“Growth Challenges in Latin America: What is Unique about the Region?”,

by

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Introduction

Growth patterns in Latin America over the last half century can best be described as extremely volatile. A period of relatively rapid economic growth that ran from the 1950s to the 1970s ended in deep economic and financial crises in the early 1980s and caused the region’s pace of economic activity to collapse. As is well known, the 1980s is characterized as the lost decade for Latin America. The early 1990s brought economic recovery, but debt and financial crises once again plagued the region during the second half of the decade and the early 2000s. Continuing with its rollercoaster-like behavior, the region’s economic growth accelerated in the mid-2000s,

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1 This paper expands upon remarks delivered at the second session of the Development Challenges for the Hemisphere Task Force and is based on the forthcoming book: Growing Pains in Latin America: An Economic Growth Framework as Applied to Brazil, Colombia, Costa Rica, Mexico and Peru, by Liliana Rojas-Suarez (editor), Center for Global Development, 2009.
driven by favorable external conditions that included a sharp improvement in the region’s terms of trade. This time, the recovery included the entire region. Indeed, in the period 2003-2007, all Latin American countries experienced consistent positive growth. Five years of region-wide, positive growth were an achievement not seen since the 1970s. However, just as hopes were mounting about the region’s capability for sustained growth, the deep financial crisis that started in industrial countries in 2008 expanded to emerging markets and damaged Latin America’s growth prospects. Now, once optimistic 2009 growth rates for the Latin American and Caribbean region have been revised, from 3.2% forecasted by the International Monetary Fund (IMF) in October 2008 to 1.1% in March 2009 and, more recently, down to -1.5% in April 2009.

Current opinions vary on how Latin America will fare in the global financial crisis, though the fact that the crisis is having an adverse impact on the region is now inarguable. Optimists believe that the market-oriented policies and reforms that have been implemented since the 1990s are providing a buffer against more severe and long-lasting effects. Under this view, Latin American countries are much better prepared to face the crisis, especially due to improved fiscal and debt management and the large accumulation of foreign exchange reserves. On the other side, more pessimistic analysts argue that the improved fiscal positions in Latin America are the result of temporary factors, such as high commodity prices, and that Latin American economies are still structurally weak. In addition, there is also the concern that political and social tensions in a number of countries might bring about a severe backlash against the market-based reforms implemented so far.

Despite differences in views regarding Latin America’s ability to weather the ongoing financial crisis, there is wide recognition that the region has a long way to go in terms of policies and reforms in order to reduce its income per capita gap relative to industrial countries and to other emerging economies with similar levels of social development. In fact, even the high GDP growth in Latin America during the period that preceded the global crisis was not able to prevent the widening of the region’s income gap relative to other regions of the world. For example, over the last three decades, Argentina, Nicaragua and Venezuela have seen the greatest increase in the gap between their income per capita and income per capita in advanced countries. Indeed, only Chile (and to some extent the Dominican Republic) has been able to get closer to the income per capita levels of industrial countries.

In light of these developments, and looking beyond the current crisis, the question is what Latin American countries should do to accelerate economic growth while ensuring its sustainability. After all, and as mentioned above, since the 1990s, most countries in the region embarked on a serious reform effort that included a number of economic and social policies and reforms. However, it is important to recall that many of these reform efforts focused primarily on achieving much needed macroeconomic stability. For example, in a number of countries, pension reform, privatizations and, in some cases, even banking sector reforms aimed at correcting for unsustainable fiscal balance sheets. The idea, of course, was that by increasing the involvement of the private sector, these reforms would also improve efficiency and, therefore, economic growth would follow.

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2 Two countries are defined as having “similar degrees of social development” if they belong to the same decile of the HDI (Human Development Index) published by the United Nations Development Programme (UNDP). Advanced economies are those belonging to the 10th decile of the HDI.
What should policymakers do to stimulate sustainable growth? This paper takes the view that in order to advance specific policy recommendations on how to proceed with the reform agenda it is first necessary to identify and understand the particular features that distinguish Latin America from other regions of the developing world. While it is essential to recognize the differences that exist among Latin American countries—and these differences should guide policy prescriptions—there are also important characteristics of the region as a whole. Understanding the characteristics and constraints to growth in the region is even more essential if the region is to maintain the overall gains (economic, social and political) of its reform efforts over the last decade in the context of the current financial crisis. Thus, the rest of this paper is organized as follows. First, it discusses some key economic and political traits that make Latin America unique. Second, based on these key characteristics, it identifies the foundations that reforms need to build and/or improve in order to achieve sustained growth in the region. Finally, the paper provides a few examples (taken from the forthcoming book Growing Pains in Latin America (Rojas-Suarez, ed., 2009) of country-specific proposals that aim to enhance the growth foundations.

**Understanding the Unique Features of Latin America**

Although many comparisons can be drawn between Latin America and the rest of the developing world, and despite differences across countries within the region, there are three main factors that distinguish the region from other parts of the world. Latin America is the most financially open and democratic region in the developing world and also the region with the most unequal income distribution.

**Most Financially Open**

Since the 1990s, Latin American countries have become increasingly financially open. By 2006, Latin America was the most financially open region in the developing world, second only to developed countries. This is evidenced in graph 1, which displays the evolution of an index of capital account liberalization (see Chinn and Ito, 2007) by regions, in which a higher number indicates a greater degree of openness. The sustained increase in financial openness in the regional index is quite representative of most countries in the region. With the exception of Argentina, Honduras, Venezuela and, more recently, Ecuador, all of the Latin American countries have increased the openness of their capital accounts since the mid-1990s.

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3 In the Chinn-Ito Financial Openness Index, openness is measured using variables indicating the presence of multiple exchange rates, restrictions on current account transactions, restrictions on capital account transactions, and the requirement of the surrender of export proceeds based on the IMF’s *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAR) dataset.

4 The index lacks a pre-defined range of values because it is based on a statistical methodology that uses “principal components.” Thus, the only interpretation that should be given to the numbers is that a higher value denotes greater openness of the capital account.
The emphasis on capital account liberalization in Latin America began in the late 1980s and early 1990s with the introduction of the Brady Plan, which was implemented in response to the 1982 debt crisis. The Brady Plan introduced the securitization of government debt, allowing countries to refinance and create more liquid forms of debt in return for economic reform. Financial openness enhances a country’s ability to meet its financing needs by allowing the free flow of capital in and out of its financial markets. While this openness to external investors expands financing opportunities, it also amplifies a country’s vulnerability to a deterioration in investors’ perceptions of its capacity or willingness to service its debt.

Since the introduction of the Brady Plan, international bonds and other highly liquid securities issued by Latin American governments have displaced unsecuritized bank loans as a major source of finance for the region. National debt financed by international bonds has different characteristics from debt financed by unsecuritized bank loans. First, in contrast to unsecuritized bank loans, there is a highly liquid market for international bonds. Second, arrangements to address collective action problems among bondholders in the case of sovereign default are still relatively undeveloped, while institutions for negotiations involving internationally-active banks are well established. These two features imply that, relative to bank finance, the international bond market is more reactive to changes, or perceived changes, in a country’s creditworthiness. This means that when fears arise regarding a country’s macroeconomic stability, investors will quickly sell off bonds, thereby lowering prices and raising yields. The increase in the country’s risk characteristics will be visible in the spread of the country’s sovereign debt over US Treasury bills if both are denominated in US dollars. The elevated external interest rate means that it will be more difficult for the country to finance its debt, while the increase in country risk will cause a spike in domestic interest rates, hindering investment and growth.

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Latin America’s domestic interest rates are particularly sensitive to deteriorations in investors’ risk perception because of the region’s low national savings rates and underdeveloped local financial markets, which mean that Latin America needs to rely heavily on external sources of finance. Under these circumstances, domestic sources of finance in a particular country cannot offset the sharp decline of external financing that often follows a deterioration in the perception of risk characteristics of that country. Unfulfilled demand for financing quickly translates into higher domestic interest rates.

In addition, Latin America is still relatively closed in terms of trade flows, and its exports are concentrated in commodities. Thus, more often than not, export flows have proven insufficient to offset a sharp decline in external financing, even if a depreciated currency accompanies the fall in external sources of finance. This was the case during the financial crises of the 1990s and early 2000s that affected a large number of countries in the region, including, Argentina, Brazil, Ecuador and Mexico. The current global financial crisis is yet another example of these difficulties. At the time of this writing, the scarcity of private external credit was taking a significant toll on the region’s prospects for growth in 2009-2010. The recent increased role given by the G-20 to the multilateral organizations, especially the IMF, as potential sources of liquidity, is recognition that most emerging markets, including many in Latin America, might not be able to meet their financial needs without multilateral support.

This increased vulnerability to changes in risk perception by investors means that Latin American countries need to ensure macroeconomic stability on a continuous basis if growth is to be sustained. Moreover, macroeconomic policies to ensure stability need to go beyond the achievement of low inflation rates and sound fiscal balances. Self-insurance policies, such as large accumulation of foreign reserves and the creation of fiscal stabilization funds, can help mitigate the effect of international economic downturns and need to be part of the macro policy agenda. For a number of countries, these policies have proven extremely useful in the current global financial crisis. Chile, for example, stands out as a country with a well-designed fiscal stabilization fund.

Interestingly enough, with a few exceptions, thus far the spreading financial crisis does not appear to have catalyzed a trend of reversing the capital account liberalization of the past two decades, and all indicators point toward a continuation of financial openness in the region. Thus, recommendations for growth-enhancing policies need to take into account this important feature of the Latin American region.

**Most Democratic**

There are a number of indices that measure the degree of democracy in individual countries, including those produced by Freedom House, the Economist Intelligence Unit (EIU) and the Polity Index. All indices differ in the *scope* of variables utilized to define advances in democracy. While some indices have a narrow definition of democracy, restricted to the rights of citizens to vote freely in elections, other are much broader in scope, including indicators of the degree of development of a political culture where citizens not only take an interest in public debates, but also actively and freely join political parties. Regardless of the index considered, however, a common result is that Latin America’s degree of democracy has drastically improved in the last three decades, making it at present the most democratic region in the developing
world. As an example, graph 2 shows the evolution of the Freedom House Index for Political Rights. The index ranges from 0 to 7, where a lower number indicates fewer obstacles to democracy.

![Graph 2: Democracy](image)

A major driver of this improvement in democracy was the eradication of military regimes in Latin America; the region has gone from having twelve military regimes in the 1970s to having none since 1991. Of course, being the most democratic region in the developing world does not mean that all countries share the same degree of democracy. Indeed, some indices, such as the Economist Intelligence Unit index, give very low ratings on political culture to Bolivia, Ecuador and Nicaragua. Likewise, in the Polity IV index, which assesses both the quality of democracy and the autocratic authority of governments, Ecuador and Venezuela got the lowest scores in the region in 2007 and Costa Rica and Uruguay the highest.

The high level of democracy in Latin America plays an important role in the achievement of sustainable growth. Pro-growth reforms might prove unsustainable if the reforms’ benefits do not reach a large proportion of voters. While Latin American countries have instituted broad pro-market reforms, there is an increasing risk that these could be reversed under pressure (through electoral and legislative processes) from dissatisfied citizens who have not benefited proportionally from the reforms and subsequent growth\(^6\). This is particularly relevant in the context of the current financial crisis, which is exacerbating concerns about a backlash against market-based reforms and policies. The year ahead will see a reduction in the consistent, positive growth that the region has maintained over the past five years. The resulting contraction, and accompanying unemployment, has the potential to heighten preexisting discontent with market-based reform. Thus, the broad sharing of the benefits of reform-driven growth becomes even more critical in order to maintain current reforms and allow for further future reforms.

\(^6\) See Birdsall, de la Torre and Menezes (2008) for an extensive discussion of these issues.
Even prior to the onset of the current financial crisis, support for market-based reform was on the decline. According to the 2007 Latinobarómetro public opinion survey, the percentage of people supporting or strongly supporting the market economy has been decreasing since the late 1990s. This decline in support has also been evident in the election of several “leftist” candidates over candidates strongly supporting market-based reforms. Most Latin American countries are young, and often volatile, democracies; in fact, twenty-four Latin American countries became democracies in the 1980s and 1990s. As voting rights for the poor increase in burgeoning democracies, the demand for redistribution of income escalates, highlighting the unequal distribution of income that exists in Latin America, which is the third unique feature of the region that policymakers must take into account.

**Most Unequal**

Latin America has had one of the world’s most unequal income distributions since the 1960s. In 2005 it surpassed sub-Saharan Africa to have the most unequal income distribution as measured by the Gini coefficient (see Graph 3). There are various explanations attempting to account for the high levels of inequality in Latin America relative to both developed and developing countries. These explanations range from historical institutional arrangements to ethnic structural and cultural diversity to the socio-economic features of ancestors at the household level.

![Graph 3: Income Inequality](image)

There is not only a social motivation to narrow the income inequality gap, but also an economic one; evidence suggests that income inequality above some level is likely to reduce growth. Moreover, there is significant theoretical and empirical evidence indicating a negative relationship between inequality and the reform process in Latin America. This result might be

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8 As stated by Marta Lagos, director of Latinobarómetro, as democracies consolidate, “people are more conscious of their rights and their expectations are higher.” *The Economist*, November 2008.
9 Birdsall (2007).
related to the unique combination of Latin America being the most democratic and the most unequal region in the developing world. Indeed, as some economists have indicated, as the poor gain political rights and the demand for income redistribution increases, inequality could act as an impediment to reform as long as these demands are not satisfied.

In a region characterized by high levels of both democracy and inequality, the already tenuous backing of market-based reform could easily be destabilized by a shock of even lesser magnitude than the current economic downturn. Now more than ever, policymakers need to ensure that they consider the specific regional and country features that influence the feasibility and effectiveness of reforms. Without an in-depth understanding of these unique features and their interactions, any attempts at reform run the risk of failure or, at the least, unsustainability.

**Foundations for Growth in Latin America**

In the context of the particular features of Latin America, what are the main foundations that reforms need to build or improve in order to generate sustainable growth? The high degree of financial openness of Latin America indicates that the region has chosen to allow market forces, through the behavior of the international capital markets, to assess the performance of their economies. With few exceptions (most notably Argentina, Ecuador and Venezuela) there are no indicators that the region as a whole will move away from a market-oriented growth model anytime soon. Even in the midst of the global financial crisis, most countries are not contemplating the implementation of tight capital controls or other obstacles to restructure the free movement of international capital flows. Thus, the first basic foundations are those that create incentives for the appropriate functioning of markets. The following three foundations are not only relevant for Latin America, but are applicable to all market-based economies:

a. **Secure property rights** for the majority of the population, to allow individuals and firms to benefit from their investments and to feel confident that they will not be unexpectedly seized by the state or by the politically powerful.

b. **Sufficiently equal opportunities** to level the playing field by lowering barriers to entry to allow individuals and firms without political connections and wealth to succeed. This foundation specifically addresses issues of access to market opportunities. One example is lack of access to finance, due to either inadequate regulatory requirements or impediments created by a weak institutional framework (such as a weak judicial system) that constrain the provision of financial services to large segments of the population.

c. **Sufficient economic and political competition** to prevent the capture of the state by elites. This foundation is important and distinct from the first two because, despite secure property rights and equal opportunities, the bulk of the state’s resources might still be funneled to a relatively small group of individuals and companies.

However, while necessary, these three foundations are not sufficient to achieve sustained growth in Latin America. The combination of the region’s high financial openness, limited trade openness, underdeveloped local financial markets, and low national savings rates, implies that the fourth foundation must clearly be:

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10 See Rojas-Suarez (2009) for a detailed discussion of the growth foundations in Latin America.
d. *Macroeconomic stability*, without which the ability of any other policies and reform efforts to deliver sustainable growth would be severely curtailed because of the region’s vulnerability to deterioration in investors’ perceptions. In the past, lack of macroeconomic stability has resulted in frequent financial and economic crises in the region, which have led to severe recessions and fiscal adjustments. These adjustments generally led to cuts in social expenditures and in infrastructure spending, which harm the poor and diminish long-term growth prospects.

A fifth foundation arises out of the need to reconcile market-based reform with the discontent of large segments of the population regarding the functioning of the market system. Latin America’s unique combination of being the most democratic and the most unequal region in the developing world implies that a necessary growth foundation is:

e. *Broad sharing of the benefits from growth*, which is crucial to sustainable growth because, even if GDP grows and certain segments of society benefit, there may be a political backlash from those who do not. Thus, *broad sharing of the benefits from growth among the population* would allow for sustainable market-based reforms backed by popular support.

**Instituting Reforms that Deliver Sustainable Growth**

The main conclusion from the discussion above is that it is essential for policymakers in Latin American countries to: (a) identify what growth foundations, among the five discussed above, are in need of improvement, (b) assess what types of reforms and policies have the potential to impact these foundations, positively or negatively, and (c) address the obstacles to reform based on the specific political, social, and economic conditions of individual countries.

Of course, given the particularities of individual countries, specific problems as well as recommendations will differ among countries. To get a flavor of how the framework of analysis described above can be applied to specific countries, this section provides some examples derived from case studies in Brazil, Colombia, Costa Rica, Mexico and Peru. The interested reader can obtain the full analysis of these case studies in Rojas-Suarez (2009).

The analysts who implemented the framework described in this paper sought to investigate which growth foundations had been strengthened and which had been weakened during the reform process of the 1990s and early 2000s.

Among growth foundations that were strengthened, the case studies agreed that *economic (although not necessarily political) competition* had improved in all countries, with the exception of Mexico. For example, in Brazil, a number of regulations limiting entry and competition were eliminated. In Costa Rica, trade liberalization shifted the country’s comparative advantage from land to human capital, increasing competition for human resources. The break-up of some public monopolies in Brazil, Colombia and Peru were also assessed as improving competition.

Most of the country studies also found that the *sufficiently equal opportunities* foundation was strengthened by trade, financial and regulatory reform. Interestingly, although it was widely
recognized that macroeconomic indicators had improved in all countries, only in Peru was the macroeconomic stability foundation significantly strengthened by reforms. This is largely due to the fact that the macroeconomic reforms implemented in the early 1990s have been maintained. In contrast to other countries in the region, Peruvians at large (the population, the monetary authorities and the government) do not tolerate high inflation. Another feature contributing to Peru’s macroeconomic stability is the high level of central bank autonomy, which is the highest among the countries in the sample.

The secure property rights foundation remained weak in most Latin American countries. In fact, by 2006, Latin America, along with South Asia and Sub-Saharan Africa, had the weakest indicators of property rights of the world’s developing regions.\(^{11}\) In Mexico and Brazil, the property rights indicator actually weakened from 1990 to 2006. Colombia’s property rights are particularly weak, with the lowest value on the indicator (4.49 out of 10). Based on this finding, a number of countries’ recommendations target the weak property rights foundation and propose reforms to the judiciary system.

The broad sharing of the benefits from growth was identified as the “missing foundation” in a number of countries. For example, data in Peru show that although economic growth has reduced income inequality at the national level, urban-rural disparities have increased. In Costa Rica, the reform that downsized the public sector lacked priorities, and budgetary restrictions were imposed across the entire public sector. As a result, the most affected government branches were precisely the most important to the broader sharing of the benefits of growth: education, public infrastructure and social assistance.

As it is easy to infer, proposals to build and/or improve weak foundations are manifold and need to tackle many areas of reform. Since the proposals advanced in Rojas-Suarez (2009) cannot be easily summarized, a few examples of country-specific recommendations are presented below, focusing on one particular area common to all countries in the sample: the area of institutional strengthening.

- In Peru, the authors of the case study emphasize improving the education system and instituting substantial reform of the state and political system so that policies can benefit the poor, especially in rural areas. The recommendations focus on enhancing implementation capacity of the state by introducing a merit-based career path for public servants, applying results-based analysis to budgetary expansions, and consolidating the twenty-five existing geographic regions into seven to ten macro-regions (for the purpose of simplifying the distribution of public resources and monitoring their utilization). The authors also recommend improving accountability through the strengthening of “watchdogs,” such as nongovernmental research and advocacy organizations.
- The focus in Mexico is on reforming competition policy following the severe problems derived from some of the privatizations that occurred in the 1980s and 1990s, such as the privatization of Teléfonos de México (Telmex) and the National Highways Concession Program. The authors of this case study specifically recommend granting full autonomy

\(^{11}\) See Gwartney and Lawson (2008).
to the Federal Competition Commission and creating specialized courts for competition and regulatory cases.

- In Brazil, in order to secure property rights, a growth foundation assessed as extremely weak, reforms to the judicial system are strongly recommended. Some proposals include: basing promotion of judges on performance indicators instead of seniority, eliminating incentives to delay court proceedings, and raising public awareness of the consequences of poor judicial performance for economic development and social equity.

- In Colombia, the focus is on reforming the Constitutional Court to reduce the excessive judicial activism that exists to the detriment of macroeconomic stability. Proposals include: reducing the politicization of the court magistrates by allowing them to run for a second term, after a cool-off period has elapsed; seeking a consensual definition of adequate social services (to prevent the current practice of upholding claims to social services far beyond those in the law); and requiring the court to review laws as soon as they are approved to avoid their being overturned later on procedural grounds. The current practices of the Constitutional Court have imposed very high fiscal costs on the government.

- For Costa Rica, the authors of the case study propose several legislative reforms to help overcome the paralysis that exists as a result of a minority antireform party with the ability to block reforms. Some of these suggestions are: setting a deadline by which the congress must vote on proposed laws; reducing the delays in current procedures for representatives to put forward their positions, place them on the record, and propose amendments; and requiring a quorum for votes only and not for debate. Previous failed reforms ended up imposing significant budgetary restrictions, limiting public investment and inciting antireform sentiments.

**Conclusion**

As explained in this paper, effective design and implementation of pro-growth reforms in Latin America need to take into account both the particular features that distinguish the region from other parts of the world, as well as the specific economic, social and political characteristics of individual countries within the region. At the regional level, Latin America is in the unique position of being the most financially open, the most democratic and the most unequal of all regions in the developing world. This paper has largely focused on discussing these features because they set constraints, as well as guidelines, for the design of policies and reforms that can deliver sustainable growth.

Examples of specific reforms proposed for individual countries yield an optimistic picture because the proposals are practical and doable. A close examination of the particularities of Latin America leads to the conclusion that to be successful, reforms need to be incremental and be implemented by reaching a consensus, rather than by being imposed vertically. Indeed, while the necessary reforms vary significantly across countries, a commonality in proposals is the push for increased dialogue between governments and civil societies.

The environment for successful market-based reform in Latin America is certainly preset, but policymakers must act quickly, while being acutely aware of the regional and country-specific challenges. The current financial crisis has only served to amplify the need for policies that are
able to provide stable, and sustainable, growth benefiting a large share of the population. While the crisis has put the brakes on the impressive growth achieved by Latin America in the last five years, with the right approach to policy, Latin America should be able to return to positive growth levels in the medium-term.

References


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