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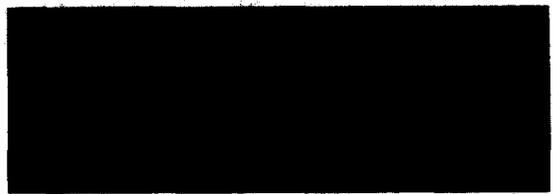
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ANNUAL WORLD BANK
CONFERENCE ON
**Development in
Latin America
and the Caribbean**
1995

Edited by
Shahid Javed Burki
Sebastian Edwards
Sri-Ram Aiyer



**WORLD BANK LATIN AMERICAN
AND CARIBBEAN STUDIES**

Proceedings

ANNUAL WORLD BANK
CONFERENCE ON
**Development in
Latin America
and the Caribbean**
1995

THE CHALLENGES OF REFORM

Proceedings of a
Conference held in
Rio de Janeiro

Edited by
Shahid Javed Burki
Sebastian Edwards
Sri-Ram Aiyer

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Washington, D.C.

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This publication is part of the World Bank Latin American and Caribbean Studies series. Although these publications do not represent World Bank policy, they are intended to be thought-provoking and worthy of discussion, and they are designed to open a dialogue to explore creative solutions to pressing problems. Comments on this paper are welcome and will be published on the LAC Home Page, which is part of the World Bank's site on the World Wide Web. Please send comments via e-mail to laffairs@worldbank.org or via post to LAC External Affairs, The World Bank, 1818 H St. N.W., Washington, D.C. 20433, U.S.A.

Introduction

SHAHID JAVED BURKI AND SRI-RAM AIYER

A TRADITIONAL CHINESE CURSE ENDS WITH THE IMPRECATION “MAY YOU LIVE IN INTERESTING TIMES.” This proceedings volume demonstrates that living in interesting times may not always be a curse. When we at the World Bank first explored the possibility of organizing a conference on development issues along regional lines, we did not anticipate just what interesting times these would be for Latin America and the Caribbean. As it turned out, late June of 1995—six months after the onset of the Mexican peso crisis—proved to be an interesting time indeed to analyze the economic and social challenges facing the region. Policymakers and analysts had gained enough distance from the initial shock of that regional “wake-up call” to exchange considered views on the lessons of the crisis. The first Annual Bank Conference on Development in Latin America and the Caribbean took stock of the immediate challenges created by the peso crisis and its aftermath and of the longer-term evidence that the region’s record in addressing poverty and inequity left much to be desired.

Most of the conference’s participants agreed that the Mexican crisis and the longer-term problems of the region were hardly to be viewed as grounds for reversing the economic reforms pursued in Latin America and the Caribbean in recent years. Rather, they should stimulate a renewed commitment to deepening and extension of the reform program. For example, most participants believe that trade reform and trade expansion have been critical areas of reform. They also believe that both areas need continuing consolidation and extension at the national level—by maintaining competitive exchange rate regimes and defending open trading arrangements against pressures for backsliding—and at the levels of regional cooperation and international policymaking.

The timing of the conference also helped highlight areas that had been undervalued during the early years of reform. The significance of domestic savings was perhaps the most

striking factor to attract attention in the wake of the crisis. Domestic savings are now recognized as crucial not only for their long-term role in supporting investment in physical and human capital, but also for their short-term role in averting the dangers of overreliance on potentially volatile capital flows. This intensified interest has also focused attention throughout the region on reforming contractual savings schemes, widely viewed as an important way of allocating domestic savings in the short term, increasing savings in the medium term, and facilitating development of domestic capital markets.

Many of the items on the region’s agenda that were analyzed at the conference fall into the category of second-generation reforms. Improving education—its availability, quality, and efficiency—is one of the most important and challenging of these reforms. Another is reshaping legal and regulatory

frameworks to make them more conducive to productive investment and employment creation. Such second-generation reforms can require extensive institutional changes that affect groups at both national and local levels. Generating the political support needed to launch and carry out transformations of this kind is one of the most demanding challenges facing leaders in the region.

More generally, the countries in the region face the challenge of building and sustaining consensus on policies that will contribute to an enduring improvement in the living standards of the people of the region. Sharing and expanding our understanding of the international experience of development economics is one way of building a

more solid base of support for economic reforms, and it is in that spirit that the World Bank's Regional Office for Latin America and the Caribbean and our cosponsors at the Getulio Vargas Foundation supported this conference.

The first conference was a great success, and we intend to make these conferences an annual event. The second conference will focus on reducing poverty and improving social conditions—an ultimate goal of economic reform. We continue to live in interesting and stimulating times. Old economic structures are giving way to new ones as the countries of Latin America and the Caribbean reach out to take advantage of growing opportunities in the world economy.

Conference Proceedings: The Challenges of Reform

S R I - R A M A I Y E R A N D K I N B I N G W U

THE FIRST ANNUAL BANK CONFERENCE ON DEVELOPMENT IN LATIN AMERICA AND THE Caribbean, cosponsored by the World Bank and the Getulio Vargas Foundation of Brazil, took place in Rio de Janeiro, Brazil, on June 12–13, 1995. Five hundred attendees included policy-makers, public officials, academics, and nongovernmental organizations. The six conference sessions focused on reform of the institutions of the state; differences in savings and economic growth in Latin America and the Caribbean and East Asia; Latin America and the Caribbean in a dynamic world economy; poverty, equality, and human capital development; education reform; and capital inflows and the Mexican peso crisis.

The opening session

Conference participants were welcomed by Marcello Alencar, governor of the state of Rio de Janeiro. Jorge Oscar De Mello Flôres, president of the Getulio Vargas Foundation, also extended his welcome and expressed the foundation's desire to broaden the scope of its activities, particularly in Brazil.

Opening remarks were delivered by Pedro Malan, minister of finance of Brazil. He stressed the importance of modernizing the state to enable efficient management of a nation's business. There is a similar need for sustained economic growth and inflation control, in Brazil and elsewhere, to combat social problems. According to Malan, achieving the necessary growth rate will require strengthening the private sector, in part by opening domestic markets to external competition.

César Gaviria Trujillo, secretary general of the Organization of American States, delivered the keynote address. He emphasized the importance of markets and pricing mechanisms and identified four pillars of regional reform: open

economies, growth, poverty reduction, and democratization. Trujillo concluded by observing that upcoming elections in the region will signal either a referendum for reform or a return to past policies.

Shahid Javed Burki, vice president of the World Bank's Regional Office for Latin America and the Caribbean, set the tone of the conference by identifying the key challenges facing the region. According to Bank projections, growth must average at least 3.2 percent a year to reduce levels of absolute poverty in the region. Achieving higher growth will require increasing domestic savings, infrastructure investment, and productivity and competitiveness; improving education systems and labor market mobility; and reforming the role of the state. Burki cited some principal lessons learned in the region—including those arising from the Mexican peso crisis, which can be viewed as the region's "wake-up call." The text of his background paper, written with Sebastian Edwards, then chief economist in the World Bank's Latin America and the Caribbean Region, appears in this volume.

Sri-Ram Aiyer is director of the Latin America and the Caribbean Technical Department at the World Bank. Kin Bing Wu is human resources specialist in the Latin America and the Caribbean Technical Department at the World Bank.

Session 1 Reform of the state

Stephan Haggard, professor at the University of California San Diego, presented the discussion paper on state reform. He observed that there are several ways to define state reform—reducing unwanted state intervention, expanding social services, and developing civil society. State reform in World Bank–related efforts usually means reforming central government bureaucracy. Haggard spoke of the need to focus on institutional changes in the region’s government machinery, since the policy challenges that accompany rapid change of the kind occurring in Latin America and the Caribbean require significant capacity in both public and private institutions. Technocratic solutions to reform the public sector are insufficient if they are isolated from social and institutional inputs. Moreover, changes in government politics are needed to counteract undue influence by vested interests and to promote government that is responsive to voter expectations, taxpayers, and consumers of government services.

A number of issues surfaced during the discussion period. Edgardo Boeninger, president of Corporación Tiempo Dos Mil and former minister secretary general of the presidency of Chile, emphasized the importance of stable and effective state institutions that can provide needed infrastructure and guide the direction of change. Some of the required changes are constitutional, such as the development of a stronger legislature and an independent judiciary, although the executive branch should maintain sufficient control over essential functions such as monetary policy and public safety. Further changes are needed to enable responsible government leadership. Boeninger suggested that stable governments will emerge only in political systems that are internally cohesive and disciplined, and he proposed electoral reforms to promote proportional representation.

The need for strong and unwavering political leadership was stressed by Roger Douglas, former finance minister of New Zealand. Strong presidentialism was viewed as an essential ingredient for state reform by Mario Henrique Simonsen, vice president of the Getulio Vargas Foundation and former minister of finance and planning of Brazil.

Reducing the opposition to reform was a third topic of discussion. Discussants agreed that simultaneous presidential and congressional elections would reduce the likelihood of divided governments and encourage congressional candidates who were tied to cohesive presidential platforms and national policies. It was also recommended that politicians in the

region continue delegating authority to autonomous agencies and regulatory bodies, while avoiding the delegation of discretionary powers that could result in reckless and ad hoc actions.

Session 2 Savings and growth in Latin America and the Caribbean and East Asia

This session began with a presentation by Sebastian Edwards, chief economist in the World Bank’s Latin America and the Caribbean Regional Office, who suggested that differences in savings rates are key to understanding differences in growth between Latin America and the Caribbean and East Asia. He showed that East Asia’s high aggregate savings rates of 30–40 percent, compared with 19 percent in Latin America and the Caribbean, are the product of a unique combination of factors involving interest rates, economic growth, borrowing constraints, taxes, and political stability. Latin America and the Caribbean could achieve annual growth rates of 6.3 percent if its savings rates were about 28 percent. And, according to Edwards, public savings do not symmetrically crowd out private savings. Recent studies indicate that a 1 percent increase in government savings will generate a 0.5 percent increase in aggregate domestic savings. Public savings can be increased through higher tax revenues, lower expenditures, or a combination of the two.

The first discussant, Carlos Langoni, director of the Getulio Vargas Foundation and former president of the Central Bank of Brazil, identified a number of reasons for the variations in economic performance between Latin America and the Caribbean and East Asia. In Latin America and the Caribbean, for example, growth has always been accompanied by inflation; in East Asia it has not. Another important difference, according to Yung Chul Park from the University of Korea, is the extent of outward-looking development strategies. Export industries have not done well in Latin America and the Caribbean but have expanded strongly in East Asia. Also, growth in Latin America and the Caribbean increased inequality in income distribution, which contributed to social tension. In East Asia growth did not adversely affect income distribution.

During the discussion an audience member suggested that greater emphasis be placed on increasing private savings over public savings. Concern was expressed that high rates of public savings would increase investments in ineffi-

cient public enterprises. Thus it was recommended that governments in Latin America and the Caribbean focus on reducing fiscal deficits instead of saving more. Participants also suggested that the East Asian experience is not sufficiently comparable to provide lessons for Latin America and the Caribbean. In China, where private savings are high, the public sector does not save. Park noted that high private savings rates in East Asia could be explained by the fact that most workers are not covered by a social security or pension scheme—contrary to the experience in Latin America and the Caribbean. East Asia's high savings rates were also the consequence of import restrictions and limits set on borrowing from international sources. In Latin America and the Caribbean, where luxury consumer goods can easily be imported, there are fewer incentives for private saving.

Session 3 Latin America and the Caribbean in the world economy

The third session covered trade liberalization in Latin America and the Caribbean since the mid-1980s and its effect on trade flows. The session focused on a paper prepared by Carlos A. Primo Braga, senior economist; Julio Nogués, executive director; and Sarath Rajapatirana, trade and industry policy adviser for Latin America and the Caribbean, all at the World Bank. Their findings suggest that the region has quickened its pace of integration with the world economy since the 1990s began. Despite the recent Mexican peso crisis, it was agreed that a return to earlier policies seemed unlikely. Still, an unfinished agenda exists—institutional changes are required to support and sustain the benefits of liberalization.

The discussants elaborated on issues that need to be resolved if the region is to compete effectively in the world economy. The first issue involves the difficulties presented by a reliance on a fixed nominal exchange rate. Another is the need for greater openness in the world economy for free trade to take root. Max Corden, professor at Johns Hopkins University, commented that protectionist sentiments in some industrial countries impede free trade.

In the view of William Lewis, director of the McKinsey Global Institute, free trade is important because—in addition to changing the structure of the economy and employment—it can foster competition to stimulate technological innovation, new products, and higher productivity. Encouraging private activity is also important. In Brazil, for

example, the private sector is as much as 50 percent more productive than the public sector in some functions. Improvements in productivity of this magnitude can increase employment opportunities. Lewis argued that, although labor market reforms are needed, product market reforms ultimately are more important. In European countries, for example, product market restrictions in service industries have impeded the incorporation of quality practices and limited new employment generation.

José Artur Denot Medeiros, Brazil's permanent representative to the Latin American Integration Association in Montevideo, pointed out that any trade regime creates winners and losers and that free trade can have negative effects on labor and the environment. Moreover, small countries that are forced to compete under free trade schemes can be at a tremendous disadvantage because they may lack sufficient capacity. Countries in the region also are more vulnerable to the risks that arise from external instability. If national policies are not well conceived, they will seriously compromise Latin American and Caribbean countries' efforts to participate in the global economy. The move to open trade regimes must be closely monitored to ensure that countries do not return to protectionism.

During the floor discussion Nogués noted differences in the effects of liberalization in the region. In Argentina trade liberalization—in the form of capital goods imports—has been a key ingredient in productivity growth. But other countries are increasingly compromising their liberalization measures, and this should be a concern. In this respect the smaller countries in the region should try to convince the three largest economies not only to maintain but also to increase their openness.

Sri-Ram Aiyer, director of the Technical Department for the World Bank's Latin America and the Caribbean Region, concluded the session by noting that trade liberalization in the region had improved competitiveness and increased outputs and income. The World Bank, he added, is focusing on competition policy and reform to improve the environment and potential for foreign direct investment. The regional agreements being pursued among Latin American countries will be important to these efforts by ensuring that trade creation and harmonization are common goals. The region should take seriously the advice to maintain pressure on the three largest global economies to minimize isolationist ten-

encies. Only by acting together can the small- and medium-size countries apply pressure to support liberalization.

Session 4 Poverty, inequality, and human capital development

Juan Luis Londoño, principal human resources economist of the Latin America and the Caribbean Region at the World Bank and former minister of health of Colombia, laid the groundwork for a discussion of the inadequacy of human capital formation in Latin America and the Caribbean. He identified this shortcoming as a major contributor to weak economic performance during the past fifteen years as well as to the lack of sufficient progress toward poverty reduction, more equitable income distribution, and democratic governance. One of every three Latin Americans lives in poverty, with an income of less than \$2 a day. Of these, 86 million people earn less \$1 a day and live in extreme poverty. Meanwhile, every minute two more people join the ranks of the poor. Moreover, the number of people who are functionally illiterate and who reach age twenty-five with little or no education is growing at an alarmingly high rate. Londoño recommended investments in health and education that would reap high dividends for the region. To further this process, centralized social sectors need to become more diversified, using incentives to improve the efficiency and quality of services rendered.

During the discussion it was noted that Londoño's aggregate data on regional income inequality do not reflect differences among and within countries in the region. On this point Oscar Altimir, deputy executive secretary of the United Nations Comisión Económica para América Latina y el Caribe (CEPAL) in Chile, said that definitions of inequality vary and that aggregating heterogeneous observations raises methodological concerns. Despite these issues, there was general agreement that the region suffers from an unusually high degree of inequality. Altimir believes that inequality evolved in different ways. Until the 1980s Argentina, Chile, and Uruguay—countries with low and interrupted levels of growth—had high levels of inequality. By contrast, during the same era countries with high growth rates, such as Mexico and Colombia, saw levels of inequality fall. During the 1980s inequality increased in nearly every country in the region, stabilizing in the mid-1980s and then dropping slightly

by the end of the decade. In some countries the reduction in rural poverty before 1980 had an important effect on later poverty levels: overall poverty increased considerably during the regional economic crisis, but rural poverty did not. Altimir suggested the need to create a virtuous circle of growth and equality, with sustained growth based on international competitiveness. This, in turn, requires modernizing technology and educating the workforce over the longer term. Achieving this virtuous circle will require economic reforms to increase production and stimulate capital investment, accompanied by education reform.

Other discussants said that education alone may not be sufficient to address the social segmentation that exists. Xabier Gorostiaga, S.J., rector at the Universidad Centroamericana in Nicaragua, commented that today poverty is urban, not rural as it was in the past, and introduces the new factor of "social exclusion." Such exclusion is becoming more pronounced as the globalization of economies moves forward without employment growth. Latin America will need to respond with deep changes in its education systems to respond to new inequalities and new poverty and to meet the challenge of growth in the absence of employment creation. In addressing the link between education and growth, Gorostiaga observed that Latin America and the Caribbean has lost competitiveness in the international market despite an increase in the number of university graduates. Thus merely increasing the number of postsecondary graduates does not solve the problem of international competitiveness. The most important adjustment to be made in the region is in education—not only in terms of spending but also of quality and content. What is needed is a symbiosis of the state, the market, and civil society, with education at its center, that leads to a structural integration based on shared values. In this sense economic and social development are interdependent—one cannot occur without the other.

Aspasiá Brasileiro Alcantara de Camargo, executive secretary of Brazil's Ministry of the Environment, pointed out that sustainable development requires that environmental and human capital development issues be considered simultaneously. The quality of life must be measured not only by income or education, but also by the availability of basic sanitation, housing, water, transportation, and cultural facilities.

Jorge Eduardo Durão, executive director of the Federação de Órgãos para Assistência Social e Educacional (FASE) in Brazil, echoed the view that a more integrated social policy is

needed to foster broader public participation. He suggested a strategy emphasizing investment in human capital based not only on education policies but also on policies for food safety, generation of new jobs, public health, and the like. At issue is whether Latin American governments will make those investments and bear the cost of this strategy. Because non-governmental organizations are dealing with the reality of poverty in Latin America, they can play a vital role in facilitating the dialogue between government and society. Clearly, Durão said, many types of social organizations will need to be involved in implementing and monitoring social policies.

Ruth Cardoso, president of the Conselho do Programa Comunidade Solidária and first lady of Brazil, agreed with the emphasis on education reforms but suggested that attitudes about equality and exclusion also need to change, particularly in Brazilian schools. New attitudes will be required, for example, to increase the length of teaching time, since the quality of the teaching-learning environment often determines the achievement levels of the poorest students. She also said that the climate was favorable for reform efforts because urban populations are highly organized. This organization is reflection in affiliations with formal organizations and in numerous community activity centers.

Session 5 Education reform

A paper on education reform presented by Ernesto Schiefelbein, director of the Oficina Regional de Educación para América Latina y el Caribe (OREAL) of the United Nations Educational, Scientific and Cultural Organization (UNESCO) and former minister of education of Chile, documented the low quality of basic education in the region, especially for the poor. Signs of low quality include the lack of basic learning materials, insufficient teaching time, inadequate screening of teachers, and inequitable resource allocation that penalizes poor households. Strategies exist to correct these deficiencies, but additional resources are needed to do so. Among the strategies Schiefelbein suggested were changing teaching methods to promote student participation, extending instructional time, rationalizing the allocation of teachers based on enrollment patterns, revamping the recruitment and training of teachers, and reorienting education ministries to be more focused on broad policy considerations, especially on the creation of an enabling

environment in which teachers and schools have incentives to improve performance.

The discussants agreed that there was insufficient commitment to education reform. Eduardo Amadeo, professor at Pontifícia Universidade Católica in Rio de Janeiro, said that the reason for this in Brazil was that rich families send their children to private schools and thus lack incentives to improve public education. A discussion theme focused on reallocating resources and introducing financing reforms in higher education to help pay for the large investments required in basic schooling. Roberto Carneiro, president of the executive board of Televisão Independente, S.A. (TVI) and former minister of education of Portugal, said that education should be at the top of the social agenda. He emphasized that reducing social inequality and eliminating the exclusion of the poor increase the demands placed on education and proposed ranking education priorities within a long-term strategy, allocating funds accordingly. Carneiro also said that education should provide the basis for social mobility and that there should be more community involvement in local schools to promote salutary and cohesive social values, with education at the center of the development concept. Simon Schwartzman, president of the Instituto Brasileiro de Geografia e Estatística (IBGE) in Brazil, agreed with Schiefelbein on the need for more research on the learning process to counter the inadequacies of classroom teaching.

Special session The role of capital flows in the Mexican peso crisis

An overview of capital flows preceding the Mexican peso crisis was provided by William Cline, deputy managing director and chief economist at the Institute of International Finance in Washington, D.C. Cline noted that significant capital inflows to Latin America took the form of direct investment, stock purchases, and bond floats. The funds came mainly from capital repatriated by Latin American investors and from institutional investors abroad seeking higher yields. The large capital inflow was countered by large current account deficits, however. Mexico's policy mistake was to adhere to a quasi-fixed exchange rate for too long, leading to overvaluation and high levels of external imbalance. The government's reliance on short-term paper to finance government debt, coupled with the political instability resulting from the Chiapas rebellion and the

Colosio assassination, left little margin for policy error. The peso was already in crisis when investors realized the extent of Mexico's debt and its low level of reserves.

A number of options were suggested to prevent another crisis: establish mechanisms to provide short-term emergency financing to countries with good policies, reform international institutions and provide an early warning by the International Monetary Fund (IMF) to countries whose policies are misaligned, double IMF quotas, and establish an international bankruptcy procedure.

One discussant, Marcílio Marques Moreira of Merrill Lynch and former minister of finance of Brazil, spoke of the ways countries sequence economic and political reforms. For example, Mexico and China initiated economic reforms without first introducing political reforms. By contrast, Brazil and Russia embarked on political reform first, followed by economic reforms. Although political turmoil has not been insignificant in either country, initial political reforms might provide a more solid platform for economic reforms. Another observation was that the success of economic reforms depends not just on top-down policies but also on bottom-up changes throughout the economy. In this regard it was mentioned that economic reforms might be perceived as more legitimate if political reforms led to more popular participation.

Also during the discussion, Suman Bery, economic adviser to the Latin America and the Caribbean Regional Office at the World Bank, remarked that the new conventional wisdom of restricting capital flows might not be the best course of action. Some countries that are short on capital might choose to liberalize foreign capital inflows. In Mexico the ability of the monetary authorities to control their current account may have been circumscribed by the large capital inflows they had to manage. The challenge for capital importers, Bery said, is to develop policies that encourage optimal use of external savings, instill confidence in both domestic and foreign investors, and create a policy climate more conducive to sound investment.

Roundtable discussion Latin America and the Caribbean in the postadjustment era

A key message of the conference, noted Carlos Langoni, was the strong link between political and economic reforms. Macroeconomic stability is obviously indispensable to any reform effort. Marta Maurás Pérez, regional director of the United Nations Children's Fund (UNICEF) in Colombia, spoke of the importance of reducing poverty, improving income distribution, and concentrating on human capital investment, since income distribution remains a source of social tension even in countries with sound economic growth, such as Chile. Brian Stewart, deputy director of the Western Hemisphere Department at the IMF, noted that Latin American and Caribbean countries have assigned increasing importance to macroeconomic stability but that conditions remain fragile and strategies that involve more public spending should be viewed with caution. In a final observation, Stewart noted that the IMF is considering establishing surveillance mechanisms to stave off crises such as that in Mexico.

Closing remarks

Marcos C. de Paiva, executive director of the World Bank, closed the conference by summarizing the challenges facing Latin America and the Caribbean. These challenges—reforming the state, developing effective social policies, and becoming integrated with the world economy—have as their counterparts three questions for the World Bank. First, how is it going to act as an investment partner in areas where the state is being replaced by the private sector? Second, how can the Bank ensure effective project implementation, particularly in the social sectors, where institutional capacity is weak? Finally, how can Bank activities be linked with local communities and nongovernmental organizations? These questions should provide the themes for future conferences.

Opening Remarks

P E D R O M A L A N

THIS CONFERENCE PROVIDES THE WORLD BANK WITH AN OPPORTUNITY TO EXPRESS ITS commitment to social and economic development in Latin America and to reaffirm its partnership with the region's countries. In the same way, it gives Latin American countries the opportunity to commit to the ongoing changes in the region.

Despite the success of Brazil's Real Economic Plan, introduced one year ago, much remains to be done to consolidate stability and keep inflation low while pursuing a higher level of social justice. Specific indicators of the Plan's success include lower costs of the basket of basic goods relative to last year, nominal increases in salaries and minimum wages with a corresponding increase in workers' buying power, and control of inflation without recession and without resorting to confiscation, freezing, breaking contracts, or government interference.

In 1994 GNP grew by 5.7 percent, industry and agriculture increased 7 percent, and the 1994–95 harvest set a record. Growth has continued in 1995. But as the government has said many times, this level of growth is unsustainable and incompatible with stabilization since it will inevitably create expectations for price increases and lead to an unfavorable balance of payments. Successful measures were implemented in March to contain unsustainable growth, and since then there has been a reversal in negative expectations about an increase in inflation. Also, there is no indication that prices will go up again, now or later.

Brazil faces three long-run challenges. The first is modernizing the state to enable the government to efficiently manage national affairs. Again, great improvements have been made in this area—but much remains to be done. The current debate on privatization is one example. The scope of public services must be broadened, but

the public sector is in no condition to assume that responsibility. Consequently, private sector assistance is essential, be it national or international.

The government should not engage in production activities where its presence can no longer be justified. Instead, it must assume its indisputable responsibility for investing in basic education, health, and sanitation. The government should also be more effective in managing its policies. This concept of an efficient government implies the need for modernizing relationships with the private sector.

Inflation is the cruelest taxation that a government can impose, since its main victims are the poor. The cultural effects of inflation and memories of past experiences help keep this problem alive. Properly dealing with these problems is essential to ensure social justice. A modern Brazilian economy depends on defeating inflation.

The second challenge is achieving sustained growth. A development boom that melts away with inflation and an

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unfavorable balance of payments serves little purpose. Brazil needs sustained development that allows a solid economy to grow, enabling the resolution of immense social problems while controlling inflation and sustaining growth.

The third challenge is to increase private sector efficiency and competitiveness. This implies increasing domestic competition, developing markets, exposing domestic products to external competition, and encouraging production that is potentially exportable and competitive with imports.

More than 70 percent of Brazilian exports are capital and intermediary goods. To compete domestically and internationally, we must consider modernizing and increasing

the capacity of our industrial parks. The question now is how to reconcile current levels of economic growth with international competitiveness as well as the extent of economic corrections to be made.

Achieving these goals will require lowering medium- and long-term capital costs; reducing the cost of work and infrastructure; tax reform; and effective action from different ministries to eliminate bureaucracy, needless regulations, inefficiency, and corruption. It is our firm intention to work on this open economic strategy and toward a significant reduction of the so-called "custo Brasil."

KEYNOTE ADDRESS

The Future of Economic and Social Development in Latin America and the Caribbean

CÉSAR GAVIRIA TRUJILLO

I WANT TO THANK THE WORLD BANK AND THE GETULIO VARGAS FOUNDATION FOR THEIR INVITATION to reflect on the future of economic and social development in the Americas. No other issue in the hemisphere generates more interest and requires more analysis today than the one that inspires this conference.

How are we going to face the future when people have the impression that economic reform has been exhausted? How can we put this continent on a path of sustained and balanced growth? Is there any way to change the fate of the growing number of people living in poverty in our countries? While I can only contribute ideas to the debate of these issues, our collective thinking—stimulated by the solid research and ideas gathered in the papers to be discussed here—can offer new insights.

What have we learned?

The discussion of development strategies in Latin America has changed significantly in recent years. In the past, economic liberalism and government interventionism were seen as two antagonistic policy options. While we spent a lot of energy and paper in that tug-of-war, the realities of the debt crisis forced the region to understand that markets are essential and that bureaucracies make too many costly mistakes.

An important economic lesson of the 1980s was to recover the status and role of markets and price mechanisms. Behind us are the times when it was sacrilegious to advocate free markets as effective and socially convenient organizing economic principles.

This recognition was accompanied by an enlightening rediscovery about economic policy. The region learned that tackling fiscal imbalances, defeating politically induced monetary expansion, and creating a stable macroeconomic environment were at the core of successful development strate-

gies. Inflation led poverty to such oppressive levels and made economies behave so erratically that along with the return of democracy came a widespread demand for price stability.

These are trying times for the economies of our hemisphere. Because of the cyclical nature of capital markets, excesses of optimism are inevitably followed by surpluses of pessimism. What happened in Mexico shook the faith of the international financial community and scattered doubts around the globe about the future of emerging markets.

Enormous change was witnessed in Latin America throughout the 1980s and the 1990s. Profound structural reform took place and, almost without being noticed, the level of integration among the Latin American countries and with global capital markets grew significantly. Financial and capital markets in Latin America opened their doors enthusiastically to foreign investors, attracting billions of dollars in direct and portfolio investments.

In the process, the nature of hemispheric economic relations changed dramatically. Governments and institu-

tions lost their predominance as the main financial actors in the region and were effectively replaced by entrepreneurs and private investors. The quantum leap in the magnitude of cross-border, market-induced trade and financial flows created a new reality for both international financial actors and Latin American economic authorities. Open economies led to more efficient yet less manageable and less predictable markets. Implementation of development policies in market-oriented economies is much more complex than in the centralized, bureaucratic, and regulated environments of the past.

We should not be surprised when, under this new set of rules, policies and decisions are influenced by global market dynamics. We should recognize that markets, more often than not, are brutal and unforgiving when imposing discipline. The countries willing to play by these tough rules—despite the pain and the cost of the adjustments—are certainly the best candidates for dynamic economies of the future.

In fact, when adjustment processes respond to market conditions and are designed to preserve market-oriented macroeconomic environments they usually result in more stable structural reforms. Mexico is a case in point. The recent crisis sparked a new round of reforms and spurred private initiative, thus guaranteeing the long-term health and prosperity of the Mexican economy. Sometimes countries have to be dragged, kicking and screaming, into prosperity.

With the shock of the Mexican crisis behind us we should now address long-term issues surrounding the Latin American and Caribbean economies. We should ask whether the political tendencies in Latin America favor the breakdown of market-driven economies and macroeconomic stability.

The recent and upcoming elections in Latin America can be interpreted as a referendum for reform, not as a return to the past. Voters have already cast their ballots in favor of macroeconomic stability and economic reform. President Zedillo of Mexico, for example, was elected on a platform that strongly favors modernization of the economy and, above all, monetary and fiscal stability. The Argentine people chose the stable and market-oriented economy built by President Menem instead of the old regime of hyperinflation. President Fujimori was reelected due to his successful program to recover institutional and economic stability. Look around and you will see the millions of Brazilians who enthusiastically voted

for President Cardoso, a symbol of economic stability. The recent approval of constitutional reform ending governmental monopolies in mining activities is an example of the momentum that reform is gathering in this country.

This widespread and renewed political mandate reinvigorates the region's economic reform agenda. We should take advantage of the fact that committed governments with popular support are devoted to guiding their societies toward prosperity using the right policies. We have a second chance to move forward.

But first we have to acknowledge what we have learned in the recent past. There seems to be consensus that expansionary credit policies and diminishing external reserves can breed disaster. Also, disregarding chronic current account deficits can be devastating when relying on short-term debt to finance both public expenditures and cover current account deficits. When the international capital markets react adversely, economic authorities are sometimes left with very little room to maneuver. Using inflexible exchange rates to stabilize the economy without a strong commitment to parity, and the sacrifices it entails, can be unsustainable. On the institutional level, inadequate supervision of financial agents and lack of effective accountability of public finances can turn off the early-warning system of the economy.

The nature and focus of the economic reform process has to be adapted to overcome the frustrations and encourage the successes of the last decade. As Shahid Burki and Sebastian Edwards advocated in their recent work, we need to enter into a phase of consolidation.

The reforms implemented by Latin America and the Caribbean during the 1980s were designed under the need to respond to severe external sector and public financial imbalances. The resulting "shock therapy" addressed the most obvious distortions and urgent macroeconomic disequilibriums. The policies were aimed at avoiding the collapse of the economy and set the general ground rules for long-term change. Although some economies require further progress on that front, for many others it is time to move on to a new stage. Without forgetting the macroeconomic objective of stability, the goal of the "second wave" of reforms should be to reduce poverty and achieve effective and democratic states. Let me comment on some of those challenges.

Stephan Haggard's paper identifies institutional and governmental transformation as the core of the reform process. Probably the most critical question for the "sec-

ond generation of reforms” is how we deal with the state. In fact, the papers prepared for this conference all refer to major institutional change as the critical variable to accelerate economic growth and to promote equality and social justice. Without doubt, political and institutional reform should be placed at the core of our new development strategies.

What else must be done?

Moisés Naím offers a good description of the size of the job in front of us. He argues that “in this new stage governments will have to do much more than maintain macroeconomic stability. The pending agenda of Latin America is overwhelming; the list of tasks is long and the necessary changes are technically, politically, and administratively complicated.”

Each country and each circumstance will demand different policy mixes. However, in all cases we will need less of what makes the state an obstacle and more of what makes service-providing institutions efficient, focused, and specialized. We need a state that is firm and stringent in its regulatory responsibilities.

But there is another side to the debate of state reform that goes beyond the concern for fiscal prudence. I am referring to the need to construct stable, efficient, and legitimate democratic states. The task of the coming years does not only require fine-tuning specific reforms, improving the transparency of markets, or achieving appropriate legal frameworks for private investment. Those things are very important and we must defend them. But it is equally important to foster the legitimacy and institutional strength of the democratic state. If we do not consolidate democracy throughout the hemisphere, our efforts on the economic front will be meaningless. This is an area in which the World Bank, the Inter-American Development Bank, and the Organization of the American States—which have mandates and capabilities to participate in the promotion of democratic institutional development in the Americas—could craft innovative approaches.

We used to blame governments, with good reason, for the difficulties that have accompanied our development efforts. But I am increasingly convinced that in our eagerness to promote private initiative we have overlooked the development of a sound and dynamic entrepreneurial spirit in the Americas. In our region, relatively high degrees of monop-

olization, corporatism, and concentration of ownership of productive assets create barriers to entry to new firms. They discourage the enthusiasm of many entrepreneurs and potential investors.

The access to competitive markets is not only denied by governments. Private actors can become serious obstacles to the dynamic entrepreneurial process. We should therefore include reform of the private sector as part of the development agenda. We need a revolution of entrepreneurship; we need to unleash the growth potential of private initiative often tamed by the absence of competitive environments.

Deliberate and strong antitrust efforts combined with measures to encourage broader access to asset ownership can have a significant impact on the investment potential of Latin American economies. This aspect has received less attention in the reform process and could emerge as a critical obstacle for translating structural adjustments into long term growth.

However, the fundamental vulnerability of the economies in Latin America is a level of domestic savings and investment that cannot support a growth rate congruent with the people’s expectations. The dramatic boom and bust nature of economic cycles in Latin America has a lot to do with inadequate savings rates. The inability to finance capital formation—both physical and human—with internal resources leads to a dependency on external finance. However, since resources eventually have to be paid back we have a tendency toward over-indebtedness. And since the flows can unexpectedly be reversed by uncontrollable international capital markets, these exogenous capital movements usually are not sustained.

Hear me correctly. I believe in the advantages that accompany open economies, foreign investment, and international financial flows. However, they will never be a substitute for the positive effect of strong domestically generated savings.

If we want to see a successful Latin America we need to develop a strategy that creates a permanent and structural increase in savings. Although no one knows exactly how to increase the propensity to save, the paper by Sebastian Edwards presented in this volume is a starting point and provides useful insights into this issue. The experiences of Chile and Colombia suggest that increasing the efficiency and coverage of private social security systems stimulates capital accumulation. Also, a more efficient and reliable financial sector capable of protecting and better remunerating individual savings efforts acts as an incentive.

Latin America and the Caribbean urgently need a revolution in education and social services. In Juan Luis Londoño's and Ernesto Schiefelbein's papers it is evident that these problems are becoming crises. Inequality and poverty have not been alleviated and the situation seems to be getting worse.

In the context of social development we have to address structural problems as well as the quality of policy formulation. Despite the increasing resource allocations to social expenditures in Latin America and the Caribbean, the target population—the poorest sectors—have not seen substantial improvement.

The lack of effectiveness of our systems suggests a better way of doing things. As the World Bank has advocated, instead of subsidizing the supply of services and creating huge governmental bureaucracies to provide them, countries should directly subsidize the demand for these services. This will allow the poor to exercise greater discretion when selecting goods and services and allow them to have their needs more closely met.

For decades we left social policymaking in the hands of weak institutions, disinterested bureaucrats, and inadequately prepared professionals. That must change. We have to be able to devote the best and the brightest to think about the

most basic problems affecting the lives of the poorest of their countrymen.

Education is the topic with the most profound implications for development. It has decisive effects on all the key variables related to economic growth, poverty, and political participation. Despite its importance, Latin America is doing poorly in comparison with other regions. As Londoño suggests, we are rapidly losing ground. The region has left segments of its population without the necessary skills to improve their income and to contribute to economic growth. If Latin America wants to experience growth rates as high as other parts of the world, a dramatic transformation of the education sector must take place.

Dear friends, to consolidate economic reform in Latin America, to sustain structural reforms, and to guarantee development and growth we need to enhance and enrich the political life of the people of the Americas. We need to promote participation, local democracy, and involvement of the people in the policymaking process. Economic growth, no matter how fast or slow, will mean nothing if it does not promote more freedom, more democracy, and better living conditions for the poorest of the hemisphere. I am sure that this conference will contribute to the region's quest for development and social justice.

Latin America after Mexico: Quickening the Pace

SHAHID JAVED BURKI AND SEBASTIAN EDWARDS

ON DECEMBER 20, 1994, A FEW DAYS AFTER THE CONCLUSION OF THE SUMMIT OF THE Americas, Mexico devalued its currency, triggering a major crisis that threatened to engulf the Latin America and the Caribbean (LAC) region. International investors reacted with panic and began to withdraw funds throughout the area. Countries that as recently as 1993–94 had been favored by international investors suddenly were considered high risks, as fear of a repetition of the debt crisis of 1982 grew. Fueled by the difficulties faced in the initial rescue attempts by the U.S. government, bearish expectations on LAC were the rule at the beginning of 1995.

Analysts throughout the world wondered whether the Mexican events indicated a systemic failure of the new LAC paradigm of market-oriented reforms or just an episode of the transitory turbulence characteristic of growing economies in transition. Some argued that mismanagement of the Mexican economy during 1994—the acute overvaluation of the currency, rapid credit expansion, and the piling up of short-term debt—provided an indication that the LAC countries were not yet ready for the rigors of a market-based system. Others pointed out that disappointment and nostalgia could bring back populism, statism, and control.

These reactions have proven groundless. In fact, the Mexican crisis has turned out to be a wake-up call not only for Mexico but for all of Latin America and the Caribbean. The crisis has made it clear to policymakers, intellectuals, and the public that there are urgent unfinished tasks. The complacency, self-congratulation, and sense of triumph with which policymakers in some countries had begun to

look at their economic performance and prospects only a few months ago have given way to a sense of urgency.

Events in Mexico also made it clear to the region's leaders that reform is an unending, continuous process and that they must be permanently alert to changes in the environment in which they operate. The global economy of the late 20th century is a bit like *Alice, Through the Looking Glass*: it takes all the running you can do to keep in the same place; if you want to go somewhere else, you must run at least twice as fast. Leaders from a growing number of countries in the region have concluded that deepening reforms—and doing so more rapidly—is the only way to counter the skepticism that emerged among international financial analysts and, more importantly, to move firmly toward prosperity and social harmony.

The Mexican crisis crystallized the need to move into a second phase in the reform process and clarified its agenda. Rebuilding the state and reducing poverty and inequality are critical for the consolidation of the reforms that have

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already been advanced as well as for future growth. More specifically, Mexican events turned caution lights on a number of the region's problems. Raising domestic savings rates, encouraging private investment in infrastructure, reforming the labor codes and education systems, and deregulating and debureaucratizing lower levels of government now top the list of reform priorities.

More important, a growing number of leaders in the region see the pressing need to rebuild the state. New institutions must be created to efficiently perform those tasks that the private sector cannot undertake—the maintenance of law and order, the provision of basic social services to the poor, the establishment of modern, independent, professional regulatory bodies, and the provision of basic infrastructure, among others.

Because the Mexican crisis drove home the need to take rapid action, it induced the implementation of policies with unavoidable short-term recessionary effects. Although these policy decisions made the first quarter of 1995 difficult for some countries in the region, long-term growth prospects have been enhanced. Deepening the reform process is the surest route to accelerating the region's average rate of growth in the medium and long run: we expect that if a set of plausible conditions is met, the region will grow, on average, at rates in excess of 6 percent a year between 1998 and 2005.

The Mexican crisis and short-term contagion effects

Recent events in Mexico raised questions regarding the sustainability of the market-oriented reform process in LAC. As we will argue, a detailed review of the Mexican episode reveals that the reform process is indeed sustainable, even more so now that the crisis produced a loud and clear message throughout the region in favor of strengthening and deepening existing policies and stepping up the effort to improve social conditions.

Why did the Mexican crisis happen?

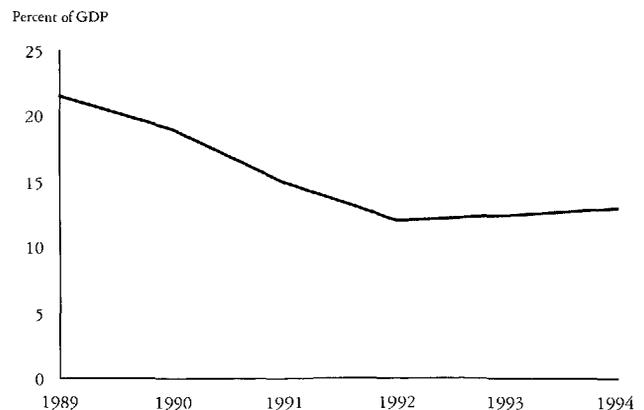
The main reason for the Mexican peso crisis was an unsustainable current account deficit, financed by large capital inflows.¹ How did the current account deficit get to this level? This was partially the result of Mexico's "success," partially the result of political developments, and partially the consequence of overconfidence. As reforms were under-

taken and inflation declined in the early 1990s, the world financial community wanted to take part in the rebirth of Mexico's economy. They did so by moving funds—mostly short run, portfolio capital—into the country. This was further facilitated by the decline in U.S. interest rates during 1993. The inflow of capital helped finance a tremendous private sector consumption boom and, in 1994, an expansion in public sector expenditures. Figure 1 shows the marked decrease in Mexican private savings during recent years.

Before the December crisis, most analysts of the Mexican situation acknowledged the need to implement some type of adjustment. The question was: when? Mexican policymakers favored a gradual rather than an immediate response. In September 1994 the World Bank argued in a public document that the excessive reliance on capital inflows had made Mexico vulnerable, citing the fall in savings rates and the link to higher consumption levels (World Bank 1994b, p. 331). The Bank also mentioned that "productivity growth has so far been insufficient to offset the loss of external competitiveness implied by the peso appreciation."

Mexican authorities recognized that the current account gap could not be maintained at the 1993–94 level in the longer run, and planned to deal with the problem gradually. This view was based on two key assumptions. First, improvements in productivity would increase export competitiveness, helping close the trade gap; and second, the approval of the North American Free Trade Agreement (NAFTA) would entice additional capital to move into

FIGURE 1
Private domestic savings in Mexico, 1989–94



Source: World Bank data.

Mexico, providing space and time for the adjustment to work.

A number of developments, however, frustrated this plan. First, political events in 1994 frightened foreign investors, who became particularly leery about currency risk.² In an effort to avoid rising peso interest rates, the Mexican authorities issued increasing amounts of peso denominated but dollar indexed, short maturity notes—the infamous tesobonos. Second, higher interest rates in the United States during 1994 further reduced capital flows into Mexico. And third, although productivity began to improve in 1993–94, it was not enough to generate the expected boom in exports so as to compensate for the increase in imports.

As a result of these factors, and in spite of the rapid increase in outstanding tesobonos, capital inflows declined markedly during 1994. The current account deficit was financed largely through a reduction in international reserves, which dropped from approximately \$30 billion in February 1994 to \$5 billion by December 22. With presidential elections looming, authorities ruled out implementing contractionary credit and fiscal policies during the first half of 1994. Despite the decline in international liquidity, the central bank decided to maintain its overall monetary program, sterilizing the reduction in international reserves. During 1993 and 1994 the fiscal stance also became somewhat loose. The overall fiscal balance deteriorated by 2 percent of GDP, while the primary balance deteriorated by almost 3 percent of GDP. Furthermore, the tripartite agreement with business and unions—the so-called *pacto*—led the government to rule out an early currency depreciation to correct the accumulated overvaluation. Wage increases had generally been set above the rate of nominal depreciation, an excess that was not compensated by productivity gains. After the presidential elections were won by the PRI candidate Ernesto Zedillo, authorities still resisted putting in place a contractionary adjustment program.

The circumstances that led to the rapid unraveling of Mexico's economy are now well known. The exchange rate band, broadened on December 20, was too little too late. The international financial community reacted in disbelief, and generated a chain-reaction financial panic. The announcement by the Clinton administration of the provision of massive loan guarantees temporarily calmed the

markets in mid-January. Soon, however, it became clear that the rescue package would not be approved by the U.S. Congress, and the peso came under renewed pressure. By that time it was obvious that Mexico faced a major crisis and that it would require a major adjustment, including a drastic turnaround in the current account, high unemployment, and a substantial decline in the level of economic activity. It was not until April, after the announcement of an extremely strict adjustment program on March 9, that the financial markets began to settle.

Mexico's policy response

After the failure of early attempts at restoring market confidence, the Mexican government finally unveiled a tight macro program on March 9, backed by a major IMF standby agreement signed in January. Its main objective is the restoration of stability and the rebuilding of international confidence. The plan also calls for aggressive moves on infrastructure privatization, decentralization, reforms in the legal and judicial system, and improvement in the effectiveness of social programs.

The main elements of the program announced March 9 are:

- The fiscal measures include an adjustment in prices of public sector goods, an increase of the value added tax from 10 percent to 15 percent on most goods, and a reduction in the real level of public expenditure. In 1995, tighter fiscal policy is expected to produce a primary budget surplus of 4.4 percent, twice as large as the one originally envisioned in January 1995.
- The authorities committed themselves to a floating exchange rate regime, with monetary policy designed to help stabilize prices. To achieve an inflation target of 42 percent in 1995, the Bank of Mexico would restrict the expansion of net domestic assets to 23 percent.
- With the assistance of a major World Bank operation, Mexico designed a program to strengthen the banking sector through intensive supervision and regulation. It increased capital requirements and loan loss reserves, and removed the ceiling for foreign ownership of Mexican banks. A foreign currency line of credit was established to enable domestic banks to meet their international commitments and created a subordinated convertible debt program to help banks experiencing a temporary fall in their capital requirements. It gave FOBAPROA (Fondo

Bancario de Protección al Ahorro) the right to convert the subordinated debt of banks into capital and to take them over.

- Notwithstanding the severe fiscal contraction, real expenditure for social and rural programs in 1995 is expected to increase by 2 percent, while other non-interest expenditure is expected to fall by almost 20 percent. An effort is being made to fortify the social safety net through an expansion of the negative income tax, an extension of public health insurance for the unemployed, the initiation of a program of public works targeted to the poorest of the unemployed and the expansion of the labor retraining program.

The March 9 program broke some new ground in Mexico's effort to stabilize and restructure its economy. Given the magnitude of the adjustment effort that was called for, the administration of President Ernesto Zedillo did not attempt to reach advance consensus with labor and the business community, as had been done since 1987. By giving up the pacto President Zedillo took upon himself the responsibility for engineering economic change. Second, by abandoning the fixed exchange rate regime, the administration shifted the burden of adjustment onto fiscal discipline.

The fact that the exchange rate has stabilized and that the stock market has regained part of the lost ground indicates that the adjustment program put in place is adequate. Despite the increase in inflation, there has been a major correction in the level of the real exchange rate, which is producing the much-needed adjustment in the trade balance. Once stabilization is completely established, growth will be restored on a much firmer basis.

Some lessons

The Mexican crisis offers—or more accurately, reaffirms—several fundamental lessons regarding the economic reform process:

- The current account is a key variable that should not get “out of line.” The magnitude of the current account deficit sustainable in the medium and long term will depend on a number of variables, including the demand for the country's securities and the rate of growth of GDP. Under most circumstances, a sustainable deficit would rarely exceed 3 percent of GDP. Since successful stabilization programs—and especially those based on a fixed nominal exchange rate—generate a private sector consumption boom, maintaining the current account under control will

generally require higher public sector savings.

- The composition of capital inflows is very important. Short-term flows are very sensitive to changes in interest rates and to political events. Keeping speculative capital under control, while encouraging long-term investment—as Chile has done—makes eminent sense. Increasing the share of long-term investment funds, however, will not be easy. Investors are looking at the analyses of investment rating agencies before committing large volumes of funds. Until now only two LAC countries—Chile and Colombia—have attained investment grade ratings. Achieving this status will require other countries to pursue their reform programs vigorously. Also, the characteristics—and especially the strengthening of the domestic financial system—will determine the way in which capital inflows are intermediated and channeled throughout the economy.

- Productivity gains are a fundamental element in the economy. They are at the heart of export expansion and, thus, contribute to keeping the current account in balance. Productivity increases, in turn, depend critically upon the amount of effort the government is prepared to make in developing human resources and improving physical infrastructure.

- There is an inherent danger in using fixed exchange rates as a stabilization device. Experience has shown that they tend to generate real exchange rate overvaluation and loss in external competitiveness. This is particularly the case in countries where contracts are subject to some inertia. Moreover, fixed nominal exchange rates tend to distract policymakers and the public from the need to implement policies to put in place—and, as important, maintain—a fiscal anchor. Fixed exchange rates are particularly difficult to preserve in situations of high capital mobility. If, however, a country decides to adopt an exchange-rate based stabilization program, it is essential that the authorities implement the policies that assure that fixed parity will be maintained. This means that the fiscal situation has to be under control and that the monetary authorities do not sterilize changes in international reserves. Maintaining this type of policy is not easy politically, since nonsterilized declines in reserves are translated into high real interest rates, reduced economic activity, and high unemployment.

- Particular attention should be given to the size, term structure, and currency denomination of public debt. The accumulation of short-term maturity debt is a signal of

underlying fiscal problems and inconsistent macroeconomic policies.

- In redefining the role of the state—as is being done both implicitly and explicitly in most of Latin America and the Caribbean—it is important not to forget that a strong state is a prerequisite for a robust economy. The state should draw its strength not by owning industrial assets, managing public institutions and conducting commerce. Rather, it should do so by building powerful institutions—legal systems, regulatory agencies, and the like—that help promote competition, protect the consumer, and provide a framework within which the response of all economic agents can be predicted with reasonable accuracy.
- Improving income distribution and alleviating poverty cannot be left to trickle-down consequences of economic growth. Government policies—in particular fiscal programs and tax administration efficiency and fairness—are critical for improving the distribution of income and reducing poverty. As Mexico is discovering, stabilization programs have a better chance of succeeding if political peace can be secured with the help of social safety nets.

Contagion effects

Despite the fact that the Mexican crisis is producing policy reactions that will bear fruit in the long run, it has generated short-term turbulence in the region. Latin America and the Caribbean is a highly diverse region, where countries face very different conditions and where economies have different strengths and weaknesses. For this reason any serious analysis of the impact of the crisis should, ultimately, focus on individual countries. Having already discussed the situation in Mexico, we now proceed to analyze the economic circumstances in five of the large countries of the region, three of which—Argentina, Brazil and Venezuela—have been mentioned in the media as facing particular difficulties following events in Mexico, and two that provide strong evidence that the best insurance against systemic risk is good economic policy—Chile and Colombia. Some of the remarkable recent achievements of Peru are highlighted in the appendix.

Argentina

In late 1994 Argentina enjoyed several advantages compared to Mexico: its current account deficit was less than half that of Mexico's, it enjoyed a credible political and eco-

nommic leadership, its level of international reserves remained high, public debt maturities were not concentrated in the short term, many of its structural reforms were deeper, and its inflation rate was extremely low and was expected to remain so.

Argentina's financial sector, however, is particularly vulnerable to negative external shocks, given the nature of the Convertibility Plan under which high-powered money has to be fully backed by international reserves. Thus, the Central Bank has very limited resources to confront a run against bank deposits. After December 1994 the generalized "flight for quality" affected liquidity across many LAC economies. In the case of Argentina, a few banks had to suspend temporarily the convertibility of deposits in order to avoid selling their assets at distress prices following the withdrawal of funds. With assistance from the World Bank and the IDB the government is engineering a far-reaching reform of the financial sector, facilitating the merging of institutions, the streamlining of provincial banks, the strengthening of supervision and the implementation of a broad deposit insurance system.³

Under crisis conditions a change in the Convertibility Law in an increasingly dollarized economy could add to economic instability. The only internal response to the recent test of the program was fiscal tightening and the further strengthening of the adjustment process. In a display of vision and with the exercise of strong leadership, the government reacted forcefully to the crisis. It took courageous measures to reestablish a fiscal surplus by cutting expenditures on, among others, exports subsidies, public sector wages and social security, while raising VAT rates and other taxes.

Argentine GDP will not grow in 1995 but will increase at the rate of 2 percent in 1996 (regional forecasts of the main macro variables appear in the appendix). This is significantly less than in 1994, but is still a favorable outcome given the magnitude of the Mexican crisis and the rigidities of the exchange rate system. If anything, this modest growth shows that convertibility withstood a major crisis; but, if rapid growth is to be resumed, major structural reforms are imperative. The current account deficit should not pose any financing problem (2.3 percent in 1995 and 2.2 percent in 1996). As expectations stabilize in the coming months and the modernization process continues, Argentina is anticipated to resume vigorous growth.

Brazil

The country's stock market was the most severely affected in the postcrisis days, losing one-third of its dollar value between December 20, 1994 and March 1995. Investors' nervousness translated into a loss of international reserves. There are, however, a number of factors that strongly indicate that Brazil is in a more solid position than Mexico. First, the maturity of Brazilian debt is more favorable. Second, when the real plan was launched the currency was clearly undervalued, providing room for appreciation. Third, substantial productivity gains took place up front. Fourth, the consumption boom that accompanies successful stabilization is only beginning, and the authorities are aware of the need to keep it under control. Fifth, international reserves are high; and sixth, the current account deficit forecast for 1995 is modest. However, the much larger than expected trade deficit in December 1994 and in the first quarter of 1995 suggests that before the eruption of the Mexican crisis, the external situation in Brazil was beginning to deteriorate.

In contrast to markets elsewhere in LAC (particularly Argentina and Mexico), Brazil's exchange rate has not been under protracted pressure and capital flows have not been as capricious. Interest rates have been rather stable (but high); a policy-induced rise in interest rates was ultimately effected in the wake of the widening of the exchange rate band in March. Such relatively stable economic and financial developments in Brazil can be explained by a variety of factors such as confidence in the stabilization plan and in low inflation; a modest current account deficit partly financed through autonomous capital inflows; and large international reserve holdings. Furthermore, domestic debt is low and is largely denominated in domestic currency. External short-term debt is also modest.

However, sustaining the present program will require a substantial tightening of fiscal policy to assure that the cyclically adjusted operational balance of the public sector is in surplus. Fiscal accounts have been in balance thus far only as a result of the strong boom in consumption since the introduction of the real; this indicates the presence of a significant underlying fiscal gap that has to be addressed through both tax and expenditure policies. In addition, a large quasi-fiscal deficit is projected to emerge in 1995, given that the Central Bank has extended support to several state banks to cover operating losses. Also, the sharp rise

in real interest rates from early March 1995 will exacerbate the interest payments burden on the Central Bank and the federal and state governments.

Inflation can be reduced in a sustainable manner only if fundamental structural reforms are implemented in support of macroeconomic policies. Above all, reforms to elicit a supply response under the newly established stability, to promote investment and the flexible use of savings, and to ensure efficient use of capital are necessary. Thus a redefinition of the role of the state within the economy, encompassing policies for deregulation, privatization, and fiscal, financial, and social security reforms are central to the overall effort. On several fronts the reform process is already under way. Since 1990 foreign exchange controls and the list of prohibited imports have been eliminated, fiscal incentives for exports and external financing requirements for imports abolished, granting of import licenses made automatic, and a multi-year tariff reduction program implemented. Further trade reforms will be conducted under the aegis of the MERCOSUR agreement with Argentina, Paraguay, and Uruguay. On the negative side, recently some protectionist policies have been established in which tariffs on cars and durable goods have been increased and broad ranging anti-dumping powers introduced. Fortunately, steps have been taken to reduce the participation of the state in various sectors of the economy and to encourage competition and reduce regulation of economic activity. The privatization program initiated in 1991 has thus far resulted in sales of 30 federal government-owned enterprises, realizing revenue of \$8.6 billion. The need to strengthen and deepen this reform process has become more pressing, following recent events in Mexico.

In all, it is expected that in 1995–96 the Brazilian economy will grow at a rate of 4.5 percent, with a current account deficit of modest magnitude in both years (1.9 and 1.7 percent of GDP in 1995 and 1996 respectively). On the negative side, inflation—though significantly lower than in the recent past—will still remain on the high side in 1995, when it is expected to be around 35 percent.

Venezuela

The country entered a deep crisis even before the recent Mexican developments. By isolating itself from international capital markets—by introducing stern controls on capital flows—Venezuela has not been severely affected by the Mexican crisis. In fact, the economic situation was already

under such strain that events in Mexico could not make it much worse. The prospect of smaller capital inflows to the region only make Venezuela's prospects dimmer.

Of the major LAC economies, Venezuela is the only one in which the fiscal situation is out of hand. The fiscal deficit is almost 9 percent of GDP. There has been a dramatic contraction of private investment, which helps explain why output growth was negative both in 1993 and 1994. The situation is not expected to improve significantly any time soon. In addition, there is a generalized banking crisis, capital controls, high inflation (71 percent), and a real exchange rate estimated to be overvalued by 17–25 percent, with a fixed nominal exchange rate.

Short-term prospects are poor, with GDP expected to decline 1.5 percent in 1995 and to increase only 1 percent in 1996. Inflation is projected to be around 70 percent in 1995 and 100 percent in 1996. As a result of the severe recession, significant current account surpluses are expected for the near future.

Chile

The example of Chile is particularly important because it represents a case in which a stable macroeconomic environment has been the norm for several years and one in which most structural reforms have been in place for quite a long period of time. Chile is the only country in the region in which capital inflows have been dominated by direct foreign investment. Gross foreign investment increased from 1 percent of GDP in 1986 to 9 percent in 1994, making the overall balance of payments much less sensitive to short-term changes in interest rates and in financial market perceptions.

In addition, the depth and strength of Chile's reform program have brought about a continuous increase in productivity. That made it possible to maintain export-led growth in spite of real exchange rate appreciation. While the peso appreciated 25 percent in real terms between 1990 and 1994, productivity has increased by an average of 3.8 percent per year. Chile's economic fundamentals and quality management suggest that they can deal well with potential risks. If a regional effect were to produce a temporary reduction in the rate of capital inflows, Chile could sustain this reduction given its small current account deficit, high savings ratio, and comfortable international reserve position.

The most recent estimates suggest that prospects are

bright. Growth is expected to remain at around 6 percent (5.9 in 1995 and 6.5 in 1996), inflation should continue its gradual decline (8.2 percent in 1995 and 6.8 percent in 1996) and the current account deficit should remain well under control (with a temporarily high level of 3.1 percent in 1996), posing no threat to the balance of payments position.

Colombia

Colombia was the only major country in the region in which the stock market rose at the same time that the situation was unraveling in Mexico. Even though Colombia has been running current account deficits that are on the high side, foreign investment in the oil sector has been dynamic enough to produce an increase in international reserves. The current account deficit is partially explained by an important recovery both in private and public investment. There has been, however, a decline in national savings calling for an important tightening of fiscal policy to increase savings and for the deepening of some structural reforms—particularly in the financial system and capital markets—in order to mobilize them more effectively.

Even though macroeconomic stability is not immediately threatened, Colombia still shows relatively high rates of inflation. The new administration of President Samper is relying quite heavily on an income policy based on the Mexican pacto. Whether these policies will have the desired results will largely depend on the accompanying fiscal and monetary stance.

In addition, and notwithstanding a tradition of macroeconomic discipline, Colombia's structural reform program is recent and, in some sense, not extremely ambitious. Recent events in Mexico have spurred protectionist pressures by several interest groups, to which the government should respond with firmness. Deepening and strengthening of reforms is required to complement a good macroeconomic record with a more sustainable growth prospect.

We expect that Colombia will continue to grow at a brisk pace (5 percent in 1995 and 5.5 percent in 1996), with inflation only gradually declining (to around 20 percent in 1995 and 16 percent in 1996) and a current account deficit that, though on the high side, should be financed with large foreign investment and medium- and long-term debt.

Challenges

In order for the region to consolidate its growth prospects

in such a way that the benefits accrue to the population at large, macroeconomic stability and the removal of allocation distortions will be necessary, but not sufficient. Recent and ongoing reforms will have to be complemented with policies that address education, poverty, and the distribution of wealth.

During the past few years LAC countries have instituted major economic reforms which have begun to generate results as exports expanded, inflation declined, productivity grew, and personal income increased. In spite of this progress, the LAC region still faces key challenges which became more evident following recent events in Mexico. The most important of these challenges is the need to consolidate the reforms by expanding the political coalition that supports the modernization process. This, in turn, will require two fundamental developments. First, the rate of growth has to accelerate significantly; second, the fruits of the reform should be distributed in a way that reduces the region's legendary degrees of inequality and poverty (Burki and Edwards 1995).

Accelerating growth while reducing poverty and inequality will require intensifying some reforms already in place as well as implementing a series of "second generation" efforts. The new reforms will have to change microeconomic and political incentives; they will have to strengthen institutions, rebuild the state, thoroughly reform civil administration and modernize the judiciary. In short, they will have to create the framework that will allow investors and workers to operate efficiently and harmoniously, while permitting them to compete successfully in the world economy. What is encouraging is that regional leaders and the population at large—as evidenced by the results of the last seven national elections in which pro-reform candidates, many of them incumbents, won by wide margins—are aware of the need to move expeditiously in implementing the next rounds of reforms.

The need to enhance growth

The recovery in the first half of the 1990s made LAC one of the most dynamic parts of the global economy. In spite of this, and even before the Mexico-induced slowdown of 1995, its rate of growth was not sufficiently high. A recent World Bank study estimated that a minimum average growth rate of 3.2 percent per annum is required to reduce the absolute levels of poverty in the region (World Bank 1993). This has been the approximate rate of growth

actually achieved during 1991–93. This means that after all the reforms, the efforts, and the accolades from the financial media, the region as a whole is making little progress toward breaking out of the quagmire of poverty. Accelerating growth to higher levels will require policy reform in, at least, the following six areas: competitiveness, domestic savings, infrastructure, rebuilding the state, labor market reform, and educational reform.

Competitiveness

Exports are at the center of the new LAC development strategy, and are becoming the "engine of growth." Until now, this approach has worked rather successfully. Between 1987 and 1994 regional exports grew at around 10 percent per annum in real dollar terms and 6 percent in volume (table 1). Moreover, during this period they have become more diversified, reducing the region's vulnerability to external shocks. Increases in productivity induced by opening the economies and, until recently, competitive real exchange rates in most countries, have been behind this positive record.

In the years to come exports will have to further accelerate if economic growth is to increase. Historical data suggest that rapidly growing countries in different parts of the world have experienced, for long periods of time, a rate of export expansion that exceeds income growth by a factor of around two. For exports to grow rapidly in a sustained fashion, it will be necessary for the region to increase its international competitiveness through continuous productivity improvements, which will depend on two basic developments. First, deregulation and privatization will have to be furthered and deepened. In particular, these reforms will have to be broadened to reach the sub-national level. Second, labor markets and the educational system will have to be reformed (see discussion below). Certainly, a trade regime characterized by openness to the rest of the world must be kept in place.

In the aftermath of the Mexican crisis, most countries in the region have continued to move briskly towards reducing resource misallocation. For instance, in April 1995 Mexico approved legislation to open transportation, storage, and distribution of natural gas to foreign investors. The deregulation of telecommunications markets has already been approved by the Mexican Congress. In Venezuela, the opening of the state-owned oil holding PDVSA to foreign investors is under consideration in

TABLE 1

Growth in export volume, Latin America and East Asia

(annual percentage rates)

REGION/COUNTRY	1982-87	EARLY 1990S
Latin America	1.8	6.0
Argentina	0.8	12.8
Bolivia	-5.3	4.5
Brazil	8.0	1.5
Chile	7.6	7.4
Ecuador	2.4	9.6
Guyana	1.5	0.4
Honduras	1.8	-3.8
Jamaica	-2.0	8.5
Paraguay	9.2	17.2
Peru	-4.0	1.3
Uruguay	-0.5	4.8
Venezuela	2.1	7.5
East Asia	9.9	10.1
Hong Kong	17.6	16.4
Indonesia	7.0	4.2
Korea	15.0	7.6
Malaysia	5.8	1.5
Philippines	2.4	8.4
Singapore	11.2	14.5
Thailand	10.7	18.1

Source: ECLAC, Statistical Yearbook for Latin America; IMF, International Financial Statistics.

Congress. If approved, the legislation will allow foreign companies to hold up to 65 percent of joint ventures. In Peru, Petroperu was sold to private (both local and foreign) investors during 1993-94, and the country's two main refineries are expected to be privatized during 1995. In Brazil, although President Cardoso has ruled out the privatization of the oil company Petrobras, electricity-generating industries are expected to be sold to the private sector within one year. In May 1995, a congressional committee voted to open the telecommunications sector to competition, allowing private local and foreign companies to compete with the state-owned Telebras. In Bolivia a privatization scheme has been established in which a significant portion of any divested company is given to its workers and the rest sold to investors. The proceeds obtained from the latter are immediately capitalized in the same firm, with the end result that assets are more evenly distributed and firms have a much more sound balance sheet.

Improving domestic competitive conditions, however, is only one of the factors that will affect export performance. At least as important will be the evolution of the world trading system. Two factors are particularly relevant in this

respect. First, the implementation of a hemispheric trading system based on a high degree of openness to the rest of the world—what has been called open regionalism—is likely to help expand exports significantly. Intraregional trade has increased greatly in recent years, but its level is still below that of other regions (table 2). Even though Chile was invited to join NAFTA during the Summit of the Americas, the Mexican crisis has created doubts that a free market zone in the Americas will be established any time soon. This is unfortunate because no action could do more to stimulate intraregional trade than NAFTA's expansion. Second, it is important that industrial countries reduce their level of protectionism. Some industrial nations' threat of using new "standards"—on labor and the environment—in trade policy is likely to jeopardize not only the region's growth, but the world trading system.

The volume of intraregional trade in LAC has exploded since the beginning of the 1990s. Intraregional exports rose from \$16 billion in 1990 to more than \$32 billion in 1994, or from 3 percent of total exports to almost 22 percent.⁴ MERCOSUR is the most dynamic group, with a total \$11.4 billion in intraregional exports in 1994. This represents a threefold increase in five years, a performance that is enhanced by the simultaneous boost of 28 percent in exports to the rest of the world. Trade within the Andean Pact countries also increased in an impressive way, with exports reaching \$3.5 billion in 1994. Bolivia, Colombia, Ecuador, and Venezuela have already formed a customs union, and Peru is expected to join toward the end of 1995. In November 1994, all five countries reached agreement on a common external tariff, to be implemented later this year. Intraregional trade doubled from 1990 to 1994 in the Central American Common Market, recovering from the meager levels of the 1980s. In the case of CARICOM, implementation problems and the more heterogeneous composition of the group resulted in the virtual stagnation of regional trade at the low levels of the late 1980s.

The new wave of trade integration strategies contrasts sharply with the early attempts of the 1960s. LAC countries have now embraced an open regionalism approach in which the increase in intraregional trade is encouraged without imposing additional barriers on countries outside the area (CEPAL 1994). As a result LAC economies have become more interdependent at the regional level, without slowing the drive for increased involvement with the rest of the

TABLE 2

Intraregional exports in Latin America and the Caribbean, 1980–93

(percentage of total exports)

COUNTRY	AVERAGE	AVERAGE	1990	1991	1992	1993
	1980–85	1985–90				
Argentina	19.0	22.7	26.1	29.3	32.9	41.4
Bolivia	49.1	52.9	44.8	48.4	38.7	37.3
Brazil	na	12.5	11.6	16.7	22.0	25.2
Chile	na	14.6	12.6	14.8	17.0	20.0
Colombia	15.7	14.2	16.1	21.6	23.8	25.3
Ecuador	17.0	13.6	17.7	17.1	17.9	21.0
Mexico	na	6.7	6.0	6.7	5.0	4.9
Nicaragua	na	14.8	21.9	26.2	28.5	27.3
Paraguay	na	49.3	52.4	46.7	50.2	49.0
Peru	15.8	14.9	14.6	18.5	18.0	18.7
Uruguay	na	33.5	39.5	40.7	41.8	51.2
Venezuela	11.4	10.0	11.9	12.6	17.1	20.0

na is not available.

Source: ComTrade, United Nations International Trade Database.

world. In addition, the recent approval of GAIT and the subsequent creation of the World Trade Organization have been important elements in assuring that regional trade growth will not clash with a multilateral trade strategy.

The integrationist boom has given rise to the establishment of several overlapping pacts. About 30 of these second-generation agreements are in place, seeking the effective liberalization of trade in the area within increasingly shorter schedules. The first sign of this trend was the bilateral pact between Argentina and Brazil, signed in 1986, which led to the formation of MERCOSUR in 1991. Its member countries formed a customs union that has been operating, with predictable imperfections, since January 1995. A common external tariff schedule was introduced, though with a short but important list of exceptions.

The impressive list of bilateral and trilateral agreements, often overlapping, will require careful coordination to achieve the desired level of integration and avoid periodic conflicts of interest. Thus this initial outburst of bilateral pacts should be followed by a process of orderly convergence.

Domestic savings

The accumulation of capital—both physical and human—plays a fundamental role in the growth process. Countries that grow faster devote a higher proportion of their GDP to investment and have developed a capital market that helps channel these funds towards high return projects. A faster

rate of capital accumulation requires, in turn, an increase in domestic savings. The LAC region has traditionally had low saving rates: in 1980 the region saved on average 19 percent of its GDP; by 1994 this ratio was basically unaltered. This contrasts with fast growing regions, that save up to 35 percent of GDP (table 3). Low saving rates are, in fact, one of the most serious constraints faced by the region's countries in their effort to accelerate growth.⁵ Recent events in Mexico triggered a significant slowdown in capital inflows, proving that foreign savings are not a long-term reliable source of funds, nor a substitute for domestic savings as a means for financing investment.

The most effective way to raise domestic savings is through higher public savings. This will have to be achieved through further improvements in fiscal positions. Recent studies suggest that increasing government savings by 1 percent will generate an increase in aggregate domestic savings of around 0.5 percent. The specific circumstances of individual countries will dictate whether public savings should increase through higher tax revenues, reduced expenditures, or a combination of both. Under most circumstances some reduction in expenditure is likely to be optimal. In most countries it seems feasible to reduce military budgets as a way to generate somewhat higher public savings. Argentina has provided a pioneering example in that regard. Of course, that is not the case in some other countries, where narcotrafficking and insurgency movements pose a threat to the sustainability of democratic institutions.

TABLE 3

Private, government, and national savings rates, various regions, 1970–93

	1970–82				1983–93			
	FIRST QUARTILE	MEDIAN	THIRD QUARTILE	AVERAGE	FIRST QUARTILE	MEDIAN	THIRD QUARTILE	AVERAGE
<i>Private savings</i>								
Latin America	13.1	13.2	21.7	16.1	10.9	14.7	17.9	13.8
Asia	na	na	na	na	17.4	19.1	22.9	20.2
Africa	11.4	14.4	18.9	15.2	10.7	16.7	19.5	15.6
Industrial countries	18.0	21.6	23.4	21.3	18.3	21.3	23.4	21.3
<i>Government savings</i>								
Latin America	-0.7	1.7	6.6	3.3	-1.3	2.4	5.5	2.2
Asia	0.0	2.7	8.8	4.4	0.0	1.6	9.0	3.9
Africa	-1.6	0.9	2.1	0.6	-1.3	1.0	4.5	0.9
Industrial countries	-0.5	2.0	3.8	1.8	-3.6	-0.1	1.3	-0.8
<i>National savings</i>								
Latin America	14.5	19.4	27.7	19.8	14.0	17.8	19.1	15.3
Asia	4.9	24.8	26.7	18.8	18.8	23.8	28.5	24.5
Africa	10.8	15.5	18.7	16.4	10.6	17.5	22.1	16.8
Industrial countries	19.6	22.8	25.8	23.1	17.5	19.1	23.4	20.4

na is not available.

Source: International Monetary Fund data.

Efforts to raise public savings should be supplemented by policies aimed at encouraging private savings. Improving the efficiency of domestic financial markets will go a long way toward achieving this goal.⁶ Comparative studies have suggested that an improvement in the provision of financial services, including increased confidence in financial institutions, are at the heart of higher household savings.

The reform of the region's social security systems provides a second and fundamental vehicle for raising private savings. Analyses have shown that private savings are affected by the extent and coverage of government-run social security systems. If individuals perceive that when they retire they will receive high benefits from the government, they will tend to reduce the amount saved during their active days.⁷ This forcefully indicates that social security reform that replaces a government-funded with a privately administered system tends to increase private savings.

Recent findings suggest that while long-term foreign investment enhances growth, short-term foreign financing may stimulate consumption, thereby substituting domestic savings. It is therefore desirable to implement policies that favor direct foreign investment over short-term speculative flows.

Perhaps the most important finding of recent work on savings is that there is a virtuous circle between growth and

private savings. Higher growth increases disposable income, and encourages savings. Higher savings, in turn, permits a higher level of capital accumulation, and thus, reinforces growth. A strategy that combines an increase in public savings with reforms geared at improving the mobilization of private savings will provide an effective way of taking advantage of this virtuous circle.

Infrastructure

During most of the 1980s and the first half of the 1990s investment in infrastructure was seriously neglected in LAC. As a result, the region faces a serious deficit in power generation, roads, water supply, and telecommunications. The World Bank has calculated that to make up for these deficiencies and provide the region with the infrastructure stock consistent with an export-led growth strategy, investment in infrastructure will have to amount to approximately \$60 billion a year until 2005 (table 4). Moreover, detailed analyses in the Bank's *World Development Report 1994* show that the quality of the services provided by LAC's existing infrastructure leaves much to be desired. A region that turns toward the external sector to drive growth cannot afford to have third-class infrastructure.

The volume of infrastructure investment required for the next decade is substantial—representing approximate-

ly 4.5 percent of regional GDP—and much larger than the combined commitments of the World Bank and the IDB. The bulk of the increase will have to come from private sector investment. International experience indicates that an efficient and credible regulatory framework overseen by fully independent and professional regulatory bodies and commissions is a fundamental requirement for getting a substantial private sector involvement in infrastructure investment. This is an area, however, where even the most advanced reformers are lagging behind and where significant effort will have to be made in the next few years. The World Bank is leading a drive for increases in infrastructure development to help countries mobilize, from private sources, the large volume of funds necessary while also providing financing. Its main contribution will come through analytical support for private participation, already proceeding rapidly in the power sector.⁸

Reducing perceived country risk is a fundamental requirement for inducing foreigners to invest in domestic infrastructure projects. Perhaps the most important step in that regard is for the LAC countries to be granted investment grade ratings by international agencies. In determining the degree of risk involved in doing business in a particular country, rating agencies focus on its ability to generate, in a timely fashion, the foreign exchange required to meet contractual payments to investors. In determining whether this requirement is met, these agencies consider the nature of capital and exchange controls, the quality of local regulatory laws, and the impartiality and effectiveness of the judiciary. Making major improvements in all three areas is an urgent task for the countries in the region.

Infrastructure investments require long-term financing. In most LAC countries, however, capital markets are still

in their infancy, with funds for longer maturities generally unavailable. Memories of inflationary years and banking scandals, untested legal structures, and young regulatory frameworks still stand in the way of truly modern financial markets. Moving swiftly toward their reform will help increase domestic savings and facilitate investment in infrastructure.

Recent calculations prepared for the *World Development Report 1995* (using a worldwide general equilibrium model) suggest that if the type of policies advocated in this report—enhanced private savings, and competitiveness and adequate provision of infrastructure—are indeed undertaken, LAC is very likely to grow strongly in the medium and longer terms. As is discussed below, our own projections suggest that the improvement in fundamentals generated by these policies are likely to result in an average rate of growth for the region of 6.3 percent a year for 1998–2002.

Poverty, inequality, and “second generation” reforms

Poverty and inequality have long been salient features of LAC. The inability to deal effectively with these issues is, perhaps, the saddest illustration of the traditional policies of government intervention. Income inequality precedes the debt crisis and the adjustment programs of the 1980s; in the late 1970s the percentage of income received by the poorest 20 percent was lower in LAC than in any other part of the developing world.⁹ The debt crisis negatively affected an already battered social picture. Although a number of countries reacted to the crisis by implementing emergency social programs, the overall level of poverty and inequality increased in many countries.

A dozen years after the debt crisis, one of the main—if not the main—challenges in LAC is to reduce poverty and reverse decades of inequalities. Addressing the needs of the poorest strata of society is both a social and political issue. This has been made even more evident by the Mexican crisis. In Mexico, social tensions generated uncertainty that rocked the financial markets and, as argued in the second part of this report, contributed to the unleashing of the crisis. Only to the extent that poverty is reduced and income distribution becomes more equal, can the structural reforms become sustainable. Moreover, attending to the needs of the poor for education, nutrition, and health will have direct effects on economic growth.

During 1994–95 the World Bank undertook several

TABLE 4

Annual infrastructure investment needs in Latin America

SECTOR	\$ BILLION, 1993 PRICES	SHARE OF REGIONAL GDP (PERCENT)
Power	24	1.8
Transport	14	1.0
Telecommunications	10	0.7
Water and sanitation	12	0.9
Total	60	4.4

Source: World Bank 1994a.

country studies on the social conditions and the extent of poverty in the region. Although methodologies are country-specific, table 5 clearly shows that the Mexican situation is by no means unique. Both poverty and extreme poverty are widely spread across the region. As expected, poverty is more significant in rural areas, though in some cases even the urban indicators are disturbingly high (table 6).¹⁰ In the next few months additional case studies will be completed, providing a relatively complete regional diagnosis.

For many years, acceleration in growth was considered the main prescription for reducing inequalities and poverty. Increasingly, however, empirical evidence indicates that, although very important, higher growth is not enough. In general, it takes time for the fruits of faster growth to spread over the most vulnerable and poorest segments of society. A number of authors and institutions, including the World Bank, strongly argue that there is a need to implement a two-prong approach toward poverty and inequality where faster growth is supplemented with social programs *targeted* at providing services to the neediest.

A recent World Bank study on several LAC countries

provides important information for the design of successful social programs (Fizsbein and Psacharopoulos 1992). It was found that four fundamental factors determine the probability of being at the bottom of the distributional scale: education, gender, ethnicity, and regional issues. Education appears to be the single most important determinant of inequality. This study, as well as others, also found that, other factors being equal, the probability of being at the bottom of the distributional scale is higher for females. Moreover, poor women tend to be older, and have fewer opportunities to improve their skills through additional training and education. In many countries, ethnicity is directly related to poverty and inequality. For example, in 1989 only 40 percent of Guatemala's indigenous population had more than 5 years of education, compared to 76 percent of the non-indigenous population. Countrywide aggregate data tend to hide significant regional variations within countries. Brazil provides the starkest example of intracountry differences in development. Rio Grande do Sul has social indicators comparable to those of Portugal and Korea, while the region of Paraiba is not significantly different from East Africa.

TABLE 5

Poverty in Latin America and the Caribbean

(percentage of population living in poverty)

COUNTRY	POVERTY			EXTREME POVERTY		
	EARLY 1980S	MID- TO LATE 1980S	1990S	EARLY 1980S	MID- TO LATE 1980S	1990S
Argentina (1980, 1986, 1993) ^a	16.2	51.1	17.6	3.3	21.1	3.4
Bolivia (1992)	na	na	72.0	na	na	na
Brazil (1980, 1986, 1990)	39.0	40.0	43.0	na	na	na
Chile (1987, 1992)	na	28.0	24.0	na	17.0	9.0
Colombia (1988, 1992)	na	33.8	32.7	na	18.7	17.7
El Salvador (1992)	na	na	38.3	na	na	9.9
Guatemala (1989)	na	75.2	na	na	57.9	na
Guyana (1992)	na	na	43.2	na	na	27.7
Honduras (1989, 1993)	na	55.0	53.0	na	36.0	32.0
Jamaica (1989, 1992)	na	26.9	34.2	na	na	na
Mexico (1984, 1989, 1992)	24.8	27.5	25.9	6.1	7.7	8.2
Nicaragua (1993)	na	na	50.3	na	na	19.4
Paraguay (1990)	na	na	20.5	na	na	3.5
Peru (1982, 1989, 1992)	46.0	52.0	53.7	21.0	25.0	21.2
Trinidad and Tobago (1992)	na	na	21.0	na	na	11.0
Uruguay (1980, 1986)	11.0	15.0	na	na	na	na
Venezuela (1982, 1989)	22.3	31.4	na	10.3	22.3	na

na is not available.

Note: Poverty is defined as the headcount index, the proportion of people who are deemed to be poor (or extremely poor). Although the poverty line (or the indigent line) is country-specific, in all cases it is defined on the basis of the cost of a basic basket of goods.

a. Refers to metropolitan Buenos Aires. The significant increase in the mid- to late 1980s is, to a great extent, the result of very high inflation.

Source: World Bank data and ECLAC, *Statistical Yearbook for Latin America*.

TABLE 6

Urban and rural poverty in selected Latin American countries

(percentage of population living in poverty)

COUNTRY	TOTAL	URBAN	RURAL
Colombia (1992)	32.7	19.8	50.5
El Salvador (1992)	38.3	36.2	41.4
Guatemala (1989)	75.2	57.2	85.7
Mexico (1992)	25.9	22.4	31.0
Nicaragua (1993)	50.3	31.9	76.1
Paraguay (1990)	20.5	19.7	28.5

Source: World Bank data.

Both from the point of view of equity as well as a matter of good economics, the region should play close attention to the redistribution of assets. Policies that, in the name of fairness, created a hostile environment for both domestic and foreign private sector initiative are a thing of the past. However, in the search for a more efficient and productive economic environment, actions that imply a more equitable redistribution of certain assets might be an integral part of a successful economic strategy.

At least two issues are worth mentioning in this regard. In some countries the land tenure system is a major cause of macroeconomic inefficiency and stagnation in productivity. When unnecessarily large plots of land are left idle or are devoted to grossly inefficient land-intensive activities, policies that strive for the redistribution of land make great sense. Of course, redistribution should be carried out in consultation with the markets. On the supply side, current landowners have to be compensated at market prices; on the demand side, specific care should be given to ensure that recipients of land will be those who would be willing to use it in the more efficient and productive manner. In any event the common practice of bailing out large farmers when land prices fall significantly should be discontinued.

In many cases public sector divestiture also creates room for asset redistribution. An interesting case already mentioned is that of Bolivia, where privatization has been carried out through a mechanism that implies capitalization of divested firms and partial ownership by employees. The former ensures that revenue from privatization is not devoted to finance current government expenditure, but rather to enhance the capital base of

firms that were formerly financially weak. The latter implies that the benefits of the scheme are widely spread in the community.

Rebuilding the state

Designing and implementing effective programs to tackle poverty and inequality will require resources and, perhaps more importantly, a thorough rethinking of the mechanisms through which social services are delivered. In many LAC countries—Venezuela being, perhaps, the best example—the main issue is the inefficiency with which programs are run, not a lack of funds. The lack of administrative capacity, the reluctance of government employees' unions to modernize themselves, and the absence of accountability mechanisms have tended to create a situation of grave mismanagement and inefficiency.

The extent to which these issues are addressed through major administrative reforms—which implies no less than rebuilding the state—will determine the level of improvement of the provisions of the social sector. The acceleration of growth and the reduction of poverty and inequality will require implementing a series of "second generation" reforms. In contrast with most of the policies undertaken in the last few years, which were addressed at correcting gross inefficiencies and macroeconomic disequilibria, the new reforms will have to deal with more subtle issues, including the strengthening of institutions, the reform of civil administration, and the modernization of the judiciary. Perhaps the most difficult aspect of this new phase is that relatively little is known about creating the type of institutions required to move forward on the path toward modernization.

Because of its nature, the initial stage of the reform process was, to a certain extent, rather simple. After all, many of the policies were designed and implemented directly by governments, with little or no need for congressional approval. They were administratively simple, with ample theoretical support and with several prior practical experiences from which to benefit. Rather than the creation of new institutions, they implied the downsizing of the government (see Naim 1994). The challenge that lies ahead is formidable. Fortunately, recent events in Mexico have reminded technocrats, politicians, and the general public that the deepening and broadening of the reform process has to be performed, and soon. Decrees that reduced

tariffs or liberalized interest rates were the typical instrument of the initial stages of reform; in what lies ahead, new institutions will have to be created and existing ones will have to be reformed. And it will no longer be the case that changes will be “evenly” distributed among members of society, as was the case, for example, with tight monetary policies to reduce inflation. In what follows, specific groups will win at the cost of others. The implementation of these changes will be costly in political terms, and much more complicated than before.

Labor market reform

The delivery of social services lies at the center of poverty and equity and is a pillar toward achieving a more productive work force. Labor issues are also at the heart of any attempt to enhance competitiveness. For decades LAC countries used labor legislation as a tool for achieving social goals. Minimum wages, job protection, and related measures were thought to be an efficient way of transferring income and protecting the poor. Although these policies were well intentioned, they ended up creating overly rigid labor markets that were unable to respond to the changing conditions of the world economy. However, the market-oriented reforms implemented in LAC since the 1980s have barely touched labor market legislation.

In most LAC countries social security contributions are seen as pure taxes, not as a component of total compensation package.¹¹ As a result, they introduce serious distortions that increase the cost of labor and reduce its mobility. Moreover, in most countries the social security system is financially insolvent, imposing additional costs by contributing to the fiscal deficit. Replacing the region’s pay-as-you-go pension regimes, where there is no link between contributions and benefits, by a combination of individual capitalization accounts and minimum services assured by the government would go a long way toward reducing the current degree of distortions. This system reduces the cost of labor, encourages savings, and provides a boost to capital markets by developing institutional investors.

The region’s labor legislation has a long tradition of trying to protect employment stability. This has been done through a series of measures, including limitations on temporary hiring and imposing substantial costs—in the form of severance payments—on dismissals. These policies had two consequences. First, they increased the cost of labor,

discouraging employment creation. Second, because of the specific way in which the legislation was put into effect, the policies strongly discouraged training activities and the acquisition of new skills. What makes existing severance payment schemes particularly inefficient is that they are related to the worker’s tenure in the firm. This introduces some serious and arbitrary distortions, as firms will tend to retain older workers, even if they are less productive than others. Relating severance payments to years of service also reduces the employers incentive to invest in human capital formation, especially if skills are not firm-specific. Transforming severance payments into a deferred compensation scheme or replacing them by unemployment insurance systems would greatly increase the degree of efficiency of labor markets. This has been partially done in some countries.

Existing labor legislation in most of LAC pre-dates recent market-oriented reforms and encourages confrontational, long, and costly bargaining processes. With the exception of Chile, the process is similar across countries. Unions with legal representation propose a collective contract, and employers must respond. The state becomes part of the negotiations from the beginning, and the final agreement applies to all workers. Strikes have been one important mechanism used to resolve disputes. The most important cost to firms is the prohibition on hiring temporary replacements. All of this encourages confrontational relations that hinder an efficient use of resources and tend to reduce the private sector’s ability to compete internationally.

But perhaps the most serious aspect of labor relations is that in many countries public sector unions—and especially those in the health and education sectors—exercise a tremendous political influence at the same time that they obstruct any attempt to introduce accountability, reform their operations, and improve the delivery of public services. Reforming labor legislation and “reinventing” the labor movement to be truly democratic, inclusive, and non-confrontational is one of the most difficult challenges that LAC will face in the future. This will not be an easy task. But if it is not attempted and, moreover, if results are not obtained, the economic and social future of the region will be clouded.

Education reform

There is now abundant evidence from the rapidly growing

nations of East Asia proving that successful competition in the international marketplace demands flexibility. Firms must be allowed to readjust their production mix according to rapidly shifting comparative advantages and workers have to be appropriately educated. The limited coverage of the Latin American educational system, its lack of science/technology emphasis, and its generally low quality stand in the way of improved productivity. Only to the extent that the dual objectives of a flexible labor market and an improved education system are achieved will the Latin American countries be in a position to systematically grasp new export opportunities. If these reforms are not undertaken, new export markets will be captured by other nations and the Latin American countries will be left (once again) on the sidelines.

The accumulation of human capital through increases in the coverage and quality of education constitutes one of the fundamental pillars of successful development strategies.¹² For instance, it has been argued that the Korean "miracle" since the mid-1960s—where living standards have doubled every eleven years—has been largely propelled by increases in productivity fueled by the accumulation of human capital. A series of recent empirical stud-

ies has strongly supported this view, indicating that the existence of a highly educated labor force, whose skills improve rapidly year after year, has been partially behind the tremendous economic success in Korea, Hong Kong, Singapore, Taiwan (China), and other East Asian economies. Table 7 presents data on recent education attainment for a group of Latin American countries. Information on three of the East Asian miracle countries—Hong Kong, Korea, and Singapore—is also provided for comparative purposes. This table shows that while there are significant differences in education coverage across Latin America, in every category with available data, educational coverage in the East Asian "tigers" significantly exceeds the LAC average.

Incomplete coverage is not, however, the only problem with the Latin American education system. A recent World Bank study has found that the average *quality* of Latin America's primary education is dismal. For example, an international comparative study on reading abilities of 9-year-old children found that Venezuelan students ranked last out of 27 countries; students in Trinidad and Tobago did better, but still significantly below the average. A 1992 study on science and mathematics achievement for 13-year-olds found that Brazilian students from São Paulo and Fortaleza were outscored by students from Korea, Taiwan, Israel, Jordan, and China as well as by students from every developed country in the sample. The only country Brazil outscored was Mozambique. Finally, a 1992 study on mathematics and science for 13-year-old students in five Latin American countries—Argentina, Colombia, Costa Rica, the Dominican Republic, and Venezuela—found that, with the exception of elite schools, in most cases test performance was significantly below that of "average" countries, such as Thailand and the United States.¹³

The low quality of the region's education system is partially reflected by very high repetition rates, which rank among the highest in the developing world. In Bolivia the repetition rate goes from 16 percent in Beni to more than 35 percent in Chuquisaca. It is estimated that in 1990 the cost of repetition exceeded \$4 billion for the region as a whole. The Eastern Caribbean, where a UK-based system operates, is the region's exception. The rate of repetition in those countries is significantly lower than in the rest of the region (World Bank 1993).¹⁴

Upgrading the quality of education is an urgent task.

TABLE 7

Educational attainment in Latin America and East Asia, 1991

COUNTRY	PRIMARY NET ENROLLMENT	SECONDARY ENROLLMENT ^a	TERTIARY ENROLLMENT ^a	PRIMARY
				PUPIL/TEACHER RATIO
Latin America and the Caribbean	87	47	18	26
Argentina	na	na	43	18
Brazil	88	39	12	23
Chile	86	72	23	25
Colombia	73	55	14	30
Costa Rica	87	43	28	32
Guatemala	na	28	na	34
El Salvador	70	25	16	44
Jamaica	99	62	6	37
Mexico	98	55	15	30
Peru	na	70	36	28
Trinidad and Tobago	91	81	7	26
Hong Kong	na	na	18	27
Korea, Rep. of	100	88	40	34
Singapore	100	70	na	26

na is not available.

a. As a percentage of the eligible population.

Source: World Bank 1994c.

Currently, low-quality public schools coexist with first-rate private schools, creating a dual educational system that tends to perpetuate inequalities and undermine the bases of democracy. Improving the quality of education will require strengthening management, reallocating resources, increasing funding, making teachers accountable, and implementing fundamental changes that enhance competition. Teachers should be trained using modern techniques, their skills should be periodically renewed, and their salaries set according to performance and not on the bases of some bureaucratic formula—the best teachers should get salaries similar to those of relevant comparison groups. Parents should get more involved in the educational system through an increased role in the decisionmaking process. If Latin America maintains its traditional neglect for education and fails to take measures that will greatly improve the quality and coverage of the system, the likelihood of the structural reforms being sustained in the long run will be greatly reduced. As the experience of the East Asia miracle countries has shown, a solid educational base is required for increasing productivity and successfully competing internationally. Moreover, a broad and high-quality educational system usually provides a ticket for social peace, harmony, and generalized prosperity.

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None of the benefits of all the above reforms will be sustainable in the long run and several of the incentives implicit in recent reforms will be unsuccessful in stimulating private sector participation if the judicial system is ineffective. The rights and responsibilities of labor unions and of privately owned “natural monopolies”; the effective rules of the game governing foreign investment and land tenure; and the threat posed by drug mafias and guerrilla movements require a new approach to governance in which the role of the state is no longer one of producing goods and providing employment.

Long-term growth prospects

A recent projection exercise performed at the World Bank indicates that by the end of the century—only five years from now—LAC could be growing at an annual rate of 6.3 percent (table 8). Broadly speaking, this doubling in the region's average rate of growth is explained by what we

forecast will be important increases in investment and advances in factor productivity.

According to an IMF study, average annual GDP growth for the 12 largest LAC economies during the fifteen years between 1970 and 1985 was 2.9 percent. This poor performance was explained primarily by low capital accumulation (1.5 percent) and a very small increase in productivity (0.3 percent). Another World Bank study recently reached the conclusion that between 1960 and 1987 productivity increased at an annual rate of only 0.9 percent. In addition, physical capital increased by 6 percent, the labor force by 2.9 percent, and human capital by 4.1 percent, combining for an average GDP growth rate of 4.8 percent. This picture contrasts sharply with that in countries in the East Asia and the Pacific region, which exhibited similar increases in physical capital (6.4 percent) and in the labor force (2.5 percent) but much higher advances in productivity (1.5 percent). As a result, the East Asian and Pacific region grew at an annual average rate of 6.1 percent, or close to a full point and a half more than the LAC countries (DeGregorio 1991; World Bank 1995c).

As we mentioned in the previous section, if LAC is to achieve higher rates of growth and if growth is to be sustainable, the accumulation of capital and labor has to be complemented by several other factors. Of particular importance are the development of infrastructure, the education of the labor force, the reduction of policy-induced distortions, the enhancement of international competitive-

TABLE 8
Some key determinants of growth
(percent)

	EARLY 1990S	PROJECTIONS 1998–2003
Savings	19.9	28.0
Private	13.8	19.5
Public	2.2	6.0
Foreign	3.9	2.5
Investment	19.9	28.0
Infrastructure	3.0	4.5
Schooling	4.9	6.2
TFP growth	0.0 ^a	1.5
GDP growth	3.4	6.3

Note: Savings and investment are percentages of GDP. Schooling is in average years. Total may not add to 100 percent due to rounding.

a. Average for 1960–87. TFP increased by 1.3 percent a year in 1960–73 and decreased by 1.1 percent a year in 1973–87

Source: World Bank 1995b.

ness, and an overall reduction in the size of the public sector.

It is worth emphasizing that these elements for growth must be complemented by a stable political environment. There is ample evidence that political conflicts deter growth. The targeting of social expenditure, the reduction in poverty, the redistribution of assets, and complementary policies that reduce social conflict are, therefore, not just desirable in and of themselves but are vital components for high and sustainable growth. In that regard, LAC offers some impressive grounds for confidence. Between 1993, when Chile held a presidential and congressional election, and May 14 of this year, when Argentina did the same, over 85 percent of the region's population voted in nationwide elections. In most of them, presidential candidates supporting economic reform were elected or re-elected. This is significant evidence that in the LAC societies there is an increasing agreement on reform and that there will be a high and unprecedented degree of policy continuity in the region looking out and beyond the end of the century.

Returning to the economic elements, many of the determinants of private savings are expected to evolve in a positive direction. On the one hand, demographic tendencies suggest that age dependency will decline, implying an increase in the population that will be working and saving. Recent World Bank estimates show that age dependency in LAC is 66 percent, as compared to 62 percent in the upper-middle income countries. Moreover, as the LAC countries continue to redefine the role of the state the private provision of certain elements of social security is expected to increase. This will have an additional positive effect on savings. All things considered, private savings as a percentage of GDP could reach close to 20 percent, compared to the single digit range in a number of LAC countries today. Public and foreign savings are also expected to develop favorably.

Under favorable circumstances, overall savings should approach 28 percent of GDP, with private savings complemented by foreign savings of around 2.5 percent and public savings on the order of 6 percent. This would allow for a level of gross investment near 28 percent. In terms of growth, the impact of enhancing savings and investment by 8 percentage points of GDP is significant. It would raise the annual growth figure by around 2 percentage points.

Factor productivity is also predicted to increase as a consequence of education, deregulation, and openness. If

results in the region approach those observed in the countries that pioneered market-oriented reforms, total factor productivity growth could add 1.5 percentage points to GDP, compared to a negligible contribution throughout the 1980s.

By increasing domestic savings while maintaining foreign savings at a reasonable and sustainable level, and by staying the course on policies that facilitate a more efficient use of resources, LAC would be able to boost its annual growth rates from 3 percent to 6 percent. This is a preliminary estimate that is likely to be affected by several factors that are very difficult to forecast, such as changes in the terms of trade. Regardless of the preliminary nature of the forecast, it is worth mentioning that early reformers, both in LAC and in other regions, have experienced such GDP increases. The attainment of such rates of growth is not heavily dependent on the ability to attract large amounts of foreign savings. In fact, the above estimates assume a regional current account deficit that is actually smaller than the one we have seen in recent years.

Conclusion

The countries of Latin America and the Caribbean have the potential to double their average growth rate to 6 percent a year over the next decade. In our view, the response of policymakers in the region to the crisis that began in Mexico in December 1994 is a very significant indication that this result can be expected. Faced with a forceful negative market reaction to the region as a whole following Mexico's currency devaluation, political authorities, economic officials and—more importantly—citizens in the country most affected by the crisis, Argentina, reaffirmed their commitment to continue and to deepen economic reform. Mexico's difficulties were a costly but important reminder of the need for urgency in moving to what we have called the second generation of reforms.

This urgency is a consequence of two important figures revealed by recent World Bank studies. The first is that in spite of the economic achievements registered in the last few years, LAC's poverty rates have not budged and income distribution, for which we have no conclusive data, may have improved only slightly. LAC's record is now unbroken: since the 1950s—for four and a half decades—the number of people living in poverty has not fallen. The impressive growth rates reached in some coun-

tries have barely pushed the region's average annual growth rate to the 3.2 percent that the World Bank considers the minimum for producing an actual reduction in poverty levels.

Moreover, for the reforms that have produced higher growth rates, a staggering amount of investment is required. The World Bank's estimate that \$60 billion in infrastructure investment is needed every year between now and the year 2005 is an indication of the order of magnitude. For that investment to materialize—whether private in the case of infrastructure or public in the case of some social services—the second generation of reforms must be incorporated into the continuing macroeconomic policymaking agenda.

When implemented and supported by the international financial community, including multilateral organizations like our own, the reforms of this second phase should reach into the daily lives of citizens throughout the region. Better educated, more secure, both personally and economically, citizens with more efficient systems of environmental and consumer protection, health, and justice, and with fewer fellow citizens living below the poverty line, will strengthen the medium- and long-term prospects for sustained economic growth. Mexico's difficulties sent a message; it has been heard.

Appendix

Recent evolution of Latin American and Caribbean economies

During 1994, and up to the eruption of the Mexican crisis, LAC continued to evolve in a positive way, following the trend observed since the late 1980s for most of the reforming countries (Edwards 1993). GDP growth for the region as a whole was 4.4 percent, almost one percentage point above the average from 1990 to 1993. While this regional average hides diverse performance across countries, it is worth underscoring that the growth rate in most countries was clustered around the average—Peru grew at a remarkable rate during 1994 (12 percent); Argentina (7.1 percent), El Salvador (5.8), Colombia (5.3) and Brazil (5.7) also performed well on the growth front. Haiti, Venezuela, and Honduras, however, did poorly (table A1).

For the region as a whole, the prospects for 1995 and 1996 show a slowdown in growth as compared to the

recent past, but no significant downturn. In fact, it is widely expected that in most countries matters will start improving as early as 1996. Under positive conditions the region's average annual growth rate would be 5.1 percent for 1995–2010, with total factor productivity increasing by 1.6 percent a year and investment reaching 25 percent of GDP (World Bank 1995c). Our own projections, discussed above, indicate that under a “best case” scenario we can expect an average rate of growth for LAC of 6.3 percent for 1998–2003.

During 1994 inflation rates continued to fall across the region (table A2). The average, excluding Brazil, was 20.3 percent. When Brazil is included, it increases to 61.6 percent. This falling trend is expected to continue over the rest of the decade, including a further reduction in Brazilian inflation, following the introduction of the real stabilization plan. The pace at which Brazil's inflation will decline is, to some extent, an open question. The acceleration of industrial activity since mid-1994, and the 43 percent increase in the minimum wage in May 1995 covering more than 15 million workers have put pressures on the wage bill and thus on aggregate demand. In Mexico, the depreciation will be partially reflected in inflation, which is expected to increase fourfold from 1994 to 1995 to around 46 percent for the year as a whole.

Information on current account balances and inflows of funds is displayed in tables A3 and A4. During 1991, 1992, and 1993, the region enjoyed abundant foreign financing due to bullish expectations of institutional investors following the process of far reaching reforms, and to significant reductions in U.S. interest rates. That situation began to change in 1994. As should have been expected, large external deficits became harder to finance calling for more aggressive export strategies and policies to enhance domestic savings. The conditions that reigned through early 1994 were totally reversed when the crisis broke in Mexico. Curtailed foreign financing is expected to last through most of 1995. However, once the markets see the emerging economies of LAC moving successfully with the second phase of reforms, foreign capital will return, and this time around direct investment will play a more important role.¹⁵

Figure A1 shows the evolution of real exchange rates in the region. It is clear that the generalized process of appreciation observed at the beginning of the 1990s has

TABLE A1

GDP growth in Latin America and the Caribbean, 1991-96

(annual percentage rates, constant prices)

COUNTRY	AVERAGE						
	1991-93	1991	1992	1993	1994	1995	1996
Argentina	7.9	8.9	8.7	6.0	7.1	0.0	2.0
Bolivia	3.8	4.6	2.8	4.1	4.2	4.5	4.7
Brazil	1.7	1.1	-0.9	5.0	5.7	4.5	4.5
Chile	8.2	7.3	11.0	6.3	4.5	5.9	6.5
Colombia	3.7	2.1	3.8	5.3	5.3	5.0	5.5
Costa Rica	5.5	2.3	7.7	6.4	3.5	1.5	3.5
Dominican Republic	3.9	0.7	7.9	3.0	4.0	2.5	3.5
Ecuador	3.5	5.0	3.6	2.0	4.1	4.2	4.6
El Salvador	4.6	3.5	5.3	5.1	5.8	6.5	6.5
Guatemala	4.1	3.7	4.8	3.9	4.0	3.0	4.0
Guyana	7.4	6.0	7.8	8.3	5.0	5.0	5.0
Haiti	-6.8	-3.0	-14.8	-2.6	-10.6	4.5	5.0
Honduras	5.0	3.3	5.6	6.1	-1.5	2.5	4.0
Jamaica	1.5	0.8	1.8	2.0	2.0	3.0	3.5
Mexico	2.3	3.6	2.8	0.4	3.8	-4.8	2.0
Nicaragua	-0.2	-0.2	0.4	-0.9	3.0	3.0	4.5
Panama	7.8	9.6	8.5	5.4	4.0	3.5	3.0
Paraguay	2.7	2.5	1.8	3.7	3.5	4.8	5.2
Peru	2.1	2.3	-2.4	6.5	12.0	6.0	6.0
Trinidad and Tobago	-0.2	2.7	-1.7	-1.7	4.0	2.0	2.5
Uruguay	4.1	3.2	7.7	1.5	4.2	2.8	3.2
Venezuela	5.1	10.4	5.4	-0.4	-3.3	-1.5	1.0

Source: World Bank data.

TABLE A2

Inflation in Latin America and the Caribbean, 1991-96

(annual percentage rates)

COUNTRY	AVERAGE						
	1991-93	1991	1992	1993	1994	1995	1996
Argentina	36.9	84.0	18.6	8.0	3.5	4.0	3.0
Bolivia	14.0	21.4	12.1	8.5	8.3	6.9	6.1
Brazil	1,368.9	475.1	1,131.5	2,541.0	929.0	35.0	25.0
Chile	16.6	21.8	15.4	12.7	11.4	8.2	6.8
Colombia	26.7	30.4	27.0	22.6	22.0	20.0	16.0
Costa Rica	20.1	28.7	21.8	9.8	19.6	20.0	15.0
Dominican Republic	21.1	53.9	4.6	4.8	9.3	7.0	15.0
Ecuador	46.7	49.0	60.2	31.0	20.0	15.0	10.0
El Salvador	13.9	9.8	19.9	12.1	8.9	8.5	5.9
Guatemala	19.6	35.1	10.2	13.4	12.6	10.0	10.0
Guyana	73.1	102.3	104.9	12.0	12.0	6.0	4.0
Haiti	17.0	6.6	17.5	26.9	52.1	20.0	15.0
Honduras	13.7	21.5	6.5	13.0	30.0	12.0	6.5
Jamaica	50.2	68.6	57.5	24.5	32.0	13.6	7.4
Mexico	12.9	18.7	11.9	8.0	7.1	45.7	18.3
Nicaragua	926.9	2,740.0	20.3	20.4	7.2	8.4	6.8
Panama	1.2	1.3	1.8	0.5	1.0	1.3	1.3
Paraguay	19.2	24.3	15.1	18.3	20.7	11.0	9.0
Peru	173.0	409.5	73.5	48.5	23.7	12.0	10.0
Trinidad and Tobago	7.0	3.8	6.5	10.8	8.3	4.4	3.4
Uruguay	74.9	102.0	68.5	54.1	45.0	41.9	34.7
Venezuela	36.3	31.0	31.9	45.9	70.8	70.0	100.0

Source: World Bank data.

TABLE A3

Current account balances in Latin America and the Caribbean, 1991-96

(percentage of GDP)

COUNTRY	AVERAGE						
	1991-93	1991	1992	1993	1994	1995	1996
Argentina	-3.1	-1.5	-3.7	-4.1	-2.8	-2.3	-2.2
Bolivia	-8.4	-6.3	-10.1	-8.8	-5.8	-6.6	-8.5
Brazil	0.3	-0.3	1.5	-0.2	-1.1	-1.9	-1.7
Chile	-2.1	0.4	-1.8	-4.8	-0.9	-1.4	-3.1
Colombia	-5.9	-4.8	-5.5	-7.4	-5.2	-4.5	-4.0
Costa Rica	0.9	5.4	1.5	-4.2	-4.2	-3.7	-3.0
Dominican Republic	-3.5	-2.1	-6.8	-1.5	-1.8	-1.3	-2.0
Ecuador	-3.0	-5.0	-0.7	-3.2	-3.1	-3.8	-3.7
El Salvador	-4.9	-5.0	-5.8	-3.9	-2.9	-1.8	-2.0
Guatemala	-5.6	-2.7	-7.6	-6.6	-6.0	-3.3	-3.3
Guyana ^a	-23.7	-13.1	-26.3	-31.6	-22.0	-22.8	-22.2
Haiti	-10.4	-12.9	-6.9	-11.4	-6.9	-20.6	-17.5
Honduras	-6.9	-5.0	-6.6	-9.2	-8.1	-3.7	-3.5
Jamaica	-3.1	-4.9	-0.1	-4.3	-1.0	-2.3	-0.4
Mexico	-6.3	-5.1	-7.4	-6.4	-7.7	-0.3	-0.1
Nicaragua ^a	-50.8	-48.9	-54.6	-48.9	-48.0	-32.0	-34.0
Panama	-4.7	-1.9	-5.7	-6.6	-5.6	-5.6	-5.5
Paraguay	-9.2	-8.1	-12.4	-7.2	-5.4	-5.2	-5.2
Peru	-5.6	-6.4	-4.6	-5.9	-3.1	-3.2	-3.9
Trinidad and Tobago	0.8	-0.9	1.7	1.6	2.1	1.9	1.1
Uruguay	-1.7	-1.8	-1.0	-2.4	-2.7	-0.9	-1.1
Venezuela	-2.4	2.8	-6.2	-3.7	6.8	5.7	5.5

a. These large figures are heavily affected by the existence of foreign aid.

Source: World Bank data.

subsidized. The exception is the Brazilian real, which, introduced at a highly depreciated level, has risen by about 30 percent against the U.S. dollar since the plan's inception. The external environment, in which the region's access to foreign financing has been temporarily decreased, requires a renewed attempt at enhancing external competitiveness. Increases in productivity and more competitive real exchange rates will be essential in this respect. However, productivity gains are long-term in nature; no short-term relief from this should be expected.

Regarding international trade, exports have continued to perform quite well, with an increase in 1994 of 14.3 percent. Imports however grew even faster (14.7 percent), contributing to the development of large current account deficits. The trade balance followed its negative trend start-

ing in 1991, reaching an \$18 billion deficit. Commodities prices have been evolving favorably in the last couple of years, in sharp contrast with events in the latter part of the

TABLE A4

Net capital flows into Latin America and the Caribbean, 1991-96

(billions of U.S. dollars)

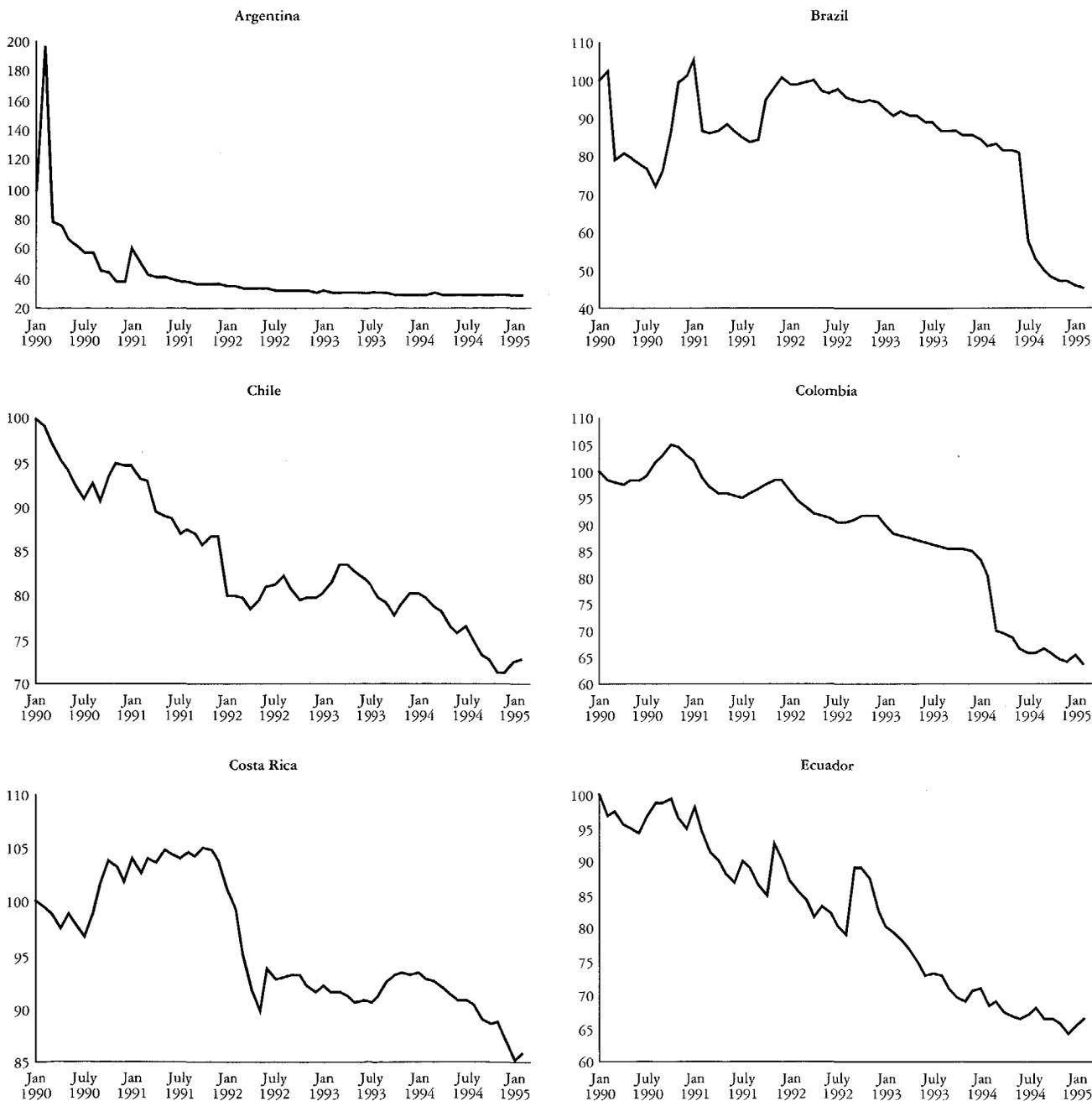
COUNTRY	1990	1991	1992	1993	1994
Argentina	-1.9	3.6	11.2	10.0	10.5
Brazil	5.3	0.8	8.8	9.0	13.1
Chile	3.0	0.8	3.5	2.8	3.1
Colombia	0.0	-0.8	0.2	2.2	3.1
Mexico	8.2	24.9	26.5	30.9	11.5
Peru	0.9	0.5	2.7	2.7	6.0
Venezuela	-6.0	1.2	2.5	1.7	-5.2
Regional total	14.6	33.8	61.7	65.1	56.6

Sources: IMF for 1990 and 1991, CEPAL for 1992-94.

FIGURE A1

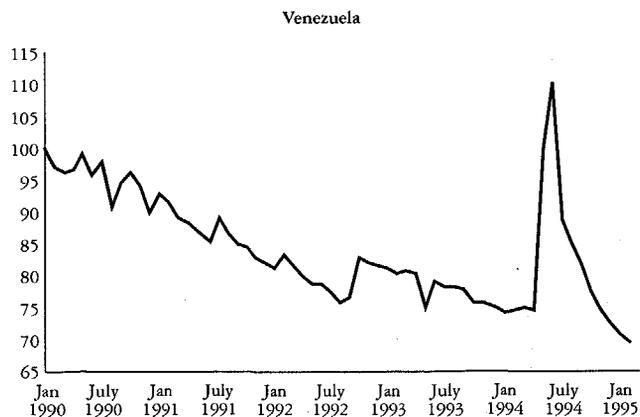
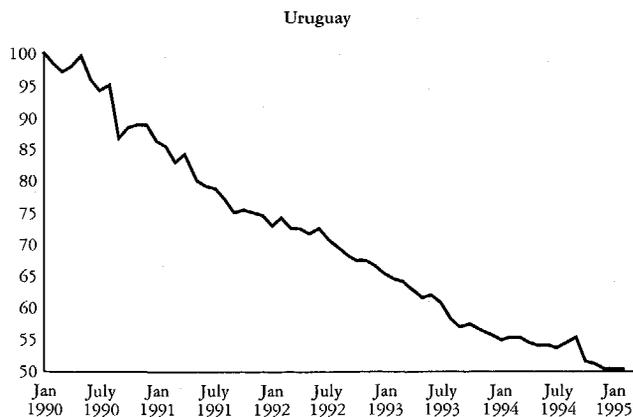
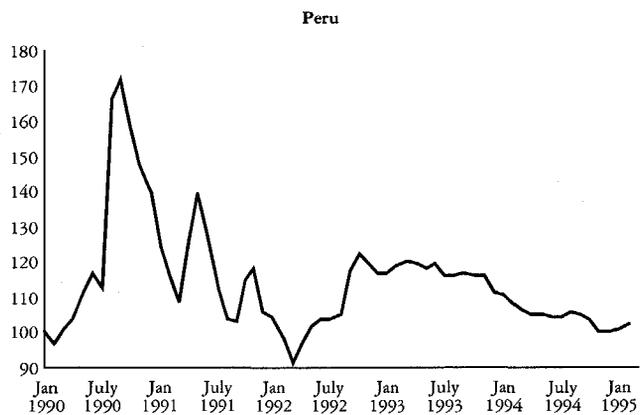
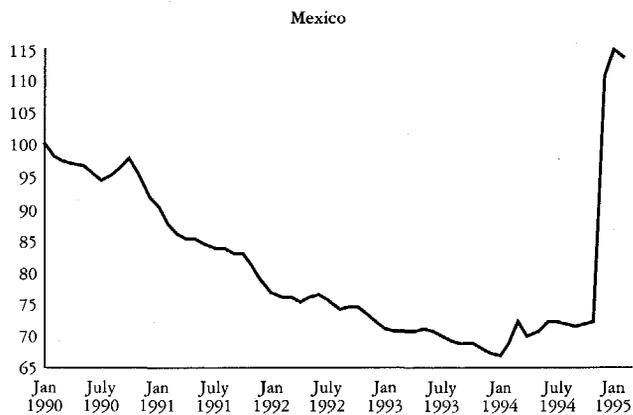
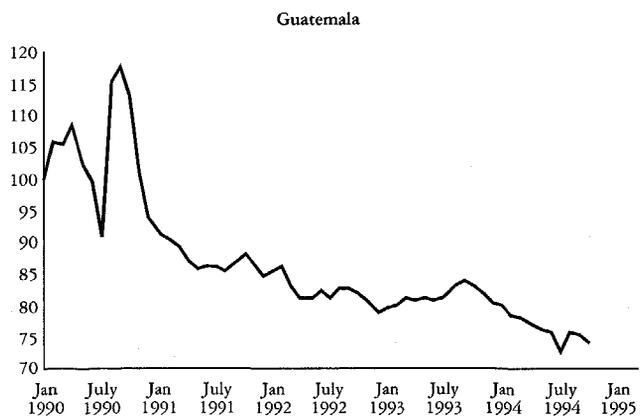
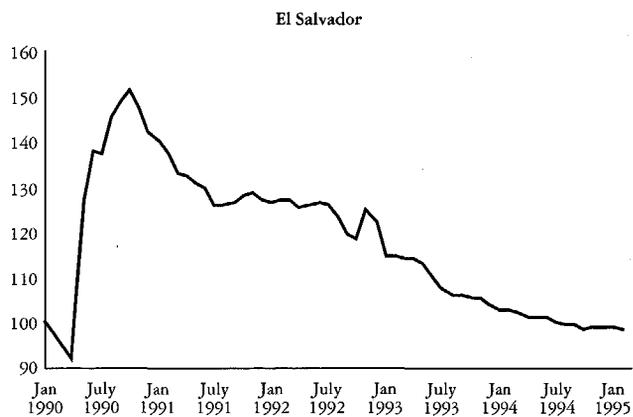
Real exchange rates in Latin America

Exchange rate index (January 1990 = 100)



Note: The indices were computed as $RER = EP^*/P$, where E stands for the nominal exchange rate in local currency units per US dollar, P^* represents the US wholesale price index, and P is the local consumer price index. Thus a decrease in the index represents a real appreciation.
 Source: IMF, *International Financial Statistics*.

FIGURE A1, continued



1980s. According to the World Bank's *Global Economic Prospects*, this trend is expected to continue during 1995 and 1996.

Notes

1. While large, and even very large, current account deficits can take place for a limited period of time, they cannot be maintained in the longer run. This is a matter of arithmetics. A current account deficit of the magnitude of Mexico's would eventually require that the country devote 100 percent of its GNP to pay interest (and dividends) to foreign holders of Mexican securities.

2. Mexico was subjected to a number of serious political shocks in 1994, starting with the Zapatista uprising on January 1; the assassination of Donaldo Colosio, the PRI presidential candidate, on March 23; the shaky start of Ernesto Zedillo, the new presidential candidate, in the presidential campaign; and the assassination of Francisco Ruiz Massieu in September.

3. The World Bank has recently committed two loans to the Argentine Republic for a total of \$1.0 billion to help privatize provincial banks and restructure the banking system. In addition, it has committed two loans for \$300 million to help strengthen the provision of social services (health insurance and a social safety net) during the adjustment process.

4. See *CEPAL News*, "The Progress of Latin American and Caribbean Integration," April 1995.

5. For a thorough analysis of savings in developing countries, see Edwards (1995).

6. It is interesting to notice that during the second half of the 1980s the level of financial depth in the region—measured by the ratio of money to GDP—was almost one half of what it was in the rest of the world.

7. Strictly speaking, what matters is the relation between contributions and expected benefits. If the retirement system is benefit-defined—as many Latin American systems are—it will tend to discourage private savings.

8. See the forthcoming World Bank document *Meeting the Infrastructure Challenge in Latin America and the Caribbean*.

9. Latin America is the only region where the share of income going to the poorest 20 percent consistently declined between 1950 and the late 1970s. See Sheahan (1987).

10. Even though the incidence of poverty—measured as the proportion of poor in the overall population—is generally higher in rural areas, the fact that population expansion is heavily concentrated in urban areas implies that the increase in the number of poor people is, essentially, an urban phenomenon.

11. This is mostly because retirement schemes are based on a defined benefit approach, where there is very little connection (if any) between workers' contributions and the benefits they obtain from the system.

12. T.W. Schultz (1961, 1978) has been the indisputable modern pioneer of this view in economics. See also Harberger (1959) and Psacharopoulos (1992).

13. Costa Rica was the exception, where second tier schools had very strong test scores.

14. It should be noted that high repetition rates reflect a myriad of factors. It is not necessarily true that a low level of repetition reflects high educational standards. In fact the ideal situation is one where rates of repetition are low, and standardized results are high.

15. In 1995 the region's current account deficit is expected to be close to 1.8 percent of GDP, down from about 3 percent in 1993–94 (see World Bank 1995a).

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Reform of the State in Latin America

STEPHAN HAGGARD

LATIN AMERICAN GOVERNMENTS HAVE GONE A LONG WAY IN THE DIRECTION OF POLICY reform (Williamson 1990; World Bank 1993). Yet the first round of crisis-driven policy change concentrated on macroeconomic and balance of payments adjustment and the restructuring of incentives and relative prices. With the exception of privatization, these early reforms did not typically address institutional issues (Haggard and Kaufman 1992; Naím 1994). Moreover, many of the reforms were administratively, though not politically, easy. Stabilization and structural adjustment could be initiated by a relatively small number of policymakers, often working as teams organized outside of routine bureaucratic channels. These reforms did not require a high level of sustained, large-scale organizational capacity to implement.¹

The next stage of reform is proving quite different (Evans 1992; World Bank 1993; Streeten 1993; Naím 1994; Grindle 1994). Institutions are being reformed, built or rebuilt, in part because the current policy challenges are much more intensive in the use of administrative resources, in part to consolidate those policy changes that have been made.

To some, the reform of the state is synonymous with the reduction of unwanted government intrusion in markets and an increase in bureaucratic efficiency: privatizing; reducing unnecessary regulation; reorienting spending priorities around core government functions; improving the delivery of services through greater contracting out; and eliminating waste, fraud, and abuse through reforms of the system of financial management. This strand of thinking was born of profound fiscal crises. Politically, it reflects the

conservative idea that the state's role should be sharply circumscribed.

A second conception of "reforming the state" implies a selective *expansion* of government activities (Bradford 1994). The crises of the 1980s created a backlog in providing public goods as well as new distributive problems: infrastructure; maintenance; provision of basic services; improving the quality and coverage of education and health care; and addressing continuing problems of unemployment, income distribution, and poverty (Grosh 1990). The move to the market has also created demand for *new* regulatory capabilities, including overseeing financial markets, industrial relations, newly-privatized utilities, and the environment. This second vision includes a more activist state and looks to the European social democracies and East Asian newly industrializing countries for models.

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Finally, there is a third, more overtly political, conception of state reform (O'Donnell 1991, 1994; Bresser Pereira, Maravall, and Przeworski 1993). The political circumstances surrounding the first phase of economic reform were quite particular. Chile and Mexico launched reforms under the auspices of a military and dominant-party system respectively. In the remainder of the continent, reform was in the hands of democratic governments, many of them quite new. Partly because of the nature of the reforms, partly because of crisis circumstances, presidents often initiated policy change without extensive consultation either with legislatures or interest groups. The transition to democracy is naturally giving rise to efforts to reassert control over the government through the expansion of legislative control and prerogatives; strengthening judicial oversight; making government responsive to a wider array of interest groups and citizens; and the reinvigoration of provincial and local governments. Reforming the state is therefore not simply an issue of efficiency, but of accountability and participation as well.

These three approaches are not necessarily mutually exclusive; a government can shrink in one area and expand in others, while also increasing its political accountability. Yet all three of these strands of thinking share one common feature: they are fundamentally normative. The analysis begins by positing certain substantive goals (efficiency, equity, accountability), outlining the administrative reforms required to achieve them, and then calling for political leaders to develop the "will" or "commitment" to initiate the favored plan. No theory is provided as to why politicians would, in fact, choose one set of institutional arrangements over another.

A further problem is that the reform of the state is typically taken to mean the reform of the government bureaucracy. However, a central insight of contemporary democratic theory is that the bureaucracy is nested in a longer chain of principal-agent or delegation relationships, from interest groups and voters to politicians; from politicians to the heads of bureaucratic agencies; and from agency heads down through the organizational chain of command (for example, Moe 1990). Given the backdrop of democratization in Latin America, institutional reform cannot be viewed simply as a question of getting internal bureaucratic incentives right; rather, it is an inherently political process.

In analyzing this political process, I depart from the well-known focus on interest groups to place greater

emphasis on the elected officials who control—or seek to control—the bureaucracy: presidents, their ministers, legislators, governors, mayors, and local council members. These political actors, and the parties they represent, constitute a major channel through which interest group pressures are translated into policy and institutional reform. The political incentives they face will influence the shape of administrative reform in the region.

I concentrate on two issues. First, how do governments build central ministries and agencies that are differentiated in their functions, autonomous, and at least partly insulated from short-term electoral and interest-group pressures? Part of the answer resides in restructuring internal organizational incentives, including the civil service. However, the problem is broader. How can effective and efficient delegation be achieved? Delegation requires both coherent legislative support and appeal to, and participation of, interested social groups.

Second, under what conditions and with what effect will politicians operating at different levels of the political system agree to decentralize the organization of government, within central government ministries, to lower levels of government, or to private agents? Again, the analysis of decentralization requires an examination not only of the incentive structure within bureaucracies, but between levels of government. Effective decentralization rests on the *political* relationships that exist between the central government and local politicians and interest groups.

The central message of this paper is a simple one: government institutions are designed and reformed to serve political ends. It may be possible to initiate reform through the exercise of concentrated executive or technocratic authority; this has been a common route to policy change in Latin America (Bresser Pereira, Maravall and Przeworski 1992; O'Donnell 1991, 1993; Haggard and Kaufman 1995, ch. 5). Consolidating policy and institutional change requires constructing bases of political and social support. Understanding how this occurs in different systems demands an examination of the central institutional features of contemporary Latin American democracy.²

Democracy in Latin America: Constitutional design, political incentives, and the organization of the state

Institutional changes are ultimately initiated by politicians who have an interest in serving their constituents.³ How

politicians perform this task is a function of the preferences of interest groups and electorates, but also of the institutional setting in which they operate. In Latin America, this setting includes a presidential form of democratic rule coupled with party systems that vary in important ways across countries. These institutions structure the incentives not only to executives, ministers and legislators, but to salient interest groups as well; as a result, they shape the efficiency of the political process.

Some features of presidential rule

The debate over the relative merits of presidentialism and parliamentarism has been intense in Latin America, but presidentialism remains—and is likely to remain—the dominant constitutional form in the region (see Linz 1993a, 1993b; Linz and Valenzuela 1994; Horowitz 1993; Lijphart 1993). There are reasons to be skeptical of some claims of the “parliamentistas”; in particular, I will emphasize that some of the supposed problems with presidentialism can be traced to features of the party system (Shugart and Carey 1992, pp. 28–54; Mainwaring and Shugart 1994; Shugart 1995; Haggard and Kaufman 1995, ch. 10).⁴ Nonetheless, the separate and independent election of the executive and legislature that is a core feature of presidential rule does generate coordination problems that are important for understanding administrative design.⁵

Divided political authority provides checks and balances that are lacking in a parliamentary system and also opens the possibility of stalemates between branches. Because presidents are elected independently of the legislature, they do not necessarily come from the majority party in the legislature, assuming one exists. While outright divided government in Latin America has proven surprisingly rare (Shugart 1995), it is not uncommon for Latin American presidents to confront legislatures in which their party or faction holds only a plurality or is even in the minority. In parliamentary systems, the electoral incentives of the prime minister and backbenchers are more tightly aligned, which serves to maintain party and coalitional discipline. Presidents lacking firm party support in the legislature must engage in difficult and costly coalitional politics for each and every item on their legislative agenda.⁶

This division of powers has implications for administrative design and the reform of the state (Moe 1990; Moe and

Caldwell 1994). Presidents have a wider national constituency than legislators, and thus have a greater interest in administrative structures that can serve as effective—if not necessarily efficient—instruments for implementing their programmatic and political agendas.⁷ In a presidential system legislators are not necessarily in the business of creating effective government; they are in the business of making themselves popular and their jobs secure (Moe and Caldwell 1994, p. 175). Depending on the nature of the electoral system, they may only be able to accomplish this objective by courting interest group backing and pursuing particular concerns.

In a presidential system with competing and overlapping centers of power, it is possible for legislators to protect their policies against future reversal by designing complicated rules that reduce the discretion of bureaucrats: decision criteria, procedures, timetables, personnel rules, and so forth (McCubbins, Noll and Weingast 1987, 1989). Given the independent institutional and electoral interests of legislators, the multiple veto points built into a division of powers system, and the interest groups that crystallize around them, these structures become extremely difficult to change once in place.

The potential for stalemate in presidential systems is partly offset by the powers of the president; these include veto and override provisions, decree powers, and broader legislative powers, for example, with respect to the budget. In Chile, the president has the power to submit the budget, and taxes and spending cannot be raised by the Congress nor expenditures shifted between categories. The president in Uruguay also enjoys substantial budgetary authority. However, these powers are exceptional in Latin America (Shugart and Carey 1992, p. 155). As a result, conditions of political stalemate between branches have frequently led presidents to use constitutional decree powers or even extra-constitutional forms of decisionmaking. Policy-making in Brazil in the early days of the Collor administration provides examples of the former; Peru under Fujimori is an example of the latter. The potential for stalemate also explains the attraction of the formation of high-level technocratic teams that operate outside of normal cabinet, ministerial, or bureaucratic channels.

Even if these devices prove useful in breaking logjams in the short run, they do not solve the problem of institutionalizing coherent decisionmaking and policy implementa-

tion over the long run. Presidents can, however, create their own agencies, authorities, and commissions. These agencies may serve as "pockets of efficiency" within an otherwise inefficient bureaucratic organization. The creation of independent statutory agencies or boards to carry out particular policy initiatives—an important but understudied feature of the recent expansion of the Latin American state—clearly reflects the efforts of executives to "lock in" their policy preferences against future reversal and to build administrative channels for currying political support.

In sum, one set of factors that influences administrative design is the degree of conflict or cooperation between the president and the legislature and the powers of the president. Where president and legislature are aligned, or where the president enjoys substantial legislative powers, there is greater likelihood of creating coherent administrative structures. Where president and legislature are at odds, where the president is constitutionally limited in his capacity to take initiatives, or where the respective powers of the two branches are ambiguous, institutional reforms will take a less coherent form. This is true in part because of the greater likelihood of competitive political interference in the existing bureaucratic structure, in part because of competing efforts to construct *new* agencies that are responsive to political command.

Party systems in Latin America

The effects of presidentialism on economic policy and institutions will depend on the nature of the party system, and in particular on the extent of its polarization or fragmentation. Polarization is defined by the ideological distance between the extreme parties in the system. (Sartori 1976, pp. 132–137; Cox 1990). Though polarization is notoriously difficult to operationalize, it can be measured by the strength of leftist, populist, and "movement" parties.

The crises of the 1980s had the surprising effect of substantially weakening such parties or transforming them in a more pragmatic direction. Nonetheless, as recent developments in Venezuela show, the resurgence of populism is an ever-present possibility in Latin America. Clearly, it is much more difficult to reform the state when there are sharp divisions among contending parties and interest groups over what the government should do. Under these conditions, there is greater likelihood that the bureaucracy

will be politicized and that policy will swing widely between alternating governments.

For the moment, the more common political problem in Latin America is the combination of fragmentation—a high number of effective parties (Sartori 1976, p. 185; Powell 1982, pp. 80–84)—and weak internal party discipline. Brazil, Ecuador, and Peru all exhibit this syndrome, as did Bolivia immediately following its transition to democratic rule. The principal effect of fragmentation is the difficulty it poses for coordination: within the ruling coalition, between executive and legislative branches, and among different levels of government. Party fragmentation in presidential systems compounds the chances that executives will become politically isolated and powerless to pursue their agenda (Mainwaring 1992). The incentives for small parties to cooperate with the government are weaker than in a parliamentary system since there is no ability to threaten early elections and the temptations of legislative blackmail are correspondingly greater. Coordination becomes even more difficult when the centrifugal pressures in fragmented systems are compounded by strong ideological polarization or sectarian tendencies, as has been true in Peru in the recent past.

Latin America also has a number of political systems with a low level of fragmentation and relatively cohesive party systems. Mexico has been a dominant party system, though with increasing competition. Colombia and Costa Rica stand out as stable two-party democracies of relatively long standing. Chile retains a relatively high number of effective parties, but has moved in the direction of two major party blocs. By contrast, Argentina, Venezuela, and Uruguay appear to be moving toward a larger number of effective parties than in the past, with the Uruguayan case further complicated by institutionalized competition *within* the major parties.

A more cohesive party system can offset some of the problems of presidential rule noted above while avoiding the pitfalls of polarization and fragmentation (Weaver and Rockman 1993; Shick 1993). Competition is organized between a smaller number of larger parties and we would thus expect politicians to crowd the political center. The left and movement parties which have resurfaced in more cohesive systems, particularly Chile and Argentina, have had strong incentives to move toward the center. When things are going well, they are less likely to press for the

wholesale reversal of government initiatives; when things are going badly, they are less likely than in the past to gravitate toward radical, polarizing solutions or to back strikes, demonstrations, and protests that complicate the ability of governments to act.

The small number of large parties will also have a moderating influence on the way interests are aggregated. In countries with fragmented or polarized party systems, *anti-reform groups are likely to have a stronger political voice*. In cohesive systems, interest groups operate in the context of encompassing coalitions in which diverse interests are represented and among which compromises must be struck (Olson 1982).

The implications of the party system for policy and administrative reform will depend on what has come before. In fragmented party systems, the move toward a more cohesive party framework can provide the opportunity to organize stable bases of legislative support for presidential programs. In cohesive party systems of long-standing, the problem is how to avoid parties becoming machines for the dispensation of patronage through the public sector. This tendency will depend on a final feature of the party system: the ability of party leaders to exercise control within their own ranks.

Internal party organization

In discussing the parliamentary-presidential debate, it was noted that legislators in a presidential system tend to be responsive to particularistic interests.⁸ However, this might be due to the lack of party discipline rather than to presidentialism. Where party leadership is strong, there is greater prospect of enforcing programmatic discipline. Party strength is likely to be reflected not only in intra-party organization, but in the design of legislative institutions themselves. Strong parties are more likely to favor rules and institutions that further buttress party discipline, such as strong oversight or control committees and extensive agenda-setting and committee assignment powers for party leaders. Of greatest interest here, however, is the fact that strong parties are also more likely to favor effective government.

The strength of the party leadership is contingent in the first instance on overall economic performance and the government's popularity; success strengthens ruling parties and weakens the opposition. However, deeper institutional

factors are also at work, and in particular the extent to which electoral rules encourage politicians to cultivate a personal reputation. Where politicians have incentives to cultivate the personal vote, they are more likely to develop narrow constituent bases of support and to press for specific policies at the expense of party platforms (Cain, Ferejohn, Fiorina 1987). The implications for the reform of the state are outlined succinctly by Shugart and Nielson (1994b, p. 18): "in decentralized systems, party programs are constantly being scavenged by individual politicians for their idiosyncratic interests—they seek to break up national policies into localized or issue-specific parcels in appeal to narrow groups." These particularistic policies take the form of patronage, pork, and the drafting of statutes that are cast in general language, but that are in fact designed to appeal to a narrow constituent—and even individual—base of support.

A number of inter-related rules affect the extent to which party control is centralized, but two are worth emphasizing in the *Latin American context*. The power of party leaders is enhanced when they control access to the ballot and the order in which candidates are elected and where voters vote for parties rather than individual candidates. Closed-list rules, which dominate in most Latin American systems, should in theory encourage loyalty to the party leadership and its platform—assuming one exists! A more open and decentralized nomination procedure and a ballot structure that allows voters to choose individuals rather than party slates allows entrants to free-ride on the party label while simultaneously encouraging them to curry a personal reputation for the provision of particularistic goods.

Politicians' behavior is also affected by whether they compete against members of their own party, as they do in some multi-member district systems. In such competition, party label has no consequence. As the size of the district goes up, and the individual politician is competing with more members both of the opposition and her own party, this competition becomes more fierce. The only way to conduct such rivalry is by stressing personal traits that differentiate the candidate; in effect, politicians are encouraged to pursue what Ramseyer and Rosenbluth (1994) call a "niche" strategy that rests on the provision of particularistic goods and personal services.

Brazil provides a virtual textbook case of an electoral

system in which there are strong incentives to cultivate a personal vote (Ames 1995). Brazil's deputies are elected through a system of open-list proportional representation. Each state is a single, at-large multimember district, ranging in magnitude from 8 to 70 seats. State parties select candidates in conventions, giving politics a strong provincial flavor, and parties cannot refuse to renominate incumbents. Voters can cast ballots either for the party or for individuals, but most opt for the candidate and only candidate votes affect the order of election within the party. A common strategy for building electoral support in such a system is to concentrate on geographically narrow bailiwicks within the district. As Ames (1995, p. 341) shows, "deputies with more clustered votes tended to be pro-Congress, antiexecutive, supportive of state intervention and welfare, and supportive of popular democracy." Above all, these legislators sought pork at the expense of a nationally-defined agenda. A second strategy is to court support from particular functional groups, such as teachers or the construction industry; such a strategy results in a kind of legislative capture, in which the policy agenda of the legislator is driven disproportionately by the interests of a narrow constituency. In either case, the policy consequences are deleterious.

Centralized party control is certainly not a guarantee of good economic policy. Centralized parties might well have ideological platforms that are hostile to economic reform, and the distribution of private goods is also of use in a centralized system (Geddes 1994); Venezuela and Costa Rica provide examples (Coppedge 1988). However, strong parties are more likely to devise mechanisms for controlling the distribution of private goods, either within the party or through delegation to reformed administrative structures (Shugart and Nielson 1994a, 1994b). The controlled distribution of political goods—and even a certain amount of patronage and pork—may actually have a salutary effect on the reform process by building support and compensating losers. The key issue is guaranteeing that such political goods are distributed in a relatively efficient way that does not undermine efficiency objectives; that, in turn, depends on the relationship between politicians and bureaucrats.

Delegation and efficient government

This process of delegation from legislators to the executive branch and from presidents to ministries and agencies is

crucial to the functioning of any democracy; it is a defining characteristic of the modern state. From an efficiency perspective, delegation is the organizational equivalent of the division of labor since it allows gains from organizational specialization and expertise.

Delegation also plays a crucial role in solving collective action problems. For example, legislators have a collective interest in effective fiscal management because it affects overall economic performance and thus their reputations as incumbents. But legislators also have electoral concerns that may tempt them to seek particularistic benefits for their constituents. If all legislators succeed in this strategy, for example through legislative logrolls, then it is easy to see how suboptimal policy might arise; Barbara Geddes (1994) has called this the "politician's dilemma." Even if the problem is recognized, it may be difficult for parties or legislators acting collectively to organize appropriate responses because of conflicts over the distribution of benefits. Delegation to "control committees" within the legislature, to party leaders, to the executive, or to bureaucratic agencies can solve these collective action problems.

The benefits of delegation have given rise to what might be called the technocratic fallacy: the idea that difficult and contentious policy problems can be solved by simply removing them from the hands of politicians and from interest group pressures and assigning them to technocrats.⁹ However, while politicians in a democracy have an interest in delegating for efficiency reasons, they also have an interest in controlling and monitoring bureaucratic agents so that they are attentive to politicians' electoral, constituent, and interest group concerns.¹⁰

There are a number of ways politicians seek to accomplish the objective of bureaucratic control; these may be divided into *ex ante* and *ex post*, or oversight, mechanisms (McCubbins and Schwartz 1984; Kiewit and McCubbins 1991; McCubbins, Noll, and Weingast 1987, 1989). The first and most obvious *ex ante* means is through the legislation or statute itself, for example, by specifying the scope of the regulatory decisions that are delegated to agencies and the legal tools that an administrative agency can use (McCubbins 1985).¹¹ A second *ex ante* control mechanism is through the screening and selection of personnel. Even if executives and legislators are willing to establish a relatively independent, meritocratic civil service, they are like-

ly to insist on political control or at least veto power over top administrative appointments.

Politicians are also likely to exercise ongoing (ex post) oversight over agencies. One way of doing this is through auditing—monitoring and reporting requirements. However, these “police patrol” mechanisms (McCubbins and Schwartz 1984) are quite costly and run up against both moral hazard problems and the difficulty of specifying against all future contingencies.

This problem can be overcome by establishing decision-making structures that build institutional or interest group checks (veto points) into the agency’s decisionmaking process. For example, politicians may require intra-agency consultation or empower affected parties directly. This can occur by allowing interest groups to comment on the agency’s decisionmaking, by structuring participation in regulatory agencies, by granting constituents standing in quasi-judicial administrative procedures, or by strengthening the judicial process more generally. These “fire alarm” structures are less costly, reveal less biased information, and shift policymaking authority to the bureaucracy while allowing for the ongoing representation of affected parties.

The “reform of the state” can thus be seen as a political process of striking a balance between the efficiency gains to be achieved by delegation, the interests of executives and legislators in controlling bureaucratic agents for political ends, and the need for politicians and bureaucrats to remain responsive to organized interest groups.

Three aspects of the political economy of institutional reform must therefore be separated. The first, and the one that has received by far the most attention is the analysis of how bureaucracies can be designed to align the incentives of individual civil servants around larger social and organizational goals. The “new institutionalism” and the application of simple principal-agent models have gone a substantial way in addressing these organizational design problems.

The second and equally important question is understanding the conditions under which politicians will find it in their interest to support efficient administrative structures in the first place. An analysis of the reform of the civil service and of the establishment and reform of regulatory and administrative agencies suggests that the answer to this second question can be found in part in the characteristics of political institutions outlined in the previous section.

Finally, we must consider the conditions under which administrative agencies are capable of maintaining their autonomy and independence over time. In contrast to the technocratic approach to bureaucratic reform, I argue that bureaucracies and agencies gain their independence precisely by building bases of organized constituent support (Evans 1992). This proposition finds validation both in the analysis of civil service reform itself—in which public sector workers constitute the key interest group—and in evidence from two quite disparate policy areas: the conduct of monetary policy and the design of institutions for targeting the poor.

Reforming the civil service

The moving force behind civil service reform in the past decade has been fiscal constraints. The growth in government spending on salaries, wages, and benefits was unsustainable prior to the fiscal crises of the 1980s. The squeeze on government revenues that followed forced a sharp compression in government spending. Most developing countries, including those in Latin America, did not respond by reducing public employment; to the contrary, public sector employment expanded. Public sector wages fell dramatically, however, and wage scales became more compressed.

At first, the perceived solution to the problem was simply to cut the size of the civil service, sometimes in an arbitrary, across-the-board fashion. As it was recognized that cutting the size and pay of the bureaucracy could reduce rather than improve performance, attention shifted to the determinants of organizational efficiency. Just as the literature on rent-seeking offered political reasons why government intervention might distort the allocation of resources, so principal-agent models produced a parallel diagnosis of the sources of bureaucratic inefficiency.

The first observation, and one to which the World Bank has given particular attention, was that pay levels were too low and provided inadequate or even perverse incentives to public sector workers (Nunberg and Nellis 1990; Lindauer and Nunberg 1994; Chaudhry, Reid, and Malik 1994). Falling public sector wages produced a well-documented set of problems including difficulties in recruiting quality civil servants in the upper organizational ranks; declining morale and effort; and increased absenteeism, moonlighting, and corruption (Klitgaard 1988; Gould and Amaro-Reyes 1983). Bureaucracies also responded to pay cuts by

launching countermeasures that only increased the complexity of pay systems, for example, by increasing reliance on bonuses and nonmonetary compensation. Although there are important debates on strategy, the central thrust of employment and pay reform for addressing these problems is increasingly clear (Nunberg 1994; Reid and Scott 1994; Nunberg 1995): targeted reductions aimed at redundant workers; incremental downsizing through recruitment freezes, natural attrition or privatization; adjustment and retraining programs to mitigate the political as well as economic costs of downsizing; and a pay structure that is competitive with comparable work in the private sector.

A second and closely related set of issues has to do with the internal incentives to effort. A number of practices in Latin America tend to weaken these incentives, including tenure guarantees based on performance evaluation, low investment in training, and compressed salary scales (Reid and Scott 1994, pp. 40–42; Klitgaard 1991, ch. 6). These anti-competitive features of bureaucratic organization are exacerbated by various barriers to entry, such as limiting the pool of job applicants for all positions except for entry-level and the very highest ranks to the civil service itself. Again, there are differences in strategy on how to overcome these problems. Nonetheless, the general direction of reform is clear: positive incentives through decompression of wage scales, more competition for advancement, and more discriminating evaluation systems coupled with stiffer punishment for corruption and abuse of office (Nunberg 1995).

Finally, an even broader complex of problems related to the way lower levels of the bureaucracy have been controlled, monitored and evaluated in Latin America exists. Any personnel system faces a tradeoff. Granting agencies discretion has advantages with respect to flexibility. However, it carries risks that lower levels within the organization will lack sufficient capacity to manage personnel decisions effectively, will pursue an independent ideological agenda, or simply shirk. Centralized control of personnel has the advantage of economies of scale and guaranteeing uniformity, but can weaken both motivation and flexibility. Drawing on the lessons of the advanced industrial states, Nunberg (1995) shows that both systems can work. However, she argues that the more decentralized system is demanding of administrative capacity.

As Reid and Scott (1994, p. 45) show, monitoring sys-

tems in Latin American bureaucracies have typically erred on the side of overcentralization, not only with respect to the management of personnel but with respect to the control of *all* inputs such as pre-control of expenditure decisions; central assignment of employment slots; centralized pre-approval of hiring, firing, promotions, and salary adjustments; and detailed specification of performance review procedures. A system that monitors on the basis of agency outputs provides greater flexibility to managers and focuses monitoring efforts on more appropriate indicators while simultaneously aligning incentives around the ultimate agency goals of producing particular public goods and services. Again, the general direction of reform is clear (Nunberg 1995). Ministers should hold agency heads responsible for output and efficiency; grant them greater discretion in the control of inputs, including hiring and firing decisions; and improve the technical quality of financial auditing and monitoring procedures.

These observations concerning the internal sources of bureaucratic failure have been buttressed by lessons drawn from apparent success stories. As with economic policy more generally, the East Asian cases are held up as models. Analyses of the Japanese bureaucracy have long stressed features that conform to the “internal incentive” model just sketched: meritocratic recruitment; high levels of status and remuneration, particularly at the senior grades; intense competition for advancement; and idiosyncratic institutions such as the ‘amakudari’ system that rewards loyal and successful civil service careers with lucrative private sector positions upon retirement (Silberman 1993, pp. 198–222; Koh 1989; Pempel 1994). Similar analyses of the internal incentive structure of the bureaucracy have been advanced to explain coherent economic policymaking in Korea, Taiwan, Hong Kong, and Singapore (see for example Burns 1994).

These incentive-based models of bureaucratic inefficiency sidestep a more fundamental explanation for internal bureaucratic inefficiency: that politicians prefer it that way. Paying closer attention to patterns of recruitment reveals the critical links that exist between the bureaucracy and politicians and suggests the conditions under which bureaucratic reform is more or less likely.

To understand these political strategies requires a differentiated view of the civil service as encompassing several distinct classes of workers (Stevens 1994). First is what

might be called the “core” civil service, which in turn is made up of an “inner core” of professionals that occupy top managerial positions and the remainder of staff support and line workers. Clearly the quality of public policy will be strongly conditioned by the professionalism, expertise, and stability of the administrative elite, and it is usually this group that is the target of incentive reforms designed to make public service more attractive. Beyond the core civil service, however—and typically larger in size—there are employees engaged in separate services, including teachers, health workers and the police, budget-dependent agencies, and public enterprises. Finally, there are a large number of workers that are hired on a short-term, even daily basis, typically at the discretion of ministries responsible for public works programs.

An undue emphasis on internal bureaucratic rules overlooks the political logic driving government policy toward these different classes of employees. Many of the occupants of high bureaucratic office in Latin America are political appointees made directly by the president or indirectly by his appointed ministers. The logic of these appointments reflects very clearly the politician’s dilemma outlined above. Presidents and their ministers clearly seek expertise on highly technical issues such as macroeconomic policy; their reputations for competence among both the electorate at large and with investors hinges on such perceptions of competence. Politicians often have strong incentives to appoint technocrats, and technical advisors have played an important role in the economic reform process in the last decade (Centeno 1994).

However, political appointments are also made with at least three other objectives in mind: to guarantee particularized benefits for constituents; to guarantee particularized benefits for party activists; and to secure the support of legislators (Geddes 1994, p. 135). These calculations play a role not only at the top—for example, in the allocation of ministerial and sub-ministerial portfolios—but at the lower levels of the bureaucracy. A crucial political fact in a number of Latin America countries is that certain segments of the bureaucracy, including teachers and employees of state-owned enterprises, are extensively unionized and can constitute a major barrier to civil service reform. The hiring of short-term and casual workers can provide a kind of indirect social safety net that can be targeted quite narrowly for political ends.

The balance between various criteria for appointment will vary depending on the institutional factors outlined in the previous section. For example, presidents who sit atop strong encompassing or established parties are more likely both to favor meritocratic reform and to be able to implement it. The choice of top advisors is more likely to be driven by calculations of competence because the ruling party’s interests are encompassing and include a desire to attract respected independents. Though such governments may pursue a partisan strategy with respect to inessential appointments, their interests with respect to the reform of the lower ranks of the bureaucracy are also more likely to be influenced by broader programmatic interests, particularly the efficient delivery of services.

Curiously, executives from parties with strong ties to labor may also be willing to pursue a strategy that favors meritocratic and loyalty considerations rather than partisan ones (Geddes 1994, p. 148); Menem provides an example. The key interest group with respect to civil service reform is, of course, civil servants themselves. Securing their support or at least acquiescence thus constitutes the primary political challenge. The Peronists were capable of achieving one of the most dramatic reforms of the civil service in Latin America in part because of the concentrated powers Menem enjoyed, but also because of the ruling party’s historical ties with labor.

By contrast, presidents with weak party support in the legislature, with weak ties to labor, or who face strong pressure from legislators face different incentives. Such executives are less likely to confront or bargain credibly with public sector unions and more likely to use the bureaucracy as a source of patronage. They are more likely to use top appointments to solidify a core base of support and to build legislative or interest group support. In times of crisis or even flagging popularity, ministers are likely to be sacrificed on short-term political grounds, generating a correspondingly high level of instability. Naím (1994, pp. 25–26) finds, for example, that since 1988, the average Latin American minister held his job for less than fifteen months. Though he suggests that these low averages probably had to do with inadequate pay, he also notes that this average was driven up by relatively long tenures in Mexico and to a lesser extent Chile and Colombia; Mexico and Chile are precisely the countries in the continent with the most cohesive ruling parties.

In weaker political systems, including those that are particularly vulnerable to labor protest, the approach to civil service reform is likely to take a fragmented or "compartmentalized" (Geddes 1994, pp. 143–44) form. Presidents will be willing to increase the competence of agencies that perform functions of key importance to the government's overall electoral chances; for example, a number of countries granted greater independence to central banks in the conduct of their personnel policy (Maxfield 1994, ch. 5) because inflation had become a salient electoral issue. But this strategy might be coupled with an unwillingness to tackle reform of other ministries or agencies.

To understand the implications of these observations for reform strategies demands a closer examination of the options. Bernard Silberman (1993) provides a useful entry point into the question. Silberman argues that modern bureaucratic organizations have evolved along one of two distinct lines. The first he labels "organizational." Under this approach to organizing the bureaucracy, individuals commit to a bureaucratic career path *prior* to entering office. An independent government agency screens eligible candidates through highly specialized courses of university training or specific schools designed exclusively as training grounds for the civil service. Commitment to the bureaucratic career is lifelong, career tracks are highly predictable though competitive, and individuals are strongly socialized into bureaucratic norms, including those of specific agencies. Such a system is typically associated with low-level political appointments to high-ranking bureaucratic positions; in Japan, for example, the prime minister's direct appointment powers in the bureaucracy are limited to the ministers! Silberman argues that this orientation emerges when new political leaders seek to provide assurances that they will not behave in an arbitrary manner and build a highly independent elite cadre of civil servants to achieve this objective; Meiji Japan and Napoleonic France constitute examples.

Under the contrasting "professional" orientation, characteristic of the United States, individuals "train" for the bureaucracy by acquiring specialized professional expertise, for example, as lawyers or economists. Individuals frequently enter the civil service laterally at high levels; as a result, the bureaucracy is more permeable to interests and values from the outside. Given that the appointment powers of political executives tend to be more extensive in such sys-

tems, career paths are less predictable and seniority plays less of a role. These arrangements are tolerable to potential civil servants because they have the option of returning to non-government work. Silberman argues that this "professional" orientation is more likely to arise in competitive democratic contexts in which governments seek to limit the costs of patronage and corruption while still maintaining control over the bureaucracy through political appointments.

Though a Japanese model of civil service reform has been suggested for Latin America, it is clear that the highly competitive nature of democratic politics in the region is more likely to push in the direction of the second, "professional" approach to bureaucratic organization; the main question is how to get there most efficiently. In countries with "strong" governments—strong presidents and parties backed with robust legislative and labor support—there is greater plausibility in pursuing encompassing reform strategies that are administratively centralized and seek to cover the entire bureaucracy. It is even possible that some countries may succeed in moving toward Silberman's more demanding "organizational" model for the upper reaches of the bureaucracy, though Argentina's attempt to create such an administrative elite did not prove successful.

However, the best should not be the enemy of the good. In weaker governments, a partial reform strategy based on pilot programs and an agency-by-agency approach is likely to be more in line with political incentives: politicians gain from reform of key agencies responsible for core government functions, particularly with respect to economic policymaking, while maintaining some latitude with respect to other portions of the bureaucracy. Such a partial strategy may also have the advantage of providing "localized" but concentrated bases of support for bureaucratic rationalization; the significance of such support can be seen by broadening the discussion to an examination of the political design of agencies more generally.

The political design of regulatory and administrative agencies

Civil service reform raises the question of the extent to which executives and legislators are willing to shield the bureaucracy from political pressures on the conduct of *personnel* policy. However, there is also the broader question of the conditions under which politicians will delegate policy-making responsibility to autonomous and indepen-

dent agencies, and the organizational arrangements that will guarantee that those agencies have the independence required to consider the public interest and the incentives to do so.¹²

This question will be a central one for Latin American countries over the next decade for three reasons. First, though economic reform implies that the core ministries will not intervene *directly* in markets to the extent that they have in the past, the government must take on a variety of *new* regulatory functions to guarantee that markets work efficiently; the oversight of the financial sector and competition policy provide examples. Second, privatization has loosened the government's ability to control firm behavior directly in a number of sectors, including utilities, telecommunications, and segments of the transportation industry. New regulatory structures will have to be devised to oversee these activities. Finally, the process of political opening and democratization has given rise to new social demands for regulation in areas such as the environment, occupational health and safety, and product liability, as well as calls for improved social services.

The design of efficient administrative and regulatory institutions is obviously a vast topic, yet two seemingly contradictory observations are important for understanding the politics of successful reform strategies. First, though politicians can delegate authority to autonomous and independent government agencies, they do so to solve particular political problems. The efficiency of delegation is thus affected by the broader political and institutional features of government outlined above; governments will vary in their willingness to grant broad bureaucratic discretion. Second, the independence of bureaucratic and regulatory agencies ultimately rests not simply on statute, but on their effectiveness in providing services to interested constituencies who provide agencies with support, and even protection.

Perhaps the clearest example of delegation has come in the area of monetary policy. As with the reform of the civil service, economic crisis has served a catalytic role in moving politicians toward granting greater independence for core economic policymaking institutions. Inflation has become a highly salient political issue and macroeconomic stability is seen as crucial for attracting both foreign and domestic investment (Haggard and Maxfield forthcoming). Yet governments face an obvious problem in establishing their credibility in the conduct of monetary policy, namely, that

stability is always reversible and reputation emerges only over time. Delegation can provide such assurances by transferring authority to agencies that have both a mandate and incentives to pursue stable policies. This process of delegation might occur through the signing of international agreements, as with the Maastricht treaty, but more commonly it comes through a strengthening of the central bank.

In the 1990s, four Latin American countries moved in the direction of more independent central banks: Argentina, Venezuela, Colombia, and Mexico (Maxfield 1994, ch. 4). Chile should be added to this list. Although Pinochet strengthened the independence of the central bank in the 1980 constitution, negotiations with the opposition in 1988–89 guaranteed that those provisions would not be overturned during the transition to democratic rule.

In all five cases, strong partisan backing constituted an important precondition for the *de jure* strengthening of central banking institutions. This strengthening occurred both through changes in the central bank's mandate, such as giving greater weight to price stability or limiting the obligation to finance government deficits, and through changes in appointment processes and procedure that guaranteed independence, such as stipulating terms of office that are independent of the electoral cycle or granting greater leeway in the hiring and promotion of personnel.

Although Pinochet had hoped to stack the board of the Banco Central de Chile with his own appointees, negotiations with the opposition led to several institutional and personnel compromises. However, the opposition was at that point cohesive, united in its political strategy, and surprisingly in agreement with the government on the virtues of maintaining macroeconomic stability. In Argentina, the process was somewhat more protracted, but a new central bank statute was passed in mid-1992 by the Peronist government (Miller 1993, pp. 1073–74); as with earlier reforms, this one drew on strong legislative backing. Venezuela and Colombia took somewhat different routes to central bank reform. In Colombia it was incorporated initially into the 1991 constitution, while in Venezuela it was handled by statute. Nonetheless, the importance of strong partisan leadership is clear. Mexico's introduction of new central banking legislation in May 1993 also conforms to expectations as do the continuing difficulties in reforming

central banking institutions in Brazil.

While politics is important in explaining the willingness to grant greater *de jure* independence to central banks, such legal autonomy is only a necessary rather than sufficient for the conduct of an independent and stable monetary policy. For example, Cukierman, Webb, and Neyapti (1992) find that independence defined in terms of legal rules has an influence on monetary policy in the advanced states but not in developing ones, where turnover is higher and informal channels of political influence operate to a greater degree. Yet even studies of the advanced industrial states have noted that legal independence is typically buttressed by patterns of representation within the bank itself that constitute checks on political manipulation.

These checks may be intergovernmental or involve the legal empowerment of key social interests. Susanne Lohmann (1994) has shown how the independence of the German Bundesbank is not simply a function of statute, but of strong representation on the bank board by regional appointees. Federalism reduces the likelihood that the central government will control appointments in such a way that they could use the bank for partisan ends. Mexico confronts the opposite problem. Even in the face of strong statute granting the bank independence, the centralization of the political system and the power of the president makes it difficult to establish checks and balances that guarantee that interference will not occur, even when the president himself wants it.

In the United States, the financial system itself plays an important role in checking monetary policy. The independence of the Federal Reserve system in the United States is buttressed by the fact that it is owned by the banking system. Similarly, Sylvia Maxfield (1994) has argued that independent central banks in developing countries are more likely where the domestic financial system is strong.

Similar points may be made by looking at a policy area completely different than central banking. How can the poor be effectively targeted? One mechanism for doing this that grew out of the crisis of the 1980s was the creation of social investment funds (Graham 1994; Glaessner and others 1994). Some, such as Bolivia's pioneering Emergency Social Fund, were launched by presidents; others, such as Peru's, were passed by legislatures. In all cases, however, the funds were initiated in conjunction with stabilization and structural adjustment programs, and had as their

objective not only the alleviation of poverty but the political motive of securing support for reform programs (see Cordoba 1994 on Mexico).

As a result of this important political motivation, politicians have had a strong interest in seeing such programs work, and have been willing to experiment with new institutional arrangements to guarantee that they do. First, as with central banking, some of the independence comes from the mandate itself. Most of the funds use targeting mechanisms based on objective poverty and income criteria to reach beneficiaries and have clearly specified project criteria; as a result, their operations are more transparent.

Second, most of the funds have a high degree of *procedural* autonomy that protects them from political interference in the project approval process by either politicians or interest groups. Key to achieving this objective have been a number of exceptions to normal bureaucratic regulations and procedures. Probably the most important has been the choice of private sector managers to direct the funds' operations and related exemption from public sector rules on staff recruitment and salaries. Glaessner and others (1994, p. 5) note a variety of other ways in which the funds have gained independence:

No less important has been the exemption of most of the funds from government procurement and disbursement procedures. . . . Perhaps even more important was that as autonomous entities, the availability of the funds' resources was subject neither to the vagaries of the annual budget cycle and central government cash management, nor to the often cumbersome mechanisms for transferring central government funds to local and municipal governments.

The political stability of the funds has not solely been a function of these "internal" features of their organizational design; it has also been related to the fact that they have been "demand driven" and thus actively engaged a geographically dispersed set of constituents. The funds are financial intermediaries rather than implementing agencies. Local and provincial governments and nongovernmental organizations have thus been mobilized to participate in the choice, design, execution, operation, and maintenance of SIF fund projects ranging across basic health care and nutrition, education, water supply, and sanitation services.

Similar points could be made by examining the myriad policy areas that have been characterized by deregulation and reregulation (Baer and Conroy 1993), however, the essential points would be the same. First, institutional reform of regulatory agencies arises to solve political problems, and not before. Second, it is most likely to be stable and thus credible where there is strong legislative support and where the party system is not polarized or fragmented in a way that would lead investors to expect the possibility of future policy reversal. Finally, the procedures that govern the operations of regulatory agencies, including the representation of affected interests, can serve as an important protective device by building in checks and veto points against undesirable policy change.

Decentralization

A second central area of debate about the reform of the state centers on the relative merits of centralization and decentralization of government. This debate has been confused by the multiple meanings given the term. An influential definition offered by Rondinelli and Nellis (1986, p. 13) refers to:

the transfer of responsibility for planning, management, and the raising and allocation of resources from the central government and its agencies to: a. field units of central government ministries or agencies; b. subordinate units or levels of government; c. semiautonomous public authorities or corporations; d. areawide, regional or functional authorities; e. nongovernmental private or voluntary organizations.

Each of these forms of decentralization poses quite different political and organizational problems. The problems surrounding delegation to semiautonomous public authorities have already been discussed. The last—the assignment of tasks to private social actors—raises a series of important issues about privatization of services, civic associations, and NGOs that are beyond the scope of this paper (Cernea 1988). I focus here on the first two forms of decentralization, which Rondinelli and Nellis label deconcentration and devolution respectively.

In the first form of decentralization—deconcentration to lower levels within existing agencies—tasks and authority are passed downward in the hope of generating production efficiencies. This might occur in several ways. Specialized

knowledge of local conditions and prices allow geographically dispersed subunits to deliver services more efficiently within their jurisdiction. Increasing the number of providers also decreases the inappropriate homogeneity of service provision typically associated with a high degree of centralization and increases the probability of innovations that can be transferred to other jurisdictions; decentralization thus increases organizational learning through intra-organizational competition.

Theorists of organization have emphasized that despite its presumed advantages, intraorganizational decentralization generates a number of control and incentive problems; for a review see Cremer, Estache, and Seabright (1994). The higher level of the organization faces both adverse selection and moral hazard problems: lower levels know what information their inputs are based on, can use them to their own advantage, and have incentives to shirk or distort policy, particularly by serving local clients at the expense of the government's programmatic purposes.

Yet an equally important problem is that this form of decentralization does not establish institutionalized checks on government action and thus permits programs to be manipulated for political ends. Indeed, it is somewhat puzzling why executives and the leaders at the top of ruling parties would prefer the more radical step of transferring powers to independently elected state and local governments. First, such delegation reduces the prerogatives of executives, who typically use gubernatorial and municipal appointments as a mechanism for building bases of electoral and social support. Second, downward delegation to lower levels of government restricts the policy freedom of ministers and central government officials as well. By maintaining central control, administrative deconcentration permits the executive to equalize the distribution of resources and services not across the entire country on the basis of need (as the normative theory of fiscal federalism would suggest), but across the politicians required to maintain a ruling coalition. Decentralization with continuing central control allows ministries to respond in a targeted way to the electoral needs of both executives and geographically-rooted legislators, particularly where governments are politically vulnerable.

Carol Graham's (1994, pp. 98–106) work on the *pueblos juvenes* or shantytowns of Peru is instructive on this point and provides a point of comparison to the more effective

social investment funds discussed in the previous section. Graham shows how the *pueblos juvenes* have a rich variety of local self-help organizations such as soup kitchens and mothers' clubs, some autonomous, some fostered or supported by municipal governments. On coming to office in 1985, the APRA government initiated two centrally-administered programs for the urban poor: a Program of Direct Assistance (PAD) and the Program of Temporary Income Support (PAIT). Graham shows that despite a decentralized organizational structure that included local offices, both were manipulated for party ends, often in an effort to upstage or undermine local governments controlled by the opposition. Moreover, both also had the effect of marginalizing and "crowding out" local organizational initiatives. Such criticisms have also been leveled against elements of Mexico's PRONOSOL program, which, despite apparent efforts to decentralize, retains a highly centralized structure that mirrors that of Mexico's strong-president, party-dominant political system (Cornelius, Craig, and Fox 1994, pp. 14–15)

The second form of decentralization—devolution to lower levels of government—is more interesting, because the resurgence of state and municipal governments constitutes one of the most important concomitants of the transition to democracy in Latin America. The larger Latin American countries already had federal traditions at the time of the transition to democratic rule. In Brazil, gubernatorial elections had been hotly contested under military rule despite electoral rules that disadvantaged the opposition in a number of ways, and Argentina has retained its federal structure. Mexico is much more centralized politically because of the extraordinary powers of the president, but it also has a formally federal system and recent state elections are increasingly contested. The transfer of powers to provincial and municipal governments is also visible in unitary systems such as Chile and Colombia, or nominally federal systems such as Venezuela, in which governors had previously been appointed.

The theory of fiscal federalism advances a number of reasons to believe that this transfer of powers and responsibilities is salutary. First, each public service should ideally be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs. It is plausible that for a number of services, this jurisdiction would be small, though in theory

this rule could give rise to a complex set of overlapping jurisdictions covering different policy areas (Oates 1972; Olson 1969, 1986) Second, since tastes vary across jurisdictions, decentralizing the allocation of taxing powers and service provision will more closely match the distribution of local preferences and thus enhance welfare.

In addition to the advantages of decentralization with respect to production and allocative efficiencies, delegation to lower but independent levels of government has an important political advantage: it will institutionalize checks on government that are lacking in the model of intraorganizational decentralization just sketched. These checks occur through the introduction of political competition at the local level. Political competition constitutes a form of monitoring, since it provides incentives for those seeking public office to ferret out those policies that would not be ratified by the local electorate or that have failed in implementation.

Political competition also creates opportunities for local policy entrepreneurship as political entrants devise and publicize alternative programs in their effort to secure electoral support. The positive effects of encouraging the development of NGOs at the local level come not only from their direct provision of services—itsself a form of slack-reducing competition—but through the performance of similar monitoring functions.

However, the decentralization process has proven extremely problematic. In some countries, revenue transfers have run ahead of expenditure or functional transfers, contributing to central government fiscal problems. Transfers are still encumbered with central government requirements, and local revenue raising capacity is falling in some countries.

Some of those problems have to do with sheer bureaucratic capacity. A leitmotif of the analysis of decentralization in Latin America is that state and local governments are incapable of managing the tasks that have been handed to them (Campbell, Peterson, and Brakarz 1991, pp. 38–43; Bird 1994, p. 10). Building such capacity is thus no less important at the local level than it is at the central; without it, hopes for an increase in production efficiencies are unrealistic.

However, as the analysis of civil service reform at the central government level has shown, capacity is only part of the problem. The political and organizational incentives that characterize the relationship between central and local

levels of government can also be problematic. Three such problems are the continuing political interest of the central government in exercising policy control; the political difficulties faced by local governments in assuming responsibilities and the corresponding incentives to shirk and maintain their dependence on the central government; and features of local government organization that make them less-than-perfectly representative of constituent interests and vulnerable to capture by local elites.

The interest of central government authorities in maintaining control over local government spending priorities—typically through the design of intergovernmental fiscal transfers and grants—can be justified on both public goods and equity grounds. Continuing control might be appropriate if the full transfer of authority results in jurisdictions of inadequate scale to fully capture the externalities from the provision of public goods. Control is also justified by concerns of both interpersonal and interjurisdictional equity.

However, it is equally plausible that the interest in maintaining central control, and thus the design of intergovernmental fiscal transfers, is directly related to coalition-building and electoral strategies.

In more centralized systems, we would expect the geographic allocation of spending to be strongly influenced by the executive, as appears to be the case in Mexico. Spending decisions by the Salinas administration's National Solidarity Program (PRONOSOL) have been concentrated in the presidential office, and have been used not only for the broader purpose of maintaining support for the structural adjustment effort (Cordoba 1994), but also for more targeted electoral purposes (Molinar Horcasita, and Weldon 1994). Interestingly, despite a Municipal Reform Act in 1984, effective political power has remained at the state and federal level; genuine delegation to municipal government has been stymied (Rodriguez 1993).

In countries where the personal vote is more important, such as Brazil, the design of intergovernmental fiscal transfers is likely to be heavily conditioned by the triangular relationship between the president or minister, individual legislators, and local governments that fall within the legislator's bailiwick. Barry Ames (1995) provides interesting evidence from Brazil on how legislators seek to build and buttress crucial local bases of support by acting as brokers between ministries and local governments.

The second problem has to do with the political incentives of the provincial and local governments themselves. It is a standard finding of the fiscal federalism literature that its beneficial effects are related not only to the transfer of responsibilities, typically service provision, but also to the enhancement of local fiscal capacity. However, the typical pattern has been for the transfer of resources to occur prior to the assumption of full policy responsibilities or local fiscal strengthening. The political reasons for this pattern are obvious. Such transfers constitute an unmitigated plus for local politicians by enhancing the ability to deliver services while simultaneously relieving local governments of the difficult task of raising taxes and user fees to fully cover the incremental cost of their provision. However, the pattern is also clearly unstable. Once such transfers are in place it becomes politically difficult to withdraw them because of the perverse incentives that result.

The difficulties of moving toward real fiscal federalism can be better understood if the relationship between levels of government is viewed as a bargaining game. The capacity of the local government to influence or blackmail the center will hinge on the political vulnerability of central government officials. This, in turn, is a function both of short-term electoral and coalitional constraints and more enduring institutional features of the political system.

In federal systems such as Argentina and Brazil, state governments are large and governors wield quite substantial political power. In Argentina, members of the Chamber of Deputies are elected from closed party lists and Senators are elected in provincial legislatures by plurality, two for each province and two from the capital. Thus not only are deputies elected provincially, but provincial party organizations have substantial independence. This tendency toward the provincialization of politics is reinforced by the timing of elections. Only one half of the deputies and one third of the senators are elected concurrently with the president. This staggering of elections means that provincial electorates vote frequently, and if the president is to avoid the ever-present possibility of a divided government, he must be continually attentive to regional demands.

Not surprisingly, there was a clear relationship between the weakness of the first Argentine democratic government and the deterioration of the balance between central and provincial governments. Since intergovernmental fiscal transfers under Alfonsín took a highly discretionary form,

there was an incentive for the provinces to compete in running deficits in order to secure a larger share of the grant. As a result, provincial government expenditures—particularly for wages and salaries—increased dramatically while revenues as a share of GNP actually fell slightly. The pre-transfer fiscal deficit of the provinces in 1986 was a full 6.2 percent of GNP, financed by a combination of a posteriori discretionary grants from the Ministry of Finance and strong pressures on the central bank to bail out provincial financial institutions. One purpose of the 1988 Revenue Sharing Law was precisely to overcome this collective action problem by making transfers more predictable and transparent.

Yet ruling parties may even be vulnerable to a municipal electoral cycle, particularly where there are nonconcurrent elections that turn municipal contests into referenda on the government's performance. The Belaunde government in Peru faced particularly strong electoral challenges from the left and populist opposition in municipal elections, challenges which played a role in derailing his reform program.

Thus the central problem of reordering intergovernmental fiscal relations can be seen as one of credible commitments. Can the government commit to greater control over transfers, for example, by establishing firm rules? The answer is clearly "yes," even in federal systems. Argentina was able to reverse the difficulties it faced through a reform effort in 1988 and Brazil is currently considering how to manage the difficulties created by the revenue-sharing provisions of its 1988 constitution. However, the exercise of control rests on political and institutional factors. Mexico has had few problems with state-level finances, because the executive branch is strong and has little political dependence on the governors. In Argentina and Chile, the strength of ruling coalitions was the basis of the reform effort. In Brazil, change will hinge on the ability of the new administration to rally support for constitutional change, even against the interests of legislators in the ruling party.

Finally, there is the key question of whether the structure of local government is conducive to an improvement in the quality of governance. Opinion on this issue remains divided, and the key questions are ultimately empirical rather than theoretical. On the one hand, local governments should be more responsive to the preferences of

smaller groups, or even individuals, and there are reasons to believe that the barriers to political entry may be lower at the local level. On the other hand, the problems of capture by local elites or party machines, and even of intimidation of opponents, is a perennial one in Latin America.

Given this indeterminacy and the need for further research, we can only conclude by noting again that institutional arrangements will play an important role in determining the responsiveness of local government just as they do at the central government level. There are a variety of institution-building activities that could reduce slack and increase responsiveness to citizen demands by improving the ability to monitor what local governments do. Some of these fall under the rubric of "capacity," such as increasing the local capability of both governmental and nongovernmental actors to analyze the effects of alternative policy choices. Other measures relate to the goal of increasing the transparency of government action, such as making public the performance records of the government with respect to particular issues (roads constructed, sewers extended, houses fitted with potable water, and so on).

The ultimate check on government must come through institutionalized forms of participation. This may either be "corporatist," such as building in NGO participation in areas in which they have expertise, or "legislative," such as adopting forms of local governance in which citizen participation is maximized. Elected municipal councils working either with a city manager or mayor that hold open meetings are superior in this regard to mayors who operate without such advisory or legislative bodies, and are thus more likely to make decisions privately, or in consultation with narrow constituencies.

However, features of the national party system may also make an important difference at the local level. Strong national parties with local roots are likely both to communicate local policy preferences upward and to act as a source of discipline on the nature of local candidate selection. Such discipline will be lacking where local political officials have an incentive to forge independent alliances with legislators around particularist programs.

Conclusion

In other work, I have emphasized the distinction between the initiation and consolidation of economic reform (Haggard and Kaufman 1995, ch. 5). This distinction is

also of use in understanding the process of administrative change or "reform of the state." The initiation of reform implies a rupture with the past that is more likely when the power of central decisionmakers is high. Major initiatives appear to be associated with the achievement of some degree of executive autonomy not only from interest groups but from legislators as well. This might occur through "honeymoon" effects and "mandates" following electoral victories, or by the exploitation of legislative or decree powers. However, it appears most effective when backed by explicit delegation from legislative coalitions.

In consolidating institutional reform, by contrast, political leaders are faced with the challenge of stabilizing expectations around a new set of incentives. For reforms to be credible, economic agents must believe that they cannot be easily reversed at the discretion of individual decisionmakers or of electoral challengers. Achieving this continuity, especially across changes of administration, implies different patterns of state-society relations from those that facilitate policy innovation. Such consolidation ultimately rests on political support from discrete groups of private sector beneficiaries, and at least the acquiescence of the major political forces competing within the political system. Without such tacit or explicit alliances between politicians, technocratic elites, and those gaining from the reform effort, reform attempts will necessarily falter.

If true, these findings have important implications for administrative reform. In particular, they call into question what I have called the technocratic fallacy: the idea that the goal of administrative reform is to remove policymaking from the hands of politicians through delegation to insulated bureaucratic agencies. Rather, the objective is to achieve such delegation while also satisfying the underlying political objectives of politicians. Like policy reform itself, the design of new administrative structures must be seen as a coalition-building process.

Notes

1. This is more true of devaluation and trade liberalization than it is of privatization, but the generalization still holds.

2. This observation can be given a formal treatment. For either a particular policy or institution to be in political equilibrium means that it cannot be overturned by any decisive coalition, that is, by a group of actors empowered by the policymaking rules to replace an old policy with a new one. See Hammond 1995, p. 27.

3. Technically, this axiom is somewhat more complicated than it

might first appear. It is typically grounded on the assumption that politicians seek re-election (Mayhew 1974). However, this may be affected by term limits or by incentives to use electoral office as a stepping stone to other positions, both governmental and non-governmental. Nonetheless, I assume that politicians are responsive to some constituent base, either through an electoral or lobbying connection.

4. A theoretical literature has also begun to explore the policy and administrative consequences of parliamentary and presidential rule (Moe 1990; Weaver and Rockman 1993; Moe and Caldwell 1994; Palmer forthcoming).

5. The existence of fixed terms for both president and legislature has also been a target of criticism. On the one hand, the bias in Latin America toward a no re-election rule means that good presidents are not capable of staying on. On the other hand, it is extremely difficult to change governments when the legislature and the president have lost political support and exhausted leadership potential. Presidentialism served to prolong economic crises in Brazil and Peru, where presidents Sarney, Collor, and Garcia outstayed their effectiveness. In Bolivia and Argentina in the 1980s, lame duck presidents were forced to resign before the expiration of their terms. Changes of government would arguably have come earlier and more smoothly under parliamentary rule through votes of no confidence.

6. Given their divergent political interests, divided political authority can also create problems even if the president's own party holds a legislative majority, and will be still more marked when executives are limited to a single term, as they typically are in Latin America.

7. See Geddes 1994 on bureaucratic corruption in presidential systems.

8. This section draws extensively on Shugart and Nielson 1994a and 1994b and the analysis by Ramseyer and Rosenbluth (1994) of the Japanese electoral system.

9. For similar criticisms see O'Donnell 1991, 1994; Bresser Pereira, Maravall, and Przeworski 1993.

10. Of course, they may not always be able to do so. Principal-agent models have suggested a number of reasons why government bureaus and agencies may exercise substantial discretion beyond politicians' control: bureaucratic control of information; agency-clientele links that protect agencies from their nominal political overseers; and the high cost of sanctioning bureaucratic malfeasance or of redirecting agency behavior through new legislation (Weingast and Moran 1983).

11. Of course, the threat of crafting new legislation constitutes an ongoing instrument of political control.

12. Such delegation is not only important for the coherence of policy in the short run, but also for the credibility of policy in the eyes of investors and market agents (North and Weingast 1989).

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Comment on "Reform of the State in Latin America," by Stephan Haggard

EDGARDO BOENINGER

THREE POLITICAL PROCESSES THAT ARE OCCURRING IN LATIN AMERICA LIE AT THE HEART of the macro level of state reform: the establishment and consolidation of democratic institutions, the transformation of state-controlled to market-oriented economies, and the search for policies and programs to cope with poverty, inequality of opportunity, and extreme disparities in incomes and assets. Firm political choices, responsiveness, effectiveness, and efficiency are required to keep these processes on track.

Politicians and technocrats must agree on policy to achieve sustained, coherent action. To facilitate consensus, technocrats should be encouraged to play political roles, politicians should continue learning more about economic matters, public decisionmaking should be based on established consultative mechanisms, and coalitions between the minister responsible for economic policy and those responsible for political affairs should be developed. In addition, politicians and technocrats should ensure compatibility between policies and measures that are friendly to growth and those that will enhance equity.

Reform priorities in Latin America should include the development of stronger legislatures and independent and modern judiciaries. Reforms should also address the polarization that has affected Latin American politics in the past. Fragmentation of the party system and lack of internal cohesion and discipline must be reversed. Electoral systems with moderate proportionality, thresholds, and a limited number of seats per district are also required.

What can Latin America do to reduce opposition to reform? First, simultaneous election of presidents and con-

gresses reduces the likelihood of divided governments and ties congressional candidates to presidential platforms and national policies. As a result postelectoral government policy is more consistent. Second, politicians in Latin America should continue delegating authority to autonomous agencies and regulatory bodies. Delegation, however, must assure that political goals can be achieved without giving agencies discretionary powers that can lead to arbitrary administrative actions or new forms of state interventionism.

As agreement is reached on the fundamentals of economic policy and as citizens become more sensitive to government performance and the evils of inflation, politicians are finding it increasingly important to consider national issues and policy goals as crucial inputs in defining their behavior. Recognizing that growth is a requisite for expanding employment, increasing salaries, and enhancing equity also encourages politicians to alter their actions.

Presidentialism is likely to prevail in Latin America in the foreseeable future despite strong theoretical arguments favoring parliamentarism. Presidential regimes should be

engineered to include clear, constitutional definitions of legislative and executive powers and be limited to short (four- to five-year), single terms. Limiting administrations to a single term will eliminate the opposition's need to adopt negative policies that destroy incumbents' chances for reelection and that make it difficult to reach consensus on national issues. It will also reduce temptations to abuse power and strengthen democratic institutions as faith is put into institutions instead of individuals.

All-in-one reforms present some inherent problems. First, bureaucracies are not capable of absorbing all the changes that accompany comprehensive reforms. Second,

comprehensive reforms are costly in terms of transaction costs and costs of learning new rules and procedures. Third, comprehensive reforms require that policymakers simultaneously deal with a broad range of issues and so make it difficult to reach agreement on specific solutions. Lack of consensus provides an opportunity for coalition building among opponents of reform. The challenge, then, is to reform gradually within the bounds of local managerial capability while avoiding control by local parties, ensuring coherent national policies, and responding to equity concerns.

Comment on "Reform of the State in Latin America," by Stephan Haggard

ROGER DOUGLAS

POLITICIANS' ATTEMPTS TO SATISFY THE DEMANDS OF INTEREST GROUPS OFTEN LEAD to economic and social problems as well as demands for government reform. Therefore, rather than focus on special interest groups, the state should concentrate on consumers, voters, and taxpayers.

How can interest group politics and its problems be overcome? First, political leadership is vital. Leadership requires understanding that political survival depends on making quality decisions and that compromises with interest groups lead to voter dissatisfaction and political suicide. It also requires an understanding that voters place a higher value on improving their medium-term prospects than on actions that make things look good in the short term. When governments focus on immediate satisfaction, the accumulated costs must be paid at some point in the future. Ideally, governments should accept initial costs and temporary discomfort in exchange for longer-term benefits.

The objectives of interest groups are complex and diverse. None welcomes the idea that their privileges may be removed, and so all work to protect their interests at the expense of taxpayers and consumers. Consensus among interest groups rarely takes place before quality political decisions are made. Instead, it develops as the implications of these decisions become apparent.

If the interests of consumers and taxpayers are put first a number of other issues will fall into place. First, the government's role in serving the interests of consumers becomes obvious. Second, governments will begin to concentrate on doing the things they do best. Finally, politicians will learn to avoid getting tied up in the means and will concentrate on end results, such as better health care and better education.

The politician's role is to focus on desired outcomes, set the policy agenda and objectives, determine the regulatory

environment needed to ensure that objectives are met, and ensure that the maximum amount of competition takes place. As a natural result government activities will become decentralized as government functions move to the private sector. Using this common-sense approach, the need to concentrate on objectives based on what is best for the country and not what is best for a particular interest group becomes clear.

This was the general approach used in New Zealand over the past ten years. In general, where quality decisions were made, political problems desisted; where there has been compromise and government has given into interest group pressures, political problems remain.

In 1984 New Zealand's government surplus was 9 percent or more. Today the government surplus is 3 percent. Inflation for the twenty years to 1984 was one and a half times the OECD average. For the past three years it has been less than 2 percent. Growth for the twenty years to

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1984 was half the OECD average. In 1994 it was 6 percent. Government debt was more than 70 percent of GDP before 1984. Today it is less than 40 percent. Within three years government debt as a share of GDP is expected to drop to 20 percent, with all foreign debt repaid by 1997. The labor market was highly regulated in 1984. Today it is highly deregulated by OECD standards. The personal tax rate has dropped from 66 to 33 percent. Corporate taxation has dropped from 48 to 33 percent. Government spending as a share of GDP has fallen to 7 percent. Employment is growing faster than it has in twenty or thirty years. Government assistance has been dramatically reduced, import protection has been lifted, and tariffs have been lowered. Public sector reform has taken place, improving productivity and accountability mechanisms. Privatization has also taken place.

Until reforms people could only be appointed to top positions from within the public sector; now they can be appointed from anywhere in the world. Pay and employment are the responsibility of the chief executive of each department. The government has a balance sheet and a profit and loss statement and works on accrual accounting.

With structural reform the most ardent support may

come from those who have lost privileges. For example, in New Zealand farmers lost their subsidies as a result of the reform, but they became advocates of continued reform once they saw its benefits. If interest groups think that they can influence politicians, they will try to gain political support for their interests rather than adapt to the changes brought about by reform.

Genuine reform implies a need for politicians to trust the public. Politicians need to tell the public what is wrong, what they intend to do to correct it, why their proposals are better than others, and the advantages and disadvantages of proposed reforms. Consistent policy and credibility increase confidence.

Finally, three additional points about implementing reforms should be mentioned. First, reform programs often become unhinged because of uncertainty. The public needs to know where politicians and governments are going, and know that government will be consistent. Second, interest groups always underestimate their ability to adjust. Third, if the costs of compensation for losers in reform are too high, evidence of the benefits of the reform will be delayed.

Mr. Haggard replies

Sir Roger rightly emphasizes the role of leadership and public considerations in initiating reform. A quest for consensus among interest groups can be paralyzing when trying to develop a reform program. But it is important to note that New Zealand's reforms benefited from powerful party backing in a majority system with a very powerful prime minister. The reform program in New Zealand only began with the formation of a new government.

There is no single model of what a government should look like. In fact, democracy is precisely about legitimate disagreement and competition between parties. Nevertheless, it is impossible to have meaningful dialogue and democratic competition over policy if governments are

continually preoccupied with the task of fiscal reform. Fiscal reform and stabilization are important not only for economic and welfare reasons but also because they permit reasonable disagreements over policy to be reconstituted.

Organized support and interest group politics are important in consolidating reform in democracies. New Zealand is a relatively egalitarian country without great disparities in wealth and income where democratic institutions are firmly entrenched; Latin America is the opposite. Thus the need for reform as well as the associated risks are greater in Latin America. Taking those risks is the task of politicians, not of academics.

Comment on “Reform of the State in Latin America,” by Stephan Haggard

MARIO HENRIQUE SIMONSEN

MUCH HAS BEEN SAID ABOUT THE REFORM OF THE STATE IN LATIN AMERICA, BUT little analysis has been performed on the economic theory of the institutions involved. What makes politicians oppose certain types of economic and social structures?

A strong president with congressional support is more likely to successfully implement reform, especially when accompanied by discipline and organization. In Brazil a matrix system of “rows”—the political parties—and “columns”—the sectoral interests (land owners, Protestants, and so on) guides the political process. Presidential campaigns are financed by the columns, votes go to the rows, and loyalty is reported. The columns usually get more than the rows.

The cultural, political, and institutional evolution that has been taking place in Latin America over the past ten years has been influenced by the collapse of the Bretton Woods system in the early 1970s, escalating inflation in the OECD countries in the late 1970s, the transformation of the European social democracies (France, Italy, and Spain now adhere to market economies), deregulation and privatization trends, liberalization in the United States (Reagan) and England (Thatcher) during the 1980s, the fall of the Berlin Wall in 1989, and the collapse of the Soviet Union in 1991. The evolution came about because Latin America and Caribbean countries recognized that the state was too involved in the production of private goods and does not possess the mechanisms required to respond quickly to the demands of a market economy.

The state should retain control over ensuring public safety and printing currency. In Brazil both the police and organized crime have shaped public safety. With respect to printing currency, the monetary policy in Brazil is passive. Currency printing is approved by the Central Bank and executed by commercial banks. The state should not main-

tain monopolies in oil or telecommunications, where it has no advantages over the private sector.

The Brazilian government has approved a number of constitutional reforms. Besides political skill, cultural change drove many of these reforms. Seven years ago, a nationalistic Constitution was adopted. Today it is being reformed. What caused the change? Ideas about the role of the state—and not the composition of parties—have changed.

The government will play a less important role in production after privatization, mainly as regulator. Regulation is unnecessary in privatized industries because the laws of the market are sufficient. Regulation is required in private services and public utilities, however. Still, there is no ideal model for regulating, say, the telecommunications industry. A number of approaches have been tried, but no one best solution has been identified.

Nor is there a model for improving public bureaucracy. Efficient bureaucracies require training, proper structuring of bureaucratic careers, and financial incentives. A common problem for Latin American countries, however, is limited

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resources for achieving these goals.

Much has already been done in terms of reform. But many changes have yet to take place. The discussion at this

conference is helpful in understanding and assuming future challenges.

Why Are Latin America's Savings Rates So Low? An International Comparative Analysis

SEBASTIAN EDWARDS

DURING THE PAST FEW YEARS THERE HAS BEEN RENEWED INTEREST, IN BOTH ACADEMIC and policy circles, in issues related to economic growth. New models and empirical studies have analyzed different aspects of this problem, including the conditions under which growth can be sustained through time. From a policy perspective this interest has been particularly high in Latin America, where, as a consequence of the debt crisis of the 1980s, growth came to a halt for almost a decade. By 1992, and after a long and impressive process of market-oriented reforms, the nations of Latin America had recovered and were once again growing. Analysts and policymakers, however, consider the average real rate of growth for 1992–94—approximately 3 percent—to be modest and estimate that the rates of economic expansion should accelerate significantly to compensate for the stagnation of the “lost decade.”¹ In discussing these issues, a number of authors have pointed out that low savings rates are seriously constraining the Latin American countries. According to the World Bank (1993a), the median ratio of gross domestic savings to GDP was only 20 percent in Latin America in 1991—more than 15 points below that of the East Asian countries.

Traditional analyses of savings and growth have concentrated on two important issues: (a) the effect of higher savings on long-run growth and (b) the impact of an increase in domestic savings on investment. Neoclassical models, inspired by the work of Solow (1956), suggest that an increase in savings ratios generates higher growth only in the short run, during the transition between steady-states. According to this view, the long-run equilibrium rate of growth will depend exclusively on structural demographic variables. However, recent models based on theories of endogenous growth developed by Romer (1986) and Lucas (1988) predict that higher savings—and the related increase in capital accumulation—can result in a perma-

nent increase in growth rates.² This is because in the presence of externalities the marginal return to capital will be bounded from below, and, under certain conditions, will exceed the rate of time preference. In this case the private sector will face a permanent incentive to add to the stock of capital, and long-run growth will be sustained.

In an open economy, however, increases in domestic savings are not necessarily translated into higher domestic investment. In principle, if capital is internationally mobile, changes in domestic savings and investment can be completely independent. Savings generated in country A can be fully or partially invested in country B. If domestic savings and investment are uncorrelated, increases in the former will not be translated into

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a higher capital stock, and thus will not result in accelerated growth. If, on the other hand, the degree of international capital mobility is limited, higher domestic savings will generate higher investment and growth. The extent to which domestic savings and investment are correlated ultimately is an empirical matter, as argued by Feldstein and Horioka (1980). Abundant empirical evidence suggests that domestic savings are highly correlated to aggregate investment. This indicates that, on average and over long periods of time, changes in capital accumulation respond mostly to changes in domestic savings (see Frankel 1985; Feldstein and Bacchetta 1991; and Montiel 1994).

Empirical work by Barro (1991), De Long and Summers (1991), Edwards (1992) and others, has recently provided support to the notion that capital accumulation—and thus savings—are central for understanding growth differentials across countries. Moreover, Young (1994) argued that capital accumulation, and not technological progress, explains the splendid growth performance of the East Asian “tigers”: the Republic of Korea, Hong Kong, Singapore, and Taiwan. The empirical evidence, however, is less clear when it comes to explaining savings behavior across countries or along time. Existing work has been affected by the lack of detailed reliable data, and has either been controversial, as in the case of the interest responsiveness of private savings,

or has offered limited help to policymakers who ask how saving rates can increase (see Schmidt-Hebbel and others 1994 for a comprehensive survey).

The purpose of this paper is to investigate the process of determining savings rates in the world economy and to analyze why savings ratios in Latin America traditionally have been so low. The analysis is based on international comparisons; data from thirty-eight countries—both OECD members and less-developed nations—are used to estimate a number of panel and cross-country regressions. An important feature of the paper is that, in contrast with previous work, it distinguishes between private and government savings.³ In particular, I assume that government savings are not completely exogenous, and that they respond to both economic and political determinants. More specifically, I draw on the recent literature on the political economy of macroeconomic policy, and I argue that governments act strategically when deciding how much to save. In the empirical analysis presented in this paper, I have also made an effort to incorporate the role of a large number of variables—including policy, demographic, structural, and political factors—as possible determinants of savings ratios. The results obtained provide insights on why savings rates differ across countries, and will hopefully help determine an agenda for future, detailed, country-specific research in the area.

TABLE 1

Private, government, and national savings rates, various regions, 1970–93

(percent)

	1970–82				1983–93			
	FIRST QUARTILE	MEDIAN	THIRD QUARTILE	AVERAGE	FIRST QUARTILE	MEDIAN	THIRD QUARTILE	AVERAGE
<i>Private savings</i>								
Latin America	13.1	13.2	21.7	16.1	10.9	14.7	17.9	13.8
Asia	na	na	na	na	17.4	19.1	22.9	20.2
Africa	11.4	14.4	18.9	15.2	10.7	16.7	19.5	15.6
Industrial countries	18.0	21.6	23.4	21.3	18.3	21.3	23.4	21.3
<i>Government savings</i>								
Latin America	-0.7	1.7	6.6	3.3	-1.3	2.4	5.5	2.2
Asia	0.0	2.7	8.8	4.4	0.0	1.6	9.0	3.9
Africa	-1.6	0.9	2.1	0.6	-1.3	1.0	4.5	0.9
Industrial countries	-0.5	2.0	3.8	1.8	-3.6	-0.1	1.3	-0.8
<i>National savings</i>								
Latin America	14.5	19.4	27.7	19.8	14.0	17.8	19.1	15.3
Asia	4.9	24.8	26.7	18.8	18.8	23.8	28.5	24.5
Africa	10.8	15.5	18.7	16.4	10.6	17.5	22.1	16.8
Industrial countries	19.6	22.8	25.8	23.1	17.5	19.1	23.4	20.4

na is not available.

Source: International Monetary Fund data.

Recent behavior of savings rates in Latin America

Broad comparative analyses of savings behavior traditionally have been plagued by data problems.⁴ Savings are usually estimated in a questionable way—usually as residuals—and until very recently, comparable data on private savings were restricted to a handful of advanced countries. Moreover, large international data sets on net savings are not currently available. In this paper I use a new data set assembled by the International Monetary Fund that distinguishes between private and government national savings ratios and permits undertaking empirical work on their determinants.

Table 1 contains the averages and distributions of private, public, and aggregate national savings for a group of

Latin American, Asian, African, and industrialized countries for the 1970–82 and 1983–93 periods (see the appendix for a list of the countries included in this sample). Figures 1–11 illustrate, for all years for which there is information, the evolution of private, public, and aggregate gross national savings for a group of eleven Latin American countries. Figures 12–16, by way of contrast, present comparable data for five East Asian nations.

A number of interesting findings emerge from this table. First, during the most recent period (1983–93), Latin America's private savings ratios have been the lowest in the world. Second, these data confirm that in the post-debt crisis period, private savings rates have tended to decline in Latin America. Third, and interestingly enough,

FIGURE 1
Savings in Argentina, 1985–92

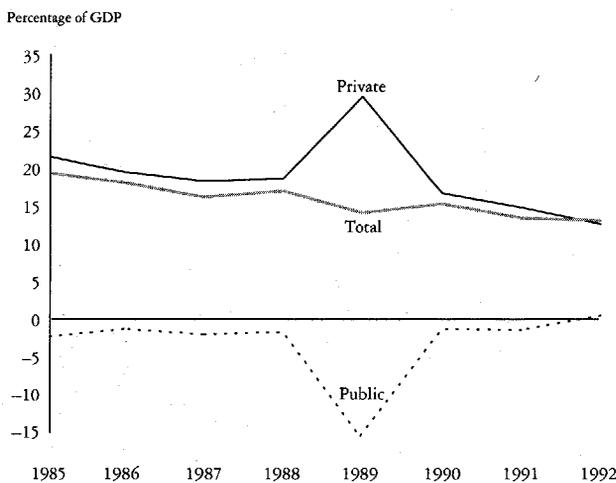


FIGURE 2
Savings in Bolivia, 1988–92

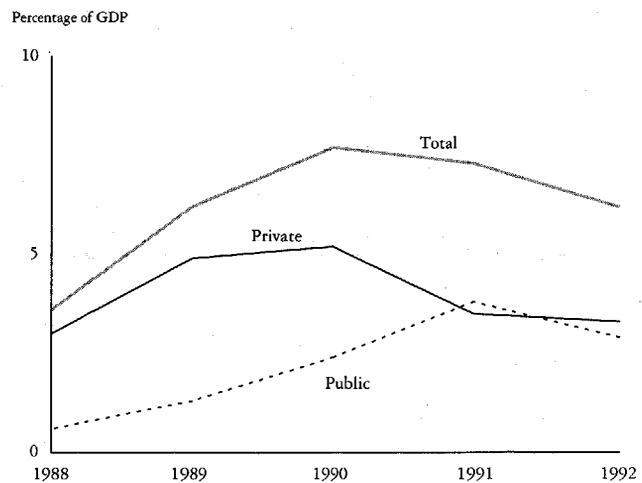


FIGURE 3
Savings in Brazil, 1977–92

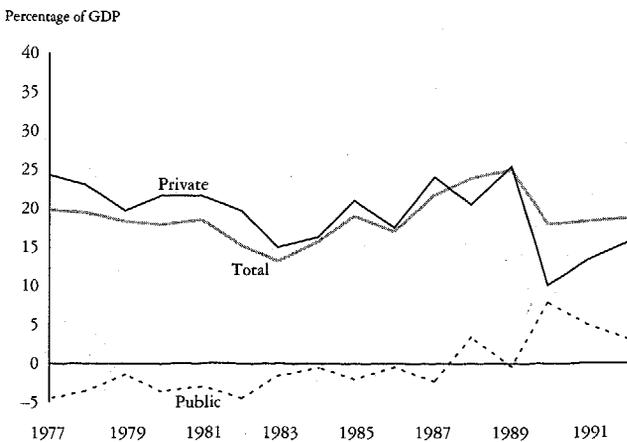
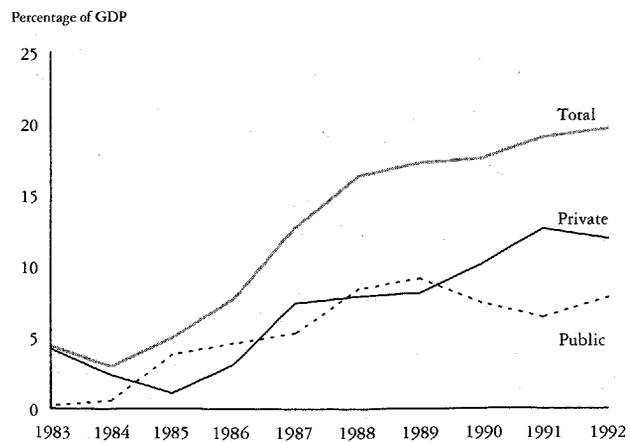


FIGURE 4
Savings in Chile, 1983–92



government savings behavior is quite different: during the 1983–93 period the Latin American countries in this sample exhibited comparatively high ratios. In fact, the region has the highest median and the second highest average government savings rates during 1983–93. This is particularly important because the generation of relatively high government savings is a rather recent phenomenon in Latin America, and one that rests on somewhat fragile bases. Moreover, recent data suggest that in some countries fiscal discipline may be slipping, generating a reduction in the government's contribution to aggregate savings.⁵ And finally, when private and government savings are consolidated in table 1, the picture continues to look bleak, with

Latin America being once again at the bottom of the scale.

The data on the evolution of savings ratios for five high-performing Asian countries provide important contrasts (see figures 12–16 and table 1). These East Asian countries not only have had very high aggregate saving rates—between 30 to 40 percent—but also have been very stable. A second fundamental difference between the Latin American and the East Asian countries is that the contribution of government savings to total national savings is significantly higher in East Asia. While, historically, government savings have barely contributed to national savings in Latin America, in the East Asian countries they represent 25–40 percent of aggregate savings. The section

FIGURE 5

Savings in Colombia, 1980–92

Percentage of GDP

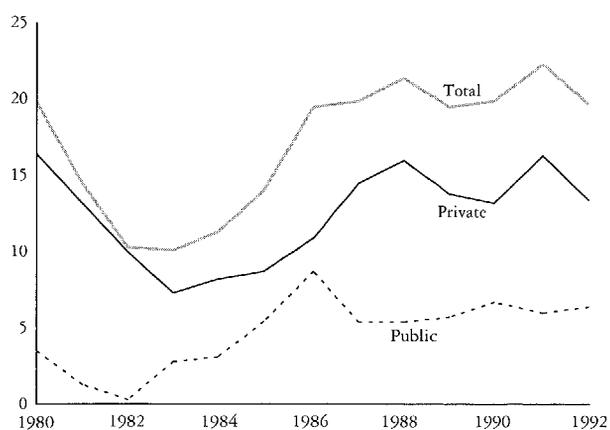


FIGURE 7

Savings in Mexico, 1980–92

Percentage of GDP

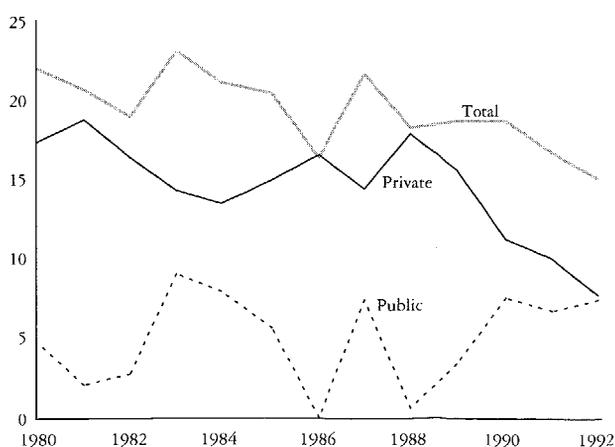


FIGURE 6

Savings in El Salvador, 1978–92

Percentage of GDP

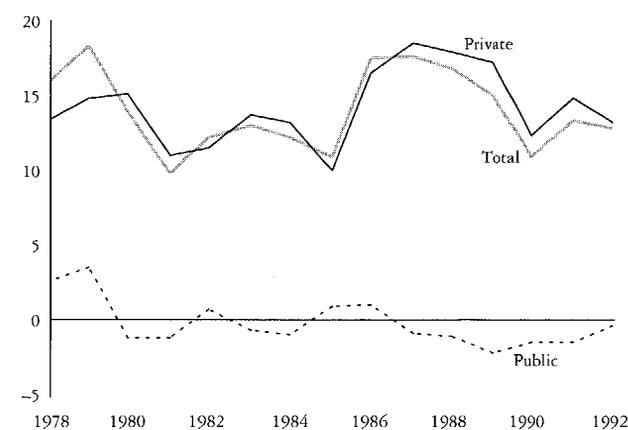
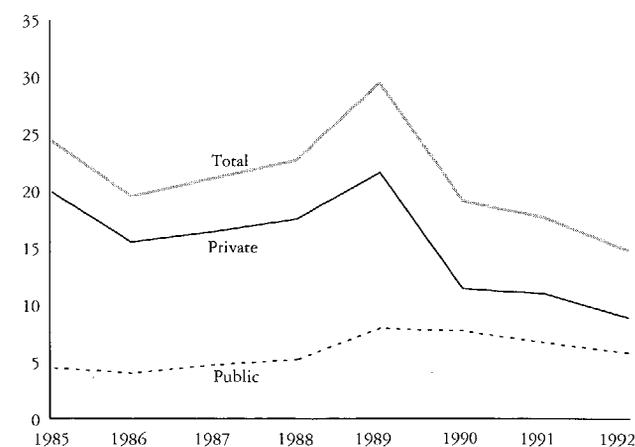


FIGURE 8

Savings in Paraguay, 1985–92

Percentage of GDP



on estimation systematically attempts to explain cross-country differentials in government savings rates, using some insights from recent models on the political economy of macroeconomic policymaking.

**Savings rates determination:
Theory and policy controversies**

Abundant theoretical literature on the determinants of private savings is now available. Different authors have analyzed specific aspects of the problem, including how savings are affected by social security contributions (Feldstein 1980), how changes in interest rates affect intertemporal consumption (Gylfason 1993; Ogaki,

Ostry, and Reinhart 1994), and how the existence of liquidity constraints impact on private savings decisions (Jappelli and Pagano 1994). The comprehensive surveys by Gersovitz (1988), Deaton (1989), and Schmidt-Hebbel and others (1994) suggest, however, that this literature is somewhat fragmented; individual studies tend to focus on one, or at most two, aspects of the problem. Because of its many policy angles and vast theoretical complexity, no single model has been able to deal with every dimension of the savings issue. This fragmentation has also been present—although to a lesser extent—in the empirical literature on the subject, as authors typically have concentrated on a few possible determinants of

FIGURE 9
Savings in Peru, 1979–92

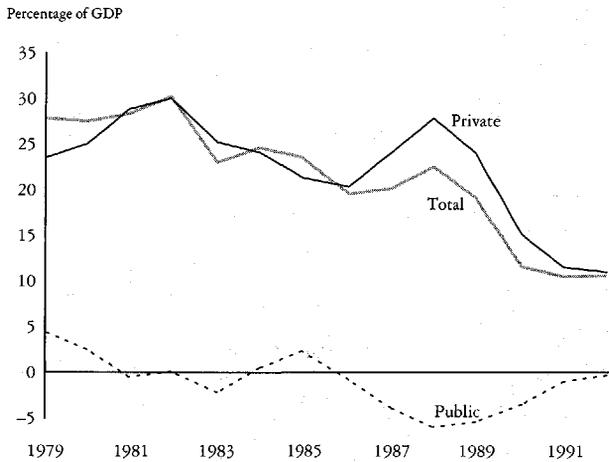


FIGURE 11
Savings in Venezuela, 1980–92

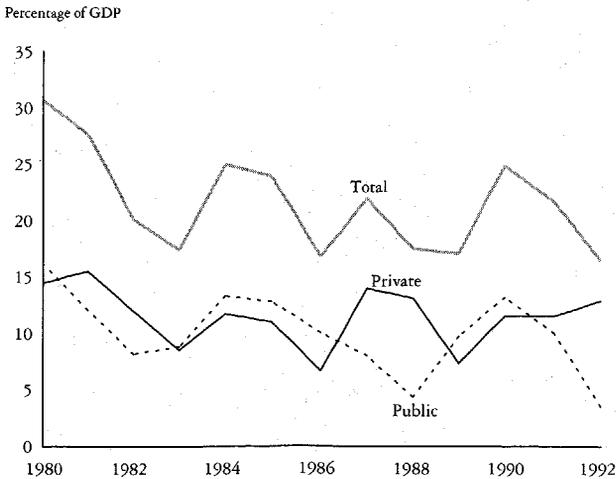


FIGURE 10
Savings in Trinidad and Tobago, 1980–92

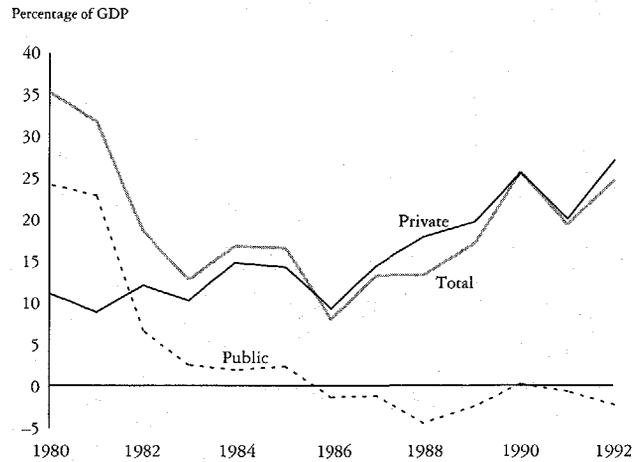
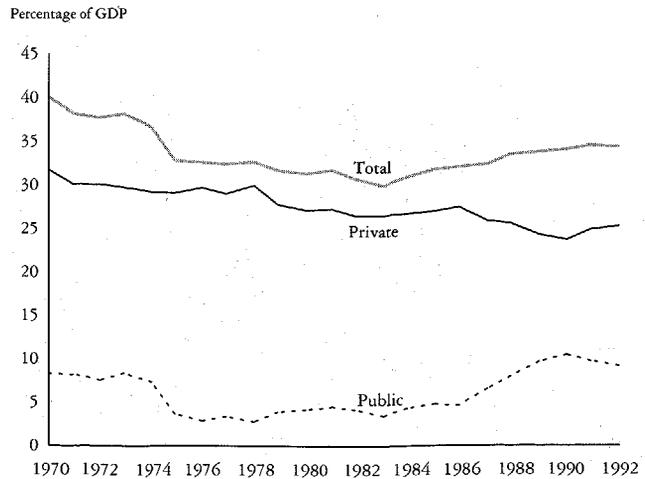


FIGURE 12
Savings in Japan, 1970–92



private savings in their attempts to understand their evolution.⁶

In contrast to the case of private savings, there has been almost no theoretical or empirical work explaining the behavior of government savings through time or across countries.⁷ Almost every analysis on the subject has either ignored the process by which government savings are determined or assumed that they are completely exogenous. What makes this especially surprising is that, as noted in the preceding section, government savings historically have provided a substantial share of total national savings in rapidly-growing economies.

The purpose of this section is twofold. First, I briefly

deal with the analytics of private sector savings behavior focusing on some important policy controversies. This discussion provides a conceptual base for the empirical analysis of the section on estimation. Second, I develop a framework based on political-economy considerations for analyzing the process of government savings behavior. The main implications of this approach are used in the empirical analysis of cross-country government savings.

The analytics of private savings behavior

Whether and how much to save are fundamentally intertemporal decisions. Households have to decide how much of their current income to consume in the present

FIGURE 13
Savings in Malaysia, 1985-92

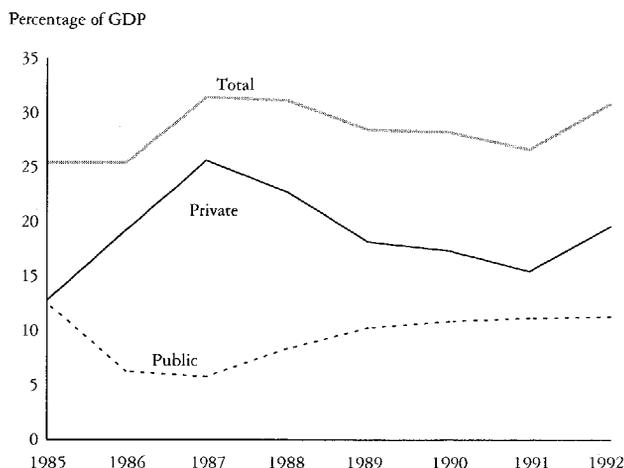


FIGURE 14
Savings in Singapore, 1985-92

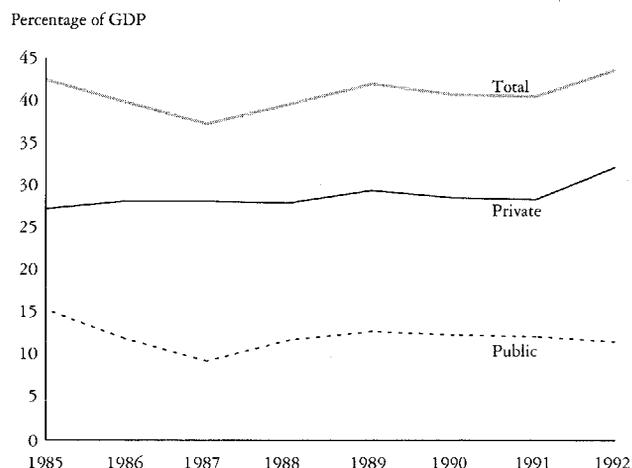


FIGURE 15
Savings in Thailand, 1985-92

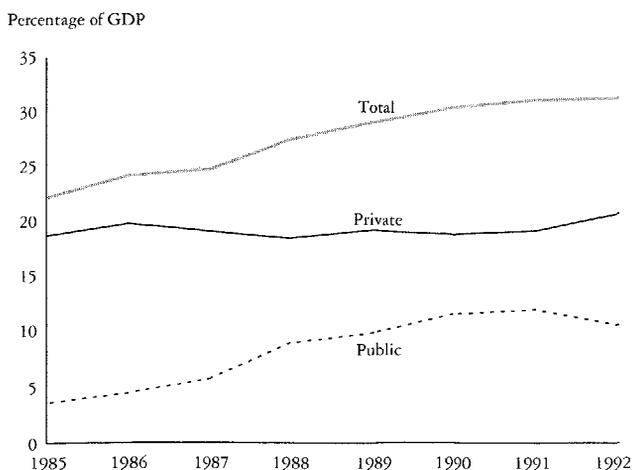
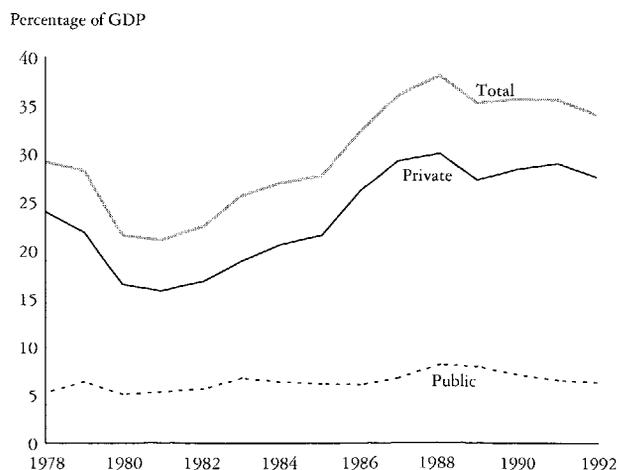


FIGURE 16
Savings in the Republic of Korea, 1978-92



and how much to put aside for future consumption.⁸ This fundamental insight has been captured by a number of models that have focused on intertemporal optimization, including the life-cycle theories originally developed by Franco Modigliani.⁹ Possibly the easiest way to formulate this problem for an (infinitely-existing) individual is as follows:

$$(1) \quad \max \int_0^{\infty} E\{U(c_t, g_t)e^{-\rho t} dt\}$$

subject to:

$$(2) \quad \int_0^{\infty} c_t e^{-\rho t} dt \leq W,$$

$$(3) \quad W = \int_0^{\infty} y_t(1 - \tau_t)e^{-\rho t} dt,$$

$$(4) \quad S_t = [y_t(1 - \tau_t) - \rho c_t],$$

$$(5) \quad -k \leq S_t \leq y_t(1 - \tau_t).$$

E is the expectations operator; $U(\)$ is the instantaneous utility function, which is assumed to be concave; ρ is the rate of time preference, and r is the interest rate. c_t is private consumption in period t , and g_t is consumption of public goods during that period; at this point their supply is assumed to be exogenous. W is total wealth, $y_t(1 - \tau_t)$ is net income, τ_t is the tax rate in period t , S_t is savings and is defined as $[y_t(1 - \tau_t) - \rho c_t]$; if in a given period S is negative, the individual in question is borrowing from the financial system. The third restriction, $-k \leq S_t \leq y_t(1 - \tau_t)$, establishes that savings has to be less than net income, and borrowing cannot exceed k . This equation establishes a "borrowing constraint," which, depending on the circumstances, may or may not be binding. In general, this borrowing constraint is expected to be more restrictive with less-developed financial systems. A particular form for the borrowing constraint is that at any point in time t , real wealth cannot be negative— $W_t > 0$.¹⁰

The first order conditions of this problem are well known in the case where the borrowing constraint is not binding: the ratio between expected marginal utilities in

any two periods has to be equal to the expected discount rate. An important implication of this result is that individuals will use borrowing and savings to smooth consumption through time. More specifically, if the marginal utility is convex there will be a *precautionary* motive for savings. Because situations of low consumption are particularly painful, households will tend to save during "plentiful" years to provide for hard times.¹¹ This means that savings will tend to be higher in those economies where income is more volatile. From an empirical point of view, this suggests that with all other things equal, savings rates will be higher in countries with a higher share of agriculture.

If the utility function in (1) is quadratic and the rate of time preference is equal to the interest rate, consumption will be equal to the annuity of wealth as predicted by the permanent income hypothesis, and there will be no precautionary savings (see Deaton 1989). A number of authors have argued, however, that the observed behavior of consumption and economic growth contradict the permanent-income hypothesis (see, for example, Carroll and Summers 1991 and Carroll and Weil 1993).¹²

In spite of its simplicity, the model sketched above is able to capture a number of the controversies that have dominated the savings-policy debate during the past few years. The rest of this subsection discusses some of the most important policy issues in this literature.

Real interest rates and private savings

The effect of increases in (real) interest rates on savings has possibly been the most broadly discussed topic in this field. From a purely analytical perspective the answer is straightforward. It is easy to see from equations (1) through (5) that changes in r will have an ambiguous effect on private savings. Whether they respond positively or negatively will depend on the relative strengths of the substitution and wealth effects (see Gylfason 1993 for a recent discussion on the subject). The early financial liberalization literature in LDCs argued that one of the most important objectives of these reforms was to generate, among other things, a significant increase in domestic savings. In the original models of financial repression of McKinnon (1973) and Shaw (1973), allowing (real) interest rates to rise to market levels altered the intertemporal rate of substitution, encouraging aggregate savings.¹³

Empirical studies for a large number of countries—both advanced and developed—have found, however, only a weak interest-rate elasticity of aggregate domestic savings. Boskin (1978) found a very low elasticity for the United States. A number of studies for the case of developing countries, including Giovannini (1983), have failed to find a significant effect of interest rate changes on private savings. McKinnon (1991) recently has acknowledged that “aggregate savings, as measured in the GNP accounts, does not respond strongly to higher real interest rates” (p. 22).¹⁴

The evidence suggesting that savings have a low degree of responsiveness with respect to interest rates has prompted analysts and policymakers to consider alternative policy mechanisms to encourage savings. Some countries, such as Chile in the mid-1980s, relied on tax reforms aimed at discouraging consumption.¹⁵ More recently a number of authors have suggested that shifting the tax base from income to consumption will encourage thrift in the economy as a whole. From an analytical point of view, these policies rely on the assumption that there is a high intertemporal substitution in consumption. As pointed out, until recently the existing evidence did not support this contention, shedding some doubts on the effectiveness of these tax-based mechanisms to increase aggregate savings.¹⁶ In an important recent paper, however, Ogaki, Ostry, and Reinhart (1994) argue that the degree of intertemporal substitutability of consumption is a function of the level of income per capita. Their empirical results, using a large macroeconomic data set, support this view.

The financial liberalization hypothesis should be interpreted broadly, going well beyond the effect of higher interest rates on savings. Data from the rapidly-growing East Asian countries suggest that a number of institutional developments in those nations—including efficient prudential supervision and the encouragement of postal savings—have positively affected private savings. Unfortunately, it is extremely difficult to find time-series or cross-country data on these indicators for empirical work. Defining appropriate proxies for the degree of financial development is, indeed, one of the challenges faced by empirical researchers.

Time profile of income flows, demographics, and economic growth

According to life-cycle models, individuals will have negative savings when they are young and have very low pos-

itive savings from income during their productive years, and once again negative savings when they are old and retired. Also, if individuals have positive bequest motives, they will tend to leave some wealth to their heirs. According to this view, then, aggregate private savings will be affected by the age distribution of the population. If there are a large number of inactive people relative to those in their productive years, aggregate savings will be relatively low. In their classical studies, Modigliani (1970) and Leff (1969) used cross-country data (mostly in advanced nations) to test this hypothesis. They found, as have numerous authors after them, that differences in demographics indeed play a key role in explaining differences in savings.

Modigliani (1970) also argued that in a life-cycle setting income growth will have an important positive effect on private savings. This is largely the result of aggregation across households. To the extent that the economy is growing, workers' savings will increase relative to retirees' dissavings and, thus, measured aggregate savings will increase. As Bosworth (1993) has pointed out, however, there also will be an effect in the opposite direction. In a growing economy, workers will anticipate future income increases and, as a result, will tend to increase present consumption and reduce savings. The dominant positive or negative is ultimately an empirical matter. A problem with analyzing this issue empirically, however, is that there is a two-way causation. On the one hand, growth will tend to affect savings through the mechanisms just described, and on the other, savings will tend to impact growth through its effect on capital accumulation. Some authors, however, have tried to deal with this endogeneity problem through a series of mechanisms, including the use of instrumental variable techniques and the computation of causality tests. In a recent paper, for example, Carroll and Weil (1993) used detailed household-level data to deal with this issue and have concluded that there is evidence suggesting that growth indeed affects private savings *positively*.¹⁷

The positive influence of growth on savings has played a central role in recent analyses of successful development experiences in East Asia. According to the World Bank (1993b), for example, there has been a “virtuous circle” going from higher growth, to higher savings, to even higher growth in these countries. Naturally, politicians and policy-

makers would like to know *how* to get on this virtuous circle!

Borrowing constraints

The extent to which individuals can actually dissave when young will depend on their ability to borrow. If the borrowing constraint in equation (5) is binding, the marginal utility of present consumption will exceed the (discounted) expected utility of future consumption; households would like to increase present consumption but will be unable to do so (Zeldes 1989). In most models, once the borrowing constraint is made less stringent, present consumption will increase and, thus, national savings will tend to decline.¹⁸ What makes this result particularly interesting is that it suggests that financial reform programs long advocated by a number of economists, such as McKinnon (1973) and Shaw (1973), could result in a reduction in savings, capital accumulation, and, ultimately, in the rate of growth. In an important recent paper, Jappelli and Pagano (1994) used cross-country data on required down-payments for mortgages as a proxy for borrowing constraints. Their econometric results on data for advanced countries support the idea that relaxing these constraints will reduce savings and economic growth. In their analysis of household savings behavior for a group of developing countries, Schmidt-Hebbel and others (1992) used beginning-of-period money balances as an indicator for the stringency of the borrowing constraint, and found that its coefficient was negative.

Taxes, government consumption, and social security

The model presented above suggests that fiscal policy—changes in g or τ —will have an effect on consumption and saving decisions. What is interesting about this formulation is that both present and future taxes will tend to reduce savings. This means that, to the extent that the government is subject to an intertemporal budget constraint, it will not matter whether increases in government consumption are financed by higher taxes or by issuing government bonds. This is, of course, the Ricardo-Barro proposition, that government bonds are not net wealth (see Barro 1974).

Increases in government consumption also will affect private savings. If the public does not value government consumption, savings will decline; this will be the case

regardless of the way in which the expansion of government expenditure is financed. If, on the other hand, the public values public goods, the effect of an increase in their provision will depend on the degree of substitutability of c and g on the individual's utility function in equation (1). From an empirical and policy perspective, it is important to determine whether increases in government savings will be offset fully by declines in private savings, or if the offset coefficient will be lower than one. Another important policy issue is whether changes in alternative taxes—value-added tax, assets tax, income tax—will have the same effect on private savings (see Kotlikoff 1984). Corbo and Schmidt-Hebbel (1991) used a thirteen-country data set to analyze the macroeconomic consequences of higher public savings. In particular, they investigated the extent to which an increase in government savings would reflect a decline in private savings. They found that, although government savings crowd-out private savings, the magnitude of this effect is far below the one-to-one relationship suggested by the simple Ricardian equivalence doctrine; overall, their empirical analysis strongly indicates that an increase in public savings will be translated into higher aggregate savings.¹⁹ Corbo and Schmidt-Hebbel also found that, on average, increasing public savings through reduced expenditures is more effective than increasing taxation.

Another important implication of the life-cycle framework—and one that can be easily incorporated into the formal model—is that private savings will be affected by the extent and coverage of social security systems. If individuals perceive that when they retire they will get high social security benefits, they will tend to reduce the amount saved during their active days (Feldstein 1980).²⁰ From a policy perspective this suggests that social security reform that replaces a government-funded system by a privately administered one tends to increase private savings.

Other potential determinants of private savings

Although the model presented above captures the essentials of household savings decisions, it has some limitations. In particular, the model ignores consumers' heterogeneity, and thus the effects of income distribution on savings; it does not incorporate directly the role of human capital accumulation; it deals only partially with issues related to the effect of the degree of development of the capital market; it does

not incorporate the possible effects of macroeconomic stability, including inflation; political considerations, such as the effect of political turmoil, violence, and instability on savings do not have a direct role; open-economy angles are ignored; and the role of firms' savings is not taken into account. Models with heterogeneous agents generally predict that households with higher income will tend to save a higher proportion of their income. At the aggregate-comparative level this has been interpreted to mean that countries with more unequal income distribution will tend to have a higher savings rate. From the instability perspective, it has been suggested that both macroeconomic as well as political instability will tend to have a negative effect on aggregate savings. Open-economy models add two perspectives to the analysis. First, domestic interest rates will be linked to international interest rates; second, in open economies, agents can use foreign borrowing to smooth consumption through time. This means that foreign savings generally will act as a substitute for domestic savings. In the empirical analysis reported below I include many of these variables as possible determinants of cross country-differences in aggregate private savings.

Explaining government savings:

A political economy perspective

Studies on savings traditionally have focused on aggregate national savings and *private* savings, and tended to ignore the process of determination of *government* savings. And yet, as discussed in the section on Latin America, government savings can be a fundamental component of national savings, representing in some cases—and especially in the successful East Asian nations—between 30 and 40 percent of the aggregate. Most studies make the very simple—but implausible—assumption that government savings are exogenous, and are set by the economic authorities in a way that maximizes (the present value of) society's welfare.

In recent years a number of authors have relied on insights from public choice and game theory to study government behavior (see Persson and Tabellini 1990 for a comprehensive discussion). Many of these models assume that political parties alternate in power, and that the group in office acts *strategically*, in an intertemporal sense, when making decisions that have economic consequences spanning more than one period (Cukierman, Edwards, and

Tabellini 1992). This type of approach can be extended fruitfully to address cross-country differentials in government savings rates.

Assume that there are two political parties (L and R) that alternate in power according to some probability rule. Further, assume that L and R have different preferences: while L prefers a vector of goods h , R prefers vector f . The amount of these goods that society can produce and consume will depend, in part, on the level of government savings and investment. Savings, however, are translated into higher investment, production, and consumption after a lapse of time. It is possible, then, that while the party in power increases government savings, the projects will come to fruition when its opponent are in power (for a formal description of the model see, for example, Edwards and Tabellini 1994).

In this setting the authorities' incentive to increase government savings—and thus the ability to produce public goods—will depend on two fundamental political-economy variables: first is the probability that the party in power will still be in office in the subsequent period. If this probability is low, the opposition party is likely to be in office once the projects mature, and will get the credit from the increased production of the public goods. Naturally, under these circumstances the incentive to increase savings will be low. The recent political-economy literature on inflation and stabilization has associated the probability of the incumbent to remain in office with the degree of *political instability* of the country in question. This analysis predicts, then, that the higher the degree of political instability, the lower government savings. The second determinant of government's incentive to save is the extent to which the political parties have different preferences. In the extreme case where their preferences are exactly the same, there will be a high incentive for the government to save—even if the probability of remaining in office is low. The difference in party preferences has been referred to in the political-economy literature as the degree of *political polarization*. This analysis predicts that, with other things given, a greater degree of polarization will result in lower government savings. In regression analyses, however, it has been difficult to find empirical counterparts for political polarization. Some authors, such as Cukierman, Edwards, and Tabellini (1992), for example, have argued that the frequency of politically motivated attacks and assassinations are appropriated proxies.

Estimation

In this subsection I present the results obtained from the estimation, using a thirty-six-country data set—eleven industrial and twenty-five developing countries—of private and government savings equations. The estimation was performed using all available panel data from 1970 to 1992. Some equations also were estimated on cross-country data based on averages for 1983–92. The results obtained from these equations were then used to address the question of why saving rates are so low in Latin America.

Private savings

Based on the theoretical discussion in the previous section, a number of equations of the following type were estimated for private saving rates:

$$(6) \quad s_{tk} = a_0 L_{tk} + a_1 G_{tk} + a_3 F_{tk} + a_4 M_{tk} + a_5 D_{tk} \\ + a_6 E_{tk} + a_7 P_{tk} + a_8 S_{tk} + u_{tk},$$

where the subindex tk denotes country k in period t . S_{tk} is the private national savings rate for country k in period t ; L is a vector of life-cycle variables, including the age-dependency ratio, the rate of growth of per capita GDP, the ratio of old and young population. G is a vector of variables related to fiscal policy, and in principle it includes the government savings rate, government consumption, and social security taxes as proportions of total taxes (which are used as a proxy for expected social security benefits). F is a vector of variables that capture the characteristics of the financial sector, including its degree of development. Of particular interest here are the degree of financial depth of the economy and the extent to which borrowing constraints are binding. Ideally, F would also include measures of the real interest rate and the borrowing-lending interest rate spread; however, this variable is only available for a small number of developing countries. M refers to macroeconomic stability variables, including the rate of inflation; E includes variables related to the external sector, such as the current account balance (or foreign savings); P is a vector of variables that captures the characteristics of the political system; and S captures all other variables not included above.

The estimation of private savings equations of the type of (6) presents several challenges. First, there are no data on all the relevant independent variables; second, a number of

them are measured with error; and third, there are a series of instances of endogeneity, which sometimes raises questions of causality.²¹ To deal with these issues I have defined proxies for some of the variables of interest, and I have estimated the private savings equation using instrumental variables (IV) techniques. As is usually the case with panel data regressions, it is rather difficult to find appropriate instruments. In this paper I have used lagged values of the endogenous variables, as well as variables that are exogenous to savings but correlated to some of the endogenous variables, such as exports and population growth, in response to this problem.²²

Table 2 contains the results obtained from the estimation of private savings equations using instrumental variables on panel data for the 36 countries listed in the appendix. The dependent variable is the ratio of private national savings to GDP and was obtained from the International Monetary Fund. The independent variables fall in the different categories described above, and were defined in the following way:

- *Age dependency*: population younger than 15 years old plus the population over 65 years old, as a percentage of working-age population. This variable was taken from the World Bank data set. According to the life-cycle hypothesis its coefficient should be negative.
- *Urban population*: proportion of total population that lives in urban areas. This variable was taken from the World Bank data set, and according to the precautionary savings model discussed above, its sign should be negative.
- *Government savings*: This variable was obtained from the IMF's data set. Its coefficient is expected to be negative, capturing the fact that government savings will tend to crowd-out private savings. An important issue is how close to -1.0 this coefficient is. If it is not significantly different from -1.0 , increases in government savings will not be fully offset by reductions in public savings.
- *Growth per capita*: This variable was defined as a three-year moving average of the rate of growth of per capita GDP. The raw data were taken from Summers and Heston (1991). The life-cycle model suggests that its coefficient should be positive. Carroll and Summers (1991), however, have argued that in a more complete model of consumer behavior, the relationship between growth and savings is ambiguous, and that in the short run they should be negatively related. To avoid simultaneity problems the equations are estimated with

TABLE 2

Determinants of private savings

Instrumental variables, panel data, t-statistics in parentheses

VARIABLE	R1	R2	R3	R4	R5	R6	R7	R8
Sample	All	All	All	All	All	Developing countries	Developing countries	Developing countries
Age dependency	-0.148	-0.088 (-2.609)	-0.056 (-1.659)	-0.074 (-2.231)	-0.083 (-2.179)	-0.054 (-1.246)	-0.281 (-2.684)	-0.056 (-1.206)
Urban population	—	—	-0.028 (-1.070)	-0.065 (-2.552)	-0.069 (-2.940)	-0.073 (-1.696)	-0.087 (-1.086)	-0.12 (-3.229)
Government savings	-0.545 (-8.338)	-0.542 (-7.456)	-0.554 (-7.611)	-0.547 (-6.657)	-0.576 (-7.181)	-0.578 (-4.386)	-0.65	-0.359 (-3.483)
Growth per capita	0.456	0.306 (1.785)	0.425 (2.360)	0.592 (3.559)	0.581 (3.587)	0.488 (2.390)	0.877 (2.835)	0.521 (2.805)
GDP per capita	—	.000684	.000549 (3.307)	.000558 (3.172)	.000579 (3.471)	.00142 (2.567)	—	.00110 (2.152)
Money/GDP	0.05	0.045 (1.619)	0.051 (5.150)	0.029 (2.082)	0.049 (4.326)	0.209 (3.466)	— (3.286)	0.289 ^a (3.490)
Private sector credit	0.056	0.045 (1.619)	0.074 (3.638)	0.055 (3.280)	0.053 (3.110)	0.049 (2.217)	—	—
Social security	-0.124 (-4.703)	-0.267 (-6.813)	-0.33 (-7.983)	-0.155 (-4.360)	-0.167 (-4.711)	-0.253 (-3.346)	-0.563 (-4.400)	-0.116 (-1.531)
Real interest rate	—	-0.951 (-0.515)	—	—	—	—	—	-0.038 (-1.104)
Current account	—	—	—	0.517	0.533 (3.658)	0.38 (1.444)	0.564 (1.846)	0.625 (2.785)
Inflation	—	-0.043 (0.595)	0.012 (0.617)	—	—	—	0.671 (1.080)	—
Income distribution	—	-0.011	0.069 (3.591)	—	—	—	—	—
Political instability	—	—	—	1.193 (1.031)	—	—	-1.72 (-3.361)	—
Political assassinations	—	—	—	0.689 (1.200)	—	—	—	—
R ²	0.439	0.547	0.484	0.379	0.365	0.374	0.401	0.605
N	355	179	243	318	318	173	90	100

a. Beginning of period money ratio used as regressor.

instrumental variables—see below for a detailed description on the instruments used. Carroll and Weil (1993) use causality tests and find that growth “causes” aggregate savings.

- *GDP per capita*: taken from Summers and Heston. To the extent that more developed countries save a higher proportion of their income, its coefficient will be positive.

- *Money/GDP*: A number of variables were used. The first two were constructed as yearly ratios of M1 and M2 to GDP. Also, the ratio of the initial (1970) stocks of M1 and M2 to GDP were used. In all cases the raw data were taken from the IMF's *International Financial Statistics*. This is one of the most difficult variables to interpret. If it is taken, as tradi-

tionally has been the case, as a proxy for the depth and sophistication of the financial system, its coefficient should be positive (McKinnon 1973). If, however, it is taken as a measure of the extent to which different countries face a borrowing constraint, its coefficient should be negative (see the discussion in the preceding section for details).

- *Private sector credit*: This variable can be considered a closer proxy for borrowing constraints and is defined in two alternative ways: the first is the yearly ratio of credit to the private sector to total domestic credit; the second is the same ratio for the initial year, 1970. As discussed earlier, the borrowing constraint should affect private savings pos-

itively. Both indexes were constructed from raw data obtained from the *International Financial Statistics*.

- *Social security*: obtained from the World Bank's data set. It is defined as the ratio of public expenditure for social security and welfare to total public expenditures. It is a proxy for expected social security benefits, and its coefficient is expected to be negative.

- *Real interest rate*: defined as the ex-post real deposit interest rate. The raw data were obtained from *International Financial Statistics*. According to the model presented above, the sign of the coefficient of this variable is undetermined a priori.

- *Current account*: defined as the ratio of the current account balance to GDP, obtained from the World Bank data set. Its coefficient measures the degree of substitutability between foreign savings (or current account deficit) and national private savings. If foreign savings crowd out private savings, the estimated coefficient of this variable would be positive.

- *Inflation*: defined as the rate of change of the CPI. This variable captures the degree of macroeconomic stability, and its coefficient is expected to be negative.

- *Income distribution*: defined as the ratio of income received by the poorest 40 percent over income received by the highest 10 percent. To the extent that lower-income households save a smaller proportion of their income, its coefficient is expected to be positive. The data were taken from the World Bank data set.

- *Political instability*: Three variables were used. The first is a proxy for the degree of structural political instability in each country. An index defined as the frequency of transfers of government for the 1971–82 period was used. The other two are the frequency of politically-motivated assassinations and attacks. These variables were taken from Edwards and Tabellini (1994). The expected sign of their coefficients is negative.²³

Equations R1–R5 in table 2 refer to the complete sample, while equations R6–R8 are restricted to developing countries. These results are quite revealing.²⁴ The R^2 s are quite high, bordering on 0.5 in most cases. As suggested by life-cycle models, the coefficient of the age dependency ratio is significantly negative, indicating that demographics play an important role in explaining differences in private savings across time and countries. This coincides with the results obtained by a number of authors, including Leff

(1968) and Modigliani (1970) in their pioneering work. When alternative demographic variables were used instead of age dependency, the results were basically unaltered. The coefficient of the ratio of urban population is negative and significant in most regressions, supporting the “buffer-stock” approach to private savings (see Deaton 1989).

The coefficient of government savings was significantly negative in every regression. However, more important, from a policy perspective it was always significantly different from -1.0 . For example, in equation R1 the 95 percent confidence interval is $(-0.673, -0.416)$. This indicates that while higher government savings crowd out private savings, there is not a one-to-one relationship, and that Ricardian equivalence does not hold strictly.

The coefficient of social security is negative and significant at conventional levels in all the regressions where it was included. This is consistent with previous findings by Feldstein (1980), and gives support to the notion that reforms that replace government-run (and partially funded) social security systems with privately-run capitalization systems will result in higher private saving rates. Notice, however, that a reform of the social security system will tend to reduce government savings in the short run. The reason is that during the transition from the old regime to the new one, the government will continue to have obligations to (older) retirees, but will receive no contributions from active workers. Also, it is possible that privately administered social security systems could result in “excessive competition,” in which a high percentage of contributions are spent on advertising. Diamond and Valdes-Prieto (1994) have argued that this has been the trend in Chile's privatized social security system.

Also, the regressions reported in table 2 show that the rate of growth of per capita GDP is significantly positive. This result was obtained previously by a number of authors—most recently by Collins (1991), Bosworth (1993) and Carroll and Weil (1993)—and provides support to the hypothesis that there is a “virtuous circle” that goes from faster growth to increased savings to even higher growth.²⁵ When GDP per capita was added to the regressions, its coefficient was always positive and significant, indicating that, all things being equal, more advanced countries tend to save a higher percentage of GDP—Collins (1991) reports a similar result in her analysis of ten developing countries.

The next three independent variables in table 2—money/GDP, private credit and real interest rate—are proxies that try to capture the extent of development of the financial market, the severity of the borrowing constraint, and the degree of “financial repression.” The coefficient of the money/GDP ratio is always significantly positive, suggesting that countries with a “deeper” financial system will tend to have higher private saving rates. To investigate the robustness of this result, several alternative definitions of this index were used, including yearly M1 and M2 ratios, as well as beginning-of-period ratios. When this was done, however, the estimates did not change in any significant way. The coefficient of private credit also was significantly positive in all regressions where it was included. Overall, these results do not provide support for the view that borrowing constraints have resulted in lower savings. This contradicts evidence presented by Schmidt-Hebbel and others (1992) and by Jappelli and Pagano (1994) who found that, using different samples, relaxing borrowing constraints negatively affected private savings. There are several possible explanations for these results, including that the share of private credit is a poor proxy for borrowing constraints and that these operate on household savings only, and not on corporate or total private savings. Unfortunately, more adequate measures of borrowing (or liquidity) constraints, such as the down payment required to buy a house, are only available for a small number of advanced countries. The role of these type of constraints—including restrictions on consumer credit—possibly constitutes one of the most important unresolved issues in research on savings behavior. To investigate the issue further, I estimated cross-sectional regressions using average data for the 1983–92 period. The instrumental variables estimates yielded a positive coefficient for the money/GDP ratio, and a *negative* one for the ratio of private sector credit over total domestic credit. The following is an illustration of the type of result obtained (numbers in parentheses are t-statistics):

$$\begin{aligned} \text{PSAV} = & 1.83(3.2) \text{ Growth} - .35(-2.1) \text{ GovSav} - 1.0(-1.9) \text{ Old} - .619(-2.2) \\ & \text{Young} + .138(1.6) \text{ Money/GDP} - .062(-1.9) \text{ Private credit} - .104(-1.7) \\ & \text{Social security} + .49.233(13.474); N = 39; R^2 = 0.57. \end{aligned}$$

More detailed and convincing analyses on the role of bor-

rowing constraints will require constructing more reliable indicators of the extent of these constraints.

The coefficients of real interest rates in table 2 were insignificant everywhere it was included. This is consistent with results obtained by a number of previous researchers (see McKinnon 1993), for example. Moreover, when an interactive real interest rate-real GDP per capita term was included, the result did not support Ogaki and others' (1994) finding suggesting that the degree of intertemporal substitutability in consumption increases with the degree of development. When alternative measures of the efficiency of the financial system, such as the spread between lending and deposit interest rates, were included in the regressions, their coefficients were not significant.²⁶

The current account balance was significantly positive in every regression, but the estimated coefficient was smaller than one, indicating that increases in foreign savings crowd out private savings in a less than one-to-one fashion. Also, the inflation and political instability coefficients were not significant in any of the regressions where they were included. Income distribution data are available for a very small number of countries—mostly advanced. In one of the regressions its coefficient was significantly positive; however, to get a clearer perspective on the role of this variable additional data would be required.

To check the robustness of the results, I performed a series of tests. In particular, I added variables related to macroeconomic stability (variability of inflation), the open economy (degree of openness and variability of the real exchange rate), and the structure of the economy (share of manufacturing, mining, and agriculture in GDP). Their coefficients were not significant. I also analyzed whether the results reported in table 2 were driven by outliers. To do this, I estimated Cook's distance statistics to identify variables with a high degree of “influence” on the results. These observations turned out to correspond to Bolivia; when they were excluded from the regression, however, the results discussed above did not change in any meaningful way. Finally, I reestimated the equations using White's procedure for estimating the variance-covariance matrix under heteroskedasticity; again the results elaborated above were not altered.

The computation of standardized beta coefficients indicates that per capita GDP growth is the most important variable for explaining cross-country differences in private

TABLE 3

Private savings and Latin America

Dummy variables estimation; t-statistics in parentheses

VARIABLE	COEFFICIENT ESTIMATES	LAC DUMMIES
Age dependency	-0.133 (-3.143)	-0.174 (-0.729)
Urban population	0.013 (0.450)	-0.626 (-3.084)
Government savings	-0.596 (-6.524)	0.383 (1.195)
Growth per capita	0.649 (2.923)	-0.486 (-1.559)
GDP per capita	-0.0000560 (-0.262)	0.0004 (3.298)
Money/GDP	0.041 (3.826)	0.055 (0.206)
Private sector credit	0.062 (3.298)	-0.098 (-1.466)
Social security	-0.119 (-2.976)	0.013 (-0.990)
Current account	0.527 (3.357)	-0.384 (-1.289)
R ²	0.454	—
N	306	—
F	—	3.75

Note: Estimates include Latin American dummy variables for each regressor. The coefficients in the third column represent the dummy estimates.

savings. This coincides with Bosworth's (1993) results. In equation R2, for example, the beta statistic for growth is 3.43; the other variables with relatively high betas were government savings (-1.36) and money/GDP ratio (0.87).

The title of this paper asks why savings rates are so low in Latin America. The results presented in table 2 suggest that this can be the consequence of a series of factors. First, some of the coefficients of the private savings equation for Latin America may be different from those for the rest of the countries in the sample. Second, even if the same equation can describe private savings across regions, the value of the left-hand-side variables may be different in the Latin nations. Naturally, a third possible explanation is a combination of the previous two.

To test whether the coefficients pertinent to the Latin countries were different, I reestimated the equations in table 2 with Latin America dummy variables for every coefficient (see table 3 for the results obtained in the case of equation R5). As can be seen, only the dummies for two of the coefficients—urban population and GDP per capita—are signifi-

cantly different from zero.²⁷ This suggests that the degree of urbanization plays a significantly more negative role in Latin America than in the rest of the sample. A possible explanation for this is that, within the context of the buffer-stock approach to savings, the traditional role of government in providing a safety net in the cities has reduced precautionary savings. What is more important, however, is that these results suggest that the policy variables and growth coefficients are not significantly different across samples.

Regarding the second possible explanation, an analysis of the left-hand-side variables unveils significant differences between the Latin American countries and the rest of the sample. This is the case both for demographic variables (Latin America has a much higher age-dependency ratio, for example), growth, and policy variables such as social security and government savings (see table 4). The results in tables 3 and 4 suggest that the poor levels of Latin American private savings are mostly a consequence of different levels of savings determinants, and not so much due to structural differences in the private savings function.

Government savings

Table 5 contains the results obtained from instrumental variable estimations of government savings equations using both panel data as well as cross-country variables for 1983–92.²⁸ In addition to political instability and polarization—proxied by politically motivated attacks and assassinations—some of the independent variables included in the private savings regressions were incorporated into the regressions.²⁹ The dependent variable was obtained from the IMF, and the independent variables were defined as discussed above.

TABLE 4

**Latin America and rest of the sample:
General statistics**

VARIABLE	LATIN AMERICA		REST OF THE SAMPLE	
	MEAN	STANDARD DEV.	MEAN	STANDARD DEV.
Private savings	13.40	5.60	18.90	7.60
Government savings	2.10	5.90	2.50	14.90
Growth	0.90	3.70	1.10	0.30
M1/GDP	10.90	5.0	22.30	28.70
M2/GDP	26.30	9.40	53.70	23.90
Private credit	0.70	0.30	0.67	0.31
Current account	-3.10	4.00	-2.80	4.20
Age dependency	0.76	0.12	0.67	0.19
Social security	18.40	13.50	16.80	16.00

TABLE 5

Determinants of government savings

VARIABLE	R9	R10	R11
Sample	Panel ^a	Panel	Cross-section
Estimation method	IV	IV-Fixed effects	IV
Age dependency	1.657 (0.298)	0.402 (0.321)	0.042 (0.533)
Urban population	0.078 (3.334)	-0.153 (0.941)	—
Social security	—	—	-0.008 (-0.103)
Growth per capita	0.632 (4.140)	0.794 (7.270)	1.801 (3.285)
GDP per capita	-0.0004 (-2.627)	-0.00062 (-2.412)	-0.00018 (-1.032)
Money/GDP	-0.012 (-1.240)	-0.001 (-0.183)	-0.074 (-0.747)
Current account	0.378 (5.044)	0.532 (4.570)	0.822 (2.449)
Political instability	-0.82 (-2.900)	-0.363 (-5.183)	-0.511 (-2.569)
Political assassinations	-0.181 (-0.259)	—	—
Attacks	-0.0901 (-2.701)	-0.018 (-4.149)	-0.002 (-0.358)
R ²	0.439	0.484	0.365
N	334	334	38

Note: t-statistics are in parentheses.

a. The following were used: assassinations, lagged growth per capita, lagged investment, ratio of social security expenditures to total expenditure, frequency of transfer of political power, attacks, lagged current account balance, urbanization, openness, inflation, ratio of broad money to GDP, and government consumption.

As can be seen, the results obtained differ from those for private savings, reported in table 2, and provide some support for the political-economy perspective on government savings. In every equation the coefficient of political instability was significantly negative. This suggests that in countries with higher political turmoil public savings will tend to be lower than in countries with a more stable political environment. Interestingly enough, when alternative measures of political instability were used—such as the estimated probability of government changes—the results were maintained. However, the proxies for polarization—politically-motivated attacks and assassinations—were significantly different from zero in only some of the regressions. It is important to note, however, that in spite of these positive results, the regressions reported here do

not permit discrimination between the political-economy, strategic-behavior approach proposed in the previous section, and alternative models based on governments' political weaknesses (see Edwards and Tabellini 1994 for a discussion on these two families of models).

As in the case of private savings, the coefficient of growth is significantly positive. Moreover, the computation of standardized beta coefficients indicates that this is the most important variable in explaining cross-country differences in government savings (political instability is the second most important beta coefficient).

Interestingly enough, and contrary to the private savings case reported in table 2, neither the demographics, social security, or money/GDP variables have significant coefficients. As in the case of private savings, the coefficient of the current account is significantly positive, indicating that a higher level of foreign savings—that is, a reduction in the current account balance—has been associated with a lower government savings rate. Its coefficient, however, is significantly below unity in both panel regressions reported here—for example, in equation R10 the 95 percent confidence interval is (0.29, 0.75), indicating that the degree of offset is not one-to-one.

Concluding remarks

Most empirical studies on national savings have either aggregated private and government savings or have concentrated on private savings behavior under the assumption that government savings are exogenous. This is indeed puzzling. There are solid theoretical reasons for believing that both types of savings are determined in very different ways; and, perhaps more importantly, in rapidly growing economies government savings have made fundamental contributions to national savings. This paper provides evidence that clearly suggests that the processes of determination of private and government savings are significantly different. While private savings respond to demographic variables, social security expenditures, and the degree of depth of the financial sector, government savings do not. Government savings, on the other hand, are affected by an important type of variable that does not affect private savings: the degree of political instability of the country in question. However, both private and government savings are affected by real growth and by the current account balance or foreign savings.

TABLE 6

Tax rates in the pre-reform and post-reform periods

(percent)

Country	PERSONAL INCOME TAX		CORPORATE INCOME TAX		WITHHOLDING TAXES ON FOREIGN REMITTANCES ^a	
	1985-86	1991	1986	1992	1986	1993
Argentina	16.5-4.5	6-30	0-33	20	23	17
Bolivia	30	13	0-30	0	25	13
Brazil	0-6	10-25	29-50	25-40	25	22
Chile	0-57	5-50	10-37	15-35	40	38
Colombia	0-49	5-30	40	30	40	12
Costa Rica	5-50	10-25	0-50	30	15	18
Dominican Republic	2-73	3-70	0-49.3	0-49.3	20	30
Ecuador	19-40	10-25	0-59	0-44.4	40	36
El Salvador	3-60	10-50	0-30	0-25	22	20
Guatemala	11-48	4-34	0-42	12-34	16	17
Honduras	3-40	3-40	0-55	0-40.2	10	18
Mexico	3-55	3-55	5-42	0-35	37	22
Nicaragua	15-50	6-50	0-45	0-35.5	20	30
Panama	13-56	2.5-56	0-50	2.5-45	30	22
Paraguay	5-30	0	0-30	0-30	23	25
Peru	2-56	5-56	0-40	0-30	42	19
Uruguay	0	0	0-30	0-30	30	—
Venezuela	12-45	4.5-45	18-67.7	20-67.7	20	15
Regional average	5-36	7-47	3.4-46.3	8.6-36.5	27	22

a. Simple average.
 Source: Shome 1994.

TABLE 7

Value-added tax rates

(percent)

COUNTRY	DATE VAT INTRODUCED OR PROPOSED	AT INTRODUCTION	JANUARY 1994
Bolivia	October 1973	5, 10, 15	14.92 ^a
Brazil ^b	January 1967	15	9, 11
Brazil ^c	January 1967	15	17
Chile	March 1975	8, 20	18
Colombia	January 1975	4, 6, 10	8, 14, 20, 35, 45
Costa Rica	January 1975	10	8
Dominican Republic	January 1983	6	6
Ecuador	July 1970	4, 10	10
El Salvador	September 1992	10	10
Guatemala	August 1983	7	7
Haiti	November 1982	7	10
Honduras	January 1976	3	7, 10
Jamaica	October 1991	10	12.5
Mexico	January 1980	10	10
Nicaragua	January 1975	6	5, 6, 10
Panama	March 1977	5	5, 10
Paraguay	July 1993	12	10
Peru	July 1976	3, 20, 40	18
Venezuela	October 1993	10	10

a. Effective rate. Legislative tax-inclusive rate is 13 percent.
 b. On interstate transactions, depending on region.
 c. On interstate transactions.

From a policy perspective, the results reported in this paper suggest that there are a number of possible avenues—many of them discussed in policy literature—for raising private savings in Latin America. An increase in the degree of depth of the financial sector will tend to have an important effect. Interestingly, for the period under consideration the ratio of M1 to GDP in Latin America was almost one-half of that of the rest of the sample. What is less clear, however, are the mechanisms by which this could happen. Also, the results presented here have not resolved the question of the impact of borrowing constraints. While the panel data analysis did not unearth such an effect, cross-section results provide some evidence in support of the notion that relaxing the borrowing constraint may reduce savings. Further research on this issue will be needed before a clearer picture emerges. At this point, however, it seems that the most fruitful type of research along these lines would be microeconomic in nature. In particular, investigating how the increased access to consumption credit affects household saving decisions would be particularly important.

The results also suggest that the reduction of government-provided social security benefits would increase private savings. Again, however, additional progress in this area would require detailed microeconomic analysis of specific country experiences. In that sense, the study of the Chilean case appears to be particularly promising.

Perhaps one of the most important results refers to the role of public savings as a determinant of private savings. While the results strongly suggest that higher government savings will depress private savings, they will do this in a less than one-to-one fashion. In fact, the results suggest that an increase in government savings of 1 percent will generate a decline in private savings of approximately 0.55 percent, with a consequent increase in national aggregate savings of 0.45 percent. To the extent that this net increase in national savings results in higher capital accumulation and growth, it would be possible to begin the “virtuous circle” discussed above.

It should be noted, however, that due to the nature of the data—very short time series and a rather large number of cross-sections—the results reported in this paper do not

provide enough information regarding the transition from low to higher savings rates. However, evidence from a score of countries—including the “East Asian miracle” nations—suggests that an increase in private domestic savings ratios is a rather slow process (World Bank 1993b). This evidence also indicates that a drastic increase of private savings usually has been influenced by an important factor not captured in the regression analysis: the creation of an institutional environment that instills confidence in small savers—the case of postal savings in East Asia is a good example of this type of institution. This, jointly with the econometric results discussed here, suggests that the development of new institutions, such as new social security systems tailored after the Chilean experience, could play a fundamental role in increasing private savings.

Another important finding is that government savings, in turn, will be positively affected by the creation of social and political institutions that reduce the degree of political instability. Countries that have a “national project” and where political forces coexist in relative harmony will find it easier to increase government savings. This suggests, then, that the strengthening of democracy will have important, and fairly direct, positive effects on growth and economic progress.

As a consequence of the debt crisis, most Latin American countries had to reform their public finances. Tax systems have been rationalized and become more efficient; the number of tax rates has been reduced, their level has been harmonized with international rates, and the number of exemptions eliminated. Tables 6 and 7 provide a summary of the most important reforms in tax rates. In spite of these important changes, however, in some countries public sector revenues continue to be rather low (see Edwards 1993). In fact, the increases in government savings reported in table 1 have been attained through a reduction in expenditures—especially in infrastructure. There is now a growing consensus that a further increase in government savings will need to come from improved tax administration—including the reduction of evasion—and increased reliance on user fees for services provided to the well-to-do (World Bank 1993a).

Appendix

Countries included in the empirical analysis

IMF CODE	COUNTRY
122	Austria
124	Belgium
128	Denmark
134	Germany
136	Italy
142	Norway
156	Canada
172	Finland
178	Ireland
182	Portugal
186	Turkey
196	New Zealand
218	Bolivia
223	Brazil
228	Chile
233	Colombia
253	El Salvador
273	Mexico
288	Paraguay
299	Venezuela
429	Iran
524	Sri Lanka
548	Malaysia
564	Pakistan
566	Philippines
576	Singapore
578	Thailand
622	Cameroon
652	Ghana
664	Kenya
684	Mauritius
686	Morocco
694	Nigeria
724	Sierra Leone
742	Togo
744	Tunisia

Notes

1. See, for example, World Bank (1993a) and CEPAL (1994).
2. See, for example, the family of Ak models pioneered by Rebelo (1991). There is now abundant literature on endogenous growth. See, for example, Grossman and Helpman (1991) and Sala-i-Martin (1992). See Gersovitz (1988), Deaton (1990) and Schmidt-Hebbel and others (1994) for detailed surveys on the links between savings and development.
3. For example, in what is possibly the most comprehensive recent cross-country study of savings determination, Carroll and Weil (1993) use aggregate savings without making a distinction between private and government savings. The lack of appropriate data traditionally has affected efforts to study in detail the behavior of savings in a broad comparative setting. Although advanced and select middle-income countries have distinguished between the two types of savings, these data have not been available for the

poorer nations.

4. See Gersovitz (1988) for a discussion on data problems in aggregate savings studies.

5. See, for example, *Financial Times*, October 28, 1994.

6. See Gersovitz (1988) for a broad survey on savings and development. Aghevli and others (1990) provide a complete discussion of recent trends and prospects. Hayashi (1986) provides a fascinating analysis of Japanese savings, and deals with the question of why Japan's savings rate is so high.

7. Summers (1988) provides a (partial) exception. See also the discussion in Feldstein and Bacchetta (1991).

8. Most empirical studies have associated private savings to household savings. This is not strictly correct, since in a number of countries corporate savings are an important component of the aggregate. In this paper I follow most recent authors, and do not deal with the theory of corporate savings. See, however, Gersovitz (1988) for a discussion. The empirical analysis of section IV, however, includes both household and corporate savings.

9. See, for instance, Modigliani and Brumberg (1954).

10. On borrowing constraints, see, for example, Deaton (1989) and Zeldes (1989).

11. For a detailed discussion on precautionary savings when the marginal utility is convex, see, for example, Caballero (1990).

12. Carroll and Summers (1991) present evidence suggesting that two key implications of the permanent-income hypothesis are not borne out in U.S. data. First, contrary to this hypothesis, anticipated income growth and consumption are not uncorrelated; second, the (real) rate of interest is not a strong determinant of the rate of growth of consumption.

13. See Fry (1988) for surveys of these types of models.

14. In spite of the relative unresponsiveness of savings to higher interest rates, financial reforms still have important effects on growth through improvement in the quality of aggregate investment, and especially private investment. For example, in a series of studies Gelb (1989), Fry (1988), and McKinnon (1991) have found robust evidence supporting the hypothesis that a reduction in the degree of repression of the capital market will tend to increase the productivity of investment. This work also suggests that reducing financial instability, and especially inflation, will also have an important positive effect on the return to investment. Also, recent work by King and Levine (1993) provides support to the idea that more developed financial sectors have been associated with faster total factor productivity growth.

15. That provision was altered in the 1990 tax reform. See the discussion in Edwards (1993). See also Edwards and Cox-Edwards (1991).

16. Carroll and Summers (1991) have argued that the comparison of the evolution of Canadian and U.S. tax systems provides an ideal natural experiment for investigating the way in which tax regimes affect savings rates. They conclude that tax systems that encourage postponed consumption, such as Canada's, indeed result in higher savings.

17. Surprisingly, however, a number of empirical studies on savings continue to ignore the endogeneity of the rate of growth. See, for example, Schmidt-Hebbel and others (1992) and Doshi (1994).

18. Gersovitz (1988) makes the important, but often forgotten, point that even though savings will be higher with borrowing constraints, household's welfare will tend to be lower.

19. On Ricardian-Barro equivalence, see Barro (1974).

20. Strictly speaking, what matters is the relation between contributions and expected social security benefits in the future.

21. In particular, the rate of growth of GDP per capita, the (real) interest rate and the current account are likely to be endogenous.

22. In the cross-section estimates I dealt with 1983–92 averages. In this case endogenous variables for 1970–82 were used as some of the instruments. Although this procedure does not fully deal with causality, it provides a convenient way to handle the simultaneity issue.

23. When alternative indices—such as the estimated probability of government change—are used to measure political instability, the basic results reported here were obtained.

24. The countries used in the regressions were chosen according to data availability and are listed in the appendix. The rate of growth of GDP per capita, real interest rates, and the current account balance were considered endogenous variables. The following instruments were used: a constant, age dependency, lagged moving average of growth, money/GDP, private credit, lagged real interest, government savings, social security, lagged current account, income distribution, political instability, GNP per capita, government consumption ratio, lagged investment, inflation, openness, and population growth.

25. The fact that the regressions reported in table 2 have been obtained using instrumental variables supports the idea that this positive coefficient is not simply the consequence of a simultaneity bias. Carroll and Weil (1993) present Granger causality tests that suggest that growth causes aggregate savings.

26. From theoretical and empirical points of view, the (possible) effects of interest rates—and other incentives—on private savings constitute a major controversy.

27. The F-test for the hypothesis that all coefficients (including the constant) are jointly equal to zero is equal to 3.75, indicating that the null is rejected at the 1 percent level.

28. The following instruments were used: a constant, lagged growth, political instability, assassinations, attacks, social security, lagged current account balance in 1970–82, age dependency, share of government consumption, GNP per capita, money/GDP ratio, inflation lagged investment, openness, and social security.

29. See Edwards and Tabellini (1994) for a discussion on the sources for these variables.

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Comment on "Why Are Latin America's Savings Rates So Low? An International Comparative Analysis," by Sebastian Edwards

CARLOS LANGONI

GROWTH RATES IN EAST ASIA AND LATIN AMERICA DURING THE FIFTEEN YEARS PRIOR TO the Latin American debt crisis were quite similar. But within that period savings rates increased from 23 percent to 29 percent in East Asia; in Latin America savings rates moved only slightly, from 19 percent to 20 percent. Why has East Asia been able to save more and outperform Latin America given similar growth rates?

Three fundamental elements led to different levels of performance. First, growth in Latin America has always been accompanied by inflation; in East Asia steady growth and low inflation rates have been maintained. Second, the export market has grown in East Asia; in Latin America export performance has been poor. Third, East Asia has been able to reconcile growth with income distribution; in Latin America growth has had a negative impact on the distribution of income.

The difference in savings rates between East Asia and Latin America contributes to the difference in performance between the two regions. The rate of public savings in Latin America is strikingly low relative to East Asia. The low savings rate in Latin America is closely related to the inflation caused by a chronic public sector deficit.

Two institutional differences contribute to the difference in public savings in East Asia and Latin America. First, East Asia is less tolerant of public sector debt than Latin America. Thus the inflation and lower public savings that come with public debt have also been less prevalent in East Asia. Second, East Asia has swiftly and efficiently adjusted to large public sector imbalances. In Latin America adjustment has been long and difficult. Without this fundamental fiscal element, low inflation and sustainable growth are difficult to achieve.

Assuming that growth in Latin America can be increased by higher public savings rates and given that public savings rates are relatively low, the prospects for growth in the region are very high. Social security and fiscal reforms are two ways in which Latin America could stimulate public savings.

Increased private savings rates in Latin America could also contribute to growth. Levels and composition of private savings are affected by variations in demographic factors, the extent of chronic inflation, real rates of return, and market, policy, and institutional uncertainties. For example, anticipated, predictable rates of return increase the propensity for private savings. Likewise, a stable political environment that minimizes political and institutional uncertainties increases private savings. Although chronic inflation may encourage voluntary private savings, these

savings will be in the form of short-term, liquid investments. Long-term, stable savings are essential for financing sustainable growth. Pension fund reform could stimulate longer-term savings.

Neither short-term savings nor short-term foreign capital finance sustainable growth. Instead, policy reforms that expand privatization opportunities and draw foreign direct investment into Latin America will help attract the desired composition of foreign savings.

Comment on “Why Are Latin America’s Savings Rates So Low? An International Comparative Analysis,” by Sebastian Edwards

Y U N G C H U L P A R K

ALTHOUGH IT MIGHT NOT SEEM OBVIOUS, ECONOMIC GROWTH HELPS BOOST PUBLIC SAVINGS. For example, suppose a country experiences an export boom. The increase in exports will increase the incomes of the working productive population. Tax revenue, in turn, increases more than proportionally. As a result public savings, aggregate savings, and investment increase.

Political stability, the current account balance, and economic growth also increase public savings. And as public savings increases, the use of funds becomes very important. Public savings can be transferred to the private sector or used for public investment. Both uses can lead to a virtuous circle of saving and growth if the corresponding investments are efficient.

The effects of borrowing constraints on consumer behavior and private savings derive from a country’s consumption and stage of development. Specifically, liquidity constraints are not likely to affect consumption and savings during the early stages of development because at that stage consumers’ concerns are focused on meeting daily needs. At the second stage of development, when incomes rise and more durable goods are purchased, borrowing constraints and import restrictions have a greater effect. This effect is less powerful during the mature stages of development, when consumption is centered on services such as travel, entertainment, and health care. Borrowing constraints reinforced by import control have played an important role in increased savings and growth rates in the Republic of Korea.

Corporations are a second factor contributing to East

Asia’s high savings rates. Corporate savings in Korea account for 45–50 percent of private savings. This high level of savings is a result of firms’ profit maximization behavior and their reliance on self-finance. Again, this is a result of liquidity constraints and underdeveloped capital markets.

Finally, outward-oriented development strategies have contributed indirectly to Korea’s increase in private savings (from 8 percent of GNP during the 1960s to 35 percent today). After these strategies were implemented in the early 1970s a substantial portion of agricultural workers moved to urban settings and began working in manufacturing industries. The resulting increase in labor-intensive commodities allowed Korea’s exports to surge. Thus export promotion policies helped generate higher levels of savings.

Floor Discussion of "Why Are Latin America's Savings Rates So Low? An International Comparative Analysis," by Sebastian Edwards

A MEMBER OF THE AUDIENCE COMMENTED THAT CONCENTRATING ON PUBLIC SAVINGS to increase aggregate savings is a questionable approach given the poor impression most citizens have of the way governments use resources. Rather, policymakers should focus on how public savings are used. During the early stages of development there should be greater emphasis on increasing private savings. Improving the investment climate as a whole would attract and encourage foreign investment and thus would generate the kind of financial reform that leads to increased private savings. And financial reform generates greater potential for growth than public savings.

Another member of the audience said that Edwards' paper shows that there is a fall in private savings and an increase in public savings after reform. One possible explanation is the fall in inflationary tax.

Eliana Cardoso, lead economist of the China and Mongolia Department of the World Bank, questioned whether there is a lesson from East Asia for Latin America. For example, in China the private sector saves 40 percent of GNP while the public sector dissaves. The high level of private savings can be attributed to growth and to the fact that 80 percent of workers are not covered by the social security and pension system. This is not a path that Latin America should follow. Policymakers in Latin America should instead be encouraged to increase public savings. Furthermore, in Korea liquidity constraints cause relatively high levels of savings. Again, this approach should not be encouraged in Latin America. Efforts are being made in Latin America to improve citizens' welfare, not to impose restrictions that force them to save more. Public savings is often invested in inefficient public enterprises. Latin American governments should reduce their overall fiscal deficits rather than save more.

Yung Chul Park (discussant) agreed that East Asia's experience is not applicable to Latin America. Increased savings in East Asia were a result of financial and import restrictions. In market-oriented economies like those in Latin America—where open financial markets allow citizens to import luxury consumption goods and borrow from international sources—such restrictions are not effective.

The broader question is whether, in an increasingly liberalized and economically integrated world, Latin American governments should be concerned with savings at all. After all, Park said, international savings and foreign investment can contribute to savings if domestic savings fall. Thus an environment that is favorable to sustainable investment is more important than savings.

Carlos Langoni (discussant) said that governments should use fiscal reform to increase public savings and improve efficiency in the allocation of public resources. Brazil, for example, is considering fiscal reform that will make the tax system more efficient and equitable. The need for private savings, trade liberalization, and consumer credit expansion produce challenging short-term problems, however. If stabilization, trade liberalization, and consumer

credit expansion take place at the same time, short-term private savings and stabilization may be negatively affected. But, Langoni said, Latin America is not in a position to choose between increased private or public savings. There is room and a need to increase the level and efficiency of both.

Edwards felt that East Asia's economic history and experiences provide useful information from which Latin America can benefit. Both regions' successes and mistakes provide lessons for the rest of the world.

On the issue of whether savings and investment are related, Edwards said that some studies have suggested a correlation between the two variables, while others show that the correlation breaks down in less-developed countries and as the world moves toward an open, international economy. We should continue to examine this issue.

On the issue of whether public savings should be used to finance private investment, Edwards said that increases in public savings do not necessarily mean that public spending on private investment should also be increased. Instead, public investment in social projects should be evaluated in terms of social rates of return, shadow prices, and other traditional analytical methods and should be undertaken only if the rates of return are sufficiently high. Given that infrastructure has long been ignored in Latin America, public spending in this sector should be encouraged if the social rates of return are adequate.

When evaluating social security reforms, Edwards con-

tinued, it is important to consider their net effect on overall savings. Specifically, as countries move toward capitalization from pay as you go systems, it is important to measure the tradeoff between increased private savings and the large public liabilities that will result as the reforms are put into effect.

An audience member asserted that the lessons that had been derived from Mexico during the conference were superficial and self-serving. The Mexican crisis should be analyzed more seriously and responsibly. According to the speaker no attempt had been made to tie Mexico's policies, based on World Bank recommendations, to the results Mexico had gotten. Moreover, the format and organization of the conference did not facilitate real dialogue; rather, it suggests that the World Bank is only interested in dispensing advice.

Edwards responded that the presence of participants of various backgrounds, including nongovernmental organizations and academics commonly known as World Bank critics, and the varied dialogue taking place at the conference show that the Bank is committed to a dialogue with its member countries. The Bank is interested in hearing both the consenting and dissenting views of its colleagues. Edwards hopes that continued dialogue and feedback will lead to a virtuous circle, with each regional conference contributing more than the previous to improving development in Latin America and the Caribbean.

Latin America and the Caribbean in the World Economy

CARLOS A. PRIMO BRAGA, JULIO NOGUÉS,
AND SARATH RAJAPATIRANA

OVER THE PAST TEN YEARS MOST COUNTRIES IN THE LATIN AMERICA AND THE CARIBBEAN (LAC) region liberalized their trade regimes, breaking away from trademark inward-oriented strategies of development. Trade liberalization has been pursued not only unilaterally but also in the context of regional integration arrangements and, more recently, in response to multilateral commitments negotiated in the Uruguay Round. Not since early in this century have so many countries in the region been as open to foreign trade and investment.

Trade liberalization has often been implemented as part of a broader package of structural reforms designed to promote macroeconomic stabilization and to redefine the role of the state in these economies; this has been called the neoliberal agenda. By mid-1994 significant progress had been achieved in trade reform and the conventional wisdom was that the most difficult stages in the process had been surpassed.

The financial crisis triggered by the devaluation of the Mexican peso in December of 1994 has been interpreted by some as posing a challenge to the neoliberal strategy. In this paper we argue that in spite of heightened economic risks to the reform programs, a wholesale return to protectionism is unlikely. The best reassurances of this include the economic ideas of the leadership elite of the region, the economic benefits that the new policies have already generated, and the determination that many governments have shown in dealing with the crisis, in spite of the risks that

renewed fiscal adjustment programs posed at the time of recent democratic elections.

Yet the crisis has increased the political clout of those who demand more protection, and against this background the need for countries to pursue corrective actions has been reinforced. These include ongoing attempts to stabilize the macroeconomy on a sustained basis, reinforced efforts to maximize transparency, particularly in the context of preferential trade arrangements, and the development of institutions that are able to resist protectionist pressures.

We begin our analysis by examining the reasons behind the observed outward-oriented trend and by documenting progress under different modes of liberalization (unilateral, regional, and multilateral) until 1994. The effects of these trade reforms are also briefly reviewed. The paper discusses how in some countries, domestic macroeconomic imbalances, currency appreciation, unemployment, and changes

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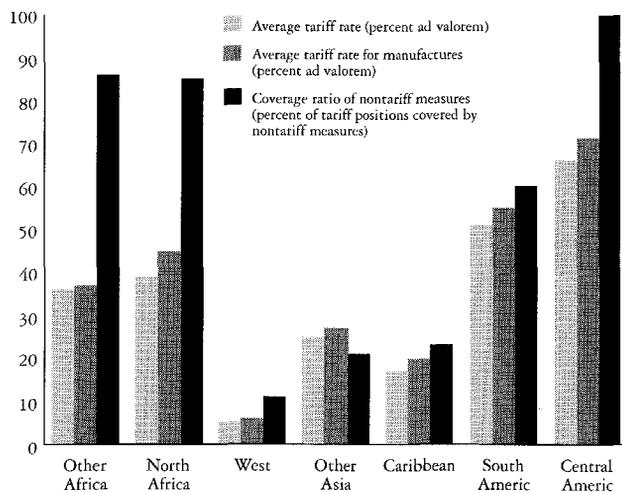
in the external environment have strengthened the forces in favor of backsliding. Although regional agreements have resulted in significant increases in intraregional trade flows for several countries, we argue that close surveillance of their compliance with basic economic principles should be a continuous process to ensure that they remain a positive factor on the road toward trade liberalization. Then the role of institutions in sustaining an outward-oriented trade regime is discussed. The final section gives conclusions and recommendations.

Trade policies in Latin America and the Caribbean: The liberalization trend

In the mid-1980s countries in the LAC region typically displayed above-average levels of protection in the developing world (figure 1). This reflected not only widespread reliance on import-substitution industrialization strategies, but also the recourse to trade instruments to cope with the foreign-debt crisis that erupted in 1982. It is worth noting that LAC countries diminished rather than increased their integration with the world economy over the 1971–85 period (figure 2).

Since then, things have changed dramatically (table 1). As pointed out by several authors (Alam and Rajapatirana 1993 and Rodrik 1994, among others) there has been a rush toward freer trade, although the journey was far from complete by 1994. Trade reforms have typically involved a

FIGURE 1
Trade protection in developing countries, mid-1980s

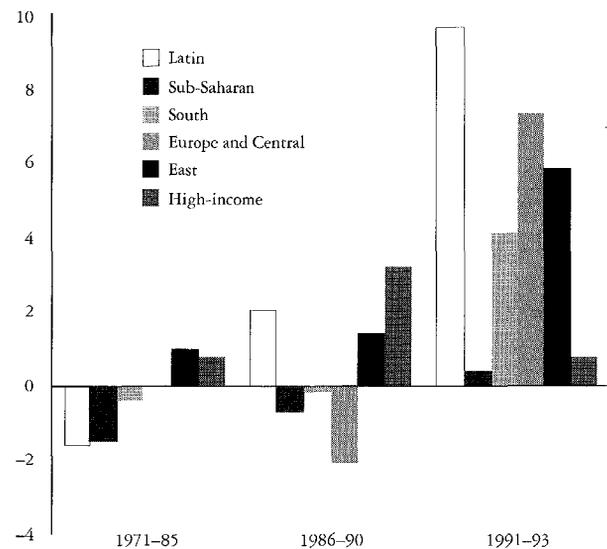


Source: Erzan, Kuwahara, Marchese, and Vossenaar 1989.

FIGURE 2

The speed of world trade integration, 1971–93

Growth rate of the sum of merchandise export and import volumes minus growth rate of output



Source: World Bank 1995a.

greater reliance on price mechanisms rather than government intervention, reductions in import and export barriers, and the pursuit of transparency (for example, a shift from nontariff barriers to tariffs). These measures have often been complemented by reforms of exchange rate regimes (for example, the elimination of multiple exchange rates), regulatory reforms, and financial market liberalization and by the opening of the capital account.

The economic case in favor of a liberal trade regime is well known. Under a liberal trade regime resources are employed in line with comparative advantage, economies of scale can be better exploited, and innovation and diffusion of knowledge are promoted. There is also ample evidence that countries that are able to sustain trade liberalization outperform those that fail in their liberalization attempts (Michaely, Papageorgiou and, Choksi 1991; Nogués and Gulati 1994; Edwards 1993a). Still, trade liberalization is often resisted by policymakers.¹

What fostered the liberalization trend in Latin America in the 1980s? The usual "suspects" identified in the literature (Dornbusch 1992; Edwards 1993b) include the "triumph" of the neoliberal ideology, the demonstration effect of the Asian "tigers," mounting frustration with the poor results of inward-oriented trade regimes, and support from

TABLE 1

Some indicators of trade regimes before and after reform

(percent)

COUNTRY (PRE-REFORM YEAR)	AVERAGE UNWEIGHTED LEGAL TARIFF RATES		TARIFF RANGE		COVERAGE OF QRS ON IMPORTS (PERCENTAGE OF TARIFF LINES UNLESS OTHERWISE NOTED)	
	PRE-REFORM	POST-REFORM (1993)	PRE-REFORM	POST-REFORM (1993)	PRE-REFORM	POST-REFORM (1993)
Argentina (1988) ^a	38 ^b	12	0-50	0-20	62 (of dom. prod.)	Minimal
Bolivia (1985)	12 ^c	8	na	5-10	na	Minimal
Brazil (1987)	51	14	0-105	0-35	39	Minimal
Chile (1984)	35	11	35	0	Minimal	0
Colombia (1984)	61	12	0-220	5-20	99	1
Jamaica (1981)	na	20	na	0-45	na	0
Mexico (1985)	24 ^d	13 ^d	0-100	0-20	92 (of dom. prod.)	20 (of dom. prod.)
Peru (1988)	66	16	0-120	15-25	100	Minimal
Trinidad and Tobago (1989)	na	41 ^b	na	0-103 ^b	na	4
Uruguay (1987)	32	15	10-55	0-20	0	Minimal
Venezuela (1989)	37	19	0-135	0-50	40	10

a. Argentina imposes a statistical tax that has varied over time, and now stands at 3 percent.

b. Includes tariff surcharges.

c. Import-weighted average tariff.

d. Production-weighted average tariff.

multilateral institutions for freer trade. A complementary argument is that the economic crisis of the 1980s diffused the political opposition against trade reform. The influence of sectoral interests was curtailed as the redistributive costs of trade liberalization were dominated by the potential benefits of stabilization (Rodrik 1994). Trade reform became a popular way to signal a clear break with the discredited economic policies of the past, and in this context was a major element of the neoliberal agenda.

In what follows we first review the journey toward freer trade in the region. In doing this, we examine not only unilateral trade reforms, but also trade liberalization accomplished on a regional and preferential basis and at the multilateral level.²

Unilateral reforms

Overall trends

Unilateral trade reforms implemented in the LAC region since the mid-1980s amounted to significant trade liberalization. The countries analyzed in this section (Argentina, Bolivia, Brazil, Chile, Colombia, Jamaica, Mexico, Peru, Trinidad and Tobago, Uruguay, and Venezuela) have liberalized their trade regimes to a greater extent than at any time in the post-World War II period. This trend has clearly helped accelerate the region's rate of integration with the rest of the world. In fact, during 1991-93 the

region was integrating with the world at a faster pace than any other developing region, and during 1991-93 the integration rate was four times faster than in 1986-90. This in itself is a remarkable fact for a continent that was withdrawing from world trade as a consequence of its inward-oriented policies just a few years ago (see figure 2).

Recent reforms

Not all countries in the region liberalized their trade regimes at the same time or to the same extent. Chile, Bolivia, and Mexico can be characterized as early trade reformers with major policy changes being reinforced in the 1985-88 period. Argentina, Brazil, Colombia, Peru, Uruguay are recent reformers, while Jamaica, Trinidad and Tobago, and Venezuela are even more recent reformers. The largest concentration of reforms during the 1984-94 period occurred from 1989-91. In terms of the strength of the reforms, as indicated by low average tariffs and minimal use of quantitative restrictions, Bolivia, Chile, and Colombia lead the group. Jamaica, Trinidad and Tobago, and Venezuela remained either with more quantitative restrictions (QRs) in place or with higher tariffs when compared to the average for the region by 1994. Argentina, Brazil, Mexico, and Uruguay fall into the middle group with respect to the extent of trade liberalization.

Arguably, the most important part of the trade liberalization packages was the reduction of QRs, allowing prices to allocate resources in a more efficient manner (Dean, Desai, and Riedel 1994). On the import side, QRs were replaced by tariffs, and tariff levels as well as their dispersions were reduced. On the export side, various specific export promotion measures (for example, subsidies) were reduced and streamlined. As mentioned above, this general package of reforms was adopted by the countries at different times and in different intensities.

Bolivia, Chile, and Mexico, as the earliest reformers, had a longer time period for the resource shifts to take place and for new investment to be guided by relative prices that reflected world prices more closely. Chile refined its already liberalized trade regime during the 1989–91 period by adopting a uniform 11 percent tariff. It continued with the protection of the motor car industry due to a long-term agreement with the industry that had been in existence since the 1970s. Chile also has few agricultural items subject to variable levies. Bolivia began a strong stabilization effort in 1985, which has helped implement its trade reforms. It has a very liberal trade regime with only two tariff rates of 5 percent and 10 percent, respectively, and no significant QRs. Mexico also undertook an early reform during the 1987–89 period but at a slower pace than Chile and Bolivia. The pace of reforms was accelerated in preparation for NAFTA, but some sectors such as the petroleum sector continued to be protected.

Argentina, Brazil, Colombia, Jamaica, Peru, and Uruguay began their trade reforms later than the countries discussed above. In Argentina the government of President Menem began a strong liberalization program simplifying a highly protective and complex trade regime to one with few tariff levels. It removed all QRs except those on a few items including motor vehicles. In 1991 Argentina reduced and streamlined all of its regional promotion policies. Brazil's trade liberalization was concentrated during the 1990–93 period, when almost all of its QRs were removed. It reduced its tariff categories significantly and its maximum tariff was brought down from 85 to 35 percent. Colombia had to abandon an earlier trade liberalization in 1984 because of adverse terms of trade and domestic macroeconomic disequilibrium. In 1989, under the government of President Gaviria, efforts were made to accelerate the rate of reforms to achieve in 1991 the measure of

trade liberalization originally planned for 1994. Some QRs on agricultural goods remained, but overall, Colombia was able to liberalize its trade regime very rapidly. Jamaica began liberalization in 1988 but the real effort was delayed until early 1991. It reduced QRs on few agricultural items and tariffs to the 0–45 percent range adopted by Caribbean Community and Common Market (CARICOM). The maximum common external tariff was reduced to 20 percent in late 1992. Peru undertook strong trade liberalization during 1990–92 and reduced tariffs to a maximum of 35 percent by 1993. Quantitative restrictions, subsidies and price controls were eliminated as a part of that process. Peru today stands in marked contrast to its highly protected trade regime that existed in the mid-late 1980s. Uruguay resumed trade liberalization after having abandoned a liberalized trade regime in the early 1980s due to macroeconomic imbalances. During the 1987–92 period it reduced the use of QRs to nearly zero, significantly curtailed the use of reference prices, and brought the average tariff down to 15 percent.

Trinidad and Tobago and Venezuela liberalized their trade regimes even more recently than the other countries discussed here. Both countries had experienced strong terms of trade improvements as oil exporters. This, combined with large increases in domestic expenditures, led to an appreciation of their exchange rates. In the case of Trinidad and Tobago high tariffs combined with extensive use of QRs, particularly in agriculture, had led to a protected trade regime. Starting in 1992, and with the floating of the Trinidad and Tobago dollar, it was able to reduce tariffs, though it has remained a more protected country compared to other countries discussed here, both in terms of reliance on QRs and with respect to average tariff level. Venezuela, on the other hand, began its trade liberalization in 1989 and undertook strong reforms in 1990, when some 98 percent of its QRs were eliminated. However, the country reintroduced exchange controls in 1994 as it found itself in the throes of a foreign exchange crisis related to the domestic banking sector problems.

Table 1 provides some indicators of the process of trade reform in the region. These reforms have some unique features. First, they represent a departure from past, when economic crisis led to trade policy tightening rather than trade liberalization.³ Second, they were implemented across the board rather than confined to particular activities. There

was little effort to provide made-to-measure protection, as in the past episodes that invariably led to the return to protection. Third, they were accompanied by other policy measures, including strong stabilization efforts, particularly fiscal consolidation, deregulation, privatization of large state-owned activities, and financial and labor market reforms. Fourth, countries were less reluctant to devalue their currencies at the time of trade liberalization than in the past. There was a significant change in the attitudes to the use of the exchange rate as an expenditure switching instrument. Finally, there were external factors that provided a supportive backdrop to the unilateral reforms, including the negotiations under the Uruguay Round, support for trade liberalization from international financial institutions, and opportunities for further liberalization at the regional level created by the new regional agreements.

Regional integration arrangements

In a parallel development to the unilateral trade reforms, several new regional integration arrangements (RIAs) were launched or revived throughout the hemisphere. The announcement of the Enterprise for the Americas Initiative in June 1990 and the negotiation of the North American Free Trade Agreement (NAFTA) brought new attention to

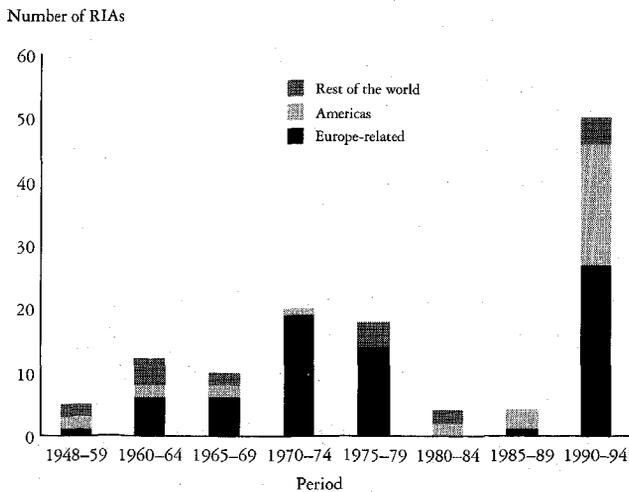
the issue of hemispheric integration from a North-South perspective. At the same time, the implementation of Mercosur (the Southern Cone Common Market) rekindled interest in regionalism from a South-South perspective. More recently, the Summit of the Americas—the meeting of thirty-four Western Hemisphere governments held in Miami in December 1994—issued a declaration calling for the negotiation of a Free Trade Area of the Americas (FTAA) by 2005.

The renewed interest in regionalism in LAC is captured in figure 3, which summarizes the number of RIAs. The 1990s have witnessed a resurgence in interest in regionalism, with Europe and the Americas characterized by the most intense introduction of new preferential trade arrangements. In most cases trade within regional groups has increased substantially over the 1985–94 period (figure 4).

The majority of the countries in the Americas belong now to one or more of the following regional integration arrangements: NAFTA, the Andean Pact, the Caribbean Community and Common Market (CARICOM), the Central American Common Market (CACM), Mercosur, and the Latin American Integration Association (LAIA).⁴ There is also a wide network of bilateral arrangements in the region (for example, Chile-Mexico and Colombia-Venezuela). NAFTA and Mercosur, however, are by far the most significant new RIAs on the continent, both in terms of trade flows and markets involved.

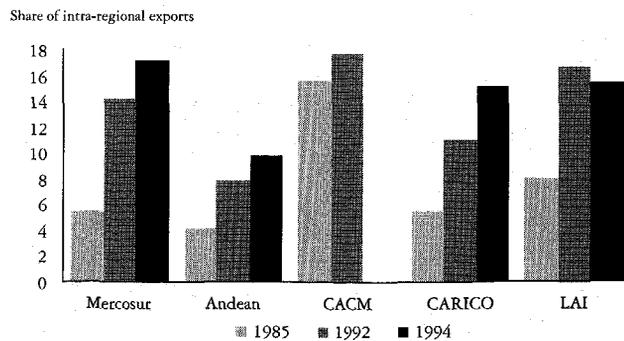
There is extensive literature on the reasons behind this renewed interest in regionalism.⁵ The roots of the “new

FIGURE 3
The proliferation of regional integration arrangements, 1948–94



Note: Reflects number of RIAs signed (most of them notified under Article XXIV or the Enabling Clause to the GATT). Only agreements involving reciprocal concessions were considered. Figures include agreements that are not currently in force. Most RIAs in the Americas involve LAC countries. The only exceptions are the U.S.-Israel free trade agreement (which was classified as an American RIA given the relative weight of the U.S. economy) and the Canada-U.S. free trade agreement.
Sources: WTO 1995; appendix.

FIGURE 4
Growth in intraregional trade in selected LAC regional arrangements



Source: United Nations, COMTRADE Data Bank, IDB 1995.

regionalism" can be traced back to the past decade. First, the widening and deepening of the European Community (now the European Union, EU) and the decision of the United States to explore the regional route (beginning with the Israel-U.S. free trade agreement in 1985) had an important demonstration effect (as had been with the Treaty of Rome in the previous outbreak of regional initiatives in the 1960s). Second, fears about the fate of the multilateral trade system (generated by protracted negotiations in the Uruguay Round) and the popular perception that the world economy was becoming increasingly regionalized also contributed to this process. Third, RIAs began to be perceived as mechanisms to advance economic integration beyond conventional liberalization of trade in goods by promoting "deep integration" (liberalization of trade in services, the harmonization of regulatory regimes, coordination of macroeconomic policies, and so on). Fourth, some countries pursued RIAs with major trading partners because they feared a future surge in protectionist practices (for example, the growing popularity of "fair trade" instruments such as antidumping actions). Fifth, RIAs have also been rationalized as instruments to "lock in" economic reforms and foster the credibility of new trade regimes.

RIAs have advanced trade liberalization beyond unilateral measures. In spite of this, the dangers posed by RIAs are well known.⁶ They can become exercises in managed trade, not to mention their second-best nature as devices for trade liberalization in the case of small economies. A necessary but not sufficient condition for regional initiatives to be compatible with global free trade is that they be organized as open trading blocs. For a bloc to be characterized as open, trade and investment barriers against nonmembers must *not* be raised.⁷

The "Understanding of the Interpretation of Article XXIV" negotiated in the Uruguay Round helped to clarify the General Agreement on Tariffs and Trade (GATT) disciplines with respect to regional arrangements.⁸ It provides, for example, guidelines for evaluating the general incidence of duties and charges before and after the creation of a customs union, based on the comparison of weighted average tariff rates and customs duties. Hence, from a "legal" perspective, a customs union could be characterized as GATT-compatible as long as the weighted average trade barrier against outsiders did not increase with its formation, even though increases

might occur at the level of specific tariff lines.⁹

The new RIAs identified in the appendix have not explicitly raised their barriers against nonmembers and could therefore be characterized as open trading blocs. Nevertheless, RIAs create a bias in favor of discrimination that needs to be closely monitored. The difficulties involved in implementing the common external tariff (CET) with respect to some products in the cases of the Andean Pact, the Central American Common Market, CARICOM, and Mercosur suggest that it is difficult to use tariff harmonization as a mechanism to foster additional liberalization. Typically, these arrangements have dealt with sensitive products by adopting exception lists and longer timetables for convergence to the CET. The good news is that LAC countries seem to be complying informally with the disciplines of Article XXIV. The bad news is that the "flexibility" in determining exception lists qualifies the commitment to open regionalism. It is important to reduce the number of products in those lists to a minimum and to avoid tinkering with the tariffs applied to these products.

The new RIAs often involve a subgroup of the members of a pre-existing RIA. Moreover, many RIAs are being formed between members of different pre-existing arrangements. As pointed out in Lustig and Primo Braga (1994), these overlapping agreements have prompted reluctant trading partners in the original regional bloc to proceed more rapidly with the establishment of free trade within the original arrangement. This has been the case in the Andean Pact with respect to Ecuador, for example. Costa Rica's impatience with the slow pace of the Central American Common Market, in turn, drove it to seek a bilateral free trade agreement with Mexico. However, this process of overlapping RIAs is far from ideal because it creates a morass of nonuniform bureaucratic procedures for enforcing commitments, not to mention conflicting demands on member countries (as illustrated by Mexico's situation as a member of both LAIA and NAFTA).

A negative by-product of the proliferation of RIAs is the growing importance of rules of origin for regional trade in LAC. Rules of origin are the instrument used to determine which goods and services in a free trade area (FTA) or in a customs union are entitled to preferential treatment. In customs unions, given the existence of a

common external barrier, rules of origin are equivalent to domestic content requirements, also being used to determine quota eligibility when quantitative restrictions apply. In FTAs, however, rules of origin impede trade deflection schemes in which outsiders could use the partner in the FTA with the lowest trade barriers to transship their products to members with more protected markets. They can, however, be used to export protection. In practice, this means that one partner can effectively impose its higher external trade barriers on another partner who has lower restrictions on an input used to produce a good qualifying for duty-free treatment within the FTA.¹⁰ Moreover, they impose nontrivial economic costs in terms of required administrative procedures by governments and compliance efforts by firms.¹¹

In sum, regionalism has so far complemented efforts in the region geared to promote outward orientation. In some cases, RIAs were promoting freer trade in nonconventional areas (for example, services liberalization under NAFTA) and expanding the amount of trade flows that are not hampered by trade barriers (for example, 85 percent of products trade among Mercosur countries has flowed freely since January 1, 1995). It is important, however, to recognize that RIAs increase the appeal of more subtle forms of protectionism under the guise of managed trade practices (for example, the adoption of restrictive rules of origin).

Multilateral liberalization

The participation of LAC countries in the Uruguay Round of multilateral trade negotiations further illustrates the new attitudes toward trade liberalization in the region. In previous rounds, LAC participation was limited because many countries were not GATT-contracting parties and had mixed feelings about the neoliberal trade regime. One of the main characteristics of the role played by LAC countries, along with other developing countries, in previous GATT negotiations was their emphasis on the need for special and differential treatment for developing countries, thus challenging the multilateral trade system's principle of nondiscrimination.

As the Uruguay Round evolved, however, LAC countries adopted a much more proactive role in the negotiations and engaged in meaningful exchanges of offers with other contracting parties. This in part can be explained

by a change in the negotiating strategy, reflecting the impact of unilateral trade reforms. In other words, countries that were already implementing unilateral trade liberalization found it to their advantage to link these reforms to multilateral negotiations as a way to foster reciprocal offers. There was also growing appreciation in the region of the fact that the GATT system, which evolved into the World Trade Organization (WTO) as a result of the Uruguay Round, despite its shortcomings, provides the best alternative to restrain the unilateral actions of large economic powers.

These developments translated into a growing participation of LAC countries in the multilateral system; this evolution is summarized in table 2. Since 1986, fourteen additional countries from the LAC region have acceded to the GATT, and by 1995 there were working groups analyzing the accession of Ecuador and Panama to the WTO. As this process is completed, the whole region will have commitments at the multilateral level.

Table 3 summarizes the tariff offers made by a selected group of LAC countries. More remarkable than the extent of liberalization generated by the negotiations (figures reported do not include unilateral tariff reductions), is the significant increase in tariff bindings offered by LAC countries.¹² This has an important effect in signaling more stability in terms of market access and by making future increases beyond the bound ceilings more difficult.

By participating more actively in the negotiations, LAC countries obtained significant tariff reductions in a series of products that are highly relevant to them (table 4). Even more impressive is the impact of the negotiations in eliminating nontariff barriers to LAC exports to OECD markets as illustrated by figure 5. These results tend to enhance the effectiveness of outward-oriented development strategies over time.

It is important, however, to recognize that some of these benefits will take a long time to materialize. In textiles and clothing, for example, existing quantitative restraints will be gradually removed over a ten-year transition period. Moreover, the process of liberalization is backloaded, as nearly half of the products will only be free of quantitative restrictions by the tenth year. In agriculture, the tariffication of nontariff measures is expected to increase the transparency of trade in agricultural products. However, in many cases the level of bound tariffs produced in this

TABLE 2

**The region's membership in the GATT/WTO
multilateral trade system, 1948-94**

NEGOTIATION ROUNDS		
NAME	PERIOD AND NUMBER OF PARTICIPANTS	LAC MEMBERSHIP (YEAR OF ACCESSION)
Geneva Round	1947; 23 countries	Brazil (1948) Cuba (1948)
Annecy Round	1949; 29 countries	Chile (1949)
Torquay Round	1950-51; 32 countries	Dominican Republic (1950)
Geneva Round	1955-56; 33 countries	Haiti (1950)
Dillon Round	1960-61; 39 countries	Nicaragua (1950)
Kennedy Round	1963-67; 74 countries	Peru (1951)
Tokyo Round	1973-79; 99 countries	Uruguay (1953)
Uruguay Round	1986-94; 125 countries	Trinidad and Tobago (1962) Jamaica (1963) Guyana (1966) Argentina (1967) Barbados (1967) Suriname (1978) Colombia (1981) Belize (1983) Mexico (1986) Antigua and Barbuda (1987) Bolivia (1990) Costa Rica (1990) Venezuela (1990) El Salvador (1991) Guatemala (1991) Dominica (1993) Paraguay (1993) St. Lucia (1993) St. Vincent and Grenadines (1993) Grenada (1994) Honduras (1994) St. Kitts and Nevis (1994)

Source: GATT.

process is prohibitive (in the 100 to 300 percent range), implying that little effective liberalization will occur in the short run. In general, the LAC region is an efficient agricultural producer and the results of the Uruguay Round have been a disappointment for the region. However, on a more positive note, it can be argued that the Uruguay Round has laid the basis for future liberalization of agricultural trade in the same way that previous rounds of negotiations promoted freer trade in manufactured products.

Services, trade-related intellectual property rights (TRIPS), and trade-related investment measures (TRIMs) were the so-called "new issues" negotiated in the Uruguay Round. Most LAC countries initially opposed the intro-

TABLE 3

Tariff concessions agreed to in the Uruguay Round

COUNTRY	PERCENTAGE OF IMPORTS THAT WERE GATT BOUND IN THE URUGUAY ROUND ^a		IMPORT-WEIGHTED AVERAGE MFN TARIFF RATES ^d	
	PRE-UR	POST-UR	TARIFF REDUCTIONS ^c	POST-UR BOUND RATES ^d
Argentina	17.1	100	4.2	31.0
Brazil	16.0	100	1.1	29.0
Chile	100.0	100	0.0	25.0
Colombia	4.4	100	3.6	39.7
Jamaica	0.0	100	12.5	56.3
Mexico	100.0	100	0.9	34.1
Peru	17.1	100	12.8	33.7
Venezuela	e	100	2.6	31.6

a. Merchandise imports during 1986-91 were used as weights.

b. Imports from the world (excluding manufacturing imports from partners in free trade areas) were used as weights.

c. Weighted average tariff reduction measured by $dT/(1+T)$. Averages cover only those tariff lines on which there were tariff reductions in the applied tariff.

d. Averages cover only those tariff lines for which rates are bound.

e. Venezuela became a contracting-part in 1990.

Source: Finger, Ingco, and Reincke forthcoming.

duction of these themes in the negotiating agenda, but gradually became active participants in the negotiations. The results of the round in these areas offer significant flexibility for developing countries and as a consequence will not impose major adjustment costs in the short run.¹³ Moreover, in the case of services—an area in which the potential benefits of trade liberalization are significant—the amount of MFN liberalization accomplished was quite limited given the many qualifications and exemptions claimed by the participants. Most offers entail a standstill promise (that is, a commitment not to introduce new distortions) and as shown in table 5, developing countries typically cover a smaller subset of service activities in their offers than developed economies. The offers of the LAC region, in particular, are very close to the average for developing countries, and suggest that there is substantial scope for further progress in this area.

Some effects of trade liberalization

Trade liberalization has helped to integrate these economies in the world economy in an unprecedented way. The average rate of integration indicated in figure 1 masks different performances among the countries of the region. The effects of the reforms can be grasped by the changes in trade ratios.¹⁴ The indicator developed in table 6 takes the

year following initiation of the liberalization episode and takes the average of the changes in this ratio through 1994 to measure changes in trade orientation. Trade ratios change with changes in world demand, prices of the exports and imports, and domestic supply elasticities for exportables and importables, and exchange rates. Indicators of openness for all the countries, however, show increases. Because different countries introduced their trade reforms at different times, using 1993 or 1994 as the end year tends to underestimate the increase in openness of the recent reformers. The reason is that the dynamic adjustment to significant policy changes takes time. For example, while Bolivia has had nine years to respond to its policy shifts of the mid-1980s, Argentina liberalized very slowly in 1989 and significantly during 1990–91. Thus, in contrast to Bolivia, Argentina has had fewer years to adjust to its open trade regime.

There were significant increases in exports following lib-

eralization for all countries (table 6). Part of the early export growth was associated with parallel stabilization efforts that reduced domestic demand. In the case of Argentina, the figures for 1994 also indicate strong export growth, part of which is associated with the improved resource allocation that has helped to raise productivity and reduce costs. Moreover, there were discernible trends in increasing investments in the tradable sectors in most countries. Rapid export growth was also experienced by Bolivia, Chile, Colombia, and Trinidad and Tobago and more recently by Uruguay. One important feature of the increase in exports is the change in their composition. Thus Chile became a strong agricultural exporter, while the non-traditional exports of Brazil, Colombia, and Jamaica responded to new incentives.

On the import side, a somewhat regular pattern was repeated. Imports surged at the time of the liberalization but fell to a slower rate of growth after a few years. In some

TABLE 4

Reductions in bound tariffs on critical export products for the region

(percent)

PRODUCT GROUP ^a	DEVELOPED ECONOMIES	NORTH AMERICA	WESTERN EUROPE	COUNTRIES WITH A HIGH EXPORT INTEREST IN THE PRODUCT GROUP
Textiles and clothing	22	15	20	Belize, Costa Rica, Dominican Republic, El Salvador, Grenada, Guatemala, Haiti, Honduras, Jamaica, St. Lucia, St. Kitts and Nevis, Uruguay
Metals	59	63	35	Argentina, Bolivia, Brazil, Chile, Cuba, Dominica, Guyana, Peru, Trinidad and Tobago, Venezuela
Mineral products, precious metals and stones	52	31	22	Bolivia, Colombia, Nicaragua, Uruguay
Fish and fish products	26	19	18	Belize, Cuba, Ecuador, Honduras
Other agricultural products	48	49	44	Nicaragua, Paraguay, Peru, Uruguay
Chemicals and photographic supplies	42	42	35	Bahamas, Jamaica, Suriname, Trinidad and Tobago
Oilseeds, fats and oils	40	43	34	Argentina, Bolivia, Brazil, Paraguay
Fruits and vegetables	36	38	32	Antigua and Barbuda, Chile, Costa Rica, Dominica, Ecuador, Grenada, Honduras, Jamaica, St. Lucia, St. Vincent and the Grenadines, Suriname
Coffee, tea, cocoa, sugar, and so on	34	35	29	Barbados, Belize, Brazil, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Grenada, Haiti, Honduras, Jamaica, Nicaragua, Peru, St. Kitts and Nevis, Trinidad and Tobago

Note: For industrial products (GATT definition) the tariff reduction is trade-weighted using as weights the imports of the product group from all sources into the region in question. For agricultural products the reductions refer to simple averages.

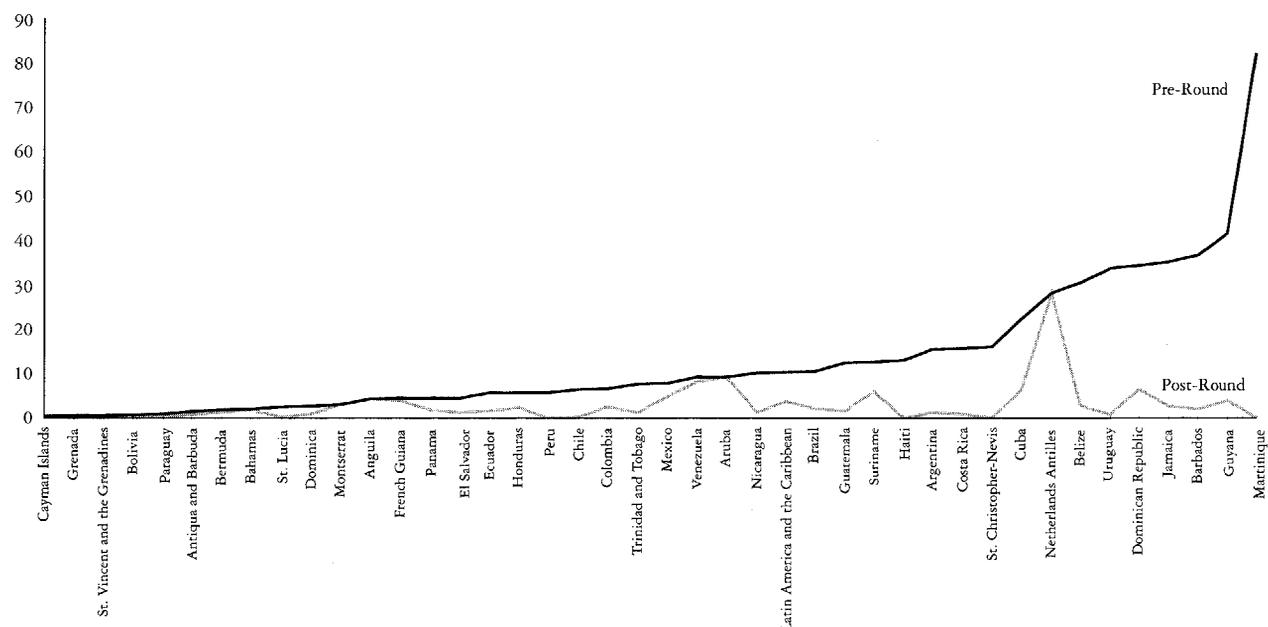
a. Only product groups critical to four or more countries are reported. A product group is defined as being critical if it accounts for 20 percent or more of foreign exchange earnings from exports of industrial products (excluding petroleum-related products) or agricultural products, respectively; and accounts for 5 percent or more of total merchandise exports (excluding petroleum). Trade data for 1988 were used as weights in the calculations.

Source: Blackhurst, Enders, and Francois 1995.

FIGURE 5

Impact of the Uruguay Round on nontariff barriers facing Latin America and the Caribbean in OECD markets

Nontariff barrier coverage (percent)



Note: The following measures were included in the computation of the nontariff barrier coverage ratio: tariff quotas; increased duties, safeguard duties, retaliatory duties, and customs surcharges; variable levies and flexible import fees; non-automatic licensing and discretionary licensing; quotas and prohibitions; voluntary export restraints, Multifiber Arrangement quotas and other restraints including textile restraint agreements, and orderly marketing arrangements; other quantitative restrictions; other restrictions imposed under the Multifiber Arrangement; minimum, reference, or other import price controls; voluntary export price restraints; state monopoly of imports; and local content regulations.

Source: World Bank-UNCTAD SMART database.

cases import growth picked up again due to the appreciation of exchange rates following capital inflows into the region. Moreover, Argentina, Brazil, Colombia, and Mexico experienced strong import growth as income recovered following stabilization.

TABLE 5

Commitments on market access for services

COUNTRY GROUP	NUMBER	SERVICES COMMITMENTS
	OF COMMITMENTS	AS SHARE OF
	IN SERVICE ACTIVITIES	MAXIMUM POSSIBLE
		(PERCENT)
High-income countries	2,423	54
Developing countries	2,159	17
Europe and Central Asia	2,362	54
Asia	796	26
Latin America and Caribbean	738	15
North America ^a	193	60
Middle East and North Africa	178	16
Sub-Saharan Africa	315	9

a. Canada and the United States.

Source: Compiled by the authors based on GATT 1994b.

Another important feature of trade during this period was the increase in intraregional trade as a result of the regional trade agreements. Trade between Colombia and Venezuela increased rapidly (by 24 percent a year during 1985–94), as did trade as between Argentina and Brazil and between Chile and Argentina, which had concluded bilateral trade agreements. This is to be expected since the countries in the sample were affected by actions taken either on a bilateral basis or in the context of a broader RIA. In this context, they have been reducing barriers to trade at a faster pace than with the nonmember countries.

In sum, unilateral liberalization was the most potent of all paths taken to trade liberalization, a fact confirmed by similar experiences in other parts of the world. In fact, without unilateral trade liberalization taking place, both regional and multilateral efforts could not have borne fruit.

The dangers of backsliding

The countries in the sample have, by and large, adhered to their unilateral trade liberalization programs. In addition,

in many countries intraregional trade has been liberalized as part of the agreements reached. Against this progress, a few retrogressions have arisen from macroeconomic developments, including the reappearance of fiscal deficits. In some countries these macroeconomic problems have been essentially of their own making. In others the problems surfaced only after Mexico's crisis produced a blow to the confidence of investors. The contagion effect that led to problems in the financial sectors also resulted in fiscal problems.

This is not to deny that some of recent trade measures may have taken place in response to demands for protection. However, based on what we know from the LAC region, the bulk of the recent trade measures that have implied reversals have been taken very hesitantly and only as part of policy measures to strengthen the fiscal positions, including tax revenues. These fiscal adjustments have been a crucial signal to investors that fiscal discipline will continue to be a major goal in a region that not long ago suffered from high inflation. Furthermore, in some countries increased taxes, including tariffs, have been imposed on a temporary basis.

The retrogressions so far have been limited and most governments in the LAC region remain committed to liberal and open trade regimes. Nevertheless, these recent episodes have left a clear message, namely, the need to sustain stable macroeconomic conditions. Moreover, decisions for temporary relief for activities that may genuinely need some adjustment assistance require transparent processes.

It is also important to note that multilateral and region-

al commitments now constrain individual actions by LAC countries in a much more effective way than in the past. Brazil, for example, will have to comply with its tariff bindings in the WTO over time and had its Mercosur partners to be notified of recent tariff increases using the available "list of exceptions." In the same vein, Mexico was recently precluded from using trade restrictions in a more comprehensive way in response to the peso crisis because of its NAFTA commitments.

Trade and fiscal policies

Time and again, experience has shown that lack of macroeconomic stability, meaning, most often, fiscal deficits, has been accompanied by reversals of trade liberalization policies. Nevertheless, reversals were not a necessary outcome of the macroeconomic situation. In the past, when serious reversals occurred in Latin America, important fiscal disequilibrium and weakened political support for structural reform policies were present (Nogués and Gulati 1994).

There is ample evidence that major reversals in trade liberalization have been associated with serious macroeconomic disequilibriums in the form of high and growing fiscal deficits. Therefore, it must be clear to governments that open trade policies should be supported by prudent fiscal policies. In recent years the experience of many successful countries, like Chile, suggests that strong fiscal discipline and a conservative monetary policy must be put in place to maintain open trade policy. For a number of reasons, fiscal surpluses may be warranted. First, a surplus

TABLE 6
Changes in trade orientation
(percent)

COUNTRY	TRADE REFORM PERIOD	OPENNESS INDEX		TRADE FLOWS		
		PERIOD	CHANGE	PERIOD	EXPORT GROWTH	IMPORT GROWTH
Argentina	1989-91	1988-94	8.01	1990-94	5.63	31.62
Bolivia	1985-88	1984-93	3.56	1986-93	8.46	4.76
Brazil	1990-93	1989-94	5.19	1991-94	6.99	9.97
Chile	1988-91	1987-94	4.17	1989-94	10.42	12.75
Colombia	1989-91	1988-94	5.93	1990-94	10.87	18.29
Jamaica	1988-91	1987-93	1.61	1989-93	3.54	4.53
Mexico	1987-89	1986-94	6.16	1988-94	4.10	19.06
Peru	1990-92	1989-93	6.98	1991-93	4.21	8.23
Trinidad and Tobago	1990-92	1989-94	12.21	1991-94	12.31	9.36
Uruguay	1987-92	1986-94	6.14	1988-94	7.93	12.83
Venezuela	1989-91	1988-94	1.69	1990-93	7.15	6.26

Note: The change in the openness index is measured as the average of the changes in the ratio between the year prior to the initiation of the liberalization episode and 1994. The change in export and import growth is measured as the average of the changes between the year following the initiation of the liberalization episode and 1994.

Source: World Bank data.

puts the country in a better position to cope with domestic or external shocks, such as an unforeseen reduction in tax revenues or deterioration in the terms of trade. Second, research shows that a fiscal surplus adds to the savings rate (Corbo and Schmidt-Hebbel 1991), and in Latin America where savings are relatively low, this is an important consideration. Third, a surplus reduces the need for inordinate capital inflows and therefore reduces the problems associated with currency overvaluation. Finally, a fiscal surplus and a conservative monetary policy may improve the credibility of the reform program. Of course, a fiscal surplus is not always necessary if the fiscal and monetary authorities have sufficient credibility and if the private sector savings-investment balance responds to their policies.

Signs of a weakening fiscal position or accelerated monetary growth may signal the resurgence of future inflation and trigger a consumption boom. This occurred in Mexico toward the end of 1994 when a lax monetary policy and a decline in the real interest rate led to a consumption boom that compromised the sustainability of the current account deficit. In contrast, other countries that suffered from crises, such as Argentina, continued to implement conservative fiscal and monetary policies (Barro 1995).

Many countries that faced fiscal deficits recently have raised tariffs. However, it is not at all clear that fiscal adjustment in the form of higher tariff rates will help these countries meet revenue targets. Other things being equal, the increase or reduction in tax receipts resulting from higher tariffs depends on a number of issues, including the starting position. It is of interest that in Chile lower and more uniform tariff policies have resulted in a better revenue performance than in many other countries in the region (Nogués and Gulati 1994; Pritchett and Sethi 1994; Rajapatirana 1994).

The crisis triggered by the devaluation of the Mexican peso has made evident the fragility of the fiscal situation of many Latin American countries. Unlike in the past, most countries in the region are responding well by announcing and implementing policies that will strengthen their fiscal positions. While some trade policy measures have been implemented in order to reinforce other fiscal measures, these have been relatively marginal and generally temporary. The dismantling of these measures depends on whether countries in the region will be able to shift to more sustainable and solid fiscal positions.

Exchange rate regimes and capital flows

Theoretically, there is no single best exchange rate regime. The fundamental issue is not the nature of an exchange rate regime, but the fiscal and monetary policies that accompany it. Latin American countries that have succeeded with their reform programs have different types of exchange rate regimes even though all of them adopted flexible exchange rates or devalued their currencies at the time of trade liberalization. Some countries, like Peru, have free floating rates. Others, like Chile, have managed floats. Still others, like Argentina, have a fixed exchange rate and a monetary policy responding to currency board arrangements. All of these countries have succeeded in maintaining their different exchange rate regimes while simultaneously reducing inflation—in some cases considerably. The reason is that they have all followed sound fiscal and monetary policies. In contrast, the countries that followed lax fiscal and monetary policies, such as Mexico during 1994, have faced important problems that have required major additional adjustment policies and the abandonment of the previous exchange rate policy.

There is also the issue that Latin America started its reform program from a situation characterized by low domestic savings. The evidence shows very clearly that far-reaching liberalization of trade and investment and ambitious privatization programs have opened more investment opportunities than domestic savings can finance. In order to close the gap, different countries have resorted to foreign savings, which led to increased current account deficits. Faced with an important savings gap, individual countries have the choice of limiting capital inflows in order to reduce currency overvaluation or letting the market determine the outcome. Again, in our view, the issue is not so much that of choosing between controlling or not controlling capital inflows, but of consistently choosing policies that avoid fiscal and monetary problems and induce fast growth of overall factor productivity.

Chile has for some time been cautious and has chosen to limit capital inflows. Because of this, and also because of increasing domestic savings (which in 1994 reached 25 percent), this country has had declining current account deficits. The important lesson from Chile's experience is the extraordinary increase in domestic savings (from an average of 13 percent of GDP in 1984 to 28 percent in 1994), not the importance of limiting capital inflows. After prudent

fiscal and monetary policies, strengthening the financial sector and creating a private pension system are some of the fundamental policies that explain this performance. These policies are being implemented by many countries in the region, and therefore, we expect that over time the region will improve its savings performance and will be less vulnerable to changes in capital flows and fluctuating real exchange rates.

In contrast to Chile, Argentina deepened its reform program in early 1991 and moved to a competitive market economy quickly to provide the country with the best chance of shifting to a sustainable competitive market economy. Decades of inflationary policies had destroyed investment opportunities and led to economic retrogression, ending with the hyperinflation of 1989. Accelerated growth of investment was considered fundamental in order to increase the overall productivity of the economy. Several policies, including complete liberalization of capital flows, were introduced to achieve this outcome. Because of this, Argentina relied more on foreign savings during the 1990s and, as has been the case in Chile, this strategy led to an increase in the domestic savings rate.

The value of the currency relates this to trade and export performance. If a country chooses to limit capital inflows to avoid overvaluation, it runs the risk of limiting investment and delaying productivity improvements. In contrast, a country may choose a policy of free capital movements and avoid the negative consequences of currency overvaluation by maximizing investment and accelerating improvements in overall productivity. This is the strategy that has been followed by Argentina. In early 1991 Argentina fixed the exchange rate vis-à-vis the dollar and clearly, by any conventional measure, the currency of Argentina has appreciated. Nevertheless, this situation has not stopped the country from experiencing improved export performance. For example, during 1994 total exports increased by 20 percent, and during the first four months of 1995 they have increased by 47 percent. In fact, after months of experiencing negative trade balances, in April 1995 the country experienced a trade surplus. This experience shows once again that policy stability and consistency may more than compensate for apparent currency overvaluation induced by large capital inflows. Obviously, the key to understanding this has been a high rate of overall productivity growth, which during the last four years has been above 5 percent a

year (Cavallo and Mondino, 1995).

While the type of exchange rate regimes in place does not by itself determine the trade or macroeconomic outcome arising from external shocks (such as changes in the terms of trade and capital flows), fixed exchange rate regimes put enormous responsibility on fiscal authorities to maintain macroeconomic equilibrium and the competitiveness of exports.

Trade liberalization and unemployment

Another factor that would threaten open trade is the political fallout of rising open unemployment. Increased unemployment usually weakens the support for stabilization and trade reform programs. These conditions also increase the demand from different interest groups for relief measures and therefore tend to increase the political efforts required from governments in order to sustain the economic transformation policies. The government can respond to these pressures in a number of different ways, some of which may partially reverse the trade liberalization policy.

In Latin America trade liberalization policies have been just one component of very ambitious reform programs. Most often these policies have also been accompanied by major stabilization, deregulation, and privatization policies. In many cases government employment has also been considerably trimmed down. Depending on the initial conditions and the speed of the reforms, these policies may have a strong impact in reducing the short-run demand for labor and increasing the unemployment rate.

In some countries, including Argentina and Chile, the open unemployment rates reached high levels at some point following the economic reforms. In Argentina, for example, the open unemployment rate increased steadily from 6 percent in 1990 to 12.2 percent in 1994. In Chile the open unemployment rate reached a high of 19.6 percent in 1982, but it has declined significantly since then, and in 1994 it stood at 5.9 percent. Obviously, it would be wrong to conclude that the increasing unemployment problems in these countries were the consequence of the trade liberalization measures. First, when there are many policies being implemented simultaneously, it is risky to attribute unemployment to different parts of the program. Second, there have also been labor supply responses. For example, in some countries, including Argentina, the reform program has induced an increase in the labor force participation rates of

women and increased immigration flows from poorer neighboring countries. Nevertheless, we think it is fair to assume that in the short run, ambitious trade liberalization programs may have exacerbated the unemployment problems.

What are appropriate ways of dealing with this problem? There are at least two different issues. First, governments have to make sure that the labor market is working properly, that is, that wages respond efficiently to shifts in the demand and supply for labor. Second, there may be some employment problems that persist even if there is a well functioning labor market. In these cases governments could help with temporary relief measures. However, care must be taken not to let this inhibit improved labor allocation.¹⁵

Increasing unemployment may be not so much the outcome of sudden and ambitious policy changes or problems of information and skill mismatch; it may be due to policy distortions in labor markets. The case of Argentina is illustrative. Clearly, the major economic reforms implemented in recent years have been accompanied by a significant increase in the unemployment rate. In our view, increases in unemployment should be linked to the fact that decades of economic policies based on corporatist-populist principles had rendered, at the eve of the reform program, onerous labor market regulations. These included anti-employment accidents legislation, collective bargaining set at the level of the industry rather than the enterprise, and high and distorted taxes on wages that are used to finance social security and inefficient public health programs.

In this regard, the case of Peru is also of interest. Since the government of Velasco Alvarado in the early 1960s and late 1970s, labor security legislation in Peru was closely enforced by the Ministry of Labor. This legislation reduced drastically the creation of productive employment opportunities in the formal sector and generated serious micro-economic adjustment problems. These problems became evident during the liberalization attempt of 1980–82 and contributed to the failure of this attempt (Nogués 1991). The second trade liberalization program initiated in 1990 has been implemented under economic policies that were far superior to those that prevailed in 1980–82. These policies included prudent fiscal and monetary policies and a major deregulation of labor markets, including the dismantling of the labor security legislation. After peaking at 9.9 percent in 1993, the open unemployment rate has

declined, and in 1994 stood at 8.9 percent.

In summary, the experience surveyed above shows that accelerated and ambitious reform programs have sometimes resulted in increasing unemployment. High unemployment rates have also been observed in countries where the labor market remained heavily regulated. As this section indicates, reformers should, at an early stage, invest part of their political capital in passing the legislation that is necessary to improve the functioning of the labor market. Waiting too long increases the social costs of the transition and may result in serious political tensions that could jeopardize the trade liberalization goals. Although reversals of past liberalization attempts have been partially influenced by inappropriate labor market policies, we do not know of any recent liberalization attempt where unemployment problems have led to reversals. This is a test of the political support for recent reform programs.

Institutional arrangements in trade policymaking

In many of the countries analyzed in this paper, institutional reform was not introduced at the same time as trade liberalization measures were implemented. Reasons for this are: 1) because trade liberalizations were undertaken at times of crises, there was little opportunity to simultaneously reform trade institutions; 2) the need to make the new trade regime credible adds to the complexity of institutional reform; 3) at the time of liberalization, trade policy had been ad hoc and little attention was paid to a systematic approach to institutional issues; and 4) GATT conventions for antidumping, countervailing, and the provision of safeguards were planned to be adopted at a later date.¹⁶

In Argentina almost all trade-related functions were previously carried out by the Ministry of the Economy. The responsibilities for external trade negotiations were shared with the Foreign Ministry (GATT 1992). However, in 1993 Argentina established a National Trade Commission responsible for advising the government on trade policy and for considering the requests for protection on a continuous basis. Its mandate includes investigations regarding unfair trade practices, analysis of safeguards and the extent of injury, and remedies to alleviate injury. These reforms have brought about dramatic change. Previous to the reforms, any import price that was 15 percent below the domestic price could be countered by a reference price that would

equate that import price to the domestic market price.

In Bolivia the Ministry of Exports and Economic Competitiveness is responsible for trade policy formulation and implementation within a general policy framework set by the Ministry of Planning and Coordination. There is no formal procedure for discussion of trade policy measures with the private sector nor an independent authority to consider contingent protection. Despite this, Bolivia remains one of the most open economies on the continent.

In Brazil, before the reforms of the 1990s, day-to-day trade policy was heavily influenced by CACEX, a department under the Banco da Brazil and the main instrument for implementing protectionist policies. During the strong liberalization phase that began in 1990, CACEX was closed. Trade policy formulation is now mainly the responsibility of the Foreign Trade Department (DECEX), a subsidiary body of the National Secretariat of the Economy. The Ministry of Foreign Affairs deals with multilateral and regional negotiations. The Customs Tariff Technical Office and the Foreign Trade Technical Office administer trade policy guidelines, dumping investigations, issuance of import and export licenses, and the provision of certificates of origin. The Chamber of Foreign Trade is responsible for coordination among different ministries.

Chile introduced one of the most wide-ranging trade reforms of any country in the 1970s. However, no attempts were made to change the institutional framework, despite the radical trade policy reforms. The main reform was led by the Minister of Economy (Corbo 1991). Institutional reform came in 1986 when Chile established a National Commission on Trade. Its purpose was to register complaints against unfair trade practices, undertake neutral inquiries, establish the veracity of the claims of injury, and propose remedies in the instance of demonstrable injury. The process is transparent. The request for an inquiry has to be published within thirty days of the application and the commission has to give the results of its analysis within ninety days. The remedies proposed could be, and indeed have been, tariff surcharges to the extent of the apparent foreign subsidy.

Formulation and implementation of trade policy in Colombia also followed complex processes. A powerful trade implementation authority, the *Instituto Colombiano de Comercio Exterior* (INCOMEX), was in place as well as complicated rules governing duty drawbacks, export credit,

and export certificate schemes. These remained in place at the time of the trade liberalization. The 1992 reforms established a new Foreign Trade Ministry that stipulated stringent criteria for safeguards, countervailing, and antidumping. These are subject to public inquiry. Under the new Colombian law, actual injury must be demonstrated. It is not sufficient to discuss potential injury. The relief granted is restricted to one year. In this sense, Colombia's law is more stringent than GATT's guidelines regarding contingent protection.

In Jamaica, too, trade reforms were taking place in a pre-existing institutional framework. There, trade policy was largely the responsibility of the Ministry of Finance. Trade policies were closely coordinated with foreign exchange allocation. Jamaica has also changed its trade policymaking apparatus. Although the decisions are still made at the ministerial level, other agencies are consulted when antidumping and countervailing issues are to be contemplated. A consumer representative was added to the antidumping committee. A one-year sunset clause was introduced for antidumping and an expiration date was defined for countervailing duties.

In Mexico the Ministry of Trade and Industrial Promotion (Secretaría de Comercio y Fomento Industrial - SECOFI) is principally responsible for formulation and implementation of trade policies and negotiations with foreign trade. Its activities are closely coordinated with other ministries involved in trade related activities, such as the Ministries of Finance and Public Credit, Agriculture and Water Resources, and Energy, Mines, and Parastatal Industries. Mexico has been reforming its trade policy in the context of NAFTA negotiations. It has a central dispute settlement commission. Wider public interest has to be taken into account in dumping and subsidization inquiries but no formal mechanism exists.

In Peru trade policymaking is decentralized and therefore highly dependent on cooperation among government entities. In the formulation of policies, the Ministry of Economy and Finance takes into account private sector proposals expressed in formal coordination meetings or ad hoc working groups. However, no formal, periodic trade policy review is made by any independent body. It enacted antidumping and countervailing legislation in 1991 and their implementation is overseen by the Dumping and Subsidies Surveillance Commission.

The situation in Trinidad and Tobago was not very different from Jamaica. Decisions regarding changes in tariffs, QRs, stamp duties, surcharges, exemptions, and the like were made by the *Ministry of Finance* under advice of the *Industrial Development Corporation*, which reported to the *Minister of Trade*. Institutional arrangements for trade policy continued as in the time of the trade liberalization. The main change in trade policy institutions was made later, with the creation of three corporations to administer trade, industry, and export development concessions, including contingent protection. The government is in the process of defining an appropriate framework in which the new institutions can operate.

In Uruguay, too, trade liberalization was not accompanied by any change in the trade policy institutions. Trade policy was made by the *Minister of the Economy and Finance*. The implementing authority was the *Office of Planning and the Budget* (Michelin 1994). Uruguay had a tariff commission in the past, but it had not been used much. In 1992 Uruguay established a commission to consider and help resolve issues relating to the injury of domestic industry due to import surges. However, it was the *Minister of Finance* who would decide on the type of measure to be adopted should a situation of dumping, subsidization, or similar unfair trade practice be directed at domestic industry.

Venezuela became a member of GATT in 1990, adopted the GATT antidumping and anti-subsidy codes in 1993, and appointed an independent antidumping commission with no connections to industry or the sector ministries. The commission was expected to balance consumers, the interests of producers, and the users of imported goods. An independent regulatory commission was also appointed to maintain domestic competitiveness. Like the other countries in the region, Venezuela centralized trade policy authority, making it independent from sectoral and related industries.

The institutional reforms identified above lend themselves to a few generalizations. First, institutional changes that support the liberalized trade regimes typically followed, rather than led, policy reform. Perhaps this is an inevitable sequence given the effort required to bring about institutional changes, with its political economy ramifications. Second, there has been an attempt to focus on trade policy institutions by moving them from different agencies to a single agency or ministry. This is the experience of

Argentina, Brazil, Chile, Colombia, and Uruguay. In Jamaica and Trinidad and Tobago the ministries of finance continue to be involved with trade policy. The centralization of trade policy decisions would serve national interests better than a sectoral ministry. Third, there have been attempts to introduce measures to provide relief to activities that have been subject to increased competition from imports. Many countries have used reference prices more than antidumping duties. Fourth, many countries have made their institutions more consistent with GATT rules even though those rules themselves were evolving. Finally, there were some attempts to provide support for export interests through public interventions. Chile gives subsidies to small and medium-size exporters under PROCHILE. Colombia reformed its plethora of promotion schemes to be confined to a Bank for Foreign Trade and an Export Promotion Trust. Trinidad and Tobago created an Export Development Corporation for this purpose.

Remaining agenda for reforms

Despite the strong reforms from the mid-1980s to the early 1990s, there are many aspects of the trade regime that need to be addressed to take advantage of the new opportunities for greater integration with the world market. These opportunities have arisen with the successful completion of the Uruguay Round and improved market access in areas that have been traditionally protected in industrial country markets.

The different country groups discussed above share common themes in regard to the unfinished agenda. Long-term macroeconomic stability is still not ensured. In many countries, including Argentina and Brazil, the fiscal discipline achieved by the central government has not translated into similar actions by provincial and state governments. This task is somewhat difficult due to the independent authority of state and provincial governments to increase expenditures.

Another source of pressure for rolling back liberalization could arise from the adjustment difficulties in some sectors with an inherent lack of flexibility, such as agriculture, where mobility is limited and political power is strong. With cars, textiles, and clothing, urban labor can pressure politicians to maintain protection.

There is a need to subject some protected sectors to greater competition and make their participation in world

trade more open. With the exception of Argentina, Brazil, and Uruguay, agriculture continues to be protected. Chile uses a variable levy to protect some agricultural commodities. Producers who have to pay higher wages to offset high food prices are put in a less competitive position than other countries outside the region. The continued protection of agriculture through import surcharges and reference prices, particularly in Jamaica and Trinidad and Tobago, imposes an unnecessary cost to those economies.

Other parts of the remaining agenda for trade reforms have to do with relatively high tariffs found in Brazil, Trinidad and Tobago, and Venezuela. Tariffs in some countries exceed the regional average tariff range of approximately 10–15 percent. Moreover, some countries, such as Venezuela, still rely on QRs to a significant extent.

The remaining agenda also includes the reform and reorientation of institutions that make trade policy. These institutions have, by and large, remained in the earlier milieu that was designed to be inward-oriented. With the liberalized policy regimes and the new rules for trade policy arising from the Uruguay Round, trade policymaking institutions have to be reformed. With the reduction in traditional forms of protection, new forms have arisen and the use of antidumping and countervailing duties is increasing. These actions have been sanctioned within the existing institutional structure of trade policy. Indeed, it is institutions that will anchor the policy regimes and give permanence to the reformed policy. It is important in this context to create mechanisms to balance producer and consumer interests when considering contingent protection under unfair trade practices.¹⁷

Conclusions and recommendations

Today, the LAC region is more open than in all its post-World War II history and is integrating faster with the world economy than any other region. Remarkable as this fact is relative to the trade orientation in the region a few years ago, there is no room for complacency. There are factors at work that could cause backsliding. Moreover, there is an incomplete agenda to be addressed unilaterally, regionally, and multilaterally. Although there is no widespread intellectual retreat from freer trade in the region and reforming governments have won by handsome majorities in recent elections in both Argentina and Peru, macroeconomic instability and waning political support for reform,

due to increases in open unemployment, pose serious challenges to the policymakers of the region. In this sense trade policy reform is not a single event but a continuous and complex process subject to macroeconomic, political, economic, and institutional factors.

Unilateral trade reforms have quickly opened individual economies in the region, some faster than others. The early reformers, such as Bolivia, Chile, and Mexico, have achieved a measure of openness that rivals that of other more successful trading regions. The recent reformers, such as Argentina, Brazil, Colombia, Jamaica, Peru, and Uruguay, have also implemented comprehensive trade reforms. The more recent reformers, like Trinidad and Tobago and Venezuela, have a larger agenda to complete, and in Venezuela some setbacks caused by domestic financial sector crisis have arisen. The agenda for unilateral policy reforms is incomplete because many countries have relatively high levels of nominal protection compared with their counterparts in other parts of the world; some countries have wide dispersions in protection and fewer continue to rely on QRs as import protection devices. Moreover, the repercussions of the recent Mexican peso crisis have led some countries to raise their tariffs. Venezuela, on the other hand, had to introduce exchange controls in dealing with the domestic banking crisis. In the area of unilateral reforms, a possible agenda would include reduction of the dispersion and average tariffs to more reasonable levels, such as in Chile.

Regionalism has been an instrument for greater trade opening in LAC. The revival of pre-existing agreements, such as the Andean Group, the CARICOM, and CACM, and the signing of new agreements, such as Mercosur and NAFTA, have given a greater impetus to the outward orientation that has been pursued under unilateral reforms. There are also ambitious objectives leading to "deep integration" going beyond trade in goods to address services, harmonization of regulatory environments, and macroeconomic coordination. Trade among the regional groups has increased faster than with the rest of the world, such as within Mercosur and between Colombia and Venezuela. However, there are concerns that while these arrangements have been so far open (in the sense of not explicitly discriminating against nonmembers), increasing integration could lead to some degree of exclusivity. Some countries may not be willing to accept a wider set of rules than those

in a conventional trade agreement. This may impede regional agreements from becoming building blocks for closer integration with the world economy. The trend toward regionalism also poses challenges with respect to the application of rules of origin, which in turn could become new trade barriers. And the coexistence of different agreements creates complex issues for meeting different requirements with respect to preferences and regulatory convergence. The antidote to these problems is to maintain open trade regimes, not to increase the cost to entry of new partners, and to follow Article XXIV of the GATT in spirit as well as in law.

Multilateral trade liberalization will further contribute to integrating the region with the rest of the world. Because these countries ventured to liberalize their trade unilaterally, they were ready and able to participate in the Uruguay Round as equals. Nearly all the countries are now members of WTO and they have adopted, by and large, its rules for domestic and multilateral trade policy. The multilateral trade negotiations have bestowed access to markets that had been previously restricted and opened new opportunities in agriculture, services, textiles, and clothing. Nevertheless, the opening will be slow because agriculture continues to be protected, textile and clothing liberalization is backloaded, and many service areas are yet to be opened. However, to take advantage of the increased access in the future, the countries of the region have to address the unfinished agenda for reforms. Indeed, in light of recent events related to the Mexican peso crisis, a case can be made to increase the speed and intensity of the reforms, to increase their credibility, and to take advantage of improved market access.

Macroeconomic stability concerns have to be addressed quickly. In this regard the key policy issue is fiscal discipline. More often than not, macroeconomic instability was engendered by fiscal disequilibrium. The need to address this issue becomes even more important because external shocks, created by situations such as the Mexican peso crisis, can create macroeconomic difficulties faster than before due to closer integration of financial markets. Unstable exchange rates retard exports and create overall macroeconomic management problems that have adverse feedback effects on trade regimes. Moreover, instability could lead to high open unemployment and political problems, inhibiting the achievement of the unfinished trade agenda.

Two factors are fundamental for maintaining macroeconomic stability. First, a strong fiscal discipline and conservative monetary policy is needed. Second, maintaining stability is not so much related to the type of exchange rate regime in place as it is to fiscal and monetary policy. Fiscal surpluses help to increase credibility, contribute to raising private savings, and reduce the need for inordinate reliance on external finance. *When combined with sound judgments regarding the manner in which a surplus is achieved, the relative rates of return to public and private investments, and alternatives to holding domestic financial assets, fiscal surpluses may be needed to emerge out of the ripple effects of external crises.* Also, it is the monetary policy of the country, not the type of exchange rate regime, that determines real exchange rate stability. Although fixed nominal exchange rates have helped countries to stabilize prices rapidly, the same arrangement can cause real exchange rate appreciation and unravel trade reforms if fiscal and monetary policies are not consistent with the exchange rate. Thus maintaining real exchange rate stability under a fixed nominal exchange rate system puts enormous responsibility on fiscal and monetary authorities.

Although the region implemented strong trade policy reforms during the mid-1980s to the early-1990s, institutional reform lagged behind. In fact, in many countries the same institutions that implemented inward-oriented policies continued well into the late 1980s. Institutional reform, when pursued, has included the centralization of trade policy in a sector-neutral authority, adoption of GATT rules for antidumping and countervailing protection, use of independent commissions for inquiring into cases of exceptional protection, and adoption of a more transparent processes for determining injury and remedies. While not all the countries follow the same rules, the region has adopted more neutral trade policy rules and institutions than before. As in the case of the unfinished policy agenda, a substantial agenda also exists on the institutional side. The institutions must have central but independent bodies to consider exceptional protection and must continuously evaluate the costs of protection, transparency of processes and inquiries, and proper balancing of consumer and producer interests. These reforms will help to anchor freer trade policy in sound trade policy institutions and in turn will contribute to the permanency of open trade regimes.

Appendix

Regional integration arrangements

ACRONYMS	TITLE	ACRONYMS	TITLE
ANDEAN PACT	Andean Subregional Integration Agreement (Cartagena Agreement)	FTAA	Free Trade Area of the Americas
CACM	Central American Common Market	LAIA/LAFTA	Latin American Integration Association/ Latin American Free Trade Association
CARICOM	Caribbean Community and Common Market	MERCOSUR	Mercado Común del Sur (Southern Cone Common Market)
CARIFTA	Caribbean Free Trade Association	NAFTA	North American Free Trade Agreement
CUSFTA	Canada-United States Free Trade Agreement	OECS	Organization of East Caribbean States
EAI	Enterprise for the Americans Initiative		

TABLE A1

Americas-related regional integration arrangements

	NICARAGUA/ EL SALVADOR	CAFTA*	CACM	CARIFTA	ANDEAN PACT
Status	Superseded	Superseded	Operational	Superseded	Operational
Date of signature (or establishment)	9 March 1951	10 June 1958	13 December 1960	15 December 1965	26 May 1969
Date of entry in force	21 August 1951	2 June 1959	13 December 1960	1 May 1968	16 October 1969
Type of agreement	FTA	FTA	CU	FTA	CU
North America					
Canada					
Mexico					
United States					
Central America					
Belize					
Costa Rica			• (1962)		
El Salvador	•	•	•		
Guatemala		•	•		
Honduras		•	•		
Nicaragua	•	•	•		
Panama					
Caribbean					
Antigua and Barbuda				•	
The Bahamas					
Barbados				•	
Dominica					
Grenada					
Jamaica					
Montserrat					
St. Kitts and Nevis					
St. Lucia					
St. Vincent and Grenadines					
Trinidad and Tobago				•	
South America					
Argentina					
Bolivia					•
Brazil					
Chile					b
Colombia					•
Ecuador					•
Guyana				•	
Paraguay					
Peru					•
Uruguay					
Venezuela					• (1973)
Other					
Israel					

TABLE A1

Americas-related regional integration arrangements (continued)

	CARICOM	LAIA (LAFTA)	OECS (ECCM) ^e	ISRAEL- UNITED STATES	ARGENTINA- BRAZIL
Status	Operational	Operational	Operational	Operational	Superseded
Date of signature (or establishment)	4 July 1973 (18 February 1960)	August 1980 (1968)	October 1980	22 April 1985	29 July 1986
Date of entry in force	1 August 1973	2 June 1961	2 July 1981	1 September 1985	29 July 1986
Type of agreement	CM	FTA	CU	FTA	d
North America					
Canada					
Mexico		•			
United States				•	
Central America					
Belize	• (1974)				
Costa Rica					
El Salvador					
Guatemala					
Honduras					
Nicaragua					
Panama					
Caribbean					
Antigua and Barbuda	•		•		
The Bahamas	• (1983)				
Barbados	•				
Dominica	• (1974)		•		
Grenada	• (1974)		•		
Jamaica	•				
Montserrat	• (1974)		•		
St. Kitts and Nevis	•		•		
St. Lucia	• (1974)		•		
St. Vincent and Grenadines	• (1974)		•		
Trinidad and Tobago	•				
South America					
Argentina		•			•
Bolivia		•			
Brazil		•			•
Chile		•			
Colombia		•			
Ecuador		•			
Guyana	•				
Paraguay		•			
Peru		•			
Uruguay		•			e
Venezuela		•			
Other					
Israel				•	

TABLE A1

Americas-related regional integration arrangements (continued)

	CANADA- UNITED STATES	EL SALVADOR- GUATEMALA	MERCOSUR	CHILE- MEXICO	COLOMBIA- VENEZUELA
Status	Superseded	Operational	Operational	Operational	Operational
Date of signature (or establishment)	2 January 1988	1991	26 March 1991	1991	1991
Date of entry in force	1 January 1989	October 1991	29 November 1991		1 January 1992
Type of agreement	FTA	FTA	CM	FTA	FTA
North America					
Canada	•				
Mexico				•	
United States	•				
Central America					
Belize					
Costa Rica					
El Salvador		•			
Guatemala		•			
Honduras					
Nicaragua					
Panama					
Caribbean					
Antigua and Barbuda					
The Bahamas					
Barbados					
Dominica					
Grenada					
Jamaica					
Montserrat					
Sr. Kitts and Nevis					
St. Lucia					
St. Vincent and Grenadines					
Trinidad and Tobago					
South America					
Argentina			•		
Bolivia					
Brazil			•		
Chile				•	
Colombia					•
Ecuador					
Guyana					
Paraguay			•		
Peru					
Uruguay			•		
Venezuela					•
Other					
Israel					

TABLE A1

Americas-related regional integration arrangements (continued)

	COLOMBIA- ECUADOR	NUEVA OCOTEPEQUE AGR.	MEXICO- CENTRAL AMERICA	VENEZUELA- CENTRAL AMERICA	NAFTA
Status	Operational	Operational	Prospective	Prospective	Operational
Date of signature (or establishment)	1991	1992	20 August 1992	1992	17 December 1992
Date of entry in force		14 May 1992			1 January 1994
Type of agreement	FTA	CU	FTA	FTA	FTA
North America					
Canada					•
Mexico			•		•
United States					•
Central America					
Belize					
Costa Rica			•	•	
El Salvador		•	•	•	
Guatemala		•	•	•	
Honduras		•	•	•	
Nicaragua			•	•	
Panama			•	•	
Caribbean					
Antigua and Barbuda					
The Bahamas					
Barbados					
Dominica					
Grenada					
Jamaica					
Montserrat					
St. Kitts and Nevis					
St. Lucia					
St. Vincent and Grenadines					
Trinidad and Tobago					
South America					
Argentina					
Bolivia					
Brazil					
Chile					
Colombia	•				
Ecuador	•				
Guyana					
Paraguay					
Peru					
Uruguay					
Venezuela				•	
Other					
Israel					

TABLE A1

Americas-related regional integration arrangements (continued)

	CHILE- VENEZUELA	BOLIVIA- PERU	ECUADOR- PERU	GROUP OF THREE	COLOMBIA- CHILE
Status	Operational	Operational	Operational	Prospective	Operational
Date of signature (or establishment)	2 April 1993	13 November 1992	8 December 1992	April 1993	December 1993
Date of entry in force					
Type of agreement	FTA	FTA	FTA	FTA	FTA
North America					
Canada					
Mexico				•	
United States					
Central America					
Belize					
Costa Rica					
El Salvador					
Guatemala					
Honduras					
Nicaragua					
Panama					
Caribbean					
Antigua and Barbuda					
The Bahamas					
Barbados					
Dominica					
Grenada					
Jamaica					
Montserrat					
St. Kitts and Nevis					
St. Lucia					
St. Vincent and Grenadines					
Trinidad and Tobago					
South America					
Argentina					
Bolivia		•			
Brazil					
Chile	•				•
Colombia				•	•
Ecuador			•		
Guyana					
Paraguay					
Peru		•	•		
Uruguay					
Venezuela	•			•	
Other					
Israel					

TABLE A1

Americas-related regional integration arrangements (continued)

	MEXICO-COSTA RICA	EAI	MERCOSUR-CHILE	MERCOSUR-BOLIVIA	FTAA	CHILE-NAFTA
Status	Prospective	Superseded	Prospective	Prospective	Prospective	Prospective
Date of signature (or establishment)	1994 ^f	1991 ^e	1994	1994	1994	1994
Date of entry in force					2005 ^h	
Type of agreement	FTA	FTA	FTA	FTA	FTA	FTA
North America						
Canada					•	•
Mexico	•	•			•	•
United States		•			•	•
Central America						
Belize		•			•	
Costa Rica	•	•			•	
El Salvador		•			•	
Guatemala		•			•	
Honduras		•			•	
Nicaragua		•			•	
Panama		•			•	
Caribbean						
Antigua and Barbuda		•			•	
The Bahamas		•			•	
Barbados		•			•	
Dominica		•			•	
Grenada		•			•	
Jamaica		•			•	
Montserrat		•			•	
St. Kitts and Nevis		•			•	
St. Lucia		•			•	
St. Vincent and Grenadines		•			•	
Trinidad and Tobago		•			•	
South America						
Argentina		•	•	•	•	
Bolivia		•		•	•	
Brazil		•	•	•	•	
Chile		•	•		•	•
Colombia		•			•	
Ecuador		•			•	
Guyana		•			•	
Paraguay		•	•	•	•	
Peru		•			•	
Uruguay		•	•	•	•	
Venezuela		•			•	
Other						
Israel						

Note: Numbers in parentheses are year of accession for countries that were not among the original founding members. CU = customs union; FTA = free trade area; CM = common market; PTA = preferential trade agreement. Type of agreement refers to the stated objective, not necessarily what has been achieved. Negotiations for a CARICOM-Venezuela FTA and a CARICOM-Colombia FTA are also under way. Cuba, Haiti, and Suriname do not participate in any of the regional integration arrangements listed in this table.

a. Multilateral Treaty for Free Trade and Economic Integration of Central America, which was superseded by the CACM in 1960.

b. Chile withdrew in 1976.

c. The Organization of Eastern Caribbean States (OECS) superseded the East Caribbean Common Market (ECCM) that was established in 1968.

d. Initially designed as a sectoral customs union.

e. Uruguay joined the Argentina-Brazil Program of Economic Cooperation negotiating trade concessions via LAIA mechanisms.

f. Expected date of signature.

g. Reflects signature of bilateral framework agreements between the United States and other countries (or groups of countries) in the hemisphere.

h. The plan of action of the Summit of the Americas determines that negotiations should be concluded no later than 2005.

Notes

1. The political economy of trade reform (that is, its distributive implications) provides an explanation for this resistance. Although trade liberalization is typically welfare enhancing, it generates winners and losers. It is easier to identify ex ante who the losers will be (for example, inefficient import-substituting industries and related factors of production, bureaucracies that control the distribution of the rents associated with protection). The winners, on the other hand, cannot be easily sorted out in advance (for example, firms that will become successful exporters once the anti-export bias of the economy is reduced) and are too diffuse to lobby for their interests (for example, consumers).

2. As pointed out by Corden (1995), among others, these two last modes of liberalization bring additional benefits because of reciprocity. Regional preferential arrangements and multilaterally negotiated liberalization improve the conditions of market access for exports of the country participating in the process. In the case of regionalism, however, these additional benefits come at the cost of potential trade diversion.

3. Before the 1980s, increases in current account deficits typically led to increasing trade restrictions and improvements in the current account to trade liberalizations. See Little, Cooper, Corden and Rajapatirana (1993).

4. see appendix and table A1 for a comprehensive list of RIAs in the Americas.

5. See, for example, De Melo and Panagariya (1992), Nogués and Quintanilla (1992), and Anderson and Blackhurst (1993). For a discussion of this topic with a focus on Latin America see Edwards (1993b), Primo Braga, Safadi, and Yeats (1994), and IDB and ECLAC (1995).

6. For a review of the literature see, for example, Hughes, Hallett, and Primo Braga (1994).

7. For more details on the preconditions for "open regionalism," see ECLAC (1994), Lustig and Primo Braga (1994), and Krueger (1995).

8. See GATT (1994a). It is worth noting that developing countries typically have modified their RIAs under the Enabling Clause that basically imposes no discipline on them.

9. It can be argued, however, that it is preferable to pay the price of a "local" violation (at the tariff line level) of the basic principle of open regionalism if the end result (a customs union) minimizes the need for complex and nontransparent rules of origin.

10. For example, a producer of finished garment in country A may find it profitable to buy fabric woven from country B's yarn rather than from cheaper imported yarn from outside the FTA in order to qualify for free access to B's market. For further details see Krueger (1993).

11. There are estimates that rules of origin impose costs (administrative costs, compliance, and so on) that amount to 5 percent of the value of traded goods. In the case of free trade agreements between EC and EFTA countries in the 1970s, Herin (1986) found that this burden led roughly 25 percent of exporters to forgo the trade preferences in order to avoid the legal formalities.

12. By binding a tariff, a country pledges not to raise the tariff above the bound level. The Uruguay Round Agreement allows for a gradual phase-in of tariff reductions. The offered most-favored-nation (MFN) rate, however, must be effective no later than January 1, 1999. An eventual increase in a tariff beyond the bound rate requires the country to negotiate compensation for the affected trading partners.

13. The TRIPS agreement will require significant reform in the intellectual property rights (IPR) regimes of several LAC countries. Its potential negative welfare implications (from a static perspective) are, however, significantly diluted by the long transitional periods adopted. For the region, the main task ahead is to transform their IPRs regimes in effective instruments to promote innovation. For further details on the implications of TRIPS for developing countries see Primo Braga (1995).

14. The trade ratio for any given year is not an unambiguous indicator of openness since it reflects the size of the country. Thus, small countries have larger ratios than large countries. However, changes in the ratios are a more reliable indicator, since the changes wash out the bias arising from the size of the country. The trade ratio is defined as $R = (X+M)/Y$ where X = exports, M = imports, and Y = gross domestic product.

15. A comprehensive analysis of employment-unemployment issues is presented in *World Development Report 1995: Workers in an Integrating World*, World Bank (1995).

16. Finger (1995) has noted that GATT provisions regarding "exceptional protection" make political rather than economic sense.

17. The Australian Industrial Commission came close to such an institution in the late 1970s. See Spriggs (1991).

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Comment on "Latin America and the Caribbean in the World Economy," by Carlos A. Primo Braga, Julio Nogués, and Sarath Rajapatirana

M A X C O R D E N

UNTIL THE 1980S TRADE LIBERALIZATION IN LATIN AMERICA WAS ASSOCIATED WITH balance of payments improvements. Since then, however, there has been a worldwide reversal in this trend. Trade liberalization in developing countries is now viewed as part of a process stimulated by balance of payments crises. This development can be observed both within Latin America and throughout the world in countries such as Australia, China, India, Indonesia, and New Zealand.

Discussions of trade liberalization encompass the issue of exchange rates and the problems generated by real currency devaluation strategies. Liberalization is usually associated with real currency devaluations, and when countries face adverse terms of trade, real depreciations coupled with nominal fixed exchange rates eventually lead to reversals in trade liberalization. Thus a strategy that avoids the need for real depreciation can assist in the implementation of successful, continuous trade liberalization policies.

To avoid trade restrictions governments should adopt preventive measures that help avoid situations that create a need for real devaluation and changes in exchange rates. For example, countries that experience favorable terms of trade should run a fiscal surplus or develop a stabilization fund. That way, when there is a decline in the terms of trade, there will be no need to adjust the exchange rate. Likewise, when a private investment boom occurs fiscal surpluses should be run to offset the effect. That way, governments can afford to run a fiscal deficit when flows into the private sector decrease.

Although these examples provide strategies for avoiding real currency devaluations and reversals in trade liberaliza-

tion policies, trade restrictions may have to eventually be imposed in times of crisis. In this event the best strategy is to be prepared. Other temporary strategies, such as simple and uniform tariff arrangements that avoid unnecessary market distortions, should be contemplated as well.

Small and medium-size countries in developing regions are including export boom strategies of manufactured goods in their economic growth policies. The success of these strategies will depend on how quickly the world moves toward multilateral trade liberalization. The European Union is currently looking inward, focused on its own liberalization. The United States and Japan, on the other hand, seem to be moving toward isolationism and protectionism. Such trends hinder the development of an open world economy.

Since the economies of Latin America's three largest economies are less dependent on free world trade than smaller countries, the responsibility for reversing this trend will fall on the smaller countries. Moreover, regional trade agreements should not distract from efforts to keep the world system open.

Comment on “Latin America and the Caribbean in the World Economy,” by Carlos A. Primo Braga, Julio Nogués, and Sarath Rajapatirana

W I L L I A M L E W I S

FOR BUSINESS PEOPLE, THE BENEFITS OF TRADE GO FAR BEYOND SHIFTING OUTPUT, JOBS, AND productivity from one region to another. More important, trade increases competition, which stimulates productivity, encourages better use of resources, increases output and job opportunities, and produces innovation in products, services, and goods.

In developing countries privatization, foreign direct investment, and antitrust policies contribute to competition. The threat of extinction that surfaces with privatization, more than the incentive for

increased profits, generates competitive intensity and pressure to improve. Although trade is important in promoting competition in some manufacturing sectors, foreign direct investment is more important for generating competition in the rest of the economy. Foreign direct investment promotes world-class performance by allowing domestic producers to overcome shortcomings in local inputs. The development of effective, efficient pro-competition policies through antitrust actions is also important. As Sweden has taught us, lack of global exposure in all sections of the economy results in stagnation, regardless of the extent of deregulation.

Growth in Latin American exports and the opening of trade could lead to tremendous protectionist pressures in world trade. These pressures would be difficult but not impossible to overcome.

Several of these examples apply to Latin America. In Brazil, for example, there is a 50 percent difference in pro-

ductivity between the public and private banking industries for the same functions. In addition, the regional private telecommunications company's total factor productivity is twice that of the country as a whole. In food processing the state will have to go beyond the three factors that increase competition (privatization, foreign direct investment, and antitrust policies) and enforce tax payment and collection and adherence to sanitation and health restrictions.

These positive changes and productivity improvements increase employment. And although labor market reform is essential, product market reform is ultimately more important. In Europe, for example, where product market restrictions have precluded the development of top-quality practices in the service industry, employment is limited. Competition could perhaps be stimulated here through foreign direct investment.

Comment on "Latin America and the Caribbean in the World Economy," by Carlos A. Primo Braga, Julio Nogués, and Sarath Rajapatirana

JOSÉ ARTUR DENOT MEDEIROS

THE ADVANTAGES OF INCLUDING OPEN TRADE IN MACROECONOMIC POLICY ARE WELL known. But the costs of transition—including political costs for economies, such as Brazil, undergoing stabilization—should be studied more extensively. Along with open economic policy measures, fiscal balance must be attained without provoking recession.

Trade policy must be considered within a wider macroeconomic framework that varies in terms of advances and recessions. Open trade is beneficial only to the extent that it is a long-term tendency and a country's internal obligations are met. Open trade in Brazil has come about too quickly and too ambitiously. More attention should be paid to consolidating achievements in order to preserve the achievements of the past five years.

References to the international atmosphere are based on an overly positive evaluation of the results from the Uruguay Round. It is important to carefully consider the risks that external instability can bring to the region. Also, concentrating on domestic policies is not sufficient to complete the task of linking Latin America to the global economy. External conditions also have to be considered.

In democracies customers are usually the people who benefit from open trade. Customers are not organized in permanent lobbies, however, and those who do not benefit from open trade are vocal and organized. The limited political power of groups who benefit from open trade may directly affect the possibilities of expanding and maintaining open trade in the region.

Between 1990 and 1994 Brazilian exports to the rest of the world (except Latin American Integration Association, or LAIA, countries) increased only 2 per-

cent; imports increased by an annual average of 12.5 percent. On the other hand Brazil's exports to LAIA countries in the Mercosur increased almost 21 percent a year. Two conclusions can be drawn from these facts. First, Latin American countries have been practicing open trade in the region. Second, the rest of the world has had more opportunity to export to the region than the region has had to export to the rest of the world.

There have been disparities in the liberalization process in Latin American countries. In Brazil, a country of great industrial maturity and considerable state control, liberalization has been painful and has affected privileged groups more deeply than in other countries. Every country that cuts subsidies should calculate them to better understand the cost of opening trade. In Brazil the cost has been great when measured in these terms.

It is a mistake to think that the Uruguay Round has had a significant influence on opening trade in Latin

America. It was just the opposite: opening was responsible for greater participation. At the beginning of the Uruguay Round Latin American countries had almost reached the formal level of the industrial nations; after the summit they found they had no significant influence on the meeting's agenda or on the definition of outcomes.

Some concerns exist about the integration of Latin America with a free trade market using the rules of the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO), especially concerning the exception specifications. However, the exceptions are a temporary mechanism and are related to the countries' taxation systems.

The importance of regional agreements in increasing wealth and productivity has not been mentioned. Mercosur is perhaps the most spectacular example, with trade business tripling in just three years. Although there have been concerns about the possibility of protectionist escape and the difficulty of administrative rules of origin in regional integration agreements, rules of ori-

gin are inherent to treaties of this kind and must be tolerated.

Some observers have claimed that institutional reform has not accompanied opening efforts in Latin America. This is not true for Brazil. The Brazilian government initiated important institutional reforms in trade policy as it opened. In this regard reforms in Brazil were more radical than in other countries.

Sectors that oppose open trade are still alive and lobbying in a democratic way. For example, agriculture in Latin American countries—and certainly in Mercosur countries—is less protected and has suffered fewer interventions from the state than in many industrial countries, especially those in the European Union. These countries underestimate their ability to adjust to new situations.

In conclusion, Latin America is gearing up for open trade. Since there are high political costs associated with the process, it should be treated with great care to prevent protectionist interests from returning.

Floor Discussion of "Latin America and the Caribbean in the World Economy," by Carlos A. Primo Braga, Julio Nogués, and Sarath Rajapatirana

A MEMBER OF THE AUDIENCE SUGGESTED THAT THE AUTHORS HAD UNDERESTIMATED THE importance of the cost of trade liberalization. The need to avoid reversals and to fight for complementary trends, especially relating to de facto markets, should be given more importance. Practically speaking, the treatment of foreign capital may be more important than the management of the capital account. Foreign capital brings technology, adjustment, adaptation, and exports. Moreover, we should consider the implications of conditionality relating to labor when discussing NAFTA. The trend is toward greater conditionality on labor, which implies less flexibility adapting to trade liberalization.

Another audience member asked whether the proliferation of free trade agreements in Latin America presents barriers to unilateral liberalization, the greatest source of benefits from trade, in most countries. Another audience member said that the paper did not pay sufficient attention to NAFTA, the free trade agreement of the Americas, and the Caribbean countries. For example, the special problems of the smaller countries in terms of external liberalization were ignored. These countries have unique problems and require additional measures to assist in the adjustment process.

Nogués responded that the region's small and medium-size countries should unite to convince the three largest economies to maintain and expand open markets. Further, recent evidence shows that short-run gains far outweigh the costs of trade liberalization. Thus the cost of trade liberalization was not discussed in depth.

Argentina provides an example of a situation where trade liberalization in terms of importing capital goods has been fundamental in explaining overall productivity growth. Although Argentina experienced a 40 percent decline in overall productivity growth for nearly a decade

during the 1980s, overall productivity growth has increased by more than 5 percent a year for the past four years. A significant portion of that productivity gain can be attributed to open trade and the substantial amount of capital goods imported into Argentina.

Rajapatirana said that trade reform must be viewed as part of a package, since reforms are not made in isolation. Although he agreed that the paper did not sufficiently address this issue, it does emphasize the macroeconomic factor, which should be the most immediate component taken into account. Although some trade reforms have taken place in Latin America, a trade regime and the accompanying institutional reform that balances the interests of consumers and producers need to be developed.

The panel was then asked to explain the World Bank's position on the relationship between labor and trade. Nogués said that *World Development Report 1995: Workers in an Integrating World* addresses the issue of labor standards in depth. As the report shows, raising labor standards in international trade negotiations transforms labor from a tool that makes sense in theory to a protectionist instrument.

A member of the audience then asked how the approach of open regionalism can lead to effective building blocks, and whether regions are moving toward building blocks. Braga said that there is reason to be concerned about the proliferation of regional trade arrangements and administration of trade flows. In 1970 rules of origin were so cumbersome for manufactured goods that countries were willing to pay tariffs rather than comply with complicated rules and administration. The World Bank, the Inter-American Development Bank, and the Organization of the American States can help ensure transparency in Latin America in terms of trade agreements.

Sri-Ram Aiyer (chair) summarized by saying that evidence shows that trade liberalization increases competitiveness, outputs, and income. In Latin America, more than any other region, the World Bank is focusing on competition policy and reform to improve the climate for foreign direct investment. In this regard the objective should be the creation of trade and harmonization of standards. Latin America should listen to advice to put pressure on its three largest economies to minimize isolationism. The small and medium-size countries need to group together to shift attitudes on an international scale.

Concluding Remarks

S R I - R A M A I Y E R

MR. SRI RAM AIYER (CHAIR) SUMMARIZED THE MAIN CONCLUSIONS OF THE PAPER, THE comments on it by Professor Corden, Dr. William Lewis and Ambassador Jose Denot and the discussion that ensued from the audience.

Mr. Aiyer noted that the paper provided four principal conclusions. First, Latin American and the Caribbean countries have more open trade regimes at present than anytime in their post World War II history. Second, these trade regimes have withstood external shocks including the December 1994 shock that arose from the Mexican peso crisis. Instead of restricting trade, which they would have done in the past, these countries continued on the path of trade liberalization, unilaterally, through regional trading arrangements and multilaterally within the context of the Uruguay Round. Third, there were still areas for reform in some of the countries which related to reducing protection further, undertaking factor market reforms and those related to increasing domestic competitiveness. Finally, the institutional arrangements for trade policy making had to be reformed to be in accord with the new and more liberal trade regimes. Many countries continued to have trade policy making institutions that came into existence during periods of strong protection.

Mr. Aiyer noted that Professor Corden's comments on the paper provided an international context for trade reform, emphasized the need to maintain fiscal viability and exulted that developed countries should help the trade liberalization process of the Latin American and Caribbean countries by further opening of their domestic markets. Summarizing Dr. Lewis' comments, Mr. Aiyer emphasized the importance of private foreign direct investment to accompany trade reform to lead to a more efficient and rapid technology transfer. The combination of these two factors has led to substantial increases in productivity in the private sectors of these countries as revealed in the studies that Dr. Lewis has conducted. Elaborating on this, Mr. Aiyer emphasized that more liberalization of trade was not enough and that it was essential that Governments ensure that proper

incentives and institutions are in place to attract foreign direct investment, of a long term nature, to activities that lead to transfer of technology. This aspect has often been overlooked by countries that have liberalized trade regimes in this Region. Mr. Aiyer remarked that Ambassador Denot was concerned with the cost of adjustment in undertaking trade reforms and that Brazil has made important institutional reforms with respect of trade policy making mechanisms.

The comments from the audience were also summarized by Mr. Aiyer. They related to the need to appreciate the problems of small economies in the global liberalization process and the importance of undertaking factor market reforms, particularly with respect of the labor market. Continued labor market rigidities would inhibit the re-

allocation of resources that trade reforms attempted to achieve and reduce the benefits arising from reforms. Mr. Aiyer thanked the authors, the commentator and the members of the audience for contributing to a very interesting discussion and noted that a future agenda for such meetings

should include issues relating to regional integration, competition policies and factor market reforms. He added that the third Annual Bank Conference on Development in Latin America and the Caribbean, to be held in Montevideo in 1997, would focus on trade.

Poverty, Inequality, and Human Capital Development in Latin America, 1950–2025

JUAN LUIS LONDOÑO

LATIN AMERICA IS KNOWN THROUGHOUT THE WORLD FOR ITS WIDESPREAD POVERTY AND inequality. Today, one out of three Latin Americans lives in poverty and 86 million people in the region struggle to survive on incomes of less than \$1 per day. Although there are differences from country to country—in some places the wealthiest 10 percent of the population has 84 times the resources of the poorest 10 percent, while in others the ratio is “only” 15 to 1—15 out of 17 countries in the region have higher than expected levels of inequality given their levels of development.

This paper argues that the most important factor contributing to the persistence of inequality and the increase in poverty is the lack of adequate education for new generations. Indeed, several factors—economic growth and structural transformation of the economy, the convergence of regional per capita income, and the diminishing rates of return on education—have combined to *lower* the region’s inequality. But the slow expansion of human capital development has counteracted development and resulted in a statistically stagnant level of high inequality.

The average Latin American worker has two years less education than would be expected given the region’s level

of economic development. The difference in education levels between Latin America and successful Asian countries has increased in recent years. Latin America’s illiterate labor force—people who reach age 25 without schooling or with incomplete primary education—continues to grow at excessive rates. The number of families dependent on illiterate workers closely parallels the number of families who are living in poverty.

Not all the news is bad. The percentage of the population living in poverty declined steadily between 1950 and 1980. Since then it increased slightly in the 1980s during the region’s economic crisis and then declined during

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1988–94 as Latin American countries continued to adjust external and fiscal imbalances. However, even as the percentage of poor people in the population declines, the region's growth rate is insufficient to reduce their absolute number. If the current rate of growth continues, poverty will grow at a rate of two people *per minute* during the next decade.

Only a rapid increase in human capital development can bring the region out of poverty quickly. In fact, what the region needs is a *human capital shock*: universal basic education for all young people within the next two decades to bring the average education of the labor force to 9 years per person.

Although high growth without human capital development will reduce the number of poor people over time, increased education levels will get the job done much more quickly. Moreover, this paper argues that rapidly expanding education will in itself lead to higher growth rates.

Rapid acceleration of education will be expensive. Direct costs will amount to an additional expenditure one-half to one full point of a nation's GNP over the next 25 years, depending on the speed of the process. Young people and their families will pay a cost, too, as they will be kept out of the labor market longer while pursuing their education.

The payoff, however, is high and fast. If the additional income generated by this additional education were taxed at today's rates, the required additional investment could soon pay for itself. After about 20 years, the demand for education would increase more slowly than the economy due to demographic transition.

A rapid increase in the development of human capital throughout Latin America will provide the surest and quickest road out of poverty. A dynamic expansion in human capital expansion coupled with growth-enhancing policies would substantially accelerate growth, eliminate the excess of inequality in the region, and upgrade the standard of living for 70 percent of Latin Americans living in poverty today.

Inequality and poverty in Latin America during the past four decades

Latin American is notorious for high income inequality and widespread poverty. Pictures of favelas clinging to the hill-sides around Brazilian cities are familiar to people throughout the world. Central American countries such as

Honduras and Guatemala and Andean countries like Peru and Bolivia are often scrutinized and portray an image of destitution for the entire region. Amid this poverty, of course, there are scenes of great wealth.

This section examines the depth of poverty in the Latin America and Caribbean (LAC) region, and the extent of inequality that accompanies it.

The excess of inequality in Latin America

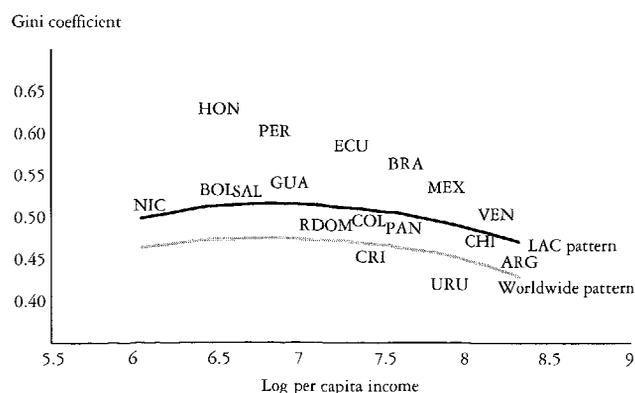
The level of inequality in the LAC region is deep as well as diverse. Figure 1, which graphs the Gini coefficients—a coefficient that measures income inequality¹—of various countries shows that levels of inequality vary between 0.63 and 0.42 within the region. This indicates that in some countries the wealthiest 10 percent of the population have 84 times more resources than the poorest 10 percent while in other countries the ratio is “only” 15 to 1. As the figure shows, the greatest levels of inequality can be found in Honduras and Peru; the lowest can be found in Uruguay and Barbados.

Although country-to-country differences exist, 15 out of 17 countries in the region have higher than expected levels of inequality given their levels of development. Empirical estimates of the Kuznets curve—which predicts inequality according to levels of development—for a sample of 102 countries show that on average the Gini coefficient for Latin American countries is 4.1 points higher than countries with similar per capita income levels.²

The diversity of inequality and income per capita in the region produces a clear excess of inequality for most Latin

FIGURE 1

Inequality in Latin America— an international comparison



American countries and for the Latin American region as a whole. In fact, the estimated Gini coefficient for the region of 0.56³ is higher than Yotopoulos's⁴ estimate for all the developing world (0.501) and higher than expected given level of development in LAC (0.50).

Continental poverty: Regional structure and trends

Regional differences

Several worthwhile attempts have been made to define Latin America's poverty level—that is, to define the level of income at which the standard of living is considered unacceptable. The Economic Commission for Latin America, after a detailed study of consumption patterns in nine countries, placed the poverty line between \$1.66 and \$2.47 per person per day, depending on the country. The World Bank, based on detailed income information from 12 coun-

tries, adopted a poverty line of \$2 per person per day across the region.⁵ This paper emphasizes the differences among countries in the region and uses a line for the region of \$2 per capita per day. To estimate extreme poverty—the poorest of the poor—half the value of the poverty line was used.

In 1995, 35.1 percent of the population in Latin America and the Caribbean was living below the poverty line and 18.8 percent below the extreme poverty line. This translates into 165.6 million poor Latin Americans in 1995, 86.3 million of whom were extremely poor, living on a daily income of approximately \$1 per person.

The highest incidence of poverty in Latin America is in Central America, where approximately 60 percent of the population is poor (figure 2). The lowest incidence is in the Southern Cone, where approximately 10 percent of the population is considered to be poor. Falling between these two extremes is the Andean region, the Caribbean countries, Brazil, and Mexico where poverty levels are 44 percent, 38 percent, 35 percent, and 26 percent, respectively. The incidence of extreme poverty falls into a similar order: 36 percent in Central America, 5 percent in the Southern Cone, 25 percent in the Andean region, 19 percent in the Caribbean countries, 23 percent in Brazil, and 17 percent in Mexico.

While problems of poverty in Brazil, Central America, and Haiti are well known, the problem of poverty in Latin America is more pervasive and widespread than is generally recognized. In absolute numbers, the population of extreme poor in Mexico is higher than the rest of Central America and the Caribbean combined; the number of extreme poor in the Andean countries is twice that of Central America and approximately equal to that of Brazil. Given such variances across the region, the solution to the problem of poverty in Latin America must be region-wide.

The evolution of poverty in Latin America

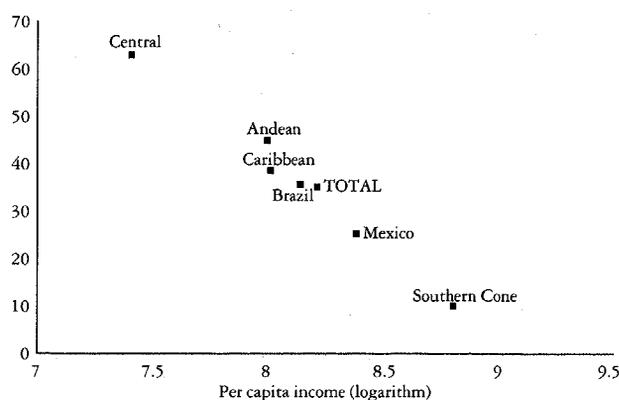
The incidence of poverty in Latin America has decreased over the long term as shown in figure 3, panel A. Specifically, the population living below the poverty line decreased 20 to 25 percentage points between 1950 and 1995. However, high, stable Gini coefficients mean that the rate of per capita income growth in the region—1.8 percent—has not been sufficient for the absolute number of poor to decrease. In fact, the number of poor people in

FIGURE 2

Poverty and extreme poverty in Latin America, 1995

Percentage of the population

a. Poverty



b. Extreme poverty

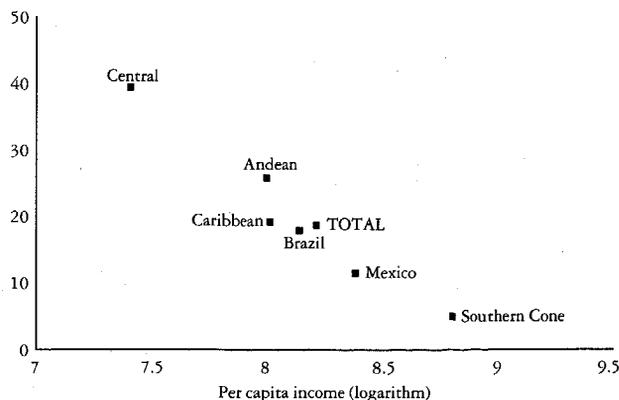
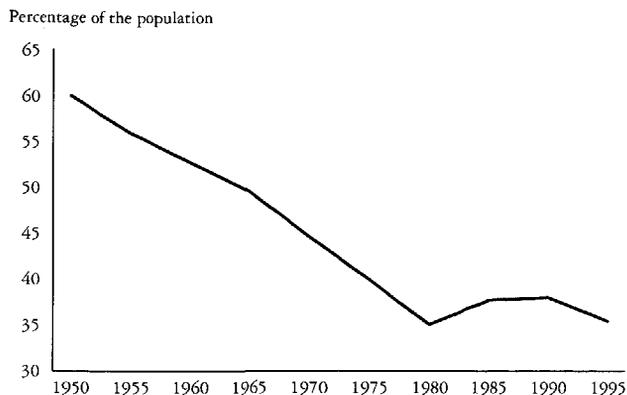
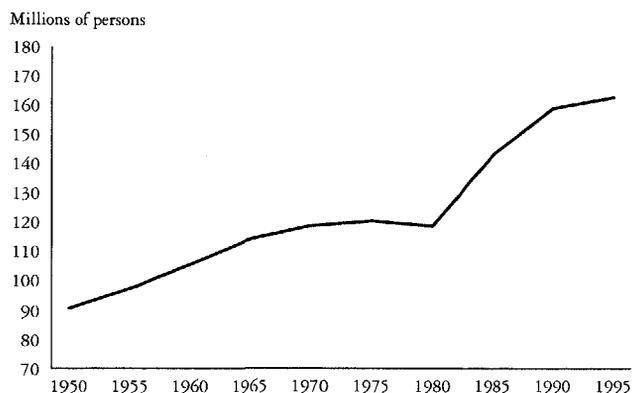


FIGURE 3

Poverty in Latin America, 1950–95*a. Head-count ratios**b. Absolute numbers*

Latin America increased from 92 million in 1950 to 165.6 million today (figure 3, panel B).

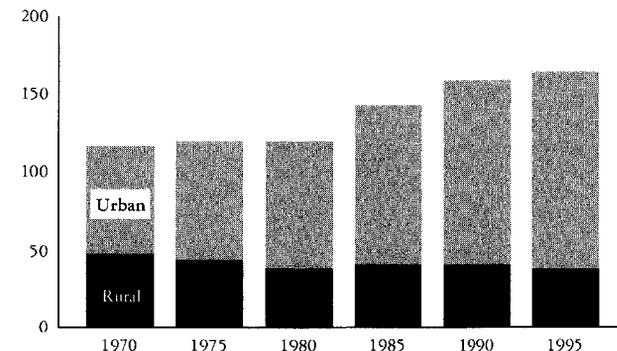
The incidence of poverty in the region has evolved differently over time. While it decreased slowly from 1950 to 1965, the absolute number of poor increased considerably. Between 1965 and 1970 the incidence of poverty accelerated, and between 1970 and 1980 poverty levels remained constant. The reversal in economic growth in the 1980s resulted in a further increase in the incidence of poverty in the region to approximately 40 million new poor. And while the short economic recovery of recent years has helped reverse the increase in the incidence of poverty, it has not been enough to reduce the absolute number of poor.

These poor people are increasingly found in the cities of Latin America. Figure 4 demonstrates that although the absolute number of poor has increased substantially in the last 25 years, the number of poor living in rural areas has decreased. The urbanization of poverty is probably the

FIGURE 4

Eruption of urban poverty in Latin America, 1970–95

Millions of persons



most important characteristic of Latin America poverty in the last few decades.

In summary, the region's 1.8 percent economic growth and the rapid relocation of the labor force to the cities have resulted in a decrease in the incidence of poverty in Latin America. However, the absolute number of poor people has not decreased. In fact, the absolute number of poor today is twice what it was 40 years ago.

Changing factors of Latin American inequality

Distribution of income in Latin America has not changed despite the rapid development process of the past decades. In this same time period, poverty has tended to increase. This section examines why.

The decreasing role of traditional factors of inequality

Economists associate unequal income distribution with the distribution of assets within a population or with the distribution of the market power of the owners of these different assets. Thus, when economists look for causes of the pervasive and persistent income inequality in Latin America, they look at both unequal asset distribution and the differences in market power between actors in different sectors.

In the 1960s, studies attributed the high level of inequality in several Latin American countries to the uneven distribution of land.⁶ At the end of the 1950s, half of the population lived in rural areas and agriculture represented more than a third of the national product. At that time, rents from land made up as much as 15 percent of the national revenue or 20 percent of household income and

contributed substantially to regional income inequality. In addition, as urban activities became five times more productive than rural agriculture from 1950 to 1970, the gap between labor productivity in the two areas widened and analysts' interests shifted towards modes of interaction between industry and agriculture.⁷

Now, 40 years later, and in accordance with normal patterns of development, the importance of agriculture has diminished tremendously. Currently, the agriculture sector barely represents 10 percent of the GNP and employs scarcely more than 20 percent of the labor force of the entire continent. Rents from agriculture account for only 2 to 3 percent of overall household income. Differences in rural-urban productivity are now half of what they were at the beginning of the 1970s and thus, on a regional scale, the importance of uneven land distribution or urban productivity gaps has decreased.

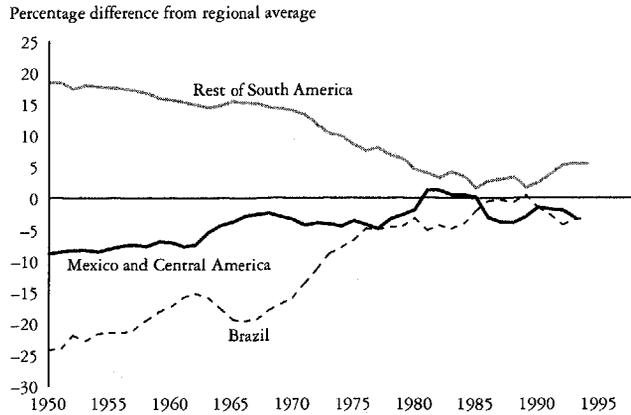
Studies looking at other income-generating assets in trying to explain the region's widespread inequality have not been particularly convincing due in part to the fact that the distribution of the ownership of fixed urban assets has not been fully studied in Latin America. The percentage of the population owning their homes has grown slowly since the early 1970s, indicating that inequality in these assets must not have increased. Productive urban assets are believed to be concentrated, but changes in this area have not been studied. And since the relationship of capital to output in urban areas has not increased much since the 1970s, the contribution of these assets would not be expected to increasingly contribute to aggregate inequality. Likewise, financial assets do not seem to be responsible for the continuing inequality. Financial assets have actually been growing faster than income in the past two decades, and most of the rents have disappeared as financial markets have been deregulated. If anything, this should have led to lower inequality; but as we have shown inequality persists.

Lack of solid documentation of changes in asset holdings in rural and urban areas has altered the focus of income distribution in Latin America to market behavior differences among agents. In the 1980s Keynesian and Latin American structuralist ideas were combined to explain the persistence of Latin American inequality.⁸ Having market power in price fixing, they reasoned, entrepreneurs tended to finance investments by increasing prices. As a result, the real

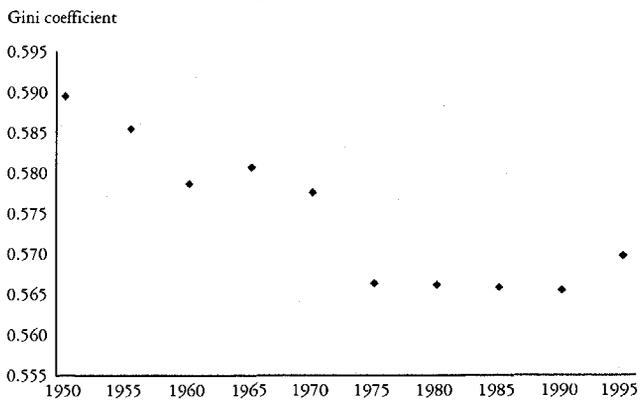
FIGURE 5

Inter-regional income inequality in Latin America, 1950-95

a. Convergence of per capita income



b. Effect of regional dispersion on income inequality



income of urban laborers and peasants deteriorated, and they in turn demanded higher wages. These actors' institutional ability to defend their income share therefore became a basic factor in generating persistent inflation. However, the opening of the economy in the 1980s and growing price competition seem to have broken the vicious cycle of incompatible market forces that led to high inequality through inflation. Thus, economists have again turned their attention to long-term factors that generate inequality.

The variance of per capita income from country to country contributes substantially to regional inequality; so, persistence in the heterogeneity of levels of development among Latin American countries could explain the high levels of inequality. However, evidence indicates that in the long-term income disparity among countries has actually

diminished considerably. Panel A of figure 5 shows how the per capita income in South American countries, excluding Brazil, was 20 percent above the continental average in the 1950s while Brazil's income was 25 percent below average. By the 1980s, these gaps had become insignificant. The reduction in the dispersion of per capita income among the Latin American countries was sufficient to have a substantial effect on regional income inequality. A simple simulation presented in panel B of figure 5 suggests that this factor alone seems to have contributed to a reduction of more than 2 Gini coefficient points in the region.

If income from land has contributed less and less to regional inequality; if the possession of physical and financial urban assets has not contributed increasingly to inequality; if monopoly market forces have decreased with the opening of the economies; and, if per capita income has tended to converge among countries, the persistent inequality in Latin America must be rooted in another income-generating factor: human capital.

Has educational expansion caused income inequality?

What is the relationship between the persistence of inequality and poverty and the formation of human capital in Latin America? This section suggests that the slow expansion of educational opportunities for young people in the past 25 years has not been sufficient to overcome the relative scarcity of human capital in the labor force in Latin America. In fact, it has caused inequality in human capital to increase and has contributed greatly to the growth of semi-permanent poverty that plagues the region.

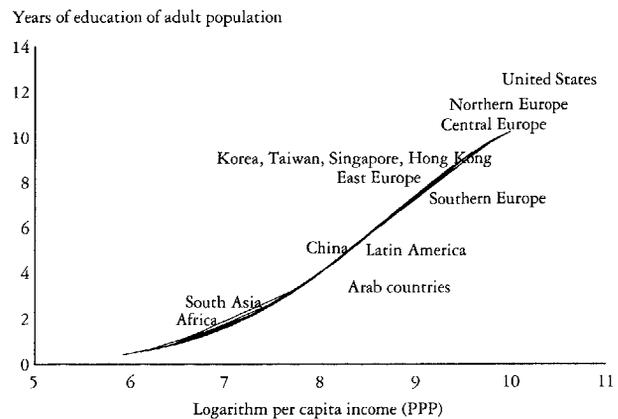
There is a strong, empirical association between a country's level of development and education of its labor force. The statistical results of a correlation of the educational level of the population above age 25 with per capita income adjusted for international purchasing power for the 173 countries in the world are very strong⁹ and allow accurate calculations of countries' expected level of education according to their level of development. The non-linear relationship between education and per capita income indicates that the intensity of education tends to increase with economic development, accelerating substantially at intermediate levels of development such as those that LAC countries have seen in the past decades.

This "pattern" is used in panel A of figure 6 to evaluate

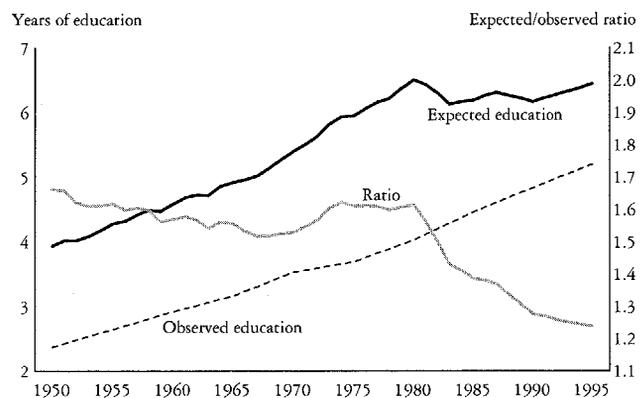
FIGURE 6

Educational insufficiency in Latin America

a. International perspective



b. Latin America in historical perspective, 1950-95

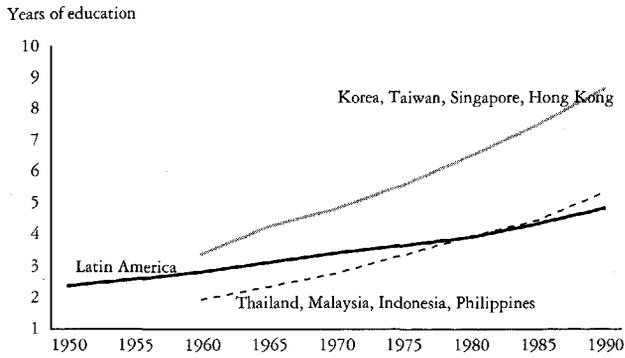


the level of education reached in different regions of the world. Asian countries and countries that are or have been socialist—China or Eastern Europe—tend to have higher educational levels than expected for their level of development. Latin America, the Arab countries, Africa, and southern Europe—Greece, Italy, Spain, and Portugal—tend to have lower educational levels than expected. Latin America, with an average of 5.2 years of education for the adult population in 1995, has approximately two years less education than expected.

Human capital development can be characterized by contrasting the education of the labor force since World War II with the expected values (figure 6, panel B). At the beginning of the post-war period, the labor force had 2.4 years of education. For the level of development at that time the expected level of education was 4 years. The edu-

FIGURE 7

Education level of the labor force in Latin America and Southeast Asia



cational gap of the labor force therefore was 1.6 years. At the beginning of the 1980s the gap had grown to 2.5 years as Latin America had 4 years of education and the expected level of development was 6.5. And although the educational level of the labor force in the 1980s in Latin America expanded at approximately the same rate as the rest of the world, a gap between observed and expected education levels continues to exist today. (The apparent closing of the gap since 1979 is a result of the fall of per capita income in this decade for Latin America, and does not indicate extra progress in education.)

In summary, compared to the rest of the world, the level of education of Latin America's labor force since World War II has been lower than it should have been, given its level of development. Also, the current level of education is insufficient, as is the expansion of the educational system.

Educational insufficiency is particularly high in Latin America when compared to Asia. Figure 7 compares the development of Asian and Latin American education over time. The four most successful Asian countries—Hong Kong, the Republic of Korea, Singapore, and Taiwan (China)—had a considerable educational advantage at the beginning of the 1960s and have widened the gap with Latin America substantially since then. In fact, the level of education in Latin America today is at the same level as that of the Asian countries in 1970. In comparison, in the 1960s the level of education in Indonesia, Malaysia, the Philippines, and Thailand was slightly more than half of Latin America; in the 1980s these countries reached equal levels of education; today, the level of education is greater in those countries than in Latin America.

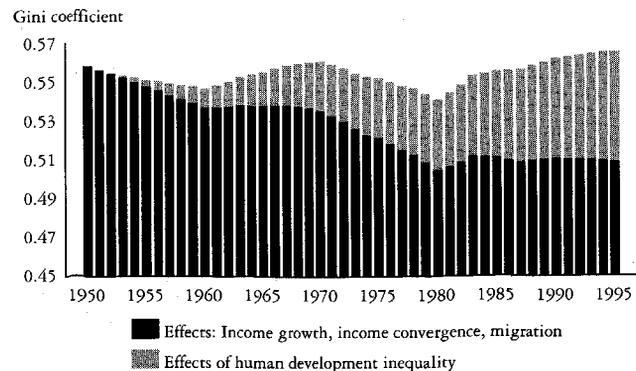
Slow expansion of education has caused serious distribution disparities in Latin America. The scarcity of human capital that resulted from prolonged low levels of education of incoming generations could have contributed to the increase in unequal distribution of human capital.¹⁰ For example, in a society in which there is no education for anyone, the level of education is zero as well as the variance of education among the population. In a society where the entire population reaches the maximum level of education, the variance is again, zero. However, as a country moves from zero to maximum levels of education, the variance of education increases, reaches a peak, and then decreases. Although the variance depends to a great extent on the relative emphasis that each country places on basic or higher education, international experience suggests that the maximum educational inequality results when average educational levels reach 6.3 years.

When the successful Southeast Asian countries reached such a turning point in the mid-1970s, the spread in education within the population was sufficient to decrease income inequality. Young people entering the labor market with more education in the last 20 years have found pay structures increasingly egalitarian—not derived from the reduction of rates of return on education.

In contrast, in Latin America the slow expansion of education has prolonged the phase of increasing educational inequality; and new education is contributing systematically to larger income inequality among the working population. Had higher levels of education been evident in the 1950s, increases in education would have caused relatively little income inequality and would have reversed after the

FIGURE 8

Changing factors of inequality, Latin America, 1950-95



beginning of the 1980s. But, faced with a low level of education from the start, the accumulation of human capital contributed greatly to labor income inequality.¹¹

The effects of educational expansion and other causes of inequality are presented in figure 8.¹² During the last 40 years, three forces have contributed to a decrease in income inequality in Latin America:

- *Economic growth along with the structural transformation in the economy*, which resulted in the reduction of the Gini coefficient by 1 percentage point through the end of the 1970s;
- *The convergence of regional per capita income*, which resulted in a reduction of the Gini coefficient by at least 2 percentage points during the same period; and
- *The diminishing rates of return on education*, which also

lowered the Gini coefficient by almost two points.¹³

On the other hand, while these three factors were lowering income inequality, the growing uneven distribution of human capital tended to make income inequality rise. In fact, as is shown in the chart, the dispersion of human capital pushed the Gini coefficient up 5 percentage points. The sum of the four effects was approximately zero for the entire period 1950–95, thus creating the statistical appearance of inequality inertia.¹⁴

Education and poverty

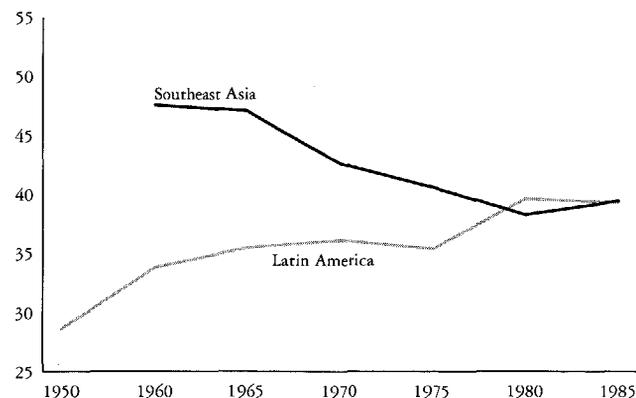
Educational expansion in Latin America has been particularly slow for the poorest sectors of the population in Latin America. A comparative look at Southeast Asia shows the extent to which educational expansion in Latin America

FIGURE 9

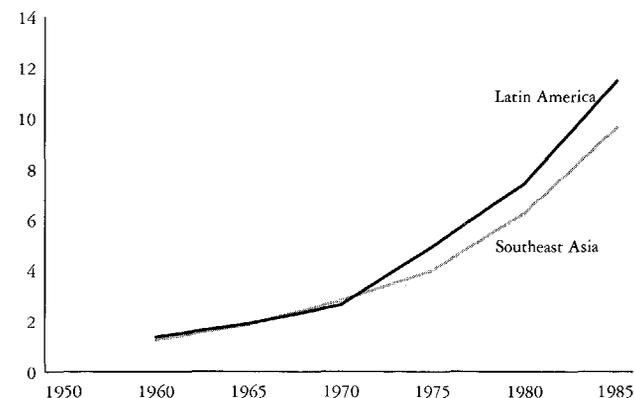
Education of the labor force in Latin America and Southeast Asia

Millions of persons

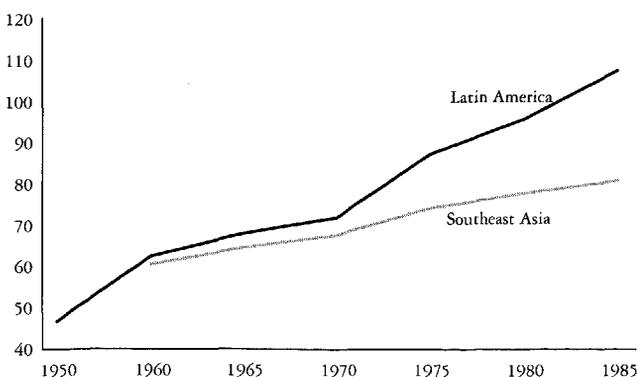
a. Without education



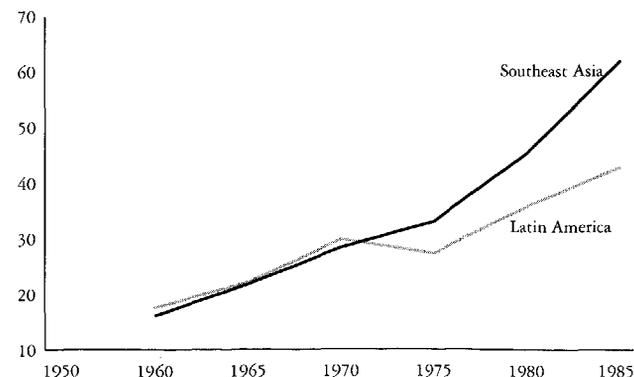
b. University education



c. Functionally illiterate



d. Secondary education



Note: Functional illiterate includes no education and incomplete primary education.

has been uneven. Both groups of countries had similarly sized labor forces at the end of the 1950s (80 million people). In Southeast Asia, due to the influence of the four less developed countries, 47 million people had no education. At that same time in Latin America, 34 million had no education. In the last 30 years, as seen in panel A of figure 9, the absolute number of people with no education in Southeast Asia has decreased by one-fifth while the number *increased* by one-sixth in Latin America. In contrast, the evolution of the university-educated population—panel B, figure 9—in the two groups of countries has been different. At the beginning of the 1960s both regions had 800,000 university-educated people in their labor forces. And through the beginning of the 1970s, both regions incorporated 100,000 university-educated people annually in their labor force. After this point, levels of education in Latin America grew at a quicker rate; 2 million more university-educated people were incorporated into the labor force in Latin America by the end of the 1980s.

Clearly, the education problem in Latin America was rooted in the lower levels of the educational spectrum. Latin America's relatively low coverage in primary education led to higher absolute numbers of the adult population with no education. As can be seen in figure 9, panel C, while Southeast Asia stabilized its functionally illiterate population, Latin America's practically doubled in the last 30 years. At the same time, 20 million more people with secondary education—with completed primary education and with complete or incomplete secondary education—entered the labor market in Southeast Asia than in Latin

America (figure 9, panel D).

Educational expansion in Latin America led to more functionally illiterate people, more university educated people, and fewer workers with secondary schooling compared to Southeast Asia.

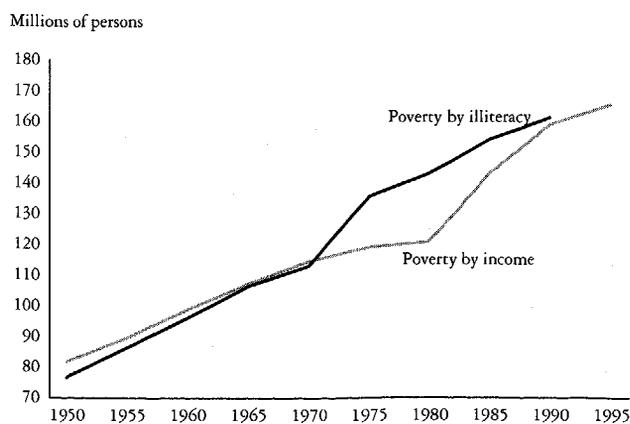
The evolution of poverty in Latin America is not a separate issue. The absolute number of family members dependent on insufficiently educated workers evolved in the last 40 years parallel to the population with income below the poverty line. As seen in figure 10, in 1950 there were almost 80 million poor in Latin America, poverty being measured by income or by lack of human capital. In the subsequent 20 years, 35 million new poor were comparable in number to those dependent on workers with insufficient education. In the 1970s, a decrease in the rate of growth in poverty related to income seems to have benefited the population with no education the most. After the inadequate performance of the 1980s, the number of poor rose again in both categories, reaching 160 million. Given the income fluctuations of the economic cycle, poverty in Latin America can be associated over long periods of time with persons dependent on others who lack human capital. The close link between education, poverty, and inequality has been found consistently in micro cross section studies, but this is the first time it is shown in a dynamic regionwide analysis.¹⁵

Summary

The above analysis shows that inequality in Latin America as a whole is very high with a Gini coefficient 5–6 percentage points above expected. Given Latin America's level of development, the analysis also suggests that with the relative convergence of per capita income among the different sub-regions of Latin America and with transformations in rural production and labor conditions, income inequality should have reached a peak and then decreased over the past 20 years. However, due to the slow expansion of educational opportunities in the region over the last two decades, this has not been the case. At the beginning of the post-war period Latin America's labor force had half the education expected according to international standards. Educational expansion did not reduce this imbalance as it did in other parts of the world such as in Southeast Asia. In addition, Latin American educational expansion has been slow and has discriminated against the poorest sectors of the population. It has left a growing part of the labor force without

FIGURE 10

Two measures of poverty in Latin America



education. The growth of the functionally illiterate labor force in the past 45 years closely parallels the growth of the population living below the poverty line.

Inequality, poverty, and human capital in the next four decades

The previous section stated that inequality in Latin America has not decreased and that poverty has increased in the past 45 years despite the loss of importance of agricultural rents and the rapid convergence of per capita income among the sub-regions. The dynamics of the urban labor market seem to be the main cause of inequality in recent years since insufficient human capital formation kept the distribution of educational benefits from equitably reaching the population.

This section studies the future of poverty and inequality in Latin America. The first part examines projected poverty resulting from expected economic growth and presents alternative scenarios for improvements in equality and a reduction in poverty in the next few decades. The second part shows how the accumulation of human capital could promote both the desired equality and the economic growth needed to reduce poverty. The third part calculates the financial consequences of human capital accumulation and its implications for income distribution.

A first look at the future

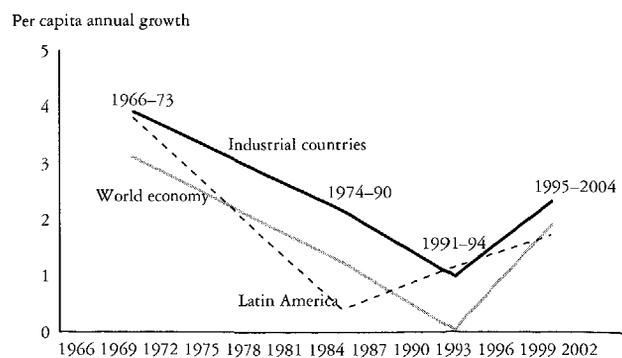
The methodology used in the first section to reconstruct the hypothetical evolution of poverty in Latin America in the last 45 years can be used to project the evolution of poverty in the future. If inequality remains static, the

amount of poverty in the region will be determined by the level of economic growth. As seen in figure 11, the world economy reached a 1.9 percent annual increase in per capita income between 1991–94. Latin America’s per capita income, after its stagnation during the 1980s, grew at 1.9 percent in the first part of the 1990s. This growth level could be maintained for the next 10 years.¹⁶

The prolongation of economic growth recovery in Latin America in the next decade could, according to our estimates, reduce the percentage of the population living below the poverty line. As shown in panel A of figure 12, the incidence of poverty would decrease from about 35 percent to 30 percent from 1995 to 2005. However, given the projected growth of the population, decreases in the incidence of poverty would not be enough to reduce the absolute number of poor in Latin America. Panel B of figure 12 shows that the number of Latin Americans living in poverty would continue to grow at a rate of 1 million people per year—

FIGURE 11

World economic growth, 1966–2004

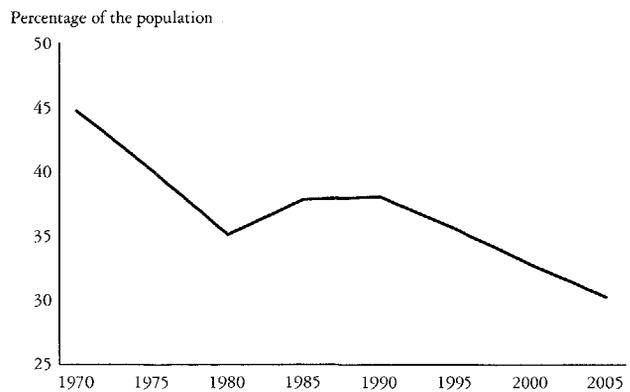


Source: World Bank data.

FIGURE 12

Poverty in Latin America, 1970–2005

a. Head count ratio



b. Absolute numbers

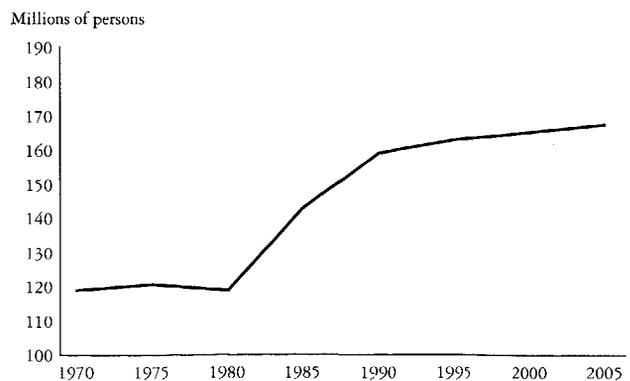
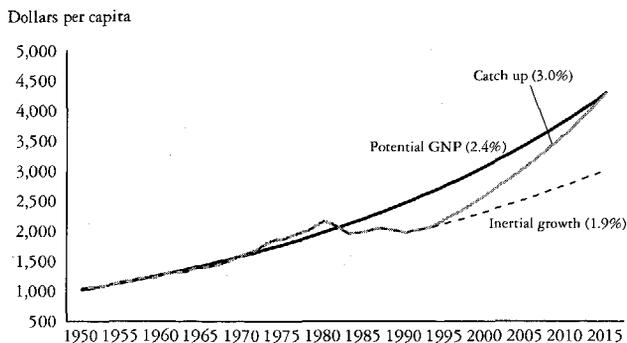


FIGURE 13

Expected growth in Latin America



equivalent to two additional poor people per minute—reaching 176 million people living in poverty in 2005.

Although a 1.9 percent per capita income growth rate greatly surpasses the stagnant per capita income in 1975–90, it is lower than the region’s historical growth rate, lower than the expected growth in other parts of the world, and insufficient to reduce poverty in Latin America. In fact, a 1.9 percent per capita growth rate is actually lower than the growth rate for Latin America between 1950 and 1974 (2.24 percent), lower than the growth rate expected in the next decade for industrialized countries (2.4 percent), and lower than the growth rate for developing countries (3.3 percent). An annual growth rate of 1.9 percent for Latin America in the next decade is not a sign of recovery. Growth at this rate would cause a permanent gap between the region’s actual and potential GNP (derived by projecting observed growth from 1950 to 1974), as indicated in figure 13.

Low growth and persistent inequality is not inevitable. Economic growth is based to a great extent on the results of an accumulation of resources and improving resource allocation. Inequality is not an “stylized fact” but rather the result of many forces subject to the influence of policies.

This simulation model can be used to project the evolution of poverty given different economic growth rates and different levels of inequality. Six scenarios for the evolution of poverty are shown in figure 14. First, if inequality remains constant at today’s high level and if growth remains slow, poverty will continue to increase steadily. Second, if inequality remains constant and per capita annual growth increases to the 2.4 percent world average, poverty would stabilize at its current level for 10 more

years, decrease in the following decade, and increase again—to 1988 levels—in 2015. Third, if per capita growth accelerates to 3.0 percent annually, the increase in the number of poor that resulted from the crisis of the 1980s could be eliminated by 2005; by 2015 the number of poor would decrease to 100 million, the same number registered in 1965.

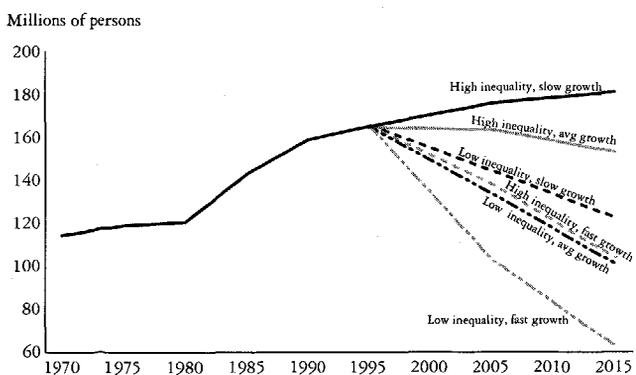
Alternatively, there are three scenarios based on lowering inequality in the region, which result in a reduction in poverty. First, if the excess 5 percentage points of inequality were gradually eliminated, poverty would be reduced to 144 million in 2005 and to 122 million in 2015, even if growth remains very low. Second, if this gradual reduction of excess inequality were combined with an increase in the annual growth rate to 2.4 percent—the world average—the number of poor would be reduced to 100 million in 2015. And finally, a 3.0 percent growth rate would lead to a dramatic reduction in the number of poor to 104 million in 2005 and to 64 million in 2015. Thus, to reduce poverty, the elimination of inequality in income distribution and economic growth are equally effective. Their combined effect could have an enormous impact on the elimination of poverty in Latin America.

Catching up in human capital: The size of the challenge

Macroeconomic performance in Latin America over the past 20 years has shown that growth cannot be sustained without macroeconomic equilibrium and that while adjustments are necessary to stabilize imbalances in fiscal or external accounts, stabilization and macro adjustments

FIGURE 14

Poverty projections: Alternative scenarios of economic growth and income distribution



are not enough to renovate economic growth. Renewing economic growth requires increases in resources or improving the efficiency of their use and allocation. Government efforts to adjust to financial and exchange rate interventions and the liberalization of commerce also foster economic growth, as has been the case in the last 10 years.

The following pages explore a complementary factor that contributes to more growth and less inequality: human development.

The dynamics of human capital accumulation 1950–1990

Insufficient education is one of the largest dynamic problems that the Latin American economy must resolve in trying to reconcile accelerated growth with equality. The first section illustrated how Latin America entered the

post-war development process with serious educational insufficiencies in its labor force and how the rate of educational expansion has not been sufficient to close the gap.

The average level of education of the labor force is the aggregate of educational levels reached by different generations. To identify the relationship between the economy and the educational system, the changes in education for future generations that will enter the labor market should be studied. To this effect, the reconstruction of the educational history of Latin American post-war generations follows.¹⁷

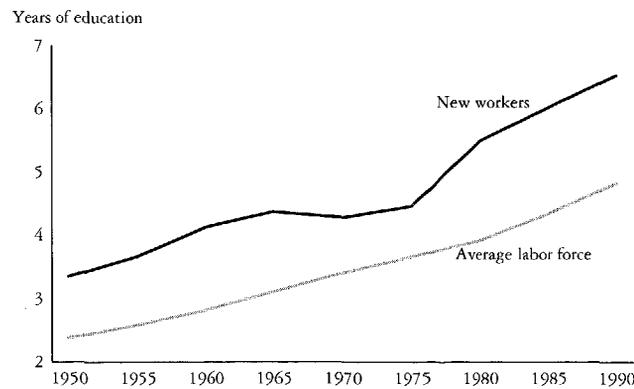
Three different phases in the history of Latin American education are shown in panel A of figure 15. As expected, the dynamics of human capital accumulation were neither continuous, homogeneous among regions, nor stood out on an international scale. While new generations entering the labor market in the 1950s received an increasing rate of education, that growth stopped for the 80 million people entering the work force in the 1960s and 1970s. Later, educational expansion in the 1970s increased the human capital of the work force during the 1980s.¹⁸

Regional differences in years of education over time are shown in figure 15, panel B. The delay in educational expansion in the 1960s and 1970s was the greatest and took more time in the two largest countries of the region—Mexico and Brazil—and coupled with the regression in Brazil at this time explains the lack of progress in education during this period (figure 16). Progress has been made in the past decade in Central America, the Andean Region,

FIGURE 15

Education of the Latin American labor force, 1950–90

a. For the whole region



b. The new labor force in three subregions

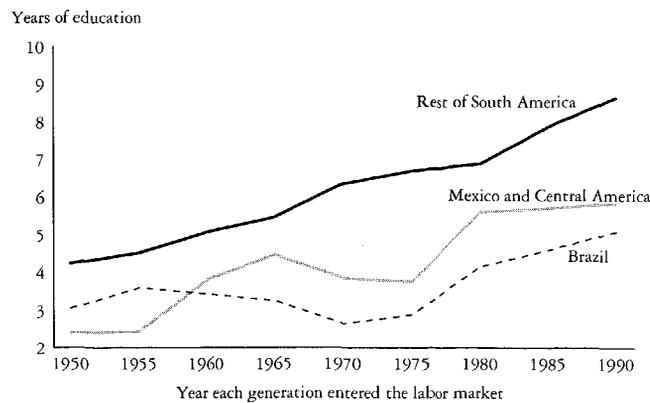
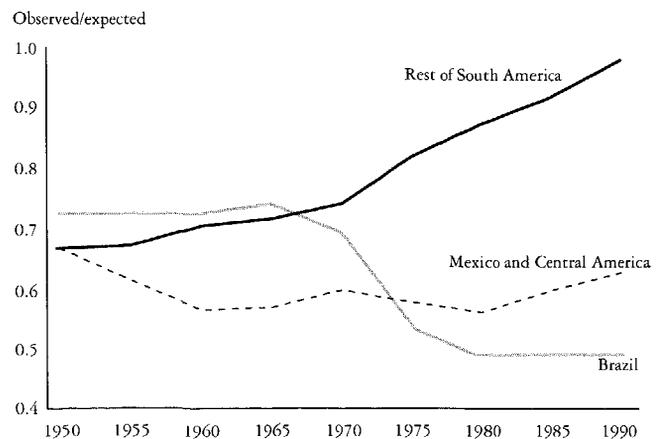


FIGURE 16

The education gap: Latin America compared with international patterns, 1950–90



and the Southern Cone, but not in Mexico or Brazil.

Future human capital requirements

The high level of educational insufficiency in the Latin American labor force is a result of a development pattern scarce in human capital. And efforts over the last 15 years have not been sufficient to eliminate the problem. Today, the Latin American labor force has little more than five years of education. For current levels of development, the expected level of education is slightly more than seven years. This equates to an average gap of two years per worker. This gap is much higher for Brazil and Mexico since their levels of development today are associated with three more years of education per worker. These two countries make up 93.5 percent of the educational gap in Latin America.

The average level of education for the labor force is 1.9 percent for the slow growth pattern studied in the previous section, 2.24 percent for the historical pattern, and 30 percent for the rapid growth pattern. The different patterns of economic growth represent enormous differences in human capital requirements for the labor force (table 1). For 2005, 7 years of education would be required to achieve slow growth; for rapid growth, 8 years would be required. For the year 2020, 7.9 and 9.1 years would be required.

These human capital requirements can be fit into the three scenarios of human capital formation in the next quarter century. In the first case, the average educational level of the labor force would grow at the same rate registered in the last decades. In the second case, the rate would

slowly increase; in the third case the rate would increase very rapidly.

If the rate of education were to grow at the same rate as it has in the last two decades, the average worker in the labor force would receive 7.2 years of education by 2020. And, as mentioned earlier, because the number of years of education required to achieve slow growth is greater (7.9), the rate of growth of education would have to expand more quickly than it has in the past two decades. If, for example, levels of education grew at a rate of 1 year every 10 years, slow growth would be achieved and Latin America would reach international standards of required education by 2020. If the average level of education grew faster at a rate of 1 additional year of education every 5 years, Latin America would achieve rapid economic growth.

In short, eliminating human capital insufficiencies within the rapid growth scenario requires a substantial acceleration in the growth in education for future generations. The magnitude of the change required is shown in figure 17. As shown, to achieve accelerated growth, future generations must receive an average of 12 years of education by 2015, implying that the increase in education must double the rates of growth that have occurred over the past 40 years.

Quantitative dimensions of the possible accumulation scenarios

Acceleration in the accumulation of human capital requires considerable financial resources. To quantify

TABLE 1
Scenarios for human capital accumulation

	1995	2005	2020
<i>Years of education required for different growth rates</i>			
Slow (1.9 percent)	6.0	7.0	7.9
Moderate (2.24 percent)	6.5	7.5	9.0
Rapid (3.0 percent)	7.3	8.1	9.1
<i>Years of education available for different growth rates</i>			
Average labor force			
Slow	5.2	6.0	7.2
Moderate	5.2	6.2	7.9
Rapid	5.2	6.5	9.0
New labor force			
Slow	6.5	7.6	8.6
Moderate	6.5	8.5	10.4
Rapid	6.5	10.1	12.0

FIGURE 17
Education of new generations in Latin America

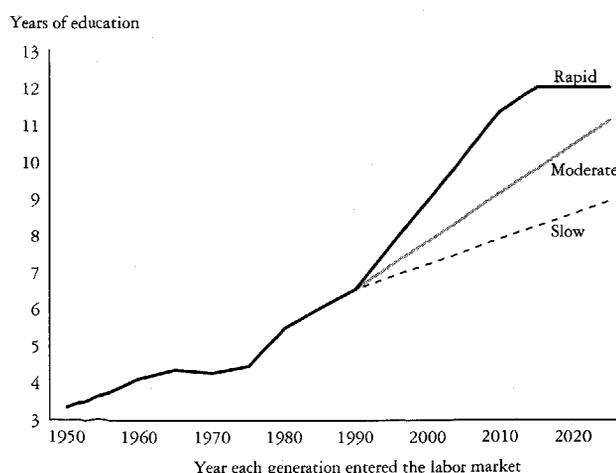
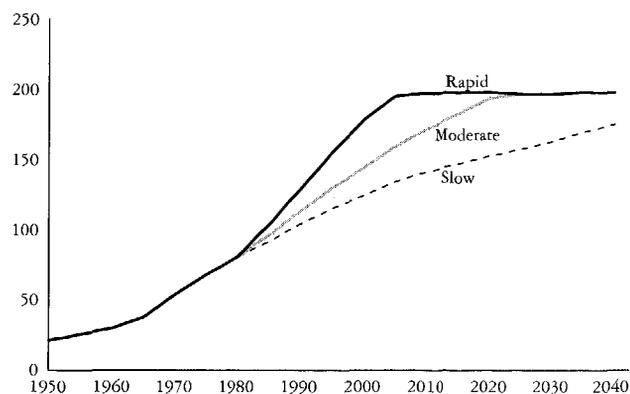


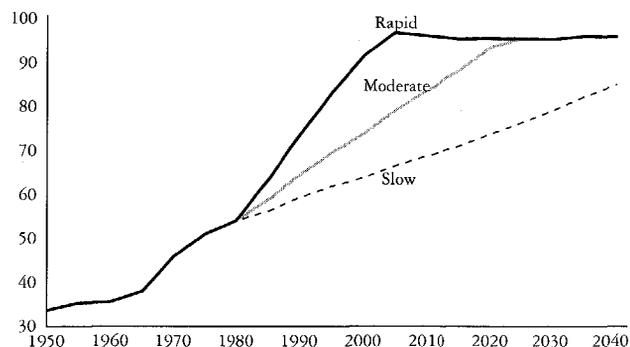
FIGURE 18

Settings for educational expansiona. *Number of students*

Millions of students

b. *Coverage of the population*

Percentage of the population 5 to 24



these dimensions of human capital accumulation, a simplified algorithm to accumulate flows of students and their direct financing was designed. Likewise, a simple model of macroeconomic consistency to evaluate the costs and social benefits of the accumulation of human capital was used.

Today, there are approximately 125 million students in Latin America.¹⁹ This equates to 65 percent of the total population between ages 5 and 24. In absolute terms, this demographic group will continue to grow over the next 20 years and will stabilize at an absolute 207 million young by 2015. If educational expansion continues at the present rate, there will be 200 million students with a 95 percent coverage of the relevant population by 2055. In the moderate acceleration scenario, the same 95 percent coverage and the same 200 million students would be reached by 2025. In the rapid growth scenario, those levels would be reached by 2005 (figure 18).

Figure 19 shows that the proportion of GNP designated to basic education financing could remain relatively constant only in a slow educational expansion scenario.²⁰ For Latin America's human capital to converge with international patterns, an additional half a percentage point of the GNP each year for the next 25 years would need to be invested. For rapid convergence with international patterns, investments would have to increase one full percentage point of GNP over the next 10 years after which additional resources would not be required due to demographic trends.²¹ For slower convergence, investments would have to increase each year for the next 25 years—although less than a full percentage point—and would begin to decrease only in 2025. Nevertheless, as shown in figure 20, additional public expenditure of half a point of GNP on basic education would allow Latin America to equal financial commitments to education in the rest of the world.

Despite the additional expenditures required over the next 25 years and regardless of the pace of the convergence, an increase in investments as a share of GDP is not permanent.

Some regionwide implications**Macroeconomic effects**

The acceleration in the accumulation of human capital has enormous implications for Latin American economic growth. Its effects can be measured using international estimates of the impact of education on aggregate production. Using Lau's results for Latin America,²² the accelera-

FIGURE 19

Expenditure on basic education under alternative scenarios, 1995–2040

Percentage of GNP

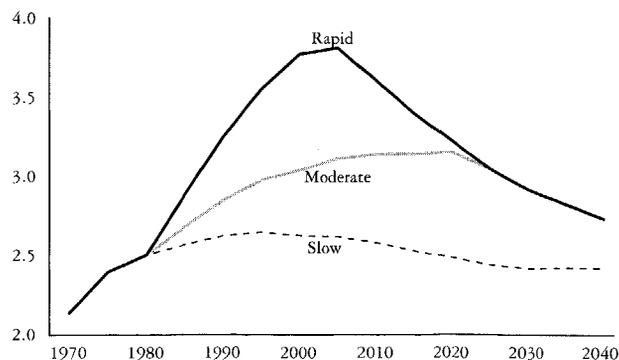
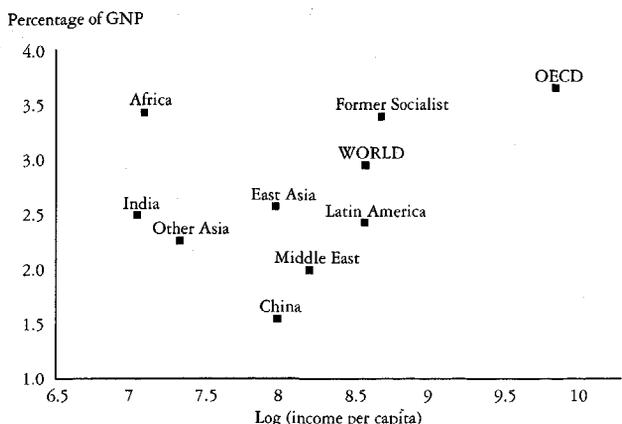


FIGURE 20
Worldwide public expenditure on basic education, 1993



tion of human capital accumulation in the rapid scenario brings an additional growth in per capita product of 0.7 percentage points per year over the next 15 years and an average of 0.8 percentage points per year for the period 2000-25. If Southeast Asia is used as a guide for the impact of education on economic growth, the effects on per capita growth are 1.1 percent and 1.2 percent for both periods respectively. After 2025, the direct impact on growth would begin to decrease because of a slowdown in human capital accumulation brought on by the decrease in student population and universal coverage.

The considerable expense that goes beyond the direct costs associated with providing educational should not be minimized. Education also represents an opportunity cost for young people who could join the labor force at an earlier age if they were not in school. Since most of the educational expansion taking place is among young people who would have ended their education before finishing secondary education, the opportunity cost associated with additional years of education is significant. Assuming the annual opportunity cost per student is 86.3 percent of annual per capita income,²³ the economic cost of massively educating the new generations is a considerable fraction of the GNP, which could surpass 10 percent in the next 15 years.

Figure 21 presents estimates of the costs and benefits of human capital accumulation under a fast growth scenario. The chart shows that the costs associated with capital accumulation are concentrated in the initial phase and that the cost of providing educational services is only a

fraction of the total cost of education. The net present value of an investment of somewhat less than \$1.0 billion²⁴ is \$2.0 billion in the next 50 years, slightly more than the region's current GNP. The rate of return is 24.1 percent, which is high when compared to other investments.

The rate of return is subject to two parameters. If the opportunity cost for each student is 10 percent less—for example, 78 percent of per capita income—the rate of return would be 36 percent. If the effect of educational expansion were similar to Southeast Asia, the internal rate of return would be 110 percent. If both parameters are changed simultaneously, the return would be 136 percent. These high rates of return indicate that the investment in human capital would pay for itself by taxing the additional income created by education at a 9 percent marginal rate. This is less than today's marginal tax rate.

In fact, the impact of educational expansion on economic growth could be even greater. Recent literature has identified enormous benefits associated with the spread of knowledge that this simple method does not recognize,²⁵ such as its effect on foreign trade.²⁶ The recent expansion of world trade has been relatively greater for goods with a higher human capital content than in earlier periods. A high expansion of human capital in the labor force will provide Latin America a comparative advantage less subject to abrupt fluctuations of basic products.

The effects on income distribution and poverty

Rapid acceleration of educational opportunities will have enormous implications on resource allocation, factorial

FIGURE 21
Financing of human capital accumulation, 1995-2050

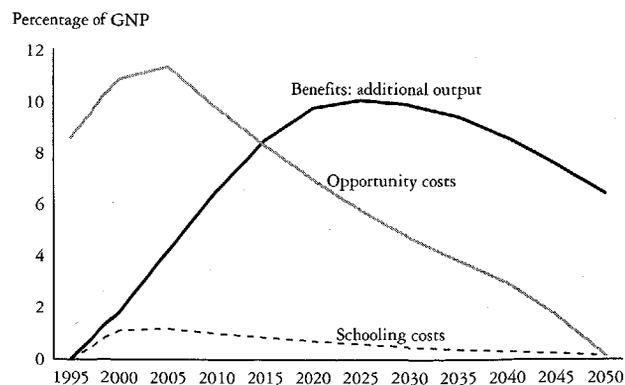
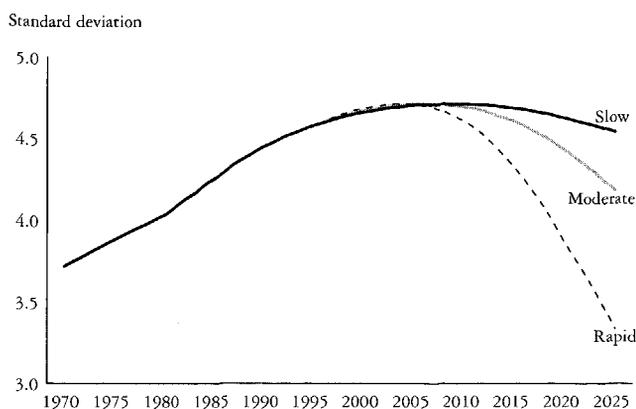
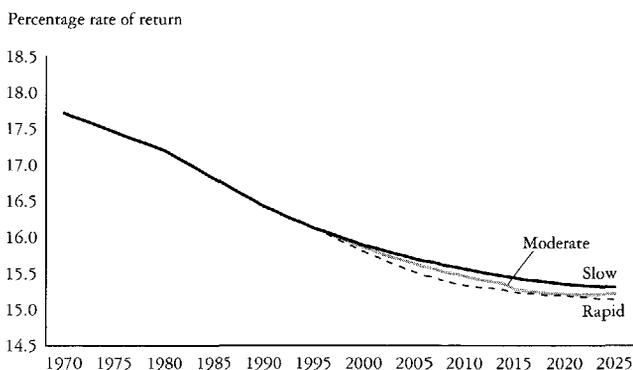


FIGURE 22

Education: Channels toward equity in three expansion scenarios*a. Standard deviation of human capital assets**b. Returns on education*

income distribution, and the price system of the economy, and indirectly on individual and family income distribution through the pricing system. While its effects can only be identified through careful general equilibrium analysis²⁷ this paper uses a simpler yet less complete methodology to analyze the impact of different paths of human capital accumulation on income distribution. If an individual's labor income is seen as the return of his human capital, the variance of the logarithm of income for the population can be expressed in terms of the rates of return on human capital and the distribution of human capital among the population.

Using this methodology, educational expansion affects labor income distribution by changing the distribution of the population's educational assets or by changing the rate of return on these assets. As mentioned, a typical empirical relationship between the level of education and its distrib-

ution among the population in different countries was calculated by Ram. The relationship between educational level, per capita income, and the rate of return has been calculated by the author of this paper.²⁸ The hypothetical effect of educational expansion on inequality indicators between 1970 and 2025 was calculated based on these empirical regularities.

The results in figure 22 indicate that educational expansion over the past 25 years in Latin America contributed to increasing educational inequality among the population.²⁹ However, education's contribution to the inequality of asset holdings would change once the average level of education reaches 6.3 years. Once past this level, the distribution of educational assets improves rapidly with further education. Panel A of figure 22 shows that the accelerated accumulation of human capital positions the curve's turning point toward the end of this century, allowing for a later rapid decrease in the population's distribution of income—which would take place in 2018 if education spread slowly. Educational expansion, nevertheless, must have had an important impact on education returns in the past 25 years as panel B of figure 22 shows. Given the expected effect on economic growth, the acceleration of human capital in the next decade could have a minimal impact on the evolution of future return rates.

The relative impact of capital accumulation on the distribution of income in Latin America through the two channels mentioned above can be contrasted with other models following the Kuznets methodology. Figure 23, which complements and extends the time period of the results of the section on educational expansion and income inequality, presents a synthesis of these effects.

According to the classic Kuznets curve, Latin America should have reached its highest point of inequality well before World War II and thus, inequality during the post-war economic growth period should have been less widespread. Also, since the region's growth ran parallel to a systematic decrease in per capita income differentials among the various sub-regions, reduction in the Gini coefficient by several points should have also been evident. The evolution of human capital seems to have been the force that counteracted the effect of the two previous factors. As can be seen in the chart, even if post-war human capital accumulation in Latin America had been similar to international patterns, labor inequality would have risen.

However, as analyzed above, Latin America did not have enough human capital accumulation during the entire period. Therefore, the contribution of human capital to inequality could have been less in the first years after the war. By the same token, educational expansion would have increasingly contributed to inequality in the last four decades. As Kuznets would have predicted, the particular characteristics of educational expansion in Latin America during this period were uneven enough to keep the Gini coefficient from decreasing.

The situation could change dramatically however if human capital is accelerated as suggested above. Given the combination of the effects of acceleration on the variance of educational capital and the rates of return, the distribution of income could change dramatically in the next few decades. As shown in figure 23, the distribution of labor income could reach the maximum point of inequality before the end of the century, after which the Gini coefficient of labor income would decrease systematically. In the absence of other elements that cause inequality, the Gini coefficient for global income distribution could decrease five or six percentage points in the next 20 years.

This is precisely the global decrease in inequality that would reduce the number of poor people in 2015 to a third of today's level (see figure 23).

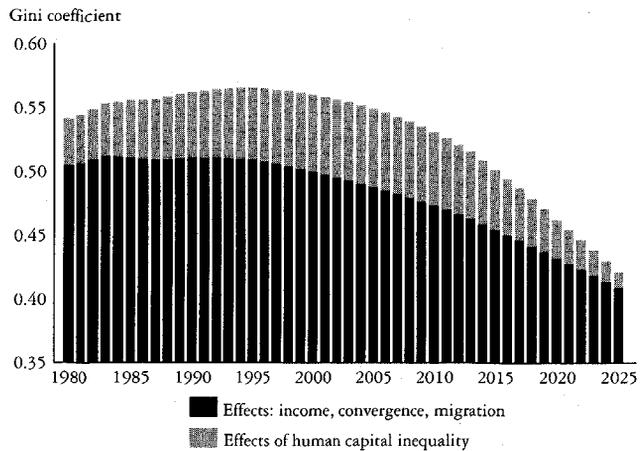
Summary

Low expectations for economic growth in the medium term and weak efforts to remove the factors that cause inequality in Latin America are not enough to reduce poverty in the next 10 years. To eliminate poverty permanently, collective efforts should be directed toward accelerating human capital growth. Today, Latin Americans are deficient in education by an average of two years. If recent tendencies of slow educational expansion continue, the insufficiency could become three years, and Latin America will be further from achieving dynamic development.

On the other hand, choosing to close the education gap in the next 15 years will be an expensive undertaking—but returns on this investment are very high. Given its major effect on economic growth, the investment can finance itself. Additionally, accelerating human capital accumulation in the above mentioned manner would be enough to raise the standard of living for more than 100 million poor people in Latin America.

FIGURE 23

Expected progress in equity under fast human development, 1995–2025



Summary and conclusions

Income inequality in Latin America has been the highest in the world since the post-World War II period. Over the past 20 years this persistent inequality combined with mediocre economic growth has led to 50 million more poor people in the region, the highest increase in absolute terms in the 20th century.

This paper argues that Latin America's high inequality, increasing poverty, and slow economic growth are related. Specifically, it argues that the unsatisfactory manner in which human capital has developed during this period is the main factor behind poor performance. Low investment in basic education has meant scarcity and uneven distribution of human capital, both of which have contributed to an increase in poverty and the persistence of high inequality in the past 20 years. The high level of income inequality has reduced support for basic education and in turn, educational quality, expectations, and demands have been reduced. As a result there are an increasing number of functional illiterates, a weakened economic growth process, and weakened efforts in the region to expand democracy.

The average worker has two years less education than expected given the region's level of economic development. This gap has not diminished during the past decades. In fact, the variance of education of the working population is now the highest in the world. This situation, combined with low expectations for economic growth in the mid

term will produce increasing numbers of poor people for the next 20 years—prolonging the vicious circle of social development in Latin America.

This paper calls for action to break that vicious circle. It recommends expanding investment in basic education to eliminate the education gap in the next two decades, expanding schooling up to secondary education to 200 million students and allowing 95 percent of the young population to complete basic education. Because of the connection between human capital development, income inequality, and poverty the expansion of basic education will eliminate all five points of excess income inequality in the region, and, if accompanied by a reasonable increase in economic growth, will lead to a virtual elimination of poverty in the region. This “human capital shock” will turn the region’s vicious circle into a virtuous one.

Such “human capital shock” will require considerable financial resources. Public expenditure on basic education must increase at least 0.5 percent of GNP over the next 25 years. With that effort, Latin America will catch up with the rest of the world in its public financing of basic education. The effort will also lead to a high rate of return. Economic growth in per capita income will accelerate almost 1 percent per year during the next four decades. And the social rate of return will be at least 24 percent. If combined with growth enhancing policies, the social rate of return could surpass 100 percent. Moreover, this investment can be self-financed by taxing the additional income at current tax rates.

Unfortunately, more than money is needed to implement this “human capital shock.” Current institutional structures of the schooling system in the region might have been adequate for the region’s early stages of development, but the bureaucratic and inflexible organization is now seriously limiting educational improvement and expansion. To be effective, financial efforts must coincide with institutional development that incorporates economic and social rationality in the social service of education. With fairer financing, pluralistic and autonomous modes of organization, incentives for efficiency and quality, more competitive provision of services, and more informed consumers,³⁰ the “human capital shock” will improve economic growth and social development as well as provide a fertile ground for a profound and sustainable democracy.

Notes

1. The Lorenz curve shows the fraction of total income received by each percentile of the population ranged from lowest to highest income bracket. The Gini coefficient is the area between the diagonal and the Lorenz curve divided by the area of the triangle formed by the diagonal and the bottom and right sides of the square. If everyone has the same income, the Gini coefficient is zero. If all income is concentrated in the hands of one individual, the Gini coefficient is one.

2. With 141 observations for 102 countries, the regression line fitted is

$$\text{Gini} = 0.36 + 0.24\ln(\text{Income}) - 0.02(\ln(\text{Income}))^2 - 0.18\text{Dsoc} + 0.041\text{Dlac}$$

(5.1) (4.3) (4.6) (8.2) (2.7)

R² = 0.49

3. The technique of aggregation was developed by Sherman Robinson “Income distribution within groups, among groups and overall: a technique of analysis.” Princeton University, Research Program in Development Studies. Discussion Paper 65, 1976.

4. Aggregates of income inequality across countries have been made by Pan Yotopoulos. “The World Distribution of Income: some estimates.” *Pakistan Journal of Economics*, 1976; Albert Berry, François Bourguignon, and Christian Morrison, “The Level of World Inequality: How Much Can One Say?” In *The Review of Income and Wealth*, 1983; and Margaret Grosh and Wayne Nafziger, “The Computation of World Income Distribution.” In *Economic Development and Cultural Change*, 1986.

5. ECLAC. *Magnitud de la Pobreza en América Latina en los Años 80*. Santiago de Chile, 1991. George Psacharopoulos and others. *Poverty and Income Distribution: The Story of the 80s*. Washington, The World Bank, LATAD, 1993.

6. See Richard Nelson, Paul Schultz, and Richard Slighton. *Structural Change in a Developing Economy*. Princeton University Press, 1969; William Cline. “Distribution of Income and Development: A Survey of Literature,” *Journal of Development Economics*, 1975; Armando di Filippo, “Raíces históricas de las estructuras distributivas de América Latina.” *Cuadernos de la CEPAL*, 1977; Eliana Cardoso and Albert Fishlow. “Latin American Development 1950–1980.” *NBER Working Paper* 161, 1989.

7. See Albert Berry. “Resource Transfers between Agriculture and Non-Agriculture.” Toronto University, 1978; Lance Taylor. *Modelos Macroeconómicos para los Países en Desarrollo*. Mexico, Fondo de Cultura Económica, 1988.

8. The World Bank produced a classic study. See Lance Taylor, and others. *Models of Growth and Distribution for Brazil*. Oxford University Press, 1980.

9. Using 173 observations from the UNDP’s *Human Development Report*, 1994, the following regression line was obtained:

$$\ln(\text{Educa}) = -14.4 + 3.2\ln(\text{Income}) - 0.15\ln(\text{Income})^2$$

(27.6) (5.8) (4.4) R² = 0.70

10. The argument is presented in Juan Luis Londoño, “Kuznetsian

Tales with Attention to Human Capital." Paper presented at the Third Inter-American Seminar on Economics in Rio de Janeiro in 1990. It was formalized by Rati Ram's "Educational Expansion and Schooling Inequality: International: Evidence and Some Implications," *The Review of Economics and Statistics*, 1990.

11. The exception to this was Colombia, recording a decrease in the rates of return for education, which more than compensated for the growing inequality of human capital. See Juan Luis Londoño. *Distribución del Ingreso y Desarrollo Económico: Colombia en el Siglo XX*. Bogotá, Tercer Mundo Editores, 1995.

12. The results on this chart are a first order approximation. As the Gini coefficient is not decomposable, I decomposed the variance of the logarithm of income consistent with that Gini coefficient, assuming a log normal distribution.

13. All studies for different Latin American countries confirm this trend. See George Psacharopoulos, *Returns to Education: An International Comparison*. San Francisco, Elsevier, Jossey Bass, 1973. "Returns to Education: An Updated International Comparison." *Comparative Education*, vol. 17, 1981. "Returns to Education: A Further International Update and Implication." *The Journal of Human Resources*, vol. 20, 1985 and "Returns to Investment in Education: A Global Update." *World Development*, 1994.

14. See Oscar Altimir's articles, "Cambios en las Desigualdades del Ingreso y la Pobreza en América Latina." Mexico, DF, *El Trimestre Económico*, 1994, and "Distribución del Ingreso e Incidencia de la Pobreza a lo Largo del Ajuste." Santiago de Chile, *Revista de la Cepal*, 52, 1994.

15. See a summary in Sam Morley, *Poverty and inequality in Latin America*. Baltimore, The Johns Hopkins University, 1995, and Ariel Fiszbein and George Psacharopoulos, "Income Inequality Trends in Latin America in the 1980s." In Nora Lustig, (editor) *Coping with Austerity: Poverty and Inequality in Latin America*. Washington, Brookings Institution, 1995.

16. The World Bank. *Global Economic Prospects and the Developing Countries*. International Economics Department, 1995. International Monetary Fund. *World Economic Outlook*, 1995.

17. We use Barro and Lee's database on the average level of education of the labor force for 1950-85, adding for 1990 data from the UNDP *Human Development Report 1994*. The education for the new labor force was generated with a small model of demographic consistency.

18. The delay between the middle of the educational cycle and entrance into the labor market is about 10 years.

19. See UNESCO, *Statistical Yearbook*, 1995.

20. This analysis has not considered the costs of university education. If its cost per student education is five times more than for basic education, Latin American invests approximately 0.8 percentage points of the GNP in university education. The growth of university education captured at least 40 percent of all the additional resources invested in education in the past twenty years.

21. This is the situation of Southeast Asia today, where the early demographic transition made it possible to accelerate the growth of the new labor force and improve its quality without taking a growing proportion of resources from the GNP. See Nancy Birdsall, David Ross, and Richard Sabot, "Inequality and Growth Reconsidered," IDB, 1994.

22. Lawrence Lau, Dean Jamison, and Frederic Louat, "Education and Productivity in Developing Countries: An Aggregate Production Function Approach," The World Bank, WPS 612, March, 1991.

23. This parameter is derived as follows: 71.8 percent of Latin America's population is of a working age. The participation rate is 35.9 percent, with an average unemployment rate of 7 percent, so 33.4 percent are employed. Productivity per worker, therefore, is 3 times the income per capita. The population between 12 and 24 years of age has a specific labor participation of 50 percent, by which its expected income might be about 1.5 times income per capita. With returns to experience at 2.8 percent annually, his or her income would be 57.6 percent of the income of an average worker. Therefore, $1.5 * 0.576 = 0.863$ is the parameter used.

24. Billion is used as one million million.

25. Paul Romer reviews the literature in "Human Capital and Growth: Theory and Evidence." *Carnegie Rochester Conference Series on Public Policy*, 32, 1990. More recent and extensive is Robert Barro and Xavier Sala-i-Martin: *Economic Growth*, New York: McGraw Hill, 1995.

26. See Jeff Lewis, Sherman Robinson, and Zhi Wang, "General Equilibrium Analysis of Effects of Human Capital and Trade on the International Distribution of Labor," Washington: The World Bank, 1995 (Background paper for the 1995 *World Development Report, Workers in an Integrating World*).

27. I have applied this general equilibrium methodology to Colombia's income distribution for the period 1938-88, Londoño, 1995.

28. Ram's equation (*op. cit.*) is:

$$StDev = 1.492Educ - 0.118 Educ^2 \quad R^2=0.96$$

(25.8) (14.4)

Londoño's equation for 64 countries is

$$Returns = 0.18 - 0.010Educ + 0.012Educ^2 \quad R^2 = 0.40$$

(1.6) (1.4)

Psacharopoulos's data for 28 Latin American countries at the end of the '80s fits this regression :

$$Returns = -2.16 + 0.65lnY - 0.044lnY^2 - 0.064lnEd \quad R^2=0.53$$

(50.0) (2.1) (2.1) (2.9)

29. A similar result was found in Brazil by J.G. Almeida dos Reis and Ricardo Paes de Barros in "Wage Inequality and the Distribution of Education," *Journal of Development Economics*, 1991.

30. This argument is developed in Juan Luis Londoño, "An horizontal mode of social organization." Washington, 1996 (Mimeo).

Comment on “Poverty, Inequality, and Human Capital Development in Latin America, 1950–2025,” by Juan Luis Londoño

O S C A R A L T I M I R

INEQUALITY IN LATIN AMERICA CAN BE MEASURED USING AGGREGATE DATA FOR THE REGION. However, an aggregate approach does not take into account the variability of inequality among Latin American countries and could present methodological problems. For example, levels of inequality vary with the coverage that is taken into account. Specifically, inequality at the national level is greater than inequality at the urban level. Moreover, different definitions of inequality can lead to the grouping of heterogeneous observations, creating methodological problems. Still, the results are the same when reliable data and a sound methodology are used: Latin America has an unusually high level of inequality.

Inequality in Latin America has evolved in various ways. Until the 1980s Argentina, Chile, and Uruguay, countries with low and interrupted levels of growth, experienced high levels of inequality. In countries with high growth rates, such as Colombia and Mexico, inequality fell until this period. During the 1980s inequality increased in most Latin American countries. But there were variations throughout the decade. In the mid-1980s levels of inequality stabilized; at the end of the decade these levels dropped slightly. Regardless of these short-term trends, the level of aggregate regional inequality was about the same at the end of the 1980s as during the pre-debt crisis period.

Inequality levels in Latin America today are relatively consistent with post-debt crisis levels when measured in aggregate terms. But different trends surface in individual countries. At the end of the crisis countries that had not regained full production and that had per capita incomes below precrisis levels experienced higher levels of inequality than before the crisis. Of those countries that had regained full production by the end of the crisis, only Colombia and Uruguay experienced lower levels of

inequality than before the crisis. The other countries, despite having regained full production, had high postcrisis levels of inequality.

In some countries the reduction in rural poverty before the 1980s had an important effect on overall poverty levels. Although overall poverty increased considerably in most countries during the crisis, rural poverty did not.

With respect to the need to generate a virtuous circle between growth and equality, sustained growth should be based on international competitiveness, which requires modernized technology and a better-educated workforce. If these goals are achieved, Latin America could observe greater levels of equality. Here the complementary effects of growth and equality are apparent.

Economic reforms directed at increasing production and stimulating fixed capital investment must be accompanied by education reform. Education reform implies an investment in human capital and should work toward providing equal access to quality education for all.

Oscar Altimir is deputy executive secretary of the United Nations Comisión Económica para América Latina y el Caribe (CEPAL) in Chile.

Comment on “Poverty, Inequality, and Human Capital Development in Latin America, 1950–2025,” by Juan Luis Londoño

X A B I E R G O R O S T I A G A , S . J .

POVERTY TODAY IS MORE URBAN AND LESS EQUITABLE THAN IN THE PAST. INEQUALITY IS becoming more pronounced as the globalization of economies advances without employment growth. Latin America needs a new, profound education system to respond to these new inequalities, new poverty, and to the new concept of growth without employment.

How should Latin America proceed with education reform? To start with, it is important to link growth, distribution, social integration, and human capital. Education reform cannot be more of the same, or more resources for the same type of education. Latin America needs a system that does not separate basic from university education; education should be seen as a continuum from preschool to university to postgraduate levels.

Thinking about how to proceed with education reform raises several questions. How can we improve the quality of teachers and of their teaching? How can we get universities to improve their education, including textbooks? How can we educate teachers at the secondary level so that they can prepare students adequately for university? How can we get universities to design timely courses that reflect the globalization of today's world? How can universities take advantage of global education systems such as international university exchange programs? How can we create catalyst institutions that promote development in Latin America?

Latin America has lost competitiveness in the international market even though the number of university graduates has increased from 500,000 to 8,000,000. Thus merely increasing the number of graduates does not resolve

the education problem. Nor does it improve the quality of education at the primary and secondary levels.

Research at the university level has been abandoned in Latin America because of insufficient resources. The impact of this loss is magnified when one considers that university research is an additional source of resources for the education system and is fundamental to improving the quality of primary and secondary education. International organizations should be encouraged to provide domestic research capital.

The most important adjustments to be made in Latin America's education system are not only in terms of quantity and finances but also in quality and content. The region needs an education system that instills both wisdom and talent in the region's future pioneers.

Comment on “Poverty, Inequality, and Human Capital Development in Latin America, 1950–2025,” by Juan Luis Londoño

A S P A S I Á C A M A R G O

AGENDA 21 IS A PROPOSAL FOR SUSTAINABLE DEVELOPMENT THAT CONSIDERS DEVELOPMENT and environmental issues simultaneously. Within its forty points the agenda focuses on poverty and social organization and rethinks the concept of development from both a social and economic viewpoint.

To understand the differences between industrial and developing countries it is important to consider environmental issues. Eighty percent of the world's natural capital is consumed by twenty percent of the world's population. Agenda 21 addresses this imbalance and proposes new ways to use and produce the world's resources. Quality of life should not be measured only by income or education. The availability of transportation, basic sanitation, housing, and water is also important to consider. Also important are dignity, well-being, and culture.

Participation—instilling local power where centralization prevails—is one of the greatest challenges confronting Brazil. Brazil's leaders welcome the participation of civil society, such as nongovernmental organizations. Local power can be used to rebuild what industrial society has destroyed and can contribute to the development of an integrated society.

The quality of education in Brazil is very low. For example, the average child in Brazil attends eight years of school

but only completes the equivalent of four grades. Education policies must therefore focus on quality, not quantity. Important considerations in education include the need for an emphasis on building up citizenship starting at the basic education level, a new administrative approach in which schools are seen as management units, and more attention to informal education and more frequent use of media resources.

Aspasía Brasileiro Alcantara de Camargo is executive secretary of Brazil's Ministry of the Environment.

Comment on “Poverty, Inequality, and Human Capital Development in Latin America, 1950–2025,” by Juan Luis Londoño

OSCAR JORGE EDUARDO DURÃO

THE PARTICIPATION OF NONGOVERNMENTAL ORGANIZATIONS (NGOs) AT THIS CONFERENCE demonstrates the desire for a more intense dialogue between government and society. NGOs represent a segment of civil society that has participated in discussions, followed projects, and played a role in elaborating and reviewing policies. NGOs live in the real world, and they have seen poverty in frightening proportions. And they have seen that the economic recovery of the 1990s has not reduced poverty or inequality in Latin America.

Should social inequalities in Latin America be attributed solely to the slow pace of education? Recent social troubles in Brazil and other parts of region show that accessibility to assets such as land, urban or rural, and the immense financial accumulation encouraged by inflation and high interest rates also have contributed to the problem.

The low levels of education in Brazil are also influenced by the current situation in the labor market. Job offers are falling, the informal economy is growing, and pressure on children to prematurely enter the job market is increasing. Thus human capital investment should be based not only

on education policies but also on generation of new jobs, income, public health, and so on—all of which suggest changes in policies. Will Latin American governments be able to make these investments and take responsibility for implementing a strategy encompassing all of these issues? What role should the private sector play in confronting this challenge?

Postadjustment strategies have been one of the themes of this conference. Events like the Mexican crisis, however, indicate that our focus should be on a permanent strategy of adjustment.

Comment on “Poverty, Inequality, and Human Capital Development in Latin America, 1950–2025,” by Juan Luis Londoño

RUTH CARDOSO

NEW MEASUREMENT STANDARDS SHOULD BE USED TO IMPROVE RESEARCH AND TO better understand the relationship between poverty and education, an issue much more complex than currently recognized.

A number of projects complementing formal education are being carried out in Brazil. For example, to provide the poor with the technical knowledge and skills needed in today's job market, the government is considering a computer instruction program for primary school students. During the project analysis it was discovered that many small community associations are already conducting experimental projects for the poor in this area. Although these programs may be of limited significance, at least they exist.

Perhaps the education question should be asked in a different way: How can there be social progress in Brazil when such poor indicators exist? The answer is that obstacles such as low schooling standards and discriminatory schools block the way.

Improving the quality of education requires both strengthening teaching requirements and changing ways of thinking. Brazilian schools still reflect Brazil's worst behaviors and biases: prejudice, discrimination, and so on. The challenge is to understand the complexity of the education

system in Brazil, using complementary actions to build on a conservative structure.

One brief comment about urban population should be mentioned. It has been said here that the urban population has been uprooted. However, the uprising of the marginal people never occurred, due in part to the creation of community activity centers. Today the urban civil society is highly organized—and thus is ready for and able to implement reforms.

Ruth Cardoso is president of the Conselho do Programa Comunidade Solidária and first lady of Brazil.

Floor Discussion of “Poverty, Inequality, and Human Capital Development in Latin America, 1950–2025,” by Juan Luis Londoño

AN AUDIENCE MEMBER EXPRESSED THE VIEW THAT EDUCATION SHOULD BE VIEWED AS AN issue of national sovereignty. Countries can be divided into two groups: those that are slow and those that are quick to respond to technological demands. The education problem will be solved by either meeting or failing to meet these inevitable requirements. In countries that meet these demands poverty should be greatly reduced or even eliminated.

Another audience member expressed surprise at the absence of a success story in the paper. He pointed out that in a small city in southern Brazil a second school meal is being provided for all public school students. In addition, a small domestic television network is being used as a pedagogical resource. The experience has been a success: absenteeism has fallen and student and teacher performance has improved. As for the municipality, the number of school hours was increased without increasing the number of classrooms or increasing spending on new teachers.

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Another member of the audience said that education cannot let go of cultural traditions, even as it contemplates the technological future.

Another person said that it was essential to have the nongovernmental organizations (NGOs) and other private associations present in order to develop more realistic solutions to education problems.

The last commentator from the floor observed that the

media can be a powerful educational tool outside of the education system, and this form of “parallel” schooling should not be ignored.

Londoño responded to the questions and points. First he noted that Oscar Altimir (discussant) had illustrated the point of diversity among countries and differentiated between short-term and long-term dynamics. But short-term trends are determined by longer-term tendencies, so the macro factors on which economists focus are small deviations from the fundamentals of long-term trends.

With regard to human capital and demand, the paper presented correlations between the level of economic growth in Latin America and the education of the most recent generation. Those countries that grew more in the past five years were those where the labor market achieved more education. The differences in stock were likely underestimated because education data in Latin America represent much less real learning than in other countries.

Specifically, and although the data are incomplete, a child in Korea may study up to twice as many hours as a child in Latin America.

Generating human capital requires human capital, Londoño continued. For example, the production of human capital is closely related to the education of teachers, doctors, and nurses. Thus it is important to strengthen the public sector's role in encouraging the pursuit of these careers.

The intellectual environment now recognizes that education is a basic social subject on which development policies should focus. Ten years ago, 5 percent of the World Bank's investment portfolio was directed to the social sector. By 1994, 30 percent of its portfolio was invested in health and education projects. This percentage is expected to increase.

The guarantee of rights such as access to health and education in most Latin American countries has been an

important achievement in the past ten years. However, if these rights are not delivered in terms of concrete programs with concrete results, it will be difficult for democracies to continue.

The need to generate incentives to provoke social participation and stable competition in the provision of services makes it necessary to rethink the current process of decentralization. Latin America is decentralizing in a closed bureaucratic model. For example, instead of having a single Ministry of Health there are thirty-three, one in each region with their own bureaucratic procedures. The institutional design of decentralization must be put into perspective.

Latin American countries are facing complex problems with limited resources. This complexity often causes policy efforts to become dispersed.

Londoño said that in the case of poverty—a dynamic, multisectoral, complex problem—we should try to avoid social policy dispersion. The results will be worth the efforts.

Education Reform in Latin America and the Caribbean: An Agenda for Action

ERNESTO SCHIEFELBEIN

LATIN AMERICAN AND CARIBBEAN COUNTRIES UNDERGOING RAPID ECONOMIC GROWTH ARE demanding better-trained human resources. Although these demands have not yet been met, it is possible to trace the causes of the delay and to suggest an effective agenda for action. However, the agenda must be tailored to each country's social consensus, level of financial resources, and specific education strategies.

Development trends, demands, and challenges

A new development model—based on opening national economies to international competition, attracting foreign investment, achieving macroeconomic equilibrium, deregulating economies and labor markets, acquiring technological transfers, implementing democratic governance, and reducing inequality—has contributed to rapid economic growth in many countries in Latin America and the Caribbean (ECLAC–UNESCO 1992; World Bank 1993; Birdsall, Ross, and Sabot 1994). This new model has taken economic activity to new levels, increasing competitiveness and adaptability to change. But it has also brought new demands, such as the need to complement economic, social, and political success with a labor force that is able to adapt, grow, and improve. Free trade zones and increasing pressures for economic integration with industrial countries make these pressing needs for better-trained human resources a priority for countries constrained by low labor

productivity (McKinsey Global Institute 1994).

During the first half of the 1990s many Latin American and Caribbean countries managed to put the legacy of the 1980s—a decade of economic crisis, with prolonged periods of import substitution, budget deficits, inflation, and authoritarian rule—far behind them. Now they are concentrating on increasing their ability to grow and to curb poverty (Burki and Edwards 1995). With annual economic growth of about 3.2 percent, Latin America and the Caribbean is now the second fastest-growing region in the world. But as economies open, local businesses will be forced to compete with companies that have a long-standing tradition of human resource development and with countries that have a much richer supply of people at all levels (Coles 1994). The challenge for private sector managers in the region is to achieve an internationally competitive labor force that is able to adapt to continuous technological change, to acquire new information, methods, and ideas, and to take on new functions and tasks.

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At the same time political parties and citizens are putting pressure on governments and congress people to provide the education that is required to participate in the new social context; to curb drugs, AIDS, and environmental problems; and to ensure peace, civil commitment, and solidarity (Mayor 1994; Augier 1994; BID-CEPAL-PNUD 1995). All groups now agree that the quality of education must be improved (UNESCO 1990).

Demands for higher-quality and better-distributed education in the region are also supported by the influence education has had on economic outcomes in East Asia, by recent research on the multiple impacts of education, and by international comparisons of educational achievement. East Asia's experience shows that better education and reduced inequality contribute to economic growth that, in turn, contributes to investment in education (Birdsall, Ross, and Sabot 1994). These findings are consistent with the link between growth and initial levels of human capital for ninety-eight countries during 1960-85 (Barro 1991). However, educational achievements in Latin America and the Caribbean are growing at a slower rate than in East Asia (Londoño 1995), and many of the weakest elements of the region's countries are related to their human resources (World Economic Forum 1994).

Basic education contributes to growth by increasing the productivity of labor, improving health, reducing fertility, and equipping people to participate fully in an open economy and in society (McGinn and Borden 1995; Lockheed and Verspoor 1991). For example, girls' education levels are associated with the age at which they marry, use contraceptives, and use health care systems. Thus higher levels of education tend to reduce sick leave by improving health. Furthermore, the social rates of return to each education level are higher than market interest rates throughout Latin America and the Caribbean (Psacharopoulos 1993; Psacharopoulos and Ng 1994; Birdsall 1995). In addition, education helps reinforce democratic institutions or traditions, builds national economic capacity, and promotes fair governance, all of which are increasingly recognized as key elements in the effective implementation of sound economic and social policies.

Finally, international comparisons of educational achievement suggest that the quality of education in the LAC region must be improved quickly. For example, near-

ly 90 percent of the students in Finland perform at a higher level than the highest-scoring 10 percent of students in Venezuela (Schleicher and Yip 1994).

Sustained economic growth is associated with the rate of accumulation of new knowledge and the pace of technological change (World Bank 1994a, 1994b), and successful private firms continually learn and adapt through the effort of all workers (Montero 1995). These findings have three important implications for education. First, workers must be able to readily acquire new skills—increasing the importance of basic competencies learned in primary and secondary schools. Second, workers should continue expanding their stock of knowledge—largely the role of higher and graduate education. Third, retraining opportunities must be available throughout workers' lives (World Bank 1994a, 1994b). Moreover, the basic competencies (language, mathematics, and communication skills) must be enhanced by the development of responsible attitudes, a creative approach to problem-solving, and teamwork in the workplace (Kamii, Clark, and Dominick 1994). Thus education and training must confer the ability to apply logic or scientific thinking, define problems, collect data, establish facts, and draw valid conclusions.

New management styles are also changing the way education systems operate. New priorities, such as responding to client demands, using interactive learning, delivering standardized inputs in a timely manner, abiding by the law, and fulfilling commitments also require new and innovative approaches to education (Montero 1995).

In Latin America and the Caribbean, where less than half the population is able to communicate in writing, these economic and political changes present an unprecedented challenge to education systems. This challenge requires a change in the attitudes and culture of the population and its leaders (Coles 1994) and is linked to the larger issue of income inequality, which must be addressed when analyzing and designing strategies (Londoño 1995).

Few education systems in the region are equipped for their new missions. Thus education reform must take advantage of the opportunities that the twenty-first century offers (ECLAC-UNESCO 1992). Governments are committed to reforming education systems and increasing human capital investment. Now is the time to act.

TABLE 1
Enrollments in Latin America and the Caribbean, 1960–92

(percent)

EDUCATION LEVEL	1960	1970	1980	1990	1992
<i>Preschool</i>					
Rate of coverage, 0–5 age group	2.4	3.3	7.8	16.7	17.4
<i>Primary school</i>					
Net enrollment rate, 6–11 age group	57.7	71.0	82.9	87.1	87.5
Gross enrollment rate	72.7	90.7	104.5	106.7	106.3
<i>Secondary school</i>					
Net enrollment rate, 12–17 age group	36.3	49.8	62.9	66.2	68.0
Gross enrollment rate	14.6	25.5	45.3	52.5	53.2
<i>Higher education</i>					
Net enrollment rate, 18–22 age group	6.2	12.6	26.1	29.1	27.5
Gross enrollment rate	3.6	7.6	16.4	20.6	21.4

Note: The gross enrollment ratio is the number enrolled in a level of education, whether or not they belong in the relevant age group for that level. The net enrollment ratio is the number enrolled in a level of education who belong in the relevant age group, expressed as a percentage of the population in that age group.

Source: UNESCO *Statistical Yearbook 1994*; CELADE data.

The state of education in Latin America and the Caribbean

Since the 1960s Latin America and the Caribbean has made remarkable progress in expanding access to education and increasing the number of days students attend each year (table 1). Classroom processes have not changed much, however. Most public schools have been unable to deliver adequate education on a sustained basis, and research productivity in universities is low. Still, a number of successful projects suggest that effective reforms can be implemented.

More children than ever attend school, and access to basic education is almost universal. Primary school access jumped from 60 percent in the early 1960s to more than 90 percent by the 1990s. In 1992 the average enrollment of the 6–11 age group was 87.5 percent; enrollment by the age of 9 is close to 95 percent. The average student attends more than six years of schooling, although only four grades are completed. Although income inequality has not been a constraint for primary enrollments, it does affect students' ability to learn and to continue on to secondary education. More than half of the 12–17 age group is enrolled in secondary education, but 15 percent is still enrolled in primary education (UNESCO 1995). Between 1960 and 1990 higher education gross enrollments increased from 4 to 21 percent in the region. Several countries have established a comprehensive structure for advanced training; however, the actual research produced by universities has had very little impact on the region's economy (World Bank 1994a).

Primary and secondary education

Despite the expansion in student enrollments and multiple attempts at reform, the quality and relevance of public education are inadequate in most countries in the region (Schiefelbein and Tedesco 1995). The six main causes of poor performance are limited overall learning time, including time for homework; lack of basic inputs, including learning materials and trained teachers; poor selection and preservice training of teachers; policies that conflict with research findings; inefficient allocation of inputs for poor students; and lack of incentives for improvements. Low salaries for teachers also explain why there is little interest in teaching as a career.

Testing programs have shown that the average public school student learns roughly half of what is achieved by students in private schools and that only half of fourth-grade students are able to understand what they read (Chile 1995; Argentina 1994). International comparisons show that cognitive achievement in Trinidad and Tobago and Venezuela—the countries with the best education systems in the region—is closer to levels in Africa than in East Asia (Arancibia and Rosas 1994) and that there are serious equity problems (Schleicher and Yip 1994). In Chile, where most inputs have improved and structural reforms have been implemented, achievement scores held steady between 1982 and 1990 for every socioeconomic group, and the achievement gap between the best 5 percent of schools and the worst 5 percent increased.

As international comparisons have shown, achievement scores of students in public urban-marginal and rural primary schools (especially in indigenous areas) are usually about half those of wealthy students (Wolff, Schiefelbein, and Valenzuela 1993). Poor public schools also have shorter school years and daily schedules that provide some students with fewer than 800 hours a year of learning opportunities—compared with 1,200 hours or more for students in good private schools, close to the industrial country average. This limited amount of time for learning is usually caused by the short supply of public school space (resulting in double shifts) and teachers' time. Teacher shortages, in turn, are mainly caused by poor allocation of teaching staff (Oliveira 1989; ECLAC-UNESCO 1992). A substantial amount of time in poor schools is wasted on unproductive activities such as checking attendance and resolving discipline problems. Moreover, between one-fifth and three-quarters of all schools are multigrade. Teachers in these schools have not been given special training or appropriate material for their challenging assignments.

Inequality is particularly difficult to curb in Latin America and the Caribbean because most public school managers send their children to private primary and secondary schools and so are not affected by poor achievement in public schools. But even the top 10 percent of students in the region's private schools are only performing near the industrial country average (Wolff, Schiefelbein, and Valenzuela 1993).

Poor-quality public education is linked to a vicious circle of complex social factors that are resistant to reform. Few high-school graduates are interested in teaching careers because of the low professional satisfaction resulting from low salaries and poor student achievement. Few teachers choose teaching as a first-choice career; most fall back on it because they are not accepted in more prestigious fields. This negative selection bias is especially detrimental given that successful teachers require high levels of formal knowledge (Rowan 1994; Buchmann and Floden 1993). And since, in the absence of effective assessment methods, all teachers assume that they meet the required standards for teaching, demands for higher salaries tend to be continuous (Hatry, Greiner, and Ashford 1994).

Salary demands are also affected by gender and work schedules. More than two-thirds of the region's teachers

are female and all work part time; however, expected salary levels are based on full-time compensation for well-trained male teachers. Problems in the public system are exacerbated because the best teachers tend to move to better jobs in other fields or to private schools, where salaries may be five to ten times higher. Thus pressure for better salaries—in the form of annual teacher strikes that are usually backed by political leaders—for public sector teachers is continuous. Yet teacher salaries have not increased, strikes have eroded achievement levels, and the formation of unions has not improved teaching methods.

Additional problems, such as selectivity, tracking, and teacher preservice training, exist in secondary education, where the range of net enrollment rates is much larger than in primary education (table 2). Countries must develop clear expansion policies (Crouch 1995) and define when and what types of technical education should be supplied. Finally, teacher training institutions should balance subject and pedagogical training with a hands-on approach. Solutions should take into account the huge gap between student expectations and the current content of secondary education.

Higher education and research

An analysis of higher education shows the need to strengthen research facilities, provide competitive salaries for performing research, launch national programs for doctoral training, increase externally reviewed competitive research project funding, support effective accreditation, and develop public information systems that reduce the uncertainty associated with the long-term lagged effects of higher-education training.

In recent years the region's higher education system has expanded to include about 8 million student and 1 million faculty members. Increasing enrollments, accompanied by cuts in public spending, have created a massive system that is fiscally unsustainable and of varying—often poor—quality (Brunner and others 1994; Schwartzman 1995). Only 20 percent of the faculty has doctoral training (Boyer, Altbach, and Whitelow 1994; Schiefelbein and Apablaza 1993), and half of the faculty has supplemental employment—including a large share of full-time faculty. The performance of higher education has also been affected by the decline in academic standards for high school graduates, the result of increased access for less-privileged populations and dwindling resources per student (Winkler

TABLE 2

Gross schooling rates in Latin America and the Caribbean, 1965 and 1991

(percentage of age group enrolled in the system)

REGION/COUNTRY	PRESCHOOL 1991	PRIMARY		SECONDARY		HIGHER	
		1965	1991	1965	1991	1965	1991
Latin America and the Caribbean	15.8	98	106	19	52	4	17
South America	15.2		107				
Argentina	21.6	101	104	28	71	14	43
Bolivia	9.8	73	89	18	34 ^a	5	23
Brazil	15.1 ^b	108	107	16	39	2	12
Chile	18.0	124	101	34	72	6	23
Colombia	9.3	84	111	17	55	3	15
Ecuador	6.3 ^c	91	116 ^a	17	56 ^d	3	20 ^a
Paraguay	4.7	102	109	13	30	4	8 ^a
Peru	18.1 ^b	99	117	25	68	8	38
Uruguay	21.6	106	99	44	84	8	32
Venezuela	20.8	68		27	34	7	30 ^a
Central America and Panama	7.2		90				
Costa Rica	12.2	106	103	24	43	6	28
Dominican Republic	13.9 ^a	87	89	12	74 ^e	2	19
El Salvador	8.9	82	76	17	25	2	16
Guatemala	5.0	50	81	8	23	2	9 ^e
Haiti	3.1 ^c	50	56 ^a	5	22 ^a	0	1 ^f
Honduras	5.9	80	108	10	31	1	9
Mexico	21.2	92	114	17	55	4	14
Nicaragua	8.3	69	101	14	44	2	10
Panama	9.3	102	105	34	61 ^a	7	24
English-speaking Caribbean	31.1						
Aruba	29.9		102				
Bahamas			104		92		20 ^d
Barbados			106		87 ^b		18
Belize			94				
British Virgin Islands	36.8		112				
Dominica	29.8		106 ^c				
Grenada	35.5		111				
Guyana	17.5		102		57 ^c		5 ^c
Jamaica	41.6	109	106	51	62 ^a	3	9
St. Kitts and Nevis	35.1		98 ^c				
St. Lucia	12.2		104 ^c				
St. Vincent and the Grenadines			114				
Suriname	35.0		130		54 ^c		9 ^a
Trinidad and Tobago	4.7	93	95	36	79	2	7

Source: World Bank 1992; UNESCO, *Statistical Yearbook 1991*; SIRI-OREAL-UNESCO data. a. 1990; b. 1989; c. 1988; d. 1987; e. 1986; f. 1985.

1990). Furthermore, the distribution of higher education across socioeconomic levels remains unequal: the wealthiest fifth of the population receives nearly half the public subsidies dedicated to higher education, while the poorest fifth receives just 5 percent (Puryear and Brunner 1994).

The massive increase in enrollment has forced governments to control the product rather than the process. The careful monitoring of processes that could be carried out in a few elite institutions has been replaced by attention to the

quality of graduates (Neave 1988). At the same time growing social demands and changing labor market needs have encouraged the development of private and nonuniversity higher-education institutions. Two-year technical centers and four-year professional institutes now enroll more high-school graduates than traditional universities in several countries. These new higher-education institutions have helped balance the highly politicized nature of public Latin American universities and have introduced flexibility in higher-education

policies. However, applicants are often not fully aware of the differences between the types of institutions. Better information should be available for students and parents to make rational decisions when selecting the institution and career that will consume their time and money.

Although research is concentrated in a few universities, it is also increasingly carried out by public and private research institutes and large enterprises. Some universities play a major research role in most countries, but their research is constrained by faculty lacking doctoral training and proper incentives, especially financial. Although consortiums of postgraduate programs, research projects, and fellowships for doctoral studies are rare, successful examples of joint university and public and private research projects do exist (Schwartzman 1995). Still, it is difficult for young researchers to plan a career that will ensure a reasonable rate of return and standard of living. As a result Latin America is in an extremely weak position in producing and using knowledge. The percentage of GDP allocated to research and development is one-fifth the proportion allocated by OECD countries and barely one-third the share in East Asia's newly industrializing economies (table 3). Externally reviewed research project funding is increasing, however, and some countries have recently started reimbursing universities for overhead costs and increasing funding levels.

Government efforts, financing, and innovations

Latin American and Caribbean countries' interest in education is reflected in the amount of resources allocated to edu-

cation and in the number of projects implemented over the past decade. Government spending on education was 3.7 percent of regional GNP in 1990, a slightly larger share than in East Asia (3.4 percent) but less than in Africa (4.7 percent). Another 1.0 percent of GNP was spent by the private sector (World Bank 1994b; ECLAC-UNESCO 1992). Although the financial crisis of the early 1980s cut public spending in education by 30 percent, spending levels have since recovered to 1980 levels. Still, these levels are much lower—one-tenth in U.S. dollars—than the levels in industrial countries.

Rather than increase teachers' salaries, the recovery in education financing was used to lower student/teacher ratios in primary schools from 27 to 23, extend the daily schedule, distribute learning materials, widen access to preschool, and develop research and graduate training. Lowering student/teacher ratios while holding teacher salaries steady has not been an effective policy, however, and research suggests that the same amount of money could be spent increasing the number of students per teacher (up to a certain level) as well as teacher salaries.

The large number of repeaters reflects the inefficiency of the region's education systems. In 1991, 29 percent of students enrolled in primary school were repeaters. Each year about \$2.5 billion—nearly one-third of public primary education spending—is spent on repeaters. The figures are similar for secondary and higher education (ECLAC-UNESCO 1992; Wolff, Schiefelbein, and Valenzuela 1993; Schiefelbein 1994). The costs in terms of

TABLE 3

Science and technology indicators, selected regions

INDICATOR	LATIN AMERICA	OECD COUNTRIES	EAST ASIAN NEWLY INDUSTRIALIZING ECONOMIES	SOUTHERN EUROPEAN COUNTRIES ^a
Per capita research and development expenditures (U.S. dollars)	10	448	23	44
Percentage of GDP allocated for research and development	0.5	2.5	1.4	1.0
Research and development expenditures per engineer or scientist (U.S. dollars)	34,858	141,861	50,160	60,647
Engineers and scientists per 100,000 economically active people	650	115	185	
University graduates per 100,000 inhabitants ^b	156	592	478	191
University graduates in engineering and technology (percent)	19.5	15.6	19.6	17.5
Research and development expenditures by source (percent)				
Public sector	78.8	43.1	35.6	46.4
Private sector	10.5	52.5	61.4	49.5
Foreign sources	3.4	0.4	2.9	3.9
Other	7.3	4.0	0.1	0.2

Note: Covers different years between 1988 and 1990.

a. Greece, Portugal, Spain, Turkey, and Yugoslavia. b. Data are for the mid-1980s.

Source: ECLAC/UNIDO Industry and Technology Division data.

wasted time and accumulated frustration are even larger than the cost of repeaters, however.

The financial crisis of the early 1980s caused higher education and research and development expenditures in the region to decline or level off. The lack of resources for expansion provided strong incentives for public universities to improve internal efficiency, obtain resources from student fees (coupled with well-designed student loans mechanisms), sell services, or hire individuals with expertise in university administration rather than politics (Riggs 1964). When these new sources of financing are added, it becomes possible to achieve growth in higher education even as public spending per student declines (World Bank 1994a). But increased coverage does not mean better quality. Research and development expenditures remain near half of one percent of GDP; East Asia's newly industrializing economies spend three times that amount.

Reasons for hope

Despite the gloomy state of education in Latin America and the Caribbean, a number of successful programs and policies have the potential to improve education (UNESCO 1993b; ECLAC-UNESCO 1992; Oliveira 1989). First, there are good schools and universities, run mainly by the private sector, although they mostly cater to rich students. Second, vocational or technical on the job training is being offered by institutions such as SENAI (Brazil) and SENA (Colombia), and dual education programs are viewed favorably by private industry. Third, massive changes in primary and secondary school processes have been implemented by *Escuela Nueva* (Colombia) and P-900 (Chile), where self-learning materials are used.

Other changes include the massive use of computers and the development of *Escuelas Líderes* (Costa Rica), the *Programa Nacional de Educación Bilingüe* (Guatemala), the *Instructores Comunitarios* (Mexico), and the *Reforma Académica de Río Grande do Sul* (Brazil). A national innovation network has successfully operated in Colombia (Toro 1993), and common core curriculums have been implemented in Argentina (Braslavsky 1995). Research capability and use of findings in education have been developed through the REDUC regional exchange network (Oliveira 1989). Attempts to provide comprehensive funding for graduate programs include research and doctoral fellow-

ships and externally reviewed research project funding. Finally, there are successful regional collaborative programs in key areas such as biology and biotechnology (PNUD 1995). Widespread implementation of successful programs could improve achievement levels and help raise teacher salaries.

The causes of delay and relationships between policies, programs, and recent progress must be carefully identified when setting priorities and designing reform strategies (Brown 1994; Hatry, Greiner, and Ashford 1994; Slavin 1991; Levin 1990). Financing in itself has not yet been identified as a cause of poor performance, given that in some countries the resources required to buy time and basic inputs could be obtained by reallocating resources, improving efficiency, removing "ghost" teachers from payrolls, or using private sector financing.

Causes of poor performance

Even though little is known about effective innovations in education, important advances in the analysis of education systems have helped identify causes of poor quality and inequality (Tedesco 1994). Latin American and Caribbean countries should discuss these causes at the national level to promote consensus and to ensure that long-term education policies are implemented effectively.

Recent studies in the United States suggest that establishing an environment for effective learning requires redefining the roles of teachers and students. Learner-centered instruction and an active role for the learner in constructing meaning should be emphasized (Hatry, Greiner, and Ashford 1994). Moreover, the traditional view of teachers' role—instilling truths and transferring knowledge—should be abandoned, at least during part of the instruction time (Ellis and Fouts 1993). Basic inputs, classroom activities, and adequate time and materials are also required for students to learn (World Bank 1994b). School feeding and health programs also may be required for poor students. Still, provision of these and other basic inputs does not guarantee that learning occurs (Chubb and Hanushek, 1990; Doyle 1994; Tedesco 1994).

To ensure that learning occurs, specific activities must be part of the daily teaching-learning routine. For example, learning occurs when students discuss the proposed task, when the task is related to their context or expectations, when sufficient time is available to learn the task, and when

formative evaluation is given to students that have not fully learned the task (Brown 1994; Kamii, Clark, and Dominick 1994; Augier 1994; Schiefelbein 1991). These activities are all simple, but they require well-trained and committed teachers (Lieberman 1995). Poor teaching techniques, temporary dropping out, and lack of preparation explain why 40 percent of students in Latin America and the Caribbean repeat the first grade. In fact, most teacher training institutions provide theoretical training—structural grammar, linguistic, or learning models—but lack specific strategies for teaching (OREALC 1993). Teachers must be provided with better skills.

Most of the region's teachers are trained to use the frontal teaching method, in which lessons consist of oral instructions and information is tailored so that the average student can memorize and reproduce the content in exams and receive good evaluation scores. This method is less damaging in private schools or in universities where students are similar in age, culture, family support, and motivation, and where good materials are available for each student. But in classrooms where teachers have insufficient training, materials are scarce, and the group of students is heterogeneous—as is the case for primary and secondary students from urban-marginal, and rural areas—poor learning results. By definition, all students below the level of the “average” student (a level subjectively chosen by the teacher) will eventually repeat. Frontal teaching seems to be the main cause of repetition and inequity. More than half the students who repeat are in the lower half of the socioeconomic distribution (Amadio 1995; UNESCO 1993). Furthermore, the frontal teaching model is especially traumatic for first-grade students, regardless of whether they have attended preschool, since they must sit through classes motionless and silent in rows of benches (Landesman and Ramey 1994).

Reforming the traditional role and teaching style of teachers could require far-reaching social changes—changes that must be widely understood and accepted to achieve the national consensus required for long-term education reform. The region's education systems are rooted in a society that developed from colonial and indigenous traditions (Coles 1994; Oliveira 1989). This legacy contributes to a highly imperfect education market in which enrollments depend on demographic trends. Market imperfections such as education brand names, long-term lagged effects, geographical monopolies, supply subsidies,

and excessive bureaucracy are reflected in underinvestment in education, inefficient allocation of resources, and use of inefficient technologies such as frontal teaching.

Reforms must be coherent and consensual to efficiently improve education. Frequent changes in strategies resulting from the personal objectives of newly appointed secretaries of education rather than from agreement with all concerned parties or based on successful projects or research findings have brought education reform to a deadlock and hindered improvement (Tedesco 1994). Fortunately, the biases of education officials is reflected in the performance of public universities. Although most officials send their children to private primary and secondary schools, their children attend free public universities. As a result the performance of public universities is usually much more efficient (Oliveira 1989).

Education planners in Latin America and the Caribbean usually do not consider current research findings in their analyses. This helps explain why inappropriate policies were implemented during the economic crisis of the 1980s, when student/teacher ratios were lowered despite reduced resources (Schiefelbein and Wolff 1995). At a time when high rates of return are estimated for investment in all levels of education, the use of reliable research findings will help convince the public, congress people, and officials of the need for reform (Birdsall 1995; World Bank 1994b; Psacharopoulos 1994). Thus research and development efforts, which receive so little attention, should be strengthened (Winkler 1990).

In summary, not enough time has been devoted to identifying, understanding, and defining key problems in primary and secondary education classrooms or to developing a tradition of empirical research at the university level. Thus designing an effective strategy for education reform will require analyzing the nature and causes of the poor quality observed in the region as well as the sequence of events of reform. In most cases reform will require gradual, complex changes rather than drastic, simple ones. Although Latin American and Caribbean countries have tried myriad approaches to education, the fight for quality reform is only just beginning.

Defining priorities for reform through consensus

Since reforms should be based on national consensus, they will differ in each country. Consensus can be achieved by

convening a representative group, providing relevant background information, and then asking the group to discuss diagnostic findings and define long-term objectives and strategies (Connell 1994). The group should include representatives from different political and religious backgrounds, various geographical regions, and the many parties concerned with the education system, including teachers, students, parents, policymakers, scholars, and politicians. Consensus among such a heterogeneous group is feasible given the widely recognized need for change. In fact, representative groups in Chile, Colombia, the Dominican Republic, Ecuador, Mexico, and other countries have already use consultative mechanisms to build consensus (Tedesco 1994; Oliveira 1989).

Three types of reform should be discussed during the process of reaching social consensus: giving preferential treatment to deprived students (Oliveira 1989), developing alternatives to the frontal model, at least during part of the class time (Lieberman 1995; UNESCO 1993), and strengthening a tradition of empirical research (Winkler 1990; World Bank 1994a). Specific strategies must eventually be defined by the group that reached consensus or by technical advisory task forces. While some strategies (such as long-term salary increases) will require additional resources, others (such as the use of self-learning and group materials rather than traditional textbooks) will only require reallocating resources to more efficient uses and changing laws and procedures. Twelve interrelated strategies for improving learning that are especially relevant to Latin American and Caribbean countries are discussed below (Wolff, Schiefelbein, and Valenzuela 1993; MEC-UNICEF-UNESCO 1994).

1. *Increase the annual amount of time spent in school to raise achievement levels.* By increasing the number of school days each year from 160 to 200 and extending daily schedules from four to six hours the region should reach attendance levels similar to those in industrial countries (1,200 hours a year). As it stands primary and secondary rural students attend school three hours a day, 100–120 days a year, which amounts to 300–400 hours a year (ANEP-CEPAL 1990). The required increase can be partly financed by reallocating resources or eliminating “ghost” teachers from payrolls. For example, in 1994 there were twenty-one students per teacher for a half-day of classes in Chile’s public primary education system. The daily schedule could be doubled in

such schools if one teacher works in the morning with forty-two students and another teacher works in the afternoon with the same group (the Republic of Korea had forty-eight students per class in 1980). This increase, which could be implemented gradually, should increase achievement (Lockheed and Verspoor 1991; Schiefelbein and Simmon 1979). Although these changes would initially benefit the most deprived students, they would eventually reach the entire system. The alternative allocations of resources generated by larger class sizes depend on the initial situation. For example, by expanding class size from twenty-one to forty-two students, learning time and teachers’ salaries could increase by 50 percent without requiring additional resources. However, in countries with student/teacher ratios above 35 and with no excess staff or “ghost” teachers, the increased time for learning implies a substantial increase in financing. One additional week represents a 2 percent increase in the total cost of the corresponding level. Extending from four to five hours a day could cost 20–25 percent more.

2. *Gradually transform frontal teaching into active and participatory learning processes using self-learning and group work.* The amount of time teachers spend going over routine information can be reduced by producing and distributing well-tested learning guides, like those the Republic of Korea asked Florida State University to produce in the 1960s (Huh 1992). This type of material has already been tested in several Latin American and Caribbean and industrial countries and can easily be used by teachers with limited on-the-job instruction (Castro 1995). Successful use of such materials usually leads to gradual diffusion to neighboring schools. Self-learning materials also help reduce the class time wasted on non-learning activities. Such materials can be adapted by bilingual teachers to meet the needs of ethnic groups, thus encouraging use of the local context and family traditions. Such material also helps teachers prepare for future computer usage as part of the regular learning process. Moreover, the cost of self-learning and group work materials is relatively low.

3. *Extend preschool education to prepare children for primary school.* This is especially important for urban-marginal and rural students, who suffer a tremendous shock upon entering first grade and being exposed to the frontal teaching method (UNESCO 1993). Enrollment at an early age

together with improved quality tends to reduce the number of repeaters, particularly in the first grade. Preschool education can initially be delivered with partial assistance from the student's mother or another relative. This approach helps keep preschool costs—which, because of the need for small classes, can be twice as high as primary education—at levels similar to those of primary education. Preschool education should eventually reduce repetition in public primary schools and free some of the enormous resources being wasted in repetition. It should also increase the average number of completed grades. Increased preschool coverage usually requires increasing education resources, since private supply cannot expand unless subsidies are available.

4. *Link learning experiences in high schools to the working world to complement active and participatory education and to ease the transition to the labor market.* High schools should give special attention to communications, mathematics, and science since these skills are necessary for jobs and further education. The participation of the local business community, opportunities for dual technical education, and internships should be actively pursued. Opportunities for work or play with computers should be encouraged. Detailed analysis of foreign-language instruction, including the pros and cons of a few-hours per week versus “immersion,” should be carried out. Strategies that develop higher-level cognitive skills, like making decisions under uncertainty, pursuing alternative approaches to problem-solving, and concentrating on projects for long periods, should also be used.

5. *Ensure that resources can be reallocated easily and quickly.* Enrollment changes are brought about by higher levels of economic activity that increase labor mobility and by reductions in the number of repeaters, especially in initial grades. Teaching staff should be reallocated each year in response to these changes, but their access to work should be guaranteed. In Rio Grande do Sul (Brazil), for example, a more efficient allocation of teachers enabled the system to expand enrollments and to increase teacher salaries without increasing the total budget. The long-term strategy for raising salaries must be complemented with a short- or medium-term strategy for extending teaching time. Both strategies should be consistent over time.

6. *Restructure and revitalize teacher training.* Although most teachers are trained to use frontal teaching methods, it is possible to improve the selection and training of future

teachers and to gradually reform traditional teaching methods (see point 2 above). The use of student guides for active learning and regular local workshops for teachers to exchange comments on such materials, for example, could improve teaching. In addition, better strategies for teaching reading and writing should be included in preservice training (UNESCO 1993c), and mentoring should be a key part of teachers' preservice programs. Selection mechanisms that raise commitment and incentives for improving preservice training should be coupled with approaches that gauge teachers' interest in teaching. Improving the quality of training and teachers is a matter of reallocating resources and political will, rather than of securing new resources.

7. *Encourage decentralization and local participation.* Although these processes in no way guarantee an increase in the quality of education—in several countries decentralization is implemented for political, financial, or administrative reasons not linked to education—the decentralization experiences in Chicago and Kentucky are encouraging (David 1994; Bryk and others 1994; Walberg and Niemiec 1994). Decentralization in Latin America and the Caribbean has yet to prove that education quality can be improved, although poor centralized administration may benefit from the process (Palma 1995; Malpica 1994; Prawda 1991; Winkler 1991; Oliveira 1989; Noah and Sherman 1979). Thus decentralization is an area that requires further study.

Community involvement is attractive policy, but it is difficult to implement in a class-stratified society. The same elements that make decentralization attractive make its implementation difficult (Oliveira 1989; Ogawa 1994). For example, the 1980 decentralization in Argentina dismantled the statistical system, and legal norms were only enacted in 1993. Decentralization mainly involves reallocating resources, not developing additional ones.

8. *Develop better testing and information to monitor the quality of education, inform the public about key education issues, build social consensus, and increase accountability of the use of educational resources* (Puryear 1995). However, simple correlation analysis between inputs and student achievement should be avoided because achievement is a complex function reflecting many interrelated factors, including past achievements, socioeconomic background, level of urban development, and selection at entrance or at the end of each school year. For example, private school students usually

have higher achievement scores than students from public schools, but the difference can sometimes be explained by different socioeconomic backgrounds or by the fact that private schools can expel poor achievers while public schools must accept all applicants. The costs of testing and information programs are about 0.1 percent of the annual cost per student. Results should be widely distributed so that parents and other concerned parties can make informed decisions and so that society can hold authorities accountable for the way education resources are used.

9. *Subsidize the production and use of education research findings to increase the efficiency of the educational system.* Production of research is an important part of graduate education, but use of research requires the continuous development of the regional exchange network (REDUC) as well national networks. Research findings should be used to diagnose education problems at the national and local level, to identify causes and possible solutions or successful projects, and to design policies (McGinn and Borden 1995). Otherwise conventional wisdom will continue to guide decisionmaking in education and inappropriate policies will continue. Given that the benefits from educational research cannot be appropriated by researchers, public subsidies are necessary. About 1 percent of the education budget should be allocated through externally reviewed project funding.

10. *Expand graduate education programs to stimulate research and to train future university professors.* Less than 20 percent of university professors have doctoral training; as a result university students are usually trained using synthesis of outdated books. Poor training is the result of the low salaries and limited opportunities that national and international graduate students confront. Even though university faculty salaries cannot be substantially raised for all faculty members in the short term, salaries should be raised for the small group of senior researchers who staff graduate programs. This group comprises about 10 percent of university faculty. A program providing research grants to such a group, including salaries and doctoral fellowships, would be equivalent to about 20 percent of the cost of public undergraduate university financing.

11. *Increase education financing over time to fund increasing salaries, extended school years, preschooling, computer networks, graduate programs, and research.* The initial reform strategy should implement successfully tested educational strategies

and start with low-cost changes (Wolff, Schiefelbein, and Valenzuela 1993). Over the longer term the flow of public resources should be increased gradually as improvements in education are objectively identified and measured. In addition, the private sector should mobilize a larger share of education resources, and resources should be distributed more equitably. Any increases, public or private, should be tied to improvements in educational quality. At the same time legal norms should be enacted to increase cost sharing to the extent possible and to secure international cooperation and financing (McMeekin 1995).

12. *Define a new role for the secretary of education, especially within decentralized or private education systems.* Six tasks should be highlighted: improving efficiency by identifying promising programs (educational and management), financing their evaluation, and widely distributing the results; supporting accountability by financing and monitoring testing systems and publishing the results; helping individual decisionmaking by launching or strengthening accreditation mechanisms, especially at higher education levels; supporting research by encouraging externally reviewed project funding; improving equity by collecting and processing information that helps identify groups needing special attention, subsidies, or incentives to reach acceptable education levels; and supporting social consensus by convening consultative mechanisms, supporting their work, and disseminating their reports to encourage participation from parents and teachers (Tedesco 1989).

These intellectually and politically challenging tasks demand a flexible public sector personnel policy that enables recruitment of dynamic leaders into the sector and continuous professional development of sector staff.

Conclusion

The twelve recommendations presented above are not of equally importance. But to a large extent they are closely linked, and work toward common goals:

1. *Achieving education reform that is inclusive and supported by the society at large.* There is a need for substantive education reform. Since many stakeholders are affected by and interested in reform, the reform process must include all important interest groups. This process should result in a national consensus on strategies that raise the quality of schooling, especially for the poor.

2. *Guaranteeing each child a minimum basket of educational*

inputs, including materials for group and personal learning, textbooks, other instructional materials, and, most important, a guaranteed number of hours of instruction. The length of the school day and the length of the school year must be extended—with important implications for teacher salaries and the teaching profession.

3. *Targeting extra resources to children of low-income families.* Improving the income distribution in Latin America will require significantly higher investments in human capital for the poor. These investments include increased access to preschool, subsidized school lunches and school materials, better teachers, and longer school days.

4. *Changing teachers' education.* The teacher is critical to improving classroom processes. Improving the quality and style of teaching will require improving teacher training, developing mentoring and group learning approaches, and changing the reputation of the teaching career. University departments and other teacher training institutes will have to be reformed and teacher salaries will have to be increased to attract and retain good teachers.

5. *Strengthening the tradition of empirical research.* Augmenting doctoral programs and research should gradually increase the training of university faculty and raise the quality of higher education. Institutional arrangements should be worked out to create critical mass, exploit scarce resources, coordinate activities with native talent working abroad, obtain first-class peer review, and retain young talent in each country.

6. *Tying education reform to the efficient use of resources and increased public education budgets.* The quality of schooling cannot be improved in a sustainable way without increasing public and private education expenditures and improving the use of these resources. On the other hand public expenditures on education should not be increased in most countries in the region in the absence of education reform.

7. *Basing education policy on good information and good analysis.* Education policy decisionmakers need to increasingly use data and research in formulating policy. Parents and teachers require information on their school's performance, especially in decentralized systems. The capacity of university faculty to produce and disseminate high-quality education research must be strengthened to inform policy analysis.

8. *Ensuring that ministries of education play a key role in reforming education and raising quality.* Important tasks include convening consultative mechanisms, obtaining

national support for reform, identifying and evaluating innovative programs, and ensuring that school performance information is widely disseminated to students, parents, and teachers. However, schools should be given incentives—not forced—to improve their performance.

Of course, the efforts made in each country will differ because their baselines are different. Therefore reform strategies should be tailored to local needs. Each society must decide on the education levels it requires to live peacefully in a democratic regime and to achieve sustainable economic development through international competition. Non scholae, sed vitae discimus—not learning for the school, but for life.

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Comment on “Education Reform in Latin America and the Caribbean,” by Ernesto Schiefelbein

ROBERTO CARNEIRO

THE INEFFECTIVENESS OF EDUCATION REFORM IN LATIN AMERICA OVER THE PAST DECADE CAN be attributed to three factors. First, education reform has been confused by administrative success, legislative production, and technocratic projects. Second, there has been too much emphasis on achieving consensus. Reforming and building education policies that last beyond electoral cycles requires political courage and stable government. Third, education reform has not been on the agendas of all members of society. Putting education at the top of the national agenda should be a priority of ministers, politicians, executives, and intellectuals, not just of the ministry of education.

Reducing social inequality and eliminating exclusion of the poor imposes increased demands on education. But in Latin America the availability of goods is growing at a much slower pace than the increase in demands. What can be done?

First, an education “new deal” involving every democratic political association should be established. The deal should work toward approving, in the medium term, a program of financial support for education. Such support should come from the state and from private groups such as companies, families, individuals, and bilateral and multilateral institutions. This program should last for at least ten years because implementation of sound and lasting education policy will not be sustainable in less time. Second, resources should be effectively and equitably allocated. Distribution of funds should be based on the following priorities:

- Universal basic education, including preschool for students under five and primary school for the next nine or ten years
- Gradual development of market and private investment mechanisms in college education, with the state responsible for ensuring access for the poor

- Graduate study support
- Improving professional standards, the social status of teachers, and general teaching conditions
- Cooperation between local administrations and the private sector to provide complementary studies and a school-work exchange so that youth and adults are more professionally qualified.

Education, including preschool, also needs to be linked to other programs and activities that seek social promotion. Schools are social institutions; they teach us the importance of social cohesion, living together in peace, and living in communities. Schools are an indispensable part of the social system.

Improving the quality of education is a dynamic process. Schools’ effectiveness should not be measured by the assets they have accumulated. Instead, an effective school should be considered one that produces an environment of strong leadership, tradition, service, responsibility, community values, and ownership of the education mission. Schools need to be given back to civil society,

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and should not be viewed as state-owned bureaucratic terminals.

In our society those who will prosper are those who can master new skills and take on risks. Poverty will only fall if human development programs are implemented that invest in building a culture that can confront adversity

and conformity. Accomplishing this will require strong, educational communities where education is more than just a factor of economic growth. Education should be the aim of development. Human potential is Latin America and the Caribbean's greatest wealth—we must believe in this resource and make good use of it.

Comment on “Education Reform in Latin America and the Caribbean,” by Ernesto Schiefelbein

EDUARDO AMADEO

FROM AN ECONOMIST'S POINT OF VIEW, THE BENEFITS OF EDUCATION CAN BE MEASURED IN two ways. For the person who receives education, returns are measured by future income; for society, education generates externalities and allows individual agents to perform. Moreover, individual performance is not independent from group performance.

Four basic points concerning the relationship between economic development and education have characterized Latin American economic development. First, Latin America has experienced intensive growth in jobs requiring few qualifications and has used a development strategy in which workers' skills play a minor role. Until a few years ago companies survived without investing in their employees' education. Today, as a result of technological advances and international competition, this scenario is changing and companies have begun to invest in their employees. But advances of this sort are taking place only in a small part of the society. Second, the importance of externalities has not been emphasized. Third, no direct strategy for improving the quality of life for the poor has been developed. Any progress in this area has been the natural outcome of economic development—that is, nothing more than a trickle-down effect. Finally, social segregation has resulted in an unequal distribution of political capital. A society cannot finance or commit to education without capital.

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has been the natural outcome of economic development—that is, nothing more than a trickle-down effect. Finally, social segregation has resulted in an unequal distribution of political capital. A society cannot finance or commit to education without capital.

What can Brazil and the rest of Latin America do in light of new international competition? One option is to participate in the competitive market by producing goods using low-skill workers. But since there is a surplus of low-skill workers throughout the world, including in more-developed countries, investments on this front will result in a no-winners war. Participating in the interna-

tional market in this way would be useless.

A second option for Brazil and Latin America is to provide some added value to workers that can potentially generate competitive advantages. This kind of action requires considerable investment in research and development strategies as well as in education. It also depends on many externalities. Nevertheless, in the long run it is the most promising option.

The presentations at this conference have painted realistic pictures of education in Latin America. They have concentrated on a "software" vision of the problem and "how to" approaches to make education work. But is it true that our main problem is software?

Statistics show that the top 10 percent of rich students in Latin America perform as well as, or even better than, those in many industrial countries. If the same methods—that is, the same software—were provided to everyone in the region, outcomes would obviously be much better. Since we already have the software, we must concentrate on the other, more difficult, delicate, and frustrating part of the problem: the unequal distribution of education.

Public education teachers in Brazil have strong political power through their unions. However, they have not been successful in getting the government to increase their salaries or improve education. The fundamental problem in Brazil and other countries is the lack of social commitment to education. Lack of commitment results in the immense segregation of poor children, low standards in public schools, and lack of sensitivity to the importance of education among the public school population.

Reaching consensus will require agreeing on methods and on making an honest commitment to changing education in Latin America. However, as an economist, it is difficult for me to imagine how to generate this consensus other than by establishing taxes where the rich pay for the education of the poor. Consensus on software is not sufficient to make education in Latin America work. In this sense I propose the following idealistic but valid suggestion: middle-class families could pay a 10 percent tax on their children's tuition to improve the education of poor children in the nearest public school.

Floor Discussion of “Education Reform in Latin America and the Caribbean,” by Ernesto Schiefelbein

AN AUDIENCE MEMBER NOTED THAT LOW DEVELOPMENT INDICATORS AND POOR-QUALITY education were often used to explain social and economic inequalities and fragile democracies in Latin America. However, the opposite is true. Authoritarian governments are not interested in improving the quality of education because education develops the critical reasoning that can turn against those in power. Another speaker observed that effective action that makes democracy grow precedes effective action that leads to a national pact on education.

Another audience member said that the education model presented in the second part of the session introduces a type of education that is both participative and liberating and that helps develop self-awareness.

A fourth person noted that education is a unique tool because it simultaneously strengthens democratic institutions and increases productivity and equity through economic development. The direct contribution of education to growth means a higher quality of education for all. Contributing to equity does not consist of reducing income inequality, however. Instead, education should generate equal opportunity where no one is prohibited from climbing the social ladder. Equal quality of education implies a system of incentives and compensation in which teachers are enticed into working in rural area schools. With persistence and commitment, the problem of poverty can be resolved and equal opportunities achieved.

Schiefelbein responded to the questions and points, noting first that consensus implies an understanding of the problem—which few countries in Latin America have. Chile is an interesting example of a country that is aware of its education problem. The government decided in a relatively short period that education was a priority

and increased resources to the sector. This was a result of their understanding that there were possibilities to confront and resolve the problem.

Education in Latin America is not on the forefront of technological progress; it is applying nineteenth-century techniques. Bearing this in mind, Schiefelbein said, there is immense possibility for progress. Using the same resources, it is possible to increase results by 20–30 percent. This does not mean, however, that the current resources dedicated to education are sufficient.

There is a paradox between the expectations placed on teachers, the importance of their role, and their low salaries. However, the paradox can be partly explained by societies’ awareness of poor results in the education system. Society is unwilling to pay teachers high salaries when only half of today’s students can read. And although salaries historically increase after teachers strike, they eventually fall again because of the poor quality of the education system.

When we talk about education in Latin America, it is important to note that few parents send their children to public schools. Thus when we talk about education problems we are often talking about the education and problems

of others, not our own. If decisions concerning the education systems affected the people who make those decisions, education in Latin America would be much better.

Textbooks used in Latin American schools contain many shortcomings. For example, they do not relate what occurs in the classroom to the family. In addition, they do not present the students with options or permit them to make decisions. Group work is not encouraged. Finally, they do not require students to write. Without writing it is difficult to ensure that thinking is taking place. And,

Schiefelbein concluded, the absence of thinking is all too evident in Latin American schools today.

Schwartzman (chair) summed up by noting that education today is being looked at in a radically new light; it is now considered a strategic and vital part of economic development and social survival. Also, we now realize that the discussion on quantitative expansion and financial investment has to be extended to examine why education systems that have been receiving funding have not improved.

SPECIAL SESSION

Capital Markets after the Mexican Peso Crisis

WILLIAM CLINE

SIX MONTHS AFTER THE COLLAPSE OF THE MEXICO PESO, INVESTORS AND POLICYMAKERS ARE asking which mistakes led to the crisis, cautiously reexamining their responses, and identifying the systemic reforms necessary to avoid such disruptions in the future. After a brief diagnosis, this paper critically reviews the list of alternative prescriptions currently being discussed.

Renaissance of the early 1990s

To understand what happened in December 1994 it is helpful to review what occurred in the previous four years. The 1990–94 period marked the most recent international capital market swing between bust and boom. Net capital flows to Latin America, which had peaked at about \$40 billion in 1981 at the end of the 1970s petrodollars boom, fell to an average of \$10 billion a year in 1983–89. Later, with the favorable conjunction of the Brady and Greenspan Plans, net flows averaged about \$50 billion a year in 1991–93 (Cline 1995).

Dramatic reforms in economic policies and structures were a prerequisite to this revival. Major Latin American debtors had reduced fiscal deficits, liberalized trade, privatized state firms, and deregulated in a continent-wide shift from an inward-looking, populist economic model toward the Washington consensus of market-oriented reform. Debt, and especially interest burdens, relative to exports and GDP had improved markedly since the early 1980s. The Brady Plan forgave about one-third of long-term bank debt and thus about one-sixth of total debt—a technically modest alleviation but a decisive lancing of the debt boil.

Even so, once-burned banks stayed on the sidelines and the capital boom of the early 1990s came in the form of direct investment, purchases of stocks, and floating bonds. An important part of the resurgence represented capital repatriation by Latin American investors. As such, the resurgence should have been recognized as a one-time readjustment of portfolio allocation between foreign and domestic assets that could subsequently imply more moderate inflows. As the smart money came back and pushed up domestic equity markets, institutional money from abroad, in search of an alternative to low returns, joined in. This resulted in capital flows too large for comfort in countries such as Chile and Colombia that were not keen on the resulting pressures for exchange rate appreciation and monetary expansion.

In February of 1994 the U.S. Federal Reserve began a long series of increases in interest rates in efforts to cool an overheating U.S. economy. The stage was set for a serious chill on the capital market, precisely as some had warned (Calvo, Leiderman, and Reinhart 1993). Even so, net capital flows to Latin America in 1994 were still more than \$50 billion and only 10 percent below the 1993 peak (ECLAC 1994).

Mexican miscalculations

The capital inflows were most buoyant in Mexico, where the added capital market euphoria associated with NAFTA provided Mexico with more than enough rope to hang itself. Net capital inflows to Mexico reached \$98 billion in 1991–94, about half of the Latin American total (ECLAC 1993, 1994). The counterpart of the large inflow was a large current account deficit reaching approximately \$30 billion, or 8 percent of GDP in 1994.

With the benefit of hindsight, most analysts—including President Ernesto Zedillo and Finance Minister Guillermo Ortiz, both PhD economists—agree that the principal policy mistake was that of holding on to the quasi-fixed exchange rate too long.¹ While this “anchor” against inflation was highly successful in the late 1980s, its excessive rigidity and the resulting overvaluation eventually brought Mexico’s external imbalance to dangerously high levels. If most of the deficit had represented investment in production capacity for tradables, this strategy might have worked. However, much of the deficit represented consumption, as the share of investment in GDP rose by much less than that of the current account deficit.

An investment-oriented strategy would also have been risky with an external deficit this large. In Mexico political shocks such as the Chiapas rebellion and Colosio assassination removed room for adventurous economic policy. Mexico should have devalued in the second quarter of 1994 while its reserves were still relatively high instead of waiting until being forced to do so at the end of the year, when reserves were down to six weeks’ imports.

Most of Mexico’s policies have been commendable and were widely seen as a prototype of the Washington consensus model. Mexico’s willingness to run a large external deficit was based on the “consenting adults” thesis (associated with former U.K. chancellor Nigel Lawson), which assumes that large current account deficits financed by private capital are not problematic for policy as long as they do not stem from fiscal deficits.² This theory, which made optimistic assumptions about the speed and automaticity of adjustment, was proven wrong in Chile in 1981, in the United Kingdom in 1986, and now in Mexico.³

Mexico’s risk-taking strategy was also evident in its heavy reliance on treasury bills (CETES) and tesobonos (peso obligations indexed to dollars). The short-term interest savings were penny-wise and pound-foolish. The condi-

tions were ripe for a peso crisis when investors realized in late December that Mexico owed approximately \$20 billion of these short-term instruments to foreigners while having only about \$6 billion in reserves.

The lessons from Mexico are at least threefold. First, safe limits to external current account deficits should be observed regardless of their origin. Second, a prudent balance between use of the exchange rate as an anchor against inflation and maintenance of a realistic real exchange rate should be achieved.⁴ Third, short-term debt, especially short-term government debt held by foreigners (whether in domestic or foreign currency) should be minimized.

Spillover and aftermath

The initial spillover from the peso crisis was widespread and ranged from more obvious victims such as Argentina and Brazil to much less likely ones such as Sweden and Thailand. One can even argue that the spillover contributed to the sharp decline of the U.S. dollar against the yen and deutsche mark. First, markets rediscovered the risks of large current account deficits (such as that in the United States). Second, there was a technically incorrect perception that the Mexico bailout by the United States tied up resources otherwise available to defend the dollar (Exchange Stabilization Fund). Third, the crisis meant a likely deterioration in the U.S.-Mexico trade balance of about \$20 billion.⁵

Financial contagion in Mexico occurred in part due to the fact that much of the short-term portfolio investment was made by investors with little experience in Latin America. Later, there was a tendency toward binary reaction, as large mutual funds sold off Latin American holdings when Mexico reneged on its pledge not to devalue. High levels of short-term debt, low reserves, an exchange rate anchor, political shocks, and a current account deficit relative to GDP unmatched by any other major country except Hungary also contributed to the contagion. The characteristics of the Mexican situation were in sharp contrast to the debt crisis of 1982 when Mexico’s problems of large external and fiscal deficits were typical of Latin America.

In 1994 Argentina was the closest possible policy-clone of Mexico. Like Mexico, Argentina had a fixed exchange rate anchor as well as a large current account deficit. However, the current account deficit relative to GDP was less than half as large as Mexico’s. The fixed exchange rate

in Argentina was part of a currency board that dictated contraction of the money supply in the event of declining reserves. In Mexico the impact of falling reserves on the money supply was sterilized. Argentina's 1989 Bonex Plan, an extreme measure that froze bank accounts and converted short-term claims to ten-year maturities, left the legacy of minimal short-term government debt; in contrast to the Damocles' sword of tesobonos, Argentine foreign exchange reserves remained high.

The rest of Latin America was even more different from Mexico and automatic contagion was therefore even more unfounded. In Chile there had been limits on short-term capital inflows. In Colombia the external deficit was strictly linked to direct investment in the oil sector. Neither country had a fixed exchange rate anchor. In Brazil there was a massive accumulation of reserves even though some problems were beginning to surface with the fixed exchange rate overvaluation problem associated with the Real Plan.

The spillover, which temporarily put particular pressure on equity and secondary debt markets, may have actually benefited several Latin American countries. Temporarily, it took some of the pressure off of excessive capital inflows in Chile and Colombia. The threat of a Mexican outcome strengthened the hand of finance ministers and presidents in obtaining fiscal adjustment from legislatures in Argentina and, to some extent, in Brazil. The events in Mexico likely influenced Brazil to devalue sooner than expected, thereby putting a stop to its widening external deficit. Even a major policy adjustment in Hungary appears to have been facilitated by the scare. This pattern tempts one to conclude that the "tequila effect" really amounted to a "tequila vaccine" against more severe policy mishaps.

Six months after the eruption of the Mexican peso crisis the initial fright of the tequila effect seems to have largely dissipated. At the outset, it was questioned whether the Mexican crisis meant that the Latin American debt crisis was back with full force and whether the Brady Plan results only papered over a fundamentally unresolved debt problem. However, these were never very likely possibilities given the major structural and policy reforms in the region and the improved debt ratios.⁶

By June 1995 the above interpretation looked even less valid. The temporary financial runs had reversed in most cases. Argentina's Brady (par) bond, which had fallen from

47 cents in December 1994 to 32 cents in early March of 1995, was back up to 50 cents by early June. Venezuelan Brady bonds similarly had fallen from 50 cents to 39 cents and rebounded to 50 cents; a similar pattern held for the Brazilian equivalents (Salomon Brothers 1995a). Stock markets, after severe declines through early March, had approximately returned to or even surpassed their December 1994 levels in Argentina, Brazil, Chile, and Peru by late May (Salmon Brothers 1995b).

The level of reserves is a key indicator of capital market contagion. By the second quarter of 1995, reserves stood close to or higher than their December 1994 levels in Chile, Colombia, Peru, and Venezuela. Although Brazil lost one-tenth of its reserves in March when it announced a possible devaluation, its reserves remained high by the second quarter. For Latin America as a whole, non-gold reserves fell from \$113 billion in September of 1994 to \$101 billion in March of 1995 (IMF 1995). However, almost \$10 billion of this decline was in Mexico alone. Therefore, reserves in the rest of Latin America fall by less than 3 percent as a consequence of the tequila effect.

Testing Argentina and Mexico

Contagion has been most severe in Argentina, followed by Mexico. In Argentina international reserves fell from about \$16 billion in December of 1994 to \$12 billion in April of 1995. Despite the currency board, the government softened the corresponding decline in money supply by reducing bank reserve requirements and by using the cushion of the limited permissible coverage of the money base by government dollar-denominated bonds. Yet the fear of bank difficulties (in a system with no deposit insurance and extremely limited lender of last resort capacity) led to major withdrawals. Overall checking and savings deposits in pesos fell by about 15 percent (by some 4 billion pesos), and dollar-deposits in Argentine banks fell by 15 percent (by \$3 billion). Although reserves remained comfortable relative to imports, the nation entered into a classic gold-standard adjustment through monetary contraction, the logical consequence of a currency board under stress with concerns about soundness of the banking system.

The government of Argentina needed to come up with cash for \$5 billion in 1995 amortizations of external debt that under normal circumstances would have been rolled over. Extraordinary fiscal measures were needed in a context

in which revenues were already likely to be under pressure from an economic slowdown. Yet the reelection of President Menem showed that the public endorsed austerity to preserve the newly found stability. In terms of inflation-phobia, Argentina seems to have become the Germany of Latin America.

Mexico is by no means out of the woods. The solution to the peso crisis had to assure that the short-term tesobonos (and dollar obligations of banks) would be honored (hence the need for the \$20 billion U.S. package with maturities of up to ten years) as well as a perception that Mexico's vaunted fiscal and monetary discipline was back on track. Toward this end, the government has reduced the money supply and (though with too much initial delay reformulated fiscal and external targets for 1995).

If the above holds true, a virtuous circle could arise. First, the peso would stabilize enough to give investors the perception that dollars placed in Mexico would not lose value from still further devaluation (beyond the move from 3.5 pesos to the dollar in early December 1994 to about 7 by the first quarter of 1995). Then, in the face of high nominal peso interest rates (over 70 percent on CETES), foreign capital would return in pursuit of high-risk, high-return assets. As the money enters, the peso would stabilize, putting downward pressure on domestic interest rates. Interest rates would decline sharply and exchange market conditions would be normalized.

By early June 1995 this scenario was arguably working. The exchange rate had stabilized to approximately 6 pesos to the dollar. CETES rates fell from an average of about 75 percent in March and April to 50 percent by late May. But the real economy was in severe recession. High interest rates were provoking bankruptcies, putting pressure on the banking system. It was questionable whether a mechanism to convert loans and deposits to an indexed basis (modeled on Chile's experience in the early 1980s) would work as borrowers resisted open-ended indexation obligations. The minimum wage increase was limited to 17 percent in the context of expected 1995 inflation of over 40 percent. This had unfavorable implications for social stability, equity distribution, and poverty.

An atmosphere of doubt resulting from economic and social strains could explain why 50 percent on CETES was required to attract capital despite a stable peso. Or, it could be that Mexican authorities prodded by their U.S. counter-

parts sought to err on the side of high interest rates and tight money to attract capital. This explanation is consistent with the fact that by June CETES auctions were oversubscribed. However, this theory may fail to recognize the attention investors pay to the real economy. Surely Mexico's top priority now is to reduce interest rates to nominal levels consistent with moderate real rates given forward-looking inflation.⁷

Institutional reform

Six months after the peso crisis, a number of lessons can be learned; some elements in the new catechism are valid, others questionable:

- *International institutions must be reformed to deal with "the next Mexico" because the \$20 billion deal with the United States and \$17 billion from the International Monetary Fund (IMF) cannot be repeated.* The problem with this conclusion is that in a meaningful sense, there won't be a "next Mexico"—there cannot be. Consider the "systemic risk" of Mexico, which lies in the fact that this was the first shock to the newly-revived capital market of the early 1990s; if handled badly, the result might be a shutdown of that market. But now, that market has been chastened. It is impossible to repeat a "first major shock" because it has already happened. Additionally, the dimensions of short-term government debt involved in the Mexican case greatly exceeded corresponding obligations elsewhere in Latin America. No other country managed to convince foreigners to hold large short-term government debt denominated in domestic currency (albeit indexed to the dollar).
- *It is necessary to establish an emergency mechanism to provide short-term financing to countries with good policies so they can deal with waves of private market speculation.* There may be merit in this proposition, but it cannot be justified by the Mexican experience. Mexico probably would not have qualified for good policy status because of its exchange rate problem and excessive current account deficit. In any event, Mexico could not have been bailed out by short-term money because the essence of the problem was converting short-term to long-term obligations by refinancing. Yet in international discourse, the Mexican events have been invoked to revive proposals originally conceived to deal with problems such as those experienced in the 1993 breakdown of the European Exchange Rate Mechanism.
- *An international bankruptcy procedure comparable to U.S.*

domestic "chapter 11" treatment is necessary. This conclusion cannot be justified by Mexican experience. Tesobonos were denominated in pesos subject to adjudication by Mexican (not New York) courts and thus could have been suspended by Mexico if the issue were institutional. But, the issue was one of reputation. Mexico had invested far too much in preserving its credit reputation in the previous decade to jeopardize the record with a unilateral bond rescheduling.

- *The IMF should provide early warning whistle-blowing on countries with bad policies and immediate country disclosure of reserves and other key information.* Full disclosure within two months would be laudable, though much shorter times could feed destabilizing bandwagons. IMF whistle-blowing (Goldstein 1995) probably makes sense, although it assumes an accuracy of IMF staff judgment not necessarily present in the Mexican case. However, the basic notions of curbing problems before they get too large and of magnifying the IMF's impact by using the leverage of its signaling effect on the private market are correct.

- *Double IMF quotas.* Some propose that the IMF quotas should be doubled from their present level of \$220 billion. However, the IMF already has a large amount of unused liquidity (about \$80 billion in 1994). Against a usable currency base of about 80 billion SDR (\$120 billion), outstanding credits in the past few years have not exceeded 30 billion SDR (IMF 1994). Although the resulting liquidity excess of about \$75 billion was narrowed by \$17 billion for Mexico in 1995, the cushion remains significant.

The most likely near-term reform will be a substantial increase, perhaps a doubling, in the General Arrangements to Borrow (GAB). This mechanism, now at about \$26 billion, amounts to an arrangement whereby the G-10 industrial countries, plus Saudi Arabia, stand ready to lend to the IMF if it needs additional liquidity to deal with a crisis in the international financial system. The United States and other authorities appear to be seeking to enlist cash-rich newly industrialized countries such as Singapore and Taiwan into this club (although it is unclear under what voting conditions). By pursuing enlargement of emergency funds through the GAB, the major industrial countries retain greater control than under a comparable increase of IMF liquidity through quota expansion.⁸ Similarly, the GAB mechanism limits the additional funds for systemic crisis use, whereas quota expansion tends to be viewed as an increase in resources available to developing countries, more

generally on a basis of quota shares.

With the larger GAB resources available, the IMF could then open an "emergency" window for lending beyond the normal quota multiples. High policy standards for country access would be required to minimize the "moral hazard" problem of inducing reckless borrowing due to foreknowledge of bailout facilities.

Beyond such measures, Cline (1995) proposes the creation of a joint private-public international bondholders insurance corporation. For a given fee of 50 basis points this entity would insure against default on sovereign bonds—just as private insurers cover U.S. municipal bonds. The corporation could vary its coinsurance rate from 80 percent of losses for countries following good policies to 20 percent for those with less adequate policies. The insurance could substantially widen the class of investors in developing country bonds (for example, to include insurance and pension funds) while at the same time providing an important signaling role about the quality of country policy, thereby contributing to the "early warning" function. Simulations of plausible scenarios suggest that the entity would usually make a profit, and hence could draw on private capital.

At some point the international community may face the question of how to reschedule sovereign bonds. The transition from syndicated bank lending to equity and bond instruments means that rescheduling would be more complicated in the future due to numerous atomistic bondholders rather than a few dozen international banks that can be mobilized by "advisory committees." Fear of the consequences of this shift has been one reason for the discussion of international bankruptcy arrangements, typically premised on the notion that the IMF could invoke its authority (under its Article 8) to approve exchange restrictions for a country in trouble.⁹

The cleanest way to establish a rescheduling mechanism would be to require bonds issued by sovereign states to incorporate a clause providing for majority bondholder approval of rescheduling without recourse to default claims by dissenting minority bondholders.¹⁰ This step would overcome the free-rider problem, although it might come only at the expense of a significant delay in development of the bond market. It would seem ill-advised to pursue the issue of potential bond rescheduling by a more heavy-handed approach emphasizing unilateral public declaration

of rescheduling or bankruptcy reorganization, even where the bondholders had not previously agreed to such a contingency. The latter approach would be much more likely to stunt the growth of the emerging sovereign bond market for developing countries.

Changing the model?

An assessment of whether the Mexican experience has set the stage for a rejection of the Washington consensus model of economic policy and development strategy leads to both positive and negative conclusions. On the positive side is the growing acknowledgment of the role of capital controls. Chile has emerged as the savvy player in this episode because its restrictions on short-term inflows, such as a 30 percent deposit requirement on funds under one year, meant that the country was not vulnerable to rapid outflows when market sentiment shifted.

A proper reading of the market-oriented Washington consensus model (Williamson 1990) shows that it did not place the same priority on free capital movements as it did on other central elements of the strategy (fiscal balance, trade liberalization, privatization, exchange rate realism, and deregulation). The literature on policy sequencing stresses that capital market liberalization comes after, not before or simultaneously with, trade liberalization. The final removal of capital controls did not occur in Europe until the early 1990s.

Limits on short-term capital inflows to reduce vulnerability have earned new respect and legitimacy since the Mexico crisis. It is less clear whether this has been the case for limits on currency convertibility for capital outflows. Although controls on outflows were always considered anathema in Mexico, in large part because of the argument that the long U.S. border meant they would not work, Brazil has never had the same compunction; even under the Real Plan the holder of local currency has no guarantee of access to dollars. A currency board arrangement (as in Argentina) grants this right, but for countries on the crawling peg or otherwise flexible rates, it is possible to distinguish between current and capital account convertibility.

Indeed, some might challenge that "Mexico was unique"—that its short-term government debt is irrelevant—because of its large tesobono obligations. A country can get into trouble to the extent of its entire money supply when there is a rush toward the exchange rate exit. The response

to this argument is that incomplete capital account convertibility can be a proper response to a run, rather than "one, two, many" Mexico-type packages through enlarged international emergency windows. Such limits imply the possible appearance of spreads between official and parallel exchange markets. But as a temporary shock absorber, such an arrangement may have merit.¹¹

If a nod in the direction of reasonable capital controls is a sensible model refinement after Mexico, the slide toward protection is a much more unfavorable development. Brazil's decision to raise tariffs on consumer durables to 70 percent and to move toward quotas on auto imports is a much more fundamental departure from the market-oriented Washington consensus model. It is a symptom that the real is becoming overvalued and there is a temptation to use protection as a substitute for real depreciation.

There is a risk that the political economy of protection may become entrenched even if initially introduced in a temporary emergency. Backing away from the proliferation of trade liberalization that emerged from the debt crisis of the 1980s would signify a serious retrogression in Latin American economic policy. Free trade projects certainly could be placed on the shelf indefinitely if the economic model in the region were to move in this direction.

Because the Mexican mistake was rooted in an excessive external current account deficit, it is important to consider what constitutes a safe deficit level. The annex sets forth a simple mathematical relationship suggesting that a safe level is likely to be in the vicinity of 3 to 4 percent of GDP if the deficit is to be sustained for a long time.¹² At this level, the ratio of external debt (including the debt equivalent of net foreign investment) will stabilize at about 40 percent of GDP if the economy is growing at 5 percent and world inflation is 3 percent. An external debt of 40 percent of GDP has in the past represented a threshold beyond which countries have tended to get into debt difficulties.

Conclusion

The preliminary verdict is that the Mexican peso crisis of 1994 was a minor aftershock of the debt crisis of the 1980s rather than a precursor of another comparable or worse international financial quake. If the promising signs are to be consolidated it will be necessary to achieve sustainable adjustment in Mexico and in the spillover case of Argentina.

In the instance that success is achieved, it is likely that the capital market for emerging economies will continue to recover from the panic and indiscriminate cutoffs that characterized the initial reactions to the Mexican crisis; there will be a move back towards more discriminating behavior that rewards good policy.¹³

The stock of financial assets of industrial country markets stands in the vicinity of \$20 trillion. Annual capital flows to developing countries are about \$120 billion, half of which has gone to Latin America. Thus, only small portfolio shifts toward the emerging markets are required to permit large proportionate growth in these flows. Despite the Mexican peso crisis, countries that pursue appropriate economic policies should expect to have ample access to international credit. The crisis, by serving as a lesson, may help assure that policies are appropriate; Mexico has shown us what can happen when they are not.

Appendix

The steady state current account deficit

Let α be the constant ratio of the external current account deficit to GDP. Let Y be nominal GDP, g the real growth rate of GDP, and \dot{p} the rate of international inflation. Let D be effective external debt (including the debt equivalent of foreign direct investment). Let CA be the current account deficit. Then in a given year t :

$$1) \quad CA_t = \alpha Y_t = \alpha Y_0 e^{g+\dot{p}t}$$

External debt is the cumulation of all past current account deficits, or:

$$2) \quad D_t = \int CA_t = \alpha Y_0 \int e^{g+\dot{p}t} = \alpha Y_0 \frac{1}{g+\dot{p}} e^{g+\dot{p}t}$$

Defining Z as the ratio of external debt to GDP, we have:

$$3) \quad Z_t = \frac{D_t}{Y_t} = \frac{\alpha Y_0 \frac{1}{g+\dot{p}} e^{g+\dot{p}t}}{Y_0 e^{g+\dot{p}t}} = \frac{\alpha}{g+\dot{p}}$$

From past experience, a safe ceiling for the ratio of external debt to GDP might be on the order of $Z = 0.4$. If real growth is 5 percent and world inflation is 3 percent,

equation 3 means that the safe upper limit on the external deficit as a fraction of GDP is 3.2 percent ($0.4 = \alpha/[0.05+0.03]$; $\alpha = 0.032$).

Notes

1. As for foresight, Dornbusch (1994) issued the most prominent early warning. Cline (1991) warned about an excessive external deficit even earlier.

2. Lawson (personal communication) now argues that he meant the theory to apply only to industrial countries, and moreover, that he did not promise painless adjustment.

3. Fiscal balance in 1994 was not quite as clear-cut as it might be, considering an expansion of about 2 percent of GDP in lending through development banks.

4. Defenders of Mexico's exchange rate level in 1994 point to brisk export growth. However, they do not mention the spectacular growth in imports in response not only to real appreciation but also to trade liberalization.

5. The third consideration technically would be neutral if there were a corresponding decline in U.S. capital flows to Mexico.

6. For Latin America as a whole, interest payments (accrual basis) relative to exports of goods and services fell from 38.7 percent in 1982–83 to 28 percent in 1988–89, 20 percent in 1992–93, and 19.1 percent in 1994 (ECLAC 1994).

7. Much of the 40 percent inflation expected for 1995 will have been concentrated in the first part of the year because of the one-time effects of a 100 percent exchange rate movement.

8. This greater control is also the reason why the industrial countries are unlikely to simply grant the IMF the right to borrow in private capital markets.

9. It is unclear that such designation could in fact preclude court challenges to a country's suspension of payment.

10. Although this arrangement would have been irrelevant for Mexican tesobonos, as they were not issued in foreign markets.

11. Unfortunately, the principal present case of controls on capital outflows is that of Venezuela, which may closer approximate their use to mask severe policy distortions rather than in an optimal way.

12. Authorities in Argentina and Chile seem to have arrived at about the same estimate of the safe ceiling, although using different approaches from the analysis here.

13. A statistical examination of bond yields in the early 1990s in Cline (1995) finds support for the notion of rational lending, as spreads above U.S. treasury bonds vary rationally with differing country performance on such measures as inflation and export growth. There is even an empirical pattern of a reputational penalty of about 85 basis points for those countries that engaged in Brady debt forgiveness rather than honoring their full original debts.

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Comment on the "Capital Markets After the Mexican Peso Crisis," by William Cline

M A R C I L I O M A R Q U E S M O R E I R A

UNTIL THE 1994 MEXICO CRISIS IT WAS ARGUED THAT ECONOMIC REFORM SHOULD PRECEDE political reform, since political reform was much easier to implement with a stable economy in place. But the Mexico crisis taught us to challenge the logic of that strategy as well as to stress the link between political democratization and market reform. The link is freedom and creativity, which are at the center of democracy and market economies.

Reform of the state requires a strong government, a more profound engagement of citizen participation, and strong governance where all actors work together toward greater participation of the social community.

The potential incompatibility between the political and economic cycles in a presidential regime can prove problematic. The political cycle is typically one in which the first year is spent settling in, the second year on savings, the third on taking action, and the fourth on spending. This pattern may be contrary to appropriate economic policy at the time. In Mexico sound economic policy was sacrificed to political considerations as the government tried to counteract the lack of foreign inflows by increasing credit, the monetary base, and money supply. Contradictions between the economic and political cycles are sometimes made worse by the international financial institutions when, at the end of the political cycle, they refuse to negotiate with the current government.

When analyzing crises, it is common to identify political triggers. But it is important not to confuse triggers with causes. For example, the assassination of Colosio, a political trigger of the Mexican crisis, was incorrectly iden-

tified as the cause. By reacting to the trigger (Colosio) instead of the cause (the Greenspan Plan), Mexico financed the flight of \$30 billion in just a few months.

Although some analysts argue for capital flow control, the destination and the matching of long- and short-term uses of these flows are more important. For example, Brazil's current account deficit stayed at zero from 1990 to 1994 without controls. This was accomplished by putting 100 percent of the flows into reserves as assurance against the unexpected. In this way capital flow quotas were avoided. Short-term capital should be used as working capital and not for investment.

The Mexico crisis emphasizes the importance of political democratization, ethical evolution, and social development. It also highlights the importance of an independent and efficient judiciary, open political debate, efficient governments with citizen participation, and full, timely, and reliable production, disclosure, and transparency of statistics. Finally, Mexico has taught us that the unexpected should always be factored in as part of the equation.

Marcilio Marques Moreira is former minister of finance of Brazil.

Comment on the “Capital Markets After the Mexican Peso Crisis,” by William Cline

S U M A N B E R Y

ALTERNATIVE FACTORS, UNRELATED TO CAPITAL FLOWS, SHOULD BE CONSIDERED WHEN looking for explanations for what went wrong in Mexico. In 1994 Mexico experienced fixed exchange rates, substantial credit expansion, and loss of federal reserves. Such events are likely to produce difficulties under any circumstances. Moreover, in 1994 Mexico was undergoing stabilization. As history has shown, consumption booms are a likely outcome of stabilization periods.

Developing countries are small relative to the capital that is being channeled their way. Instead of trying to keep current account deficits under control by segregating and controlling capital inflows—a strategy that introduces a great number of distortions into the economy—

developing countries should consider nondiscretionary, countercyclical instruments that do not interfere with their right to absorb the capital that the rest of the world wants to send to them.

Suman Bery is economic adviser to the Latin America and the Caribbean Regional Office at the World Bank.

Floor Discussion of "Capital Markets After the Mexican Peso Crisis," by William Cline

A MEMBER OF THE AUDIENCE POINTED OUT THAT THE INABILITY TO EMPIRICALLY PROVE that the Mexican crisis was caused by factors related to financial management leads us to search for other, political explanations. As a result the basic causes of the crisis have not been clearly identified. However, we should not resort to alternative explanations related to Mexico's political or democratic structure to explain why and how the crisis occurred. Instead we should recognize that the Mexico crisis was rooted in the financial management of internal public debt.

At the end of 1987, the speaker continued, most of Mexico's credit portfolio was assigned to the public sector. As a result internal debt was significantly amortized and elevated. Debt then took the form of short-term public debt through the sale of CETES. The sale of these instruments, in essence, led to a substitution of public for private debt.

The quasi-automatic way in which the denomination of this debt changed from national currency to indexed dollars (with the change from CETES to tesobonos) negatively influenced the reserves of the Bank of Mexico. Their reserves, converted to short-term debt in dollars, reached extremely low levels simply because of the change to tesobonos and the abuse of CETES. The International Monetary Fund and the Treasury provided sufficient resources to convert the tesobonos and short-term debt to longer-term debt, thus helping to resolve the crisis.

An economy that enters into a free trade agreement such as NAFTA needs freedom in managing its capital account

and balance of payments. For this reason, rules for managing the current account should not be enforced. Instead the capital account should be managed based on the natural evolution of fundamental economic variables such as investment behavior and internal savings. Fixing rules to manage debt goes against the basic orientation of market economies.

Others speakers believed that Mexico provides an additional valuable lesson: the models we use today can be bad examples tomorrow. Still others thought that the crisis in Mexico resulted from financial mismanagement of debt.

Before the crisis, an audience member noted, the economic team in Mexico was considered to be one of the best in the world. After the crisis it is said that they made mistakes. Before the crisis the international financial institutions considered the Mexican economy to be a model in terms of reforms and processes. After the crisis it is viewed as a model to avoid. Something should be done at the international level to avoid similar events in other economies.

ROUNDTABLE DISCUSSION

Latin America and the Caribbean in the Postadjustment Era

THIS SESSION WAS CHAIRED BY SHAHID JAVED BURKI. CARLOS LANGONI IS DIRECTOR OF THE Getulio Vargas Foundation and former president of the Central Bank of Brazil. Marta Maurás Pérez is regional director of the United Nations Children's Fund (UNICEF) in Colombia. Brian Stewart is deputy director of the Western Hemisphere Department at the International Monetary Fund.

Carlos Langoni

Four fundamental questions should be asked with respect to the themes of this conference: Is it possible to speak of Latin America's development in both a quantitative and qualitative sense? How successful has the region's new wave of reform been? What are the prospects and challenges for the near future? And is there reason for optimism when looking toward the region's future?

The answer to the first question is clearly yes. A cultural revolution is taking place, not just isolated events. In most countries reform is taking place in a democratic setting—or at least in a setting in transition to democracy. In any event the current development process is qualitatively distinct from anything the region has experienced so far.

The answer to the second question depends on how success is defined. If success means the ability to implement reform then the results are positive, despite the different pace of development in each country. But concrete results in achieving sustained development have been small, even disappointing. And in some cases economic retrocession has occurred.

The divide between implementation efforts and concrete results shows that reform is a complex process in Latin America. For example, Chile is the only country in Latin America that has achieved sustained growth with democracy. But, strangely enough, most of its structural economic

reforms took place at the height of an authoritarian regime. In Argentina and Mexico, where conditions seemed to indicate advances toward stability, reforms have faltered. Now these countries face the difficult task of restoring expectations and correcting course. In Venezuela reforms have failed because of political crises. In Bolivia, despite success in controlling hyperinflation, growth has not taken place. Finally, there are countries like Brazil, where the political situation precluded effective structural reforms until recently.

The least progress has been achieved in social reform. In many countries modernization has worsened income distribution, increased the number of low-level jobs, and in some cases led to the emergence of absolute poverty. Few creative changes have been implemented in terms of social and political reform.

Answering the third question requires careful attention to the relevance and impact of political factors. Unpredictable political factors can quickly destabilize reform. Also, small macroeconomic mistakes have serious consequences in today's international market and can result in a reversal of capital flows. Thus the management of external accounts, exchange rates, and fiscal and monetary policies is also a challenge. In a broader sense, the challenge is to create and maintain conditions for sustained expansion of exports and direct investments as well as macroeconom-

ic stability. Increasing domestic savings is another challenge, and one that will require broad fiscal reforms. In addition, conditions for continuous expansion of private savings need to be created.

Social reform is the biggest challenge, however. Investment in human capital and education is the fundamental variable that will reduce growth conflicts, inequality, and poverty. But this challenge will not be resolved through quantitative expansion. Instead, qualitative improvement of the education system is required.

Finally, in answering the fourth question, it is important to take a realistic view of reform. But there is reason to be optimistic about Latin America's future. Social progress has moved ahead of political progress, indicating that there is social demand for change. These forces will allow reforms to advance and make them more difficult to reverse. Moreover, sources of growth are more sustainable than in the past. Growth will result from productivity gains generated by the private sector.

Reducing inequalities is a long-term process, and distortions and inequalities will be with us for some time. In the meantime attaining social harmony will require ensuring political stability until income inequalities are resolved. The virtuous cycle that is the region's goal should be thought of as a process that sustains growth, increases savings, and gradually improves income distribution. If this can be achieved, the words "the new Latin America" will change from rhetoric to reality.

Marta Maurás Pérez

The discussions of the past two days evoked three important issues: social equity, the timing of reforms, and education, democracy, and children.

Although fiscal reforms are being implemented throughout Latin America, social and political reforms have not been sufficiently developed. As a result Latin American societies are having a hard time getting on their feet. Poor national performance, low levels of employment (especially among women and youth), and poor distribution of income contribute to this problem.

In modern societies poor income distribution can be corrected by improving tax collections and by targeting social expenditures. One suggestion in terms of tax collection can be found in Edward Wolf's book *Top Heavy*. Wolf suggests that, in the United States, taxing a few at 10 percent of

their wealth (wealth being determined by household assets minus liabilities) could generate sufficient resources to pay for the subsidies being cut.

On social spending, the social reform needed to complement economic reform has not occurred. For the social sector to grow, more needs to be done to empower people. Transforming a culture from one that satisfies needs to one that guarantees rights is also critical to achieving social reform.

National performance as measured by under-five mortality rates and per capita income and by children reaching fifth grade and per capita income is low throughout Latin America. In 1993 the region's national performance in terms of under-five mortality rates and per capita income was negative in nine of twenty-two countries. That is, in nine countries there was less improvement in under-five mortality rates than expected, given their per capita incomes. By comparison, in Southeast Asia only one of thirteen countries had a negative performance gap. For children reaching fifth grade, fourteen of twenty countries in Latin America and the Caribbean showed negative performance. In Southeast Asia only one of eleven countries for which data were available recorded negative figures.

Although economic reforms in Latin America and the Caribbean in recent years have caused nearly 4 percent growth in production, the region has not been successful in generating employment, especially for women and young people. This gap accentuates the complexity of disparities among regions and ethnic groups and between the sexes and age groups.

Productive institutional transformation needs to be guided by human concerns, and human concerns are not met by economic adjustment and growth. For example, controlling inflation does not necessarily lead women to deliver healthier babies, nor do children go to better schools or receive better education. Cultural transformation is required to make reform sustainable in the hearts and minds of people. Within this framework, disparate interests need to converge and local participation and democratization of information for decisionmaking must be developed.

Human capital formation is related to competitiveness as well as to productivity. It is related to the need to instill values such as cooperation, solidarity, altruism, citizenship, innovation, and creativity from early ages. If we focus on

human capital formation in that way, if schools can teach us to live together and instill knowledge in their students, and if education is put at the center of integrated social policies, then the countries of Latin America and the Caribbean will be able to participate as equal partners in the opening of global economies.

There is reason to be optimistic about the future. Mexico has sent a wake-up call to the world about the importance of implementing the first phase of reforms and beginning the second phase. This second phase will require careful attention to poverty and inequality.

Brian Stewart

Three areas of consensus have emerged at this conference. First, we must maintain the fiscal controls and macroeconomic balance that have been achieved in most of the region's economies over the past five years. Second, we cannot solve the problems that remain in Latin America simply by throwing more money at them. No one has claimed that the countries in the region need to run larger current account deficits or that they need to borrow more to deal with the problems that remain. Third, we must improve the quality of public administration, social programs, and social spending.

More generally, though, we need to change the way we think about the problems facing Latin America. There is a difference between the political support needed for the remaining reforms and that needed for the macroeconomic adjustment and structural reforms that have already taken place. Although the practical implications of this distinction are not clear, political leadership and education have taken on greater importance than in the past.

The International Monetary Fund will continue to provide policy advice, technical assistance, and financing for countries as well as continue to collaborate with the World Bank and the Inter-American Development Bank in their support for the social and structural reforms in Latin American and the Caribbean.

Today's world is much riskier and more intertwined than we recognized even six months ago. Events in one country can affect events in another much more quickly and severely than we thought—regardless of the distance between them. Thus the Fund's role in the new postadjustment era must be more active than was originally thought. The Fund will play a more active role in supporting adjustment programs, helping countries identify and address problems, and surveying the exchange rates and other macroeconomic policies of its member countries.

The Mexico crisis has uncovered the Fund's need to adapt surveillance procedures to minimize the risk of crises in the new global economic environment. Procedural changes will involve stricter requirements for the regular and timely communication of key economic indicators; the establishment of standards for timely publication of economic data that enable markets to work more efficiently; continuous policy dialogue with all member countries, including adjusting internal procedures to bring country matters to the attention of the executive board; more regular visits to member countries; and more board meetings. More pointed and candid surveillance procedures also imply more critical dialogue than in the past.

The Fund will review its quotas and explore ways to borrow money from its members. Consideration will also be given to the use of Special Drawing Rights, international reserves that the Fund can draw on to support strong policy programs, and to making permanent the concessional fund facility available to the poorest member countries. Preliminary work, similar to an international bankruptcy proceeding, has started on the development of a system to work out country debt.

The postadjustment era looks different than it did six months ago. But the objectives and policy framework for achieving lasting and equitable growth are basically the same.

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