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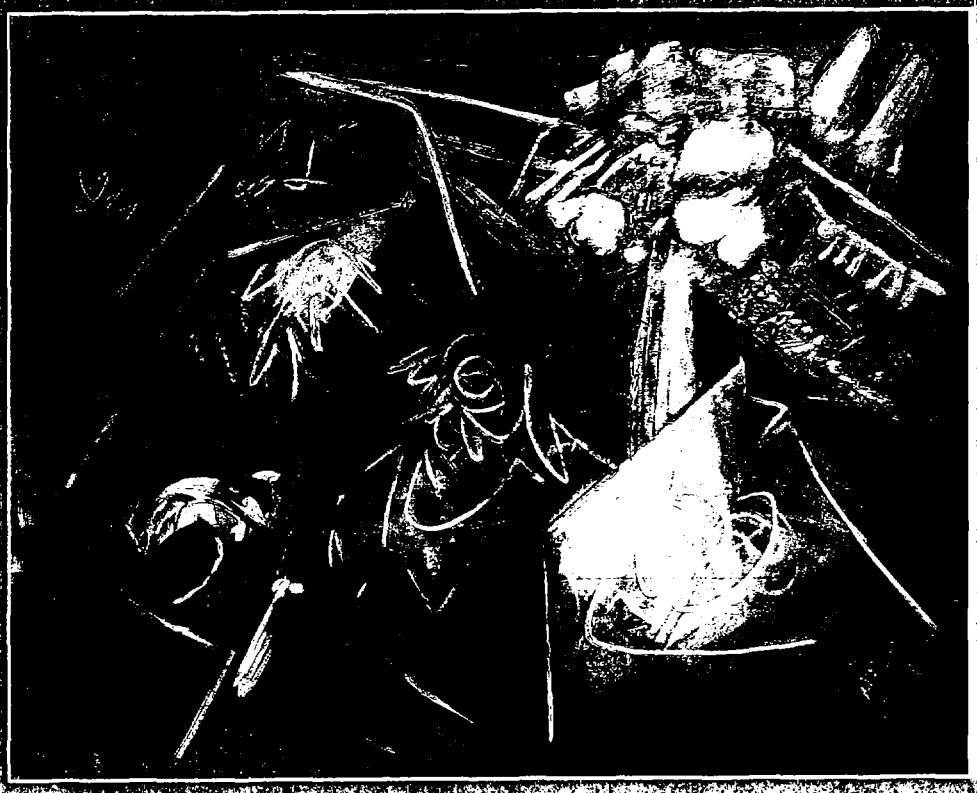
Dismantling the Populist State

The Unfinished Revolution in Latin America and the Caribbean



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INTRODUCTION

IN THE AFTERMATH OF THE MEXICAN PESO CRISIS the Latin American economies proved that they are structurally healthy and resilient to external disturbances. Following the peso meltdown, the much feared economic collapse of the region failed to materialize.[2] As we pointed out a year ago in *Latin America After Mexico: Quickening the Pace*, the Mexican crisis was a "wake up" call for the Latin American nations: In most countries political leaders are increasingly aware that the reform process is a never-ending challenge. Regional leaders are now dealing with dismantling the economic and social structures of the traditional Latin American state, including its populist institutions, while inventing and constructing its successor: the modern, efficient, administrative state. This process is, however, economically and politically difficult and, if not managed carefully, it can have negative effects on social conditions. With democratic rule solidified in virtually every country, it is increasingly less possible to implement reforms by decree. A major challenge that the region's leaders will face in the years to come, therefore, is to obtain and maintain voter support in order to proceed with the necessary reform of the state.

The great risk is that failure to tackle the complex and politically charged institutional reforms—reforms for which there are few adequate or appropriate blueprints—will distort the hard won accomplishments of the first phase of the process. If broad segments of the population perceive that they are being excluded from the gains, despite having shared the pain, the probability of a backlash becomes palpable. In turn, such a reaction would be likely to dissolve the

Table 1. Real GDP Growth in Latin America and the Caribbean
(percentages)

	1991	1992	1993	1994	1995	1996	1997
Argentina	8.9	8.6	6.0	7.4	-4.4	2.5	4.0
Bolivia	4.6	2.8	4.1	4.2	3.8	4.4	4.4
Brazil	0.4	-1.2	5.3	5.8	4.2	3.5	4.2
Chile	7.2	11.0	6.2	4.2	8.4	6.5	6.5
Colombia	2.0	4.0	5.2	5.7	5.3	4.5	4.0
Costa Rica	2.2	7.7	6.1	4.5	2.5	3.0	4.5
Dominican Republic	0.9	7.8	2.9	4.3	4.8	3.5	3.0
Ecuador	5.0	3.6	2.0	4.0	2.5	3.0	3.8
El Salvador	3.9	5.0	5.9	6.2	6.0	4.5	5.0
Guatemala	3.7	4.8	3.9	4.0	5.0	4.5	4.5
Guyana	6.1	7.8	8.3	8.5	5.1	6.3	5.0
Haiti	-3.0	-14.8	-2.6	-10.6	4.5	3.0	3.0
Honduras	3.1	5.6	3.9	-1.5	3.6	4.5	4.5
Jamaica	0.8	1.8	2.0	0.8	0.5	2.0	3.0
Mexico	3.6	3.0	0.4	3.5	-6.9	2.0	3.0
Nicaragua	-0.7	0.8	-0.7	3.3	4.2	4.7	5.0
Panama	9.6	8.5	5.4	4.7	3.5	4.0	4.0
Paraguay	2.4	1.8	4.1	3.5	4.2	3.5	4.5
Peru	2.9	-1.8	5.9	12.8	6.9	3.0	4.0
Trinidad and Tobago	-2.7	-1.7	-1.6	4.2	3.5	4.5	4.0
Uruguay	3.2	7.4	2.5	5.1	-2.5	1.0	2.5
Venezuela	9.7	6.1	0.3	-2.8	2.2	0.5	4.5
Mean	3.4	3.6	3.4	3.7	3.0	3.6	4.1
GDP-Weighted Mean	3.5	2.7	3.9	4.9	0.8	3.1	4.0
Weighted Mean, w/o Mex. & Arg.			4.5	4.9	4.3	3.5	4.3
Median	3.1	4.4	4.0	4.2	4.0	3.5	4.1

Source: World Bank. Projections by LAC Region Lead Economists.

political will of the region's leaders, making the reconstruction and invention of the kinds of institutions required to spread the benefits ever more difficult. The region faces, yet again, the dangers of entering a vicious circle.

Although Latin America overcame the most pessimistic post-Mexican crisis forecasts, economic growth was too anemic to keep poverty from growing. During 1995, and largely as a result of Mexico's tailspin, Latin America and the Caribbean grew at modest rates—0.8 percent, compared with 4.89 percent in 1994. On the positive side, inflation continued to decline, and the regional current account deficit was barely above 2 percent of GDP. Largely because of the crisis in Mexico, the entire region has suffered a setback that, given the feeble forecast for 1996, will have lasted for two years. For 1996 we predict overall GDP growth of 3.1 percent, a further reduction in inflation, and a current account deficit of the order of 2 percent of GDP. [See Tables 1, 2 and 3.][3] The Latin American recovery is proceeding at a slower pace than was anticipated by most analysts, ourselves included.

The slow recovery of the regional economies is troublesome for a number of economic, social and political reasons. In many countries, modest economic performance over the last few years is generating impatience and a sense of disappointment with the reform process. An increasing number of people are disillusioned and beginning to look at policy alternatives. Although this disenchantment has not been translated into an activist "anti-reform" movement, it is slowly generating "reform-skepticism." What makes this particularly disturbing is that the reform-skeptics do not have a coherent plan and tend to offer an assortment of mutually inconsistent policies with an unmistakable populist flavor.

This slowly growing disappointment has been reflected, for example, in the strong showing of the anti-reform candidate, Abdala Bucaram, in Ecuador's recent presidential elections, and in the decline in the approval ratings

Table 2. Inflation in Latin America and the Caribbean
(change in CPI, percentages)

	1991	1992	1993	1994	1995	1996	1997
Argentina	84.0	18.6	8.0	3.9	1.6	2.4	2.5
Bolivia	21.4	12.1	8.5	7.9	10.2	11.0	6.4
Brazil	475.1	1,131.5	2,541.0	929.3	21.1	15.0	15.0
Chile	21.8	15.4	12.7	11.4	8.2	6.5	5.5
Colombia	26.8	25.1	22.6	22.6	19.5	22.0	20.0
Costa Rica	28.7	21.8	9.8	20.0	22.0	12.6	10.0
Dominican Republic	53.9	4.6	4.8	8.3	12.5	15.0	10.0
Ecuador	49.0	60.2	31.0	25.4	22.8	19.5	18.0
El Salvador	9.8	19.9	12.1	10.6	10.1	8.7	6.0
Guatemala	35.1	10.2	13.4	12.6	8.6	9.0	7.0
Guyana	101.5	28.2	11.7	13.6	12.1	5.4	4.2
Haiti	6.6	17.5	26.9	42.6	21.1	20.0	17.0
Honduras	21.5	6.5	13.0	21.7	29.5	16.5	8.0
Jamaica	68.6	57.5	24.5	32.0	25.5	15.0	12.0
Mexico	18.7	11.9	8.0	7.1	52.0	26.0	12.5
Nicaragua	2,740.0	20.3	20.4	7.7	11.2	9.9	7.6
Panama	1.3	1.8	0.5	1.3	0.9	1.3	1.3
Paraguay	24.3	15.1	18.3	20.6	10.5	10.0	8.0
Peru	409.5	73.5	48.6	23.7	11.7	10.1	7.0
Trinidad and Tobago	3.8	6.5	11.1	8.5	5.3	4.2	3.5
Uruguay	81.5	58.9	52.9	44.1	35.4	20.0	15.0
Venezuela	31.0	31.9	45.9	70.8	56.6	70.0	30.0
Mean	196.1	75.0	133.9	61.2	18.6	14.6	10.3
GDP-Weighted Mean	228.6	434.6	920.5	348.5	25.1	17.7	12.7
Median	29.9	19.3	13.2	16.8	12.3	11.8	8.0

Source: World Bank. Projections provided by LAC Region Lead Economists.

of presidents Fernando Henrique Cardoso in Brazil, Alberto Fujimori in Peru and Carlos Menem in Argentina.[4]

Reversing the course or backtracking on the reforms effort would be a tragic mistake. Policy reversals and aborted reforms are common in Latin America's history and invariably resulted in still greater setbacks and frustration. Equally harmful would be wide acceptance of the opinion that it is now possible to lower the guard on the macroeconomic front. The region's macroeconomic stability was won only with tremendous effort and remains fragile. There is overwhelming international evidence indicating that macroeconomic stability is a precondition for rapid and sustained growth. Renewing support for the reform program is one of the most fundamental and difficult challenges that Latin American governments face in the immediate future. In order to maintain—or increase—voter support for the reforms it will be necessary to achieve the following interrelated and concrete results:

- Generate, sooner rather than later, a significant revival of growth. In order for this growth to have the desired economic, social and political effects, it will have to be inclusionary, benefiting broader segments of the population.

- Consolidate the early achievements of the reforms, especially the virtual eradication of inflation.

- Address some of the most pressing social concerns of the population, including the elimination—or substantial reduction—of corruption, the reduction of overall violence and crime, and improvement in the delivery of social services, such as education and health.

- Reduce the extent of poverty and inequality, particularly in the region's megacities and among the rural indigenous populations.

Table 3. Current Account Balances in Latin America and the Caribbean
(percentages of GDP)

	1991	1992	1993	1994	1995	1996	1997
Argentina	-1.5	-3.7	-4.1	-3.6	-1.4	-1.9	-1.9
Bolivia	-5.2	-7.8	-8.8	-4.0	-6.3	-8.8	-9.9
Brazil	-0.3	1.5	-0.2	-0.3	-2.7	-1.9	-1.8
Chile	0.4	-1.8	-4.8	-1.4	-1.1	-2.0	-2.5
Colombia	5.5	1.8	-3.9	-4.6	-5.3	-6.2	-6.0
Costa Rica	5.4	1.5	-4.2	-1.9	-1.4	-2.7	-2.5
Dominican Republic	-2.1	-6.8	-1.5	-2.0	-0.5	-2.0	-1.8
Ecuador	-5.7	-1.3	-4.4	-4.9	-4.9	-3.9	-3.4
El Salvador	-5.0	-5.8	-3.9	-3.7	-5.5	-4.7	-4.4
Guatemala	-2.7	-7.6	-6.6	-6.0	-4.5	-5.0	-4.5
Guyana	-39.8	-21.6	-21.7	-9.8	-12.8	-9.4	-10.3
Haiti	-12.9	-6.9	-11.4	-6.9	-21.6	-18.2	-14.0
Honduras	-5.0	-6.6	-9.2	-11.8	-7.5	-7.4	-6.6
Jamaica	-4.9	-0.1	-4.3	-1.0	-4.5	1.1	3.1
Mexico	-5.1	-7.4	-6.4	-7.7	-0.2	-1.0	-1.3
Nicaragua	-48.9	-54.6	-48.9	-54.0	-36.2	-34.7	-23.2
Panama	-1.9	-5.7	-6.6	-6.9	-6.4	-4.2	-4.2
Paraguay	-8.7	-9.5	-12.2	-9.6	-14.6	-13.6	-13.3
Peru	-1.9	-3.9	-4.1	-4.2	-6.4	-4.0	-3.9
Trinidad and Tobago	-0.6	2.0	1.6	3.9	3.6	1.5	2.5
Uruguay	0.4	-1.0	-2.4	-2.5	-2.9	-1.9	-1.6
Venezuela	3.3	-6.2	-3.3	4.2	2.5	3.8	2.6
Mean	-6.2	-6.9	-7.8	-6.3	-6.4	-5.8	-5.0
GDP-Weighted Mean	-1.4	-2.6	-3.4	-2.9	-2.2	-2.1	-2.1
Median	-2.4	-5.8	-4.4	-4.1	-4.7	-4.0	-3.7

Source: World Bank. Projections provided by LAC Region Lead Economists.

Achieving these interrelated goals will only be possible if the reform process is broadened to new spheres, including disassembling the remains of the old populist structures, the creation of new institutions and the rebuilding of the state—the key elements of second generation reforms.

In last year's *Quickening the Pace* we argued that if the Latin American countries were able to implement a number of key reforms affecting labor markets, education, social security and the institutions of the state, it would be possible for the region's rate of growth to accelerate significantly in the medium run. We believe that this jump in economic performance is still feasible, but that it will probably take somewhat longer to materialize. There are two reasons: First, the modest performance of 1995 suggests that the recovery from the "tequila" episode will be slower than we anticipated. Second, the needed institutional "second generation" reforms are technically very difficult, and are likely to take time to be implemented and to generate their beneficial effects.[5] Countries will tend to proceed cautiously, and mistakes are likely to be made. This process may generate frustration and, at times, disenchantment. A great deal of leadership and consensus-building will be needed to push forward with the much needed next phase of the reform process.

This paper is the second annual report by the Office of the Latin America and Caribbean Regional Vice President of the World Bank on the state of the region's economies. The first report—*Latin America After Mexico: Quickening the Pace*—dealt with the direct consequences of the Mexican crisis, including the probability of a contagion effect. This year we focus on some of the most important challenges that the region will have to face in order to dismantle the old populist state and create the new one, essential for moving effectively toward recovery and take-off. Throughout the analysis we deal with some important political economy issues related to the pending reforms and some of their most important ramifications. Section II provides a general overview of recent developments. In Section III

we address five systemic issues that are attracting ever more attention from regional policy makers: high real interest rates; high and increasing unemployment rates; low domestic savings rates; a slowdown in exports growth; and the need to rebuild the weakened state. In Section IV we deal with the future of the reforms, and we concentrate on the need to consolidate macroeconomic stability and on social sector policies, such as education, health and labor reforms. Section V is a challenge to new thinking and action in our attempts to define and build the new Latin American state. Section VI contains the concluding remarks. The paper also has an Appendix that deals in greater detail with selected country performance.

II REGIONAL DEVELOPMENTS IN 1995–96

CAPITAL INFLOWS INTO LATIN AMERICA plummeted as a consequence of the Mexican peso crisis. During 1995 net capital inflows amounted to US$33.9 billion, compared with US$49.7 billion in 1994 and US$58.8 billion in the first half of the same period in 1994 and US$58.8 billion in 1993, forcing almost every country to implement deep macroeconomic adjustments. [See Table 4.] Almost everywhere monetary policy was tightened and aggregate expenditure was cut. By the end of the year the region had reduced its current account deficit from 2.9 percent of GDP to 2.2 percent of GDP.[6] During the first half of 1995 there was considerable concern over the probability that the Mexican crisis would generate a major contagion effect throughout the region. International investors quickly realized, however, that there were significant differences among Latin American countries and that in the vast majority of them the economic fundamentals were healthy.

Remarkably, and in contrast with previous crises, during 1995–96 the region was able to implement a major current account adjustment while at the same time bringing inflation down. By mid-1996 the speculative attacks on the regional economies were largely contained. Capital once again moved into some countries, stock markets recovered, as did the prices of the region's Brady bonds. However, as pointed out above, growth lagged behind.

The resumption of vigorous growth, while maintaining macroeconomic stability, is probably the most fundamental short-term challenge the Latin American nations face. Without substantially higher growth, it will not be possible to even begin to satisfy the social demands that are being

Table 4. Net Private Capital Flows to LAC and Other Developing Countries
(US$ billions)

	1991	1992	1993	1994	1995(p)
I. TOTAL					
All LDCs	61.6	100.3	154.2	158.8	167.1
LAC	22.7	30.4	58.8	49.7	33.9
Mexico	11.9	9.2	21.9	17.4	10.9
Brazil	3.2	9.7	16.1	11.9	6.9
Argentina	2.9	5.8	13.7	8.2	8.8
Rest of LAC	4.7	5.7	7.1	12.2	7.3
II. NET FDI					
All LDCs	35.0	46.6	68.3	80.1	90.3
LAC	12.6	14.5	15.7	20.8	17.8
Mexico	4.7	4.4	4.4	8.0	4.1
Brazil	1.1	2.1	1.3	3.1	3.1
Argentina	2.4	4.2	6.3	1.2	3.9
Rest of LAC	4.4	3.8	3.7	8.5	6.7
III. PORTFOLIO DEBT					
All LDCs	12.8	13.2	38.3	32.2	33.7
LAC	4.1	4.7	19.8	12.7	n.a.
IV. PORTFOLIO EQUITY					
All LDCs	7.6	14.1	45.6	34.9	22.0
LAC	6.2	8.2	25.1	13.2	6.2
Mexico	4.4	5.4	14.3	4.5	n.a.
Brazil	0.8	1.7	5.5	5.1	n.a.
Argentina	0.4	0.4	3.6	1.2	n.a.
Rest of LAC	0.6	0.7	1.7	2.4	n.a.
OTHER NET FLOWS*					
All LDCs	6.2	26.4	2.0	11.6	21.1
LAC	-0.2	3.0	-1.8	3.0	n.a.

* Includes commercial bank loans and other private flows.

Source: World Bank, *World Debt Tables 1996.*

called for with increasing urgency. The good news is that after having withstood the consequences of the "tequila effect," most countries are now well positioned to move from adjustment toward accelerated growth. The bad news is that, contrary to what analysts expected in the early 1990s, the external environment has become increasingly volatile, and even hostile. The Mexican crisis had political ramifications in the United States that suggest that expansion of the North America Free Trade Area (NAFTA) will be slow in coming, if it happens at all in the near future. As a result, the countries in the area will have to devise new ways of becoming more closely integrated with the rest of the world—and among themselves through agreements such as Mercosur. New efforts are required to achieve more rapid export growth. Moreover, in the aftermath of the Mexican crisis, it is clearer that it is neither possible nor, perhaps, advisable to rely too heavily on foreign financing to supplement traditionally anemic domestic savings rates.

The modest growth performance in 1995 was, to a large extent, the result of negative growth in two large key countries—Argentina and Mexico—and very modest performance in Venezuela, the fourth largest economy in the region. In both Argentina and Mexico the reduction in foreign financing had a deeper effect on economic activity than most analysts predicted. In Argentina the temporary—and we believe unjustified—loss of international investor confidence led to a significant liquidity squeeze, very high real interest rates, a significant increase in unemployment and a major reduction in domestic activity. In Mexico, on the other hand, the need to shore up the peso and to meet the adjustment program targets also resulted in very high interest

rates during 1995 and the early part of 1996, a deep decline in internal demand, a weakening of the banking system and a sharp increase in unemployment. In both nations the weak position of the banking system contributed to poor GDP performance. Investors—international and domestic—feared that a collapse of important banks could result in major economic dislocations, massive and costly bailout programs, and a resurgence of inflation. In the case of Argentina the weakness of the banking sector affected the credibility of the convertibility program and, in particular, confidence in the inviolability of the exchange rate regime.

On the positive side, in both Argentina and Mexico exports responded in a very positive way to the new economic circumstances, growing at 17.1 percent and 24.5 percent, respectively, in volume during 1995. [See Table 5.] In Mexico the surge in export growth is the result of both a more competitive real exchange rate and lower internal demand. In Argentina, on the other hand, export expansion was the result of lower domestic activity and higher productivity, as well as increased demand from its Mercosur partner, Brazil. The dollar value of Argentine exports to Brazil grew at an average rate of of 45.6 percent during the last three years.[7] Both countries, like the rest of the region, have benefited from improved international prices.

During the next 18 months, a rapid recovery of these economies will require maintaining the momentum in export expansion, as well as a significant increase in the level of internal demand, especially in investment. We address these issues in greater detail in the Appendix.

Venezuela's poor performance in 1995 was the result of a very different set of circumstances. For a number of years the Venezuelan authorities negated the basic realities of modern economics. Fiscal policy was very expansive (the deficit exceeded 8 percent of GDP), credit expansion was rampant, and exchange controls were maintained for almost two years. These policies generated major distortions, heightened uncertainty and widespread speculation. The continuing crisis of the Venezuelan banking system also contributed to the country's modest growth in 1994–95.

Table 5. Latin American Export Performance: Rates of Growth of Export Values and Quantities
(percentages)

	Year	*Value*	*Quantum*
Argentina	1993	7.2	5.1
	1994	20.8	18.4
	1995	30.1	17.1
Brazil	1993	8.4	10.6
	1994	12.3	5.5
	1995	7.9	-2.8
Chile	1993	-8.1	2.9
	1994	25.4	8.6
	1995	37.8	12.5
Colombia	1993	2.3	7.0
	1994	17.9	0.7
	1995	22.5	0.8
Mexico	1993	12.3	5.8
	1994	17.3	11.8
	1995	33.2	24.5
Peru	1993	-0.6	8.0
	1994	31.5	15.4
	1995	20.3	0.3
Venezuela	1993	0.1	6.7
	1994	10.4	8.8
	1995	16.5	5.4
South America	1993	4.3	8.1
	1994	16.0	7.9
	1995	17.5	3.6
Central America and the Caribbean	1993	6.8	7.1
	1994	14.8	7.9
	1995	17.0	2.9
LAC Total	1993	7.0	7.3
	1994	16.4	9.2
	1995	22.7	10.5
LAC Median (20 countries)	1993	6.2	5.9
	1994	17.3	8.7
	1995	22.5	4.4

Source: ECLAC, *Preliminary Overview of the Latin American and Caribbean Economy, 1995*, table A.9, p. 55.

Paradoxically, the reluctance to implement minimal, and obviously necessary stabilization measures resulted in a steep deterioration in living conditions among the Venezuelan poor. Indeed, the postponement of adjustment generated exactly the kind of social costs—including serious political unrest—that the country's political leadership had tried to avoid.[8] A vastly ambitious adjustment program was announced in April, 1996. Although it is too early to know what the final outcome of this program will be, preliminary signals are encouraging.

The region's low average growth tends to hide the fact that a number of medium size and smaller countries experienced solid growth dur-

Table 6. Poverty in Latin America and the Caribbean
(percentage of population living in poverty, headcount index)

Country (year of surveys)	*Poverty*			*Extreme Poverty*		
	Early 1980s	*Mid/Late 1980s*	*1990s*	*Early 1980s*	*Mid/Late 1980s*	*1990s*
Argentina (1980, 86, 93)	16.2	51.1	17.6	3.3	21.1	3.4
Bolivia (1992)			72.0			
Brazil (1980, 86, 90)	39.0	40.0	43.0			
Chile (1987, 92)		28.0	24.0		17.0	9.0
Colombia (1988, 92)		33.8	34.6		18.7	18.8
Dominican Rep. (1992)			20.6			9.0
Ecuador (1994)			35.0			15.0
El Salvador (1992)			38.3			9.9
Guatemala (1989)		75.2			57.9	
Honduras (1989, 93)		55.0	53.0		36.0	32.0
Mexico (1984, 89, 92)	24.8	27.5	25.9	6.1	7.7	8.2
Nicaragua (1993)			50.3			19.4
Paraguay (1990)			20.5			3.5
Peru (1982, 89, 92)	46.0	52.0	53.7	21.0	25.0	21.2
Uruguay (1980, 86)	11.0	15.0				
Venezuela (1982, 89)	22.3	31.4		10.3	22.3	

Source: World Bank.

ing 1995. For example, Chile, Colombia, El Salvador and Guyana grew at rates above 5 percent. Peru also had an impressive growth rate in 1995—over 5 percent—although its economy slowed down significantly by the end of the year. As Table 1 shows, however, with the exception of Guyana, a slowdown in economic activity is expected in all of these countries for 1996. We predict that in the majority of them, as in most of the region, inflation will continue to decline and the current account will be kept at sustainable levels.

Inflation dropped dramatically for Latin America as a whole from an average of 61.2 percent in 1994 to 18.6 percent in 1995. The success of Brazil's *real* plan highlighted the region's anti-inflation efforts, as it pushed inflation down from almost 1,000 percent to 21.1 percent a year later. Latin American countries did not relax their fight against inflation in spite of the macroeconomic rumble touched off by Mexico, in sharp contrast to the past when crises exacerbated inflation. [See Table 2.]

Social conditions are an area of growing concern in Latin America and the Caribbean. Even though data on the social sectors become available with a lag, there are indications that during the last few years the extent of poverty remained high throughout the region. In most countries with available data the percentage of the population living below the poverty line was slightly higher in the 1990s than in the early 1980s. [See Table 6.]

The World Bank has argued that successful poverty reduction strategies should be based on three components: first, a policy package that will foster rapid growth; second, aggressive social programs targeted at the poorest; and, third, building social capital to mediate between the poor and the state.[9] The Latin American nations continue to do relatively poorly on all three counts. An improvement in social conditions in general, and the reduction of poverty in particular, are becoming increasingly urgent factors in the quest for boosting political support for the reform process. As we argue below, an important element in the battle against poverty is increasing the efficiency of social services delivery. Reducing waste, corruption, and inefficiencies will require major administrative, financial and technical reforms. In many cases these have been opposed by public sector unions, which defend old privileges and refuse to become accountable. There is little doubt that making progress in this area will require leadership, vision and a significant degree of political courage. We address some of these issues in the context of their structural characteristics in Section III.

III TROUBLING SIGNS AND SYSTEMIC SHORTCOMINGS

POLICY MAKERS AND POLITICAL LEADERS in a number of countries have recently become concerned about five factors that appear to be affecting the region's prospects for recovery and growth, both in the short and long run: (a) very high real interest rates; (b) high and increasing rates of unemployment; (c) low savings rates; (d) a slowdown in export growth; and (e) rebuilding weakened state institutions. In the context of the increasing degree of democratization, some of these factors—in particular, the high real interest rates and the increase in the rate of unemployment—are seen as detracting a quotient of political support for pro-reform administrations. All five factors result, to a degree, from leftover populist policies, including the inability to implement lasting fiscal discipline. In a number of countries, the political authorities, becoming somewhat impatient and looking for quick "solutions" to these problems, are in danger of falling back on tired, chimerical formulas. Argentina, Colombia, Ecuador and Peru are good examples of this trend. In order to avoid costly mistakes, including the implementation of inappropriate policies and reform reversals, it is important to understand what lies behind these developments.

High Real Interest Rates: In most countries in the region, real lending interest rates have been extremely high during the last few months—in some cases exceeding 25 percent per annum. [See Table 7.] These high real rates have been the result of both the Mexican cri-

Table 7. Selected Real Lending Rates in Latin America
(percent per annum)

Country	Nominal Rates (A)			Inflation Rates (B)			Real Rates (A-B)		
	1994	1995	1996Q1(p)	1994	1995	1996(proj)	1994	1995	1996(p)
Argentina	23.2	29.4	21.0	3.9	2.0	2.4	19.3	27.4	18.6
Brazil	n.a.	104.0	60.5	929.3	21.1	15.0	n.a.	82.9	45.5
Chile	46.9	41.7	36.4	11.4	8.2	6.5	35.5	33.5	29.9
Colombia	40.5	42.8	43.4	22.6	19.5	22.0	17.9	23.3	21.4
Peru	53.6	36.6	35.9	23.7	11.7	10.1	29.9	24.9	25.8

Description of nominal rates:
Argentina: Loans to non-financial private sector, single firms, 90+ days, weighted averages.
Brazil: Effective cost of loans.
Chile: Charged by banks on 1-3 year non-indexed transactions.
Colombia: Loan rates charged by banks and other financial institutions, weighted averages.
Peru: Rates charged by commercial banks on 360-day-or-less loans, averages.

Sources:
Argentina: Banco Central de la Republica Argentina, Boletin Estadistico.
Brazil: BBT Perspectivas e CENARIOS.
Chile: Banco Central de Chile, Boletin Mensual.
Colombia: Banco de la Republica, Revista del Banco de la Republica.
Peru: IMF, International Financial Statistics.

sis—the reduction in capital inflows has been particularly important—and domestic policy measures. The high rates have dual effects: First, they are slowing the recovery and contributing to the region's weak growth. Second, in many countries, high interest rates are putting stress on already weakened banking sectors.

There are three fundamental causes for the high capital costs. First, in most countries—Chile, possibly, being the only exception—banks are still highly inefficient. High administrative costs, combined with continuing barriers to entry, result in significant spreads between borrowing and lending interest rates. In many countries this situation is compounded by the fact that if reserve requirements do not earn interest, even moderate inflation will amplify the real spread between borrowing and lending interest rates.

The second, and relatively more important, reason behind current generalized high real interest rates is the *policy mix*, characterized by tight monetary policy and a (relatively) lax fiscal policy, that is currently in effect in a large number of countries in the region—Brazil, Colombia, Ecuador, Peru and Venezuela, for example. In some countries, the existence of large government contingent liabilities—mostly stemming from unfunded social security systems—is also contributing to keeping interest rates high. Third, Latin American "country risk" assessments remain high—and they increased after the Mexican crisis—reflecting investor unease regarding the sustainability of some of the reforms, as well as the perception that the region's legal structures are outdated and inefficient.[10]

Achieving a reduction in interest rates should be an important policy goal throughout the region. As we discuss in greater detail in Section IV, this will require significant fiscal tightening, reducing the level of government contingent liabilities, and the implementation of reforms aimed at improving the region's degree of "country risk."

High and Increasing Rates of Unemployment: In the last year or so unemployment grew markedly in a number of countries in the region—Argentina, Brazil, Ecuador, Mexico, Peru, Uruguay and Venezuela. Although in Nicaragua and Panama unemployment has not increased, it continues to be very high. The picture becomes even bleaker if one considers the fact that in many countries real wage rates are still below their 1980 levels. [See Tables 8, 9 and 10.]

The sluggish behavior of these labor markets—low wages and slow employment creation—constitutes one of the most grave concerns of Latin American populations and has serious economic, social, and political consequences. It contributes to poverty—many of the poor are unemployed, or employed at very low

Table 8. Unemployment Rates in Latin America

Country	*1991*	*1992*	*1993*	*1994*	*1995*
Argentina[a]	6.5	7.0	9.6	11.5	18.6
Argentina [b]	6.0	7.0	9.3	12.2	16.4
Argentina[c]	5.3	6.7	9.6	13.1	17.4
Brazil[d]	4.2	4.5	4.4	3.4	4.4
Chile [e]	6.1	5.7	5.9	6.9	6.0
Chile[f]	5.3	4.4	4.5	5.9	4.5
Chile[g]	7.4	6.0	6.3	6.9	6.0
Colombia[h]	10.2	10.2	8.6	8.9	8.6
Ecuador[a]	8.5	8.9	8.9	7.8	8.4
Honduras[a]	7.4	6.0	7.1	6.3	4.5
Mexico[i]	2.7	2.8	3.4	3.6	6.4
Nicaragua[a]	14.2	17.8	21.8	20.7	20.2
Panama[a]	16.0	14.7	13.2	13.7	14.3
Peru[a]	5.9	9.6	9.9	8.8	8.2
Uruguay[a]	8.9	9.0	8.4	9.1	10.7
Venezuela[a]	10.1	8.1	6.8	8.7	10.3

Sources:
[a] ECLAC, annual average urban unemployment rate.
[b] Ministerio de Economía y Obras y Servicios Públicos, *Informe Económico*. Data refer to October of each year.
[c] Ministerio de Economía y Obras y Servicios Públicos, *Informe Económico*. Data refer to the Gran Buenos Aires area, October of each year.
[d] *Boletim do Banco Central do Brasil*. Data refer to December of each year, for population 15 years or older, average for 6 cities. This figure reached 5.3% in early 1996, and the rate of unemployment in Sao Paulo reached 6.3%, and 7.1% in Salvador.
[e] Banco Central de Chile. *Boletín Mensual*. Data refer to the Greater Santiago area, based on Universidad de Chile surveys, December of each year.
[f] National Bureau of Statistics Surveys. Oct.-Dec., except 1995 = Nov. 1995 - Jan. 1996.
[g] Universidad de Chile, Economic Surveys; average of 4 annual surveys for 1991-93, Dec. survey for 1994-95.
[h] *Revista del Banco de la República*; annual average of total for 7 cities.
[i] Banco de México. *Indicadores Económicos*, based on INE National Urban Employment Survey. Open urban unemployment, 12 years and older and actively seeking employment for 2 months.

wages in the informal sector—and it erodes the political support of reformist governments. There is some preliminary evidence suggesting that in many—if not in most—of the Latin American countries the positive impact of lowered inflation on political support is beginning to fade and voters are now demanding improved performance in terms of higher growth, wages and employment.[11] As we have already argued, if these are not delivered, it is likely that voters will begin to desert the reformist ranks, increasing the risk of a populist relapse. In Part B of Section IV we argue that reforming labor markets and the educational system, and building social capital in the large cities of the region constitute essential steps in addressing these employment issues, consolidating the reforms, and moving the region toward sustainable and inclusionary growth. Only to the extent that labor market distortions are eliminated and human skills are upgraded will wages increase and employment grow at the pace required to absorb those joining the labor force.[12]

Table 9. Real Wage Indexes, 1980 and 1995
(1990=100)

Country	*1980*	*1995*	*Percent Change*
Argentina[a]	130.0	100.9	-22.4
Brazil[b] Rio de Janeiro	87.9	-6.5	
Chile[c]	95.4	123.3	29.3
Colombia[d]	85.0	104.2	22.6
Costa Rica[e]	115.6	111.5	3.5
Mexico[f]	128.3	112.0	-12.7
Peru[g]	309.3	122.6	-60.4
Uruguay[h]	108.5	109.1	0.6

Source: ECLAC.

Notes:
[a] Wages in manufacturing.
[b] For workers covered by social and labor legislation.
[c] For 1991-April 1993: wages to non-agricultural wage-earners. Onwards: based on general index of hourly wages.
[d] Wages of manual workers in manufacturing.
[e] Remunerations declared by those covered by the social security system.
[f] Wages in manufacturing.
[g] Wages of private-sector manual workers in the Lima metropolitan area.
[h] Average salaries.

Low Domestic Savings Rates: One of the most important lessons of the Mexican crisis is that domestic savings matter. They are important because they help finance the accumulation of capital and, thus, facilitate growth. Moreover,

Table 10. Growth of Average Real Wages in Latin America and the Caribbean
(percentages, negatives in parenthesis)

Country	*1991*	*1992*	*1993*	*1994*	*1995*
Argentina[a]	1.3	1.4	(1.7)	1.0	(1.1)
Bolivia[b]	(6.6)	4.0	6.7	7.9	3.0
Brazil[c]					
Rio de Janeiro	(20.7)	0.3	7.8	1.6	0.9
São Paulo	(11.7)	(3.4)	10.9	3.6	0.2
Chile[d]	4.9	4.5	3.6	4.7	3.8
Colombia[e]	(2.6)	1.2	4.7	0.9	0.1
Costa Rica[f]	(4.6)	4.1	10.2	3.8	(2.0)
Mexico[g]	6.5	7.3	8.9	3.7	(13.2)
Peru[h]	15.2	(3.6)	(0.8)	15.6	(3.8)
Uruguay[i]	3.8	2.2	4.8	0.9	(2.8)

Source: ECLAC.

Notes:
[a] Wages in manufacturing.
[b] Wages in the private sector in La Paz.
[c] For workers covered by social and labor legislation.
[d] For 1991-April 1993: wages to non-agricultural wage-earners. Onwards: based on general index of hourly wages.
[e] Wages of manual workers in manufacturing.
[f] Remunerations declared by those covered by the social security system.
[g] Wages in manufacturing.
[h] Wages of private-sector manual workers in the Lima metropolitan area.
[i] Average salaries.

high domestic savings are associated with lower current account deficits. Latin America, however, has traditionally had very low savings rates: In 1970, for example, the region saved on average only 20 percent of its GDP; by 1994 this ratio was basically unaltered.[13] This contrasts sharply with fast growing Asian regions, which save up to 35 percent of GDP. Most policy makers now recognize that raising domestic savings is one of the region's fundamental challenges—President Ernesto Zedillo, for example, has made it the key goal of Mexico's development plan. Acknowledging the importance of savings represents great progress relative to the early 1990s, when most regional analysts were oblivious to the problem.

There are three fundamental determinants of domestic savings rates: (a) Fiscal prudence, resulting in higher public savings, increases aggregate domestic savings. (b) A sound, modern, and safe financial—and especially banking—sector will encourage the private sector to increase savings. (c) A retirement system based on an individual's accumulation in pension funds will result in higher private sector savings. Additionally, researchers have found that there is a virtuous circle that goes from higher growth to higher savings, and then back to higher growth.[14]

Unfortunately, the Latin American countries are moving slowly on all of these fronts. In many countries political opposition by interest groups, including public sector unions, has precluded increases in public savings. In a number of countries the financial sector—and in particular the banking sector—has been badly weakened. And pension reforms have been implemented in only seven countries. In some of them the effort has been timid and is far from making a serious contribution to savings. All of this suggests, then, that despite the heightened recognition of the need to increase savings rates, little has actually happened. Implementing the right policies to encourage domestic savings continues to be a very high priority in the region.

Export Growth: By opening up their economies to the rest of the world in the late 1980s and early 1990s, the Latin American countries made the decision, implicitly or explicitly, to rely on export expansion as one of the main forces behind growth. There is, indeed, abundant international evidence suggesting that countries that have more open economies tend to grow faster than those countries that restrict international trade.[15] During the initial years of the reforms—the early 1990s—exports did indeed grow faster

in most countries in the region.[16] In a large number of countries, however, this trend seems to be slowing down. CEPAL, for example, reported that South America's export volume grew by merely 3.6 percent during 1995 while Central America and Caribbean export volume increased only 2.9 percent. [See Table 5.][17] In some of the largest countries—Brazil (-2.8 percent), Colombia (0.8 percent) and Peru (0.3 percent), for example, export volume grew very slowly or even declined during 1995. Preliminary data for 1996 suggest that export performance is not improving.

There is little doubt that for the region to achieve significantly faster rates of growth than attained in the last few years, exports must pick up very significantly. This, in turn, will require (a) avoiding real exchange rate overvaluation; (b) increasing the investment in infrastructure, especially in roads, telecommunications and ports; and (c) attracting larger amounts of foreign direct investment. Successful policies in these areas will not only encourage exports but are also likely to result in a higher value-added content to the region's exports.[18]

Rebuilding Weakened States: Regional leaders are becoming increasingly aware that the institutions of the Latin American state are inadequate for the current times. While in many countries economic and financial reforms have proceeded swiftly, the administrative organization of the state harks back to an era where dirigisme and planning were dominant. Clumsy and ineffective even when well intentioned, the remnants of the populist state can be treacherous in undermining the ability of macroeconomic reform to find solid support in judicial and regulatory foundations. Equally dangerous, the leftover populist bureaucracies in the area of social services block the capacity for delivering improved education and health to the population.

The Chiapas crisis in Mexico is perhaps the most vivid and dramatic illustration of the failure of the traditional Latin American state. In spite of massive assistance channeled to Chiapas by the federal government, very few resources actually reached the intended beneficiaries. Projects were developed from above without community participation and were fraught with corruption. There were no mechanisms for involving the modern private sector in broad-based projects, and there were no effective communication channels between the people and the federal authorities. The judiciary did not act efficiently and the population's legal complaints went unanswered for years. The fact that to so many the Chiapas crisis was a surprise reflects deep misunderstanding about the importance of state institutions.

In most countries in the region there are numerous ministries that are supposed to deal with economic issues in a command fashion and few modern and autonomous supervisory agencies. Social services are provided in a centralized fashion and with little, if any, participation by the people. There is a clear need to move faster and deeper in restructuring the public sector in order to increase efficiency and accountability. The experience of East Asia strongly suggests that a very professional, efficient—and well paid—bureaucracy plays an important role in that region's economic success.

In Latin America there are urgent reasons to to modernize the judiciary system. Among them are critical economic needs. The credible protection of property rights through a well functioning and transparent court system is a key element for encouraging investment and ensuring the sustainability of the new economic regime. Additionally, in modern economies it is fundamental to have a lean and transparent conflict resolution system that protects the rights of individuals and groups at the same time it defuses costly confrontations. Justice is slow and ineffective in most of the region; corruption is common, and cases tend to drag for long periods of time.

IV. THE TASKS AHEAD: THE CONSOLIDATION AND DEEPENING OF REFORM

SINCE IT BECAME CLEAR that the Latin American countries successfully withstood the "tequila effect," analysts and observers throughout the region are asking, "And now, what?" The answer is straightforward: it is imperative that governments concentrate on the unfinished business of structural reforms. Failure to do so imperils the victories already won against the dysfunctional apparatuses of closed, populist, interventionist policies. Those reforms already undertaken have to be consolidated and deepened and new reforms have to be implemented to solve some urgent and perennial regional problems, especially poverty and inequality. In particular, as we have pointed out on more than one occasion, traditional populist states have to be dismantled and new institutions of the state have to be created. These should ensure that social services are delivered efficiently, that a minimum safety net exists and that property rights are broadly protected. In this section we discuss two broad reform areas that we believe have to be intensified in the next year or two. We first address issues related to macroeconomic policy, broadly defined. We then turn our attention to policies related to the social sectors and human development. In Section V we deal with the characteristics and the need for the creation of a new Latin American state. We conclude by discussing, in general terms, some of the principles that should guide the creation of the new Latin American state.

A. The Consolidation of Macroeconomic Stability

The reduction of inflation is, perhaps, the region's most important economic accomplishment of the last few years—for 1996 we expect

an average inflation rate of 17 percent, down from almost 1,000 percent in 1993. Now that inflation has greatly declined there may be a temptation to forsake further macroeconomic gains. This would be a serious mistake. In spite of significant progress, in most countries the macroeconomic situation continues to be fragile and vulnerable. In a number of them, including Brazil, Colombia and Venezuela, the public sector deficit continues to be high. Unfunded pension systems have generated very large public sector contingent liabilities and, therefore, large expected future deficits. In Mexico, for example, the actuarial deficit of the pension system, prior to the new reform, was estimated to be 75 percent of GDP and, with expected new affiliates, could have even reached 140 percent of GDP.

A rebound in inflation would not only have negative economic effects, but would also damage governments politically. The challenge faced by Latin American nations is to achieve faster growth and improved social conditions, while *at the same time* making further progress on macroeconomic stability. Facing this challenge successfully will require action on two broad fronts: First, further fiscal adjustment will have to be undertaken, and second, institutional reforms that add transparency and credibility to macroeconomic policies by making the state an honest and forceful referee will have to be implemented.

Fiscal Imbalances and Real Interest Rates: Recent public sector imbalances, in combination with tight monetary policy, have contributed to generating the very high real lending interest rates discussed above. These, in turn, are having a number of undesirable effects. First, they are delaying the recovery by discouraging expenditure, crowding out credit to the private sector, and inhibiting investment.

Second, high real interest rates are putting additional pressure on already, in some cases highly, vulnerable banking systems. In most countries banks have recently seen a very substantial increase in the percentage of nonperforming and past due loans. In fact, if high real interest rates persist, bank failures can be anticipated in a number of countries. As the region's history has verified again and again, generalized banking crises can be extremely costly. They not only disrupt the normal course of economic activity, but they also can generate a very substantial cost in terms of fiscal resources. For example, the Chilean banking crisis of 1982-83 resulted in a fiscal cost of 7.8 percent of GDP in 1985 alone; the cost of the Venezuelan banking collapse of 1994 was about 15 percent of GDP; and, it is estimated that the cost of the current Mexican banking crisis could be well above 6 percent of GDP. Moreover, recent losses in a handful of Brazilian banks have already surpassed 2 percent of GDP. Efforts to strengthen the region's banking systems are at the core of the World Bank's lending program in the region. During 1995–96, 14 percent of all lending was directed toward financial sectors. Major loans to Argentina and Mexico were directly geared to improving the regulatory framework, bringing accounting practices up to international standards, privatizing and restructuring public sector banks, and recapitalizing ailing banks. In addition, the World Bank has recently approved technical assistance loans related to the banking sector in Bolivia, Guyana and Mexico.

Third, as a result of high real interest rates, politicians in a number of countries are calling for a return to discretionary allocation of credit and administratively imposed caps on interest rates. These measures would, of course, have devastating efficiency effects and would greatly harm the Latin American economies. Moreover, administrated allocations of funds encourages corruption.

Clearly, the answer to high real interest rates is not to reestablish financial "repression." On the contrary, the solution to this problem will require increasing the efficiency of the financial sector—including the implementation of sound, modern supervisory frameworks. Also, major fiscal corrections—especially budgetary control at the subnational level—would allow for a change in the current policy mix and, thus, result in lower real interest rates.

Macroeconomic Stability and Institutional Reform: In order to safeguard the continuity of the reforms, prudent macroeconomic management will have to be maintained and the nostalgia for

populist panaceas will have to be eroded through education and government performance. Fiscal adjustment must be intensified in order to generate higher public sector savings that should allow for a decline in real interest rates. Monetary policy should be cautious and real exchange rate overvaluation has to be avoided.

With the return of democracy and competitive elections, public finances have become subject to pressures from electoral cycles. Indeed, there is now evidence that in the months preceding the Mexican presidential elections of 1994 the fiscal and credit stances in that country were loosened considerably. Politically motivated relaxation of fiscal policy has also been detected in other countries, including Peru, Ecuador and Argentina.

Institutions that add transparency to macroeconomic policy and isolate macroeconomic management from the vagaries of short-term political pressures have to be developed. This should be an essential element in the strategy for creating a new Latin American state. It means that governments have to impose limits on themselves and some of their own actions. For such restrictions to be understood as in the interest of the political class, it is crucial that they weigh equally, where applicable, to both the acting government and the opposition. A number of countries in the region have taken positive steps in this direction by granting independence to their Central Banks, creating some distance between monetary policy and political coercion. Abundant historical evidence suggests that countries with more independent Central Banks tend to have lower inflation and, thus, higher growth in the long run.[19] In the Latin American context, successful cases of Central Bank institutional reform include Chile, Argentina and Colombia. The Central Banks of Venezuela and Mexico have also become legally autonomous, but there have been some questions regarding their effective degree of independence.[20] In Colombia, on the other hand, there has recently been talk about reducing the extent of independence of the Central Bank.[21] This would be a serious mistake that would hurt the quest for macroeconomic stability and increase the degree of country risk.

For Central Bank reform to be truly effective it has to have public legitimacy. This means creating broad support among the electorate at large for the principle and the practical implications of a truly independent central bank. Chile's 1989 experience is interesting and suggests that even if the electorate initially has mixed views regarding this type of institution, it can, with the passage of time, come to support it strongly. Today, the vast majority of the Chilean population has come to understand that the independent Central Bank plays a key role in safeguarding macroeconomic stability. On the other hand, the experience of Venezuela in April 1994, when the majority of the Central Bank board members resigned under political pressure, indicates that when there are extreme differences of opinion between the executive branch and the Central Bank, the formal independence of the latter may not be relevant in determining the course of monetary policy. This is an important point leading to the conclusion that if policy makers have no respect for the long-term benefits that accrue from Central Bank autonomy, macroeconomic stability is not assured by *de jure* imposition.

There is also a need to redefine the rules and regulations that govern the preparation, approval and implementation of public sector budgets. Spelling out clear and mandatory budgetary procedures constitutes a basic but extremely important institutional security that has often been absent in Latin America. Congress should be required to approve a consolidated budget for the public sector as a whole before the initiation of the fiscal year, and the executive should be legally (and literally) constrained by it. Some analysts have recently gone further, and suggested that Latin American countries should create independent *Budget Councils*, which would set limits to the accumulation of public debt, limit the use of unapproved expenses, and ensure a balanced budget.[22] Although it is probably too early to evaluate the merits of this specific proposal, it is clear that a move toward more effective and transparent budgetary

processes would help the region attain sustainable macroeconomic stability.

In many Latin American countries subnational governments have historically been a major source of fiscal imbalances. States, provinces and municipalities are seldom subject to tough budget constraints and, as a result, contribute greatly to the overall costs of the public sector. This is the case, for example, in Argentina, Brazil and Colombia. Reforming subnational governments—and in particular their financial relationships with central governments—is a major unfinished task in virtually all of the region.

Domestic Savings, Macroeconomic Policy and Institutions: As the Mexican peso crisis painfully underscored, low domestic savings continue to be one of the most serious weaknesses in the region's macroeconomic picture. Contrary to what many expected, the deregulation of the financial sector did not result in higher domestic savings. In fact, the massive capital inflows of the first half of the 1990s were accompanied by a decline in domestic savings.

Low aggregate savings are limiting the pace of capital accumulation, slowing down new investments in infrastructure and stunting faster productivity growth. In 1995 the median of gross domestic savings to GDP ratio was 20 percent, more than 10 points below that of the East Asian countries.[23] In order to achieve rapid economic growth in the years to come, the need to increase domestic savings and investment to levels approaching those of the successful countries of East Asia will be a policy priority and a practical precondition.

Increased public savings constitutes the most effective way of increasing aggregate domestic savings. Moreover, recent evidence from East Asia suggests that when higher public savings are accompanied with reforms that create safe and reliable financial institutions—especially banking sectors—increases in private savings are likely to follow.[24] Recent banking crises in a number of countries in the region are not helping. As pointed out above, there is an urgent need to implement efficient and effective regulatory and supervisory systems in order to create a solid financial system that will, among other things, encourage savings.

The way in which government savings are raised matters. Generally speaking, higher tax rates should be avoided. Improvements in tax administration and tax compliance should result in higher revenues. In particular, the prosecution of tax evaders should be stepped up and penalties for tax evasion increased. In many cases this will require a broad revision of tax legislation and a modernization of the judicial system, as well as of the tax collection agencies, themselves. On the expenditure side, subsidies should be eliminated and government waste should be tackled. Reductions in military allocations provide an important possible source of income, but the potential should not be overestimated. In many countries an acceleration of the privatization process could also affect public savings. This would happen primarily through the reduction of subsidies and transfers made by central and regional governments to money-losing, state-owned enterprises.

The reform of the traditional pay-as-you-go social security systems provides an important mechanism for raising domestic savings. These reforms force governments to recognize explicitly the unfunded, and often very large, liabilities of the old system. Comparative empirical analyses have shown that private savings are substantially affected by the extent and coverage of government-run social security systems. If individuals perceive that they will receive high social security benefits from the government when they retire, they will tend to reduce the amount saved during their economically active years.[25] Retirement systems based on capitalization programs tend to have additional positive effects on the economy, including the development of capital markets, the deepening of insurance markets and the creation of larger pools of resources to finance infrastructure investments.

During the last few years, seven countries in the region—Argentina, Chile, Colombia, Costa Rica, Mexico, Peru and Uruguay—implemented reforms of their social security systems. In most cases, pay-as-you-go systems are being replaced by hybrid regimes where

private and public "pillars" coexist. By and large, these initiatives represent a welcome and very necessary first step in the right direction. As noted, however, in a number of countries the reform initiatives are timid and have barely scratched the problem's surface. In many countries the new systems will only make small contributions towards reducing the fiscal cost of pensions and increasing domestic savings. After much political debate, the Brazilian Lower House of Congress passed a very basic reform that falls considerably short of what is needed to ease the system's fiscal burden. For example, the executive power's original version of the bill increased the retirement age and linked pension benefits to contributions. Congress overruled these changes and the system remains basically the same. Uruguay has enacted a hybrid system that still restricts the role of the private sector and maintains unfunded liabilities at more than 100 percent of GDP. Mexico's reform is broad-ranging and innovative; it has, however, some provisions that are likely to reduce its effectiveness. These include allowing workers to choose whether to switch to the new system after they retire, requiring contributions to be channeled through the government social security agency (IMSS), and retaining an obligatory housing tax administered by an inefficient government agency. Even after the reforms, total social security contributions—those going to fund individual capitalization accounts and the state-run program—remain high in some countries. This is the case of the Argentine reform, for example, where total contributions exceed 21 percent of wages.

The challenge of furthering social security reforms in order to truly make progress in the quest toward increasing aggregate domestic savings will mean putting more teeth in the timid reforms in some countries, while in others—including the pioneering reformer Chile—it will require an improvement in regulations and a reduction in the operational costs of the system. Only to the extent that truly innovative reforms are undertaken in this area will Latin America increase savings sufficiently and give a definitive boost to domestic capital markets.

B. THE SOCIAL SECTORS, POVERTY, HUMAN RESOURCES AND REFORM

Latin American countries have neglected the social sectors. This resulted in staggering poverty and the most unequal income distribution in the world in the early 1980s. After a brief decline in the late 1970s, the number of poor increased steadily in the region since 1975. [See Table 6.] Today, approximately 165 million people live in poverty; the poorest 20 percent of Latin Americans receive less than 4 percent of GDP. Most of the poor now live in the cities, creating new challenges for the delivery of social services. As a result of the rapid increase in urban poverty, traditional social institutions are becoming obsolete; there is an urgent pressing need to create new social capital that will allow the cities' populations to participate more actively in the development process.

Expectations for improved social conditions grow daily among Latin American voters. While during the early stages of the reform process people were willing to make sacrifices in the name of macroeconomic stability, they are now demanding better jobs, higher wages and a more efficient provision of social services.

A fundamental policy objective in the years to come is to address poverty and inequality with vigor and urgency. This will not only improve the living conditions of the population, but will also provide stability to the new economic system, and will and help consolidate the region's new democracies. Failure to act aggressively in this area will exacerbate distributive conflicts and, in some cases, may make the dismantling of the populist state a much more difficult task.

In last year's report we argued that there was a dire need to upgrade the delivery of social services. Today we believe this task to be even more compelling. There are two interrelated reasons for greater celerity. First, the region's recovery from the "tequila" crisis has been slower than most analysts envisaged; as a result during the last 18 months the extent of poverty in the region grew. Second, and as previously pointed out, this

Table 11. Educational Expenditures and Achievement in LAC

A. Reading Literacy Studies, 1992–1993
(13-year-old children tested)

Country	*Average Scores*	*Per Capita Exp. in 1987 US$*
Argentina	361	120.2
Bolivia	284	17.5
Chile	366	61.9
Costa Rica	381	87.9
Dominican Rep.	303	n.a
Ecuador	308	31.2
Trinidad & Tobago	451	n.a.
Venezuela	383	83.7
Indonesia	394	11.0
Spain	504	176.4
Singapore	515	686.0
Hong Kong	517	n.a.
United States	547	139.9
Finland	569	1,133.7

Sources: Test scores from Schiefelbein (1995); expenditures per capita from Cominetti (1996) and *World Development Report, 1995*

B. Mathematics and Science Tests, 1992
(13-year-old children tested)

Country	*Math Avg. Score*	*Science Avg. Score*	*Per Capita Exp. in 1987 US$*
Argentina	38	38	120.2
Colombia	40	37	n.a.
Costa Rica	55	56	87.9
Dominican Rep.	40	37	n.a.
Venezuela	40	41	83.7
Thailand	50	55	57.1
USA	52	55	139.9

Source: Test scores from Wolff, Schiefelbein and Valenzuela (1994)

slow recovery is generating disappointment with the reforms and, in some quarters, even nostalgia for past populist policies. Improving the quality of social services, and especially education and health, will have direct positive effects in the battle against poverty and, at the same time, will make a concrete contribution of maintaining the population's support for reform. Additionally, reforming labor market legislation will have a positive effect on employment creation, easing one of the most serious concerns among the region's people.

Education Reform: A recent World Bank study based on 10 countries—Argentina, Bolivia, Brazil, Colombia, Costa Rica, Guatemala, Honduras, Panama, Uruguay, and Venezuela—found that the level of education is the single most important determinant of inequality and poverty. For example, in the case of Panama, people with less than five years of education have an 83 percent estimated probability of being in the lowest 20 percent of income distribution. The corresponding figure for Argentina is 69 percent. These figures contrast sharply with those for people with 13 or more years of education; in most countries, the likelihood that they will be in the bottom 20 percent of the distribution is less than 5 percent. The importance of education in determining inequality has recently been confirmed in a series of detailed studies for Brazil during the 1960s and 1970s. Two-thirds of the increase in inequality in that country between 1960 and 1970 is rooted in education.[26]

The region has a major educational deficit. Latin American children have two years' less formal education than children in regions at a comparable stage of development. This comparison is particularly sharp when made with the four most successful Asian economies (Hong Kong, Taiwan, South Korea, and Singapore). A recent World Bank study has shown that, in order to reduce poverty and inequality, this gap will have to be closed in the next decade.[27]

Public sector spending on education is relatively higher in Latin America than in East Asia—3.7 percent versus 3.4 percent of GDP. Yet, the quality of Latin American education is one of the poorest in the world. Standardized tests indicate that Latin American children are systematically at the bottom of international scales. [See Table 11.] Approximately 30 percent of students in primary education are repeaters, and children spend close to half of the time receiving instructions on how to perform mechanical exercises. Students in public primary schools are subject to 800 hours of instruction a year, compared with approximately 1,200 hours in rapidly growing countries and in the advanced nations. And in some countries students in rural areas are subject to as little as 300 instruction hours per year. Teachers have little motivation, are reluctant to use new techniques—including self learning materials—and are resistant to becoming accountable to their communities.[28]

There is tremendous waste in the region's educational system. In many countries up to 20 percent of teachers are "ghost" workers who perform no function whatsoever, and administrative departments tend to be highly inflated with bureaucrats. Books and other learning materials often are not distributed and often are of poor quality. Teaching techniques are antiquated and neglect the needs of most students, especially of poor indigenous children. Technical and professionally oriented secondary education programs are developed in isolation from the private sector, producing graduates who often cannot find work. Some recent reforms, including the reduction of the student-teacher ratio, have been shown to be costly and highly ineffective. To make things even worse, waste is accompanied by tremendous inequality. Middle- and upper-class students—especially those attending subsidized universities—obtain very large subsidies, while poor students, especially in the rural areas, often lack learning materials.[29]

Even with limited resources, it is possible to greatly improve the quality of the region's educational system in a relatively short period of time. This, however, would require reallocation of resources and the implementation of some important reforms. A key element of the new approach should be significantly increasing the number of instruction hours. This could be achieved by raising the ratio of teachers to students from the current rather low levels to more effective ones.[30] Resources could also become available by eliminating "ghost" workers and reducing the extent of administrative bureaucracy. Using modern teaching techniques, including self learning materials, would greatly improve the quality of education with very little additional expense. Cost recovery at the higher educational level—especially universities—would also free resources that could be used to increase the efficacy of the system where it is most needed, especially at the pre-school and primary levels.[31] By relying more heavily on local communities—something that is increasingly feasible given the extent of subnational level decentralization in the region—it is possible to exercise budgetary control and make teachers more responsive. The recently announced educational reform in Chile contemplates many of these elements and is a promising move in the right direction.

An important requirement for improving education is upgrading teachers' skills and accountability. Eliminating the widespread practice of standardized pay—where teachers salary levels are virtually independent of performance—will go a long way in this direction. This will allow raising salaries as a teacher's commitment and involvement increases. In some countries this type of reform may run into political opposition. However, unless it is undertaken, the chances of improving education and with it, economic competitiveness and civic awareness, are extremely low.

In the longer run, a successful upgrading of the educational system will require additional financial resources. A World Bank study has calculated that in order to remedy the current educational deficit, Latin America will have to increase its primary education expenditure by one percent of GDP well into the next century. This represents approximately US$26 billion per year, or over US$500 million of additional primary education expenditure per week. It has been estimated that to the extent that reforms of the type sketched above are indeed undertaken, the positive social impact of these additional expenditures would be substantial, allowing the region to begin moving away from poverty. We cannot emphasize sufficiently, however, that a fundamental precondition for this program to succeed is that it be *preceded* by fundamental reforms in teaching methods and curricula. The mistakes of the past, when resources for the social sectors were increased without a coherent reform program to ensure their effective use, should be avoided.

Health Reform: Health indicators have improved steadily in Latin America during the last 20 years. That is the good news. The bad news is that they have improved at a slower pace than in the rest of the world. Latin America has slipped in international comparisons of health achievements. Today the delivery of health services is worse in Latin America and the Caribbean—as measured by health related

losses in productivity—than regions at a comparable level of development.[32]

This is *not* the result of a lack of financial resources devoted to health. The region annually spends approximately 7 percent of GDP, or US$28 billion, on health, a high figure when measured against other countries with similar income-per-capita. [See Table 13.] If anything, Latin America overspends on health. An analysis of other "inputs" into the provision of health services—doctors, hospitals, beds, and nurses—also indicates that Latin America does not have a deficiency in these areas. [See Table 12.] Yet, it is estimated that today 105 million people in the region have no regular access to health services. This is especially the case among children, mothers, the poor, and indigenous populations.[33]

A traditional problem with health services in Latin America is that in many countries the emphasis is on funding and subsidizing curative medicine, rather than concentrating on basic preventive care. This approach is not only inefficient, but it is also highly regressive, since the benefits tend to accrue to the middle and upper classes. Recent efforts to tackle this problem have been hampered by the lack of adequate medical support staff, including nurses, technicians, and nurses' aides. The World Bank has recently identified the lack of proper distribution of pharmaceuticals as an element standing in the way of an effective expansion of preventive care.[34]

For decades, the lack of adequate sanitary conditions was central to Latin America's health problems. Diarrhea and other water-related diseases were the cause of a high percentage of the region's infant mortality. During the early 1990s more than 80 million urban dwellers and 18 million people in the rural sector obtained drinkable water services. In spite of these improvements, sanitary conditions in the region are still far from adequate. This was clearly reflected in the outburst of cholera in the late 1980s. A particularly serious problem is the inadequate treatment and disposal of sewage. In many countries this problem has been related to the neglect of infrastructure maintenance during the 1980s and early 1990s. There is increasing evidence suggesting that most countries in the region lack the required institutional support for adequately maintaining infrastructure investment, an issue we emphasized last year in our report *Latin America After Mexico: Quickening the Pace.*

As in the case of education, the poor state of the region's health is more a matter of effectiveness, than scarce resources. While additional resources could be used effectively—and, if administered correctly, could generate very positive effects—the key to improved health care is reforming the system. As noted, there is need to move from curative to preventive medicine. The number of nurses—today in relative short supply—should be increased and rural clinics

Table 12. Health Services in LAC

Doctors, Hospital Beds and Infant Mortality per 1,000 Population

Country	*Doctors (1988–1992)*	*Hospital Beds (1985–1990)*	*Infant Mortality*	*Per Capita Exp. (1992)*	*US$ Cost per (1990 US$)*	*Adj. Per Hospital Bed Capita Exp.*
Argentina	2.99	4.8	29.0	312	65,000	0.094833
Brazil	1.46	3.5	57.0	222	63,429	0.07957
Chile	0.46	3.3	17.0	153	46,364	0.070183
Colombia	0.87	1.5	21.0	65	43,333	0.051181
Mexico	0.54	1.3	35.0	112	86,154	0.043411
Peru	1.03	1.5	52.0	59	39,333	0.057843
Venezuela	1.55	2.9	33.0	102	35,172	0.038491
Canada	2.22	16.1	7.0	1,945	120,807	0.099033
U.S.A.	2.38	5.3	9.0	2,763	521,320	0.123458
World	1.34	3.6	n.a.	323	89,722	0.078398

Source: Lee and Bobadilla (1994).

Table 13. Health Services and Efficiency of Expenditures in LAC

Country	Doctors per 1,000 People (1988–1992) (A)	Hospital Beds per 1,000 (1985–1990) (B)	Infant Mortality (1992) (C)	Per Capita Health Expenditures (1990 US$) (D)	Per cap GNP (1990 US$) (E)	Adjusted Per Capita Expenditures F = (D/E)	US$ Cost per Hospital Bed (G)=(D*1000)/(B)	Adjusted Cost per Bed (H) = (G)/(E)	US$ Cost per Doctor (I) = (A*1000)/(B)	Adjusted Cost per Doctor (J) = (I)/(E)
Argentina	2.99	4.8	29	312	3290	0.095	65,000	19.76	104,347.83	31.72
Bahamas	1.3	4.2	25	688	11940	0.058	163,810	13.72	529,230.77	44.32
Barbados	0.89	8.2	10	419	6550	0.064	51,098	7.80	470,786.52	71.88
Bolivia	0.48	1.3	82	34	700	0.049	26,154	37.36	70,833.33	101.19
Brazil	1.46	3.5	57	222	2790	0.080	63,429	22.73	152,054.79	54.50
Chile	0.46	3.3	17	153	2180	0.070	46,364	21.27	332,608.70	152.57
Colombia	0.87	1.5	21	65	1270	0.051	43,333	34.12	74,712.64	58.83
Costa Rica	1.04	2.6	14	186	1790	0.104	71,538	39.97	178,846.15	99.91
Dom. Rep.	1.08	2.0	52.5	59	890	0.066	29,500	33.15	54,629.63	61.38
Ecuador	1.04	1.7	45	39	980	0.040	22,941	23.41	37,500.00	38.27
El Salvador	0.64	1.5	40	58	1030	0.056	38,667	37.54	90,625.00	87.99
Guatemala	0.44	1.7	62	33	920	0.036	19,412	21.10	75,000.00	81.52
Jamaica	0.48	2.4	14	83	1670	0.050	34,583	20.71	172,916.67	103.54
Mexico	0.54	1.3	35	112	2580	0.043	86,154	33.39	207,407.41	80.39
Peru	1.03	1.5	52	59	1020	0.058	39,333	38.56	57,281.55	56.16
Trinidad&Tobago	1.04	3.8	15	200	3600	0.056	52,632	14.62	192,307.69	53.42
Uruguay	2.9	4.6	20	123	2640	0.047	26,739	10.13	42,413.79	16.07
Venezuela	1.55	2.9	33	102	2650	0.038	35,172	13.27	65,806.45	24.83
Canada	2.22	16.1	7	1,945	19,640	0.099	120,807	6.15	876,126.13	44.61
U.S.A.	2.38	5.3	9	2,763	22,380	0.123	521,320	23.29	1,160,924.37	51.87
World	1.34	3.6	n.a.	323	4120	0.078	89,722	21.78	241,044.78	58.51

Sources: Total health expenditures and health statistics from Lee and Bobadilla (1994); GNP per Capita from *World Development Report.*

created and maintained. To the extent that these reforms are enacted, the worse consequences of poverty and backwardness will begin to recede, and the region will be able to move forward on the development path. A likely, and important, side effect would be that if the populations perceive improvement in the delivery of these services, political support for the reform governments would become more firm. This will give leaders additional time to pursue pending state reforms that will, in the longer run, set the foundations for more rapid and equitable growth.

Employment, Unemployment and Labor Markets Reform: Historically, many Latin American countries have attempted to use labor legislation—including minimum wages, regulations on dismissals and restrictions on temporary hiring, among others—as a way of improving income distribution and reducing poverty. These policies, however, have failed badly. Instead of helping the poorest groups of society, they introduced serious distortions that discouraged employment creation and created a small group of more highly paid jobs in the "protected" sector. Again, the past is a guide for avoiding mistakes. Social policy concerns should be addressed using direct and well focused instruments and not through distortions in labor markets. These should be dynamic and flexible, stimulating the creation of jobs and allowing the economy to respond rapidly and productively to changing international competitive challenges. This has, indeed, been one of the most fundamental lessons of East Asia's success.

The increase in and persistence of unemployment, discussed in the preceding section, is, to a large extent, a product of antiquated labor market regulations still in force in most countries. Argentina presents the most dramatic recent case of high unemployment in Latin America and clearly illustrates the policy problems many countries in the region face. In early 1995 the Argentine rate of unemployment reached 18.6 percent. Although it declined to 16.5 percent by October of that year, it was still at one of its highest historical levels. The unyielding high unemployment rate is generating growing political dissatisfaction that some fear could even result in backtracking on market-oriented reforms.[35]

The causes of Argentina's unemployment are complex and are related to structural, histori-

cal and, especially, policy factors. The most important historical factor is the "abnormal" behavior of the labor market during the 1980s, when, in spite of negative growth, employment grew at approximately 1 percent per year. This artificial situation had to be reversed sooner or later. The corrective process started in 1991–92, when the Argentine private and public sectors began to restructure. The case of the giant oil producer YPF is, perhaps, the best example of this phenomenon. After being privatized YPF reduced its number of employees from 55,000 to 5,000, while significantly increasing output.

Demographic and structural factors also play a role in Argentina's poor labor market performance. In particular, an increase in women's labor force participation has generated a hike in labor supply. Demographic projections suggest, however, that this is a permanent factor and will continue to affect the Argentine labor market in the years to come. The "tequila"-induced crisis of 1995–96 also contributed to the unemployment problem. As domestic credit contracted and economic activity declined, many firms were forced to lay off workers or cancel hiring plans.

Labor market distortions, however, are at the heart of Argentina's unemployment problem. High taxes on labor, including high social security contributions, amplified the employment costs of the trade liberalization reforms, and discouraged formal employment. Moreover, arcane labor relations legislation in Argentina, based on centralized collective bargaining, add to the problem. A recent World Bank study suggests that a reform of the labor code that would replace the current bargaining system by one based on decentralized wage negotiations would reduce unemployment by at least 4 percentage points.[36] In spite of efforts by the Menem administration to reduce taxes on labor—labor taxes were lowered in 1994, for example—and truly reform the legislation on collective negotiations, Congress has been slow in acting.

Argentina is, by no means, the only country facing labor market difficulties. Rates of unemployment are currently high—above 8 percent—in Ecuador, Nicaragua, Panama, Peru, Uruguay and Venezuela. As a consequence of the peso crisis, Mexico's rate of open unemployment has doubled, and in Colombia unemployment has experienced a rapid surge in recent months. [See Table 8 for unemployment data on selected countries.] Chile, however, provides a vivid contrast. Open unemployment has dropped from more than 20 percent during the early 1980s, to around 5 percent during much of the 1990s. In fact, Chile is possibly the only country in the world that has gone from Spanish-style, i.e., high structurally based, to low and predictable rates of unemployment. This was largely the result of a fundamental labor market reform that (a) greatly reduced high payroll taxes, especially social security taxes; (b) reformed an onerous severance payment system that made restructuring firms difficult and slow; and (c) changed the nature of labor-management relations from a confrontational system to one largely based on cooperation.

IV INSTITUTIONS AND THE SEARCH FOR THE "NEW" LATIN AMERICAN STATE

THERE IS A GROWING CONSENSUS AMONG analysts and regional leaders that virtually every Latin American country needs to reform the institutions of the state. Concepts such as "second generation reforms," "reforms of the state," and "institutional reforms" now appear in many analyses of the region's future.

The traditional Latin American state was subject to a paradox: It was both omnipresent and yet extremely weak. It was weak in at least two ways: First, it was unable to accomplish its functions with a minimum level of efficiency; and second, it was "captured" by numerous interest groups that competed to extract rents from the state. In an effort to solve these problems politicians burdened the state with additional obligations—which it could not perform—and tried to regulate people's behavior through multiple rules. The results: inefficiency, corruption and inequity.

Latin America is a highly diverse region. Countries have different traditions, cultures and histories. Naturally, these individual backgrounds will affect the way in which countries tackle the reform of the state. In spite of this diversity, however, there are general principles that should guide the institutional reforms that are the core of the second generation of the process. Perhaps the fundamental principle is that the state's role should be *limited* but it should also be *strong*. Limited, in two senses: First, it should only be involved in activities that the private sector does not perform or performs poorly. Second, it should impose limits on its own actions in order to credibly assure the public that it will not be engaged in political, social or economic abuse. The self-imposition of limits is, perhaps, one of the most important and difficult challenges in creating the new Latin American state. This can

be partially accomplished by creating autonomous institutions such as Supreme Courts, independent Central Banks, and independent regulatory bodies. The state should also be strong, in the sense that it performs its functions well and has effective safeguards to avoid being controlled by interest groups.

From an economic point of view the institutions of the state should aim at reducing "transaction costs."[37] That is, they should provide a framework where individuals, confident in the system, devote their time to productive activities, rather than defending their property and lobbying for special favors from bureaucrats. More practically, this means that the institutions of the state should protect broadly defined property rights, enforce contracts, and provide an efficient system of conflict resolution. This requires, as mentioned previously, not only the traditional separation of constitutional powers but also, as mentioned previously, the creation of independent and professionally run regulatory bodies. Today, even after years of reform, the Latin American state falls considerably short on these points. Conflict resolution mechanisms are primitive, the judiciary is inefficient and corrupt, and property rights—especially the rights of minority stakeholders—are systematically violated. As a result, in most countries individuals spend significant amounts of resources in unproductive ways.

The state should also protect individuals from abuse; protect the commons, including the environment; deliver social services in an efficient way; and provide a safety net to the poor. In order for these activities to be carried out efficiently and with little waste, there is need for a modern civil service. This should be professional, well paid and motivated—a far cry from its current condition. Administrative reform is a fundamental component of the Latin American reform process. In that regard, the East Asian countries, with their efficient meritocracies, provide an interesting example worth analyzing for its contribution to their success.

Prosperous and harmonious societies have a wealth of enterprising institutions that facilitate the interaction among individuals and between individuals and the state—these institutions, which include neighborhood organizations, clubs, PTAs,—have been called *social capital.*[38] The new Latin American state should protect and encourage the creation of social capital, including the organizations of civil society and non-governmental institutions. More important, perhaps, the state should avoid and prevent their destruction. In societies with abundant social capital there is significant "trust" among individuals who are able, therefore, to engage in fewer non-productive activities.

Defining the relations between national and subnational governments will have to be an important aspect of the Latin American institutional reforms aimed at rebuilding the state. In recent years there has been a rapid growth in political participation at the local level—after the return to civilian rule political leaders have been freely elected in more than 12,000 local governments in the region. Local governments now have greater spending authority and, in some cases, a significant increase in their capacity to tax. In some countries—Argentina and Brazil are possibly the best examples—subnational governments traditionally operated without budget constraints, contributing heavily to the national public deficit. Even as central governments tried to achieve macroeconomic stability, many subnational governments continued to practice economic populism. In other countries, subnational governments have failed to modernize and economic and social relations continue in quasi-feudal patterns—for example, the south of Mexico, the north of Brazil and many Central American countries.

Within the general framework discussed above, and at a more practical level, the institutional reforms of the Latin American state should, specifically, aim at:

- Maintaining macroeconomic stability. This requires the creation, and consolidation of truly independent central banks, and the implementation of modern nonpartisan budgetary processes.

- Imposing hard budget constraints on subna-

tional governments—states, provinces and municipalities.

- Revising the current relationships between subnational and central governments. In particular, encouraging subnational governments to compete among themselves—as in China, for example—while the central government ensures the existence of a common national market.[39]

- Creating a modern, and effective national civil service.

- Improving citizen security.

- Creating a labor-management negotiating framework that avoids excessive conflict and fosters cooperation.

- Protecting property rights, in a broadly defined fashion. In this regard, respecting the rights of minority claimants is extremely important. Some countries are moving in that direction. In others, however, recent episodes suggest that there is still a long way to go. This is particularly the case of Mexico where, despite recent legislation, the process of corporate debt restructuring in the aftermath of the crisis has been fraught with irregularities.[40]

- Reforming the judiciary, in order to ensure a fair and prompt conflict resolution framework.

Implementing these institutional *second generation reforms* will not be easy. Relatively little is known about the process leading to massive institutional changes, and the reforms will affect many interest groups. This process may generate frustration and, at times, disenchantment. In fact, if not managed properly, in the short run social conditions may be negatively affected. What is fundamentally important, however, is that the region's leaders recognize that without these reforms Latin America will be at a disadvantage in the global economic race, and that harmony and prosperity will be harder to attain.

VI CONCLUSION

THE ECONOMIC REFORM PROCESS in Latin America has delivered. The region weathered its worst post-debt crisis storm which arose in Mexico in December 1994 and, for a while, threatened to engulf the region. Moreover, investment continues to be attracted to many Latin American countries in growing amounts. Our fears are two: first, that leaders will be lulled into complacency or tempted by siren songs of populist cure-all solutions; second, that the slow speed at which the region is growing threatens the synchronization of pain and gain, which, in turn, creates public disaffection and anti-reform political pressures, as well as the obvious consequence of reduced resources for more and better social spending.

We are convinced that the vise can be broken only by quickening the pace of reform, as we said last year, but specifically and especially by taking action to dismantle the shards of the populist state. In Latin America and the Caribbean, the state must redefine itself. If the public agencies that administer and regulate education, health, safety net services and other social services providers, both public and private, are innovative, efficient, accountable, and trustworthy, broad support for continuing reform, with its difficult adjustments still to come, is far more likely to be maintained. If the agencies that define the context for investor confidence—the judicial system, regulatory agencies, Central Banks, the civil service—are independent, autonomous, transparent and strong, capital is more likely to continue to be available and with declining costs and increasing maturities.

Modern economies require modernized institutions. Improving the health, education, employment levels and wage rates of Latin America's populations is critical for economic recovery and political stability. The second generation reforms will be responsible for, first, consolidating the gains of the first generation, and, second, for meeting the region's long overdue debt to reduce poverty and improve income dis-

tribution. We estimate that it would be possible to double the rates of growth maintained from 1991 to 1994 if the state can reorient itself, making it possible for savings and investment rates to increase and for foreign capital markets to retain confidence in the region.

Reconstructing the state menaces many of the entrenched interests that, by holding public institutions hostage, benefited in the past. It is a challenge that demands public understanding of why it is crucial for economic stability and growth. It is a job for comitted political leadership with the courage to confront predictable resistance and periodic accountability to voters. The vision that drove the revolution in Latin American economic policy must now be turned to what remains unfinished—reforming the state.

APPENDIX

RECENT ECONOMIC EVOLUTION IN SELECTED COUNTRIES

IN THIS APPENDIX WE PROVIDE brief discussions on recent developments in selected countries in the region. For statistical information on a larger group of countries, see the Tables in the text.

Argentina: The so-called "tequila" effect hit Argentina in a particularly brutal way. Capital inflows stopped suddenly, and domestic residents rushed to withdraw bank deposits. As a consequence, domestic credit declined sharply, interest rates skyrocketed and fears of a major banking crisis became generalized. The Argentine authorities reacted promptly and in an exemplary way. An IMF program was adopted, fiscal correction was implemented and, with the assistance of the World Bank and the Inter-American Development Bank, an ambitious support program for the banking sector—including the privatization of a number of weak provincial banks—was put in action. These policies successfully discouraged speculators, and already by the end of 1995 it was clear that the country would not go through a Mexico-style meltdown, as some overly pessimistic observers had predicted.

The adjustment has not been without costs, however. As a result of the decline in liquidity and the heightened uncertainty, the level of economic activity declined by 4.4 percent in 1995. Unemployment increased rapidly to a modern record of 18.6 percent in May of 1995. Although it declined to 16.4 percent in October 1995, it continues to be remarkably high by historical standards. Worse, the prospects for a speedy reduction in unemployment are rather limited. A key question is whether this scenario will have political consequences by strengthening the position of "reform skeptics." The timing of the next national elections—October 1997 for Congress—does, however, provide an important breathing space to the government, which continues to be committed to furthering the reform program.

Before the Mexican peso crisis, Argentina ran a current account deficit that exceeded

US$10 billion. This imbalance was fully financed with capital inflows—mostly short term portfolio monies—which exceeded 4 percent of GDP in 1994. This situation became clearly unsustainable after the Mexican crisis. In 1995 Argentina was one of only two countries in the region that had a negative capital account—the deficit reached US$0.5.[41] What made this situation particularly difficult is that, due to the Convertibility Law, Argentina had to go through this major adjustment without relying on a relative price correction. Although it is difficult to come up with a precise figure, there is generalized agreement among analysts that at the outset of the crisis Argentina experienced an important degree of relative price disequilibrium.

In the aftermath of the Mexican crisis some observers have asked whether Argentina should abandon the Convertibility Law and the one-to-one peso-dollar rate. We strongly stand by the view we expressed last year in *Quickening the Pace*. On that occasion we said: "[a] change in the Convertibility Law in a...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." We are convinced that by having followed this strategy the Argentine authorities managed to avert a much deeper and more costly crisis.

During the first quarter of 1996 economic activity remained sluggish. Although confidence in the program has greatly increased, bank deposits continue to lag the level of late 1994, and interest rates remain very high. Toward the end of the first semester, however, there were some welcome signs of recovery.

Exports are growing at a spectacular pace—17 percent in volume terms in 1995. Moreover, improvements in the terms of trade (in particular, the prices for grains and beef) have further contributed to a strong external sector performance. A sustained recovery of the economy will require the revival of domestic activity and demand. An important question is whether this can be accomplished without generating new relative price disequilibria. To the extent that exports remain strong, confidence in the banking sector increases, and new structural reforms in the areas of provincial management, pensions, and especially labor are enacted, we can expect a growth rate of 2.5 percent for 1996.

Brazil: The year 1995 was crucially important in Brazil, as the *real* stabilization program was largely consolidated. As we pointed out above, in many ways the results of the program have been nothing short of spectacular: Inflation dropped from almost 1,000 percent in 1994 to 20 percent in 1995; real growth was a healthy 4.2 percent; and the current account deficit was held at 2.6 percent of GDP. Moreover, the executive continued to pursue basic reforms, including some privatizations.

Despite this progress, however, there is still much to be done. Public finances got badly out of hand during 1995, with the operational fiscal deficit reaching a scary 5 percent of GDP; short-term public sector debt has accumulated at a very fast pace; export growth slowed down considerably; real interest rates, although declining, continue to be extremely high; real growth was negative during the first quarter of this year; the banking system is weak; and, in spite of some progress, overall structural reforms continue to move at a slow pace.

External balance was maintained mainly through large capital inflows, which have made monetary policy management increasingly difficult. These inflows have been sterilized by the monetary authorities, at the cost of high real interest rates and a rapid accumulation of short term debt—the Federal Public Debt outside of the Central Bank increased from R$62 billion at the end of 1994 to R$138 billion in April 1996.

Sustaining the early successes of the *real* plan and ensuring a continuing recovery of the economy will require substantial action on the macroeconomic and structural reform fronts. In particular, a major fiscal correction is essential and urgent. This would allow a change in the policy mix, and a reduction in real interest rates that would lift the pressure on the banking system, allowing for a pick-up in economic activity. The prospects of prompt fiscal correction will depend on two broad policies: first, on the authorities' ability to maintain the line on public

sector wages. There is little doubt that in order to achieve even minimal progress on deficit reduction, wages in the public sector bureaucracy will have to be maintained constant in nominal terms. During the early months of 1996 the authorities showed great resolve on this issue, successfully fending off union pressure. It is still to be seen, however, whether this determined stance can be maintained as the October municipal elections approach. Second, a permanent solution to Brazil's perennial fiscal blues will require the approval of the Administrative Constitutional Reform by Congress. This reform would allow the Federal Government and (more importantly) the states to restructure their civil services, reducing the size of the public sector workforce to reasonable levels. In fact, one of Brazil's heaviest fiscal burdens is related to the surrealistically high level of wage expenses. Consider the case of the state of Rio de Janeiro, where wages and benefits to public employees surpass 85 percent of total revenues.

The prospects for action on the administrative reform are, at best, mixed. Since taking over the government, President Cardoso has proved to be a visionary leader, able to persuade the legislative branch to pass important laws. Increasingly, however, the reform measures pursued by the executive are being watered down by Congress. The reform of the social security system passed in March of this year is a good example. The administration presented a rather timid—but deemed passable—project to Congress, aimed at reducing some of the most blatant inefficiencies of social security system. At the end, and after major and often heated debate, a very minimal—and largely inconsequential—version of the project was approved. The need to reduce the fiscal burden of the current retirement regime continues to be urgent. The weakness of the Brazilian banking system—and especially of state-owned banks—adds significant uncertainty to the public deficit picture. Already the federal government has committed itself to providing more than US$12 billion to recapitalized two banks. The recent failure to place new Banco do Brazil shares in the market captures a generalized concern on behalf of investors—national and international—over the future of the country's banking system. A continuation of this trend would add significant tension to the country's public finances, making the success of the real plan increasingly difficult.

After exhibiting fast growth in 1993 and 1994, Brazilian exports slowed down. In 1995 the volume of exports declined by almost 3 percent, and the trend during the first quarter of this year has not improved. In particular, exports of manufactured goods have shown weakness. This poor performance, coupled with a surge in imports, generated a trade deficit of US$3.2 billion in 1995, compared with a surplus of more than US$10 billion in 1994. There are two main causes behind this loss of export dynamism. First, in spite of the reforms mentioned above, Brazil continues to be a highly distorted economy, where high costs and low quality of services—including in telecommunications, energy and ports—do not allow the private sector to fully exploit the opportunities offered by the global economy. Only to the extent that the structural reforms (including privatization) initiated by the Cardoso administration are deepened will these constraints be lifted, allowing Brazil's exports to grow once again at a fast pace. Second, the *real* plan has generated a real exchange rate appreciation that has reduced the competitiveness of Brazilian exports. The adoption of a sliding band system in early 1995 represented an important step in the direction of providing more flexibility to the exchange rate regime. It is important to stress, however, that returning to the old practice of mechanically adjusting the nominal exchange rate by past inflation would have extremely negative consequences. Exchange rate indexation without accompanying changes in fundamentals creates inertia, inflationary distortions and, sooner rather than later, a decline in economic growth. Exchange rate flexibility coupled with fiscal adjustment and major structural reforms, on the other hand, can provide an incentive package for encouraging exports.

If Brazil, as well as the rest of the region, for that matter, is to resume rapid growth it will be necessary to achieve a more competitive position that will encourage export growth. This, in turn,

will require moving forward on the reform path—including administrative, banking, social security and labor reforms—implementing a major fiscal adjustment and revising the credit policy stance.

Colombia: During 1995 Colombia continued to exhibit solid growth—5.3 percent, compared with 5.7 percent in 1994 and 5.2 percent in 1993—while experiencing a slight reduction in the rate of inflation. The current account balance is on the high side at 5.3 percent of GDP. This is especially the case in light of the recent Mexican crisis, which created a generalized legion of "current account watchers." Although the new consensus seems to be that countries should not run current account deficits in excess of 3 percent of GDP, Colombia represents an exception, where the higher deficit is justified and should not be a cause for serious concern in the short term. What distinguishes Colombia from other countries with recent current account deficits is their association with surges in investment, particularly portfolio flows, rather than with an explosion in consumption. In that regard Colombia looks more like an East Asian country than it does, say, Mexico in the early 1990s.

The stubbornness of Colombia's inflation—which in 1995 reached 19.5 percent, compared with 22.6 percent in 1993 and 1994—is the result of a combination of factors, including an ingrained system of (implicit) indexation, which has generated a significant degree of inertia. In addition, during 1994 and 1995 a relatively lax fiscal policy was followed. During the last year this was coupled with a tight monetary policy, creating a policy mix that resulted in very high real lending interest rates. These, in turn, affected the level of economic activity and began to put stress on the banking system. To a large extent Colombia's fiscal problems, as those of other countries in the region, stem from very large obligatory transfers from the central to subnational governments. Achieving a sustainable fiscal equilibrium will require, sooner rather than later, revising the financial relations between the national government, provinces, departments and municipalities.

During the last year Colombia has been affected by a serious political crisis that erupted after President Ernesto Samper's campaign was accused of accepting drug cartel money. This delicate situation was complicated further by the U.S. decertification of Colombia as a drug-fighting nation and by the imprisonment of some important politicians on related charges. As a result of the crisis, uncertainty has increased and investment has stalled. A recent survey by the country's leading think tank, *Fedesarrollo*, shows that Colombians have lowered their economic expectations significantly. According to *Fedesarrollo*, growth projections for 1996 have fallen to 3.8 percent, significantly below the 5.3 percent average for the last three years.

Although the political crisis introduced a significant degree of uncertainty and volatility, Colombia continues to have a very promising future. Oil exports are expected to increase steadily, the Central Bank continues to pursue policies geared at achieving macroeconomic stability and the authorities have announced that the privatization program will be stepped up. It is important, however, that a vigorous fiscal adjustment be implemented during the next few months so interest rates can decline, a banking crisis can be avoided and investor confidence in the country can return.

Mexico: 1995 was a roller coaster year for Mexico. Things started badly, only to stabilize somewhat in April-May after the US government and the international financial organizations, led by the IMF, announced a major assistance package. By mid-year it seemed that the worse was over and some international financiers were returning to the country. From October through November, however, new doubts on the strength of the economy arose, with the peso losing significant ground and interest rates skyrocketing. The year closed with an inflation rate of 52 percent, negative growth of 6.9 percent, a largely balanced external sector, and a rate of unemployment that was more than double the pre-crisis level. Throughout most of the year the fear of a collapse of the banking system dominated the concerns of analysts and policy makers.

During 1996, however, the economy has begun to recover. Exports have grown at a spectacular rate, and, in contrast with many countries

in the region, interest rates have declined significantly. Some progress has been made on the structural reform front—a social security reform is being implemented—and an effort has been made to upgrade banking regulation. Although the banking crisis was contained, it is still too early to know what its overall fiscal cost will be. An important issue that will have to be resolved in the months to come is how to distribute the fiscal cost of this crisis. Advances in privatization have been slow, but are expected to accelerate in the future. Overall, after a difficult 1995, Mexico is beginning to recover at a steady pace. Maintaining the current policy stance will be necessary to keep up the momentum.

Venezuela: During 1995, and throughout the first quarter of 1996, Venezuela continued to muddle through. Public finances were in shambles; exchange controls generated serious distortions, including corruption; monetary policy was erratic; and the management of the weak banking system left much to be desired. Then, in late March of 1996, President Caldera announced the implementation of a major adjustment program—worked out jointly with the International Monetary Fund, the World Bank and the Inter-American Development Bank. The program is aimed at addressing the country's fundamental problems. Although at this point it is too early to know whether its final outcome will be positive, a detailed analysis of the program suggests that, to the extent that its goals are, in fact, achieved, it should result in an ordering of the Venezuelan macroeconomy and a resumption of growth.

The new Venezuelan adjustment program has four main components: (a) measures aimed at reducing the overall fiscal deficit from 8 to about 2 percent of GDP; (b) policies geared toward reducing distortions, including exchange controls and interest rate ceilings; (c) actions directed toward a permanent solution of the banking crisis that has dragged on since 1994; and (d) policies to strengthen the social safety net for the poor. The fundamental policy actions contemplated by this program included a stiff—on average, 500 percent—increase in the price of gasoline; the unification and free floating of the nominal exchange rate; the freeing of interest rates; the creation of a "contingency fund" to restructure the banking system; and a package of subsidies to public transportation as an aid to poor families and public employees. In spite of their massive increase, gasoline prices continue to be at 50 percent of opportunity cost (that is the export price). Moreover, the rule to adjust gasoline prices in the future will be clarified—some officials say they will be pegged to the value of the dollar, while others argue there will be no further adjustments for the rest of the year. The program was received by the public—both in Venezuela and in the financial centers—cautiously. The free bolivar/dollar exchange rate initially jumped above its black market level prior to the reforms, only to settle down at approximately that value after a few days of trading; interest rates on government 90 days paper more than doubled. The market reaction to the Venezuelan program was positive. However, sckepticism remains over the country's actual ability to sustain it and meet the IMF targets during the life of the program.

An important component of the Venezuelan program is the recapitalization and strengthening of the banking system. This part of the program contains several elements, including cleaning up *Banco Latino*, the strengthening of the regulatory framework, the normalization of the so-called "migratory" deposits, and the liquidation of banks that are deemed nonviable in the short run.

From a statistical point of view 1996 will be a poor year for Venezuela. As can be seen in Tables 1 and 2, we expect an inflation rate in excess of 70 percent and a contraction of the economy of between zero and 0.5 percent. What is important to note, however, is that to the extent the authorities are willing—and able—to fully implement the recently announced program, it is possible that by mid-1997 the country will begin to see some recovery. If, on the other hand, the program stalls and the country returns to populist policies, we can expect a new collapse in the real economy, further speculation and an explosion of inflation.

NOTES

[1] In this report Latin America should be interpreted as referring to the nations of Latin America and the Caribbean.

[2] Naturally, as with all forecasts, these figures are subject to a degree of uncertainty. For alternative forecasts, see World Bank (1996b).

[3] In the case of Brazil this change in mood was vividly captured by a recent article titled "Brazil's Economic Plan Loses Support as Inflation Fight Hurts Middle Class." See, *The Wall Street Journal*, May 22, 1996. See, also, "Centrist Winning Ecuadoran Vote," *The Washington Post*, May 20, 1996, and "Peru's President Loses Some Luster," *The New York Times*, May 19, 1996.

[4] The need to implement these institutional reforms has been discussed by Burki and Edwards (1995), Edwards (1993a, 1995), and Naim (1995).

[5] The region's current account deficit was 3.4 percent in 1993.

[6] See the International Monetary Fund publication *Direction of Trade Statistics*, (1996). International Monetary Fund, Washington, D.C.

[7] See "Whatever Happened to Venezuela's Middle Class?" *The New York Times*, February 9, 1996.

[8] See the "Task Group on Social Development Report (World Bank, 1996d). The Task Group on Social Development, working under the chairmanship of Shahid Javed Burki, has submitted its draft report for review by the World Bank's senior management. Its main recommendation is that the World Bank needs to incorporate social concerns, social consequences of development policies and programs, and social imperatives for development in its work.

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[10] There is growing international evidence indicating that the degree of political support enjoyed by reformers depends on a small number of key economic variables: (a) the extent to which inflation has been reduced; (b) the behavior of real wages; (c) the rate of economic growth; and (d) the evolution of unemployment. Naturally, this is a phenomenon that goes beyond the Latin American countries. For instance, unemployment was an important variable in determining voters preferences in the recent Indian congressional elections. See *The Washington Post*, April 4, 1998. The way in which these variables actually affect political preferences is complex and varies from country to country. Recent broad studies on the subject, however, permit the extraction of some general rules. First, the positive effect of lower inflation is particularly high when inflation declines from very high to mid levels. Further reductions—to the low single digits, say—have a very small positive effect on political support. Second, while voters are sometimes willing to accept short-term sacrifices, they become impatient rather rapidly. In general, voters will accept short-term costs in the form of reduced growth and wages if they believe that these are necessary to correct past mismanagement or to face external shocks. On these political economy issues see, for example, Remmer (1991 and 1993), Haggard and Kaufman (Chapter 5, 1995), Stokes (1995), and Edwards (1996).

[11] On the recent evolution of the region's labor markets, see Cox Edwards, A. (1995).

[12] See World Development Reports for 1995 and 1996, Tables 9 and 13, respectively.

[13] See, for example, Edwards (1995b).

[14] See Edwards (1993b) for a survey of the relationship between openness, trade orientation and growth.

[15] See, for example, the analysis in Edwards (1995).

[16] Not surprisingly, this table unearths very diverse experiences throughout Latin America.

[17] Higher value added exports are associated with higher real wages. See, for example, Leamer (1984, 1995) and Edwards (1996).

[18] See Alesina, A. and L. Summers (1993).

[19] On monetary policy and the Mexican crisis see, for example, Sachs, Tornell and Velasco (1995) and Dornbusch, Goldfajn and Valdes (1995).

[20] See *El Espectador*, April 26, 1996.

[21] This proposal was made by the Office of the Chief Economist of the Inter-American Development Bank in March 1996. See, for example, Eichengreen, Hausman and Von Hagen (1996). For an interesting theoretical analysis of the relationship between budget institutions and macroeconomic stability, see Alesina and Peroti (1996).

[22] See World Development Report (1996).

[23] In this way a virtuous circle can develop: Higher public savings result in increases in capital accumulation and growth. In the presence of adequate institutions higher growth results in Higher private savings, further increases in capital accumulation, and even faster growth. See World Bank (1993e).

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

[25] See, for example, Fiszbein and Psacharopoulos (1992), Barros (1992) and Cardoso and Hewlege (1992).

[26] See Londoño (1995)

[27] See, for example, the two papers on education presented in last years World Bank's Latin America and Caribbean Annual Conference on Economic Development by Londoño (1995) and Schiefelbein (1995).

[28] See, for example, Puryear and Brunner (1994).

[29] Schiefelbein (1995) argues that in Chile, for example, the number of hours could almost be doubled by raising the number of students per teacher from 21 to 42. He points out that in Korea—considered to be one of the success stories in educational achievement—the student-teacher ratio was 48 as recently as 1980.

[30] Schiefelbein (1995) presents a set of a dozen reforms that would increase greatly the effectiveness and quality of the educational system, without significant new resources. However, as he points out persuasively, in order for the reform to succeed it is necessary to establish national consensus.

[31] See Londoño (1996).

[32] On these issues see Grosh (1990), The World Bank's *World Development Report 1993*, and Londoño (1996).

[33] See Psacharopoulos, G. (1992).

[34] See, "Argentine upturn puts hope back on menu," *Financial Times*, May 31, 1996.

[35] See "Estimating the Benefits of Labor Reform in Argentina," World Bank (1996).

[36] This view has been extensively developed by Nobel Laureate Douglass North in. In particular see, North, D.C. (1990).

[37] See Putnam, R. (1993).

[38] See Weingast (1994) on these issues.

[39] *The Wall Street Journal*, May 13 1996.

[40] The other was Venezuela, with a capital account deficit of almost US$4 billion.

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