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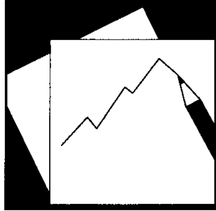

IMF Working Paper

Sustaining Latin America's Resurgence: Some Historical Perspectives

Anoop Singh and Martin Cerisola

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IMF Working Paper

Western Hemisphere Department

Sustaining Latin America's Resurgence: Some Historical Perspectives

Prepared by Anoop Singh and Martin Cerisola[1]

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Abstract

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This paper looks at the historical lessons that might serve to entrech Latin America's newly resurgent growth phase. It briefly reviews the post-World War II experiences in Latin America and Asia, focusing on the conditions that favored capital accumulation and productivity growth in the faster growing economies. Among these, the paper highlights the importance of stable macroeconomic policies, especially fiscal policy.

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I. Introduction

Latin America is in a resurgent phase. Regional growth exceeded the historical average during 2004–06 and is continuing at a rapid clip, exceeding 4 percent. What is more, macroeconomic stability in the region has been generally well maintained, inflation has trended down for more than a decade, and poverty and unemployment indicators have shown remarkable improvement in some countries. This recent performance is in welcome contrast to historical average growth during the post-World War II period, when Latin America underperformed compared with most other regions in the world. Over this period as a whole, the gap between per capita GDP in the United States and the region remained large, certainly compared with most of Asia.[2] Relatively high poverty and inequality have also persisted in he region. This paper tries to draw lessons from Latin America's long-term relative performance and assess the priorities for sustaining the current expansion.

Latin America's long-term weak growth performance has been associated with high levels of macroeconomic instability. The import-substitution development strategy that was pursued until the 1980s, ending with the debt crisis, was unsuccessful in closing the income gap. In subsequent years, the region experienced swings in policy strategies, shifting between orthodox stabilization plans and heterodox programs, largely associated with similar shifts in views on the role of the state and the importance of market-based incentives for growth.

Latin America's experience in most of the post-war period contrasts with that of Asia. As noted by Elson (2005) Latin America was the most developed region outside the industrial world in the early 1950s, but its relative position has declined since then, despite individual successes, of which the most notable has been the sustained rise of Chile. Starting generally from a lower base, many Asian countries have more than doubled their per capita income relative to the United States over the same period. China and India are only the latest examples of Asia's success (see Tseng and Cowen, 2005) that began with Japan, then was joined by the "tigers"—South Korea, Singapore, Hong Kong SAR, and Taiwan, Province of China—and later by the newly industrializing economies of Thailand, Malaysia, and Indonesia.

Why has Latin America's growth potential remained largely unfulfilled? There are no easy answers to this question, particularly because of the diversity of policy approaches followed in Latin America and because there is no single Asian model of development. Most notably, the Asian tigers, particularly Korea, as well as China and India, have followed markedly different development strategies, especially regarding the role of the state.[3] Nevertheless, there are some important common elements in the experiences of the two regions that stand

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[2] Cole (2004).

[3] See Ito and Weinstein (1996); and Westphal (1990).

out, notably the importance of creating conditions that favor high savings, capital accumulation, and productivity growth. Critical in this regard have been a stable macroeconomic environment and outward-oriented trade policies

The policies that facilitated these conditions and their implications for growth are the principal focus of the remainder of this paper. Section II reviews the stylized facts on the composition of growth in the two regions and discusses some of the key explanatory factors underlying the different growth experiences. Section III explores in more detail the role of macroeconomic instability in explaining Latin America's comparatively weak growth record—in particular, the importance of volatility in fiscal and monetary policies, as well as the limited success in promoting financial intermediation and sustaining broader reforms. Section IV examines the more recent trends in Latin America that have built a strong recovery, including with regard to macroeconomic stability. Section V offers suggestions for the key policy priorities for Latin America to consolidate this recent progress and entrench stability and growth.

II. Determinants of Relative Growth Performance

The most notable feature of Asia's growth record has been its success in spurring capital accumulation and then catalyzing rapid productivity growth. Asian economies generally relied heavily on high rates of physical and human capital accumulation—much higher than those in Latin America—to kick-start their post-war development. As Alwyn Young (1994) highlighted in his seminal work, high rates of factor accumulation were important contributors to growth. Investment rates rose to the 35 to 40 percent range, supported by a strong domestic savings effort and rising financial intermediation.[4] As illustrated in the table below, these high savings rates translated into rapid investment which, in turn, contributed to a significant proportion of the productivity growth seen in East Asia, China, and India during the past four decades. By contrast, capital accumulation in Latin America, and its contribution to growth, have been much weaker since the 1970s.

While Asia's growth was initially built on extraordinary savings and investment rates, countries in the region were also generally successful in catalyzing rising productivity gains. In China and India, for example, capital accumulation had been the principal driver of productivity growth during the 1960s and 1970s, but total factor productivity—often used as an indicator of technological progress—became the principal engine of growth thereafter. And in East Asia, total factor productivity growth generally accelerated since the 1980s, except during the period of the 1997–98 financial crisis.

[4] Young (1994) focused in particular on the critical role of capital accumulation for growth among the newly-industrializing countries in Asia, noting the importance of a doubling of the investment-to-GDP ratio in Taiwan, a tripling in Korea, and quadrupling in Singapore during 1960–80.

Table 1. A Comparison of Sources of Growth, 1960–2003

	Latin America			East Asia 1/			China			India		
	Output per worker	Contribution of: Capital 2/	Contribution of: TFP	Output per worker	Contribution of: Capital 2/	Contribution of: TFP	Output per worker	Contribution of: Capital 2/	Contribution of: TFP	Output per worker	Contribution of: Capital 2/	Contribution of: TFP
1960–70	2.8	1.1	1.6	3.7	2.2	1.5	0.9	0.4	0.5	1.9	1.2	0.7
1970–80	2.7	1.6	1.1	4.3	3.4	0.9	2.8	2.0	0.7	0.7	1.0	-0.3
1980–90	-1.8	0.5	-2.3	4.4	3.1	1.3	6.8	2.5	4.2	3.9	1.4	2.5
1990–2003	0.3	0.5	-0.2	3.1	2.5	0.6	8.5	3.6	4.7	3.4	1.9	1.5
1960–2003	1.0	0.9	0.1	3.8	2.8	1.0	5.0	2.2	2.7	2.5	1.4	1.1

Sources: Bosworth and Collins (2003); updated tables, The Brookings Institution.

1/ Excluding China

2/ Includes physical capital and education.

How did Asian economies switch from relying on savings and investment to spur productivity and spark technologically driven growth? This transformation was especially remarkable when one considers that other regions of the world—such as the former Soviet Union—could not make this shift. There appear to be some common elements that help explain the productivity takeoff in Asia, related to how Asian economies increasingly harnessed the opportunities provided by international trade and globalization. For example, China encouraged foreign direct investment, which helped ensure the steady adoption of best practice technologies from the more advanced economies. In other cases in the region, similar benefits were reaped by embracing trade—both within the region and more broadly—which helped create a virtuous cycle in which technological progress was encouraged by heightening competition, strengthening the role of private enterprise, and facilitating the import of technology—amplifying the increase in productivity.

This is not to say that the state did not have a role in Asia's development. The state did play an important role in a number of ways, and in many Asian countries, through more controversial activist industrial and credit policies, which are still the subject of considerable debate.[5] However, these policies and other governance concerns did not distract the state from steadily advancing overall reforms, maintaining macroeconomic stability, including low inflation and exchange rate stability, and ensuring a business environment that has been broadly investor friendly and competitive. For much of the post-war period, India was an exception to this model—as was China at least until the mid-1970s—but the reforms that were initiated during the 1980s and intensified since the early 1990s have yielded significant gains in spurring private sector-led growth.

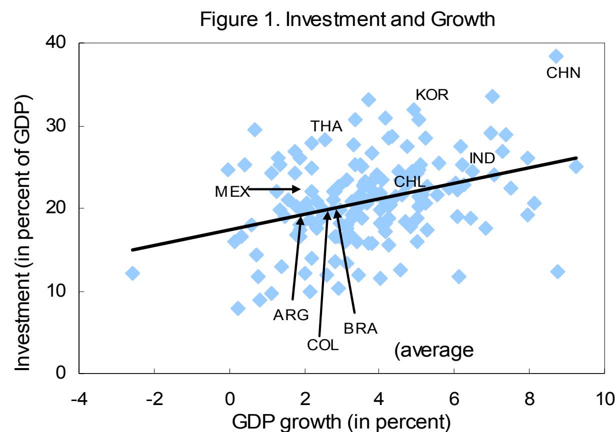
[5] See Westphal (1990) for an interesting discussion of the Korean case.

Let's now sum up some of the lessons from the Asian experience. First, Asian economies were able to raise savings and investment to rates and levels that many other regions have not been able to achieve. Second, Asian economies were able, over time, to raise the contribution of technological progress to achieve their higher productivity growth.

A. Latin America

Until recently, Latin America has been less successful in promoting the savings and investment trends needed to spur productivity growth. Except for the import substitution development phase in Latin America—that exhausted itself and ended in crisis—the region has been unable to achieve or sustain sufficiently high savings and investment rates. Public sector dissaving has generally been the norm and the private sector has not been able to compensate for government deficits.[6] Productivity growth began to decelerate in the 1970s, even before capital accumulation collapsed during the 1980s, a "lost decade" for many of Latin America's large economies. Indeed, since 1960, output per worker has grown consistently faster in East Asia as a whole than in Latin America, by nearly 3 percentage points per annum. Cole and others (2004) attribute this relative stagnation in productivity to protracted barriers to competition (largely associated with the import-substitution strategy).[7] Chile has, however, been a notable exception, as capital and productivity continued to grow during the 1980s, despite the crisis, and has accelerated sharply since the 1990s, yielding rich lessons (Box 1). And while the reforms implemented in Latin America over the past decade or so have allowed for some recovery in capital accumulation and output per worker, these have yet to narrow the "performance gap" (Figure 1).

Figure 1. Investment and Growth



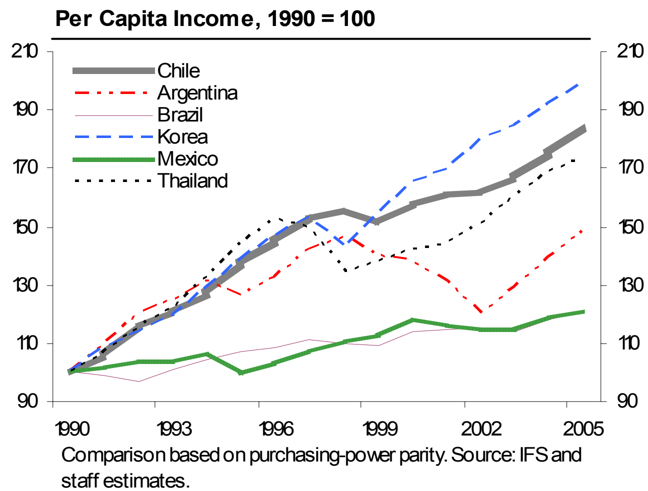
Source: Based on Mody and Schindler (2004).

[6] However, the substantive capital flight from Latin America since the 1980s, caused by macroeconomic and political instability, has resulted in considerable measurement problems regarding private sector savings.

[7] Cole also finds that differences in human capital has not been a determinant of Latin America's weak productivity.

Box 1. Chile: Institutions and Policies Underpinning Stability and Growth 1/

During the last twenty years, Chile has enjoyed strong growth and macroeconomic stability. Chile's macroeconomic performance has been characterized by faster and smoother trend economic growth, and lower and less volatile inflation than in other Latin American economies. This owes much to the sustained implementation of a broad range of market-oriented policies that has enabled the country to take advantage of an increasingly global environment.



Comparison based on purchasing-power parity. Source: IFS and staff estimates.

Critical in this regard has been Chile's policy framework and its long-term underpinnings. This framework has helped its economy withstand the negative effects of "sudden stops" to capital flows that have adversely affected many other emerging markets countries. As a result, Chile has been able to reap the benefits of open external trade and capital markets without giving back these gains during global financial crises.

The main policies underpinning Chile's success have been:

- *Strong fiscal discipline.* Over the last two decades, only in Chile were years of fiscal deficits roughly offset by years of surpluses; most other Latin American countries displayed a bias toward deficits. Fiscal discipline was reinforced by the introduction of the structural surplus rule in 2000. The reward has been a vastly lower debt-servicing burden, as fiscal discipline resulted not only in lower government debt but also in lower real interest rates.

- *A credible inflation targeting framework has helped anchor inflation expectations at a low level.* Under this framework, the central bank aims at keeping inflation within a 2–4 percent target range. In recent years, the central bank has also let the peso float freely.

- *The financial system was strengthened and capital markets deepened.* Financial liberalization was a mainstay of policy reform in Latin American in the 1990s, mainly focusing on deregulation and privatization. Chile took strong actions to strike the right balance of market discipline and sound banking supervision, while its capital market rapidly deepened.

- *Trade integration, in conjunction with a broad financial opening, was significant.* Chile's export sector, one of the most open and diversified in Latin America, has proven an important buffer against current account shocks, while also boosting Chile's growth potential.

- *Institutional arrangements were set to create a more certain macroeconomic environment.* Sound economic policies and reforms have been carried out within a stable institutional framework to avoid reversals. These institutional arrangements have helped reduced the incentives problems that have led to a lack of fiscal discipline, complex and distorted trade polices, and moral hazards in the financial system see elsewhere in the region.

1/ Based on Kalter and others (2004).

Against this background, it is not surprising that episodes of growth in Latin America have not been sustained. Berg and others (2006) have recently explored the duration of "growth spells" across countries. Their findings suggest that Latin America has generally done less well than other regions in sustaining significant growth over prolonged periods of time, and that this inability has been magnified by a tendency to suffer from episodes of severe contractions (Figure 2). Thus, less than half of the growth spells initiated in Latin America in the post-War period continued after seven years, as opposed to over 85 percent for high-income countries, and 100 percent for emerging Asia.

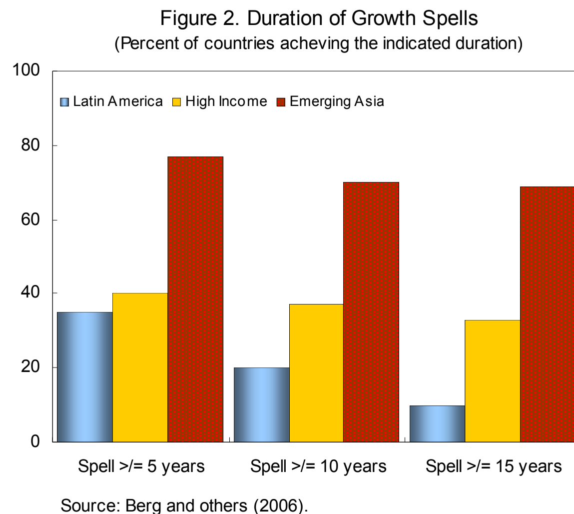


Figure 2. Duration of Growth Spells
(Percent of countries acheving the indicated duration)

Source: Berg and others (2006).

Low savings and investment rates have accentuated the problem of regional disparities. Serra and others (2006) show that the speed with which poorer regions in Latin America (particularly in Brazil, Peru, and Chile) have converged with richer regions is much slower than the pace seen in advanced and many other developing economies. Thus, the dispersion in the level of per capita output across regions has declined relatively slowly in several Latin American countries. Asian countries have also suffered from regional disparity issues, especially in China and India. In the case of China, for example, Aziz and Duenwald (2001) find that while the per capita income of poor provinces has been catching up with those in the rich, the relative income distribution seems to have stratified into a bimodal distribution: the coastal provinces gravitating toward one mode, and the remaining provinces toward the other, with economic structure and policies, particularly those related to provinces' openness to trade, playing important roles in the growth dynamics.

The regional disparities in many countries have been associated with generally high poverty and inequality. Although recently improving, poverty rates in Latin America have shown only slow improvement over the decades, and income inequality—as measured by Gini

coefficients—has been generally higher than in Asia.[8] Arguably, the polarization of economic well being in some countries has contributed to polarization in the political sphere which, in turn, has made it more difficult to build a lasting consensus for reform in Latin America (Annett, 2002). In Asia, Srinivasan (2003) notes that, despite serious conceptual and data issues relating to levels of poverty and their time trends, India and China have made considerable progress in alleviating poverty. For example, the ratio of India's population living below the national poverty line fell from almost 40 percent in 1987–88 to almost 25 percent in 1999–2000 in rural areas, and from 23 percent to 12.5 percent in urban areas. More recently available data for China show that rural poverty has been virtually eliminated, falling from 31 percent in 1979 to 9½ percent in 1990 and to 4½ percent in 1998.

B. Key Explanatory Factors

Considerable recent research has focused on the macroeconomic record of Latin America and Asia. Indeed, there is growing empirical evidence on the importance of a supportive macroeconomic environment for growth, supplementing policies and institutional factors related to education, openness, and the role of government. Fischer (1993) has noted that predictable macroeconomic policies reduce uncertainty, maximize efficiency in resource allocation, and create incentives for both capital accumulation and technical progress. In his multi-country study, Fischer demonstrated that growth was negatively associated with inflation, and positively associated with good fiscal performance and undistorted foreign exchange markets, and that the causality ran from good macroeconomic policies to growth. In Asia, stable macroeconomic conditions appear to have paved the way for the persistent and high rates of capital accumulation, productivity gains, and sustained growth. The fast growing economies of Asia have generally enjoyed lower and steadier inflation rates, real exchange rates, while also generally avoiding the large negative shocks and frequent balance of payment crises—with the notable exception of the 1997–98 crisis. As stressed by Fischer (1993) and Collins, Bosworth, and Rodrik (1996), this latter episode represented a significant setback for growth in several countries in the region, but recoveries were quick and growth in the region appear to have largely continued unabated.

A number of more recent papers have also focused on the important role of macroeconomic policies in explaining Latin America's weaker growth performance. For example, Loayza, Fajnzylber, and Calderon (2005) explore the role of macroeconomic policies, and their implications for domestic and external stability, over time. Their results point to price stability, as well as trade openness and financial system stability and development, as important contributors to per capita growth. Adrogué, Cerisola, and Gelos (forthcoming) extend the analysis by Loayza, Fajnzylber, and Calderon across countries and present

[8] The World Bank (1993) documents the progress that many of the Asian economies achieved in alleviating poverty since the 1960s. For example, by 1987, the percent of the population below the poverty line in Malaysia was 14 percent, down from 37 percent in 1973.

evidence that external financial stability—closely linked to macroeconomic policies—has been an important determinant of long-term growth. Similar conclusions are reached by Sahay and Goyal (2006) who adopted an "episodic approach" across 17 Latin American countries to explore periods of high and low growth, with a view to finding common patterns of influence. Their results stress that low-growth episodes in Latin America have tended to be associated with high volatility of macroeconomic policies and outcomes, primarily reflecting volatile discretionary fiscal policy and reversals of market-oriented reforms. Finally, Berg and others (2006) show that inflation and exchange rate crises—interacting with income inequalities—present the highest risks to dissipating growth spells. Among other explanatory factors, they argue that growth spells are more likely to endure in countries where the share of manufacturing in total exports rises over time, and where primary education improves and infant mortality declines.

Summing up, the macroeconomic dimension clearly appears to play a critical part in explaining the contrasting growth experiences of Asia and Latin America. Our brief empirical review points, in particular, to the importance of maintaining a policy framework that encompasses some or all of the following features:

- A stable macroeconomic environment conducive to attracting and sustaining domestic and foreign investment. This has much to do with the conduct of monetary and fiscal policies and their impact on public debt and financial stability.

- Maintaining open economies, especially on the trade account, which ensures that competitive price signals are transmitted to domestic economies.

- Financial stability with rising intermediation to support capital accumulation, while minimizing output losses associated with banking crises (Levine, 1997; Loayza, Fajnzylber, and Calderon, 2005).

- An enabling business environment, which lowers the cost of capital, especially the protection of property rights and a lowering of competitive barriers (Cole, 2004).

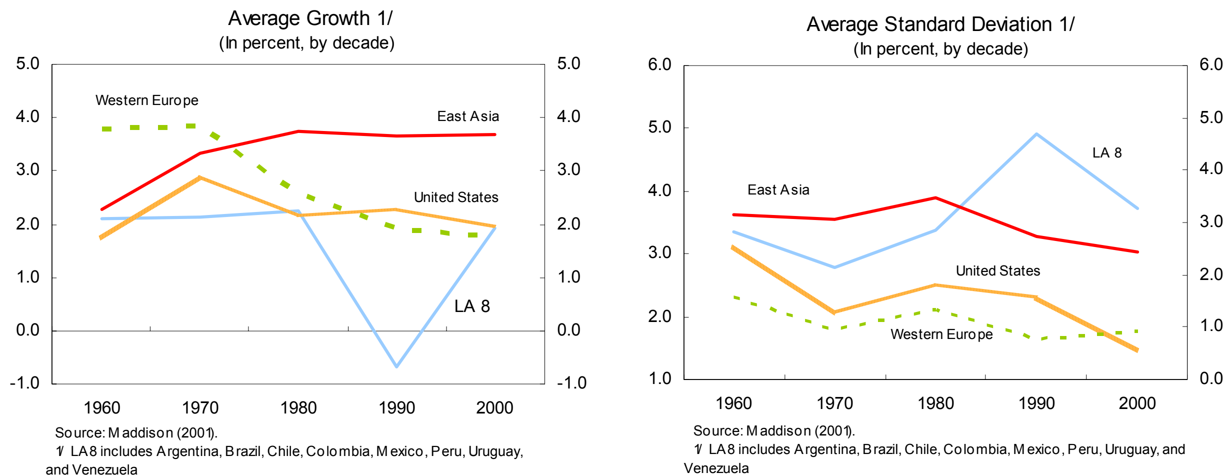
- Strong institutions, especially efficient bureaucracies and a high quality and coverage of education, Sala-i-Martin and others (2004)

III. The Importance of Macroeconomic Stability

Applying this framework to Latin America, we see that the limited success during much of post-ward period in entrenching macroeconomic stability has been among the key differences in the region (Figure 3). Latin America has been prone to boom-bust cycles, high chronic inflation and bouts of hyperinflation (mainly in the 1980s and early 1990s), exchange rate devaluations, banking sector crises, and debt restructurings. Of course, this is changing, with the rise of Chile, and the important progress toward entrenching macroeconomic stability

being made in Colombia, Mexico, Peru, and more recently by Brazil and Uruguay. Nevertheless, over the longer-term in Latin America, in the absence of such an enabling framework to foster capital accumulation and innovation, real per capita income growth has been low for most countries in the region and its volatility has been high. Although periods of strong growth have been achieved, they have tended to be relatively short-lived, often ending in deep recessions, financial instability, and crisis. In turn, this has kept poverty and inequalities very high in Latin America, setting in train social and political trends in some countries that have made it more difficult to maintain a strong reform consensus.

Figure 3. Growth and Volatility in Selected Regions and Countries



What explains Latin America's history of recurrent macroeconomic instability? External shocks have played a role, reflecting the region's dependence on commodity exports and foreign capital, and terms of trade volatility and global capital market conditions have at times weighed on the region's macroeconomic performance. At the same time, however, recent IMF research finds that over 70 percent of the volatility of real GDP per capita growth in Latin America is due to country-specific shocks.[9]

Thus, it would appear that the macroeconomic instability witnessed in Latin America has mainly reflected policy instability. At the root of this instability have been unsustainable fiscal and monetary policies that have interacted with weak financial systems and given rise to frequent reversals of market-oriented reforms. While monetary and exchange rate policies have tended in the past to amplify rather than dampen the cycle in the region, the predominance of fixed-type exchange rate regimes also left the region highly vulnerable to macroeconomic and financial instability. However, the primary driver of macroeconomic

[9] "Output Volatility in Emerging Market and Developing Countries," Chapter II, *World Economic Outlook*, (April 2005).

instability in the region appears to have been fiscal policy, with large fiscal deficits and high levels of debt creating an inflationary bias and sowing the seeds for periodic debt crises. Large deficits, coupled with fixed exchange rate regimes and monetary accommodation, created cycles characterized by a ratcheting up of public debt, accelerating inflation, growing dollarization, and eventual crisis.

The remainder of this section reviews these key dimensions of domestic policy volatility. In particular, the discussion illustrates the role in the region of the volatility of discretionary fiscal policy, the frequency and intensity of changes in exchange rate regimes, the vulnerability of financial systems, and the extent and frequency of policy reversals.

A. Volatile Fiscal Policy

Recent research suggests that fiscal policy volatility has been a key contributor to the region's record of weak macroeconomic performance.[10] Fiscal volatility is seen as hurting growth and its sustainability mainly through reducing productivity. High fiscal volatility—especially in discretionary fiscal policy—implies a lack of consistency and predictability in policy, and dampens investment in productivity-enhancing areas.[11]

In this context, Latin America's record of fiscal volatility over the period 1960–2000 is generally higher than other regions and has been closely associated with its lower growth performance. Within the Latin American region, the correlation also seems to hold. More broadly, Figure 4 illustrates that the volatility of discretionary fiscal policy has been generally negatively related to growth in a sample of 92 countries that includes Latin American and Asian countries. Moreover, Latin America's record of fiscal policy volatility over the period 1960–2000 is generally higher than in Asia, most notably in Argentina, Venezuela, and Peru. However, in Asia, this negative correlation seems to be present as well, and for several countries, the volatility of discretionary fiscal policy has not been markedly lower than in some countries in Latin America. Thus, Figure 4 illustrates that, in Asia, countries with stronger track records of prudent fiscal policy conduct—i.e., less volatile discretionary fiscal policy—like Hong Kong SAR, Japan, and Thailand, have tended to experience faster growth than others with weaker track-records, such as Indonesia and the Philippines.

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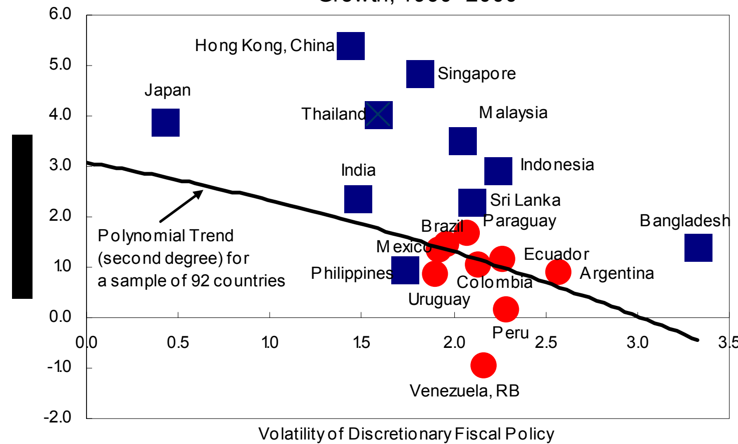
[10] Fatas and Mihov (2003), Reinhart and Rogoff (2002), and Sahay and Goyal (2006).

[11] Discretionary fiscal policy is defined as those changes in fiscal policy that are implemented for reasons other than current macroeconomic conditions or as a result of automatic stabilizers. The volatility of discretionary fiscal policy is measured as the standard deviation of the residuals of a regression of government real expenditures on several control variables, including inflation.

Figure 4. Discretionary Fiscal Policy and Per Capita GDP Growth, 1960–2000



Source: Based on Mody and Schindler (2004).

The volatility of discretionary government spending has been seen as explaining a large part of the substandard per capita growth in a number of countries.[12] Sahay and Goyal (2006) suggest that fiscal policy volatility is particularly damaging to the extent that it is discretionary—that is, where it does not constitute an automatic response to the cycle. It is this discretionary policy, and its procyclicality, that adds to macroeconomic instability, by amplifying economic fluctuations from other sources. Sahay and Goyal present evidence that the volatility of discretionary fiscal policy has tended to raise output volatility and hamper growth in the region.

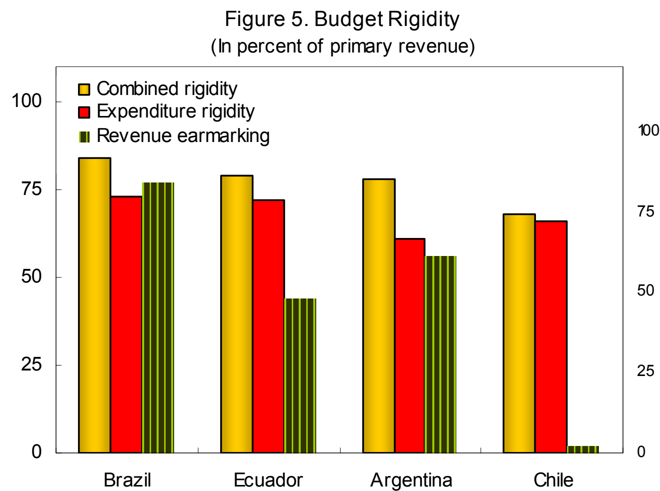
While the sources of fiscal policy volatility in Latin America have varied, there have been some common elements. Among these, most notably, are those related to institutional weaknesses, such as the influence of electoral cycles on budgetary implementation, difficult intergovernmental fiscal arrangements and, often, the absence of medium-term fiscal goals to provide an additional anchor to budgetary implementation. The absence of a sufficiently strong institutional framework to discipline policies is seen as becoming especially problematic during periods of rapid growth, leading to rapid debt build up, procyclicality and, eventually, contributing to crisis and a collapse in growth. The weakness associated with the absence of fiscal institutions has been particularly damaging in Latin America, given the region's high unemployment, poverty, and income inequality, since these conditions have also created social tensions that have periodically destabilized the conduct of fiscal policy in many countries.

Latin America's generally inflexible budget structures may have evolved, in part, as a response to its fiscal volatility. To a large extent, these rigidities were introduced to limit fiscal policy discretion and preserve budgetary allocations in a context of high inflation.

[12] See Mody and Schindler (2004).

Alier (forthcoming) notes that "budget rigidities" in many countries in Latin America have included, to varying degrees, revenue earmarking, minimum expenditure requirements, and mandatory transfers to sub-national governments, and many times these rigidities have been incorporated in constitutions.[13] Alier's estimates of "combined rigidities," which encompass the impact of revenue earmarking and spending requirements, show that more than three-quarters of the federal government budgets in Argentina, Brazil, and Ecuador, for example, are inflexible (Figure 5). Despite broad consensus about the inefficiencies for fiscal management, equity, and growth, the complex political economy underlying budgetary rigidities has made reforms difficult to advance in Latin America. In contrast, budgetary structures in Asia have remained relatively flexible, with limited revenue earmarking and minimum expenditure requirements.

Figure 5. Budget Rigidity
(In percent of primary revenue)



Source: Alier (forthcoming).

These factors have added to the procyclicality of fiscal policy in Latin America, exacerbating overall macroeconomic volatility. In particular, fiscal policy has tended to be expansionary in economic booms and has not been effective in counter-acting economic downturns. For example, using the methodology proposed by Kaminsky, Reinhart, and Vegh (2004), Table 2 shows that growth in real government spending has been positively correlated with real GDP growth in Latin America.[14] The results also illustrate that, since 1990, fiscal policy became increasingly procyclical in Latin America, especially in countries with high budgetary rigidities, like Argentina, Brazil, and Colombia, as well as in others like Uruguay and Venezuela. In Asia, only the Philippines and Thailand seem to have had procyclical fiscal policies during the 1990s.

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[13] Echeverry, Ferguson, and Querubin (2004) discuss and present evidence of budget rigidities in Colombia.

[14] Kaminsky, Reinhart, and Vegh correlate the cyclical components (based on the Hodrick-Prescott filter) of real government spending and GDP growth. A positive correlation is evidence of a procyclical fiscal policy.

Table 2. Procyclicality of Fiscal Policy

	KRV Measure	
	1963–90	1990–2005
Latin America	**0.12**	**0.35**
Argentina	0.22	0.55
Brazil	...	0.33
Chile	0.17	0.08
Colombia	-0.32	0.31
Mexico	0.04	0.11
Uruguay	0.19	0.56
Venezuela	0.40	0.52
Asia	**0.30**	**0.03**
China	0.26	0.05
Hong Kong	0.15	-0.34
Korea	0.04	-0.40
India	0.33	0.03
Indonesia	0.48	0.00
Malaysia	0.60	-0.18
Philippines	0.58	0.41
Thailand	-0.04	0.65

It is not surprising that these weaknesses in fiscal policy have resulted in high levels of public debt generally over a long period in the region. Gross public indebtedness has risen markedly again since the early 1990s, and still remains relatively high for most of the region, with the notable exception of Chile (Table 3).

Table 3. Debt Indicators, 1993–2005
(In percent of GDP)

	Gral. Govt. Gross Debt			Total External Debt		
	1993	2000	2005	1993	2000	2005
Latin America	**38.5**	**43.5**	**46.7**	**44.4**	**45.7**	**40.4**
Argentina	30.6	51.1	85.9	34.0	54.5	74.4
Brazil	n.a.	67.6	75.1	33.2	36.1	21.3
Chile	29.7	14.0	5.9	40.2	49.4	39.4
Colombia	n.a.	46.2	47.4	28.0	43.1	32.1
Mexico	27.3	49.3	45.1	32.2	28.7	22.5
Uruguay	32.3	38.5	69.9	36.0	44.3	68.4
Asia 1/	**57.5**	**58.4**	**51.7**	**43.0**	**61.4**	**41.0**
China	9.4	20.0	19.3	13.9	12.2	13.4
India	76.8	75.7	84.8	34.0	22.1	17.3
Philippines	96.6	88.1	86.5	65.7	75.6	63.8

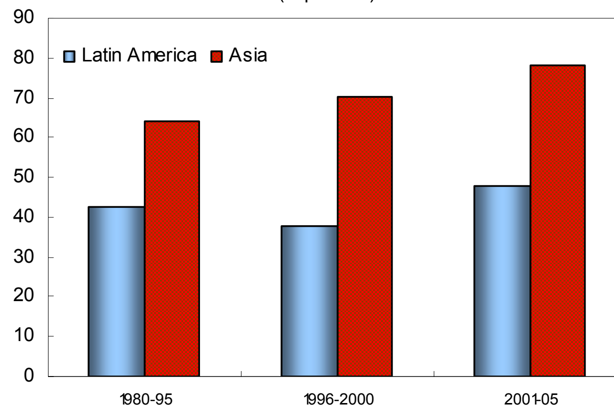
Source: IMF.
1/ Excludes China and India.

High public debt has weighed heavily on economic stability and growth. For example, Benelli (2006), as well as Patillo, Poirson, and Ricci (2002) show that for Latin American countries, external public debt to GDP ratios above a certain threshold tend to reduce countries' growth potential. Thresholds tend to be quite low—possibly as low as 65 percent of exports or 20 percent of GDP—and the impact of debt tends to be quantitatively important: doubling debt at or above the threshold dampens annual per capita growth by

about 1 percentage point. This analysis suggests that the transmission channel for this effect is complex, with one third of the effect due to lower capital accumulation and the rest to slower productivity growth. In other words, high debt dampens productivity and growth directly—by crowding out private investment—and also indirectly—for example, by increasing the reliance on distortionary taxes and macroeconomic uncertainty.

Latin America's weak debt structure has added to its macroeconomic volatility. For example, the share of floating-rate and exchange rate-linked domestic debt rose markedly during the 1990s, making the region much more susceptible to shifts in domestic confidence and global capital market conditions (Figure 6). By contrast, Asian economies have tended to keep gross public indebtedness lower—with India and the Philippines being notable exceptions—and have also tended to increase steadily the share of fixed rate debt. The vulnerabilities implied by weak debt structures has been illustrated by Sahay and Goyal (2006), who show that low-growth periods in Latin America have tended to be associated with higher and more volatile U.S. interest rates. Arora and Cerisola (2001) have also documented that sovereign bond spreads in both Latin America and Asia tend to rise with higher and more volatile U.S. interest rates.

Figure 6. Share of Fixed Rate Domestic Debt
(In percent)



Source: Emerging Market Database (Jeanne and Guscina, 2006).

B. Monetary Policy and Exchange Rate Regimes

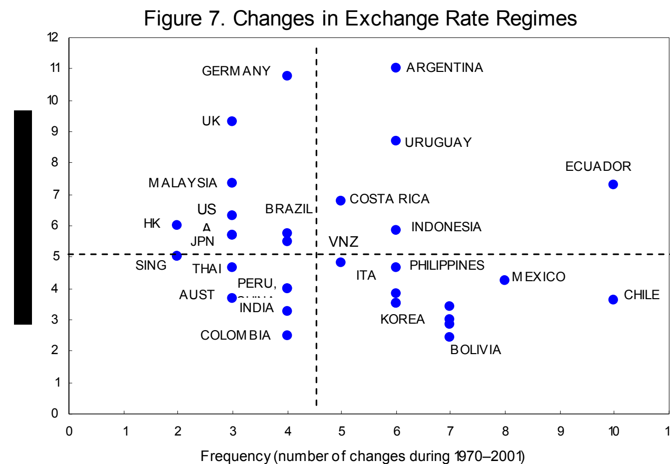
Weaknesses in Latin American exchange rate and monetary policies have also contributed to the region's record of high inflation and external crises. In the past, a key contributor has been the phenomenon of "fiscal dominance" in which central banks have lacked the independence to resist pressures to provide financing for large fiscal deficits. The resultant rapid rates of monetary growth have spurred bouts of high or hyper inflation and—given the predisposition toward fixed exchange rates—contributed to frequent and highly disruptive

changes in exchange rate regimes.[15] Edwards and Yeyati (2003) find that fixed-type exchange arrangements have been especially associated with increased macroeconomic volatility. They show that, in a sample of 183 countries, those with more rigid exchange rate regimes have tended to experience amplified effects from terms of trade shocks. Edwards and Yeyati argue that this evidence also provides support to the view that more flexible regimes tend to be more effective in dealing with terms of trade and other shocks.

The volatility of Latin American exchange rates has been high. The Reinhart and Rogoff (2004) indices suggest that the frequency and intensity of exchange rate changes in Latin America was much more than in other regions over the past 30 years (Figure 7). These included experiments with the "*tablitas*" in the late 1970s (e.g., Argentina, Chile, and Uruguay), dual and multiple exchange rate regimes in the aftermath of the debt crises in the 1980s (Argentina, Brazil, Mexico, Venezuela), and a currency board, full dollarization, and crawling pegs in the 1990s (Argentina, Ecuador, and several others in Latin America). These fixed-type arrangements were typically undermined by unsustainable fiscal policies and ended in crises.

Although many Asian countries maintained formal or *de facto* fixed exchange rates during much of this period, they experienced less volatility in their regimes. This reflects, to a large extent, the fact that they have also generally maintained fiscal policies compatible with those regimes and avoided tensions (sometimes through capital controls) between domestic and external balance. As illustrated in Figure 7, this meant that Asian economies were much less prone to exchange rate regime changes, with only Indonesia and the Philippines exhibiting close to the same level of frequency and magnitude of change as countries in Latin America.

Figure 7. Changes in Exchange Rate Regimes



Source: Calculations based on Reinhart and Rogoff (2004).

[15] Sahay and Goyal (2006) stress the difficulty in finding good measures of monetary policy instability, as well documented in the literature. The effect of exchange rate changes on growth is far from obvious: the frequency and intensity of exchange rate regime changes could be abrupt and unexpected, with significant adverse impact on uncertainty and growth, or could be an orderly response to shocks, with positive consequences for growth.

C. Financial Intermediation

Latin America's propensity for macroeconomic volatility has also had important implications for financial intermediation. There is a growing literature that suggests that macroeconomic volatility likely interacted with the region's relatively less developed financial markets and institutions to perpetuate macroeconomic and financial vulnerabilities, slow financial market development, reduce resilience to shocks, and keep growth low.

Thus, Latin America has been relatively less successful in building deep and liquid financial markets, while also being subject to more frequent banking and financial crises. Despite a recent rising trend, bank credit to the private sector in Latin America is still, on average, only about 30 percent of GDP—about a third of the level in the advanced economies (Table 4). Similarly, de la Torre, Gozzi, and Schmukler (2005) document that stock market capitalization in Latin America has risen much more slowly over the past 15 years and stands at just over 40 percent of GDP, compared with rates of nearly 100 percent in the G-7 and nearly 150 percent in East Asia, with Latin America exhibiting similarly weaker indices of bond market development. However, as noted by Tseng and Cowen (2006), several banking systems in Asia, notably in China and India, also still face major challenges to strengthen domestic intermediation, including from sustained capital inflows and large reserve accumulation, as well as from the long-standing dominance of public banks.

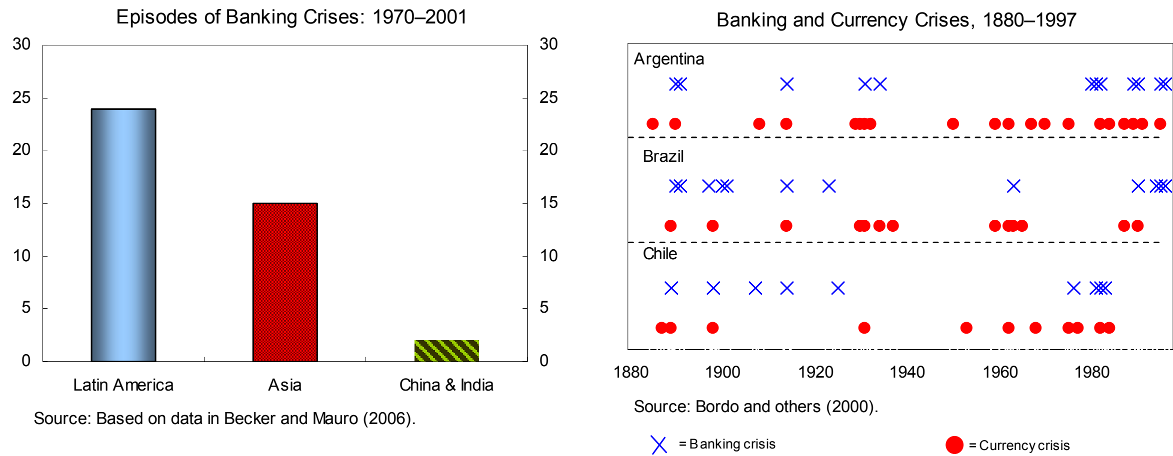
Table 4. Private Sector Credit
(In percent of GDP)

	1961–70	1971–80	1981–90	1991–2000
Latin America	15.2	22.2	27.0	29.6
East Asia (excl. Japan)	18.4	27.7	50.7	98.7
Middle-East and Central Asia	24.5	37.9	43.3	47.2
North America (US and Canada)	44.9	64.7	76.3	95.8
South-Asia	10.1	15.4	20.4	21.2
Sub Saharan Africa	19.6	22.3	22.7	25.0
Western Europe	49.3	55.0	74.4	90.7

Sources: *International Financial Statistics*, and WDI.

Broader macroeconomic instability has been an important contributory factor to these trends. There seems little doubt that the region's periodic inflation and currency crises have undermined the ability of financial systems in Latin America to attract domestic savings, compounded in some cases by substantially negative real interest rates, and a lack of confidence in bank soundness, especially following banking crises in the 1970s and 1980s (Figure 8). As a result, since the late 1960s, most countries in the region could not significantly raise their levels of financial intermediation, measured by the share of broad money to GDP. In addition, the evidence presented by de la Torre (2006) suggests that large fiscal deficits have played an important role in discouraging financial market development in the region.

Figure 8. Episodes of Banking and Currency Crises, 1880–2001



Source: Based on data in Becker and Mauro (2006).

Source: Bordo and others (2000).

Other contributory factors may also have had their roots in fiscal weakness. For quite some time, Latin America's financial systems were subject to interest rate controls, high (and typically unremunerated) reserve requirements and, more recently, greater reliance on financial transactions taxes (Table 5). These factors weakened incentives to build a deposit base and added to intermediation margins, in turn increasing the cost of funds and, thereby, increasing the overall risk of bank loan portfolios.

Table 5. Bank Debit Taxes and Revenues, 2005

	Tax Rate	Revenue 2/
Argentina	0.60 1/	1.80
Bolivia	0.25 1/	0.80
Brazil	0.38	1.50
Colombia	0.40	0.85
Peru	0.08 1/	0.30
Venezuela 2/	0.50	1.00

Source: IMF staff estimates.
1/ On each side of a transaction.
2/ In percent of GDP.

With the region's macroeconomic volatility, financial market underdevelopment, institutional weaknesses, and low economic growth, elements of a vicious cycle have likely been at work. Responsiveness to shocks has likely suffered. In a recent study, Aghion, and others (2006) show that countries whose financial development falls below a certain threshold will be less capable of coping with exchange rate volatility. At the same time, financial sector vulnerabilities may have exacerbated macroeconomic volatility, in part by raising the fiscal and output costs of currency crises.[16] Disintermediation and underdeveloped capital markets has meant that borrowers in Latin America have had more limited access to credit, and have been required to borrow short-term, in dollars, or offshore, increasing their mismatch with the nature and currency composition of their incomes, and leaving them exposed to sudden stops of capital that triggered large exchange rate depreciations and "balance-sheet" disruptions (Mexico, 1994 and Argentina, 2001).

[16] IMF research suggests that emerging market economies experiencing currency crises typically suffer cumulative output losses of about 15 percent. However, when a currency crisis is coupled with a banking crisis, the cumulative output loss is closer to 28 percent (see Box 3.3, *World Economic Outlook*, April 2002).

Underdeveloped financial markets have also been an additional drag on growth. There is substantial accumulated evidence that countries with deeper banking systems and capital markets have tended to grow faster (Levine, 1997; Calderon and Liu 2002; and McKinnon, 1973). In part, this reflects the important role that domestic financial and capital markets play in facilitating risk-sharing, as well as monitoring and enforcing corporate governance. As stressed by Levine, financial systems help to ameliorate informational asymmetries and transaction costs and, by facilitating the development of standardized contracts, markets, and institutions, expand the opportunities available to both savers and borrowers. In other words, the evidence seems to suggest that, the more actively involved a financial system is in allocating credit, the more effective the system is in monitoring firm performance, providing risk management services, and mobilizing savings. This helps explain the positive correlation between real per capita GDP and the extent of private sector credit.

The prevalence of banking crises in Latin America also reflected institutional weaknesses over a long period. Carstens, Hardy, and Pazarbaşioglu (2004) suggest a number of factors that have left the region vulnerable, including substandard accounting and supervisory practices, the absence of creditor rights, and bank resolution frameworks that have resulted in recurrent freezing and confiscation of deposits (even in recent years). Moreover, past crises had lingering effects on the credit culture, including by reducing the ability of borrowers to establish a credit history, while hyperinflations undermined the quality of bookkeeping and therefore supervisory norms. Finally, the lack of well-defined and well-enforced bankruptcy laws that discouraged bank lending to the private sector meant that banks portfolios were excessively exposed to government debt.

D. Policy and Reform Reversals

Latin America's experience with the persistence and implementation of market-oriented reforms has also been different. In Asia, reforms have been introduced at an earlier stage, following a relatively steady pace, with reform reversals infrequent. The first wave of reforms in Asia began in the 1960s, most notably in Hong Kong SAR, Korea, and Singapore. In the 1970s, China, Malaysia, Indonesia, and Thailand also began to introduce reforms that boosted investment and productivity. In China, for example, the reforms that began in the 1980s have been characterized as "incremental and experimental" (Prasad and Rajan, 2006), with a view to enabling market-driven efficiency gains in certain sectors and regions of the economy. Qian (2003) notes that a series of institutional changes, including hardened budget constraints and competition, driven by market liberalization, were successful in boosting efficiency without creating major losers in the economy, thereby sustaining consensus for reforms. In India, major reforms were initiated in the 1980s and then accelerated in the early 1990s in response to a balance of payments crisis (Ahluwalia, 2002). Even in areas where China and India have compared less favorably to Latin America, such as property rights and informality, steady progress has been achieved.

Latin America also made important strides in promoting market-oriented reforms, but typically in a less consistent and sustained manner. With the exception of Chile, limited, if any, progress with market-oriented reforms was made between 1970 and 1985, and much of this progress was largely undone in the aftermath of the 1982 debt crisis (Figure 9). As noted by Edwards (1994), as well as by Morley, Machado, and Pettinato (1999), many countries responded to the crisis with financial repression, capital controls, and tariff and non-tariff barriers, particularly in Argentina, Brazil, and Mexico.

However, since the early 1990s, Latin America has sought to accelerate reforms. Steps have been taken to strengthen property rights, liberalize international trade and financial transactions, and reduce government intervention (Figure 10). Most significantly, Chile made significant progress with market-oriented reforms, with reform indices for this country reaching industrial-country levels. However, elsewhere in the region, the recent progress has been less steady, and reforms have been interrupted by financial crises, as well as by some disappointment with the outcome of reforms during the 1990s.

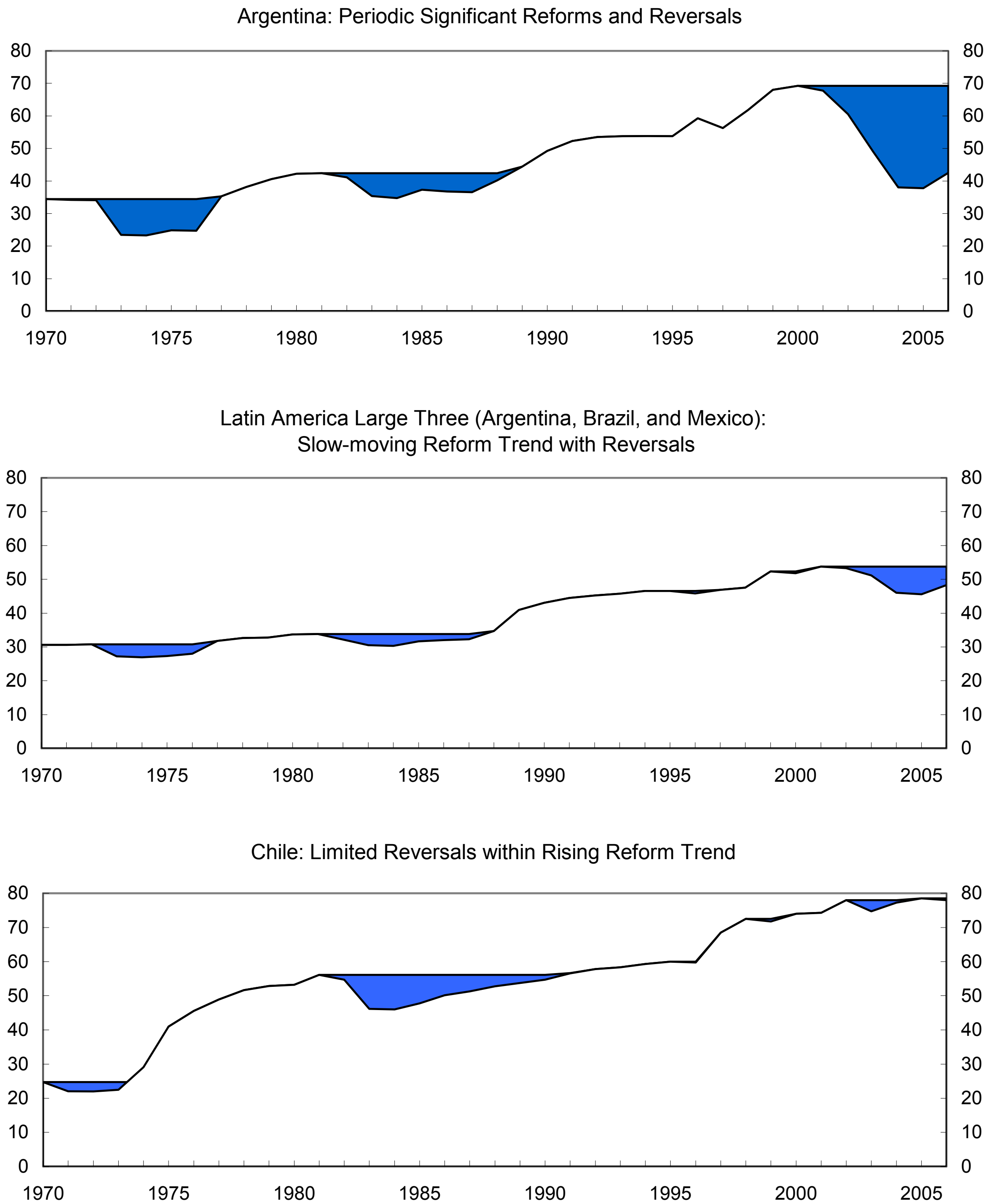
The experience with market-oriented reforms and reversals shows that growth in countries that have successfully sustained reforms has been faster and less volatile. Indeed, the earlier and steadier implementation of market-oriented reforms are important conditions for promoting higher investment and productivity growth. Sahay and Goyal (2006) show that, in Latin America, reversals in market-oriented reforms have been strongly related to macroeconomic volatility, which in turn hinders investment and productivity growth. More generally, these reform reversals have occurred not only in response to crises, but often have pre-dated crises as well.

IV. Recent Progress toward Stability and Sustained Growth

In contrast to the long-term trends, significant progress has recently been made in Latin America toward establishing conditions more propitious for investment and growth. Most importantly, a number of steps have been taken to strengthen macroeconomic policies. Monetary policy has been increasingly geared toward maintaining a stable macroeconomic environment. Carstens and Jacome (2005) emphasize the importance of institutional reforms that have provided central banks with increased operational independence as well as accountability, which has helped bring inflation to the single-digit rates in a clear majority of the countries in the region.

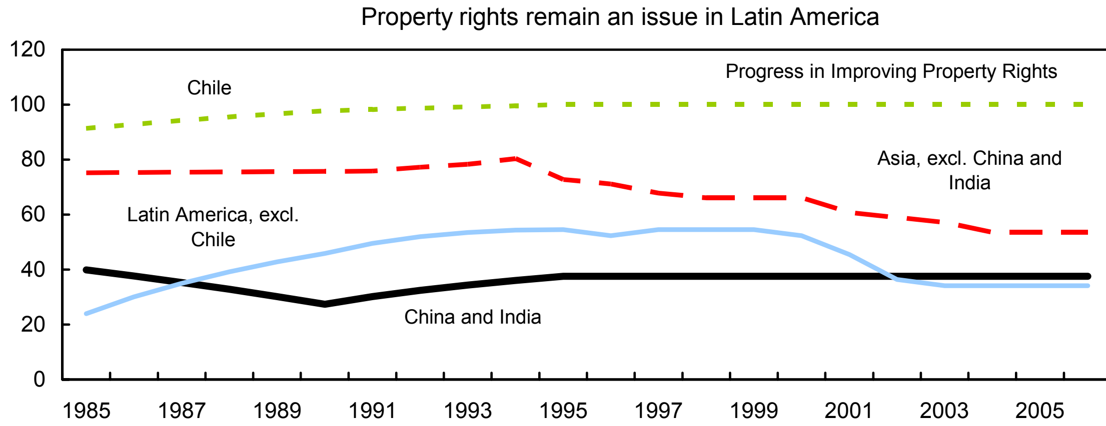
Improvements in fiscal discipline have followed. During most of the 1990s, however, fiscal policy continued to place pressure on monetary policy and exchange rates, and has only become more effective in recent years following the crises in the late 1990s and early 2000s. But, since then, helped by the cyclically strong environment for revenues in many countries, budget deficits and indebtedness have been trending downwards and active debt management and reforms are helping to develop domestic capital markets, extend maturities, and raise the share of fixed rate domestic debt.

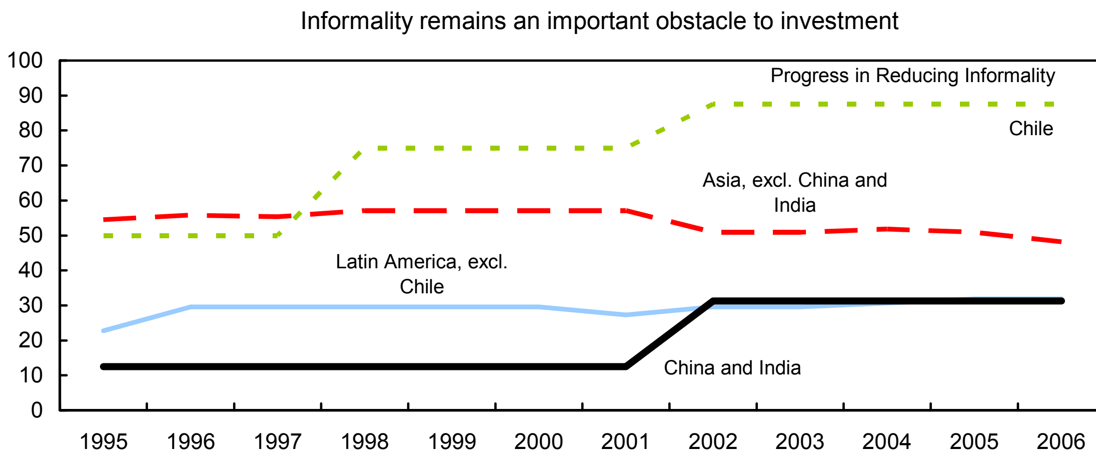
Figure 9. Market-Oriented Reforms in Latin America: Progress and Reversals
(Morley-Heritage Composite Index)

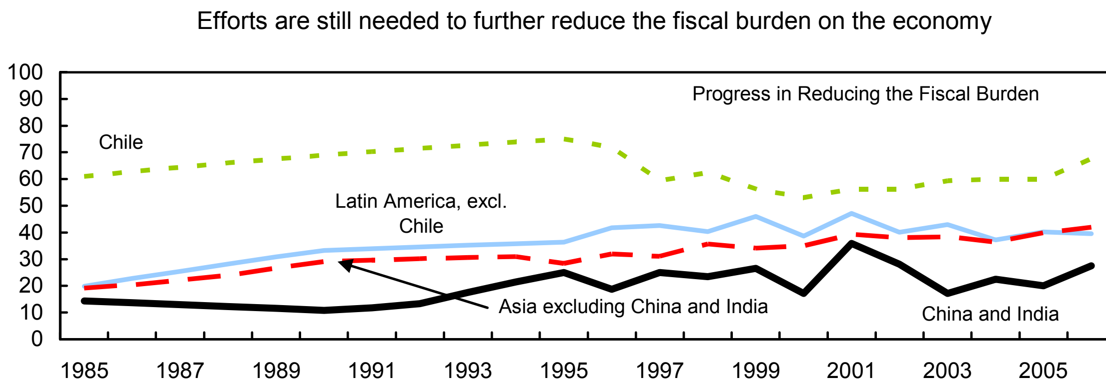


Source: Based on Sahay and Goyal (2006), who construct an index of structural reforms using the Index of Economic Freedom from the Heritage Foundation and the index as presented in Morley (1999).
Note: Dark areas refer to the period of structural reform reversals.

Figure 10. A Comparison of Investment Determinants, 1985–2006



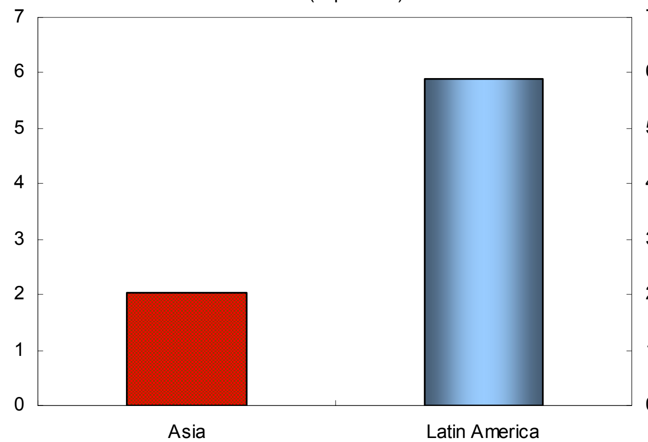




Sources: 1985–94 based on Frazer Institute; and 1995–06 based on Heritage Foundation, Morley (1999) .

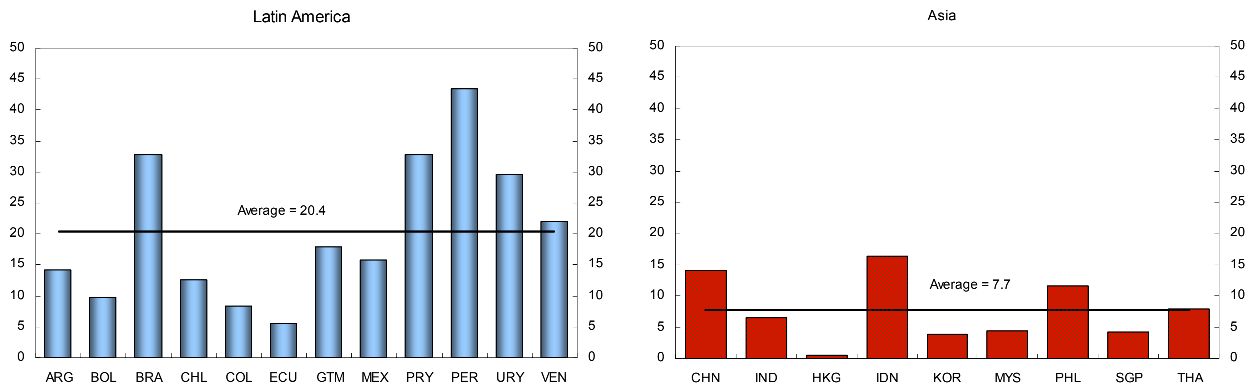
Financial intermediation has also risen in recent years. Rising financial intermediation, particularly increased access to credit, has been the result not only of favorable cyclical conditions, but also of regulatory and supervisory improvements undertaken over the past decade, that have strengthened credit risk information, contract enforcement and loan recovery procedures. Nevertheless, Gelos (2006) illustrates that intermediation costs and real interest rates still remain well above those in other regions, and public banks continue to play an important role in many countries (Figures 11 and 12).

Figure 11. Net Interest Margins of the Banking Sector 1/
(In percent)



Source: IMF staff estimates.
1/ Averages for 1995–2004 for selected countries in each region.

Figure 12. Effective Reserve Requirements for the Banking System 1/
(In percent, as of December 2005)



Source: IMF staff estimates based on International Financial Statistics.
1/ Reserve requirements defined as reserves held by the banking system over total deposits of the banking system. There are countries, like Mexico, where no compulsory requirements are imposed.

Over the past decade, Latin America has become increasingly integrated with the rest of the world. Led by Chile's and Mexico's impressive trade liberalization efforts, the region has become more open—building up on the steady rise in world trade linkages that have taken place over the past four decades. This is demonstrated by the indices presented by Kose, Prasad, and Terrones (2005). For Latin America, the ratio of total external trade to GDP rose by more than 10 percentage points on average during the 1990s. In addition, the region's financial markets also become increasingly integrated with the rest of the world, with the ratio of gross capital inflows to GDP rising most prominently in Argentina, Chile, and Venezuela. However, Latin America's rapid financial integration during the 1990s outpaced its trade integration and contributed to its volatile macroeconomic conditions, even though Latin America still remains significantly less integrated with the world economy than most Asian and industrialized economies.

Table 6. Trade and Financial Integration,1960–2000

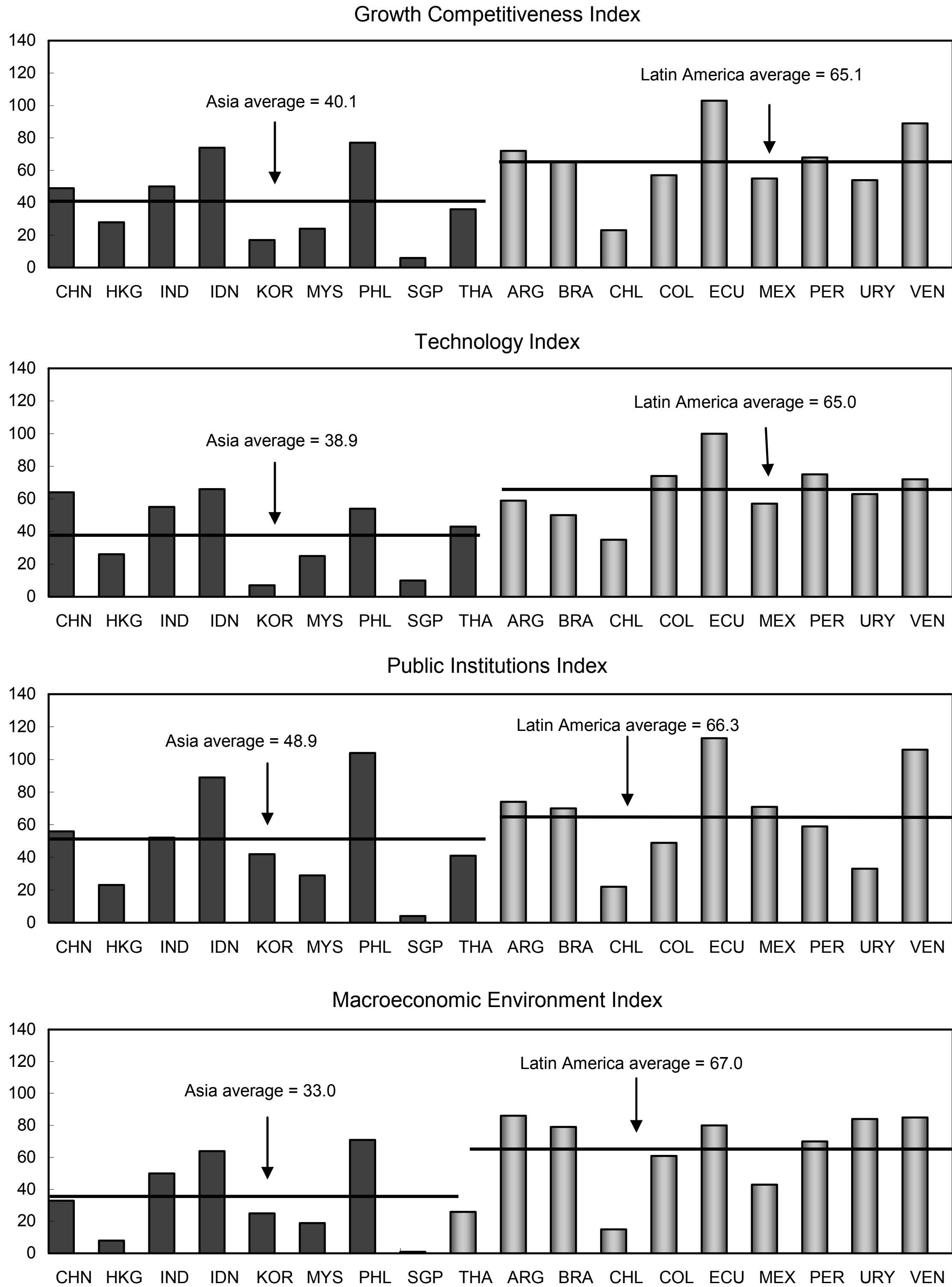
	Trade Integration		Financial Integration	
	1960–90	1990–2000	1960–90	1990–2000
Latin America	**27.6**	**39.2**	**1.5**	**7.4**
Argentina	13.8	19.0	0.1	8.4
Brazil	15.8	18.5	1.2	3.6
Chile	40.2	59.7	0.1	14.2
Colombia	28.2	36.2	2.9	5.3
Mexico	22.5	50.5	2.0	5.3
Venezuela	45.0	51.1	2.6	7.4
Asia	**42.1**	**77.9**	**3.8**	**6.2**
China	12.8	40.5	0.6	6.8
India	12.6	23.6	0.6	2.7
Indonesia	37.0	56.4	13.1	1.8
Korea	50.7	66.6	2.4	6.3
Malaysia	94.0	182.9	4.5	8.8
Philippines	42.9	84.6	2.4	11.4
Thailand	44.6	90.4	3.2	5.6
G-7	**35.6**	**44.0**	**6.0**	**16.3**

Source: Kose, Prasad, and Terrones (2005).

The progress in establishing more stable macroeconomic conditions has been supported by some institutional strengthening and steps to create a more investment-friendly business environment. Since the early 1990s, Latin America strengthened property rights, while important gains were made in promoting education and in strengthening governance. At the same time, there is scope for further progress in many areas, to catch up with other regions. This is highlighted in international surveys, where, for example, Latin America's business environment remains less attractive than Asia's (Figure 13). Major constraints have been the weak public infrastructure, greater uncertainty in the rule of law, weaker public institutions, and significant obstacles to establishing new businesses, as well as to adapting and incorporating new technologies.[17]

[17] Blazquez-Lidoy and others (2006) stress the importance of reforms to boost infrastructure to preserve Latin America's comparative advantage amid China's increasing global trade influence.

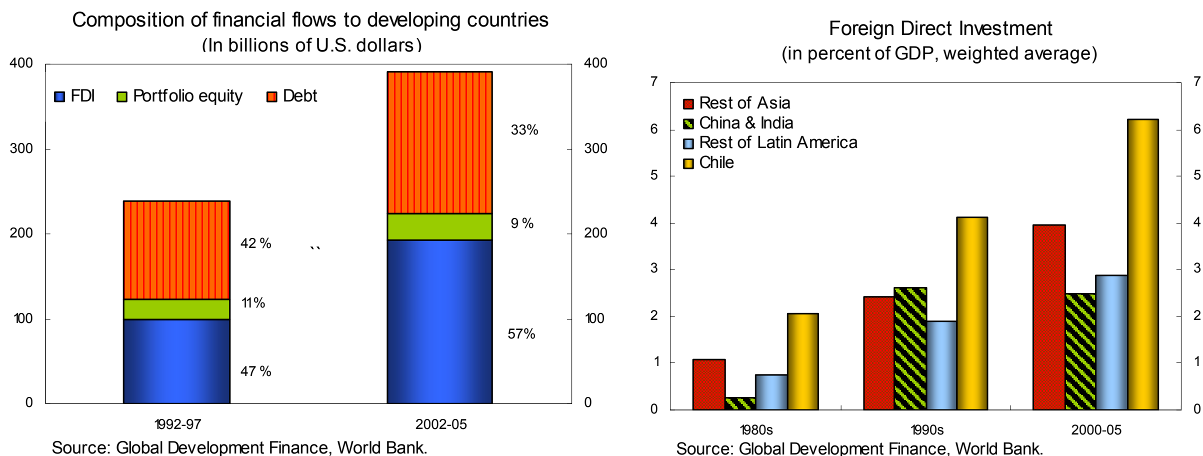
Figure 13. Latin America and Asia: Growth Competitiveness, 2005–06
(Rankings)



Source: World Economic Forum, *Global Competitiveness Report, 2005–06.*

The more stable macroeconomic conditions and increased integration are attracting a renewed wave of capital flows into the region. Since 2002, international private capital inflows to developing countries have surged to record highs. But in contrast to the previous wave in 1992–97, the composition of capital flows has noticeably shifted away from debt-creating flows (especially short-term) toward equity, particularly foreign direct investment (Figure 14). This new wave of flows is being led by privatizations, cross-border mergers, portfolio equity, reflecting global strategic diversification. And the trend toward equity in the composition of private capital flows has been pronounced in East Asia and is also being witnessed in Latin America. Private flows to Latin America have risen markedly, and major equity and bond markets in the region are being increasingly driven by foreign investor inflows. Equity prices in Brazil and Mexico have hit record highs recently, and, following the development of local bond markets, the share of nonresident holdings of government bonds has increased markedly, notably in Brazil, Colombia, and Mexico.[18] With the region experiencing favorable macroeconomic performance and high commodity prices, foreign direct investment has also picked up markedly. While several of the traditional advanced economies have remained as main sources of investment, flows from other emerging market economies have also risen. Brazil, Chile, Colombia, and Mexico, have continued to be favored destinations, although most Andean countries have also witnessed a marked increase in FDI, partly reflecting China's strategic investments in primary sectors, such as in Ecuador and Peru. In general, most countries in Latin America are much better prepared than in the past to deal with this new wave of capital flows. Many now have flexible exchange rate regimes, less evident real exchange rate misalignments, and current account surpluses, which leaves them less exposed to capital flow reversals.

Figure 14. Recent Trends in Capital Inflows



Source: Global Development Finance, World Bank.

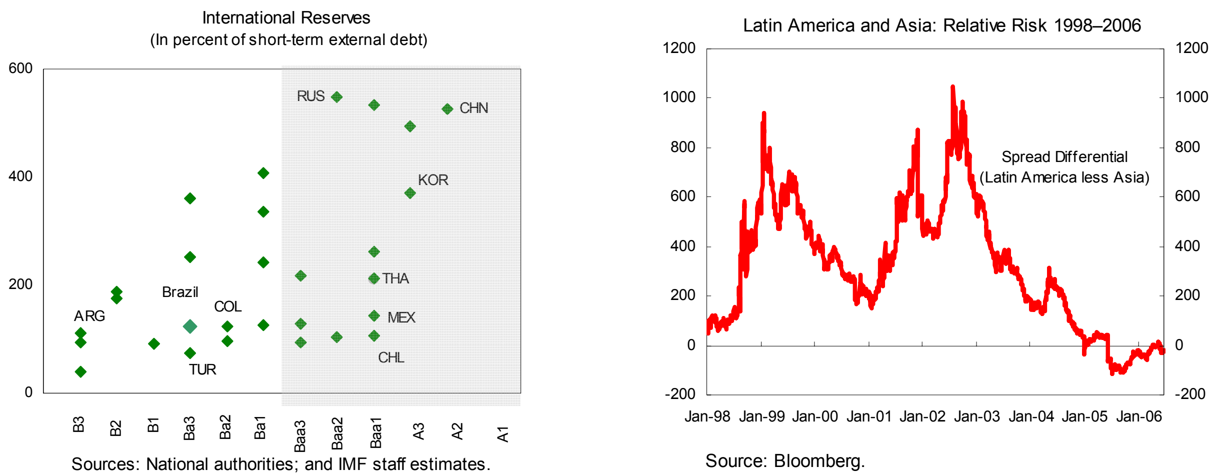
Source: Global Development Finance, World Bank.

[18] IMF, *Global Financial Stability Report*, various issues.

V. Some Lessons and Policy Challenges

How can Latin America best leverage its recent progress to entrench stability and sustainable growth? Our review suggests that much will continue to depend on Latin America's commitment and ability to preserve a stable macroeconomic environment and to build lasting investment and productivity improvements. In this regard, the conduct of macroeconomic policies in recent years has been the best in a long time. Latin America is now experiencing the highest per capita growth rates since the early 1960s. Fiscal policy has remained prudent, supported by high primary surpluses, and the institutional commitments to low inflation have been strengthened in many countries with the adoption of inflation targeting and flexible exchange rates. By building up international reserves, Argentina, Brazil, Colombia, Mexico, and Peru have taken "additional insurance" against the risks of external shocks, especially those associated with "sudden stops." For the first time in almost a decade, market assessments of Latin America's country risk do not differ significantly from those of Asia (Figure 15).

Figure 15. Reserves and Country Risk



Sources: National authorities; and IMF staff estimates.

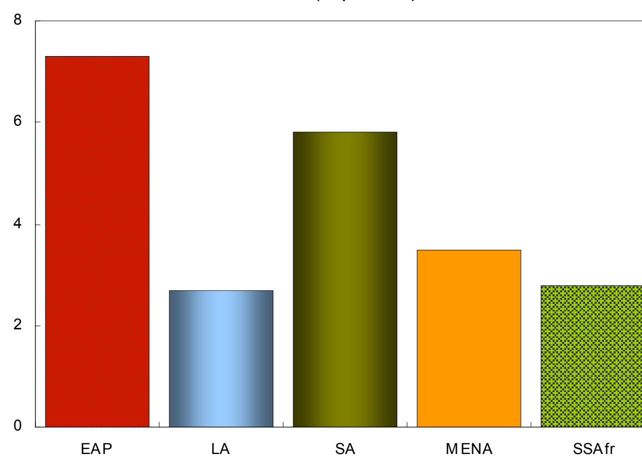
Source: Bloomberg.

However, it remains a challenge to sustain and strengthen the social consensus for policies that will help consolidate macroeconomic stability and growth. While growth has recovered markedly in Latin America, it continues to lag that of other regions (Figure 16). In this regard, the social consensus in Latin America for low inflation seems to be better established than it has been for a long time.[19] On the other hand, as Zettlemeyer (2005) illustrates, views on broader reforms in the region continue to diverge markedly, and there have been recent calls for protectionism and nationalization of private industries in some countries. This

[19] Singh (2006b) notes that the debate on how best to ensure that macroeconomic stability becomes entrenched in the region is greatly facilitated with a shared goal of macroeconomic stability. In this regard, the region's policymakers will need much agility and domestic political support in keeping inflation low and their macroeconomies stable in the period ahead, given likely tests from the global environment.

reflects a divergence of view between those in the region that believe that reforms in the 1990s did not go far enough, those that believe that reforms went too far, and those that believe that reforms missed the point. What is heartening, however, is the evidence that macroeconomic performance since the early 1990s has been better in the reforming countries, particularly those that preserved macroeconomic stability, liberalized trade, and strengthened their financial sectors.

Figure 16. GDP Per Capita Growth, 2002–05
(In percent)



Source: IMF, *World Economic Outlook*.
Note: Growth at t defined as log difference of constant price GDP between t + 1 and t.

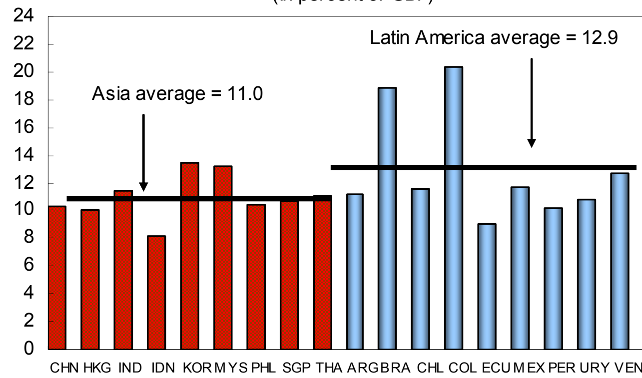
Based on our review, we offer the following suggestions for the key policy priorities that could help consolidate macroeconomic stability and boost growth prospects in Latin America:

- Lessen the government burden on the economy. While Latin America has successfully used higher tax revenues to boost primary surpluses during the current expansion, primary spending is again on the rise in some economies in the region, and few countries have been able to follow Chile's example and ensure lasting savings out of the windfall earnings from commodity prices (Figure 17). Against the backdrop of still-high levels of public debt, new government spending commitments need to be carefully balanced with further progress toward debt reduction, and toward avoiding imparting a procyclical impetus to the economy.

- Advance fiscal reforms to help both growth and equity. Latin American tax structures (especially tax exemptions) have generally tended to favor upper-income groups, while high subsidies in some countries—generally devoted to energy use—often do not benefit the poor. Reforms in these areas, along with a gradual phasing out of minimum expenditure requirements and associated budgetary rigidities, would provide governments with more room to allocate spending toward much needed public investment, primary and secondary education, and social assistance programs.

In this regard, the strengthened institutional frameworks for fiscal policies provide scope to reduce budgetary rigidities while limiting the impact on discretionary fiscal policies. These reforms could entrench a virtuous cycle of fiscal adjustment, macroeconomic stability, and poverty alleviation, thus broadening public support for prudent policies.

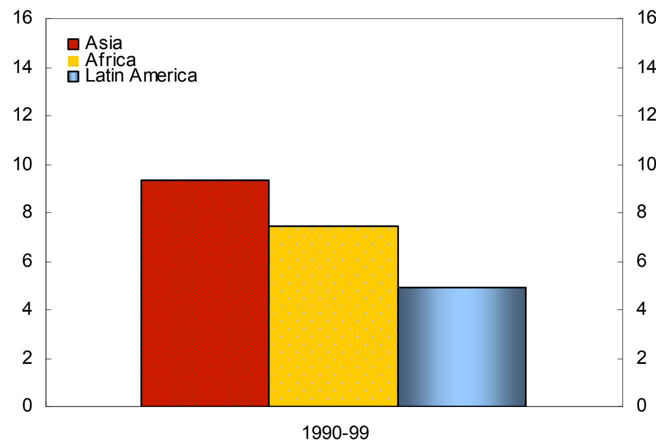
Figure 17. General Government Final Consumption Expenditure, 2004
(In percent of GDP)



Source: World Bank, World Development Indicators (2005).

- Improve public infrastructure. Greater budgetary flexibility would help lift the constraint on growth in Latin America that arises from its weak public infrastructure, largely associated with low public investment in the region (Figure 18). Blazquez-Lidoy and others (2006) repeats the call for better infrastructure that would help enable Latin America better exploit its comparative advantage and benefit more fully from globalization. Among the many priority areas, Blazquez-Lidoy and others (2006) cite, in particular, the importance of bringing port efficiency to OECD levels to help reduce transportation costs in the region, which for many countries, like Brazil, Chile, Ecuador, and Mexico, are still high by international standards.

Figure 18. Public Investment by Region
(In percent)



Sources: Country authorities; and IMF staff estimates.

- Solidify monetary and exchange rate frameworks. For many economies, this entails strengthening the credibility of inflation targeting regimes by consistently meeting official targets, which would further anchor inflation expectations and extend their time horizon. Preserving the commitment to flexible exchange rate regimes, by ensuring that exchange rates continue to respond to underlying fundamentals, is an essential part of the process. These efforts will best be served by enhancing the transparency of intervention policies and institutionalizing central bank autonomy.

- Provide banking systems with better means of supporting growth. Consolidating recent trends would entail additional reforms aimed at reducing the tax burden on financial intermediation. At the same time, it would be important to lower high reserve requirements, particularly in economies like Brazil and Paraguay, as well as selective credit requirements. Limiting the role of public banks in domestic systems and lowering barriers of entry, through privatization, restructuring, and increased foreign participation, would also foster much needed competition and reduce intermediation margins. Building policy credibility will also assist in reducing dollarization and in enhancing the role of banking systems in supporting growth.

- Continue to enhance the attractiveness of the business environment and proceed with further trade liberalization. To provide a predictable environment for investment, reform efforts need to remain focused on fortifying the judiciary, strengthening the enforcement of contractual obligations, and providing greater transparency and stability to rules and regulations governing private investment. It would also be important to take advantage of unilateral and multilateral initiatives to further liberalize external trade and to proceed with labor market reforms to increase flexibility and remove other restrictions that negatively impinge on labor demand, wages, and productivity.

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