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Consolidating Economic Reforms in Latin America and the Caribbean

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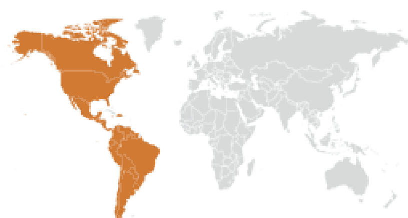

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THE ECONOMIC reforms that have been sweeping Latin America and the Caribbean since the late 1980s are bearing fruit. To consolidate these reforms, governments now need to move quickly to accelerate economic growth and reduce poverty. The Mexican peso crisis lends some urgency to this approach.

The eagerness with which countries in Latin America and the Caribbean are pursuing free trade agreements today is in sharp contrast to the determination with which they pursued economic isolationism and autarky just ten years ago. Most countries in the region adopted economic policies in the 1930s that called for heavy government intervention, regulation, and protectionism. The first to abandon these policies in favor of market-oriented reforms was Chile, in the 1970s. Since the late 1980s, however, the entire region has been swept by economic reforms—interestingly enough, at a time when democratic forms of government have been restored in virtually all of Latin America.

The region is already reaping the benefits of economic modernization: productivity and exports have expanded rapidly, and personal income growth is increasing steadily. Many countries are close to achieving single-digit inflation. GDP growth rates have improved significantly—the average for the region rose to 3.2 percent in 1994. There is no reason why the crisis in Mexico, handled correctly, should leave a lasting imprint on the region's economies.

The economic landscape in Latin America and the Caribbean has been transformed, but the region still faces a number of important challenges—the most serious is the persistence of widespread poverty, particularly in the large cities. According to a recent World Bank study, Latin America's GDP growth rate for 1994, although higher than in previous years, is still not high enough to bring about a decrease in the number of poor people. To reduce poverty, governments in the region need to develop strategies to accelerate growth significantly; they also need to design more effective social programs for the poor, or they may not be able to garner the broad political support they need to continue with economic modernization. Acceleration of growth and reduction of poverty will require a series of difficult "second-generation reforms" that involve consolidating macroeconomic stability, rebuilding the state, overhauling the educational system, and making labor markets more flexible.

Accelerating growth

If Latin America achieves improvements in three key areas—export competitiveness, domestic savings, and investment in infrastructure—its average annual rate of growth could increase substantially by the end of the decade.

More competitive exports. Latin America's new development strategy gives exports a central role, as did East Asia's during the 1960s and 1970s. Between 1987 and 1992, exports from Latin America and the Caribbean grew annually by approximately 10 percent in real dollar terms and 6 percent in terms of volume. For Latin America and the Caribbean to achieve higher economic growth rates, however, it will not be enough to maintain this momentum; exports will have to grow even faster. Historical data suggest that rapidly growing countries have enjoyed a sustained rate of export expansion that is more than double the growth rate for income.

To accelerate the growth of exports, countries in Latin America and the Caribbean will have to become more competitive by improving productivity. Future productivity gains will depend on three basic developments: prudent fiscal policies, domestic deregulation and reform of the educational system, and the continued liberalization of world trade.

Prudent fiscal policies will be necessary to maintain and consolidate macroeconomic stability. The importance of this message cannot be overemphasized: as the region's history has repeatedly shown, fiscal imbalances have often led to serious crises that encourage speculation, retard growth, and increase poverty and frustration.

Almost every country in the region has received large volumes of foreign portfolio capital during the past few years. The increased foreign resources have challenged governments' ability to manage monetary policy, pressured real exchange rates, and allowed countries to run large current account deficits and accumulate sizable international reserves.

There is little doubt that, for most countries, the current capital inflows will not continue in the long run. Once international financial conditions change—and investors have the desired amount of Latin American securities in their portfolios—the volume of foreign resources flowing into the region will decline. And that will require an adjustment. If public finances remain under control and credit policy is consistent, the adjustment is likely to be gradual and smooth. But if macroeconomic management is less than prudent, capital inflows could grind to a sudden halt, unleashing potentially serious macroeconomic dislocations. This means, among other things, that governments should strive to avoid the overvaluation of the real exchange rate and that the volume of capital inflows must remain at sustainable levels to avoid exchange rate crises, such as the devaluation of the Mexican peso in December 1994.

Recent deregulation reforms will have to be broadened and deepened; in particular, there will have to be deregulation at the local level, to reduce the controls, distortions, and red tape that still exist in states, provinces, and municipalities. The educational system and labor markets will also have to be reformed.

Improvement of domestic conditions to achieve greater competitiveness is only one factor determining the performance of exports, however. Equally—if not more—important is the evolution of the world trading system. For Latin America's exports to grow faster, the region will have to be more open to trade with the rest of the world, and—as is expected to happen with the ratification of the Uruguay Round—markets in industrial countries will have to be more open to exports from the developing world.

Raising domestic savings. The accumulation of capital is fundamental to the growth process. Countries with high growth rates devote a higher proportion of their GDP to investment and—perhaps more important—have developed domestic capital markets that efficiently allocate funds to high-return projects. For capital accumulation to occur more rapidly, however, domestic savings must increase, and Latin America has traditionally had very low saving rates. In 1980, for example, the region saved only 19 percent of its GDP, on average; this ratio had not changed by 1994. In contrast, East Asia, the fastest-growing region in the world during this period, saved, on average, 35 percent of GDP.

Evidence from a score of countries—including the "East Asian miracle" nations—suggests that increasing private domestic savings ratios is a rather slow process. So, the most effective and direct way to increase aggregate domestic savings in the short and medium term is to raise government savings through changes in the public deficit. Recent statistical studies suggest that, although government savings crowd out private savings, the effect is not one-to-one—a 1 percent increase in government savings will generate a 0.5 percent increase in aggregate domestic savings. These studies also found that increasing public savings by reducing expenditures is more effective than increasing taxation.

The best combination of higher tax revenues and reduced expenditures to increase public savings depends on the specific characteristics of the country. If tax compliance is low, and the tax effort clearly below par, an increase in tax revenues will be called for. But, under most circumstances, some reduction in expenditure is likely to be optimal. In most countries in the region, cutting the military budget is a way to both finance the expansion of social programs and generate higher public savings.

Efforts to raise public savings should be supplemented by measures to encourage private savings—for example, establishing regulatory and prudential supervisory frameworks that make domestic financial markets more efficient, and improving the provision of financial services. Building confidence in local financial institutions will be necessary if household savings are to increase. Comparative empirical analyses have also shown that private savings are strongly affected by the extent and coverage of government-run social security systems; individuals tend to save less if they expect to receive generous social security benefits when they retire. This suggests that a reform that replaces a government-funded pension system by a privately administered one—as in Chile, for example—could lead to an increase in private savings.

Perhaps the most important finding of recent studies on savings behavior—including those focused on East Asia's experience—is that there is a virtuous circle between growth and private savings. Higher growth increases disposable income and encourages private savings. Higher savings, in turn, permit a higher level of capital accumulation, and thus reinforce higher growth. A strategy that combines measures to increase public saving with reforms designed to improve the mobilization of private savings enables countries to take advantage of this virtuous circle.

Investing in infrastructure. Investment in infrastructure was seriously neglected in Latin America during most of the 1980s and the early 1990s. As a result, the region now faces a serious deficit in power generation, roads, water supply, and telecommunications. According to World Bank calculations, approximately $60 billion will have to be invested in infrastructure every year between now and the year 2000 to make up for past neglect and to provide the region with the infrastructure stock needed for an export-led growth strategy (Table 1). Moreover, detailed analyses in the World Bank's *World Development Report 1994: Infrastructure for Development* show that the quality of the services provided by Latin America's existing stock of infrastructure leaves much to be desired.

Table 1Infrastructure in Latin America and the Caribbean Annual investment needs, 1995-2000

Sector	1993 prices (billion dollars)	Percent of regional GDP
Power	24	1.8
Transportation	14	1.0
Telecommunications	10	0.7
Water and sanitation	12	0.9
Total	**60**	**4.4**

Source: World Bank, *Infrastructure Initiative for Latin America and the Caribbean* , available early 1995.
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The volume of infrastructure investment required during the rest of the decade is substantial. It represents approximately 4.5 percent of the region's total GDP and is much larger than the annual combined total gross commitments of the World Bank and the Inter-American Development Bank for projects in Latin America and the Caribbean. The bulk of the increase in investment in infrastructure, then, will have to come from the private sector—both domestic and foreign.

To encourage private sector participation in infrastructure projects, governments will need to set up modern regulatory frameworks that serve a dual purpose. On the one hand, they should enable governments to make a credible commitment to respecting, over the long run, the rules and regulations governing tariffs, market access, and expansion plans; on the other, they should protect consumers from potential breaches in competition.

Reducing poverty

With the acceleration of economic growth, governments in Latin America and the Caribbean will be able to turn their attention to the grave problems of poverty and

income inequality. Addressing the needs of the poorest citizens is a political as well as a social issue. Only to the extent that they succeed in reducing poverty and making income distribution more equal will countries be able to sustain recent structural reforms. Moreover, as a larger proportion of the population benefits from better education, nutrition, and health, growth will accelerate significantly.

In spite of progress in a number of countries (Table 2), poverty continues to be prevalent throughout the region. One characteristic that distinguishes Latin America from other developing regions is the extent and depth of urban poverty. About two thirds of Latin America's absolute poor—those who are poor not only in terms of income but who are also deprived of basic necessities—live in large cities.

Table 2Poverty in Latin America and the Caribbean Percentage of population living in poverty

	Poverty			Extreme poverty		
	Early	Mid/late		Early	Mid/late	
	1980s	1980s	1990s	1980s	1980s	1990s
Argentina	16.2	51.1	17.6	3.3	21.1	3.4
(1980, 1986, 1993)						
Bolivia	--	--	72.0	--	--	--
(1980, 1986, 1990)						
Brazil	39.0	40.0	43.0	--	--	--
(1992)						
Chile	--	28.0	24.0	--	17.0	9.0
(1987, 1992)						
Colombia	--	33.8	32.7	--	18.7	17.7
(1988, 1992)						
El Salvador	--	--	41.4	--	--	36.2
(1993)						
Guatemala	--	75.2	--	--	57.9	--
(1989)						
Guyana	--	--	27.7	--	--	43.2
(1992)						
Honduras	--	55.0	53.0	--	36.0	32.0
(1989, 1993)						
Jamaica	--	26.9	34.2	--	--	--
(1989, 1992)						
Nicaragua	--	--	50.3	--	--	19.4
(1993)						
Paraguay	--	--	20.5	--	--	3.5
(1990)						
Peru	46.0	52.0	53.7	21.0	25.0	21.2
(1982, 1989)						
Uruguay	11.0	15.0	--	--	--	--
(1980, 1986)						
Venezuela	22.3	31.4	--	10.3	22.3	--
(1982, 1989)						

Source: World Bank and UN Economic Commission for Latin America and the Caribbean. -- Data not available.
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Not only is poverty widespread in Latin America and the Caribbean, it has increased during the past decade. The unequal distribution of income is generally seen to be at the heart of poverty in the region—the bottom 20 percent of the population receive less than 4 percent of total income. What determines income inequality in a country at a given time? A recent World Bank study of ten countries in the region found that the four most important factors determining position on the income scale were education, sex, race, and locality.

Education appears to be the single most important determinant. In Panama, for example, people with less than five years of education have an estimated 83 percent probability of finding themselves in the bottom 20 percent of the income distribution scale. The corresponding figure for Argentina is 69 percent, for Brazil, 42 percent. In contrast, the likelihood that people with 13 or more years of education will find themselves in the bottom 20 percent is less than 5 percent in most countries in the region.

Women tend to be poorer than men. In Venezuela, for example, households headed by single mothers are significantly more likely to be below the poverty line. Age

is also a factor: many poor women are older and less able to improve their skills through training and education.

Race is directly related to poverty and income inequality in many countries. For example, in 1989, almost 60 percent of Guatemala's indigenous population had less than five years of education, compared with 24 percent of the nonindigenous population. In Bolivia, 12 percent of the indigenous population had no schooling at all, compared with 2 percent of the nonindigenous population.

There are significant variations in income distribution and human development within countries, although these are often hidden in countrywide aggregate data. The starkest differences in human development can be seen in Brazil—for example, Rio Grande do Sul has social indicators comparable to those of Portugal and the Republic of Korea, while Paraiba's are closer to Kenya's. Extreme regional differences are reflected in almost all of Brazil's social indicators: illiteracy rates, for example, range from 11 percent in the urban south to more than 55 percent in the rural northeast.

More reforms needed

In contrast with past reforms, which were designed to correct gross inefficiencies and macroeconomic disequilibria, the second generation of reforms needed to accelerate growth and reduce poverty will have to be directed at political and social institutions and microeconomic incentives.

For decades, governments in Latin America failed to develop the institutions needed to handle their populations' basic problems because they concentrated most of their resources on managing their countries' economic assets and regulating almost every aspect of economic life.

But institutions determine the course of economic policy. Now that most countries have undertaken basic economic reforms and reduced the role of the state in economic affairs, they must create institutions that enable the state to be effective in areas that are more properly its domain. At the macro-economic level, the consolidation of the pro-competition reforms will be greatly helped by the creation of institutions that ensure the transparency of policymaking, help avoid short-term political pressures, and allow the authorities to credibly commit themselves to a course of action. This means, among other things, instituting clear and mandatory budgetary processes, and making central banks independent to isolate monetary policy, and in some cases exchange rate policy, from partisan short-term political battles. This is one obvious lesson to be learned from the Mexican peso crisis. Quickly and simultaneously, countries also need to reform the legal and judicial systems and the civil service, and decentralize government. Civil society also needs to be strengthened as a way of generating much-needed “social capital.”

Designing and implementing programs to tackle poverty and income inequality will require resources and, perhaps more important, an overhaul of the institutions that deliver social services. In many Latin American countries—Venezuela may be the best example—the main problem is not a lack of funds, but the inefficiency and mismanagement of social programs caused by inadequate administrative capacity, the reluctance of government employees' unions to modernize, and an absence of accountability. Major administrative reforms will be required just to raise the delivery of social services to a minimally acceptable level.

Educational reform. One of the basic pillars of successful development strategies is the accumulation of human capital, by improving the coverage and quality of education. In Latin America, access to education varies greatly among different groups and regions. In every population group for which data are available, educational coverage in the East Asian “tigers” is far greater than in Latin America and the Caribbean.

The second fundamental problem of Latin America's educational system has to do with quality. A recent World Bank study found that the quality of primary education in the region tends to be dismal. For example, in an international comparative study on the reading abilities of 9-year-old children from 27 countries, Venezuela's students scored the lowest; Trinidad and Tobago's students did better, but still scored well below the average. Repetition rates in Latin America and the Caribbean (except in the English-speaking Caribbean countries) are among the highest in the developing world. In Bolivia, for example, the repetition rate ranges from 16 percent in Beni to more than 35 percent in Chuquisaca. The estimated cost of repetition for the region as a whole in 1990 was more than $4 billion.

Although there are some first-rate private schools in the region, the disparity between public and private schools tends to perpetuate inequalities, undermining the basis of democracy. Improving the coverage and quality of education is an urgent task that requires strengthening management, reallocating educational resources, increasing funding, and, most of all, making teachers accountable. Teachers should be trained using modern techniques and be required to refresh their skills periodically; salaries should be based on performance rather than on bureaucratic formulas. Parents need to become more involved in the educational process. If countries in the region continue to neglect education, the likelihood of sustaining recent structural reforms over the long term will be greatly reduced.

Labor reforms. For many decades, countries in Latin America and the Caribbean have used labor legislation as a tool for achieving various social goals. A minimum wage, job protection, and related measures were thought to be an efficient way of redistributing income and protecting the poor. However well intentioned these policies may have been, the result was overly rigid labor markets that were not responsive to changing conditions in the world economy. Unfortunately, recent market-oriented reforms have barely touched labor market legislation, and the situation has not improved. The region's distorted labor markets are in sharp contrast with East Asia's dynamic, modern labor markets. In general, East Asia's labor force is better educated, and its labor markets are flexible, allowing companies to change product mix in response to rapid shifts in comparative advantage.

In addition to improving the education of its work force, the region should implement reforms to correct the three most serious labor market distortions: high payroll taxes—especially social security taxes—that discourage employment expansion and make local firms less competitive in the international marketplace; high severance payments that make corporate restructuring difficult and slow; and confrontational labor-management relations that entail costly settlement procedures.

Sustaining reforms

The countries of Latin America and the Caribbean have made great progress during the past few years. Macroeconomic stability has been achieved and GDP is growing, as a result of deep reforms. During the next phase of the reform process, governments should seek ways to accelerate economic growth and reduce poverty.

A faster rate of growth and investment in human capital are necessary to ensure that the structural reforms of the past few years are sustained and not reversed. Poverty reduction and improvements in education, nutrition, and health will have a strong positive impact on economic growth. Faster economic growth, in turn, could cause living standards to improve and the number of poor to decrease. The twin policy goals of economic growth and poverty reduction reinforce each other and need to be tackled together.

Suggestions for further rending: “Latin America and the Caribbean a Decade After the Debt Crisis,” The World Bank, Latin America and Caribbean Regional Office, Washington, DC. September, 1993: Sebastian Edwards, Crisis and Reform in Latin America: From Despair to Hope. *Oxford University Press, to be published in 1995*.

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