GROWTH CHALLENGES FOR LATIN AMERICA
REFORMS, WHAT HAS HAPPENED, WHY AND HOW TO REFORM THEM
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Synopsis
Latin America faces a twin challenge, of achieving economic growth and reducing extreme inequality. Notwithstanding the heterogeneity among Latin American countries (LACs), most of them exhibit both (i) low GDP growth and (ii) increased inequality since the early 1980s. This long period includes the “lost decade”, when outcome in both variables was evidently negative. But, also the subsequent period, since the early 1990s, of intense reforms under the Washington Consensus approach, has been negative in both grounds.

The development gap between rich and developing countries (difference in GDP per capita or per worker) has broadened in this period. For instance, GDP per capita in LACs increased merely 1% annually in 1990-2005, while in the USA rose 1.8%, and for the world it averaged 1.2%.

Understanding which are the main failures and main missing ingredients required to produce equitable growth should contribute to design reforms and policies allowing to face efficiently the development challenge. Our analysis will search into the recent past, though only when we consider it relevant for building the future.

We will work with average figures for the standard 19 LACs, as well as search into some paradigmatic country cases, such as Argentina, Brazil, Chile and Mexico. We will examine in general the performance since 1990, but in the case of Chile we will make brief comparative analysis of the structural reforms of the 1970 with those of other LACs in the 1990s, stressing some strategic similarities in trade, financial and macroeconomic reforms. These similarities in the reforms approach explains a significant share of similar economic outcomes: unstable and low average GDP growth; in fact, GDP growth averaged 2.9% in Chile in the sixteen year period 1974-89 and 2.7% in Latin America in the sixteen year period 1990-2005.

We intend to focus on the behavior of capital formation (GKF) and total factor productivity. GKF has exhibited notably low averages as compared to East Asian economies; interestingly, reforms were able to increase significantly “financial savings”, but failed in increasing “domestic savings”; that is savings that finance capital formation, a variable that is a crucial determinant potential GDP growth. We would identify variables behind that poor performance, trying to explain, for instance, (i) why Chile was able in the period 1990-98 (when GDP grew 7%) to invest 8 points of GDP more than in 1974-89 when GDP growth averaged 2.9%, and (ii) why Chile lost dynamism in 1999-2006 falling to a growth plateau of 4% and exhibiting a diminished GKF ratio.

We will examine if and how the level (and maybe the composition) of GKF (i) do affect income distribution, particularly through effects on the labor market; and (ii) might affect the level of actual and potential TPF.

Finally, we will evaluate at the macro, meso and micro dimensions (i) the macroeconomic environment in which agents make their decisions (in LACs, usually an economic activity operating significantly below potential GDP; outlier macro-prices and fluctuating aggregate demand); (ii) features of financial reforms (usually intensive in short-term segments and weak financing of risk and long-term

financing), and their implications for capital formation and the distribution of opportunities in the domestic economy, and (iii) the distribution of productivities (whose average determines the evolution of the average PTF), which is closely linked to the space granted for the development of SMEs.

INTRODUCTION

Latin America lived through a period of deep economic reforms during the 1990s, framed by the so-called Washington Consensus. Dramatic changes affected the relative importance of the State, which saw its sphere of action diminished amidst deregulation, massive privatization, the reduction of public investment and expenditure, giving broader space for the working of private agents. One of the crucial objectives of reforms has been to improve the environment for productive activities and to achieve a sustainable higher GDP growth. Two purposes commonly stated by neo-liberals have been the achievement of a ‘market friendly’ environment and ‘right prices’. Throughout this text it will become evident that reforms have failed in both aspirations: productive activities—firms, entrepreneurs, labor—have faced, frequently, an unfriendly domestic scenario, with wrong outlier macro prices such as exchange and interest rates. It is evident that there is need to be market-friendly and to have right prices for a market economy to achieve development. The crucial point is that priority must be granted to productive activities and employment; it is impossible to have, in general, good consumers that are bad producers. In contrast, frequently, priority to purely financial activities has resulted in outlier exchange and interest rates and volatile aggregate demand, all providing a most unfriendly environment for productive activities. Here we are concerned about how to be efficient in fulfilling those two desired conditions and additionally having a market performance that leads to growth-with-equity.

These reforms were conducted under pressures from international financial institutions, some governments, and those economists following the recipe, in strong fashion, of a neoliberal approach. It was a time of the supposed ‘end of history’, with a naive interpretation that there was a unique road to a market economy, in a globalizing world that limits drastically the room for choice. Within the voices taken into account by authorities and the trainings requested, financial dimensions took a predominant place at the expense of other economic and social dimensions. Broadly speaking, notwithstanding heterodoxies and contradictions, among the
emerging economies (EEs), Latin American countries (LACs) were the most active implementers of neo-liberal reforms (NLRs).

One and a half decade of intensive and profound reforms have left a mix of successes and failures. It is evident that there are clearly positive results in several areas. Outstanding are the eradication of hyperinflation, more balanced public budgets, a rise in the share of exports in GDP, reduced room for bureaucratism, and less microeconomic decisions taken centrally. Notwithstanding, the net balance, in terms of growth and equity, has been notoriously poor. In all, the net outcome is ‘disappointing’, using an expression summarizing an evaluation by John Williamson (2003b), the outstanding economist that coined the expression “Washington Consensus” in his well-known publication of 1990. GDP per capita hardly rose 0.9% per year, while in the USA and the whole world it increased 1.8% and 1.1%, respectively, between 1990 and 2004. Fifteen years after 1990, wages averaged a level below that of 1980, the number of poor people was higher, and investment ratios were as low as in the 1980s. In addition, accountability has been absent. There are impressive flaws in the design of reforms and in the capacity to recognize failures and correct them timely. In this book we examine the evolution of reforms, policies and results, and seek to reform them, starting from the present situation. That is why we label our proposal as a “reform of the reforms”. We will focus in the more outstanding features of macroeconomic policy-making, trade liberalization, capital flows and financial reforms that contribute to explain why growth performance has been poor on average.

In section 1 we will summarize the results achieved. In section 2 we describe, first, some major features of neo-liberalism, that underlied the actual implementation of the Washington Consensus; in section 3, we highlight the main analytical features of our approach.


Year 2004 posed a record annual growth rate since 1980, bringing back widespread optimism among international and national authorities. Also year 1997 was a peak year and of notably intense optimism. This year, together with 1994, had been the two best after 1980. This peak

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1 See descriptions, assessments and measurements of reforms in ECLAC (1998; 2002a); Easterly, Loayza and Montiel (1997); Edwards (1995); Gauza, et al. (2001); IDB (1997); Kuczynski and Williamson (2003); Morley, Machado and Pettinato (1999); Ocampo (2004); Stallings and Peres (2000); World Bank (1997).
came after economic reforms that had proceeded at a fast pace across Latin America along the 1990s. By early 1998, an optimistic mood prevailed among public and private leaders in LACs, and in financial and official institutions abroad. Optimism related both to recent performance and the future of the region. The predominant view was that reforms were working well.

Significant progress had been attained in several fronts. There had been a generalized recognition by regional authorities of the need of preserving macroeconomic balances. As proof of the effectiveness of this recognition, hyperinflation had disappeared, and many countries were experiencing one-digit inflation rates. Also, budget balances and fiscal savings had improved considerably. Actually, in the quinquenium before the contagion of the East Asian Crisis, the average fiscal deficit was 1.5% of GDP; a significant improvement *vis-à-vis* the 1980s performance, and quite a positive figure as compared to that of several developed economies. Monetary expansion to finance public deficits had nearly ceased. In another front, the quantum of exports was expanding rapidly—about 50% faster than world trade—and was diversifying in terms of items exported and markets of destination. Many countries were accumulating significant international reserves. A long wave of massive privatizations had been made.

Frequently, it could be heard that, already accomplished this first generation of reforms, it was time for the implementation of the second generation of reforms, that had been left behind; this second set includes areas such as education and the judicial system reforms (Camdessus, 1997; IDB, 1997; World Bank, 1997). By 1997, the predominant view was that growth had picked up. Actually, GDP rose 5.2% in that year. But also, actual growth had been similar in 1994 (5.2%), just before the explosion of the tequila crisis.

High instability of GDP was an outstanding fact. It is a signal of real macroeconomic instability, associated with changes in the mood of risk rating agents, political authorities, international financial institutions and influential mediatic economic observers. The present influences excessively expectations about the future. There is an overwhelming short-termism that leads to pro-cyclical performance.

Development and welfare are linked to the sum of short terms. That is, average economic welfare depends on the evolution of GDP in long periods. After the meager 1.3% yearly growth in the 1980s, in 1990-97 growth jumped to 3.2%. It was a sizable improvement, but notably below the 5.6% average achieved in the 1970s (see table 1). The two good years—1994 and
1997– were not enough to compensate for weak performance in the rest of that period.

When a new prolonged period of restricted supply of foreign financing (a binding external constraint, BEC) reigned since 1998, the economic performance worsened sharply. In the sexennium 1998-2003, GDP growth collapsed to 1.2%, implying an annual per capita fall of 0.4%. In general, along this period optimism disappeared, and it became fashionable to hold the contradictory view that reforms had been insufficient and weak. A sharp GDP recovery, to 5.8% in 2004, once more improved the mood of observers and authorities.

In all, annual GDP rose scarcely 2.6% during the fifteen years between 1990 and 2004 (see table 1). Additionally, active population (the labor force, comprising all workers and entrepreneurs) also increased 2.6% annually since 1990; consequently, the mediocre output growth merely matched the additions to the labor force. As a matter of fact, output per worker in the long period 1990-2004 stagnated. This, plus a regressive bias in reforms and policies, contributes to explain the poor performance of wages: 2004 recorded an average wage lower than in 1980 and similar to that in 1990 (see table 1.2). But, wages refer to the formal segment of labor markets. Actually, labor markets expelled workers from the formal to the informal segments, with more instability of jobs and falling average income of non-waged workers (ECLAC, 2004c, based on ILO data for LACs; IDB, 2004; Tokman, 2004).

Economic reforms have tended to result in a worsening of the macrosocial balance (as we have labeled the set of general social conditions like poverty levels, employment, social programs, and the distribution of income, voices and opportunities). In terms of poverty, after the sharp rise in the number of poor recorded in the 1980s (see table 2), an additional worsening took place during the NLRs; now there are 22 million more of poor people than there were in 1990, and income distribution remains notably regressive (World Bank, 2003). This is partly associated to the slackness of labor markets, higher open unemployment, the low physical investment ratio (that is, productive investment or fix gross capital formation, GKF), and the underrated role granted to reducing the equity gaps in education, labor training and access to capital markets. The hard fact is that the distribution of opportunities and of productivity has
become even more skewed than before this sort of reforms (Altimir, 2004).\textsuperscript{2} This is especially grave in the region that traditionally has been the most unequal in the World (Bourguignon and Morrison, 2002).

Tables 1 and 2

As a consequence, there was a double development divergence in LACs: like in the 1980s, per capita GDP did not converge to that of the developed world. In addition, within LACs, the regressive gaps between high-income brackets and low-income brackets increased. Presently, Latin America has a GDP per capita (in PPP equivalent) of merely one-fifth of that of the richer countries; and the average Latin American country records an equity gap, between the income of the richer quintile and poorer quintile of households, that is about twice as large as compared to that within the richer countries of the world. Latin America has a much larger equity gap in comparison with the ‘best practices’ in the world. These trends are inconsistent with the consolidation of democracy and it’s deepening.

The meager GDP growth was associated, to a significant degree to a low ratio of productive investment (see F-D, 2006, ch. III). This is one of the areas where the reforms have performed more poorly. In fact, in the 1990s, Latin America invested six percentage points of GDP less, on average, than it did in the 1970s, and just one point more than in the 1980s "lost decade" (see figure 1). As of 1999 has fallen further: in 1999-2004 averaged a ratio similar to that recorded in the 1980s.

Figure 1

Not all sectors exhibited low GKF. In general, it was vigorous in the production of exportable goods and services. That contributes to explain why export volume grew 7 to 8% per year, a rather good comparative performance with respect to that of the world economy. But the rest of GDP –that is, about 6/7– was stagnant and likely with notably low GKF, given that the sum of GKF in exports and in non-exports is equal to total GKF. Evidently, for vigorous overall growth, there is need for the rest of the economy (non-exports) to expand fast. Actually, that has happened in all really successful exporting EEs: for instance, in Korea, Malaysia, and Taiwan

\textsuperscript{2} That was clearly the case of Chile, during the 1970s and 1980s, when most neoliberal reforms were implemented. Some significant correction, with reforms to the reforms, took place with the return to democratic rule in the 1990s
along several decades, and Chile in 1990-97, the output of non-exports expanded annually around 6%; in Latin America, it scarcely rose 1% in 1990-2004 (see ch. V and table V.2). Consequently, managing to achieve a higher investment ratio in non X-GDP is one key factor missing in the production function.

Low GKF makes it harder to incorporate technical change; increases in productivity are closely associated with diverse forms of higher productive investment (De Long and Summers, 1991). An *unfriendly* domestic macro environment appears to be a crucial factor explaining that insufficiency of capital formation. The "unfriendliness" is a consequence of (i) the persistent boom-and-bust evolution of aggregate demand, associated to the strongly cyclical behavior of net capital flows and, to a lesser degree, unstable terms of trade; (ii) *wrong* macroprices (like outlier exchange and interest rates, which entrepreneurs and workers face); (iii) the weaknesses of policies directed to *complete* markets of productive factors (labor training, technology, and long-term segments of capital markets), and (iv) insufficient investment in infrastructure and public goods.

Real macroeconomic instability in EEs is one strong force behind the poor achievement of investment ratios in the 1990s. A significant, well-documented, variable underlining the drop recorded in productive investment is the output gap between actual and potential GDP (Agosin, 1998). The gap reflects the underutilized installed capacity in firms and other components of the stock of physical capital, unemployment of labor, and reduced actual total factor productivity (TFP). Profits tend to decrease while the mood of lenders becomes sombre. A notorious effect of these recessive situations, usually, has been a sharp reduction in investment ratios; for instance, a drop of capital formation in 1995, of 13% in Argentina and 30% in Mexico; in 1999 it fell 18% in Chile, and between 1998 and 2002, 56% in Argentina, and 11% in all Latin America.

It is evident that *market friendly* reforms and *right* prices are inputs for growth. However, actual poor performance indicates that *friendship* has not been effective and prices have diverged from *rightness*. For instance, it is common to observe in neoliberal reforms notably high real interest rates (i.e., Chile had an annual average of nearly 40% for over 8 years from 1975 to 1982, and many LACs exhibited outlier rates during the 1990s and the present decade; ECLAC, 1998, ch. IX; ECLAC, 2004a, ch.3); as well, real exchange rates cyclical fluctuations are a

(see Ffrench-Davis, 2002, ch. 9).
known fact. Evidently, these outlier rates pose obstacles to accurate project evaluation for the allocation of resources, do promote speculative rather than productive investment creating larger capacity, and contribute to the deterioration of the portfolio of financial institutions.

The other relevant explanatory variable is the scarcity of the ingredients required by a productive investor. There is need for long-term financing, access to technology and capacity to absorb it, availability of well-trained labor, and infrastructure complementary to productive investment. Neo-liberalism assumed, and still assumes, that liberalization and privatization bring along, spontaneously, a rising supply of these ingredients of potential GDP. Usually, it does not emerge spontaneously and in the right time; hence, it is a challenge for reforms and economic policy to take account of it. It is what is called completing factors markets, since incomplete, under-developed or inexistent markets cannot work well: they are missing factors in the aggregate production function. This incompleteness is an intrinsic feature of underdevelopment and reveals a lack of enhanced systemic productive capacity or systemic competitiveness.

That source of discouragement for domestic private investment has been reinforced by a change in the relative composition of FDI, from greenfield investment to acquisitions; the first one has been discouraged by the “unfriendly” environment for GKF, and acquisitions have been stimulated by privatization, depressed prices of domestic assets and depreciated currencies.

2. FROM NAIVE NEOLIBERALISM TO PROGRESSIVE PRAGMATISM

a) Market fundamentalism

There are a wide variety of paths and timings chosen by LACs in the design of their structural reforms and economic policies. However, there are some distinctive features that reflect common external influences or common domestic approaches, which are at the core of significant shortcomings of the first generation of reforms across Latin America. Most reforms were

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3 As documented by Easterly and Servén (2003), most LACs also "witnessed a retrenchment of the public sector from infrastructure provision and an opening up to private participation", that was not fully replaced by private investment.
performed under the umbrella of the so-called ‘Washington Consensus’. The neoliberal fashion tackles various real problems, of great significance, that had been emerging or developed in recent decades, particularly in the 1970s and early 1980s. In the case of LACs, those economic pitfalls generated costly disequilibria, such as the huge fiscal deficits, high and variable inflation, a worsening accountability of public firms, negative real interest rates, the arbitrariness of effective protection and too many microeconomic decisions centralized by national authorities. Naturally, I share this view. However, the right changes can be made in the wrong way. That is what happened, frequently, with several of the neoliberal reforms. Usually, they have been too loaded with ideologism, depicting a poor understanding of how markets actually do work and their degree of maturity and completeness.

It is a significant feature that neoliberalism has an extreme faith in the efficiency of the traditional private sector and mistrust for the public sector and non-traditional forms of private organization. There is a tendency to implement reforms abruptly and to the extreme, assuming that when markets are liberalized they become complete rather spontaneously; this view regularly disregards crucial inter-relationships among variables, and it is too short-termist.

The predominant approach assumes that market signals flow transparently and fluidly among markets and among generations. In doing so, structural imbalances are assumed away, except those generated by state intervention. These naive assumptions lead to an underestimation of the negative effects on (i) capital formation, (ii) the utilization rate of potential GDP, and (iii) the distribution among people of productivity and opportunities. Neo-liberal adjustment processes tend to generate regressive effects in face of external shocks and of one-anchor anti-inflationary programs; the outcome is associated with the specific features of the set of structural reforms that have been implemented.

Paradoxically, the view still in fashion, which is built on microeconomic theory and optimization, jumps to policy recommendations based on the maximization of liberalization. It usually disregards gradualism and intermediate positions between the extremes of indiscriminate liberalization and arbitrary interventionism; it also underrates the deep implications of the absence of complementary reforms.

In fact, typical failures have been: (i) the liberalization of the capital account, together
with large external inflows, which usually has given way to cases of crowding-out of domestic savings and increased external vulnerability; (ii) trade liberalization has proceeded *pari passu* with exchange rate appreciation, contradicting all reasonable recommendations; (iii) bank privatization without prudential regulation and supervision has brought-in moral hazard, and related non-transparent loans, which have produced banking crises and rescues at government expense of up to 50 per cent of an annual GDP, according to figures published by the World Bank; (iv) the absence of effective prudential regulations of public services, parallel to their liberalization or privatization.

The prevailing approach has involved the repetition of costly mistakes, particularly in the macroeconomic management, the design of trade and financial reforms, and in the weakness of efforts to *complete* markets. For example, it is impressive that the policy errors carried out in the financial reforms of Argentina and Chile during the 1970s, were replicated in many other countries of the region since the mid 1980s, and in Asian countries during this decade. They share the weakness of prudential supervision, but also the booms in short-term segments, the crowding-out of domestic savings, and financial crises highly expensive for the treasury. Comprehensive *accountability* seems to be rather absent, judging from the frequent applause for many ill-designed reforms whose objectives have not been accomplished or which have ended up in critical scenarios (recall the exuberant praises of Argentinean reforms by 1997).

In all these cases there has been responsibility for reformers, resulting from the lack of pragmatism in the design and sequencing of reforms. They should be extremely dissatisfied and revising radically their recipes. However, accountability, learning and pragmatism have been quite limited among the influential IFIs and the main political and economic leaders, in this strong wave of transformation of Latin American economies.\(^5\)

It is clear that many outstanding specialists in the northern academic world do not share many of the traits of the neo-liberal paradigm, and that well developed standard neoclassical analysis can be used to show the dangerous pitfalls of naive market fundamentalism (for instance, a short, incomplete list, should include Krugman, 1990; Rodrik, 2003; Sachs, 1987;\(^4\) For instance, led by exchange rate peg or real appreciation, or by restrictive monetary policy in isolation from other complementary policies.

\(^5\) A recent IMF report (see Singh, et al., 2005), apparently, refers to a definition of macroeconomic balances that moves somewhat in the direction of the approach that we develop in ch. II, but their policy proposals do not reveal significant pragmatic changes.
Moreover, the actual implementation was in several cases more ideological and incomplete (in a comprehensive sense, not in the sense of more of the same) than the written “consensus” (see Williamson, 2003c). In fact, NLRs were, generally, conducted under the belief that there is a unique (one-size-fits-all) good policy recipe: liberalizing markets across-the-board, abruptly if possible, and until the extreme (more of the same is always good). There was no significant consideration of the fact that the selection of policies should depend (i) on the objectives democratically chosen by society; (ii) on the degree of development of domestic markets; (iii) on the degree of homogeneity of these markets; (iv) on the particular domestic macroeconomic situation, and (v) on the nature of international institutions and markets.

The spread of NLRs has been reinforced by the phenomenon (mistakenly evolved into an ideology) of economic globalization. It is beyond discussion that globalization, and especially the ability to move money rapidly from one place to the other, has limited the room for discretionary policy from governments and has taken certain policy issues virtually off the agenda. The debt crisis of the eighties brought into the forefront the economic agents linked to the financial sphere, in public and private enterprises as well as in ministries and other governmental departments, and in mass media. This situation imposed the predominance of a short-termist bias over concerns for productivity and additions to productive capacity (the financierism and its intrinsic neo rent-seeking, see ch. II). In speculative markets, as Arrow (1974) points out, a considerable part of the efforts of economic agents focuses on acquiring information leading to capture benefits at the expense of the rest of the economy (capital gains and the associated neo rent-seeking), and tends to lead to a negative sum redistribution, given that real resources are used in the process.

At a distributive level, indiscriminate deregulation also concentrates opportunities in favor of sectors with greater access to the financial system and more short-termist approach; in fact, usually the long term segments of capital markets and small and medium productive firms (SMEs) have tended to loose shares in the financial markets. Macroeconomic policy-making has become to be excessively influenced, probably not purposely, by well-trained specialists in short term and liquid finance (see draft on Macro).
However, the extent of this loss of room for exerting policy discretion has been exaggerated, as revealed by the effective macroeconomic activism exhibited by some LACs. In fact, still there is significant room to make globalization, according to domestic requirements for achieving growth-with-equity, notwithstanding the new context of increasingly integrated markets. In F-D (2006, chapters VII and IX) we illustrate the room for maneuver and the high efficiency its use may imply, with the cases of Korea and Malaysia in 1998-99 and Chile in 1990-95.

It is evident that we are not condemned to an extreme, unique option of no room for active policies. Understanding the real working of markets, strong personality, political will for giving priority to the common good, and transparency, are crucial ingredients. It is true that they are very demanding requirements. That explains why few countries have reached development. But, indeed, it is possible.

Next, we present some policy-oriented principles that would allow to progress on the path of reforms impregnated with pragmatism, suitable for development with equity and for the enhancement of democracy. In this search for more appropriate policies we have benefited from work of diverse authors concerned about the disappointing record (see, for example, Krugman, 1990a; Stewart, 1997; Rodrik, 2003; Williamson, 2003b; Ocampo, 2004; Stiglitz, 1998). The disappointing market record can be improved significantly by reforming the reforms.

b) Our analytical approach

Criticism of neoliberalism tends, frequently, to lack concrete policy proposals. Here we adopt a systematically policy-oriented approach. Our policy-orientation is pragmatic (or realistic) in the sense of considering the actual working of markets and the response capacity of different economic agents; we search for pragmatism with a progressive bias, in the sense of being efficient in achieving our goals, that is growth-with-equity.

Reforms should not become a goal themselves, but a means for progress. An identification of the results being sought should be made; then accountability should be demanded. For instance, it turns to be necessary to reform or correct the reforms (i) if success in

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6 Our alternative approach can be associated to the so-called neo-structuralism (Sunkel, 1993), or productive transformation with equity (ECLAC, 1992; 2002a; Fajnzylber, 1990), or growth with equity (Ffrench-Davis, 2002).
reducing inflation and imposing fiscal discipline results unable to provide stable aggregate demand and right macroprices to domestic producers (see F-D, 2006, ch. II); or (ii) if a domestic financial reform, implemented in order to increase domestic savings and enhance the volume and quality of investment, implies that financial savings increase while national savings decrease, and investment remains low; or (iii) if a vigorous export expansion does not generate a dynamic GDP growth (see F-D, 2006, ch. V).

Here we present some of the analytical pieces, policy-oriented, that contribute to explain the failures of the neo-liberal implementation of reforms under the Washington Consensus, and offer a robust alternative. We stress three features most relevant in emerging economies, which should have a determinant bearing on the design of specific policies. They relate to (i) the structural heterogeneity of factors and markets; (ii) the implications of asymmetries in instability, and (iii) the diverse links between different macroeconomic approaches and economic development (growth and equity).

Factor heterogeneity or market segmentation is one of the most typical features of developing countries. This naturally affects the transparency and flow of information, and the diverse capacity of different agents to respond efficiently to a given policy. Various dimensions of structural heterogeneity play a crucial role: among others, heterogeneity within each factor market; heterogeneity in the openness and stability of various external markets; heterogeneity between stages (expansive and contractionary) of the business cycle; variety in the elasticity of response to incentives among regions and among market segments (large and small businesses, rural and urban enterprises, infant and mature firms, consumers and producers, productive and speculative investors); heterogeneity in the time horizons and variables maximized by productive as compared to purely financial agents, heterogeneity in the degree of mobility of factors (financial funds highly mobile, while most producers of GDP tend to be immobile in the short term). All these forms of heterogeneity have significant implications on the effects of the adjustment path and the feasibility of attaining different combinations of objectives (hysteresis), which implies that there is no single equilibrium but rather multiple ones.

In brief, the particular features of the transition to new equilibria make a crucial difference, and naive reforms may have an extremely long and costly adjustment period, given
the presence of imperfect and *incomplete* markets. What happens during the process (hysteresis effects on the flows of human and physical capital), together with the time involved, can have significant implications for the well-being of people. We must always take into account that their welfare is the ultimate objective of economics.

Hence there arises the recommendation of contributing to improve the working of markets, enhancing the role of longer-term horizons and productivistic factors. The target is an endogenous development process guided by reforms and policies designed within the national economy and accommodated to its markets features and objectives (Fajnzylber, 1990; Sunkel, 1993). A crucial space corresponds to the application of a productive development policy. This includes systematically developing and *completing* factor markets, guiding the allocation of resources towards investment in physical and human capital, deliberately improving the distribution of productivity and opportunities across society, and promoting the acquisition of comparative advantages.

Reforms and policies should strive to actively contribute to complete and integrate factor markets rather than increase segmentation, as it has often tended to occur with the recent style of reforms. Meso policies, such as labor training, dissemination of technical knowledge, and space for small and medium firms are at the core of spreading productivity through society. That is the most sustainable road to endogenous dynamic growth with equity. This is the constructive option, in contrast to inward-looking development in the more naive old ISI approaches, or outward-looking ones in the approaches based on the integration into world markets via abrupt and indiscriminate import and financial liberalization, and the fading-out of the sense of Nation.

Our approach requires a dynamic and modern private sector, together with active linkages with global markets and an efficient state. Given a framework of structural heterogeneity, achieving an efficient state –central and local governments, regulatory agencies, and public enterprises– is not easy. Furthermore, it is necessary to be selective also in the sense of dealing only with that quantity and quality of actions that the state is capable of designing and implementing with social efficiency, and focusing efforts where they will have the greatest impact. These principles help to minimize ‘State failures’.

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7 The issue of structural heterogeneity and its implications on economic development has been widely studied at ECLAC. See, for example, Fernando Henrique Cardoso (1977); Ocampo (2002); Pinto (1970); Prebisch (1977).
Financial instability has become an outstanding feature of the EEs. We distinguish two sorts of instability. One is the very short-termed, which can be faced by the producers of GDP with derivatives or waiting a short while before closing dealings in the market. But the strong globalization of financial volatility is of a second, damaging nature. Capital surges have not been one shot events but a process of several continued flows along a mid-term. Actually, they have taken place in medium-term cycles generated by successive waves of optimism, then followed by contagion of pessimism in international financial markets. Indeed, an essential feature of financial flows to developing countries have been strong medium-term cycles: abundant financing in the 1970s followed by a drought in flows in the 1980s; a new period of large inflows in 1990-97 followed by negative financial flows since the Asian crisis. Although short-term lending has made the cycle more severe, fluctuations in liquid inflows into stock markets, and longer-term flows, such as mid-term bank lending and bond financing have been equally important in generating these cycles. The extended term of these cycles -thus affecting expectations about macro-prices, among other variables-, have generated significant allocative effects. Given irreversibility of resource allocation, sudden stops in inflows have been a common source of costly crises: for all LACs in the 1980s, Argentina and Mexico in 1995, East Asia in 1998, and most of Latin America in 1998-2003 (see ch. VII).

Instability of the real economy is asymmetrical, and inevitably implies, in average, underutilized potential productivity and lower actual output. In fact, economic recovery may increase the flow of output in the present up to the full use of existing capacity, but it cannot recover output not generated yesterday. This obviously has significant implications for average actual TFP and GDP.

Instability also tends to be asymmetrical with regard to income distribution, since high-income sectors, more diversified and with better access to financial markets, can take better advantage of the opportunities emerging during economic booms, and then adjust more easily during recessive periods. The available data indicates that distribution has a tendency to deteriorate during recessions and to improve with recoveries, but with less strength on the latter than the former (Morley, 1995; Hausmann and Gavin, 1996). The labor market is negatively affected via the depressive incidence of instability on the investment ratio. The more incomplete
the financial markets and the smaller the capital formation ratio, the larger will the probability be that the regressive effects predominate.

The repetition of conjunctures with significant underutilization of productive capacity, results from external shocks and unsustainable domestic macroeconomic policies and outlier macroprices, as illustrated by the cases of Argentina and Mexico in 1995. The actual productivity of the total stock of factors evidently decreased in these two nations in 1995, given that this stock kept growing (although at a slower pace) while actual output decreased. Output recovered in 1996-97, giving way to widespread assertions that the crisis had been superseded fast and efficiently. This sort of wishful thinking or neopopulism tends to lead to a dangerous underestimation of the costs of policy mistakes and to the persistence of ideologism in the design of reforms. Always, the present value of recoveries, as well as of drops in output and welfare, should be considered in assessing performance of a reform, a policy or an adjustment process.8

There is a worrisome tendency to underrate the significance of instability and underutilization of capacity (Stiglitz, 1998).

In the last two decades, as shown above, policies have been taking place in a framework where capital formation is comparatively very low. It is a well-established empirical fact that there is a strong correlation between physical investment and growth, resulting from the interrelation of capital accumulation, productive employment and the absorption of technical progress (Schmidt-Hebbel, Servén and Solimano, 1996). Hence, careful attention should be devoted to the effects of given reforms or policies on investment ratios and productivity growth. In this book we examine in detail effects of trade and financial reforms, of capital flows and macroeconomic management, on capital accumulation and its rate of use and overall productivity.

3. A POLICY-ORIENTED MENU ON MACRO, TRADE AND FINANCE

A financieristic or neo-liberal approach emphasizes macroeconomic balances of two pillars: low inflation and fiscal balances, together with full opening of the capital account. We

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8 Several varieties of reforms might work in the sense of generating growth and welfare increase in the margin after the adjustment process is finished.
can call it financial macroeconomic balances. This financieristic approach assumes, either that that is enough for achieving productive development in a liberalized economy, or that it becomes enough with the addition of microeconomic reforms. As mentioned, several LACs were successful after 1990 in reducing inflation to one-digit figures, and balancing their fiscal budgets. However, economic activity was notably unstable; in the period covered, overall changes in GDP were led by ups-and-downs in aggregate demand, and these responded to shifts in net capital flows. Similarly, in the 1990s, East Asia continued to fulfill the two conventional pillars –low inflation and fiscal surpluses– but lost the third pillar, of sustainable macrobalances for the real economy. Therefore, most EEs were implementing a financial or two-pillar macroeconomics at the outset of the Asian crises, with the euphoric support of specialists in microfinance. A financieristic rather than productivist approach had become binding.

An alternative, appropriate definition of macroeconomic balances should include a comprehensive set of fundamentals. That is, –alongside low inflation and fiscal responsibility, which are indeed, crucial variables–, it should include a balanced real economy, that is, an aggregate demand consistent with the productive capacity of the economy and a “sustainable external balance”. This implies, first, a high rate of use of productive factors (capital and labor), since a low rate of utilization discourages investment in human and physical capital, hampering future growth and macrosocial balances. The way in which a persistent gap tends to negatively affect the speed of expansion of the production frontier and actual productivity is illustrated by examples from the lost decade (the 1980s) up to the lost sexennium (1998-2003), including the Tequila effects and the East Asian contagion.

At the same time, a balanced real economy must avoid vulnerability to costly external crises, by keeping sustainable external deficits and net debt, low net liquid and short-term liabilities, non-outlier real exchange rates and price-earnings ratios in stock markets, and strong prudential regulation, supervision and transparency of the financial system.

Naturally, broader macroeconomic goals require more and better policy instruments. A review of complementary domestic macro policies to achieve a sound real macroeconomics, covers five key areas (monetary, exchange rate, and fiscal policies, the regulation of capital flows, and the supervision of financial institutions). An outstanding feature in all of them is the need of a strong counter-cyclical character, in a framework of globalized markets.
The need for effective measures to ensure that capital inflows crowd-in productive investment and are consistent with a sustainable macroeconomic environment is emphasized: the composition, the level and deviations from the trend of the volume of flows are crucial. The explanation rests on the diverse capacity to react of different markets and agents, and on the asymmetries intrinsic to instability already discussed. In periods of surges (as opposed to a stable trend), liquidity constraints for consumers tend to be released faster than for investors, given the weaknesses of long-term segments of capital markets. As well, consumers can react faster than productive investors since the latter need to identify, design and develop new projects, which is a time consuming process; given the irreversibility of investment, optimistic expectations assumed at a particular time by long-term investors must be taken as sustainable for a longer horizon.

It is impossible to achieve sustained growth without a substantial increase in capital formation. This result contrasts with the assumption that what matters for growth is only productivity. We prove that what some empirical work measures as productivity gains (TFP) is, to a great extent in our volatile economies, a rise in the rate of use of existing productive factors. In order to move toward a macroeconomics-for-growth we need to have a systematic clear differentiation between economic recovery and the generation of additional capacity. This has been a common misleading factor for both leftist and rightist governments in Latin America. That pitfall leads, not only to neglect of the importance of investment from the point of view of public policies, but also stimulates the private sector to run a destabilizing intertemporal adjustment. Indeed, interpreting that a mere recovery is a sustainable growth of potential GDP, widely advertised as supported by a high TFP, leads authorities to believe and the population to feel richer and to start consuming the future, while not being really richer. Sharply distinguishing between creating capacity and using existing capacity should be guiding our macroeconomic policy. Subsequently, we focus on the influence of the macroeconomic environment for capital formation, emphasizing the role of macro-prices such as the exchange rate, interest rates and import tariffs, and the management of aggregate demand. The significance of a productivistic as opposed to a financieristic environment is stressed.

Structural heterogeneity among firms, members of the labor force, and regions, plays a key role. It explains why one of the main achievements of economic reforms –the significant export dynamism– has not been accompanied by overall GDP growth. Indeed, GDP is
compounded by tradable and non-tradable sectors. And within tradable sectors, there are in turn exportable and import-substituting sectors; still, for many LACs, exports are a minor proportion of GDP.

Deep trade reforms, particularly import liberalization, has been implemented in LACs in the past two decades. A sharp increase has been recorded in the neutrality of trade policy, drastically reducing the dispersion of effective protection; the reformers had foreseen that this would result in more competitive firms, higher productivity and rising export-oriented production of tradables. We stress that, in order for trade reforms to be successful, it is necessary that the present value added by the creation of new activities (mostly exportables) exceeds the present value subtracted by the destruction of existing ones (mostly importables). This tends to require an increase in exports greater than the decrease in import substitution; consequently, with an expansion of the share of tradables in GDP. Additionally, it is expected that export activity will have positive spillover effects on the rest of the economy, which will depend upon the degree of diversification and the quality of value-added in goods and services exported; and international competitiveness must be attained through a continuing increase in productivity rather than by low wages and rising subsidies or tax exemptions.

The analysis of trade reforms shows that several LACs adopted abrupt import liberalization together with a weaker export promotion (or non-existent, beyond the direct impact of tariff reductions on imported components of exportables); this implies a sharp contrast with successful East Asian experiences. Indeed, significant inconsistencies have prevailed, particularly the coexistence of import liberalization with exchange rate appreciation; usually, real interest rates have also been extremely high, discouraging investment and the restructuring of output. In addition, a scant comprehensiveness has characterized policy sets, with weak or negligible efforts to improve factor markets, such as labor training, technology, infrastructure and long-term segments of capital markets. The shortcomings or incompleteness of these markets during the transition, have been a significant deterrent for private investment. Overall, negative pulls appear to have been stronger than positive pulls on investment during the transition to post-reform equilibria.

Most LACs have given priority in their governmental programs to export-led development. In chapter V we analyze how dynamic exports may contribute to sustained GDP
growth. Once again, however, what matters is the net aggregate effect of economic policies on both exported GDP and non-exported GDP. Since exported GDP (net of imported inputs) still represents only about one-seventh of total output in Latin America, the challenge is to get export dynamism-cum-growth of non-exported GDP.

In LACs, exports have had unstable prices (we know with certainty) and (presumably) they have weak linkages with the rest of the economy (non-exported-GDP). There is a role for i) the level and stability of the real exchange rate (we know that RER instability deters non-traditional exports, and, hence, diversification); ii) a sustainable macro for growth, and iii) for factor market completion in enhancing productive linkages.

One relevant component of Latin American exports is their reciprocal trade. Intra-regional exports tripled in the seven years up to 1997, covering then one-quarter of total exports of goods, but since then have been affected by swings in regional output. If attention is focused on growth and shares of non-traditional products (more intensive in value-added), both are notably higher in intra-regional trade. These goods and services face distortions and incomplete domestic markets, which preferential regional trade agreements (PRAs), in an environment of open regionalism, can contribute to removing progressively and efficiently. PRAs are significant for these products rather than for traditional exports, for which extra-regional markets will remain the main source of destination. In this sense, regional trade contributes to a more dynamic productive transformation of the domestic economies, and can complement policies directed to enhance systemic productivity.

Financial reforms were other outstanding components of the Washington Consensus package. International finance has played a leading role in defining business cycles in Latin America. Indeed, from the debt crises of the 1980s, external crises and subsequent recoveries have shaped the pattern of economic instability of most LACs. Figure I.2 shows that, for the average LAC, generalized booms and recessions were led by sharp changes in aggregate demand; with the exception of 2004, those changes were led by sharp shifts in the supply of external financing.

Figure 2

The high costs generated by business cycles in EEs are thus related to the strong connections between domestic and international capital markets. This implies that an essential
objective of macroeconomic policies must be how to reap the benefits from external savings, but reducing the intensity of capital account cycles and their negative effects on domestic economic and social variables.

In this sense, our approach challenges the common assertion in the mainstream economic literature that the correct way to conduct policy is with an open capital account. It is relevant to review the analytical foundations of the role of capital flows in development and the issue of capital account opening, discussing the contribution it can make to capital formation and macroeconomic stability through different channels. We will stress that the conventional arguments are based on assumptions that are often unrealistic regarding the functioning of international capital markets and their interaction with EEs. Therefore, across-the-board capital account liberalization, intensive in financial rather than in long-term capital and greenfield FDI, can be a destabilizing source of shocks.

The intertemporal character of financial transactions, the incompleteness of markets and the predominance of short-termist agents contribute to making finance one of the most imperfectly functioning (for our purposes, which are achieving growth with equity). This explains why a negative association between financial flows and domestic economic activity has been an outstanding feature of EEs during the past quarter century. Indeed, in a framework where both supply and demand of capital are led by private agents, the volatile dynamics of capital flows has been the result of the interaction between (i) the nature of (domestic and foreign) agents driving financial markets –short-sighted “by training and by reward”–, and (ii) a process of pro-cyclical domestic adjustment, allowed by passive macroeconomic policies. Indeed, during booms there tends to be a contagion of over optimism that pushes asset prices up (creating bubbles), which in turn, stimulates additional capital inflows since for the most influential financial operators, the more relevant variables are not related to long-term fundamentals but to short-term profitability.

Thus, it is the short-termist segment of the markets which generates incentives for EEs to enter the vulnerability zones during booms, inducing deviations of macro variables from sustainable levels (short term and liquid external liabilities, deficit on current account, appreciated real exchange rate, real estate prices, etc.). The longer and deeper the economy’s penetration into those zones, the higher the likelihood of crisis and its severity. Hence, improved
information, financial sector regulation and comprehensive prudential macromanagement of financial flows constitute a public good for which there is a shared role for governments on the supply side (creditor nations) and on the demand side (debtor nations).

The external crises experienced since the 1990s by Latin America and East Asia. Latin America followed a booming expansion of capital flows during 1991-94 and subsequently in 1996-97. These inflows overcame a binding external constraint that was responsible for the severe economic recession and low domestic investment of the 1980s. Nevertheless, these inflows also had undesirable effects on exchange rates, balance on current account, and control over the money supply, resulting in vulnerability to negative external shocks. The costs were felt in late 1994 (Tequila crises) and in 1998 (the Asian contagion).

We argue that the impact of the Tequila effect did not spread more widely to other countries in 1995, mainly due to several positive external shocks experienced by the region, associated with terms of trade improvement, highly dynamic growth of world trade, devaluation of the US dollar and, in addition, IFIs/US timely massive intervention. Nevertheless, the global impact was significant in that Latin America saw negative growth rates up to March 1996, while domestic investment fell substantially. The negative effect was clearly stronger in those countries, such as Argentina and Mexico, considered more successful by financial markets that had applied more permissive policies toward the heavy volatile capital inflows, and had experimented greater exchange rate appreciation between 1991 and 1994. On the contrary, Chile, other country classified as successful, as previously mentioned, applied effective policies deterring volatile inflows and actively intervened to moderate exchange rate appreciation; thus, it was able to remain immune to the Tequila effect.

After a period of financial euphoria, international financial markets were heavily hit by the Asian crisis that started in 1997 in Thailand. It is quite remarkable that the East-Asian economies—with superior macro-policies in previous decades—succeeded to crises in the 1990s, when they adopted policies similar to those of Latin American economies. The East Asian crisis showed that the two regions faced common destabilizing external forces. The common factor was that, starting in the early 1990s, several East-Asian economies started opening their rather closed capital accounts, to liquid and short-term financial flows. The opening of the capital account was undertaken at the time that the surges in the supply of capital to the so-called
emerging markets’ economies were taking place. Capital inflows caused actual and expected gradual exchange rate appreciation, that in turn encouraged the use of additional inflows to finance rising current account deficits. In the meantime, external liabilities accumulated with mismatches in the maturity structure of the balance sheets of domestic financial intermediaries. As a consequence, these economies moved in a rather similar path with LACs toward vulnerability zones.

A new and generalized recessive adjustment was under way in Latin America since 1998 and until 2003, associated to the contagious effect of the Asian crises and the new vulnerabilities that arose in 1996-97. Once again, GDP growth experienced a downswing, productive investment was affected and the social indicators were deteriorated. Chapter VII closes examining the significant economic recovery exhibited by the major part of the region in 2004-05; we highlight that recovery, in this occasion, was not associated to a capital surge, but to sharp positive shocks in the terms of trade and volume of exports.

The experience with volatile capital flows in recent decades has left behind a track of instability and crises in EEs and particularly in Latin America. But critical episodes have also given origin to valuable lessons that can help us to understand better the process of financial globalization and to improve the future macroeconomic management.

From an analytical point of view, recent crises have shed light over a number of wrong hypotheses that became part of the “conventional wisdom” of the financial world. We summarize five wrong assumptions: (i) recovery from crises is rapid; (ii) open capital accounts discourage macroeconomic disequilibria; (iii) corner exchange rate regimes are the only viable today; (iv) financial inflows complement domestic savings, and (v) prudential regulation of banks suffices for deterring financial crises. These beliefs have misleadingly prescribed a passive approach in the management of macroeconomic policies.

As an alternative approach, we have grouped a set of active policies for open economies. In all of them, the underlying principle is that usually crises are the consequence of badly managed booms; consequently, the main aim of macroeconomic policies should be of prudential nature, by controlling booms before they become unsustainable. In particular, since international capital markets give rise to frequent cycles of abundance and scarcity of funding and systemic crises, policy makers should exercise active capital account management, in order to ensure that
capital inflows are consistent with macroeconomic stability, investment, and growth based on systemic competitiveness. Indeed, in the last decades we have learnt that, in spite of the new challenges imposed by globalization of financial volatility, still there is significant room for successful domestic policies. There is no unbeatable reason why LACs cannot improve the balance between positive and negative effects of positive and negative external shocks.

It is interesting to compare the long experience of Chile with reforms, and that of most LACs that proceeded one or two decades later. In Ffrench-Davis (2002) we analyzed reforms and economic policies in Chile since 1973. There we explain why average growth was short of 3% during the dictatorship (1973-89), and examine the policy variables underlying the jump to 5.2% since the return to democracy (1990-2006). The more significant change took place in the first half of the 1990s with the return to democracy. We will discuss the Chilean case of successful implementation during this quinquennium of what we call a macroeconomics-for-growth. This experience is especially relevant for three reasons: (i) the Chilean economy is the only LAC that has grown at satisfactory rates since 1990, averaging 5.2% in these sixteen years; (ii) Chile led the way in neo-liberal reforms, carried out under the prolonged umbrella of the dictatorship of Pinochet, in the long period 1973-89, and (iii) the case has become paradigmatic, which grants great relevance to understanding the process, its ingredients and outcome. Those reforms to the reforms represented a sharp move toward a macroeconomics-for-development.

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Table I.1

**Latin America: GDP growth, 1971-2005**
(annual growth rates, %)

<table>
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<tbody>
<tr>
<td>Argentina</td>
<td>2.8</td>
<td>-1.0</td>
<td>5.0</td>
<td>-1.3</td>
<td>8.8</td>
<td>3.0</td>
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<tr>
<td>Brazil</td>
<td>8.6</td>
<td>2.3</td>
<td>2.0</td>
<td>1.5</td>
<td>3.7</td>
<td>2.0</td>
</tr>
<tr>
<td>Chile</td>
<td>2.5</td>
<td>2.8</td>
<td>7.0</td>
<td>2.7</td>
<td>6.0</td>
<td>5.2</td>
</tr>
<tr>
<td>Colombia</td>
<td>5.4</td>
<td>3.7</td>
<td>3.9</td>
<td>1.1</td>
<td>4.1</td>
<td>2.9</td>
</tr>
<tr>
<td>Mexico</td>
<td>6.5</td>
<td>1.4</td>
<td>3.1</td>
<td>2.9</td>
<td>3.6</td>
<td>3.1</td>
</tr>
<tr>
<td>Peru</td>
<td>3.9</td>
<td>-0.7</td>
<td>3.9</td>
<td>2.0</td>
<td>5.4</td>
<td>3.4</td>
</tr>
<tr>
<td>Uruguay</td>
<td>2.7</td>
<td>0.4</td>
<td>3.9</td>
<td>-2.1</td>
<td>9.1</td>
<td>2.2</td>
</tr>
<tr>
<td><strong>Latin America (19)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>5.6</td>
<td>1.3</td>
<td>3.2</td>
<td>1.3</td>
<td>5.1</td>
<td>2.7</td>
</tr>
<tr>
<td>Per capita</td>
<td>3.0</td>
<td>-0.8</td>
<td>1.4</td>
<td>-0.3</td>
<td>3.6</td>
<td>1.0</td>
</tr>
<tr>
<td>Per member of LF</td>
<td>1.7</td>
<td>-1.5</td>
<td>0.5</td>
<td>-1.1</td>
<td>2.7</td>
<td>0.2</td>
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</table>

**Source:** ECLAC.

Table I.2

**Latin America: social indicators, 1980-2005**

<table>
<thead>
<tr>
<th>(millions)</th>
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<th>(millions)</th>
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<tbody>
<tr>
<td>1980</td>
<td>7,633</td>
<td>136</td>
<td>40.5</td>
<td>102.7</td>
<td>7.7</td>
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<tr>
<td>1990</td>
<td>6,925</td>
<td>200</td>
<td>48.3</td>
<td>96.2</td>
<td>7.2</td>
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<tr>
<td>2005</td>
<td>8,392</td>
<td>209</td>
<td>39.8</td>
<td>96.8</td>
<td>9.3</td>
</tr>
</tbody>
</table>

**Source:** GDP per capita, poverty, and population based on ECLAC data for 19 countries. Real wage regional index is based on real indices provided by ECLAC for 12 countries, weighted by labor force in each year. Unemployment is calculated by ECLAC with information for 24 Latin American and Caribbean countries.
Figure I.1
(% of GDP, scaled to 1995 prices)

Source: ECLAC data for 19 countries.

Demand-led changes in GDP, 1990-2005

Figure I.2
Latin America (19): GDP and Aggregate Demand, 1990-2005
(annual growth rates, %)

Source: ECLAC data for 19 countries.