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Latin America's Growth and Equity Frustrations During Structural Reforms

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The debt crisis that the Latin American economies experienced during the 1980s led to a decline of 0.9 per year of per capita GDP, a "lost decade" in terms of economic growth. This experience shocked the region, as per capita GDP had increased by 2.7 percent annually from 1950 to 1980. This earlier growth had been based on development patterns characterized by high protection of domestic markets and strong state intervention. Despite rapid growth and industrialization, orthodox analysts considered these policies a source of inefficiencies, macroeconomic imbalances and a major cause of the debt crisis. With external pressure but also growing internal political support, Latin America embraced structural economic reform in the late 1980s and early 1990s aimed at reducing state intervention and exploiting the opportunities provided by international markets. Reforms had thus the dual objective of overcoming the "lost decade" and the patterns of development that had prevailed prior the debt crisis.

Structural economic reforms varied in intensity across sectors and countries. All countries in Latin America significantly liberalized international trade, external capital flows and the domestic financial sector. Policy decisions in these areas included reducing tariffs and their dispersion; dismantling nontariff barriers; eliminating most restrictions on foreign direct investment; phasing out many or most foreign exchange regulations; granting greater or total autonomy to central banks; dismantling regulations regarding interest rates and credit allocation; reducing reserve requirements on domestic deposits; and privatizing several state banks.

In the fiscal area, reforms strengthened the value added tax, reduced income tax rates and strengthened tax administration, though with only a limited effect on tax evasion. Social security systems were overhauled in several countries to allow for

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the participation of private agents and a more clear balance between benefits and (employers' and workers') contributions.[1] Reforms were more limited in relation to privatization and labor markets. Despite the sale of many public-sector firms, most countries kept state enterprises accounting for large shares in GDP, particularly those operating in the mining and oil sectors, but also in public utilities and the financial sector. Also, although some labor contracts were made more flexible, liberalization of labor markets remained limited.

Aggressive reformers like Argentina, Bolivia, Chile and Peru carried out reforms in a short period of time, generally coupled with major macroeconomic stabilization packages, and were more ambitious in several areas, particularly in privatizations. Cautious reformers like Brazil, Costa Rica, Colombia, Jamaica and Mexico were more gradual and less ambitious (Stallings and Peres, 2000). However, even the aggressive reformers had major exceptions in some areas; for example, Chile, widely regarded as the most successful economic reformer, maintained state ownership of its copper and oil companies, as well as her commercial and development public-sector banks, and relied significantly upon capital account regulations throughout the 1990s.

Moderate rates of economic growth returned to Latin America in 1990–1997. Per capita GDP rose at an annual rate of 2.0 percent, generating positive evaluations of the reform effort (Edwards, 1995; IDB, 1997; World Bank, 1997). However, the region experienced a new "lost half-decade" in 1998–2002, when per capita GDP declined again by 0.3 percent per year, followed by a weak recovery in 2003. This grim return to stagnant growth brought an extensive reevaluation of the effects of structural reforms (ECLAC, 2003a; Kuczynski and Williamson, 2003).

It is obviously difficult to generalize about the effects of structural economic reform in a region as large and diverse as Latin America. Countries differ in how aggressively economic reforms were pursued; in their level of development, size, geographical proximity to the United States; in the magnitude of their external and fiscal debt overhangs; and in the strength or weakness of their economic, social and political institutions. However, a body of recent evidence suggests that the new development strategy has succeeded in some areas, but not in others.

In particular, the new development strategy has been effective in generating export dynamism, attracting foreign direct investment and increasing productivity in leading firms and sectors. In most countries, inflation trends and budget deficits were effectively brought under control, and confidence in the macroeconomic authorities (including newly independent central banks) increased. Reflecting the democratization wave that simultaneously swept over the region, social spending rose and innovations were introduced in the way social policy is undertaken. Nonetheless, economic growth remained frustratingly low and volatile, and domestic savings and investment remained depressed. Productivity growth has been poor, particularly when measured as output per worker, largely as a result of a growing

[1] Throughout the paper this term refers to the integral view of social security systems, which include not only old age pensions, but also health, insurance against work accident and death and, in a few countries, unemployment insurance.

underutilization of the available labor force. In turn, low economic and productivity growth is associated with the fact that the reform process brought an increasing dualism, with the expansion of "world class" firms (many of them subsidiaries of multinationals) coinciding with increasing unemployment and growth of the informal labor employment. This dualism, together with other factors like the technological biases that led to an increase in the relative demand for skilled labor, generated adverse effects on an already poor income distribution record, weakening the effects of growth on poverty reduction.

This paper evaluates the economic reform process in Latin America and how it affected economic and social outcomes. It is based on wide-ranging research undertaken by the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) in recent years; a useful starting point to that research is ECLAC (2003a).[2]

Economic Performance

Macroeconomic Performance

The expectation of reformers was that structural economic reforms, coupled with improved fiscal and monetary management, would lead to low inflation, stable access to external capital flows, high investment rates and, particularly, strong productivity performance and economic growth. The reforms did bring low inflation, but the other gains failed to materialize.

The most salient macroeconomic advances in the 1990s were improvements in fiscal conditions and reductions in inflation rates. Average central-government budget deficits declined significantly in the second half of the 1980s, remained in an average range of between 1 and 2 percent of GDP through most of the 1990s, but increased to levels of around 3 percent since 1999. Government spending also increased from a simple average of 17.4 percent of GDP in 1990 to 21.1 percent in 2001, allowing in particular a strong expansion of social spending (see below), but government revenues increased enough to keep deficits under control. However, progress in the fiscal area has been uneven across the region, as reflected in the fiscal crises that several countries experienced in recent years. Particularly, the ability to avoid a skyrocketing public-sector debt dynamics during financial crises has been limited, as the reduction in tax revenues is matched during recessions by an increase in the debt service generated by high domestic interest rates and exchange rate depreciation. Progress against inflation has been more uniform and long lasting. Average inflation in Latin America fell steadily up to 2001, when it reached single digit levels in most countries. Setbacks in 2002, when average

[2] The overall assessment in ECLAC (2003a) can be complemented with the analysis of social trends in ECLAC (2000a, 2000b, 2001) and of issues associated with integration into the world economy in ECLAC (2002a, 2002b). The results of a long-term ECLAC project on the impact of structural reform in Latin America and the Caribbean are summarized in Stallings and Peres (2000), Moguillansky and Bielschowsky (2001), Katz (2001), Morley (2001) and Weller (2001).

Table 1
Latin America's Growth, 1950–2002

	1950–1980	1980–1990	1990–1997	1997–2002	1990–2002
GDP growth					
Weighted average	5.5	1.1	3.6	1.3	2.6
Simple average	4.8	1.0	3.9	1.7	2.9
GDP per capita					
Weighted average	2.7	−0.9	2.0	−0.3	1.0
Simple average	2.1	−1.2	1.9	−0.3	1.0
GDP per worker					
Weighted average	2.7	−1.7	1.0	−1.3	0.1
Simple average	2.4	−1.9	0.9	−1.2	0.0
Total Factor Productivity[a]					
Weighted average	2.1	−1.4	1.1	−1.1	0.2
Simple average	2.0	−1.4	1.9	−1.1	0.6

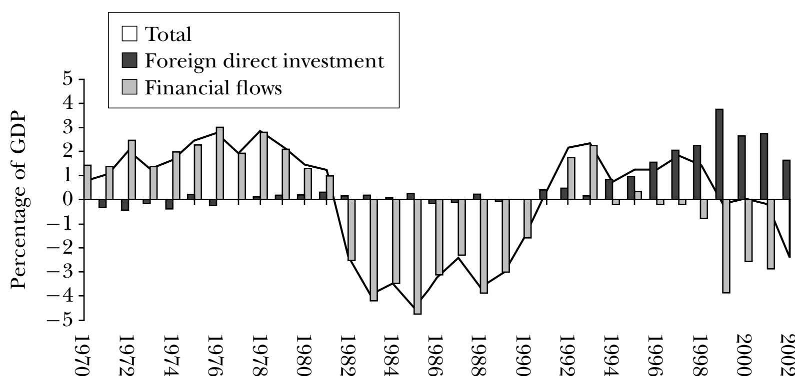
Source: Author calculations based on GDP series published in ECLAC *Statistical Yearbook for Latin America and the Caribbean,* and labor force series in ECLAC/CELADE *Demographic Bulletin,* various issues. TFP according to Hofman (2000) and updates facilitated by the author.
[a] Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, Peru and Venezuela.

inflation increased for the first time in a decade, were concentrated in a few countries and were followed by a renewed downward trend in 2003.

However, economic growth did not return to pre-1980 levels. Table 1 presents a variety of measures of annual growth, which include both simple averages across countries and weighted averages. The pattern is clear: Latin American economic growth in the 1990s has been frustratingly low. Even the acceleration of GDP growth to 3.6 percent in 1990–1997 does not look especially strong compared with the period 1950–1980. Contrasting GDP growth, rather than per capita GDP growth, makes some sense for this region because shifting age distributions can make comparisons of per capita GDP misleading. Indeed, Latin America's labor force grew in the 1990s at rates similar to those in 1950–1980. Thus, as Table 1 indicates, GDP per active worker grew at a slower rate in 1990–1997 than GDP per capita, reflecting a much poorer performance relative to the historical pattern before 1980. Furthermore, this growth recovery was followed by a sharp slowdown during the "lost half-decade" of 1998–2002, when GDP grew at a rate not unlike that in the 1980s. As a result, for the period 1990–2002 as a whole, the rate of growth of GDP and GDP per capita was less than half of those that characterized the three decades prior to the debt crisis.

These data are consistent with the record of poor productivity performance. Except for Chile and the Dominican Republic, average labor productivity—measured as the ratio of GDP to the labor force—stagnated in 1990–2002, a sharp contrast with an annual increase of 2.7 percent in 1950–1980. Rising unemployment and underemployment, largely due in both cases to poor overall economic growth, drove aggregate labor productivity. Total factor productivity also grew at a very slow rate for the period 1990–2002 as a whole and, for the weighted average, even during the years of faster economic growth, 1990–1997.

Figure 1
Net Resource Transfers



Source: ECLAC estimates, based on IMF, *International Financial Statistics*.

A major hope behind economic reforms was that they would lead to a steady inflow of external capital. Instead, fluctuations in the capital account became the major single determinant of the Latin American business cycle. Renewed access to international capital markets was evident in the early 1990s, as the sharp turn from negative to positive net resource transfers through the capital account in Figure 1 indicates. This pattern was the result of the low U.S. interest rates at the time and the 1989 Brady plan, which converted many bank loans to Latin America into securitized debt instruments, effectively creating a secondary market for Latin American securities. In the second half of the 1990s, foreign direct investment became the leading source of net resource flows to Latin America. After the east Asian financial crisis of 1997–1998, financial flows to Latin America turned negative again, and while foreign direct investment served as a compensatory factor up to 2001, its sharp fall in 2002 generated a large negative overall net resource transfer out of the region for the first time in more than a decade, which was followed by only a slight improvement in 2003.

The strong dependence of Latin America's economic growth on external capital flows operated in several ways. Since Latin America's domestic savings remained depressed in the 1990s, investment became highly dependent on external savings at the margin. Fixed investment rates (estimated at 1995 prices) experienced a partial recovery, to over 21 percent of GDP by 1997, but remained below the average 24.9 percent of GDP of the 1970s. Furthermore, this recovery was cut short by the interruption of capital flows since the east Asian crisis, which brought fixed investment to only 17.6 percent of GDP in 2003, a level lower than the worst annual records of the 1980s. Viewed from the point of view of balance of payments, there was deterioration in the trade balance/growth tradeoff (see below) that generated an increase in the demand for external funds to finance the current account deficit with the rest of the world.

The major links between capital flows and economic activity were associated, however, with the tendency to adopt procyclical fiscal and, particularly, monetary and credit policies, which made domestic macroeconomic policy a

mechanism through which unstable capital flows were not only transmitted domestically but actually magnified. The result was lending booms facilitated by sharp drops in interest rates followed by crises characterized by marked monetary contraction and high interest rates. In addition, the strong bias in favor of currency appreciation that characterized the periods marked by an abundance of external financing was partly responsible for the adjustment problems faced by tradable sectors. Furthermore, the dependence on external finance created the risk of domestic financial crises when there was a sudden stop in capital flows. About half of the Latin American countries experienced domestic financial crises during the 1990s, absorbing considerable fiscal resources and affecting the functioning of financial systems (ECLAC, 2002b, 2003a, chapter 3; Ffrench-Davis, 2003; Ocampo, 2002b; Stiglitz, 2003).

Integration into the World Economy

Dynamic export growth and the surge of foreign direct investment are the clearest signs of how Latin American countries became more integrated into the world economy. From 1990 to 2000, the region posted the fastest growth of export volumes in history at close to 9 percent per year; the world economic slowdown of 2001–2002 led to a sharp drop in real export growth to 1.5 percent per year, with only a partial acceleration in 2003 to 4.4 percent. The strong growth of Mexican exports explains much of this strength in the 1990s. On the opposite side, up to 1999, Brazil experienced export growth below the regional average and her own historical performance since the 1960s. The performance of other countries fell in between but was generally dynamic.

Intraregional trade was also very dynamic, particularly among the two major South American economic integration processes: the Southern Common Market, or Mercosur, which includes Brazil, Argentina, Uruguay and Paraguay as full members with Bolivia and Chile as associate members, and the Andean Community, made up of Bolivia, Colombia, Ecuador, Peru and Venezuela. Trade growth within these two groups was very rapid in 1990–1997: 26 percent per year for Mercosur and 23 percent per year for the Andean Community. However, the expansion of trade within the two South American integration blocks was abruptly interrupted in 1998–2002, giving way to strong fluctuations in intraregional trade and a weakening commitment to regional integration.

As Table 2 indicates, export expansion has been generating two patterns of specialization, which approximately follow a regional "North-South" divide. The "Northern" pattern, shared by Mexico, several Central American and some Caribbean countries, is characterized by manufacturing exports with a high content of imported inputs, mainly geared towards the U.S. market. This pattern goes hand in hand with traditional agricultural exports and agricultural export diversification in Central America, as well as the growth of tourism in Mexico and the Caribbean. The "Southern" pattern, typical of South American countries, is characterized by the combination of extraregional exports of commodities and natural-resource-intensive (and in many cases, also capital-intensive) manufactures, and a diversified intraregional trade. A third pattern of specialization, found in Panama and some

Table 2
Composition of Latin American Exports
(*percentages of exports*)

	Primary Products		*Manufactures Based on Natural Resources*		*Manufactures with Low Level of Technology*		*Manufactures with Middle Level of Technology*		*Manufactures with High Level of Technology*		*Nonclassified Products*	
	1990	*2000*	*1990*	*2000*	*1990*	*2000*	*1990*	*2000*	*1990*	*2000*	*1990*	*2000*
Northern pattern												
Mexico	29.4	11.7	9.4	5.8	10.6	14.7	31.8	38.5	14.9	25.3	3.9	3.9
Central America	57.9	27.7	11.1	9.2	21.0	39.7	5.4	6.6	3.4	14.5	1.2	2.2
Southern pattern												
Mercosur	36.5	34.7	23.6	24.1	14.8	11.0	20.7	21.2	3.2	6.6	1.1	2.4
Andean Community	58.1	59.5	30.0	24.5	5.6	6.3	4.4	6.4	0.3	0.9	1.5	2.4
Chile	41.9	40.3	49.4	48.6	2.4	3.0	3.5	5.7	0.3	0.7	2.4	1.7
Latin America	39.3	27.3	22.6	17.0	11.5	14.0	18.7	24.6	5.7	14.0	2.2	3.1

Source: Author estimates based on ECLAC and World Bank (2002).

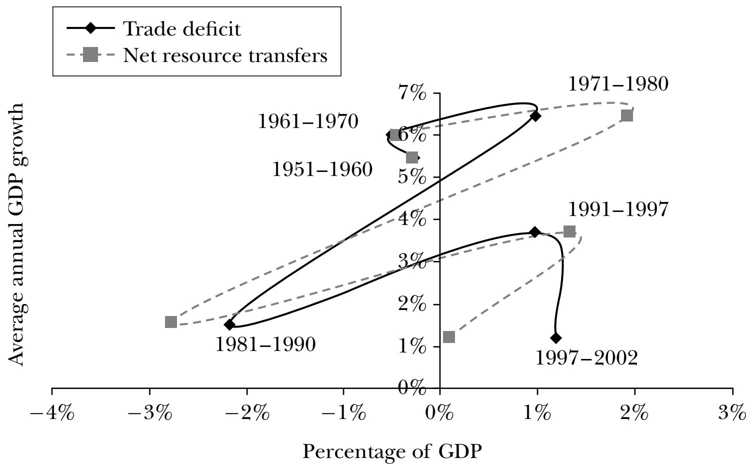
small economies in the Caribbean basin, is one in which service exports—like financial, tourism and transport services—predominate.

In general, and with major exceptions associated with intraregional trade, this pattern may seem to imply that Mexico and some Central American and Caribbean countries have been participating to a greater extent in the more dynamic world markets for manufactures, whereas South America has focused on the less dynamic commodity markets. Nonetheless, a more detailed breakdown indicates that most Latin American countries, whatever the region, tend to specialize in goods that are not playing a dynamic role in world trade (ECLAC, 2002a, 2002c).

Trade specialization and patterns of foreign direct investment have been closely linked. The “Northern” pattern has attracted multinationals actively involved in internationally integrated production systems. In South America, investment in services, natural resources and production for regional integration processes is more prevalent. The surge of foreign direct investment has included a large share of acquisitions of existing assets, initially through privatization but increasingly through private mergers and acquisitions. This pattern has led to a rapid increase in the share of foreign firms in sales—from 29.9 percent of the sales of the largest 1,000 firms operating in the region in 1990–1992 to 41.6 percent in 1998–2000—basically at the cost of public sector enterprises but also, in recent years, of large private domestic firms.

The contrast between the dynamic internationalization of the Latin American economies—increased trade and rising shares of foreign firms—and the weak GDP performance analyzed in the previous section is one of the paradoxical effects of structural reforms in the region. One explanation is that increasing international business connections have weakened or destroyed the previous links among domestic firms characteristic of the more protective environment of the past, leading in particular to a larger share of capital goods and intermediate goods bought in international markets. In addition, many internationalized sectors have an “en-

Figure 2
Trade Balance/Growth Tradeoff



Source: Author calculations based on ECLAC *Statistical Yearbook for Latin America and the Caribbean* and IMF, *International Financial Statistics,* various issues.

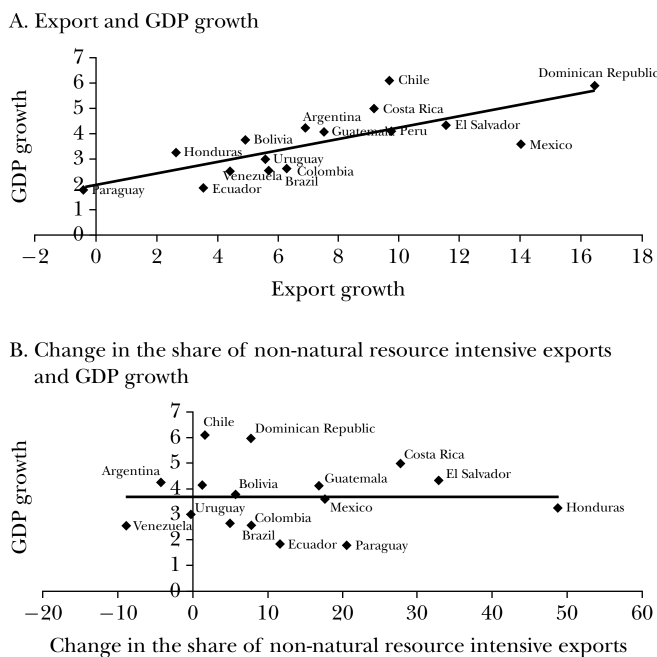
clave" component: they participate actively in international transactions but much less in the generation of domestic value added. Indeed, the natural-resource-intensive sectors of the "Southern" pattern of specialization may ultimately provide more opportunities for the formation of domestic production and technological linkages than the assembly activities characteristic of the "Northern" pattern (ECLAC, 2003b, chapter 3; World Bank, 2002).

A traditional expectation has been that rapid economic growth may be accompanied by a larger trade deficit, because a rapidly growing economy draws in imports and financial capital more quickly that it can increase exports. Figure 2 shows that Latin America's rapid growth in 1971–1980 fits this pattern (in the figure, the trade deficit is measured as a positive number, representing a net inflow of resources). However, a similar trade deficit in 1991–1997 occurred at growth rates that were close to three percentage points below those registered in the 1970s.[3] This reflects the fact that the joint effects of the contraction of import-substitution sectors, the larger demand for imported intermediate and capital goods and the weakened domestic links of export sectors prevailed over the generation of new export capabilities.[4] As pointed out above, the macroeconomic bias toward currency appreciation during periods of booming capital inflows may have reinforced this trend. This process further worsened during 1998–2002, when the trade deficit remained stubbornly high in the face of slow economic growth.

[3] The analysis of UNCTAD (1999) indicates that a similar deterioration has occurred throughout the developing world in recent decades, except in China and some fast-growing Asian economies.

[4] An alternative way to look at this dynamics is to notice that the reduction in the technological gap vis-à-vis the world frontier was not enough to compensate for the extraordinary increase in the income elasticity of demand for imports and the consequent deterioration of the trade multiplier (the ratio of the technological gap to the income elasticity of the demand for imports), thus generating overall net adverse effects on growth (Cimoli and Correa, 2004).

Figure 3
Specialization Patterns, Export and GDP Growth, 1990–2000



Source: Author calculations based on ECLAC *Statistical Yearbook for Latin America and the Caribbean,* various issues, and ECLAC and World Bank (2002).

Despite the weakened linkages between the internationally oriented activities and the domestic economy, export success has been a major determinant of overall national economic success during the 1990s, as the strong cross-country correlation between export and GDP growth in Figure 3a shows. However, GDP growth has not been associated with the extent to which a country shifted away from reliance on natural resource-intensive export patterns, as shown in Figure 3b. As indicated, the high import content of manufacturing exports and the tendency to specialize in technologically simpler tasks within internationally integrated production systems may, indeed, result in natural-resource-intensive exports generating more domestic value added and linkages than manufacturing exports.

Changing Sectoral and Productivity Patterns

The poor performance of aggregate production and productivity growth in Latin America reflects a diverse experience of some successful and some lagging sectors.[5]

One paradoxical effect of policies aimed at deeper integration into the world economy was the relative dynamism of nontradable sectors in many countries.

[5] The discussion of different sectors in this section draws upon ECLAC (2003a), chapters 4 and 5, Stallings and Peres (2000), Katz (2001), Moguillansky and Bielschowsky (2001) and, for agriculture, David (2000) and Ocampo (2000).

Transport, communications, energy and financial services, as well as construction, were dynamic, particularly during the expansionary phases of the regional business cycle in the early and mid-1990s. Some of these sectors like telecommunications, along with mining, most clearly demonstrate increases in productivity in the 1990s associated with the reform process as such—particularly the combination of privatizations, increasing involvement of multinational corporation participation and stronger protection of property rights. Mining has tended to grow rapidly, but extraction activities have grown more rapidly than those that generate more value added, like refining. Agriculture experienced significant divergence in performance across the region. Some of the most dynamic activities in this sector, like soybeans and poultry production, as well as their sustained increases in productivity, followed long-term trends largely unrelated to the reform process.

Among tradable sectors, economies specializing in manufacturing exports were characterized by the relative growth of manufacturing production, while the opposite was true of economies that specialized in natural-resource-intensive exports.[6] The manufacturing sectors that performed better include: *maquila* activities, in which inputs are shipped over the border into a special zone for processing and assembly before being shipped back, with no tariffs charged; the automobile industry, which is favored in Mexico by access to the U.S. market and in South America by special protection mechanisms; some natural-resource-processing industries; and, during periods of booming demand, activities geared toward the domestic market such as processed foods, beverages and construction materials. Some of the manufacturing industries that performed the worst in the 1990s include traditional, non-*maquila* labor-intensive industries like apparel, footwear and leather manufactures and furniture.

Productivity performance was to a large extent contrary to what traditional neoclassical analysis would suggest. Thus, productivity rose in Latin American manufacturing as a whole, but the gap with the industrialized economies, particularly the United States, widened in many sectors in the 1990s. Indeed, in many countries and manufacturing activities, the productivity gap in relation to the United States narrowed more quickly during the 1970s and 1980s than during the 1990s, reflecting in part the slower pace of technological change in U.S. manufacturing during those previous decades. At the sectoral level, the closing of the technology gap vis-à-vis the United States had more to do with the pace of economic growth in a particular sector and country than with patterns of technological catch-up induced by the reform process (Katz, 2001). For example, automobile production, for which selective instruments of protection were maintained, experienced productivity increases just as large as the natural-resource-intensive export activities, whereas import-competing sectors challenged by external competition did poorly in terms of productivity performance. Thus, the corresponding dynamics is closer to a Kaldorian pattern, in which growth determines productivity

[6] It is interesting to recall, in this regard, that the rising share of manufactures in GDP was a universal feature of Latin American countries in 1950–1980. During the reform period, this feature was found only in economies with a strong manufacturing export bias.

(Kaldor, 1978; Cripps and Tarling, 1973), rather than the opposite neoclassical causal link.

In more general terms, patterns of productivity performance highlight the increased diversity of production sectors and agents within each economy and, thus, the increasing dualism or "structural heterogeneity" that characterized the Latin American economies during the reform period. The expectations of economic reformers that rising productivity in internationalized sectors would spread throughout the economy, thereby leading to rapid overall economic growth, turned out to be overly optimistic. Productivity *did* increase in dynamic firms and sectors, and external competition, foreign direct investments and privatization played a role in that process. However, these positive productivity shocks did *not* spread out, but rather led to greater dispersion in relative productivity levels within the economies. The slow overall productivity performance in 1990–2002 reflects the fact that labor, capital, technological capacity and, sometimes, land that were displaced from sectors and firms undergoing productive restructuring were not adequately reallocated to dynamic sectors. This pattern also means that restructuring was not "neutral" in terms of its impact on different economic agents and sectors.

Summing up Economic Performance

In summary, the sluggishness of Latin America's economic growth in recent years is a sign of macroeconomic, mesoeconomic (sectoral and intersectoral) and microeconomic problems. Macroeconomic causes of sluggishness include a worsening of the relationship between economic growth and trade, an insufficient recovery of investment ratios, a propensity to procyclical macroeconomic policies that increase the sensitivity of economic activity to unstable external capital flows, and an associated propensity for financial crises. At a mesoeconomic level, it results from weak production and technological linkages from internationalized activities, the associated inability to transmit fully improved productivity in competitive sectors to other domestic economic activities, growing dualism and the associated underutilization of productive factors, including those displaced from uncompetitive activities. At a microeconomic level, it was the outcome of the fact that investors responded to the sharp changes in the rules to which business was subject and to uncertainty in growth prospects with "defensive" strategies that minimized fixed capital investment, rather than "offensive" strategies that would have combined restructuring efforts with substantial increases in investment in new equipment and technology.

These results are radically different from the expectations upon which the market-oriented structural reforms of the late 1980s and early 1990s were based. Thus, to what extent can we find a relation between these reforms and the patterns of GDP growth, either across time or across countries? This issue has been explored in the recent literature with no conclusive results. Although this article is not the place to review this literature in detail, some conclusions emerge.

It is clear that the reform period represented an improvement over the miserable growth record of the 1980s, but not a return to the strong performance

of 1950–1980, a period in which economic policy of Latin America was characterized by interventionist state-led industrialization,[7] not economic liberalization. By itself, this pattern calls into question the association between reforms and improved economic performance. Even some supporters of economic liberalization now regard the period of state-led industrialization as a "golden age" and the growth rates achieved during that period as a goal for future Latin American performance (for example, Kuczynski and Williamson, 2003, pp. 305, 329).

Contradictory econometric results also lead to questions about the association between reforms and economic growth. Evidence coming from ECLAC research indicates that different components of the reform package probably had different effects on economic growth, which tended to balance out to a statistically insignificant overall net effect (Stallings and Peres, 2000; Escaith and Morley, 2001; Correa, 2002). Also, while the long-term effect of some reforms may have been neutral or positive, their short-term impact was more commonly adverse. Among defenders of the positive effects of reforms on growth, recent estimates indicate that those effects were weaker and more temporary than originally estimated with earlier data covering only the period of faster economic growth up to 1997 (compare, for example, Lora and Panizza, 2002, with Lora and Barrera, 1998).

A typical confusion in the literature has been the tendency to mix the analysis of the effects of *structural reforms* aimed at reducing the public sector's role in the economy and liberalizing markets with those of *macroeconomic stabilization* policies. Most aggressive reformers introduced liberalization together with major stabilization packages—for example, Chile in the mid-1970s, Bolivia in the mid-1980s and Argentina and Peru in the early 1990s—but this pattern is far from universal. Macroeconomic balances can be achieved with large differences in the degree of economic liberalization and, conversely, liberalized economies can maintain significant macroeconomic imbalances. Whereas strong macroeconomic frameworks are essential for growth, links between structural reforms and growth are at best weak (Rodríguez and Rodrik, 2001).

There has also been a tendency in this literature to confuse structural *characteristics* with structural *reforms*. For example, Loayza, Fajnzylber and Calderón (2002) claim, in a recent paper, that reforms had significant effects on long-term growth, but they actually show the effects of some structural *characteristics* like long-term effects of human capital accumulation and infrastructure. They also show positive but somewhat weaker impacts of effective trade openness and financial depth, but do *not* estimate those of trade and domestic financial *reforms*. Indeed, structural characteristics that may have positive effect on growth—like the accumulation of human capital, improved infrastructure, openness to trade and financial depth—can be achieved in a variety of ways, with quite different degrees of public-sector involvement.

Thus, considerable work remains to be done on the determinants of economic growth and the role played by the market-oriented economic reforms of the late 1980s and early 1990s. But, at least so far, research has failed to show the strong

[7] For reasons that are extensively discussed in Cárdenas, Ocampo and Thorp (2000, chapter 1), this term is preferable to the widely used concept of "import substitution industrialization."

links between reforms and economic growth upon which the reform agenda was built.

Fragility of Social Trends

Social Spending and Restructuring of Social Services

The most positive feature of the 1990s in the social area of Latin America was the significant increase in spending in basic social services, social security and additional forms of social protection. This increase should be seen as a basic dividend of democracy that led, contrary to the initial expectations of some reformers, to an expansion of government spending.

Social sector government spending rose from 10.1 percent of GDP in 1990–1991 to 13.8 percent in 2000–2001, reaching the highest levels in the region's history (ECLAC, 2000a, 2000b, 2003c). Moreover, the increase was relatively faster in countries with lower per capita income, where social spending has been traditionally low. Uruguay and Brazil strengthened their relatively high levels of social spending, together with Costa Rica, Panama and, up to the recent crisis, Argentina. Colombia was the only country moving from a relatively low level of social spending to an average pattern given her per capita income levels. In any case, regional disparities remain large, and in several countries social spending continues to be clearly inadequate.

Increased social spending was accompanied by more selective allocation criteria (that is, better targeting), which account for differences in the distributive impact of different types of spending (ECLAC, 2000a, 2000b). Changes have also been made in the way public resources are allocated, basically through more decentralized systems.

Rising social spending was reflected in improvements in education, health and other social standards, maintaining the long-term trend in the region toward improvements of living conditions as measured by indicators such as the Human Development Index—a feature even of the "lost decade." However, the only available long-term index of this type indicates that improvements over the 1990s tended to follow the slower pace of the 1980s rather than the more rapid betterment that characterized the period 1940–1980 (Astorga, Bergés and Fitzgerald, 2003).

Despite increasing attendance to secondary and university education, disparities in access between the top and the bottom quartiles/quintiles of the income distribution increased over the past decade (ECLAC, 2002a, chapter 10; World Bank, 2003, chapter 2). Also, the efficiency and quality of social services continued to be low, and social security coverage remained stagnant in most countries.

In some countries, increased spending led to the development of arrangements for private-sector participation in the provision of certain social services, particularly in the administration of social security pension plans and low-income housing. These arrangements may have brought progress in terms of efficiency, including the use of equivalence criteria for equating contributions paid into the social security system with benefits received from it, but strong evidence in this

regard is not available. In some cases, however, private-sector provision has gone hand in hand with a concentration of providers in the higher-income, lower-risk sectors and a weakening of the principles of universality and solidarity that should be honored by social security systems (ECLAC, 2000a). It should be noted, however, that for the most part, these principles were not properly applied in the region in the past either, when a common pattern was incomplete and segmented social security coverage that included the proliferation of special arrangements that benefited certain social sectors.

Labor Market Weakness

The worst performance in the social area during the reform period was experienced in labor markets (ILO, 1999; ECLAC, 2002a, chapter 10; Weller, 2001). In Latin American economies, deterioration in this area should be measured both by rising unemployment and employment in low productivity activities (particularly in the informal sector), with the exact mixture in any country depending on the patterns of economic growth, labor market policies and international labor migration. Most countries experienced deterioration in either one of these indicators or in both of them. Despite faster economic growth since 1990 in relation to the "lost decade" of the 1980s, open unemployment in Latin America rose by almost three percentage points during the 1990s and shot up even higher in some countries, particularly during major external shocks. In turn, the share of urban informal-sector employment rose from 43.0 to 48.4 percent between 1990 and 1999, generating seven out of ten new jobs. The resulting deterioration in job quality is also evident in the relative increase in temporary employment, in reduced coverage of social security systems (particularly for workers in small enterprises) and in the rising number of individuals working without a written labor contract (Tokman and Martínez, 1999; ECLAC, 2002a, chapter 10).

One specific factor that played a significant role in labor markets was the pattern of international specialization (ECLAC, 2002a, chapter 10; Stallings and Weller, 2001). As Table 3 indicates, the "Northern" pattern of specialization in manufactures (and some services) proved much more effective in generating employment, particularly wage-labor employment in tradable sectors, than the "Southern" specialization in natural-resource-intensive goods. As employment did not follow specialization patterns in nontradable sectors (particularly in relation to wage employment), whereas in tradable sectors it did, the growth of employment was more dynamic in the Northern part of the region.

The considerable increase in the wage gap between skilled and unskilled workers—and, particularly, between college-educated workers and others—has been another widespread phenomenon (ECLAC, 1997 and 2002a, chapter 10; Morley, 2001). The widespread character of this trend indicates that divergent specialization patterns within the region are not part of the explanation; rather, technological change and the relative growth of sectors with high demands for human capital (particularly some services) seem to be the determining factors. According to a recent World Bank report, this trend may be associated also with the tensions that characterize middle-income countries in the current global order, as

Table 3
Patterns of Employment Generation, 1990–1999
(*annual average growth rates*)

	Total employment			*Wage earner employment*		
	Total	*Tradable sectors*[a]	*Nontradable sectors*[b]	*Total*	*Tradable sectors*[a]	*Nontradable sectors*[b]
Simple average						
Mexico and Central America	3.6	2.1	4.8	3.6	3.1	3.7
		(3.9)	(3.1)		(4.4)	(2.9)
South America	2.6	1.3	3.1	2.5	1.0	3.1
		(1.3)	(2.5)		(0.8)	(2.6)
Total	3.0	1.7	3.9	3.0	1.9	3.3
		(2.5)	(2.7)		(2.4)	(2.7)
Weighted average						
Mexico and Central America	3.2	1.8	4.1	2.8	2.0	2.7
		(4.1)	(4.3)		(3.6)	(3.6)
South America	1.8	0.2	2.6	1.8	0.1	2.5
		(0.2)	(2.5)		−(0.1)	(2.6)
Total	2.2	0.8	3.0	2.1	0.7	2.6
		(1.5)	(2.9)		(0.9)	(2.9)

Source: ECLAC (2002a), Table 10.8.
[a] The data between parentheses correspond to manufacturing sector.
[b] The data between parentheses correspond to government, social, community and personal services.

the wages of the more-skilled labor are being pushed up by the incomes they earn in the industrial world, whereas those of low-skilled labor are determined by competition in the international market for goods with lower-income countries, particularly China (World Bank, 2003, chapter 6). This explanation is consistent with Rodrik's (1998) view that globalization tends to benefit the more mobile factors like capital and skilled labor relative to the less mobile factors like unskilled labor. Given these adverse trends, the greater participation of women in labor markets is the most positive pattern found across the region. Also, in most countries the growing labor force participation of women has been accompanied by a reduction in the (still large) gender income gap.

Poverty and Income Distribution

Poverty rates shot up during the "lost decade," from 40.5 percent of the total population in 1980 to 48.3 percent in 1990, and fell as growth recovered, to 43.5 percent in 1997—although the absolute number of poor stagnated at roughly 200 million.[8] These positive trends were sharply interrupted during the "lost half-decade," causing an additional 20 million persons to fall below the poverty line.

[8] The poverty rates used here are those of ECLAC, estimated on the basis of a specific food consumption basket for each country. At the regional level, they differ in magnitude but not in the overall trend from those estimated by the World Bank on the basis of a poverty line estimated as $2 a day on the basis of purchasing power parities.

In this recent period, whereas per capita GDP has exceeded 1980 levels by some 6 percent, the poverty rate of 43.4 percent in 2002 remained three percentage points above the 1980 level.

Success in reducing poverty has varied across the region.[9] Figure 4 shows some differences in how growth affected poverty during the period of faster economic growth (1990–1997). Chile, which experienced the fastest economic growth, also had a strong performance in terms of poverty reduction. Costa Rica's good performance and the poor record of Honduras can be attributed to differences in the rates of economic growth. Nevertheless, other countries show significant divergence from the average pattern: Uruguay and Brazil did much better than expected given their rates of growth, whereas Argentina, Bolivia, Mexico and Venezuela did much worse. Specific policies can explain deviations from the pattern, including the extensive system of social protection in Uruguay and the targeted minimum pension policies in Brazil. The end of hyperinflation also had a positive effect in all countries that had gone through that traumatic experience, indicating that indexing of lower incomes was more imperfect than that of higher incomes during episodes of very high inflation. Also, there is evidence that minimum-wage policies also had a broadly positive effect in this regard.

Unlike poverty rates, income distribution trends have been uneven across the region but, on the whole, show a tendency to deteriorate. There are several countries where income distribution, measured by either the Gini coefficient or relative poverty,[10] displayed an adverse trend over the past decade and only a handful where the opposite is true. Deterioration was more common in South America,[11] indicating that there may be an association between the patterns of specialization and income distribution, probably through the divergent employment effects of different specialization patterns. Although comparing data on income distribution over long periods of time is a complex matter, there is probably no country in the region where inequalities have declined relative to what they were three decades ago and, on the contrary, many countries where inequality has increased.

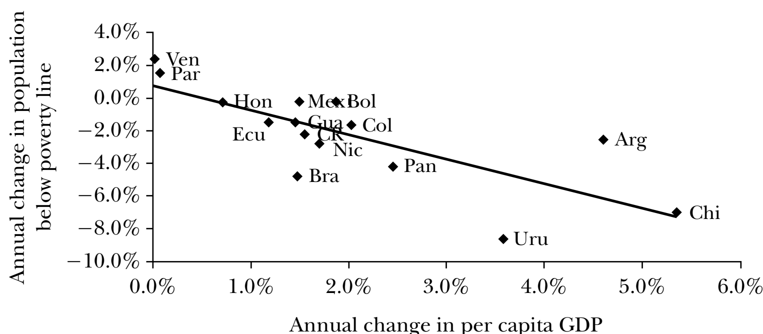
Inequality of income is due to a combination of factors relating to education, demographics, employment and the distribution of wealth. As regards the first two,

[9] On the determinants of poverty and income distribution, see ECLAC (1997, 2000a, 2000b, 2001), IDB (1999), Morley (2001) and World Bank (2003).

[10] Relative poverty is estimated by ECLAC as the proportion of the population with an income below half of national per capita household income. This proportion tends to be higher when income is more unequally distributed and can thus be considered a measure of income distribution rather than poverty.

[11] This concentration of adverse distributive trends in South America is a conclusion of the recent report of the World Bank (2003, chapter 2) but is consistent with ECLAC estimates. There are, however, significant differences in individual calculations. The World Bank estimates an improvement in income distribution in Brazil over the 1990s, which is not confirmed by ECLAC. The opposite is true of Uruguay. Adjustments in the original household data explain the difference. Possible improvements in Brazil are the basic reason for the conclusion of the World Bank that regional income distribution, weighted by population, improved slightly in Latin America over the 1990s, a conclusion that is not confirmed with alternative data. However, both ECLAC and the World Bank agree that there was a deterioration of the average (unweighted) Gini coefficient.

Figure 4
Poverty Reduction and Per Capita GDP Growth, 1990–1997



Source: Author calculations based on ECLAC *Statistical Yearbook for Latin America and the Caribbean* and ECLAC *Social Panorama of Latin America,* various issues.

some progress was made during the 1990s. Educational coverage improved, as noted, though there are signs of growing dispersion in that coverage and, probably, in the quality of education across social sectors. Reductions in birth rates generated a slower growth of the dependent youth population and facilitated a larger participation of women in the labor force. The combination of these two factors tended to reduce inequality, as the poorer households tend to be larger. These positive effects were, nonetheless, weaker than the negative shocks in the job front, which included rising unemployment and low-quality employment. Also, in some countries, there was a narrowing of disparities between the incomes of workers who have received only primary education and those who have some secondary education, but this has been overwhelmed by the growing income gap between college-educated and other workers, and by greater dispersion of incomes among college-educated workers (Morley, 2001; World Bank, 2003). Not much is known about what has happened in terms of wealth inequality, but it is likely that it became more unequal, as well.

There is considerable disagreement in the current literature as to why income distribution has tended to deteriorate (Altimir, 1997; Berry, 1998; Morley, 1995, 2001; IDB, 1997, 1999; ECLAC, 1997; World Bank, 2003). Some studies focus on factors specific to Latin America like the effects of the debt crisis of the 1980s or the structural reforms of the late 1980s and early 1990s. Other papers focus on more universal trends associated with technological and other factors influencing wage/skill differentials. Berry (1998) stands out for his early emphasis on the adverse distributive effects of structural reforms, a hypothesis that has received increasing support in later research. In the light of previous analysis, it seems that the increasing dualism generated by reforms, the patterns of specialization in manufactures versus natural-resource-intensive goods, and the worldwide factors generating adverse trends in the relative incomes of workers with higher skills also played a role.

In any case, adverse distributive patterns have long been evident in Latin America. Thus, the lack of equity is not just a characteristic of the recent reform

period, but a pre-existing condition that reflects serious problems of social stratification and wealth inequality that have been handed down from generation to generation (ECLAC, 2000a, 2000b).

The Way Forward

This paper has argued that the benefits of market-oriented economic reforms that Latin America undertook since the mid-1980s were overstated and their risks largely overlooked. Structural economic reforms, together with an increased monetary and fiscal discipline, were successful in many areas, particularly in bringing down inflation, inducing export growth and diversification, and in attracting foreign direct investment. But frustration also resulted from economic growth that remained low and volatile, from increasing dualism of the economy and, particularly, from the disappointing social outcomes. Some basic assumptions of reformers proved to be entirely wrong, particularly the assumptions that low inflation and better control of budget deficits would ensure stable access to international capital markets and dynamic economic growth, and that higher productivity in leading firms and sectors would automatically spread throughout the economy, leading to a broad acceleration of economic growth.

The interpretation of these poor outcomes of reforms remains highly controversial. One view explains these results as the effect of an insufficient commitment to the original reform agenda and thus posits that the solution to the current frustrations is even more liberalization. An alternative view, much in vogue recently, argues that the agenda of market liberalization and strong macroeconomic frameworks was laudable but incomplete, and should now be complemented with a "second generation" of reforms based on strengthening domestic institutions and more active social policies (Birdsall, de la Torre and Menezes, 2001; Kuczynski and Williamson, 2003). A third approach argues that some of the basic assumptions of the liberalization process were in fact wrong and, thus, that the first generation of reforms may have created some of the problems that Latin America is facing today and that it is necessary, in some cases, to "reform the reforms" (Ffrench-Davis, 2000; ECLAC, 2000a).

My own preferred alternative is to acknowledge that we must build upon the positive aspects of the economic reform process, as well as the new agenda of institutional and social reforms but also to correct the basic problems that the first generation of reforms has evidenced. A view along these lines has been advocated by Rodrik (1999, 2001a, 2001b), by ECLAC (2000a) and by this author (Ocampo, 2002a, 2002b, 2004), among others. This view implies that changes must be introduced in three areas.

First, the view of macroeconomic stability needs to be expanded to include not only low inflation rates and budget deficits, but also high and stable growth rates and employment. For this purpose, it is essential to overcome the existing procyclical macroeconomic policies that heighten the effects of volatile external markets, especially capital markets, and thus generate adverse effects on investment as well

as the latent risks of financial crises. The design of countercyclical macroeconomic fiscal and monetary policies is thus central to any alternative agenda. In view of the central role played by external capital flows in the determination of the Latin American business cycle, this policy may require an active regulation of external capital flows.

Second, the earlier reforms failed to realize that the emergence of dynamic economic activities is not necessarily a spontaneous outcome of liberalized, open economies. It requires adequate exchange rate management as well as active technology and domestic financial policies, to guarantee access to technology and long-term financing in domestic currencies to all firms; public-private partnerships to support the emergence of new economic activities (including, in some cases, the design of strategic, time-bound subsidies); and an active trade diplomacy. In the light of recent trends, two issues are particularly important. The first is to accept that production and technological linkages between dynamic firms and sectors and the rest of the economy do not occur automatically. Instead, special mechanisms must be designed to create such linkages, particularly through clearinghouse markets to facilitate local suppliers meeting with local demanders. The second is that active policies must be implemented to counteract dualism in productive structures, by strong policies of support to small-sector firms and their links with larger enterprises.

Third, the previous reforms failed to recognize that successful social outcomes are not just social but also *economic* objectives. The "residual" view of social policies, so common today, in which social policies are supposed to take care of those who are unable to adjust to more competitive markets, must be overcome. The accumulation of assets of the poor—including education, access to technology and credit markets, and to land—as well as the design of integral systems of social protection should be combined, under Latin American conditions, with explicitly redistributive policies. None of these conditions is likely to be satisfied without increasing progressive taxation and social spending and without improving efficiency in the delivery of social policy. Given the very serious deterioration that has characterized labor markets, a fresh social dialogue and series of interventions to improve employment generation must be added. But, beyond these interventions, it is essential that social objectives be mainstreamed into economic policy—that is, that the design of economic policy should consider social effects from its inception, thus abandoning the practice of assuming that social problems will be managed with residual social policies.

Reversing the errors of the macroeconomic and structural reforms of the 1980s and early 1990s does not mean returning to policies that Latin America adopted during its period of "state-led industrialization" from the 1940s to the 1970s. This article is not the place to debate the historical controversy about how much the policies of state-led industrialization contributed to the robust growth rate of growth of Latin American over that period (for a discussion along these lines, see Cárdenas, Ocampo and Thorp, 2000). Regardless of one's position in that debate, there is little reason to believe that the specific policies popular in Latin America at that time would produce the same growth rates in the very different

global economic environment of today. But there is also little reason to believe that a policy focused on market liberalization, even if accompanied by stronger safety nets, will suffice to bring more rapid economic growth and improved social indicators, either. Furthermore, there are diverse solutions to the problems of economic and social development, and democracy must play an essential role in finding the appropriate policies for each particular context. No unique "recipe" for economic development will work for every country. The essence of democracy and institutional development is diversity and learning.

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