1

Setting the Stage

PEDRO-PABLO KUCZYNSKI

Latin America—excepting Argentina, whose golden age was in the decades before 1914—grew as never before or since in the years between 1940 and 1980. The commodity price booms ignited by World War II finally laid to rest the Great Depression. When the war ended, rapid worldwide growth and the active developmentalist policies adopted throughout the region, which included first-stage import substitution, maintained rates of growth that averaged 5.2 percent a year between 1945 and 1981 (Thorp 1998, 318). Social indicators also improved rapidly (table 1.1).

Yet even during this time, there was a lot to be concerned about. The income gains that were being achieved were concentrated on those who were already best off, so that the pattern of highly unequal distribution bequeathed by the region's colonial history continued. And the income gains, though impressive by historical standards, did not match those being realized elsewhere in the world at the same time. While GDP per capita increased by between 60 percent in Venezuela and almost 240 percent in Brazil from 1950 to 1980, comparable increases were much larger elsewhere, especially in Southern Europe and East Asia (table 1.2). Moreover, in the last decade of this golden age, there were more and more reasons to doubt the sustainability of the growth model, as budget deficits

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Table 1.1 Social indicators for selected Latin American countries and East Asia, 1960-98

Country	Approximate year	Life expectancy at birth (years)	Infant mortality to age 5 years (per 1,000 live births)	Adult literacy (percent)	Access to safe water (percent)
Argentina	1960	65.2	72	91.0	51
	1980	69.6	38	94.4	58
	1998	73.3	22	96.6	65
Brazil	1960	54.9	177	61.0	32
	1980	62.7	80	74.5	56
	1998	67.1	40	84.5	72
Mexico	1960	57.3	134	65.0	38
	1980	66.8	74	82.2	50
	1998	72.1	35	90.8	83
Latin America	1960	56.5	154.1	74.0	35
	1980	64.7	78.5	79.9	53
	1998	69.7	37.7	87.8	76
East Asia	1960	39.2	198.2	—	—
	1980	60.0	81.7	68.8	—
	1998	68.9	42.6	84.5	84

— = not available

Sources: World Bank, *World Development Indicators*; Edwards (1993a); Morawetz (1977).

grew, inflation accelerated, foreign borrowing exploded, and in consequence debts accumulated faster than the ability to service them.

The growing macroeconomic imbalances made the region progressively more vulnerable, and so it proved unable to withstand the strains induced by the anti-inflationary tightening of monetary policy in the United States in the early 1980s. Interest rates soared; the dollar, in terms of which most foreign debts were denominated, appreciated; the price of commodity exports collapsed; and the markets for noncommodity exports shrank. In August 1982, Mexico ran out of reserves and was unable to borrow more, and so it was forced to declare a moratorium on debt service. Within weeks, the whole region was immersed in what became known as the debt crisis.

Growth ground to a halt in the following months and years. But because population continued to grow, the result was an erosion of living standards and a reversal of the downward trend in poverty of the preceding decades. The region entered what was before long labeled the "lost decade."

Toward New Policies to Promote Growth

It was in the midst of this lost decade, in the darkest days of the debt crisis, that the Institute for International Economics sponsored a study titled

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Table 1.2 GDP per capita for selected Latin American countries and countries in other regions, 1950-2000
(US dollars at 1995 prices)

Region and country	1950	1966	1980	1998	2000	Ratio of 2000 to 1950
Latin America						
Argentina	5,314	6,678	9,084	11,230	10,981	2.1
Brazil	1,803	2,788	6,092	6,193	6,094	3.4
Chile	4,009	5,617	6,715	8,214	8,217	2.0
Colombia	2,687	3,383	5,328	5,615	5,226	1.9
Mexico	2,987	4,898	7,210	7,202	7,625	2.6
Venezuela	6,021	9,588	9,370	5,430	4,911	0.8
Southern Europe						
Greece	2,562	5,730	11,171	13,035	13,829	5.4
Portugal	2,075	4,349	8,753	13,743	14,679	7.1
Spain	3,292	7,728	12,071	15,156	16,408	5.0
Turkey	1,984	3,573	5,857	6,004	5,728	2.9
East Asia						
China	—	—	780	2,903	3,286	—
South Korea	1,274	2,259	5,682	12,600	12,795	10.0
Singapore	1,699	3,697	11,177	22,633	23,026	13.6
Taiwan	1,438	2,845	7,140	15,425	16,500	11.5

— = not available

Sources: For 1950 (at 1995 prices and exchange rates), Balassa et al. (1986, table 1.2); for 1950, 1966, 1980, and 1998 (at 1995 prices and purchasing power parity), World Bank, *World Development Indicators 2000;* US Central Intelligence Agency, *World Factbook 2000.*

Toward Renewed Economic Growth in Latin America. The authors were Bela Balassa, then a visiting fellow at the Institute, and three Latin American economists: Gerardo Bueno of Mexico, Pedro-Pablo Kuczynski of Peru, and Mario Henrique Simonsen of Brazil.

This study laid out a policy agenda that was starkly at variance with conventional thought in Latin America at that time. It argued that the still-prevalent policy of import substitution, which may have been constructive during its first easy phase, had long since outlived its usefulness and become a drag on industrial development, for it had largely precluded a boom in manufactured exports such as that experienced in the more dynamic developing regions. The study viewed the large fiscal deficits that were almost ubiquitous at the time as a demand on the savings needed to finance growth rather than as a Keynesian stimulus to output. And it criticized the overwhelming economic role of the state (including the prevalence of state-owned enterprises) as undermining the ability of the private sector to generate growth.

The sort of policy reversal called for by the study had in fact been pioneered by Chile in the 1970s. This did not immediately strike other countries as an example that they might want to emulate—partly because of

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the dictatorial political regime that was responsible, and partly because the initial fits and starts did not suggest this to be an attractive economic model. But from the mid-1980s onward, Chile developed a sustained economic boom. Economists such as Balassa had for years been arguing that Latin America was making a mistake in not emulating the policies of openness and macroeconomic discipline that had served East Asia well and led to an economic miracle there; the presence of a local model powerfully reinforced this message. And so, in the second half of the 1980s, policy started to shift in a similar direction in other countries of the region.

The Birth of the Washington Consensus

This change surely encouraged the incoming US administration of George H.W. Bush to propose the Brady Plan for resolving the debt crisis soon after it took office in 1989. The extent to which Latin American policy reforms were being implemented was, however, not widely understood in the United States when the Brady Plan was being discussed in Congress. In an attempt to remedy this, the Institute for International Economics convened a conference in November 1989 under the title "Latin American Adjustment: How Much Has Happened?" And with the aim of providing some coherence to the papers that were commissioned to examine the extent to which individual countries had already embraced reform, the conference's organizer, John Williamson, laid out in a background paper what he understood to be the main reforms that were widely agreed in Washington to be needed to restore Latin American economic growth.[1]

This was the origin of what Williamson termed the Washington Consensus. The term has been used and misused in all sorts of ways in the subsequent years, to mean laissez-faire and minimalist government and disdain for all values but the growth of GDP, but its original meaning was vastly less ideological. It was intended to identify those policies that mainstream Washington institutions like the US Treasury, the International Monetary Fund, the World Bank, and the Inter-American Development Bank agreed to be key to the restoration of growth in Latin America.

Some of these policies, like privatization, had indeed been pioneered by such market-oriented regimes as Margaret Thatcher's government in Britain but had subsequently won wide endorsement. Others, like free trade and fiscal discipline, had been advocated for decades for industrial

1. Williamson (1990); this book contains country papers by Juan Cariaga, Patricio Meller, Pedro-Pablo Kuczynski, Juan Carlos de Pablo, Eliana Cardoso and Daniel Dantas, Javier Beristain and Ignacio Trigueros, Rudolf Hommes, Ricardo Hausmann, DeLisle Worrell, Sylvia Saborio, and Enrique Iglesias.

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countries by the Organization for Economic Cooperation and Development, but general recognition of their appropriateness in developing countries was more recent. The agenda of the conference omitted ideologies like supply-side economics and monetarism that were widely questioned just as much as it excluded the socialist dream that was collapsing in Eastern Europe at the very time that the conference was held. It was largely the agenda sketched out in *Toward Renewed Economic Growth in Latin America*: a mainstream agenda that recognized the importance of both the market and the state.

The hope of a better future for Latin America in the 1990s rested on a combination of liberalizing and stabilizing policy reforms, the Brady Plan for debt relief, and democratization. Mexico had already joined the GATT in 1986, and substantial other reform efforts were reported in a number of countries in the Institute's November 1989 conference, but the year 1989 was nonetheless something of a watershed. The plebiscite in favor of the return of civilian elected government in Chile marked the effective end of military rule in most of the region. Privatization started in a big way with the sale of the controlling interest of the state in Teléfonos de Mexico to a private consortium, and Mexico secured the first Brady debt reconstruction in September of that same year. Argentina began to put its fiscal house in order during a period of unprecedented hyperinflation, and it also sold off control of its state-owned telephone company. And Venezuela attempted a radical adjustment program.

By the early 1990s, a majority of the countries in the region, including several of the smaller economies in Central America and the Caribbean, were engaged in opening up their foreign trade, cutting budget deficits, and selling off state assets, including many utilities. The combination of domestic privatization and declines in US interest rates from 1990-91 and on unleashed a flood of foreign portfolio investment onto the larger Latin American stock markets, which appreciated by 25 percent annually from 1989 to 1994. Economic growth began to pick up, and for the region as a whole it averaged 4.2 percent annually in the period 1990-95, compared with barely 1 percent in 1982-89. Per capita incomes started to increase after a decade of decline, although unemployment remained high and real wages recovered only slowly.

Two important positive events occurred in the region in 1994. In Brazil, the trade liberalization and privatization (initially of the steel and petrochemical industries) of the early 1990s were finally complemented by an effective stabilization plan, the Plano Real. This brought the largest economy of the region into line with the policies of the other major countries. And Mexico completed its entry into the North American Free Trade Agreement (NAFTA) after lengthy negotiations with Canada and the United States, setting the stage for the fourfold expansion of its export earnings in the following 6 years.

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Crisis Returns

However, that same year witnessed the return of crisis to the region. Shortly after a new administration had been inaugurated in Mexico in December 1994, the unsustainable current account deficit of the years 1992-94 created a crisis of confidence that ultimately led to a large and disorderly devaluation. To avoid a debt default, an international mega-rescue package that in principle totaled almost $50 billion had to be organized, and this led to much controversy in the US Congress because it followed so shortly the accession of Mexico to NAFTA.

The large devaluation (eventually threefold in terms of pesos per dollar) was beneficial to Mexican exports, but it sparked renewed protectionist sentiment in some sectors in the United States. The devaluation caused devastation to the Mexican banking and capital markets: interest rates had to stay at high levels for balance of payments reasons, choking off investment and growth; massive domestic defaults, especially of mortgages and consumer credit debt, wiped out the capital of most banks; that, combined with a "moral hazard" culture that encouraged default even by those who could pay, eventually led the Mexican government to put in close to $100 billion to rescue the banking system, six times what it had collected when the banks were reprivatized in 1991-92; the emerging domestic bond and equity markets, which had made a promising recovery in 1990-94, went into dormancy. The "tequila crisis" reverberated throughout the region, especially in Argentina, although in the end no other country was engulfed.

Just over 3 years after the start of the Mexican devaluation, Brazil faced a similar problem with some similar causes, reinforced by the world financial crisis that had started in Thailand in July 1997, and exposed the fragility of the East Asian economic miracle, then surfaced in Russia, and devastated the Long-Term Capital Management hedge fund based in the United States. At $42 billion, the international rescue package for Brazil was almost as big as that of Mexico. Fortunately, it proved more effective in limiting the damage than most of the preceding rescues had been: the devaluation was smaller, the banking system was stronger, and the determined actions of the central bank limited inflation; so after a few months of uncertainty, Brazil returned to weak growth. Nevertheless, Brazil has had to maintain high domestic real interest rates to limit the devaluation of the real (60 percent, in reais per dollar, in 1999) and hold inflation within single digits.

The traumatic financial events in the two largest economies of the region, which together account for 60 percent of regional GNP, undoubtedly affected all of Latin America. For the second half of the 1990s, regional growth barely reached 2.5 percent annually, well below the performance

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of the United States (3.9 percent annually in the same period). To be sure, the East Asian economic crisis, particularly its negative impact on commodity prices and on the availability of private international debt finance, contributed to the poor result, especially in Argentina, Chile, and the Andean countries. The Russian crisis of 1998 reinforced the virtual shutdown of the flow of finance from the international bond market and from banks to emerging markets that had begun a year earlier.

The outcome of these internal as well as external events is that the 1990s were another disappointing decade for Latin American economies. Of the several possible causes of this disappointment—such as an apparently secular commodity downturn, the high dependence on volatile foreign financing, and the persistence of weakness in public finances—one in particular stands out: the proclivity of key countries in the region to be unable to manage their macroeconomic policies—the combination of fiscal, monetary, and exchange policies—in a sustainable manner that avoids periodic crises. This has been the case for Mexico, then Brazil, and now Argentina.

There are several reasons for this inability. One is the desire of policymakers to reconcile what are in practice irreconcilable objectives: exchange rate stability to achieve low inflation on one hand, and balance of payments viability in a world of volatile capital flows on the other. A second is political myopia, which has again and again led policymakers to spend during good times without thought for the future. That is one reflection of a more general problem, the weakness of key institutions, so that decisions that are considered essential and normal in more advanced economies in practice become highly politicized in a Latin American setting.

There is of course nothing of particular statistical significance about a decade or about a collection of fairly diverse countries that stretch over 10,000 kilometers. Nonetheless, international investors and financial markets tend to look at the geographic region as a whole, and the slow economic growth in almost all these countries during a long period of about 20 years hardly inspires them to regard this as a dynamic region in which they must have a presence.

Social Progress—Nevertheless

Despite Latin America's disappointing economic growth, it has made much progress during the past two decades in improving standards of longevity, nutrition, public health, and literacy, keeping its averages above those of East Asia. Yet it has shown no sign of progress in remedying its long-standing and endemic maldistribution of wealth; indeed, the region may have retrogressed in what were already among the most highly skewed distributions in the world. And its progress in longevity

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and health poses an additional challenge to countries that have slow economic growth. As I have written elsewhere:

> In the case of a number of South American nations there is a danger that they will grow old before they grow up: rapidly improving health care and declining birth rates will eventually lead to an aging population (as in Argentina and Uruguay) before these countries have had an opportunity to reach reasonably modern living standards. Once the population stabilizes, only a near-miraculous productivity gain can propel a country to modernity. In other words, there is the risk of growing old before growing up. Of all the elements necessary in order to avoid this economic *progería* (premature aging), what countries in the region perhaps need most is a tradition of solid, competent and honest institutions. (Kuczynski 2002)

The unsteady and in the end disappointing growth of the past 50 years, and in particular the past 15—since *Toward Renewed Economic Growth* was written—poses some key questions. Can most Latin American countries do better? What policies would allow the region's countries to realize their potential? As a significant part of the region's population starts aging, are the next few years its last chance for a real period of sustained economic growth?

The 1940-80 period was one of special blessings for Latin American economies: a commodity boom in the wake of three wars, after the drought of the Great Depression; abundant international credit, first from international agencies that had few other outlets, and then in the 1970s from international banks that needed to place newfound profits from energy exporters; and goodwill from the United States, which was worried about the spread of communism, especially after the accession of Fidel Castro in 1959. Yet, despite these favorable circumstances, annual growth averaged barely above 5 percent, with much of that concentrated initially in Mexico and then in Brazil. Admittedly, rapid population growth held back saving and thus made investment highly dependent on capital imports.

Growth Prospects

Making a careful judgment on the region's growth prospects therefore requires looking at its past experience. Unless Latin Americans, and especially their governments, are able to significantly raise their rate of saving, it is unlikely that growth on a sustained basis will top 5 percent annually. Even to achieve such a target, the macroeconomic mix of policies has to be scrupulously maintained, avoiding major imbalances that can lead to setbacks such as the Mexican devaluation and financial crisis of the mid-1990s, the Brazilian devaluation of early 1999, and the Argentine and Brazilian crises of 2002. Without these events, growth for the region would have been in the range of 4.5 to 5 percent, close to the target. Thus, the maintenance of a coherent and realistic set of macroeconomic policies is essential to achieve even minimum growth.

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As economies grow, they increase their domestic savings, and this in turn reinforces growth. The fact that few Latin American countries have gross domestic savings as a percentage of GDP above the high teens (the main exceptions being Chile, Ecuador, Mexico, and Panama; see table 1.3) is due in part to the high proportion of poor people. In Peru, for example, as of 2001 the proportion of people living in poverty (defined as living on $2.00 a day or less) was 54 percent; of those, one-quarter live in extreme poverty (defined as less than $0.75 a day). Although most other countries have less extreme situations, with those living in poverty accounting for one-quarter to half of the population, the extent of poverty makes it impossible to create a mass market for industry and services, and impedes the creation of the savings necessary to finance rapid growth.

The task of reaching higher levels of savings is a complex one. But the experience of other countries—including Chile in Latin America—suggests several avenues. First, there must be income growth; high growth rates are the easiest way to generate savings. Second, governments must lead the way and provide the example by being savers themselves, particularly in their social security systems—a rare occurrence in Latin America. Public pension systems are a major fiscal drag in a number of countries and need to be reformed.

Governments must also have enough revenue to finance substantial productive investment expenditure, especially on education and basic infrastructure, so as to provide opportunities to the large masses in the middle and at the lower end of the economic spectrum. If governments spend most of their limited resources on paying wages and servicing their external debt—the situation of a number of the region's governments—they make little or no contribution to savings. A determined effort has to be made in education, raising both quantity (coverage and the years of schooling) and quality. In East Asia, economic growth, savings, and education have gone hand in hand. There is no reason why the same combination—hard as it may be to implement—cannot work in Latin America.

New ways also have to be found to mobilize private savings through independent pension systems, following the example of Chile. This is being done in a number of countries, although many improvements still need to be made. Private pension systems are the most hopeful innovation for the development of local capital markets in the region.

Will Latin American countries be able to reach high growth rates, in the 7 percent range, on a sustained basis? History suggests not, at least not without more profound policy changes than currently seem on the horizon. Matching the growth performance of the 1945-81 era (5.2 percent) will already be a stretch and would be a major achievement, especially in light of recent experience (no net growth in 2001-02, as this is being written). Aspirations beyond that are wonderful. But for now, a steady, moderate rate of growth could set the stage for better performance in the future.

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Table 1.3 Gross domestic savings for selected Latin American and Caribbean countries, 1990-2000
(percent of GDP)

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Argentina	19.7	16.2	15.2	16.7	16.9	17.6	17.5	17.2	17.4	17.2	15.3
Brazil	21.4	20.5	21.4	22.3	22.5	20.5	18.6	18.6	18.6	19.3	20.1
Chile	28.4	27.0	25.2	24.1	25.4	27.6	24.7	24.5	22.4	23.0	24.5
Colombia	24.3	23.4	18.7	19.0	19.8	19.6	16.5	15.0	13.5	11.3	13.3
Costa Rica	20.6	15.7	16.6	15.8	15.7	17.1	14.1	15.4	17.6	23.8	18.9
Ecuador	22.9	23.8	25.0	21.7	22.0	19.7	24.4	21.2	18.0	24.2	28.4
El Salvador	1.2	2.1	2.2	3.8	4.6	4.2	2.3	4.2	4.5	4.2	1.8
Mexico	22.0	20.4	18.3	17.1	16.9	22.5	25.2	25.8	22.2	21.9	21.5
Panama	21.4	18.7	22.7	24.5	28.0	28.2	28.7	27.1	23.0	24.0	24.1
Peru	18.4	15.0	14.4	15.5	18.9	19.4	18.4	20.2	18.9	19.7	18.2
Uruguay	17.6	18.0	16.2	15.2	15.3	15.3	15.1	15.1	14.9	13.6	12.5

Source: World Bank, *World Development Indicators.*

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The Purpose of This Book

The purpose of this study is to develop a policy agenda for reviving economic momentum in Latin America. A resumption of growth is undoubtedly a key aspect of this objective, but we believe that the region needs more than faster growth if the bulk of its population is one day to reach the sort of living standards typical of industrial countries, while achieving a decent social system and preserving the physical environment in the process. Clearly, achieving industrial country living standards for the bulk of the population requires that the rate of economic growth be a lot higher than it has been for the past 20 years; by itself, redistribution of income could not begin to do the job. At the same time, aggregate economic growth alone will not remedy the highly skewed distribution of income and wealth that gives Latin America much more poverty than any industrial country would have at those levels of average income. Hence, our focus is on both accelerating growth and improving income distribution. We believe that both are possible and both are necessary.[2]

The region's poor growth performance during the past 20 years—certainly a long enough period to detect a trend—has bred a skeptical attitude among some policymakers about the importance of economic dynamism and growth; mediocre expansion rates of 3 to 4 percent a year are often received with comfort and complacency. It is crucial, if Latin America is to have a chance at overcoming unemployment and poverty, to set aside this attitude of resignation and refocus policy thinking on the urgency of rekindling economic growth on a long-term, sustainable basis.

The same can be said emphatically about issues of economic equity. The challenge now is not only to rekindle a bare minimum of 5 percent growth over a long period, a base target that can hopefully be exceeded, but to do so in a far more egalitarian and equitable manner than in the past. Unless the region's great masses, who constitute the overwhelming majority of its 500 million inhabitants, have a meaningful stake in its development, development itself will not be achievable.

The study has a further nine topical chapters, plus a concluding summary chapter and an appendix. The nine chapters cover the broad subjects that we believe are essential for the main purpose of the book. The first deals with reforming the state. The second focuses on poverty, equity, and social policy. The next six are devoted to specific policy areas: fiscal and budgetary policy, the financial system, exchange rates and monetary policy, trade policy, education and training, and labor markets. Chapter 10 deals with the political-economy problems of reform, specifically with so-called second-generation reforms.

2. Is there a conflict between them? We think not, which is a condemnation of the existing state of policy in the region. Efficient policies would have put countries on the frontier, where any improvement in one would come at the expense of the other. That is not where we see the region as being.

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Clearly, this is not an all-encompassing compendium of the subjects that affect development. But the contents of the book reflect our judgment of the topics that are of key importance in achieving rapid and equitable growth. Two of the most important issues that we omit and that are likely to be of great importance in determining the quality of life in Latin America are the drug trade and environmental issues. We touch briefly on these in the final chapter, where we also summarize the policy agenda that emerges from the nine chapters on specific topics. An appendix deals with the relationship between the reform agenda we develop in this book and the Washington Consensus.

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