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Latin America's Seven Deadly Sins: Myth, Reality and Consequences

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'All happy families are alike;
but each unhappy family has its own unique reasons for its misery.'
Leon Tolstoy
Anna Karenina

'One must work to fuse the pessimism of intelligence and the optimism of the will.'
Antonio Gramsci

Introduction

The heavy investments of important Spanish companies in Latin America in recent years have significantly increased Spain's concern with the region's macroeconomic developments. Unfortunately, most analyses of the region's complex social and economic realities have unrealistically attempted to offer a brief yet conclusive evaluation of Latin America in its entirety, feeding one or another preconceived generalization, depending on the political agenda of the author in question. Indeed, either 'Latin America is the region of the future' or it is a place that will continue to be so for a long time to come.

The significant deterioration in the international economic environment since 1997, along with the negative consequences of the Asian and Russian financial crises, particularly for other emerging market economies, have certainly not served to clarify the debate. Growing risk aversion among investors – and its most concrete expression, a drop in net capital inflows – has revealed political, social and economic 'vulnerabilities' we had believed to be resolved some time ago. Gradually, but steadily, the balance of risks within the region began to tip, first toward caution and then in the direction of an overt pessimism. Academics and politicians who had previously invested their intellectual capital defending 'the Latin American model of liberalizing and opening reforms' began to claim, very Spanish-like, that 'no, that was not it'.

As one might expect in such a Calvinist discipline like economic analysis, the reason behind this change in perception as to the nature of the region's predicament can explained by what has come to be known as Latin America's 'original sin' [1]: the excessive level of *de facto* dollarization in the region's financial liabilities. Soon, a long list of weaknesses were dragged into the debate: a litany of economic vulnerabilities constituting a virtual catechism of the region's deadly sins.

Latin America's Seven Deadly Sins

I. ***Quality of Democratic Institutions and Political Governance.***
II. ***Corruption.***
III. ***Inequality in the Distribution of Income and Wealth.***
IV. ***Low Rates of Domestic Savings.***
    - *Low Rates of Private Sector Savings in Local Currency.*
    - *Public Sector Dissavings and Risk of Default on Public Debt.*
V. ***Dependence on Foreign Savings and Insignificant Exposure to International Trade.***
    - *High level of external debt.*
    - *Significant net transfers of resources abroad.*
    - *Insignificant weight of exports in final demand.*
    - *Need for intense adjustments in the trade balance as a result of 'sudden stops' in the inflow of capital.*
    - *Exchange rate volatility.*
VI. ***Low Rates of Investment in Physical and Human Capital.***
VII. ***Low Levels of Medium- and Long-Term Finance in Local Currencies.***
    - *Public sector debt financing "crowds out" private sector investment.*
    - *Underdeveloped capital markets.*
    - *De facto dollarization of financial liabilities.*

This chapter attempts to quantify the true significance of these supposed 'sins' for each of the seven principal Latin American economies[2] and provide a regional evaluation of the severity of such vulnerabilities. The final section illustrates the apparent connection between these 'weaknesses' and economic experience, both in terms of growth and macroeconomic instability.

The most compelling conclusion is that Latin America is not in any way an economically homogenous geographic area. The region has witnessed structural changes which challenge the historical pessimism implicit in the oft-heard contention that 'Latin America has always been and always will be like this,' an excuse offered by those emulating the Zavalito of 'Conversations in the Cathedral' in their efforts to account for the 'Latin American curse' which seemingly condemns the region to political, economic and social failure.

But beyond the pessimism expressed in this general and oversimplified view of the region, one uncovers the details of national histories from which emerge the images of a continent where both 'histories of success' and 'histories of decline' have always coexisted. While it is true that the majority of the region's countries share the 'weaknesses' contained in our list of deadly sins, each country – as Tolstoy reminds us – is unhappy in its own way and for its own reasons. And this has been so across

[1] Ricardo Haussman, (2002).
[2] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

historical periods and all the various political and economic models that have developed during the last three decades, only to be later discarded.

The immediate implications of all of this are clear: in Latin America – as in any other part of the world – one can be optimistic, so long as one learns to blend the pessimism of the intellect with the optimism of the will. Or, as the jesuit Baltasar Gracián (1601-1658) might have said, when the reforms needed by a region are finally undertaken, '...pursuing the easy things as though they were difficult, and the difficult things as though they were easy; because in this way we avoid, on the one hand, the failure that comes from overconfidence and, on the other, the failure that comes from a lack of faith.'

The Myth of a Cursed Continent
Table 1 presents the average economic growth rates of a representative group of Latin American economies between 1960 and 2003.[3] From this table we can arrive at two conclusions:

(a) Brazil, Mexico and Chile have grown at an average annual rate of more than 4% during the last 40 years. To place this into a relevant context, one could point to another success story, Spain, which grew at exactly the same rate and with a similar level of volatility during this period.[4]
(b) All of these economies grew more between 1960 and 1973 than after the formal breakdown of the Bretton Woods system and the oil shock. Brazil and Mexico, in particular, grew between 1960 and 1973 at a growth rate double that experienced in 1973-2003.

Table 1. Average GDP Growth

Growth	1960-2003 Ave	1960-1973 Ave	1973-03 Ave	1990s Ave	1997-2003 Ave
Brazil	*5.0*	*8.5*	*3.8*	*2.3*	*1.3*
Mexico	*4.6*	*7.1*	*3.7*	*3.5*	*3.8*
Chile	*4.0*	*3.5*	*4.0*	*6.4*	*3.0*
Colombia	*3.9*	*4.9*	*3.6*	*2.7*	*0.9*
Peru	*3.3*	*5.6*	*2.3*	*4.1*	*2.4*
Venezuela	*2.8*	*5.5*	*2.4*	*2.1*	*-1.7*
Argentina	*2.3*	*5.1*	*1.6*	*4.2*	*-1.1*
Uruguay	*1.9*	*1.3*	*2.3*	*3.1*	*-0.1*
Latin America	4.2	6.7	3.4	3.2	1.6
Spain	*4.0*	*6.8*	*2.7*	*2.5*	*3.3*

Source: International Monetary Fund, World Economic Outlook Database. April 2002,2003.

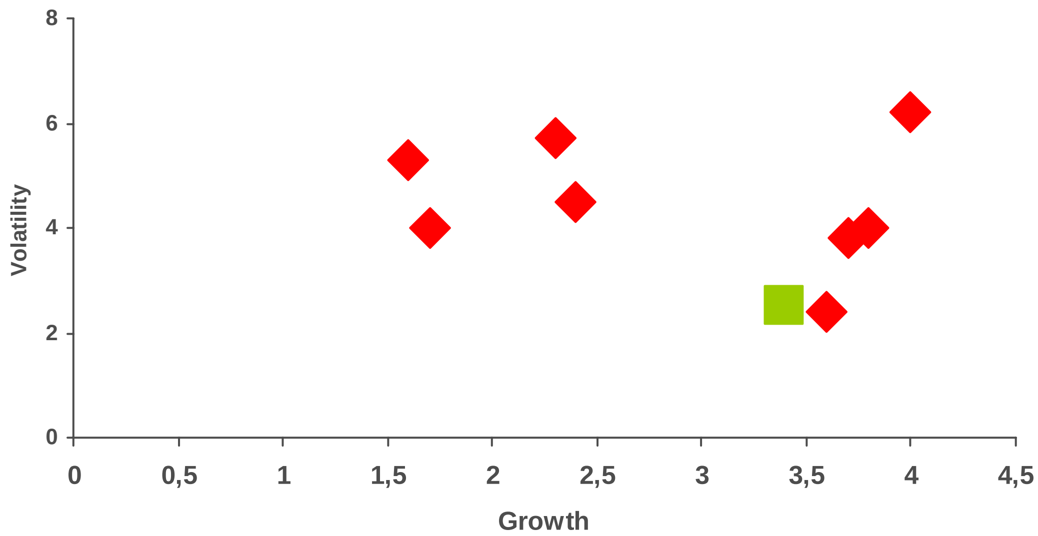
Although it is true that since 1973 the region as a whole has grown at rates below the average for the emerging market economies of Asia – some 2.5 percentage points below

[3] The average growth of the Latin American-7 is obtained by using the fixed weightings derived from the weight each economy had within the regional GDP during 2002.
[4] The standard deviation of Spanish economic growth has been 2.8, while the weighted average of Latin America has been 2.9, even though the lack of synchronicity between the economic cycles of each of the region's economies makes the regional average much less volatile than that of the individual economies. In fact, only one country – Colombia – had a growth volatility lower than that of Spain between 1960 and 2003.

– countries like Brazil, Mexico and Chile have registered growth rates above the world average and certainly above those experienced in the developed world. During the 1990s, Chile rose to a very competitive position within world growth tables – behind only China, Singapore and Malaysia – while Mexico matched the world average. All of this suggests that there is no such thing as a 'Latin American curse.' The region's economies include 'success stories' as well as others which are less impressive. On the whole, however, Latin America has not been left behind in any significant way during the last long phase of world growth.

The search for growth is the leading motive behind the decisions of investors when justifying their strategic direct investments and international acquisitions, while the primary preoccupation of analysts evaluating the prospects of investment companies is the economy's volatility. Graph 1 presents the map of growth and risk which has characterised the region since 1973 and suggests an uncomfortable conclusion: over the middle run, and viewed exclusively through the prism of growth, the countries with the lowest volatilities have not been those which have grown the most.

Graph I. Growth and Volatility
1973-2003



One possible explanation for this apparent paradox could be that none of the economies of the region has yet reached the critical mass of stability necessary for reaping the benefits normally associated with a higher level of predictability in macroeconomic variables. Alternatively, one might argue that the kind of 'volatility' that really matters is that associated with macroeconomic variables other than the growth of GDP – for example, the real exchange rate, real interest rates, or inflation – or even that 'stability' is too recent an achievement to be already yielding significant benefits in terms of the mid-term potential growth rate.

A broader interpretation might argue that the costs of the volatile growth pattern experienced by many of the region's economies have tended to reflect themselves not in

GDP growth rates but rather in other social and economic variables (like income distribution patterns, depth and maturity of national financial systems, or a capacity to attract foreign investment) which might exert an appreciable influence over future potential growth rates. This is to a large extent the interpretation implicitly favoured by the region's economic authorities when they betray their preference for 'sustainable economic growth' capable of reducing poverty levels in a sustained fashion and allowing for the creation of a middle class.

The many good intentions of the region's politicians, according to some observers, still collide with a reality which has until now been impossible to change: a range of structural weaknesses – the region's so-called 'deadly sins' -- which continue drag the economy down. Nevertheless, despite the importance these 'sins' are afforded, there have been almost no attempts to quantify, more or less objectively, the extent of their ultimate reach. Even more infrequent have been attempts to verify whether or not these 'weaknesses' have grown over time. Rarer still have been those studies measuring the impact of these 'deadly sins' within the growth context of each of the region's economies.

There are no doubt good reasons for this, but until we can identify with relative precision what is actually preventing these economies from growing at their potential growth rates, government agendas are likely to be oriented toward objectives which are not true priorities. [5] If this remains the case, it is nearly certain that the interpretation of the region's economic realities will continue to respond more to myth than to reason.

Institutional Weakness and Corruption

Consensus – some might also say history – identifies corruption and weaknesses in democratic institutions as the first deadly sin of the region. Considering the tumultuous political history of most of these countries, the tenuous separation and independence of democratic powers which frequently characterize the region's democracies, and the apparent thinness of region's civil society, one is nearly obliged to immediately concede the argument.

However, quantifying 'institutional weakness' and determining whether this has improved and deteriorated in recent years is an altogether more complex affair. To elaborate an objective index which expresses the quality of institutions is certainly not an easy task, and much less so is the attempt to make international and inter-temporal comparisons. Nevertheless, in recent years this type of indicator has proliferated[6] and begun to be employed in certain academic studies.[7]

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[5] First, there is a serious 'measurement' problem, particularly with respect to the institutional 'deadly sins.' Second, there is another no less serious problem with regard to 'causality': in many cases there are good reasons for thinking that the relationship between the 'sin' and the impact on growth is mutually reinforcing, or bi-directional.

[6] Kaufmann, et. Al. (2002), Transparency International (2002), World Competitiveness Report, Index of Economic Freedom (2002). Since 1975 the Fraser Institute has published the 'Index of World Economic Freedom,' in which appears two sections which could be associated with 'institutional quality': 'size of State' and 'legal structure and protection of property rights.' In the latter category are included indicators expressing the independence of the Judiciary, the impartiality of the courts, the defence of intellectual property rights, the participation of the military within the Executive branch, and the integrity of the legal system. For this section, Latin America receives its worst rating of any section of the index: 4.2 against a world average of 5.5 and 9.0 for the US. In inter-temporal terms the situation has gotten worse with the passage of time: Latin America's rating for 2002 is 33% below that of 1990 while the world average has actually risen 4%. The differences between countries in the region is quite marked: Chile (6.2), Uruguay

The Index of Kaufmann, Kraay and Zoido-Lobaton is probably one of the most widely used indices of this type and one with the most widely accepted methodology.[8] Table 2 presents the data from the latest edition of the Kaufmann index for selected countries. The first conclusion that stands out is that Latin America as a region has a worse rating than that which would be derived from the sum of the individual country ratings, an observation that might feed the suspicion that there indeed exists a 'Latin American curse,' or at least a negative externality.[9] In any case, the clearest result presented in Table 2 is the high level of dispersion among the national indices: while Chile is perceived to be an economy which 'institutionally' is similar to Spain – indeed, Chile occupies a position only three spots below that of Spain in the overall international ranking – Venezuela is clearly within the second decile of countries with the worst levels of governance, on par with Kenya, Bielorussia, and Georgia.

Table 2. Quality of Institutions and Governance (Part I)

	Synthetic			Representation			Stability	
	Level	Ranking		Level	Ranking		Level	Ranking
Venezuela, RB	**25.3**	*40*	**Peru**	**27.9**	*49*	**Colombia**	**9.1**	*15*
Colombia	**33.8**	*54*	**Colombia**	**47.7**	*85*	**Peru**	**27.9**	*45*
Latin America	**37.2**	*61*	**Mexico**	**48.3**	*86*	**Mexico**	**35.1**	*56*
Mexico	**47.4**	*78*	**Latin America**	**56.2**	*101*	**Latin America**	**36.4**	*59*
Argentina	**48.1**	*79*	**Venezuela. RB**	**61.0**	*110*	**Brazil**	**38.3**	*62*
Peru	**52.6**	*86*	**Argentina**	**66.3**	*119*	**Venezuela, RB**	**40.3**	*65*
Brazil	**64.3**	*104*	**Brazil**	**67.4**	*121*	**Uruguay**	**63.0**	*102*
Uruguay	**71.4**	*115*	**Chile**	**69.2**	*124*	**Chile**	**67.5**	*109*
Chile	**84.4**	*135*	**Uruguay**	**73.8**	*132*	**Argentina**	**69.5**	*112*
Simple Average	***51.6***			***57.5***			***43.0***	
Weighted Average	***53.3***			***58.1***			***40.0***	
Standard Deviation	***19.0***			***14.4***			***20.0***	
Pro Memoria								
Spain	***85.7***	*138*	***Spain***	***87.8***	*157*	***Spain***	***72.1***	*116*
US	***89.0***	*143*	***US***	***95.9***	*171*	***US***	***85.7***	*138*
Denmark	***100.0***	*160*	***Switzerland***	***100.0***	*178*	***Switzerland***	***100.0***	*160*

Source: Based on data from Kaufmann, Kraay, Zoido-Lobaton (2002).

(5.8) and Brasil (4.9) are far above Venezuela (1.9), the region's worst country in this category according to the Fraser Institute.

[7] IMF Working Paper WP/03/12, *Is Transparency Good For you, and Can the IMF Help?*

[8] The Index incorporates five groups of variables – 'representation and accountability,' 'political stability and violence,' 'efficiency of government,' 'regulatory burden,' and 'rule of law' – and is compiled for 170 countries and geographic areas. The values in the series range between 0 and 100, and higher index levels indicate better levels of governance. The most recent update of the index dates from 2002 although we have not found historical series which would allow for inter-temporal comparisons.

[9] Against a maximum of 100, the index gives the region a rating of 37, although when the individual national ratings are weighted according to each one's relative GDP weighting within the region, the regional rating becomes 53. This difference implies a negative Latin American bias of some 30%.

Table 2. Quality of Institutions and Governance (Part I)								
	Govern. Efficacy			Regulation			Rule of Law	
	Level	Ranking		Level	Ranking		Level	Ranking
Venezuela, RB	**14.8**	*24*	**Venezuela, RB**	**44.8**	*78*	**Colombia**	**22.4**	*38*
Latin America	**37.3**	*61*	**Brazil**	**47.3**	*82*	**Venezuela, RB**	**29.1**	*49*
Brazil	**47.1**	*78*	**Latin America**	**55.4**	*96*	**Peru**	**33.3**	*57*
Colombia	**52.9**	*87*	**Colombia**	**58.8**	*102*	**Mexico**	**35.2**	*60*
Peru	**65.8**	*107*	**Mexico**	**75.2**	*129*	**Latin America**	**37.9**	*65*
Mexico	**67.1**	*109*	**Argentina**	**77.6**	*133*	**Brazil**	**47.3**	*82*
Argentina	**69.7**	*113*	**Peru**	**78.2**	*134*	**Uruguay**	**63.6**	*110*
Uruguay	**76.8**	*124*	**Chile**	**89.7**	*154*	**Argentina**	**64.8**	*112*
Chile	**85.8**	*139*	**Uruguay**	**92.7**	*159*	**Chile**	**86.1**	*148*
	57.5			***68.9***			***46.6***	
	56.2			***62.6***			***44.5***	
	21.9			***17.8***			***20.8***	
US	***90.3***	*146*	***Spain***	***85.5***	147	***Spain***	***83.6***	*143*
Spain	***94.2***	*152*	***US***	***95.2***	163	***US***	***87.9***	*151*
Singapore	***100.0***	*161*	***Singapore***	***100.0***	171	***Switzerland***	***100.0***	*171*

Source: Based on data from Kaufmann, Kraay, Zoido-Lobaton (2002).

The Kaufmann Governance Index underlines two other relevant developments. On the one hand, the liberalization and deregulation of the past decade have brought the region closer to the standards of developed countries – the region's average is highest for this indicator – while there does exist a well-developed and vibrant freedom of expression, despite the peculiarities of the region's civil and political systems, and a reasonable expectation that political power is accountable for its behaviour. On the other hand, the partial indicators which marginalize Latin America from the governance ideal are, first, political instability and violence (the indicator on which the region performs the poorest) and, second, regulatory risks which stem from weak rule of law.

In general, these results fit well with the typical preconceptions with respect to the quality of the region's 'politics and governance.' It is nevertheless difficult to extract from these results any normative prescription that might be effectively incorporated into an 'agenda for growth.' On the one hand, this is due to the weakness of the correlation between 'governance' and growth, as can be seen in a simple comparison of Tables 1 and 2. Furthermore, the two indicators with the most room for improvement are, by definition, long-term. The memory of past institutional instability continues to exert negative impact on the value of the index for a long time. In a similar fashion, the rule of law is subject to similar dynamics affecting the reputation of an individual: one spends a lifetime creating it while it takes only one bad moment to lose it. The best evidence of this is the privileged place in Table 2's classifications which Argentina still occupied in 2002.

The publication of Transparency International's Corruption Perceptions Index since 1996 nevertheless allows us a certain dose of optimism with respect to the capacity of Latin American countries to improve the perception of their vulnerable societies. Table

3 presents the Index's historical data pointing to the least corrupt country in each year. [10] As one can see by comparing the index value in 2002 with the average for the period 1997-2000, there is only one country (Peru) that has lost ground in relative terms, and another (Argentina) which has not advanced. The rest of the region's countries have seen their perceived levels of corruption decline with time. In certain cases – Colombia is the most notable – this decline has been significant.

Table 3. Corruption Perceptions Index

	2002			2001	2000	1999	1998	1997	Average	
	Level	% 2002-2000	% 1999-1998						2002-2000	1999-1997
Argentina	29%	68%	100%	37%	36%	30%	30%	28%	54%	29%
Brazil	42%	70%	108%	42%	40%	41%	40%	36%	60%	39%
Chile	79%	89%	120%	79%	76%	69%	68%	61%	88%	66%
Colombia	38%	61%	155%	40%	33%	29%	22%	22%	65%	24%
Mexico	38%	66%	121%	39%	34%	34%	33%	27%	59%	31%
Peru	42%	73%	94%	43%	45%	45%	45%	45%	59%	45%
Uruguay	54%	75%	125%	54%	49%	44%	43%	42%	71%	43%
Venezuela	26%	60%	103%	29%	28%	26%	23%	28%	49%	26%
Spain	75%	86%	120%	74%	71%	66%	61%	59%	85%	62%
USA	81%	91%	107%	80%	80%	75%	75%	77%	88%	76%
Denmark	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

Source: Corruption Perceptions Index. http://wwwuser.gwdg.de/~uwvw/index.php?datei=cpi_olderindices

When the absolute level of perceived corruption is analyzed, the regional differences are quite pronounced: while Chile appears as a 'first world' country – its ranking is higher than that of Spain – Venezuela and Argentina are a long way from being perceived as honest societies. In fact, Argentina occupies the same level as the Ivory Coast and Uzbekistan, while only 15 countries have rankings, according to the index, worse than that of Venezuela.

The conclusion we get from this first glance at the quantitative indicators on Latin America's first deadly sin is clear: it does not make much sense to speak of the institutional weakness of 'Latin America' since the differences between the countries of the region are simple breathtaking on a number of these indicators. On the other hand, when one attempts to relate 'institutional quality' with 'growth,' the argument that superior institutions pays dividends in terms of faster growth holds only for the exceptional case of Chile, while it is undermined by the disappointing macroeconomic performance of Uruguay. We will return to this issue in the last section of the chapter.

Income Distribution and Poverty

The region's second deadly sin is its highly unequal distribution of wealth and income. Whatever indicator is used, Latin America comes out much less egalitarian than any other region of the world. Table 4 presents the data on income distribution found in the World Bank's annual Social Indicators publication. Both the Gini Index and the simple relationship between the income of the top 10% of the population and that of the poorest

[10] The privileged top spot has always been occupied by a Nordic country, like Finland or Denmark, with the exception of 1997 when the least corrupt country was perceived to be New Zealand.

10% show Brazil as the most unequal country in the region, followed by Colombia, Chile and Mexico. The most egalitarian economies include Uruguay and Argentina (at least before the tragedy of 2002).

Table 4. Income Distribution

	Ginni Index	% Income Received by Each Decile Poorest 10%	20%	30-40%	50-60%	70-80%	80-100%	Richest 10%	Ratio 10% Extreme
Argentina	49	2	5	8	16	23	48	35	18
Brazil	60	0.9	2.5	5.5	10	18.3	63.8	47.6	53
Chile	56.5	1.4	3.5	6.6	10.9	18.1	61	46.1	33
Colombia	57.1	1.1	3	6.6	11.1	18.4	60.9	46.1	42
Mexico	53.7	1.4	3.6	7.2	11.8	19.2	58.2	42.8	31
Peru	46.2	1.6	4.4	9.1	14.1	21.3	51.2	35.4	22
Uruguay	42.3	2.1	5.4	10	14.8	21.5	48.3	32.7	16A
Venezuela	48.8	1.3	3.7	8.4	13.6	21.2	53.1	37	28
Simple Average	51,7	1.5	3.9	7.7	12.8	20.1	55.6	40.3	27
Weighted Average	54,5	1.3	3.3	6.7	11.6	19.2	58.1	42.9	34

Years in which the Survey was undertaken

Argentina	*Brasil*	*Chile*	*Colombia*	*Mexico*	*Peru*	*Uruguay*	*Venezuela*
E	*1996*	*1994*	*1996*	*1995*	*1996*	*1989*	*1996*

Source: World Bank, World Economic Report 2000-2001.
http://www.worldbank.org/poverty/wdrpoverty/report/tab4.pdf

A quick reading of these numbers might lead one to the conclusion that the most unequal countries are precisely those which have grown the most. However, the most reasonable observation would be that the clearest priority of Latin American countries has been to increase the growth rate rather than to improve income distribution. Furthermore, one could also claim that the high level of volatility and the weakness of active income redistribution programs have combined to produce a result which ex-ante would have been difficult to identify as a distinct target of economic policy. Given this problem's economic, political and moral significance, any alternative hypothesis would require much more significant research than feasible within the scope of this current chapter.

Another similar, if distinct, regional characteristic concerns the evolution of poverty. The 'Battle Against Poverty' – particularly extreme poverty – has often been the centrepiece of economic policy statements by Latin American and has systemically figured in the recent proliferation of criticisms of the 'neoliberal' model. The ECLAC figures presented in Table 5 help situate the problem with a minimum of rigour.[11] Here we see that the tendency has been for poverty – particularly indigence, or extreme poverty – to fall sharply during most of the 1990s as economies stabilized and absorbed the dramatic social consequences of the hyperinflation of the 'Lost Decade' of the 1980s. Nevertheless, the slowdown in economic growth beginning in 1998 partially reversed the achievements of the years of reform in this regard. Obviously, the

[11] Data is not available for all countries or for all years. We have chosen to rely on the ECLAC data which most closely reflects the title of the table and to use social indicators from the World Bank as substitutes in cases where ECLAC figures are not available. Data for 1998 and 2001 are ECLAC estimates based on national household surveys.

Argentine case – not yet fully incorporated into the picture revealed in Table 5, as its data comes from 2001 – has exercised a significant impact on this result: when Argentine is excluded from the regional figures, between 1998 and 2001, the percentage of households both below the poverty line and below the indigence threshold continued to decline (3% and 2%, respectively).

Table 5. Percentage of the Population Below the Poverty Line and Indigence Threshold

	2001		1998		Circa 1990		% 2001 vs. 1998		% 1998 vs. Circa 1990	
Country	Poverty	Indigence	Poverty	Indigence	Poverty	Indigence	Poverty	Indigence	Poverty	Indigence
Argentina	30.3	10.2	19.7	4.8	12.3	2.1	53.8%	113%	60%	129%
Brazil	36.9	13	37.5	12.9	41.4	18.3	-1.6%	1%	-9%	-30%
Chile	20	5.4	21.7	5.6	33.3	10.6	-7.8%	-4%	-35%	-47%
Colombia	54.9	27.6	54.9	26.8	50.5	22.6	0.0%	3%	9%	19%
Mexico	42.3	16.4	46.9	18.5	39.3	14	-9.8%	-11%	19%	32%
Peru	49	23.2	48.6	22.4	53.5	22.4	0.8%	4%	-9%	0%
Uruguay	11.4	2.4	9.4	1.8	11.8	2	21.3%	33%	-20%	-10%
Venezuela	48.5	21.2	44	19.4	34.2	11.8	10.2%	9%	29%	64%
Latam Weighted	40.3	15.0	40.4	14.7	37.1	14.6	-0.4%	2%	9%	0%
Latam ex - Argentina	35.2	13.9	36.4	14.2	35.8	14.4	-3.2%	-2%	2%	-2%
Millions of Persons	146.3	53.2	138.2	50.3	144.6	62.4	5.9%	6%	-4%	-19%

Source: ECLAC, 2003.
http://www.eclac.org/prensa/noticias/comunicados/8/11258/cuadrospanosoc1.pdf

http://www.eclac.org/publicaciones/DesarrolloSocial/8/LCG2138PI/PSI2001_annex.pdf
World Bank, 2001-2002. *http://www.worldbank.org/poverty/wdrpoverty/report/tab4.pdf*

Although the poverty levels revealed in Table 5 remain high, the most telling conclusion coming from the data is the strong relationship established between economic growth and poverty reduction. Two (Brazil and Chile) of the three countries which have had the greatest success in fighting poverty are among the three economies of the region which have experienced the strongest economic growth during the last 25 years. Brazil has managed to reduce the percentage of households living below the poverty line by 11% and the percentage of households living in indigence by 29%, while the progress in Chile has been even more dramatic (reductions of 40% and 49%, respectively). On the other hand, the three countries which have grown the least – Argentina, Uruguay and Venezuela – are those where both poverty and indigence have expanded most rapidly. The idea that growth is a pre-requisite for poverty reduction has therefore been given solid statistical backing.

Combining income distribution patters with the evolution of per capita incomes produces a very clear picture of one of the most salient economic features of the region – the marked and universally recognized contrast in levels of living standards – but from which only rarely is the logical conclusion drawn: the existence of a significant number of consumers enjoying a level of purchasing power not dissimilar to that found in the most advanced economies and which now represents a respectable percentage of the total population.

Using the data presented in the above tables allows us to conclude – if only tentatively – that Brazil has more than 70 million consumers with a purchasing power (when adjusted for relative price levels, ie using the PPP method) above $US 5,000 a year and, of these, 34 million have a per capita income (adjusted for PPP) of around $US 21,000 a year, some 3% higher than the average Spanish consumer. The equivalent estimate for Mexico would put some 60 million consumers at a PPP-adjusting purchasing power of more than $US 5,000 of which 20 million possess a PPP-adjusted per capita income of around $US 26,500 (or 29% higher than the average Spanish consumer). Expressed in different terms, if the level of Spanish per capita consumption is taken to mark the threshold of the middle class, Mexico then has a middle class twice as large as that of Spain, while the Brazilian middle class is some 1.25 times larger than its Spanish equivalent. Looking at the phenomenon in these terms leaves us with little doubt as to why Mexico and Brazil have become primary direct foreign investment destinations for those searching for 'growth' opportunities.

Domestic Savings Rates

The region's first deadly macroeconomic sin is found in its low domestic savings rates. The typical description of the region has been one in which the private sector saves little, and usually abroad, while the public sector dissaves much, going excessively into debt and therefore creating a situation in which the region is often forced to default.

If this was ever an accurate characterisation of the region, today it no longer is. The average private sector savings rate in Latin America during the 1990s was 21.3%, with countries like Brazil registering a healthy 26.3% in 2003, Chile 21.1% of GDP and Mexico a rate of 23.3%. All of these countries are producing private savings rates that are higher than that of the Spanish private sector , to say nothing of the US private sector – a mere 14.6% of GDP – or the even lower savings rate of US households (4%).

The most relevant sign of the structural change occurring in recent years among Latin America's principal economies is not so much the increase in the region's private savings rates, but rather how and where these economies are saving. [12] Table 6 presents Latin America's financial savings map, comparing it to that of Spain. The first conclusion one can draw from it – and no doubt a surprising one for any analyst that had not previously internalised the cliché that Latin America saves very little – is that the entire Latin American savings market is smaller than that of Spain, perhaps the single most important symptom of the financial wounds the region has been nursing from its discouraging macroeconomic past.[13]

Table 6. Map of Latin American Financial Savings

2002 (US$bn)

	Deposits		Invest. Funds		Pension Funds		Total		
	US $	% Region	US $	% Region		% Region	US $	% Region	% GDP
Argentina	20	6%	8	5%	11	12%	39	7%	36%
Brazil	121	35%	100	62%			221	37%	59%

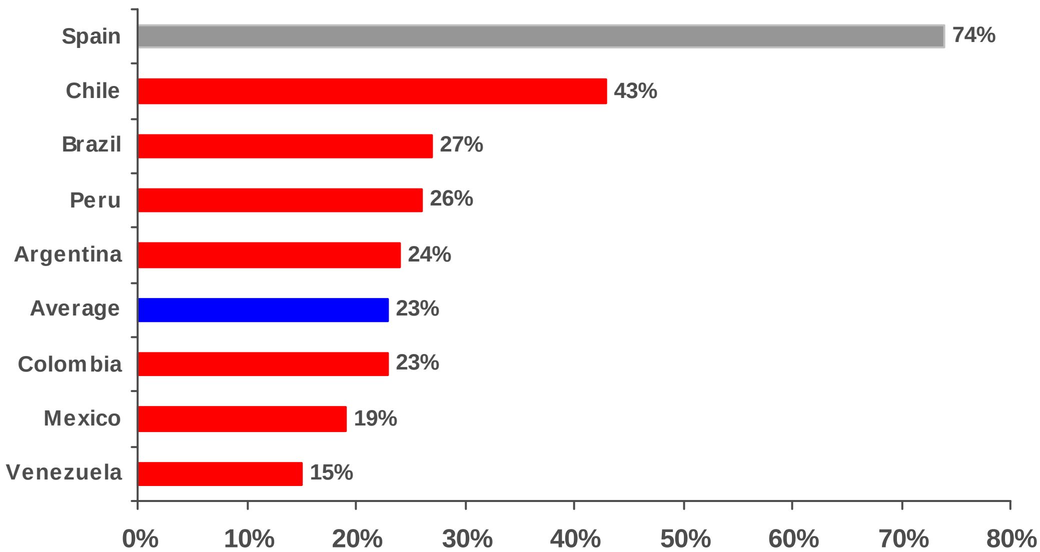
[12] Although there are no generalised public releases of consolidated financial wealth in the region, one can analyse private savings behaviour by analysing the data provided by each country's regulatory authorities on their banking systems, and investment and pensions funds.

[13] Although, while the volume of deposits in the Latin American financial system is only 58% of the Spanish market, when investment and pension funds are included, it is some 75% of the Spanish market.

Chile	**36**	**10%**	**7**	**4%**	**35**	**40%**	**78**	**13%**	**122%**
Colombia	**11**	**3%**	**8**	**5%**	**7**	**8%**	**25**	**4%**	**26%**
Mexico	**125**	**37%**	**31**	**19%**	**31**	**35%**	**187**	**32%**	**32%**
Peru	**12**	**3%**	**3**	**2%**	**4**	**5%**	**19**	**3%**	**33%**
Uruguay	**6**	**2%**			**1**	**1%**	**7**	**1%**	**81%**
Venezuela	**12**	**3%**	**4**	**3%**			**16**	**3%**	**16%**
Latin America	**343**	**100%**	**161**	**100%**	**88**	**100%**	**591**	**100%**	***40%***
Spain	***593***		***162***		***52***		**807**		***116%***
% Spain	***58%***		***99%***		***170%***		***73%***		

Source: International Financial Statistics IMF, regulatory bodies and the Bank of Spain

Graph II. Deposits/GDP
2001



Brazil, México and Chile again lead the pack in all possible categories. Together they account for 82% of the region's financial savings and 75% of the long-term savings managed by the pension funds. Although it is clear that all countries in the region have room to improve – see Graph 2 – the increasing use of the banking system is a structural change which has been underway for some time now in most of the region's economies. [14] This development has an obvious macroeconomic origin – the improvement in the domestic savings rate – and a no less important consequence: captured savings must be invested. As Table 7 suggests, whether it is forced or voluntary, the domestic savings rate has been increasing gradually throughout the 1990s. The region's average savings rate for the period 1990-2003 was 18.3% and it is forecast to reach 19.5% in 2003.

[14] This includes Argentina, which in 2001 – once the run on bank deposits had begun, eventually leading to the tragedy of 2002 – had deposits in the banking system of some US$82bn, equivalent to 25% of GDP. In 1990, Argentine deposits barely came to US$11bn.

Nevertheless, the region's diversity remains clear, as far as savings is concerned. The most successful countries continue to be those with the highest savings rates.

Table 7. Domestic Savings Rates (% of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	Average 1990-2003
Argentina	17.2	14.3	14.2	15.6	15.6	15.9	18.9	20.6	21.1	19.1	17.9	15.8	11.1	12.1	16.4
Brazil	19.1	17.3	22.4	21.3	20.5	18.0	18.5	19.2	19.1	18.7	19.1	19.6	21.1	21.6	19.7
Chile	21.5	19.6	20.1	19.2	20.2	21.8	26.4	27.1	26.1	21.1	21.0	21.0	21.7	22.3	22.1
Colombia	18.0	20.3	17.6	14.7	18.7	17.4	21.6	20.2	19.0	13.3	12.6	14.2	14.4	14.4	16.9
Mexico	16.0	15.1	14.0	12.8	12.3	15.6	17.9	19.5	20.9	21.2	21.4	19.6	21.4	22.8	17.9
Peru	11.2	12.2	10.7	11.7	15.5	16.4	22.5	23.8	23.5	21.7	20.1	18.2	21.0	23.3	18.0
Uruguay	14.1	13.8	14.1	13.1	12.0	12.4	14.0	14.4	15.2	14.5	13.2	12.1	12.7	13.2	13.5
Venezuela	31.2	21.4	15.2	16.7	22.0	19.1	15.8	18.7	19.0	15.7	14.2	16.4	14.0	13.2	18.0
Simple Average	*18.5*	*16.6*	*17.5*	*16.7*	*17.2*	*17.1*	*17.3*	*16.9*	*15.9*	*16.0*	*15.9*	*14.7*	*15.8*	*15.8*	*15.8*
Weighted Average	*18.4*	*16.7*	*17.5*	*16.8*	*17.3*	*17.1*	*18.9*	*20.0*	*20.2*	*18.8*	*18.6*	*18.3*	*18.8*	*19.5*	*18.3*
Dispersion	*6.0*	*3.4*	*3.8*	*3.3*	*3.8*	*2.8*	*3.9*	*3.7*	*3.3*	*3.3*	*3.6*	*4.8*	*5.5*	*5.5*	*5.5*

Source: Author's own elaboration based on IFS data from the IMF (http://ifs.apdi.net/imf/).

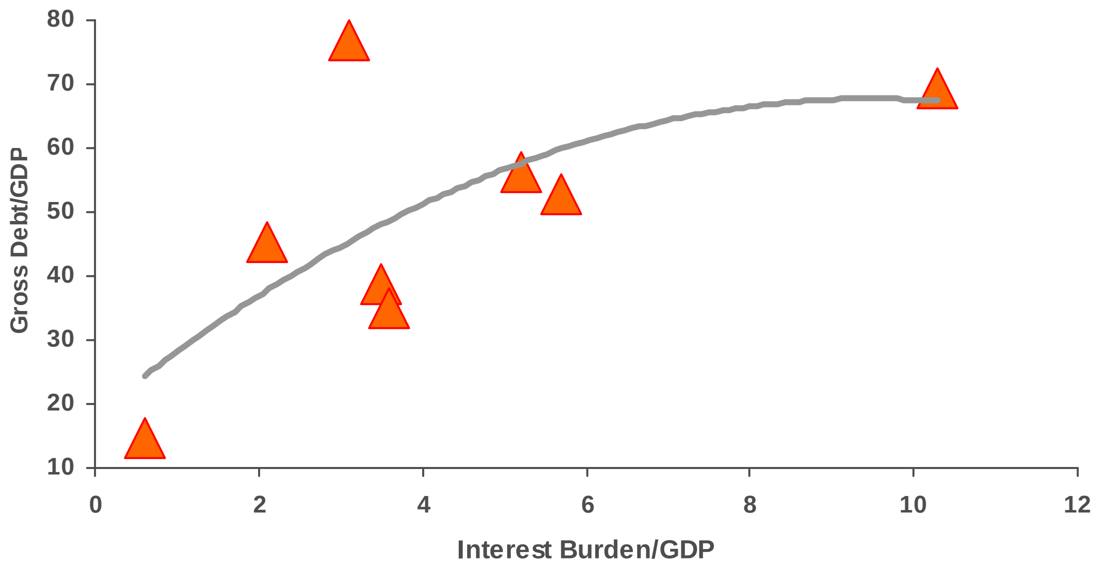
Given that domestic savings is nothing more than the sum of private and public savings, it is attractive in macroeconomic terms to identify what has happened to each economy's public sector savings rate. The general assumption has been that the 1990s was a 'decade of fiscal adjustment' during which deficits were gradually reduced across the region. One of the implicit conclusions – at least a priori – is that such a reduction of public dissavings should have reduced the necessity to absorb private sector funds or, alternatively, substituted for foreign savings and therefore reduced the vulnerability of these economies to the kind of sudden stops of net capital inflows which frequently have ravaged the region.

The hypothesis that the 1990s were 'years of fiscal adjustment' is undeniably correct. The region's consolidated public deficit fell from 3.1% in 1990 to 2% in 2003, even despite negative developments in revenue collection which could have been expected from the region's slow economic growth. Aside from Venezuela, which continues to generate deficits above 4% of GDP, there remain no countries in Latin America employing expansive fiscal policies. The degree of this adjustment is even more significant if we analyse the development of the region's primary surplus which has increased from 1.7% of GDP in 1999 to 2.8% of GDP in 2003. [15] Brazil, Colombia, México and Argentina will all finish 2003 with primary surpluses above 2.5% of GDP.

The difference between primary surpluses and consolidated public deficits is the amount of interest paid on accumulated public debt. The cost of such debt service in the region is on average some 4% of GDP (see Graph 3). Brazil and Colombia carry a debt servicing burden of even more than 5% of GDP. Except in the cases of Brazil and Argentina, public debt is not exorbitantly high by international standards, but it is certainly high enough to generate fears among domestic and international investors, a factor which expresses itself in the high yields they demand in order to acquire government paper.

[15] Defined as the consolidated deficit minus payment of interest on public debt.

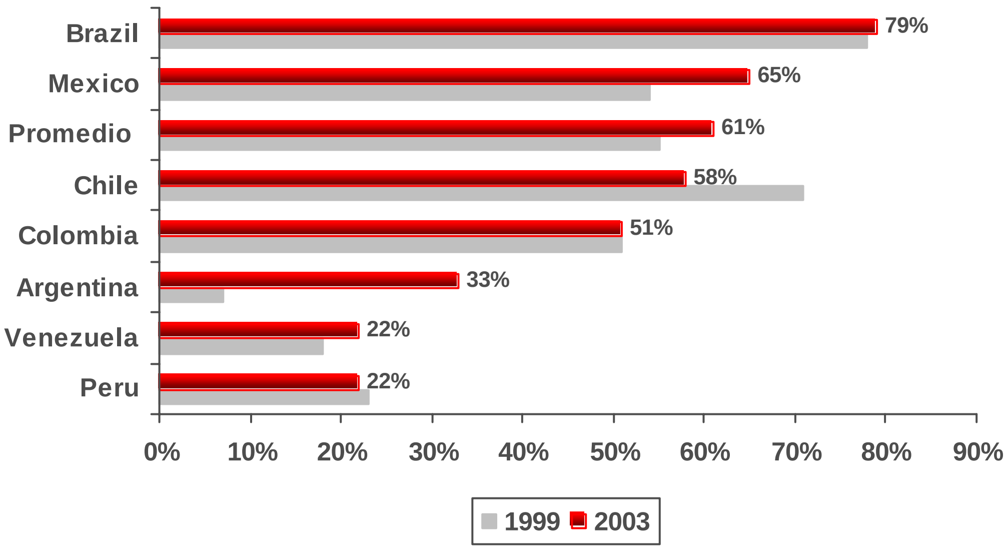
Graph III. Debt and Interest Burden
1990-2000



The big change has been that the region has been able to developed organized markets which permit – except in the case of Argentina – growing portions of public debt to be finance with domestic resources and, as a result, issued in paper denominated in local currency. [16] In other words, the reduction of public deficits and the creation of primary surpluses have served fundamentally to replace foreign financing with domestic private savings. The consequences of such an economic policy on the financing of growth will be analysed in the section dealing with the region's 'seventh deadly sin': the low level of long-term private sector financing in local currency.

[16] Typically, local currency issues are linked to a variable interest rate and, to protect investors, they are also often indexed to market interest rates, the inflation rate or to a portion of local currency depreciation.

Graph IV. Public Debt in Local Currency
% Total Gross Public Debt



Graph 4 compares the situation in 1999 with that estimated for the end of 2003. In a very short time, the percentage of public debt denominated in local currency has increased from 50% to 66% of the total stock – or, expressed in different terms, from one in every two dollars of debt to two of every three dollars of total debt stock.[17]

Among the many conclusions that one might draw from such a phenomenal transformation, one of the most relevant is quite simple: the incentives which Latin American governments have for declaring debt default are increasingly small. This is because a growing portion of public sector liabilities are held by domestic investors – along with domestic banks and other institutional investors. Therefore, any potential public debt restructuring implies a much higher domestic 'wealth effect' than was previously the case, when public debt was basically external. Furthermore, the experience of countries which have declared default in the past (and, above all, the still unfolding experience of Argentina) has made clear the high economic and political costs which a country's citizens must bear when the state unilaterally breaches its contractual commitments. In Latin American, as elsewhere, one extracts the convenient lessons of history.

Although the only solid guarantee that the region has left behind the experience of debt default would be the maintenance of sustainable financial policies over the long run – and specifically, to achieve growth rates significantly higher that the interest rates charged on public debt, an achievement which, combined with the maintenance of primary surpluses over the medium run at current levels, would mathematically produce a dramatic reduction in the ratio of public debt to GDP – the dynamics of public debt appear today to be much less likely to generate the kind of shocks which in the past have destabilised confidence. Things have changed and for the better.

[17] In Brazil, it is four out of every five dollars of debt, which perhaps explains why Lula's government has two macroeconomic policy objectives: the ratio of debt to GDP and the inflation rate.

Can one therefore conclude that Latin American has fully redeemed itself with respect to its fourth deadly sin?

Not completely. First, there are still countries – like Argentina, Uruguay, Colombia and Venezuela – with quite low domestic savings rates. Second, nearly all the region's economies still must demonstrate that they are willing to put into place tax systems capable of revenue generation with minimal distortions in the allocation of resources. Finally, Latin American governments must demonstrate that policies designed to control social spending and investment in physical and human capital do not simply result in structural reductions in the long-term potential output of their economies.

But even if absolution can not be complete, it would only be just to recognise that Chile, Brazil and Mexico have achieved a significant step forward. For more than a decade now, Chile has been committed to healthy public finances, while in Mexico and Brazil – the country whose public finances and debt dynamics raise the most serious doubts – citizens with savings capacity have become 'Ricardians', compensating for public sector dissaving with their own higher private sector savings rates, and channelling such savings to public paper denominated in local currency. This trend has reduced the public sector's external vulnerability and generated an important long-term externality: the creation of deep, organised markets which can be used to finance long-term 'productive investment' as soon as the current crowding out of private credit – which inevitably results from public borrowing – has receded.

Dependence on External Savings and Low Degrees of Economic Openness

The region's second macroeconomic deadly sin – largely a consequence of the first – is it high degree of dependency on external savings and, as a result, its tendency to accumulate foreign liabilities.

On the face of it, there is not much to criticize in this vulnerability: indeed, Latin America depends on capital inflows in order to grow at rates which allow the regions to augment its physical and human resources and to improve its institutional architecture. Such a dependency is not at all unusual in a globalized economy and should not necessarily be considered a liability. Since 1971 the US economy has depended on external savings in order to continue growing at rapid rates. Spain, too, has been characterized by this dependency during much of its contemporary economic history.

However, the big difference between the US and Spanish experiences, on the one hand, and the reality of Latin America, on the other, has been that the former could be reasonably confident that such inflows of external funds would remain stable,[18] while in Latin America capital inflows have often slowed down abruptly – sometimes for endogenous reasons, sometimes due to exogenous factors – or even transformed into net outflows, forcing the economies in question to engage in painful adjustments in their levels of domestic absorption (spending) and their relative price structures.

[18] Sometimes erroneously, as in the case of Spain – and other countries of pre-euro Europe – during the EMS crisis of 1992-93.

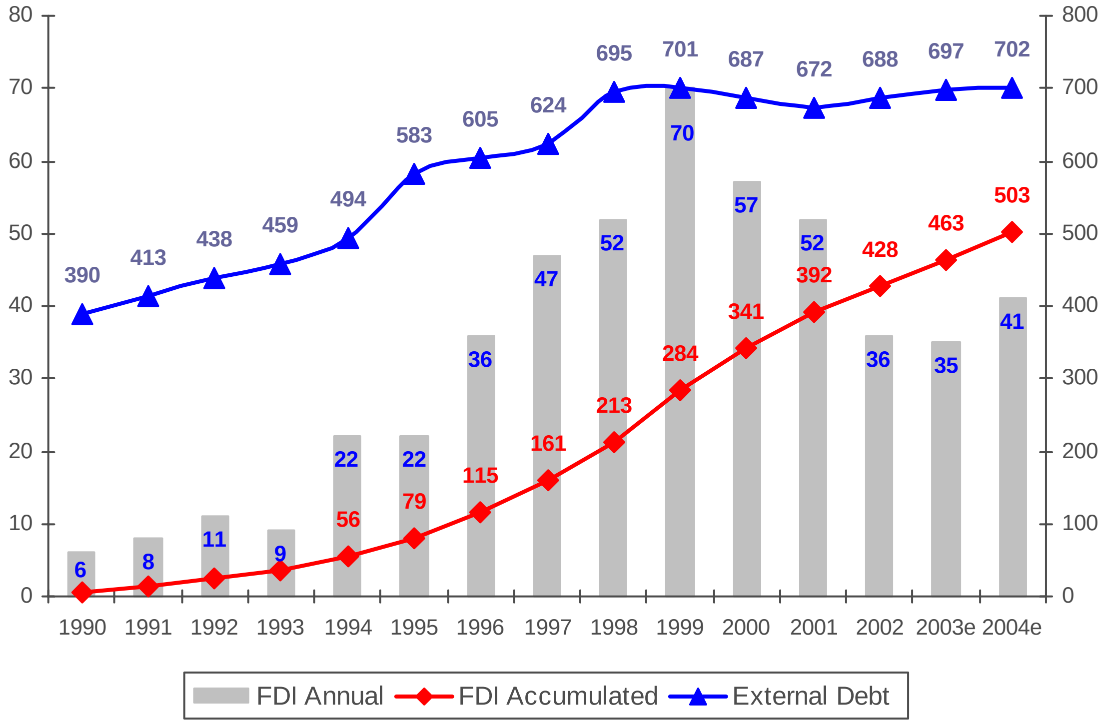
Table 8. Reliance on External Savings During the 1990s								
	Average 1990-1999		Structure of Capital Inflows (US$ bn)			Structure of Capital Inflows (%)		
	US$ bn	% GDP*	FDI	Mercados	FMI	FDI	Mercados	FMI
Argentina	10.49	2.5%	5.5	4.61	0.38	52%	44%	4%
Brazil	16.64	1.8%	9.5	3.18	3.97	57%	19%	24%
Chile	3.11	3.4%	1.93	1.46	-0.29	62%	38%	
Colombia	2.65	2.3%	1.52	1.12	0	58%	42%	
Mexico	17.55	4.2%	8.3	7.34	1.92	47%	42%	11%
Peru	2.96	5.4%	1.51	0.5	0.96	51%	17%	32%
Uruguay	0.21	1.1%	0.11	0.11	-0.01	51%	49%	
Venezuela	-0.19	-3.6%	1.69	-1.882	0	100%		
Regional Total	*53.4*	*2.6%*	*30.06*	*16.42*	*6.93*	56%	31%	13%

Source: Author's elaboration based on IFS data from the IMF. http://ifs.apdi.net/imf/

Table 8 reveals the intensity of Latin America's dependence on external savings during the 1990s. On average, the region attracted US$53.5bn annually in net capital inflows, underlining the use the Argentina, Brazil, Mexico and Chile have made of external savings.[19] Particularly interesting is the central role that FDI had in the region during this decade. Graph 5 presents a surprising picture for those still dominated by the idea that the region remains stuck in an increasingly intense external debt trap: the value of the region's external financial debt has remained static since 1999 while direct investment has taken on a central role – as suggested by Table 8. The mere accumulation of annual flows during the decade brings the stock of direct investment to around US$500bn, the equivalent of some two-thirds of the continent's external financial debt.

[19] Gross capital inflows were even larger given the fact that many of these countries partially rolled over their external debt and made further investment abroad in the form of both FDI and portfolio investment.

Graph V. Capital Inflows in Latin America
1990-2002



There are many ways by which to interpret the region's structural transformation. Some focus on the link between FDI inflows and the region's privatization processes, and typically conclude that this was, by its very nature, a transient phenomenon given that, once the bulk of state assets have been sold off, the inflow of FDI will inevitably fall off.[20] Others focus on the positive impact on productivity that should derive from the significant investments undertaken in key economic sectors – like telecommunications, energy and water infrastructure, other public services and financial systems -- and claim that the region has discovered in FDI a short-cut to higher levels of efficiency and productivity that will manifest itself in increases in potential growth rates over the medium run. Still others warn that FDI has gradually concentrated in the two largest economies, and in Chile, and that in the wake of the Argentine crisis this tendency will only strengthen, making the debate over the future of FDI in the rest of the countries of the region somewhat academic.

Even allowing for the caution demanded by the ever-sensitive situation in Argentina, the most plausible hypothesis would be that, should the governments of the region prove capable of persuading the investment community that they are truly ready to respect property rights, play by the rules of the game and, above all, achieve a deeper and more orderly integration of their markets with the world economy – as they most

[20] Obviously, this has not been the case in all countries – Mexico and Brazil have maintained important public sector firms – and all sectors – energy and media remain off limits, by and large, to foreign investment.

certainly will attempt to do -- there exists more than a small possibility that we will witness a 'second wave' of FDI linked to these economies' tradable goods sectors. From this perspective, the debate over the most appropriate model of regional trade integration – NAFTA, FTAA, EU-MERCOSUR, etc.– becomes one of the utmost importance for the future of capital flows to Latin America.

Irrespective of these hypotheses about the future, the recent past offers clear evidence of the crucial importance of both trade openness and the capacity to attract stable flows of FDI. As has been the case on so many other occasions in the region's history, since the outbreak of the emerging market crises in Asia during the summer of 1997 and, particularly, since the Russian 'default' in August 1998, the risk appetite of the international financial community has shrunk significantly. Table 9 details this collapse in net capital inflows suffered by nearly all of the region's economies (the notable exception being Mexico, which received 18% more net capital inflows in 2002 than in 1998). The intensity of this sudden stop of net capital inflows is encapsulated in a single figure: in three years, Latin America has experienced a reduction of net capital inflows of 91%, with certain countries like Argentina shifting from a recipient status to a 'net exporter of capital'.

Table 9. External Debt and Net Transfers of Resources

	External Debt*				Net Capital Inflows					Virulence Sudden Stop 1999-2002		
	US$bn	% GDP	% Exports	Debt Service[aa]	1998	1999	2000	2001	2002	% 02 vs 98	% X 1998	% M 1998
Argentina[a]	147	135.5%	5.5	70%	18.0	13.1	8.4	-7.6	-14.0	-178%	137%	52%
Brazil	229	50.7%	3.9	77%	25.4	17.5	22.0	26.5	7.3	-71%	38%	36%
Chile	38	60.8%	2.1	39%	1.7	-0.8	1.1	0.6	0.8	-56%	6%	-6%
Colombia	40	49.5%	3.2	68%	3.8	-0.8	0.4	2.8	1.2	-68%	22%	-8%
Mexico	167	26.5%	1.1	23%	18.2	14.6	21.0	25.3	21.1	16%	-2%	10%
Peru	28	50.8%	4.0	22%	2.3	1.1	1.5	1.5	1.9	-17%	7%	17%
Uruguay	6	48.4%	2.5									
Venezuela	32	36.0%	1.0	14%	0.3	-2.5	-7.2	-6.0	-12.0	na	na	na
Region	*688*	*46.1%*	2.9	51%	69.9	42.2	47.2	43.1	6.4	-50.5%	30.2%	20.4%
Debt Payments					83	108	109	101	86			
Recourse to Gross External Debt					153	150	156	144	93			
% GDP					8.3%	9.3%	8.7%	8.3%	6.3%			

Data on external debt from 2002

a. Argentine data from 2001

aa. Debt service is defined as the sum of interest and principal payments divided by exports of goods and services

Source: Strictly Macro, Santander Investment (July 2003) and author's own elaboration based on IFS data from the IMF. http://ifs.apdi.net/imf/

To confront a situation like this in the short run is not possible except at a very high price. The table attempts to transmit an idea of the 'effort undertaken' in order to adapt to the new environment, calculating the percentage which exports would have to increase (30%) or imports fall (20%) so as to substitute with income or savings of foreign exchange the evaporation of international finance. In the case of Brazil, an economy whose degree of openness (imports/GDP) is some 11%, in order to substitute for the 2% of GDP which on average Brazil received in annual external financing would require something of a 20% reduction of imports. Whatever might be Brazil's import elasticity in relation to GDP or the real exchange rate, to affect an adjustment of this magnitude in the short run would require a brutal contraction of domestic absorption and an intense adjustment in the country's structure of relative prices. In other words, from the moment investors lost confidence in the country – and began to withdraw their money – a Brazilian recession and a collapse of the Real's exchange rate became inevitable. The Argentine case was even more difficult given that the policy of convertibility blocked any adjustment in the nominal (one-to-one) exchange rate upon which the government had attempted to construct the growth and stability of the economy.

These calculations have been validated by recent experience. At the high point of capital inflows in 1997, the region was experiencing a US$5bn trade deficit, compared with a surplus of some US$38bn last year. This turnaround was not at all due to exports (which were severely limited by slow world growth and depressed raw material prices) but rather almost exclusively to the universal collapse in the region's imports. Excluding Mexico from the figures (while this country alone accounts for about half of the region's international trade, it has not been affected by the 'sudden stop' of capital inflows), regional exports in dollar terms increased by 6% between 1999 and 2002, while imports fell 4% on average.

Argentina's imports collapsed to levels not seen in two decades – to US$9bn, from US$25bn only two years earlier – while in Brazil imports fell 16% in dollar terms in a single year. Even though the nominal exchange rate devaluations were quite severe – 46% on average for the region and 32% excluding Argentina – the required fall in domestic absorption was very significant. Taking 1996 as the base year, the cumulative growth in domestic demand (consumption plus investment) by the end of last year was negative 17% in Argentina, 0% in Colombia and Venezuela, around 7% in Peru and Brazil, while only two countries – Chile and, above all, Mexico – proved capable of registering 'decent' growth: 13% in Chile and 33% in Mexico. In other words, four years of declining capital inflows have translated into stagnation of the spending of 75% of the inhabitants of the region.[21]

The table's left-hand columns present another dimension of the problem. The region not only needs capital 'flows' to grow; it also needs them in order to deal with its 'stock' problems: the region's high level of indebtedness – US$700bn – necessitates that some 50% of annual export earnings be dedicated to servicing interest payments or paying off principle. Put in another way, when capital inflows dry up, the percentage of principal payments which need to be 'rolled over' must increase for the region to continue to honour its external debt. If more 'roll overs' are not arranged, the risk of default increases exponentially. This vulnerability – common to most developing and emerging economies – is very real for Latin America.

The lower portion of the table emphasizes another question of equal importance. When debt is rolled over, it is not always renewed by the original creditor. On occasion, certain creditors (typically financial creditors) will locate financiers willing to substitute

[21] Mexico accounts for 75% of the growth in private consumption in Latin America during the period 1997-2002 and for 130% of the increase in the region's gross capital formation.

for them as resource conduits to countries in crisis. Thus, while the ‘markets’ still met some 46% of the region’s need for gross external savings in 1998, by 2002 they were contributing a mere 7% of the region’s gross capital inflows.[22] In 2002 the IMF was forced to stump up two of every three dollars of gross capital inflows into the region in order to mitigate ‘systemic risk,’ although this cost the Fund dearly in terms of its reputation. The IMF’s supposed role as leader and arbiter of the international financial situation was consequently picked up by the ratings agencies, while the Fund was ferociously attacked by all those who believe that the risks stemming for such ‘moral hazard’ – the development of a habit of designing financial aid packages to ‘bail out’ countries which persist in erroneous macroeconomic policies, thus contributing to future crises – would be far worse than even a severe regional recession.

The rest of the external savings requirement was picked up by direct investment. Analyzing the stability of the contribution coming from FDI – some 33% of gross financing requirements and, in terms of flows (as seen in Table 8), some 60% of the registered current account deficits – one can conclude that, apart from the positive externalities in terms of the efficiency and productivity generated by direct investments over the past decade, there has already by one concrete, tangible result: FDI has become the region’s most predictable and stable source of external financing. Without the US$38bn in FDI that entered the region in 2002, the level of net capital inflows would not have been compatible with the maintenance of stability, regardless of how much the IMF and other multilateral institutions could have possibly contributed.

The eruption of FDI onto the Latin American financial scene raises some serious questions concerning the design of the international financial architecture. During the ‘lost decade,’ for example, when a ‘problematic’ country bent over backwards to do everything in its power to demonstrate sufficient respect for contracts and property rights (by paying its debt, for example, even if with reductions in its net present value), it was reasonable to expect that the principal preoccupation of the IMF would be how such a country could secure the highest possible sustainable primary surplus so as to service new commitments, while the major worry of governments was how to reconcile the efforts required to achieve this surplus with the survival of some ‘light at the end of the tunnel’ – that is to say, with economic growth and social improvements, once the adjustment had been made.

In the new context, however, the situation has become much more complex. On the one hand, there are more ‘property rights’ to respect: those of bondholders, those of the adjudicated parties in privatizations or concession agreements, those of direct investors and, or course, those of the local citizens, increasingly well-versed in how to use the democratic system to protect their individual and collective interests. To attempt to focus all intellectual and political energy on the special defence of just one of these groups would be doomed to failure from the start.[23] When problems emerge, multilateral negotiation and an equal distribution of the resulting burdens is the only realistic approach. This means that all of those who have decided to become long-term

[22] If we exclude Mexico, gross capital inflows channelled into the region by the ‘markets’ were actually negative, to the tune of US$15bn.
[23] As, for example, when the IMF, at the outbreak of the Argentine crisis and for much of 2002, insisted on making its project to create an international mechanism for resolving debt crises (SDRM) the central item on its international agenda.

partners of the country in question must feel a 'sense of ownership' toward the adjustment program needed to resolve the problem.

In practice – and Argentina will be a good test case for this – 'heterodox' solutions of the kind occasionally used in the past will be much more difficult to employ and maintain over time as a result. On the other hand, if all goes well and the situation in Argentina is resolved favourably, FDI could help moderate the volatility of the region's cycles.[24] The dynamic consistency and quality of economic policy will increasingly become the preferred object of attention for foreign direct investors. It is indeed difficult to imagine that voluntarism will ever again be able to take the place of a rational analysis of what can or cannot be realistically done with economic policy.

The conclusions of the above analysis of the region's dependence on external savings are more balanced than the broad brushstroke vision that is typically wielded in such discussions. Given its level of development, Latin America naturally needs to rely on foreign savings – at least according to traditional economic theory – in order to complement its domestic savings. If growth does not accelerate as a result, at least the region would be able to continue to service the external debt which it has accumulated over the years and which during the 1990s began to give way to large inflows of FDI. Although it is clear that FDI also produces a transfer of resources abroad – in the form of repatriation of dividends or surplus capital – the long-term 'strategic alliance' implied by FDI has the potential to mitigate one of the most worrying characteristics of the region: susceptibility to 'sudden stops' of capital inflows.

Doubts concerning the region's capacity to attract sufficient funds in the current context (post-Argentina 2002) have quickly given way to concerns as to how 'Policy' – with all its implications for the institutional framework and international agreements, might contribute to making heightened certainty regarding the stability and transparency of the rules of the game, and increased trade openness and access to global markets the key levers for producing a 'second wave' of FDI in the region which – as occurred in the Spanish case – might serve as a new stimulus for greater economic interdependence between the economies of Latin America and the rest of the world.

The economies which have exhibited the best practices in the region – Mexico, Brazil and Chile – are also the best positioned – due to the size of their markets, their advantages in terms of institutional stability, or their particular international trade agreements -- with respect to this new kind of agenda.

Low Levels of Investment in Physical and Human Capital

One does not need to be a fanatical disciple of the Harrod-Domar model to come to the conclusion that an increase in the growth rate must be preceded by – in addition to solid policies and institutions – investment which expands and deepens an economy's stock of physical capital.

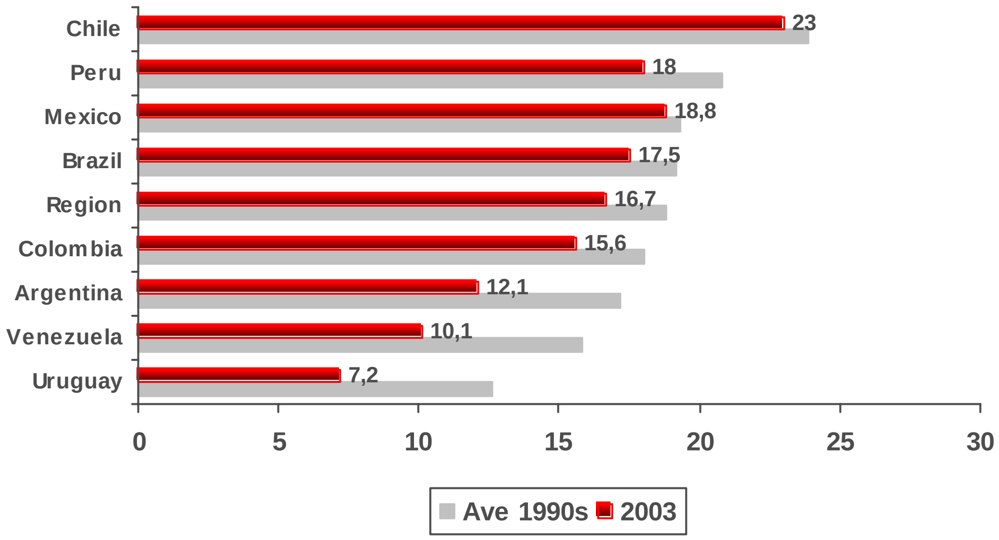
Although it would be difficult – and risky – to make a summary judgement as to the long-term potential growth rate based solely upon the rate of investment in terms of

[24] This would imply that fair compensation payments be made to foreign direct investors for property damage deriving from administrative and judicial decisions, that agreements are reached on norms for guaranteeing the maintenance of business activity, and that negotiations on the outstanding defaulted debt are begun.

GDP, one could say that – to paraphrase Oscar Wilde – only a macroeconomic snob would try to evade the most obvious facts and argue that low growth rates do not necessarily derive from low rates of investment.

As can be seen in Graph 6, the region's average investment rate (in terms of GDP) during the 1990s was 18.8%, falling one point during 1997-2002 and finally settling at 16.7% in 2003. This has implied that given an already low investment rate – one, in fact, more typical of developed than emerging economies – the external constraint which has been evident during the most recent years has been even more costly than it might have been.

Graph VI. Investment/GDP



The investment rate has fallen in all the countries of the region, while in some – Argentina, Venezuela and Uruguay – there has been marked collapse. One could probably risk the claim that in all the region's economies the sustainability of a lasting economic recovery depends critically on the possibility that these investment rates begin to rise once again above 18% of GDP. At the opposite end of the spectrum we find Chile – the region's investment leader, with an average investment rate of 23% during 1990-2002 and economic growth above 6% on average – along with Peru and Mexico (even despite the Tequila Crisis of 1994-95 and the absence of significant private bank. Investment in Brazil has also been above the regional average, even if its investment rates have reflected the difficulties the Brazilian economy has faced since 1999 and the high interest characteristic of its recent growth model.

While investment in human capital is more difficult to measure, it probably has an even greater impact upon potential growth than the mere augmentation of the capital stock or the incorporation of new technologies to the productive process. An entire branch of growth theory (ie, the endogenous growth models) in one way or another rests upon some type of measurement of investment in education and culture as an explanation of the differing evolution of countries in the process of development. Among all the possible measurements, we have chosen to depict in Table 10 certain indicators which compare the basic characteristics of primary and secondary education systems both within the region and against certain international references. The figures come from the exemplary data base of Robert Barro as well as from the countries themselves.

Table 10. Investment in Human Capital										
	Public Spending/Student, $US 1985 PPP						Teacher Salaries		Failure Rate	
	Primary			Secondary			Primary			
	1960	1990	% Income	1960	1990	% Income	US $	% Income	1970	1990
Argentina							2,997	77	36.3	34.3
Brazil		364							78	80
Chile	185	356	8.2	476	326	7.5			22.7	23
Colombia	153	210	6.4	442	329	10.0	8,081	279	43	44
Mexico	128	200	3.4	264	476	8.2	3,817	72	11.1	28
Peru	122			370			3,056	123	34.2	29.8
Uruguay		395	8.6		416	9.0	4,270	114	14	7
Venezuela	276	149	2.5	1018	478	7.9	7,954	132	40.5	52
Regional Average	173	279	5.8	514	405	8.5	5,029.2	132.8	35.0	37.3
United States	1,079	2,721	15.1	1255	4,181	23.1	24,728	149	11	11
Spain	100	1,154	12.0	177	1,322	13.8	17,937	238	2	3
Sweden		7,003	47.5		2,834	19.2	50,498	379	0	0
World Average	235	961	12.9	696	1,171	24.3	13,087.8	314.6	29.2	24.9

Source: Barro-Lee Data Set: International Measures of Schooling Years and Schooling Quality

Referring to the data, as opposed to preconceptions, one must agree with Getulio Vargas when he said that ‘finding the truth is not difficult. The complications begin when one decides to live with it.’ The fact of the matter is that the level of spending on education is above that of economies with levels of development far superior to that of the region.

Possibly as a result of the republican spirit which animated the ‘construction’ of many Latin America nations during the first half of last century, the national efforts dedicated to education in these countries has been notable. Brazil, for example, has 74% of the youth population enrolled in school,[25] while Mexico is providing secondary education to 30% of the population. Spending on education in national budgets varies between 3% of total public expenditures in Peru and the 5.3% registered by Mexico. Despite this, the numbers of Barro and Lee – Table 10 – moderate the enthusiasm that might come from the budget data. Public spending on education in the region – which in 1960 was higher than in Spain and 70% of a simple international average – today barely accounts for a third of the average in the rest of the world, while the percentages for school failure have increased to the point where they are now worryingly high in Venezuela, Colombia and Brazil. All of this suggests that ‘education’ needs a second regional ‘push’, even if only because it is the most potent weapon for improving social mobility and broadening the middle classes.

[25] In some countries, the school serves as a vehicle for broader social programmes. For example, in the case of Brazil, during the previous Administration an interesting education campaign was undertaken – ‘the School Fund’ – offering incentives for youth to attend school in the form of a direct subsidy to their parents on the condition that they comply with the condition of regular attendance. In other cases, the school forms a central aspect of food programs, like Zero Hunger.

Low Level of Medium- and Long-term Finance in Local Currencies

In addition to the problems of institutional instability and macroeconomic volatility, the relatively low rates of investment registered in the region are typically attributed to the difficulties faced by households and businesses in securing medium- and long-term financing at reasonable prices and in local currency. Indeed, in addition to the supposedly weak intermediation capacity of the banking system and the lack of deep and efficient capital markets, another familiar characteristic in the literature on the roots of underdevelopment – and which to a certain degree is the inevitable corollary of many of the vulnerabilities which have been analysed above – is a kind of reticence with respect to the allowing the Judicial system to enforce the rules, honour contracts, and effectively defend property rights over and above the priority objectives of income redistribution, improving low domestic savings, moderating macroeconomic volatility and dealing with the stark discontinuities in the growth process.

This 'sin' is reasonably clear. Table 11 tracks the development of domestic credit as a proportion of GDP from the early 1980s. From the table one can verify that, in line with the low levels of deposits/GDP analyzed in Section V, the level of credit to GDP is also low overall: barely 40%.

But it is also clear that this percentage is growing: in 2002 it was double that registered in 1980. The problem is that the lever which is increasing the level of bank asset intermediation has been a rise in banks' exposure to the public sector. On average, credit to the public sector was some 17% of GDP across the region in 2002, while two decades ago it was only 6%. In other words, more than three-fourths of the deepening bank intermediation within the region can be explained by the demand for credit from national public sectors. This is actually the opposite side of the coin which we raised above in our discussion of the level of domestic savings: more than ever before the region is substituting foreign for domestic savings and a large part of these savings has gone to finance regional public sectors.

Table 11. Credit and Banking Systems

Countries	Domestic Credit/GDP			Credit to Public Sector/GDP			Credit to Private Sector/GDP			% Credit Public Sector/Total Credit		
	1981	1995	2002	1981	1995	2002	1981	1995	2002	1981	1995	2002
Argentina	26.1%	26.4%	49.5%	*4.4%*	*8.2%*	*34.3%*	*21.7%*	*19.7%*	*15.1%*	**16.8%**	**31.2%**	**69.4%**
Brazil	18.4%	63.1%	45.9%	*5.8%*	*8.7%*	*16.7%*	*12.6%*	*32.6%*	*29.2%*	**31.3%**	**13.8%**	**36.3%**
Chile	39.0%	49.7%	64.1%	*0.7%*	*0.7%*	*1.1%*	*38.3%*	*51.9%*	*63.0%*	**1.7%**	**1.4%**	**1.7%**
Colombia	15.0%	18.9%	28.6%	*1.1%*	*2.3%*	*8.6%*	*14.0%*	*18.0%*	*20.0%*	**7.0%**	**12.3%**	**30.1%**
Mexico[a]	18.8%	30.0%	31.2%	*1.4%*	*4.8%*	*20.8%*	*15.6%*	*25.2%*	*10.4%*	**7.4%**	**16.0%**	**66.7%**
Venezuela	28.2%	15.9%	14.3%	*0.9%*	*7.5%*	*4.2%*	*27.3%*	*8.7%*	*10.1%*	**3.2%**	**47.2%**	**29.5%**
Region	**21.3%**	**40.9%**	**39.2%**	**3.2%**	**6.3%**	**17.1%**	**17.6%**	**27.2%**	**22.1%**	**14.9%**	**15.5%**	**43.6%**

a. Mexico includes IPAB Notes
Source: International Financial Statistics IMF. Bank Deposits Series. http://ifs.apdi.net/imf/

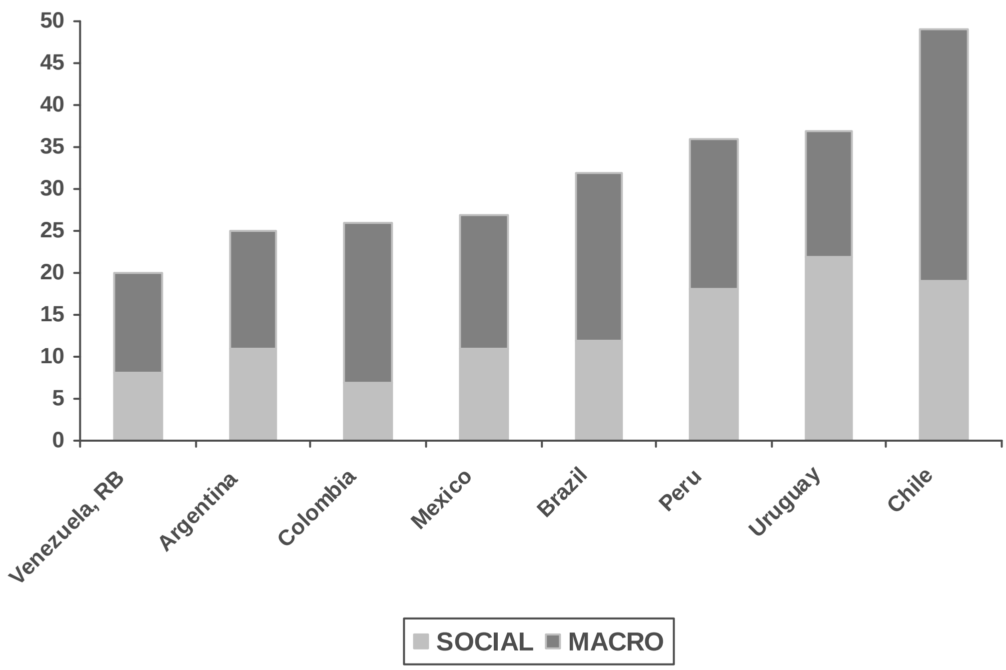
While the data on credit/GDP suggest that the 'crowding out' has not been complete, it appears highly probably that the public financing demand has affected the price of credit, the length of loans and the type of borrowers that the banking sector has been able to finance in the various national private sectors. An easy yet powerful way to demonstrate this phenomenon would be to point out that between 1995 and 2002 115% of the increase in deposits held by the region's financial systems funded loans to the region's public sectors. This has obviously necessitated the development of alternative markets and instruments for the provision of liquidity which was accommodated by the growth in the region's banking systems.

The heterogeneous nature of the region is even greater – if that is possible – with regard to this vulnerability. As can been seen in Table 11, Chile has managed to find efficient financing mechanisms for its otherwise disciplined public sector and has based the increase of its banking intermediation on the expansion of finance granted to the private sector. By far Chile is the Latin American country with the most significant degree of – and most balanced – banking intermediation. In second place comes Brazil, with a ratio of credit to the private sector around 30%, nearly double the level experienced at the beginning of the 1980s. Although the weight of public credit has increased in these years, only half of the increase in bank intermediation can be explained by the augmented exposure by banks to sovereign risk. Finally there is the case of Mexico, which continues to pay for the residues of its banking crisis during the 1990s. The percentage of credit extended to the private sector is now at an historic low, while the paper issued to facilitate the transition to a normalized banking system – the IPAB notes – continues to distort the potential growth of a system which has been radically transformed in recent years. The opposite of such situations can be found recently in Argentina – where the banking system will have to be restructured – and in Venezuela, a country where the financial system has seen its size and involvement in the economy reduced.

Reviewing: Who Sins and How Much Does it Matter?

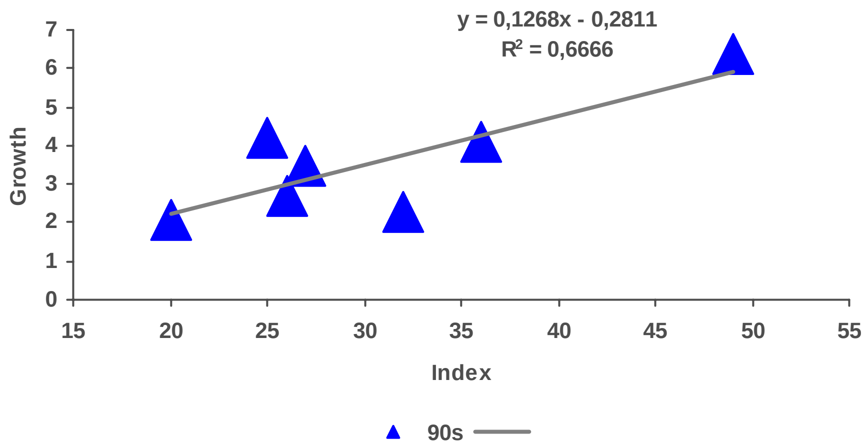
The central idea of this paper is that Latin America is a heterogeneous region formed of countries which, while sharing reasonably similar vulnerabilities, with the passage of time have proved capable of finding differentiated solutions which have mitigated – or aggravated – the importance of such factors in their recent growth paths.

Graph VII: Latin America's Mortal Sins

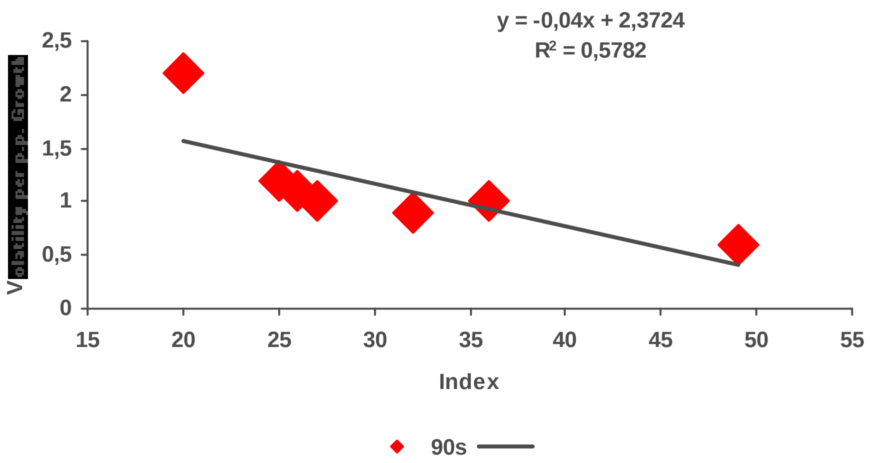


While to synthesize all of the above analysis into a 'regional standings of sinners' would obviously be an overwhelming simplification, this is exactly the objective of Graph 7.[26] Here we can clearly see that Chile is the 'smallest sinner' of the region, followed by Uruguay, Peru, Brazil and Mexico. Colombia, Argentina and Venezuela, in that order, finish off the ranking. As we can see, a ranking of these countries according to social indicators – including the quality of institutions, the level of perceived corruption, and the distribution of income – would be slightly different from that which classified these same countries by their macroeconomic vulnerabilities – domestic savings rate, dependence on external finance, investment in human and physical capital, and the level of credit extended to the private sector as a percentage of GDP – or from that given by the synthetic index which aggregates all of the factors under consideration. Concretely, Uruguay and Peru base their relative strengths on 'social indicators' and as a result move up in position within the global ranking, while on the contrary Brazil and Colombia see their macroeconomic advantages undermined by their social 'weaknesses' – income distribution in the former and political instability and violence in the alter – pulling both countries down within the synthetic ranking.

Graph VIII. Growth, Volatility and the Global Index
(*1990-2000)*



[26] The problems involved in aggregation have been resolved in a convenient way: for each of the 'sins' the eight countries have been ordered according to the analyzed indicator, with the most vulnerable country occupying the first position and the least vulnerable occupying the eighth position. The aggregate indicator is the sum of the position occupied with respect to each of the 'sins' by each country, such that the country which obtains the most points is the country least vulnerable overall, and the country which receives the least number of points is the most vulnerable. To incorporate the differences among the positions occupied an estimated deviation from the regional average for each country has been used for each of the vulnerabilities. Normalizing these deviations with the help of the variance in each series allows one to obtain the global index which, obviously, is identical to the ranking presented in Graph 8.



This situation makes the result illustrated in Graph 8 very predictable: the adjustment of growth patterns to the values comprising the Synthetic Index of Vulnerabilities is only moderately satisfactory[27], while the correlation between the values of the index and the volatility registered for each percentage point of growth is also not that high (57%)[28]. But there is at least some 'smoke and mirrors' in this explanatory capacity of Latin America's 'sins': it would be enough to simply eliminate Chile from the sample for the volatility and the average growth rate to become independent of the values incorporated into index. In other words, the list of 'sins' only explains the behaviour of the country which, in the opinion of the international community, has been able to take off from the rest of the region and begin to leave it behind: Chile. For the rest of the countries in question, the correlation is either very low or statistically insignificant.

Clearly this does not mean that good institutions, high savings rates, and efficient and profitable financial systems are irrelevant to growth rates and volatility. On the contrary, what really emerges from the data is that – excepting Chile, a country which has followed the textbook on growth –the other countries of the region have attempted to

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[27] As demonstrated by the adjustment equation, the index only explains 66% of growth. It is also immediately clear that if we exclude Chile from the simple, the explanatory capacity of the 'sins' on growth between 1990 and 2000 simply collapses (to less than 10%), revealing a completely new situation in which the observed growth pattern is inelastic with respect to the values of the Index.

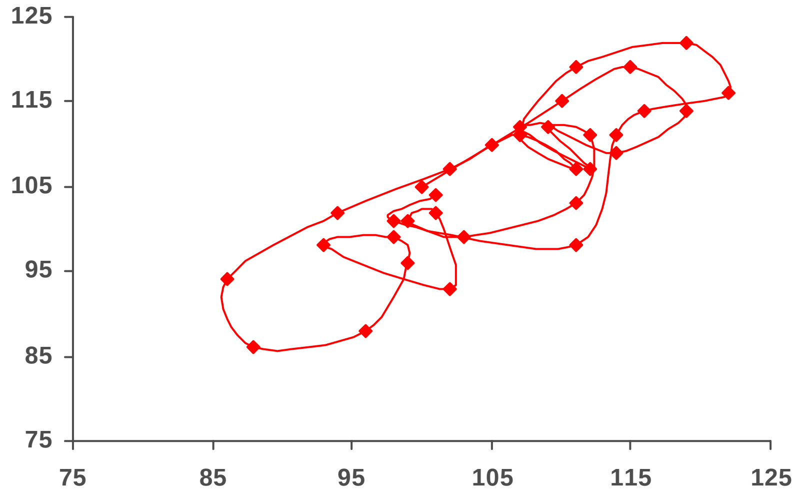
[28] One possible explanation of this failure is that the synthetic index is merely a static and arbitrary representation of Latin American reality. Nevertheless, while it is true that our indicator has been constructed upon what could fairly be called heroic assumptions, it is comforting to know that other authors arrive – if by different paths – at basically the same regional classifications. The most recent version of The Economic Freedom Index (2002), elaborated by the Fraser and Cato Institutes from more than 38 integrated indicators in 5 broad thematic groupings, presents the very same countries in its first three positions. Among the rest of the countries, their ranking differs from ours only in that it fails to capture the effects of the Argentine crisis of 2002 and still situates the economic freedoms of Argentina at a higher level than those of Mexico or Brazil. Furthermore, the IMD's 2003 World Competitiveness Report also ranks Latin American economies more or less in the same way, with Chile leading the region, followed by Colombia, Brazil, México, Argentina and Venezuela.

find ‘shortcuts’ to growth in the past. Sometimes they have found such ‘shortcuts,’ but other times they have not. On such occasions all the progress of a decade has simply been swept away by steep recessions and dramatic instabilities.

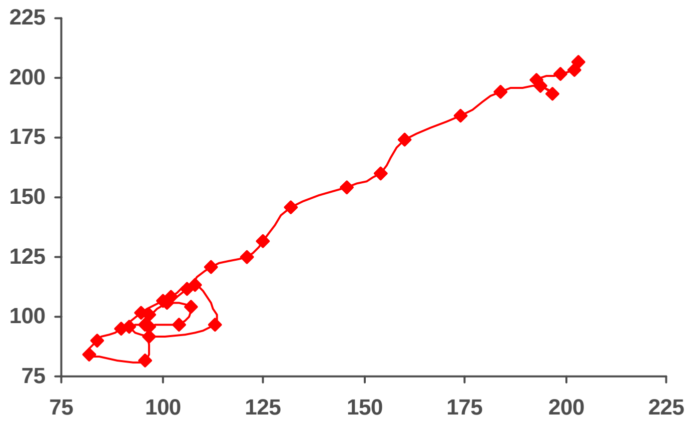
The consequences of the distinct paths to prosperity chosen by the countries of the region can be seen in Graph 9, which presents the growth in per capita income in constant dollars in both Chile and Argentina during the period 1970-2002. The differences are stark: while in Chile the growth in per capita income has been a continuous process, Argentina appears trapped in a kind of vicious cycle from which it continues to fight to free itself, even to this day.

Optimism does come from the clear capacity of different countries to undertake reform. Chile has not always been the economy that it is today. In 1970, Chile was the country with the worst performance on the Fraser Institute’s Economic Freedom Index, occupying the last position among 54 countries, while Venezuela was the regional leader in the 12th position, even ahead of Spain. Thirty years later, this picture has radically changed. Chile is now the regional leader, occupying the 20th position from among 152 countries – 15 positions ahead of Spain – while Venezuela has fallen back dramatically to position 103. There is no better proof that ‘change’ is possible, and the results are clear. Chile is today the Latin American country with the highest per capita income and which has least suffered the consequences of the loss of credibility in the region since the crisis of 1997.

Graph IX. Per Capita Income in Contant US $ 1970-2003.
1970=100
Argentina



Chile



During the second half of the 1980s, Chile demonstrated that 'change' was possible and that therefore there is no Latin American curse. Other countries, including Brazil and Mexico, are attempting to follow the same 'State Agenda' and while the process has not yet been successfully concluded, there are clear signs that they have laid the essential macro foundations for their growth processes to become more stable and socially responsible than in the past.

The region is better off than it was 20 years ago. There is no doubt about that. The problem is that the world has also 'improved' and what was 'sufficient' back then no longer is. In the global economy of the first decade of this century, Latin America encounters many more formidable competitors than in the past. Countries like China and other Emerging Asian economies, along with the enlarged European Union, are now competing with Latin America for external financing with which to accelerate their own growth rates. The region will have to adapt to this new challenge and must outline a new agenda of institutional transformation that is truly consistent with the objective of achieving sustainable growth without ignoring important social aspects of Latin American realities. It is in this terrain – that of social stability and legal security – where the most glaring international competitive weaknesses of the region are still to be found.

Conclusions

In the end, there is not much of a case for continuing to insist that Latin America's 'damnation' is the consequence of a fixed and unchanging list of original or deadly 'sins.' The preconceptions shrouding the region must give way to more detached and subtle analyses capable of recognizing that important structural transformations over the course of the last decade have modified the nature and intensity of the region's vulnerabilities.

Today the region bears little resemblance to the Latin America of the mid-1980s, with its authoritarian governments besieged by hyperinflation, debilitating public deficits, external debt defaults, exchange rate problems and the dramatic intensification of poverty. Today Latin America is democratic, with inflation below 10%, primary budget surpluses larger that those ever achieved in the EU during the euro convergence years, sustainable exchange rate regimes, and a renewed commitment to respect the rules of the game and to integrate into the international economy.

The region might not yet be ‘perfect’, but it is better than it was 10 years ago. The rates of transformation have differed and the results are certainly not homogeneous. A look at the countries in the area inclines one to agree with Tolstoy: each Latin American nation is ‘unhappy’ in its own way, and in its own way it will have to resolve its permanently frustrated ambitions of seeing its economy finally taking off.

Seneca once said that there are no favourable winds for those who do not now where they are going. To know the direction in which to go, to know what ambitions and objectives are feasible for a country, is the most difficult challenge facing leaders and societies in Latin America today, particularly in countries that have not been capable of convincing their citizens or the rest of the world that their project for nation is clear and feasible.

Of all of Latin America’s ‘historic sins’ the most devastating has probably been the region’s immoderate tendency toward ‘foundational’ reforms, those which wipe away everything which existed or came before. Reforms which modify the rules, contracts or rights established in previous periods – obviously failed periods – of economic development. The price paid for such changes has been very high in the majority of cases. But the lesson has been learned. There are no institutional shortcuts or magic economic policies that by themselves guarantee success. Prosperity can only be guaranteed by the existence of a ‘State Agenda’ which is reasonable, well-balanced and accepted by a broad consensus. Above all, there must be persistence and continuity in the pursuit of such an agenda. One must stay the course.

In his induction address, the current Brazilian Minister of Finance, Antonio Palloci, put it very clearly:

> *‘Ministros da Fazenda nem sempre são portadores de boas novas. Nem são tampouco, obrigatória e inversamente, portadores de más notícias. Ministros da Fazenda são, por dever do ofício, forçados a trabalhar com o cálice nem sempre doce dos números e do realismo renitente, talvez até irritante para os mais apressados. Nações, entretanto, não são construídas apressadamente. Precisam de sólidos alicerces, de pedra sobre pedra, de estabilidade, de regras claras, de solidez institucional.’*

Some countries in the region have already learned this. They make institutional continuity and the maintenance of a reform consensus their central objectives on the road to progress. Respect for the rule of law and previously acquired commitments is the best way to remain reliable.

The others will continue on the same path on which sooner or later all of the region’s success stories have embarked. Each is their own way, but it is clear that they will do it, for the lesson has been learned. The only truly unforgivable regional ‘sin’ is to have so many times and for so long frustrated the expectations of Latin Americans for a better life.

Madrid, July 2003

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