

**Title:** A (Pooled) Test of the Complementarity Hypothesis in the case of Latin America, 1980-2002.

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### Abstract

This paper analyzes the theoretical and empirical links between key economic variables and private investment spending in Latin America during the 1980-2002 period. The empirical findings in this paper address directly the complementarity hypothesis which suggests that increases in public investment spending raise the marginal productivity of private capital, thereby inducing higher rates of private investment spending. The paper also addresses the issue of whether the real exchange rate, particularly its volatility, has a deflationary effect on the economies of Latin America. All in all, the findings in this paper make an important contribution to the ongoing debate about which policies need to be promoted to raise and sustain the rate of private capital formation--Latin America's future source of employment and income creation.

The paper is organized as follows. The first section compares and contrasts the poor investment performance of Latin America to that of East Asia. Next, it develops a theoretical model that analyzes the optimal path of investment by a representative firm in a two-sector model (tradeable and non-tradeable). The production function of the representative firm in each sector explicitly includes the public capital stock as an input in its production function. The following section presents an empirical model that pools both cross-section and time-series data for nine major countries of Latin America over the 1980-2002 period. The fourth section presents Generalized Least Squares (GLS) and Seemingly Unrelated Regression (SUR) estimates for the pooled investment model which suggest that real (lagged) public investment, lagged domestic credit to the private sector, and lagged percentage changes in real GDP have a positive and significant effect on private capital formation, while the standard deviation of the real exchange rate index has a negative effect on private capital formation. The last section summarizes the main conclusions and offers suggestions for future research. (JEL: H40, O10, O54).