Sustainable Development: Promoting Progress or Perpetuating Poverty?
edited by Julian Morris
published by Profile Books, London, August 2002

Chapter 5

Unsustainable Development, Latin Style

Fabiano Pegurier and Gilberto Salgado

Introduction

In 1900, Latin America (all the countries on the American Continent south of the United States) had a population of about 70 million; today that population stands at over 500 million. In 1900, per capita income in the region was approximately 14% that of the US; this rose during the early part of the century but fell again and today it is probably lower than it was in 1900.[1] This chapter focuses on the most critical factors shaping the course of the last 50 years of the region's economic development, especially the rise of government intervention and inflation, as well as subsequent reforms.

Import-Substitution Industrialization (ISI)

After World War II, the governments of Latin American countries adopted deliberate measures intended to reduce their dependence on the export of primary goods. The justification for such policies came from a belief that income from the sale of primary exports would not grow in proportion to the increase in the income of the wealthiest countries.[2] It was argued that the terms of trade between agricultural and manufactured products had a secular tendency to deteriorate and that this was a structural problem. In other words, countries reliant on exports of agricultural products would inevitably grow less quickly than countries whose main exports were manufactured goods. To get out of this bind, developing countries were advised to adopt measures to promote import-substitution industrialization, or ISI.

ISI proponents disputed the argument put forward by classical economists that market-driven specialization, comparative advantage (in international trade) and domestic savings were the engines of growth. Indeed, according to one variant, no matter how much domestic saving occurred, investment would be structurally limited by the lack of foreign exchange required to import the necessary raw materials and intermediate products. Specialization, even if accompanied by some gains in productivity, would not lead to development, but to deeper specialization, and the gains would accrue entirely to the more advanced countries.

The prevailing view was that of the United Nations' Economic Commission for Latin America (ECLA), under the direction of Raúl Prebisch. According to this view, known as "structuralism", Latin America needed significant government intervention in order to develop. In particular,

---

[1] World Bank (2001); Thorp (1998); Precise estimates are difficult because of the chaotic economic situation in one of the regions largest countries, Argentina.
[2] In economic jargon: the income elasticity of such exports was believed to be less than unity.

structuralists argued that government should promote industrialization through the protection of the domestic manufacturing sector from foreign competition, thus reserving scarce foreign exchange for essential purposes only.

It is worth bearing in mind that structuralists and other proponents of ISI promoted a particular form of industrialization. Critics of ISI policies did not argue that industrialization was not desirable – they simply questioned the methods chosen by the supporters of ISI. This is why a major participant in these debates, Professor Gottfried Haberler, would often quite deliberately refer to ISI not as such, but as "the policy of extreme protection."[3]

Aiming at ISI, Latin American governments adopted import restrictions, exchange controls, limits on the export of products "needed" by the domestic manufacturing sector, and gave financial subsidies to certain industries. They also often became directly involved in import-substituting production. In addition, governments kept local currencies generally overvalued, which hurt primary exports, lowered incomes in rural areas, and made agricultural products more abundant and cheaper domestically. This amounted to an additional subsidy to industry, as it simultaneously stimulated migration to urban areas and kept the price of food low, reducing industry's labor costs.

The Impact of ISI Policies

These policies had several undesirable consequences. The artificially low prices of imported intermediate products and capital goods helped to make industry more capital intensive (and less labor intensive) than it need have been. The expectation that a dynamic industrial sector would generate enough jobs to absorb workers displaced from the rural areas was unfounded. Income inequality was aggravated and the breakneck speed of industrialization was accompanied by the creation of gigantic urban slums. Also, the high level of trade protection, combined with the scarcity of foreign exchange, made it strategically profitable to import obsolete and highly polluting equipment.

Since the export sector was hurt by the overvalued exchange rate and the misdirection of resources to industry (which consequently had less incentive to compete in foreign markets even if it could), export revenues dwindled, with at least two significant consequences:

First, it restricted the amount of foreign exchange available for imports, decreasing the flexibility of local demand for imported goods and making Latin American countries more, rather than less, vulnerable to eventual unfavorable changes in the terms of trade. Since the industrialization drive could not be kept alive by indefinitely increasing trade deficits, the need for foreign direct investment as a source of foreign currency became crucial. This was a rather ironic unintended consequence, as it ran counter to the driving idea that national industry should supersede the need for reliance on foreign producers.

Second, the ailing export sector had the effect of reducing government revenues, which had depended heavily on high taxes on exported products. That in turn placed a heavy burden on the public budget, as government expenses had been growing with the policies that increased direct and indirect interference in the economy, including a large bureaucracy, overstaffed public enterprises, and nationalized industries. The result was greater pressure on governments to print money to cover their deficits, fuelling inflation. Fiscal imbalance became characteristic of Latin

[3] Haberler (1974), p. 152, for instance.

American countries and especially Argentina, Brazil, Chile, Uruguay, Colombia, Peru, and Venezuela during this period.[4]

In the early 1960s, the economic imbalances caused by industrial protectionism, and also a complete neglect of agriculture became obvious. The initial stimulus to economic growth that ISI helped to promote could not be sustained, and manufacturing output grew at half the rate it did in the 1950s. However, the initial apparent effectiveness of ISI policies increased hopes for their eventual success and undermined the prospects for those who sought other paths to economic growth. This led to costly dependence on continued government support and to the formation of pressure groups to maintain these privileges. In most cases, the narrow goal of helping industries to become self-sufficient and self-sustaining turned into a distant hope. Tariffs were increased, as more and more sectors needed some form of government support to protect them from foreign competition.[5]

In 1962, manufacturing output represented 32% of Argentina’s GDP, but only 3.2% of its exports. Other Latin American countries following ISI policies showed similar ratios: Brazil (26% and 3.2%); Chile (29% and 3.7%); Colombia (17% and 3.5%).[6]

In the mid-1960s, beginning with Chile, Brazil, and Colombia, most Latin American countries started to change their policies. Gradual devaluations became the rule, export subsidies were widely adopted and some reasonably successful attempts were made at reducing fiscal deficits and control inflation. These measures allowed growth to occur at a faster pace by the end of the 1960s, and Latin America’s GDP per capita grew at an average of 3.4% in 1965-70, versus 2% in 1960-65. Even Mexico, whose average annual per caput GDP growth was 4% in the first half of the decade, managed to increase the pace to 4.4% in the second half.

It is instructive to look at the contrasting patterns of growth in Peru and Colombia. From 1950 to 1965, Peru was a relatively open economy, with virtually no deliberate industrial policy, and from 1960-65 GDP per capita grew at an average rate of around 3 per cent – far faster than the regional average. In the late 1960s, Peru’s government adopted heavy-handed industrial protection and growth in GDP per capita almost stagnated, with growth during the 1970s averaging only 0.8%. Colombia, on the other hand, grew more slowly than the regional average from 1950-65, but as it started to reduce the level of protection and to promote exports, output responded and GDP per capita went from an average of 1.3% in 1960-65 to 3.0% in 1965-70 and 3.6% during the 1970s.[7]

---

[4] The first four countries listed were the ones that reached particularly high inflation rates in the 1950s and 1960s. Bolivia reached even higher rates in the 1950s, but it was going through a civil war.

[5] Average tariffs and charges for semi-manufactured and durable consumer goods in 1957-59: Brazil, 143%; Argentina, 139%; Chile, 96%; Colombia, 48%; Mexico, 58%; Peru, 25%. Moreover, negative interest rates were also used to reduce the cost of capital in the local market. In absolute values, these rates went from 21% in Brazil, to 1.2% in Peru, following the above country sequence. Sheahan (1987), p. 87.

[6] Ibid., p. 90. The figures for the ratio of manufactured products to GDP are overestimated, especially in those countries where protection was greater and domestic prices were much higher than international prices. Ibid., p. 86. What is clear is that industrial production was directed toward the domestic market. Since manufacturing did depend on protection, the growth in manufacturing had to rely on the level of domestic demand during a period in which international trade was booming.

[7] Ibid., pp. 95-96.

Besides support for export promotion, which was eventually favored by structuralist thinkers, the 1960s and 1970s saw defenses of regionalized trade as a means to broaden the scope of ISI.[8] The Andean Pact of 1969, which included Bolivia, Chile, Colombia, Ecuador, Peru, and, later, Venezuela, may have been the foremost achievement along these lines. Despite a reduction in the very highest marginal rates – which began in the mid-1960s – tariffs remained very high and unequal towards goods from countries outside these accords.

During the late 1960s and the 1970s, Brazil, Mexico, and Colombia promoted exports through subsidies. Despite some significant increases in exports, however, such programs did not have substantive effects on the structure of their economies.[9]

Moreover, the region as a whole performed dismally during this period. Between 1965 and 1980, exports *fell* an average of 1% per year in Latin America, while they *grew* an average of 10% per year in the "Asian Tiger" countries, which included South Korea and Taiwan. A myriad of factors have been adduced to explain this difference.[10]Abnormally high tariffs hurt potential exports that required imported inputs. Local substitutes, when available, were rarely affordable or up to standard. Indeed, a primordial problem in countries attempting to create new industries (and support existing ones) is the lack of relevant skills by the local labor force. However cheap, such labor tends to be quite costly. ISI did nothing to increase the cost-effectiveness of local labor. On the contrary, decades of high protection were a cause of uncompetitive wages.

Regardless of how they were promoted, investments in Latin America tended to yield a low return. In part this was because the economies of the region have been very heavily regulated. Not only have incentives been distorted - the rules and regulations themselves have often been contradictory and impermanent.

Finally, the promotion of exports was not a particularly measured attempt to generate foreign exchange. Unlike East Asian policy, subsidies were not usually conditioned on results or set to expire within definite time periods. The policies that gave governments discretionary power to set very uneven tariffs eventually also allowed for the arbitrary disbursing of subsidies to chosen sectors. There was no real quest for efficiency. Instead, as had happened to protectionist measures for industry, support for exports became the source of rent through wasteful privilege-seeking activities.

ISI led to an endless stream of unintended consequences. The policies made income distribution more unequal and the long-run level of growth was lower than would have been the case if there had been fewer interventions in the market. More importantly, ISI caused huge silent disruptions in people's lives. Massive migrations from rural areas may have helped boost the growth of the manufacturing sector temporarily. But absent the ISI's market-distorting policies, many of those migrants would probably have continued to live where they were respected, working on activities they had already mastered, instead of moving into cities to live anonymously in slums, looking

[8] This fact is acknowledged on the historical background offered by the internet site of the new version of Pacto Andino, Communidad Andina (Andean Community).
[9] EDWARDS (1997), p. 66.
[10] See BRUTON (1998) for a balanced, relevant discussion, that considers South Korea's ISI efforts and relates the experiences of that country, after the mid-1960s, to that of Latin America. Our discussion is more straightforward, as is Edwards, op. cit., pp. 69-74 and 150-153.

for work in unfamiliar trades. Similarly disturbing is the evidence that these masses have fallen prey to populist politicians responsible for some of the worst calamities ever to afflict their lives.

Inflation

High inflation has been one of the main problems in Latin American countries during the last fifty years. The issue is particularly serious because governments of the region have been engaged in the promotion of growth, and policies so oriented. As Haberler said, even if such policies were acceptable on other grounds, "[they] cannot be justified if [they have] to be financed by rapid inflation since the resulting growth invariably proves unsustainable."[11]

The basic problem has been the enduring tendency for governments to spend beyond their means, eventually financing their deficits through monetary expansion. In most countries, stabilization plans have been periodically implemented, but no plan that failed to deal with this issue was ever successful. Despite this, many theorists in Latin America, especially those of structuralist persuasion, have insisted that there were underlying social and economic forces that were more important. Some successful (basically orthodox) programs nevertheless contained elements of government intervention in the practices of the private sector, aimed at avoiding unnecessary costs of adjustment related to indexation, which established demands on future output based on previous inflation, in effect anticipating effects the causes of which the programs sought to eliminate.

In the 1950s and 1960s, Argentina, Brazil, Chile, and Uruguay were the countries with particularly high inflation rates. The worst case may have been that of Brazil, where inflation approached 100% in 1963. Between 1964 and 1966, military-led Brazil adopted a largely successful program that contained and brought down accelerating inflation. The government concentrated its efforts on deficit reduction, but it also adopted less orthodox means, such as a wage policy, to help break the inflationary memory of the system. Inflation rates fell significantly, providing the basis for the subsequent "Brazilian miracle" years (1967-74) of very high growth and increased productivity.

The oil crisis of 1973 put pressure on these governments to devalue their currencies and established a tendency for real wages to fall, in order for the shock to be absorbed.[12] But many governments were committed to growth and thought that they could avoid the adjustment, hoping, instead, to take advantage of the high liquidity of international financial markets. Indeed, due to the extraordinary revenues of oil-exporting countries, commercial banks became a major source of capital for developing nations, which allowed fiscal policies to become even more expansive than usual. Governments used foreign exchange reserves to intervene in currency markets in an attempt to keep inflation under control, by keeping fiscal deficits down and financing rising imports. Nevertheless, inflationary pressures increased.

At the end of the 1970s and in the beginning of the 1980s, the world went through a second oil crisis. The consequent rise in international interest rates, and the slowdown in economic activities hurt Latin American exports. With dollar revenues declining and foreign debt service payments rising, Latin American indebtedness rose at an unsustainable average of 20% a year.

[11] Haberler (1974), p. 152.
[12] But note that Mexico, Venezuela and Colombia were oil exporters, while Argentina, Chile, and Peru were basically self-sufficient.

Between 1973 and 1982 the real dollar value of foreign debt grew sevenfold; as a percentage of GDP it rose from 19% in 1975 to 46% in 1982.[13]

The Debt Crisis and the 'Lost Decade'

In 1982, after a decade of borrowing to finance huge increases in government expenditures, Mexico, despite being an oil exporter, was unable to meet its obligations to foreign creditors. As a result, new credit to the region became extremely limited.[14] It was the beginning of the "debt crisis." Accustomed from years of heavy protectionism to direct production and local consumption, Latin American countries had no recourse but to reduce imports and stimulate exports, and many responded with sharp currency devaluations.[15]

Governments sought to finance themselves with credit from domestic commercial banks, which led to a rise in interest rates, with a deleterious effect on private investment. This reinforced the tendency for declining economic activity and hurt revenues further. It became impossible to service the external debt or to finance public debt without inflating the money supply.[16] The pressure over domestic prices mounted and high inflation became an endemic problem. Most affected was Bolivia, where the consumer price index, CPI, rose on average by 2692.4% per year during 1981-85. During the same period, Argentina's CPI rose on average by 382%, Brazil's by 153.9%, and Peru's by 104.9%. The IMF index of consumer price inflation for non-oil-exporting developing countries in the Western Hemisphere went from 38.7% in the 1970s to 95.9% in 1980-84 and to 163.6% in 1984-85.[17]

The impact on growth was dramatic. The 1980s became known as "the lost decade," though perhaps the period should be extended to include the 1970s too. Average gross product per capita for the region fell 0.9% in 1970-80, 1.5% in 1980-85, and 0.2% in 1985-90. In the 1990s, the region's average gross product grew by a modest 1.2%.

Besides the huge nominal devaluations in exchange rates, efforts to reduce imports and increase exports included enhanced use of traditional ISI measures. The adoption of higher tariffs and the broadening of the scope of import licenses and quotas became standard responses. Despite significant achievements, these efforts were insufficient to generate the needed resources to service the debt and protracted negotiations took place, involving multilateral institutions and foreign commercial banks.

---

[13] The average real interest cost of floating rate dollar debt rose from minus 8.7% in 1977-80, to nearly 16% in 1981-83. The fall in the prices of exports, in turn, had a serious impact even in a country such as Colombia, which did not otherwise have significant macroeconomic or current account imbalances. The same applied to countries that had engaged mainly in fixed interest rate contracts.

[14] Net transfers to the region went from US $39.8 billion in 1979-81 to negative US $90.8 billion in 1983-85, for a reversal of US $149 billion in 1979-85.

[15] In South America, no country had nominal devaluation of less than 200% in 1982-87. In Mexico, it was of 4,756%, and in the region as a whole, 250,327%. Nevertheless, inflation was such that in some countries domestic currencies actually appreciated.

[16] A study of seignorage revenue in the Bank of England Group estimates that the ratio of inflation tax to government revenue in 1979-1993 was 43.7% in Argentina and 23.6% in Mexico. FRY et al (1996), pp. 133ff.

[17] IMF, *International Financial Statistics*.

In the mid-1980s several adjustment plans were implemented, including three whose failures had significant consequences for future transformations in the region.[18] In Argentina and Brazil, the plans placed almost exclusive emphasis on inertia – the element in price inflation related to the generalized indexation of the economies. A relatively modest effort to control the fiscal deficit took place in the early stages of Argentina's "Austral Plan". Such effort was not even envisaged in Brazil's "Cruzado Plan". In Peru, the "APRA Plan" actually stimulated demand.

These plans failed miserably because they concentrated on the elimination of the symptoms of inflation rather than its causes. In the process, they fostered major intrusions and disruptions in private activities. An important share of professional local economists saw in them the occasion for promoting a concerted increase in government participation in the economy. But their failure changed perceptions about the importance of fiscally responsible management and the ineffectiveness of attributing to the private sector ills that are of the government's own making.

Reforms

By contrast, in the late 1970s Chile's government decided to free prices, eliminate quotas and tariffs, free interest rates, eliminate credit controls, free the flow of foreign capital, and reduce the share of the public sector in production.[19, 20] These policies were vehemently attacked by economists of structuralist conviction. But after a period of difficulty, due to macroeconomic mismanagement and the onset of the debt crisis, the economy began to grow rapidly. These pro-market policies, initiated under the military rule of General Pinochet, were continued by the democratically elected Aylwin government, which was inaugurated in 1989. The policies were even backed by some of their former critics.

Several factors combined to encourage other countries of the region to adopt market-oriented reforms in the late 1980s and 1990s. Among them were the Chilean experience, the fiasco of heterodox stabilization programs in the mid-1980s, the perception of the "Asian Tigers" as comprising basically unhampered market economies, and the encouragement of multilateral institutions, both financially and through studies showing the benefits of liberalization.[21]

In the mid-1980s, several countries started to use the secondary market to rescue their sovereign debt. This strategy gained impetus in 1988, as Chile used debt capitalization to pay for the privatization of state enterprises. Starting in 1989, countries used an important American initiative - the Brady Plan - to negotiate with foreign banks ways of reducing and rescheduling debt payments. Bolivia, Chile, and Mexico were among the countries that opted for using the secondary market; Argentina, Brazil, Costa Rica, Mexico, Uruguay, and Venezuela reduced their debts with the help of the Brady Plan.

Debt renegotiations and financial support from multilateral institutions, conditional on reforms, were instrumental in changing policy and institutions and set Latin American countries on the

---

[18] Edwards, *op. cit.*, ch.3, discusses in detail the factors responsible for the emergence of interest in the market-oriented reforms of the late 1980s and the 1990s.
[19] Fishlow and Cardoso (1992).
[20] These policies were attempted with less emphasis also in Uruguay, where they had some measure of success, and in Argentina. Fiscal policies were lax, and hence inconsistent with the fixed exchange rate established by the plans, leading to overvaluation and loss of reserves. In Chile, a major inconsistency lied in fixing the nominal exchange rate while keeping wage indexation - inertia led to an appreciation of the peso.
[21] See Edwards, op. cit., pp. 68-81. Cf. Bruton, *op. cit*., pp. 626 ff.

path to liberalization. Among the most aggressive reformers were countries in such dire situations that they had little to lose from radically changing course, such as Argentina and Peru, as well as the early reformers, Chile and Bolivia. Several distortions were addressed. A more favorable macroeconomic environment was achieved through greater fiscal restraint and increased revenues from the privatization of previously burdensome companies. The sale of major state-owned telecommunications, transport, mining and steel enterprises, for instance, and the regulation of newly competitive sectors were important achievements, since earlier market-oriented reforms did not even address privatization.

With respect to trade liberalization, according to the Inter-American Development Bank, "average tariffs fell from close to 50% in 1985 to around 10 percent in 1996, and maximum tariffs fell from an average of 84% to just 41%. By 1996, non-tariff barriers affected only 6% of imports, while in the pre-reform period they affected 38%."[22] Lower tariffs and the end of export subsidies caused the miserable failure of industries that had been protected for as many as 30 to 35 years, under the assumption that they would eventually become competitive. The auto parts industry in Brazil is one of the most remarkable cases.

Since 1994, when Brazil tamed hyperinflation (2,489% in 1993), the average growth rate of the consumer price index for the region (including the Caribbean) has fallen dramatically, from 25.8% in 1995 to 6.3% in 2001.[23] Ecuador, with inflation approaching 40% in 2001, was practically the only country significantly removed from the single-digit rate. But the country has now replaced its currency for the U.S. dollar, and inflation should drop to single-digit levels in 2002; indeed, most of that 40% occurred prior to the May 2001 change.

Some Persisting Problems

It would seem that, after 40 years of growth promotion, Latin American governments have finally become more interested in creating a market-friendly environment conducive to sustainable development. That path, however, is not yet clear.

The continued existence of powerful interest groups makes it unlikely that fundamental reforms will be approved without meaningful popular support. In such an environment, it is doubtful that politicians will have the courage to reduce government interventions in labor markets or promote fiscal reforms that would reduce distortions without in some way balancing these by creating more privileges for those with vested interests.

It is therefore unfortunate that there is so little appreciation among Latin Americans for the close relationship between free markets, the rule of law and economic growth. The enormous popular support for detailed, costly and inflexible labor legislation illustrates the barriers to meaningful reform. Labor laws are much less flexible in Latin America than in East Asia, for instance. This is the case even though a large proportion of the Latin American population is outside the formal labor market and does not have access to the "protection ensured" by labor legislation. Of course, it is the labor laws themselves that have to a large extent led to this problem of economic exclusion. Nevertheless, questions are rarely raised in the media or other public fora as to why governments are able to place themselves between an unemployed person and a job; or why they

[22] IDB (1998).
[23] The 2001 rate is a projection from the IMF (2001).

are able to prevent a person from accepting the most favorable employment package she can find.

Few can appreciate the extent to which the rule of law and the principle of administrative decentralization have been compromised in the name of stimulating growth and combating inflation. Latin American societies have become accustomed to their rights as individuals being assaulted in the name of the greater good. During nonsensical stabilization plans of the 1980s, which were focused exclusively on price controls, people of all social classes responded with tremendous intensity to the call to forcibly prevent exchanges at freely agreed terms.

With respect to foreign trade, the prevailing mentality sees tariff reductions as the "price" that must be paid in order to obtain access to foreign markets. Tariffs are never portrayed as an artificial restriction on the choices of local producers and consumers. The protectionism of more developed countries encourages that distorted view, as such policies are interpreted not so much as resulting from well-organized privilege-seeking, but as a means to defend "the interest" and "the jobs" of those countries. The appropriate response in Latin America, according to the President of Brazil's House of Representatives, is to "do the same, and protect ours."[24]

Although there is at least a modest understanding that interest groups are active in the region, seeking the rents available from government control, people do not seem to understand why they exist. Indeed the conventional view is quite topsy-turvy. Whereas the underlying reasons for such rent-seeking is the labyrinthine system of rules and restrictions imposed by government, which enables discretionary disbursements of favors by officials of the state, the public simply equates the seekers of special favors with 'rapacious entrepreneurs'. This is tragic because true entrepreneurship and the free market, *a system founded on the rule of law*, are the solution to Latin America's troubles, not the problem.

A closely related issue is corruption. It is not generally appreciated (in Latin America or elsewhere) that corruption is a symptom of other, underlying problems, and that there are ways of organizing society which are more conducive to low levels of corruption than others. On one level, the emphasis on corruption is misplaced because in some nations the size of the bureaucracy and the scope and complexity of regulations are such that without corruption there might be no economic activity at all. Excessive bureaucracy operates as a major barrier to potential entrepreneurship.[25]

On another level, the emphasis on corruption *per se* is misplaced to the extent that it betrays disregard for the source of large-scale corruption, which is to be found in governments with enormous powers to promote and to discourage, to take and to give. This is not to belittle the fact that enormous resources are wasted every year on account of corruption and that these resources are exceptionally scarce in Latin America. The point is that if one's concern is the efficient use of resources and encouraging economic growth, then one should not focus primarily on

[24] In the televised words of the current President of the House of Representatives in Brazil, in response to recent measures by the US government to protect its steel industry from foreign competition.

[25] For an analysis of the Peruvian case, see De Soto (1989). The issue is of literally tragic consequences, for these are poor countries that often are not so poor of resources. Entrepreneurship at all levels is the only activity that actually creates value. Entrepreneurship alone identifies hitherto overlooked, highly valued uses, for currently misemployed, undervalued resources.

corruption itself. Rather, one should focus on the underlying problems: the size of the state and the number of rules and regulations it promulgates.

Significant progress has been made to reduce both fiscal and external imbalances. But continued improvements in economic performance depend on additional progress along these lines. While it is certainly exciting that inflation has in recent years been the lowest since World War II, it is worrying that some of the other foundations for continued progress are not as sound as might be desirable.

A leading concern is the serious current account problems facing many countries. This makes them vulnerable to a reduction in foreign direct investment or to a rise in the spread of their international bonds. Domestic savings are crucial to economic development and can help overcome current account vulnerability. But Latin America traditionally has had a very low level domestic savings (in part because of the high levels of inflation and the consequent uncertainty about the future value of savings). So it is important that, at the very least, governments balance their budgets. But despite recent efforts to avoid macroeconomic imbalances, in 2000 the region had a (simple average) deficit of over 2% of GDP, with a projected deficit of over 3% of GDP for 2001.[26] If we consider that taxes tend to be already high in the countries with greater fiscal problems, that situation is not sustainable without significant crowding out of private investment by the financing needs of government. It is unlikely that private savings will grow significantly in this scenario. A virtuous circle with higher levels of savings and income leading to even higher levels of savings and income cannot be counted on just yet.[27]

A 1999 study by Arthur Andersen showed that, of 28 countries surveyed, only six charged taxes on gross revenues, but of those, five were from South America (Argentina, Bolivia, Brazil, Colombia, and Venezuela).[28] Taxing revenues rather than profits discourages local economic activity – it is effectively a tax on production. In Brazil, 25% of all revenues come from highly distorting cumulative taxes. High taxes on production, especially if they are cumulative, stimulate imports and discourage exports. That is certainly harmful to countries that seek to grow through trade.

There is, however, reason for hope. By 2005 the countries of the region should become integrated into a single Free Trade Area of the Americas (FTAA). That could induce many countries to adopt more sensible domestic policies and introduce important institutional reforms.

References

Arthur Andersen, (1999) "Pesquisa sobre tributação," mimeo.
Bruton, Henry. "A Reconsideration of import substitution," in *Journal of Economic Literature Vol. XXXVI*: June, 1998, pp. 903–936

[26] ECLAC; projection made by mid-2001. 12 out of 17 of the largest economies of the region had current account deficits projected to be above 3.5% in 2001.
[27] On the positive side it should be remembered that the 80s were debt crisis years and that since 1994 the region has been affected by the Mexican, the Asian, and the Russian crises, which in turn were followed by the slowdown in US and world economic activity. Therefore, at the smallest persistent improvement in external conditions, a better domestic environment should be able to deliver high growth rates over a depressed baseline.
[28] Arthur Andersen (1999).

De Soto, Hernando. *The Other Path – The Invisible Revolution in the Third World*. New York: Harper & Row, 1989.
Edwards, Sebastián. *Crisis y Reforma en América Latina: del Desconsuelo a la Esperanza*. Buenos Aires, Argentina: Emecé Editores, 1997
Fishlow, Albert and Eliana Cardoso. "*Desarrollo económico en América Latina: 1950-1980,*" in *De la Estabilizacion al Crescimiento en Latin America*, Fernando H. Barbosa, et al. San Francisco, CA and Rio de Janeiro, Brazil: CINDE and FGV, 1992.
Fry, Maxwell, Charles Goodhart and Alvaro Almeida. *Central Banking in Developing Countries, Objectives, Activities and Independence*. London: Routledge, 1996
Haberler, Gottfried. *Economic Growth and Stability: An Analysis of Economic Change and Policies.* Los Angeles, CA: Nash Publishing, 1974
Inter-American Development Bank (1998), *Annual Report, Inter-American Development Bank*, Washington DC: Inter-American Development Bank.
International Monetary Fund (2001), World Economic Outlook, December 2001, Washington DC: IMF.
International Monetary Fund, *International Financial Statistics*.
Sheahan, John. *Patterns of Development in Latin America*. Princeton, NJ: Princeton University Press, 1987, p. 87.
Thorpe, R. (1998) Progress, Poverty and Exclusion: An Economic history of Latin America, Washington DC: Inter-American Development Bank.
World Bank (1990). World Development Report, World Bank, Washington, DC.
World Bank (2001) World Development Report, Washington DC: World Bank.