

Latin American Economies: The Good, the Bad, and the Ugly

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During the 1990s, many important things changed for the better in Latin America. Inflation reached a 50-year low, and economic growth replaced the prolonged economic stagnation that at times seemed chronic. Financial crashes that once created decade-long debacles now last just a year or two. Commerce among countries in Latin America boomed from less than one-fifth of the region's total international trade early in the decade to nearly one-half of all trade in 1999. Elections have become common, and the few authoritarian impulses that resurfaced during the decade have hitherto been kept in check by domestic and international pressures.

But many other important things have not changed. The poverty and inequality that have traditionally characterized Latin America persist. While the region's rate of economic growth in the 1990s was much better than that in the prior decade, it was not enough to have any significant impact on the region's huge unmet social needs. In the last 10 years, per capita income grew by a meager 1.4 percent. The dependency on foreign money to fuel growth and maintain macroeconomic stability is still deeply embedded in the region's economies. Latin America's international competitiveness—though vastly improved—remains insufficient to reduce the countries' dependence on agricultural and mineral exports. Furthermore, although the political instability that beset the Andean nations during the 1990s and flared up at decade's end has very different origins and more country-specific differences than commonalities, it illustrates the continuing vulnerability of Latin America to deeply impoverishing political instability.

Some of the changes that Latin America has experienced in the last 10 years were clearly driven by new forces originating outside the region. Others were old and homegrown. Thus, for example, the opportunities and dilemmas created by the surges in foreign capital availability that result from changes in the global financial system coexist with the problems created by a political system that rests on historically weak institutions. On the other hand, despite the often strident opposition to the market

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reforms of the early 1990s and the many financial, political, and even climatic incidents that have impaired their implementation and lessened their results, there has been no widespread or sustained reversal of market policies across Latin America.

New business activities spurred by the global information economy are also creating opportunities that some Latin American countries like Argentina and Costa Rica are fully exploiting. In some countries, Internet-related ventures have displaced privatization opportunities as the major magnets for foreign investment. The Latin American countries that have positioned themselves to take advantage of these new opportunities will be prime examples of the potential of the Internet to help developing countries leapfrog some of the traditional obstacles to prosperity. Here, too, Latin America's legendary inequality plays a role, however. Even in the countries that are making the greater inroads into the information economy, the majority of the population does not have a telephone—although even the poorest households have access to television. Therein perhaps lies the potential of this revolution when the two technologies are effectively merged.

The result of all these circumstances is that a region that was always quite varied has become even more so. Differences among the region's nations are mounting, and countries that exhibited extraordinary imbalances in wealth, income, and opportunity across regions, social classes, and age groups have become even more heterogeneous.

The Decade of the 1990s

The decade of economic reforms? Of financial crises? Of economic integration? Of violence? Any of these names could describe the Latin American experience of the 1990s, which was characterized by the good, the bad, and the ugly.

Over the past decade, Latin America has been characterized by cross-cutting and contradictory currents. The most positive aspects—the *good*—have included the resurgence of democracy, the implementation and subsequent resilience of market-oriented economic reforms, the taming of inflation, the return of foreign investment to the region, and the unprecedented degree of economic integration inside the region. Such favorable developments were tempered by the *bad*—Latin America's continued vulnerability to external economic shocks, a tepid and volatile record of economic growth, continued poverty and income inequality, and the weakness of the region's public institutions. Finally, new and challenging problems are beginning to emerge—the *ugly*—such as a surge of violence and crime in the region. The extent and impact of a drastic rise in street crime, an increase in murder rates, generalized violence, and personal insecurity have yet to be systematically incorporated into most analyses of Latin America's current situation and its perspectives. Yet, crime is rapidly becoming one of the central causes of concern for policymakers, foreign investors, and, most of all, for the region's citizens.

Rediscovery of the Market

The 1990s will undoubtedly be remembered as the decade when Latin America rediscovered the market. It was also the decade when economic shocks periodically

threatened to derail the region's newfound commitment to economic orthodoxy and international openness.

Latin America's surprising turnaround in ideology and policy has many roots. The end of the Cold War and the drying up of public sources of capital associated more with the geopolitical chess game than with sound economics clearly played a role. But the sad experiences associated with the economic malpractice and the failures of the 1980s were crucial in fueling Latin America's turn to the market. Indeed, in hindsight, it seems likely that the very depths of the economic crisis during the 1980s helped push policymakers in the region to implement painstaking market-oriented economic reforms in the decade that followed. The inability of traditional political parties to address the exhaustion of old economic models led to a new generation of leaders and reformers willing to radically alter their countries' economic landscape.

Although by now this reform effort is well-known and often taken for granted, its historical significance should not be underestimated. The economic reforms of the 1990s—including trade liberalization, deregulation, privatization of state-owned industries, and financial liberalization—represented a radical departure from the prior policy path of inward-looking, state-heavy development plans that dominated the region during much of the post-Cold War period.

Perhaps the single most impressive result of the reform process was the taming of inflation. After reaching hyperinflationary levels in several Latin American countries during the late 1980s and early 1990s, inflation fell to the single digits or low double-digit range in all countries by the end of the decade. Brazil showed a particularly dramatic reduction in inflation rates, falling from over 2,500 percent in 1994 to less than 25 percent the following year, and dipping below 5 percent by 1997. Argentina and Peru experienced similarly steep declines in their rates of inflation. In 1999, regional inflation fell to approximately 10 percent. Only countries such as Ecuador and Venezuela—which have not engaged in comprehensive macroeconomic reforms—have proven unable to keep price increases in check.¹

The initial impact of the reforms on economic growth was similarly noteworthy. By 1994, several Latin American economies had stabilized and appeared to be on a sustainable growth path, with regional gross domestic product (GDP) growth reaching 5.1 percent that year. Foreign investment returned to the region—pulled in by privatizations, the more attractive government policies, and changes in the international financial system. After virtually disappearing from 1983 to 1990, foreign direct investment (FDI) flows averaged some \$18 billion per year between 1990 and 1994; furthermore, FDI grew steadily throughout the rest of the decade, reaching nearly \$78 billion in 1998 and a record \$97 billion in 1999. This last year marked the first time since 1986 that FDI to Latin America was greater than that to Asia (\$84 billion).² Although privatization programs tend to garner significant headlines, most of the foreign investment flowing into Latin America is aimed at the creation of new assets (60 percent) rather than the purchase of existing state or private assets (40 percent).³

Early successes naturally bred high popular expectations, which were compounded by political overselling of both the speed of the reforms and their likely short-term benefits for the population at large. In those heady and triumphant days of the early 1990s, it was easy for many to believe that the age-old puzzles of develop-

ment would be solved and that Latin America was finally reaching the ranks of the world's advanced economies. Mexico's joining of the Organization for Economic Cooperation and Development (OECD) was seen by some as final confirmation that the region had turned a historical corner and that, although problems persisted, the formula to deal with them had been discovered. At the time, few analysts foresaw the obstacles and speed bumps that the region would soon encounter along the road of economic reform.

Reform Resilience

In December 1994, just a few days after the hemisphere's leaders had gathered in Miami, Florida, to praise the reform process and point to an imminent and inevitable future of free trade among all countries in the Americas, Mexico's peso crisis struck with unexpected ferocity. Mexico's economy nose-dived by 6 percent in 1995, and the contagion effect dragged down other economies in the region, most notably that of Argentina, which suffered a severe recession in 1995. This was the first of many external financial shocks to buffet emerging economies in Latin America.

The Asian crisis of 1997–1998 disrupted trade and financial flows and placed Latin American economies under severe market stress, as foreign investors became more aware of the region's severe fiscal and external imbalances as potential trouble spots.⁴ Stock indexes throughout Latin America lost ground during much of 1998, with the Russian debt default in August 1998 only aggravating the slump. The region's export revenues actually declined slightly in 1998 over those in the prior year, while the overall trade deficit rose from \$31 billion in 1997 to approximately \$50 billion in 1998. Finally, regional GDP growth decelerated significantly following the Asian shock, from 5 percent in 1997 to 2 percent the following year to stagnation—zero growth—in 1999. The slump appears to have bottomed out, however, with most forecasts for 2000 showing regional GDP growth in the neighborhood of 3.5 percent.

Amid this disappointing economic performance, which fell far short of the prosperity that the reforms were supposed to achieve, and growing uncertainty over the future, the reforms of the early 1990s remained largely in place. This reform resilience was perhaps the most salutary aspect of Latin America's economic experience during the past decade. There has been no wholesale backlash in fiscal and monetary discipline, no re-nationalizations of privatized companies, no resurgence of trade protectionism, and no introduction of capital controls. In fact, the Chilean government, which had maintained some controls on short-term capital flows, moved to reduce and eventually eliminate the controls at the height of the international uncertainty, just as fickle international economic commentators were praising the policy.

Such staying power contrasts starkly with modern Latin American history. During the 1980s, several governments responded to the debt crisis by slapping on new tariffs, restricting imports, imposing multiple exchange rates, and levying inefficient taxes in hopes of mitigating their ballooning internal and external deficits. Mexico was a particularly egregious offender in these categories. By contrast, when the peso crisis hit in 1994, Mexican authorities responded by deepening—not departing from—the country's market-oriented policies. Similarly, Argentina did not abandon its currency convertibility program in 1995 when the economy contracted by more

than 3 percent and bank deposits fled into neighboring Uruguay. Such reform permanence is particularly remarkable in light of the consolidation of democratic governments in most of the region. Under freer political regimes, citizens have more room to protest poor economic conditions, and opposition leaders face few inhibitions against denouncing government policies that fail to deliver positive economic results quickly. Even in this less patient setting, the reforms have endured.

The region's private sector, battered by macroeconomic volatility and weakened by forced march from hyperprotectionism to hypercompetition has emerged battle-tested and better equipped to survive and compete in the global economy. After decades of protection and government subsidies, private firms suddenly saw tariff barriers almost eliminated, government subsidies slashed, and their cozy oligopolistic structures shattered by the entry of new foreign competitors with better technology and lower costs of capital. The region's need for capital and technology has prompted transnational partnerships and joint ventures with foreign firms. The total value of mergers and acquisitions (M&A) activity in Latin America grew from less than \$11 billion in 1990 to \$87 billion in 1998 (although it declined to just over \$50 billion during recession-plagued 1999).

Certainly, a slowdown (though not reversal) of the reform process seems to be materializing. But it would be wrong to interpret this apparent slowdown solely as the result of slacking political will and a resurgence of the political left. Some of these factors may be playing a role in some countries (for example, Venezuela), but the slower visible progress in the adoption of new reforms is more a function of the inherent difficulty of implementing a second generation of more complex institutional reforms than of a decline in political will or popular support. A recent survey concluded that trade opening, domestic financial liberalization, and capital account opening were the first reforms to be adopted widely throughout Latin America, but that there has been less convergence in areas like privatization and tax reform. This analysis is broadly consistent with earlier studies suggesting that Latin America's "first stage" of reform, though still politically courageous, was relatively straightforward to introduce and implement. The elimination of price and foreign exchange controls, the simplification of tariff regimes, and the liberalization of capital flows were all achieved relatively quickly via presidential decrees or other executive orders. The second stage of reform—involving the development of more effective tax and labor policies, better regulatory agencies, and stronger public institutions—has proven much more complicated and time-consuming; hence, the greater unevenness in reform experiences.⁵

Regional Integration

Together with economic reforms and external economic shocks, regional integration was a hallmark of economic activity during the 1990s. Although the North American Free Trade Agreement (NAFTA) between Canada, Mexico, and the United States garnered most of the headlines, multiple subregional and bilateral trade pacts have also criss crossed the region during the past decade. The Common Market of the South (MERCOSUR)—encompassing Argentina, Brazil, Paraguay, and Uruguay, with Chile and Bolivia as associate members—is the most notable example. Total

exports among these economies grew by more than 25 percent annually from 1991 to 1997.⁶ Meanwhile, the Andean Pact—seemingly dormant for much of its long history—was roused back to life in the 1990s, with exports from member states growing from \$32 billion in 1989 to nearly \$60 billion in 1998. Even as momentum for Chile's accession into NAFTA disappeared with the death of fast-track trade negotiating authority in the United States, Chile has developed bilateral agreements with Bolivia, Canada, Colombia, Ecuador Mexico, Peru, and Venezuela during the 1990s.⁷ Partially resulting from regional trade agreements, but also stemming from unilateral efforts, average tariffs in Latin America declined from more than 40 percent in the pre-reform era to less than 14 percent by 1995. Similarly, trade-impairing currency controls have been largely eliminated from the region.

Ultimately, these trade pacts are not only about trade. For many Latin American countries, trade agreements are more about foreign investment. Having recently adopted an export-oriented development strategy and still critically dependent on external capital to finance growth, Latin American nations feel that they must become part of an economic alliance, particularly with large industrialized economies, to ensure their participation in the global economy. Additionally, the international treaties formalize and lock in free trade agreements, thus reassuring foreign investors by making it more difficult for future leaders to backslide on current macroeconomic policy reforms.⁸

Latin America and Globalization

Traditionally, analysts have looked to international trade indicators in order to assess the extent of a country or a region's integration with the global economy. On such measures, Latin America is making steady progress toward joining the global economy. From 1990 to 1998, Latin America's exports grew at an average annual rate of 8.5 percent, while the corresponding global figure reached only 6.5 percent. Similarly, Latin American annual imports expanded by more than 11 percent over the same period, nearly twice the pace of increase for the world as a whole.

Trade alone is too narrow a metric to gauge the full nature and speed of the globalization process in Latin America, however. An array of less orthodox indicators helps paint a more nuanced picture. An examination of the listing of Latin American companies in stock markets overseas, for example, shows that Chile's *Compañía de Telecomunicaciones* was the only company from South or Central America listed on the New York Stock Exchange (NYSE) in 1990. As of March 2000, the shares of 103 companies from eight Latin American nations were being traded on the NYSE.

In addition, individual economies are improving their use of, and access to, the technology and communications tools of globalization. In 1994, Costa Rica had 2.4 Internet hosts for every 10,000 citizens. By 1997, the number had risen to 12.4 per 10,000 people. In 1993, each Mexican long-distance telephone user averaged 40 minutes of outgoing international calls; this rate nearly tripled (to 115 minutes) by 1997. In 1980, Argentina had 66.8 telephone lines per 1,000 inhabitants. By 1997, this number had nearly tripled to 191. In 1992, Peru had six personal computers per 1,000 people; 5 years later, the number had more than doubled. Similar increases in connectivity can be found throughout the region.

Despite such progress, however, many Latin American nations remain far behind the rest of the world in getting wired to the global economy. Although Latin America is the fastest growing Internet market in the world, only 0.8 percent of the region's population are regular Internet users, for example, compared with more than 25 percent in the United States and nearly 7 percent in other OECD nations. Individual countries such as Argentina and Costa Rica appear to be making more progress on these fronts, but for the foreseeable future, much of the rest of the region will lag behind in introducing the infrastructure needed to log on to the Internet with the rest of the world.

Policy Innovations

Latin America has been at the forefront of policy innovation, providing a laboratory for the rest of the world to observe and, in some cases, emulate. For example, Chile's successful pension privatization of 1981 spawned like-minded reforms elsewhere in the region and throughout the world. Chile moved from a traditional pay-as-you-go system in which worker contributions funded retiree benefits to a system in which workers contribute to individual accounts managed by private pension operators. (Some analysts are even suggesting that the United States should employ the "Chilean model" in order to reform its own Social Security system.)

Similarly, the debates on "dollarization" are gathering steam, with policymakers in Argentina, Ecuador, and elsewhere contemplating a move toward fully dollarized economies as a means to reduce domestic interest rates and import macroeconomic stability. Although the use of the American currency may not be appropriate in all cases and is certainly no substitute for sound economic policies, the discussion reflects a healthy willingness to experiment with policies aimed at reducing vulnerability within a market-oriented framework.

Political power in the region remains concentrated in capital cities or centers of business, but several Latin American nations are moving toward more decentralized forms of government, with greater devolution of authority to regions and localities. For example, in 1980, mayors were appointed by the central government in all but three Latin American nations. In 1997, however, 18 countries in the region had mayors elected by popular vote. Several governments—notably in Brazil, Bolivia, and Colombia—have made significant strides in decentralizing expenditures and allocations of resources. In Colombia, for instance, municipalities are gaining greater influence over nutrition programs, primary education, and public health—all formerly the exclusive domain of the central government. Such changes may help policymakers and institutions throughout Latin America become more responsive to the diverse needs of their heterogeneous populations.

Major Concerns

Volatile and Insufficient Economic Growth. In 1995 and 1996, Latin America's growth was shattered by the Mexican crash, the subsequent contagion in other parts of the region, and a crippling banking crisis in several countries. In 1997, the region surprised all analysts when it posted its highest growth rate in a quarter cen-

tury. In 1999, economic growth turned negative. These swings are not just recent and isolated events. Latin America's economic volatility is one of its main characteristics. Indeed, detailed econometric studies show that Latin America suffers from the highest economic volatility in the world. So, while economic growth in the 1990s was much better than that in the 1980s and in several years one or another Latin country exhibited the world's highest growth rate, the overall regional performance in the last decade fell short of needs and expectations.

Real annual GDP growth averaged 3.2 percent in 1991–1999—more than three times the rate of growth of the 1980s—with only Cuba and Haiti showing negative average rates.⁹ On a per capita basis, however, the region's average annual economic growth rate during the 1990s was a less impressive 1.4 percent. Several economies, including those of Cuba, Ecuador, Haiti, Paraguay, and Venezuela, experienced negative per capita GDP growth during the 1990s.

The aggregate growth figures have been tepid due to the extreme volatility of the region's economy during the 1990s. Argentina, which averaged a moderate 3.3 percent rate of per capita GDP growth during the decade, is an apt example. After growing by more than 8 and 9 percent in 1991 and 1992, respectively, the Argentine economy contracted by more than 4 percent in 1995, following the contagion from the Mexican peso crisis. After rebounding to grow by nearly 7 percent in 1997, the economy closed out the decade with 4.5 percent growth in 1999. Several other economies experienced similarly severe boom-bust cycles during the decade, due in part to the aftershocks of the financial crises that rocked the global economy in the 1990s.

Uneven economic growth has contributed to a similarly erratic performance in social indicators. Urban unemployment for Latin America as a whole rose slowly, but steadily, over the last 10 years, from 5.8 percent in 1991 to nearly 9 percent by the end of 1999. This average glosses over significantly higher rates in individual countries. (Urban unemployment in Ecuador, for example, nearly doubled during the latter half of the decade, rising from 7.7 percent in 1995 to more than 15 percent in 1999.) High economic volatility generates fear and insecurity among workers. Firms cannot make long-term commitments to employees, rendering stable labor relations less likely.

Poverty persists as a serious problem throughout the region; the economic reforms of the 1990s accomplished only marginal progress in this area. After rising from 35 percent in 1980 to 41 percent in 1990, the percentage of Latin American households living in poverty declined slightly to 36 percent by 1997. But even this decline masks deteriorating conditions in several countries, notably in Venezuela, where the households in poverty rose from 32 percent in 1990 to 42 percent 7 years later.¹⁰ In rural areas throughout the region, poverty remains high at more than 50 percent, with extreme poverty mired above 30 percent. It is likely that some of the slight, regionwide reductions in poverty made in the early to mid-1990s were reversed during 1999, when several economies in Latin America suffered recessions. Overall, some 150 million Latin Americans (or about one-third of the region's population) live on less than \$2 per day—regarded as the minimum level of income needed to cover basic needs.

The boom-bust cycles and ongoing vulnerability to macroeconomic crises have aggravated the poverty picture. At a macroeconomic level, Latin American econo-

mies now appear to recover more quickly from crises. Crises lasted for several years in the 1980s, but the region now displays greater resilience, with a year or two of negative or stagnant growth invariably followed by renewed economic activity. However, the poor in Latin America are particularly vulnerable to such crises because they often have little access to social insurance programs and because formal credit will likely be less forthcoming for the poor during economic downturns. Studies have estimated that for every percentage point decline in economic growth, poverty in Latin America increases by 2 percent. Indeed, if Latin America enjoyed the same level of macroeconomic stability as the industrialized nations, about one-quarter of the region's poor would be lifted out of poverty.¹¹

Persistent Income Inequality. As of the late 1990s, Latin America still displayed the most skewed distribution of income of any region in the world. The top 10 percent of the income earners account for some 40 percent of national income, while the poorest 30 percent take in less than 8 percent of total income. The skewed distribution of income also affects the extent of poverty in the region. Some studies conclude that if income distribution in Latin America were consistent with the international average, poverty in the region would decline by half.¹²

Macroeconomic volatility only aggravates the problems surrounding income inequality. The economic recoveries and renewed growth that follow a crisis period do not eliminate the income inequality created during the crisis—severe economic downturns appear to have a persistent ratcheting-up effect on inequality. Meanwhile, the new demands of a high-technology global economy have aggravated income inequality among the labor force—wage returns for skilled workers have grown more rapidly than those for their unskilled counterparts in Chile, Colombia, Mexico, and Peru.

Latin America's chronic problems of poverty and income inequality only underscore the need for government financing for social programs in such areas as health and education. The new policy mantra for many governments in the region—most notably, for the newly elected presidents in Chile and Argentina—seems to be that the market-oriented model must be buttressed with a strong social safety net to protect those who are left behind in the race toward globalization.

But this new synthesis raises a new challenge: How can governments fund sorely needed social programs and safety nets at a time when market forces demand ever greater fiscal restraint? Indeed, the goal of reducing public sector deficits has been one of the key aspects of macroeconomic reform in several economies in the region. The results in this area have been mixed. Economies in some countries (for example, Argentina, Mexico, and Peru) have been able to reduce their fiscal deficits during the 1990s, while those in other countries (for example, Ecuador, Colombia, and Venezuela) have seen their public imbalances balloon over the same period.

Partly because of the mandate for increased fiscal austerity, governments have been unable to fund significant increases in social expenditures. In 1980–1981, regionwide social spending averaged 10.5 percent of the GDP. Fifteen years later, this average remained virtually unchanged, moving only to 10.6 percent in 1994–1996. Similarly, social spending as a percentage of total government budgets remained at a virtual standstill during the 1990s, rising from 35 percent to 36 percent from 1990–1991 to 1994–1996. The average percentage of Latin America's national budgets de-

voted to education actually declined slightly, from 14.8 percent in 1989 to 14.1 percent in 1996.

Poor Institutions. Of course, poverty and inequality are not merely a function of governments' social services budgets. For many Latin American nations, ineffective public institutions have been the black holes of economic reform. In most countries, they absorb efforts and investment that yield obscenely low returns to society, distort labor markets, reduce overall productivity, impair international competitiveness, and easily fall prey to vested interests.

Indeed, much of the widespread concern about Latin America's rampant corruption is, in fact, a concern about the institutions, such as ministries of education or the courts, that endemic corruption has rendered completely ineffective or even counterproductive. Now that the more pressing concerns of economic stagnation and high inflation have been addressed in most countries, institutional reform ranks high on the policy agenda.

In most poor countries, public sector institutions do not function properly or simply do not work at all. Many, such as schools, hospitals, or police departments—which are overwhelmed by a booming demand for services—do not have, and have never had, adequate personnel or equipment to respond to the public's needs. Others are paralyzed by labor laws and regulations that stifle efficiency. Still others, such as tax and customs agencies, jails, or agricultural subsidies' boards, are often corrupt to their core.

Latin American nations have discovered that economic growth matters little to people if hospitals do not have medicines and that a booming stock market can be very dangerous if the domestic equivalent of the U.S. Securities and Exchange Commission is ineffectual. An exchange rate that makes a country's products cheaper abroad does not suffice to sustain an export-led strategy of economic growth if inefficiency and corruption paralyze the ports, and fiscal reform matters little if taxes cannot be collected. The elimination of restrictions on foreign investment, while indispensable for attracting foreign capital, is far from sufficient to make a country internationally competitive in the race to attract long-term foreign investment. A reliable justice system, a well-educated workforce, and an efficient telecommunications infrastructure are some of the additional factors that give a country an edge in its effort to attract foreign investors. In short, stronger and more effective institutions are urgently needed to complement macroeconomic policy changes.

Unfortunately, institution building cannot be achieved at the stroke of a pen, and the process will remain vulnerable to political discontinuities and economic volatility. A change of minister or a sudden budget cut can do away with years of efforts aimed at building competent teams or modernizing the organizational culture of a public agency. The real challenge will be to ensure that the urgent need to strengthen institutions (and, therefore, the political will to allocate massive resources to these initiatives) does not get too far ahead of the limited existing knowledge about the best way to accomplish this goal. Again, whatever progress may be achieved in expanding and consolidating market reforms will depend on the identification of the reliable approaches to institution building that are now sorely lacking.

Crippling and Pandemic Crime

In this context of high poverty, stubborn income inequality, and incompetent and corrupt institutions, violent crime has emerged as a significant problem for the region. From 1980–1984 to 1990–1994, homicide rates in Latin America more than doubled, jumping from 10.4 per 100,000 people to 25.4 per 100,000.¹³ Even this high regional rate masks staggering rates in individual cities. For example, Cali experiences 91 homicides per 100,000 inhabitants each year.

In Latin America, rates of crime and violence are positively correlated with the expansion of city size. Some studies also find positive relationships between increased income inequality and higher homicide rates, while others make the broader connection between violence and crime and the region's young population. The drug trade is also a major contributor to violence in countries such as Colombia, Mexico, and Peru. Finally, tight fiscal constraints in conjunction with chronically malfunctioning institutions such as the police, the judicial system, or penitentiaries that are riddled with graft and incompetence surely have a role in boosting crime rates.

Regardless of the causes, it is clear that increased violence exacts a severe toll in terms of foregone investment and destroyed physical capital. In Colombia, for example, had the homicide rate remained steady since the 1960s—rather than rising significantly since that period—annual investment in Colombia today would be some 20 percent higher.¹⁴ An even more dramatic effect is now becoming evident in countries such as Venezuela, where the professional middle class is for the first time migrating en masse as a result of a crime wave that leaves 60 people dead every weekend in the capital city of Caracas alone. The capacity to attract and retain foreign managers and professionals is also impaired by the surge in crime. Foreign investors are wary of starting or expanding operations in countries where the personal safety of their staff is a constant worry and where the costs of maintaining the security of their operations greatly erode their profit margins. Multinational corporations in Colombia, Mexico, and Venezuela have asked the government to consider some form of tax rebate that would compensate them for the exorbitant security costs that they are facing there.

The multifaceted nature of the problem of rising crime; the difficulty of uprooting many of the causes, which are deeply embedded in the countries' socioeconomic structure; and the intensification of these causes in recent years ensure that this problem will become even more of an issue in the future.

Economic Future: Three Scenarios

The world's finance and trade systems have changed dramatically in years past and will continue to change in years to come. Governments everywhere face new demands while mushrooming new actors at home and abroad, both governmental and nongovernmental, erode the executive branch's autonomy and capacity to act unilaterally. These are global trends from which no government can escape—Latin American administrations are certainly no exception. In some respects, they may even be more vulnerable.

Latin America's volatility has forced its policymakers to respond every 2 years or so to a major global or regional financial crisis. The standard—and effective—response has typically been a tightening of the fiscal belt and of monetary policy. Additionally, the countries' fiscal discipline has been constantly and sorely tested by climactic disasters like Hurricane Mitch, El Niño, La Niña, and torrential rains and floods that were either unprecedented or surprising in their impact. Latin American policymakers also have to deal with some of the world's best funded and better organized crime cartels and with an explosion of new political, economic, and social actors that make the task of governing quite daunting.

Governing is also impaired by the adoption of global standards of fiscal behavior that limit how much money the public sector can spend to acquire the talent that it needs. This constraint is rendered even more acute as governments have to compete for professionals in what is increasingly a well-integrated global marketplace where skilled individuals command world-class salaries and are highly mobile. The private sector has had to contend with world markets dominated either by Asian exporters that enjoy ultralow labor cost or American and European exporters that have hypertechnological advantages. Latin firms are thus forced to compete in global markets without many advantages in labor or technology, while also burdened by one of the world's highest costs of capital.

But Latin America is not just the passive recipient of the shocks and opportunities that emanate from the global economy. As the region belatedly discovered in the late 1980s, domestic policies matter, and governments can make a huge difference. Thus, while the changing nature of international politics and economics intertwines with Latin America's legendary volatility to ensure that almost any prediction will be wrong, a consideration of the outcomes of different policy scenarios does have heuristic value. This is particularly true in the case of economic integration. After all, while it is true that trade and investment flows in the hemisphere are largely driven by the private sector, it is also true that progress in this arena requires well-coordinated and multigovernment action. For example, a multilateral effort to create the rules and institutions that facilitate the development of a web of links among the Western Hemisphere's economies will naturally have an outcome different from that of a situation in which governments behave largely as spectators to the trade and investment decisions are taken by individual corporations.

The obvious example, proposed as one of the three hypothetical scenarios (see table 1), is the emergence of strong political will in Brazil and the United States to move hemispheric integration forward. Should this admittedly improbable scenario materialize, the region, and indeed the hemisphere, will look very different in just a few years. This is the Big Bang scenario.¹⁵

Table 1. Latin American Scenarios

Backlash	Big Bang	Three Latin Americas
Description		
<p>Another wave of international macroeconomic accidents combines with domestic frailties and local globalization fatigue to induce major reversals of some of the reforms adopted in the 1990s. Economic instability and political turmoil spread.</p>	<p>United States and Brazil implement joint plan for hemispheric integration. Rest of the continent cannot afford to be left out. Access conditions lock in reforms aimed at ensuring Maastrich-like macroeconomic targets. Conditions also include legislative commitments to investment and regulatory frameworks. As a result, cross-border investment and trade soar, as does growth.</p>	<p>A free trade agreement with Chile and some limited trade initiatives with the Caribbean constitute the essence of U.S. ambitions with respect to hemispheric integration. The rest of the countries continue in their current paths. Policy inertia reigns.</p>
Defining Policy Decisions		
<p>Capital controls and higher trade barriers are established. Regional integration efforts and new privatizations are stalled, re-regulation and some transfer of privatized companies back to the state take place.</p>	<p>Leaders in the United States and Brazil decide that hemispheric integration is a top priority and that they will do it together. Rest of the hemisphere accelerates reforms to comply with conditions for access.</p>	<p>Other global and regional priorities and domestic politics result in little U.S. attention to Western Hemisphere integration efforts. Intraregional trade continues to grow, but subregional agreements become stumbling blocks to further integration.</p>
Drivers		
<p>External economic shock occurs. The reform urgency associated with old crises finally fades. Tepid growth, high-income inequality, and popular opposition to further reform contribute to an antimarket political tilt. High vulnerability to external shocks reveals shallow nature of the region's new (continued) "free market culture." Troubles on Wall Street compel investors to seek refuge in U.S. debt instruments; capital to Latin America becomes scarce.</p>	<p>Hemisphere-minded administration in U.S. partners with Brazil and other Latin leaders to promote a true hemispherewide trade area. Regional blocs (MERCOSUR, Andean Pact) become building blocks for larger trade zone. Private sector takes lead in sponsoring joint ventures and capitalizing on (continued) improvements in a business environment stabilized by lower volatility in national economic policies.</p>	<p>Other global and regional priorities and domestic politics result in little U.S. attention to Western Hemisphere integration efforts. Intraregional trade continues to grow, but subregional agreements become stumbling blocks to further integration.</p>

Backlash	Big Bang	Three Latin Americas
Economic Outcomes		
Growing fiscal imbalances fuel inflation; trade imbalances stimulate adoption of protectionist measures. Foreign investment slows and capital flight is pervasive. Illiquid financial markets depress asset values. Growth slows, while unemployment and inflation soar.	Higher growth is driven by trade and investment booms and lower interest rates. Improvement in fiscal conditions frees funds for social expenditures.	Development picture is uneven. Growth and integration occur in Southern Cone; stagnation, in the Andean region. Trade and foreign investment drive growth in the northern tier of countries that are more closely linked with the United States.
Political Outcomes		
Threats to democratic governance and popular appeals to the armed forces to restore order become frequent. Some authoritarian regimes reappear. Constitutional changes are frequent. Turnover of presidents, ministers, and congresses is high. Judicial instability, heightened violence, mass migrations occur.	Costs of parting with democratic practices become prohibitive. "Democratic conditionality" acquires unprecedented influence. Multilateral initiatives to consolidate democracy and safeguard political freedoms become common.	Democratic consolidation in the south and rise of semi-authoritarian, illiberal regimes in the Andes; governmental vulnerability to capture by narco-politicians is increased by generalized turmoil. Constitutional tinkering takes place to change basic rules or extend or remove specific leaders.

Another scenario, based on the somewhat inertial extrapolation of current conditions, yields three differentiated clusters of countries in the hemisphere:

- The first is a southern group led by Brazil and organized around MERCOSUR. The main characteristic of this group is that its sizable domestic—mainly Brazilian—market and its large exports of raw materials provide two crucial rails for the evolution of its subregional economic integration and its overall economic performance.
- The second group is composed of the Andean countries: Venezuela, Colombia, Ecuador, and Peru. It is characterized by intractable sociopolitical instability that severely impairs performance of both countries and their capacity to integrate within or without the region beyond their international trade and investments in oil or drugs.
- The third group includes Central American and Caribbean countries that, like the northern part of Mexico, have developed strong ties with the United States and Canada, ranging from trade to tourism to migration. Not all countries in this region have now or will have in the foreseeable future a strong degree of integration with their northern, highly industrialized neighbors, but countries like Costa Rica and the Dominican Republic, as well as Mexico, are more integrated now

with the United States and in a more varied way than ever before. This trend is likely to continue.

This analytical categorization is not organized according to the formal integration schemes to which the countries belong. Rather, countries are grouped according to their main integration inertias, which not surprisingly also overlap quite significantly with their locales. This is the Three Latin Americas scenario.

Finally, the third scenario is called Backlash. It rests on the possibility that the fiscal stability and openness to trade and investment that prevailed in the 1990s do not survive the combination of globalization fatigue and yet another international financial accident that rapidly spreads across the region, unleashing a painful wave of macroeconomic instability and political turmoil. Such international financial accidents are as frequent as they are unpredictable. Indeed, Latin America has already experienced a lesser variant of this scenario. The 1998 financial crisis in Russia, for example, wrought havoc in the region's finances. The crisis induced international investors to liquidate their positions in Latin American debt and equity markets to cover their losses in Russia. It also led other investors to pull out from emerging markets altogether as a precaution against a generalized meltdown in those markets. As a result, the foreign capital on which Latin America is critically dependent suddenly became prohibitively expensive for governments and corporations. Interest rates skyrocketed, the banking sector was hurt, projects were stopped, intraregional trade plummeted, economic activity shrank, and unemployment soared. Other than sharing some of the same foreign investors in their stocks and bonds, Russia had almost no significant economic ties to Latin America. Fortunately, the region's policy response was swift, effective, and in some cases—notably that of Brazil's President Fernando Henrique Cardoso, who was running for reelection—politically very courageous.

The lesson from this episode is that if the contagion from a financial accident of a country with almost no connections to Latin America can be so costly, the crash of a close neighbor that is deeply integrated with the region can be truly disastrous for Latin America. Two obvious candidates with the potential to badly hurt Latin America in the event of a major, uncontrolled, crisis are the United States and Brazil.

The potential for an international financial accident to torpedo Latin America's integration is high. A central lesson from the 1990s is that the fundamental precondition for economic integration is macroeconomic stability. Trade complementarity, low or no trade barriers, efficient dispute resolution mechanisms, frequent presidential summits, good trading infrastructure, the harmonization of standards, and an active private sector are important ingredients for the success of economic integration. But none of these ingredients counts much if the prices of goods, services, credit, and the currencies of the different countries involved are spinning out of control. Politicians and opinion makers in the United States looked at NAFTA through much more critical eyes in the immediate aftermath of Mexico's crash. It did not take long for Argentines who had been lauding MERCOSUR as the model for the entire hemisphere to voice grave doubts about the value of sticking with the agreement after Brazil devalued its currency. Shortly after Brazil's macroeconomic crisis, Argentina imposed trade restrictions on Brazilian imports, and President Cardoso admitted a

few years later that “MERCOSUR would not exist today if we had not made trade concessions to Argentina at the time.”¹⁶

A new wave of widespread macroeconomic instability can propel what until now have been mostly rhetorical denunciations of the reforms adopted in the 1990s into concrete legislative initiatives that slow or limit the region’s integration with the global economy. Such a “backlash” is very likely to be associated with widespread political instability that in some countries may escalate to the point of posing grave threats to democracy.

Conclusion: What’s Next?

None of these three scenarios is likely to materialize. More likely, elements of the three will be combined with some of the surprises that have always characterized Latin America’s evolution in the past and are surely going to shape its future. It is, nonetheless, illustrative to probe the analytical possibilities raised by these three scenarios.

For example, it does not seem probable early in this millennium that the leaders of the United States and Brazil will soon develop the appetite or the political capacity needed to absorb the short-term political costs and risks of an unequivocal commitment to integrate their two nations. Yet, such a move could forever change the nature of the hemisphere and even the dynamics of the global economy. As noted in table 1, once such a bilateral initiative between Brazil and the United States were launched, no country in the region could afford to be excluded. Given that no countries suffering from chronic macroeconomic instability or authoritarian proclivities would be allowed to participate, the improvement in the hemispheric situation in these two fronts would be unprecedented. Moreover, the adoption of common regulatory frameworks for trade, investment, and, in general, for the treatment of the private sector would provide for a more stable business environment. This stability would, in turn, help lower the high-risk premiums that investors in Latin America now require to compensate for the frequent changes in the rules of the game. A massive program of trade and cross-border investment facilitation, aimed at improving the physical and institutional infrastructure necessary for deeper hemispheric economic integration, would also spark higher levels of economic activity.

The political obstacles, economic costs, and institutional risks of this initiative are high. To some, they may even seem prohibitive. Moreover, such an initiative may be as repugnant to some politicians and specific segments of the business and labor communities in Brazil as it surely is to some of their counterparts in the United States. (Indeed, the Brazilian government has called for talks aimed at launching a South American Free Trade Agreement, and invited regional leaders to a summit in Brasilia.) But Brazil’s resistance to a free trade agreement with the United States may lessen if a new and enthusiastic U.S. leadership emerges, committed to the notion of hemispheric free trade. The incentives and attractive possibilities bound to result from a more integrated and stable hemisphere—in which Brazil’s continental heft is bound to be crucial—would not take long to capture the Brazilian imagination.

This scenario is too ambitious to be probable. The now commonly identified most likely next step in the integration efforts of the United States toward Latin

America is a free trade agreement with Chile. While no doubt a welcome and positive step, its effects will be more in the realm of political symbolism than in economic reality. True, such an agreement would be further confirmation that small and remote Chile is at the vanguard of Latin America's market reforms and democracy. It may also serve to signal other Latin American countries that all is not lost and that they should not lose hope for an economic integration treaty with the United States some day. A free trade agreement between the United States and Chile is a minimalist scenario, however. That such an agreement is currently the frontier of all realistic thinking about what could be next in hemispheric integration speaks volumes. Indeed, that free trade with Chile is the outer limit of U.S. ambitions for hemispheric integration is a portent of the level of political imagination and courage that prevail in the country that is poised to be the main beneficiary of any increase in the liberalization of the international movement of goods, capital, and ideas.

The emergence of a more ambitious hemispheric entrepreneurship in the United States is also stifled by myriad global distractions, from the crises in the Balkans to the tensions between China and Taiwan, and from the Middle East to Russia. Regardless of the protestations of U.S. Government officials and the hortatory writings of American academics, the Nation's policy toward Latin America has, with the possible exception of NAFTA, always been reactive and driven by emergencies. Aid to Colombia; interventions in Haiti, Panama, or Grenada; the engagement in the Central American wars; and the financial rescues of Mexico and Brazil—all were improvised responses to unexpected emergencies.

Moreover, any bold new hemispheric initiatives have to overcome the disrepute of partnering with neighbors that are seen by many U.S. citizens as unreliable, unstable, and overpopulated by workers willing to work for nothing. Despite NAFTA successes, Mexico's financial crash in 1995 and the constant headlines about corruption, drugs, and violence have soured U.S. citizens on free trade agreements with other Latin American countries. Of course, the need to come up with \$42 billion to rescue Brazil in 1999, the need to make Colombia the third largest recipient of aid after Israel and Egypt in order to give the country a chance in its losing war against narco-guerrillas, the election of a stridently anti-American President in Venezuela, and Ecuador's political and economic implosion do not make the selling of ambitious hemispheric partnerships any easier.

Fortunately, a widespread backlash against the reforms of the 1990s and the ensuing political instability that such a turnabout would engender is as improbable as the scenario in which courageous, visionary leaders in the United States and Brazil attempt to build an unprecedented hemispheric arrangement. The spark that would ignite such a regionwide backlash would be a massive global financial crisis that results in a drastic drop in capital flowing into Latin America, higher interest rates that increase foreign debt burdens, and a global recession that lowers the prices and volumes of Latin American exports. The region has already been there and done that several times in the 1990s. Instead of creating a backlash, however, these shocks spurred governments in countries like Mexico, Brazil, and Argentina to pass new reforms.

It may be that the pains of yet another global financial shock would finally exhaust the tolerance of these polities for the austere government responses typical of the 1990s. This time around, the political opportunities created by a macroeconomic shock may be seized not by reform-minded leaders, but by the politicians who have been railing against savage capitalism for a decade. They will soon discover that sustaining whatever policy reversals they engineer is much harder than just launching a backlash. Financing a backlash has become too expensive. It can surely be sustained for several years, but its costs in terms of economic imbalances, slow or no growth, high unemployment, inflation, and less public funding available for social programs make it very difficult for any government to retain the necessary political support to sustain a backlash indefinitely. Not even the government headed by Venezuelan President Rafael Caldera, who gained office in 1993, thanks in great measure to his fiery denunciations of neoliberal economic reforms, and who enjoyed the benefits of a state-owned oil economy that could sustain for more than a year his government's departure from economic orthodoxy, could do so. Caldera was forced by circumstances to grudgingly ask the International Monetary Fund (IMF) for help, a move that he repeatedly and convincingly swore he would never make.

Caldera's successor, Hugo Chávez also won the presidency on an antimarket reform, anticorruption platform. Even though he presided over a period when oil prices reached a decade-high peak, his rhetoric and his economic team's lack of credibility unleashed a severe recession in Venezuela. During his first years in office, Chavez kept free capital mobility, did not impose price controls, did not reverse any privatizations, paid Venezuela's external financial obligations on time, and did not go on a public spending binge. Yet, investment disappeared and capital flight, unemployment, and social conditions became unsustainable.

Few countries in Latin America have the wherewithal to sustain policies that isolate them financially. True, external macroeconomic shocks also slow growth down, boost unemployment, exacerbate poor social conditions, and reduce the access to external financing—but not forever. As the experience of the 1990s shows, these crises tend to be resolved very rapidly. Mexico, Brazil, South Korea, and even Russia have surprised analysts with the speed and strength of their recovery from what had been horrendous financial blows.

Some countries in Latin America, indeed in the world, may prefer to opt out of the global economy and adopt policies aimed at protecting their economies and societies from the shocks, poverty, and inequality that are presumably brought about by an open economy. Sooner or later, however, their governments will be forced to adopt economic policies with a better chance of producing more growth, investment, exports, and employment. Possibly, when some of these countries may be rejoining the countries with policies that are market-friendly and open to international trade and investment, other market-oriented countries may elect governments that will pull them away from the reforming group. It is safe to assume that there will always be a minority group of countries experimenting with policies that are radical departures from what has been the norm since the early 1990s. Even though the countries in this group will vary over time, it appears unlikely that the large, defining countries in Latin America—Brazil, Mexico, and Argentina—will be part of such a backlash.

The low probability that Latin America will experience either a reinvigorating integration boost led by the United States and Brazil or that it will sink into the instability and social deterioration unleashed by a widespread backlash against market reforms leaves an immense middle ground of more likely scenarios. Of these, the Three Latin Americas scenario serves to highlight some of the main drivers and outcomes that determine the likely evolution of the region. It assumes that the “integration inertias” that are now at work will continue to drive the three main clusters of countries described earlier (see table 1). This scenario does not assume any heroic initiative or a major catastrophic event of prolonged consequences. It does allow for the possibility that a few, minor countries will adopt isolationist postures and retain them for as long as their international reserves and domestic pressures permit. It also assumes that countries actively and successfully engaged in building a wide web of commercial and political ties with their neighbors will achieve greater economic progress than those whose internal politics and economic instability make them unreliable partners. Moreover, while this scenario does not ignore the fact that continuous progress will be made in the attempt to create a Free Trade Area of the Americas by 2005, as formally agreed by all the presidents and heads of state who met in Miami in 1997, it does assume that such a process requires more committed, proactive, and sustained attention to Latin America from the United States than has been the case in the past.

While this scenario is certainly not as exciting as the possibility of a major push for hemispheric integration, it does represent a cautious but still positive outlook for a region that has been burned too often in the past by too much excitement. 🌐

Notes

¹ The tactics employed to defeat inflation varied significantly from country to country. For example, Argentina established a currency board that maintained a one-to-one relationship between the local currency and the U.S. dollar; Brazil maintained a crawling currency peg for 4 years as part of its Real Plan; and Peru introduced a dirty or managed float for its currency. The new tendency in the region—employed by countries such as Brazil and Chile—is to let exchange rates float freely, but at the same time set explicit inflation targets. If inflation can be controlled under such disparate exchange rate regimes, the clear implication is that a host of complementary policies—in particular, fiscal discipline—play an equally significant role in maintaining price stability.

² Enthusiasm over the vast increases in investment should be tempered by a recognition of the high concentration of investment flows. In the second half of the 1990s, Argentina, Brazil, and Mexico accounted for nearly two-thirds of the region’s total foreign investment flows. Brazil alone accounted for nearly 42 percent of the region’s foreign investment in 1998, with Mexico ranking a distant second at 13 percent. Preliminary estimates show that Brazil accounted for roughly one-third of total foreign direct investment into Latin America in 1999.

³ Violy, Byorum and Partners, *Latin America: Positioned for Growth*, November 1999.

⁴ On a regional level, the current account balance displayed a consistent deficit throughout the 1990s, growing from a \$17.6 billion regional deficit to more than \$90 billion by 1998. Here the trend is uniform virtually across the board, with all the major economies displaying persistent deficits. In 1999, the regional current account deficit declined slightly, from 4.5 percent of gross domestic product in 1998 to approximately 3.2 percent, as recessions in several countries reduced the appetite for imports.

⁵ Carol Graham and Moisés Naím, “The Political Economy of Institutional Reform in Latin America,” in *Beyond Trade-Offs: Market Reforms and Equitable Growth in Latin America*, eds. Nancy Bird-sall et al. (Washington, DC: The Brookings Institution Press, 1998). See also Moisés Naím, “Toward

Free Trade in the Americas: Building Blocks, Stumbling Blocks, and Entry Fees,” in *Integrating the Americas: Shaping Future Trade Policy*, ed. Sidney Weintraub (Miami, FL: North-South Center Press, 1998).

⁶ Riordan Roett, *Mercosur: Regional Integration, World Markets* (Boulder, CO: Lynne Rienner Publishers, 1999).

⁷ The United States remains a key partner for Latin America. The region’s exports to the United States more than doubled from 1991 to 1998, reaching nearly \$145 billion in 1998. At the same time, Latin America’s share of total U.S. imports increased, from 12.7 percent in 1991 to almost 16 percent in 1998. Latin America’s share of U.S. exports rose from 15 percent to almost 21 percent over the same period, reaching \$142 billion in 1998.

⁸ Naím, “Toward Free Trade in the Americas.”

⁹ *Comisión Económica para América Latina y el Caribe*, Balance Preliminar de las Economías de América Latina y el Caribe (Santiago, Chile: CEPAL, 1999).

¹⁰ Chile remains a stellar performer in reducing poverty, with the percentage of poor households declining from 39 percent in 1987 to 20 percent in 1996.

¹¹ Ricardo Hausmann, “Will Volatility Kill Market Democracy?” *Foreign Policy* 108 (Fall 1997).

¹² Inter-American Development Bank, *Economic and Social Progress in Latin America: 1998–1999 Report* (Washington, DC: Inter-American Development Bank, 1998).

¹³ Mayra Buvinic and Andrew Morrison, “Living in a More Violent World,” *Foreign Policy* 118 (Spring 2000).

¹⁴ *Ibid.*

¹⁵ This scenario was originally discussed in Moisés Naím and Robin King, “Free Trade Express?” *Harvard International Review* (1997).

¹⁶ Fernando Enrique Cardoso, interview, *Epoca*, February 2000.