



2004
DMR

Reporte de Economía
y Desarrollo

Recovering growth in Latin America

Trade, productivity and social inclusion

Executive Summary



Acknowledgements

The Division of Economic Studies, of the Vice-presidency of Development Strategies of the Corporación Andina de Fomento, under the direction of Fidel Jaramillo and Luis Miguel Castilla, are responsible for this report.

Academic advisors of this project were *Patricio Meller* and *Joaquín Vial*.

The main authors are:

| | |
|-----------|---|
| Chapter 1 | <i>Luis Miguel Castilla</i> |
| Chapter 2 | <i>José Pineda and Stefania Scandizzo</i> |
| Chapter 3 | <i>Osmel Manzano</i> |
| Chapter 4 | <i>Germán Ríos</i> |
| Chapter 5 | <i>Luis Miguel Castilla</i> |

José Pineda provided contributions to chapters 3 and 4. *Bartolomé Ríos* provided contributions to chapter 5 and to the overall editing of the book.

Other contributors include:

Camilo Arenas, Juliano Assunção, Marcela Benavides, Ana Mercedes Botero, José Camargo, Luis Chang, Ramón Espinasa, Gustavo Fernández, Rafael Fuentes, Horst Grebe, Luis Carlos Jemio, Jacobo Kiriatty, Andrés Langebaek, Manuel Malaret, Gabriel Ortiz de Zevallos, Silvia Oteyza, Lenin Parreño, Bernardo Requena, and Alejandro Soriano.

For valuable comments, the authors thank Victor Albuquerque, Juan Blyde, Fernando Candia, Albert Fishlow, Marino González, Carlos Guaipatin, Roberto Junguito, Alicia Polo y La Borda, Ricardo Rocha, Miguel Rodríguez Mendoza, and Hugo Santa María.

Research assistants were Erika Balducci and Federico Ortega. Special thanks to Andrea Otero, who besides providing valuable research assistance, contributed to the writing of several sections and was in charge of the book's final edition.

Foreword

L. Enrique García

Executive President and CEO – Corporación Andina de Fomento

Latin America has begun the twenty first century in the midst of a complex economic, political and social situation. Although significant progress has been made regarding democracy and macroeconomic stability, the region has lost economic importance in global markets in the last five decades, falling from second position to third to last, just above Africa and the poorest Asian countries.

Latin American countries are characterized by low and volatile growth rates, mainly due to high vulnerability to external shocks, that cause severe economic and social crises. In this context, poverty has increased in most countries, and income distribution remains the most unequal in the world. Social polarization has notably worsened violence and marginality, and has been accompanied by a process of environmental deterioration and unsustainable use of key resources, such as forests and water.

Under these circumstances, Latin America's challenge is to attain high and sustainable economic growth, and that this growth be inclusive, broad-based, and respectful of both cultural diversity and the environment. Achieving this goal requires establishing a renewed development agenda, that improves living standards and promotes the sustained accumulation of capital in all its different forms: physical, financial, natural, social, and human. Furthermore, this agenda must include key factors of quality growth, namely macroeconomic stability, microeconomic efficiency, social justice, ethical behavior, environmental responsibility, and the valorization of cultural assets.

A critical aspect of this renewed development agenda is Latin America's participation in the global economy. This is of the utmost relevance, since several Latin American countries are currently immersed in complex trade negotiations and in the reshaping of regional integration schemes. Although priorities and circumstances differ, countries share the need to take advantage of such strategies as a means to recovering growth and increasing participation in the global economy.

This publication by CAF presents analyses and proposals geared towards resuming growth in the region, with special emphasis on the use of trade agreements and regional integration as instruments for improving the quality of participation in global markets, and achieving greater market access. Likewise, it analyzes the possibility of transforming production patterns, so as to generate value added and reap the benefits of the region's comparative advantages. In addition, it highlights the need to design mechanisms that guarantee social equality and inclusion, as vital components of a successful strategy for increasing Latin America's participation in the global economy.

With this publication, CAF seeks to contribute to the debate on development strategies for the region. This publication has been the result of a thorough process of discussion and reflection within CAF, with the participation of numerous academics and intellectuals from across the region. We hope it stimulates the debate and helps in the design and implementation of public policies, oriented toward improving Latin America's participation in the global economy, and resuming economic growth. We regard this as the foundation for sustainable development and the improvement of living standards for the people of our region.

Toward a better development strategy

Latin America has made notable progress during the past two decades toward achieving macroeconomic stability, greater openness to trade and international capital flows, and the consolidation of democracy over large part of the region. On the macroeconomic level, most Latin American countries were able to heavily reduce their inflation and fiscal deficits through the application of stabilization programs. Major advances are also reflected in the State's decreased involvement in productive activities and a marked reduction of unnecessary interference in the pricing system, together with an enlargement of the sphere of action of the private sector.

In addition, the regulation of financial systems and natural monopolies in telecommunications, energy and water, among others, has been modernized. Thanks to liberalization reforms involving the lowering of barriers to trade and foreign direct investment (FDI), the region has been able to achieve greater participation in the global economy, raising the relative weight of its foreign trade from 25% of GDP in 1980 to 43% in 2002¹. In fact, by the mid nineties, the region had also become the most important recipient of FDI among the developing countries. The most recent report put out by the United Nations Development Program (UNDP) reveals that much has also been accomplished toward ensuring the exercise of political rights over a large part of the region².

Notwithstanding these advances, Latin America has not grown enough to close a development gap that dates back to the mid twentieth century, as compared with the rest of the developing world, which has been able to maintain high economic growth rates over a long period of time. A comparison of the region's real *per capita* GDP with that of the developed countries reveals a decline in recent decades. In fact, if this trend continues, that figure may drop to only one-fifth of the *per capita* income of the industrialized countries. This poor economic performance, as is to be expected, has

resulted in the deterioration of social conditions in most countries.

The percentage of the population living in extreme poverty has risen in almost all of the Latin American countries over the past five years. According to ECLAC, today a little over 100 million inhabitants in the region are considered indigent, a 10% increase between 1999 and 2002. On top of this, Latin America has the worst income distribution in the world. This only adds to the problems of governance in the region, increasingly bringing into question the benefits to be gained from the current economic model and democratic system.

Higher and sustained economic growth rates are a necessary requisite to begin improving conditions in the region, but are not enough to ensure its development. The participation of lower-income groups and an orientation toward creating equal opportunities for all are needed if a series of proposals to generate economic growth in a democratic environment are to be successful. As Amartya Sen (1987) points out, improving living conditions should become the overriding –if not the most important– objective of the entire economic process. In other words, it is important not to confuse the means with the ends: economic growth is merely a mechanism for improving the people's welfare, reducing poverty and ensuring greater equality. International experience during the second half of the twentieth century reveals unmistakably that without economic growth, it is virtually impossible to make lasting improvements in the welfare of the poorest sectors.

What can Latin America do to reach the sustained long-term economic growth it needs in order to reduce poverty and income inequality? Rodrik (2003) maintains that we must distinguish between these two aspects of growth –achieving sustained long-term growth as opposed to growth renewal. Our focus, in this book, is on the former. The proposals we elaborate on in the course of this study

¹ ECLAC (2004a).

² UNDP (2004).

are grounded in the objectives of obtaining greater access to international markets and deeper regional integration, changing production patterns to generate increased value added, making fuller use of the region's comparative advantages, and attaining more equality among and inclusion of all population sectors. We should stress here that it is important to consider these elements jointly in order to reach an appropriate balance of objectives.

Creating opportunities by making the most of comparative advantages and developing the productivity of each individual country are key for reducing poverty, improving income distribution and cutting down on exclusion. The overriding aim is to provide the poorest population sectors with the assets and sources of employment they need to ameliorate their situation. Effective social protection networks and long-term policies to strengthen human capital and improve labor market operations play an essential role in increasing welfare.

Whether these proposals can be implemented will depend on the ability to mobilize and improve the allocation of public and private resources to underpin public policies needed to enhance the competitiveness of national production and reduce the social gap characteristic of most Latin American countries. The ability to deal with existing political and institutional factors will determine the success of these policies, particularly considering that the governments' margin for maneuver is restricted by its political capital, which is continually being eroded by unsatisfied expectations. In order for the institutional changes to endure within a democratic environment, and the benefits of the proposals to extend to all population sectors, agreements must exist on fundamental issues. The support that is marshaled must be broad and diverse enough to legitimize the proposed changes and to create an awareness of the need for reinforcing democratic governance.

This document is organized in the following way: the next section evaluates Latin America's economic performance in recent decades, highlighting

the region's insufficient and volatile growth. The link between this poor economic performance and the region's state of governance are explored, as is the weakness of its political and economic institutions, which tend to widen the development gap with respect to other world regions. In conclusion, and in response to this situation, a series of recommendations are presented toward the recovery of sustained growth in Latin America.

Latin America: insufficient growth, social deterioration and weak governance

In the past, Latin America's *per capita* economic growth has been insufficient to improve the welfare of its people, a pattern that has only intensified over the past two decades. Observed growth rates are relatively low from three viewpoints: the region's average growth in the nineties was lower than that of the sixties and seventies, lower than that of other developing regions, such as Southeast Asia, and substantially lower than what is needed to generate the necessary resources for improving the living conditions of the Latin American people.

In the first place, *per capita* GDP growth in Latin America between 1990 and 2003 was only 1% per annum—considerably below levels registered during the sixties (3.3%) and seventies (2.4%)³. Secondly, the region's growth levels lag far behind those of Southeast Asia, with *per capita* income averaging only one-fourth of the growth reached by those countries over the past four decades. This means that while Southeast Asia's *per capita* income increased seven-fold in forty years' time, Latin America did not even succeed in doubling its *per capita* GDP⁴. And thirdly, the poor growth attained in the nineties was indicative of the fact that no significant reductions in poverty could be expected, as compared to the sixties and seventies, when high growth rates acted to put major improvements into effect⁵.

Figure 1.1 illustrates Latin America's pronounced divergence in *per capita* income. A comparison with the United States reveals the existence of a

³ It should be noted that growth slowed worldwide in the nineties, as compared with the sixties and seventies.

⁴ De Gregorio and Lee (2003).

⁵ Dollar and Kraay (2000) consider the relationship between poverty reduction and growth to be one-to-one. Other works, like those of Agenor (2001) and Baldacci *et al* (2002), on the other hand, demonstrate that the relationship between the economic cycle and poverty is asymmetrical.

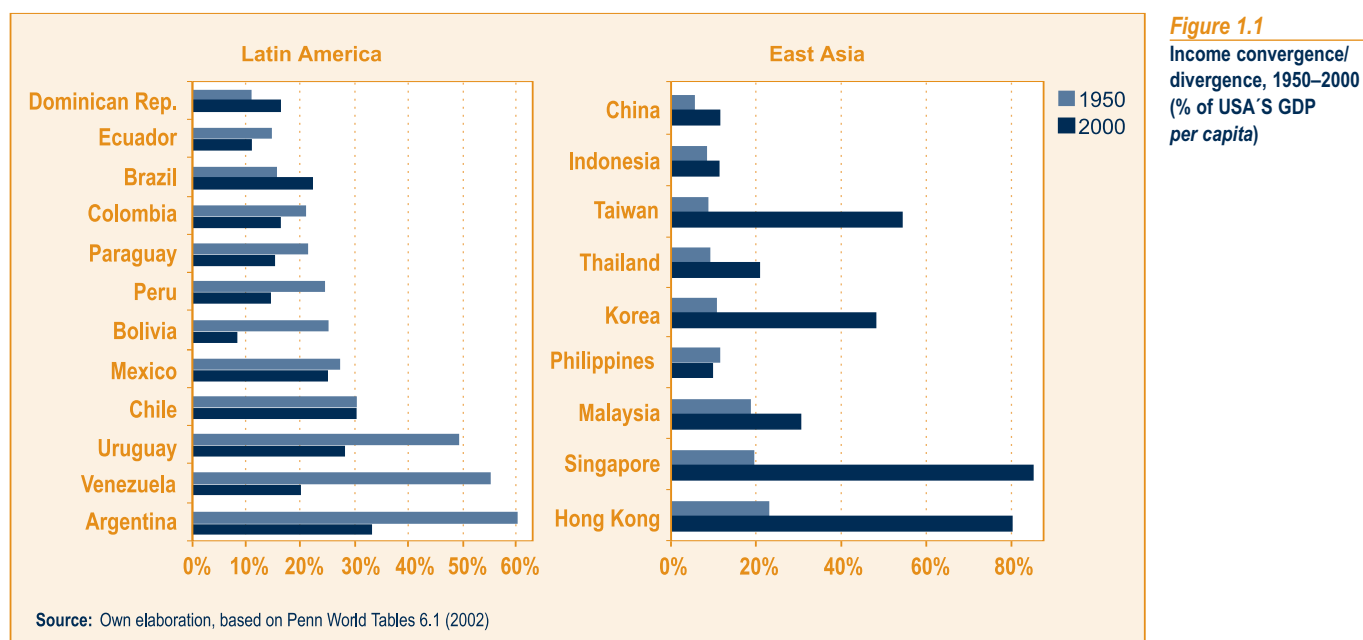


Figure 1.1
Income convergence/
divergence, 1950–2000
(% of USA'S GDP
per capita)

growing differential in *per capita* income between the two over the past fifty years. When the Asian countries are added to the comparison, two conclusions can be reached: there is an obvious convergence between the *per capita* incomes of these countries with respect to the United States, while those of Latin America diverge⁶.

Factors of production and productivity

The reasons for this gap between Latin America and other developing and developed regions are several. Among the most important is the poor performance in terms of factor accumulation and productivity. The persistent volatility created in part by the region's vulnerability to adverse changes in its terms of trade and capital flows, has also impacted negatively on the economic environment. Together, these elements make it impossible to improve living standards, thereby accentuating income inequality. The result is dissatisfaction with the market economy and the democratic sys-

tem, creating in some cases situations of weak governance.

In seeking to understand what has happened in the region, we can point to Latin America's unsatisfactory performance in accumulating its factors of production and in the area of productivity. In their study of the differences in growth between Latin America and Southeast Asia between 1960 and 2002, De Gregorio and Lee (2003) found that half of this differential can be attributed to factor accumulation⁷. Investment in physical capital, for its part, has remained low in Latin America over the past two decades, particularly as compared with such investment in the Southeast Asian or OECD countries.

This low level of investment can be traced, in part, to the region's poor capacity to generate domestic savings⁸, in sharp contrast to the accelerated growth observed in recent decades in countries like those of Southeast Asia, where savings in the nineties

⁶ We chose the Southeast Asian countries as a reference for comparison because their *per capita* GDP was similar to or lower than that of the Latin American countries 50 years ago. Even so, while the former have exhibited outstanding economic performance, reducing their gap with the industrialized countries, the opposite is true in the case of Latin America.

⁷ This differential can be broken down as follows: 20 percent is due to differences in investment levels (lower levels in Latin America), nearly 20 percent to differences in fertility rates (higher in Latin America) and 10 percent to differences in levels of human capital (lower in Latin America).

⁸ According to figures published by ECLAC (2003a), average domestic savings in the region declined as a percentage of GDP from 22.8% in the eighties to barely 17.7% during the 1998–2001 period.

accounted for more than 35% of GDP. Regarding human capital⁹, although Latin America has made important strides in broadening educational coverage, particularly of elementary schooling, it continues to experience important problems in the quality of education at all levels, thereby widening its gap with other developing countries.

Low productivity levels are a further reason why the Latin American countries have not been able to achieve sustained growth. Total factor productivity has not resumed the vigorous growth exhibited in the sixties and seventies, thus widening Latin America's productivity gap with the rest of the world. Although productivity did decline in other developing regions as well, it continued to expand at a noteworthy rate in the developed world and in most of the Asian countries, with positive growth rates in both the eighties and nineties.

Economic volatility and external vulnerability

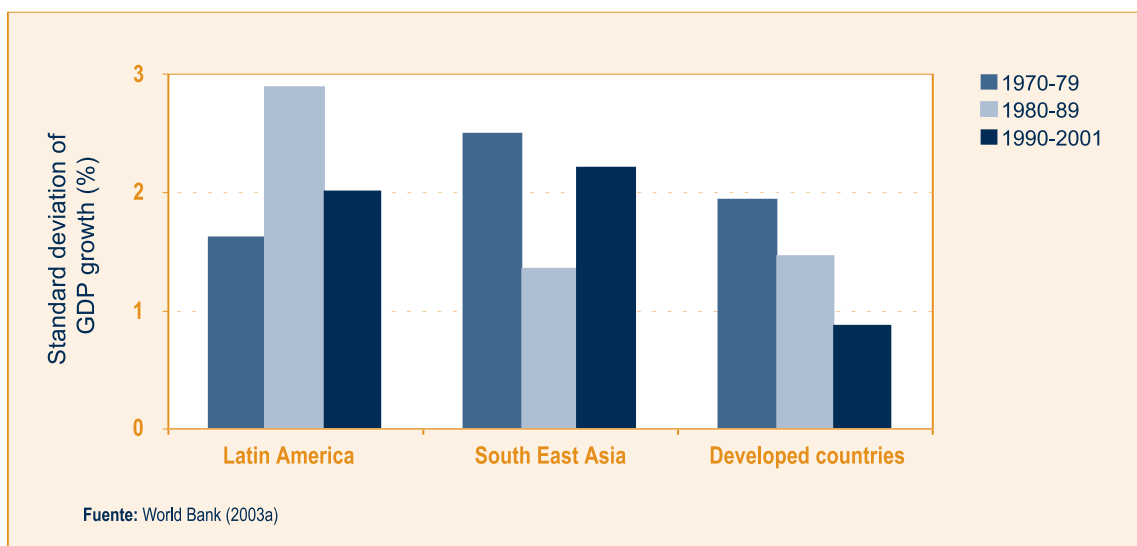
Not only has Latin America's growth been insufficient, it has also been among the most volatile in the world. Economic volatility in the region over the nineties –measured by the coefficient of variation of GDP– was double that registered in the industrialized countries (see Figure 1.2). The World Bank (2000) offers the following breakdown of the causes for the region's excess volatility: one-third is

a result of exogenous shocks; one-third is due to insufficient financial integration and the poor level of development of domestic financial markets; and one-third can be traced to the volatility of domestic macroeconomic policies.

Insofar as its external volatility is concerned, Latin America is known for the high level of volatility of its terms of trade and capital flows¹⁰. During the nineties, the volatility of these two indicators in Latin America was more than four times that noted in Southeast Asia and the OECD. Although their magnitude has been declining in recent years, the average terms of trade shocks in the region continue to be strong. In the nineties, average terms of trade shocks in Latin America exhibited a variation of 9%, as compared with 2% in Southeast Asian or OECD.

Although external capital flows entering Latin America swelled substantially in the nineties –up from 2% of GDP in 1989 to 7% in 1998. This was accompanied by a large increase in their volatility, subjecting the region to sudden outflows that took a heavy toll on productive activity. The interruption of economic recovery and the slowdown of sustained economic growth can be traced, in part, to the numerous financial crises set off in the emerging economies by external and internal factors. Rodrik (1999a) offers empirical evidence that

Figure 1.2
Economic volatility



⁹ Human capital refers to the accumulation of skills, expertise and know-how that contribute to the social and economic development of both individuals and the community. This concept can be broadened to include qualities like loyalty, motivation and teamwork.

¹⁰ See CAF (2003).

unstable private capital flows are the foremost determinant of the macroeconomic volatility noted in Latin American countries during the nineties.

Strong external vulnerability has an adverse effect on economic growth. Calderón and Schmidt-Hebbel (2003) are of the opinion that external factors—terms of trade shocks, changes in international interest rates, and fluctuations in capital flows—play a fundamental role in the course of long-term economic growth. Fernández Arias and Montiel (2000), for example, estimate that a deterioration in the external environment triggered a 2% annual decline in economic growth in the typical Latin American country during the nineties.

One should ask whether the Latin American countries, confronted by stronger external volatility than the rest of the world, have built mechanisms to allow them to move ahead in spite of this volatility. Such mechanisms could include institutions and counter-cyclical policies to facilitate private savings during economic bonanzas, flexibility of relative prices, and an unconstrained fiscal policy that could serve as a counterbalance to international cycles. Given the above evidence, the answer is no, although the experiences of Colombia in the pre-nineties and of Chile in recent decades would tend to suggest some possible courses to be taken.

The degree of trade openness also plays a part in the external volatility of countries. The IMF (2003) has found that low levels of trade openness, combined with strong financial integration, make countries more vulnerable to external crises. Protection levels continue to remain high in Latin America in comparison with other developing regions, even though the average tariff rate is considerably lower than that of two decades ago and non-tariff barriers to trade have been significantly reduced. According to Morsink *et al* (2002), Latin America is the only region in the world where financial openness exceeds trade openness. Countries that are less open to trade have lower export earnings, and their capacity to service external debt is smaller or more dependent on balance effects.

Domestic financial systems and fiscal policy transmit this strong external volatility to the interior of

the economies. In the case of the financial system, domestic credit has been shown to operate procyclically in the face of external shocks. This can be seen most clearly in countries that have financial mismatches or are highly dollarized. As for fiscal policy, countries where government spending was more correlated with terms of trade are those where, in general, spending tended to be more pro-cyclical. Fiscal expenditure, then, is one of the strongest transmission mechanisms of external volatility.

Vulnerability, social welfare and governance

External vulnerability, as expressed in high volatility rates, affects social conditions in the region and the poor are hardest hit, according to Lederman and Perry (2002). The poor in fact are less equipped with the human capital needed to adjust to shocks in the labor market. Furthermore, they possess few “assets” and these are not always securitized¹¹, limiting access to credit to facilitate consumption during crises. If no appropriate safety nets exist, as in the case of Latin America, losses in terms of nutrition and educational levels can be irreversible. Further evidence is available to the effect that the poor lose more during economic recessions than they gain during recovery. These asymmetries are described in works such as those of Agenor (2001) and Baldacci *et al* (2002).

The debate currently underway in Latin America blames income inequality and social exclusion for people’s dissatisfaction with democratic institutions and for the governance crises experienced in some countries. According to the most recent data published by ECLAC, in 2002 44% of Latin Americans were living in total poverty and 19.4% were indigent, meaning that they were unable to cover their minimum daily food needs. As for income distribution, not only does Latin America have the worst income distribution in the world, income inequality actually increased in the nineties.

Moreover, poor macroeconomic performance and volatility have been important factors in the proliferation of informal employment activities in Latin America. Low levels of economic growth combined with a swelling labor supply have triggered growing informal employment, characterized by

¹¹ De Soto (2000).

low wages and limited productivity. Also according to ECLAC, the inability to create enough new jobs increased unemployment heavily in the nineties to rates topping 10% (over 19 million people), as compared with about 4.6% at the opening of that decade. These rates appear especially high when compared with unemployment in other parts of the world.

The economic results illustrated above, combined with disappointing social and labor indicators, are the cause of deep frustration among Latin Americans, who have cast doubt on the present economic model and the functioning of democracy. In effect, according to *Latinobarómetro* (2004), only one-fourth of Latin American public opinion is satisfied with the operation of the market economy and with the democratic system. Many Latin Americans, in their search for whom to blame for their problems, consider the governments the main culprits. This perception, however, is at odds with the desire for a State that will take a more active role, even in the sphere of production¹².

The credibility problems plaguing some heads of state in the region, amplified by the absence of clearly-defined courses of action, unstable and inactive economic policies, and a climate of uncertainty that jeopardizes the continuity of presidential rule, send a clearly negative message to possible investors and drive up country risk perception. The dissatisfaction of public opinion with democratic government can be traced to a widespread feeling that political parties do not properly represent the interests and needs of the people, and that some heads of state are incapable of fulfilling those needs. All of these elements contribute to weak governance, placing a heavy burden on the economy and curbing economic growth.

Renewal of quality growth in Latin America

Starting in the mid-eighties, most Latin American countries embarked on an ambitious program of

reforms in response mainly to the external debt crisis, an upsurge in inflation, and the disappointing results of import substitution-based industrialization strategies and unsustainable macroeconomic policies. As a result, a sizeable number of countries were able to attain high growth rates during the first half of the nineties. In fact, several different authors have concluded that these reforms had a significant impact on the region's economic growth¹³. Post-reform economic growth, however, has been insufficient, as mentioned above, creating a serious problem of frustrated expectations.

This situation touched off a debate over the effective impact of these reforms on economic growth and the need to redirect or deepen them. Lines have been drawn between those who consider the reforms to have been a mistake and those who deem them correct, but incomplete or inconclusive. On the one hand, the existing crisis is said to be the "natural outcome" of economic reforms in countries that suffer from weak institutions and powerful interest groups. According to studies conducted by ECLAC (Ocampo, 2002), except for the positive effect of macroeconomic balances on growth, the relationship between reforms and growth is in fact weak, given that not all reforms have had a positive effect on growth.

On the other hand, there are those who attribute the present crisis to the incomplete implementation of reforms within a political and economic environment characterized by ineffective governments and weak institutions (Calderón and Schmidt-Hebbel, 2003). In fact a large part of the differences in growth between Latin America and other regions, such as Southeast Asia, can be attributed to the failure of the former to carry out these reforms with the necessary depth and breadth¹⁴. Other authors argue instead that the problem lies in certain weaknesses, such as: the failure to develop strong institutions, the lack of a comprehensive social strategy or the failure of certain markets, like the labor market, to operate appropriately (Birdsall and De la Torre, 2001).

¹² *Latinobarómetro* figures reveal that 70% of the people want the State, and not the private sector, to furnish basic public utilities like water and electricity. But given the absence of previous polls, no pattern can be seen in these results.

¹³ According to Fernández-Arias and Montiel (2000), for example, the contribution of macroeconomic and structural reforms to long-term growth has been estimated at 1.63% for the typical Latin American country.

¹⁴ Fernández-Arias and Montiel (2000) are of the opinion that applying the values of the reform indicators existing in Southeast Asia to the region would halve the differential in *per capita* growth rates.

In an effort to bring fresh insights to this debate, the Andean Development Corporation (CAF) has begun a process of reflection. This is aimed at identifying the elements of a comprehensive proposal for recovering growth in Latin America, emphasizing the potential offered by increased participation in the global economy, while limiting the risks inherent in that participation and encouraging the inclusion of all sectors of society.

The proposals we put forward in this book are grounded for the most part in three elements. First, increased international integration and participation in traditional and emerging markets in the spheres of both trade and finance. Second, improved access to those markets by changing production patterns so as to increase total economic productivity through improved resource allocation and greater factor productivity. This will ensure greater added value and more export diversification. It is necessary, in this undertaking, to make the most of the countries' comparative advantages. And third, greater social inclusion that focuses on providing marginal sectors with the tools needed to ensure self-sustaining development. At the same time, due account should be taken of the short and medium-term effects of the proposed policies on wealth redistribution.

In implementing these proposals, it is clearly necessary to capitalize on opportunities and reduce risks. As a result, the strategy should be complemented by policies that will ensure that increased participation in the global economy produce a positive impact, minimizing any potential negative effects. These policies could take the form of measures to safeguard macroeconomic stability and to expand the margin of maneuver given to governments for attenuating the adverse impact of external shocks. It is also essential to ensure the fiscal and financial viability of the proposals. Public finance reforms must be implemented to enable authorities to supply the public goods needed for the restructuring of production patterns: skilled labor that meets market needs, regulatory and institutional improvements to further develop financial markets, an infrastructure platform to connect production centers and markets, and an innovation system capable of generating and adapting knowl-

edge in order to boost competitiveness and financial viability.

The success or failure of the proposed changes could well depend upon the region's social and political situation. The discredit of the political class, the dwindling confidence in public institutions and in the State and the disillusionment with the market economy, despite a halfhearted acknowledgement that there is little other alternative, combined with serious problems of social exclusion, highlight the need to build a platform that will ensure a climate of political stability and democratic government. Only in this way it will be possible to move ahead with the public policy agenda we propose as a vehicle for returning to a course of economic growth and development. In other words, in order for the proposed changes to be lasting, it is necessary to ensure that the proposal is politically viable. The following text describes the various components of the comprehensive strategy we propose.

Increased participation in the global economy and regional integration

Trade liberalization is a common element of the reform processes undertaken in the region's countries. As a result, average tariff levels were brought down from 40% in the mid eighties to less than 11% in the nineties. Although this represents enormous progress, it should be stressed that these levels are still high in comparison with the rest of the world, given that all countries have been progressively dismantling their barriers to trade. Furthermore, a large percentage of non-tariff restrictions were removed or heavily trimmed and the tariff spread was reduced from 30% in the eighties to 6% today on average¹⁵. Despite these efforts, Latin America has seen its weight in world trade shrink, as that of the Southeast Asian countries and China grows.

In order for trade openness to result in more growth and development for the region's countries, it is necessary to broaden existing and potential markets by increasing trade presence and regional integration. Many Latin American countries have chosen to make the negotiation of Free Trade Agreements (FTA) with the United States, a key element of their

¹⁵ Tariff spread is a measure of tariff heterogeneity and is measured by the standard variation of tariffs. See Estevadeordal (2002).

strategy for increasing participation in the global economy. There are other alternatives from which to choose, however: multilateral negotiations within the World Trade Organization (WTO), sub-regional agreements like the Andean Community and Mercosur, or increased openness toward the European market and the new major players in world trade (China, for example).

Some questions that arise, given this array of options, are: What is the correct course of action? Are there options that will allow us to benefit in other spheres of negotiation? Does an ideal combination for all countries exist, or does the best strategy depend on each country's individual characteristics? The first point to be made here is that the various options are not mutually exclusive, but can complement each other. Countries must first weigh the pros and cons of each alternative before deciding on the best strategy toward increased participation in the global economy. They must also consider any asymmetries between potential integration partners, in terms of *per capita* GDP, competitiveness, degree of industrialization, market structure, etc.

With reference specifically to subregional integration schemes, it is important to stress that member countries can increase both the size and the coordination of their markets. Because these integration processes are far deeper, their goals include both the integration of goods and of factor markets, as well as physical integration and policy coordination, both of which are key to making the most of economies of scale and improvements in competitiveness. Furthermore, this type of integration also gives partners more negotiation capacity to achieve agreements with developed countries on better terms.

In effect, the region lags far behind in terms of intraregional trade, and South America in particular is one of the regions with the least intraregional trade in the world. Trade agreements to reduce tariffs are not enough to make a substantial improvement in this situation. Bureaucratic barriers must also be removed and physical integration facilitated, in order to permit a freer flow of goods, capi-

tal and people throughout the region. Otherwise, it will be difficult to develop high value-added sectors, which must be able to exploit economies of scale to be competitive.

Without the underpinning of complementary measures designed to boost competitiveness, efforts to improve the region's trade presence and the quality of its exports could be doomed to failure. Unfortunately, the outlook here is not good, for the Latin American countries are considered among the least competitive in the world¹⁶. Furthermore, to maximize the chances of success of a multicourse strategy for increasing trade presence, it is necessary that this be accompanied by complementary measures that ensure its effective and efficient implementation. The most important complementary measures that can be taken include export promotion strategies, incentives to foreign direct investment (FDI) and the development of infrastructure that supports production.

The design and implementation of export promotion policies can deal effectively with serious market failures and trade barriers that limit the competitiveness of countries in the region. Inasmuch as the aim is to resolve market failures, but by establishing a link between incentives and demand, it is important for these policies to be as market-oriented as possible. As a result, the instruments and policies to be used in this undertaking must be extremely simplified and highly transparent.

FDI, combined with policies to link domestic industry and investment, play a key role in helping countries to better position themselves in global production chains. Among the most important elements for attracting FDI are several that are associated with public action: the creation of a quality business climate, the proper use of fiscal incentives, the existence of institutions to promote that investment, and the facilitation of physical and trade integration, all entailing a cooperative approach to the attraction of investments.

The international competitiveness of the region's productive sectors (and of its exports) rests on developing the necessary infrastructure. Without

¹⁶ According to the World Economic Forum's 2003 - 2004 Global Competitiveness Report, Latin American and Caribbean countries occupy on average the 66th position in a sample of 102 countries, with eight countries among the lowest twenty.

such infrastructure, any progress achieved in trade liberalization may fail to materialize because of high transaction costs. A priority for the region in this area should therefore be to develop quality transportation, telecommunications and energy infrastructure. Although the public sector admittedly has a basic role to play in directly supplying or regulating infrastructure, initiatives are needed to compensate for the limitations in public investment (due mainly to fiscal shortages in the region's countries). There is a need for more aggressive promotion of private sector investment in infrastructure through concessions and shared initiatives, especially public-private partnerships.

Changing production patterns: diversification and value added

If the region's countries are committed to achieving greater participation in the world economy, it is important that this participation also focus on quality. Of course the best way to enter international markets is by making the most of the region's comparative advantages, namely exporting natural resources. This has fueled longstanding concern over the role such exports play in countries that possess abundant natural resources and over how to reduce any adverse effects. Nonetheless, literature on the subject offers little or no evidence that the presence of natural resources has a negative impact on growth, while instead excessive export concentration has been shown to be harmful to growth.

This implies that it would be a mistake to approach the problem in terms of what to do with these resources, or of how to use the export earnings they produce to "alleviate" their negative effects. The question to be answered, instead, is: what is the best way to ensure the diversification of exports? The strategy we propose in this context is to promote diversification by adding value to our comparative advantages, which in most of the region's countries consist of natural resources.

Given this proposal, the question that arises is why hasn't the proposed change in production patterns

yet occurred? There are several reasons for this, such as, for example, the business climate and regulations, that have not been favorable for creating new enterprises—a key element in generating value added. Furthermore, not only is labor productivity relatively low, it is not geared to the needs of the internationally oriented productive sector. Another contributing element is the low level of innovation to be found in the region, as reflected in the design of the domestic innovation systems and in mistaken conceptions of what innovation implies. The problem in most cases lies in the association of innovation with the development of new technologies only, when in reality it also implies the improvement of processes or functions. In the case of our countries, there is scope for innovation through the adaptation of technologies or processes that have already been developed in more advanced regions¹⁷.

Nonetheless, it is Latin America's very diversification strategy that is at the heart of the region's failure to become more diversified. It has chosen for a variety of reasons to diversify toward products different from those in which it enjoys a comparative advantage. This stands in sharp contrast to successful experiences, where the focus was placed on first adding value to those comparative advantages and only then diversifying.

Faced with this situation, we propose a strategy of adding value to exports, based on clusters constructed around the region's comparative advantages. The first step to be taken in that direction, then, is to rectify the variables identified as obstacles to the diversification of the region's economies. By way of example, the business climate should be improved by making regulations more efficient. This implies facilitating the creation of new enterprises and easing labor market regulation, leaving the protection of the weakest to social policy instruments. Institutions in the natural resource sector must also be placed on a sound footing by, among other things, establishing clearly defined rules for the use of those resources and creating the necessary regulatory mechanisms to ensure their rational exploitation. It is important

¹⁷ Large investments are another key element, in addition to those already identified, for industrialization and diversification in countries that possess abundant natural resources. As Leamer (1998) explains, inasmuch as many of the associated industries born of diversification are capital-intensive, the operation of capital markets must be improved and the high premium on country risk to be paid by companies that invest in the region must be reduced.

that these rules and mechanisms are easily understandable and transparent so that investment in the sector is not inhibited.

Improving labor productivity is another key element for removing barriers to diversification. In this direction actions whose effects go beyond the improvement of labor productivity are necessary, such as education reform, which would also have an important social impact. There are, however, a series of measures specifically aimed at enhancing labor efficiency that can be taken in the short term. It is necessary, in particular, to improve the skills of currently employed labor and in this undertaking training programs are an essential instrument.

Without necessarily supplying the actual training, the State can play an important role in this area by offering incentives for the private sector to act more efficiently. Foreign investment can also play a key role in raising the educational level of labor, given that transnational enterprises tend to invest more in training their workers and can even open these activities to other local businesses. It is the government, however, that must offer the incentives to make this possible.

The second step in rethinking the diversification strategy is to prepare a three-pronged plan of action for developing clusters. The first involves the State's action within the clusters themselves, through an active role in coordinating and providing information. Experience in this area would tend to indicate that the State's function should be exercised in the following spheres: coordination among institutions, the creation of technical competence specialized in the promotion of association schemes, the creation or promotion of joint financing mechanisms for production-oriented projects and support for initiatives that promote productive entrepreneurship. This does not mean that the State cannot play an important role in productive sector "innovation" –i.e. identifying the sectors in which the country can become competitive. Very careful study of this role is needed, however, because the application of policies of this kind requires a thorough familiarity with the country's situation in order to determine the proper mix of policy instruments to be used.

The second sphere of State action involves national innovation systems, where it should play a proac-

tive role in disseminating business practices that will encourage innovation and in promoting dialogue among key players. Resources should be made available for innovation activities and, at the same time, be redirected toward finding solutions for the productive sector.

Finally, it is important to take advantage of the role of FDI in introducing new technologies. In the short run, benefits from technology transfers include the supply of better quality products, lower costs and enhanced productivity. In order for developing countries to make the most of this technology transfer in the long run, it is important to eventually transform it into "local innovation capacity". A promotional strategy must therefore be designed taking into account the elements needed to ensure FDI generates positive spillover effects.

It can be seen, then, that two types of policies are needed to improve the quality of the region's participation in the global economy. First, there are the actions the State can take on its own, such as implementing the recommendations for improving the business climate. And second, there are initiatives that involve the State's coordination with the private sector. Cooperation between the public and private sectors is necessary, whether it be to define the areas for labor training or to determine the research and development areas that will benefit from fiscal resources. Perhaps the first essential step in this strategy is a dialogue between these two actors over the country's potential and how it can be realized.

The challenge posed by social inclusion

As stated earlier, Latin America's low growth levels have been a key factor in the region's inability to significantly reduce poverty. Income distribution among Latin Americans is extremely uneven, and exclusion is a common element to many countries of the region. In other words, not only has economic growth been disappointing, its fruits have not been shared equitably, nor have they reached the destitute in any significant way. In the same way, income inequality and exclusion have not contributed to the process of economic development.

A rapid glance at social statistics for recent years shows little improvement in poverty reduction du-

ring the nineties, as compared with the previous decade. In addition, Latin America has the greatest income inequality of the entire developing world, situation that has only worsened in recent years. Despite significant advances in health and education, the region continues to lag far behind in this topics.

The proposed strategy for increasing and improving participation in the global economy will open up new opportunities for the poor and excluded, while at the same time the necessary investment in human capital will ensure that these new opportunities materialize. Unless measures are taken to deal with the region's deep-rooted and complex social problems, however, the proposals that have been put forward will not be viable. In fact, implementing these proposals could produce short-term losses for some social sectors, with a consequent deterioration of their quality of life. Temporary protective measures will be needed during the transition period to moderate these losses.

There is irrefutable evidence that growth is essential to achieving significant poverty reduction. Chile –an example taken from within the region itself– was able to halve its existing poverty rates, from a level approaching 40% of the population at the close of the eighties to about 20% at the end of the nineties. Its success can be attributed to highly active social policies and particularly to the increase in employment and wages triggered by strong economic growth. Another benefit of that growth was the provision of the resources needed to finance the larger fiscal transfers envisaged in the social programs. Nonetheless, Chile's experience also reveals that high growth and good progress in poverty reduction are not enough of themselves to improve income distribution.

The social strategy put forward in this book seeks to provide the poor and excluded with opportunities to generate wealth and to take advantage of the economic growth that can be expected from a greater participation in the global economy and a change in production patterns. Some risks, however, are difficult to foresee, such as, for example, temporary economic shocks and natural catastrophes. Furthermore, it is necessary for the region's countries to invest today in tomorrow's human capital if productive restructuring is to be successful.

In order for the poor and excluded to take advantage of the opportunities to be created by the proposed strategy, assets must be generated, and those that exist, reinforced by creating and improving human capital, investing in infrastructure for the poor (rural electrification, water and sanitation, irrigation systems for small farmers, etc.) and providing access to credit. Given the fact that human capital is the most important asset of the less favored social sectors, public and private initiatives that guarantee access to a quality education and to a good health system are essential for reducing poverty and inequality. Greater access to financial institutions specializing in microcredits, the supply of social investment funds, improvement of land tenure systems, corporate social responsibility, and strengthening of social capital, are some of the policies we propose as a way to take advantage of opportunities.

The poor are more vulnerable to unforeseen economic shocks, natural disasters and disease, because they are less equipped than other sectors of the population to weather the impact of these events on their wellbeing. For this reason, the region's governments should provide the tools for alleviating these risks, which could take the form of counter-cyclical economic policies, and policies of prevention and support in the event of negative economic events, natural disasters and epidemics. A social protection network to serve the less favored sectors during crises is especially important. Specific policies for creating or reinforcing social safety nets could include enhancing the efficiency and protection of social expenditure, localized transfers to vulnerable groups, and greater protection against volatility, including, in this final case, establishing temporary employment plans and unemployment insurance protection.

To conclude, social strategy should be conceived with a long-term outlook. Governments should accordingly continue their efforts to broaden the coverage and improve the quality of education and public health services in order to build human capital and guarantee improvements in welfare of the population at large, and of the poor in particular. Labor markets should be rendered more flexible and brought into line with the strategy of increased participation in the global economy and productive transformation. Furthermore, it is necessary to

address the problem of Latin America's growing informal employment, which reduces productivity and makes it more difficult to fight poverty and inequality.

Financing and governance

Implementation of the proposals put forward in this book will depend upon the availability of resources both of the State and the private sector. It will be necessary to offset the fiscal impact of tariff reductions implicit in the different strategies for increasing trade presence in the global economy, especially in the case of smaller countries, and to finance the establishment of a platform –infrastructure and the promotion of exports and FDI– that will link and at the same time adjust domestic supply to international market requirements. Other requirements include financing public policies to raise labor productivity, dealing with market failures associated with financial market imperfections, the provision of resources to national innovation systems, and the financing of a social strategy. What Latin American governments are capable of accomplishing on their own is limited by their weak fiscal situation, making joint efforts between the public and private sector essential. The State must maintain fiscal discipline in order to supply public goods, mobilize private domestic savings, and further develop capital markets.

Meeting the costs of these proposals requires implementing a series of fiscal recommendations. In the first place, in order to broaden the tax base, tax evasion must be reduced and the number of taxpayers increased. This means taking measures to bring down informal employment, such as simplifying administration and removing obstacles to the formalization of employment relations. Countries must also work toward an institutionally stable fiscal system with clearly defined accounting rules and bureaucrats equipped with technical competence and legal authority, among other things. Efficient budget resource allocation, for its part, calls for the planning and definition of public spending priorities in the medium term and the participation of the private sector and civilian society in the various phases of the budget process. Experience in the region, as exemplified by the enormous progress

made by Peru and Ecuador in increasing tax collections in recent years, has shown that this is possible.

It is also necessary to improve the public debt profile by reducing financial mismatches and establishing an efficient local currency debt market that does not crowd out private activity. This will require operations designed to lengthen debt maturities, taking into account the increased costs involved in extending deadlines. Furthermore, inasmuch as Latin America is highly prone to external shocks, it will be necessary for countries in the region to operate with more capital and less debt. In other words, it is not only a question of the profile of the public debt, but also of its size. It is necessary to reduce the number of contingencies to which the Treasury is exposed, including bank bail-outs, pension reforms and decentralization. To conclude, an institutional framework must be designed so it is conducive to maintaining fiscal discipline and that will introduce incentives for saving during bonanzas, thus reducing the pro-cyclical nature of fiscal policy.

Even with the implementation of these fiscal recommendations, financing needs are so large that it is beyond the capacity of the State to cover them. In this context, private financing is key. It is necessary to mobilize domestic savings, because local financial systems are not fulfilling their role of channeling firms' and households' surplus funds toward the financing of productive investments. Although important reforms were conducted to stimulate financial intermediation, Latin America's financial markets remain shallow, given the level of relative economic development¹⁸. Volatility, fragmentation and the failure to fully serve important economic sectors are the distinguishing features of these markets. Domestic capital markets in most of the region's countries are still underdeveloped despite the emergence in recent years of institutional investors like private pension funds, insurance companies and investment funds.

In this context, the financial restrictions that plague most Latin American countries must be resolved. Efficient resource intermediation, in order to finance productive investment, requires making improvements in the regulatory framework to allow the State to deal with market failures that keep the financial

¹⁸ IADB (2001b).

system from developing further and from operating appropriately. Asymmetric information is one of the major market failures characteristic of financial intermediation, and requires improving the quality of credit information systems. Transparency and public scrutiny are key elements for effective financial intermediation and to reduce the frequency of financial crises. It is important to actively promote the adoption of internationally recognized auditing practices and data dissemination standards that encourage greater monitoring by the private sector.

Generally speaking, a legal system should be established to back the operation, control and supervision of the financial system. Although the Latin American countries have made some progress toward establishing legislation to protect shareholder and creditor rights, investors and minority shareholders need to be given a minimum level of control, protection and information. In other words, good corporate government practices are needed. In the area of prudential supervision, it is important to improve the definition of this concept and to reinforce the supervisor's functions and control. In this process of strengthening the institutions that regulate the financial system, the interference of other State powers should be avoided.

To help deepen local capital markets, dissemination programs regarding this market and its operation, together with alliances between small stock exchanges and international financial centers, are recommended. It is also necessary to promote the entry of new players into the markets for fixed and variable interest securities, by lowering the associated costs of issues and generating more demand. The cost of such issues needs to be reduced and the process simplified through a more careful distribution of responsibilities among the various actors involved. With new issues, market competition should lead to lower costs. Although the menu of recommendations for developing the various means of participation in the capital market is broad, a common element is the need to maintain a stable and reliable macroeconomic, legal and regulatory environment.

The success of the proposals put forward in this book depends not only on the availability of resources, but also on the political viability of those

proposals. A consensus platform that will guarantee an environment of political stability and democratic governance must be constructed. We are convinced that not only will this platform result in greater economic development, but that any process of reform and structural change aimed at recovering sustained economic growth will need such a base to ensure its future viability. Although sound democratic governance depends upon a series of aspects, two elements in particular are essential: voice, participation and accountability on the one hand and, on the other, intermediation between the State and society. Insofar as the former is concerned, private participation mechanisms and political decentralization processes should be promoted as key instruments for ensuring fuller coverage of the needs of citizens and greater accountability. As for the latter, it is necessary to resolve the crisis of representation by reinstating the political parties as intermediaries between the State and society.

To conclude, the political viability of the proposals will also depend on the lasting nature of the proposed reforms and changes. Public policy changes will be lasting if a group of agents large enough is firmly convinced that they constitute a better system—one that is more legitimate and is more beneficial to them. If the necessary resources can be obtained and the rules can be enforced for a long enough period of time, the actors will begin to feel the effects of the new system of rules. A critical mass will be formed, with the potential for political mobilization if enough actors perceive that the institutional change is beneficial. This will make it possible to resist any pressure to return to the previous status quo or to move toward another system of rules.

Latin America needs to recover a sustained course of economic growth that will benefit a majority of the population, particularly the poor. As we have seen, results are urgently needed, given the situation of weak governance and widespread frustration prevalent in many countries of the region. We propose a comprehensive strategy, based on three pillars: increased participation in the global economy, changing production patterns to diversify and increase the value of domestic supply, and a social agenda that offers an all-out attack on poverty and income inequality.

The viability of these proposals will depend on the ability to increase domestic saving, to mobilize resources for financing the public policies needed in the identified areas, and to reach a social consensus on the advantages of the proposed changes. It is

our hope that our recommendations with regard to each of these three pillars will serve as a basis for the discussion of growth strategies aimed at the final objective: comprehensive development that will ensure the welfare of all Latin Americans.

References

- Agenor, P.R. (2001), "Business Cycles, Economic Crises, and the Poor, Testing for Asymmetric Effects", Country Economics Department Working Paper N° 2700, World Bank. Washington, D.C.
- Baldacci, E., L. De Mello and G. Inchauste (2002), "Financial Crises, Poverty, and Income Distribution", Working Paper No.02/4, International Monetary Fund, Washington, D.C.
- Birdsall, Nancy, Augusto De La Torre and Rachel Menezes (2001), "Washington Contentious: Economic Policies for Social Equity in Latin America", Carnegie Endowment for International Peace and Inter-American Dialogue. Washington, D.C.
- Calderón, César and Klaus Schmidt-Hebbel (2003), "Macroeconomic Policies and Performance in Latin America", Working Paper N° 217, Banco Central de Chile. Santiago, Chile.
- Corporación Andina de Fomento (CAF) (2003), "*Temas Críticos para América Latina*", Caracas.
- De Gregorio, José and Jong-Wha Lee (2003), "*Crecimiento y Ajuste en el Este Asiático y América Latina*," Banco Central de Chile, Working Paper N° 245. Santiago, Chile.
- De Soto, Hernando (2000), "*El Misterio del Capital: Por qué el capitalismo triunfa en occidente y fracasa en el resto del mundo*", Editorial El Comercio. Lima.
- Dollar, David and Aart Kray (2000) "Growth Is Good for the Poor" mimeo, World Bank.
- Economic Commission for Latin America and the Caribbean (ECLAC) (2003a), "Social Panorama of Latin America, 2002-2003", Social Development Division and the Statistics and Economic Projections Division. Santiago, Chile.
- Economic Commission for Latin America and the Caribbean (ECLAC) (2004), "Latin America and the Caribbean in the world economy, 2003-2004", Division of International Trade and Integration. Santiago, Chile.
- Estevadeordal, A. (2002), "Traditional Market Access Issues in RTAs: An Unfinished Agenda in the Americas?", paper presented to the WTO Seminar on Regionalism and the WTO, Geneva, 26 April 2002.
- Fernandez-Arias, Eduardo and Peter Montiel (2000), "Reform and Growth in Latin America: All Pain, No Gain?" IADB, Research Department Working Paper No. 351.
- Heston, Alan, Robert Summers and Bettina Aten (2002) "Penn World Table Version 6.1", Center for International Comparisons at the University of Pennsylvania (CICUP), Philadelphia, PA.
- Inter-American Development Bank (IADB) (2001b), "Competitiveness: The Business of Growth", Economic and Social Progress in Latin America 2001, Washington, D.C.
- International Monetary Fund (2003), "Public Debt in Emerging Markets: Is It Too High?", Chapter III del World Economic Outlook 2003. Washington D.C
- *Latinobarómetro* (2004), "*Una década de mediciones*", Informe-Resumen, Agosto 2004. Santiago, Chile.
- Leamer, Edward E. (1998), "In Search of Stolper-Samuelson Linkages between International Trade and Lower Wages." In Imports, Exports and the American Worker, ed. S. Collins. Brookings Institution, 141-202. Washington, D.C.
- Lederman Daniel and Guillermo Perry (2002), "Adjustments after Speculative Attacks in Latin America and Asia: A tale of Two Regions", Chief Economist Office for Latin America and the Caribbean, World Bank, Washington, D.C.
- Morsink, James and Tamim Bayoumi (2002), "A Peek Inside the Black Box: The Monetary Transmission Mechanism in Japan", IMF Staff Papers, International Monetary Fund, vol. 48(1), pages 2.

- Ocampo, José Antonio (2002), “Rethinking the Development Agenda”, Economic Commission for Latin America and the Caribbean (ECLAC), Santiago, Chile.
- Rodrik, Dani (1999a), “Where Did All The Growth Go? External Shocks, Social Conflict, and Growth Collapses”, NBER Working Paper 6350, National Bureau of Economic Research. Cambridge, MA.
- Rodrik, Dani, ed. (2003), “In Search of Prosperity: Analytic Narratives on Economic Growth”. Princeton University Press.
- Sen, Amartya (1987), “On Ethics and Economics”, Oxford and New York, Basil and Blackwell.
- United Nations Development Program (UNDP) (2004), “Democracy in Latin America: Towards a Citizens' Democracy”, Alfaguara. Buenos Aires, Argentina.
- World Bank (2000), “The World Business Environment Survey (WBES)”. Washington, D.C.
- World Bank (2003a), “World Development Indicators”, Washington, D.C.
- World Economic Forum (2003), “Global Competitiveness Index 2003-2004”, Oxford University Press.