KIELER DISKUSSIONSBEITRÄGE

408 KIEL DISCUSSION PAPERS

From Washington to Post-Washington? Consensus Policies and Divergent Developments in Latin America and Asia

by Rainer Schweickert and Rainer Thiele

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- Most Latin American countries have made considerable progress in implementing the core recommendations of the Washington Consensus. The comparison with fast-growing Asian countries shows, however, that higher and more broad-based growth can only be achieved with more comprehensive reforms which contain four important additional elements.
- *First, external stability should be given priority* in order to support export activities. More flexible exchange rates and the prudent use of capital market policies could stabilize real exchange rates as well as capital inflows. At the same time, the need for capital inflows could be reduced by increasing domestic savings through higher government savings and efforts to overcome the segmentation of domestic capital markets.
- *Second, the adoption of best-practice technologies* should be encouraged in order to accelerate technical progress. Measures which could ease the transfer of technology are the use of FDI as a source of technology for export-oriented sectors and human capital formation with an emphasis on technical and job-related skills. More flexible labor markets could bring higher employment levels, which is important for mobilizing resources through learning-on-the-job.
- *Third, poverty should be alleviated* and inequality be reduced in order to broaden the participation of the population in economic activities and to facilitate the establishment of small and medium-sized firms. The highest priority should be given to a strong basic education system, labor market reforms which facilitate the migration from the informal sector to higher-paid formal employment, and a comprehensive titling program for land and property which allows access to the formal credit market.
- *Fourth, the formal institutional framework* should be reliable in order to guarantee a certain degree of predictability. Only then investors will have an incentive to undertake projects with a longer gestation period. In addition, the establishment of informal institutions (social capital) should be encouraged in order to reduce transaction costs. This can best be achieved indirectly by means of targeted support for the poor which reduces the extent of social exclusion and polarization, a higher level of education which raises the acceptance of norms transcending narrow kin groups, and better formal institutions which constrain the ability of the government to act arbitrarily.
- Taken together, export orientation, technology transfer, poverty alleviation, and institution-building could allow developing a more flexible economic structure and a more dynamic performance of investment and exports, which would in turn be reflected in higher and more equitable growth. In order to start such a process, the countries need to design their own strategies. This is because most reforms, especially institution-building, have to be tailored to domestic conditions. The poverty reduction strategy papers (PRSPs), which have to be set up by highly indebted poor countries (HIPC) in order to get debt reductions, could provide a blueprint for the development of national reform strategies.

INSTITUT FÜR WELTWIRTSCHAFT KIEL • Februar 2004

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The discussion paper is based on the final report for the research project "Macroeconomic Stabilization and Economic Growth in Emerging Market Economies" which the Kiel Institute for World Economics has completed for the Federal Ministry of Finance in December 2003. The authors thank Rolf J. Langhammer for valuable comments, Christiane Gebühr and Michaela Rank for technical support, and Sylvia Künne and Kerstin Stark for the final layout.

1 The Consensus Debate

Since the beginning of the 1990s, the debate about the development problems of Latin American countries centers around what John Williamson labelled the Washington Consensus (Williamson 1990). The formulation of the Consensus was driven by the demand for a checklist of reforms to be implemented by Latin American countries in order to guarantee that financial resources made available through debt reduction granted under the framework of the Brady plan would actually contribute to economic growth rather than feed capital flight. Given this background, John Williamson summarized those reforms which he thought to be undisputed among the majority of economic policy advisors, including the IMF and World Bank staff as well as the U.S. government.

Thus, the Washington Consensus was meant to address only the specific problems of Latin American countries in the late 1980s. It does not deny alternative and more comprehensive ideas about development policies. In the public debate, however, the Washington Consensus was seen to represent *the* reform agenda of the international institutions, especially of the IMF. It came under attack during the Asian crisis when the IMF provided highly controversial policy advice which was believed to be based on the Consensus. Additionally, it was asked why rapidly growing Asian countries and Latin American reform countries could come under pressure although they were thought to have followed the Washington Consensus. Especially in Latin American countries, the turnaround in capital flows destroyed positive effects of reforms based on the Washington Consensus which had been small and disappointing anyway.

The fact that the public debate linked the crises in emerging and developing market economies to the Washington Consensus led to the demand for a Post-Washington Consensus by international institutions and nongovernment organizations (see, e.g. Stiglitz 1998; Stallings and Peres 2000; Unmüßig and Walther 1999). Since then the debate has gone far beyond the initial idea of the Washington Consensus to define a necessary set of conditions for a special group of countries trying to regain access to the international capital markets in that it claims to arrive at sufficient conditions for an economic reform agenda conducive to sustainable catching-up growth (Schweickert 2003a).

This report assesses the question to what extent the arguments put forward in the Washington Consensus and the Post-Washington Consensus debate can help explain the different economic performance of Latin American and Asian countries. Starting with the observation that it is the economic policy instruments rather than the reform targets which are heavily debated (see Kuczynski and Williamson 2003), the report shows that Latin America and fast-growing Asia indeed significantly differ with respect to all economic policy areas under consideration. As a consequence, a comparison of these groups of emerging market economies can actually help develop a comprehensive development strategy.

Section 2.1 starts with an outline of the Washington Consensus policies (stabilization, opening up, liberalization). It links differences in the implementation of consensus policies and in the use of the heavily debated exchange rate and capital market policies to differences in the economic performance between selected Latin American and fast-growing Asian emerging market economies. Section 2.2 reports the debate on poverty alleviation and income distribution, human capital development, and institutional reforms, policy areas which proponents of the Post-Washington Consensus claim to be crucial for sustained and equitable growth. As in Section 2.1, differences in performance and policies between Latin America and Asia are shown to be remarkably large. Chapter 3 summarizes the main results and tries to formulate a comprehensive reform strategy.

2 Necessary Conditions: The Washington Consensus

2.1 Definition and Implementation of the Washington Consensus

John Williamson formulated the Washington Consensus in ten points which can be summarized as stabilization, opening up, and liberalization (Williamson 1996; see Box 1). The Inter-American Development Bank (IADB) tried to measure the implementation of these policies in an Index of Structural Reforms (Lora 2001). Structural reforms were evaluated for nineteen Latin American countries for the period 1985–1999. Table 1 shows the average results for all countries (LA-19), the country results and the average results for the seven major emerging markets Argentina, Brazil, Chile, Costa Rica, Mexico, Uruguay, and Venezuela (LA-7), as well as the results for two low-income countries, Bolivia and Peru, which made considerable progress in most reform areas. Table 1 reveals three stylized facts about structural reforms in Latin America:

- A comparison of reform efforts in the 1980s and 1990s shows that the Washington Consensus seems to have increased the speed of reforms. The exceptions are the areas "trade" (where the level of reforms had already been high), "taxation", and "labor market" (an issue not mentioned explicitly in the Washington Consensus).
- Low-income countries are catching up. The speed of reform in the 1990s was generally faster for this group, with the exception of "labor market" where no significant reforms have taken place in most Latin American countries.
- Generally, reform indices show that Latin American countries made considerable progress with respect to those policies which have the highest priority in the Washington Consensus, i.e., macroeconomic stabilization and trade liberalization.

Box 1:
The Washington Consensus

Stabilization
Fiscal Discipline: Public deficits should be so small that they can be financed without an inflation tax, i.e., by printing money. This implies a primary budget surplus that depends on the amount of debt accumulated. The total deficit after debt service should not exceed 2 percent of GDP.
New Priorities for Fiscal Spending: Public expenditure should be restructured in favor of spending categories with high economic and social benefits. This implies less resources for administration, defense, subsidies, and state-owned enterprises and more resources for poverty alleviation, health, education, and infrastructure.
Tax Reform: Taxes should be levied on a broader base and with lower tax rates, which implies an easier tax administration.

Opening Up
Trade Liberalization: Quantitative restrictions on trade should be transferred into tariffs with a uniform tariff rate of between 10 and 20 percent. The transition process, which can last from 3 to 10 years, may be interrupted if required by macroeconomic imbalances.
Exchange Rate Adjustment: At least for trade transactions, multiple exchange rates should be given up. The single exchange rate should be on a sustainable level that allows for the growth of nontraditional exports.
Direct Investment: Foreign direct investment should not be restricted and should be treated like domestic investment.

Liberalization
Capital Market Liberalization: Interest rates should be set by the market. The precondition is that reliable institutions exist for controlling the domestic capital market. In case that this is not given, real interest rates should be positive and the same for borrowers with comparable risk.
Privatization: State-owned enterprises should be privatized.

Deregulation: The government should abolish regulations which restrict the entry of new enterprises and competition. Regulations are justified only concerning internal security, environmental protection, and the stability of the financial sector.
Property Rights: The judicial system should supply reliable property rights at moderate costs, which are also accessible for the informal sector.

Table 1:
Index of Structural Reforms for Latin America, 1985–1999[a]

	Argentina	Brazil	Chile	Costa Rica	Mexico	Uruguay	Venezuela	LA-7	Bolivia	Peru	LA-19
						Score					
Differences											
1990–85	13.0	17.1	8.2	11.9	13.4	0.3	5.9	10.0	17.6	5.6	9.5
1999–90	14.8	18.0	3.6	13.2	8.7	10.5	17.1	12.3	22.4	32.4	14.7
Averages											
1985–89	33.4	32.5	52.8	39.2	45.2	35.7	27.6	38.1	36.7	29.6	37.2
1990–99	58.1	50.5	57.8	49.1	49.2	43.6	45.5	50.6	58.1	54.7	52.0
						Trade					
Differences											
1990–85	11.8	50.2	17.7	45.6	26.4	13.7	21.3	26.7	5.0	27.8	24.0
1999–90	6.3	26.4	0.9	9.1	–4.5	17.8	18.2	10.6	4.8	33.4	12.3
Averages											
1985–89	53.8	30.9	87.4	70.8	76.1	63.0	44.4	60.9	86.4	29.3	60.8
1990–99	85.4	78.4	94.8	86.3	85.4	84.8	81.5	85.2	94.6	82.4	84.6
						Capital market					
Differences											
1990–85	39.9	10.9	19.3	–2.2	24.9	–3.9	11.7	14.4	54.2	8.7	12.7
1999–90	39.4	8.9	0.2	52.2	31.2	28.4	16.1	25.2	30.9	48.1	30.8
Averages											
1985–89	31.6	28.1	58.1	20.1	30.1	43.6	31.2	34.7	19.6	19.5	28.7
1990–99	92.8	45.5	72.5	42.5	62.3	65.0	52.1	61.8	69.6	59.5	55.8
						Taxation					
Differences											
1990–85	12.7	2.7	3.2	15.9	11.1	–7.7	0.5	9.0	29.9	–3.0	9.9
1999–90	–6.0	0.7	3.3	2.9	–0.2	8.6	6.3	3.1	–14.6	15.9	5.3
Averages											
1985–89	2.4	29.5	48.1	39.7	30.4	45.5	28.7	35.1	54.6	35.2	47.5
1990–99	3.2	47.0	49.2	49.6	40.6	43.9	43.5	43.7	59.6	35.9	47.6
						Privatization					
Differences											
1990–85	6.1	0.1	3.5	0.4	7.6	0.8	0.0	2.6	0.0	0.0	1.8
1999–90	33.3	49.8	12.3	1.6	19.4	–0.4	26.7	20.4	90.4	60.3	23.9
Averages											
1985–89	0.0	0.0	1.4	0.2	1.8	0.0	0.0	0.5	0.0	0.0	0.7
1990–99	24.9	13.1	5.3	1.7	26.5	0.5	18.7	12.9	43.5	29.2	13.5
						Labor market					
Differences											
1990–85	–0.5	–0.3	–0.4	0.0	–2.6	–1.2	–3.6	–2.3	–0.9	–5.2	–1.1
1999–90	0.0	–0.2	–1.1	0.0	–2.8	–2.0	18.2	1.6	0.6	4.2	1.5
Averages											
1985–89	5.7	7.4	69.2	65.4	34.9	26.3	33.3	51.4	23.0	64.0	58.9
1990–99	5.5	6.9	67.5	65.4	31.3	23.8	31.8	49.0	23.2	66.2	58.4
						Memorandum item: capital flows					
Differences											
1990–85	4.2	0.4	8.7	33.0	13.6	15.4	0.1	16.7	34.0	32.0	13.8
1995–90	1.7	1.8	17.8	0.0	8.9	–1.5	14.7	10.6	–4.3	28.1	16.5
Averages											
1985–89	46.0	44.0	51.6	78.4	69.4	65.0	78.0	61.8	83.6	31.1	59.9
1990–95	95.3	53.5	65.9	100.0	82.9	76.4	88.2	80.3	91.1	84.9	77.9

[a]The total score is determined by the unweighted average of all factors but "capital flows". The scale for each factor runs from 0 (worst figure in total panel) to 100 (best figure in total panel).

Source: Lora (2001); Morley et al. (1999) for capital flows; own calculations.

In its *Global Competitiveness Report 2002–2003*, the World Economic Forum (WEF 2003) also analyzes these figures and argues that there have been reform efforts, but that they have not been correlated with economic performance (Larraín 2003). This is not surprising. The Index of Structural Reforms lacks an international comparison. It is normalized to range between the weakest and the best performance in the Latin American sample. But relative progress within the peer group may not be significant at the international level. Additionally, the impact of macroeconomic stability, an issue which figured prominently in the Washington Consensus, is completely neglected.

The Index of Economic Freedom constructed by the Heritage Foundation in cooperation with the *Wall Street Journal* allows for such an international comparison. Table A1 gives detailed results for the years 1995–2003 and a sample of countries consisting of the nine Latin American countries already included in Table 1 and a reference group of fast-growing Asian countries including Korea, Malaysia, Thailand, India, and China. The Index of Economic Freedom largely covers the policy areas mentioned in the Washington Consensus. It has to be recognized, however, that there is a bias towards deregulation: less government intervention is always better. Hence, the Index of Economic Freedom does not fully represent the Washington Consensus as intended by John Williamson but rather the Washington Consensus as perceived by IMF critiques and anti-globalizationers (Williamson 2003).

Table A1 shows that the average assessment for all sample countries does not change over time. This result is strongly affected by the deteriorating assessments for the Asian crisis countries Korea, Malaysia, and Thailand. Not very different from Latin American crisis countries, these countries tried to stabilize their economies by reducing economic freedom. While this was a broad-based approach in the case of Thailand, Korea especially increased government interventions in the economy and Malaysia increased regulations of foreign direct investment, which is an important result. It shows that there is no strictly positive correlation between economic freedom and macroeconomic stability and that a temporary restriction of economic freedom may be part of a strategy to restabilize the economy if not to prevent a crisis. Another important result is that Asian countries do not perform better than the Latin American countries. Chile, for instance outperforms all Asian countries; it exhibits the highest level of economic freedom as well as the highest speed of reform.

Table 2 adds macroeconomic development to this picture. It allows to compare indicators for the average macroeconomic performance of the sample countries with the indicators for the average performance with respect to structural reforms in the 1990s, i.e., the decade following the formulation of the Washington Consensus. The sample countries have been ordered according to real economic growth, and averages have been calculated for countries with an average growth below (above) 5 percent as well as for Latin American (Asian) countries. A first observation is that there are clear differences between slow-growing and fast-growing countries with respect to macroeconomic performance. Fast-growing countries, i.e., the Asian reference group plus Chile and Costa Rica, are characterized by lower inflation rates, lower public deficits, lower current account deficits, real devaluation instead of real appreciation, more stable real exchange rates, higher savings and investment ratios, higher export growth, and higher openness. The fact that fast-growing countries have benefited on average from terms-of-trade adjustments is basically due to terms-of-trade gains for Chile.

A second observation from Table 2 is that fast-growing countries do not differ from slowly growing countries when it comes to the indicators of structural reform. The same holds when comparing the Latin American countries with the Asian reference group. The picture is a little bit different if one calculates an index for structural policies neglecting the area of "monetary policy," which is only measured by the inflation rate. In this case, Latin American countries outperform the Asian reference group.

All in all, there is no convincing correlation between structural reforms and economic growth, but a very strong correlation between macroeconomic performance and economic growth. This implies that macroeconomic per-

Table 2:
Macroeconomic Development and Structural Reforms in Latin America and Asia, 1990–2000 (period averages)

	GDP growth (%)	Inflation (%)	Overall budget balance (% GDP)	Current account balance (% GDP)	Real appre-ciation (%)	Stability of real exchange rate[a]	Savings (% GDP)	Invest-ment (% GDP)	Export growth (%)	Terms of trade ad-justment (% GDP)	Terms of trade ad-justment (% exports)	Openness adjust-ment (% GDP)
						1990–2000						
South Africa	1.5	9.5	–4.8	–0.0	–2.5	3.2	17.5	14.7	4.6	–0.3	–1.1	42.7
Brazil	2.1	767.3	–3.7	–2.0	–0.7	5.0	20.3	20.8	5.4	–0.1	–1.8	16.3
Venezuela	2.5	34.1	–1.6	4.1	5.4	4.2	24.8	18.1	5.4	–12.9	–36.3	53.3
Uruguay	2.9	44.9	–1.2	–1.2	4.9	2.4	15.4	15.0	6.2	7.8	22.9	74.1
Peru	3.2	734.8	–1.5	–5.6	–1.9	5.6	17.7	20.9	7.7	–0.2	–0.9	29.7
Mexico	3.7	19.4	0.0	–3.7	1.1	5.4	21.3	23.0	12.8	–0.5	–2.0	46.7
Bolivia	3.9	9.9	–2.2	–5.9	–0.3	2.4	9.9	17.0	4.7	–4.1	–17.0	51.3
Argentina	4.1	229.8	–1.0	–2.6	3.6	4.0	16.9	17.6	7.8	–0.1	–0.8	19.2
Turkey	4.1	75.2	–7.0	–1.1	–1.3	3.9	20.1	24.2	9.5	–1.2	–5.5	49.0
Costa Rica	5.1	16.3	–1.8	–3.5	0.7	1.7	16.5	19.4	10.9	2.3	5.5	87.0
Thailand	5.2	4.7	–0.2	–1.8	–2.3	3.0	34.8	34.9	10.9	–2.7	–5.3	91.7
India	5.5	9.0	–5.7	–1.3	–2.5	4.3	21.1	23.6	10.8	–1.4	–10.8	24.0
Chile	6.4	11.0	1.3	–2.9	2.7	2.5	25.2	24.9	9.3	7.1	18.9	81.3
South Korea	6.5	5.4	–0.3	0.7	–4.1	3.3	34.8	33.9	14.8	–2.9	–6.0	61.8
Malaysia	7.3	3.5	0.8	–1.4	–1.8	2.8	40.8	35.0	13.7	3.8	4.2	184.2
China	9.6	7.1	–1.8	1.8	–2.6	3.5	40.8	38.3	13.3	–0.6	–3.7	31.8
GDP <5.0	3.1	213.9	–2.6	–2.0	0.9	4.0	18.2	19.0	7.1	–1.3	–4.7	42.5
GDP >5.0	6.5	8.2	–1.1	–1.2	–1.4	3.0	30.6	30.0	12.0	0.8	0.4	80.3
Asia	6.8	5.9	–1.4	–0.4	–2.7	3.4	34.5	33.1	12.7	–0.8	–4.3	78.7
Latin America	3.6	177.5	–2.1	–2.2	1.1	3.7	18.7	19.6	7.7	–0.2	–1.6	50.1

	Index of Economic Freedom[b]											
	Score	Trade	Fiscal burden	Govern-ment inter-vention	Monetary policy	Foreign direct in-vestment	Banking and finance	Wages and prices	Property rights	Regu-lations	Black market	Structural policy[c]
						1995–2000						
South Africa	2.9	4.5	4.0	2.3	3.0	2.0	3.0	2.0	3.0	2.0	3.2	2.9
Brazil	3.4	4.2	3.4	2.8	5.0	3.0	3.0	2.7	3.0	3.3	3.5	3.2
Venezuela	3.3	3.5	2.7	2.3	5.0	3.0	2.8	3.0	3.0	2.8	4.5	3.1
Uruguay	2.7	2.3	3.4	2.0	4.8	2.0	2.2	2.0	2.3	3.0	2.8	2.5
Peru	2.8	3.0	2.5	1.6	4.5	2.0	2.0	2.0	2.8	3.7	3.8	2.6
Mexico	3.1	2.8	2.9	2.3	4.3	2.0	4.0	3.0	2.8	4.0	2.8	3.0
Bolivia	2.8	2.0	3.2	2.8	3.2	2.0	2.3	1.0	2.8	4.0	3.8	2.7
Argentina	2.4	3.7	2.5	2.0	3.5	2.0	2.2	2.0	2.0	2.0	2.2	2.3
Turkey	2.8	1.8	3.6	1.8	5.0	2.0	2.0	3.0	2.0	2.7	3.2	2.5
Costa Rica	2.9	3.8	3.0	2.4	4.0	2.0	3.0	2.0	3.0	3.0	2.8	2.8
Thailand	2.4	3.0	2.2	1.7	2.2	2.5	3.0	3.0	1.5	3.0	2.0	2.4
India	3.8	5.0	3.9	3.0	3.0	3.3	4.0	3.8	3.0	4.0	4.5	3.8
Chile	2.3	2.7	2.9	1.1	3.2	2.0	3.0	2.3	1.0	2.0	2.3	2.2
South Korea	2.3	2.8	2.8	1.8	2.3	2.5	2.3	2.0	1.0	3.0	2.0	2.3
Malaysia	2.6	3.3	3.3	2.8	2.0	3.0	3.0	2.8	2.0	2.0	2.0	2.7
China	3.6	5.0	2.5	4.0	3.0	3.0	3.0	3.0	4.0	4.0	3.7	3.6
GDP <5.0	2.9	3.1	3.1	2.2	4.3	2.2	2.6	2.3	2.7	3.1	3.3	2.7
GDP >5.0	2.8	3.7	2.9	2.4	2.8	2.6	3.1	2.7	2.2	3.0	2.8	2.8
Asia	2.9	3.8	2.9	2.7	2.5	2.9	3.1	2.9	2.3	3.2	2.8	3.0
Latin America	2.9	3.1	3.1	2.1	4.1	2.2	2.7	2.3	2.5	3.0	3.2	2.7

[a]Based on standard deviations of the monthly real effective exchange rate data for each year. — [b]The scale for each of the ten factors runs from 1 (best) to 5 (worst). For determining the score, the factors are weighted equally. —[c]Excluding "monetary policy".

Source: World Bank (2003); JP Morgan (various issues); IMF (various issues); Heritage Foundation (various issues); own calculations.

formance should be high on the reform agenda for emerging market economies (as claimed by proponents of the Washington Consensus) but that less government does not necessarily lead to higher growth (as claimed by the critiques of the Washington Consensus). A comprehensive re-

form agenda has to define a positive set of government interventions, which will be discussed in more detail in Section 2.2. It also remains open to debate which exchange rate and capital market policies are adequate to achieve macroeconomic stability as well as high domestic savings, investment and export growth, which characterize fast-growing countries.

2.2 Exchange Rate Policy and Export Growth

While the need for macroeconomic stability is generally acknowleged, there is no consensus with respect to the exchange rate policies which support this priority. After the financial crises of the last decade, there has been an increasing trend towards flexible exchange rates. Nevertheless, there are considerable doubts about whether fully flexible exchange rates consitute a plausible exchange rate regime for emerging market economies. These doubts arise because the recent crises have not only pointed to the risks involved in fixed exchange rate regimes not embedded in a consistent reform package, but also to the importance of exchange rate developments for small open economies. This explains why active exchange rate policy has been used in Asia and Latin America, albeit for different reasons (Schweickert 2000a).

Exchange rate policy in rapidly growing Asian countries has traditionally focused on external rather than internal equilibrium. The idea was to support export expansion by a stable relative price for tradable goods (Corden 1996; Fischer 1997). This strategy is in line with the Washington Consensus which argued in favor of competitive exchange rates. From a macroeconomic perspective, the key variable which drives the allocation of resources is the real exchange rate, i.e., the relative price of tradable to nontradable goods. A comparison of the development of the real exchange rate in Asian and Latin American countries reveals two important stylized facts.

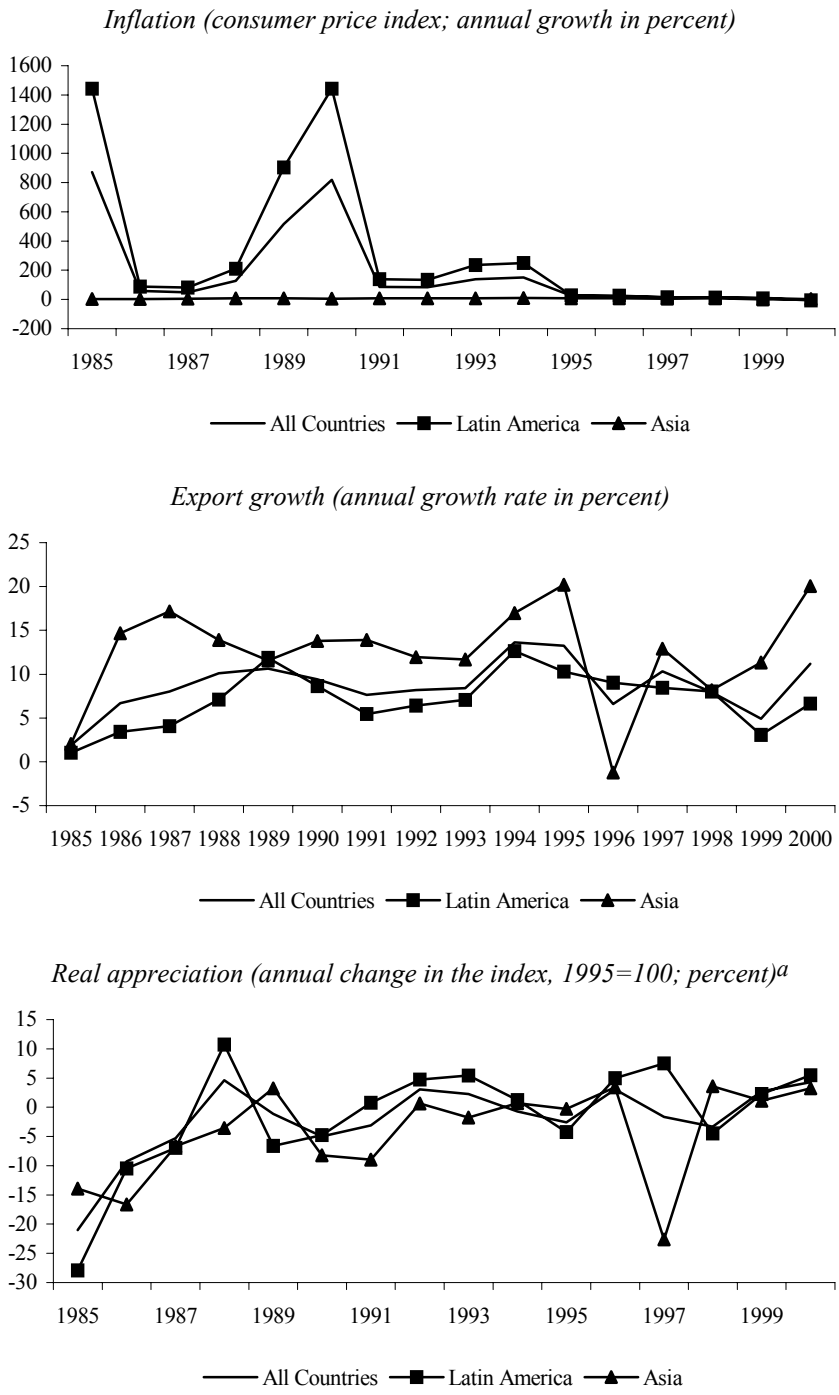
First, empirical evidence shows that export growth in fast-growing Asian countries was supported by stable real exchange rates and the avoidance of real appreciation. Several reasons can be put forward to explain why high productivity growth has not, as assumed by the Balassa–Samuelson hypothesis, increased wages and the inflation rate: high foreign exchange reserve ratios, strong labor supply, and strong competition also for nontraded goods (Schweickert 2000b).

Second, exports of Asian countries show a positive reaction to real devaluation, and the current account is driven by the development of exports rather than imports as is the case for Latin American countries. Hence, exchange rate management has also been facilitated by flexible and demand-responsive exports. As shown in Figure 1, the strong devaluations after the debt crisis of the 1980s and the financial crisis of the 1990s initiated an export boom which allowed these countries to regain macroeconomic stability rather fast. It has been almost forgotten that, in the 1980s, the debt problems of Korea and the public sector imbalances in Malaysia where at least as severe as the problems of Latin American countries at that time.

In contrast to Asia, the exchange rate in Latin America was mainly used as a nominal anchor (Diehl and Schweickert 1997). Given the high degree of dollarization and de facto indexation of domestic inflation, fixing the exchange rate was a plausible disinflation strategy (Schweickert 1996). As a result, Figure 1 shows that the inflation rates in the Latin American sample countries converged towards Asian levels during the 1980s. It is remarkable that even after the more recent crises and the floating of exchange rates inflation remained under control. The flip side of the coin is that exchange rate policy was not adequate to foster export performance. It is evident from Table 2 that only Mexico, Costa Rica, and Chile were able to reach export growth comparable to Asian standards. This was due to an appreciation of the real exchange rate, which was also less stable than in Asian countries.

After disinflation has largely been achieved, monetary policy in Latin America can now be readjusted in an environment with flexible exchange rates. Among the monetary strategies currently debated, inflation targeting and de jure flexible exchange rates figure prominently (Schaechter et al. 2000). The proponents of inflation targeting

Figure 1:
Macroeconomic Stability in Latin America and Asia, 1985–2001



[a]On the basis of the real effective exchange rate from JP Morgan except for Bolivia, China, Costa Rica, and Uruguay (IMF).
Source: World Bank (2003); JP Morgan (various issues); IMF (various issues); own calculations.

claim that this strategy, which was developed for industrialized countries giving high priority to controlling inflation (see, e.g. Bernanke et al. 1999), can be adopted in an emerging market

environment as well (see, e.g. Loayza and Soto 2002). However, inflation targeting faces, at least, two difficulties when adopted by emerging market economies (Mishkin 2000). The first problem is that the transmission mechanism is much more unstable in emerging market economies, which reduces the effectiveness of targeting the inflation rate considerably. The second problem are balance-sheet effects. Because assets as well as liabilities of Latin American countries are largely dollarized, devaluations may cause financial crises (Aghion et al. 2001; Céspedes et al. 2000). Emerging markets and especially Latin American countries can therefore hardly ignore exchange rate developments completely (Williamson 2000; Braga de Macedo et al. 2001; Goldstein 2002).

Empirical studies reveal that the risk of higher debt service due to unforeseen devaluations indeed increases risk premia for emerging market economies (Berganza et al. 2003) and that de jure and de facto exchange rate regimes differ considerably, with de facto regimes showing a higher degree of exchange rate intervention by central banks (Calvo and Reinhart 2002; Levy-Yeyati and Sturzenegger 2002). Additionally, the reaction functions of central banks show that interest rates react to exchange rate movements (Monetary Policy 2003) or that, as was the case in Chile, interventions in the foreign exchange market have been used as a parachute in order to safeguard external equilibrium in cases of global financial crises (Hammermann 2003).

It can be argued, however, that, independent of the type of intermediate exchange rate regime chosen by Latin American countries, macroeconomic management will still suffer from a weak and inflexible export base. This constrains the potential to support an exchange rate target as well as the potential to reduce the debt burden. Additionally, while real devaluation tends to be expansionary in Asia because the increasing prices for tradable final goods support the export sector, real devaluation tends to be contractionary in Latin American countries because increasing prices for tradable inputs hamper the export sector. As can bee seen in Figure 1, large devaluations in Latin American countries do not lead to export booms; before export growth gains momentum the next phase of real appreciation hampers competitiveness again.

Thus, the development of a strong export base seems to be more promising for solving Latin America's macroeconomic stability problems than fine-tuning exchange rate systems. Latin America urgently needs a higher degree of export diversification and a higher share of manufactured exports (Rojas-Suarez 2003). The Asian example demonstrates that an export-oriented policy increased productivity growth and enabled Asian countries to reap the potential gains from globalization (Nunnenkamp 2003; Pack 1997). Contrary to Latin America, the development of export sectors created demand for the labor supplied by smallholders and urban informals, which are the poorest households in developing countries, thereby increasing productivity and reducing poverty. Additionally, Asian export sectors are characterized by the dominance of small and medium-sized enterprises (SMEs) which adopt advanced technologies for labor-intensive production.

This outcome can be explained by a bundle of preconditions and policies which together constituted a critical mass for the dynamic development of exports. Among the preconditions for the export flexibility of Asian countries were a relatively even income distribution which facilitated credit access and the foundation of SMEs, a high level of human capital which especially led to high competence in natural science and technology, and a nondiscrimination of exports. This allowed Asian companies to adopt new technologies and to respond to relative price adjustments. The bad news for Latin America is that the preconditions for improving the export base are either not given or difficult to create in the short run. The good news is that with increasing macroeconomic stability dynamic processes may not be interrupted as in the past. In this case, increasing exports could lead to learning-by-doing and, thereby, to a self-enforcing dynamic development. Such a process has to be started.

In recent years, Latin American countries have tried to increase the platform for such a development beyond national borders. New regional integration strategies have not aimed at discrimination but at maximizing market entry (Dieter

2003). These initiatives have gone into the right direction because they increase the potential for competition and learning-by-doing. However, there is the danger that global integration is undermined by an ever-increasing number of regional integration schemes (Wei and Frankel 1998; Busse et al. 2000), resulting in the so-called "spaghetti bowl phenomenon" (Bhagwati 1998). Additionally, being successful in concluding ever more regional agreements could weaken the awareness of domestic shortcomings with respect to macroeconomic stability, technology policy, capital market access, enterpreneurial culture, and human capital development. To a large extent, manufactured products from Latin America are still not competitive (Nunnenkamp 2001).

Even less promising are current attempts to foster monetary integration. These attempts are inspired by the example of EU accession countries which have a perspective to enter European Monetary Union (EMU) in a few years (Schweickert 2001). Empirical studies show that there are indeed positive effects of monetary integration for trade (Vinhas de Souza 2002) and labor markets (Belke and Setzer 2003), which are of relevance for emerging market economies, e.g. for the MERCOSUR (Belke and Gros 2002). The preconditions for the realization of monetary integration are, however, considerably worse than in Europe (Schweickert 2002). In Southeast Asia, countries are still struggling with using the large foreign exchange reserves of the region more efficiently (Dieter 2003), but attempts to adopt a common monetary policy or even a common currency are as unrealistic as for Latin American countries (Berg et al. 2003; Schweickert 2000c). It seems to be more promising to supplement flexible exchange rate regimes by regional monitoring as argued by Williamson (2000). In the medium run, this could help increase peer pressure and formulate common positions with respect to good macroeconomic management (Braga de Macedo et al. 2001).

2.3 Capital Market Policy, Savings, and Investment

The differences between Latin American and Asian countries are even more pronounced with respect to savings and investment ratios. Savings and investment ratios between the two groups of countries differ on average by more than 15 percentage points (Table 2). Even Chile's savings ratio, with 25 percent of GDP the highest in Latin America during the 1990s, was still considerably lower than Thailand's and Korea's (about 35 percent of GDP) or even Malaysia's and China's (about 40 percent of GDP). It is, therefore, rather surprising that the public debate concentrates on the stability of external savings, i.e., capital flows, and on the rather moderate progress of reforms of the international financial architecture, e.g., the lack of institutionalized insolvency procedures (Griffith-Jones and Ocampo 2003).

The Washington Consensus does not include explicit views on capital controls. This demonstrates that there was no consensus about whether and, if yes, when capital flows are to be liberalized. However, the debate about the reasons for the Asian currency crisis led even the proponents of open markets to a more sceptical view about free capital movements, leading to a far-reaching consensus that trade liberalization and the reform of the domestic capital market has to precede the complete opening up towards external capital (Nsouli et al. 2002; Collier and Gunning 1999). Only few authors (e.g. Lal 1987) claim that an early liberalization of capital flows increases the speed of reform by increasing competition on the basis of world market prices.

The majority view, which, however, is not shared by the US government, can be summarized in two points. First, capital controls are more effective in the short than in the long run. They are also more effective with respect to inflows than to outflows and when targeted at specific sectors rather than at the whole economy (Kenen 1996). This implies that it should be easiest to implement controls on short-term inflows into the financial sector provided that an efficient regulation of the financial sector is in place. Such a regulation, which is explicitly re-

commended in the Washington Consensus, requires, to a considerable extent, capital controls, e.g. in the form of limitations to currency risks.

Second, capital controls like the taxation of inflows with short maturities are a legitimate instrument of macroeconomic risk management in order to prevent or to overcome financial crises (Rogoff 2002; Bhagwati and Tarullo 2003; Williamson 2003). It was after the Asian crisis that the awareness of the risks involved in capital inflows due to globalization effects increased. This is surprising given the fact that the lessons should already have been learned in the early 1980s when Latin American countries, especially Chile, experienced a turnaround in capital flows, which led to deep recessions. The higher capital inflows, the higher the risk of reversals and the more likely it becomes that bad news fuel self-fulfilling expectations about a financial crisis (Schweickert 2000b). Consequently, capital market policies have moved towards encouraging foreign direct investment (FDI), which is the most stable type of capital flow, and towards the view that further opening up of the capital account should be conditional on the development of domestic capital markets. Emprical studies on the effectiveness of capital controls show mixed results but they indicate that it is at least possible to influence the structure of capital inflows (Cárdenas and Barrera 1997). However, without the liberalization of FDI and a stable macroeconomic framework, as was the case in Chile, capital controls do not make any sense because they will not have any predictable effects on the structure of capital inflows (Williamson 2000).

Given the scepticism about FDI in the past, the recent optimism is quite astonishing. That FDI is assumed to be stable and favorable for economic growth is hardly debated at all. But this is not self-evident:

- The possibilities to influence the amount of FDI inflows in the short run are limited because this type of capital inflow is driven by supply rather than by demand. The fact that FDI is more stable than other types of capital inflows also means that it is less flexible.
- To the extent that FDI has to be attracted in order to finance a savings gap, its function as a means of technology transfer is not given first priority, implying negative consequences for its growth impact.
- Inflows of FDI can lead to governance problems. This is more likely when single projects are relatively large, the host country relatively small, and it's administrative capacity rather limited.
- The growth impact is also diminished when FDI, e.g. in the primary sector, has no spillover effects because of the lack of complementary factors like human capital.

Hence, the reasons why the preconditions for positive effects of FDI are worse in Latin America than in Asia are similar to those mentioned above in the case of export dynamics: the prime motivation for attracting FDI is to generate capital inflows rather than technology inflows and there is no tradition of SMEs equipped with sufficient human capital to implement new technology in an efficient search process.

This corresponds to the evidence that, in contrast to trade, Latin America is not lagging behind Asia in drawing on FDI (Nunenkamp 2003; UNCTAD 2003). Both regions host a similar share of global FDI stocks. In recent years, the contribution of FDI inflows to overall capital formation was much higher in Latin America (19 percent in 1997–2002) than in Asia (11 percent). Nevertheless, the correlation between FDI and growth of per capita income is loose at best for the region (Nunnenkamp 2003). The absence of significantly positive growth effects of FDI may be due to several factors:

- In various Latin American host countries, notably in Brazil, FDI traditionally was oriented towards local markets and concentrated in capital- and technology-intensive manufacturing industries in which host countries lacked international competitiveness. Nunnenkamp and Spatz (2003) show that the growth effects of such market-seeking FDI tend to be smaller than the growth effects of efficiency-seeking FDI.
- Foreign investors operating in protected Latin American markets often had to meet local content requirements. In other words, the degree of competition through imports was limited for

both foreign investors and local input suppliers. The lack of competition had a markedly negative impact on the hosts' prospects for development (Moran 1999).

- Survey results also indicate that FDI brings somewhat less new technology to Latin America than to Asia (World Economic Forum 2003). Productivity-enhancing spillovers of FDI to local enterprises are constrained further by an insufficient endowment of Latin American host countries with complementary factors of production. The literature suggests that the extent to which local enterprises benefit from spillovers has an important impact on the economic growth effects of FDI (Kokko 2002).
- Finally, FDI has crowded out domestic investment in Latin America, whereas FDI induced additional domestic investment in Asia (Agosin and Mayer 2000).

As in the case of trade, new regional initiatives are unlikely to change that picture significantly. Large scale increases of the market size can only be realized in North-South integration schemes. Additionally, the advantages of globalization or regional integration can only be reaped if domestic reforms allow for spillover effects in a competitive environment.

Given the low level of savings in Latin America, it is also clear that capital inflows are insufficient to finance an investment ratio needed to start a catching-up process without generating unsustainable external imbalances. Only a substantial increase in domestic savings would reduce the dependence on external savings and the corresponding instabilities and risks. The Washington Consensus demands positive real interest rates and excludes the financial sector from the list of deregulation policies. However, in the meantime most Latin American countries have realized positive real interest rates over a long period without experiencing a significant increase in the savings ratio (Schweickert 2003b).

Empirical studies on the question of why savings are so low in Latin America support the following correlations:

- The level of real per capita income positively affects savings rates. The influence of income is typically larger in developing than in industrial countries. In developing countries a doubling of income per capita is estimated to raise the long-run private savings rate by 10 percentage points. The distribution of income has no clear-cut influence on savings. Income concentration has a positive effect on household savings but a negative effect on corporate and public savings, resulting in an ambiguous effect on aggregate savings (Loayza et al. 2000; Schmidt-Hebbel and Servén 2000).
- Public sector savings seems to be one of the most direct and effective tools available to increase national savings as they only partially crowd out private savings. The crowding-out effect, however, differs widely between regions and is especially high for Latin American countries (Burnside 1998). Regarding the composition of public savings, the international evidence shows that cutting expenditures is a more effective way to increase national savings than raising taxes (Corbo and Schmidt-Hebbel 1991; Edwards 1996).
- Empirical evidence shows that countries that increase the funding of their mandatory retirement programs tend to achieve higher private savings rates. Evidence for Chile, the first emerging market country that reformed its pension system, suggests that one-third of the 12 percentage point increase in the national savings rate since the mid-1980s can be attributed to the pension reform (Schmidt-Hebbel 1999). Negative effects of pay-as-you-go systems increase with the systems's coverage rate (Samwick 2000).
- Positive effects of financial liberalization are only indirect if liberalization improves the efficiency of financial intermediation and hence investment, contributing to higher growth. Thus it is only through faster growth that financial liberalization will increase private saving rates.
- Increases in external savings in most cases lead to lower overall savings (Loayza et al. 2000).

All in all, empirical studies come to the conclusion that economic growth is the single most important determinant of savings (Edwards 1995). The example of countries which ex-

perienced surges in both economic growth and savings demonstrates that higher growth leads to higher savings which, in turn, makes the surge in growth sustainable. On the contrary, initial surges in savings do not lead to sustained surges in economic growth (Rodrik 2000). Arguably, productivity shocks increase profits and induce higher investment and growth. Because consumption habits are rather stable, this leads to higher savings and further investment and growth. Looking at the country results, economic policies played a different role. In Asian countries like Korea, Singapore and Taiwan the virtuous cycle has been initiated by investment and export incentives as well as by complementary public investment. In contrast, increases in growth and savings in Chile have been supported mainly by the reform of the pension system. This implies that higher savings ratios in Asia than in Latin America do not reflect differences in preferences but better investment perspectives. A calculation of hypothetical Asian savings ratios under the assumption of Latin American growth rates even shows that potential savings are lower in Asia than in Latin America (Gavin et al. 1997).

Hence, incentives for investment seem to be more important than incentives for savings. As was the case for exports, the problem is to start a dynamic process. Additionally, there are direct links between export performance and savings. First, export sectors exhibit higher-than-average savings ratios. This holds especially for exports of the primary sector. Second, exports are a reliable tax base. Hence, increasing exports improves the prospects for public savings considerably. Finally, trade allows to make use of comparative advantages, which leads to higher growth and, thus, indirectly also to higher savings (Reichel 1993, 1996). As argued above, the structural and institutional preconditions for improving export and investment conditions are poor in Latin America compared to fast-growing Asia. Because of a highly unequal income distribution and deficiencies in human capital formation poor individuals in Latin America lack social mobility and the incentives to invest. Furthermore, access to formal credit is limited for the poor, which implies that economic development takes place only in a small sector of the economy and that small and medium-sized enterprises are difficult to establish.

All in all, the discussion of exchange rate and capital market policies showed that the Washington Consensus is not a sufficient agenda for sustainable growth. A widening of the reform agenda is justified because even those Latin American countries which implemented the Washington Consensus are far from experiencing a dynamic economic development like the fast-growing Asian countries.

As outlined by Kuczynski and Williamson (2003), a comprehensive reform agenda has to define new targets and policies which are to be discussed next. At the same time, the vulnerability of Latin American countries has to be reduced so that positive effects of reforms can develop at all. In order to reduce vulnerability, Kuczynski and Williamson argue in favor of an anti-cyclical fiscal policy and regional monitoring "…analogous (though helpfully more sophisticated than) the European Growth and Stability Pact…" (Williamson 2003: 12) which should supplement more flexible exchange rates and efforts to increase domestic savings. However, attempts to implement European-type monitoring and anti-cyclical fiscal policy in Latin America seem too ambitious. With respect to fiscal policy, Calderón and Schmidt-Hebbel (2003) show that only credible governments were able to allow for automatic stabilizers. Hence, the reduction of vulnerability would be the precondition for an anti-cyclical policy. Therefore, this report emphasizes the role of exports and, more generally, of technological progress for reducing vulnerability and improving growth prospects.

3 Sufficient Conditions: The Quest for a Post-Washington Consensus

When he was still chief economist at the World Bank, Joseph Stiglitz coined the term "Post-Washington Consensus" in an article with the programmatic title "More Instruments and Broader Goals: Moving toward the Post-Washington Consensus" (Stiglitz 1998). Arguably, not all the changes demanded in this article will command a consensus. In particular, the assertion that macroeconomic stabilization should not be too ambitious and that inflation rates of up to 40 percent might be tolerable is likely to remain a minority view (see the discussion in Section 2.1.1). In two areas mentioned by Stiglitz, a broad consensus is emerging, however. First, it is increasingly acknowledged that, in addition to economic growth, poverty and the distribution of income and wealth have to be considered explicitly, with a strong emphasis put on human capital formation through mobilizing the potential of the poor. Second, there is mounting evidence that sustained growth is only possible if a reliable institutional framework is in place. Differences in these two areas are important determinants of the diverging developments in Latin America and Asia.

3.1 Poverty Alleviation and Redistribution

The absence of poverty considerations in the Washington Consensus is partly due to the special problems facing most Latin American economies in the 1980s, but it also reflects the view prevailing at that time that growth is the single-most important means of poverty alleviation, rendering a separate poverty reduction strategy unnecessary. Income distribution objectives were left out of the Washington Consensus because there was assumed to exist an almost inevitable trade-off between economic growth and an egalitarian income distribution. In addition, only the reduction of absolute poverty, as opposed to relative poverty, was accepted as a legitimate goal of development policy.

Empirical evidence indeed reveals a strongly positive correlation between sustained growth and poverty reduction. A much-cited World Bank study, for example, estimates for a broad cross-section of countries that on average poor and rich population groups benefit roughly equally from economic growth (Dollar and Kraay 2001). Available data on the evolution of absolute poverty in Asia and Latin America also show that growth is a necessary condition for successful poverty alleviation. Only the high-performing Asian economies and Chile have achieved dramatic improvements in the living standards of the poor during the 1990s, while poverty has proven to be highly persistent, on average, in the Latin American countries with low or moderate growth (see Table 3). At the lowest end of the scale, Venezuela's economic stagnation was even associated with a considerable rise in the poverty headcount.

In spite of this evidence, growth alone is unlikely to be sufficient for effective poverty alleviation. This is particularly so if one tries to pursue a pro-poor growth strategy, where the poor are to benefit disproportionately from higher average incomes (Klasen 2003; Nunnenkamp and Thiele 2004). It has been shown that those among the poor who lack access to productive assets (human capital, physical capital, land, networks) hardly benefit from increases in average living standards based on growth (e.g. Christiaensen et al. 2002). As a result of extreme economic inequality and social exclusion, this group tends to be fairly large in Latin America, which is even true for wealthier countries such as Brazil. This is, for instance, reflected in the fact that none of the larger Latin American countries has been able to reduce employment in the urban informal sector, where earnings tend to be low and stagnating (Saavedra 2003).

Beside the lack of resources controlled by the poor, labor market regulations, which have hardly been dismantled over the 1990s, have contributed to the persistently large informal sectors in Latin America. Specifically, nonwage labor costs and severance payments are much higher in Latin America than in Asia (Djankov et al. 2003). Both factors have forced low-skilled

Table 3:
Poverty and Income Distribution in Latin America and Asia, 1989–2000

	Poverty rate[a]		Gini coefficient[b]	
	first year	last year	first year	last year
Argentina	18.4	17.9	0.47	0.49
Bolivia	65.6	61.4	0.54	0.60
Brazil	48.3	41.3	0.57	0.58
Chile	32.4	16.1	0.55	0.56
Colombia	42.4	39.4	0.57	0.56
Costa Rica	35.9	30.5	0.46	0.46
Ecuador	49.5	48.0	0.56	0.56
Mexico	19.7	21.2	0.53	0.54
Paraguay	52.1	51.0	0.57	0.57
Peru	41.9	42.4	0.46	0.49
Uruguay	23.1	13.6	0.41	0.44
Venezuela	12.6	20.6	0.43	0.47
Average	—[c]	—[c]	*0.51*	*0.53*
China	31.5	17.4	0.36	0.40
India	40.9	28.6	0.31	0.36
Korea	n.a.	n.a.	0.34	0.32
Malaysia	17.1	9.6	0.41	0.42
Thailand	21.1	8.6	0.47	0.41
Average	—[c]	—[c]	*0.38*	*0.38*

[a]Share of the population with income below the poverty line. — [b]Most common summary indicator of income distribution; lies between 0 (perfect equality) and 1 (perfect inequality); coefficients of about 0.5 and more indicate high inequality. — [c]Averages were not calculated because the figures are based on national poverty lines and are therefore not comparable across countries.

Source: Behrman et al. (2001); Chen and Wang (2002); Warr (2002); World Bank (2003).

workers either to stay in the unprotected informal sector or to become unemployed (IADB 2003). In some Latin American countries (e.g. Brazil and Colombia), this effect seems to have been reinforced by high minimum wages.

The assertion that there is an almost inevitable trade-off between economic growth and an egalitarian distribution of income or wealth is increasingly called into question. Rather, recent research argues that severe disparities may hinder the growth process, via two main channels (e.g. Bénabou 1996): first, highly polarized societies are likely to experience political instability, e.g. in the form of violent protests against the privileges of ruling elites. This hampers investment and thereby lowers growth (see Section 2.2.3). Second, high inequality implies that a high proportion of the population lacks the means to undertake profitable investments, because liquidity is low and at the same time access to capital markets is constrained. This is particularly obvious in the area of human capital formation, where expected future earnings cannot be used as collateral, but it is also true for smallholders and micro entrepreneurs, whose access to credit is frequently limited by a lack of secure land and property rights (De Soto 2000). Case studies for China and Peru suggest that land and property titles tend to improve credit availability and that, on average, the beneficiaries of titling programs are enabled to increase investment (Deininger and Jin 2003; Larson et al. 2003).

Together with some Southern African states, Latin America as a region exhibits the most unequal distribution of income and assets worldwide. The Gini coefficient, the most common summary measure of income distribution, is slightly above 0.5 on average, which is considerably higher than the average of below 0.4 for the fast-growing Asian economies (Table 3). This aggregate pattern has barely changed over time. On the country level it turns out that even Uruguay, the most egalitarian economy in Latin America, falls short of the Asian average. During the 1990s, no Latin American country experienced improvements in the distribution of in-

come; in countries like Bolivia and Venezuela the distribution even deteriorated. The picture for Asia varies with income levels: while the catching-up process in the relatively poor countries—China and India—has been accompanied by increasing disparities, disparities in Korea and Thailand decreased over the 1990s.

In terms of asset inequality, differences between Latin America and Asia are even more pronounced than in terms of income inequality. Despite recent efforts in some Latin American countries (e.g. Colombia and Brazil) to initiate market-oriented land reforms (Birdsall et al. 2001), the region's land distribution remains particularly skewed, but access to education—approximated by school enrollment—is also significantly more unequal than in Asia (Birdsall and Londoño 1997). The latter is reflected in the structure of public education expenditures, which tend to favor basic education in Asia and university education in Latin America. South Korea, for instance, allocated only 12 percent of the 1998 education budget to tertiary education, while the average share for Latin America was 22 percent (Wolff and de Moura Castro 2003). Due to a private contribution to overall university financing of more than 80 percent, South Korea's total expenditures per student nevertheless exceeded those of all Latin American countries apart from Brazil.

Empirical studies show that the unequal distribution of land and human capital has impaired economic development in Latin America (e.g. Birdsall and Londoño 1997), while an early focus on basic education and equal access to land have been crucial for the sustained and broad-based growth of East Asia's most successful reformers, South Korea and Taiwan (Rodrik 1994). Cross-country studies also detect a strongly positive relationship between an equal distribution of wealth and subsequent growth (Deininger and Olinto 2000). Evidence with respect to income distribution is less robust: while the correlation between equality and growth seems to be weakly positive for developing countries (Barro 2000), the reverse result obtains when industrialized countries are additionally included in the sample (Forbes 2000).

All in all, differences in the distribution of assets stand out as a determinant of diverging developments in Latin America and Asia. By restricting access to credit and investment opportunities, the lack of assets for broad segments of the population puts Latin America at a disadvantage in terms of both growth and poverty alleviation.

3.2 Human Capital Formation

The role of human capital formation is not confined to augmenting individual earning capacities; it is also expected to matter for aggregate economic growth. The relationship between human capital formation and economic growth has been investigated in a large number of cross-country studies. Many of these studies confirm the hypothesis of a positive impact (e.g. Mankiw et al. 1992; Dollar and Kraay 2001), but there is also an increasing number of investigations which cannot detect a significant relationship between the two variables (e.g. Pritchett 2001). This ambiguity can to a large extent be explained by the fact that human capital formation is usually approximated by the years of schooling, an indicator of the quantity of education, and thus neglects quality differences. Recent empirical research has demonstrated the decisive importance of educational quality for economic growth (e.g. Hanushek and Kimko 2000). Educational quality is also the key factor determining the poverty impact of human capital formation. Gundlach et al. (2001) show in a cross-country study that investment in human capital favors the poor disproportionately if quality aspects are taken into account.

A comparison between Latin America and Asia reveals no systematic differences in quantity terms (Table 4). Access to primary schooling appears to be almost universal in both regions. The somewhat higher enrollment figures for Latin America do not indicate superior access to primary education; rather, they reflect the fact that in Latin America more primary school attendants than in Asia are above the standard primary school age (see footnote in Table 4). At

Table 4:
School Enrollment in Latin America and Asia, 1990 and 2000[a]

	Primary		Secondary		Tertiary	
	1990	2000	1990	2000	1990	2000
Argentina	106	120	71	97	39	48
Bolivia	95	116	36	79	21	36
Brazil	106	125	38	88	11	17
Chile	100	103	73	75	21	37
Colombia	102	112	50	70	13	23
Costa Rica	101	107	42	60	27	16
Ecuador	116	115	55	57	20	18
Mexico	114	113	53	75	15	21
Paraguay	105	111	31	60	8	10
Peru	118	127	67	81	30	29
Uruguay	108	109	81	98	29	36
Venezuela	95	102	35	59	29	28
Average	*106*	*113*	*53*	*75*	*22*	*27*
China	125	106	49	63	3	8
India	97	102	44	49	6	10
Korea	105	101	90	94	39	78
Malaysia	94	99	56	70	7	28
Thailand	99	95	30	82	17	35
Average	*104*	*101*	*54*	*72*	*14*	*32*

[a]Enrollment rates are calculated as the ratio between the number of students enrolled and the number of children having the standard school age. In primary education, enrollment rates can take on values of above 100 when some of the pupils are older than the country's standard primary school age.

Source: World Bank (2003).

the secondary level, almost all countries made considerable progress during the 1990s. Most notably, Brazil and Thailand could increase enrollment from 38 to 88 percent and from 30 to 82 percent, respectively. With an almost universal access to secondary education, Argentina and Uruguay are now even up with South Korea. Only a few Latin American countries (e.g. Ecuador and Venezuela) as well as China and especially India are still lagging behind. Tertiary enrollment exhibits the largest variance across countries, but there is no discernible regional pattern.

Substantial quality differences between the two regions persist, however. There are indications that, unlike Asia, Latin America has paid for broader access to education in terms of lower quality. A number of symptoms can be found for Latin America's quality problems: first, the increase in the number of pupils has not been matched by increasing expenditures for learning materials and teachers, i.e., the endowments available per pupil have fallen. It has to be taken into account, however, that additional expenditures probably only have the intended effect on educational quality if they are backed up by institutional reforms such as stronger school autonomy or the formulation of educational standards in combination with regular evaluations, which provide appropriate incentives for all actors participating in the schooling system (Wößmann 2002). Second, the successes in terms of improved access to education have to be qualified because of high drop-out rates. In Bolivia and Colombia, for example, only three quarters of the children entering primary schools finished the 6th grade in 1999; in Brazil, the share was only 70 percent (Wolff and de Moura Castro 2003).

Finally, the few Latin American participants in the recent international rankings of school performance (TIMSS, TIMSS Repeat, and PISA) have all done badly (Table 5). Mexico and Brazil come last in all three categories (reading, mathematics, and science) of PISA, behind countries with lower per capita income such as Poland and

Table 5:
Ranking of Selected Countries in International Educational Achievement Studies

PISA[a]								
Reading			Mathematics			Science		
Country	Position	Score	Country	Position	Score	Country	Position	Score
Finland	1	546	Japan	1	557	**South Korea**	1	552
Canada	2	534	**South Korea**	2	547	Japan	2	550
Australia	4	528	Australia	5	533	UK	4	532
South Korea	6	525	Canada	6	533	Canada	5	529
UK	7	523	UK	8	529	Australia	7	528
Japan	8	522	France	10	517	France	12	500
France	14	505	USA	19	493	USA	14	499
USA	15	504	Germany	20	490	Germany	20	487
Italy	20	487	Russia	22	478	Poland	21	483
Germany	21	484	Poland	24	470	Italy	23	478
Poland	24	479	Italy	26	457	Russia	26	460
Russia	27	462	**Mexico**	30	387	**Mexico**	30	422
Mexico	30	422	**Brazil**	31	334	**Brazil**	31	375
Brazil	31	396						

TIMSS[b]						TIMSS Repeat[c]					
Mathematics			Science			Mathematics			Science		
Country	Position	Score	Country	Position	Score	Country	Position	Score	Country	Position	Score
Singapore	1	643	Singapore	1	607	Singapore	1	604	Taiwan	1	569
South Korea	2	607	Japan	3	571	**South Korea**	2	587	Japan	4	550
Japan	3	605	**South Korea**	4	565	Japan	5	5,579	**South Korea**	5	549
France	13	538	England	10	552	Canada	10	531	Australia	7	540
Russia	15	535	Australia	12	545	Russia	12	526	England	9	538
Australia	16	530	Russia	14	538	Australia	13	525	Canada	14	533
Canada	18	527	USA	17	534	**Malaysia**	16	519	Russia	16	529
Thailand	20	522	Germany	18	531	USA	19	502	USA	18	515
Germany	23	509	Canada	19	531	England	20	496	Italy	21	493
England	25	506	**Thailand**	22	525	Italy	23	479	**Malaysia**	22	492
USA	28	500	France	28	498	**Thailand**	27	467	**Thailand**	24	488
Colombia	40	385	**Colombia**	40	411	Turkey	31	429	Indonesia	32	435
South Africa	41	354	South Africa	41	326	Indonesia	34	403	Turkey	33	433
						Chile	35	392	**Chile**	35	420
						Philippines	36	245	Philippines	36	345
						South Africa	38	275	South Africa	38	243

[a]Programme for International Student Achievement; results refer to 15-year-old pupils for the year 2000; a score of 500 marks the OECD average. — [b]Third International Mathematics and Science Study; results refer to students at 8th grade for the years 1994 and 1995; a score of 530 marks the average. — [c]Repetition of TIMSS; results refer to students at 8th grade for the year 1999; a score of 500 marks the average.

Source: Artelt et al. (2001); Gonzalez et al. (2000).

Russia. Colombia was placed 40th out of 41 countries participating in TIMSS, the international study that compares knowledge in mathematics and science. And even Chile, Latin America's showcase in almost all other respects, only ranks between Indonesia and the Philippines in TIMSS Repeat, well behind Malaysia and Thailand, let alone South Korea, which is among the very top scorers in all three tests.

Viewed against the background of the empirical results obtained from cross-country studies, one can argue that Latin America's deficiencies in educational quality have not only had a negative impact on growth, but that they have also prevented a stronger participation of the poor in the growth process.

3.3 Institutional Reforms

The general catchword "institutions" encompasses a wide range of partly very heterogeneous factors. In institutional economics, a rough classification distinguishing formal and informal institutions has become the rule (see Stiglitz 2000), where formal institutions comprise, for example, the laws which frame economic activities, while traditions, norms, and mentalities are important

informal institutions. The importance of a suitable set of formal institutions for economic development has been acknowledged in much of the development economics literature. For a long time, however, a convincing approach to operationalize the concept was lacking. This implied that it was not possible to quantify the effect of institutions on economic development. This, together with the fact that institutional reforms are much more complex and take much longer time to materialize than reforms in other areas, largely explains why "institution-building"—or "good governance", as it is now frequently called—has not become part of the Washington Consensus.

Recently, there has been remarkable progress towards operationalizing institutions. In particular, a comprehensive World Bank project compiled data for a large country sample from many different sources (e.g. the Global Competitiveness Report of the World Economic Forum and the country reports of the Economist Intelligence Unit) and came up with an assessment of six dimensions of institutional quality, which were aggregated to form an overall Index of Institutional Quality (Kaufmann et al. 1999).

The six dimensions are

- Political stability and absence of violence,
- Voice and accountability,
- Government effectiveness,
- Quality of regulations,
- Rule of law, and
- Control of corruption.

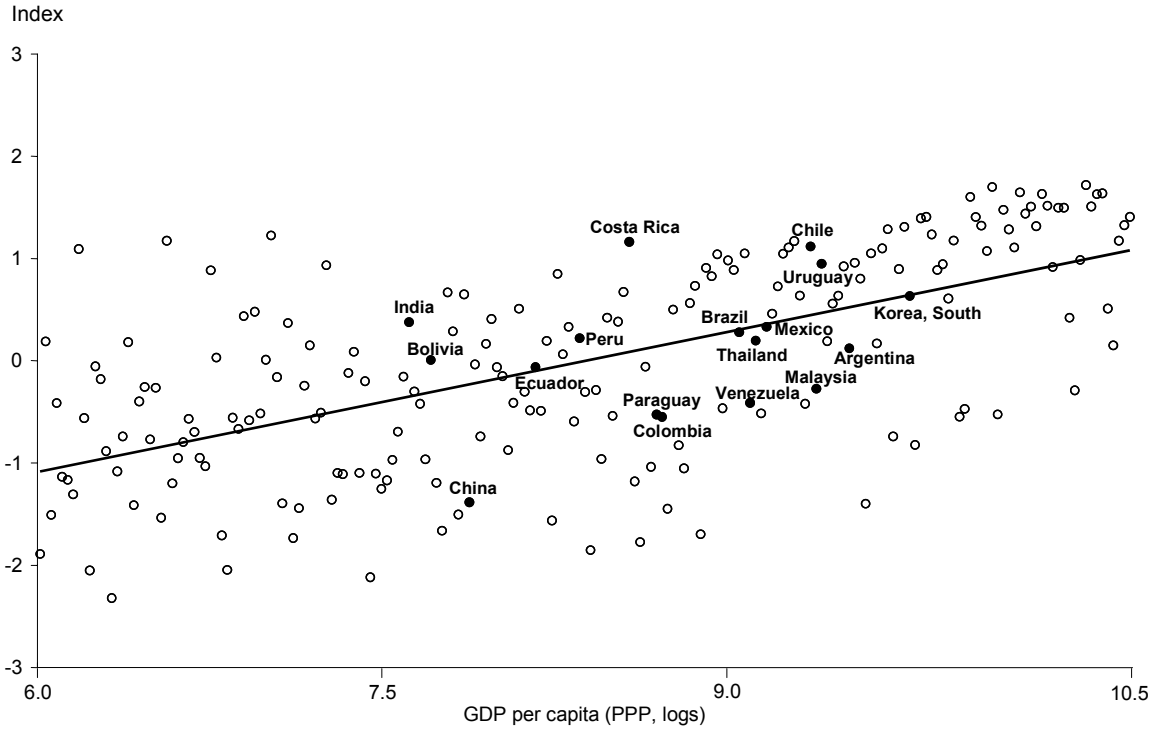
The work by the World Bank and other similar efforts have provided the basis for the empirical analysis of institutions. From the existing empirical studies, a clear picture emerges: whether one measures institutional quality by means of a broad indicator or by means of a more specific indicator such as the security of property rights, the result is always that institutions are an important explanatory variable for differences in economic performance (Edison 2003). Cross-country regressions show that the six indicators mentioned above are roughly equally important for economic development (Kaufmann and Kraay 2002). Current evidence even suggests that institutional weaknesses are the only fundamental reason for development failures (Acemoglu et al. 2001; Easterly and Levine 2002; Rodrik et al. 2002; Rodrik 2003). This implies that long-run differences in income levels are solely determined by differences in institutional quality, while short to medium term variations in growth rates may also be due to other factors such as economic policies. A plausible interpretation of this result is that "good" economic and social policies cannot be sustained over longer time periods if they are not backed by sound institutions, or that their effectiveness is low because they are not believed to be sustainable. Reversed causality, i.e., a positive impact of income levels on institutional quality, does not seem to exist (Kaufmann and Kraay 2002). This means that institutional improvements will not occur automatically when the development process unfolds.

If one compares Latin American institutions with those in Asia, it turns out that in 7 out of 12 Latin American sample countries the institutional quality falls short of the level expected given their income per capita, where the expected level is defined by the regression line that describes the average relationship between institutional quality and per capita income estimated for a large country sample (Figure 2). Deviations from the regression line are particularly pronounced in Argentina, Colombia, Paraguay, and Venezuela, and somewhat less so in Brazil, Ecuador, and Mexico. The Asian countries as well as Bolivia, Peru, and Uruguay are rather close to the regression line for most indicators. Finally, Chile and Costa Rica stand out: their institutional quality is assessed to be very high relative to per capita income; assessments for Chile even approach those for industrialized countries like France and Japan.

What are the factors behind the large deviations from the normal pattern observed in many Latin American countries? One interpretation is that the income levels of these countries are to a large part determined by other factors than institutions. A less optimistic interpretation suggests that in large parts of Latin America the relatively high income levels are inherently fragile because they are not supported by sound institutions (Kaufmann and Kraay 2002). For Chile and Costa Rica, the second interpretation would imply that the institutional preconditions for further economic advances are already given.

Figure 2
Index of Institutional Quality and Per Capita Income, 2002[a]

Voice and accountability



Political stability

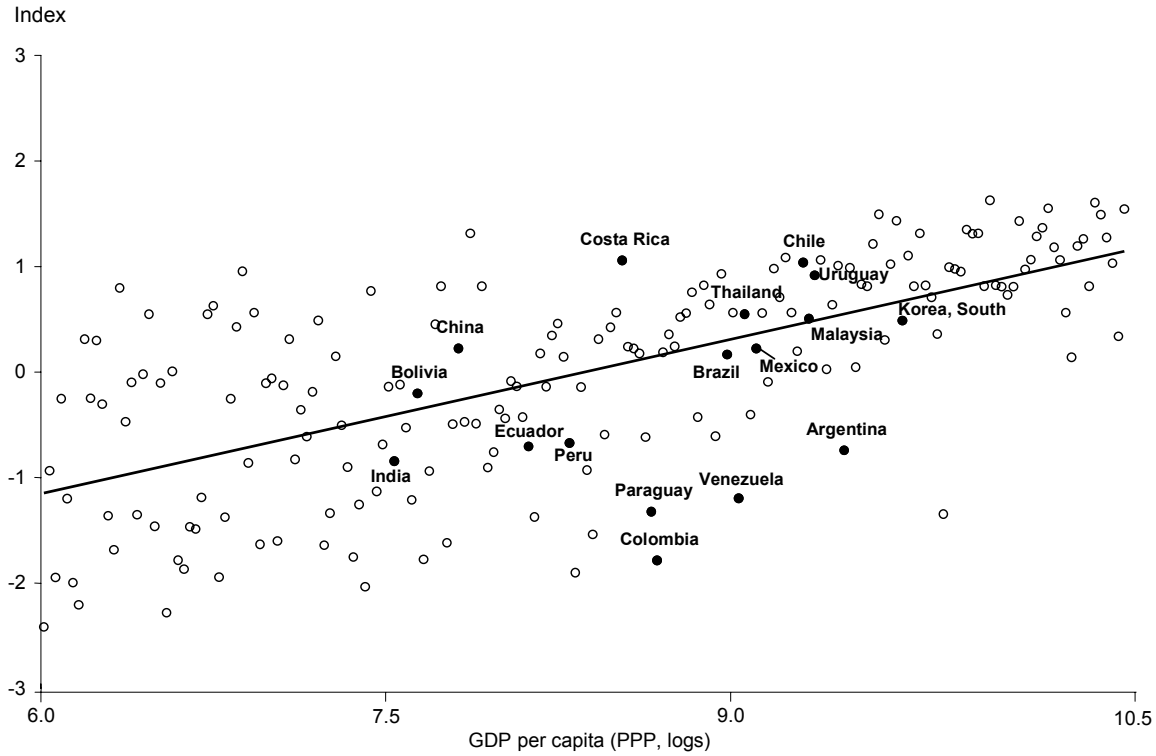
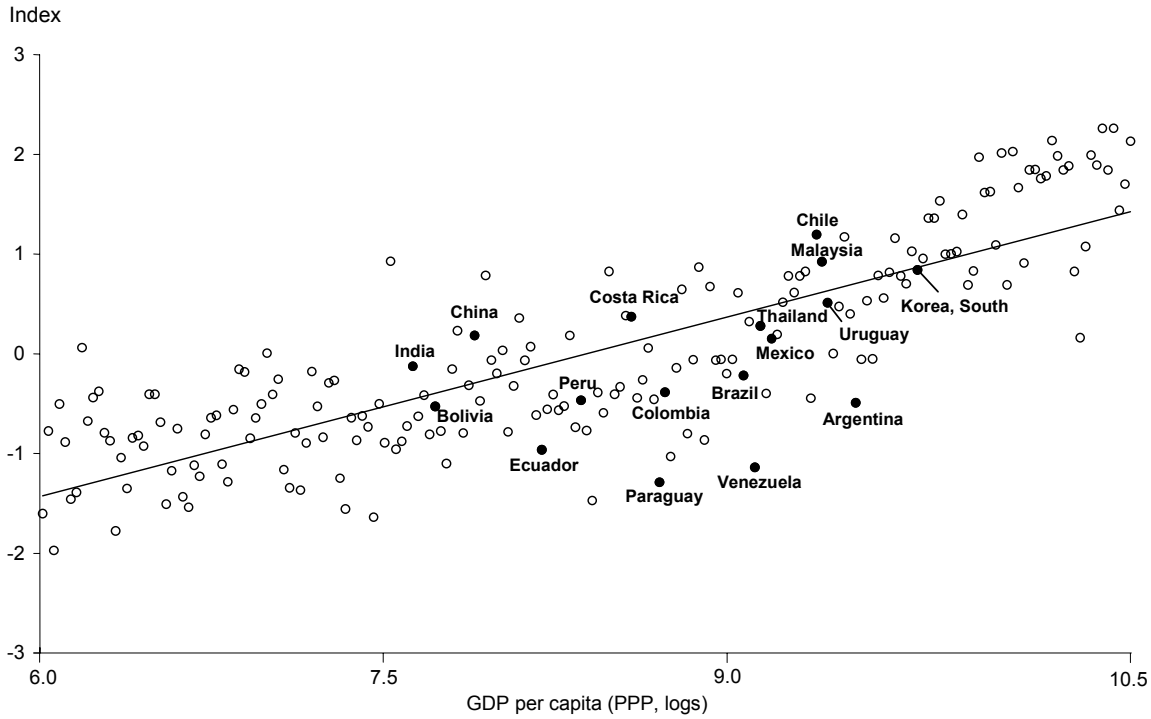


Figure 2 continued

Government effectiveness



Regulatory quality

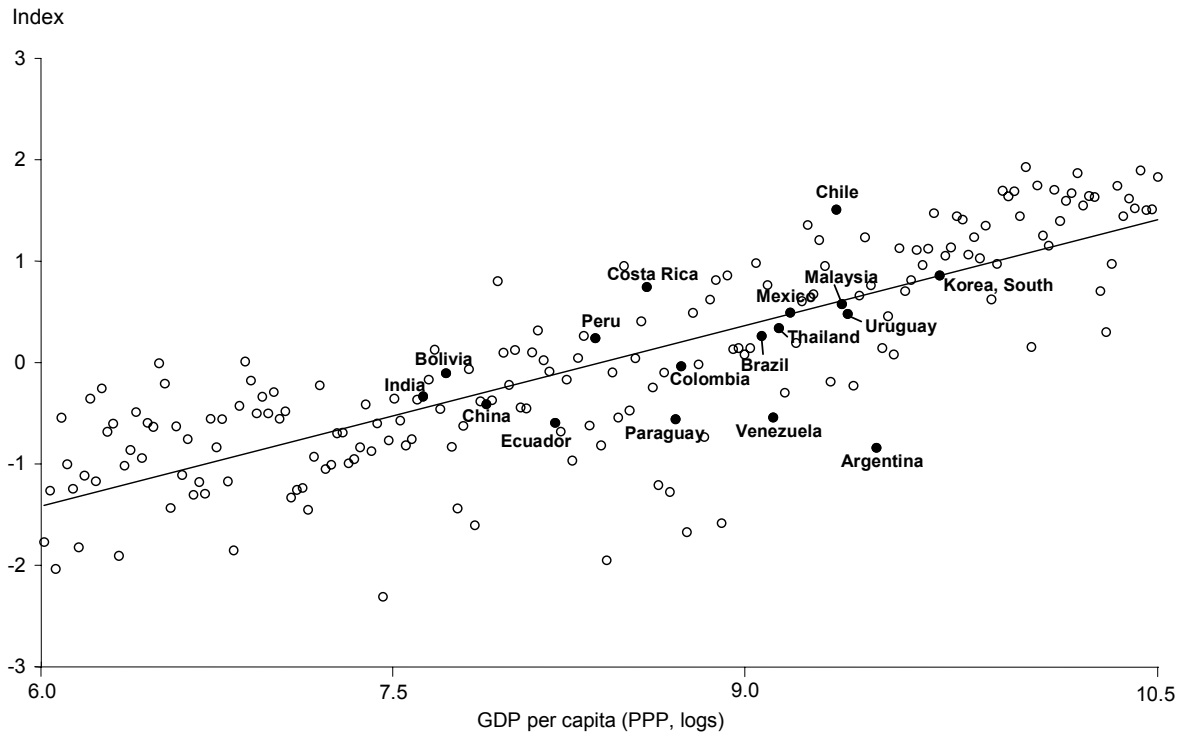
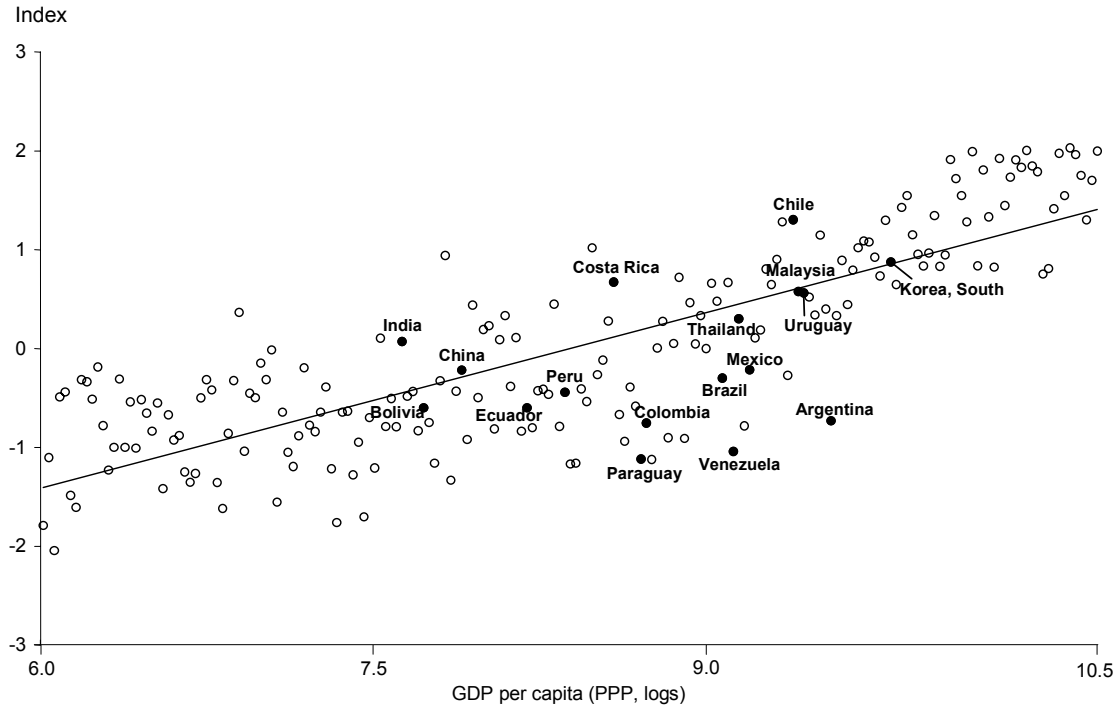
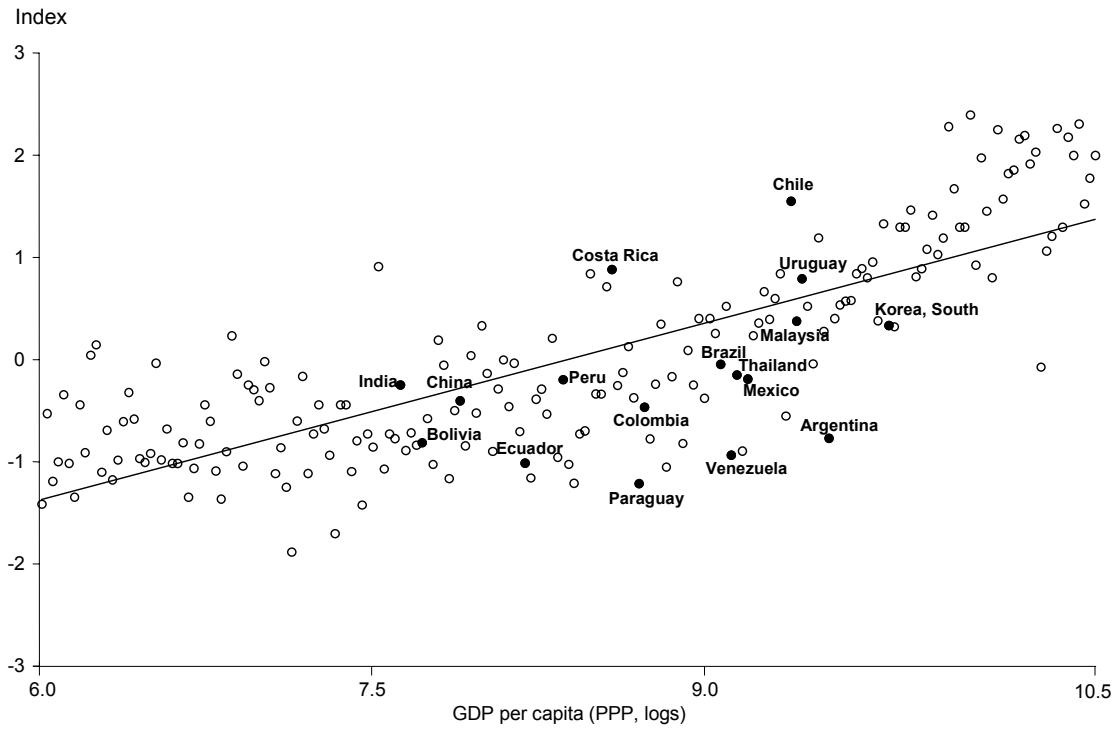


Figure 2 continued

Rule of law



Control of corruption



[a]For each indicator, the index of institutional quality can take on values between –2.5 and 2.5; a higher value of the index indicates higher institutional quality.

Source: Regressions based on data from Kaufmann et al. (2003).

Measurement errors provide a third possible explanation for the fact that the indicators of institutional quality can only partly explain differences in economic development. Both technical and conceptional reasons can be put forward for measurement errors. On the technical level, one has to keep in mind that the data are based on interviews with local experts and thus include a strong subjective element. The case of Argentina's dramatic downgrading in 2002 (Table A2) forcefully illustrates the danger of large measurement errors; it can be assumed that the downgrading mainly reflected the insecurity prevailing before and during the financial crisis rather than deteriorations in institutional quality.

On the conceptional level, the problem is that despite a general consensus on the institutions which have to be analyzed a number of questions about details—e.g. finding the right balance between competition and regulation in network-based services such as telecommunication—do not have a clear answer. In general, it is more difficult to define institutional standards which are suitable for a diverse set of countries than to propagate the dismantling of excessive interventions as the Washington Consensus does. In his programmatic article, Stiglitz (1998) even argued that with respect to competition policy a consensus is neither possible nor desirable, because economic research will not be able to identify a competition policy that is optimal for all countries at all times. This implies that country-specific factors have to figure prominently, which in turn requires a stronger disaggregation than that given by the six dimensions of institutional quality. The World Bank has made a step in that direction by developing detailed questionnaires for assessing the institutional quality of various countries, including Bolivia, Peru, and Colombia from Latin America (e.g. World Bank Institute 2001).

Work on informal institutions such as norms and mentalities, which in their entirety are often called "social capital", used to be the domain of sociologists and political scientists. After the publication of a study by Robert Putnam (1993), in which the concept of social capital was used to explain differences in the economic performance of northern and southern Italy, economists have increasingly taken up the topic and mainly investigated whether an impact of social capital on economic development can be detected empirically. The operationalization of the concept for empirical analyses has greatly benefited from the so-called *World Values Surveys* (Inglehart et al. 2000). During the wave of the *World Values Surveys* for the years 1995 and 1996 (the last wave for 2001 has not yet been processed), people in 41 countries—including the most important Latin American countries as well as China, India, and South Korea—where interviewed about a multitude of dimensions of social capital. Economic research has mainly concentrated on two aspects which are assumed to be important determinants of the level of transaction costs: first, this is the level of trust among private agents and the trust private agents express vis-à-vis the government, and second this is the strength of norms of civic cooperation. In both categories, Latin American countries are among the worst performers, whereas India and South Korea are roughly on par with industrialized countries such as Austria and the Netherlands (Knack and Keefer 1997).

The existing empirical evidence, which—as in the case of formal institutions—has to be interpreted cautiously because of the high potential margins of error, suggests that the low stock of social capital has had a negative impact on Latin America's development. Most notably, cross-country studies estimate a significantly positive growth effect of both norms and trust (La Porta et al. 1997; Knack and Keefer 1997; Zak and Knack 2001). The transmission mechanism mainly runs through higher investment in physical and human capital. A high level of social capital encourages physical investment in several ways. It implies, for example, that informal networks can more easily substitute for formal institutions, such as formal credit markets, and that government officials are perceived as more trustworthy, which lowers perceived investment risks. One reason why human capital formation becomes more attractive in societies well endowed with social capital is that hiring decisions will more likely be based on educational credentials rather than on personal attributes such as blood ties.

The existing empirical studies also examined which factors mainly determine the level of social capital. The results show that a low degree of polarization in a society, i.e., a relatively egalitarian income distribution and ethnic homogeneity, strongly facilitate the formation of social capital. The same is true for the existence of enforceable laws and other formal institutions which constrain the ability of governments to act arbitrarily. In addition, high educational standards and—contrary to the case of formal institutions—high incomes have a positive impact.

4 Towards Sustainable Catching-up Growth in Latin America

Since the early 1990s, the debate about a comprehensive reform strategy has made considerable progress. The reform agenda as proposed by the Washington Consensus was restricted to formulate policies which are (technically) easy to implement and to monitor in order to show whether reform efforts were going into the right direction. The debate about a Post-Washington Consensus made it clear that these policies may be necessary but that they are far from sufficient. First, the Washington Consensus is biased towards a reduction of government intervention. Important aspects like the restructuring of public expenditures, the provision of property rights, and a prudent regulation of the financial sector are mentioned but not given high priority. Second, the Washington Consensus neglected that the preconditions for positive effects of stabilization, opening up towards world markets, and deregulation are much worse in Latin America than in Asia. Given Latin America's high concentration of income, low diversification of production and exports, weak human capital formation, segmented capital markets, and weak entrepreneurial tradition, it proves difficult and time-consuming to initiate a dynamic development process.

The general discussion of different policy areas and the comparison of Latin American and East Asian economies in this report have shown that the areas of reform listed in the Washington Consensus, in particular the requirement of macroeconomic stability, are still crucial for emerging economies and developing countries alike. It has to be acknowledged that most Latin American countries have made considerable progress in implementing the core recommendations of the Washington Consensus. To achieve higher and more broad-based growth, reform programs should contain four important additional elements, with a focus on a dynamic development of investment and exports:

(1) Priority for external stability in order to support export activities.
(2) Adoption of best-practice technologies in order to speed up technical progress.
(3) Poverty alleviation and a more equal income distribution in order to allow poor segments of the population to participate in the formal economy and to allow small and medium-sized enterprises to develop.
(4) Reliable formal and informal institutions in order to give investors an incentive to realize long-term projects.

First, external stability could be supported by more flexible exchange rates and the prudent use of capital market policies, a policy mix which could stabilize real exchange rates as well as capital inflows. Competitive and stable exchange rates support export development by giving investors in this sector a reliable basis for calculating long-term projects. This would ease structural adjustment and foster reform processes. The preconditions for such a policy have improved considerably because of the successful reduction of inflation rates. Even after the recent large-scale devaluations, Latin American countries have been able to hold inflation under control. This implies considerably less pressure on macroeconomic management because the exchange rate is no longer bound to provide an anchor for domestic prices. In the same vein, increasing domestic savings through higher government savings and efforts to overcome the segmentation of capital markets could reduce the need for capital inflows

and reduce the vulnerability of Latin American countries to external shocks. This would improve the environment for other reforms to show positive effects.

Second, the adoption of best-practice technologies could be supported by technology and education policies which are targeted at facilitating the transfer of technology. In this respect all possibilities given by licensing agreements and technology transfer from importers to domestic producers of export products should be exploited. FDI should be encouraged in sectors where it competes with domestic firms in order to maximize competitive pressure. To a large extent, this implies a new view on FDI as a means to encourage the transfer of technology instead of regarding it primarily as a source of investment finance. This is another reason to increase domestic savings. An important precondition for actually improving the transfer of technology is that the incentives for the adoption of new technologies are matched by abilities to adopt them. Therefore, education policy should give priority to the formation of high-quality human capital, with an emphasis on technical and job-related skills.

Third, in their efforts to alleviate poverty and reduce extreme inequalities, Latin American governments should follow the example of the successful Asian economies and focus on measures which enable the poor to accumulate assets and thus to increase their future earning capacities. The highest priority should be given to improvements in the quality of human capital formation at the primary and secondary education level, e.g., via universal supply of learning materials and the training of teachers. In order to assure that the additional expenditures needed for this purpose have the intended effects, they have to be complemented by institutional reforms such as greater school autonomy or the specification of educational standards in combination with regular school evaluations, which provide appropriate incentives for the actors participating in the educational system. As witnessed in East Asia, a strong basic education system would not only help alleviate poverty but also contribute to long-run growth, i.e., it is a win-win option. Labor market reforms, such as cuts in severance payments, which facilitate the migration from the informal sector to higher-paid formal employment are likely to reinforce the positive impact of these investments in human capital. The same is true for a strengthening of vocational training.

A comprehensive titling program for land and property would constitute another possible win-win option as it would help poor people to use their assets more productively, for instance as collateral. In rural areas, such a titling program can only be effective if it is complemented by a market-based land reform, which achieves a more equal distribution of land without relying on expropriations. For those in the informal sector lacking command over assets of any kind, microcredit initiatives might provide support. An extended access to credit along these lines would be a promising instrument for the establishment of a *Mittelstand* consisting of small and medium-sized enterprises, all the more so if it was combined with the deregulation of firm entry conditions and the provision of extension services.

Fourth, with respect to improvements in the formal institutional framework, the empirical literature does not help in setting priorities. Rather, it suggests that all six indicators of institutional quality are roughly equally important for economic growth. For Latin America, this implies that most countries have to reform their institutions across the board. Only a few countries may concentrate their reform efforts on specific institutional weaknesses. Uruguay, for example, is characterized by high political stability and a relatively low level of corruption, whereas government effectiveness in the provision of public goods is still lagging behind international standards. To derive more specific policy recommendations, a stronger disaggregation than the identification of six broad indicators is required. Detailed questionnaires developed by the World Bank to assess the institutional quality of various countries show, for example, that in Colombia the most effective means in the fight against corruption is to contain bribes in public procurement. Such specific recommendations can rarely be generalized for a larger group of countries. One exception might be the cut in severance payments mentioned above.

If Latin America wants to strengthen its social capital, direct interventions, such as stricter laws punishing the violation of norms, will hardly be successful. More promising are movements towards a more egalitarian income distribution, a higher level of education, and better formal institutions which constrain the ability of the government to act arbitrarily. According to recent empirical research, these factors would indirectly contribute to the formation of social capital.

All in all, the reforms proposed in this report support the agenda of Kuczynski and Williamson (2003): deepening Washington Consensus reforms, reducing vulnerability, improving income distribution, and developing reliable institutions. However, with respect to reducing vulnerability, Kuczynski and Williamson favor more flexible exchange rates and higher domestic savings—as proposed here as well—but also an anti-cyclical fiscal policy and regional monitoring following the European idea of the Growth and Stability Pact. Because the preconditions for such ambitious policies are not given in most Latin American countries, it seems to be more plausible to improve export performance and technological development in order to reduce vulnerability and, at the same time, to foster economic growth. An important insight gained by the Post-Washington Consensus debate is that in order to achieve these goals social mobility and reliable institutions matter more than assumed at the beginning of the 1990s.

Taken together, export orientation, technology transfer, poverty alleviation, and institution-building could lead to a more flexible economic structure and a more dynamic development of investment and exports, which would in turn be reflected in higher and more equitable growth. In order to start such a process, the countries need to design their own strategies. This is because most reforms, especially institution-building, have to be tailored to domestic conditions. This is the second important insight from the Post-Washington Consensus debate.

The poverty reduction strategy papers (PRSPs), which have to be set up by poor and highly indebted countries in order to get HIPC debt reductions, could also provide a blueprint for the development of national reform strategies for more advanced countries. PRSPs establish a framework for a national dialog, integrate poor households into the decision-making process, and improve the awareness of reform targets through quantitative targets (Schweickert et al. 2003). The fact that the countries themselves have to design strategies in the first place improves the identification with reforms (*ownership*). It is a well established fact that the failure of World Bank and IMF programs was to a large extent a lack of ownership and, hence, support in developing countries (Thiele and Wiebelt 2000).

The chances that such comprehensive reforms could be implemented in Latin American countries have improved over the recent years. First, the Post-Washington Consensus debate has paved the way towards deeper reforms because economists, international institutions, and policy makers seem to agree that the role of governments should be more active but also more focused than the one described in the Washington Consensus. Second, a reorientation towards a pro-poor growth strategy should not endanger fiscal stability. Fiscal policy could improve tax revenue by increasing income taxation using a moderately progressive tax structure. Fiscal budgets also allow for more restructuring in favor of investment in human capital formation. Third, macroeconomic stability has improved considerably, with a range of countries now approaching single-digit inflation rates. This will reduce the probability of crises and free the resources of policy makers for concentrating on a credible and comprehensive reform package rather than muddling through with ad hoc measures. Finally, in some countries like Mexico and Chile, indicators on institutions improved over relatively short time periods, indicating that even in this most difficult reform area progress is possible.

Unfortunately, international support for comprehensive reforms has rather weakened. Progress with respect to reforms of the international financial system has slowed down. Industrialized countries also prefer bilateral or regional integration schemes, which allows them to use their superior political leverage. Instead, they should open up for exports from emerging market economies in a most favored nation fashion in order to avoid discrimination and maximize learning-by-doing and help emerging market economies

to design and implement comprehensive national PRSPs.

Because careful optimism is justified with respect to the potential of Latin American countries to implement pro-poor growth strategies, industrialized countries would be well advised to support this process in their own interest because it reduces the risks of crises with considerable contagion effects.

Appendix Tables

Table A1:
Index of Economic Freedom for Latin America and Asia, 1995–2003[a]

	Chile	South Korea	Thailand	Argentina	Uruguay	Bolivia	Malaysia	Peru	Costa Rica	Mexico	Brazil	Vene-zuela	China	India	Average
								Score							
1995	2.6	2.2	2.4	2.8	2.9	3.1	2.4	3.3	2.9	2.9	3.3	3.0	3.6	3.8	2.6
1996	2.6	2.3	2.4	2.6	2.9	2.7	2.7	2.9	3.0	3.1	3.6	3.5	3.6	3.9	2.6
1997	2.2	2.3	2.3	2.6	2.7	2.7	2.8	2.9	3.0	3.3	3.5	3.4	3.6	3.8	2.6
1998	2.2	2.3	2.4	2.3	2.7	2.6	2.6	2.9	3.0	3.3	3.5	3.4	3.5	3.8	2.5
1999	2.1	2.2	2.4	2.1	2.7	2.8	2.6	2.6	3.0	3.2	3.3	3.3	3.6	3.8	2.5
2000	2.0	2.4	2.7	2.1	2.6	2.7	2.7	2.5	2.9	3.0	3.5	3.3	3.4	3.8	2.5
2001	2.0	2.3	2.2	2.3	2.4	2.4	3.0	2.5	2.7	3.0	3.3	3.6	3.6	3.9	2.4
2002	1.9	2.5	2.4	2.5	2.6	2.7	3.1	2.8	2.7	2.9	3.1	3.7	3.6	3.6	2.5
2003	2.0	2.7	2.6	3.0	2.5	2.7	3.0	2.8	2.7	2.8	3.0	3.5	3.6	3.5	2.5
Average	*2.2*	*2.3*	*2.4*	*2.5*	*2.6*	*2.7*	*2.8*	*2.8*	*2.8*	*3.0*	*3.3*	*3.4*	*3.6*	*3.8*	*2.5*
Change	*–0.6*	*0.6*	*0.2*	*0.2*	*–0.4*	*–0.5*	*0.6*	*–0.5*	*–0.3*	*–0.1*	*–0.3*	*0.5*	*–0.1*	*–0.3*	*–0.1*
								Trade policy							
1995	4	3	3	4	3	2	3	5	4	3	4	4	5	5	3.3
1996	4	2	3	4	3	2	3	4	4	3	4	4	5	5	3.1
1997	2	3	3	4	2	2	5	3	4	3	4	4	5	5	3.1
1998	2	3	3	4	2	2	3	2	4	3	4	3	5	5	2.8
1999	2	3	3	3	2	2	3	2	4	2	4	3	5	5	2.7
2000	2	3	3	3	2	2	3	2	3	3	5	3	5	5	2.8
2001	2	3	2	3	1	2	4	3	2	2	4	4	5	5	2.6
2002	2	3	2	4	3	2	4	3	2	2	4	4	5	5	2.8
2003	2	3	4	4	3	3	3	4	2	2	4	4	5	5	3.0
Average	*2.4*	*2.9*	*2.9*	*3.7*	*2.3*	*2.1*	*3.4*	*3.1*	*3.2*	*2.6*	*4.1*	*3.7*	*5.0*	*5.0*	*2.9*
Change	*–2.0*	*0.0*	*1.0*	*0.0*	*0.0*	*1.0*	*0.0*	*–1.0*	*–2.0*	*–1.0*	*0.0*	*0.0*	*0.0*	*0.0*	*–0.3*
								Fiscal burden							
1995	3	2.5	2	2.5	3	3	4	2	3	2.5	3	2	3	5	2.5
1996	2.5	3	2	2.5	3.5	3	4	2	3	3	3.5	3	2	4.5	2.6
1997	3	3	2	3	3.5	3	3	3	3	3	3.5	3	2	4	2.6
1998	3	3	2	2	3.5	3	3	3	3	3	3.5	3	2	4	2.6
1999	3	2.5	2	2	3.5	3.5	3	3	3	3	3	2	3	3	2.5
2000	3	2.5	3	3	3.5	3.5	3	2	3	3	4	3	3	3	2.7
2001	3	3	2.5	3	3.5	3	3	2.5	2.5	3.5	3.5	2.5	2.5	3.5	2.6
2002	3	3.5	2.5	3	3.5	3.5	3	2.5	3	3.5	3.5	2.5	3	3.5	2.7
2003	2.5	3	2.5	3	3.5	3	3	2.5	3	3.5	2.5	3	3	4	2.6
Average	*2.9*	*2.9*	*2.3*	*2.7*	*3.4*	*3.2*	*3.2*	*2.5*	*2.9*	*3.1*	*3.3*	*2.7*	*2.6*	*3.8*	*2.6*
Change	*–0.5*	*0.5*	*0.5*	*0.5*	*0.5*	*0.0*	*–1.0*	*0.5*	*0.0*	*1.0*	*–0.5*	*1.0*	*0.0*	*–1.0*	*0.1*
								Government intervention							
1995	1	1	1.5	2	2	3	2	3	2	1	2	1	4	3	1.8
1996	1	2	1.5	2	2	3	3	1	2.5	2	3	3	4	3	2.1
1997	1	1.5	1	2	2	3	3	1	2.5	2.5	3	2	4	3	2.0
1998	1.5	2.5	1.5	2	2	3	3	1.5	2.5	3	3	3	4	3	2.2
1999	1	1.5	1.5	2	2	3	3	1.5	2.5	3	3	3	4	3	2.1
2000	1	2.5	3	2	2	2	3	1.5	2.5	2	3	2	4	3	2.1
2001	1	2.5	2.5	2.5	2	2	2	1.5	3	2	3	2	4	3	2.1
2002	1	3.5	3	2.5	2	2	3	2.5	2.5	2	3	3	4	3	2.3
2003	2	4	1.5	2	2.5	2	3	3	2.5	3	3	2	4	3	2.3
Average	*1.2*	*2.3*	*1.9*	*2.1*	*2.1*	*2.6*	*2.8*	*1.8*	*2.5*	*2.3*	*2.9*	*2.3*	*4.0*	*3.0*	*2.1*
Change	*1.0*	*3.0*	*0.0*	*0.0*	*0.5*	*–1.0*	*1.0*	*0.0*	*0.5*	*2.0*	*1.0*	*1.0*	*0.0*	*0.0*	*0.6*
								Monetary policy							
1995	4	2	2	5	5	4	2	5	4	4	5	5	3	3	3.3
1996	4	3	2	5	5	3	2	5	4	3	5	5	4	3	3.3
1997	3	2	2	5	5	3	2	5	4	5	5	5	4	3	3.3
1998	3	2	2	3	5	3	2	5	4	5	5	5	3	3	3.1
1999	3	2	2	2	5	3	2	4	4	5	5	5	3	3	3.0
2000	2	3	3	1	4	3	2	3	4	4	5	5	1	3	2.7
2001	2	1	1	1	3	2	2	2	3	4	4	5	1	3	2.1
2002	2	1	1	1	3	2	1	2	3	4	3	5	1	2	1.9
2003	2	2	1	1	2	1	1	1	3	3	3	4	1	2	1.7
Average	*2.8*	*2.0*	*1.8*	*2.7*	*4.1*	*2.7*	*1.8*	*3.6*	*3.7*	*4.1*	*4.4*	*4.9*	*2.3*	*2.8*	*2.7*
Change	*–2.0*	*0.0*	*–1.0*	*–4.0*	*–3.0*	*–3.0*	*–1.0*	*–4.0*	*–1.0*	*–1.0*	*–2.0*	*–1.0*	*–2.0*	*–1.0*	*–1.6*

Table A1 continued

	Chile	South Korea	Thailand	Argentina	Uruguay	Bolivia	Malaysia	Peru	Costa Rica	Mexico	Brazil	Vene-zuela	China	India	Average
								Capital flows							
1995	2	3	3	2	2	2	2	2	2	2	3	3	3	3	2.1
1996	2	3	3	2	2	2	3	2	2	2	3	3	3	3	2.2
1997	2	3	3	2	2	2	3	2	2	2	3	3	3	3	2.2
1998	2	2	2	2	2	2	3	2	2	2	3	3	3	3	2.1
1999	2	2	2	2	2	2	3	2	2	2	3	3	3	4	2.1
2000	2	2	2	2	2	2	4	2	2	2	3	3	3	4	2.2
2001	2	2	2	2	2	1	4	2	2	3	3	3	4	4	2.3
2002	2	2	2	2	2	1	4	2	2	3	3	3	4	3	2.2
2003	2	2	3	3	2	1	4	2	2	3	3	3	4	3	2.3
Average	*2.0*	*2.3*	*2.4*	*2.1*	*2.0*	*1.7*	*3.3*	*2.0*	*2.0*	*2.3*	*3.0*	*3.0*	*3.3*	*3.3*	*2.2*
Change	*0.0*	*–1.0*	*0.0*	*1.0*	*0.0*	*–1.0*	*2.0*	*0.0*	*0.0*	*1.0*	*0.0*	*0.0*	*1.0*	*0.0*	*0.2*
								Banking and finance							
1995	3	2	3	3	3	4	3	2	3	4	3	2	3	4	2.6
1996	3	2	3	2	2	2	3	2	3	4	3	3	3	4	2.4
1997	3	2	3	2	2	2	3	2	3	4	3	3	3	4	2.4
1998	3	2	3	2	2	2	3	2	3	4	3	3	3	4	2.4
1999	3	3	3	2	2	2	3	2	3	4	3	3	3	4	2.5
2000	3	3	3	2	2	2	3	2	3	4	3	3	3	4	2.5
2001	3	3	3	2	2	2	4	2	3	3	3	3	4	4	2.6
2002	2	3	3	2	2	2	4	2	3	2	3	3	4	4	2.4
2003	2	3	3	4	2	2	4	2	3	2	3	3	4	4	2.6
Average	*2.8*	*2.6*	*3.0*	*2.3*	*2.1*	*2.2*	*3.3*	*2.0*	*3.0*	*3.4*	*3.0*	*2.9*	*3.3*	*4.0*	*2.5*
Change	*–1.0*	*1.0*	*0.0*	*1.0*	*–1.0*	*–2.0*	*1.0*	*0.0*	*0.0*	*–2.0*	*0.0*	*1.0*	*1.0*	*0.0*	*–0.1*
								Wages and prices							
1995	3	2	3	2	2	1	2	2	2	3	3	3	3	3	2.1
1996	3	2	3	2	2	1	3	2	2	4	3	3	3	4	2.3
1997	2	2	3	2	2	1	3	2	2	3	3	3	3	4	2.2
1998	2	2	3	2	2	1	3	2	2	3	3	3	3	4	2.2
1999	2	2	3	2	2	1	3	2	2	3	2	3	3	4	2.1
2000	2	2	3	2	2	1	3	2	2	2	2	3	3	4	2.1
2001	2	2	2	1	2	1	3	2	2	2	2	3	3	4	1.9
2002	2	2	2	1	2	2	3	2	2	2	2	4	3	4	2.1
2003	2	2	2	2	2	2	3	2	2	2	2	4	3	3	2.1
Average	*2.2*	*2.0*	*2.7*	*1.8*	*2.0*	*1.2*	*2.9*	*2.0*	*2.0*	*2.7*	*2.4*	*3.2*	*3.0*	*3.8*	*2.1*
Change	*–1.0*	*0.0*	*–1.0*	*0.0*	*0.0*	*1.0*	*1.0*	*0.0*	*0.0*	*–1.0*	*–1.0*	*1.0*	*0.0*	*0.0*	*–0.1*
								Property rights							
1995	1	1	1	2	3	3	2	3	3	2	3	3	4	3	2.1
1996	1	1	1	2	3	3	2	3	3	3	3	3	4	3	2.2
1997	1	1	1	2	2	3	2	3	3	3	3	3	4	3	2.1
1998	1	1	2	2	2	2	2	3	3	3	3	3	4	3	2.1
1999	1	1	2	2	2	3	2	2	3	3	3	3	4	3	2.1
2000	1	1	2	2	2	3	2	3	3	3	3	3	4	3	2.2
2001	1	1	2	3	2	3	3	3	3	3	3	4	4	3	2.4
2002	1	1	2	3	2	4	3	4	3	3	3	4	4	3	2.5
2003	1	2	2	4	2	4	3	4	3	3	3	4	4	3	2.6
Average	*1.0*	*1.1*	*1.7*	*2.4*	*2.2*	*3.1*	*2.3*	*3.1*	*3.0*	*2.9*	*3.0*	*3.3*	*4.0*	*3.0*	*2.3*
Change	*0.0*	*1.0*	*1.0*	*2.0*	*–1.0*	*1.0*	*1.0*	*1.0*	*0.0*	*1.0*	*0.0*	*1.0*	*0.0*	*0.0*	*0.5*
								Regulations							
1995	2	3	3	2	3	4	2	4	3	4	4	2	4	4	2.8
1996	2	3	3	2	3	4	2	4	3	4	4	3	4	4	2.8
1997	2	3	3	2	3	4	2	4	3	4	3	3	4	4	2.8
1998	2	3	3	2	3	4	2	4	3	4	3	3	4	4	2.8
1999	2	3	3	2	3	4	2	3	3	4	3	3	4	4	2.7
2000	2	3	3	2	3	4	2	3	3	4	3	3	4	4	2.7
2001	2	3	3	2	3	4	3	3	3	4	3	4	4	4	2.8
2002	2	3	3	3	3	4	3	4	3	4	3	4	4	4	2.9
2003	3	3	3	3	3	4	3	4	3	3	3	4	4	4	2.9
Average	*2.1*	*3.0*	*3.0*	*2.2*	*3.0*	*4.0*	*2.3*	*3.7*	*3.0*	*3.9*	*3.2*	*3.2*	*4.0*	*4.0*	*2.8*
Change	*1.0*	*0.0*	*0.0*	*1.0*	*0.0*	*0.0*	*1.0*	*0.0*	*0.0*	*–1.0*	*–1.0*	*2.0*	*0.0*	*0.0*	*0.2*
								Black market							
1995	3	2	2	3	3	5	2	5	3	3	3	5	4	5	3.0
1996	2	2	2	2	2	2	2	2	2	2	2	2	2	2	1.8
1997	3	2	2	2	3	4	2	4	3	3	4	5	4	5	2.9
1998	2	2	2	2	3	4	2	4	3	3	4	5	4	5	2.8
1999	2	2	2	2	3	4	2	4	3	3	4	5	4	5	2.8
2000	2	2	2	2	3	4	2	4	3	3	4	5	4	5	2.8
2001	2	2	2	3	3	4	2	4	3	3	4	5	4	5	2.9
2002	1.5	3	3.5	3.5	3	4.5	3	3.5	3	3.5	3.5	4	3.5	4	2.9
2003	1.5	3	3.5	3.5	3	4.5	3	3.5	3	3.5	3.5	4	3.5	4	2.9
Average	*2.1*	*2.2*	*2.3*	*2.6*	*2.9*	*4.0*	*2.2*	*3.8*	*2.9*	*3.0*	*3.6*	*4.4*	*3.7*	*4.4*	*2.8*
Change	*–1.5*	*1.0*	*1.5*	*0.5*	*0.0*	*–0.5*	*1.0*	*–1.5*	*0.0*	*0.5*	*0.5*	*–1.0*	*–0.5*	*–1.0*	*–0.1*

[a]The scale for each of the ten factors runs from 1 (best) to 5 (worst). For determining the score, the factors are weighted equally.

Source: Heritage Foundation (various issues); own calculations.

Table A2:
Index of Institutional Quality for Latin America and Asia, 1996 and 2002[a]

	Argentina	Bolivia	Brazil	Chile	China	Costa Rica	Ecuador	India	Colombia	Malaysia	Mexico	Peru	Paraguay	South Korea	Thailand	Uruguay	Venezuela
									Overall institutional quality								
1996	0.36	–0.24	0.00	1.03	–0.24	0.66	–0.41	–0.15	–0.25	0.61	–0.11	–0.26	–0.24	0.53	0.18	0.60	–0.41
2002	–0.58	–0.38	0.02	1.27	–0.34	0.81	–0.66	–0.19	–0.66	0.45	0.13	–0.18	–1.01	0.67	0.25	0.70	–0.88
									Quality of regulations								
1996	0.66	0.66	0.13	1.28	–0.10	0.54	–0.10	–0.13	0.37	0.70	0.46	0.51	0.45	0.55	0.38	0.80	–0.12
2002	–0.84	–0.11	0.26	1.50	–0.41	0.74	–0.60	–0.34	–0.04	0.58	0.49	0.24	–0.56	0.86	0.34	0.48	–0.54
									Rule of law								
1996	0.27	–0.62	–0.24	1.19	–0.43	0.61	–0.38	–0.01	–0.44	0.80	–0.11	–0.33	–0.48	0.77	0.46	0.49	–0.62
2002	–0.73	–0.60	–0.30	1.30	–0.22	0.67	–0.60	0.07	–0.75	0.58	–0.22	–0.44	–1.12	0.88	0.30	0.56	–1.04
									Control of corruption								
1996	–0.11	–0.81	–0.10	1.14	–0.01	0.71	–0.70	–0.29	–0.40	0.48	–0.31	–0.09	–0.46	0.51	–0.30	0.42	–0.67
2002	–0.77	–0.82	–0.05	1.55	–0.41	0.88	–1.02	–0.25	–0.47	0.38	–0.19	–0.20	–1.22	0.33	–0.15	0.79	–0.94
									Voice and accountability								
1996	0.58	0.10	0.22	0.89	–1.22	1.30	0.07	0.27	–0.06	–0.05	–0.21	–0.69	–0.37	0.68	0.01	0.74	0.06
2002	0.12	0.01	0.28	1.12	–1.38	1.15	–0.06	0.38	–0.55	–0.27	0.33	0.22	–0.53	0.63	0.20	0.95	–0.41
									Political stability								
1996	0.50	–0.28	–0.01	0.72	0.23	0.79	–0.66	–0.55	–0.97	0.92	–0.27	–0.72	0.10	0.19	0.21	0.69	–0.39
2002	–0.74	–0.20	0.17	1.04	0.22	1.06	–0.70	–0.84	–1.78	0.51	0.22	–0.67	–1.33	0.49	0.55	0.91	–1.20
									Government effectiveness								
1996	0.27	–0.49	–0.19	0.95	0.11	0.02	–0.66	–0.16	0.02	0.81	–0.22	–0.24	–0.67	0.48	0.31	0.46	–0.69
2002	–0.49	–0.53	–0.22	1.19	0.18	0.37	–0.96	–0.13	–0.39	0.92	0.15	–0.47	–1.29	0.84	0.28	0.51	–1.14

[a]Values for each of the indices run from –2.5 to +2.5. The index for overall institutional quality is the unweighted average of the subindices.

Source: Kaufmann et al. (2003); own calculations.

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Kiel Institute for World Economics