



Inter-American Development Bank (IDB)

CALL FOR RESEARCH PROPOSALS

Industrial Policies in Latin America and the Caribbean

An IDB research project
funded by the Country Studies Initiative

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I. **Justification for the Study**

In the post-Washington Consensus, the question of industrial policy appears to be not whether but how. Notwithstanding its falling in disrepute in many countries, important parts of its machinery remained in place and development banks heavily invest in it. Nowadays there is a revival of its respectability in theory and in practice. This project attempts to challenge preconceived notions about industrial policy and discuss systems currently in place with new eyes, hopefully deriving a useful perspective for the industrial policy of the future. Our first step is to get rid of the label “industrial”, which is responsible for much of the misunderstandings. In this project we look at policies that may promote overall productivity irrespective of the economic sector or type of activity in which they are applied. We call them productive development policies (PDPs).

“Productive development policies can be broadly defined as policies that aim to strengthen the productive structure of a particular national economy. This broad definition includes any measure, policy or program aimed at improving the growth and competitiveness of large sectors of the economy (manufacturing, agriculture); specific sectors (textiles, automobile industry, software production, etc.); or the growth of certain key activities (research and development, exports, fixed capital formation, human capital formation). The final objective is to raise growth and improve the competitiveness of the overall economy while maintaining a rising trend in living standards” Melo and Rodríguez-Clare (2006), p. 5.

Although the Washington Consensus called for a dismantling of the heavy and complex set of productive development policies (PDPs) that existed in the region at the beginning of the 1980s, the reality is that many of these policies survived and new ones were introduced in the 1980s and 1990s (see Melo and Rodríguez-Clare, 2006). Import substitution policies are largely gone, but most countries still maintain fiscal incentives for exports and FDI, tax breaks for certain sectors (e.g., hotels and forestry), public development banks, and fiscal incentives for R&D. More recently, governments throughout the region have introduced export promotion programs, technology funds, cluster promotion, and strategies in favor of Information and Communication Technologies.

PDPs result from a variety of reasons. Of course, in some cases they are the product of lobbying by rent-seeking organizations resulting in pure transfers



with no positive spillover, or simply bad policies. But often they are introduced in response to perceived market failures and result in efficiency gains, even if some of the interested parties were motivated by the capture of some rents. For example, the notion that there are spillovers associated with exports and FDI may explain the prevalence of subsidies or tax breaks to these activities.¹ Information spillovers associated with innovation may explain fiscal incentives to R&D and programs to encourage innovation (Hausmann and Rodrik, 2003). Coordination failures at the level of sectors or clusters may explain the introduction of a host of programs under the umbrella of competitiveness strategies in the mid 1990s (Rodríguez-Clare, 2004, Rodrik, 2004).

What we have in the region is the accumulation of several layers of PDPs created in different periods under different prevailing economic strategies and political economy circumstances. The result is a set of PDPs that may not be coherent and effective, and certainly not efficient. Of course, one would not expect to find a completely coherent set of PDPs anywhere, as these never respond to a single rational design, which is unfeasible and possibly undesirable. But the fear is that if the process by which these policies have evolved to their present stage has been haphazard or misguided, then the current system of PDPs may have important contradictions, redundancies, holes, waste, etc.

It is well known that aggregate productivity (TFP) growth is the key factor behind the region's lagging growth performance, accounting for some two-thirds of the observed growth gap in labor productivity relative to the rest of the world (the rest being physical and human capital deepening). Why is it the case that investment delivers low growth in our region? The analysis of existing PDPs may help answering the question of why social returns to investment are low and may suggest how to design PDPs to generate higher productivity.

II. Objectives of the Study

The country studies in this project will have two main objectives supporting the overall goal of providing useful directions on policy design in each country under study:

a) A critical review of the status quo of PDPs from an analytical viewpoint. This review is not intended as an impact assessment of the policies, which could be effective but flawed, neither as full-fledged welfare evaluations that

¹ See Rodríguez-Clare (2004) for a critical discussion of this motivation for PDPs.



would exceed the scope of this foundational effort. Rather, the proposed review would center on the analysis of whether existing programs are justifiable in terms of the failures they address and the public capacities to address these failures. The critical review will also include a discussion of the adequacy of the institutional setting and agencies in charge of implementing the policies on the basis of the views and behaviors of the actors involved.

b) A general proposal for reform and new directions of the policy content of PDPs. The objective is to derive broad classes of policies that could be justified in terms of addressing market failures (or offsetting deep-seated government failures) and public ability to address them, especially those that appear more important as growth impediments in the country. We are mindful of political economy explanations of a possibly dysfunctional status quo that would tend to block reform, but believe that solid analysis and open debate is a good check on it.

III. Research Methodology and Contents of Country Studies

The study should consider at least three different aspects of PDPs: **sectors, activities and actors**. Regarding the first aspect, how are the different **sectors** (or clusters) in the economy affected by PDPs? What are sectors that seem to receive particularly favorable treatment? In many countries tourism and forestry benefit from tax breaks, for example, while a few countries have also instituted programs to promote the software and biotechnology sectors. The second aspect involves the **activities** that are affected by PDPs. The study should describe the PDPs directly connected to activities such as exports, FDI, access to finance, SMEs, R&D and Science and Technology, as well as higher education and training. Finally, the study should analyze the public, semi-public and private **actors** involved in the formulation and implementation of PDPs.² What are the ministries that coordinate these policies? Do they have the human and financial resources to do this as intended? What are the public or semi-public agencies in charge of export promotion, attraction of FDI, support of SMEs, training and R&D? Are these agencies effective in practice? Finally, what is the role of private organizations such as chambers of commerce and industry, and other business associations? Are these private actors involved in the design and implementation of PDPs in collaboration with the Government?

² While some of the actors and institutions participate in the formulation and implementation of a broad set of PDPs, others will play a role only in specific policies. While we are mostly interested in the former, more general players, we will ask the authors to analyze the key specific players that play a role in the specific PDPs selected below.



The distinction between PDPs for sectors and for activities is fundamental in this project because of their distinctive economic rationale and institutional requirements. PDPs for sectors or clusters entail choosing favorites, or some would say “picking winners”. Most economists would agree that these PDPs have the potential to solve specific bottlenecks in a focused way but they also appear more prone to capture by lobbies. In other words, government may easily fail. PDPs for activities, on the other hand, appear less subject to political economy domination and government failure. For these reasons, “horizontal” policies of this kind have been generally preferred by economists provided that a market failure rationale to justify the intervention can be established.

Another interesting dimension to analyze PDPs is the degree to which the policy intervention takes the form of a public input complementary to the market (e.g. infrastructure) or, rather, the use of the power of the state to affect market incentives and in this way alter the market outcome (e.g. subsidy, or regulation designed for this purpose). Either modality of channeling the policy intervention may be applicable irrespective of the degree of horizontality. The choice along this dimension depends in part on the flexibility and resourcefulness of existing markets to arrive at the desired outcome under appropriate incentives.

A useful way to identify and organize the information above is to consider the following 2X2 matrix, which combines the Horizontal/Vertical dimension of PDPs with the Public/Market channel of intervention. Thus, interventions on the left are general or horizontal in nature, while those on the right generate benefits for specific sectors of the economy. The Public/Market channel of intervention is represented on the vertical axis. PDP interventions on the top of the matrix represent direct provision by the state, while PDPs based on market intervention are placed at the bottom. The combination of these two dimensions gives rise to four quadrants; we have included a few examples of PDPs in each of them as an illustration. Some of the policy interventions included, however, are not necessarily well justified.

The Horizontal-Public (HP) quadrant is the core of traditional macroeconomic studies on competitiveness, and the preferred domain of policies inspired by the Washington Consensus. In order to sharpen the focus of this project concerned with policies specifically addressed at improving productivity rather than the overall economic framework, in principle we will leave out the analysis of this quadrant (notwithstanding the extent it may inform the other three quadrants of interest). Therefore, it is expected that in the proposals and research papers, the analysis of PDPs for activities, or



horizontal policies, be mostly confined to the Horizontal-Market (HM) quadrant.³ As to PDPs for sectors or clusters, or vertical policies, they can be classified into the VP quadrant, perhaps the most common, and the VM quadrant.

	-H-	"Transversality"	-V-
Public Input -P-	Business Climate Educated labor force Basic Infrastructure		Rural roads for certain areas Cold storage logistics Food safety controls
Market Intervention -M-	R&D subsidies Training programs Tax exemption for capital goods High uniform tariffs		Sector-specific quotas Sector-specific subsidies to promote some sector

The study will briefly characterize the universe of PDPs mapped according to the matrix above. The study should also include a discussion of the economic situation and its relation with the system of PDPs. Research teams should take fully into account previous aggregate productivity studies, especially our own IDB growth diagnosis study where available, to assess the relevance of the system of PDPs. To what extent is it possible to argue that PDPs have caused some of the economic transformations that the country has experienced? Conversely, is it the case that the system of PDPs has evolved in response to that economic transformation, whatever its causes? We are particularly interested in understanding whether there is a "healthy" process by which PDPs are designed and reformed in light of the economic realities (see Hausmann, 2008). What factors have brought important changes to the system of PDPs?

The study will then focus on a selected group of PDPs, and review and assess, *prima facie*, whether they are justifiable on the basis of generally accepted economic analysis, along the lines of the discussion below. The

³ There are exceptions, however. For example, some activities of export promotion by specialized public agencies fall in the HP category. Furthermore, there may be countries with particularly weak markets in which some important horizontal productivity policy is not channeled through the market and deserves analysis even if in the HP quadrant..



criteria for the selection of PDPs could include quantitative aspects such as the amount of resources used, as well as qualitative aspects such as their priority in the government's program, their potential for improvement, or the extent to which there is an ongoing debate around these policies.

For each of the selected policies, we want to answer questions such as: a) was there a failure that needed to be addressed with a policy intervention?; b) was the choice of instrument appropriate to address it? A good general reference in this connection is the recent analytical survey by Harrison and Rodríguez (2008).

As already mentioned, in theory, governments implement PDPs that affect market incentives because there are certain market failures. For example, when a firm invests in R&D generates knowledge that can be used by other firms. Consequently, it cannot fully appropriate the benefits from its investment due to the presence of externalities. Therefore, without any government intervention investment in R&D will be less than the socially desirable amount. Governments may also choose to implement PDPs in order to offset structural government failures distorting market activity. For example, the failure to ensure property rights, commitment to fair taxation, labor market flexibility, etc. may lead to the creation of export processing zones as a way to offset these government failures, in the spirit of second-best policy.

As a way to analyze whether PDPs are justifiable, it is useful to critically review the validity of the stated justification and understand why governments choose to do PDPs in each quadrant. Many countries engage in PDPs to favor activities such as exports; foreign direct investment; access to finance; support of small and medium enterprises; innovation, R & D, science and technology; education and training to improve productivity. These policies are rationalized in terms of market failures under a variety of economic rationales which may be justified but need to be taken with a grain of salt, and in some cases outright skepticism (see Harrison and Rodríguez 2008). On the other hand, higher tariffs for all goods –to protect local producers in general-, does not seem to correct for any failure. As a consequence, government intervention in this case may be unjustified.

In addition to the stated justification, when implementing PDPs for activities, the study should examine whether the instrument chosen is appropriate to address the identified failure. For instance, if there are market failures in the credit market constraining the ability of firms to finance investment through the domestic financial sector, a tax exemption for capital goods may help



firms but would not address this market failure specifically. Therefore, alternative policies could better tackle this issue. The choice of instrument, in this case a subsidy in the goods market instead of a financial intervention, may be revealing of the underlying justification of the policy, as opposed to the stated one.

In the case of vertical policies, it is important to understand whether there is a valid rationale to target specific sectors or clusters and why the ones targeted by existing PDPs were chosen. Is there a coordination failure or some specific missing element blocking the healthy development of the sector or cluster? Is it the case that, were the coordination failure resolved, the economy would have a comparative advantage in this sector? Should the sector be treated as an infant industry on account of latent comparative advantages due to Marshallian externalities? Was the sector selected because it was important for the productivity of the overall economy (i.e. inter-industry externalities) or as a bet to move towards “higher income” goods à la Hausmann, Hwang and Rodrik (2007) to promote “structural transformation”? Was this logic explicit in the selection of these sectors?

Again, the kind of instrument chosen to address a stated failure may reveal the underlying specific justification of the intervention. PDPs utilizing policy instruments in the VP quadrant tend to address specific needs of sectors that are filled by the provision of specific public inputs. On the other hand, policy interventions inside the VM quadrant would be appropriate to address certain market failures distorting the sector’s development that can be remedied by altering market incentives to reflect social costs and benefits; in this case it would be quite relevant to understand those sector-specific failures. If the sector or cluster was selected not because there is an undue impediment but because its further development would produce inter-industry positive externalities (it is a “strategic sector”), then perhaps the most appropriate instrument would be some kind of subsidy directly affecting the bottom line. A blanket subsidy predicated on this kind of self-serving declaration of virtue should of course deserve close examination as to the positive externality associated with the particular sector or cluster.

The study will also review PDPs on the basis of best practices/successful experiences. There has been a recent interest in the academic debate on the general issue of designing effective PDPs in the current context.⁴ Also, there have been reviews of specific country cases as well as specific country

⁴ The best known papers are Rodrik (Industrial policies) and Hausmann and Rodrik (2006). Additionally, Rodríguez-Clare (2004 and 2005) and Lall (2004) present a review of the general issue.



recommendations.⁵ More specifically, there is also literature on best practices on export promotion and FDI attraction⁶, cluster promotion⁷ as well as horizontal interventions.⁸ In this regard the study should review the relevant literature on these issues and use it to contrast the PDPs selected for analysis.

Beyond the economic analysis of the content of PDPs, whether for sectors or activities, this project will also look at the actors involved and their institutional arrangements. In parallel with the review of the policy content of PDPs, the study will provide a brief characterization of the general institutional framework and analysis of the key specific institutions for the selected PDPs if it appears relevant for such analysis. Given the complexities of this subject, the research teams are given ample freedom to implement a research strategy to comply with this objective. The following questions are provided as suggestions for that elaboration.

For example, how are these policies decided? How and why have policies changed in the past? How are policies designed and implemented? What is the role of policymakers, private sector and academics in this regard? On one extreme, a centralized technocratic agency may define policy and make complete proposals for implementation, with or without input from independent technical advice. On the other extreme, the private sector may organize itself and make proposals, or apply pressure, for public action. In this case, the process may result in a reasonably productive combination between private knowledge and public muscle or a system of dysfunctional corporate welfare for the well connected. What is the kind of interaction observed on the ground?

The authors may want to review the quality of the institutional framework in this regard by looking at the historical experience in the country and, if possible, its contrast with international experience.⁹ Are business associations organized mainly for rent-seeking or do they also have an interest in improving policy and implement programs to improve productivity

⁵ See Blomström et al (2002) for the experience of the Scandinavian countries, Hasumann et al (2008) for South Africa and Hausmann et al (2007) for Uruguay. In recent times, there have been also country-strategies done by special committees or government bodies that outline the main challenges and possible solutions for competitiveness in the respective country.

⁶ See Lederman et al (2006) and World Bank Reading List on Attracting FDI (in <http://rru.worldbank.org/PapersLinks/Policies-Attract-Foreign-Direct-Investment/>)

⁷ See Altenburg and Meyer-Stamer (1999) and the Cluster Initiatives Greenbook by Solvell, Lindqvist and Ketels (2003) and references therein.

⁸ See De Ferranti (2003) and Chandra and Kolavalli (2006).

⁹ See the references from note 3 to 7.



in their area? Is the relationship between business organizations and the Government one of sharing information and collaboration, or is it an adversarial relationship associated with discussions regarding taxes, exchange-rates, and trade policies?

The study will attempt to review the implementation of the system of PDPs, or of individual PDPs, with respect to a number of relevant characteristics. For example, does the private sector participate in the definition of policies? does it take upon itself to cooperate in a way that suggest that its interest is more than rent seeking? are PDPs transparent to society? do PDPs add new bureaucracy or take advantage of effective private and public agencies? are they evaluated in a timely fashion and discontinued if ineffective? are they implemented in an “experimental phase” and scaled up as they prove successful? is there a process of knowledge accumulation and dissemination?

The analysis of the PDPs conducted by the authors will take into consideration information recovered from interested parties in the country, and its conclusions will be contrasted with their views. In effect, the study should provide a characterization of the current state of the debate on the subject. What are the positions of the different political parties/individual politicians, experts and technocrats, public and semi-public agencies, and business associations? It is expected that the research team will conduct interviews to elicit this information from the main actors.

The study will also include a preliminary proposal indicating directions for reform of the PDPs (both changes to the status quo and new initiatives). This proposal will be organized in terms of the classification matrix above for easier reference. The methodology to undertake such preliminary proposal should of course respond to the particular conditions of each country, but at the very least should address:

- a) An assessment of the weaknesses of the current system of PDPs, as well as the specific PDPs selected for analysis, both in terms of policy content and institutional setting
- b) Preliminary proposals for improvement of the system of PDPs as well as specific policies.
- c) The identification of important areas of PDP intervention that are not currently being addressed and the kind of policies that would be recommendable.
- d) The characterization of the debate among interested parties mentioned above. Are there important reforms on which there is a substantial



agreement? This debate should inform the proposals in points b) and c) above.

IV. Contents of Research Proposals

The project will be based on a set of country studies in all Bank regions based on the common methodological approach explained in the previous section. Research teams wishing to participate should send a proposal for the analysis of a particular country in Latin America and the Caribbean by July 28, 2008. Selected proposals will be notified by August 4, 2008. Researchers need not be nationals of the countries they propose to analyze, although it is advisable for teams led by research centers outside the country under study to have a local counterpart who is highly familiar with the local context.

The proposal will include a tentative outline of the study that will be informative of its scope and the methodology that will be utilized. The scope and methodology proposed should include:

1. A preliminary characterization of the current system of PDPs, including its most salient features in terms of stylized facts and observed outcomes, and a description of the kind of failures that may hypothetically justify them.
2. A list of the main specific PDPs that the team would be prepared to include in the critical review, specifying the main aspects of their rationale that the team plans to review and an explanation of why they appear interesting to study in light of the quantitative and qualitative criteria provided in the previous section. This list of PDPs will include five (or more) sectors or clusters benefitting from PDPs as well as a few horizontal PDPs addressing activities, such as exports; foreign direct investment; access to finance; support of small and medium enterprises; innovation, R & D, science and technology; education and training to improve productivity. Based on the information contained in the proposals received, the coordinators will then agree with the teams of selected proposals on a subset of PDPs to be individually analyzed in the research to be conducted.
3. A preliminary characterization of policy implementation and the institutional setting, including how the various actors and agencies interact, and a discussion of the main implementation and institutional aspects that the team would be prepared to critically



review in terms of the adequacy of instruments to address failures and the efficiency of the institutions to carry out policies.

4. The sources of information available (primary or secondary) to do the above reviews, including best practices and international experience if applicable.
5. A plan of interviews to gather information and characterize the debate among policymakers, private sector and academics.
6. A description of preliminary hypotheses (prior beliefs) about the main reforms to PDPs that a study like this may yield and that would make it important for policymakers.
7. An explanation of the kind of economic analysis that would be conducted to identify important new PDPs that could be justified to address bottlenecks and tap unexploited growth opportunities that the current system is neglecting.
8. An explanation of the relation of the proposed study to existing similar studies for this country and its contribution to knowledge.

The dissemination of this study to contribute to the debate is very important. The proposal will include a plan for the organization of a national workshop to discuss findings with interested parties. The budget necessary to carry it out is not included in this call and will be discussed later as a separate project if this activity is approved.

In addition, the proposals must include:

- ❑ A list of the researchers that will be involved in the project. The center should present a research team justification of their capacity to meet the objectives of the project, including relevance of prior experience. Curricula vitae of the researchers may appear in a separate annex. Subsequent substitutions for researchers originally specified in the proposal may be made with prior approval from the IDB Project coordinator, but the project leader should lead the entire project until its full completion.
- ❑ A budget (in a separate annex) indicating the time and resources that will be used within the context of the research work plan must be included. The budget proposed by the research center should disaggregate items financed by the IDB contribution and those financed by the research center. The budget should distinguish among amounts assigned to professional honoraria, data collection, "overhead" and other major categories of research expenditures.



Note: ALL proposals should be submitted in English

V. Selection Criteria

The research proposals will be selected according to five main factors:

1. Quality of the research proposal. Ability to translate the proposed methodology into a technically sound research proposal that demonstrates policy interest and a high likelihood of attaining the objectives of the project.
2. Approach to particularities of the economy under study. Restrictions or extensions to the application of the kind of methodological approach suggested in this call for proposals to the selected country must be spelled-out upfront and proposed adjustments to the methodology sketched.
3. Data and information sources. Data collection issues should be spelled out in detail (what sources of data will be used, what are the chances of success in obtaining such data, what channels are they planning to use to obtain data, etc.). Likewise with information to be collected through interviews and secondary sources.
4. Team Experience. The relevance of the team's experience for the proposed project will be a very important criterion in the selection process.
5. Effectiveness of the plan for organizing a national workshop to discuss findings and, over time, to build on this work to contribute to the domestic debate.

VI. Coordination and Tentative Schedule of Activities

In addition to the individual country teams undertaking these studies, there is a team of IDB coordinators (Eduardo Fernández-Arias, Fidel Jaramillo, Ernesto Stein, Christian Daude) and external advisors Andrés Rodríguez (Penn State University) and Charles Sabel (Columbia University).

The tentative schedule of activities is as follows:

- **June 26, 2008:** Call for papers issued.



- **July 28, 2008:** Due date for receiving proposals. Institutions should assure that the complete documentation is submitted to the evaluation committee. Complete documentation includes: "Registration form" with all information requested; the research proposal and CVs (CVs up to three pages long) should be sent to: res@iadb.org.
- **August 4, 2008:** Announcement of selected research proposals and arrangements for videoconferences or teleconferences to discuss particular aspects of each proposal that may need to be revised.
- **August 25, 2008:** Due date for receiving a preliminary report containing a revised proposal, an annotated outline of the research paper with data sources, and a tentative illustrative analysis of one sector or cluster, one activity subject to a horizontal policy, and one actor or institution.
- **September 4-6, 2008: I Discussion Seminar (Washington DC)** of team directors and coordinating committee to discuss preliminary reports and how to develop the paper.
- **November 10, 2008:** Due date for receiving a **First Draft** of research papers.
- **Around November 20: II Discussion Seminar (LACEA Rio)** of team directors and coordinating committee for the purpose of receiving feedback on first drafts.
- **December 31, 2008:** Due date for receiving a **Final Draft** of research papers.

Studies that are of good quality will be considered for publication as working papers. A selection of the best papers may be included in special issue of academic journal or in an edited volume on Productive Development Policies in Latin America.

VII. Financial Aspects

The **IDB Country Studies Initiative** will provide up to **US\$30,000** as a contribution to the total budget of the study. The Bank will provide additional finance to cover travel expenses to attend the workshops. Teams researching a country different than their own will receive additional aid to cover travel expenses.



The payment schedule is as follows:

- ❑ 30% within 15 working days of signing the formal agreement between the IDB and the respective research center.
- ❑ 30% within 15 working days of approval by the Bank of the **first draft** of the research paper.
- ❑ 40% within 15 working days of approval by the Bank of the **final research paper**.

Note: Fees for unjustified delays at any stage of the project will be charged in the form of a reduction in the corresponding payment of \$200 per day of delay. Failure to comply with any of the terms of the contract will imply a partial return of the funds paid up to the stage at which the failure occurs.



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