. As opposed to the rest of Latin America, they are on the export side of China, not on the import side of China. Chinese competitiveness – and the competitiveness of East Asian countries more broadly – has represented a big challenge for Mexican exports to the United States.

And then there is Venezuela. I cannot

explain to you the level of human suffering that the management by the radical left has caused.

So, the question would be “will the move be to the left or to the right?”, and my guess is that in Colombia the move is probably going to be to the right; in the case of Brazil it is more uncertain; in the case of Mexico, there is a risk of a “populist backlash,” which is what people fear the most at this time. Yet, in Mexico the question is not so much about how many votes will the left-wing candidate Andres Manuel López Obrador get, but instead on how fragmented will the votes of the center right be. If the left gets up to 40 percent, what is going to happen to the remainder 60 percent?

In the end, the question is going to be, “Did Latin America speak with a clear voice as to how do they see their future?” Chile has spoken, for instance. Argentina seems to have spoken last October and they want more of the same. In Peru, even though they are going through a period of very significant political weakness, the opposition is dominated by the center right. So, I think that Latin America will broadly stay in the center right of the political spectrum, but it will very much depend on what happens in Mexico and Brazil.

LAPJ: Are Latin American countries doing what they have to do vis-à-vis the current political and economic crisis in Venezuela? What role should they play?

RH: I must say that Latin American countries have not played a constructive role for a very long time while the crisis was being created. The crisis was hidden behind high oil prices and especially behind a lot of international borrowing. When oil prices came down, international borrowing became impossible, and the situation

in Venezuela deteriorated dramatically because the government had used the bonanza to destroy the opposition-led domestic productive apparatus. For a long period after the beginning of the collapse, the international community remained quite ineffective.

However, through the leadership of the Secretary General of the Organization of American States Luis Almagro, and increasingly through the leadership of other important political players, there has been a growing coalition of countries that want change.

Initially this was attempted through the Organization of American States (OAS). Yet, it is clear that in the OAS the English-speaking Caribbean countries used their overrepresentation in the organization to support Maduro in a way that history will remember and that they will remember with great shame. Then the countries of Latin America decided to create an alternative group, known as the Lima Group, and they have been quite forceful, as forceful as Latin America has ever been, in terms of expressing the need for change in Venezuela. Whether this will be enough or not, I am not sure, but what I am definitely sure is that when the history of this period is written, Venezuela will be the largest humanitarian catastrophe that Latin America has probably ever seen, short of “The War of the Triple Alliance” that started in 1864.

LAPJ: What have been the main obstacles preventing the Opposition to succeed?

RH: Venezuela is governed by a totalitarian regime, so the Opposition has to be organized in a context in which if you organize you go to jail, you are exiled, or you are blackmailed. Thus it is a situation where your behavior does imply enormous

personal or organizational threats. I like to give the example of *Voluntad Popular*, a party which is led by Kennedy School graduate Leopoldo López (MPP’96). It has a Managing Board with 12 members, of which only three are free in Venezuela, others are either in jail, as Leopoldo is, or in exile. So, this is an enormously difficult and aggressive environment in which to operate, and there is not much you can ask from people who fight with democratic tools against a totalitarian dictatorship.

LAPJ: Some people think that the solution to the crisis in Venezuela has to come from the inside, while others are already calling for a foreign intervention. What needs to be done to start solving the problem?

RH: The problem is that elections have shown not to determine power, because the Opposition won the National Assembly with a two-thirds majority, but the National Assembly is prevented from making any decisions because the Armed Forces are not willing to enforce any decision made by that body. So the problem is the loyalty of the Armed Forces to the Constitution, and that is not going to be solved through elections. Democracy is when the people choose the President. Democracy is not when the President chooses the Opposition candidate, which is what has just happened. I think that there has to be a break within the Armed Forces, but I have argued that an international threat would be amazingly useful because I do not believe that the Armed Forces are led by people who are willing to die for their country. I think they are led by people who are willing to murder for a salary, but only if the opponent is an unarmed civilian. And since that is not enough for them to live a posh life, they complement their income with smuggling, narco-trafficking, grand larceny, and corruption. Under that system we are talking about a rogue state, a criminal state. I am sure that

if there was an international military threat that regime will collapse.

LAPJ: At the Center for International Development (CID) you are working on a project with participation from other Venezuelan and international experts, which aims to plan what ought to be done when democracy returns to the country. Can you tell us a little bit about it?

RH: The initiative is called “The Morning After.” We applied our tools and techniques to diagnose the situation. We asked ourselves, “What is the binding constraint to growth or to output in Venezuela?”, and we came to the conclusion that beyond property rights, which have been decimated, it was access to imported raw materials, intermediate imports, and spare parts.

When you have a shortage of these kinds of inputs, the rate of return on all other complementary inputs collapses: human capital, physical capital, and everything else have very low returns because without imported inputs, there is not much that can be produced. So, in our mind, in the transition we have to assure that there is a big increase in intermediate inputs and raw materials. We must ensure that these are efficiently allocated to support the expansion of production, because the rest of the installed capacity is there, human capital is sort of there, although it is dwindling right now because of massive outmigration, given that the returns to human skills has collapsed.

We therefore need to recreate a market mechanism, which involves unifying the exchange rates, freeing prices, bringing monetary emission under control – at last count the monetary emission of the Central Bank of the last 12 months has grown 2600 percent and inflation is in the order of 6000 percent – so in that context you need to focus not only on how can

you reduce the fiscal deficit in the medium term through economic growth, but how will you be able to fund the fiscal deficit in the short term with real resources and not with monetary emission.

That means that we need to restructure the foreign debt and get substantial international financial assistance. In the process of doing that, we will create space for intermediate inputs and raw materials to grow, output to grow, and out of the increase in output, we will get tax revenues that will help us lower the fiscal deficit.

LAPJ: The CID will have its 20th year anniversary next year. What do you think are its biggest achievements to date? What are you envisioning for the future?

RH: I think that we should be very proud of our contributions. Growth Diagnostics is a tool that is being used everywhere, at the World Bank, the Inter-American Development Bank, and bilateral agencies such as the UK’s Department for International Development and the Millennium Challenge Corporation, in countries, etc. The Problem-Driven Iterative Adaptation approach developed by Matt Andrews, Lant Pritchett, and Michael Woolcock is also a very powerful way of thinking of implementation. The way the Evidence for Policy Design group has been transforming randomized control trials from being a mechanism to audit and evaluate the performance of others into really a tool to help design the programs that practitioners are trying to get done in a process that they call Smart Policy Design. Finally, the efforts we have done in trying to understand economic complexity are allowing countries to think of what are the paths to diversification and prosperity in ways that were not visible before and that are also of increasing use. Going forward our goal has to be to create new

frameworks, new conceptual apparatuses, new tools, that can help people find paths to prosperity.

LAPJ: One last message for the Latin American students completing their studies at Harvard.

RH: The first thing is that there is nothing more challenging and more exciting than to lead your country to prosperity. So, we are trying to form leaders and empower leaders with the tools to succeed, so the first thing is to try to do that.

The second thing is that there is an enormous value in the network, in the fact that

you came here, that you were all in class and interacting together. You have become like a brethren of co-travelers and there is a lot of value in using your peers as a sounding board, as a resource, as a way to access talent and achieve common goals. This network can make it easier for each one of you to achieve great things for the world.

I find that in the countries where we have not just one student but a whole tradition of students, when I go and visit those countries, I see the transformation they can create, and the fact that it is not just one person alone in one part of the space but a whole community of people that are trying to transform that space.



Ricardo Hausmann

Ricardo Hausmann is the Director of Harvard's Center for International Development and Professor of the Practice of Economic Development at the Kennedy School of Government. Previously, he served as the first Chief Economist of the Inter-American Development Bank (1994-2000), where he created the Research Department. He has served as Minister of Planning of Venezuela (1992-1993) and as a member of the Board of the Central Bank of Venezuela. He also served as Chair of the IMF-World Bank Development Committee (1992-1993). He was Professor of Economics at the Instituto de Estudios Superiores de Administración (IESA) (1985-1991) in Caracas, where he founded the Center for Public Policy. He holds a PhD in economics from Cornell University.