Introduction
Vision for Latin America 2040
Achieving a More Inclusive and Prosperous Society

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Region's Natural Endowments and Strengths

Latin America is arguably the most richly endowed developing region of the world. With vast areas of fertile land, plenty of sunshine, and abundant water resources, it stands in stark contrast to most developing regions including Africa, East, Central and South Asia as well as the Middle East, which are increasingly threatened by water stress and shortages. In addition, Amazonia has the largest remaining rainforests in the world, an intensely valuable natural defence against the threat of climate change. The harvest of its oceans, such as tuna and shrimp, is highly desired by people throughout the world. And, its abundance of mineral resources including oil, gas, copper, silver, and coal is also eagerly sought by both developed and developing countries, especially in fast growing Asia.

The region also enjoys a number of other crucial advantages that facilitate economic development and social progress. With over two hundred years of independence and self-governance, compared to Asia and Africa which achieved independence from colonial rule only after 1945, Latin America has had plenty of time to build on the institutions left by Europeans. A majority of people share a common history, language, culture and religion. There is widespread pride in being a Latin American. Furthermore, the countries enjoy strong historic ties and physical proximity to the world's two largest markets, North America and Europe.

Photo Credit: CAF

Throughout the twentieth century and continuing today the region has been building modern physical and institutional infrastructure at national and regional levels, to leverage these natural advantages. Since the 1960s the region has also invested in regional infrastructure such as the Pan American highway, linking Mexico in the north to Chile in the south (90 percent complete) and the regional hydro-electrical complexes in the Southern cone. It has set up numerous regional and sub-regional institutions and coordination mechanisms.

The strong natural advantages, proximity to, and close business ties with, North America and

Europe, and relatively advanced institutional and physical infrastructure had made Latin America the most prosperous developing region by a wide margin.

Until the late 1970s, the region enjoyed economic growth above the global average, and appeared to have great promise. Income levels compared to the United States rose from 12 percent in 1970 to 17.7 percent in 1981. In 1980, Latin America's per capita GDP was US$7,474 compared to US$789 for East Asia, US$1,798 for Sub Saharan Africa and US$4,708 for the Middle East and North Africa.[1] As Latin America's per capita income steadily rose, by 1980 most Latin economies joined the ranks of middle-income societies—well before Asia—and appeared to be steadily closing the remaining income gap with the developed countries.

Consequently, until the late 1970s Latin America was generally regarded as the developing region with the greatest promise, while Asia was not only the poorest region but also judged as both socially and politically fragile.

Recent Economic and Political Developments

After suffering repeated economic crises from the 1970s to the early 2000s, Latin America, along with most other regions, entered a new era of economic progress and robust growth during the past six years. This improved economic performance has generated a welcome combination of self-satisfaction and optimism in the region after almost two decades of pessimism. The following indicators illustrate the recent progress:

- Despite expected major variations between countries, the region as a whole enjoyed an average annual economic growth of 4.7 percent between 2003 and 2008, the highest growth recorded since the 1970s. With slowing population growth, this yielded a per capita income growth of 3.4 percent a year.
- Unlike previous periods of high growth, the latest episode was not accompanied by higher inflation or external imbalances. This hard won price stability should yield major benefits over the longer term through increased consumer and investor confidence, hopefully leading to higher savings and investments rates (provided that they are accompanied by improvements in business climate and deepening of financial systems).
- During these six years, good progress was achieved in another major social and economic problem plaguing the region: huge disparities in incomes and living standards. Between 2003-2008, there was a noticeable decline in absolute poverty and a reduction in inequities in many countries including the two largest economies, Brazil and Mexico.
- The region as a whole has weathered the latest global economic and financial crisis reasonably well though Mexico and some countries in Central America have been very hard hit. Unlike the OECD countries and some developing regions (such as Central and Eastern Europe), overall Latin America suffered a much more modest slowdown in economic activity. Its financial systems withstood the storm quite well. Many countries, led by Brazil, are already on their

1 Using constant 2005 US$

way to recovery though some countries are still suffering the ravages of the Great Recession.

All in all, the region can derive much satisfaction from its economic performance since 2003 (with Mexico being a major exception). An important factor behind this performance was the very positive global economic environment through 2007—including the expansionary monetary policies adopted by most major economies—under which the world enjoyed several years of unprecedented —and one might say unsustainable—prosperity, booming international trade and private capital flows. Higher global growth in turn contributed to record commodity prices. This favourable global economic environment in turn helped fuel Latin America's growth. At the same time, domestic policy reforms during the 1990s (which led to prudent monetary and fiscal policies, more realistic exchange rates, stronger regulation and supervision of banks) played a critical role in keeping inflation low and removing vulnerabilities.

Having finally secured macro-balances and price stability that had eluded it for so long, the region can now focus on policies and issues important for its longer-term growth and well being. This is the focus of this book.

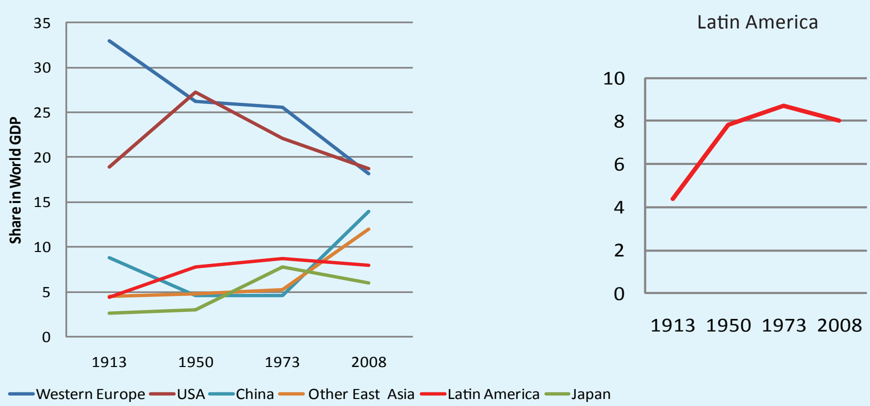
Longer Term Performance and Comparison with East Asia

The above-noted progress in absolute terms during the past few years is both real and laudable. But, it must not obscure the fundamental longer-term trends and issues.

A review of Latin America's longer-term performance paints a much more sombre portrait. It portrays a region that has essentially been stagnant relative to the rest of the world through the 1990s and only keeping pace with others since then. It is a region that suffers the highest disparities in the world, and that is steadily losing, and may have already largely lost, its long standing position as the world's most advanced and prosperous developing region. Consider the following facts:

- In 1965, Latin America accounted for 5.6 percent of global GDP. Forty years later, in 2005, it still had only 5.7 percent (at market exchange rates). In other words, while Latin America's per capita income rose between 1965 and 2005 by 136 percent, so did it for the world as a whole, leaving the region no better in relative terms after forty years. Latin America's income level has similarly not converged with that of the United States (it was 12.9 percent that of the US in 1970 and 13.5 percent in 2009).
- In general, the ups-and-downs of Latin America's importance in the world economy have followed the cycles of commodity prices rather than reflecting sustained self-generated development.
- In 1981, Latin America accounted for 31 percent of developing country GDP. In 2009, Latin America's share of developing country GDP had dropped to only 20 percent.
- In 1981, Brazil and Mexico were each one-third larger than India or China, and Argentina had the same GDP as Indonesia, a country with almost six times the population. By 2009, Indonesia's GDP was 50 percent larger than Argentina's, and India's one-third larger than Mexico. Today, China is almost 50 percent larger than all of Latin America combined.
- Brazil and Mexico were the two largest emerging economies in 1980. Latin America had 4

Figure 2 **Share of Regions/Countries in World GDP**



Source: Madisson, A, 2004.

countries in the top ten list. Today, 7 of the top ten emerging economies are in Asia. Argentina and Venezuela have dropped off the list altogether. Now, only Brazil (#2) and Mexico (#4) are on the list.

- In contrast, successful Asian countries—the NICs, China and India—continue their unrelenting march towards converging with the developed economies. For example, in 1965 the per capita income of NICs was 10.2 percent of the US and by 2009 it had reached 47.1 percent. China has risen from 0.8 percent to 7.7 percent.
- Perhaps the single most troublesome longer-term issue is that LAC has been the most prosperous developing region for almost a hundred years, but it suffers from the highest disparities of income, even higher than in Africa. Despite the recent progress cited above, the disparities today essentially remain as large as forty years ago. These disparities are a hidden and ticking time bomb that can destroy the very social and political fabric of the region.

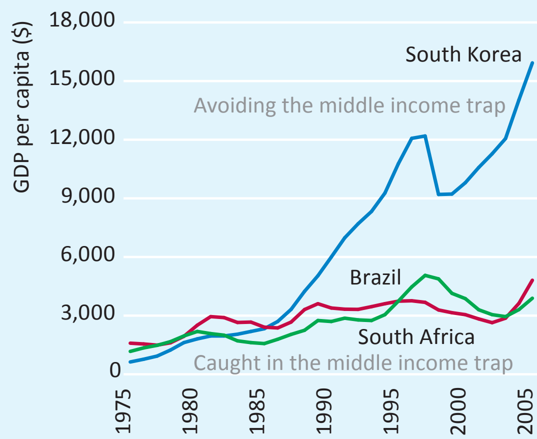
There are two basic messages here. First, most countries in Latin America—with the exception of Chile—have stopped converging with the United States (in the last few years Brazil has regained growth momentum but it is too soon to say whether this is a longer-term trend). Second, Latin America is gradually but steadily surrendering its leadership of the developing world to Asia.

Are Latin American Economies Mired in the Middle-Income Trap?

The inability of the Latin American economies to further close the productivity and income gap with developed countries during the past forty plus years suggests that the region has become mired in the "middle income trap" (Box 1). Their persistent subpar performance is in sharp contrast to that of most Asian economies.

Box 1 **What is the Middle Income Trap, and how did some East Asian Countries Avoid it?**

The middle income trap refers to countries stagnating after achieving middle income status and not growing to advanced country levels. This is illustrated in the figure, which plots the income per capita of three middle income countries between 1975 and 2005. In a steadily growing country, the line would be continuously rising over time (positive growth), that is towards higher income levels. That is the experience of South Korea.



But many middle income countries do not follow this pattern. Instead, they have short periods of growth offset by periods of decline. Rather than steadily moving up over time, their GDP per capita simply moves up and down. That is the middle income trap—unable to compete with low income, low wage economies in manufacturing exports and unable to compete with advanced economies in high skill innovations.

Asia's recent superior performance can be explained by many "technical" aspects, such as its much higher savings and investment rates, better human development, export orientation, better global competitiveness and cost of doing business rankings etc. However, we believe that Latin America's fundamental problems arise from deeper structural weaknesses, lack of an effective long-term development strategy, past focus on short-term issues and, above all, an ideological approach to policy.

Few countries sustain high growth for more than a generation, and even fewer continue high growth rates once they reach middle-income status. Some features differentiating growth beyond middle income from growth from low-income to middle income are clear. Growth tends to become more capital intensive and skill intensive. The domestic market expands and becomes a more important engine, especially for growth of services. Wages start to rise, most rapidly for highly skilled workers, and shortages can emerge. The traditional low-wage manufacturing for export model does not work well for middle-income countries. They seem to become trapped in a slow growth mode unless they change strategies and move up the value chain. Cost advantages in labour-intensive sectors, such as the manufactured exports that once drove growth, start to decline in comparison with lower wage poor country producers. At the same time, middle-income countries do not have the property rights, capital markets, successful venture capital, or critical mass of highly skilled people to grow through innovations as affluent countries do. Caught between these two groups, middle-income countries can become trapped without a viable high-growth strategy.

This seems to be what has happened to Latin America. In many countries, wages are too high to be globally competitive in basic manufacturing. The collapse of Latin America's garments producers after protection was withdrawn is proof of that. Yet, Latin America does not have the research and development capabilities that allow it to develop new products in advanced areas (exceptions are by now familiar: Embraer in Brazil).

Photo Credit: Ahunt

Importance of the Middle-Class in Fuelling Growth

In some middle-income countries, the domestic market can complement export markets as the economy matures and the local market becomes large. In most countries, domestic consumption typically starts to grow quickly when incomes per capita reach around US$6,000 in PPP terms. This did not happen in Latin America, perhaps because of its relatively small middle class.

Compare Brazil with South Korea, for example. Brazil's growth started to slow after 1980, when it had reached a per capita income level of US$7600 (PPP). At that time, its middle class, defined as households with incomes of between US$10 and US$100 per capita per day, was just 29 percent of the population. This made it impossible for the middle-class to drive further growth. In contrast, South Korea's income per capita reached US$7700 (PPP) in 1987. By that time, South Korea's evenly distributed growth had produced a sizeable middle class, which accounted for 53 percent of the population. The country capitalized on the demand from this large middle class to grow its service industries and create the building blocks for a knowledge economy. Today 94 percent of Korea's population is middle class.

The middle class can provide an impetus for growth in ways other than just consumption demand. For example, the middle class typically values and demands a high-quality education for their children. The causal channel is less important than the suggestion that distribution plays an important role in sustaining growth.

What Makes East Asia Different from Latin America?

Latin America's loss of its long standing position as the most prosperous and promising developing region is best illustrated by comparing its economic and social development relative to East Asia in general, and the so called NICs more specifically.

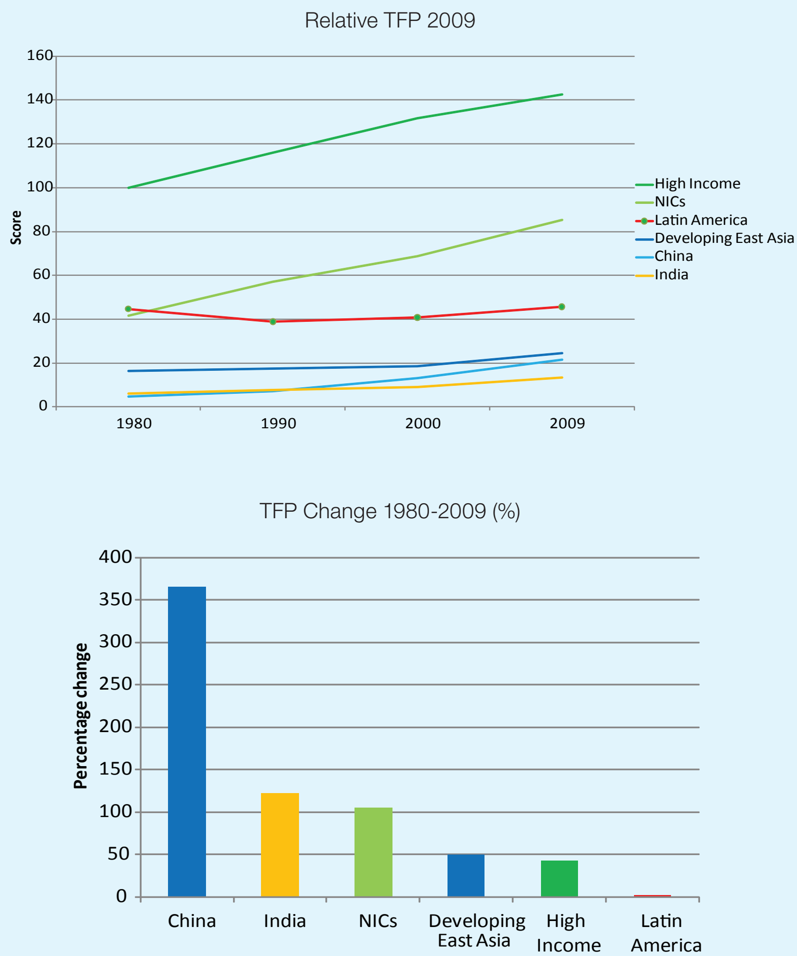
Between 1965 and 2009, the per capita income of the NICs grew at an average annual rate of 6.8

percent, while Latin America recorded a growth rate of only 3.7 percent. As a result, in terms of per capita income, the NICs—that lagged well behind Latin America in 1965 (US$1,778 vs. US$3,403)—leapfrogged over the region (US$20,308 vs. US$7,028) in 2009[2]. This illustrates how the most dynamic economies in Asia, now joined by China and India, have continued to converge with the most prosperous nations, while most Latin American economies have become mired in the middle-income trap. Other striking differences between East Asia and Latin America include:

- Political leaders in East Asia are intensely focused on economic issues and are not preoccupied with geo-political issues or ideological debates. This is in sharp contrast to Latin America.
- All successful East Asian countries, as well as China and India, have achieved major gains in total factor productivity (TFP) while Latin American countries have remained stagnant. The two largest economies (Brazil and Mexico) have even regressed somewhat (Figure 2).
- East Asian countries have much higher savings rates (51 percent vs. 23 percent of GDP) and investment rates than LAC.
- East Asia has placed much greater emphasis on human development and put a high premium on meritocracy in its education system. It has achieved, in relative terms, much higher educational standards, and graduates a significantly higher number of engineers, scientists and doctors than Latin America.
- East Asia's investment, public as well as private, in infrastructure has been much higher than in LAC, and it has deeper financial markets, particularly non-bank financial institutions.
- NICs have much more open economies than Latin America, with total trade to GDP ratios of 159 percent vs. 41.5 percent for LAC.
- The structure of production in East Asia has changed dramatically in the past forty years with the region becoming the manufacturing hub of the world, while Latin American economies remain highly dependent on commodities and agricultural products.
- Even as East Asian economies moved from low-income to middle-income and finally to upper middle-income status their income distribution and other social indicators have remained much more equitable, while Latin America continues to suffer from the highest disparities of any region in the world.
- East Asia's more equitable distribution of incomes and assets allowed it to develop a large middle class as soon as the countries achieved middle-income status and this fast growing middle class in turn gradually became an engine of innovation, entrepreneurship and domestic consumption that fuelled further economic growth. In contrast, Latin America's policies were ungeared at developing a strong middle class, but at extracting resources from there through high inflation, expropriation of financial assets and generally poor incentives for savings at an individual level.
- Intra-regional trade (over 55 percent of total trade) and investment (FDI) flows in East Asia

2 In constant 2009 US$

Figure 3 **TFP, Relative Levels and Changes During 1980-2007 (%)**



Source: Estimates by Homi Kharas - 2009

approach European Union levels and are much higher than in Latin America (around 20 percent, excluding the US). Unlike the EU, these flows are market- and not policy-driven thanks to extensive production networks developed by private businesses. Latin America has few if any such production networks (except between Mexico and the US).

Latin America in 2040: Under "Business as Usual" Scenario

How would Latin America look if the trends of the recent past were to persist over the next thirty years?

According to our model of the global economy, under the "business as usual" scenario, Latin

America would grow at about 4 percent a year, and less than 3 percent on a per capita basis. The region's share in world GDP would decline from about 6 percent now to 4.8 percent. Its per capita income in 2040 would be US$18,000, compared to the average global GDP per capita of US$24,000. As a result, three developing regions of the world—East Asia, the Middle East and Central and Eastern Europe—will be more prosperous, with Latin America joining Africa and parts of Asia as the laggards. Equally important, Latin America could continue to have by far the highest disparities between its citizens. Most likely, these conditions will further exacerbate the law and order situation and perhaps lead to unacceptable levels of social unrest and crime.

Chile is the only Latin American country in the sample to meet the criterion for inclusion in the "convergers" category of having a track record of at least 3.5 percent per capita income growth over the past twenty-five years, at least prior to the recent earthquake, and as recognized by its accession to the OECD.[3]

But Brazil, Mexico and other Latin American countries do not meet the criterion. What is shown in the business-as-usual scenario is what would happen if they continue down a path of relatively low TFP growth and relatively low capital investment. This scenario is presumably unacceptable to the region's political, social, business and intellectual leadership, and to its citizens at large.

Latin America in 2040: Payoffs from Reducing by Half the Growth Differential with Asia

On the other hand, what would be the economic and social outlook of the region should it manage to narrow the historic difference in its growth rate with that of Asia?

While it is not realistic to assume that Latin America can suddenly grow at the same rate as the leading economies—China and India—we have developed a scenario under which the region cuts by half its current differential with East Asia (and China and India) and lifts its growth to about 6.5 percent a year between now and 2040 (we assume that two large and two medium-sized economies would manage to escape the middle income trap and move from being non-convergers to join Chile in the convergers category).

Photo Credit: CAF

Under this scenario, the size of the region's economy by 2040 would be four times its current size. Its share of global GDP would rise to 10 percent, not including a possible impact of a secular appreciation of the currencies of the region on

3 It is important to point out that Mexico is also an OECD member, and has been characterized recently by a non-converging performance.

the basis of increases in productivity. This will allow the region to retain its position as one of the most prosperous developing regions (though this will still not allow the region to catch up with the NICs).

If Latin America can develop along such a "prosperous scenario", it would sharply reduce poverty within 20 years. Currently, under the World Bank's US$1.25 a day poverty threshold, the region had some (60) million poor in 2008. If the region sustains income growth at 6.5 percent, some 3 million people could be lifted out of poverty every year. Equally important, as discussed below, this higher economic growth can be achieved only by successfully tackling the current inequities. This success, combined with rising average per capita income, would bring a much greater sense of optimism and commitment to shared prosperity amongst all segments of society. It is the only way to ensure social cohesion and peace in the region.

The region's leaders and public must embrace and strive for this scenario of a more equitable and prosperous Latin America. Only then will the region continue to close the gap with OECD countries and keep pace with the successful Asian economies.

A Shared, More Ambitious Vision for the Region

Given Latin America's rich natural endowments, there is no reason why Latin America cannot do as well as East Asia. Indeed, as demonstrated by the successful Asian countries, the region's destiny is firmly dependent on its own actions. Only through its own efforts will the region prosper.

Photo Credit: CAF

To do so, all concerned—governments, bureaucracy, the business community, academia, think tanks, media and other opinion makers as well as multilateral agencies active in the region—must adopt a focus on simultaneously achieving a much more inclusive and equitable society and much higher economic growth. The region's leaders must aim much higher, be pragmatic and focus single-mindedly on achieving this vision.

Such a vision, and a commitment to realizing it, must be shared both within the countries themselves and across the region as a whole. This commonly shared vision must be accompanied by a very different mindset across the political and social landscape: abandonment of the past ideological divides and adoption of pragmatism, as has been the case in East Asia.

A main characteristic of the economic history of Latin America has been the emphasis on ideology and ideological policies, as opposed to Asia's emphasis on outcomes. In the past, policies have been formulated on the basis of economic theories under the assumption that results would follow automatically over time. Over the last quarter century two schools of thought have prevailed. According to both the standard reform-oriented Latin American model and the alternative heterodox model, if policies are right, growth will follow ultimately. In the first case the assumption is that markets will provide an adequate response to policies. The heterodox model questions the market approach of the Washington Consensus but also assumes that the alternative interventionist policies will yield growth and equity. Under both ideological camps, no significant modification of policies was considered irrespective of the results. More often than not, popular support for the policies collapsed over time because of the ideological adherence to a rigid interpretation of what would be the "right" economic model and policies even when they failed to produce expected results, mainly because of a narrow interpretation of the models.

A major lesson of the Asian success in the past fifty years is that Latin America needs to pursue a more pragmatic and non-ideological set of policies, based on strong market principles and measured government intervention, but with the understanding that the policies should be aiming at attaining commonly agreed social objectives and economic outcomes. Under this pragmatic approach, policies and the right mix of government-private sector association would be adjusted as needed to realize the outcomes sought under the shared vision (while respecting the principles of good governance, transparency, and with a good understanding of the costs of these policies).

Of equal importance, there must be a consensus on policies and objectives within the region to achieve effective complementarities between individual economies by helping integrate across the region. This is in contrast to the current practice, where polices in one country are often introduced at the expense of others rather than seeking to exploit the comparative advantages of each country for an effective integration with the rest of the world.

Realizing the Shared Vision

Given the diversity of the region and differing resource endowments, human capital, structure and efficiency of individual countries as well as vastly differing institutional capacities, it is neither prudent nor possible to lay out a detailed strategy for achieving this common vision across the entire region. That can only be done at the level of each individual country.

However, learning from the region's own experiences in the past forty years and contrasting them with East Asia, it is possible to define the broad contours of the strategy required to achieve this more ambitious vision. In our view, to realize the above vision Latin America needs to adopt a strategy that comprises three complementary pillars:

- More inclusion

- Higher productivity
- Greater competition and openness (within Latin America and towards Asia)

Importantly, actions under these three pillars will need to be underpinned by improved governance and accountability for results.

Achieving a More Inclusive Society

Latin America has recently made important strides in improving the conditions of its poor. Nonetheless, income and wealth distribution remains highly skewed. Politically and socially the current situation is unsustainable over the long term. Tackling structural inequities is therefore obviously essential from the point of view of equity. But, as demonstrated by Asia, achieving a more equitable society is equally relevant to sustaining growth over the longer term by expanding the size of the middle class and attaining greater equality of opportunities.

With significant numbers of Latin Americans not fully integrated into the mainstream economy and society (indigenous Americans, Afro-Americans and women) and with current high degrees of informality, in the past the benefits of economic growth have not reached large segments of citizens. This particularly affected those without European ethnicity and women, leading to the disillusionment of large portions of the population with the current economic policies and institutions. Only when growth is much more inclusive, will there be realistic prospects of high sustained and sustainable growth over time for Latin America, as has been achieved in Asia.

Thus, striving for a more inclusive society promises a win-win situation, and not one where there is a trade-off between growth and equity. The fundamental approach to achieving a more inclusive society will involve the removal of numerous current structural inequities by:

- Providing access to quality education and other public services including rural infrastructure,
- Breaking the current economic dominance by entrenched vested interests, and
- Ensuring jobs and finance to those who are today left at the margins of the society.

Such an approach must be clearly additional to the ongoing efforts in countries such as Brazil and Mexico that have been generally successful in reducing poverty and indigence.

Towards this goal, this book focuses on four priority areas: i) basic and secondary education; ii) infrastructure; iii) "inclusive" innovation and technological development; and iv) governance.

This list is by no means comprehensive but, in our view, includes the most critical issues requiring immediate attention by the region's political leaders and policy makers.

At the same time, Latin America must pay much more attention to the looming problems of environmental degradation, rising crime, and corruption. These issues, however, are not covered in this book.

Sharply Enhancing Productivity

The key to achieving a higher growth rate on a sustainable basis and to converging with the developed economies lies in sharply enhancing productivity and competitiveness of Latin American economies. Unfortunately, as noted above, the region has not been able to improve its total factor productivity.

Indeed, the two larger economies—Brazil and Mexico—have even regressed. This must be reversed.

Improved productivity and competitiveness would in turn help Latin America to achieve much higher economic growth than it has managed in the past forty years (or even the last five years), while loosening the historic dependence of its economic fortunes on the ups and downs in international commodity prices. This will require much more emphasis on:

- Improved human capital,
- Better business environment,
- Much higher investment rates necessary to transform the structure of production of goods and services in light of the changing global economic environment, and
- More innovation and technological development.

In our view, a better business environment is the key to unlocking the virtuous cycle of greater efficiency and competitiveness, higher business confidence, increased private investment, higher domestic savings and improved productivity. India's recent higher investments, savings and the resultant economic growth rates can be traced back to the major economic reforms undertaken starting in 1990 that significantly improved the business climate. With most of Latin America is finally enjoying macro economic stability, improvements in the business climate could add equally impressive results albeit with some time lag.

Again, without attempting to be comprehensive, this book presents suggestions in three priority areas: i) infrastructure (particularly physical connectivity and energy); ii) tertiary education, innovation and technological development; and iii) governance.

Promoting Greater Competition and Openness to Neighboring Economies, Towards Asia, and to Global Economy

The third pillar of the new strategy for the region should be the promotion of much greater competition, both in internal markets and with external sources. Given the relatively smaller share of trade in total GDP, Latin American countries must give the highest priority to enhancing domestic competition, starting with dismantling of monopolies—whether public or private—and enforcement of well-structured competition laws. In parallel, there is a need to promote and facilitate much greater openness to other countries in the region, closer links with fast-growing Asia that is emerging as the new center of gravity of the world economy, and dismantling of remaining barriers to trade and investment with the global economy as a whole.

For many decades, Latin America was characterized by an overwhelming presence of government in economic activity (as was the case in many other regions of the world), well beyond a regulatory role. The situation changed dramatically starting in the 1970s in Chile, and in subsequent decades in many countries including Argentina, Brazil, Colombia, Mexico, and Peru. Most importantly, during this period there was a major effort at privatizing many activities that were not considered as central to the role of the state or of strategic relevance. There were many different methods pursued for the sale of government assets, some of them seriously flawed. In some circumstances, public monopolies were replaced by private monopolies. Several industries continue to be dominated by one or very few companies and, frequently, the dominance in the market is accompanied by restrictions on imports of goods and services, or limitations to investment in specific areas, and thus helps consolidate the monopoly power of the companies. Improved domestic competition thus remains a work in progress in the region. While it is beyond the focus of this book to deal in depth with the specific area of domestic competition, the consolidation of the competitiveness and productivity aspects of economic policy rest in significant part on the opening of markets. A further push in the process of privatization, of improved regulations and opening of markets, as well as government sector productivity enhancements would go a long way in helping the region in attaining a more effective growth path in the future.

In parallel with measures to enhance domestic competition, Latin American economies must also pursue two avenues to improve their trade performance in support of accelerated growth: regional cooperation leading to expanded intra-regional trade; and continued diversification of export markets beyond North America and Europe and of export products beyond the dominance of commodities and fuels (except in the case of Mexico).

Latin America lags far behind Europe and Asia in regional cooperation, particularly as measured by intra-regional trade. There are three basic reasons for which the Latin America region should seriously consider significantly enhancing intra-regional trade, including through improved regional cooperation: i) to permit the economies to specialize, an important strategy to escape the middle income trap; ii) to overcome the reality that Latin America economies—with the exception of Brazil and Mexico—are small by global standards and thus do not have domestic markets large enough to permit the economies of scale needed by firms to be globally competitive; and iii) to allow local firms to take advantage of their superior knowledge and understanding of the needs of customers in the neighboring countries compared to the competitors from other continents.

Latin America must gradually reduce its dependence on the slow-growing economies of North America and Europe and develop much closer ties with the world's fastest growing region: Asia. The region also stands to make significant gains by increasing the value-added of its output and exports and, within manufacturing, to move up the technology ladder—a critical measure for getting out of the middle income trap and making progress toward high income status. Finally, dismantling of remaining barriers to trade with and investment from the global markets as a whole will be a very powerful vehicle to curb the current monopolistic power of large companies, to increase competition at all levels, and to spur innovation. This book includes specific suggestions actions in these areas.

Improved Governance: Focus on Results and Accountability

As with many developing economies, Latin America's Achilles heel is its poor governance in all its facets. Indeed, this overarching issue is the biggest hurdle to Latin America achieving a sustaining a more inclusive society and higher economic growth rate over the next thirty years.

A closer look at each and every crucial issue facing the region reveals that the most underlying problems are rooted in poor governance, and that without fundamental improvements in governance it will not be possible to tackle these issues effectively.

Most political scientists equate good governance with democratic governments. In our view, while a democratic political system is indeed highly desirable and Latin America has made marked progress in that direction, governance comprises of many facets that go well beyond the political system. The various facets of governance are intertwined with each other like pieces of a jigsaw puzzle.

Our own definition of governance comprises all facets of governance that affect economic management: role and focus of governments; importance given to economic and social development by the top political leaders and policy makers; delivery of quality and universality of basic public services (law and order, rule of law, education and health services); and focus on results and enforcement of accountability.

Specifically, Latin America must transform the following ten facets of governance in order to kick start the economies to achieve higher economic growth and make the societies much more inclusive:

- Make economic and social development the primary focus of the political leaders and policy makers, not just in words but also in reality
- Reverse the deterioration in political governance, while strengthening democratic institutions
- Make governments smarter, more focused and more credible
- Decentralize, where possible, both the authority and accountability for most public services to local bodies as close to the people as possible
- Modernize and make more effective all institutions involved in economic management
- Reform the civil service to meet the needs of modern economies and of democratic, more open and more inclusive societies
- Improve the quality, honesty and credibility of all public services including the police, judiciary, education and health services
- Actively promote and enforce competitive markets and prevent capture of state organs by big business
- Inculcate a code of self discipline and ethical behaviour within the business community
- Implement agreed policies and priorities, monitor results and enforce accountabilities at all levels of government (national, state and municipal).

Undertaking such a transformation of governance will require Latin American leaders to emulate the four characteristics that have distinguished East Asia from other developing regions:

- Sharp and primary focus of political leaders and policy makers alike on economic issues
- Ability to implement policy decisions
- Insistence on achievement of results on the ground, and
- Enforcement of accountability

These and other facets of governance are discussed in more detail in the relevant sections of the book.

Role of CAF

Advocating a More Ambitious Vision of Latin America:
CAF is in a unique position to help the region lift its sights and aim higher. It can fill a major void in the region that currently has no clear, ideologically-neutral and credible advocate for a more ambitious vision of long-term social and economic development of the region. Such a vision also must be anchored in a clear strategy on how to realize it.

CAF is well positioned to do this: it is the only multilateral institution owned exclusively by countries within the region (except for Spain); is the largest multilateral donor in its countries of operations; has a reputation for not being wedded to any particular ideology; has a well-deserved image of being a "friend" of the member countries; and its leadership has direct access to the top decision makers throughout the region.

CAF can and should help forge the needed consensus amongst top political, policy and business leaders of the region: that the current economic and social prospects are both unsustainable and unacceptable politically as well as socially; that the region needs to focus much more on higher, more inclusive and sustainable growth; and that to do so the countries must adopt different strategies and policies in addition to adopting a different mindset.

Towards that end, CAF should become a vocal and persistent advocate of this new and more ambitious vision of Latin America. CAF leadership would need to assume a leading role in this effort, starting with face-to-face meetings with the political leaders and key policy makers. A major short-term objective would be to help start a pragmatic, evidence-based and ideology-free dialogue on the region's economic performance amongst the top political leaders and decision makers in the region.

In addition, CAF could consider the following steps:

- Discussion of the proposed new vision at forthcoming meetings of the region's political leaders, policy makers and top business executives.
- Launching of a coordinated media campaign to educate general public and build a grass roost support for the proposed changes in strategy, policy and mind set.
- Creating a network of professionally led think tanks with necessary critical mass of experts and each focused on a few of the critical issues highlighted in this book. CAF supported think tanks would be regional—and not national—in their focus.
- Reporting to the heads of state at their regular Annual Summits on the progress being made by Latin American economies relative to other regions of the world as well as on any common social and economic agenda adopted by them.

Realigning CAF Operations to Above Strategy:
As a leading advocate of a new, more ambitious vision for Latin America, CAF must also align its own operations to help realize this vision. But, in doing so it must not stray away from two key reasons for its past success: remaining pragmatic and focusing its core agenda on activities in which it already has or can develop a comparative advantage.

Keeping these factors in view, CAF should carefully review its potential assistance under each of the three pillars of the proposed new strategy for the region: a) achieving a more inclusive and cohesive society; b) helping achieve and sustain higher productivity and economic competitiveness; c) and enhancing competition and openness, including through greater regional cooperation and openness to Asia.

In addition, CAF must give greater priority to environmental and climate change issues.

CAF operations already are aimed to achieve many of these adjustments. Therefore instead of starting anew, in many areas CAF will need to make only modest adjustments or put greater emphasis on some existing activities (e.g., infrastructure development and regional cooperation). But, there are also some areas that are not yet covered adequately by CAF and need to be added to the array of its core activities (articulation of a new vision for the region; addressing inequities; and promoting stronger links with Asia).

CAF should consider the following areas for particular emphasis under the above three pillars:

- *Achieving a More Inclusive Society:* Five priority activities fit well with CAF's existing strengths and should be emphasized more in its operations:
  - rural roads
  - 24/7 power supply to all
  - widespread access to the internet
  - low cost housing
  - micro-finance

In addition, CAF should consider adding two aspects of education that will involve only modest investment of CAF resources but could have a major impact on the quality of education in the region over the long term: a) training of teachers (including primary school teachers); and b) a program to systematically measure education quality at the primary, secondary and tertiary levels across countries. If the results from these activities are positive, over the longer term CAF could consider adding education to its core activities, as is currently the case with infrastructure and regional cooperation.

- *Sharply Enhancing Productivity:* Historically, this has been CAF's core area of focus, with heavy emphasis on infrastructure development.
  - The focus on infrastructure development should continue but with renewed efforts to assist the region increase overall infrastructure investment level to 4-5 percent of GDP, including through private sector participation
  - CAF's past excellent work on the region's competitiveness should be followed up with similar work at country level, and a special initiative to enhance the business environment on an urgent basis.
  - Two other new areas for CAF support should be considered to meet priority needs of the region: a) privately sponsored, funded and managed tertiary education institutions (professional colleges, universities) and vocational schools; and b) a network of technological research and development institutions and centers of excellence that also act as a bridge between the region's top universities and businesses.

- *Fostering Greater Competition, Regional Cooperation and Openness:* Fortunately, CAF is already both a leading advocate of regional cooperation in the region and a major source of financing for regional projects.
  - This traditional work should be reinforced by: a) regular analytic studies demonstrating benefits of regional cooperation; b) public advocacy of greater regional cooperation; and c) concrete support for initiatives to promote regional cooperation (e.g. above-proposed regional think tanks, networks of research and development centres.)
  - In the area of regional projects, CAF could focus more on projects that would: a) create physical connectivity between two or three countries at a time (roads, bridges, energy trade) rather than on Pan-American projects that require sustained political support and commitment from a large number of countries with different political philosophies; b) focus much more on trade logistics (border crossings, customs procedures); and c) create a network of ports and airports to facilitate trade along the Pacific within Latin America and with Asia.
  - CAF also needs to become a leading advocate of greater competition within the countries, stronger links with fast growing Asia, and of much greater openness to rest of the world and of.
  - Finally, CAF should act as an intellectual bridge between Latin America and Asia, perhaps by developing a closer institutional relationship with the Asian Development Bank.

Over time, as more and more countries put in place the above recommended reforms and the region achieves the much higher investment and domestic savings rates anticipated in this book, CAF may need to reconsider the volume of its own financial support—both to public and private sectors—to underpin and support the much higher investment levels and financial needs of the region. But, that should come after, and not before, the countries have improved their investment and savings performance through domestic policy and institutional reforms.