VIII Lessons and Priorities for Future Agenda

The aim of this study has been to take stock of the achievements and disappointments in Latin America since the start of market-based reforms in the early 1990s, a period that also witnessed growing democratization in the region. This concluding section draws lessons from this period and, based on this experience, discusses policy priorities and the future roles of the major players involved—the policymakers in Latin America; the international institutions, and especially the IMF; and industrial country governments—in order to make a decisive break from the region's long history of recurrent crisis and to entrench growing prosperity.

Looking Back

When Latin America's experience since the early 1990s is viewed against the backdrop of the 1980s—an unsettled period for the region—it is clear that much has been achieved. This study has pointed to the following principal achievements.

Policy Performance

The 1990s saw the establishment of low inflation, a major achievement for much of Latin America, given its past record of high and volatile inflation. An important reason has been the emergence of widespread public awareness of the need to bring inflation down, leading to popular resistance to policies that would risk reigniting inflationary pressures. Thus, for example, the deep economic and financial crises of Argentina and Uruguay resulted in only a temporary acceleration of inflation, followed quickly by a return to single-digit rates. Similarly, strenuous efforts have kept inflation low in Bolivia despite fiscal and financial imbalances in a situation of political difficulty. Nevertheless, in many countries across the region, the sustainability of low inflation still needs to become fully entrenched, which will require sustained progress to bring down public debt and to address concerns raised by financial dollarization.

Policy Flexibility

The adoption of much more market-determined exchange rates by many Latin American countries in recent years has greatly improved the flexibility of the macroeconomic policy frameworks. In parallel, the region is also successfully developing a new basis for monetary policy by moving away from exchange rate anchors and toward placing growing reliance on inflation-targeting regimes, which has contributed to successful inflation outcomes. The shift to inflation targeting has underscored the importance of central bank autonomy and encouraged greater transparency in communicating the rationale for monetary policy decisions to the wider community.

Role Models

The region has yielded important role models. The experiences of Chile and Mexico in delivering sustained and less volatile growth, improving policy flexibility, and striving for social consensus have become important examples for the region. Both countries have established sound macroeconomic frameworks and open trade regimes that have allowed them to successfully avoid the financial difficulties affecting other countries in the region during recent years. Moreover, they offer valuable lessons on the benefits of containing public debt, implementing an inflation-targeting framework, and building a strong regulatory and supervisory framework for the banking system. Other countries in the region have also demonstrated successes in important areas that can be followed by others—for example, Brazil's success in building a strong set of institutions for fiscal management.

Crisis Resolution

Although financial crises have recurred in the region, the speed with which the affected countries have been able to recover has generally exceeded expectations. For example, Brazil has endured two periods of high stress since 1998, but, each time, the government's commitment to low inflation and fiscal prudence has fostered a rapid stabilization of the situation and return of the country's access to international markets. Elsewhere in the region, Argentina and Uruguay have now returned to growth faster than had been anticipated, although recessions were very deep after their crises in 2002. Thus, countries in the region have generally been better positioned to benefit from the global recovery over the past year.

Speed of Response

The international community has also demonstrated its ability to act swiftly and comprehensively in addressing crisis situations. IMF-led support packages were assembled in record time in many cases, incorporating increasing safeguards against moral hazard. An important feature of recent IMF-led official assistance in many Latin American countries has been the ability to support economic policy continuity, thereby smoothing political transitions. Thus, in different ways tailored to individual circumstances, recent IMF-supported programs in Argentina, Brazil, Bolivia, Guatemala, and Paraguay have helped maintain macroeconomic stability through periods of political change. There have also been improvements in the role of the private sector in crisis resolution. Uruguay was able to complete a debt exchange in record time last year, and collective-action clauses have become standard in new emerging market bond issues.

Disappointments

Nevertheless, the past decade has also witnessed many disappointments. Most importantly, in contrast to objectives set at the start of the 1990s, a number of Latin American countries have not been able to boost growth in an enduring way and to reduce the recurrence of financial crises. Moreover, efforts to address the region's high poverty and income inequality have had very disappointing results, leading to concerns about the political sustainability of reforms.

Key Disappointments

The revival of growth and initial improvements in poverty in the early 1990s were not generally sustained. Since the latter part of the decade, per capita income has increased very little, thereby extending for another decade the stagnation of the 1980s. Repeated episodes of financial instability again proved to have lasting adverse effects in terms of lost output and rising poverty and income inequality. Overall, no clear trend emerged toward reducing the region's high poverty rates and income inequalities. As a result, the gap in living standards with North America has grown over the past decade, and Latin America has continued to fall behind fast-growing economies in Asia.

Prolonged Use of IMF Resources

The period since the early 1990s was marked by continued and prolonged use of IMF resources. Argentina and Bolivia—together with Honduras, Nicaragua, Panama, and El Salvador in Central America—had almost continuous financial arrangements with the IMF in this period. They were not alone, however, since virtually all countries in the region—with the exception of Chile—made substantial use of IMF resources.

Political Economy Factors

The disappointments of the 1990s have had important political economy implications for a number of countries in the region. There has been a risk that popular support for reform programs would be seriously undermined by repeated adjustment programs. Moreover, there has been a growing sense, in many countries, that the benefits of global integration have been unevenly distributed, accruing primarily to those in upper-income brackets although the costs have been borne by the less wealthy majority. In a few countries, there has even been a growing militancy among disenfranchised groups. Thus, the experience of the last decade has emphasized to policymakers and the international community that much more needs to be done to secure and maintain a domestic consensus on continuing economic reforms. In many countries, new or enhanced dialogues with civil society are now under way—auguring well for maintaining the consistency of the reform process in the future.

Explanatory Factors

Although external factors certainly played a role in explaining the recent disappointments in Latin American economic performance, this study suggests that shortfalls in domestic policies bore the principal responsibility. Three types of problems have been identified: policy imbalances, the lack of policy resilience ("crisis proofing"), and the need for more sustained reforms.

Policy Imbalances

The study points to a number of inconsistencies and imbalances in the stabilization and reform programs adopted by Latin American countries in the 1990s:

- ***Macroeconomic imbalances.*** With public debt rising, rather than falling, during the 1990s, a key vulnerability was allowed to persist, constraining overall macroeconomic policy. Fiscal policy remained procyclical; and monetary policy was constrained, first by the fixed exchange rate regimes and then by the events surrounding the disorderly exits from these regimes, including financial-system pressures and strains.
- ***Financial systems.*** The liberalization of financial systems that occurred in the early 1990s was not accompanied by consistently strong regulatory and supervisory frameworks and effective strategies to curtail fiscal dominance. As a result, financial systems remained exposed to systemic risk from public debt and dollarization, which, in turn, created balance-sheet mismatches owing to exchange rate fluctuations. Even well-regarded financial systems, such as that of Argentina, harbored vulnerabilities, especially exposure to public debt and government interference, that were not adequately addressed.
- ***Structural reforms.*** Notwithstanding the ambitious plans of the early 1990s, progress on structural reforms was inconsistent and unbalanced. As indicated earlier in this paper, Latin America's financial liberalization and capital-market opening in the early 1990s proved to be faster than the adoption of key supporting reforms. Thus, trade opening moved ahead more slowly, and labor and key product markets remained inflexible, with the result that adjustment of trade balances in response to external shocks proved much more difficult than it had been, for example, in Asian economies in the aftermath of the Asian crisis of 1997–98.

Need for "Crisis Proofing"

Latin America's failure to provide greater insurance against shocks can be attributed to its persisting macroeconomic vulnerabilities, especially in fiscal policy and public debt. In a number of countries, crisis proofing probably weakened, rather than strengthened, as public debt climbed to an average of 60 percent of GDP, despite the Brady debt-restructuring initiative and large-scale privatization programs in many countries that helped to reduce their debts in the early 1990s. Moreover, the debt was often foreign currency-denominated or indexed and issued at short maturities. This debt structure contributed to vulnerabilities, especially when a loss in market confidence entailed higher interest rates or exchange rate depreciation.

The lack of progress with crisis proofing reflected underlying weaknesses in spending and revenue systems and institutions. In addition, there were the heavy costs of dealing with vulnerabilities in banking systems and the recognition of "fiscal skeletons" whose existence was initially hidden in off-budget accounts. Overall, for many countries in the region, "debt intolerance" rose again.[178]

Sustainability of Reforms

Sustainability of reforms was another problem. Even where reforms were implemented, too often the supporting institutional structures remained weak. Sustainability problems were evidenced in the persistence of informal dollarization because of the continued lack of credibility of macroeconomic policy frameworks. Sustainability issues were most important in the public finances, where problems in tax administration contributed to low collections despite high rates (especially for income taxes and indirect taxes). Low revenues, combined with high revenue volatility and expenditure earmarking, increasingly limited resources for infrastructure and growth while imparting a procyclical bias to fiscal policy and raising the public debt. Structural reform policies, however, also were subject to sustainability problems. In a number of reform areas—including, for example, privatization—the results fell short of expectations because of a lack of complementary policies to strengthen regulations or to ensure an adequately competitive business environment.

Priorities for Future Agenda

In looking at the future agenda for Latin America, the focus needs to be much broader than short-run policies alone. It needs to embrace institutional change that will enhance the sustainability of policy frameworks. Thus, when policymakers are reviewing the priorities in each of the major areas of macroeconomic and structural policies, they need to emphasize institutional change.

Macroeconomic Policies

Monetary and Exchange Rate Policies

Many countries have exited fixed exchange rate systems and have adopted inflation-targeting regimes that offer promising frameworks for imple-

[178]Reinhart, Rogoff, and Savastano (2003) make the point that once a country slips into being a serial defaulter, it generates a high level of debt intolerance that is difficult to shed. A corollary of this point is the difficulty countries face in graduating from prolonged use of IMF resources.

menting monetary and exchange rate policies in the region. Inflation targeting has the key strength of focusing the policy debate on what monetary policy can do on a sustainable basis—that is, controlling inflation—rather than on what it cannot do—raising output growth or boosting external competitiveness. It also provides a suitable framework for implementing flexible exchange rate regimes, which provide greater resilience in the face of shocks. Two important challenges remain, however. First, in those countries that have already adopted inflation targeting, how can the institutional framework for inflation targeting be reinforced to improve implementation and, therefore, entrench credibility? And, second, how can suitably robust frameworks for monetary and exchange rate policies be developed for those countries that choose to pursue alternative policy approaches?

To ensure the credibility of inflation targeting, it is important to establish a clear framework for central bank autonomy. A number of countries have already made good progress toward this goal. This progress can be reinforced by developing stronger central bank laws that clearly assign monetary policy responsibility to senior bank officials; provide appropriate objectives, incentives for performance, and budgeting independence; and further reduce fiscal dominance and financial sector vulnerabilities. Regarding implementation, an important task is to increase transparency about the decision-making process and generally progress further in putting in place all the enabling conditions for full-fledged inflation targeting. This includes the publication of regular reports that discuss the outlook for inflation and the consistency of policy settings with meeting the inflation target. Such an approach would help to convey to markets how the authorities intend to meet their objectives, especially in the face of shocks such as sudden, sharp exchange rate movements.

In contrast to countries with inflation targeting and flexible exchange rate regimes, a number of countries in the region, especially in Central America, continue with less flexible exchange rate systems in which monetary policy is geared toward exchange rate objectives. For many of these countries, priority must be given to developing an institutional and policy framework that will gradually allow for greater flexibility in an orderly way. Some countries, however, may choose to remain with an inflexible exchange rate system or to progress toward full dollarization. Choice of the latter regime typically reflects a country's circumstances, including trading patterns, degree of dollarization, and past record of inflation control. Countries making such choices must then ensure that fiscal policy is sufficiently robust to support such a regime while making sure that structural policies provide sufficient flexibility in the economy to absorb shocks.

Fiscal Policy and Public Debt

Debt burdens in many Latin American countries are above prudent levels and must be brought down. Reinhart, Rogoff, and Savastano (2003) suggest that the safe range needs to be particularly low for countries with a history of default and high inflation. At the same time, historical experience has taught us that such a transition does not become credible simply through the running of large primary budget surpluses. The pursuit of surpluses needs to be demonstrably sustainable and rigorously implemented, ensuring that—in particular—it is not based on unrealistic spending cuts and distortionary taxes inimical to efficiency and growth. More generally, the pursuit of debt sustainability must be based on a broader agenda to raise growth and implement structural reforms, especially institutional reforms, that can set in motion a virtuous circle of improving confidence, lower interest rates, and higher growth. Short-run policy adjustments that are not accompanied by efforts to achieve broader institutional change are unlikely to bring about such a virtuous circle or be sustained and, therefore, are not likely to succeed in bringing the public debt ratio down in an enduring way.

Institutional weaknesses in fiscal systems identified in this study include reliance on distortionary taxes, low effective tax rates, revenue volatility, and expenditure earmarking and other budgetary rigidities. Raising the effective tax rate depends on addressing tax avoidance and strengthening weak tax administration. Revenue volatility can be dampened by reducing the reliance on the taxation of commodity exports and broadening the tax base. Expenditure earmarking and special wage regimes for protected public sector employees raise difficult issues requiring, in many cases, constitutional changes to implement reforms.

Broader reforms to the overall fiscal framework may also be helpful in instilling fiscal discipline. Legislation to impose conservative and sustainable debt limits may be useful, particularly in countries where strong political forces are driving spending decisions, or where their natural resource revenues are subject to wide short-term swings, but experience has shown that such rules can all too easily be circumvented. Chile's success with fiscal consolidation in the 1990s illustrates the effectiveness of a range of institutional reforms to support prudent fiscal policy decisions. Important factors that contributed to debt reduction in Chile included giving more power to the finance ministry than to other ministries or the legislature; prohibiting the central bank from extending credit to the government; and preventing lower levels of government from borrowing, thus eliminating the subnational free-rider problem. Brazil's recent success in strengthening its fiscal position and consistently meeting fiscal objectives has also benefited from a series of fundamental improvements in the budgeting process and the structure of center-state relations in the context of a fiscal responsibility law.

Improving the composition of debt is as important as reducing the level of debt. Specifically, countries should take every opportunity to replace short-term, floating-rate, and foreign currency-linked debt with longer-term domestic debt. Otherwise, countries are left vulnerable to high rates of rollovers and changes in credibility and global financial conditions. To this end, domestic debt must be made more attractive to investors, which requires working to entrench a sound framework for sustaining macroeconomic stability. Inflation indexing domestic debt would reduce the risk of fluctuations in real value, both to lenders and borrowers. This approach has succeeded in promoting longer-term domestic financial intermediation in Chile and Colombia. In addition, experience—especially in Mexico—underlines the importance of maintaining an active investor-relations program, especially to provide transparency and transmittal of information on economic and debt developments.

Structural Reforms for Raising Growth and Reducing Poverty

Latin America has suffered from a chronically weak growth performance, with the structural reforms of the 1990s providing only a temporary reprieve from disappointing outcomes. To improve growth and poverty reduction, macroeconomic policy strengthening needs to be supported by a broad-based structural reform agenda and, in particular, institutional reform. What should be the priorities?

Financial Systems

Achieving sound and resilient financial systems is a key element in reducing Latin America's vulnerability to crisis and sustaining long-term economic growth. In particular, financial systems across the region require strengthening to enable them to deliver the steadily rising financial intermediation that is needed to support sustained growth. Argentina's experience shows, however, that even a well-regarded financial system is not safe as long as public debt remains a key vulnerability. Although considerable progress was made during the 1990s in strengthening banking systems, there is a continuing need to improve banking regulation and supervision. It will be important to encourage provisioning requirements based on more forward-looking risk assessments and to ensure that these requirements are reviewed and enforced, minimizing the need for regulatory forbearance as much as possible. Moreover, further efforts are needed to implement crisis-management and bank-resolution frameworks, to improve legal protection for bank supervisors, and to monitor risks arising from cross-border financial integration. In some countries, the legacy of financial crisis persists in the form of nonperforming loans that remain to be efficiently liquidated and public banks that need to be restructured.

Enhancing the transparency of financial activities would help to promote prudent decision making and risk taking. Accounting and auditing standards need to be strengthened to improve the availability and reliability of information to the public while encouraging the emergence of formal credit rating of borrowers, which would help to reduce the cost of lending for banks. Moral hazard implied by deposit-insurance systems would be contained by introducing explicit limits on payouts and restricting benefits to small depositors.

Lack of suitable financing remains an important constraint on growth in Latin America. Sustained credit creation would be encouraged by reducing the costs of dealing with defaults on problem loans. A key step toward achieving this objective is to strengthen lenders' ability to recover value from distressed loans. In many countries, antiquated bankruptcy laws favor borrowers over creditors, making it difficult to appropriately resolve claims in cases of default. Increasing the operational efficiency of banks, especially of public banks; enhancing competition; and allowing lenders to make more informed decisions would help deepen financial intermediation. It is also important to develop alternative vehicles of financing—for example, through the deepening of capital markets and expansion of microfinancing initiatives.

Trade Opening

Despite considerable efforts to liberalize trade during the 1990s, Latin America remains much less open than other dynamic regions of the world. Reforms to further liberalize trade are critical to stimulating growth and reducing vulnerabilities. The greatest benefits would flow from successful multilateral trade negotiations, which could bring countries improved market access for their key exports, such as agricultural products and textiles. Even if progress on the multilateral front were slow, there would remain considerable scope and benefit for Latin American countries to encourage trade opening, including within the region, by doing the following:

- curtailing still-widespread protectionist practices in Latin America—in particular, the use of nontariff barriers, high tariffs on processed goods, and restrictions on trade in services;

- addressing the shortcomings of existing regional trade agreements to make them more comprehensive in scope in terms of the products and types of policies (investment, regulatory, etc.) covered; and
- advancing bilateral trade agreements with industrial country trading partners—as well as agreements within the region—that would help to reduce problems of trade diversion and bring a number of advantages, including increased investment flows and technology transfers.

For these initiatives to bear fruit, however, it will be important for Latin American countries to maintain a stable macroeconomic environment with appropriate exchange rates and to further develop trade-related institutions and infrastructure. In particular, improvements are needed in port and customs administrations, which currently impose costly delays and inefficiencies in many countries. Other institutional weaknesses that have hindered trade flows—including legal uncertainties and corruption—and need to be remedied to permit sustained growth are discussed more broadly in the next subsections.

Labor Markets

Labor market reforms—which were notably absent from the reform agendas of most Latin American countries in the 1990s—assume even greater significance in the context of increased trade liberalization. International experience suggests that this is a key step toward increasing flexibility, private investment, and growth in the economy. Recent research has stressed that reaping the full benefits of trade integration depends upon the flexibility within economies for labor to move across employment sectors—from less productive to more productive ones.[179] Institutional arrangements in the form of high severance costs and restrictions on hiring temporary workers act as significant barriers to entry and exit and, therefore, to such flexibility. Elevated nonwage labor costs are also an impediment to employment. Although initial political obstacles must be overcome, labor market reforms that make it more attractive to hire workers will, over time, yield broad-based benefits, including more rapid growth of employment in the formal sector, that would, in turn, likely increase popular support for the reform process. The state has an important role, in this context, in providing for efficient mechanisms to deal with transitional problems associated with intersectoral mobility, and to invest in workers' training and skill upgrading, especially in the context of increased external trade openness.

Role of State in Governance and Institutional Reforms

In a number of Latin American countries, weak institutions of governance have undermined market activity; support for broad-based reforms; and, ultimately, growth. Institutional reforms are needed to confront these weaknesses, create a firmer foundation for economic activity, and thereby sustain growth.[180] The task is arguably more difficult now, since institutions in the region have been successively weakened by a history—in many countries—of recurrent crisis.[181]

Corruption has tended to hamper economic growth and foreign investment, which relies on investors' perceptions of contract viability, ease of profit repatriation, and the probability of payment without delay. The poor have been hardest hit by corruption, given their greater reliance on public services and inability to pay the high costs of bribery or fraud. Visibly reducing corruption would provide a positive impetus to growth and help to sustain support for the reform process. For example, fostering greater accountability of the public sector—for example, by assuring public access to government information—would help to deter corruption.

Reforms are also needed in the judicial system, which is often regarded as weak and highly politicized rather than impartial in predictably enforcing laws. The absence of a strong judicial system tends to undermine investor confidence and property rights, hindering the introduction of new reforms, increasing lending risk, and ultimately restraining economic activity. Establishing an independent and responsible judiciary is central to increasing the credibility of the rule of law and improving the environment for the operation of market forces. Strengthening the judicial process will require improving the accountability of judges—including through publishing information

[179]For example, Chapter II in IMF (2004) discusses the implications of China's integration for the international economy.

[180]In the context of Chile's experience, Foxley (2004) explains the importance of institutional reforms for sustaining poverty reduction.

[181]Rodrik (2003) emphasizes the importance of institutional reforms for *sustaining* growth, as opposed to igniting economic growth. Many of the specific components of institutional reforms that he discusses—sound monetary policy, debt sustainability, and the rule of law—are also crucial for attracting private investment, especially the domestic private investments that are necessary for the *acceleration* phase. In any case, his distinction between accelerating and sustaining growth is less relevant in the context of Latin America, where there have been frequent false starts and recurring macroeconomic volatility.

on judicial performance. Judicial efficiency could be improved by simplifying legal procedures and establishing specialized court systems—such as bankruptcy and commercial courts—or alternative dispute-resolution mechanisms.

Many of these concerns directly affect the business environment, which is crucial for attracting and increasing private investment. As previously discussed, Latin America generally does less well than other, more rapidly growing regions in providing the key ingredients of a friendly investment climate. A number of surveys have shown the increased deadweight costs associated with heavy regulation of the entry and exit of businesses, labor force management, and contract enforcement. These costly distortions in the regulatory and incentive structures in many Latin American countries divert domestic capital and investment overseas, and often hit hardest small and medium-sized enterprises and those in rural areas, which typically face greater difficulty than urban enterprises in accessing public services. Improving the investment climate can directly help attract new private investment that is crucial for productivity and growth; and provided the improvements are equitably implemented within countries, they can also help to integrate the small enterprises and the rural economy—thereby reducing income inequalities and poverty. The state has a crucial role in improving regulatory governance and better securing property rights to help establish a more enabling investment climate.

IMF Role: Supporting Growth Agendas

Faced with the economic and financial crises in Latin America, as well as in other emerging market countries, over the past decade, the IMF has understandably emphasized crisis resolution and prevention. Much progress has been made, especially in drawing lessons from these crises in emerging markets, expanding the tools of crisis prevention, and deepening IMF surveillance of key risks and vulnerabilities.

Taken together, the various initiatives have already brought about a sea change in the role of the IMF:

- The need to reduce vulnerabilities to crises has led the IMF to emphasize developing a framework of internationally agreed standards and codes for monetary, fiscal, and financial transparency (reflected in countries' preparation of reports on standards and codes, or ROSCs); encourage deeper cooperation on financial sector issues, including through the Financial Stability Forum; emphasize greater transparency of IMF staff work, including through the publication of country reports and policy papers; and deliberately focus on the social costs of crises and their alleviation.
- The IMF has also been at the center of the continuing debate on crisis resolution that has led to the widespread acceptance of collective-action clauses (CACs) in new bond issues with no evidence of any additional interest premium resulting from their use. The increased issuance under local law of international sovereign bonds including CACs in New York, where they had not been the market standard, has been a major positive development since 2003.
- The IMF's stronger focus on potential vulnerabilities, with more rigorous and candid assessments of debt sustainability, exchange rate arrangements, and balance-sheet exposures have raised the bar for surveillance and Article IV consultations.

Although they are still being consolidated, these initiatives have helped to catalyze stronger and more transparent policymaking in Latin America, which has already had a considerable impact on markets. There is evidence that contagion risks have lessened; the dispersion of spreads on emerging market debt has increased; and cross-country correlation of financial market developments has been reduced—all evidence of greater market discrimination between countries.

The agenda for the region's future includes, in particular, sharpening the IMF's surveillance role, particularly in countries that have had a succession of IMF-supported programs, and increasing the focus on entrenching growth. Several aspects of these issues warrant further discussion:

- The experience in Latin America of prolonged dependence on IMF arrangements and financial assistance, in a situation of recurrent financial crisis, has exposed the need for the surveillance process to include "a fresh pair of eyes." This applies to both sides of the dialogue. Prolonged use of IMF resources has probably also been inimical to a process of widening contact in the community and building awareness for longer-term institutional change, given the typically small group of officials charged with the responsibility of putting together IMF-supported programs in times of crisis. In particular, the IMF's surveillance role, carried out through the Article IV consultation process, should be strongly maintained even while the country has a current IMF-supported program.
- A parallel challenge for the IMF lies in sharpening its focus on promoting growth. A growth-focused agenda will have many dimensions—

including infrastructure investment, the corporate sector, the labor market, and other issues that lie outside the IMF's core expertise—and thus heighten the need for effective coordination with the other relevant international financial institutions (IFIs)—the World Bank and the Inter-American Development Bank. To be sure, in recent years, a number of important initiatives have already helped to improve such coordination—such as the poverty reduction strategy paper (PRSP) process for low-income countries and the broadening use of Financial Sector Assessment Programs (FSAPs). There is room, however, for expanding collaboration in the higher-income countries in the region, where PRSPs are not prepared, and especially in helping identify and raise funds for efficient public investments and coordinating technical assistance.

- Institutional reforms have been a recurring theme of this paper. Recent IMF research indicates that institutional factors—including those related to governance and corruption issues—are more important than capital-labor ratios in explaining cross-country differences in per capita incomes. Institutional strengthening is seen as crucial to build and foster increased levels of "crisis proofing," improve the business climate, attract private investments, and support growth. Achieving the priority objectives for Latin America that were discussed in the previous subsections will depend heavily on achieving institutional change. Such an approach will also place increased demands on closer coordination among the IFIs.

Experience in Latin America over the last decade and a half suggests two important lessons for the IMF and the other IFIs to keep in mind as they increase their emphasis on institutional change and reform:

- first, broad country ownership of the institutional policy agenda will be even more essential, since political interests would be directly involved; and
- second, external incentives or anchors can play a crucial role in catalyzing the process of domestic institution building in Latin America.

Establishing country ownership of institutional change will, most likely, prove to be an even more daunting challenge than doing so for ownership of prudent short-run macroeconomic management—particularly since it involves even greater political sensitivities and trade-offs. In addition, institutional reforms do not always lend themselves to "best-practice" formulations because of the diversity of individual circumstances and conditions.[182] The payoffs from doing this would be considerable, however, most notably because tensions over short-run policies could be reduced. The shift to inflation targeting is a good example of an institutional change that has generally reduced controversy over short-run monetary policy. Accordingly, conditionality in IMF lending programs will need to evolve further and emphasize institutional change rather than short-term policy adjustment. In many countries, such a shift would be regarded as politically intrusive. The ground therefore needs to be carefully prepared by an outreach strategy that is well coordinated among the IFIs. Such an outreach strategy could include the following elements:

- *Contacts with national congresses*. The IFIs could present coordinated seminars for members of congress in selected countries to encourage greater understanding of the policies that the IFIs are advocating and improve the IFIs' understanding of the concerns of lawmakers and the constraints that they face.
- *Contacts with civil society*. In the course of their country work, staff members of the IFIs need to find opportunities to explain policy options to civil society. These contacts are essential to ensure that the IFIs fully understand the issues facing a country and communicate effectively the logic behind IFI policies to as wide an audience as possible, thereby helping encourage ownership. It is especially important to explain the need for civil service reforms; and, toward this end, the IFIs will need to undertake presentations to groups—such as teachers, health service workers, and the military—that typically have special wage and/or pension regimes.

Finally, an improved set of external incentives or anchors can play an important role in supporting the process of domestic institution building in Latin America. International trade offers clear possibilities for such anchors and incentives:

- Greater trade openness in Latin America would—in addition to its other benefits—help to strengthen institutions. The opening up of markets can play an important role in weakening vested interests and reducing economic rents associated with long-standing economic and institutional arrangements. Trade can thus spur improvements in domestic institutions that otherwise would not have been possible.
- International agreements can be an important external anchor and catalyst for institutional change by breaking through domestic impediments to reforms. For example, participation in NAFTA has helped to build stronger institutions in Mexico than might otherwise have been possi-

[182]Rodrik (2003) stresses this point.

ble. The emerging trade agreements with the United States that are under consideration—such as the U.S.-Central American Free Trade Agreement—are likely to provide a boost to institutional development in a number of countries. From a broader perspective, membership requirements of the World Trade Organization will also contribute to reforms.

Access to IMF arrangements that rewards good policies and, thereby, strengthens the incentives for good practice is also likely to continue to be very beneficial as an external anchor. Although prolonged use of IMF resources may have perversely reduced program ownership in many countries, well-designed instruments that reward good behavior could catalyze the opposite effect.

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