Australian Government
Productivity Commission

Latin America in the Global Economy: Challenges and Opportunities

Vittorio Corbo

Richard Snape Lecture
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Foreword

Richard Snape capped a long and distinguished career as Professor of Economics at Monash University with a new and accomplished career at the Industry Commission, and then as Deputy Chairman of the Productivity Commission. In the eight years that he spent at the Commission before his untimely death in October 2002, he played a pivotal role in overseeing our research program, as well as participating in major public inquiries.

This is the sixth in a series of lectures in memory of Richard Snape. With Richard’s own interests and high standards in mind, the lecture series elicits contributions on important public policy issues from internationally recognised figures, in a form that is accessible to a wide audience.

Vittorio Corbo, our 2008 Lecturer, is an eminent economist who has had a distinguished career in academia and in the private and public sectors (most recently, as Governor of the Central Bank of Chile). He became friends with Richard Snape when Richard spent some time at the World Bank in the 1980s. It is apparent from their writings that they had much in common. Dr Corbo has been a strong advocate for market-based reforms, in Latin America and more widely. This Lecture demonstrates the cogency of his arguments and their wider relevance.

I am grateful to Vittorio Corbo for agreeing to come to Australia to present the Richard Snape Lecture for 2008.

Gary Banks AO
Chairman

November 2008

RICHARD SNAPE 1936 – 2002

Richard Hal Snape was Deputy Chairman of the Productivity Commission and Emeritus Professor of Monash University. He was a Board Member of the Australian Research Council, Fellow of the Academy of the Social Sciences in Australia and a Distinguished Fellow of the Economic Society of Australia.

VITTORIO CORBO

Dr Vittorio Corbo was Governor of the Central Bank of Chile from 2003 until 2007. His previous positions include Head of the Macroeconomic Development and Growth Division, World Bank; Professor, Concordia University, Pontificia Universidad Católica de Chile; and Professorial Lecturer at Georgetown University. He is currently a Senior Research Associate at the Centro de Estudios Públicos and a member of the Advisory Council of the Chief Economist of the World Bank. In recent years he has been advisor to the World Bank, the IMF and the IDB.

Dr Corbo is a recognized authority on macroeconomics, international trade and economic development. He is the author of nine books and over a hundred articles. From 1998 to 2002 he was Vice-President of the International Economic Association. He has a PhD in economics from MIT.

Latin America in the global economy: challenges and opportunities

Vittorio Corbo[1]

1 Introduction

One of the areas of reforms of policies and institutions where Latin America has changed the most in the last thirty years is in trade. This is also the area that was at the heart of the professional work of my late friend Richard Snape. While Richard's work was motivated by the opportunities to improve welfare in Australia, my interest in the subject has been motivated by the opportunities to improve welfare in Latin America and, especially, for the very small economy of Chile. Our careers met while we were both associated with the Research Department of the World Bank in the 1980s.

Although Latin America was quite integrated into the world economy up to the Great Depression, the impact of the depression was such that most elected governments fell and the new governments that emerged had as their main objective getting their economies working again. For that purpose they pursued expansionary fiscal policies and raised tariffs to foreign trade. As the post World War II period opened, most Latin American countries found themselves with a local import competing sector that had developed behind the expansionary policies of the thirties and the artificial and natural import protection that was in place during that period. Import protection was provided by the high tariff barriers that were built as a response to the Great Depression and by the natural protection that resulted from the lack of transportation facilities during World War II.

In the post war period, a debate emerged in Latin America over what long-term development strategy Latin America should choose. On one side were the producers of exportable goods (agriculture and mining) and the traders of imported goods, who argued for reducing the bias of the trade regime against imports of goods and services. On the other side of the debate were the leaders of the import competing activities (mainly light manufacturing) and their workers, all of whom advocated keeping or even intensifying the protectionism, especially now that transportation had been restored. Clear manifestations of this debate appeared in Argentina, Brazil, Chile and Colombia. ECLA (the UN Economic Commission for Latin America

[1] I thank Ricardo Gonzalez for very efficient research assistance and Centro de Estudios Públicos for financial support.

started in the late forties) entered the debate head on, proposing a Latin America Development Strategy based on industrialization through import protection and state investment in infrastructure. Receptivity to policies of import-substitution industrialization was enhanced by political developments. As a side effect of the hardship that the Great Depression created in the region, in the late 1930s and in the 1940s populist governments came to power in Chile, Brazil, and Argentina. These movements had a common agenda of removing power from the conservative agrarian oligarchies and vesting it increasingly in mass movements of urban workers. These latter groups made important alliances with the new industrialists against export oriented mining companies and landowners. In this setting, programs of government led import-substitution industrialization encountered strong political support.

It was left for the recurrent balance-of-payments crisis and outbursts of inflation of the late fifties and early sixties to open the doors for a re-examination of the development strategy. The initial response was to pursue import substitution at the regional level to deal with the high efficiency cost of protectionism in small economies. Thus, in 1969 a group of Latin American countries created the Andes Pact. The Pact called for a gradual automatic reduction of import tariffs and for the allocation of new manufacturing activities to individual countries to avoid duplication and to reap the benefits of economies of scale. A common external tariff was also to be negotiated later on. The management of import substitution at a regional level proved much more difficult than that within a country at the same time that severe macroeconomic imbalances in some country members created tensions. As a result, the Pact lost dynamism in the second half of the 1970s. The final blow came when Chile withdrew from it after failing to get agreement on accelerating the pace of trade liberalization and for lifting the Pact´s discrimination against FDI.

In parallel, new developments in the evaluation of the welfare economics of trade regimes, pioneered by another great Australian economist, Max Corden, provided the analytical tools to study the costs of protection. These studies showed the large welfare costs of the very restrictive trade regimes that Latin America had put in place. These studies were mainly carried out by economists who had been trained in graduate school in the 1960s in the United States. The import substitution trade strategy was also criticized early on by Roberto Campos in Brazil.

An important obstacle to the successful opening up of Latin America was the periodic balance of payment crises that resulted from the combination of large fiscal deficits, central bank financing of the deficits, price controls and fixed or quasi-fixed exchange rates.

Thus, by the middle of the 1970s most Latin American economies were characterized by very restrictive trade regimes, very intrusive and large government sectors, and large government deficits that resulted in severe macroeconomic imbalances. Those imbalances took the form of high and sometimes accelerating inflation and large current account deficits. Throughout the region, microeconomic policy included price controls, a very protective and highly distorted trade regime (with a high mean tariff in a context of great variance in nominal import tariffs, and a wide variety of non-tariff barriers), multiple exchange-rate systems, a distorted process of credit allocation, and very restrictive labour practices.

The old development model not only led to a highly distorted and inefficient economy but also failed to achieve the ultimate objectives of sustainable improvements in output growth, reduced income distribution inequality, and a significant reduction of poverty. Failures on this front were due both to the inefficient economic system, and the recurrent economic crises, which affected the poor disproportionately. This development model was in place until the middle of the 1970s when some countries in the southern-cone of the region started reforms oriented to opening their economies to foreign trade, reducing the involvement of government in economic activity and reducing the macroeconomic imbalances.

2 The Volker shock, the crisis and the policy response

These reform attempts were disrupted in the early 1980s by the deepest world recession since the Great Depression. As the recession resulted from the sharp rise in world interest rates, which followed the Federal Reserve’s efforts to reduce inflation in the United States, it led to a sudden reversal of capital inflows, which hit the countries that were running large current account deficits and had a fixed or quasi-fixed exchange rate. Mexico and the southern-cone countries were among the most affected. The southern-cone countries were riding a private spending boom resulting from the improvement in economic prospects, the liberalization of their financial systems and opening up to capital inflows. Mexico was in the middle of a public spending boom associated with the increase in the price and the quantity of oil and large public sector foreign borrowing. The existence of a sort of predetermined exchange rate not only facilitated the boom but also made the adjustment to the sudden reduction in capital inflows much more difficult.

The sudden reversal of capital inflows not only precipitated a currency and financial crisis which set back the region for years to come but also forced the introduction of adjustment programs geared to rebuilding the basic macroeconomic balances, rebuilding the financial system and creating the basis for a recovery in growth.

Thus, as a response to the crisis, most Latin American countries introduced widespread reforms aiming to restore the basic macroeconomic balances and create the basis for sustainable growth at rates that could help to reduce the gap in GDP per capita with industrial countries. In these circumstances, adjustment was inevitable. Typically, the country suffering an external crisis also had a large and unsustainable fiscal deficit, and, in many cases, was experiencing very rapid inflation. Thus, macroeconomic problems were at the root of the crisis and macroeconomic adjustment programs were at the forefront of the adjustment effort. The adjustment programs of the 1980s had to find quick ways to reduce current account deficits. In the short run, reducing current account deficits (which are equal to the difference between domestic expenditures and national income), required policy measures focussed more on expenditure reduction than on boosting output, as the latter policies produce results much more slowly. Thus, adjustment programs were dominated by stabilization components, often with the support of the IMF and other international financial institutions.

But reform programs went beyond controlling the macroeconomic crisis. The adjustment programs included drastic reductions in public sector deficits; monetary and exchange-rate policies geared to produce real depreciation, while avoiding an acceleration of inflation; and the privatization of public enterprises operating at a loss. Once the worst of the crisis was over, countries initiated more profound policy and institutional reforms to complement stabilization policies, with a view to creating conditions for achieving sustainable growth and reducing poverty. These changes in policy and institutions emphasized actions to maintain macroeconomic stability and to establish the conditions to make markets operate more efficiently and to reduce government interference. Measures to enhance the role of markets have included the creation of a more open trade regime, the development of competitive market structures, and the restructuring of the public sector. In the process, one by one Latin American countries drastically changed the traditional import substitution-cum-government intervention development model, which most Latin American countries had pursued since World War II.

The change in economic philosophy was radical. After pursuing economic policies based on a deep distrust of markets, heavy government intervention and isolation from foreign trade, as described by Edwards (1995), Corbo (2000a) and IDB (1996; 1997), Latin American countries introduced policies that emphasised macroeconomic stability, competitive market structures, integration into the world economy (outward orientation) and a new role for government. These changes followed a new development model, discussed by Williamson (1989) and Corbo and Fischer (1995), according to which the government was responsible for establishing the institutions necessary for the proper functioning of a market economy, together with the provision of public goods and improved access to social services by the poorest in the population.

As a direct consequence of these policy changes, macroeconomic stability improved during the 1990s: the annual average inflation rate that had been over 100 per cent in the 1980s fell to less than 10 per cent by the end of the 1990s, and several large economies experienced inflation below 5 per cent (table 1). A sharp fiscal adjustment was behind the reduction of inflation. Chile, before its short-lived recession of 1999, enjoyed a fiscal surplus for over 10 years, and fiscal deficits were low to moderate in Mexico, Argentina and Peru (table 2). However, they remained high in Brazil, Ecuador, Colombia and Venezuela, as did inflation in Venezuela, Colombia and Ecuador and accelerating in Brazil.

In all countries, independent of the policy used to reduce inflation (exchange-rate based, money based or inflation targeting), the reduction of inflation was accompanied by an increase in the GDP growth rate, as shown in table 3. Thus, the observed 'sacrifice ratio' was positive rather than negative. This result is not so surprising if one considers the high growth costs of the debt crisis and the extreme inflation experienced in the region during the 1980s.

Table 1 **Annual average inflation rate**

Per cent

Country	*1980–5*	*1986–90*	*1991–7*	*1996*	*1997*	*1998*	*1999*
Argentina	335.6	1192.7	30.8	0.2	0.8	0.9	-1.2
Bolivia	2249.9	68.0	11.8	12.4	4.7	7.7	2.2
Brazil	141.9	1056.9	823.6	15.5	6.0	3.2	4.9
Chile	23.8	19.4	11.9	7.4	6.2	5.1	3.3
Colombia	23.1	25.0	23.9	20.8	18.5	18.7	10.9
Mexico	56.4	75.7	20.8	34.4	20.6	15.9	16.6
Peru	97.4	2341.4	83.8	11.6	8.6	7.3	3.5
Latin America and the Caribbean[a]	107.1	321.9	110.11	22.3	13.1	10.2	9.3

[a] GDP weighted average.

Source: Burki and Perry (1997) and World Economic Outlook Database, IMF, September 2000.

Table 2 **Non-financial public sector balance**

Percentage of GDP

Country	*1980–5*	*1986–90*	*1991–7*	*1996*	*1997*	*1998*	*1999*
Argentina	-14.5	-6.4	-1.8	-3.2	-2.1	-2.1	-4.1
Bolivia	-10.3	-6.3	-3.7	-1.9	-3.3	-4.0	-3.9
Brazil	**-4.3**	**-3.9**	**-1.8**	**-5.9**	**-6.1**	**-8.0**	**-9.5**
Chile	-1.2	1.9	2.0	2.1	1.0	-1.2	-2.5
Colombia	-5.7	-1.1	-1.5	-2.0	-3.1	-3.4	-6.0
Mexico	-11.3	-10.6	-0.2	-0.1	-0.6	-1.2	-1.1
Peru	-8.0	-7.7	-1.9	-1.0	-0.1	-0.6	na[a]
Latin America and the Caribbean	-8.6	-7.0	-2.8	-1.1	-1.3	-2.5	-3.1

[a] na: not available. The 1999 Peru central government balance was –3.0 per cent of GDP.

Source: Banco Central de Bolivia (1997), Banco Central de la Reserva del Perú (1998), Burki and Perry (1997) and IMF, *World Economic Outlook*, various issues

Table 3 **Real annual GDP growth rate**

Per cent

Country	*1980–5*	*1986–90*	*1991–7*	*1996*	*1997*	*1998*	*1999*
Argentina	-1.1	0.4	2.6	4.2	8.4	3.9	-3.1
Bolivia	-1.4	2.3	4.0	4.1	4.3	4.7	2.5
Brazil	2.5	2.0	3.0	2.8	3.0	-0.1	0.5
Chile	2.3	6.5	7.4	7.2	7.1	3.4	-1.0
Colombia	2.6	4.6	4.0	2.0	3.2	0.4	-5.1
Mexico	3.1	1.5	2.9	5.2	7.0	4.8	3.7
Peru	0.6	-0.8	5.4	2.6	7.5	0.3	3.5
Latin America and the Caribbean[a]	1.8	3.4	3.7	3.6	5.4	2.2	0.3

[a] GDP weighted average.

Source: Burki and Perry (1997) and World Economic Outlook Database, IMF, September 2000.

Following the Mexican crisis of 1994, a set of initiatives was developed to avoid similar crises. That crisis provided early warning of the importance of strong financial systems, of avoiding the build-up of short-term debt and large current account deficits. In response to these concerns, countries improved their macroeconomic management policies and strengthened institutions related to the regulation and supervision of the financial system. At the same time, these countries altered their exchange-rate policies, moving away from fixed but adjustable pegs, towards more flexible arrangements. The exception to this was Argentina, which continued with its currency board.

3 The Asian and Russian crises and their effects

As the policy and institutional changes descried above were taking place, Latin America suffered the effects of the shocks related to the Asian and Russian financial crises. The first shock, which followed the 1997 Asian crisis, took the form of a sharp deterioration in the terms of trade. Following the Russian crisis, the deterioration in terms of trade was accompanied by higher costs and reduced access to foreign financing. The external crisis surfaced in Brazil in early 1999 following a severe attack on its currency which forced the country to abandon the defence of its pegged exchange-rate system and adopt a floating exchange rate. The response to the crisis was twofold. First, macroeconomic policies were altered to avoid excessive current account deficits that could not be financed, and second, protective measures were introduced to mitigate the effects of a capital flow reversal.

When the crisis came, Latin American economies were in better shape than at the outset of the debt crisis in the early 1980s. By the end of 1997, an important group of Latin American countries – Argentina, Chile, El Salvador, Mexico and Peru – had transformed their economies; another group of countries – Bolivia, Brazil, Colombia, Costa Rica, and Nicaragua – had made important changes, but still had a way to go; Ecuador, Venezuela, Guatemala and Honduras lagged far behind.

The economies most affected by the shocks associated with the Asian crisis were Argentina and Brazil. Argentina’s vulnerability was associated with its monetary and exchange-rate regime and its still weak fiscal situation. However, in spite of the attack on its currency board regime, Argentina was able to defend the system, although the economy entered a long and deep recession that set the stage for the severe crisis at the end of 2001. Brazil's vulnerability was the result of many years of large fiscal deficits, accumulating in a large domestic debt with a short maturity, and a sharp real exchange-rate appreciation. Between 1994 and 1997, an exchange-rate-based stabilisation strategy, which combined a loose fiscal policy and a restrictive monetary policy, resulted in high real interest rates and a sharp real appreciation of the domestic currency – the real. Brazil experienced an attack on its currency in October 1997. The Brazilian government responded by raising interest rates and announcing a programme to reduce the fiscal deficit. As a result, the narrow exchange-rate-band system survived the attack. However, as the presidential election approached, the promised fiscal adjustment did not materialize, resulting in increased vulnerability.

Pressure on the Brazilian currency intensified with the onset of the Russian crisis. As Brazil was unable to implement a full adjustment programme in the middle of a presidential election, high real interest rates and foreign reserves were used to defend the attack on the currency. This situation could not continue for long without creating insuperable real costs or exhausting international reserves, so shortly after the elections the authorities introduced a fiscal package. On the strength of this fiscal programme, Brazil was able to mobilise US$41 billion as part of an IMF programme.

This adjustment programme, supported by the IMF, was supposed to restore confidence and contribute to a substantial reduction in real interest rates. The latter, through its effects on the interest component of the budget, was intended to make the fiscal situation more sustainable. But slow implementation of the adjustment programme and conflict between the federal government and some state governors made it less credible. As a result, pressure on the currency intensified, forcing the government to devaluate before exhausting reserves. Then, after another substantial loss of foreign reserves, the Central Bank decided to abandon the recently modified exchange rate band in favour of a floating rate. As no programme followed on the fiscal and monetary front, the currency went into free fall, resulting in a nominal depreciation of over 60 per cent in just two weeks. The exchange-rate crisis helped to mobilise enough political support to win approval for a substantial fiscal adjustment at the beginning of Cardoso´s second term, which yielded a primary surplus of over 3 per cent of GDP, with plans to increase it further in 2000 and 2001. This allowed Brazil to stabilise its financial markets, halt the loss of reserves and start to reduce short-term interest rates. The sharp reduction in real interest rates that took place following the adjustment programme made the internal debt dynamics less explosive and reduced the risk of domestic debt restructuring, setting in motion a virtuous circle.

Thanks to its serious fiscal adjustment Brazil was able to stabilise its economy and avoid a major crisis. Furthermore, with the stabilisation of the Brazilian financial markets the spreads in foreign debt started to come down again. Indeed, after an initial jump the stripped spreads on Latin American sovereign bonds returned to the pre-Brazilian crisis levels.

4 Latin America in the last ten years

The crisis of the 1990s raised important questions about the appropriate institutions and macroeconomic policies that would make individual economies more resilient to external shocks, facilitate adjustment in the event of a shock, and create the basis for sustainable growth at a rate high enough to reduce the income per capita gap with industrial countries in a limited period of time. On the macro side two issues emerged: the choice of exchange-rate regime and the choice of monetary regime to reduce inflation to levels in industrial countries. These issues have dominated the macroeconomic agenda of this decade. Learning from history, most countries have moved to more flexible exchange-rate regimes and have adopted inflation targeting monetary regimes. Today, among the medium and large countries of the region, Brazil, Chile, Colombia, Mexico and Peru have quite well developed inflation targeting systems with different degrees of exchange-rate flexibility, while Argentina is in somewhat of a transition to an inflation targeting regime.

However, despite the reform efforts and the large income per capita gap with advanced economies, the growth response has been disappointing: growth in Latin America has been slow and volatile in comparison with other emerging countries, especially in East Asia. In the 1990s, growth resumed in the region but remained below pre-debt-crisis levels, at about 5 per cent per year from 1950-80.[1] Income gaps with respect to the G-7 remained large and even widened in some countries. Furthermore, macroeconomic crises have become recurrent, poverty reduction has been modest and income inequality has worsened. Although recently declining, poverty rates in Latin America have shown only slow improvement over the decades, and income inequality – as measured by Gini coefficients – has been generally higher than in Asia. This polarization of economic wellbeing in some countries has contributed to polarization in the political sphere, which, in turn, has made it more difficult to build a lasting consensus for reform in the region

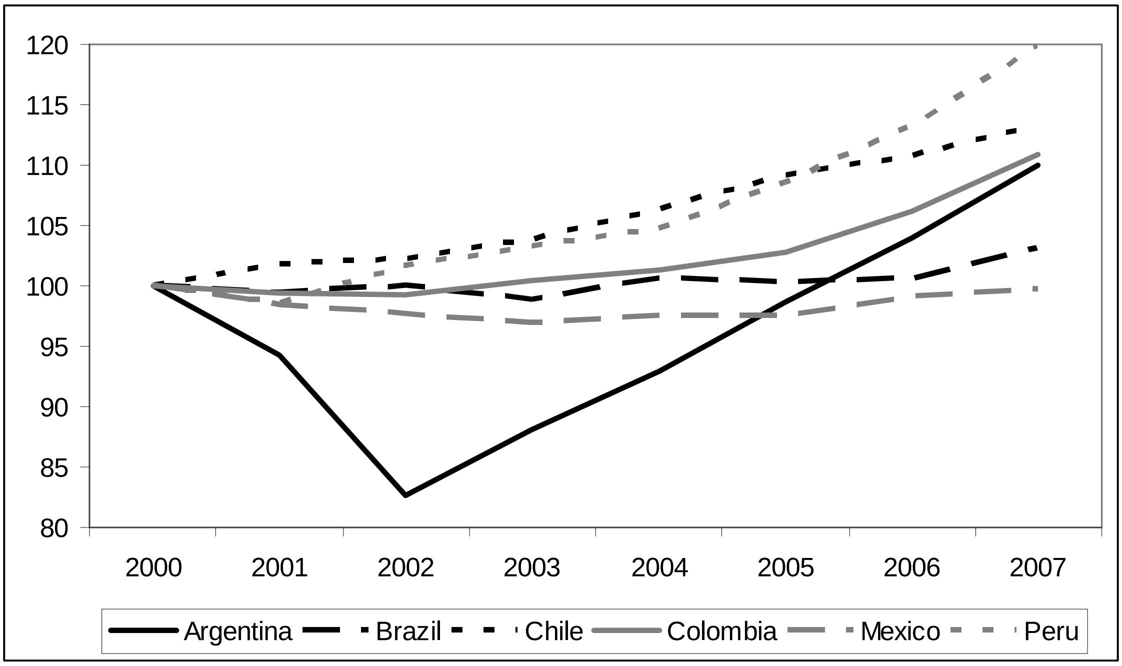
Table 4 **Average of GDP per capita**
PPP

	1980–1989	*1990–1999*	*2000–2007*
G7	23786	29363	34440
Latin America	7455	7909	8937

Source: World Development Indicators, World Bank (2008).

[1] Growth in LAC averaged 2.5 per cent during 1991-97, compared to -0.1 during the 1980s.

Figure 1 **Relative per capita output**[a]



[a] This figure shows country per capita GDP expressed relative to per capita GDP of G-7 countries (2000=100), using PPP prices.

Source: World Development Indicators, World Bank (2008).

5 Where are the opportunities to increase growth today?

After the disappointing performance of recent years much discussion has occurred on what is required to achieve a higher rate of growth for a sustained period of time to allow the region to start reducing its income per capita gap with industrial countries. This preoccupation with achieving a higher level of income per capita is not surprising as a higher income per capita is a means to achieving poverty reduction, better education, health and housing, and better opportunities for the population at large.

Rather than presenting my own list of what is required to increase the rate of growth in Latin America for a prolonged period of time (a decade or more) I am going to draw on the findings of the recent report of the Growth Commission[2] to identify priorities for policy and institutional reform that could help raise the sustainable rate of growth in Latin America.

[2] The Growth Report, Commission on Growth and Development, May 2008.

The report analyses, drawing on the guidelines of growth theories, the experience of countries that in the postwar period have been successful in sustaining average annual growth rates of 7 per cent or more for a period of 25 years or more. Although it is not easy to establish with certainty the factors that account for the success of the countries that achieved high growth, there are a set of characteristics that are common.

- First, they used the opportunities offered by integration into the world economy to achieve a better allocation of resources: competition, economies of scale, access to final products and inputs of a wider variety and of better quality, and incorporation of new ideas and technologies.
- Second, they achieved and maintained macroeconomic stability with prudent fiscal and monetary policies and an exchange-rate regime that avoided large exchange-rate misalignments. A stable macroeconomic environment raises the information content of relative prices, promotes saving and investment and facilitates the incorporation of new technologies with a long gestation period. In particular, low and stable inflation and a sustainable balance of payments situation gives investors assurance that the performance of an investment project is less likely to be affected by macroeconomic instability.
- Third, they mostly used the market to allocate resources with minimum interference in the price determination process. A regulatory framework that promoted competition supported the working of markets.
- Fourth, they had high levels of investment and saving rates.
- Finally, they had a competent state with governments that had a clear growth orientation that provided quality public goods and an enabling environment for the development of private initiative: rule of law, contract enforcement, expeditious procedures to initiate and to terminate a business, etc.

Policies and institutions in these five areas affect growth through their effects on the rate of growth of factor accumulation (labour, human capital and physical capital) and on the rate of growth of total factor productivity.

There was not much agreement in the Commission on the area of industrial policy and the use of a weak currency to promote tradeable activities. In the case of industrial policy the Commission recognized the difficulties of picking winners and therefore recommended a careful evaluation of cost and benefits before moving into this area. In the case of a weak currency, there was concern about the distortions that it generates and the implicit taxing of non-tradeable activities and labour.

Let us see where Latin America is today in these five areas.

Integration with the world economy

Although Latin America is much more open today than in the second half of the twentieth century, its progress has been much slower than other regions of the world, especially on the trade side. Many efforts to open the economies to foreign trade were derailed by macro/financial crises and by political economy factors. However, some individual countries have made important progress through the unilateral reduction of import tariffs and also through preferential trade agreements with other Latin American countries and even with some industrial countries. Chile has gone the furthest in both directions with a unilateral reduction in import tariffs that brought the maximum tariff rate to only 6 per cent and signing preferential trade agreements with major countries, including the United States, the European Union, Japan and Canada. Peru, Brazil and Colombia have also made much progress in reducing import tariffs.

As it can be seen in table 5, import tariffs were reduced from an average of 28.2 per cent in the second half of the 1980s to an average of 8.9 per cent in the period 2005–2007. The most remarkable reductions took place in Brazil and Peru, which went from an average of 45.8 per cent to an average of 12.2 and 8.8 per cent respectively.

Table 5 **Import tariffs in Latin America**

	1985–1989	*1990–1994*	*1995–1999*	*2000–2004*	*2005–2007*
Argentina	27.5	13.9	14.7	14.0	10.5
Brazil	45.8	21.0	15.1	14.7	12.2
Chile	18.0	11.8	10.7	7.0	3.0
Colombia	29.4	16.6	12.7	12.2	11.3
Mexico	16.7	12.8	14.1	16.1	8.6
Peru	45.8	17.2	13.9	11.0	8.8

Source: Data on Trade and Import Barriers, World Bank (2007).

However, in spite of the progress achieved so far, the current levels of import tariffs in Latin America are close to the rates applied in Emerging Asian countries, but are higher than the average for Eastern European countries. Only Chile equals the average import tariff level applied in those countries (table 6).

Table 6 **Regional tariffs**

	1985–1989	*1990–1994*	*1995–1999*	*2000–2004*	*2005–2007*
Latin America	28.2	15.4	12.3	11.4	8.9
Emerging Asia	32.9	32.1	15.8	10.8	7.6
Eastern Europe	19.2	9.4	8.7	5.7	3.3

Source: Data on Trade and Import Barriers, World Bank (2007).

Also non-tariff barriers are still higher in the region than in Emerging Asia and Eastern Europe. The exception again is Chile, which, after Hong-Kong, has the lowest non-tariff barriers.

If one examines trade openness by the share of total trade in GDP, one can observe important progress in the last fifteen years. The countries that have progressed the most are Chile and Mexico (table 7). In the case of Mexico, most of its trade expansion has been in trade with the United States, and to a less extent with Canada.

Table 7 **Trade openness in Latin America**[a]

	1980–1984	*1985–1989*	*1990–1994*	*1995–1999*	*2000–2004*	*2005–2007*
Argentina	13.8	16.6	15.6	21.6	33.2	44.0
Brazil	19.2	16.2	18.0	16.6	26.2	25.7
Chile	45.8	58.8	58.6	56.2	66.6	77.0
Colombia	26.6	29.8	34.8	35.8	41.8	43.7
Mexico	25.6	33.2	36.4	61.6	58.8	64.3
Peru	37.6	31.6	28.2	31.8	35.0	46.3

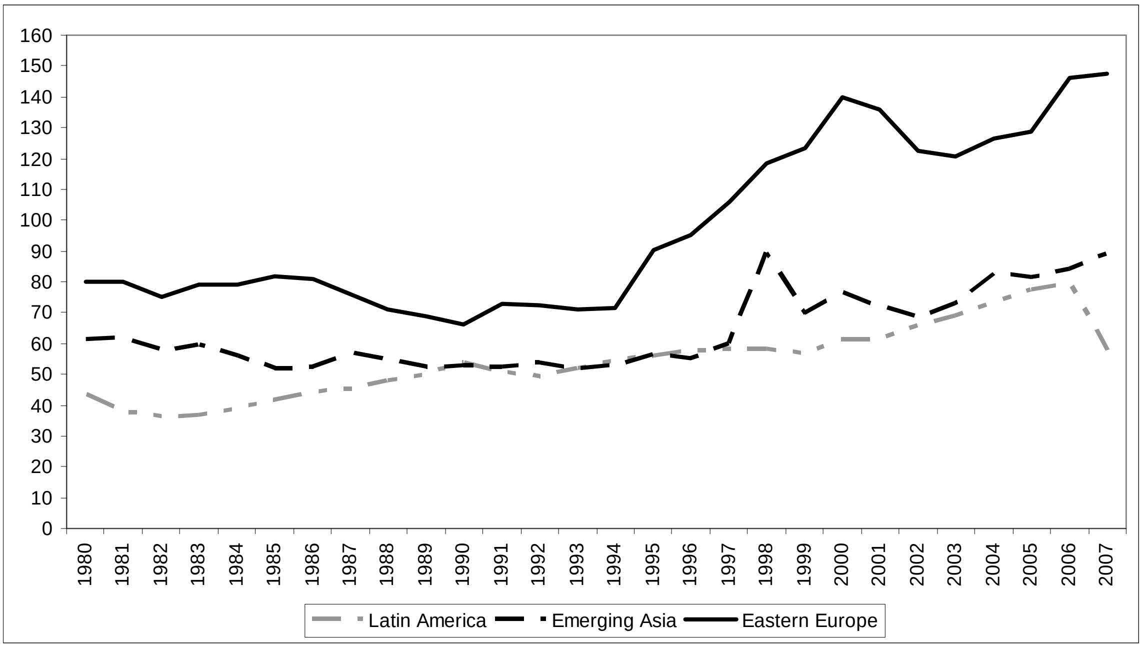
[a] Trade openness is measured as the sum of exports and imports as a percentage of GDP. Each cell contains the average over the period of reference.

Source: *World Development Indicators*, World Bank (2008).

When one compares with other regions of the world one observes that once again the progress of Latin America in this measure is not as dramatic as the one achieved by Emerging Europe. However, it should be noted that Emerging Europe has benefited from preferential access to the European Union while Latin America, with the exception of Mexico and to a lesser extent Chile, has not obtained similar treatment from the United States. Furthermore, distance acts as an artificial trade barrier.

As illustrated in figure 2, over the last three decades, Latin America has been much less integrated with the global economy than Emerging Asia and Eastern Europe. Latin America has a similar trade openness trend to Eastern Europe and a lower trend than Emerging Asia.

Figure 2 **Trade openness**[a]



[a] Trade openness is measured as the sum of exports and imports as a percentage of GDP.

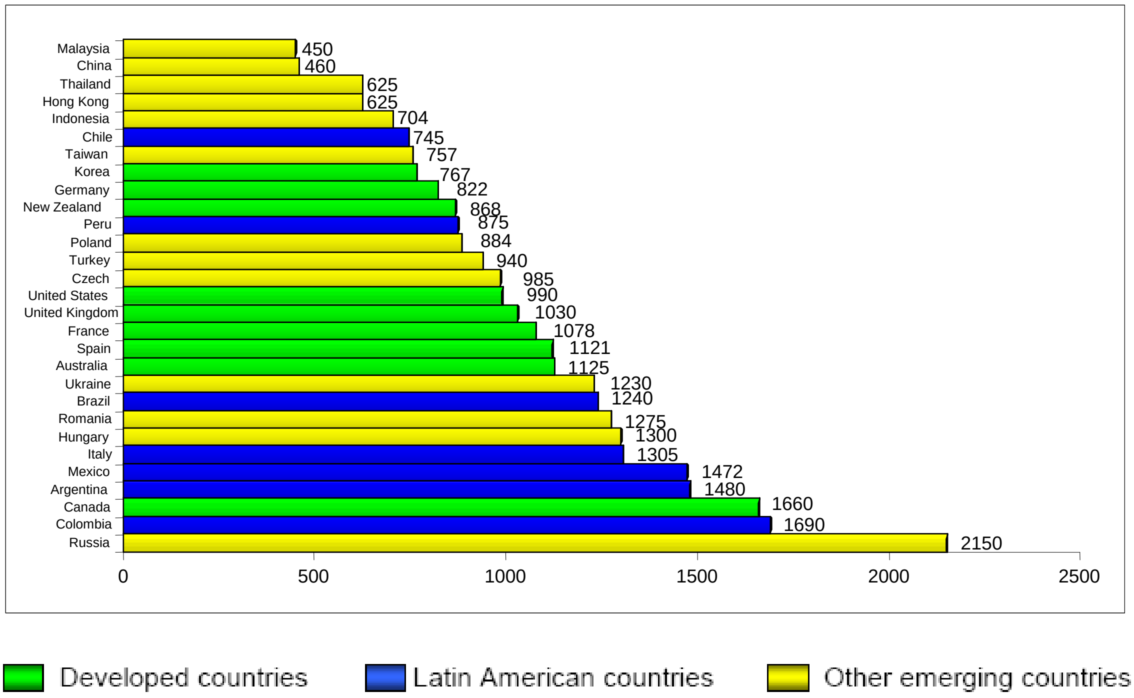
Source: World Development Indicators, World Bank (2008).

The main reasons behind lower trade openness are again, higher import tariffs, higher transportation costs (because of distance to the main external markets and inefficient and expensive ports), the existence of many non-tariff barriers and the overall policy environment. Indeed, the region does not rank well in terms of the cost of engaging in trade activities when measured as the number of documents required to perform an export or import operation and the time required to perform an export or import activity. Again Chile and Peru are the countries in the region with the lowest costs of engaging in trade activities. But even so, their costs are still higher than the one of successful traders in Emerging Asia.

Thus we conclude that in the area of trade opening, there are still important opportunities to benefit from a more active participation in the world economy by reducing tariff and non-tariff barriers and the costs associated with foreign trade activities.

Figure 3 **Cost to export**

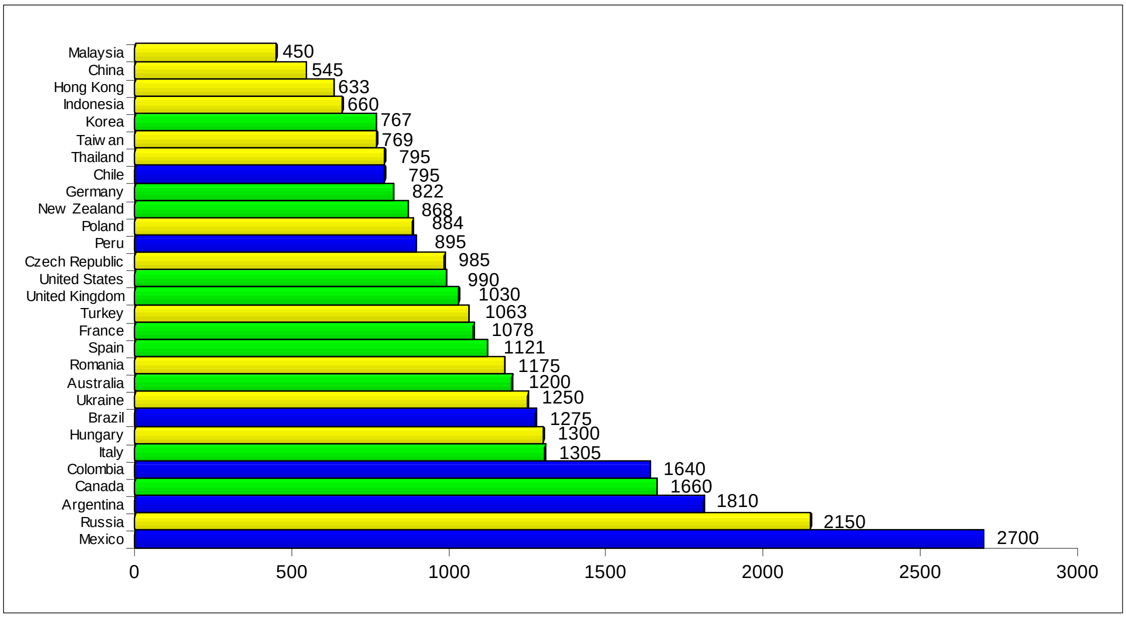
US$ per container



Source: Doing Business 2009, World Bank (2008).

Figure 4 **Cost to import**

US$ per container



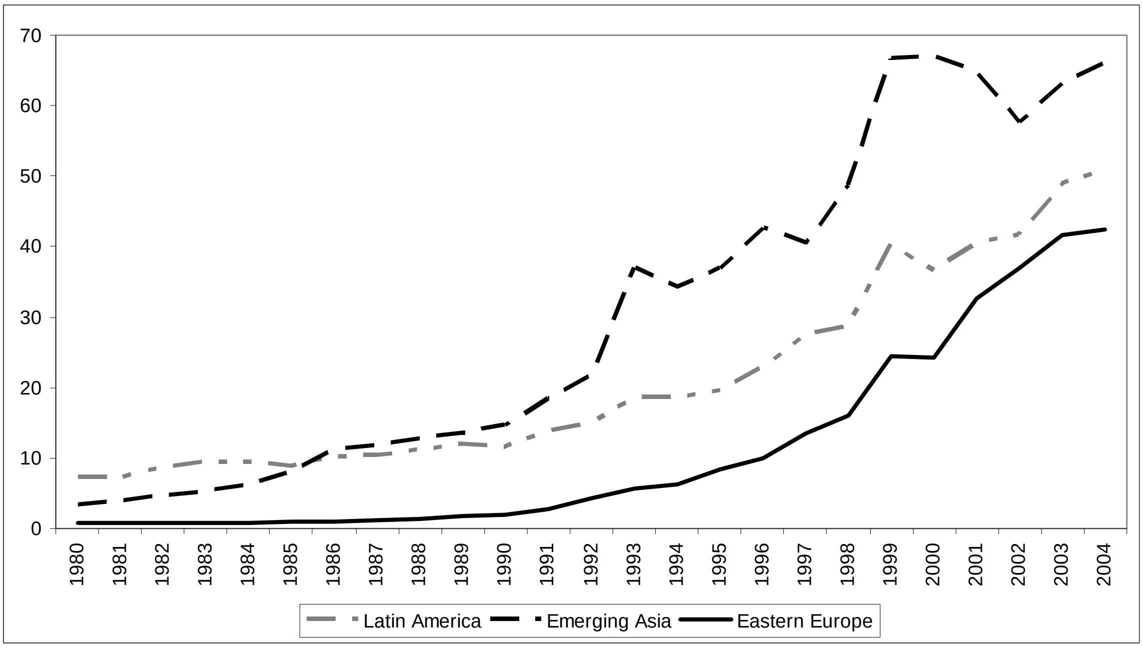
Source: Doing Business 2009, World Bank (2008).

The region has made much more progress in the area of financial opening with a series of reforms that have contributed to a more competitive and open financial system, including the practical elimination of capital controls. Financial opening has been facilitated also by:

- progress in restoring macroeconomic stability
- deregulation of domestic financial activities
- privatization of banks
- allowing foreign ownership of banks
- privatizations of non-banking activities
- pension reforms that replaced pay-as-you-go systems for defined contribution pension systems administrated by private companies that could invest part of the accumulated funds outside the country.

The process of financial openness accelerated in the 1990s after the debt crisis of the 1980s was left behind, the financial regulation and supervision had been strengthened and private capital returned to the region. But as figure 5 shows, the growth of financial openness was even higher in Emerging Europe, where it was facilitated (once again) by its proximity to Western Europe.

Figure 5 **Financial openness**[a]



[a] Financial openness is the sum of the stocks of external assets and liabilities of foreign direct investment and portfolio investment as a percentage of GDP.

Source: Lane and Milesi-Ferretti (2006).

Table 8 **Financial openness in Latin America**[a]

	1980–1984	*1985–1989*	*1990–1994*	*1995–1999*	*2000–2004*
Argentina	3.7	7.9	12.2	28.4	50.3
Brazil	13.9	11.2	14.4	24.4	45.4
Chile	20.8	23.0	35.4	64.4	108.3
Colombia	6.0	9.6	11.8	18.3	27.4
Mexico	5.5	10.5	17.7	29.4	35.6
Peru	6.2	5.1	7.8	29.2	42.1

[a] Financial openness is measured as the sum of the stocks of external assets and liabilities of foreign direct investment and portfolio investment as a percentage of GDP. Each cell contains the average over the period of reference.

Source: Lane and Milesi-Ferretti (2006).

Another factor that played a central role in financial opening was the lifting of capital controls and of restrictions on FDI and other capital flows. Before the 1982 financial crisis, net FDI flows in Latin America were 0.5 per cent of GDP, well above the levels of comparable regions. After the debt crisis, net FDI flows in Latin America stagnated at the same levels as those of Eastern Europe but with less volatility than Emerging Asia (see figure 6 below). FDI became important again in the 1990s. In the beginning of that decade, FDI reached around 2.5 per cent of GDP in Latin America and later on 3.5 per cent of GDP, similar to Eastern Europe's level, and substantially higher than Emerging Asia which had suffered huge instability following the Asian financial crisis. The evolution of Latin America FDI flows is mainly explained by privatizations of public enterprises and asset acquisitions by foreigners.

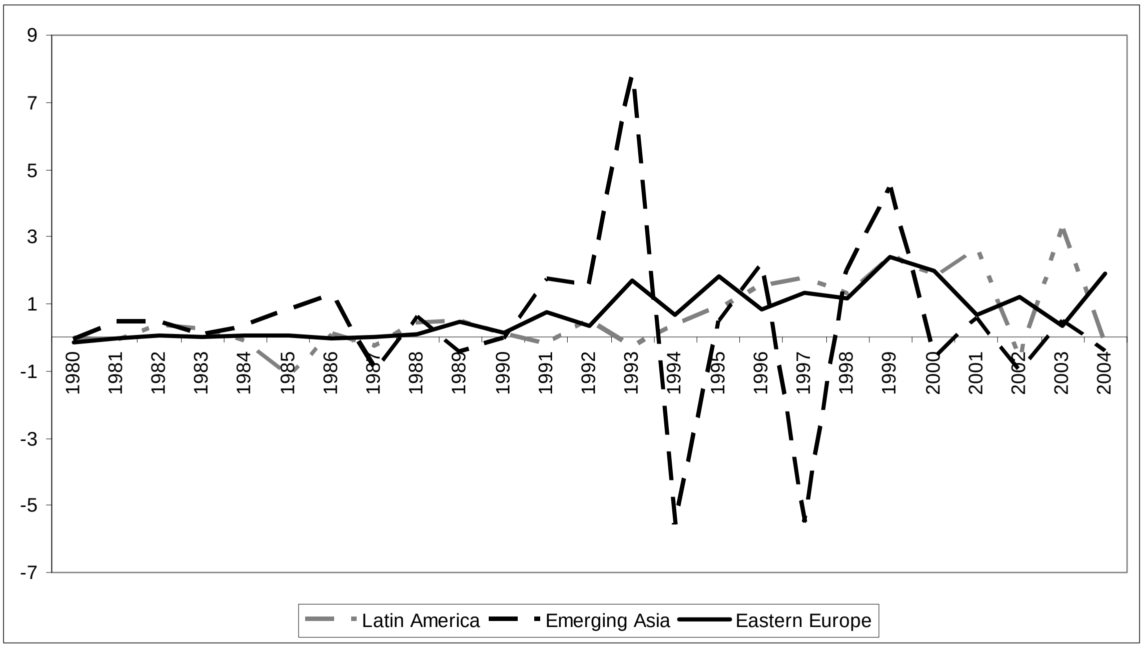
Table 9 **Net foreign direct investment in Latin America**[a]

	1980–1984	*1985–1989*	*1990–1994*	*1995–1999*	*2000–2004*
Argentina	0.5	1.2	-0.2	2.6	-0.1
Brazil	-0.3	-0.8	0.3	0.1	2.0
Chile	0.7	0.2	0.6	4.6	0.2
Colombia	0.2	0.7	-0.2	1.0	1.8
Mexico	0.5	0.6	-0.4	2.2	1.2
Peru	-0.6	-0.2	1.6	3.0	1.0

[a] Net FDI is the change of the difference between FDI liabilities and assets as a percentage of GDP. Each cell contains the average over the period of reference.

Source: Lane and Milesi-Ferretti (2006).

Figure 6 **Net foreign direct investment**[a]



[a] Financial openness is measured as the sum of the stocks of external assets and liabilities of foreign direct investment and portfolio investment as a percentage of GDP.

Source: Lane and Milesi-Ferretti (2006).

In the 1990's, the main source of private capital inflows were portfolio equity and to a much lesser extent bank loans which had been the main source of capital inflows in the 1980s.

Macroeconomic stability

Much progress has been achieved in the area of macroeconomic stability in the last fifteen years. The level and volatility of inflation have been substantially reduced, the volatility of GDP growth has also been reduced, fiscal accounts have been strengthened, current account deficits have been reduced and real exchange-rate misalignments have been avoided with prudent macroeconomic policies and flexible exchange rates. Independent central banks, with a clear price stability objective, have played a central role in this good performance.

Table 10 **Inflation in Latin America[a]**

	1980–1984	*1985–1989*	*1990–1994*	*1995–1999*	*2000–2004*	*2005–2007*
Argentina	268.2	863.2	505.2	0.8	8.2	10.0
Brazil	132.5	532.2	1667.4	19.4	8.8	5.0
Chile	22.4	20.4	17.4	5.8	2.8	3.3
Colombia	23.0	24.0	26.6	17.8	7.2	4.7
Ecuador	24.8	43.0	44.8	33.2	31.4	2.3
Peru	83.8	878.6	1607.8	8.4	2.4	2.0

[a] Inflation is the average annual change in consumer prices. Each cell contains the average over the period of reference.

Source: World Development Indicators, World Bank (2008).

The progress in the reduction of inflation and inflation volatility is impressive when compared to the history of Latin America (tables 10 and 12) as well as to what has been accomplished in Eastern Europe (tables 11 and 13). But the macroeconomic progress has not been restricted to inflation and its volatility, the volatility of output growth has also been reduced as well as the current account deficits (tables 14 and 15, respectively). These developments are important for their direct contribution to economic welfare and also for their indirect effects on investment.

Table 11 **Inflation[a]**

	1980–1984	*1985–1989*	*1990–1994*	*1995–1999*	*2000–2004*	*2005–2007*
Latin America	76.3	357.8	289.0	12.5	8.7	5.4
Emerging Asia	9.7	6.0	8.0	7.8	2.4	4.4
Eastern Europe	31.1	44.6	308.0	51.1	16.5	6.5

[a] Inflation is the average annual change in consumer prices. Each cell contains the average over the period of reference.

Source: World Development Indicators, World Bank (2008).

Table 12 **Inflation volatility in Latin America[a]**

	1980–1984	*1985–1989*	*1990–1994*	*1995–1999*	*2000–2004*	*2005–2007*
Argentina	176.4	918.9	794.3	1.9	10.8	2.5
Brazil	33.5	610.1	966.5	406.7	3.4	2.7
Chile	9.3	4.6	5.0	2.0	1.1	1.0
Colombia	3.9	3.6	2.7	3.8	2.1	0.8
Mexico	25.7	42.2	16.2	9.9	2.7	0.3
Peru	25.9	1605.4	1967.9	6.7	1.7	0.6

[a] Inflation volatility is the 5 year rolling window standard deviation of the average annual change in consumer prices. Each cell contains the average over the period of reference.

Source: World Development Indicators, World Bank (2008).

Table 13 **Inflation volatility**[a]

	1980–1984	*1985–1989*	*1990–1994*	*1995–1999*	*2000–2004*	*2005–2007*
Latin America	170.1	383.8	249.4	30.8	1.8	1.1
Emerging Asia	2.9	1.9	1.0	3.9	1.8	0.9
Eastern Europe	12.5	41.7	286.4	96.0	6.9	1.0

[a] Inflation volatility is the 5 year rolling window standard deviation of the average annual change in consumer prices. Each cell contains the average over the period of reference.

Source: World Development Indicators, World Bank (2008).

Table 14 **GDP growth volatility in Latin America**[a]

	1980–1984	*1985–1989*	*1990–1994*	*199–-1999*	*2000–2004*	*2005–2007*
Argentina	9.3	9.9	8.2	6.2	9.2	5.7
Brazil	7.2	4.5	4.2	2.3	3.3	3.2
Chile	9.0	4.4	4.8	3.9	2.6	2.3
Colombia	1.7	1.9	3.4	3.4	2.9	3.0
Mexico	6.0	5.0	3.5	6.4	3.4	2.2
Peru	9.3	10.3	6.1	5.7	3.3	3.4

[a] GDP growth volatility is the 5 year rolling window standard deviation of the GDP growth. Each cell contains the average over the period of reference.

Source: World Development Indicators, World Bank (2008).

Table 15 **Current account deficits**
(% of GDP)

	1980–1984	*1985–1989*	*1990–1994*	*1995–1999*	*2000–2004*	*2005–2007*
Argentina	-4.0	-2.2	-1.2	-3.4	2.6	3.3
Brazil	-3.6	-0.2	0.2	-3.2	-1.4	1.0
Chile	-9.4	-4.6	-2.4	-3.0	-0.6	3.3
Colombia	-5.2	-1.0	0.2	-3.8	-0.8	-2.3
Mexico	-1.6	-0.4	-5.6	-2.2	-2.0	-0.5
Peru	-3.8	-6.8	-5.4	-6.2	-1.8	2.0

Source: World Development Indicators, World Bank (2008).

On the stock side, public debt to GDP ratios have improved as well as the ratio of the stock of gross external debt to GDP (tables 16 and 17). The improvement in the public debt to GDP ratio has been associated with progress in public finance and the improvement of the external debt to GDP ratios with the improvements in the current account balances and the real appreciation of recent years.

Table 16 **Public and publicly guaranteed debt in Latin America**

(% of GNI)

	1980–1984	*1985–1989*	*1990–1994*	*1995–1999*	*2000–2004*	*2005–2006*
Argentina	21.7	48.6	24.2	24.8	61.6	32.7
Brazil	24.6	29.1	20.8	12.6	17.5	9.6
Chile	30.9	73.1	24.6	7.4	9.7	7.8
Colombia	16.4	35.8	29.2	17.4	26.9	19.5
Mexico	31.6	49.6	22.7	25.0	15.7	13.0
Peru	36.3	71.7	47.3	36.3	36.9	27.9

Source: World Development Indicators, World Bank (2008).

Table 17 **External debt in Latin America**

(% of GNI)

	1980–1984	*1985–1989*	*1990–1994*	*1995–1999*	*2000–2004*	*2005–2006*
Argentina	49.8	61.6	33.8	45.4	102.8	67.0
Brazil	40.4	39.2	30.6	27.6	41.4	20.5
Chile	77.8	108.4	49.4	39.0	57.0	40.0
Colombia	27.2	45.6	37.6	32.8	41.8	28.0
Mexico	48.2	64.0	35.4	44.4	26.4	20.5
Peru	51.6	101.6	66.8	55.8	50.8	36.0

Source: World Development Indicators, World Bank (2008).

Progress has been made also in developing deeper markets for government debt issued in local currency, in the process making the fiscal accounts more resilient to changes in the exchange rate.

Although the progress in the macroeconomic area looks quite impressive, there are still many opportunities to strengthen policies and institutions to make this progress sustainable and to reduce the risk of reversals in a less favourable external environment. The challenge is to sustain the gains achieved during this decade when external conditions facilitated a worldwide reduction in inflation and its volatility. Furthermore, during the last five years Latin America also benefited from favourable terms of trade that improved the fiscal accounts and contributed to a currency appreciation. The progress in fiscal accounts has to be consolidated and the commitment to price stability has to be strengthened with monetary policy regimes oriented towards price-level stability. Increased independency, accountability and credibility of the monetary authority will result in a controlled inflationary environment, a crucial element for entrepreneurs to make better resource allocation decisions and to create an enabling environment for private investment. Countries like Chile, Brazil, Colombia, Mexico and Peru, which have complemented the inflation-targeting scheme with a floating exchange rate, have made significant advances in the macroeconomic front.

On the fiscal side, public debt remains high in many countries. A reduction in debt to GDP ratios is essential to reduce vulnerability and facilitate the use of countercyclical fiscal policy. There is room for improvement in the composition and quality of spending, especially in countries with rigid budgets and meager fiscal revenues. Efficiency in tax collection can be boosted, and pension systems – which are increasingly in need of public funding in our aging societies – should be revised to make them more fiscally sustainable.

The second challenge lies in creating solid institutional frameworks. The quality of institutions still lags behind that of developed countries, and although changing them is costly as they tend to be largely inertial, there are many examples of the great benefits it yields when done successfully (WEF 2005). Strong institutions, especially efficient bureaucracies, together with an enabling business environment, all induce better appropriation of the opportunities offered by global integration.

Role of the market in resource allocation

The conditions for achieving a better allocation of resources have improved substantially in the last twenty years with Latin America's increasing integration with the global economy (real and financial), the practical elimination of price and interest rate controls (tables 18 and 19), and the spectacular progress in achieving and maintaining macroeconomic stability.

However, there remains much room to improve the efficiency of domestic markets, and to facilitate the process of creative destruction. Creative destruction plays a central role in determining the rate of growth of total factor productivity and thus is a key factor in achieving a higher and sustainable rate of growth. In particular, even today, in Latin America there are important entry and exit barriers to businesses. Among the barriers to starting a business, costs of starting a business are high (figures 7 and 8) and the access to credit markets has much room for improvement. On the exit side, the costs of exiting a business are high (high severance payments, as shown in figure 10, and costly bankruptcy processes).

Table 18 **Price controls**[a]

	1995	*2000*	*2004*	*2005*	*2006*
Latin America					
Argentina	8	8	1	1	0
Brazil	6	7	6	6	5
Chile	10	9	8	9	10
Colombia	5	6	5	5	6
Mexico	5	7	4	4	3
Peru	6	8	6	6	6
Emerging Asia					
China	4	3	2	2	1
Hong Kong	9	9	8	9	8
India	4	4	5	3	5
Indonesia	3	2	2	1	2
Korea	0	1	1	3	1
Malaysia	4	3	4	2	3
Thailand	5	3	4	4	2
Eastern Europe					
Czech Republic	6	4	7	7	7
Hungary	8	8	6	7	8
Poland	7	4	1	2	3
Romania	6	6	1	0	1
Russia	5	5	3	2	1
Turkey	5	6	5	5	7
Ukraine	4	6	4	4	4

[a] The index range is 1 to 10, with a 10 indicating more freedom to set prices.

Source: Gwartney, J., Lawson, R., Hall, J. and Norton, S. W. (2008). Economic Freedom of the World: 2008 Annual Report. The Fraser Institute.

Table 19 **Interest rate controls/negative real interest rates**[a]

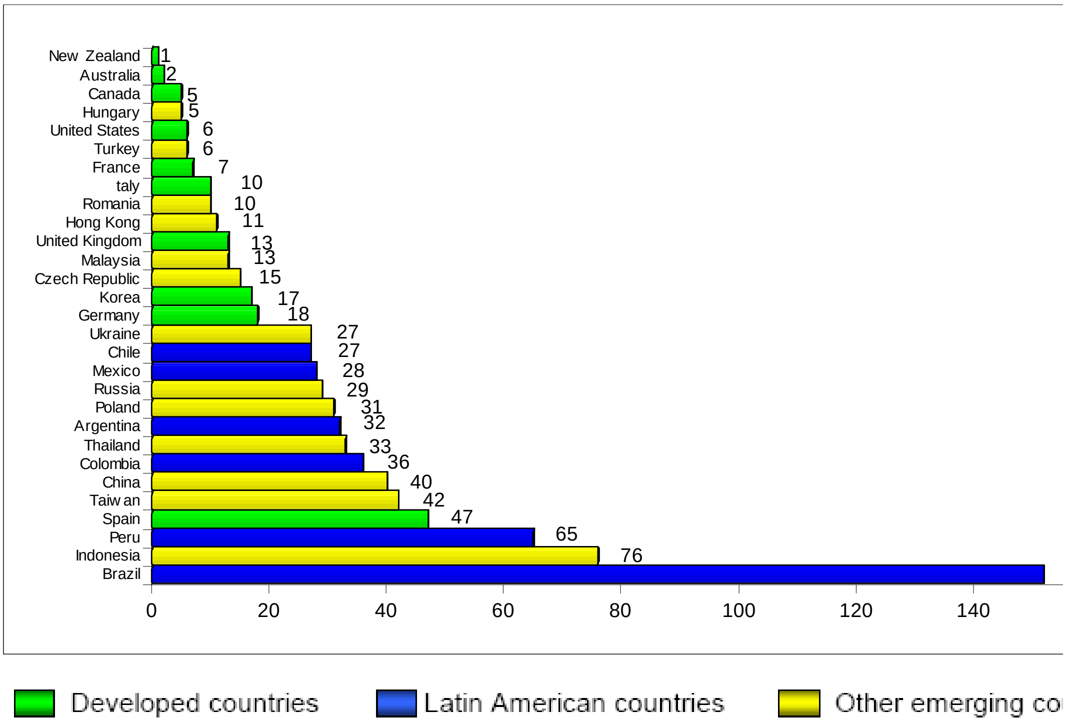
	1980	*1985*	*1990*	*1995*	*2000*	*2004*	*2005*	*2006*
Latin America								
Argentina	0	0	0	10	10	9	10	9
Brazil	4	0	0	0	8	5	5	5
Chile	8	8	8	10	10	9	10	10
Colombia	8	8	8	8	8	10	10	10
Mexico	4	4	8	8	4	10	10	10
Peru	0	0	0	6	8	9	9	8
Emerging Asia								
China	0	0	0	4	10	9	10	10
Hong Kong	10	10	10	10	10	10	10	10
India	8	8	8	8	8	10	10	10
Indonesia	2	4	10	10	8	10	10	10
Korea	4	10	10	10	10	10	10	10
Malaysia	6	10	10	10	10	10	10	10
Thailand	4	10	8	10	10	10	10	10
Eastern Europe								
Czech Republic				6	8	10	10	10
Hungary		6	6	6	10	10	10	10
Poland			0	6	10	10	10	10
Romania			0	0	0	8	8	8
Russia	0	0	0	8	2	10	9	10
Turkey	0	8	2	8	8	6	10	10
Ukraine				0	6	9	10	10

[a] The index range is 1 to 10, with a 10 indicating more freedom to set interest rates.

Source: Gwartney, J., Lawson, R., Hall, J. and Norton, S. W. (2008). Economic Freedom of the World: 2008 Annual Report. The Fraser Institute.

Furthermore, adjustment to change in relative prices to achieve a higher efficiency in resource allocation is significantly impaired by rigid labour laws in the form of minimum wages that distort wage structures (table 20), limitations to adjustments in working hours and high firing costs. These restrictions not only act as a barrier to improving resource allocation (figure 9) but also complicate access to the labour market for low skill workers, especially young workers with low education, and housewives with low human capital**.**

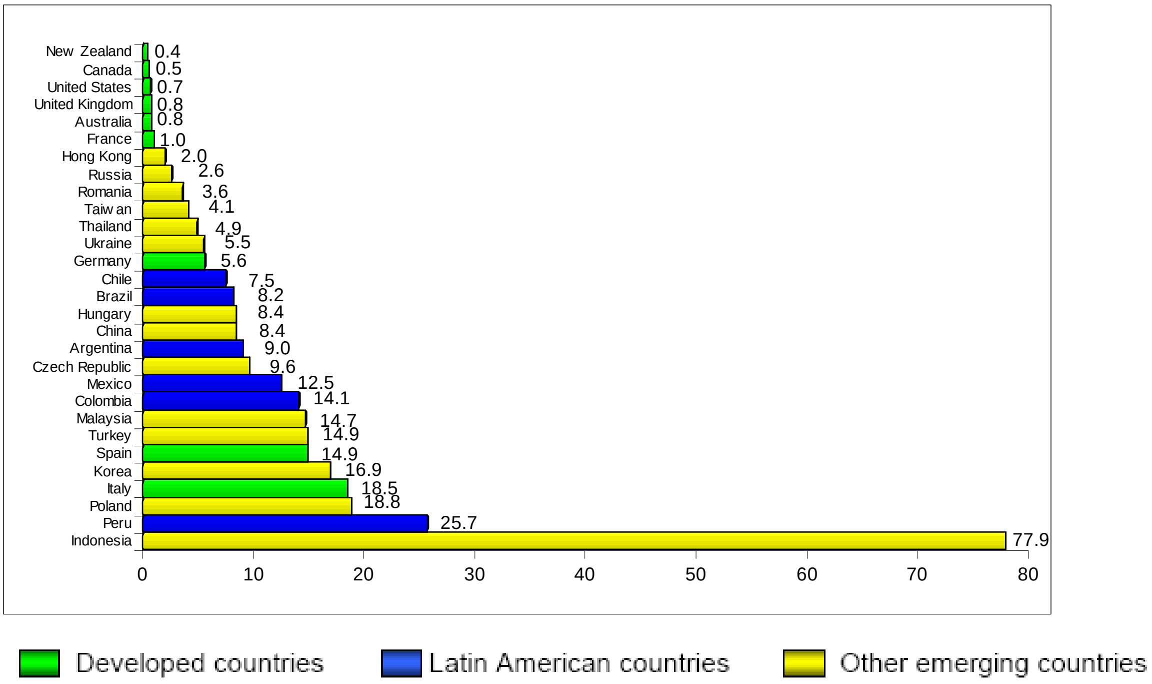
Figure 7 Number of days to start a business



Source: Doing Business 2009, World Bank (2008).

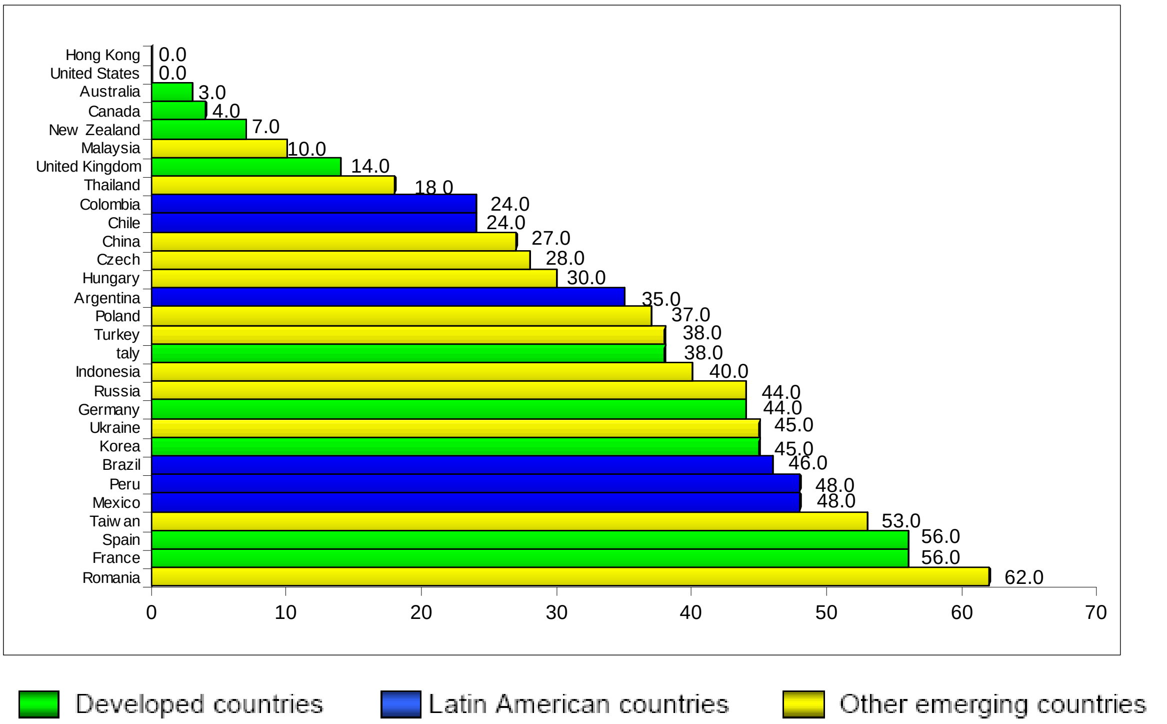
Figure 8 Cost of starting a business

(% of income per capita)



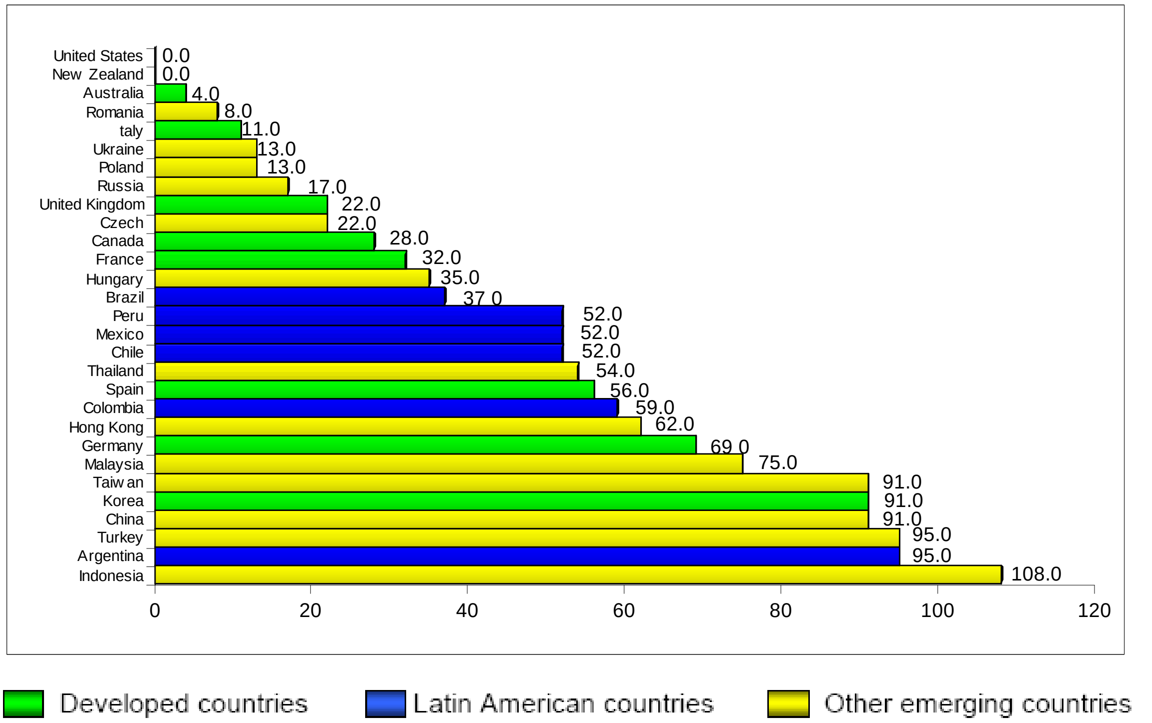
Source: Doing Business 2009, World Bank (2008).

Figure 9 **Employment rigidity index (0-100)**



Source: Doing Business 2009, World Bank (2008).

Figure 10 **Firing cost (weeks of salary)**



Source: Doing Business 2009, World Bank (2008).

Table 20 **Minimum wage**[a]

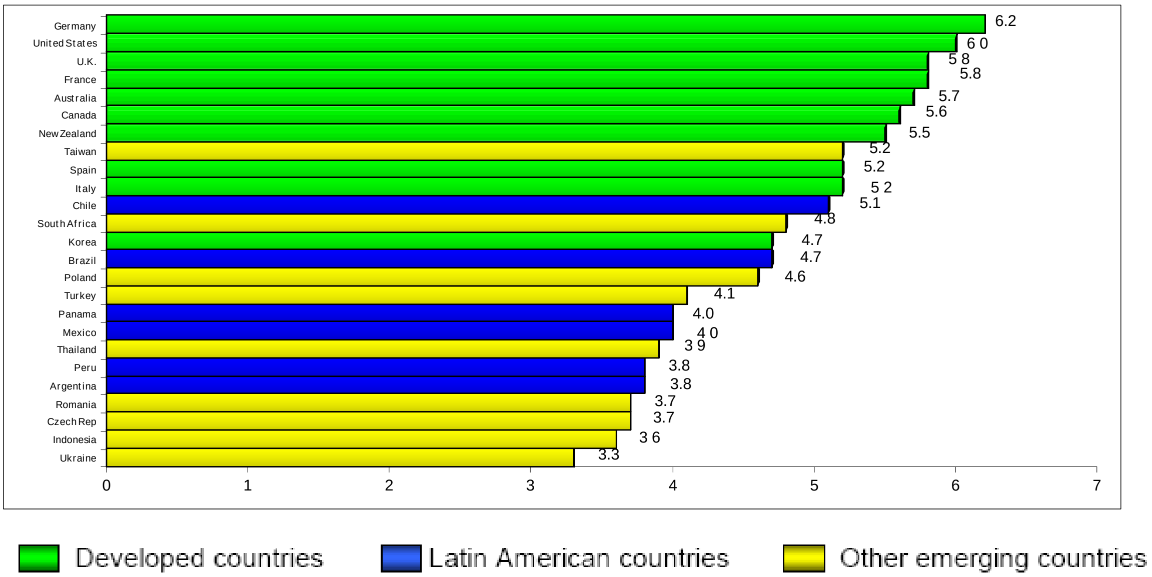
	1995	*2000*	*2004*	*2005*	*2006*
Latin America					
Argentina	5.95	4.42	6.21	6.21	5.24
Brazil	6.67	3.46	7.23	7.23	7.04
Chile	5.68	3.36	7.26	7.26	10.00
Colombia	6.83	2.85	3.17	3.17	3.65
Mexico	7.92	2.75	8.18	8.18	8.76
Peru	6.45	3.08	4.58	4.58	5.20
Emerging Asia					
China	5.80	4.37	5.07	5.07	4.96
Hong Kong		7.40	10.00	10.00	10.00
India	6.23	4.35	3.42	3.42	7.89
Indonesia	5.12	4.62	6.69	6.69	3.63
Korea	5.83	4.14	6.70	6.70	6.36
Malaysia	6.73	4.47	10.00	10.00	10.00
Thailand	5.77	3.94	7.64	7.64	8.15
Eastern Europe					
Czech Republic	6.58	5.09	7.28	7.28	7.08
Hungary	6.67	4.65	6.81	6.81	6.85
Poland	5.38	3.39	6.81	6.81	6.94
Romania		4.66	6.93	6.93	6.96
Russia	6.00	2.58	9.32	9.32	9.34
Turkey	6.35	3.38	4.04	4.04	2.77
Ukraine	6.62	1.87	5.75	5.75	6.25

[a] The index range is 1 to 10, with a 10 indicating more freedom to set wage rates.

Source: Gwartney, J., Lawson, R., Hall, J. and Norton, S. W. (2008). Economic Freedom of the World: 2008 Annual Report. The Fraser Institute.

With respect to competition policies and institutions, although laws have been in place since the 1920s in Argentina and later in Mexico, Colombia, Chile and Brazil (1962), enforcement was weak as it ran at cross purposes with the import substitution model that restricted the most important source of competition, imports. As part of the reforms of the last fifteen years, competition has been enhanced through the opening to trade and from specific laws that promote competition in non-tradable activities, especially services. Also, regulation policy has been revised to promote efficiency in the allocation of resources in public utilities run by the private sector. However, in this area there is much room for improvement both in the design and the enforcement of regulation.

Figure 11 **Anti-monopoly policy**[a]



[a] This measure is based on the answer to a question about the effectiveness of ‘antimonopoly’ policy: if law is lax and not effective in promoting competition (= 1) or effectively promotes competition (= 7), surveyed by the Global Competitiveness Report.

Source: Nicholson, M. (2008). ‘An Antitrust Law Index for Empirical Analysis of International Competition’. Journal of Competition Law and Economics.

Although some progress have been made in the use of the market to allocate resources, there is still much room for improvement in labour markets, competition policies and in reducing the cost of doing business. For the latter it is central to improve the efficiency of the public sector. Furthermore, progress has not been smooth, and important countries have done a lot of back tracking.

Saving and investment rates

Saving and investment rates in Latin America have risen in recent years most likely as a result of the progress in macroeconomic stability, the development of domestic capital markets, and the growth in private pension systems. However, they are still much lower than what is required for growth at rates above 5 per cent per year for a sustainable period of time. They are also below the levels in Emerging Asia and even in Emerging Europe. Many explanations have been given for the low saving and investment rates, among them macroeconomic volatility, the lack of support for public infrastructure for the development of private investment projects, the poor definition and enforcement of property rights and many other institutional weaknesses. Also, in many countries public investment is low and of poor quality and so does not promote private investment.

Table 21 **Foreign ownership/investment restrictions**[a]

	1995	*2000*	*2004*	*2005*	*2006*
Latin America					
Argentina	9.06	9.31	7.08	5.88	5.47
Brazil	7.29	7.56	6.40	6.16	6.05
Chile	7.98	8.61	8.57	8.38	8.22
Colombia	7.04	7.87	6.35	6.81	6.77
Mexico	7.77	8.70	7.21	7.54	7.58
Peru	9.22	9.30	6.85	7.27	7.47
Emerging Asia					
China	4.82	4.66	6.15	6.71	6.41
Hong Kong	9.40	9.92	9.08	8.96	9.05
India	4.67	4.05	7.43	7.40	7.13
Indonesia	7.53	8.12	6.42	8.36	8.30
Korea	4.66	7.16	6.67	5.82	7.12
Malaysia	7.31	6.61	7.39	7.67	7.53
Thailand	7.30	7.02	6.48	6.25	6.47
Eastern Europe					
Czech Republic	6.44	7.92	7.82	8.42	7.84
Hungary	7.76	8.29	8.48	7.86	8.02
Poland	5.41	6.78	6.81	5.65	6.00
Romania		7.55	5.75	6.23	6.52
Russia	5.08	5.71	4.38	4.22	3.95
Turkey	8.98	9.27	6.05	6.55	7.23
Ukraine	4.86	7.13	4.12	4.61	4.55

[a] The index range is 1 to 10, with a 10 indicating more freedom to foreign ownership.

Source: Gwartney, J., Lawson, R., Hall, J. and Norton, S. W. (2008). Economic Freedom of the World: 2008 Annual Report. The Fraser Institute.

Furthermore, smaller firms continue to face important financing constraints that hold back investment, despite the opportunities resulting from the global economy and progress in macroeconomic stability. A recent study shows that the cost of finance for small firms in the region is almost double that in Asia (IMF, Latin America Regional Economic Outlook, October 2008).

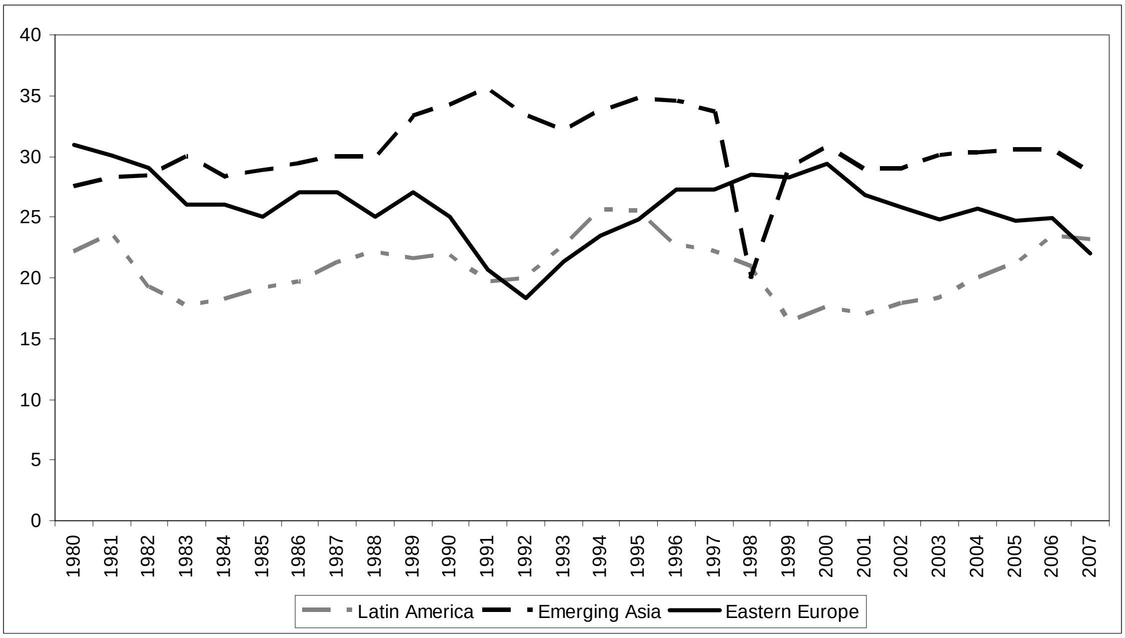
Quality of public policies and growth commitment

With the exception of Brazil and Chile, the capacity of the state in Latin America is quite limited and therefore public policies are unpredictable, slow to be implemented and costly for businesses. One of the areas where the costs for efficiency and long term growth are quite clear is in the quality of health and education services and innovation policy. The merit system is not common in the public sector and as a result the bureaucracy is selected more along party lines than professional capabilities. As a result not only is the bureaucracy of low quality but tenure is directly linked to the duration of the government. The notable exceptions are Brazil and Chile, in that order. Given the poor quality of public administration, it is not surprising that public services are of low quality, the protection of investors has much room to be improved and the enforcement of contracts is expensive and slow, even when compared to other countries with a similar income per capita.

Research and development and innovation policies suffer from the low human capital base and the low quality of public services in this area.

Figure 12 **Gross capital formation**

(% of GDP)



Source: World Development Indicators, World Bank (2008).

Table 22 **Gross capital formation in Latin America**[a]

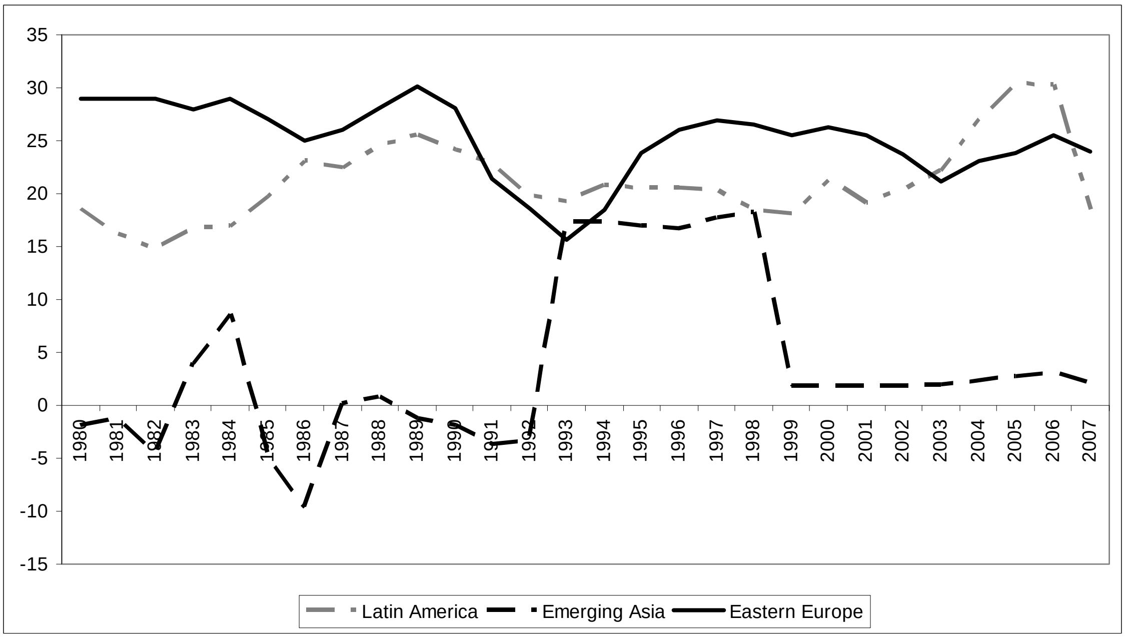
	1980–1984	*1985–1989*	*1990–1994*	*1995–1999*	*2000–2004*	*2005–2007*
Argentina	22.2	18.0	17.0	18.6	15.2	22.5
Brazil	20.0	22.0	20.4	17.0	17.0	18.3
Chile	15.8	21.2	24.6	25.8	21.4	21.0
Colombia	20.0	19.0	19.8	20.4	15.8	23.0
Mexico	23.6	21.0	22.4	23.4	21.8	22.3
Peru	28.4	23.0	18.2	23.4	19.2	19.7

[a] Each cell contains the average of the gross capital formation, as a percent of GDP, over the period of reference.

Source: World Development Indicators, World Bank (2008).

Figure 13 **Gross domestic saving**

(% of GDP)



Source: World Development Indicators, World Bank (2008).

Table 23 **Gross domestic saving in Latin America**

	1980–1984	*1985–1989*	*1990–1994*	*1995–1999*	*2000–2004*	*2005–2007*
Argentina	23.4	21.2	17.0	17.0	22.0	28.0
Brazil	20.8	26.0	21.4	15.4	18.2	21.3
Chile	12.8	25.4	26.8	25.4	25.2	33.0
Colombia	17.6	22.8	21.0	15.6	16.0	21.3
Mexico	27.2	24.0	18.8	23.6	19.8	20.3
Peru	28.6	23.2	16.2	18.8	18.8	27.0

Source: World Development Indicators, World Bank (2008).

Table 24 **Features of public policies in Latin America since 1980's[a]**

Country	*Stability*	*Adaptability*	*Enforcement and implementation*	*Coordination and coherence*
Argentina	Low	Medium	Low	Low
Brazil	High	High	High	High
Chile	High	High	High	High
Colombia	High	High	High	Medium
Mexico	High	Medium	High	Medium
Peru	Medium	Medium	Medium	Medium

[a] Stability refers to policy stability over time. Adaptability refers to the ability of adjustment of policies when they fail or when circumstances change. Enforcement and implementation refers to the quality of implementation and enforcement itself. Coordination and coherence refers to the consistency of policies with related policies and if that policy results from well-coordinated actions among the actors who participate in their design and implementation. These measures are intended to capture features of a country's public policies over the last couple of decades, or since the return to democracy, and do not necessarily reflect the characteristics of policies in the current administration.

Source: Stein and Tommasi (2005).

Table 25 **Features of public policies in Latin America since 1980's**

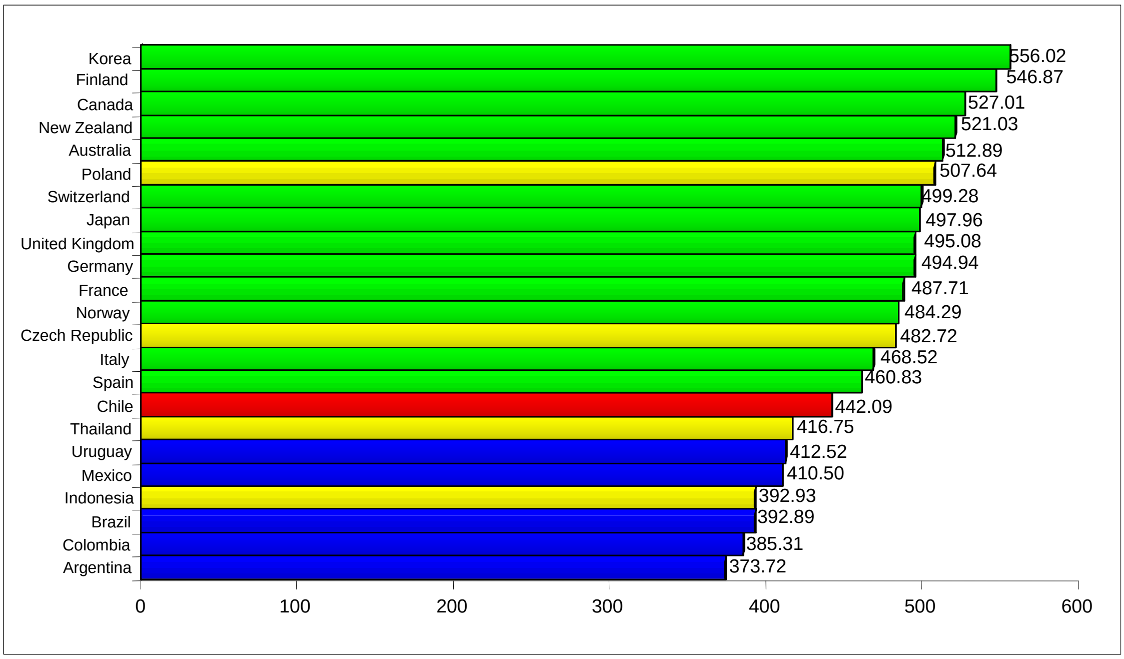
Country	*Public-Regardedness[a]*	*Efficiency*	*Policy index*
Argentina	Medium	Low	Low
Brazil	Medium	Medium	High
Chile	High	High	Very High
Colombia	Medium	Medium	High
Mexico	Medium	High	High
Peru	Medium	Medium	Medium

[a] Public-regardedness refers to the degree to which policies pursue the public interest. Efficiency refers to the extent to which policies reflect an allocation of scarce resources that ensures high returns. These measures are intended to capture features of a country's public policies over the last couple of decades, or since the return to democracy, and do not necessarily reflect the characteristics of policies in the current administration.

Source: Stein and Tommasi (2005).

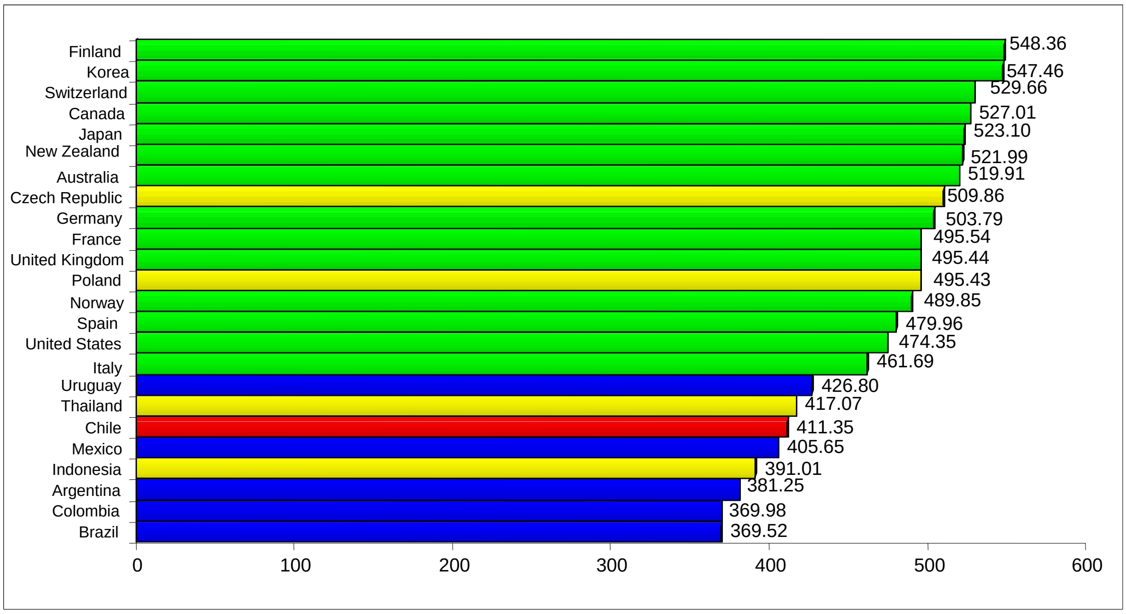
One of the weakest areas of government policy is education and health. Public education and public health suffer the consequences of low budgets, poor incentives, lack of accountability and difficulties in introducing and implementing measures oriented to improving efficiency. In the case of education, although much progress has been made on school enrolment and attainment, Latin American countries still rank very low in international achievement tests, even after controlling for the level of per capita income.

Figure 14 Mean score of student performance in reading



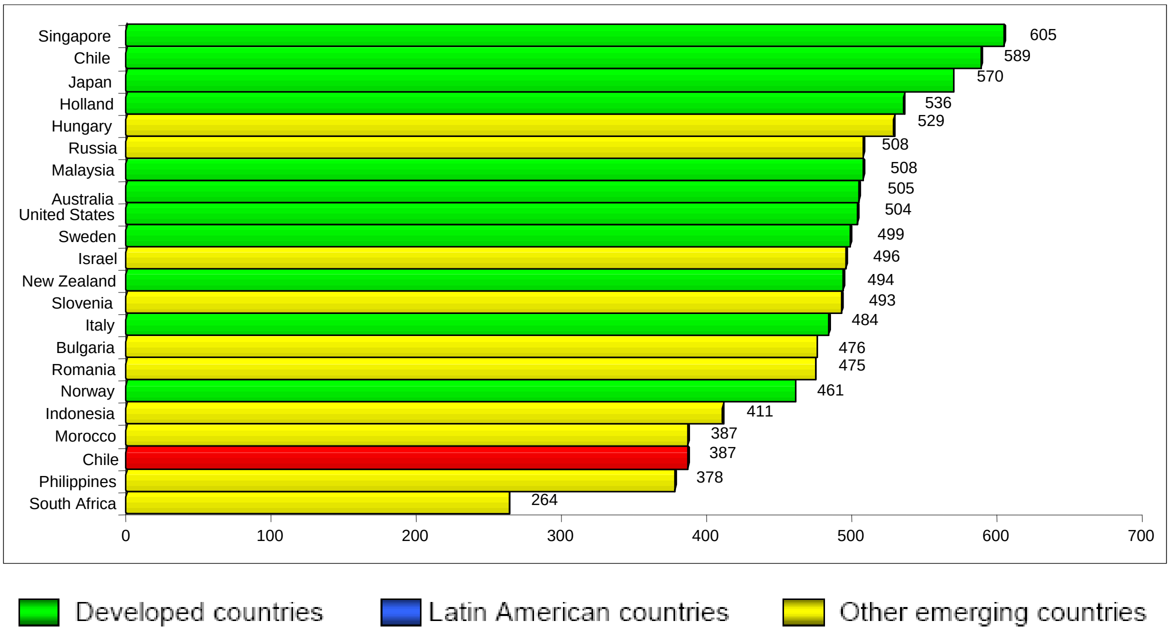
Source: PISA 2006: Science Competencies for Tomorrow's World, OECD (2007).

Figure 15 Mean score of student performance in mathematics



Source: PISA 2006: Science Competencies for Tomorrow's World, OECD (2007).

Figure 16 **Mean score of student performance in mathematics**



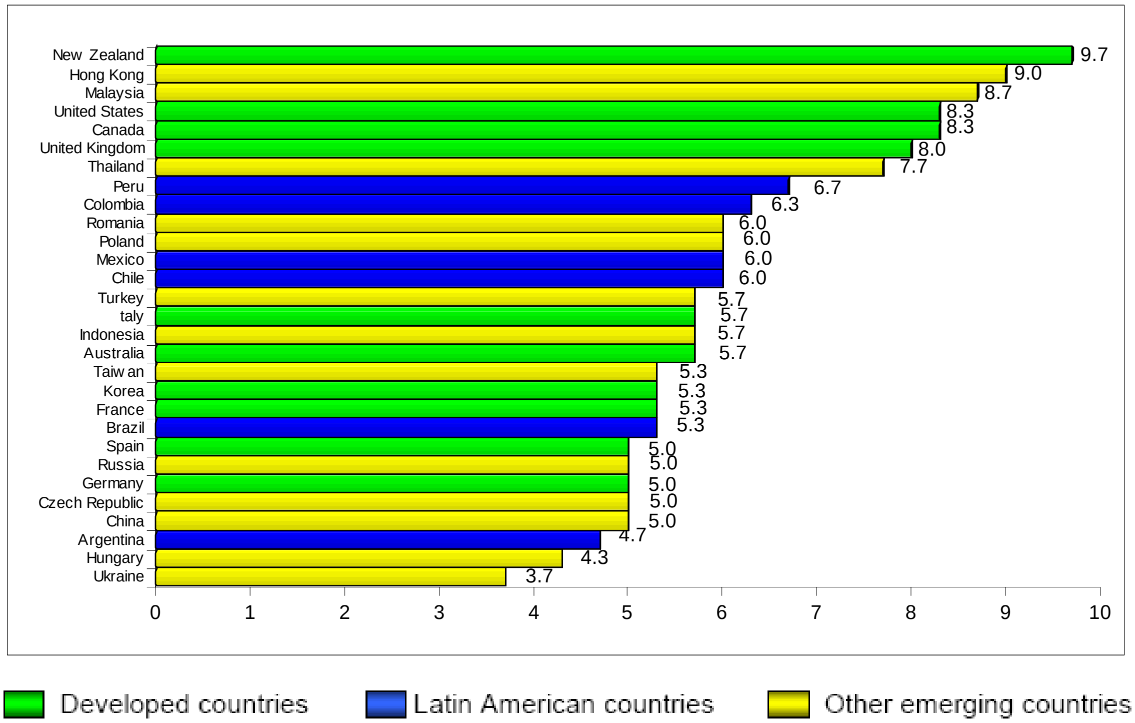
Source: Highlights from the Trends in International Mathematics and Science Study (TIMSS) 2003.

The poor level of cognitive skills is a serious handicap to the development of the region, as these types of skill have powerful effects on individual earnings, on the distribution of income, and on economic growth (Hanushek and Woessmann, 2008). Although there are still many uncertainties about the best policies to increase knowledge throughout Latin America, the education system lacks incentives for improved student performance. Recent research suggests that the best opportunities here are in: (1) strong accountability that accurately measures student performance; (2) local autonomy that allows schools to make appropriate educational choices with respect to student material, coverage, methods and management of resources, including teachers; (3) choice and competition in schools (Hanushek and Woessmann, 2008).

In Latin America it has been very difficult to move in this direction not so much because of low budgets, but because of institutional weaknesses, incapacity to decentralize, and difficult political economy problems that have made it very hard to establish the right incentives for all the sectors involved in the production of education to act in ways that advance students performance.

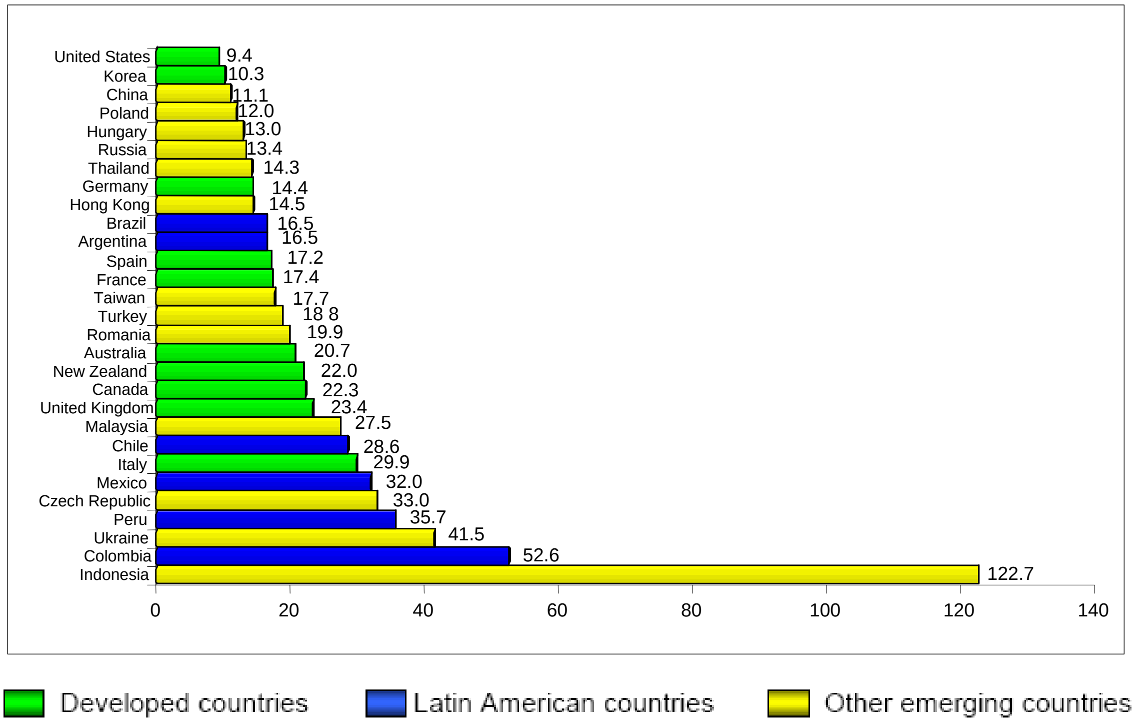
In the areas of policies and institutions that protect investors, they determine the costs of enforcement of contracts, and determine the cost of insolvency. Latin America has again much room for improvement as it ranks quite low when compared to countries in other regions of the world.

Figure 17 **Strength of investor protection index (0-10)**



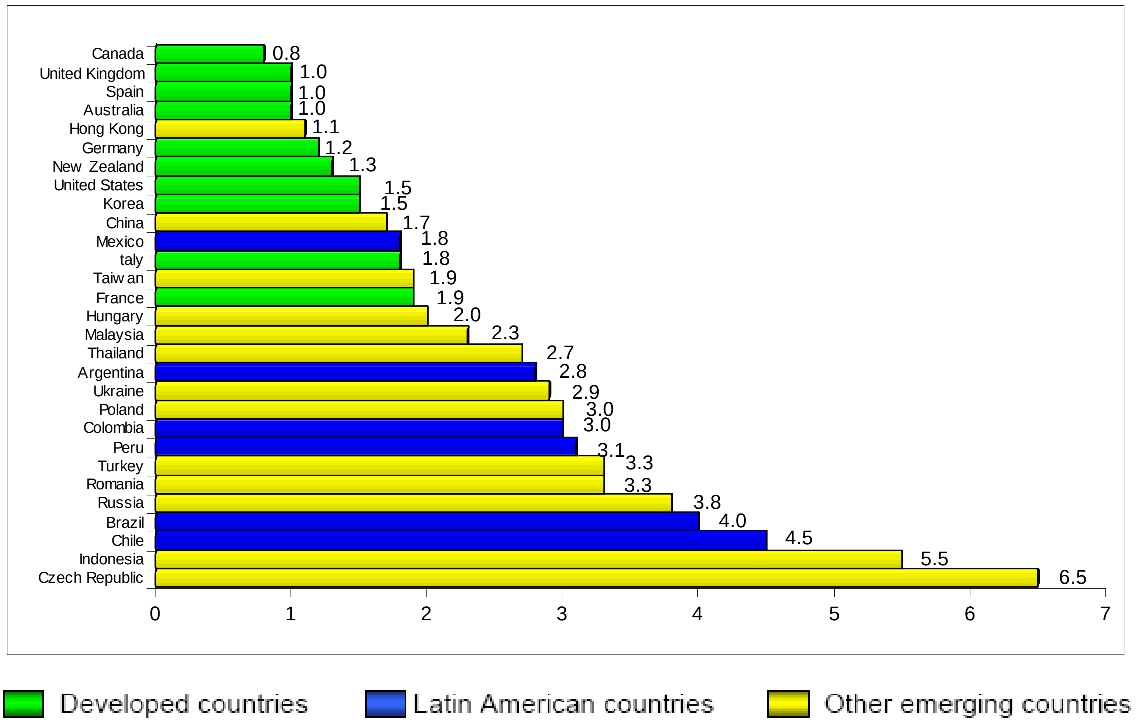
Source: Doing Business 2009, World Bank (2008).

Figure 18 **Cost to enforce a contract (% of claim)**



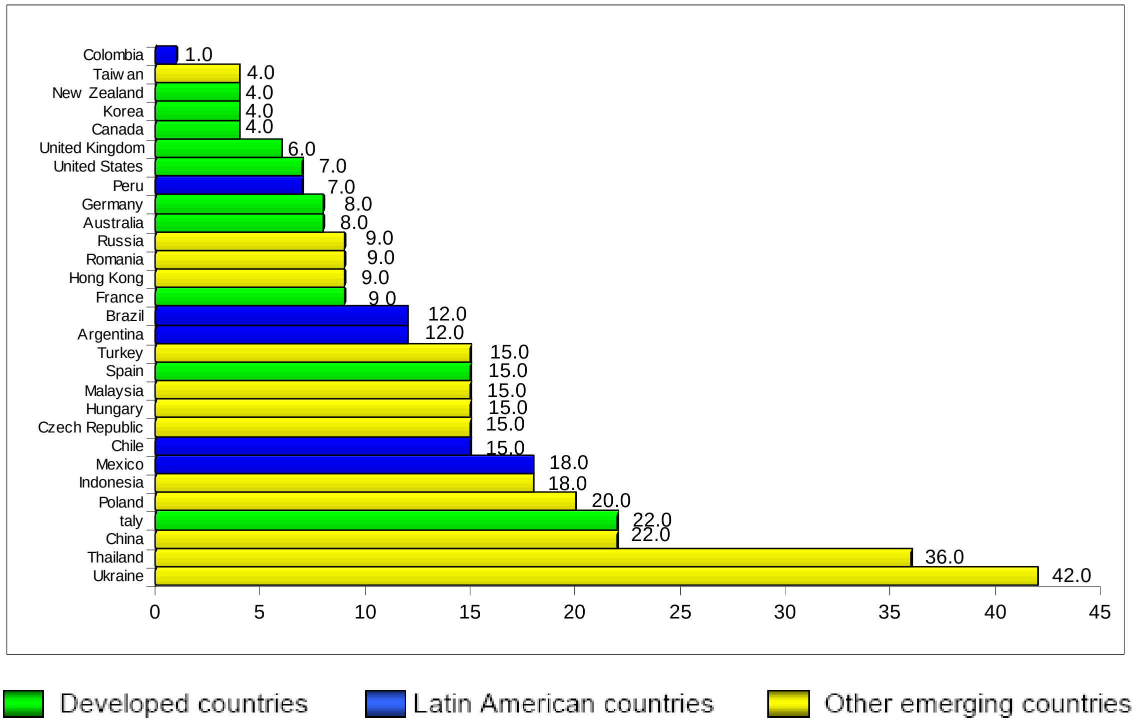
Source: Doing Business 2008, World Bank (2008).

Figure 19 **Time to go through insolvency (years)**



Source: Doing Business 2009, World Bank (2008).

Figure 20 **Cost of insolvency (% of estate)**



Source: Doing Business 2009, World Bank (2008).

It is in this area of governments and public sectors – that are credible, capable, and efficient and that have a strong correlation with economic growth – where Latin America has great weaknesses. In particular, there is much room for improvement in public policies aimed at achieving a substantial improvement in human capital and the environment for doing business. A substantial handicap to innovation is the low level of human capital, which reduces the absorption capacity of new technologies impedes increases in total factor productivity and overall economic growth.

6. Conclusions

Although much has changed in Latin America over the last two decades, there are still many impediments to achieving a higher rate of growth and to continued progress in improving opportunities for the poorest groups in the population. Much progress has been achieved in opening up the economies to foreign competition and achieving and maintaining macroeconomic stability, but much is still required to improve education, the quality of the state and the business environment, especially in the cost of doing business, the functioning of the labour market and the environment for the development and adoption of technologies. Lack of progress in these areas could result in frustration with macroeconomic responsibility and create the conditions for another round of populist policies that have caused so much damage to the region in the last fifty years. To make significant progress in these areas, the quality and independence of the public sector are required to improve significantly. Here there is much to learn from the experience of countries such as Australia, Canada and New Zealand.

Notes

1. For a critical view of this consensus see Baker, Epstein and Pollin (1998).
2. For a review of economic policies in Latin America in an historical perspective see Diaz-Alejandro (1982; 1983) and Corbo (1988 and 2000b).
3. For an analysis of the effects of terms-of-trade shocks, see Gavin (1990).
4. The interest rate that is the instrument of monetary policy can be the real rate, as in the much indexed Chilean economy, or the nominal rate as in most other countries.
5. For minority views in favour of exchange-rate bands see Willamson (1996) and Frankel (1999).
6. On the choice of monetary anchors in Latin America see Corbo et al. (1999), Corbo (2000a) and Mishkin (1999). On the Latin American experience with inflation targeting see Corbo and Schmidt-Hebbel (2001).

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