Part ONE

Latin America and the Caribbean in 1996: Adjusting to Reform

INTRODUCTION

Latin America staged a recovery in 1996 from the economic and financial turbulence that had affected much of the region during the previous year. The region's rate of economic growth rose to 3.6 percent from 1 percent in 1995, a recovery primarily propelled by relatively high rates of growth in Argentina and Mexico, the two economies most affected by the crisis. In other countries of the region, however, growth generally slowed somewhat in 1996. Preliminary indications are that prospects for growth continue to improve during 1997, with a probable growth rate of roughly 4 to 4.5 percent.

Inflation remained relatively subdued in 1996, with the median rate barely above single digits. Particularly notable was the ability of Mexico to bring inflation under control, as well as the continued success of the Brazilian stabilization, which has brought inflation down from well over 1,000 percent in 1994 to 11 percent in 1996.

Fiscal policy remained restrained in most countries of the region, with the (population-weighted) average fiscal deficit at about 1.5 percent of GDP. In several countries, however, large fiscal deficits complicated macroeconomic policy management and posed potential threats to macroeconomic and financial stability over the medium term.

Taking the region as a whole, the recovery of investment that has been a hallmark of the 1990s in Latin America continued during 1996, when investment grew by 5.6 percent. However, this increase is due to a large extent to major expansions of investment in Argentina and Mexico from very depressed levels of 1995. Investment in the remainder of the region was disappointing, rising only 2 percent in Brazil, and declining, on average, in the rest of the countries. Investment fell significantly in the Andean subregion as well as in Central America and the Caribbean.

More encouraging was the performance of exports, which grew robustly in most of the region. With the major exception of Brazil, where real exports of goods and services stagnated for the third year, strong export growth was widespread, with real exports growing at or near double-digit rates in all of Latin America's major subregions.

Consumption grew more slowly than income in 1996, signifying that saving rates in the region continue

Table 1. Major Economic Developments

	1994	1995	1996
Real GDP growth (% change)			
Regional average (GDP-weighted)	5.8	1.0	3.6
Regional average (population-weighted)	5.2	1.8	3.4
Argentina	8.5	-4.6	4.4
Brazil	6.0	4.2	3.0
Mexico	4.5	-6.2	5.1
Other countries	4.1	4.9	2.8
Growth of real demand (% change)			
Consumption	5.9	3.7	2.8
Investment	9.6	2.6	5.6
Exports of goods and nonfactor services	6.8	11.6	8.3
Imports of goods and nonfactor services	16.0	17.4	8.4
Consumer price inflation (Dec/Dec % change)			
Median	14.8	12.0	11.3
Average (population-weighted)	457.4	27.3	19.3
International payments (US$ billions)			
Current account surplus	-48.4	-31.9	-36.6
Net capital inflows	43.8	56.4	63.2
Reserve accumulation (increase = -)	4.6	-24.5	-26.5

Sources: IDB economic and social database and IMF, *International Financial Statistics*. Unless otherwise noted, regional averages are population-weighted.

FIGURE 1

GDP Growth

(Percent)

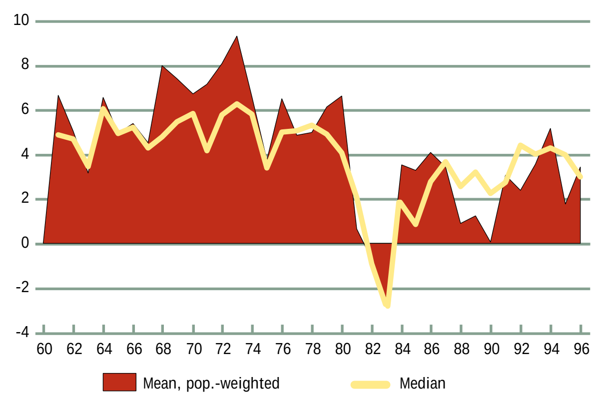
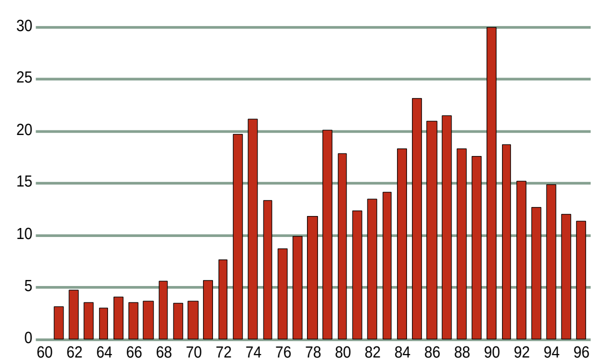


FIGURE 2

Median Inflation Rate

(Dec/Dec percent change in CPI)



to rise after the sharp decline experienced in the first years of the 1990s. Brazil, however, is a major outlier. Still in the early stages of its inflation stabilization, the country experienced a major decline in its rate of saving during 1995 and 1996. In other countries of the region, however, the average rate of saving has risen from a low of 15.3 percent in 1993 to 18.1 percent in 1996, returning to the levels of the late 1980s. Still, with only a few exceptions, rates of saving in the region remain below the levels reached in the 1970s.

International capital flows returned to the region with enthusiasm. At $63 billion, net capital flows averaged about 3.5 percent of GDP and roughly matched the rate of 1993, despite substantially reduced rates of net borrowing by Argentina and Mexico, which had been the major borrowers during the early 1990s. In the other countries of the region, net capital flows reached 4.5 percent of GDP, driven by large inflows to Bolivia, Brazil, Colombia, Chile and several of the smaller economies, including a notable surge of capital flows to Jamaica, where they reached nearly 10 percent of GDP.

Indicators of the perceived creditworthiness of Latin American borrowers, such as Brady bond prices, showed sharp improvements during 1996. Several countries used the favorable conditions in international financial markets to access those markets for the first time, or to restructure their international debts to obtain better financing terms and an improved debt profile.

The capital inflows were used to finance current account deficits that averaged just over 2 percent of the region's GDP, roughly the same as in 1995, and to finance reserve accumulation of roughly 1.5 percent. However, current account deficits increased to potentially problematic levels in a number of countries.

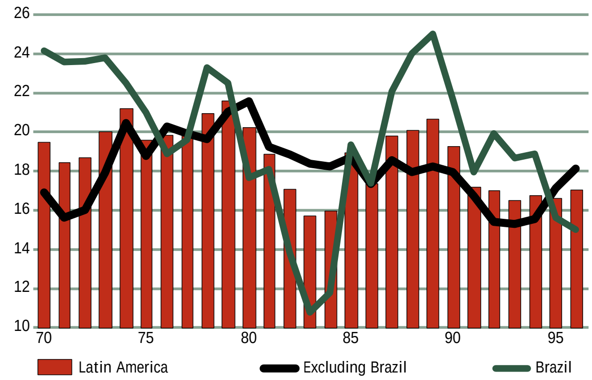
The modest rate of economic growth in 1996 was insufficient to secure a reduction in the region's unemployment rate, which increased to about 8 percent. The (population-weighted) average rate of unemployment in the region is now approaching the level reached at its recent peak of 1984, and has increased by nearly two percentage points since 1990.

However, as we will discuss in more detail below, this trend is somewhat exaggerated by the extraordinary experience of Argentina, where unemployment has risen from the low single digits in the 1970s to nearly 18 percent in 1996. Unemployment has increased and remains a grave problem in most of the region, but in countries other than Argentina the increase since 1990 has been much smaller, and the rate of unemployment remains substantially below that recorded in the mid-1980s.

FIGURE 3

National Saving, 1970-96

(Percent of GDP, pop.-weighted)



Source: IMF, *World Economic Outlook* database, and IDB projections.

FIGURE 4

Capital Flows, 1979-96

(Percent of GDP)

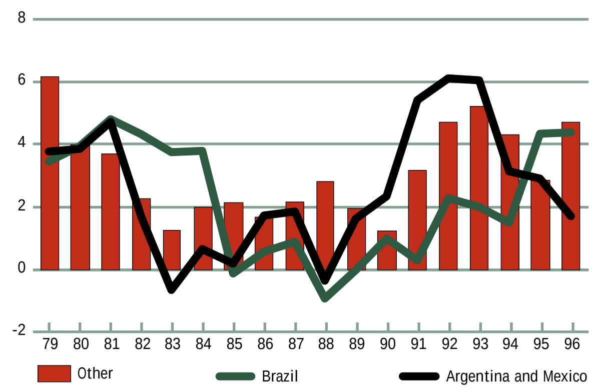
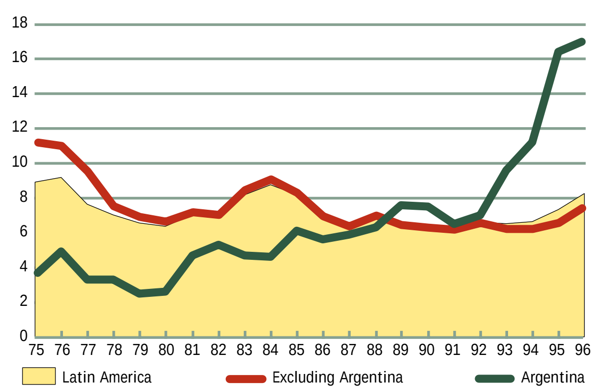


FIGURE 5

Unemployment, 1975-96

(Percent of labor force, pop.-weighted)



Perhaps most striking about economic developments in 1996 is the very substantial diversity of experience among the economies of the region. Argentina and Mexico are in the midst of a robust recovery from the economic crisis of 1995. Brazil finds itself managing an expansion of domestic demand that threatens to generate unsustainable external imbalances, while in many other countries, including in particular several in the Andean region and in Central America and the Caribbean, the year saw relatively slow economic growth, disappointing investment performance, and in some cases the appearance of economic and financial tensions.

Some of the divergences are explained by differences in the external environment faced by the various countries, and others by important differences in policy stance. Economic outcomes in most countries were also significantly influenced by the process of economic adjustment to the stabilization and reform programs of the 1990s. As was discussed in last year's report on Economic and Social Progress in Latin America, the adjustment to such reform programs has tended to involve a fairly well-defined process that includes an initial expansion in private spending and financial intermediation, a period of deceleration as the economy is forced to cope with fiscal, financial and external vulnerabilities generated by the preceding expansion, and a period of correction that sometimes, but not always, involves a crisis. Finally, if macroeconomic stability is not lost or is rapidly restored after the correction, the economy enters a post-correction period. What distinguishes this period from the ones that preceded it is neither the depth or quality of the reforms that have been implemented, nor the need for further reforms, but simply the fact that the short-term, cyclical dynamics associated with adjustment to the stabilization and reform program gradually cease to be the dominant influence over economic activity.[1]

EXTERNAL ENVIRONMENT

World Economic Activity and Financial Markets

The external environment remained relatively favorable during 1996. The economically advanced economies grew about 2.5 percent in 1996, the same rate as in 1995.[2] Growth accelerated somewhat in the United States and Japan, and declined in Europe and the other advanced economies. Growth in the developing economies increased from the 6 percent recorded during 1995 to 6.5 percent in 1996.

Despite this continuation of moderate economic growth, there was a slowdown in the growth of world trade volumes. Real imports of the advanced economies grew by only 5.3 percent in 1996, significantly lower than the 8.7 percent growth rate recorded during 1995. Real import demand of the world's developing economies also grew more slowly in 1996.

International Monetary Fund projections suggest that the climate for international trade will improve somewhat in 1997, with the rate of economic activity expected to accelerate modestly in the industrial economies, and growth in the volume of world trade to increase.

International financial markets provided a favorable climate for developing economies. Short-term interest rates fell during 1996 in all major currency areas, and capital flows from industrial to developing economies increased. In the first quarter of 1997, U.S. interest rates rose slightly, as the monetary authorities acted to ensure that robust economic growth would not create inflationary pressures. But large increases in U.S. interest rates are not expected; for 1997 as a whole, IMF projections are that short-term interest rates will rise by about 40 basis points in the United States and 30 basis points in Japan, while remaining roughly unchanged in Europe.

Table 2. External Environment

(Percent)

	1994	1995	1996	1997p
Real GDP growth				
Advanced economies	3.1	2.5	2.5	2.9
Developing economies	6.8	6.0	6.5	6.6
Growth of real imports				
Advanced economies	9.7	8.7	5.3	5.9
Developing economies	7.2	11.6	8.3	10.7
Short-term interest rates				
Dollar	4.2	5.5	5.1	5.5
Deutsche mark	5.3	4.5	3.3	3.3
Yen	1.9	1.0	0.3	0.6

Source: IMF, *World Economic Outlook*, April 1997. Figures for 1997 are IMF projections.

[1] This process is described in more detail in Box 1, and at much more length in the 1996 Report on *Economic and Social Development in Latin America*.

[2] The International Monetary Fund now classifies a number of newly industrialized economies in Asia (Hong Kong, Korea, Singapore and Taiwan), as well as Israel, together with the industrial economies, reflecting the advanced stage of economic development that these countries have reached.

Box 1. Tendencies in the Adjustment to Stabilization and Reform in Latin America

The 1996 Report on *Economic and Social Progress in Latin America* contained an extended account of the stabilization and economic reform programs of the 1990s and an analysis of their short-term macroeconomic consequences. Those consequences remain an important influence on macroeconomic outcomes and policy dilemmas in 1996 and 1997, so we provide here a brief summary of the stylized facts.

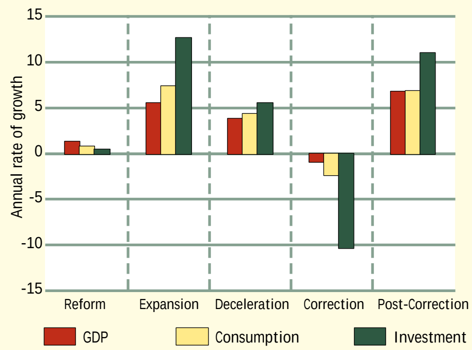
While no two reform programs have been identical, a pattern is frequently, though not universally, observed. This can be divided into four key periods: (i) an initial period of economic expansion, followed by (ii) a period of deceleration, during which there has frequently appeared economic and financial stress, which in turn often requires (iii) a correction or crisis, which is then followed by (iv) a post-correction period, when the stabilization and reform package gradually ceases to be the dominant influence on macroeconomic developments.

Post-reform expansion: Stabilization and reform are generally followed by recovery of economic activity. The recovery is fostered by the improved confidence that typically follows an inflation stabilization, and by elements of the reform programs such as liberalization of trade and financial markets, which promote a short-term increase in private spending. The strong response of consumption and investment spending to the economic reform is illustrated in the first figure above, which compares the growth rates of domestic production and spending with those of a normal year.

This expansion in private spending is typically accompanied and magnified by a boom in domestic bank lending, which is itself fostered by the remonetization of the economy that follows inflation stabilization. Such lending booms often reduce the quality of bank portfolios; thus, financial vulnerabilities tend to grow as the boom proceeds. The private spending boom also generates a transitory public revenue boom that may mask an underlying fiscal disequilibrium. It is also typically accompanied by substantial current account deficits that render the economy vulnerable to a loss of confidence.

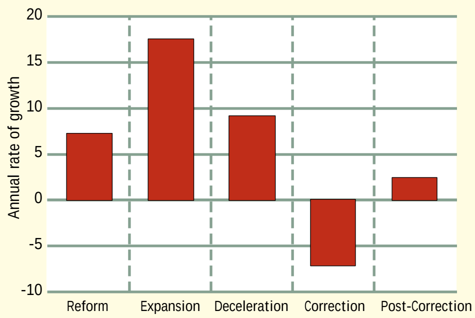
Growth Rates of Real GDP and Spending

(Percent)



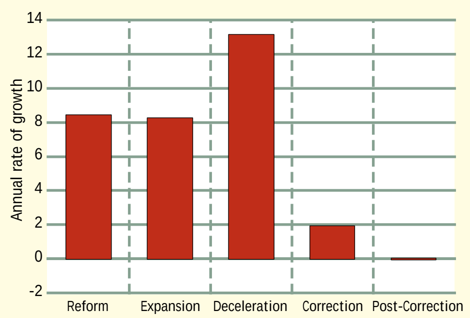
Real Bank Claims on the Private Sector

(Percent)



Real Interest Rate

(Percent)



Deceleration: Eventually, the growth in private spending and bank lending slow to more sustainable rates. As bank credit becomes more scarce, previously hidden flaws in bank balance sheets may become more apparent, reducing confidence in the domestic financial system. Scarcer credit and concerns about the viability of the monetary and financial system contribute to higher interest rates, aggravating the difficulties faced by the financial system. The slowdown in private spending reduces the public revenue boom, making latent fiscal imbalances visible. And international investors, already beginning to contemplate the prospect of a potentially painful external adjustment, are increasingly asked to finance large external deficits. These circumstances make the economy vulnerable to domestic or foreign shocks, or to a loss of confidence.

Correction: The economic and financial imbalances that develop during the recovery phase require correction. This correction has frequently, though not always, been traumatic, with domestic output and spending falling sharply, generally in the context of a major contraction of bank credit and an acceleration of inflation. The experiences of Argentina and Mexico in 1995, Venezuela in 1994-95, and Chile in 1982-83 illustrate in extreme form the crisis that can emerge when the vulnerabilities that develop during the boom are large.

Post-correction: What comes next depends in large part upon whether authorities can rapidly contain the macroeconomic instability that may be generated during the correction. If this is not achieved, as in Argentina and Uruguay in the early 1980s and Venezuela in 1993-94, the country faces the task of restarting the process of stabilization. If macroeconomic stability is preserved or rapidly reestablished, as in Chile and Bolivia in the 1980s, and Argentina and Mexico in the 1990s, the economy can look forward to a period of renewed recovery, during which the short-term, cyclical dynamics associated with reform become of decreasing significance.

Increased Capital Flows

Capital flows to Latin America increased to $63 billion in 1996, roughly 3.5 percent of the region's GDP. In dollar terms, these inflows roughly matched those received by the region during the previous peak year of 1993. There are some important differences, however, in the composition of the flows. Unlike in 1993, when inflows to Argentina and Mexico accounted for nearly two-thirds of the total, these two countries received less than 20 percent of the total in 1996. Brazil became the dominant destination for international capital flows to Latin America in 1996, accounting for about 60 percent of the total. In other countries of the region, capital inflows averaged nearly 5 percent of GDP.

There was an equally important change in the composition of capital flows between 1995 and 1996. During 1995, over half the total flows to Latin America were from official sources, mainly associated with the international response to the crises in Argentina and Mexico, while private capital flows fell sharply. In 1996, on the other hand, official flows to the region were negative, as Mexico repaid most of the official support that it had received in 1995, while private capital flows increased dramatically.

The very large flows of capital to Latin America and other regions of the world are attributable in large part to financial conditions in the industrial economies. But they also reflect a substantial improvement in market perceptions of the creditworthiness of Latin American borrowers. This improvement is visible in the Brady-bond interest rate spread over U.S. Treasury bonds that is charged by financial markets.

At the end of 1995, when signs of recovery from the Tequila crisis were only beginning to emerge, investors were imposing spreads of 9.5 to 15.5 percent as compensation for the country risk embedded in Latin American Brady bonds. By the end of 1996, this premium had declined to between 5.25 and 8.25 percent, with most countries registering significant further declines in the first quarter of 1997.

Several countries took advantage of the favorable conditions in international financial markets to restructure their international obligations to secure more advantageous financial terms and an improved debt profile. A notable feature of the borrowing programs of many countries in the region was the lengthening of debt maturity that they were able to accomplish. Several countries, including Argentina, Colombia and Mexico, successfully issued debt of 20 and 30-year maturity in a number of major currencies. In one particularly innovative program, Mexico issued 30-year bonds and used the proceeds to buy back outstanding Brady bonds, managing both to lower debt servicing costs and to extend the effective maturity profile. Similarly, in mid-1997 Brazil completed a $3 billion international bond issue, with a maturity of 30 years, and used the proceeds to buy back outstanding Brady bonds.

Table 3. Stripped Spreads on Latin American Brady Bonds

(Percent)

	Dec. 95	Dec. 96	March 97
Argentina	9.56	6.44	4.87
Brazil	9.33	5.39	4.48
Ecuador	15.68	8.25	8.62
Mexico	10.46	6.27	5.19
Venezuela	14.87	5.21	5.36

Note: Figures represent the spread over comparable U.S. Treasury bonds of representative Brady bonds, after the collateral has been stripped out of the bond.
Source: West Merchant Bank.

The favorable conditions in international financial markets also permitted some countries to enter for the first time—or reenter after long absences—the international bond markets. Ecuador and Panama have recently completed substantial issues, Guatemala is in the process of completing a $150 million issue, and a number of countries are expected to enter the markets in the relatively near future.

Terms of Trade

During 1996, the terms of trade were roughly unchanged in Latin America as a whole. There were important regional differences, however. Argentina and the Andean economies saw improvements in their terms of trade, largely driven by higher prices for petroleum and some agricultural products.

Most Central American and Caribbean economies, on the other hand, suffered reductions in their terms of trade, largely as a result of lower world prices for coffee, as the boom of 1994 and 1995 began to unwind, and higher petroleum prices.

Guyana, Venezuela, Jamaica, Ecuador and Argentina experienced substantial improvements in their terms of trade. Chile experienced the most significant deterioration, due to the adverse effects of a decline in copper

Table 4. Terms of Trade in Latin America

(Percent change)

	1994	1995	1996
Latin America	4.6	2.7	0.3
Argentina	-0.1	1.4	5.5
Brazil	3.7	4.0	na
Mexico	1.5	-1.4	-1.2
Other countries	8.1	7.2	0.2
Southern Cone*	3.6	4.2	-0.4
Andean economies	8.3	6.2	4.8
Central America and the Caribbean	7.1	8.4	-4.4

*The Southern Cone subregion excludes Brazil, which would otherwise dominate the average.
Note: All regional averages are population-weighted.
Source: IDB economic and social database.

Table 5. Growth Rates of Real Output and Demand in Latin America, 1996

(Percent change)

	Real GDP	Investment	Exports	Consumption
Latin America	3.5	5.6	8.3	2.8
Argentina	4.4	7.0	13.6	4.9
Brazil	3.0	2.0	0.0	3.7
Mexico	5.1	27.6	18.7	2.4
Other countries	2.8	-2.8	9.6	1.8
Southern Cone*	4.9	6.1	11.1	5.1
Andean countries	1.9	-4.5	8.7	0.5
Central America and the Caribbean	3.3	-2.6	12.2	2.7

*The Southern Cone subregion excludes Brazil, which would dominate the regional average.
Note: All regional averages are population-weighted.
Source: National and income accounts data from the IDB economic and social database.

FIGURE 6

Growth in Terms of Trade, 1996

(Percent change)

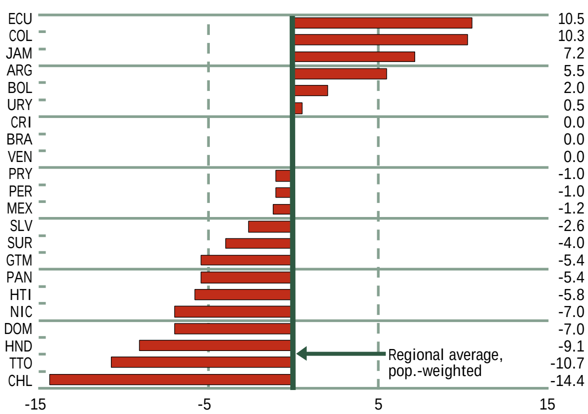
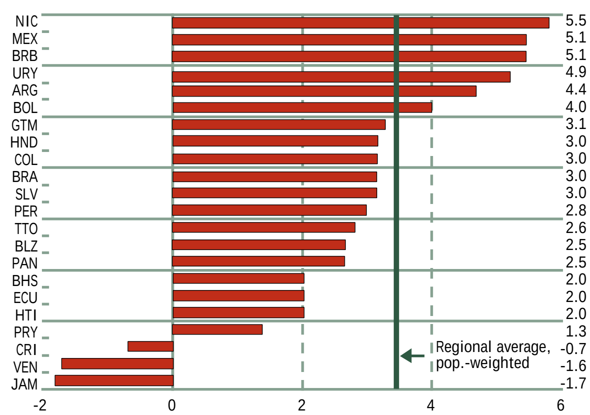


FIGURE 7

GDP Growth, 1996

(Percent change)



prices of more than 20 percent. Hardest hit in Central America and the Caribbean were Trinidad and Tobago, Honduras, the Dominican Republic, Nicaragua, Haiti, Panama and Guatemala, all of which experienced declines in the terms of trade of more than 5 percent during 1996.

ECONOMIC GROWTH AND EMPLOYMENT

The year 1996 was one of modest economic recovery for Latin America, during which the (population-weighted) average rate of real GDP growth rose to 3.5 percent from less than 2 percent in 1995. The recovery was primarily led by growth in exports, which rose 8.3 percent, and investment, which rose by 5.6 percent. The increase in consumption fell short of the growth rate of real output, indicating a modest increase in the region's low rate of saving.

Though a substantial improvement over 1995, economic growth was modest throughout the region. Only Argentina, Barbados, Chile, Mexico, Nicaragua and Uruguay managed growth rates higher than 4 percent in 1996, while three countries, Costa Rica, Jamaica and Venezuela, experienced economic contractions during the year.

The robust growth of exports was quite generalized. With the major exception of Brazil, where exports stagnated for the third consecutive year, all major subregions

FIGURE 8

Real Investment, 1960-96

(Percent of GDP)

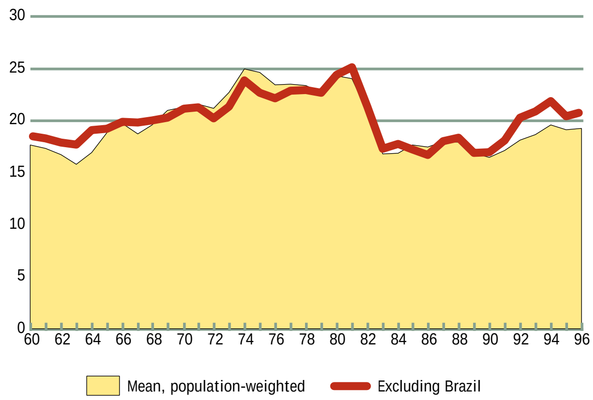
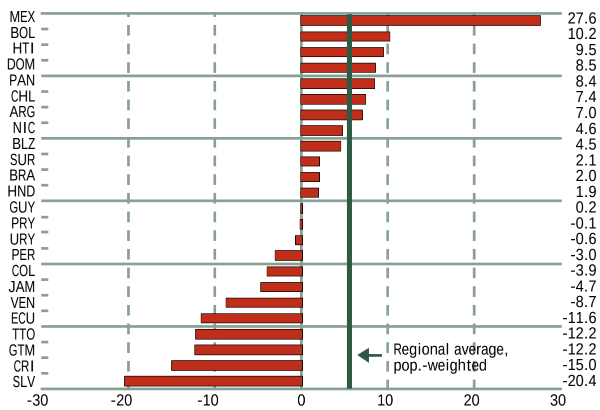


FIGURE 9

Investment Growth, 1996

(Percent change)



of Latin America experienced increases in real exports at or near double-digit rates.

For the region as a whole, the relatively robust growth in domestic investment reestablished the recovery of investment that had been a hallmark of the recovery of the 1990s. As Figure 8 shows, the share of real investment in GDP collapsed in the early 1980s, and only began to recover during the 1990s. Since then, the investment ratio has risen from 16.5 percent of GDP in 1990 to 19.2 percent in 1996. If we exclude Brazil, where the recovery of investment had to await the 1994 inflation stabilization, the investment ratio has risen to over 20 percent, which is still below the levels reached during the late 1970s, but comparable with the levels of the 1960s.

However, the growth of investment during 1996 was insufficient to raise it to the share of GDP recorded during the precrisis year 1994. Furthermore, investment growth was not widespread, and is largely attributable to robust recoveries of investment in Argentina and Mexico from the depressed levels of 1995.

During 1996, investment grew only 2 percent in Brazil, and declined by an average of 4.5 percent in the countries of the Andean region and by 2.6 percent in Central America and the Caribbean. Real investment grew by more than 5 percent in only seven countries, and by more than 10 percent in only two, while it fell in 11 countries.

The recovery of investment apparent at the aggregate level thus masks considerable differences across countries of the region as well as weakness in a substantial number of countries.

Adjustment to Stabilization and Reform

Economic performances in the region were in important respects uneven, with Argentina and Mexico staging strong economic recoveries from the 1995 crisis. Brazilian policymakers acted to contain an expansion in domestic demand that threatened to generate excessive external imbalances, while a number of other countries experienced a sharp deceleration in the rate of economic growth and investment.

One potential explanation for these varying performances is differing external circumstances. For example, the relatively sluggish economy and poor investment performance in Central America and the Caribbean may have something to do with the adverse terms of trade shock that the region suffered. In the past, such shocks have tended to be accompanied by a period of lower growth in GDP and investment.

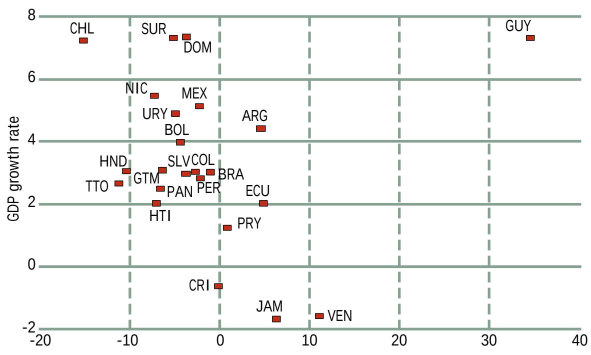
This cannot, however, be the whole story; in 1996, terms of trade shocks do not provide much help in accounting for differences in economic growth and investment in the countries of Latin America. For example, the terms of trade improved for the Andean countries, but growth and investment performance in that subregion was even weaker than in Central America and the Caribbean. A number of Central American countries, including Nicaragua and Honduras, suffered adverse shocks to the terms of trade without experiencing a major economic slowdown or decline in investment. More generally, the correlation between terms of trade changes and output growth was, if anything, negative during 1996.[3]

[3] The correlation between terms of trade shocks and investment was also negative, but it was not statistically significant.

FIGURE 10

Change in GDP and Terms of Trade, 1996

(Percent)



This does not mean that adverse terms of trade shocks were not painful for the economies concerned, but instead that some additional factor was important. A key factor in 1996, as discussed above, was the progress various countries made in adjusting to the stabilization and reform programs initiated earlier in the decade. Table 6 documents that progress. During the early years of the decade, a large number of countries, accounting for most of the region's population and income, were passing through the initial expansion phase of the process. By 1994, three countries, including Argentina and Mexico, were experiencing the deceleration phase, as the fiscal and financial vulnerabilities associated with the adjustment process began to make themselves felt. In 1995, four countries, most notably Argentina and Mexico, passed through the correction or crisis phase of the process. During 1996, most countries entered the post-correction phase, while a number of other countries began to experience significant economic and financial stress associated with the preceding years of expansion.

Thus, in both 1995 and 1996 fewer countries were in the initial expansion phase of the adjustment process. In 1996, for the first time in the decade, more countries were in the deceleration or correction phases than were in the recovery phase, which helps explain the slowdown in overall economic activity.

This very stylized account of the adjustment process does not, of course, provide a complete explanation for economic developments during 1996. Table 7 presents average growth rates of real GDP, investment and consumption for countries in different phases of the adjustment process during 1995 and 1996. In both years the patterns are similar to the stylized account of the adjustment process that was sketched out above; growth and spending are high during the recovery phase, slow dramatically during the stress and correction phase, and recover during the post-correction phase. However, in 1996 investment growth slowed by comparison with 1995 in each phase of the process except post-correction. This means that something other than the stylized adjustment process is needed to explain the growth and investment performance of countries passing through the other phases of the cycle. This could be either unrelated shocks or a somewhat different policy response to the macroeconomic dynamics that tend to be triggered by stabilization and reform. We shall argue that the latter were important, particularly in Brazil and Peru.

One way to summarize developments during 1996 is that Latin American growth and investment recovered mainly because two large economies, Argentina and Mexico, passed through the crisis phase and embarked on the post-correction phase of the adjustment process, when growth and investment typically recover. Growth in other countries slowed in part because they were moving from the recovery to the stress or correction phase.

But other factors were, of course, at work during the year. Such country-specific factors are required, in particular, to explain the relatively weak performance of investment in countries that were in the recovery and the stress phases of the adjustment process.

Table 6. Stages of Adjustment to Stabilization and Reform

(Percent of population and number of countries in each phase)

	Adoption	Initial expansion	Deceleration or correction	Post-correction
1991	7.9 (4)	49.2 (10)	0.0 (0)	3.1 (1)
1992	5.7 (2)	50.4 (12)	1.6 (1)	3.1 (1)
1993	0.3 (1)	47.8 (12)	8.6 (3)	4.7 (2)
1994	35.1 (1)	21.4 (10)	33.7 (5)	6.4 (3)
1995	0.1 (1)	53.0 (8)	35.9 (7)	7.6 (4)
1996	4.7 (1)	41.3 (5)	15.3 (7)	35.4 (6)

Note: The first number represents the percent of the Latin American population in countries judged to be in the indicated phase of the adjustment process. The number in parentheses gives the number of countries in the indicated stage.
Source: IDB calculations as described in the text.

Table 7. Output and Demand by Stage of Adjustment Process

(Percent change)

	1995	1996
Real GDP		
Initial expansion	4.7	5.2
Deceleration or correction	0.5	1.6
Post-correction	5.3	5.5
Real investment		
Initial expansion	9.7	1.2
Deceleration or correction	1.9	-11.4
Post-correction	8.4	10.0
Real consumption		
Initial expansion	6.1	5.2
Deceleration or correction	-0.4	1.9
Post-correction	5.8	5.6

Source: IDB calculations as described in the text.

Mexico: In 1996, Mexico overcame the economic and financial turbulence that afflicted the country in 1995 and began a strong recovery, while working to overcome the fiscal and financial imbalances that emerged during the crisis. Real GDP increased just over 5 percent, making up much though not all of the 6 percent decline in 1995. Unemployment declined over the course of the year, although it remained above the precrisis level.

With both fiscal and monetary policy oriented toward reestablishment of macroeconomic stability, inflation fell sharply from more than 50 percent in 1995 to less than 30 percent in 1996. The growth in domestic demand was led by exports, which grew nearly 20 percent in real terms, and investment, where growth of nearly 30 percent was impressive but still insufficient to bring real investment to the prerecovery level. Real consumption, on the other hand, grew less than 3 percent, implying an increase in national saving for the second consecutive year. The increase in domestic saving ensured that the current account of the balance of payments remained near balance in 1996, despite the strong recovery of domestic investment.

Securing a recovery of the domestic banking system required a substantial policy effort. The authorities intervened in eight banks and initiated a number of programs of fiscal support to the banking system to support the restructuring of bank portfolios. In addition, strengthening the legal and regulatory framework laid the groundwork for a stronger financial system. Reforms included increased capital requirements for market risk and the adoption of international accounting standards for banks.

While making important headway in reestablishing macroeconomic and financial stability, the authorities also acted to deepen the country's structural reforms and strengthen macroeconomic policy management. Over the course of the year the authorities took advantage of favorable conditions in international financial markets to restructure the country's international debt, retiring most of the relatively expensive short-term debt associated with the international response to the 1995 crisis and replacing it with less expensive and much longer-term debt. Some progress was also made in privatization, including an opening of the petrochemical sector to private participation. And a major pension reform was enacted, which replaces the pay-as-you-go, defined benefit program with a system of individually capitalized retirement accounts. The new system is expected to come into force in mid-1997, with about 10 million workers contributing to the new accounts. When fully operational, the new system should prove an important positive force for the deepening of domestic capital markets.

Prospects for Mexico over the near term are promising. Inflation has continued to moderate during 1997, and could fall to about 20 percent for the year as a whole. Growth is expected to remain strong. In contrast with the early 1990s, economic growth during the past two years has been underpinned by very strong export growth as well as a strong recovery of investment from the steep decline of 1995, while consumption has grown more modestly, national savings have risen, and households and businesses have gradually become less overextended to the domestic banking system. Longer-term prospects will depend in substantial part on the underlying policy environment. As Part II of this Report suggests, despite the deep reforms that Mexico has made over the past decade, there remain areas of policy in which deeper reforms are possible.

Southern Cone: This subregion contains both the first and one of the most recent of the region's reforming economies. The structural policies now in place in Chile were largely established under the major stabilization and reform program of the late 1970s and early 1980s. That reform program led to a spectacular boom that ended in an equally spectacular crisis in 1981-82. Chile is thus one of the very few countries on the continent more than a decade into the post-correction period, and current economic developments there are largely unrelated to the short-term cyclical responses to stabilization and reform that have affected much of the region. Brazil, on the oth-

Table 8. Economic Developments and the Adjustment Process, 1996

(Real growth rate, in percent)

	GDP	Investment	Consumption	Real exports	Terms of trade	Real exchange rate	Real interest rate
Adoption							
Venezuela	-1.6	-8.7	-4.2	4.3	11.8	22.0	-35.2
Initial expansion							
Brazil	3.0	2.0	3.7	0.0	0.0	-7.9	21.6
Guyana	7.3	0.2	9.5	8.2	34.7	-1.4	na
Nicaragua	5.5	4.6	-3.1	37.0	-6.1	na	7.7
Peru	2.8	-3.0	1.5	10.2	-1.0	-2.8	21.9
Suriname	7.3	2.1	14.3	1.2	-4.0	-8.8	na
Deceleration or correction							
Colombia	3.0	-3.9	1.6	12.0	-1.6	-1.1	17.0
Costa Rica	-0.7	-15.0	-0.3	5.7	na	-0.5	10.9
Guatemala	3.1	-12.2	3.2	9.1	-5.2	-1.8	10.7
Jamaica	-1.7	-4.7	-1.2	5.0	7.2	-5.1	24.3
Trinidad and Tobago	2.6	-12.2	6.3	8.2	-10.7	-1.6	12.4
Ecuador	2.0	-11.6	1.6	3.6	5.8	-2.4	23.1
El Salvador	3.0	-20.4	2.4	7.3	-2.6	-6.3	10.5
Post-correction							
Argentina	4.4	7.0	4.9	13.6	5.5	0.4	10.5
Bolivia	4.0	10.2	3.6	9.4	-3.2	-5.3	na
Chile	7.2	7.4	8.1	10.9	-13.8	-3.2	10.1
Dominican Republic	7.3	8.5	9.0	6.1	-2.5	-2.9	na
Mexico	5.1	27.6	2.4	18.7	-1.2	-9.5	6.0
Uruguay	4.9	-0.6	5.6	12.3	-3.8	-0.7	11.6

Note: The real interest rate is a lending rate; for Brazil, Mexico and Uruguay the lending rate is estimated assuming a spread over the deposit rate of 8 percentage points. The real exchange rate is a trade-weighted effective rate, and a positive sign denotes a depreciation.
Source: Calculations based on IDB economic and social database, and IMF, *International Financial Statistics.*

er hand, is one of the most recent economies to undertake stabilization, though some important structural reforms predate the mid-1994 stabilization, and the country is in the relatively early stages of adjustment. The Brazilian experience differs in some interesting respects from the typical expansion, highlighting the impact of different policy responses on the nature of economic outcomes. Argentina, like Mexico, is in an intermediate position, having experienced a boom and undergone a correction, from which the country is now emerging.

Argentina began a recovery during the year from the Tequila crisis of 1995. Real GDP grew roughly 4.5 percent, following a decline of approximately the same magnitude in 1995. Recovery was led by investment and exports, which grew in real terms by 7 percent and 14 percent, respectively, while real consumption grew nearly 5 percent. Recovery was also supported by renewed confidence in the Argentine financial system, as reflected in a substantial increase in demand for domestic bank deposits, which eliminated the liquidity crisis of the previous year and allowed a reactivation of domestic credit.

The major challenges that face Argentina are to reduce high levels of unemployment and attain a more solid fiscal balance. The rate of unemployment rose steadily during the 1990s, even while economic growth was rapid, and it reached 18 percent of the labor force in 1996. This is to a substantial extent a reflection of rapid growth in the workforce, rather than reductions in unemployment, but it nonetheless poses a major challenge for the country. The policy response to this challenge in 1996 was a significant reform of labor laws, which would have reformed the system of severance payments and the collective bargaining process, in hopes of rendering the labor market more flexible and promoting employment. These reforms have not, however, been approved by the Congress.

Despite reasonably robust growth and policy measures designed to raise fiscal revenue and reduce spending, the balance of Argentina's nonfinancial public sector deteriorated in 1996. Though the existing deficit is a relatively small share of GDP, it renders public finances vulnerable to an economic downturn or adverse shock, as is discussed in more detail in Part III of this Report.

Brazil's Real Plan of mid-1994 brought inflation down from roughly 5,000 percent per year in the first half of 1994 to 26 percent in 1995 and 11 percent in 1996, which triggered an immediate and powerful spending boom. Real consumption grew 9 percent in 1994 and nearly 12 percent in 1995, while investment grew by roughly 13 percent in both years.

Two policy responses have made the ongoing Brazilian recovery somewhat different from the typical one. First, the inflation stabilization was associated with a substantial fiscal expansion, which the Brazilian authorities have yet to address in full. This has amplified the spending boom that would normally result from private responses to the stabilization, while the rapidly growing public debt tends to crowd out private borrowers. Second, to manage this spending boom the authorities have implemented restrictive credit policies, which has thus far prevented the bank lending boom that often emerges during the post-stabilization recovery, at the cost of very high real interest rates. Real deposit rates averaged about 20 percent in 1995 and remained in the double digits in 1996 and early 1997.

One result of these policies was a severe slowdown in the rate of investment growth in 1996. Investment rose only 2 percent, substantially below the rate that is typical for the initial expansion phase of adjustment. This is one reason why investment growth of countries in this phase of adjustment was atypically low during 1996.

Given the fiscal rigidities that are imposed by the Brazilian Constitution, and the time and uncertainties involved in attempts to change them, it is hard to think of an alternative to the course that the Brazilian authorities are now pursuing. By preventing a bank lending boom, the strategy may forestall development of major weaknesses in the financial system, though the long period of very high real interest rates poses dangers of its own for the banks. But the fiscal vulnerabilities associated with the need to finance large deficits and roll over a large public debt are substantial and rapidly growing.

Economic growth in Chile, at more than 7 percent, was the most rapid in the region. This occurred despite a 14 percent decline in the terms of trade, the result of a large drop in copper prices, an increase in petroleum prices, and a fairly contractionary monetary policy, which brought inflation down to roughly 7 percent, its lowest rate in 35 years. Demand growth was to some extent export-led, but otherwise relatively balanced; in real terms exports grew roughly 10.9 percent, investment by 7.4 percent, and consumption by 8.1 percent. Real wages rose by roughly 4.5 percent, and unemployment fell over the course of the year.

Economic growth in Chile has been driven by high rates of saving and investment, which have risen from extremely low levels during the crisis of the early 1980s to roughly 30 percent of GDP in the 1990s. Prospects for the near term appear good. Inflation is expected to fall somewhat further in 1997, while the economy is expected to grow 5 to 6 percent. A recovery of copper prices is expected to reduce the current account deficit that appeared in 1996, and the government is once again expected to run a fiscal surplus, as it has for each year of the past decade.

Andean economies: Economic developments in most countries of the Andean region were heavily influenced by their continuing or, as in the case of Venezuela, renewed engagement with the process of stabilization and reform. In the middle of 1996, Venezuela entered the adoption phase of the process, initiating a stabilization and reform program that picks up the pieces from the 1993 collapse of a previous stabilization program.[4] Ecuador and Colombia spent most of 1996 coping with many of the usual features of the stress and correction phases of the adjustment process. Peru, similar in some respects to Brazil, attempted to manage the spending boom associated with the recovery phase. Only in Bolivia, where stabilization took place in the mid-1980s, were economic developments largely unaffected by macroeconomic forces related to stabilization and reform.

Venezuela entered the adoption phase of the adjustment process in April 1996, when it reinitiated a stabilization of the country's 1989 program, which collapsed at the end of 1994. The new stabilization program, which involved abolishing exchange controls and making an associated maxi-devaluation, began in a burst of inflation that totaled approximately 100 percent in 1996. However, after the initial surge, inflation began to decline and is expected to subside to roughly 40 percent in 1997.

The very substantial overshooting of the exchange rate that initiated the reform program has importantly

[4] The Venezuelan reform program, *Agenda Venezuela*, also incorporates important structural reforms, most notably a deep reform of the social security system and the labor code, and a privatization program.

conditioned the economic response to the stabilization program. The depreciation generated an enormous transfer of wealth from the nonbank private sector to the banking system and the government, as the real value of bolívar-denominated liabilities collapsed. This largely resolved the crisis of banks that had not been intervened in by mid-1996, while at the same time reducing the purchasing power of domestic consumers. The real depreciation also had a favorable impact on the fiscal accounts.

Finally, confidence that the currency would stabilize at the new, more depreciated level led to a reversal of the previous years' capital flight. Combined with a large favorable shock to oil prices, this caused the real exchange rate to appreciate sharply during the second half of the year and the first months of 1997, as domestic inflation greatly exceeded the nominal depreciation of the bolívar. This appreciation was associated with highly negative real interest rates, which had the effect of eroding the real value of bolívar liabilities of the crisis-ridden banking system and the public sector.

Recovery in private demand has been somewhat slow, perhaps because the transfer of wealth from the nonfinancial private sector associated with the 1996 devaluation has depressed consumption demand. It seems likely, as well, that the much anticipated reform of Venezuela's labor legislation is creating uncertainty among the business sector and contributing to a reluctance to hire new workers until the new regime is established. (The new labor law was approved by Congress in July 1997.) However, when the increase in domestic demand arrives, the banking system will be well placed to magnify a spending boom with another domestic lending boom. The challenge for the authorities in coming years will be to manage the recovery to minimize the financial and fiscal vulnerabilities likely to emerge in the absence of a forward-looking policy stance.

Colombia and Ecuador display many characteristics associated with the stress and correction phases of the adjustment process. In both cases, the early 1990s witnessed inflation stabilization—mild in Colombia and more substantial in Ecuador—and significant structural reforms. Both economies remonetized and a bank lending boom resulted, again relatively mild in the case of Colombia and more pronounced in Ecuador. The resulting private spending booms were characterized in particular by rapid growth in domestic investment, especially in Colombia, where there was investment spending to develop new oil fields.

Both economies showed signs of stress in 1996. As the bank lending boom slowed, real interest rates rose dramatically, curtailing investment demand. And as the economies slowed, substantial fiscal imbalances emerged that required the authorities to make a fiscal correction just when private demand was weakening. The challenge for policymakers in 1997 is to manage this correction in a way that minimizes the likelihood of a major economic downturn.

In Peru, the problem is managing the boom in private demand that has been with the economy since 1993, when the country's reform program brought inflation below 50 percent, compared with the quadruple-digit inflation rates of the late 1980s and early 1990s. The strong spending boom triggered by the stabilization and reforms generated an increase in the current account deficit that, in 1996, induced policymakers to tighten fiscal policy. This fiscal adjustment curtailed economic activity in the first part of the year, leading to sharply lower growth in real output and a decline in investment. Thus, as in Brazil, policy adjustments during 1996 interrupted the boom phase and led to much weaker investment than is typical of the early stage of adjustment to stabilization and reform.

This interruption in the recovery is likely to be short-lived, however. The economy displays few signs of stress—money demand continues to rise, capital flows remain high and there are, as yet, few signs of distress in the banking system, which continues to expand its lending to the private sector at a rapid rate. The challenge for Peru is to manage this recovery and prevent it from generating dangerous vulnerabilities. A potential concern is the very substantial boom in bank lending, which has the potential to destabilize the financial system and derail recovery.

In Bolivia, the economy grew 4 percent, driven by rapid growth in real investment (10.2 percent) and real exports (9.4 percent). Consumption grew 3.6 percent, implying a small increase in the country's low rate of saving. Inflation fell to 8 percent in 1996, down from nearly 13 percent in 1995.

The country implemented important structural reforms during the year. A major pension reform law was approved that establishes privately managed, individually-capitalized accounts. The law also established Bono Solidaridad, a program that provides support to those 65 years and older and is financed by the shares of capitalized enterprises. The capitalization of the public petrochemicals company YPFB was completed, making Bolivia one of the few Latin American countries that has been able to privatize in this sector. The country also approved a law to improve land tenure and titling systems, a forestry law to rationalize use of forest resources, and a new hydrocarbons law and tax regime for the hydrocarbons sector. The decentralization of fiscal responsibilities to municipalities and prefectures continued, while the 1997 budget law established mechanisms to limit the indebtedness of decentralized and autonomous agencies. Bolivia is also being considered for additional debt relief under the Highly Indebted Poor Countries Initiative.

Central America and the Caribbean: These subregions were subjected to two important external shocks in 1996: the decline in world coffee prices as the coffee boom of 1994-95 began to unwind, and a loss of international competitiveness vis-à-vis Mexico, which resulted from that country's recent sharp depreciation of the real exchange rate and its position in NAFTA. However, these shocks do not fully explain the subregion's modest rate of growth or decline in investment. As we have noted, several countries of the subregion performed relatively well despite a decline in the terms of trade, and the converse is also true for some other economies. Indeed, in volume terms, export growth was actually strong in the subregion. Real exports of good and nonfactor services (as measured in the national income and product accounts) grew an average of 12 percent, and in only two economies (Belize and Suriname) did real exports grow less than 5 percent.

Thus, important though the competitiveness shocks may have been, another important reason for the weakness of many Central American and Caribbean economies during 1996 was the development of economic and financial stresses associated with adjustment to their stabilization and reform programs. Countries that suffered particularly large declines in real investment all displayed signs of economic and financial stress. We cannot examine each country of the subregion in detail, but instead explore some countries that are representative of the process.

In Jamaica, the inflation stabilization began in 1991, when inflation reached 80 percent. This was cut in half in 1992, and inflation continued to fall to its current level of roughly 15 percent. The inflation stabilization triggered a remonetization of the economy, which helped to finance a domestic lending boom. This, in turn, supported an expansion of domestic spending that brought the country's current account deficit to 6.5 percent of GDP in 1995 and nearly 8 percent in 1996.

During 1996, the economy came under stress. Interest rates rose dramatically, placing pressure on already overextended banks and insurance companies. Some important financial institutions collapsed, and a costly financial crisis emerged. As a result of high real interest rates, costs of the financial crisis, the recession, and other fiscal developments, the Jamaican fiscal balance swung from a surplus of nearly 2 percent of GDP to a deficit of at least 8 percent. Dealing with this fiscal problem, and ensuring that the financial crisis does not intensify and aggravate the recession in the nonfinancial economy, will need to be high priorities for Jamaican policymakers.

In Costa Rica, the credit and spending boom took place during 1992-93, when investment growth averaged roughly 25 percent and consumption growth about 7 percent. This boom brought the current account deficit from 1.3 percent of GDP in 1991 to more than 8 percent in 1993. The spending boom was supported by large inflows of foreign direct investment and an expansion of credit to the private sector of about 25 percent per year. The public sector surplus remained near balance during these years, despite the favorable impact of the spending boom on public revenue. Public spending increased in tandem with the temporarily higher revenue.

Thus, when the spending boom ended in 1994, a large fiscal deficit emerged. Despite efforts to achieve fiscal consolidation, the public sector balance remains in deficit of about 5 percent per year, which has contributed to the higher real interest rates. This helps explain the country's disappointing investment performance over the past three years.

The Dominican Republic brought down high inflation in 1991, and this stabilization was followed by a domestic spending boom fueled by a substantial increase in bank lending to the private sector that brought the current account deficit to roughly 8 percent of GDP in 1991 and 1992. A correction began in 1993, during which consumption demand fell and, somewhat later, investment demand began to grow less rapidly, until domestic spending fell into line with income. By 1996, the macroeconomic adjustment to the stabilization was largely complete, and the economy grew by more than 7 percent, with strong investment growth despite a substantial decline in the terms of trade.

The substantial variation across the region in economic performance during 1996 is thus largely, though not of course completely, explained by the progress that countries have been making through the adjustment process, and the policy responses that national authorities have made to the economic forces associated with that adjustment. This provides some basis to expect that the economic and financial stresses now being experienced by several countries of the region are the result of transitory, cyclical phenomena that can be overcome. An optimistic note is provided by the experience of the six countries that appear by 1996 to have overcome these stresses. All of these countries experienced at least respectable growth accompanied (except in Uruguay) by robust investment growth.

Increased National Saving

During the first three years of the decade, national saving[5] declined precipitously in Latin America, from roughly 20 percent of income in 1990 to a low of 16.5 percent in 1993. Since then, the average rate of saving has stayed roughly constant, rising slightly in 1997.

But the recent stability of the region's average rate of saving masks an important difference between the behavior of Brazil—where in the early stages of a major inflation stabilization consumption has recently boomed and saving fallen—and the rest of the region, which is generally further along in the stabilization process and has begun to see a recovery of saving.

As Figure 11 illustrates, the average rate of saving in Latin American countries other than Brazil rose from a low of 15.3 percent in 1993 to 18 percent in 1996, returning to levels of the late 1980s. This increase in national saving has been fairly widespread; between 1990 and 1996 most countries' rate of saving returned to or exceeded that recorded in 1990. Only in Haiti and Brazil is the saving rate now greatly below the 1990 level.

Employment and Unemployment

The modest rate of economic growth in 1996 was not sufficient to reduce the region's rate of unemployment, which rose slightly to just above 8 percent of the labor force (Figure 5).

The region's average unemployment rate has risen considerably during the 1990s, and now stands near its 1984 peak. However, this increase in the regional average is driven to a very large extent by the extraordinary experience of Argentina, where the unemployment rate has risen almost uninterruptedly from low single digits in the 1970s to nearly 18 percent today. In countries other than Argentina, unemployment increased in 1995 and 1996, but the increase was much more modest (about a percentage point), and the average stands well below previous peaks.

Unemployment rates differ widely across the region, partly for definitional and statistical reasons. In 1995 and 1996, the measured unemployment rate exceeded 10

FIGURE 11

National Saving, 1996 vs. 1990

(Percent of GDP)

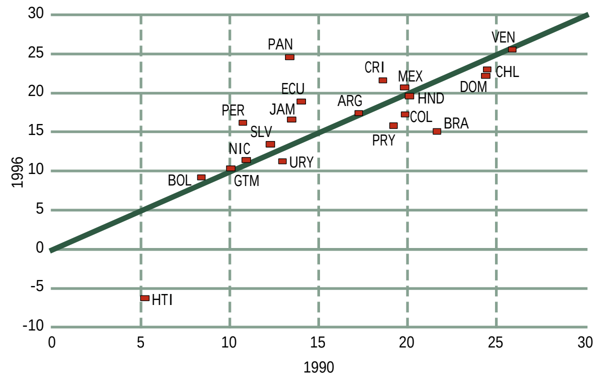
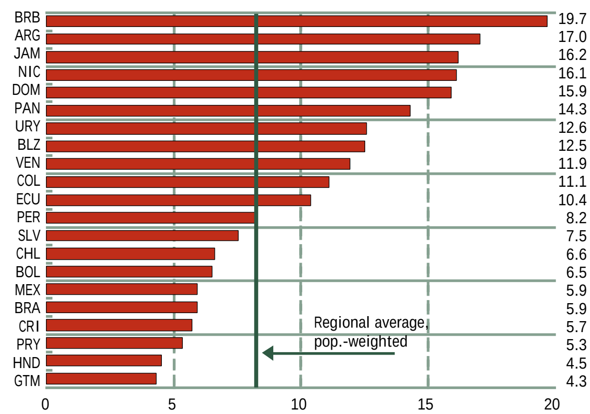


FIGURE 12

Unemployment, 1996

(Percent of labor force)



Note: Figures are for 1996 if available, otherwise 1995.

percent in 10 countries. During 1996, unemployment increased in eight countries and declined in only two.

In most countries, the failure of the 1990s recovery to reduce unemployment appears primarily attributable to the recovery's relatively slow pace, rather than to special characteristics of the recovery itself, though the nature of the reforms has also been important in some countries. (Part II of this Report analyzes in more detail the impact of the region's reforms on unemployment.) As Figure 14 illustrates, countries that have managed more rapid rates of economic growth have tended to experi-

[5] We focus on national saving, rather than domestic saving, because our emphasis is on the resources available for internal financing of domestic investment, which is best measured by national saving.

FIGURE 13

Unemployment, 1995 vs. 1996

(Percent of labor force)

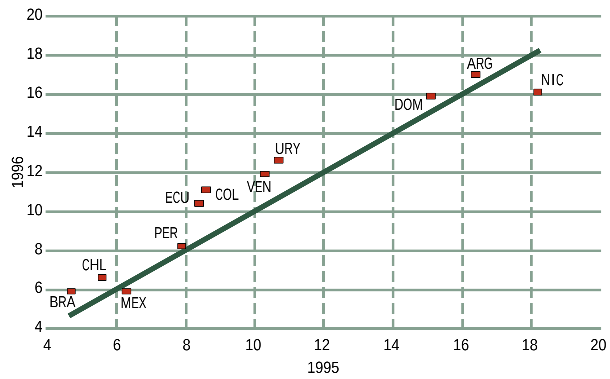


FIGURE 15

Poverty in Latin America, 1970-95

(Percent of population)

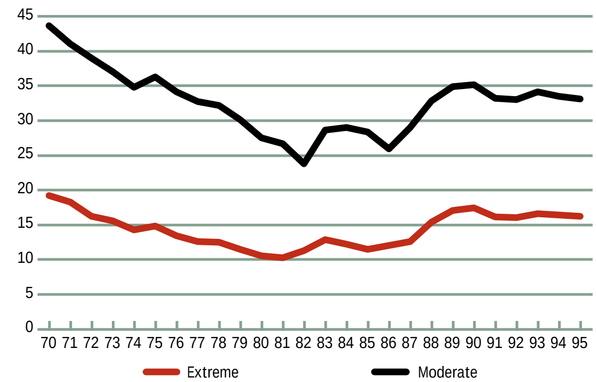
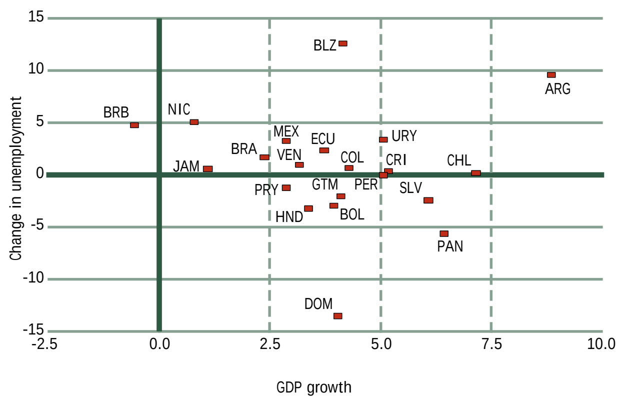


FIGURE 14

Unemployment and GDP Growth, 1990-96

(Percent)



ence declines in the rate of unemployment, with a growth rate above 3 to 4 percent required to secure reductions in unemployment.

As we have noted, Argentina is a major outlier here. Despite rapid growth during the 1990s, unemployment increased by a full 10 percentage points. It seems most plausible that this increase is related to the nature of the country's deep economic reforms over this period.

POVERTY AND INEQUALITY IN THE 1990s

After falling continually throughout the 1970s, poverty increased dramatically in Latin America during the 1980s.[6] By the end of the decade, the proportion of the population living in moderate poverty had risen to 35 percent, and the share of the population in extreme poverty had risen to roughly 17 percent.

During the recovery of the 1990s the poverty rate has declined very slightly, while the number of poor has increased somewhat. However, this stability of the aggregate poverty rate masks important differences in country experience. Since 1990, poverty has increased in Mexico, Honduras and (from a relatively low level) the Bahamas, while decreasing at least slightly in the other countries of the region.

As with unemployment, the relatively minor impact of the recent economic recovery on poverty rates primarily reflects the overall weakness of the 1990s recovery.

Figure 16 charts the change in the poverty rate over the most recent period for which measures exist against the rate of growth of real GDP.[7] (The years listed with each country indicate the beginning and end of the period; for example, in Peru we have measures of poverty for 1986 and 1994). The figure demonstrates that higher economic growth has been associated with reductions in poverty, and suggests that a growth rate of substantially higher than 3 to 4 percent is required to secure meaningful reductions in the poverty rate. The failure of the recovery of the 1990s to reduce the region's poverty rate despite average GDP growth of just under 3.5 percent is thus largely attributable to the weakness of the recovery to date.

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[6] This section draws upon Londoño, Juan Luis and Miguel Székely (1997) "Distributional Surprises after a Decade of Reforms: Latin America in the 1990s," Inter-American Development Bank.

[7] The changes graphed in Figure 16 are not equal to the difference between the 1990 and 1995 figures presented in Table 9 because the latter figures include projections by Londoño and Székely. We chose observations as close to five years apart as possible, but in some cases were forced by data limitations to work with somewhat longer or shorter time periods. Most of the observations in Figure 16 cover the 1990s, but in a few cases the most recent observations available covered the late 1980s.

Table 9. Poverty in Latin America during the 1990s

(Percent of population in poverty)

	Moderate poverty		Extreme poverty	
	1990	1995	1990	1995
Bahamas	7.5	8.9	5.0	7.6
Brazil	46.3	43.5	24.5	22.9
Chile	31.0	21.5	8.1	3.1
Colombia	24.4	21.9	9.0	6.8
Costa Rica	24.0	21.3	9.4	8.1
Dominican Republic	42.4	36.6	15.6	11.6
Guatemala	45.5	42.5	24.5	23.1
Honduras	67.6	68.3	39.2	41.6
Jamaica	27.4	25.5	5.4	3.8
Mexico	19.9	22.3	11.3	11.8
Panama	53.5	46.0	30.5	25.8
Peru	39.6	32.8	11.0	10.0
Venezuela	14.3	13.4	8.7	7.7

Note: Because the required household data do not exist in each year for all countries, some of the figures in this table are projections that account for the impact of macroeconomic fluctuations, but assume that the household distribution of income is the same as in the most recently available household survey data.
Source: Londoño and Székely (1997).

FIGURE 16

Poverty and Growth

(Percent)

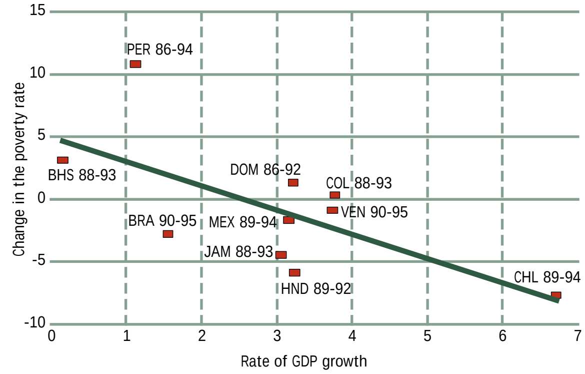


FIGURE 17

Income Inequality in Latin America, 1970-96

(Gini coefficient)

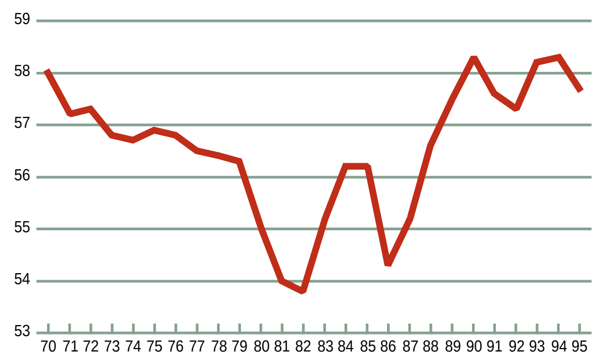
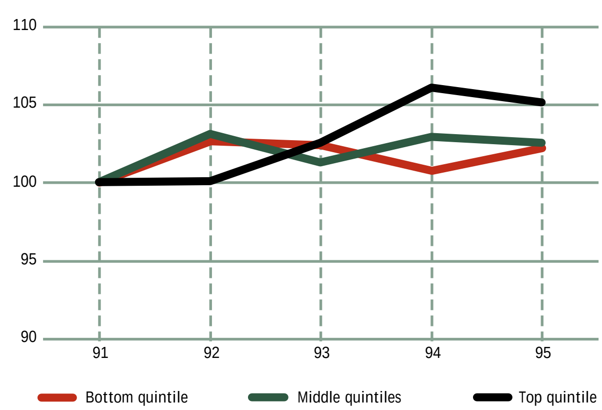


FIGURE 18

Income Per Capita by Income Group

(1990 = 100)



Income Distribution

The failure of poverty to decline may also reflect the manner in which the gains from recovery were distributed. During the 1990s, the distribution of Latin American income did not improve, although the persistent deterioration that characterized the late 1980s was arrested.

As we discuss in more detail in Part II of this Report, poorer income groups typically benefit disproportionately from economic recovery, just as they are disproportionately hurt by bad times (Londoño and Székely, 1997). The income distribution thus tends to improve in periods of economic recovery and deteriorate in bad times. But the relatively well-off groups of Latin American society appear to have benefited from the recovery of the 1990s somewhat more than the poorest classes.

According to estimates by Londoño and Székely, the per capita income of the top income quintile grew by 5 percent between 1991 and 1995, while the per capita income of the middle and lower income groups grew only 3 percent.

The experience of the 1990s suggests that substantially more rapid growth will be required to make significant progress toward reducing unemployment and poverty and improving the distribution of income. Part II of this Report examines the role of structural policies, and argues that other policy reforms, particularly in the area of education, can make an important contribution to reductions in poverty and inequality as well.

INFLATION

Inflation generally fell in 1996, with the median rate of inflation down slightly to 11 percent from about 12 percent in 1995. Inflation fell or remained approximately constant in nearly every country of the region. Only in Venezuela did inflation increase substantially, from about 55 percent in 1995 to over 100 percent in 1996. This acceleration was associated with the adoption of the April 1996 stabilization and reform package, which eliminated domestic price and exchange controls that had been in place to defend an overvalued exchange rate. The stabilization program thus began with a burst of high inflation, pushing the inflation rate for the year to just over 100 percent. Inflation began to decline in the early months of the program, and is projected to decline to 30 to 40 percent in 1997.

In other countries of the region inflation either fell or remained roughly unchanged. Brazil, Costa Rica, Haiti and Jamaica brought inflation down from about 25 percent to the 10 to 15 percent range, while inflation in Suriname declined from 37 percent in 1995 to 0.5 percent in 1996.

FISCAL POLICY

In the region as a whole, fiscal policy remained relatively restrained in 1996, with an average (population-weighted) fiscal deficit of about 1.5 percent of GDP.[8] This is slightly smaller than in 1996, and while it is larger than the deficits recorded from 1991-94, it represents a remarkable turnaround from the 1980s.

The 1996 result reflects, however, disparate results in different countries. Venezuela achieved an enormous increase in its fiscal surplus, which improved by nearly 13 percentage points of GDP. This was due to fiscal policy changes associated with the mid-1996 initiation of the stabilization program, the very favorable shock to the country's public finances occasioned by higher petroleum prices, and a reduction in the cost of the 1994 banking crisis, which had raised spending by 4 percent of GDP in 1995. Chile also experienced a substantial increase in its fiscal surplus, which reached 5.6 percent of GDP during 1996 despite the adverse shock to copper prices.

The fiscal balance deteriorated by more than 2 percent of GDP in Barbados, El Salvador, Ecuador, Jamaica, Nicaragua, and Suriname. In Barbados, El Salvador and Suriname, the 1995 fiscal stance was sufficiently strong that the 1996 fiscal outcome remained in balance or relatively small deficit. But in the other countries, the 1996 fiscal deficit exceeded 4 percent of GDP.

Improvement in the region's fiscal balance was in substantial part attributable to a reduction in the Brazilian fiscal deficit from nearly 5 percent in 1995 to about 4 percent in 1996, which was itself sufficient to raise the

FIGURE 19

Inflation, 1996 vs. 1995

(Percent)

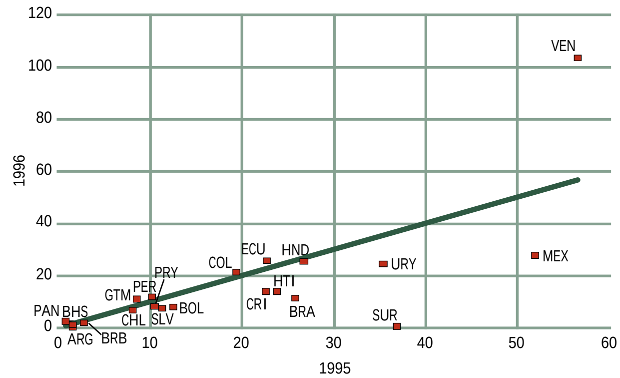
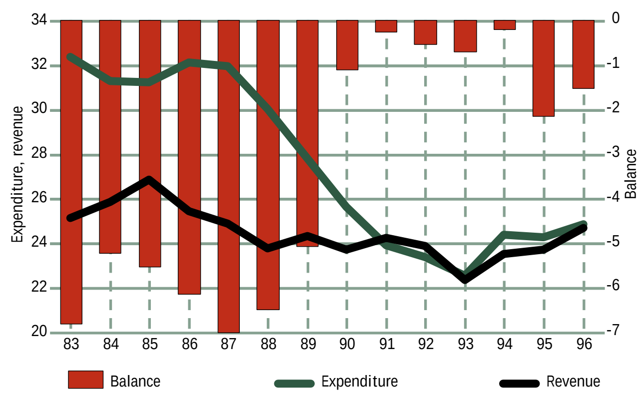


FIGURE 20

Fiscal Accounts, 1983-96

(Population-weighted averages, in percent of GDP)



Note: Brazil is in the sample for the balance but not for the revenue and expenditure averages.

[8] In this section we refer to data on the nonfinancial public sector in the 15 countries for which it was available. For the other countries we used data for the central government.

FIGURE 21

Fiscal Balance, 1995 vs. 1996

(Percent of GDP)

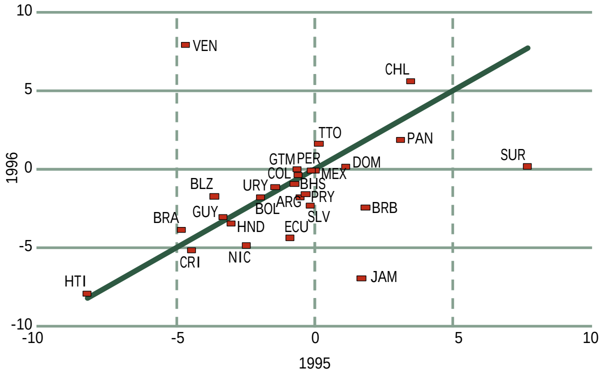
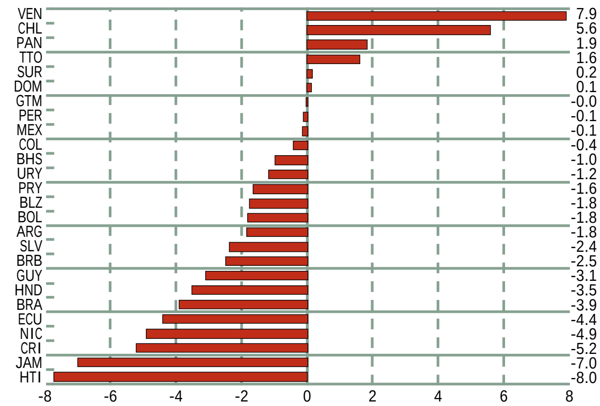


FIGURE 22

Fiscal Balance, 1996

(Percent of GDP)



regional average by about .3 percentage points.[9] Despite these improvements, however, the public sector fiscal imbalance remains a critical policy problem for Brazil. Fiscal deficits were also large in Nicaragua, Costa Rica, Jamaica and Haiti.

INTERNATIONAL TRADE AND PAYMENTS

Latin American trade continued to expand in 1996, and the region's current account deficits remained relatively low. The value in U.S. dollars of both exports and imports grew by roughly 10 percent in 1996. The expansion of exports follows an increase of nearly 20 percent in 1995, and at over $300 billion, Latin American exports now exceed 17 percent of the region's GDP, up substantially from the 14 percent share recorded in 1993.

The region's current account deficit increased slightly, reaching $26.5 billion, or 2.1 percent of GDP, during 1996. The deficit thus remained substantially below those recorded in 1993 and 1994, though as we note below in several countries the deficit reached a high level in 1996. Capital flows of $63 billion, 3.6 percent of the region's GDP, were more than sufficient to finance this deficit, and for the second consecutive year, countries of the region accumulated international reserves at a rate equivalent to roughly 1.5 percent of GDP.

Table 10. International Trade and Payments

	1993	1994	1995	1996
US$ billions				
Exports, goods and nonfactor services	199.4	231.1	274.6	304.8
Imports, goods and nonfactor services	-220.5	-256.5	-283.6	-316.5
Factor income and transfers (net)	-23.0	-23.0	-22.9	-24.9
Current account balance	-44.1	-48.4	-31.9	-36.6
Net capital flows	65.4	43.8	56.4	63.2
Reserve accumulation (- = increase)	-21.3	4.6	-24.5	-26.5
Percent of GDP				
Exports, goods and nonfactor services	14.2	14.7	16.5	17.3
Imports, goods and nonfactor services	-15.7	-16.3	-17.0	-17.9
Factor income and transfers (net)	-1.6	-1.5	-1.4	-1.4
Current account balance	-3.2	-3.1	-1.9	-2.1
Net capital flows	4.6	2.8	3.4	3.6
Reserve accumulation (- = increase)	-1.5	0.3	-1.5	-1.5

Note: Figures for imports and exports in 1996 are based in part upon IDB projections.
Source: IDB economic and social database.

Exports Continue to Expand

As in 1995, export growth was particularly dramatic in Mexico, where exports increased by nearly 20 percent during 1996, following an expansion of more than 25

[9] Unlike most of the fiscal accounts described in the section, the Brazilian data represent the operational fiscal outcome, that is, after subtracting the component of interest expenditure that represents the inflationary component of domestic current interest rates. This definition is for most purposes more meaningful than the conventional definition, but constraints on the availability of data prevent us from adopting it for all countries of the region. In any event, in the relatively low inflation environment of 1996, the differences between the operational and the conventional fiscal accounts are relatively minor.

percent during 1995. The 1996 increase was due in some part to increased oil prices, but reflected primarily an expansion in the volume of Mexican exports. Since 1993, the U.S. dollar value of Mexican exports has risen by nearly 75 percent, bringing them from 15 percent of GDP in 1993 to 37 percent in 1996.

Exports also grew rapidly in Argentina, rising in U.S. dollar terms by over 16 percent. In sharp contrast, Brazilian exports barely increased during 1996, and have risen by only 25 percent since 1993. This relatively slow growth in Brazilian exports has been accompanied during the past two years by very rapid growth in imports, with the result that the Brazilian current account has moved rapidly into deficit.

In other countries of the region, export growth was generally between these extremes. In Southern Cone countries other than Argentina and Brazil, export growth was low, reflecting in substantial part a reduction in the value of Chilean exports associated with a sharp decline in copper prices. The value of exports grew by nearly 12 percent in the Andean economies, boosted in part by increases in oil prices, and by nearly 8 percent in Central America and the Caribbean, despite the generally unfavorable trends in this subregion's export prices.

Table 11. Exports of Goods and Nonfactor Services

(Billions of U.S. dollars)

	1993	1994	1995	1996
Latin America	199.4	231.1	274.6	304.8
Argentina	15.6	18.5	23.9	27.9
Brazil	43.6	49.0	52.6	54.3
Mexico	61.4	71.2	89.8	106.7
Other countries	78.8	92.4	108.3	115.8
Southern Cone*	32.7	39.3	50.8	54.2
Andean economies	35.1	41.2	47.5	53.0
Central America and the Caribbean	26.7	30.4	33.9	36.5

Note: Some figures for 1996 are based upon IDB projections.
*Excludes Brazil, which would otherwise dominate the subregional average.
Source: IDB economic and social database.

Increased Private Capital Flows

Unlike in 1995, when a large portion of the capital flows to the region were official flows associated with international support provided to help Argentina and Mexico overcome the Tequila crisis, the $63 billion in capital flows to Latin America in 1996 reflected a return of private investors. Official flows were in the aggregate reduced to insignificance by the large Mexican repayments of the loans granted by the U.S. Treasury and the IMF during 1995.

Capital flows to Argentina and Mexico declined sharply over the past two years, falling from nearly two-thirds of the regional total in 1993 to roughly 16 percent of the total in 1996. Meanwhile, reflecting the successful stabilization and reform program initiated in 1994, capital flows from Brazil rose from 2 percent of GDP during 1993 and 1.5 percent in 1994 to nearly 4.5 percent in 1995 and 1996. Capital flows to Brazil now account for nearly half the regional total.

In countries of the region other than Argentina, Brazil and Mexico, capital flows increased from about 3 percent of GDP in 1995 to nearly 5 percent in 1996. Capital flows were particularly large in Bolivia, Colombia, Guyana, Jamaica and Nicaragua. In Bolivia, Colombia and Guyana, the inflows reflected large direct foreign investments, associated in the case of Bolivia with the country's capitalization program. In Nicaragua, the inflows represented large official flows, while in Jamaica, the inflows seem to have reflected short-term portfolio flows attracted by high domestic interest rates.

Table 12. Net Capital Flows to Latin America

(Percent share of GDP)

	1993	1994	1995	1996
Latin America	4.7	2.8	3.4	3.6
Argentina	4.4	3.6	0.8	2.4
Brazil	2.0	1.5	4.3	4.4
Mexico	7.3	2.8	4.5	1.2
Other countries	5.2	4.3	2.8	4.7
Southern Cone*	4.6	4.3	1.1	3.1
Andean economies	5.1	3.4	2.8	4.7
Central America and the Caribbean	5.1	4.1	4.2	4.3

*Excludes Brazil, which would otherwise dominate the subregional average.
Source: IDB economic and social database.

Foreign Direct Investment Remains High

At roughly $33 billion in 1996, foreign direct investment accounted for over half the net capital flows to the re-

FIGURE 23

Net Capital Inflows, 1996

(Percent of GDP)

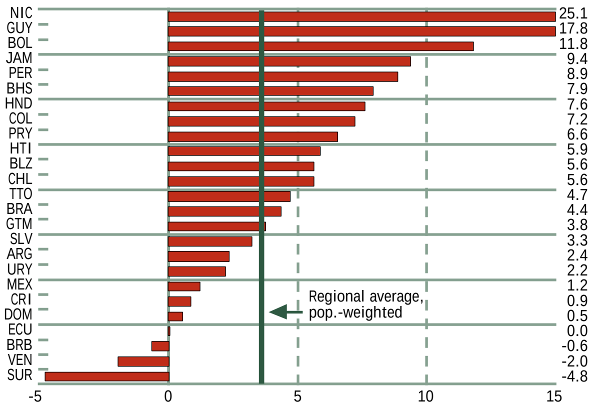


Table 13. Current Account Balance, 1993-96

(Share of GDP)

	1993	1994	1995	1996
Latin America	-3.1	-3.1	-1.9	-2.1
Argentina	-2.7	-3.3	-0.9	-1.0
Brazil	0.0	-0.2	-2.5	-3.2
Mexico	-5.8	-7.8	-0.3	-0.6
Other countries	-4.4	-2.5	-2.6	-1.7
Southern Cone*	-3.2	-3.1	-0.8	-1.8
Andean economies	-4.3	-2.1	-3.1	-0.5
Central America and the Caribbean	-4.4	-3.5	-3.3	-2.3

Source: IDB economic and social database.
*Excludes Brazil, which would otherwise dominate the subregional average.

gion, and amounted to nearly 2 percent of GDP. This compares favorably with 1992 and 1993, when foreign direct investment accounted for only about a third of total capital inflows, though the 1996 figure is somewhat lower than those recorded during 1994 and 1995.

Current Account Deficits High in Some Countries

As noted above, the large capital inflows of 1996 were not accompanied by a significant increase in the region's current account deficit, which remained at about 2 percent of GDP, but were instead used in large part to finance a substantial increase in international reserves. However, in some countries current account deficits have become sizable.

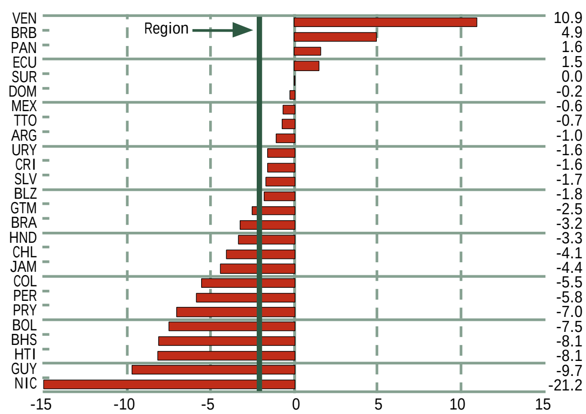
During the past two years, current account deficits in Argentina and Mexico have declined dramatically. At the same time, reflecting the spending boom associated with its successful inflation stabilization, the current account deficit in Brazil has increased from rough balance in 1993 and 1994 to about 3 percent of GDP in 1996. Though this is substantially smaller as a share of GDP than was Mexico's deficit in 1994, Brazil's deficit already represents a larger share of its exports, reflecting the fact that Brazil is substantially less open to international trade than is Mexico.

The current account deficit in 1996 was large—approaching or exceeding 5 percent of GDP—in a number of countries, including the Bahamas, Bolivia, Colombia, Guyana, Haiti, Nicaragua, Paraguay and Peru. Ecuador and Venezuela recorded current account surpluses, reflecting a combination of weak domestic demand and the impact of higher oil prices. The surplus was a relatively modest 1.5 percent of GDP in Ecuador, but reached over 10 percent in Venezuela.

FIGURE 24

Current Account Balance, 1996

(Percent of GDP)



Current Trends in Intraregional Trade

During the 1990s, intraregional trade has grown more rapidly than trade with nonregional partners, as trade liberalization has opened natural trading opportunities within the region. These opportunities have been fostered as well by the important subregional trade agreements of the 1990s aimed at further opening markets, intensifying competition and creating new trade and investment links.

This trend is particularly pronounced in the case of exports. Since 1990, intraregional exports have grown by 18 percent a year on average, compared to 9 percent growth in nonregional exports, and now account for 18 percent of total Latin American and Caribbean exports, up from 12 percent in 1990.

In 1996, however, the region's intraregional exports grew at a slower rate (7 percent) than exports to third markets (12 percent). Three subregions—the Central American Common Market (CACM), the Andean Community and the Group of Three (G-3)—followed this overall trend, while NAFTA and MERCOSUR did not. In all subregional markets except NAFTA, growth in intrasubregional commerce slowed markedly in 1996.

Intra-CACM exports expanded by just 5 percent in 1996, a growth rate much lower than the average for the 1990-95 period. While intraregional trade has expanded less rapidly than that of other integration groups in Latin America, such trade now accounts for roughly 20 percent of total CACM exports, up from 16 percent in 1990.

After several years of rapid growth, intra-Andean trade stagnated in 1996, growing by only 1.2 percent compared to 1995. While intraregional exports still account for only 11 percent of the subregion's total exports, the Andean market is of much greater significance for some countries (notably Colombia and Bolivia).

Trade among the G-3 members declined by 2 percent in 1996. Intragroup trade accounts for less than 3 percent of overall G-3 exports, although such exports have tripled in absolute value since 1990.

Trade among MERCOSUR member countries slowed in 1996 to 12 percent, compared to over 20 percent in 1995. As in previous years, however, intra-MERCOSUR trade again expanded at double the rate of the subregion's exports to third markets, and now accounts for 22 percent of total exports, up from 9 percent in 1990.

Intra-NAFTA exports expanded more rapidly than NAFTA's total exports, contrary to what happened in 1995. One of the most notable developments in 1996 was the recovery of Mexican imports from the United States, following a sharp drop in 1995 as a result of the Mexican peso crisis. Since 1990, intra-NAFTA trade has expanded by almost 11 percent a year. This is faster than the 7 percent increase in NAFTA's trade with third countries, and now accounts for almost 50 percent of total NAFTA exports.

From 1990-95, intra-CARICOM exports grew more than twice as fast (9 percent) as CARICOM exports to the rest of the world (4 percent). Like other subregions in the hemisphere, CARICOM countries thus seem to be taking increased advantage of regional export opportunities. Nevertheless, intra-CARICOM exchanges still represent only around 10 percent of the subregion's exports.

The picture for imports is slightly different: here, nonhemispheric markets have slightly increased their share as suppliers to the Latin American market. In 1995, almost 35 percent of the region's imports were supplied by countries outside the hemisphere (mainly the EU, Japan and the Asian NICs), compared to a 33 percent share in 1990.

Regional Trade Initiatives

The past year has seen a number of initiatives among Latin American and Caribbean countries to deepen and widen their regional trading arrangements, while also seeking closer links with their nonregional trade partners.

The countries of the Central American Common Market (CACM) have agreed on a new schedule for convergence to a lower common external tariff (CET). By the year 2000, all countries will have a CET of between zero and 15 percent depending on the nature of the products. CACM members have also taken steps to coordinate future trade negotiations with third countries and blocs: some negotiations may be undertaken jointly by Central American governments. One of the immediate concerns for the isthmus is the erosion of preferences with the United States and Canada due to the NAFTA agreement between these countries and Mexico. Central American countries have announced that they will seek a reciprocal free trade agreement with the United States, rather than pursue their earlier request for nonreciprocal NAFTA parity. They are also engaged in talks for a free trade accord with Mexico and CARICOM, and have voiced their intention to pursue closer relations with MERCOSUR.

Members of the Caribbean Community (CARICOM) have advanced steadily in terms of convergence to a lower common external tariff. On the external front, CARICOM faces major challenges, among them the possible revision of the European Union's banana regime following a recent finding by the World Trade Organization (WTO) that the regime in its present form is incompatible with multilateral trade rules. Several Caribbean countries depend heavily on income from this special regime, as well as other preferences granted by the EU under the Lome IV Agreement, which expires in the year 2000. Moreover, CARICOM countries have not been successful to date in their efforts to secure NAFTA parity. In order to face these challenges and to participate effectively in the hemispheric integration process, CARICOM governments decided in late 1996 to create a joint negotiation facility; to this end, a chief negotiator for CARICOM was appointed in early 1997.

In an effort to revitalize their integration scheme, Andean Group presidents agreed in Trujillo in March 1996 to implement wide-ranging institutional reforms, including the creation of a new Andean Integration System to strengthen management of integration at the political level and to foster more effective coordination between the various Andean institutions. Recent political and economic problems in some member countries have clearly complicated the Andean integration process. One of the most serious challenges has been related to Peru's continued special status vis-à-vis the rest of the Andean Group. Peru left the Andean free trade area in 1992 and has since maintained bilateral trade agreements with its Andean partners. A breakdown in talks regarding the conditions of Peru's reincorporation has recently led to the announcement of that country's separation from the regional trading bloc.

Members of the Southern Cone Common Market (MERCOSUR) continued efforts to deepen and widen their integration scheme. At its December 1996 meeting in Fortaleza, Brazil, the Common Market Council took concrete steps towards solving certain remaining obstacles to intraregional commerce. It also announced the establishment of a MERCOSUR development bank to finance integration-related investment projects, as well as a secretariat, with headquarters in Montevideo, which is to provide administrative support to the integration process. In 1996, MERCOSUR signed free trade agreements with Chile and Bolivia. With the incorporation of these two countries as associate members of MERCOSUR, the subregion has taken the first step in its plans to create a much wider integration scheme. The area of free trade that will emerge from these agreements incorporates half of the region's population and almost 60 percent of its GDP. MERCOSUR has also entered into expansion talks with the Andean Group. An agreement between the members of the two blocs could establish an area of free trade encompassing virtually all of South America.

Since implementation of the North American Free Trade Agreement (NAFTA) in 1994, tariff reductions among the countries have proceeded as scheduled; a decision was taken in early 1997 to speed up liberalization for some products. NAFTA countries have also progressed in dismantling nontariff barriers to trade, which are of particular importance in the agricultural area. The U.S. decision in early 1997 to lift an 83-year ban on the import of Mexican avocados has sparked optimism that the two countries may be set to resolve further issues related to agricultural trade. While NAFTA enlargement is being delayed by the U.S. government's lack of fast-track negotiating authority, both Canada and Mexico have independently pursued bilateral trade talks with countries in the hemisphere. Canada signed a free trade agreement with Chile in November 1996, and has expressed its intention to pursue trade negotiations with other Latin American countries as well. In 1996, Mexico reinitiated trade talks with Central America and began negotiations with Ecuador; it currently has agreements with Chile, Costa Rica, Bolivia, Venezuela and Colombia.

At the hemispheric level, the 34 countries participating in the Free Trade Area of the Americas (FTAA) process have made significant progress in their preparatory work and are now discussing the possibility of launching formal free trade negotiations in 1998. There is no decision as yet on the specific timetable of negotiations and the priority of subject areas to be negotiated, although upcoming ministerial meetings are likely to produce specific decisions in this respect. Areas of identified consensus include the need for negotiations to be a single undertaking, and agreement that subregional agreements can coexist with a hemispheric accord, countries can negotiate in blocs or individually, a secretariat must be formed to support upcoming negotiations, and an FTAA agreement must be consistent with the rules of the WTO.

The past year also witnessed some setbacks in the region's trade liberalization efforts. Brazil's recent imposition of new import finance restrictions is one example. Colombia and Ecuador, too, resorted to some import-restricting measures in early 1997, while other countries have witnessed certain delays in complying with their agreed tariff reduction schedules. These measures were generally taken in response to fiscal or balance of payments disequilibria in some of the region's economies.

CONTINUED STRUCTURAL REFORMS

In addition to the trade policy reforms just described, countries of the region made important progress in structural reforms in the areas of financial markets, tax and fiscal matters, privatization, labor markets, and social security systems.

Financial Reform

Financial reform has advanced at an uneven pace, with liberalization measures well ahead of supervisory and regulatory reforms. This disequilibrium, which contributed to financial crises in several countries in the last few years, was partly corrected in a number of countries in 1996. In Mexico, several relief programs have been implemented to reduce the number of the nonperforming loans that resulted from the crisis of 1995 and have since burdened the banking sector. The adoption of the U.S. Generally Accepted Accounting Principles in 1997 will improve supervision, but may bring to the surface larger amounts of nonperforming debts in a number of banks. Measures taken in 1996 to strengthen the regulatory framework include higher capital requirements, new standards for loan classification, and a revised methodology of asset valuation.

In Paraguay, where the financial sector was under stress in 1996, a new banking law has been issued. Universal banking will be adopted, capital requirements determined according to levels of risk of the assets, and supervision strengthened. Four intervened banks are now subject to rehabilitation programs and the process of reduction and harmonization of reserve requirements, which was interrupted in 1995, has been reinitiated. As in Mexico, the financial crisis is imposing a heavy burden on the fiscal side, which may crowd out other public expenditures.

Emergency measures were also taken in Ecuador to deal with several insolvent financial institutions. Belize improved legislation related to the central bank and strengthened its supervisory capabilities. Guyana issued rules aimed at raising capital ratios and improving competition in the financial sector. In Haiti, the central bank established prudential norms that facilitate supervision and regulation of banks. In Peru, laws were issued to improve and modernize the supervisory system. Capitalization requirements have been raised, the principle of consolidated supervision established, and the regulatory capacity of the supervisory institution strengthened.

Fiscal Reform

Tax reforms aimed at strengthening fiscal revenues and simplifying the tax codes were passed in several countries in 1996. In Argentina, the reform increased the excise tax on gasoline and the marginal income tax rates for corporations and individuals, improved the tax administration system, and introduced changes to a number of other taxes. A proposed widening of the value-added tax (VAT) base was not approved by Congress. In Bolivia, major changes were introduced to the tax system of the hydrocarbons sector. A tax on the extraction of nonrenewable resources was implemented and the system of royalties and excises restructured.

Barbados and Belize introduced VATs to replace consumption and import taxes and reduce tax distortions. A total of 23 countries in the region have adopted VATs to replace more distortionary taxes. Guatemala raised the VAT tariff from 7 percent to 10 percent and introduced a temporary surcharge to the income tax.

Measures to improve tax collection administration were also implemented in the Dominican Republic, Guyana and Mexico.

Important tax changes could take place in Colombia and Mexico in 1997. In Colombia, a tax reform introduced by government decree in early 1997 was declared unconstitutional, and new measures to strengthen tax collection or to reduce intergovernmental transfers may be discussed in the near future. Mexico is considering several tax reductions as a means to encourage investment and saving, which would partly reverse measures taken in 1995.

Privatization

The privatization process has gotten a second wind in the region, due to ambitious programs in Brazil and Bolivia and a new round of sales in Peru, Mexico, Colombia and Venezuela, among others. In a large number of countries, however, privatizations are facing major political opposition, and in a few cases have been halted altogether.

Brazil sold public assets in 1996 worth nearly $6 billion, its peak level since the initiation of the privatization program in 1991, and in early 1997 launched a program of sales of mining, petrochemical and infrastructure firms that is expected to raise $50 billion in two years.

Bolivia made substantial progress in its innovative program of capitalizations initiated in 1995. Of the six companies included in the program, only one remained to be capitalized as of the end of 1996 (a tin and antimony smelter). After much discussion and delays, the capitalization of the hydrocarbon company took place in December.

In Peru, the privatization process continued, with divestiture of 22 public enterprises, sale of minority stakes in telecommunications and electricity companies, and some important sales and concessions in the hydrocarbon and petrochemical sectors.

After being halted in 1995, privatizations were reinitiated both in Mexico and Colombia in 1996. In the midst of political opposition, the Mexican government is proceeding with liberalization of sectors such as telecommunications, port and airport management, and with divestiture of railways and airports and sales of minority stakes in petrochemical plants. Colombia reinitiated divestitures in 1996, with important sales of electricity generating plants and a bank.

In Venezuela, in spite of some delays, several transactions were completed. A 49 percent stake in the telephone company was sold and several financial institutions that had been intervened in during the financial crisis were transferred to the private sector. There were sizable divestitures of ports in Panama, and in Guyana, six public companies were brought to the point of sale in 1996 and are expected to be transferred to the private sector in 1997.

Changes in the regulatory framework for the eventual privatization of utilities took place in El Salvador, Guatemala and Panama.

Labor Market Reform

Labor reforms have so far been rare in Latin America, and 1996 was no exception. A profound reform was decreed in Argentina, which is intended to replace severance payments by monthly contributions in personal saving accounts and to reform the collective wage bargaining process, ending the automatic renewal of collective agreements. The reform was contested by Congress and had not been approved as of May 1997.

In Venezuela in mid-1997, a Tripartite Commission representing labor unions, employers and the government reached an agreement to reform the costly severance system, within the context of a major reform of the country's social security system. Over a period of five years, workers will receive twice the amount corresponding to the severance rights acquired until 1996. The system of severance payments will be transformed into one in which employers make annual mandatory contributions to individual workers' accounts, which would become available to workers in the event that the employment relation is terminated, and be required to pay a penalty for an unjust dismissal of workers. The new labor law was approved by the Congress in June 1997.

Social Security Reform

Social security reform proceeded in Mexico, with registration of the private pension funds that are initiating operations in mid-1997. The new pension system, based on individual capitalization, will replace the old pay-as-you-go system, in one of the deepest pension reforms undertaken in Latin America in the last decade. In Uruguay, following decisions taken in 1995, the old system was split into two pillars, whereby the private pension funds complement the pay-as-you-go system. In Bolivia, a law was approved replacing the pay-as-you-go system with a system based on individual contributions administered by private companies, scheduled to start operations in mid-1997. The new system, to be partly funded by the revenue flows from capitalized companies, involves payments to all Bolivian citizens aged 65 or over. In El Salvador, Congress cleared the way for creation of private pension funds, which will start to operate in 1997 and gradually replace the traditional benefit-defined system.

The above-mentioned Venezuelan agreement on a reform of the social security system would replace the existing pay-as-you-go pension system with individual capitalized accounts and a publicly-funded minimum pension. It would also reform the health and unemployment compensation funds of the existing social security system.

CONCLUSION

The year 1996 produced mixed results: growth recovered from the anemic rate of the preceding year, but the rebound was largely due to strong recoveries in Argentina and Mexico, and growth was generally weaker in the rest of the region. Although investment demand was robust in the region as a whole, this too was largely due to developments in Argentina and Mexico, and investment demand slackened in much of the rest of the region. Several countries displayed signs of economic and financial stress. In many countries, domestic saving rates appear to be recovering from the substantial declines of the first years of the decade, but in Brazil national saving has recently declined dramatically.

Much of this variation can be understood in light of the progress that countries have been making through the process of adjustment to economic stabilization and reform programs. This suggests at least two messages.

First, with respect to prospects over the near term, experience suggests that the period of economic deceleration and financial stress that often materializes as an economy adjusts to a major stabilization and reform program is temporary, reflecting transitory cyclical dynamics, and not necessarily any fundamental shortcoming in the underlying reform strategy. If the correction is effected without a loss of macroeconomic stability, or if stability is rapidly restored, these short-term, cyclical dynamics become of gradually declining significance, and longer-term factors related to the external environment and the adequacy of the policy environment become the key determinants.

Though there is not yet much experience, it is noteworthy that the countries of the region that have entered this post-correction phase have recently exhibited moderate to high rates of economic growth, with generally strong investment and rising rates of national saving. While it would be unwise to draw strong generalizations from this experience, given the rather different structural policy stances in the various countries, it is nevertheless an optimistic message for the region's medium-term growth prospects.

Second, with respect to policy implications, the challenges facing most countries of the region continue to concern maintaining adequate management of the macroeconomic response to reform. Countries in the early expansion stage of a stabilization and reform episode have the opportunity to act preemptively to ensure that the recovery does not generate the fiscal and financial vulnerabilities that generate subsequent financial stress. This means ensuring that the fiscal stance is sufficiently strong that a transitory deceleration in the rate of economic expansion will not generate fiscal deficits large enough to require major, destabilizing fiscal contraction. It also means keeping a sharp eye on the domestic financial system to ensure that an excessively rapid bank lending boom does not unduly amplify economy expansion, and set the financial system up for difficulties when the economy slows. These aspects of macroeconomic policy management are described in more detail in Part II of this Report, while the institutional context of fiscal policy management is analyzed in Part III.

For a number of countries in the region, the immediate policy problem is ensuring that the economic and financial stresses that have emerged do not lead to a painful crisis. Here the main challenges are to address fiscal shortfalls that may emerge as the economy slows, avoid a potentially destabilizing decline in confidence, and scrutinize domestic banks and intervene early to ensure that weak banks do not magnify the likelihood and costs of a banking crisis by "gambling for resurrection."

For countries that are no longer heavily influenced by the dynamics of adjustment to stabilization and reform programs, the challenge is to bear in mind that the task of reform is not therefore complete, and that much remains to be done on the policy agenda to promote economic growth, assure macroeconomic stability, improve prospects for employment, and ensure that the benefits of economic reform are distributed fairly. Part II of this Report describes in more detail the state of the structural policy reforms in different countries of the region, the impact on longer-term macroeconomic performance of these reforms, and the potential to improve long-term performance with deeper reforms.