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Viewpoints

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Latin America after Mexico

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Shahid Javed Burki
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Shahid Javed Burki is vice president for the Latin America and Caribbean regional office of the World Bank. Sebastian Edwards was chief economist in that office when this paper was written.

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This is the first report in the Annual Conference on Development in Latin America and the Caribbean series. Future reports on the state of the economies in the region will be presented at each of the coming conferences.

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INTRODUCTION

ON DECEMBER 20, 1994, a few days after the conclusion of the Summit of the Americas, Mexico devalued its currency, triggering a major crisis that threatened to engulf the Latin America and the Caribbean region.[1] International investors reacted with panic and began to withdraw funds throughout the area. Countries that as recently as 1993-94 had been favored by international investors suddenly came to be considered high risks, as fear of a repetition of the debt crisis of 1982 grew. Fueled by the difficulties faced in the initial rescue attempts of the U.S. government, bearish expectations on LAC were the rule at the beginning of 1995.

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

These reactions have proved groundless. In fact, the Mexican crisis has turned out to be a "wake up call" not only for Mexico but for all of Latin America and the Caribbean. The crisis has made it clear to policymakers, intellectuals, and the public that there are urgent unfinished tasks. The complacency, self-congratulation and sense of triumph with which policymakers in some countries had begun to look at their economic performance and prospects only a few months ago has given way to a sense of urgency.

Events in Mexico also made it clear to the region's leaders that reform is a continuing process which never stops and that they must be permanently alert to changes in the environmen in which they operate. The global economy of the late 20th century is a bit like *Alice, Through the Looking Glass:* It takes all the running you can do to keep in the same place. If you want to go somewhere else, you must run at least twice as fast. Leaders from a growing number of countries in the region have concluded that deepening reforms—and doing so more rapidly—is the only way to counter the skepticism that emerged among international financial analysts and, more importantly, to move firmly toward prosperity and social harmony.

The Mexican crisis crystallized the urgency of moving to a second phase in the reform process and clarified its agenda. Rebuilding the state and reducing poverty and inequalities are critical for the consolidation of the reforms that have already been advanced as well as for future growth.

More specifically, Mexican events turned caution lights on a number of the region's problems. Raising domestic savings rates, encouraging private investment in infrastructure, reforming the labor codes and education systems, and deregulating and de-bureaucratizing lower levels of government now top the list of reform priorities.

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

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

This report introduces a new annual publication by the Latin American and Caribbean Region of the World Bank. Each year the Vice President and the Chief Economist will present a review and analysis of some of the most important developments in LAC during the preceding 12 months. This year's report places particular emphasis on the Mexican peso crisis, its impact and the challenges that lie ahead. Section II contains a detailed discussion of the causes of the Mexican crisis, of the March 9 adjustment program, and of the likely effects of this episode on some of the largest countries in the region. Section III presents an analysis of the main economic and institutional challenges for LAC in the years ahead. Section IV discusses medium- and long-term growth prospects. Section V provides the conclusions. In addition, recent economic developments in the region are presented in an appendix.

II. THE MEXICAN CRISIS AND SHORT-TERM CONTAGION EFFECTS

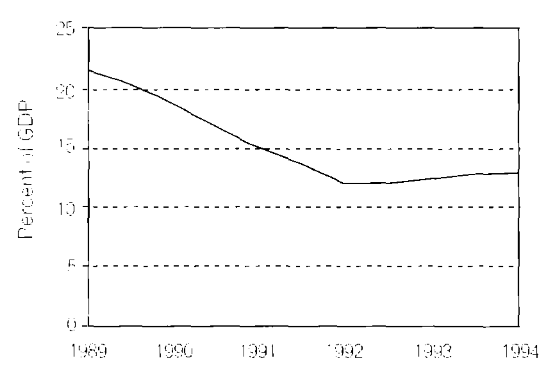
RECENT EVENTS IN MEXICO raised questions regarding the sustainability of the market-oriented reform process in LAC. As we will argue, a detailed review of the Mexican episode reveals that the reform process is indeed sustainable, even more so now that the crisis produced a loud and clear message throughout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

A. Why Did the Mexican Crisis Happen?

The main reason for the Mexican peso crisis was an *unsustainable current account deficit*, financed by large capital inflows.[2] How did the current account deficit get to this level? This was partially the result of Mexico's "success," partially the result of political developments, and partially the consequence of over confidence. As reforms were undertaken and inflation declined in the early 1990s, the world financial community wanted to take part in the rebirth of Mexico's economy. It did so by moving funds—mostly short run, portfolio capital—into the country. This was further facilitated by the decline in U.S. interest rates during 1993. The inflow of capital helped finance a tremendous private sector consumption boom and, in 1994, an expansion in public sector expenditures. Figure 1 shows the marked decrease in Mexican private savings during recent years.

Before the December crisis, most analysts of the Mexican situation acknowledged the need to

Figure 1:
Private Domestic Savings In Mexico, 1989-94



Source: The World Bank

implement some type of adjustment. The question was: when? Mexican policymakers favored an eventual rather than an immediate response. In September 1994, the World Bank argued in a public document that the excessive reliance on capital inflows had made Mexico vulnerable, citing the fall in savings rates and the link to higher consumption levels.[3] The Bank also mentioned that "productivity growth has so far been insufficient to offset the loss of external competitiveness implied by the peso appreciation."

Mexican authorities recognized that the current account gap could *not* be maintained at the 1993-94 level in the longer run, and planned to deal with the problem gradually. This view was based on two key assumptions: First, improvements in productivity would increase export competitiveness, helping close the trade gap; and second, the approval of NAFTA would entice additional capital to move into Mexico, providing space and time for the gradual adjustment to work.

A number of developments, however, frustrated this plan. First, political events in 1994 frightened foreign investors, who became particularly leery about currency risk.[4] In an effort to avoid rising peso interest rates, the Mexican authorities issued increasing amounts of peso denominated but dollar indexed, short maturity notes—the infamous *tesobonos*. Second, higher interest rates in the United States during 1994 further reduced capital flows into Mexico. And third, although productivity began to improve in 1993-94, it was not enough to generate the expected boom in exports so as to compensate for the increase in imports.

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

The circumstances that led to the rapid unraveling of Mexico's economy are now well known. When, under pressure, the exchange rate band was broadened on December 20, it was too little too late. The international financial community reacted in disbelief, and generated a chain-reaction financial panic. The announcement by the Clinton administration of the provision of massive loan guarantees temporarily calmed the markets in mid-January. Soon, however, it became clear that the rescue package would not be approved by the U.S. Congress, and the peso came under renewed pressure. By that time it was obvious that Mexico faced a major crisis, and that it would require a major adjustment, including a drastic turnaround in the current account, high unemployment and a substantial decline in the level of economic activity. It was not until April, after the announcement of an extremely strict adjustment program on March 9, that the financial markets began to settle.

B. Mexico's Policy Response

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

Here are the main elements of the program announced March 9:

- The fiscal measures include an adjustment in prices of public sector goods, an increase of the value added tax from 10 percent to 15 percent on most goods and a reduction in the real level of public expenditure. In 1995, tighter fiscal policy is expected to produce a primary budget surplus of 4.4 percent, twice as large as the one originally envisioned in January 1995.

- The authorities committed themselves to a floating exchange rate regime, with monetary policy designed to help stabilize prices. To achieve an inflation target of 42 percent in 1995, the Bank of Mexico would restrict the expansion of net domestic assets to 23 percent.

- With the assistance of a major World Bank operation, Mexico designed a program to strengthen the banking sector through intensive supervision and regulation. It increased capital requirements and loan loss reserves, and removed the ceiling for foreign ownership of Mexican banks. A foreign currency line of credit was established to enable domestic banks to meet their international commitments and created a subordinated convertible debt program to help banks experiencing a temporary fall in their capital requirements. It gave FOBAPROA (Fondo Bancario de Protección al Ahorro) the right to convert the subordinated debt of banks into capital and to take them over.

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

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

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

C. SOME LESSONS

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

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

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

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

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

- Particular attention should be given not only to the size but also to the term structure and currency denomination of public debt. The accumulation of short-term maturity debt is a signal of underlying fiscal problems and inconsistent macroeconomic policies.

- In redefining the role of the state—as is being done both implicitly and explicitly in most of Latin America and the Caribbean—it is important not to forget that a strong state is a prerequisite for a robust economy. The state should draw its strength not by owning industrial assets, managing public institutions and conducting commerce. It should do so by building powerful institutions—legal systems, regulatory agencies, and the like—that help promote competition, protect the consumer, and provide a framework within which the response of all economic agents can be predicted with reasonable accuracy.

- Improving income distribution and alleviating poverty cannot be left to trickle down consequences of economic growth. Government policies—in particular fiscal programs and tax administration efficiency and fairness—are critical for improving the distribution of income and reducing poverty. As Mexico is discovering, stabilization programs have a better chance of succeeding if political peace can be secured with the help of social safety nets.

D. Contagion Effects

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

Argentina

In late 1994, Argentina enjoyed several advantages compared with Mexico: (a) its current account deficit was less than half that of Mexico's; (b) it enjoyed a credible political and economic leadership; (c) its level of international reserves remained high; (d) public debt maturities were not concentrated in the short term; (e) many of its structural reforms were deeper, (f) its inflation rate was extremely low and expected to remain so.

Argentina's financial sector, however, is particularly vulnerable to negative external shocks, given the nature of the Convertibility Plan, under which high-powered money has to be fully backed by international reserves. Thus, the Central Bank has very limited resources to confront a run against bank deposits. After December 1994, the generalized "flight for quality" affected liquidity across many LAC economies. In the case of Argentina, a few banks had to suspend temporarily the convertibility of deposits in order to avoid selling their assets at distress prices following the withdrawal of funds. With assistance from the World Bank and the IDB the government is engineering a far-reaching reform of the financial sector, facilitating the merging of institutions, the streamlining of provincial banks, the strengthening of supervision and the implementation of a broad deposit insurance system.[5]

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

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

Brazil

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

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

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

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

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

Venezuela

The country entered a deep crisis even before the recent Mexican developments. By isolating itself from international capital markets—by introducing stern controls on capital flows—Venezuela has not been severely affected by the Mexican crisis. In fact, the economic situation was already under such strain that events in Mexico could not make it much worse. The prospect of smaller capital inflows to the region only make Venezuela's prospects dimmer.

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

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

Chile

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

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

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

Colombia

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

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

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

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

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In order for the region to consolidate its growth prospects in such a way that the benefits accrue to the population at large, macroeconomic stability and the removal of allocation distortions will be necessary, but certainly not sufficient. Recent and ongoing reforms will have to be complemented with policies that address education, poverty and the distribution of wealth. We now turn our attention to these pressing issues, ones that will have to be confronted in the immediate future.

III CHALLENGES

DURING THE LAST FEW YEARS LAC countries have instituted major economic reforms, which have begun to generate results as exports expanded, inflation declined, productivity grew fast and personal income increased. In spite of this progress, the LAC region still faces key challenges, which became even more evident following recent events in Mexico. The most important of these challenges is the need to *consolidate* the reforms by expanding the political coalition that supports the modernization process. This, in turn, will require two fundamental developments: First, the rate of growth has to accelerate significantly. Second, the fruits of the reform should be distributed in a way that reduces the region's legendary degrees of inequality and poverty.[6]

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

A. The Need to Enhance Growth

The recovery of the first half of the 1990s made LAC one of the most dynamic parts of the global economy. In spite of this, and even before the Mexico-induced slowdown of 1995, its rate of growth was not sufficiently high. A recent World Bank study estimated that a minimum average growth rate of 3.2 percent per annum is required to reduce the absolute levels of poverty in the region.[7] This has been the approximate rate of growth actually achieved during 1991-93. This means that after all the reforms, the efforts, and the accolades from the financial media, the region as a whole is making little progress toward breaking out of the quagmire of poverty. Accelerating growth to higher levels will require policy reform in at least the following six areas: competitiveness, domestic savings, infrastructure, rebuilding the state, labor market reform, and educational reform.

Table 1. Growth in Export Volume, Latin America and East Asia
(annual percentage rates)

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

Sources: ECLAC, *Statistical Yearbook for Latin America;* IMF, *International Financial Statistics*

Competitiveness

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

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

In the aftermath of the Mexican crisis, most countries in the region have continued to move briskly toward reducing resource misallocation. For instance, on April 1995, Mexico approved legislation to open transportation, storage and distribution of natural gas to foreign investors. The deregulation of telecommunications markets has already been approved by the Mexican Congress. In Venezuela, the opening of the state-owned oil holding PDVSA to foreign investors is under consideration in Congress. If approved, the legislation will allow foreign companies to hold up to 65 percent of joint ventures. In Peru, Petroperu was sold to private (both local and foreign) investors during 1993-94, and the country's two main refineries are expected to be privatized during 1995. In Brazil, although President Cardoso has ruled out the privatization of the oil company Petrobras, electricity-generating industries are expected to be sold to the pri-

Table 2. Intraregional Exports in LAC
(percent of total exports)

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

Source: ComTrade, United Nations International Trade Database

vate sector within one year. In May 1995, a congressional committee voted to open the telecommunications sector to competition, allowing private local and foreign companies to compete with the state-owned Telebras. In Bolivia a privatization scheme has been established in which a significant portion of any divested company is given to its workers and the rest sold to investors. The proceeds obtained from the latter are immediately capitalized in the same firm, with the end result that assets are more evenly distributed and firms have a much sounder balance sheet.

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

The volume of intraregional trade in LAC has exploded since the beginning of the 1990s. Intraregional exports rose from US$16 billion in 1990 to more than US$32 billion in 1994, or from 3 percent of total exports to almost 22 percent.[8] MERCOSUR is the most dynamic group, with a total US$11.4 billion in intraregional exports in 1994. This represents a threefold increase in five years, a performance that is enhanced by the simultaneous boost of 28 percent in exports to the rest of the world. Trade within the Andean Pact countries also increased in an impressive way, with exports reaching US$3.5 billion in 1994. Bolivia, Colombia, Ecuador and Venezuela have already formed a customs union, and Peru is expected to join toward the end of 1995. In November 1994, all five countries reached agreement on a common external tariff, to be implemented later this year. Intraregional trade doubled from 1990 to 1994 in the Central American Common Market, recovering from the meager levels of the 1980s. In the case of CARICOM, implementation problems and the more heterogeneous composition of the group resulted in the virtual stagnation of regional trade at the low levels of the late 1980s.

The new wave of trade integration strategies contrasts sharply with the early attempts of the 1960s. LAC nations have now embraced a so-called "open regionalism" approach according to which the increase in intraregional trade is encouraged without imposing additional barriers to trade with countries outside the area.[9] As a result, LAC economies have become more interdependent at the regional level, without slowing the drive for increased involvement with the rest of the world. In addition, the recent approval of GATT and the subsequent creation of the World Trade Organization have been important elements in assuring that regional trade growth will not clash with a multilateral trade strategy.

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

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

Domestic Savings

The accumulation of capital—both physical and human—plays a fundamental role in the growth process. Countries that grow faster devote a higher proportion of their GDP to investment and have developed a capital market that helps channel these funds toward high return projects. A faster rate of capital accumulation requires, in turn, an increase in domestic savings. The LAC region has traditionally had low saving rates: In 1980 the region saved on average 19 percent of its GDP; by 1994 this ratio was basically unaltered. This contrasts with fast-growing regions, which save up to 35 percent of GDP (Table 3). Low savings rates are, in fact, one of the most serious constraints faced by the region's countries in their effort to accelerate growth.[10] Recent events in Mexico triggered a significant slowdown in capital inflows, proving that foreign savings are not a long-term reliable source of funds, nor a substitute for domestic savings as a means for financing investment.

The most effective way to raise domestic savings is through higher *public* savings. This will have to be achieved through further improve-

Table 3. Regional Comparison of Private and Government Savings Rates, 1970-93

	1970–1982				1983–1993			
	Q1[a]	*Median*	*Q3*[a]	*Average*	*Q1*[a]	*Median*	*Q3*[a]	*Average*
a. Private Savings								
Latin America	13.1	13.2	21.7	16.1	10.9	14.7	17.9	13.8
Asia	na	na	na	na	17.4	19.1	22.9	20.2
Africa	11.4	14.4	18.9	15.2	10.7	16.7	19.5	15.6
Industrialized	18.0	21.6	23.4	21.3	18.3	21.3	23.4	21.3
b. Government Savings								
Latin America	-0.7	1.7	6.6	3.3	-1.3	2.4	5.5	2.2
Asia	0.0	2.7	8.8	4.4	0.0	1.6	9.0	3.9
Africa	-1.6	0.9	2.1	0.6	-1.3	1.0	4.5	0.9
Industrialized	-0.5	2.0	3.8	1.8	-3.6	-0.1	1.3	-0.8
c. National Savings								
Latin America	14.5	19.4	27.7	19.8	14.0	17.8	19.1	15.3
Asia	4.9	24.8	26.7	18.8	16.8	23.8	28.5	24.5
Africa	10.8	15.5	18.7*	16.4	10.6	17.5	22.1	16.8
Industrialized	19.6	22.8	25.8	23.1	17.5	19.1	23.4	20.4

a. Q1 is the first quartile, Q3 is the third quartile.
Source: International Monetary Fund

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

Efforts to raise public savings should be supplemented by policies aimed at encouraging private savings. Improving the efficiency of domestic financial markets will go a long way toward achieving this goal.[11] Comparative studies have suggested that an improvement in the provision of financial services, including an increased confidence in financial institutions, are at the heart of higher household savings.

The reform of the region's social security systems provides a second, and fundamental, vehicle for raising private savings. Analyses have shown that private savings are affected by the extent and coverage of government-run social security systems. If individuals perceive that when they retire they will receive high benefits from the government, they will tend to reduce the amount saved during their active days.[12] This forcefully indicates that a social security reform that replaces a government-funded system by a privately administered one will tend to increase private savings.

Regarding foreign savings, recent findings suggest that while long-term foreign investment enhances growth, it might well be the case that short-term foreign financing stimulates consumption, thereby substituting for domestic savings. It is therefore desirable to implement policies that favor direct foreign investment over short-term speculative flows.

Perhaps the most important finding of recent work on savings is that there is a virtuous circle between growth and private savings. Higher growth increases disposable income, and encourages savings. Higher savings, in turn, permit a higher level of capital accumulation, and thus, reinforce growth. A strategy that combines an increase in public savings with reforms geared at improving the mobilization of private savings will provide an effective way of taking advantage of this virtuous circle.

Infrastructure

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

The volume of infrastructure investment required for the next decade is substantial—representing approximately 4.5 percent of regional GDP—and much larger than the combined commitments of the World Bank and the IDB. The bulk of the increase will have to come from private sector investment. International experi-

Table 4. Infrastructure Investment Needs in Latin America during the 1990s

Sector	*US$ billion, 1993 prices*	*Percent of regional GDP*
Power	24	1.8
Transport	14	1.0
Telecommunications	10	0.7
Water and Sanitation	12	0.9
Total	60	4.4

Source: World Bank, *Regional Infrastructure Initiative* ence indicates that an efficient and credible regulatory framework, overseen by fully independent and professional regulatory bodies and commissions, is a fundamental requirement for getting a substantial private sector involvement in infrastructure investment. This is an area, however, where even the most advanced reformers are lagging behind and where significant effort will have to be made in the next few years. The World Bank is leading a drive for increases in infrastructure development, by which it serves as a catalyst to help countries mobilize from private sources the large volume of funds necessary, while also providing financing. Its main contribution will come through analytical support for policy reform to open the sectors to private participation, which is already proceeding rapidly in the power sector.[13]

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

Infrastructure investments require long-term financing. In most LAC countries, however, capital markets are still in their infancy, with funds for longer maturities being generally unavailable. Memories of inflationary years and banking scandals, untested legal structures and young regulatory frameworks, still stand in the way of truly modern financial markets. Moving swiftly toward reforming them will not only help increase domestic savings, but will also facilitate investment in infrastructure.

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

B. Poverty, Inequality and "Second Generation" Reforms

Poverty and inequality have long been salient features of LAC. The inability to deal effectively with these issues is, perhaps, the saddest illustration of the traditional policies of government intervention. Income inequality precedes the debt crisis and the adjustment programs of the 1980s; in the late 1970s the percentage of income received by the poorest 20 percent was lower in LAC than in *any* other part of the developing world.[14] The debt crisis negatively affected an already battered social picture. Although a number of countries reacted to the crisis by implementing emergency social programs, the overall level of poverty and inequality nevertheless increased in many countries.

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

During 1994-95 the World Bank undertook several country studies on the social conditions

Table 5. Poverty in Latin America and the Caribbean[a]
(percentage of population living in poverty)

Country	Poverty Early 1980s	Poverty Mid/late 1980s	Poverty 1990s	Extreme Poverty Early 1980s	Extreme Poverty Mid/late 1980s	Extreme Poverty 1990s
Argentina (1980, 1986, 1993)[b]	16.2	51.1	17.6	3.3	21.1	3.4
Bolivia (1992)	na	na	72.0	na	na	na
Brazil (1980, 1986, 1990)	39.0	40.0	43.0	na	na	na
Chile (1987, 1992)	na	28.0	24.0	na	17.0	9.0
Colombia (1988, 1992)	na	33.8	32.7	na	18.7	17.7
El Salvador (1992)	na	na	38.3	na	na	9.9
Guatemala (1989)	na	75.2	na	na	57.9	na
Guyana (1992)	na	na	43.2	na	na	27.7
Honduras (1989, 1993)	na	55.0	53.0	na	36.0	32.0
Jamaica (1989, 1992)	na	26.9	34.2	na	na	na
Mexico (1984, 1989, 1992)	24.8	27.5	25.9	6.1	7.7	8.2
Nicaragua (1993)	na	na	50.3	na	na	19.4
Paraguay (1990)	na	na	20.5	na	na	3.5
Peru (1982, 1989, 1992)	46.0	52.0	53.7	21.0	25.0	21.2
Trinidad & Tobago (1992)	na	na	21.0	na	na	11.0
Uruguay (1980, 1986)	11.0	15.0	na	na	na	na
Venezuela (1982, 1989)	22.3	31.4	na	10.3	22.3	na

a. Poverty is defined as the headcount index, the proportion of people who are deemed to be poor (or extremely poor). Although the poverty line (or the indigent line) is country-specific, in all cases it is defined on the basis of the cost of a basic basket of goods.
b. It refers to Metropolitan Buenos Aires. The significant increase in the mid to late 1980s is, to a great extent, the result of very high inflation.
na. Not available
Source: World Bank and ECLAC

and the extent of poverty in the region. Although methodologies are country-specific, Table 5 clearly shows that the Mexican situation is by no means unique. Both poverty and extreme poverty are widely spread across the region. As expected, poverty is more significant in rural areas, though in some cases even the urban indicators are disturbingly high (Table 6).[15] In the next few months additional case studies will be completed, providing a relatively complete regional diagnosis.

For many years, acceleration in growth was considered the main prescription for reducing inequalities and poverty. Increasingly, however, empirical evidence indicates that, although very important, higher growth is not enough. In general, it takes time for the fruits of faster growth to spread over the most vulnerable and poorest segments of society. A number of authors and institutions, including the World Bank, strongly argue that there is a need to implement a two-prong approach toward poverty and inequality, where faster growth is supplemented with social programs *targeted* at providing services to the neediest.[16]

Table 6. Urban and Rural Poverty in Selected Latin American Countries
(percentage of population living in poverty)

Country	Total	Urban	Rural
Colombia (1992)	32.7	19.8	50.5
El Salvador (1992)	38.3	36.2	41.4
Guatemala (1989)	75.2	57.2	85.7
Mexico (1992)	25.9	22.4	31.0
Nicaragua (1993)	50.3	31.9	76.1
Paraguay (1990)	20.5	19.7	28.5

Source: World Bank, several country-specific reports

A recent World Bank study on several LAC countries provides important information for the design of successful targeted social programs.[17] It was found that four fundamental factors determine the probability of being at the bottom of the distributional scale: education, gender, ethnicity, and regional issues. Education appears to be the single most important determinant of inequality. This study, as well as others, also found that, other factors being equal, the probability of being at the bottom of the distributional scale is higher for females. Moreover, poor women tend to be older, and have fewer opportunities to improve their skills through additional training and education. In many countries, ethnicity is directly related to poverty and inequality. For example, in 1989 only 40 percent of Guatemala's indigenous population had more than 5 years of education, compared with 76 percent of the non-indigenous population. Countrywide aggregate data tend to hide significant regional variations *within* countries. Brazil provides the starkest example of intracountry differences in development: Rio Grande do Sul has social indicators comparable to those of Portugal and Korea, while the region of Paraiba is not significantly different from East Africa.

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

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

Public sector divestiture in many cases also creates room for asset redistribution. An interesting case, already mentioned, is that of Bolivia, where privatization has been carried out through a mechanism that implies capitalization of divested firms and partial ownership by employees. The former ensures that revenue from privatization is not devoted to finance current government expenditure, but rather to enhance the capital base of firms that were formerly financially weak. The latter implies that the benefits of the scheme are widely spread in the community.

Rebuilding the State

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

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

Because of its own nature, the initial stage of the reform process was, to a certain extent, rather simple. After all, many of the policies were designed and implemented directly by governments, with little or no need for Congressional approval. They were administratively simple, with ample theoretical support and with several prior practical experiences to benefit from. Rather than the creation of new institutions, they implied the downsizing of the government.[18]

The challenge that lies ahead is formidable. Fortunately, recent events in Mexico have reminded technocrats, politicians and the general public that the deepening and broadening of the reform process has to be performed, and soon. Decrees that reduced tariffs or liberalized interest rates were the typical instrument of the initial stages of reform; in what lies ahead new institutions will have to be created, and existing ones will have to be reformed. And it will no longer be the case that changes will be "evenly" distributed among members of society, as was the case, for example, with tight monetary policy to reduce inflation. In what follows, specific groups will win at the cost of others. The implementation of these changes will be costly in political terms, and much more complicated than previous ones.

Labor Market Reform

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

In most LAC countries social security contributions are seen as pure taxes, not as a component of total compensation package.[19] As a result, they introduce serious distortions that increase the cost of labor and reduce its mobility. Moreover, in most countries the social security system is financially insolvent, imposing additional costs by contributing to the fiscal deficit. Replacing the region's pay-as-you-go pension regimes, where there is no link between contributions and benefits, by a combination of individual capitalization accounts and minimum services assured by the government would go a long way toward reducing the current degree of distortions. This system reduces the cost of labor, encourages savings and provides a boost to capital markets by developing institutional investors.

The region's labor legislation has a long tradition of trying to protect employment stability. This has been done through a series of measures, including limitations on temporary hiring and imposing substantial costs—in the form of severance payments—on dismissals. These policies had two consequences. First, they increased the cost of labor, discouraging employment creation. Second, because of the specific way in which the legislation was put into effect, the policies strongly discouraged training activities and the acquisition of new skills. What makes existing severance payment schemes particularly inefficient is that they are related to the worker's tenure in the firm. This introduces some serious and arbitrary distortions, as firms will tend to retain older workers, even if they are less productive than others. Relating severance payments to years of service also reduces the employers' incentive to invest in human capital formation, especially if skills are not firm-specific. Transforming severance payments into a deferred compensation scheme, or replacing them by unemployment insurance systems, would greatly increase the degree of efficiency of labor markets. This has been partially done in some countries.

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

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

Educational Reform

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

The accumulation of human capital, through increases in the coverage and quality of education, constitutes one of the fundamental pillars of successful development strategies.[20] For instance, it has been argued that the Korean "miracle" since the mid 1960s—where living standards have doubled every eleven years—has been largely propelled by increases in productivity fueled by the accumulation of human capital. A series of recent empirical studies have strongly supported this view, indicating that the existence of a highly educated labor force, whose skills improve rapidly year after year, has been partially behind the tremendous economic success in Korea, Hong Kong, Singapore, Taiwan and other East Asian countries. Table 7 presents data on recent education attainment for a group of Latin American countries. Information on three of the East Asian miracle countries—Hong Kong, Korea and Singapore—is also provided for comparative purposes. This table shows that while there are significant differences in education coverage across Latin America, in every category with available data, educational coverage in the East Asian "tigers" significantly exceeds the average for LAC.

Incomplete coverage is not, however, the only problem with the Latin American educational system. A recent World Bank study has found that the average *quality* of Latin America's primary education is dismal. For example, an international comparative study on reading abilities of 9-year-old children found that Venezuelan students ranked last out of 27 countries; Trinidad and Tobago students did better, but still significantly below the average. A 1992 study on science and mathematics achievement for 13-year-olds found that Brazilian students from Sao Paulo and Fortaleza were outscored by students from Korea, Taiwan, Israel, Jordan and China, as well as by students from every developed country in the sample. The only country Brazil outscored was Mozambique. Finally, a 1992 study on mathematics and science for 13-year-old students in five Latin American countries—Argentina, Colombia, Costa Rica, the Dominican Republic and Venezuela—found that, with the exception of elite schools, in most cases test performance was significantly below that of "average" countries, such as Thailand and the United States.[21]

The low quality of the region's educational system is partially reflected by very high repetition rates, which rank among the highest in the developing world. In Bolivia the repetition rate

Table 7. Educational Attainment Levels
Latin America and East Asia Comparative Data, 1991

Country	*Primary net enrollment*	*Secondary enrollment*[a]	*Tertiary enrollment*[a]	*Primary pupil/ teacher ratio*
Argentina	na	na	43	18
Brazil	88	39	12	23
Chile	86	72	23	25
Colombia	73	55	14	30
Mexico	98	55	15	30
Peru	na	70	36	28
Costa Rica	87	43	28	32
Guatemala	na	28	na	34
El Salvador	70	25	16	44
Jamaica	99	62	6	37
Trinidad & Tobago	91	81	7	26
Latin America and the Caribbean	87	47	18	26
Hong Kong	na	na	18	27
Korea	100	88	40	34
Singapore	100	70	na	26

a. As a percentage of the eligible population.
Source: World Bank, *World Development Report 1994.*

goes from 16 percent in Beni to more than 35 percent in Chuquisaca. It is estimated that in 1990 the cost of repetition exceeded US$4 billion for the region as a whole. The Eastern Caribbean, where a UK-based system operates, has the region's exception. The rate of repetition in those countries is significantly lower than in the rest of the region (World Bank 1993).[22]

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

• • •

None of the benefits of all the above reforms will be sustainable in the long run, and several of the incentives implicit in recent reforms will not be effective in stimulating private sector participation, if the judicial system is ineffective. The rights and responsibilities of labor unions and of privately owned "natural monopolies"; the effective rules of the game governing foreign investment and land tenure; the threat posed by drug mafias and guerrilla movements. All of these issues require a new approach to governance, in which the role of the state can no longer be as a producer of goods and provider of employment.

IV LONG-TERM GROWTH PROSPECTS

A RECENT PROJECTION EXERCISE performed at the World Bank indicates that by the end of the century—only five years from now—LAC could be growing at an annual rate of 6.3 percent (see Table 8). Broadly speaking, this doubling in the region's average rate of growth is explained by what we forecast will be important increases in investment and advances in factor productivity.

According to an IMF study, average annual GDP growth for the 12 largest LAC economies during the 15 years between 1970 and 1985 was 2.9 percent. This poor performance was explained primarily by low capital accumulation (1.5 percent) and very small increase in productivity (0.3 percent). Another World Bank study recently reached the conclusion that between 1960 and 1987 productivity increased at an annual rate of only 0.9 percent. In addition, physical capital increased by 6 percent, the labor force by 2.9 percent, and human capital by 4.1 percent, combining for an average GDP growth rate of 4.8 percent. This picture contrasts sharply with that of countries in East Asia and the Pacific region, which exhibited similar increases in physical capital (6.4 percent) and in the labor force (2.5 percent), but much higher advances in productivity (1.5 percent). As a result, the Asian and Pacific region grew at an annual average rate of 6.1 percent, or close to a full point and a half more than the LAC countries.[23]

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

It is worth emphasizing that these are necessary elements for growth to materialize. But they must also be complemented by a stable political environment. There is ample evidence that political conflicts deter growth. The targeting of social expenditure, the reduction in poverty, the redistribution of assets, and complemen-

Table 8. Some Key Determinants of Growth

	Early 1990s	Projections 1998–2003
A. Savings	19.9	28.0
Private	13.8	19.5
Public	2.2	6.0
Foreign	3.9	2.5
B. Investment	19.9	28.0
Infrastructure	3.0	4.5
C. Schooling	4.9	6.2
D. TFP growth	0*	1.5
E. GDP growth	3.4	6.3

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

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

Source: "Long Run Prospects for LAC: Rapid Growth is Possible," mimeo, LACCE. May 1995

tary policies that reduce social conflict are, therefore, not just desirable in and of themselves but are vital components for high and sustainable growth. In that regard, LAC offers some impressive grounds for confidence: Between 1993 when Chile held a presidential and congressional election, and May 14 of this year when Argentina did the same, over 85 percent of the region's population voted in nationwide elections. In most of them, presidential candidates supporting economic reform were elected or re-elected. This is significant evidence for the view that in the LAC societies there is an increasing agreement on reform and that there will be a high and unprecedented degree of policy continuity in the region looking out to the end of the century and, in some cases, beyond it.

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

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

Factor productivity is also predicted to increase as a consequence of education, deregulation and openness. If results in the region as a whole approach those observed in the countries that pioneered market-oriented reforms, total factor productivity growth could add 1.5 percentage points to GDP, compared with a negligible contribution throughout the 1980s.

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

V CONCLUSION

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

This urgency is a consequence of two important figures revealed by recent World Bank studies. The first is that in spite of the economic achievements registered in the last few years, LAC's poverty rates have not budged and income distribution, for which we have no conclusive data, may have improved only slightly. LAC's record is now unbroken: Since the 1950s—for four and a half decades—the number of people living in poverty has not fallen. The impressive growth rates reached in some countries have barely pushed the region's average annual growth rate to the 3.2 percent that the World Bank considers the minimum for producing an actual reduction in poverty levels.

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

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

APPENDIX

RECENT EVOLUTION OF LATIN AMERICAN AND CARIBBEAN ECONOMIES

DURING 1994, AND UP TO THE ERUPTION of the Mexican crisis, LAC continued to evolve in a positive way, following the trend observed since the late 1980s for most of the reforming countries.[24] GDP growth for the region as a whole was 4.4 percent, almost one percentage point above the average from 1990 to 1993. While this regional average hides a diverse performance across countries, it is worth underscoring that the growth rate in most countries was clustered around the average—Peru grew at the remarkable rate of 12 percent during 1994, and Argentina (7.1 percent), El Salvador (5.8), Colombia (5.3) and Brazil (5.7) also performed well on the growth front. Haiti, Venezuela and Honduras, however, did poorly (see Table A1).

For the region as a whole, the prospects for 1995 and 1996 show a slowdown in growth as compared with the recent past, but no significant downturn. In fact, it is widely expected that in most countries matters will start improving as early as 1996. A background study for the World Bank's *World Development Report, 1995* estimated that under positive conditions the region's average annual growth rate would be 5.1 percent for the period 1995-2010, with total factor productivity increasing by 1.6 percent per year and investment reaching 25 percent of GDP.[25] Our own projections, discussed in some detail in Section 4 of this report, indicate that under a "best case" scenario we can expect an average rate of growth for LAC of 6.3 percent for 1998-2003.

During 1994 inflation rates continued to fall across the region (see Table A2). The average excluding Brazil was 20.3 percent. When Brazil is included, it increases to 61.6 percent. This falling trend is expected to continue over the rest of the decade, including a further reduction in Brazilian inflation, after the introduction of the *real* stabilization plan. The pace at which Brazil's inflation will decline is, to some extent, an open question. The acceleration of industrial activity since mid-1994, and the 43 percent increase in the minimum wage in May 1995 covering more than 15 million work-

Table A1. GDP Growth in Latin America (Annual percentage rates, constant prices)

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

Source: World Bank

ers, have put pressures on the wage bill and thus on aggregate demand. In Mexico, the depreciation will be partially reflected in inflation, which is expected to increase four-fold from 1994 to 1995, to around 46 percent for the year as a whole.

Information on current account balances and inflows of funds is displayed in Tables A3 and A4. During 1991, 1992 and 1993, the region enjoyed abundant foreign financing due to bullish expectations of institutional investors following the process of far reaching reforms, and in part due to significant reductions in U.S. interest rates.

Table A2. Inflation in Latin America (Annual percentage rates)

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

Source: World Bank

Table A3. Current Account Balances in Latin America
(percentage of GDP)

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

a. These large figures are heavily affected by the existence of foreign aid.
Source: World Bank

That situation began to change in 1994. As should have been expected, large external deficits became harder to finance, so that more aggressive export strategies and policies to enhance domestic savings were called for. The conditions that reigned through early 1994 were totally reversed when the crisis broke in Mexico. Curtailed foreign financing is expected to last through most of 1995. However, once the markets see the emerging economies of LAC moving successfully with the second phase of reforms, foreign capital will return, and this time around direct investment will play a more important role.[26]

Figure A1 shows the evolution of real exchange rates in the region. It is clear that the generalized process of appreciation observed at the beginning of the 1990s has subsided. The exception is the Brazilian real, which, introduced at a highly depreciated level, has risen by about 30 percent against the U.S. dollar since the plan's inception. The external environment, in which the region's access to foreign financing has been temporarily decreased, requires a renewed attempt at enhancing external competitiveness. Increases in productivity and more competitive real exchange rates will be essential in this respect. However, productivity gains are long term in nature, so that no short-term relief should be expected from it.

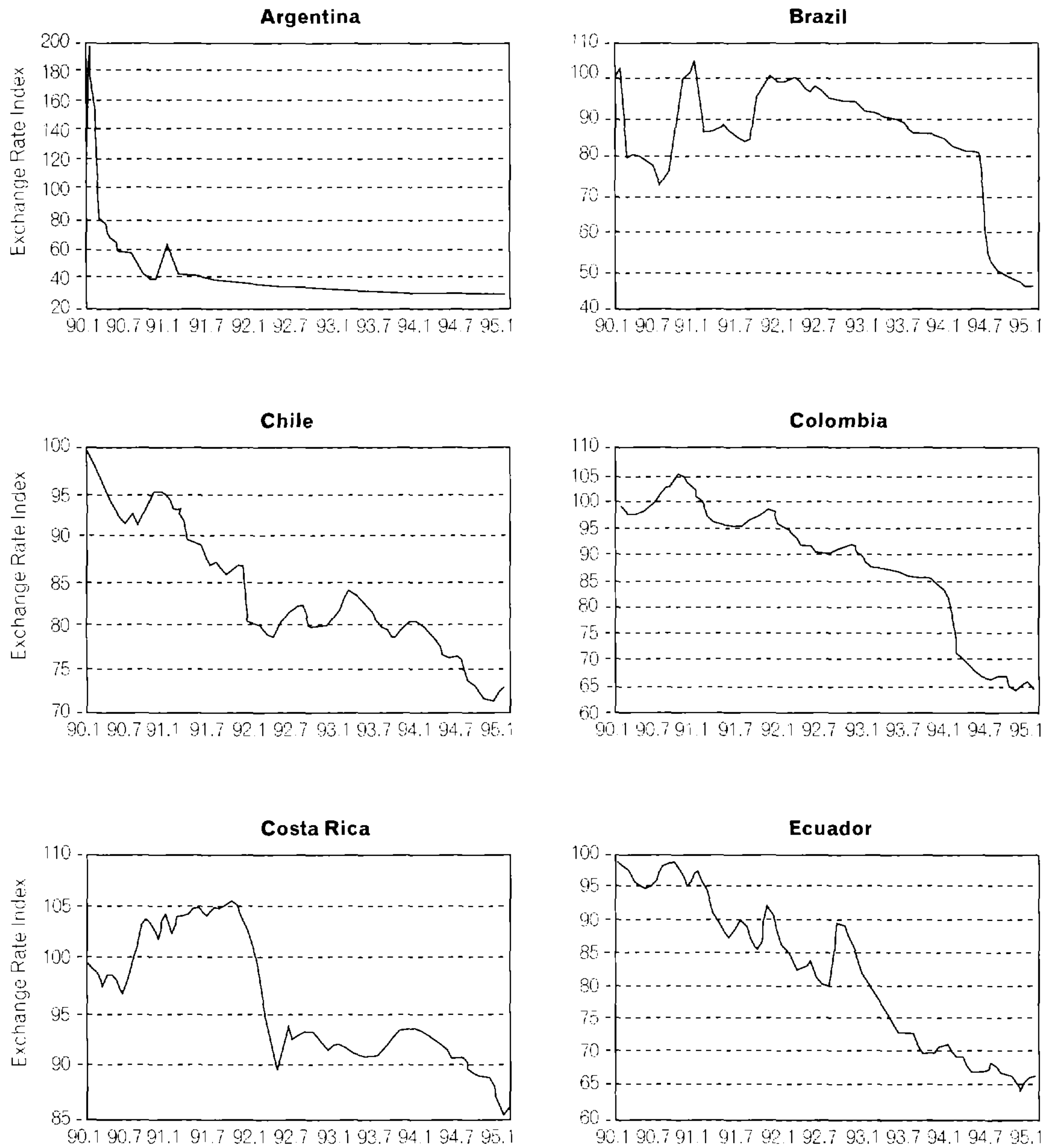
Regarding international trade, exports have continued to perform quite well, with an increase in 1994 of 14.3 percent. Imports, however, grew even faster (14.7 percent), contributing to the development of large current account deficits. The trade balance followed its negative trend started in 1991, reaching an $18 billion deficit. Commodities prices have been evolving favorably in the last couple of years, in sharp contrast with events in the latter part of the 1980s. According to the World Bank's *Global Economic Prospects*, this trend is expected to continue during 1995 and 1996.

Table A4. Net Capital Flows into Latin America
(billions of dollars)

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

Sources: IMF for 1990 and 1991, CEPAL for 1992 to 1994.

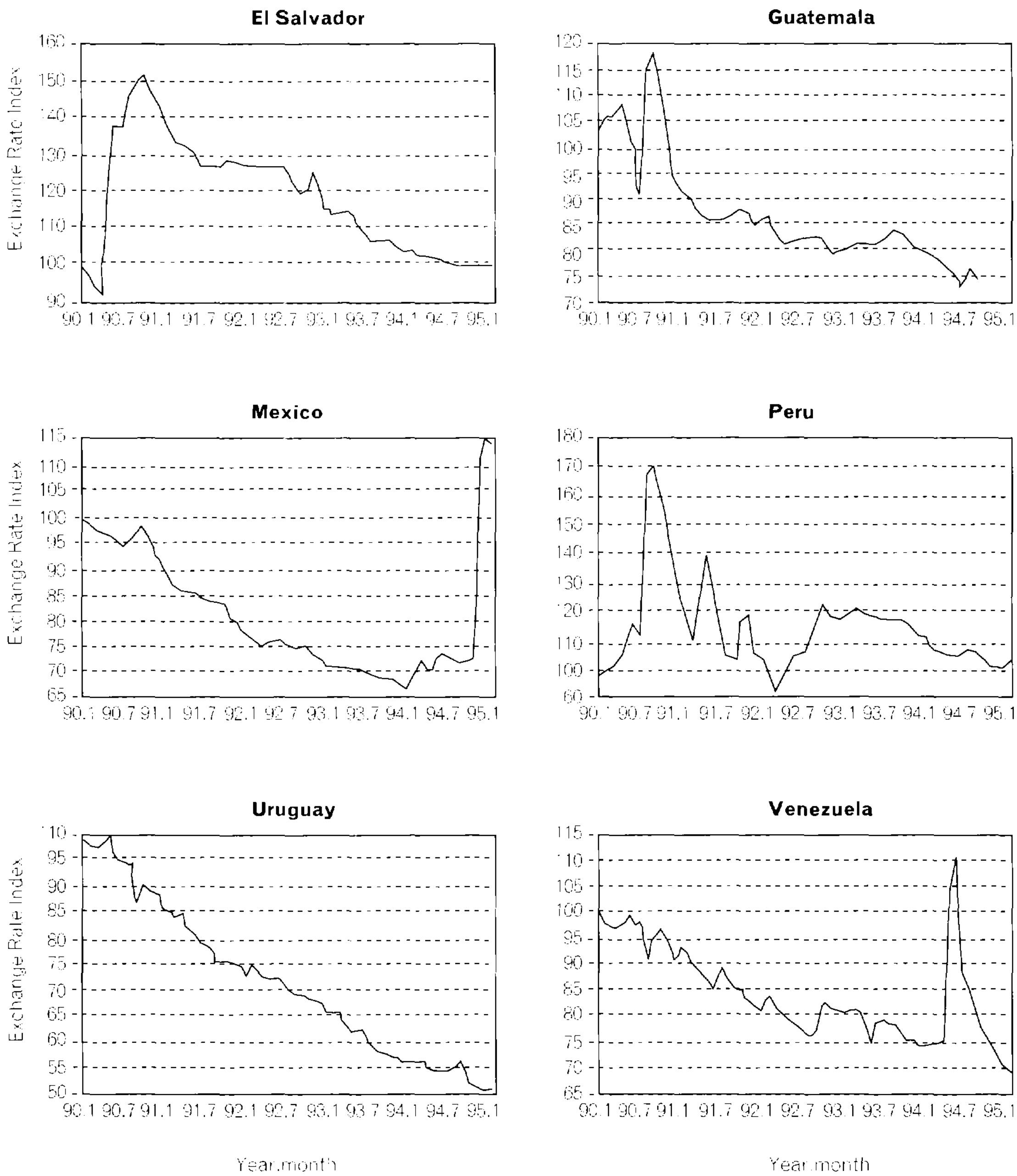
Figure A-1. Real Exchange Rates in Latin America
(January 1990=100)



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

Source: IMF, International Financial Statistics

Figure A-1. Real Exchange Rates in Latin America
(January 1990=100)



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Source: IMF, International Financial Statistics

NOTES

[1]LAC region in what follows.

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

[3]See World Bank, *Trends in Developing Countries 1994*, p. 331.

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

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

[6]This section draws partially on Burki and Edwards (1995).

[7]*Implementing the World Bank's Strategy to Reduce Poverty: Progress and Challenges*, April 1993.

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

[9]See CEPAL (1994).

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

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

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

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

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

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

[16]World Bank (1992).

[17]Fiszbein and Psacharopoulos (1992).

[18]Naim (1994) has written the pioneer piece on this subject.

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

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

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

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

[23]See De Gregorio (1991) and *World Bank Development Report 1995*

[24]See Edwards (1993).

[25]*World Development Report, 1995 to be published.*

[26]In 1995, the region's current account deficit is expected to be close to 1.8 percent of GDP, down from about 3 percent in 1993-94 (see World Bank, *Global Economic Prospects*).

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HEADQUARTERS

1818 H Street, N.W.
Washington, D.C. 20433 USA

Telephone: 202.477.1234

Facsimile: 202.477.6391

Telex: MCI 64145 WORLDBANK
MCI 248423 WORLDBANK

Cable Address: INTBAFRAD
WASHINGTONDC

World Wide Web: http://www.worldbank.org

E-mail: books@worldbank.org

EUROPEAN OFFICE

66, avenue d'Iéna
75116 Paris, France

Telephone: 1. 40.69.30.00

Facsimile: 1. 40.69.30.66

Telex: 640651

TOKYO OFFICE

Kokusai Building
1-1, Marunouchi 3-chome
Chiyoda-ku, Tokyo 100, Japan

Telephone: 3. 3214.5001

Facsimile: 3. 3214.3657

Telex: 26838

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