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Introduction: A New Approach to Growth in Latin America

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Before the eruption of the severe global economic and financial crisis in the third quarter of 2008, *all* of the countries of Latin America had been experiencing positive rates of economic growth for five consecutive years. Five years of continuous growth, with no economic or financial crisis, might sound unimpressive in a global context where even a deep crisis in East Asia in the late 1990s produced only a relatively short pause in an otherwise sustained path of rapid growth. But for Latin America, long known as the world's most economically and financially volatile region,[1] five consecutive years of generalized positive growth was an achievement not seen since the 1970s.

Although recent growth in GDP has indeed been high by the region's standards over the last three decades, growth in income per capita has not been suffi-

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1. See, for example, Hausmann and Gavin (1996), Caballero (2001), and Guidotti, Rojas-Suarez, and Zahler (2004).

Table 1. *Income per Capita in Latin America Relative to the Most Developed Countries, 1975–2005*
Percent[a]

Country	*1975*	*1980*	*1985*	*1990*	*1995*	*2000*	*2005*
Argentina	–36.0	–40.1	–55.0	–63.5	–55.2	–58.0	–58.8
Bolivia	–85.2	–87.2	–90.4	–91.5	–91.1	–91.7	–91.9
Brazil	–68.3	–65.8	–70.3	–73.3	–72.4	–75.0	–75.7
Chile	–79.7	–76.4	–79.0	–76.1	–68.3	–68.3	–65.3
Colombia	–76.0	–75.6	–77.4	–76.8	–75.3	–79.4	–78.9
Costa Rica	–67.3	–67.6	–74.0	–73.9	–71.2	–71.6	–70.6
Dominican Republic	–78.6	–78.5	–80.6	–81.9	–80.5	–76.9	–76.3
Ecuador	–82.5	–82.8	–85.2	–86.6	–86.8	na	–87.5
El Salvador	–73.3	–78.9	–83.8	–85.0	–82.6	–84.0	–84.8
Guatemala	–80.6	–80.0	–84.6	–85.9	–85.2	–85.9	–86.8
Honduras	–85.8	–85.1	–87.3	–88.6	–88.8	–90.0	–90.1
Mexico	–63.0	–59.9	–63.7	–68.0	–69.9	–68.1	–69.0
Nicaragua	–65.6	–79.1	–82.7	–88.4	–89.3	–89.2	–89.4
Panama	–73.4	–75.4	–75.9	–81.2	–78.8	–79.0	–78.0
Paraguay	–81.7	–76.8	–80.0	–81.5	–81.4	–85.8	–86.6
Peru	–69.6	–73.8	–78.2	–84.1	–81.9	–83.6	–82.6
Uruguay	–64.5	–62.1	–72.1	–70.8	–67.4	–69.5	–71.2
Venezuela	–58.0	–64.9	–73.3	–76.0	–75.7	–80.0	–80.9

Sources: United Nations Development Program and World Bank, *World Development Indicators 2007.*
a. Values are expressed as the percentage deviation of the indicated country's income per capita from average income per capita (in current dollars at purchasing power parity) among countries in the top decile on a social subindex of the Human Development Index (see footnote 5 in the text).
na = not available.

ciently rapid to reduce Latin America's income gap relative to other world regions.[2] Indeed, with a few exceptions, the gaps are widening not only relative to the most advanced economies, but also with respect to other emerging market economies at similar levels of social development.[3] Table 1 traces the evolution of this gap for individual Latin American countries relative to the world's most advanced economies in terms of social development (for example, on indicators of health and education). Table 2 does the same relative to countries whose social

2. See Birdsall et al. (2008) for an estimation of the gap in income per capita between developing regions and the countries of the Organization for Economic Cooperation and Development (OECD). Taking a long-term view, Pritchett (1997) established that the income gap between rich and poor countries widened significantly in the last century.

3. See Edwards (2007) for a historical analysis of economic growth in Latin America and a comparison with other emerging economies. The papers in Edwards et al. (2007) present analyses of economic growth from a historical perspective for a number of Latin American countries.

Table 2. *Income per Capita in Latin America Relative to Countries with Similar Social Development, 1975–2005*
Percent[a]

Country	*1975*	*1980*	*1985*	*1990*	*1995*	*2000*	*2005*
Argentina	18.4	5.1	−16.0	−36.3	−28.0	−34.1	−37.2
Bolivia	−6.5	−11.0	−27.6	−35.0	−34.2	−38.2	−44.2
Brazil	−32.6	−17.8	−3.0	3.8	15.3	18.1	15.4
Chile	−19.4	−8.2	−14.2	−5.9	6.1	7.5	12.7
Colombia	−29.3	−14.5	2.0	37.7	−5.9	−12.6	−18.6
Costa Rica	−39.5	−43.1	−51.5	−54.5	−53.6	−55.5	−55.2
Dominican Republic	−36.7	−24.6	−12.5	7.1	−25.5	−2.2	−8.4
Ecuador	−48.5	−39.7	−32.9	−20.3	−49.6	n.a.	−51.6
El Salvador	−43.1	−49.3	−47.1	−41.8	−27.2	−24.5	−27.8
Guatemala	22.9	38.9	16.0	7.4	9.7	4.8	−9.5
Honduras	−10.4	3.6	−3.8	−13.3	−17.0	−25.7	−32.0
Mexico	46.4	55.5	48.5	26.1	0.9	8.3	0.7
Nicaragua	−26.9	−49.8	−43.7	−54.9	−55.2	−48.9	−49.5
Panama	5.4	−4.4	−1.6	−26.0	−29.1	−28.8	−28.8
Paraguay	−27.6	−10.0	−18.3	−27.1	−37.7	−51.8	−56.5
Peru	−10.1	−8.2	−1.5	−6.0	−31.1	−30.6	−32.7
Uruguay	−34.2	−33.5	−48.0	−49.1	−47.6	−52.2	−56.2
Venezuela	66.3	36.4	9.0	−5.6	−18.6	−32.2	−37.9

Sources: United Nations Development Program and World Bank, *World Development Indicators, 2007.*

a. Values are expressed as the percentage deviation of the indicated country's income per capita from average income per capita (in current dollars at purchasing power parity) among a group of countries in the same decile on the social subindex of the Human Development Index as the indicated country (see footnote 5 in the text).

n.a. = not available.

development, as defined by the social components of the Human Development Index (HDI), is similar to that in Latin America.[4]

With the exception of Chile (and a slight improvement in the Dominican Republic), the last three decades have seen the gap in income per capita widen in all Latin American countries relative to the most advanced economies (the numbers in table 1 are increasingly negative). Some countries (such as Bolivia,

4. The HDI has three components, the first relating to health, the second to education, and the third to income. To group countries by level of social development, here we construct a social subindex formed by the first two components (equally weighted). The economies in the advanced group are those in the top decile of the constructed social subindex. Countries are categorized as having a similar degree of social development if they belong to the same decile of the social subindex (calculated for every year reported in table 2). In both tables, each number indicates the percentage difference between the indicated country's income per capita and the average income per capita of the relevant group of countries. Thus, a negative number implies that that country's income per capita is below the average income of the relevant comparator.

Ecuador, Honduras, and Nicaragua) have seen a steady deterioration in relative income per capita, while in others (such as Argentina, Brazil, Colombia, El Salvador, and Uruguay) some improvement took place in the early to mid-1990s but was later reversed. Of all the countries considered, Nicaragua's income per capita relative to that in advanced countries has deteriorated the most (by 24 percentage points) over the entire period, closely followed by Argentina and Venezuela (almost 23 percentage points in each).

A similar result emerges when we compare the Latin American countries with their peers in terms of social development. By 2005 only Chile and Brazil had achieved incomes per capita above the corresponding average for this group of countries. A closer look at individual countries reveals even more disappointing results. For example, Mexico, which by the mid-1970s had an income per capita well above the average for its peers, has been steadily losing ground ever since, so that by 2005 it had fallen back close to the average. Even more dramatic are the cases of Argentina, Guatemala, Panama, and Venezuela. In all these countries income per capita relative to their peers' average has declined significantly, from an above-average position in 1975 to a sharply below-average position by 2005.

The deep international financial crisis taking place at this writing raises increasing concerns about the sustainability of even the modest recent gains. Views differ on the relative ability of Latin America to weather the current crisis. Some analysts remain optimistic, arguing that the reforms and policy decisions of the last decade and a half in many countries in the region will help them absorb the adverse shock without drastic disruptions. These analysts recognize that Latin America will not be insulated from the global crisis and that the region's growth is almost certain to slow significantly, but they argue that the reforms and policies of the 1990s and early 2000s,[5] especially those that contributed to improved macroeconomic indicators—better fiscal positions, lower external debt, and large accumulations of foreign exchange reserves—will spare most countries in the region from a major crisis in their own economies.[6]

Other analysts paint a more skeptical picture. Without denying the benefits of the reform efforts, they argue that when properly measured to control for cyclical fluctuations (such as a temporary increase in fiscal revenue in many countries, due to temporary increases in commodity prices), fiscal stances in the region are not particularly strong on a permanent, "structural" basis. Indeed, the argument is that

5. Improved financial regulatory and supervisory frameworks, freer trade arrangements, and improvements in macroeconomic management are cited as key reforms.

6. Not even the most optimistic analysts, however, saw all countries in the same favorable position as of late 2008. For example, the majority of experts (optimistic and otherwise) viewed the weak fundamentals in Venezuela as self-generated problems that had been building long before the current international crisis.

in many countries, fiscal vulnerabilities to external shocks in the period 2003–07 remained practically as large as in the 1990s.[7] In this view the possibility of a serious crisis in some Latin American countries cannot be ruled out.[8] Despite these diverging views, experts find common ground in recognizing the enormous differences among countries in the region. For example, even analysts with opposite points of view regarding Latin America's prospects as a region praise Chile's domestic growth capacity as well as its ability to face sudden adverse external shocks. At the other extreme, a large majority of analysts do not find Venezuela's current economic, social, and political conditions to be conducive to sustainable growth.

This book tackles a complex issue that looks far beyond the current crisis: What can Latin American countries do to accelerate economic growth while ensuring its sustainability? The issue is complex because many countries in the region have already undertaken a significant number of reforms and policies in a variety of areas, yet positive results, in terms of rapid and sustained economic growth, have remained for the most part elusive. An additional, and perhaps more important, complexity arises from the fact that large segments of the population, deeply discontented with the results of market-based policies, are unwilling to support additional efforts at reform. As will become evident throughout the book, "inaction," "paralysis," and "impasse" are terms frequently used to describe the current state of problems facing a number of countries in the region.

A large and growing literature, briefly discussed below, already examines both the theory of growth acceleration and the diagnostics of growth in developing countries; there are, in addition, a host of empirical studies of Latin America as a whole and of specific countries.[9] What, then, does this book add to the discussion? In a nutshell, this book's major contribution is twofold. First, it approaches the subject matter by developing a straightforward and simple analytical framework *especially designed for Latin America.* Second, and related to the first, it uses this framework to advance specific policy recommendations for a

7. Among supporters of this view are Izquierdo, Ottonello, and Talvi (2008).

8. Supporters of this view argue that the favorable external environment that Latin America faced from 2003 through mid-2008—unprecedentedly high export prices, rapid growth in the global economy, and benign financial conditions—explain the lion's share of the region's improved economic performance during that period. These external conditions led to an "endogenous" increase in fiscal revenue and thus to an improvement in reported fiscal balances. However, as the external environment deteriorates, fiscal revenue will decrease, exposing the underlying fiscal vulnerabilities. These vulnerabilities are viewed as particularly important in those countries where increases in fiscal expenditure (financed by temporary increases in revenue) focused mostly on current rather than investment spending. Some of the case studies in this book raise this issue as a serious problem that weakened the foundations for growth.

9. See, for example, Birdsall et al. (2008), where the emphasis is on policies to achieve growth and improved equity in Latin America.

sample of countries on how to proceed with the reform process, taking into account the *specific local conditions (economic, social, and political) that characterize those countries.*

The book is the collective effort of many authors, all of them experts in the economics and politics of growth in Latin America. Some of them participated in the Task Force that constructed the book's analytical framework, which is summarized below and fully presented in chapter 2. Although simple and intuitive, the framework is capable of dealing with the many ingredients that shape the process of economic growth in the region: from the macroeconomic stance to the quality of political institutions; from productivity to income inequality; from advances in democracy to popular resistance to further reform. Most important, the framework specifically avoids applying a straitjacket to the region's problems: the particularities and uniqueness of each country are highlighted wherever the framework is applied.

A second group of experts formed teams to apply the framework to each of five countries in the region: Brazil, Colombia, Costa Rica, Mexico, and Peru. Large and small, and representing various parts of the region, these five countries clearly illustrate both the commonalities and the sharp differences within Latin America. The resulting analyses are presented in chapters 3 through 7. In each chapter the emphasis is on specific recommendations for policy actions that are *doable,* in both the economic and the political sense.

The rest of this introductory chapter has four sections. The first discusses some essential economic and political characteristics that distinguish Latin America from other world regions and that had to be taken into account in constructing the analytical framework. The next section walks the reader through the main elements of the analytical framework, emphasizing the differences between it and other approaches in the literature. The third section summarizes the most important results obtained from applying the framework to the five countries listed above. The chapter concludes with some final thoughts about the relevance of the lessons from the country studies for other countries and the region as a whole.

What Is Different about Latin America? Some Key Stylized Facts

In creating an analytical framework tailored specifically to Latin America, we considered it important to identify some key features that distinguish the region from other developing areas of the world. Of course, Latin America shares many common features with the rest of the developing world, and countries within Latin America differ significantly among themselves, but three particular features are shared by most countries in the region. The first is of an economic nature: Latin America is the most financially open of the world's developing regions. The second is political: Latin America is also the world's most democratic developing region. The third encompasses both the economic and the social arenas: Latin

America is also the world region with the greatest economic and social inequality. This section will explore all three of these features and the constraints they impose on achieving sustained growth.

Latin America Is the World's Most Financially Open Developing Region

Using data from the Annual Reports on Exchange Arrangements and Exchange Restrictions published by the International Monetary Fund, a recent study (Chinn and Ito, 2007) constructed an annual index of financial openness for 181 countries.[10] Table 3 presents regional averages of Chinn and Ito's index covering the period 1970–2006. Like the country-specific indices on which they are based, the regional indices take higher values the more open the region is to cross-border capital transactions.

Two things are worth noting about the indices for Latin America. The first is that since the mid-1990s, the region as a whole has embarked on a continuous process of liberalization of the capital account: the financial openness index has steadily increased. The second, perhaps more important, is that except for the industrial countries (the "high-income" group in the table), Latin America is the most financially open region in the world. By 2006 Latin America's index of financial openness was more than double that of the Middle East and North Africa and triple that of Eastern Europe and Central Asia. All other regions lagged significantly behind. Moreover, this trend in the regional index is quite representative of the situation in most individual countries in Latin America.[11] With the exception of Argentina, Honduras, and Venezuela, all of the Latin American countries have increased the openness of their capital accounts since the mid-1990s.[12]

Why might a highly open capital account deserve special consideration when designing an analytical framework for understanding economic growth in the region? To answer this question it is important to recall that the *impetus* toward capital account liberalization in Latin America started in the late 1980s and early

10. The study used principal components methodology to construct the index from the first standardized principal component of the following variables: the presence of multiple exchange rates, restrictions on current account transactions, restrictions on capital account transactions (in turn divided into thirteen categories reflecting restrictions on different types of financial instruments, activities, and financial entities), and requirements that exporters surrender the foreign exchange proceeds of their exports. Given the methodology used, the index lacks a predefined range of values.

11. The median index among Latin American countries is even higher than the regional average in all years since 1995. Using the median rather than the average does not, however, change the ranking of regions on the financial openness measure.

12. By 1995 Argentina had one of the most open capital accounts of the region (as did Peru). However, following the eruption of that country's financial crisis in the early 2000s, a number of restrictions were imposed on cross-border transactions. By 2006 Argentina had become the most financially closed country in the region.

Table 3. *Financial Openness Indices by World Region, 1970–2006*[a]

Region	*1970*	*1975*	*1980*	*1985*	*1990*	*1995*	*2000*	*2005*	*2006*
East Asia and Pacific	–0.44	–0.41	–0.32	0.01	–0.05	0.32	–0.17	–0.10	–0.13
Eastern Europe and Central Asia	–1.13	–1.13	–1.80	–1.46	–0.78	–0.09	–0.30	0.36	0.46
High-income countries	0.21	0.30	0.61	0.85	1.08	1.73	1.70	1.85	1.85
Latin America and Caribbean	0.13	–0.06	–0.13	–0.96	–0.78	0.17	0.66	1.06	1.03
Latin America	0.21	–0.01	0.07	–1.09	–0.82	0.36	1.09	1.58	1.54
Caribbean	–0.22	–0.36	–1.35	–0.71	–0.71	–0.17	–0.13	0.12	0.11
Middle East and North Africa	–1.03	–0.78	–0.47	–0.35	–0.38	0.06	0.33	0.51	0.60
South Asia	–1.05	–1.23	–1.24	–1.00	–1.00	–0.16	–0.47	–0.42	–0.42
Sub-Saharan Africa	–0.93	–0.63	–0.90	–0.83	–0.86	–0.55	–0.52	–0.47	–0.53

Source: Chinn and Ito (2007).

a. A higher value indicates greater openness of the capital account.

1990s, when, in an attempt to end the region's "paralysis" following the 1982 debt crisis, the Brady Plan first allowed for the *securitization* of governments' external liabilities (beginning with Mexico in 1989). Since then, a highly liquid market for international bonds and other securities issued by Latin American countries and other emerging markets has developed, displacing unsecuritized bank lending as a major source of portfolio flows to the region.[13] Two basic differences between international bank loans and international bonds are central for understanding the importance of international securitization for the achievement of sustained growth in Latin America.[14] The first is that a well-developed secondary market exists for international bonds, but not for unsecuritized bank loans. The second is that, in contrast to the institutions now well established for negotiations involving internationally active banks, concerted arrangements among bondholders to deal with collective action problems in cases of sovereign default are still in the early stages. (The inclusion of collective action clauses in recent bond issues by a number of emerging market countries is a step in the right direction.) Together, the existence of this well-developed secondary market for international bonds and the absence of pre-established arrangements for default on those bonds imply that any news affecting investors' perceptions of a country's capacity or willingness to service its debt is reflected immediately in bond prices. A key measure here is the spread between the yield on bonds issued by a given country and the yield on U.S. Treasury bonds of corresponding maturity. If both bonds are denominated in U.S. dollars (or in euros, as some recent bond issues have been), both are free of exchange rate risk, and the spread between them can be considered a measure of country or default risk.

When investors' perceptions of risk deteriorate significantly for a given country, the yield and the spread on that country's external debt increase sharply, raising the country's financing costs and severely limiting the availability of external sources of finance. Because an increase in spreads constitutes a market signal of an increase in country risk, it quickly translates into higher domestic interest rates.[15] Since the financial system in most Latin American countries is dominated by

13. This process started with the emergence of the Brady bonds. We explicitly emphasize here the process of international securitization rather than the more general process of financial integration. Although the latter is often the focus when describing the depth of countries' participation in a wide variety of cross-border flows as well as structural processes (such as the role of foreign banks in the region), countries in the region increasingly resort to the international bond market, rather than more traditional loans from international banks, to meet their financing needs.

14. I previously presented this argument in Rojas-Suarez (2003) to explain the importance of international securitization for the conduct of monetary policy in Latin America.

15. For evidence on how country risk affects domestic interest rates in Latin America, see Rojas-Suarez and Sotelo (2007).

short-term instruments, domestic interest rates at all maturities are affected, with adverse implications for investment and economic growth.[16]

This transmission mechanism from international to domestic interest rates is reinforced by two additional characteristics of the region's economies. The first is that national saving rates remain very low, and local financial markets remain underdeveloped. Indeed, a recent study by Gutierrez (2007) shows that the average national saving rate for the region has remained at the low (20 to 23 percent) levels observed in the 1960s and 1970s. In this context, domestic sources of finance are very limited and thus cannot offset the severe curtailment of external financing that often follows a deterioration in investors' perceptions of creditworthiness.[17] Thus, in countries with "freer" capital accounts, domestic interest rates are likely to be strongly influenced by international perceptions of country creditworthiness.

The second characteristic is that in sharp contrast to its financial openness, most of Latin America (with the notable exception of most of the Central American countries) remains relatively closed in terms of trade flows, and exports remain highly concentrated in commodities.[18] Although the situation has improved in recent years, standard indicators of trade openness, such as the simple ratio of

16. In addition, the experience in Latin America shows that, to a large extent, private debt can be considered a contingent liability of the government. Historically, when the private sector has encountered severe difficulties, governments have often "absorbed" its liabilities into the public sector accounts. Thus, it is difficult in practice for investors to distinguish between government risk and private sector risk. In this context, adverse shocks increase the perceived risk of liabilities issued by *both* the public and the private sector. This, of course, pushes interest rates up.

17. At any point in time, a country's given stock of debt (both domestic and external) becomes riskier if the country's capacity to roll over maturing debt decreases sharply. If, following a sudden adverse shock, increased perceptions of default lead to an increase in spreads and a severe reduction in market access, the country's overall capacity to service its existing obligations decreases. Domestic interest rates increase as domestic holders of the country's liabilities perceive the deterioration of borrowers' capacity to meet payments. Notice that this transmission mechanism from default risk to domestic interest rates operates even if the country has a flexible exchange rate system. The reason is that even a large depreciation of the currency cannot generate external resources quickly enough to offset a sharp decrease in the availability of foreign sources of finance. This problem, of course, is greater, the larger the stock of debt and the shorter the maturity structure. It is precisely the recognition of limited capacity of domestic financial and capital markets, in the context of an open capital account, that has encouraged a number of governments in recent years to accumulate large stocks of international reserves and to buy back expensive external debt and issue new debt at better terms (lower rates and longer maturities).

18. Some extreme examples of commodity concentration are Ecuador and Venezuela; on the other hand, countries like Brazil, Costa Rica, El Salvador, and Mexico are diversifying significantly into manufacturing exports, which now exceed 50 percent of all goods exports in those countries. A critical problem associated with the lack of trade diversification is the high volatility that characterizes commodity prices. The events of 2007–08 provide the most recent example. After dramatically increasing during 2007 and the first half of 2008, prices of a number of commodities exported by the region fell sharply in the second half of 2008. At this writing, it is still too early to assess whether the region will face a significant adverse terms of trade shock, compounding the adverse effects of the capital account shock associated with the U.S.-led global financial crisis.

exports plus imports to GDP, show that the region has a long way to go to reach the level of openness of East Asia and the industrial countries.[19] This characteristic implies that export flows have very limited scope to mitigate the lack of financing resulting from a severe adverse shock to the capital account, even if that shock is accompanied by a significant depreciation of local currencies.

The message, therefore, is clear: to maximize the growth benefits from access to international capital markets, liberalized capital accounts need to be accompanied by macroeconomic stability *at all times.* Any deviation will quickly result in reduced perceptions of the country's creditworthiness, a wider spread on the country's external debt, and higher domestic interest rates, to the detriment of investment and growth.

Increased access to international capital markets is by no means a panacea, however; it also brings potential risks. As the current international financial crisis has demonstrated, sudden reversals of capital inflows *not related to local developments* can dramatically affect countries' growth prospects. Self-insurance policies, such as the accumulation of foreign exchange reserves and fiscal stabilization funds that build up resources during economic booms to be used in harder times, need to be important components of a strong macroeconomic agenda.

In spite of the current deep uncertainties in the international capital markets, there are no indications that Latin America will cease to be the world's most financially open developing region any time in the foreseeable future.[20] As mentioned above, very low national saving rates imply that most countries in the region need external sources of funding to finance growth, and this need will remain in place long after the current turmoil ends.[21] Hence countries in the region simply cannot

19. Of course, the region has made important progress in reducing tariffs and (in some countries) nontariff restrictions, and these policies help explain the sustained improvement in the region's trade openness in the last two decades. The point advanced here, however, is that Latin America needs a large, dynamic, competitive, and diversified export sector to help offset the severe impact on growth from a deterioration in investors' perceptions of countries' creditworthiness. This is also the reason why we prefer the simple ratio of exports plus imports to GDP as the appropriate indicator of trade openness, rather than other more sophisticated indicators such as that advanced by Sachs and Warner (1995) and updated by Wacziarg and Horn Welch (2003). Those indicators do not include some key factors that restrict trade openness, such as the lack of adequate infrastructure and bureaucratic customs arrangements (see Birdsall and Rojas-Suarez 2004).

20. In recent years external government liabilities of a number of countries in Latin America have achieved investment grade ratings by international credit rating agencies. Some other governments have placed the achievement of investment grade among their top priorities. Moreover, a number of countries in the region depend on inflows from foreign direct investment, and this type of flow is quite sensitive to the extent to which cross-border flows (including transfers of dividend payments) are free of encumbrances. In this context it is safe to state that open capital accounts are "here to stay" in most countries in the region.

21. Most studies of the relationship between saving and growth conclude that sustained growth is needed for saving rates to increase (although some others, such as Gutierrez, 2007, find an ambiguous causality). Thus, increasing saving rates in Latin America is a long-term process. In the short and the medium term, savings from abroad, in the form of foreign direct investment and portfolio flows, are perceived by policymakers in many countries in the region as an engine of growth.

afford important deviations from macroeconomic stability (including the establishment of self-insurance policies to deal with the vagaries of international capital markets) if they are to achieve sustained growth. Add to this the region's repeated experience with hyperinflation and financial crises in the 1980s and 1990s, and it becomes apparent that Latin America has less room for macroeconomic *mistakes* than most other regions.[22]

Latin America Is the Developing World's Most Democratic Region

The indices of the strength of democratic institutions often used in country comparisons differ in their definition and measurement of democracy. Some indices adopt a relatively narrow concept, focusing on the rights of citizens to vote freely in fair elections between competing parties; others define democracy more broadly, to include indicators of the degree of "participation" and the development of a "political culture," where citizens actively and freely take part in public debate, elect representatives, and join political parties. Two of the best known indices of democracy are those of Freedom House and the Economist Intelligence Unit (EIU); the latter is the broadest measure of democracy among those that cover the majority of countries in the world.[23]

Despite their differences in definition and measurement, Latin America stands out on both these measures as the most democratic region in the developing world. Table 4 presents regional averages of two indices from Freedom House's democracy survey: the index of civil liberties and the index of political rights.[24] The former is a narrow index that concentrates on the freedom and rights of expression, belief, and association of individuals, as well as on respect for the rule of law. The latter is a broader index that seeks to measure the quality of the electoral process, the strength of political pluralism and participation, and the ability of the government to implement democratically based decisions. Both indices range from 0 to 7, where a lower number indicates fewer or smaller obstacles to democracy. Data for both indices are available for the period 1973–2008.

Both indices show that democracy has improved significantly in Latin America from the 1970s to the present, and that as of 2008 Latin America enjoyed the

22. Although this volume does not focus on the issue of volatility (which would require an entire book in itself), macroeconomic stability (broadly defined to include self-insurance policies) is essential to contain the high volatility of economic and financial indicators that have characterized the region and that have been shown to be detrimental to growth. Indeed, unless countries have adequate macroeconomic and self-insurance policies, freer capital markets can lead to higher economic and financial volatility.

23. In addition, the United Nations Development Program (UNDP) has an "Electoral Democracy Index," but it is constructed for Latin America only and therefore does not allow for regional comparisons. Also, the index has been calculated only until 2002. In any case, the results for individual countries on the UNDP index are similar to those of the other indices considered here.

24. The regional averages are simple averages. The classification of countries by region follows the World Bank's *World Development Indicators.*

Table 4. *Political and Civil Rights Indices by World Region, 1973–2008*[a]

Region	*1973*	*1975*	*1980*	*1985*	*1990*	*1995*	*2000*	*2005*	*2008*
Political rights[b]									
East Asia and Pacific	5.2	5.3	4.8	4.5	4.3	3.7	3.9	3.6	4.0
Eastern Europe and Central Asia	6.0	5.9	5.9	6.0	4.0	4.0	3.8	3.8	3.7
High-income countries	2.9	2.7	2.5	2.2	2.1	1.9	1.9	1.8	1.8
Latin America and Caribbean	4.1	4.4	3.8	3.0	2.5	2.7	2.3	2.3	2.2
Latin America	4.1	4.4	3.9	2.9	2.4	2.9	2.3	2.3	2.3
Caribbean	4.3	4.6	3.6	3.2	2.7	2.4	2.3	2.4	2.2
Middle East and North Africa	5.8	5.8	5.4	5.4	5.7	5.8	5.8	5.9	5.8
South Asia	3.3	3.9	4.4	4.3	4.8	4.6	4.6	4.6	4.9
Sub-Saharan Africa	5.8	5.9	5.5	5.9	5.6	4.6	4.5	4.3	4.3
Civil liberties[c]									
East Asia and Pacific	4.9	4.8	4.6	4.7	4.4	4.0	3.8	3.5	3.5
Eastern Europe and Central Asia	6.0	5.9	5.5	6.0	3.9	4.2	4.0	3.4	3.3
High-income countries	2.8	2.6	2.4	2.5	2.1	2.1	2.1	1.8	1.7
Latin America and Caribbean	3.5	4.0	3.7	3.2	2.9	3.0	2.7	2.7	2.6
Latin America	3.3	3.7	3.8	3.2	2.9	3.3	2.8	2.6	2.6
Caribbean	4.3	5.2	3.7	3.4	2.7	2.6	2.5	2.7	2.5
Middle East and North Africa	5.5	5.5	5.4	5.6	5.2	5.9	5.5	5.2	5.2
South Asia	3.9	4.0	4.3	4.8	4.8	5.3	4.8	4.5	4.4
Sub-Saharan Africa	5.3	5.2	5.5	5.8	5.1	4.6	4.4	4.0	4.0

Source: Freedom House.

a. Each index ranges from 0 to 7, where 7 indicates the greatest weakness.

b. Component indices measure the strength of the electoral process, political pluralism, and participation, and the functioning of government.

c. Component indices measure the strength of freedom of expression and belief, associational and organizational rights, rule of law, and personal autonomy and individual rights.

highest average level of democracy of any developing region.[25] Of course, the central reason behind the improvement is the abandonment of military regimes in Latin America. Whereas in the 1970s twelve of the eighteen Latin American countries had a military government, there has been none in the region since 1991.[26] Other indices, such as the new EIU Index of Democracy, first estimated for 2006, confirm this result and provide additional information about the *depth* of democracy. For example, although the region as a whole ranks high for the quality of its electoral processes, the extent of political participation and the development of a political culture are still very low. As stated by Kekic (2007) of the EIU, a democratic political culture requires not only a politically engaged citizenry, but also the willingness of losing parties to accept the judgment of the voters and allow the peaceful transfer of power. The EIU gives very low ratings on political culture to Bolivia, Ecuador, and Nicaragua.

A similar result is obtained by the Polity IV Index, which assesses in a single index both the quality of democracy and the autocratic authority of governments.[27] Once again, Latin America as a whole stands out as the most democratic region in the developing world. By this index, Ecuador and Venezuela had the lowest scores in the region in 2007, and Costa Rica and Uruguay the highest. The differences in scores indicate that not all democracies are alike in Latin America—a fact that will become evident in the country analyses presented in chapters 3 through 7.

Like its financial openness, Latin America's overall improvement on these indicators of democracy needs to be taken into account when designing an analytical framework linking policy reforms and growth. Some economic reforms might not be sustainable, even if they deliver growth, if a significant proportion of voters do not share in the benefits of that growth or in other reform outcomes. A disgruntled population can use its newly acquired voice to express its dissatisfaction through the electoral process, the legislature, and other forums. As has been widely documented (see, for example, Birdsall, de la Torre, and Menezes, 2008), there is an important (and in some countries increasing) risk of a backlash against "markets" and, by association, against the market-based policies and reforms imple-

25. Over the last thirty years, Latin America and South Asia have traded places in terms of the degree of democracy. In the 1970s South Asia was the most democratic region in the developing world, according to the Freedom House political rights index, but democracy has been weakening in almost every country in this region since then, and South Asia is now the second-least democratic region of the developing world, after the Middle East and North Africa.

26. General Augusto Pinochet led the last military government in Latin America, that of Chile, which ended in 1991.

27. The Polity Index (an index of the Polity Project; www.systemicpeace.org/polity/polity4.htm) consists of six measures that document key qualities of executive recruitment, constraints on executive authority, and political competition. It also documents changes in the institutionalized qualities of governing authorities.

mented in the region since the early 1990s. Chapter 2 discusses the relationship between democracy and the reform process in more detail.[28]

Indeed, results for 2007 from Latinobarómetro, a well-known regional survey of public opinion, indicate that about half of Latin Americans are dissatisfied with the "workings of the market system."[29] As figure 1 shows, public support for free markets has been declining since the late 1990s. Dissatisfied citizens want greater government intervention in economic activities and increased social protections. The declining trend in the number of "market supporters" is consistent with the fact that over the last few years, several "leftist" presidential candidates have scored victories over candidates more openly supportive of market-based policies.[30]

As of this writing, the deep financial and economic crisis in the United States and other industrial countries is exacerbating concerns about a potential backlash against market-based reforms and policies in Latin America. Although the crisis has appropriately underscored the need for major changes in the global financial regulatory and supervisory framework, a number of politicians (and some analysts) around the world are using the opportunity presented by the crisis to fulminate against markets in general. Thus, rather than advancing proposals on how to improve the functioning of markets through adequate regulation and countercyclical policies, these critics often focus solely on increased restrictions on the scope of market activity.

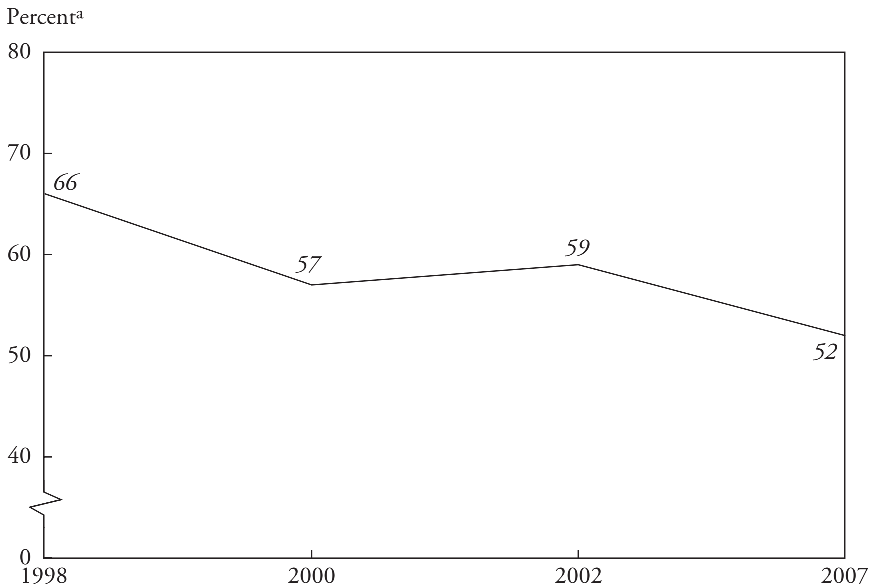
Given the global economic slowdown that is accompanying the financial crisis, Latin America is likely to face, over the next few years, a significant deterioration of the international environment in which it operates, affecting both financial and trade flows. The result may be a sharp reduction in economic growth in the region, a rise in unemployment, and thus the potential for even further popular discontent with market-based reform. This discontent runs the risk of inducing not only an abandonment of the future reform agenda, but even a reversal of policies and reforms already in place that have helped generate growth. Under these circumstances, time is of the essence, to allow the gains from growth—however modest—to be shared more broadly among the population. These considerations

28. Przeworski, Alvarez, and Cheibub (2000) is an important reference in the literature on the relationship between democracy and development.

29. Corporación Latinobarómetro (2007).

30. Three of the five countries where Latinobarómetro finds increased support for democracy—Bolivia, Ecuador, and Nicaragua—are precisely the countries that the EIU index classifies as least democratic (together with Venezuela). This apparent paradox can be resolved by noting that the low score obtained by these three countries on the EIU index is due to very low levels of "political culture" (as described in the text). However, the current presidents of Bolivia, Ecuador, and Nicaragua represent constituencies that have previously felt excluded from government, which explains the improved support for a democratic system highlighted by the Latinobarómetro survey.

Figure 1. *Popular Support for the Market Economy in Latin America*



Source: Latinobarómetro.

a. Percent of individuals surveyed who said they "support" or "strongly support" the functioning of markets in their country.

therefore need to be an essential ingredient in any framework dealing with the linkage between reform and growth in Latin America.

Latin America Has the World's Most Unequal Distribution of Income

As figure 4 in chapter 2 shows, since the 1960s Latin America has persistently had one of the most unequal distributions of income of all world regions. By 2005 it had taken first place away from Sub-Saharan Africa on income inequality as measured by the Gini coefficient.

The causes of this inequality, and the reasons why it has persisted as a deep, structural phenomenon, are subjects of an ongoing academic debate. Explanations run from historical institutional arrangements at the country level; to ethnic, structural, and cultural diversity; to the socioeconomic characteristics of ancestors at the household level.[31] Many authors have also extensively analyzed the relationship between income inequality and economic growth in developing

31. Some important references on the causes of persistent inequality are Alesina et al. (2003), Fearon (2003), and Putterman and Weil (2008).

countries,[32] identifying the channels through which inequality might adversely affect growth.[33] As Birdsall (2007) concluded in a recent review of the literature, the evidence suggests that inequality above some level is likely to reduce growth. This finding by itself should be a matter of concern for policymakers in Latin America, given its highly unequal income distribution.[34]

There are also a number of reasons why high income inequality, together with inequality of land ownership and education, might act to deter the implementation of pro-growth *reforms and policies.* A prominent study in the Latin American context is that by Birdsall et al. (2008). These issues will be developed further in chapter 2. Suffice it to emphasize here that, among all regions in the developing world, *Latin America has the unique combination of being the most democratic and the most unequal.* Together these two characteristics affect the policymaking process, influence policy options, and contribute to explaining the results presented in figure 1. No analytical framework aimed at achieving sustainable growth in Latin America can ignore these characteristics.

The Analytical Framework

This section briefly explains the main elements of this study's analytical framework, described further in chapter 2, and the differences between it and alternative methodologies used to analyze the linkages between policy reforms and growth. What sets the analytical framework presented in this book apart from others in the literature is that it incorporates the three features, discussed above, that distinguish Latin America from its developing peers: its greater financial openness, its greater strength of democratic institutions, and its greater inequality. This framework is called the CGD Framework in later chapters.

Although the framework as designed is Latin America–specific, that does not imply that it does not build on previous analysis. Indeed, it is important to recognize its most important commonality with other contributions to the literature, namely, the search for "foundations for economic growth." As in a number of

32. Some literature reviews include Birdsall (2007) and World Bank (2006).

33. For example, Birdsall (2007) concludes from a review of the literature that high inequality affects growth in developing countries through three channels: through the interaction of inequality with imperfect markets for capital and information; by discouraging the evolution of economic and political institutions consistent with accountable governments (which in turn allow for an adequate investment climate); and by undermining the civic and social life that sustains effective collective decision making. An example of the last channel is the correlation observed between income inequality and criminal violence (see, for example, Fajnzylber, Lederman, and Loayza, 2002).

34. Citing a study by Cornia, Addison, and Kiiski (2004), Birdsall cautiously (because of serious measurement problems) identifies a Gini coefficient of 0.45 as a threshold level. As the Gini coefficient increases, the effect of income distribution on growth is reportedly more negative. As figure 4 in chapter 2 shows, the regional income Gini coefficient for Latin America has fluctuated around 0.5.

other analyses, the fundamental question asked here is the following: What are the main foundations that encourage the accumulation of physical and human capital as well as improvements in productivity—the three factors that lead to economic growth?[35]

Researchers have tried to answer this question using several different approaches.[36] For example, the identification of growth foundations is at the core of the recent literature on *institutions.* Following North (1991), institutions can be broadly defined as the set of formal rules and informal conventions that shape incentives for economic and social behavior. In this literature, pro-growth institutions are those that ensure an adequate structure of rewards for those who provide labor and capital; that secure property rights and contract enforcement for all economic agents; that promote competition as a means of providing incentives for productivity growth; and that allow for relatively equal access to economic opportunity.[37] From a policy perspective, the question is then how to achieve such outcomes. As noted by Zettelmeyer (2006), a number of analysts as well as multilateral organizations have answered this question by promoting what are now known as "second generation" reforms, so called because they complement the reforms encompassed in the earlier "Washington consensus" (Williamson, 1990) by addressing the deep constraints to growth more directly. An example of this type of reform is reform of the judicial system, whose inefficiencies and lack of independence from political pressures in many countries undermine respect for the rule of law, the enforcement of contracts, and the protection of property rights. At the empirical level, indicators of the "quality of institutions" are being used to assess the impact of institutions on economic growth.[38] Quite often the analysis takes the form of cross-country regressions of the type pioneered by Barro (1991).[39]

More recently, the approach developed by Hausmann, Rodrik, and Velasco (2005) addresses the issue of growth foundations by arguing that countries need to identify the *single most important binding constraint* on economic growth and then focus on removing it. These authors argue that the presence of multiple distortions in an economy makes it very difficult, if not impossible, to identify and avoid the unintended adverse consequences of a reform agenda covering a variety

35. José De Gregorio, a member of the Task Force that produced the analytical framework, poses the question in this precise form in De Gregorio (2005).

36. A good survey of the literature on reforms and growth as applied to Latin America is contained in Zettelmeyer (2006).

37. See, for example, Acemoglu, Johnson, and Robinson (2005) and Easterly and Levine (2003).

38. Commonly used indicators of institutional quality are the governance indicators constructed by Kaufmann, Kraay, and Mastruzzi (2008), the measures of economic freedom developed by the Cato Institute and the Heritage Foundation, and the measures of political institutional quality from the Polity IV database by Marshall and Jaggers (2007).

39. See, for example, De Gregorio and Lee (2003) and Blyde and Fernandez-Arias (2004).

of economic areas: reforming one area might worsen existing distortions in other areas. The authors ground their alternative framework in economic first principles, arguing that capital accumulation and entrepreneurship are the basic *foundations* for economic growth. Thus, insufficient investment, and therefore low economic activity, can be explained by either financing costs that are too high or private returns to investment that are too low. From these two *potential* restrictions on growth, the authors build a "decision tree" for policymakers.

For example, if the problem is a high cost of finance, it could be due to either insufficient access to international capital markets or insufficient local sources of finance. If the latter is the obstacle, it may be because of either low domestic saving or problems with intermediating saving, and so on. This process of *branching down the decision tree* continues until policymakers are satisfied that the truly binding constraint has been identified. In the authors' view, this simple approach will facilitate getting the right *diagnosis* of impediments for growth, from which the appropriate recommendations for policy reform will logically follow.[40]

The Hausmann-Rodrik-Velasco approach is appealing in its simplicity and for explicitly recognizing that policy and reform recommendations need to take into account that different countries face different circumstances. However, a major criticism is that in most countries, constraints are present at every fork of the decision tree. In other words, there may be not one or a few but *many* binding constraints, with no particular reason (at least at the theoretical level) to prioritize any over the others. This leaves policymakers with little basis for choosing among a large set of possible policy actions.[41] In contrast, as will be discussed below, the framework in this book and its application to a number of countries show the intricacies, interrelations, and complementarities of a large number of constraints (political, social, and economic) that Latin American countries face simultaneously. Moreover, from the recommendations developed in chapters 3 through 7, the reader will find that dealing with identified constraints entails a policy and reform agenda that is multidimensional and layered.

The quest for sound analysis of the foundations of growth and an associated reform strategy that is adequate to individual countries' circumstances is far

40. In the authors' view, because the resulting list of policy and reform recommendations to deal with the binding constraint will be relatively short and focused, it will also be relatively simple to trace the potential effects of those reforms in other areas of the economy, thus minimizing unintended adverse consequences.

41. In their assessment of the Hausmann-Rodrik-Velasco framework (as applied by World Bank economists in twelve pilot studies), Leipziger and Zagha (2006) could not reach definitive conclusions. In their view the growth diagnostics approach, while providing a framework for formulating hypotheses on growth constraints, "provides neither the hypotheses nor the empirical tools for testing them" (Leipziger and Zagha, 2006, p. 2).

from over. In 2008 the Commission on Growth and Development (2008) published its "Growth Report," also known as the Spence Report after the commission's chairman Michael Spence. The focus of the report was on learning from successful growth experiences, defined as episodes where countries grew at an average annual rate of 7 percent or more over at least a twenty-five-year period. From an analysis of thirteen such experiences, the report identified a number of policy and reform *ingredients* that appeared to be necessary for sustained growth; among these was significant public investment in infrastructure, health, and education. But the report refrained from offering either a recipe based on the identified ingredients or a specific growth strategy applicable to all countries. In the authors' view, the right combination of ingredients—as well as their timing, sequencing, and quantities—varies so much across countries that it should be left in the hands of skilled and experienced leaders and policymakers in each country.

In this context of an already large amount of work on growth and reform, how does the framework in this book deal with the identification of growth foundations in Latin America, and with the empirical design of policies and reforms to impact those foundations? In brief, the framework is developed in four *building blocks.* The first is to identify the foundations for growth that apply in Latin America, taking into account the particular features that distinguish Latin America from other developing regions. This is perhaps the most important difference of the present framework from others aimed at linking reform and growth. The second building block is to ask, based on the existing literature on reform in Latin America, whether alternative reforms and policies have the potential to affect (positively or negatively) the identified foundations. The third building block is to develop a taxonomy of the types of obstacles—economic, social, or political—that specific countries might face that can prevent reforms from having a *positive* impact on one or several of the foundations. The last building block, of a completely empirical nature, is to address those obstacles, either head on or by finding legitimate ways to work around them.[42]

Since the framework is fully developed in chapter 2, it is unnecessary to describe it in detail here. However, it will be useful to discuss briefly how the foundations for growth in Latin America were identified. As stated above, the identification process was guided by Latin America's unique status as the most financially open, most democratic, and at the same time most unequal region of the developing world.

42. In contrast to the Hausmann-Rodrik-Velasco approach, the framework in this book does not try to identify one or two *binding obstacles.* Instead, as will be seen below, the empirical search is for "weak growth foundations" and the policies and reforms that can strengthen them. As can be seen from the empirical studies in this book, the obstacles to effective implementation of policies and reforms can truly be multidimensional.

Latin America's greater financial openness reflects past decisions on the part of policymakers in the region to let market forces, through the behavior of the international capital markets, assess the performance of their economies. Recognizing that growth and development require external sources of finance, policymakers throughout Latin America pay considerable attention to international *market signals.* One such signal is the Global Emerging Market Bond Index (EMBI Global) spread, which is broadly used as a measurement of investors' perceptions of risk in individual countries. That is why, with a few exceptions (most notably Argentina and Venezuela), the trend in Latin America since the mid-1990s has been toward removing capital controls and obstacles to foreign direct investment in a number of economic sectors (including, quite prominently, the banking sector). Even in the midst of the international financial crisis taking place at this writing, there is no indication that the vast majority of Latin American countries are considering reimposing restrictions on cross-border financial transactions.

These circumstances imply that, in general, the policy choice has been for market-based growth. This has allowed the international capital markets to play a significant role in assessing the appropriateness of policies and reforms, rewarding the implementation of policies and reforms that strengthen the functioning of the markets while penalizing those that constrain it. The first three foundations for growth in Latin America, therefore, generate incentives for the adequate functioning and behavior of markets and market participants. These three foundations, which are in line with those proposed by supporters of the *institutional approach,* are

- *secure property rights* for the majority of the population, so that individuals and firms can benefit from their investments;
- *sufficiently equal opportunities* for broad segments of the society, which essentially means lowering barriers to entry to individuals and firms without political connections or great wealth—in other words, *leveling the playing field* for market-based interactions; and
- *sufficient economic and political competition,* to avoid capture of the state by powerful elites.

As we have seen, however, liberalization of capital accounts and exposure to international capital markets also mean that for growth to be sustainable, macroeconomic stability is a must. Achieving such stability requires the implementation of self-insurance policies by both the fiscal (stabilization funds and active debt management strategies) and the monetary authorities (accumulation of reserves) to deal with the vagaries of the international capital markets. As discussed above, in Latin America, with its combination of high financial openness, limited trade openness, underdeveloped local financial markets, and low national saving rates, capital inflows are likely to reverse course at the first sign of economic instability. Add to this the region's long history of economic

and financial crisis (including periods of hyperinflation and the total collapse of banking systems), and the need for the fourth growth foundation becomes clear:

- *macroeconomic stability,* to ensure that sufficient public funds are allocated to pro-growth reform efforts and that the reform process will not be interrupted to deal with macroeconomic crises.

In other words, in Latin America macroeconomic stability is more than just a policy objective; it becomes a foundation that is needed for any other policy or reform to deliver growth. Recognizing the crucial need to maintain macroeconomic stability if growth in the region is to be sustained, for purposes of the framework the Task Force *upgraded* macroeconomic stability from a policy goal to a foundation for growth.

Latin America's unique status as both the most democratic and the most unequal region in the developing world formed the basis for the inclusion of a fifth and last foundation in the growth framework. As discussed above, these two features have together played a key role in slowing or distorting countries' market-based reform agendas (and at times stopping them altogether).

How does one reconcile the need for well-functioning markets with the discontent of large segments of the population with the workings of the market system? Clearly, this clash between what the region needs and what many of its people seem to want threatens sustained growth. To resolve this conflict, the fifth foundation for sustained growth in Latin America calls for

- *broad sharing among the population of the benefits from growth,* to ensure that market-based reforms and policies conducive to growth are sustainable.

As will be discussed below, the experiences of several Latin American countries show that this foundation has often remained weak during the implementation of pro-growth reform agendas. Birdsall et al. (2008) also emphasize this point and therefore recommend, as part of their *toolkit to promote fair growth* in Latin America, the implementation of well-designed programs to reach the poor and the middle class.

The five foundations cannot be prioritized; all must be built simultaneously. Without the first three, there cannot be market-based growth, but without the last two, no acceleration of growth can be sustainable. The rest of the framework builds on these foundations to guide policymakers in assessing the strengths and weaknesses of the foundations in their individual countries and in identifying policies and reforms that can fortify these foundations. At the same time, the framework stresses that the local conditions specific to each country—economic, social, and political—are essential to determine whether reforms and policies are needed to directly affect a certain foundation or foundations, or to deal with obstacles that prevent reforms from *reaching* the foundations in the first place.

Everything else that the reader needs to know about the framework is developed in chapter 2. The next section discusses some of the results achieved when the framework was actually applied to a sample of five Latin American countries.

Applying the Framework: What Did We Learn?

The analyses and results from applying the framework to Brazil, Colombia, Costa Rica, Mexico, and Peru are the subject of chapters 3 through 7. As the reader will discover, the studies provide a wealth of knowledge for understanding the linkages between reforms and growth in each country. In applying the framework, the chapters' authors not only identified the local constraints that had prevented reforms from being implemented or from being effective, but also explained *how* these constraints came to be.

Throughout their analyses, the authors deal with a number of fascinating and intriguing questions, such as the following: Why, in Brazil, despite great advances in reducing inflation, improving the fiscal stance, and reducing the external debt, does macroeconomic stability remain one of the *weakest* foundations for growth? Why, in Peru, where the constitution gives considerable formal authority to Congress, do legislators very often choose *not* to legislate or even to deliberate on major policy issues? How, in Costa Rica, did it come to pass that a road that everybody agrees is needed, and that faces no financing constraints, still has not been built? The answers to these and many other questions contribute significantly to our understanding of the dynamic of the reform process and the reasons for its successes and failures in each country.

Most important, each case study provides very specific policy recommendations intended to answer the following question: how to proceed with a reform agenda conducive to sustainable growth? Each case study is thus truly unique. The variety of reforms that the authors have chosen to focus on, in the context of the framework, is as large as it is rich. The detailed recommendations that they present are equally rich and varied.

Thus, rather than summarizing the findings of each case study, which would fail to do justice to the authors' efforts, the rest of this section discusses some of the key issues that the authors tackle when applying the analytical framework to their countries. All of the studies base their analysis in the reform period that started in Latin America in the early 1990s and that, at different paces and intensities, continues today.

Have Reforms Been Able to Strengthen the Growth Foundations?

With the analytical framework as their guide, each of the country studies distinguishes between the foundations that reforms *aimed* to strengthen and those that were *actually* strengthened (or weakened). Of course, the policymakers in

charge of the design and implementation of reforms did not have in mind the foundations-based framework utilized in this book, but it is not hard to identify intentions and outcomes ex post.

All the country studies assessed that, albeit with different intensities, the reform process of the 1990s aimed at *directly* strengthening two of the growth foundations: macroeconomic stability and economic competition. This is not surprising, because these two foundations coincide with some of the central recommendations of the Washington consensus, which most countries in the region embraced in the 1990s following either a period of deep crisis (Brazil, Mexico, and Peru) or a period of very slow growth (Colombia).[43]

Strengthening the broad sharing of the benefits from growth was also an important policy objective in two countries in the sample, Colombia and Brazil, but for different reasons. In Colombia, efforts to contain the drug cartels and to facilitate a peace agreement with the country's guerilla movements led to the writing of a new constitution in 1991. Under that constitution, expenditure on health and education was significantly expanded, and the population was granted increased access to the judicial system and the political process. Thus, broadening the beneficiaries of the growth process was seen as a means of restoring peace in an unsettled domestic security situation. Brazil likewise enacted a new constitution, in 1988, but for the purpose of solidifying democracy and ending twenty years of fiscal centralism. Under the new constitution a large number of public expenditure items were created or expanded, to encourage a broader sharing of the benefits from growth. Particularly important were the creation of an unemployment insurance system and the generation of income transfers through social assistance programs.[44]

Although a number of countries aimed at *leveling the playing field* for market participants (the equality of opportunities foundation) through reforms that liberalized markets (trade and financial reforms, for example), improving property rights was not a direct policy objective. In some cases (the pension reforms in Colombia and Peru, for example) reform did contribute to enhancing property rights ex post, but this was not a central objective.

Objectives and outcomes, however, differed significantly across countries. In some cases the reforms indeed contributed to enhancing some of the growth foun-

43. Costa Rica did not experience a crisis in the late 1980s or the 1990s. Having recovered from the 1982 debt crisis that plagued the entire region, the country saw a decent pace of growth in the early 1990s, but with high inflation and a large public debt. Extensive government intervention in economic activity, including a state monopoly on banking, was perceived as generating important inefficiencies that constrained the activities of the private sector, and therefore as an obstacle to growth.

44. In an effort to improve the sharing of growth benefits, in recent years an increasing number of countries in the region have been implementing targeted antipoverty programs, such as conditional cash transfers, which allow poor families to receive a certain amount of money under a "social contract," in which the beneficiaries agree to send their children to school regularly or to bring them to health centers. Two well-known programs of this kind are the Oportunidades program in Mexico and Bolsa Familia in Brazil.

dations; in others, however, attempts to enhance a foundation either missed the goal or had the undesirable effect of weakening other foundations. A few examples will illustrate these outcomes, focusing first on the positive ones.

Examples That Improved the Growth Foundations

All of the case studies identified foundations that were actually strengthened following reform. With the exception of the study on Mexico, all the studies also agreed that economic (but not necessarily political) competition had improved, albeit to different degrees in different countries. This success is largely attributed to important advances in trade and financial liberalization, as well as the establishment of adequate regulatory and supervisory authorities.[45] In the case of Brazil, a number of regulations limiting entry and competition, such as widespread price controls, were eliminated, and a new competition law and revamped antitrust agencies were put in place. As the study of Costa Rica emphasizes, trade liberalization there has shifted the country's comparative advantage from land to human capital, so that there is now strong competition for human resources, to the benefit of workers. In some countries, such as Brazil, Colombia, and Peru, privatization involving the breakup of public monopolies was also assessed as contributing to improved competition. In contrast, certain privatizations, discussed below and in the chapters on Costa Rica and Mexico, were perceived more as a problem than as a solution.

Most of the studies also agreed that the financial, trade, and regulatory reforms had contributed to *leveling the playing field,* thus improving the equal opportunities foundation. The study of Costa Rica is vocal in underlining the positive effects of trade openness and diversification on equalizing and improving opportunities. For example, underqualified workers—notably women in the textile sector—have found employment in manufacturing, where before they had access only to lower-productivity jobs. Meanwhile professionals in some fields have been able to find private sector jobs where in the past only public sector jobs were available to them, and entrepreneurs have found external sources of finance willing to take risks that the local financial markets would not have taken. A number of other reforms were also assessed as having effectively contributed to equalizing opportunities. For example, in Brazil, minimum age requirements and a new rule for calculating benefits (the *fator previdenciário*) made eligibility for pensions more similar for poor and rich workers.

Although all the case studies pointed to improved macroeconomic indicators, one of the most interesting findings is that only the study on Peru strongly asserted that the reform process has indeed strengthened the *macroeconomic stability*

45. In the Mexican case, it is recognized that the trade reform successfully contributed to economic competition. However, these gains are assessed as being largely offset by important deficiencies in the privatization process.

Table 5. *Indices of Central Bank Autonomy by World Region, 2003*[a]

Region	*Economic autonomy*	*Political autonomy*	*Overall*
East Asia and Pacific	0.60	0.41	0.51
Eastern Europe and Central Asia	0.73	0.80	0.76
High-income countries	0.73	0.56	0.64
Middle East and North Africa	0.64	0.35	0.49
South Asia	0.58	0.32	0.45
Sub-Saharan Africa	0.58	0.31	0.44
Latin America	0.83	0.47	0.65
Brazil	0.75	0.50	0.63
Colombia	0.88	0.13	0.50
Costa Rica	0.88	0.50	0.69
Mexico	0.75	0.63	0.69
Peru	1.00	0.38	0.69

Source: Arnone et al. (2007).
a. Each index ranges from 0 to 1, where 1 indicates maximum autonomy.

foundation. This conclusion is based not only on current macroeconomic indicators, but also on the overall economic and political infrastructure that supports the sustainability of adequate macroeconomic policies. Unlike in some other countries in the region, high inflation in Peru is tolerated neither by the population nor by the monetary authorities nor by the politicians. And even though President Alberto Fujimori's government was tainted by one of the most serious corruption scandals in all of Latin America, the main thrust of the macroeconomic reforms undertaken during his presidency has been maintained and solidified. One indicator of Peru's increased strength in conducting sound macroeconomic policies is the capacity of the central bank to freely pursue monetary policy. As table 5 shows, Peru's central bank today has the greatest economic autonomy among the countries in the sample. However, it does not rate as highly in terms of political independence, since the tenure of its governor coincides with that of the president, and the governor is designated by the executive branch. Nonetheless, Peru's overall score on central bank autonomy is above both the Latin American average and that of all other developing regions except Eastern Europe.

As mentioned above, strengthening property rights was not perceived as an objective of most reform efforts, and indeed, indicators of the strength of this growth foundation do not paint an encouraging picture for Latin America as a whole. As shown in table 6, which reports regional averages on the Gwartney and Lawson (2008) index of legal structure and security of property rights, by 2006 Latin America, together with South Asia and Sub-Saharan Africa, stood out as one of the developing regions with the weakest property rights. Among countries in the sample, Costa Rica recorded the highest value on this index. This is consistent

Table 6. *Index of Legal Structure and Security of Property Rights by World Region, 1970–2006*[a]

Region	*1970*	*1975*	*1980*	*1985*	*1990*	*1995*	*2000*	*2005*	*2006*
East Asia and Pacific	5.19	4.20	4.99	5.08	5.10	5.12	4.70	5.31	5.26
Eastern Europe and Central Asia	4.38	2.78	5.57	5.65	6.11	5.62	5.70	5.57	5.58
High-income countries	7.56	5.87	6.77	6.79	7.17	7.70	7.90	7.92	7.67
Middle East and North Africa	3.42	3.55	2.79	3.89	3.61	5.52	5.87	6.34	6.05
South Asia	3.13	1.96	3.71	3.58	2.96	4.95	4.61	4.91	4.49
Sub-Saharan Africa	5.08	4.31	4.23	4.20	4.23	4.67	4.55	4.44	4.24
Latin America	3.39	3.26	4.38	3.98	4.60	5.06	4.52	5.04	4.87
Brazil	6.16	5.40	5.86	5.72	6.19	5.76	5.35	5.22	5.19
Colombia	2.82	3.33	3.98	3.40	3.41	2.85	3.53	5.03	4.49
Costa Rica	na	na	5.21	5.25	5.46	5.80	6.87	6.91	6.79
Mexico	4.69	4.09	6.29	5.38	6.76	5.30	4.25	5.68	5.45
Peru	1.36	1.15	3.77	2.23	2.93	4.76	3.94	5.06	5.00

Source: Gwartney and Lawson (2008).

a. The index ranges from 0 to 10, where 10 indicates the highest level of legal structure and security.

with the assessment by the authors of the country study that Costa Rica's institutional framework is strong and has actually been getting stronger since the beginning of the reform efforts of the 1990s. Especially strong are those institutions, related to the country's trade agreements, that helped to consolidate the guarantees against undue uncompensated expropriation that the constitution grants to both local firms and foreigners. In Peru, despite some important setbacks associated with both corruption and inefficiency of the legal and judicial systems, the broad indicator of security of property rights has improved over time; however, it remains quite low. Mexico and Brazil are cases of particular concern; by 2006 the property rights indicator in both countries was well below its level of 1990. Colombia's deficiencies in this area are also apparent: that country reports the lowest value on this indicator among the countries in the sample. As will be discussed below, weaknesses in this foundation are an important reason why the authors of most of the case studies include proposals to reform the judiciary system among their recommendations.

When Unintended or Undesirable Results Happen: Examples of Weakened Foundations

Together the analyses in the case studies provide a comprehensive explanation of why some foundations for growth were weakened rather than strengthened during the reform process. There are several possible reasons for this outcome. First, a given foundation may simply have been disregarded during the reform process, despite factors signaling its deterioration over time; these can be described as "missing foundations." Second, a reform attempting to strengthen a foundation may have failed to deliver and instead weakened the foundation. Third, reforms aimed at strengthening one foundation may have had the *unintended consequence* of weakening other foundations. Each of the case studies presents vivid discussions of all three plausible explanations. This subsection briefly describes some examples:

- In Peru, the broad sharing of the benefits from growth was the *missing foundation* during the reform process of the 1990s and early 2000s. At the national level, poverty rates have started to decrease significantly only since 2004, but to a large extent this success can be attributed to the economic boom brought on by high commodity prices. Moreover, the recent reduction in poverty rates has not been sufficiently inclusive. As the authors of the Peru chapter—Eduardo Morón, Juan Francisco Castro, and Cynthia Sanborn—show, although economic growth has reduced income inequality on a national basis, urban-rural disparities are widening: the incidence of poverty in Peru's urban areas declined from 37 percent in 2004 to 26 percent in 2007, but that in rural areas declined only from 70 percent to 65 percent in the same period. More worrisome is the authors' view that the reduction in poverty cannot be attributed to particular past reform efforts; this leaves poverty and inequality

highly vulnerable to future developments in the economic cycle. Especially in the context of the current global crisis, Peru's gains in poverty reduction run the risk of being reversed. Not surprisingly, the authors focus their recommendations on reforms that aim directly at broadening the benefits from growth on a *permanent basis.*

- Improving the efficiency and allocation of resources, thereby strengthening the foundation for *economic competition,* was an explicit aim of Mexico's extensive privatization program of the 1980s and 1990s. Although some analysts have praised the program's overall benefits (see Chong and López-de-Silanes, 2005), major problems were associated with certain key privatizations. As Gerardo Esquivel and Fausto Hernández-Trillo discuss in their chapter, the privatization of the public telephone company Telmex (Teléfonos Mexicanos) was implemented without an appropriate institutional framework and resulted in predatory behavior and the use of monopoly power. The National Highways Concession Program of the 1990s also failed to meet expectations, and the Mexican government had to embark on an extremely costly road recovery program. Since the large losses associated with the highway bailouts were socialized, this reform also had a negative impact on the broad sharing of the benefits of growth foundation. Both these cases provide clear examples of reforms that aimed at but failed to strengthen growth foundations.
- The study of the Brazilian experience by Armando Castelar Pinheiro, Regis Bonelli, and Samuel de Abreu Pessôa reveals a number of reforms that actually weakened the macroeconomic stability foundation in that country. The interplay between democratization and Brazil's highly unequal income distribution resulted in increased demand by large segments of the population for policies and reforms to redirect government expenditures toward the poor. However, the ability of current beneficiaries to veto cuts in existing expenditures, in the context of a fragmented party system, resulted in an overall increase in current government expenditure and transfers, rather than a redistribution of a constant level of expenditure. A major challenge for policymakers ever since Brazil's democratization has been how to finance increased government expenditure. At first, inflation provided the financing source. When the eruption of hyperinflation—and the subsequent policies to correct the problem—in the late 1980s made apparent the unsustainability of this strategy, the government instead relied on expanding the net public debt. When the Russian crisis of the late 1990s spread to other emerging markets, including Brazil, exposing the extreme economic fragilities associated with high external debt ratios, the Brazilian government turned to raising existing taxes and creating new ones; many of these were quite distortionary, especially for financial intermediation. By 2007 the total tax burden had reached 37 percent of GDP, 12 percentage points higher than the average during 1968–86. However, the increase in public consumption was so large that even higher taxes were not enough, and public investment, particularly in infrastructure, was severely curtailed.

Overall public investment declined from an average of 8 percent of GDP in 1968–78 to a meager 2.7 percent by 2003–05. A growth decomposition exercise included in the Brazil chapter reveals, not surprisingly, that physical capital accumulation has been negative over the last decade.[46] Thus, since the early 1990s, even as Brazil has implemented policies and reforms, such as price stability and flexible exchange rates, designed to strengthen the macroeconomic stability foundation, electoral incentives have led politicians to implement a poorly conceived structure of public spending, greatly skewed toward current expenditures at the expense of public investment. This type of expenditure policy, combined with an extremely high tax burden on investment and financial intermediation and a large public debt (both for the purpose of financing public consumption), has kept Brazil's macroeconomic stability foundation quite fragile.

- Another example of a weakened foundation in Brazil is the lack of protection of *property rights* in spite of reforms of the judiciary and the legal system. Once again, in the context of a highly unequal income distribution in a society where democratization has given greater voice to the disenfranchised, there are strong political incentives to overlook the law as a way to attenuate income disparities. For example, it has become accepted practice for supposedly landless peasants to trespass on rural land, and for supposedly homeless families to trespass on urban land. The desire to reduce the country's stark income inequality also motivates judges to bias their contract enforcement decisions to favor the poorer party. This weakened enforcement of the law is a serious constraint on the property rights foundation (as reflected in the low value of the index in table 6) and a severe obstacle to productive private investment.
- The case of Colombia presents some clear examples of reforms that strengthened some growth foundations while weakening others. Policies and reforms aimed at broadening the beneficiaries of growth through fiscal decentralization, the enhancement of social expenditures, and improved access to the judicial system resulted in deep-rooted fiscal costs that have at least partly offset the benefits of other policies aimed at strengthening macroeconomic stability. As Roberto Steiner, Irene Clavijo, and Natalia Salazar observe in their chapter on Colombia, a key part of the problem is that the 1990 constitution commits the nation to building a *welfare state,* a provision somewhat at odds with the market-oriented reforms being introduced at the same time. The constitution also granted the Constitutional Court very broad powers, and the result has been a very activist

46. Growth decomposition exercises were conducted for all case studies, and the results are shown in the individual chapters. A particular characteristic of Brazil is that economic growth in the last decade can be mostly explained by a recovery of total factor productivity from the sharp decline during the "lost decade" that followed the debt crisis of 1982. Accumulation of human capital decelerated in the most recent decade while physical capital actually contracted.

judicial system. For example, the court has intervened in the determination of public sector wages, has allowed citizens to claim health benefits far beyond those provided for under the health care law, and has extended to *all* pensioners benefits that were supposed to compensate only some retirees whose pensions had not been fully adjusted for inflation. All these interventions have imposed large fiscal costs on the government—the cost of the pension decision alone has been estimated at 12.5 percent of GDP. Clearly, the court has taken the notion of equality too far, and its decisions have severely affected the government's ability to undertake prudent fiscal management and have even compromised financial sector stability. Another, truly frightening example involves the 1998 crisis affecting the country's mortgage banks. To provide support to low-income borrowers, the government forced banks to temporarily accept properties returned by debtors in exchange for the complete write-off of their mortgage. Basing its decision on an overly broad concept of equality, the Constitutional Court extended this benefit to *all debtors.*

• In some ways the case of Costa Rica contrasts with that of Colombia. The reform of the Costa Rican public sector sought to *reduce* the role of the state-centered system in order to improve macroeconomic stability and enhance economic competition through increased private sector involvement. But the implementation of this reform actually weakened political competition and the broad sharing of the benefits of growth. How did this happen? As Jorge Cornick and Alberto Trejos explain in their chapter on Costa Rica, the public sector was downsized without any clear definition of priorities among different government entities and programs; instead, budgetary restrictions were imposed across the whole of the public sector, and public servants were encouraged to leave. The best, the youngest, and the brightest did just that. For those who stayed, the pride of working as a public servant was dramatically curtailed as they were hit by a triple whammy: first, the perception became widespread that they were the "low-quality" workers in the economy; second, budget allocations for many projects were sharply reduced; and third, a complicated system of checks and balances intended to control corruption instead tended to criminalize even honest mistakes, complicating interactions between the private sector and the government. Checks and balances are certainly essential to the appropriate functioning of any government, but the systems put in place in Costa Rica were poorly designed, generating serious obstacles to the execution of projects. Unfortunately, the government branches most affected were those most important to the broader sharing of the benefits of growth: education, public infrastructure, and social assistance. The weakening of this key growth foundation contributed to the solidification of an antireform political party. In the context of a legislative system where any congressman can delay, and ultimately stop, the approval of a bill by recourse to the Supreme Court, the antireform party, although small, has been able to block the passage of needed reforms. Legislative paralysis thus goes hand

in hand with ineffective political competition—a negative outcome for an important growth foundation.

The Proposals

The examples presented above provide just a flavor of the issues and problems discussed in the country chapters in this book. As the reader can easily infer, the discussions in all the chapters provide fertile ground for advancing policy recommendations, and the authors took this task to heart. Keeping within the parameters of the book's analytical framework, all the recommendations aim at enhancing the identified growth foundations. Once again, to avoid repetition, the rest of this section briefly summarizes some of the most important proposals. Also, given the variety of areas tackled in the proposals, the focus here is on a common theme in all chapters: the area of institutional strengthening. Another common theme is the recognition that the implementation of recommendations requires delicate political economy balancing acts.

• How to *better share the benefits from growth* in Peru? In addition to proposals to reform the education system (what the authors identify as a missing reform), Morón and his coauthors suggest that deep reforms of the state and the political system are essential so that legislation can be passed, and policies executed, that will reach the poor, especially in the country's rural areas. An important component of the diagnosis with respect to reform of the state is that lack of *implementation capacity*—reflected in a shortage of professional civil servants—constrains the process of fiscal and political decentralization, which in turn delays and even prevents the execution of much-needed projects, especially in infrastructure and the delivery of social services. Recommendations include introducing a merit-based career path for new public servants; programming budgetary expansions in a results-based format; and consolidating small geographic units into fewer, larger ones. As the authors emphasize, in the face of managerial constraints it would be easier to distribute public resources and monitor their utilization if the focus were on seven to ten macroregional governments rather than on the twenty-five existing regions. For this purpose, the authors encourage the creation of a pilot macro-region as a way of demonstrating the potential benefits of consolidation.

• Although Peru's existing political parties are weak and fragmented, reform of the political system is more easily said than done, because politicians face few incentives to modify the existing structure once elected. Contributing to the problem is the fact that parties revolve around personalities rather than programs or ideology and have few roots in society. Party weakness, in turn, translates into members of Congress lacking technical capacities or political incentives to hold government accountable and to appropriately represent their constituencies. Morón and his coauthors offer several recommendations to strengthen the party system, from enhancing the electoral authority, to strengthening the monitoring of compliance with the existing party law, to building a well-endowed congres-

sional research service available to all members. But because the Congress lacks incentives for internal discipline, external vigilance of its activities is the indispensable force for change. In this regard a central recommendation is to enhance the capacity of nongovernmental research and advocacy organizations of different orientations, and of the independent media, to monitor public agencies, try to hold politicians accountable, and educate the general public so as to improve the quality of citizen demands.

• Reforming *competition policy* is one of the central recommendations in the chapter on Mexico. Although a law was passed in 2006 enhancing the powers of the Federal Competition Commission (FCC), the judicial and legal systems continue to be major obstacles. Through a number of judicial protection mechanisms (called *amparos*), decisions by the FCC can be delayed for prolonged periods. Moreover, legal deficiencies have limited the collection of fines in cases where monopoly practices have been detected. Thus, among their specific recommendations, Esquivel and Hernández-Trillo call for full autonomy (including financial autonomy) for the FCC, to allow it to avoid capture by other government agencies, and for the creation of specialized courts in competition and regulatory cases (similar to Chile's Tribunal for the Defense of Free Competition). These measures aim at improving transparency and accountability on the part of those in charge of implementing the antimonopoly laws, thereby generating incentives to avoid unnecessary delays in executing the law.

• Reforms of the judicial system are also proposed in the Brazil case study, in this case to secure *property rights,* which the authors assess as extremely weak, with contracts constantly breached and rulings delayed by politically motivated judges. Among the authors' specific proposals are the following: adopt performance indicators as a criterion for promoting judges, replacing the current practice of promotion by seniority (one proposed indicator is the percentage of a judge's decisions that are confirmed on appeal); impose discipline on the executive (by far the leading litigator in judicial proceedings in Brazil) in its use of appeals for the purpose of delaying expenditure; index judicially imposed obligations and debt to the SELIC (the policy-determined interest rate) so as to reduce financial incentives to delay final court rulings; and raise public awareness of the consequences of poor judicial performance for economic development and social equity.

• A key recommendation of Steiner and his coauthors is to curtail the ability of Colombia's Constitutional Court to tamper with economic matters in general and with *macroeconomic stability* in particular. As mentioned above, an extreme interpretation of the concept of "fairness" has resulted in excessive judicial activism, to the detriment of macroeconomic stability. Recognizing that the court is a tremendously popular institution, and one that contributes to social cohesion, the Colombian team advances three recommendations aimed at providing incentives for the court to encourage the strengthening of all of the growth foundations. The first is to reduce the politicization of court magistrates by allowing them to run

for a second term, after a cool-off period of perhaps five years has elapsed; this would replace the current system under which magistrates may not be reelected but face practically no restrictions on their involvement elsewhere in politics after completion of their tenure. The second recommendation is to seek a consensual definition by all powers of what constitutes an adequate health care plan and other social services, so that judges cannot decree the provision of services beyond what is in the agreed plans. To make this consensual agreement sustainable, the definitions in the plans should be enhanced as the country achieves higher levels of development (which would also need to be defined). The third recommendation would implement a process by which the Constitutional Court reviews laws as soon as they are approved. If a law were then overturned on procedural grounds, this would happen before it becomes operational.

- Finally, the authors of the Costa Rica chapter view as central a reform of that country's legislative system that would enhance *all* of the growth foundations, but particularly the *broad sharing of the benefits of growth.* Congressional rules that used to work adequately in a two-party system have proved ineffective, leading to reform paralysis in the current context where a minority antireform party forms part of the political landscape. Some of the legislative reforms the authors propose to deal with these obstacles include the following: setting a deadline by which the Congress must vote on proposed laws; granting the executive limited power to declare certain bills urgent, to shorten the decision time (a practice followed in Chile); creating alternative ways for representatives to put forward their positions, place them on the record, and propose amendments, without causing the long delays to which the current procedures are subject; and requiring a quorum only for votes and not for debate. Citing the success of the CAFTA referendum in late 2007, Cornick and Trejos stress the advantages of such referenda: a vote happens on a fixed date without the possibility of filibustering, and the results are binding and widely viewed as legitimate. Recognizing the high costs of this second-best (or third-best?) alternative for passing growth-enhancing reforms, the authors propose that consideration of this mechanism take place at the same time that national elections occur.

Some Concluding Remarks

It is hoped that this introductory chapter has increased readers' appetite to get immersed in the complex, sometimes intriguing, sometimes disturbing, but always fascinating interactive process of reform and growth that started in Latin America in the late 1980s and early 1990s and continues to evolve today. In the chapters that follow, the reader will find well-thought-out—and thought-provoking—answers to a number of important questions: Why did two similar reforms generate very different outcomes in different countries? How did political interests interact with the technical design of reforms in individual coun-

tries? Why, given the current state of development of Latin American countries, is it neither useful nor practical to advance recommendations at a very general level? Most important, what should be done to enhance the foundations for sustained growth? Although the detailed and specific reform agendas proposed in the individual case studies can at times be daunting, the reader will be left with a feeling of optimism, as the solutions proposed are not only well conceived but doable. Indeed, in keeping with the analytical framework that has guided this book, the recommendations focus on finding solutions to deal with existing obstacles—directly when possible, and with second-best policies and incentives when necessary.

Although the specific recommendations for reforms and policies differ substantially from country to country, two commonalities in the *process of implementing reforms* emerge from all the country studies. The first is an emphasis on incremental reform. Even in those cases where a major revamping is recommended (for example, in competition policy in Mexico, or the reform of the state in Peru), the proposals are not for "big bang" reforms. Instead the authors call for "pilot projects," designed to build constituencies that will support and endorse further change and reform, and to enhance the ability of the media and nongovernmental organizations to educate public opinion and monitor the government's and politicians' actions. The second commonality, related to the first, is the need for enhanced communication between governments and civil societies, focusing on persuasion and collaboration rather than the top-down imposition of policies and reforms. To return to where this introduction started, the emphasis on reform through *agreement and negotiation* rather than by decree is fully consistent with the reality of Latin America today as the most financially open, most democratic, but also most unequal region in the developing world. Under these conditions, the way to move forward with reform, while at the same time preventing (and in some cases containing) a backlash against market-oriented reforms and possible civil unrest, is to encourage much greater collaboration between governments and civil societies than was perceived as necessary in the early days of reform.

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