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Is Latin America Saying Adios to Market-Friendly Reforms?

by William C. Gruben and Richard Alm

The presidential candidates who have won in the past nine years seem to signal a leftward shift in at least five countries.

By the mid-1980s, governments' reckless spending and economic meddling had brought hyperinflation, stagnation and economic crisis to many Latin American countries. The hard times opened the door to what became known as the Washington Consensus of the 1990s, shorthand for a set of market-oriented policies that included fiscal discipline, deregulation, privatization and freer trade.¹

More than a decade and a half later, analysts increasingly wonder whether Latin America may abandon its free market policies and return to its socialist past.² The presidential candidates who have won in the past nine years seem to signal a leftward shift in at least five countries.

Hugo Chavez, who advocates "a new socialism" for the 21st century, won Venezuela's presidency in 1998 and has since been reelected. Chavez has made good on his populist rhetoric by spending lavishly on new social programs, taking control of foreign-led



oil ventures, letting squatters take wealthy farmers' land, nationalizing telephone and electric companies, and threatening to seize banks and other privately held enterprises.

Chile has had a Socialist Party president since 2000, first Ricardo Lagos and since last year, Michelle Bachelet. In Brazil, Workers Party candidate Luiz Inácio Lula da Silva took office in 2003. Cuba's Fidel Castro was among the heads of state attending the 2003 presidential inauguration of Néstor Kirchner, leader of Argentina's Peronist Party. In 2005, socialist Evo Morales, a former coca-leaf grower and union leader, became Bolivia's president.

Assessing the leftward tilt in Latin America's economic policies requires going beyond election results. The Fraser Institute's *Economic Freedom of the World* report provides a broad, long-term gauge of nations' commitment to market-oriented policies.³ In the mid-1980s, Latin America started gaining economic freedom faster than the rest of the world (*Chart 1*). In the next decade, the Washington

Consensus provided added momentum, allowing the region to achieve the world average at the turn of the century. Latin America, however, has since fallen off the global pace.

Despite the recent lag, it may be too soon to write an obituary for Latin America's market reforms. A country-by-country survey leads to a less sweeping conclusion: A few leaders have steered their countries to the left, but the bulk of Latin America hasn't lost faith in markets.

Economic Freedom Trends

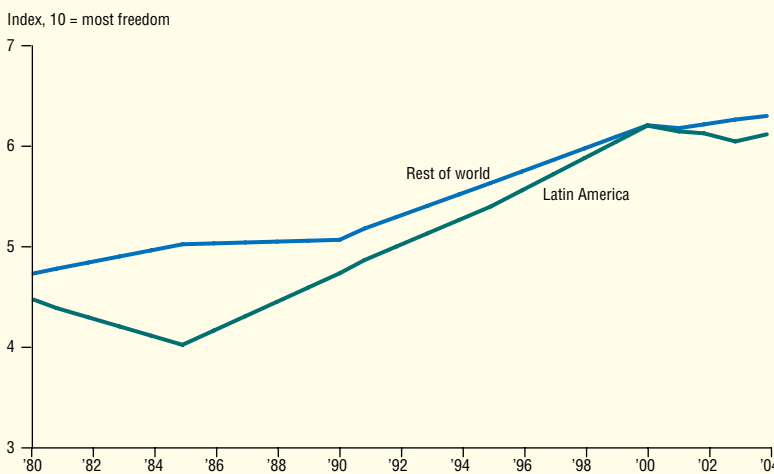
We can delve deeper into Latin America's economic policies by analyzing individual countries' performance on the Fraser index since 2000. In general, Fraser equates economic freedom with greater reliance on market forces and less government intervention. Countries do better to the extent they open trade, welcome foreign investment, keep taxes and regulatory burdens low on business and labor, control government spending, hold down the hidden tax of inflation and enforce property rights.

To simplify the process, we looked at the dozen nations with the largest populations and economies (*Table 1*). Cuba has been omitted because of a lack of data.

Individual countries' most recent Fraser scores go in every direction—up, down and mostly sideways (*Chart 2*). Venezuela, Argentina and the Dominican Republic moved sharply away from a market orientation in 2000–04. Venezuela's rebound at the end of the period isn't likely to be sustained, given Chavez's subsequent actions, such as limiting foreign companies to minority stakes in oil and gas exploration projects.

Where did these three countries veer off Fraser's free market path? Venezuela lost points because it tightened limits on holding foreign currency, imposed price controls, meddled in exchange rate markets, added bureaucratic hassles and regulation, and burdened foreign investment. Argentina experienced rising inflation and imposed price controls—signs of monetary policy lapses that exposed

Chart 1
Falling Behind on Economic Freedom?
(Fraser index, weighted by population)



SOURCE: Fraser Institute, *Economic Freedom of the World: 2006 Annual Report*.

Table 1
Latin America's Largest Countries

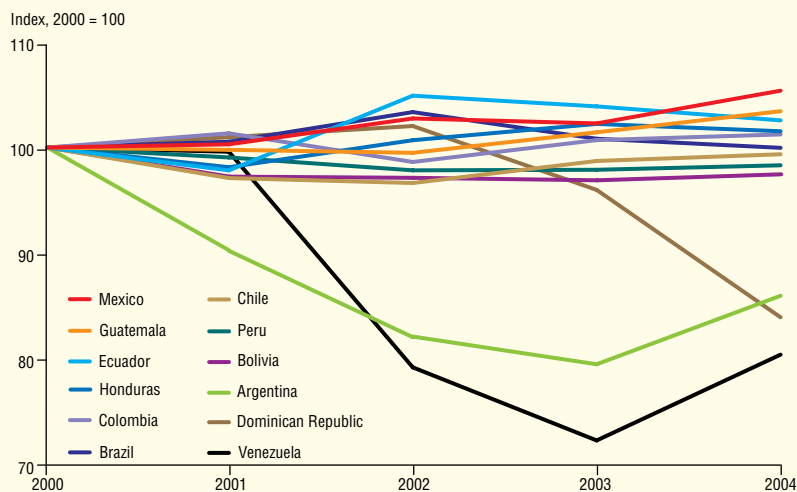
	Population (millions)	GDP per capita
Brazil	186.4	\$4,271
Mexico	103.1	\$7,454
Colombia	45.6	\$2,682
Argentina	38.7	\$4,728
Peru	28.0	\$2,838
Venezuela	26.6	\$5,275
Chile	16.3	\$7,073
Ecuador	13.2	\$2,758
Guatemala	12.6	\$2,517
Bolivia	9.2	\$1,017
Dominican Republic	8.9	\$3,317
Honduras	7.2	\$1,151

NOTES: Data are for 2005. Cuba is excluded because of a lack of data. GDP is in U.S. dollars.

SOURCE: World Bank, World Development Indicators.

Chart 2

Gauging Changes in Economic Freedom—Fraser Index



SOURCE: Fraser Institute, *Economic Freedom of the World: 2006 Annual Report*.

the private sector to increased risk. The country also had problems with burdensome regulations, growing benefits to labor, and maintaining the law and order necessary for economic stability. The Dominican Republic added red tape, lost inflationary discipline and effectively drove real interest rates below zero.

While these countries curtailed economic freedom, Mexico moved in the opposite direction. Improvements came largely from policies promoting market interest rates, less restrictive minimum wages and lower tax burdens.

Elsewhere, Fraser's assessments of economic freedom changed little over 2000–04. Chile and Peru were already among Latin America's most market-oriented countries—so they remained exemplars of free market policies despite a lack of upward movement in their indexes (*Table 2*). Colombia's slight regression and Ecuador's meager progress may be reason for greater concern because both entered the new century relatively low in the economic freedom rankings.⁴

The Index of Economic Freedom,

calculated by the Heritage Foundation and *The Wall Street Journal*, offers another country-by-country assessment.⁵ We've adjusted the measure to provide a sharper focus on domestic policies.⁶ Components for openness to trade and foreign capital have been deleted, leaving data on fiscal burden, government intervention in the economy, monetary policy, banking-market openness, wage and price controls, protection of property rights, regulation and prevalence of informal markets.

Like the Fraser index, the Heritage/WSJ data show that Argentina, Venezuela and the Dominican Republic experienced marked erosion in market orientation (*Chart 3*). The 2000–05 data may also provide an early hint of an ebbing in Bolivia's index. Morales nationalized the oil and gas industry in May 2005, so the country's small decline may be a harbinger of a trend that will emerge in subsequent reports.

While Fraser indicates that Venezuela lost the most ground, Heritage/WSJ finds Argentina a bigger backslider. Argentina, however,

achieves a higher overall ranking every year, signaling that it surpasses Venezuela in market orientation.

According to the Heritage/WSJ data, Argentina's domestic economic freedom faltered because authorities failed to control inflation, crimped the banking system and allowed property rights to deteriorate. The biggest contributor to Venezuela's declining score was the growing size of government, a reflection of Chavez's penchant for spending the country's oil riches. The country also did worse on measures of financial freedom and corruption.

The Dominican Republic's deterioration was widespread, with lower readings for fiscal policy, size of government, monetary policy, finance and corruption.

Beyond the backsliders, Heritage/WSJ finds most Latin American nations didn't forsake market-friendly policies. However, meaningful progress toward markets is hard to find outside Ecuador, which showed eye-popping progress. Ecuador's results should be interpreted with caution, how-

Table 2

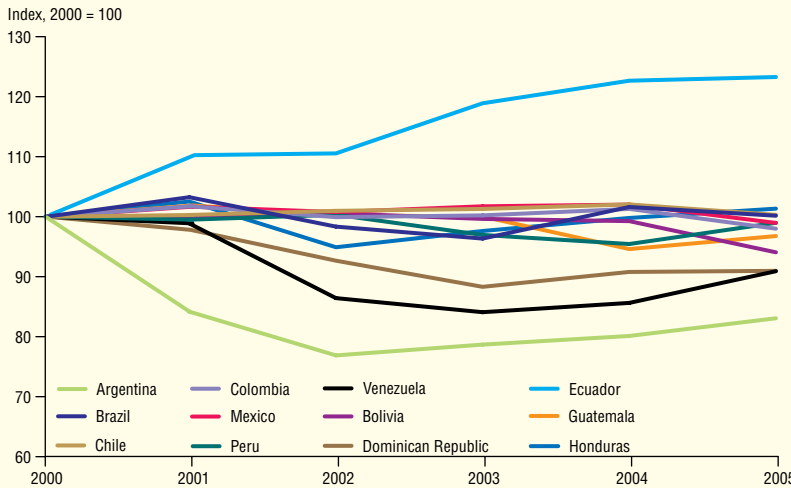
How Nations Rank on Economic Policies

	Fraser Index 2004	Heritage/WSJ Domestic Index 2005
Chile	7.44	8.10
Peru	6.82	6.66
Guatemala	6.64	6.17
Mexico	6.62	6.46
Bolivia	6.53	5.89
Honduras	6.47	6.14
Argentina	6.19	5.69
Brazil	5.88	6.28
Ecuador	5.75	6.00
Colombia	5.46	6.16
Dominican Republic	5.43	5.69
Venezuela	4.44	5.06

SOURCES: Fraser Institute, *Economic Freedom of the World: 2006 Annual Report*; The Heritage Foundation/Wall Street Journal 2007 Index of Economic Freedom.



Chart 3
Gauging Changes in Economic Freedom—
Heritage/WSJ Index



SOURCE: The Heritage Foundation/Wall Street Journal 2007 Index of Economic Freedom.

ever. The small Andes nation had the region's lowest Heritage/WSJ domestic-policy score in 2000, the year it scrapped its currency in favor of the U.S. dollar, a move designed to corral runaway inflation. Dollarization brought improvements in monetary policy and the financial system, the biggest contribution to Ecuador's better showing in 2005.

The past five years' progress, however, merely restored Ecuador to its 1998 level. Perhaps more telling, the country's Heritage/WSJ ranking in 2005 puts it ahead of only Argentina, Bolivia, the Dominican Republic and Venezuela—not the best of neighbors when it comes to economic freedom.

Business Burdens

Regimes moving to the left typically favor workers over employers and hinder companies with excessive rules and red tape. Market-friendly reforms, on the other hand, relieve the burdens on businesses. Fraser and Heritage/WSJ pick up changes in these policies, but the World Bank's Doing Business series provides additional detail on the everyday burdens companies and entrepreneurs face.

The series collects 42 indicators for 2003 through 2006, covering a time when Chavez, Kirchner, da Silva, Morales and others were in office. The data measure hurdles private enterprises encounter in a range of areas—among them, starting a business, employing workers, registering property, getting credit, enforcing contracts and closing a business. The World Bank doesn't present data for every country and every year, but we did find meaningful comparisons on 19 aspects for the 12 Latin American countries we studied.

Looking at those aspects, we found that 212 of the indicators point to the same or greater market orientation (*Table 3*). All countries but Chile—the most market friendly—improved their scores in at least five categories. Only 16 measures indicate a retreat from markets. The Dominican

Table 3
Doing Business Measures Show
Markets Still in Favor

	Market orientation indicators		
	Increasing	No change	Decreasing
Argentina	6	13	0
Bolivia	5	12	2
Brazil	5	12	2
Chile	2	16	1
Colombia	7	12	0
Dominican Republic	5	11	3
Ecuador	7	12	0
Guatemala	7	11	1
Honduras	6	10	3
Mexico	6	12	1
Peru	5	13	1
Venezuela	5	12	2
Total	66	146	16

NOTE: Data are for 2003–06.

SOURCE: World Bank, World Development Indicators.



Republic and Honduras had three each; Bolivia, Brazil and Venezuela had two.

From a freer market perspective, the most encouraging Doing Business trends center on new businesses, which increase competition and create jobs. Latin America's best environments for entrepreneurs can be found in Chile, Guatemala and Mexico, where starting a business takes a month or less (*Chart 4*).

The biggest improvement, however, came in Argentina, which hasn't otherwise received high marks for market-friendliness.⁷ The country reduced the number of days required to start a business from 68 in 2003 to 32 in 2006. Mexico shaved off 31 days, Ecuador 27 and Peru 26. Brazil and Venezuela remain unfriendly to entrepreneurs, but none of our 12 Latin American nations added to business start-ups' time burden.

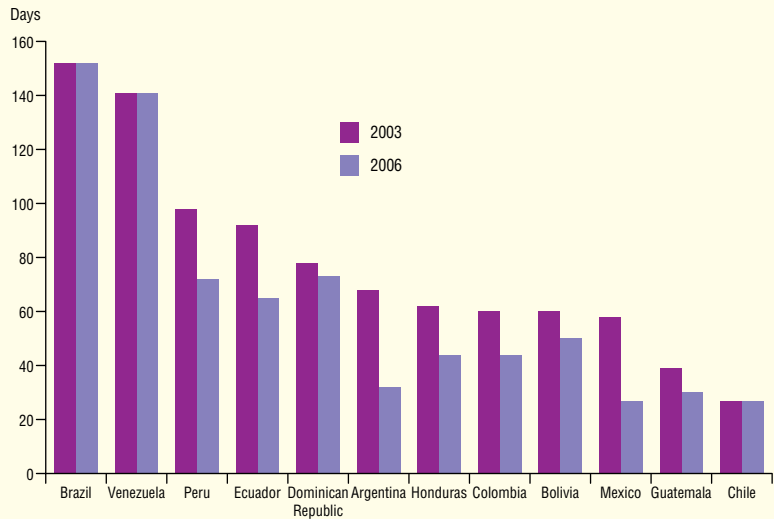
The environment for entrepreneurs has improved in other ways. Eleven countries reduced financial barriers to starting a business, measured as the cost of opening up as a percentage of per capita income. Seven whittled down start-ups' capital requirements. Three cut the number of procedures for opening a business. All told, nearly half the 66 increases in market orientation came in World Bank measures related to getting a new enterprise off the ground.

Closing a business can be just as important as starting one. An efficient bankruptcy and foreclosure system allows creditors, tax authorities, employees and others to recover a greater portion of their claims. They fare better when proceedings take less time and money and enterprises keep operating in the interim.

The World Bank calculates the cents per dollar likely to be recovered from a business that's shutting down (*Chart 5*). Between 2003 and 2006, all countries except Chile had higher recovery rates, a signal their bankruptcy and foreclosure systems had become more market friendly.

Chart 4

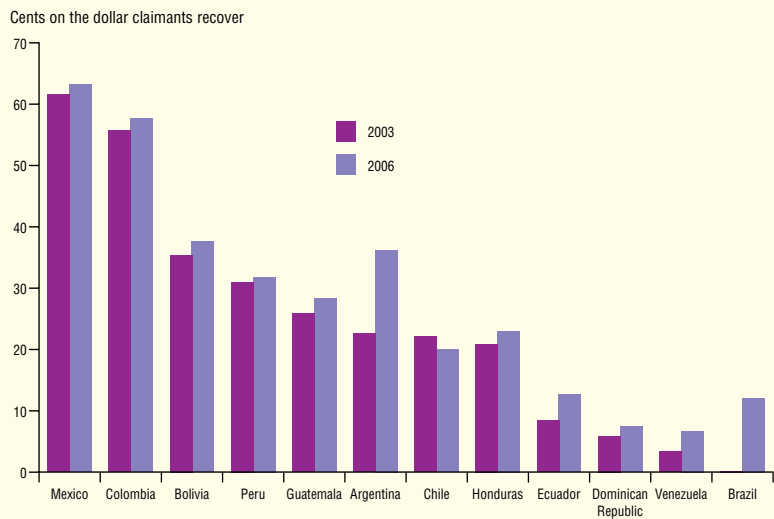
Days Required to Start a Business



SOURCE: World Bank, Doing Business database.

Chart 5

Closing Business Recovery Rate



SOURCE: World Bank, Doing Business database.



Latin America can't escape the fact that left-leaning policies have historically been a drag on growth. Market reforms offer the region a chance to better itself, particularly in an era of globalization.

Gains were largely modest outside of Argentina and Brazil, the latter a dismal performer in 2003.

Some progress came in registering property, with 10 nations lowering the cost relative to property value. Brazil, the Dominican Republic, Honduras and Peru cut the number of days it takes to enforce a contract. Colombia did, too, but only managed to come down to an astronomic 1,346 days, making it second to Guatemala.

Scant progress was made in freeing labor markets. Indeed, 10 of the 16 instances of decreasing market orientation involved restrictions on hiring and firing. Bolivia, the Dominican Republic and Honduras reduced market orientation in two of the five Doing Business labor measures. Argentina, Brazil, Guatemala and Mexico became less market friendly in one each. Venezuela showed improvement in two workplace measures, although its labor market scores remained decidedly antimarket.

Among the 12 countries with the bulk of Latin America's population, the Fraser, Heritage/WSJ and World Bank measures—taken together—find no wholesale erosion of market-based policies outside of Argentina, the Dominican Republic and Venezuela. In particular, Mexico continues to do well. A regional leader in market

orientation at the start of the decade, it subsequently gained economic freedom on the Fraser index and improved its performance on six Doing Business indicators. Among the 12 largest nations, Mexico led in fewest days to start a business and highest recovery rate in liquidations.

The leftward lurch perceived by many observers has been exaggerated. Even so, the data don't show a groundswell of support for new market-oriented policies. Progress is spotty, with few countries pursuing ambitious reforms and most of them running in place. The momentum of the Washington Consensus has flagged in the new century.

Growth and Reform

The success of previous reforms may be one reason Latin American nations aren't moving as briskly as they once did toward market-friendly policies. When they began to loosen the state's grip on their economies two decades ago, most countries had long reform agendas that included opening markets, controlling inflation, deregulating industries and privatizing government enterprises.

A lot of that heavy lifting has already been done. From 1990 to 2004, Latin America's Fraser index, weighted by population, rose 30 percent. What's left for Chile, Mexico and the other more market-oriented nations is consolidation and fine-tuning—decidedly smaller steps. Most countries have maintained the market-oriented policies put in place.

In the handful of countries where economic freedom has faltered, we can't deny the pull of populism. Bolivia, the Dominican Republic and Venezuela are relatively poor and underdeveloped, making them susceptible to the message of a Chavez or Morales. Argentina is a bit different. It ranks as one of Latin America's richest countries but has a history of populist politics dating to Juan Perón in the late 1940s.

Some analysts contend that countries adopting market-oriented policies

in the 1990s grew more slowly than reformers had promised. When the reforms didn't deliver as expected, they say, it strengthened forces opposed to economic liberalization. In this political dynamic, some nations would retreat from the market ideology. Other nations may still move toward freer markets but at a slower pace than countries with more vigorous economies.

The data, however, don't support a link between sluggish economies and turning away from economic freedom. From 1997 to 2000, growth rates varied among the 12 Latin American nations: Mexico, Guatemala and the Dominican Republic gained the most, while output declined in Ecuador, Colombia, Argentina and Venezuela.

Subsequent changes in economic freedom, measured by either the Fraser or Heritage/WSJ domestic index, appear random (*Chart 6*). Guatemala made significant progress by Fraser's reckoning but regressed slightly by Heritage/WSJ's. By both indexes, the growing Dominican Republic became less market friendly and slumping Ecuador gained economic freedom. Colombia's results are mixed.

Only in Argentina and Venezuela did poor economic performance precede sharp declines in economic freedom. Fraser scores show Argentina pursued market measures with some vigor in the 1990s. When the economy again slipped into a hyperinflationary quagmire, the country could have been disillusioned with the policies' payoff. Venezuela, on the other hand, registered little overall progress toward markets in the 1990s, so it's hard to make the case that bad results from reform led to Chavez's election and skepticism about markets.⁸

The Fraser, Heritage/WSJ and World Bank data are consistent through time and across countries, making them useful for international comparisons. The bare numbers, of course, don't fully capture the complexities of economic policy. In addition to internal political forces, nations



face external pressures from markets and lenders that have at times led to sudden policy shifts. Some policies have unanticipated consequences. During the 1990s, tough stances on pegged exchange rates adopted to hold down inflation sometimes triggered an outward rush of financial capital. Evidence suggests that investors thought the stances couldn't last because they were too tough. Tactics differ. To fight inflation, some countries have adopted specific targets, which some evidence suggests helps reduce inflation and its volatility.⁹

Is Latin America saying adios to market-friendly reforms? It doesn't look like it—left-leaning election results notwithstanding. The retreats have been limited to a few countries and a small segment of the overall population. Elsewhere, the region largely retains market reforms, while some countries continue to move forward, albeit cautiously. Economic performance shouldn't be a stumbling block. The World Bank projects healthy growth in the region—4.8 percent in 2007 and 4.3 percent in 2008. Few countries will have reason to question the effectiveness of market-oriented policies, making it less likely the contagion of a Chavez or Morales will spread.

Still largely poor by U.S. and European standards, Latin America can't escape the fact that left-leaning policies have historically been a drag on growth.¹⁰ Although they sometimes roil enterprises, industries and even economies, market reforms offer the region a chance to better itself, particularly in an era of globalization, when isolation leads to stagnation. The slow pace of Latin America's market reforms in recent years is cause for concern, leaving the region's market advocates looking for ways to restore the momentum of the 1990s.

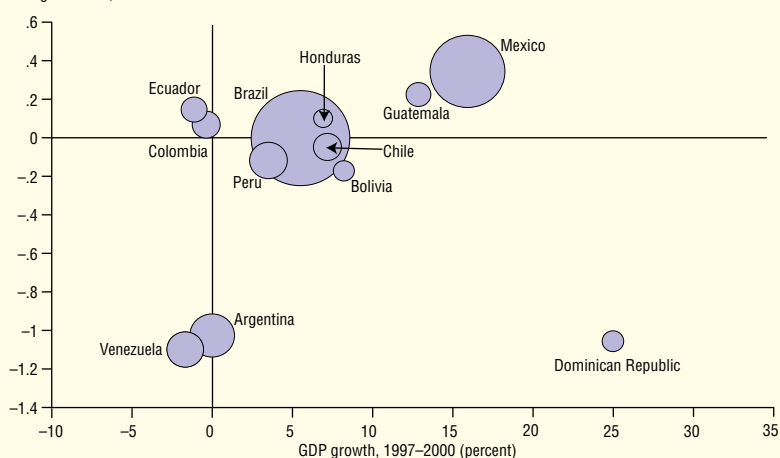
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Chart 6

Does Slower Growth Sap Economic Freedom?

Fraser Index

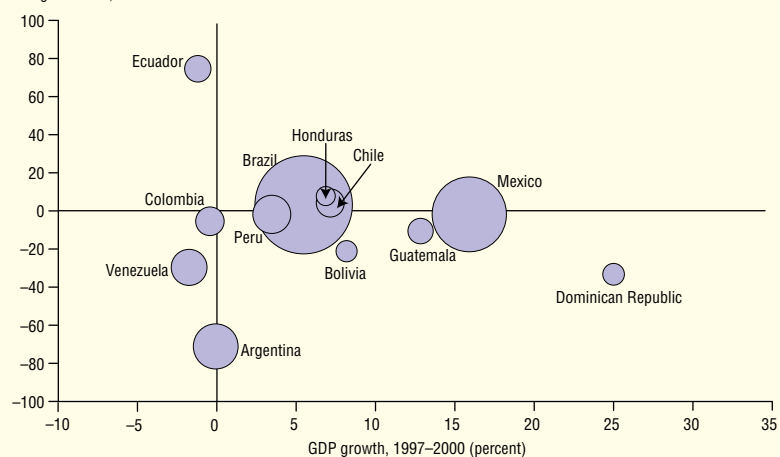
Change in index, 2000–04



SOURCE: Fraser Institute, *Economic Freedom of the World: 2006 Annual Report*.

Heritage/WSJ Domestic Index

Change in index, 2000–05



SOURCE: The Heritage Foundation/Wall Street Journal 2007 Index of Economic Freedom.

NOTE: Population determines bubble size.

Notes

The authors thank Genevieve R. Solomon and Julia K. Carter for their research assistance.

¹ The term *Washington Consensus*, coined by John Williamson of the Institute for International Economics, refers to the advocacy of market-oriented policies at such Washington-based institutions as the World Bank, International Monetary Fund and Treasury Department.

However, Joseph Stanislaw and Daniel Yergin, authors of *The Commanding Heights*, contend the policies were developed “in Latin America, by Latin Americans, in response to what was happening both within and outside the region.”

² Pro-socialist web sites present the election results as prima facie evidence of a welcome shift to the left. Some conservative web sites find these same elections prima facie evidence of an unwelcome shift to the left. See http://weblogs.elearning.ubc.ca/leftturns/2006/10/about_this_blog.php; http://hurryupharry.bloghouse.net/archives/2007/01/15/kirchner_boycotts_ahmadinejad.php; and <http://www.zmag.org/Sustainers/Content/2003-05/19adamovsky.cfm>.

³ *Economic Freedom of the World: 2006 Annual Report*, James Gwartney and Robert Lawson, Fraser Institute, www.freetheworld.com. To avoid distortions from changes in the index's components over time, we used the institute's chain link index, which maintains the same components from year to year. Fraser dates the index based on year of publication. We have used the year that applies to most of the index's underlying data; thus, Fraser's 2006 scores are for the year 2004.

⁴ Most of the smaller Latin American countries showed only small changes in their Fraser scores. Among the exceptions were Belize and Panama, two nations relatively strong on economic freedom that posted significant gains between 2000 and 2004.

⁵ The Heritage Foundation/Wall Street Journal 2007 Index of Economic Freedom, www.heritage.org. Heritage/WSJ dates the index based on year of publication. We have used the year that applies to most of the index's underlying data; thus, the 2007 scores are for the year 2005.

⁶ Analysts who emphasize the role of globalization sometimes fail to appreciate the importance of domestic policies in a global context. Bottlenecks in the nontradables sectors, for example, constrict Mexico's expansion in tradable goods

production. See “NAFTA and Mexico's Less-Than-Stellar Performance,” by Aaron Tornell, Frank Westermann and Lorenza Martinez, National Bureau of Economic Research Working Paper no. 10289, February 2004.

⁷ El Salvador, a smaller Latin American country not discussed in this article, reduced the time to start a business from 115 to 26 days.

⁸ Venezuela's Fraser scores were 5.5 for 1990, 4.2 for 1995 and 5.5 again for 2000. The country's score was 4.4 for 2004. Higher scores indicate greater economic freedom on a 1–10 scale. Comparable Heritage/WSJ data aren't available for 1990, but our domestic index for Venezuela is 4.8 for 1995 and 5.57 for 2000. It is 5.06 for 2005. Higher scores indicate greater economic freedom on a 1–10 scale.

⁹ Our analysis of Latin American economic policies covers the relatively brief period since 2000, a time when doubts arose about the region's economic reforms. We find no link between growth and policies. Longer-term analyses, however, show that declines in competitiveness, a policy-related concept, tend to slow growth in Latin America and increases in competitiveness tend to increase growth rates. Better policies seem to foster growth. See “Latin America in the Rearview Mirror,” by Harold L. Cole, Lee E. Ohanian, Alvaro Riascos and James A. Schmitz Jr., National Bureau of Economic Research Working Paper no. 11008, December 2004.

¹⁰ Chavez's Venezuela had strong economic growth in recent years, fueled by government spending and financed by rising oil revenues. Despite price controls, inflation remains high—17 percent in 2006, the highest in Latin America. Despite exchange controls, the currency has lost value. Shortages of basic goods have angered consumers and created headaches for producers. Oil production has faltered, although Venezuela remains the world's fifth-largest producer. Little investment is being made in the industry, and key managers and workers have left the country.

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