



Economic Premise

APRIL 2010 • Number 10

A Brave New World for Latin America

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With variations across countries, Latin America's economic agenda will change over the next few years. Fiscal policy will be monitored more independently, and may lean more against cycles. Financial regulation will be heavier, and less attuned with a single international model. Innovation will be at the center of trade strategies. Equity will begin to replace equality as the driver of social programs. More state agencies will be managed by results, starting the long process of earning citizens' trust. The region will play a larger global role, led by Brazil. And if the world's economy holds, most Latin Americans will be on a faster development path.

Introduction and Summary

In 2009, Latin America dodged a bullet. Its efforts over the previous decade at better economic management and smarter social policy paid off, and the worst global recession in a generation caused only minor damage. Does this mean that the region will go back to business as usual, back to a commodity-fueled bonanza, back to *la vida loca*? No, it doesn't. The crisis has opened challenges that our policy makers will be forced to address, and opportunities they will be foolish to ignore.

This report describes those challenges and opportunities, and uses them to visualize how the region's economic policy agenda will change over the coming years. It does not focus on all the issues that will be relevant, but on those that will be relevant and different.¹ Specifically, it will argue that six new issues will appear on the radar of Latin American policy makers: fiscal decision making that smoothes, rather than exacerbates, business cycles; a profound preoccupation with innovation as a means to commercial survival; adaptation to

a changing regulatory wisdom in finance; the shifting of social policy from equality to equity; the use of results to rebuild trust in the state; and the realities of having a bigger role in world affairs.

Not all Latin American countries will move along the new agenda at the same speed. A few have already started, and a few may even go for a while in an opposite direction. Overall, however, the picture that emerges is one of second-generation policies, a reflection of well-managed economies making the most of a promising development horizon.

Independent Fiscal Agencies

The crisis has shown the wisdom of governments that save in good times to spend more during downturns—the wisdom of “countercyclical fiscal policy.”² That simple principle brought huge economic and political rewards to those that practiced it (for example, Chile). But it did more than that. It opened the door to a new way of thinking about public

finance. Much as in the early 1990s when worries about inflation led many Latin American countries to stop printing money to pay for fiscal deficits and to shift control of the printer to an independent central bank, worries about unemployment may now lead them to link taxation and public investment to growth. In the 1990s, half a dozen of our countries adopted “inflation targets,” and met them. The times for more independent fiscal decisions that take into account “growth targets” cannot be too far away.

Will independent fiscal agencies become common in Latin America? Probably. But they will have advisory rather than decision-making roles. That is, they will be fiscal “councils” rather than fiscal “authorities.” In fact, a couple of councils already exist (Brazil, Chile), mostly in the form of technical support for parliaments. As more countries in the region implement “fiscal frameworks” or “fiscal responsibility laws” (and 10 already have), independent monitoring will become a necessity—both to judge the realism of budget projections and to hold government’s accountable during execution. To some extent, private organizations (for-profit and not-for-profit) have been providing that kind of monitoring service for a while. As pressures mount for fiscal policy to be (and be perceived to be) countercyclical, the role of fiscal watchdog will become institutionalized within the apparatus of the state, but outside the control of incumbent governments.

There may be an additional force pushing for independent fiscal opinions: the continuing accumulation of commodity-related revenues. In the baseline global scenario, growth in Asia will keep commodity demand strong and commodity prices high. Volumes may also increase, driven by recent discoveries of oil and gas (Brazil, Colombia). This will translate into fiscal abundance for many Latin American countries. In that event, some of those monies will have to be saved in sovereign wealth funds, whose rules of operation will be the subject of much debate. Having independent agencies monitor the application of those rules and, at times, provide technical input (for example, in forecasting prices) will become a more accepted practice—and a way to avoid political meddling.

Innovate or Perish

Successful Latin American countries will have to learn to live with appreciated currencies. With interest rates in the developed world likely to stay floor-low for a while, money will continue to flow into the region’s more promising economies. This will make them less competitive. There is not much they can do about it—accumulate reserves, impose capital controls and taxes, keep banks from credit sprees, increase productive efficiency. But those are either unsustainable measures or long-term reforms. The reality is that living in,

or exporting from, places like Bogotá, Lima, São Paulo, or Santiago will be more expensive in U.S. dollars. It will be more difficult to sell our products in the United States and in any other country that keeps its currency tied to the U.S. dollar (notably, China). That is why success in trade will now depend more on new products. Although getting additional free trade agreements will still be good, creating new brands will be even better.

The problem for Latin America is that, on the whole, it has not excelled at innovation. It invests too little in research and development, provides few tax incentives, does not protect intellectual property well, and has universities that are disconnected from its businesses. This is reflected in minute levels of patent registration, declining total factor productivity (relative to the U.S. benchmark), few firms acquiring quality certifications (less than a quarter), and a commercial penetration that has been stagnant for decades (only about 5 percent of world trade has a Latin American as partner) (figure 1). Even the precrisis years of abundant financing saw only a handful of new Latin American business lines come to market—premium foods, medical tourism, aeronautic engineering, software development, and call centers.

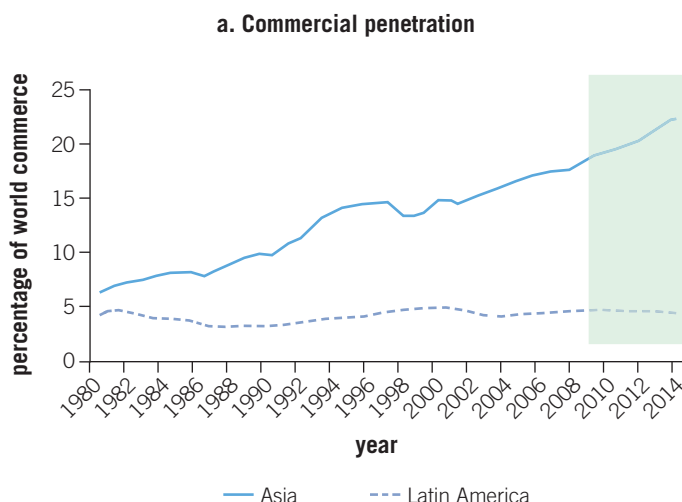
It will take years to fix those problems, but the new global reality will make change unavoidable. Will there be a single formula to foster innovation in Latin America? No. Our countries differ in terms of technological stock, efficacy of tax systems, quality of human capital, legal predictability, and institutional capacity. But successful innovation strategies show some common features that point the way forward: they are priorities of the state (they do not change from government to government); they are not based solely on markets; all relevant stakeholders are engaged (big and small, public and private); somebody is accountable for results; they are part of a broader effort of integration; they are well funded; they are continuously evaluated and adjusted; they begin with quick wins (usually in the area of quality standards); they include reforms in tertiary education; and they operate within a reliable legal framework.

It is interesting to note that more private innovation in Latin America will call for better public action. From venture funding to skill improvement, the state will have a new role to play. Rather than taking the exclusive leadership as it tried in the past (with poor results), it will become a catalyzing partner in multiagent efforts. In some cases, it will contribute resources; in others, it will contribute reforms.

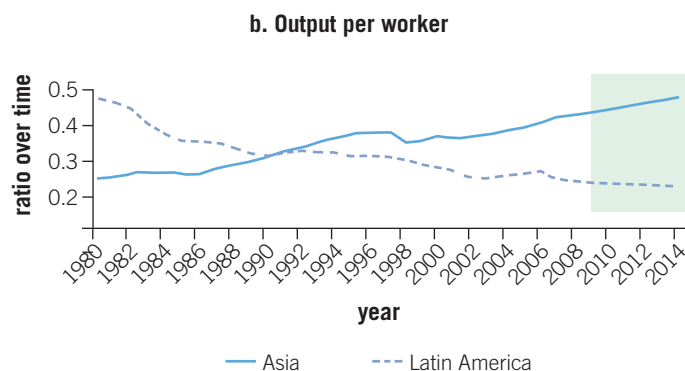
Reinventing Finance

We will be wary of fancy finance. Our banks and bourses sailed through the crisis rather well. There were no subprime surprises in Latin America. In part, that is because our financial sectors are small, unsophisticated, and with limited ex-

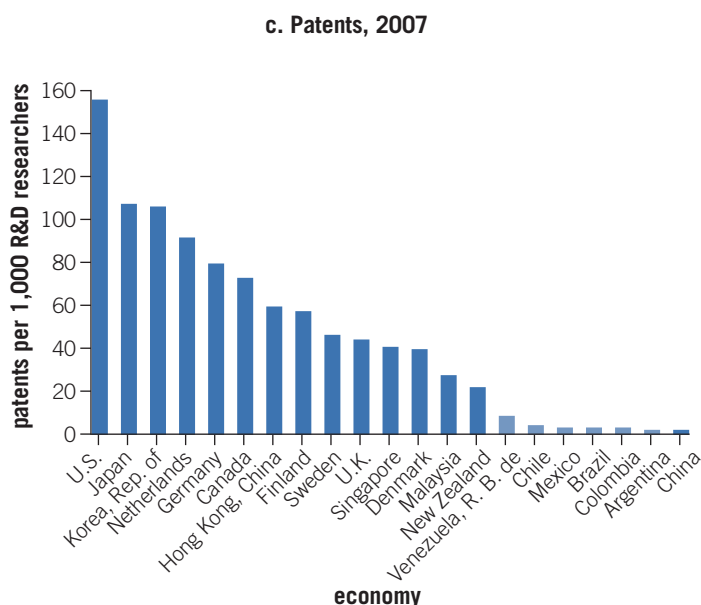
Figure 1. Symptoms of Innovation, or Lack of It



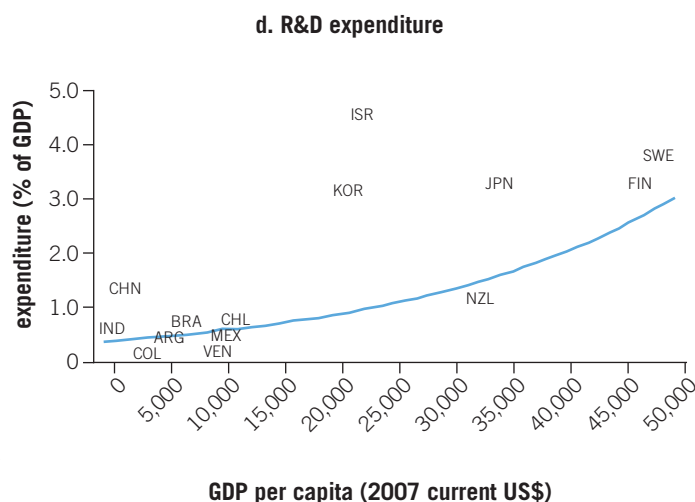
Source: World Bank staff calculations and projections, based on International Monetary Fund (World Economic Outlook) data
 Note: Commercial penetration is defined as exports plus imports as a percentage of world commerce.



Source: World Bank staff calculations and projections, based on Heston, Summers, and Aten (2006).
 Note: The chart shows the output per worker as a ratio of the U.S. output per worker over time. The Latin America aggregate is calculated as the unweighted average of Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, Peru, Uruguay, and República Bolivariana de Venezuela. The Asia aggregate is calculated as the unweighted average of China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Singapore; Taiwan, China; and Thailand.



Source: World Bank staff calculations, based on World Intellectual Property Organization and World Bank data.
 Note: R&D = research and development. The chart shows the number of patents in the United States per 1,000 researchers in research and development.



Source: World Bank staff calculations, based on World Bank data.
 Note: The chart shows the relationship between R&D expenditure as a percentage of GDP and the GDP per capita.

ternal connections; and, in part, because we still regulate them in a heavy-handed, old-fashioned way. On top, our remaining publicly owned banks came in handy to keep credit flowing. Meanwhile, the developed world, shocked by the excesses on Wall Street, entered a wide debate about new ways to control financiers without killing their creativity. From how much capital banks should hold to how much

bankers should be paid, and from who is “too big to fail” to how savers should be protected, it is all up for discussion. Over the next couple of years, governments in our region will have to decide how much of the new thinking to adopt, adapt or avoid.

In practice, regional policy makers will be dealing with financial issues at both ends of the technical spectrum. On the one hand, postcrisis second-generation questions will have to be addressed—countercyclical regulation, systemic risk, and nonbank intermediaries. On the other hand, a long list of basic but critical matters that preceded the crisis remains

pending, especially in terms of competition and efficiency, access by the poor, and underdeveloped equity markets.

That policy dichotomy will play out at a time when Latin America's financial sector will be under pressure. In the short-term, and as described earlier, foreign capital inflows will be abundant. Much of these inflows will be reflected in excess liquidity among domestic banks and in larger domestic lending. Some will flow into the regional equity markets, which (given their relatively small size) may quickly experience a surge in prices. In both cases, the domestic financial sector will be exposed to sudden capital flow reversal. Regulating this risk away will not be easy.

A different challenge emerges in the medium term. The region's largest countries are expected to continue experiencing surpluses in their balance of payments' current accounts, led by high commodity prices. The counterpart of those surpluses—large domestic savings—will need to be intermediated. In other words, the balance sheet of Latin America's financial system will expand considerably. Whether this fosters consumption or investment, at home or abroad, by the public or by the private sector, will depend on the regulatory parameters under which the system is made to operate. In the recent past, markets could be relied on to set some of those parameters (for example, through credit ratings); de facto, the crisis has shifted that responsibility almost entirely back to governments.

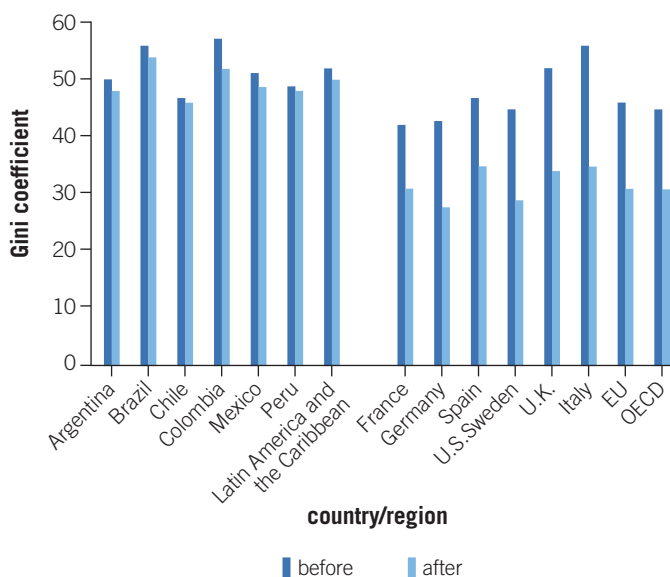
Equity, More than Equality

We have learned the value of knowing the poor by name. An estimated 8 million Latino-Americans fell into poverty in 2009, and about 5 million missed their chance to leave poverty behind. Those are sad numbers; but, compared with past experience, they are very small. What sheltered us? We avoided jumps in inflation, so people's purchasing power did not melt. But more remarkably, for the first time we had effective mechanisms to protect the poor. Thirteen of our countries had spent the previous decade identifying the poor one by one, and setting up channels to transfer cash directly to them—not an easy task when you think that the poor rarely have bank accounts or even postal addresses.³ This has provided a platform for the next big move in Latin American social policy: to focus on equality of opportunity, on giving everybody the same chances rather than the same rewards, on equity rather than equality.

Latin America remains the most unequal region on earth. Inequality dominates virtually all its development outcomes—income, educational achievement, landownership. Taxation and public expenditures have made little difference in addressing the problem (figure 2).

The result has been acrimonious political disagreement over the proper role of the state: should it redistribute wealth

Figure 2. Gini Coefficients before and after Public Transfers, circa 2006



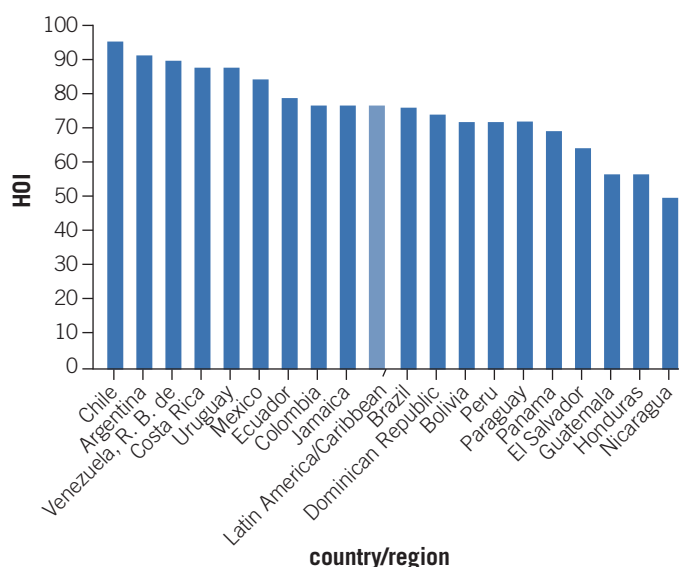
Source: World Bank staff calculations, based on World Bank and OECD data.
Note: EU = European Union; OECD = Organisation for Economic Co-operation and Development.

or protect private property? This has weakened confidence in the region's legal security, to the detriment of long-term investment. There is no disagreement, however, over the need to give all Latin Americans the same opportunities, as a matter of social justice or as a call to personal effort. Equity enjoys support across the political spectrum. The problem was that we had never been able to systematically measure inequality of opportunity, in Latin America or anywhere else. The development profession simply lacked the methodological tools to monitor equity, making it all but impossible to design, implement, and evaluate public policies that target human opportunity.

That changed in 2008. A new technology to measure inequality of opportunity—the Human Opportunity Index (HOI)—became available, the creation of a team of Latin American researchers. In essence, the HOI calculates how personal circumstances (like gender, skill-color, or family income) affect the probability a child has of accessing the services that are necessary to succeed in life (like timely education, basic health care, or connection to electricity). Figure 3 shows the 2010 HOI for Latin America.

The HOI, combined with the data and logistics embedded in the direct cash transfer programs that Latin America now has, will make it possible to redirect its social policy toward equity (where there is consensus) and away from equality (where there is not). How? Many existing social policies and programs are already equity enhancing. But focus on equity reveals new points of emphasis along the individual's

Figure 3. Human Opportunity Index, 2010



Source: World Bank 2010 Human Opportunity Report.

life cycle. Early interventions, from pregnancy monitoring and institutional births to toddlers' nutrition and neurological development, get a new sense of priority. So do pre-school access (such as prekindergarten social interaction) and primary-school achievement (such as reading standards and critical thinking). The physical security, reproductive education, mentoring, and talent screening in adolescents—all areas that are often overlooked—gain new relevance. A battery of legal and institutional preconditions becomes essential: from birth certificates, voter registration, and property titles; to the enforcement of antidiscrimination, antitrust, and access-to-information laws. And blanket subsidies that, at the margin, are consumed by those who do not need them (free public college education for the rich, to name one) turn into opportunity-wasting aberrations. If nothing else, the quest for equity will lead to a final push in the decade-long process of subsidy focalization, and will spell the end for a way of giving out public assistance that was blind to the needs of the recipient (a way that was intrinsically unfair).

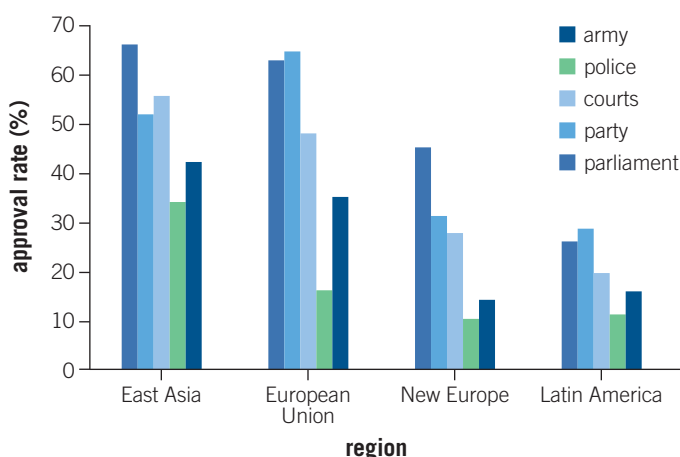
Trust the State

From now on, we will demand a lot more of the state—to spend more, to regulate more, to protect more. Trust in free markets has been damaged. But Latino-Americans never really trusted the state either. That is why they refuse to fund it, and remain trapped in a vicious circle of tax evasion and deficient public services. Even progress in fighting corruption (which, unheralded, has occurred) has not done much to rebuild the relationship between our state and our people (figure 4).

That will need to change soon. Technology and politics will help. New ways to hold public institutions accountable have been penetrating the region for a while, initially among municipalities and provinces where mayors and governors face voters more closely. We now have standards to measure the quality of education, infrastructure, security, and any other public service. How many words per minute should a second-grader read? At least 60. How much should the cost of logistics be for every dollar exported? No more than 10 cents. What should be the “normal” annual homicide rate? Three for every 100,000 people. The list goes on. Few services in few of our countries are, of course, up to par. But political leaders who have committed publicly to this kind of results do very well in the polls (for example, in Brazil). Others will surely follow. The average Latin American state will be increasingly managed and judged by the results it achieves.

There will be another force pushing the state toward results-based management—devolution. Ushered in by the return of democracy in the 1980s, Latin America entered a rapid process of decentralization in the mid-1990s. Tax and expenditure responsibilities were delegated to provinces and municipalities. The quality of public services did not always improve. But decentralization proved popular and is bound to deepen. At the same time, the new ways to do social assistance described earlier showed the possibilities opened by the state's ability to communicate with, and transfer resources to, individual citizens. On a simple magnetic card or even a cell phone, the state can transfer directly to the beneficiary the funds to buy or the right to access almost any service, from vaccination to college education. There is no longer a need for intermediaries. Decentralization will be gradually moving down to the citizen's level; in a way, it will become “devolution.” This new, direct relationship between

Figure 4. Trust in the State



Source: Blind 2006.

people and the state is generating, and will continue to generate, a wealth of information—about costs, quality, targeting, needs, outcomes, impacts. Monitoring and evaluation of policies and programs will be much easier. And management by results will become natural.

A Global Player

The 2009 crisis created new forms of external support and integration for Latin America. Our multilateral lenders were promised larger lending capacity and more fair representation. Flexible financing for good performers was quickly offered. The G-20 brought Argentina, Brazil, and Mexico to the table where the decisions that will shape the world will be made. In the redesign of financial regulation, the next round of trade negotiation, or the efforts to slow climate change, Latin Americans now have a better opportunity to be heard. They will also count in the rebalancing of the global matrix of saving and consumption; after all, their consumption is larger than China's in absolute dollar terms and as a proportion of GDP. The region is even seeing the emergence of its first, own global leader—Brazil.

But our contribution to global commons will go farther. A new generation of former national leaders left, or will soon leave, office in success and popularity (in Brazil, Chile, Colombia, Costa Rica, Mexico, and Uruguay, to name a few). Playing by market rules but listening to their people's needs, they delivered prosperity and social progress for their countries. Their governments have not only done well using traditional policy tools, but have also pioneered new ones (such as structural fiscal balances and conditional cash transfers). They are now credible spokespeople for good administration, and are much sought after in the international conference circuit. They have become global assets who will give the region a new voice.

This new relevance will bring new disciplines, and will reinforce others. It will be more difficult for Latin American countries to backtrack in trade and financial openness, and more painful to lose investment grades. Worldwide rankings will have larger domestic impact (call it the “embarrassment factor”), from those dealing with public transparency to those dealing with the quality of the business environment. And light may begin to shine on long-postponed reforms, without which the benefits of integration are diluted—notably, in education and infrastructure.

Conclusion: If the World Holds, Latin America Will Take Off

The alignment of domestic and external factors augurs well for Latin America's future. Macroeconomic and financial discipline, combined with smarter social policy and a more

responsive public sector, may not yet be universal values in the region; but an increasing number of countries are adopting them as part of their development strategies. Our voters begin to reward sensible policy making. At the same time, the rapid growth of the middle classes in Asia should ensure high, long-term prices for what Latin America sells. If well managed, this “commodity platform” could be the stepping-stone for the region to upgrade its productive capacity (especially its human capital) and expand its brand beyond natural resources.

Are there downside risks? Yes, many. Most come from the global economy. The recovery could be a slow, protracted process, dragged down by balance-sheet adjustments (for example, in mortgage markets) or second-round effects (such as persistent unemployment). Commodity prices may dive if the liquidity injected by the G-7 during the crisis is rolled back too quickly, or if China's domestic consumption does not compensate for the return of its public investment to prestimulus levels. Massive fiscal imbalances in the United States will not be easy to correct, hinting at much higher interest rates (and/or dollar inflation) in the near future. A downgrade of sovereign debt among developed countries could trigger a flight to safety and away from emerging markets. And there are plenty of uncertainties at home: specific countries could still run into overheating and high inflation, breakdowns in internal security, or political turbulence.

Any of those risks could derail Latin America's growth, at least for a while. But for the first time in decades, its fundamentals look solid and the horizon promising. In the base external scenario, and with variations across countries, the region as a whole is converging on a path of sustained development.

Notes

1. The views presented in this report are the author's own, and do not necessarily represent those of the World Bank Group or of its board of executive directors.
2. At the margin, the crisis also showed the wisdom of building agile public investment systems. Several countries (Brazil, Chile, Colombia, Peru) quickly embarked on strengthening those systems.
3. The process of identifying the poor forced a parallel process of integration of individual social records across ministries and agencies; this should further facilitate tailoring social programs to individual needs.

About the Author

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