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Non-Technical Summary

Latin America has been dominated by explosions of growth that have generally ended in crises, followed by long periods of relative stagnation. During the nineties, some economies enjoyed high growth rates, outperforming the world in general, while others came to an abrupt halt. Only a few countries have managed to cope with the scarce capital inflows and an unstable international scenario for emerging markets. Lately, the external setting has been good for these economies, but there is concern in several Latin American countries about how to resume, or in some cases start, a long-lasting growth process.

This note focuses on the role played by openness to global trade and low intraregional trading, which certainly erodes the chances of attaining sustained growth. A brief discussion follows on ways to prevent a crisis, a recurrent phenomenon that has been a fundamental factor in slow growth. One of the most complex problems in Latin America is also reviewed, namely its severe inequalities, and how these relate to the quality of public policies. Finally, more general issues are discussed regarding the fundamentals that stimulate economic growth.

Sustained Growth in Latin America *

José De Gregorio
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March 2005

By sustained I mean long lasting, a very elusive concept in Latin America. The region has been dominated by many outbursts of growth, but they have usually ended up in crisis and a long period of slow growth. The 1960s and 70s—particularly the former—are remembered as periods of high growth, but in those days Latin American growth was slower than that of the world and many other regions (table 1). Perhaps the most important feature of the 60s was that growth variability across countries in the region was very low. In contrast, during the 90s, with the world growing much less, some economies were growing strongly, at much higher rates than the rest of the world. But in a number of those countries growth came to a sharp stop. Few have been able to cope with scarce capital inflows and an unstable international environment for emerging markets. More recently, the external atmosphere has been positive for emerging markets, but the issue in many Latin American countries is how to resume, or in many cases start, a process of sustained growth. These notes focus on the role of openness and the low regional trade among Latin American countries, which certainly reveal a weakness to sustain growth. I discuss briefly how to avoid crises, a recurrent phenomenon in the region that has been a fundamental cause of low growth. Then I tackle one of the most difficult problems in the region, namely severe inequalities, and discuss how it can affect the quality of public policy. Finally, I discuss more general issues regarding fundamental factors that spur growth.

Before beginning our discussion, we must have a more comprehensive vision of the long-term evolution of economic growth in Latin America, and compare it with other regions, particularly more developed economies. In this way it is also possible to determine whether there has been convergence to the level of income the advanced world.

The long run evolution of the gap between per capita GDP in Latin America and developed economies for the 20th century is presented in figure 1. Each line represents a measure of the GDP per capita of Latin America as a percentage of the GDP per capita of a sample of advanced economies and the US. I use data from Maddison (1995) from 1900 through 1950, and put them together with the Penn World Tables of Heston, Summers and Aten (2002) until 2000. In order to build a long series, only the largest economies in the region were considered, for which there was information available, namely Argentina,

* These notes are mostly based on De Gregorio (2004) and De Gregorio and Lee (2004), and have evolved for presentations at the University of Southern California, Yale University, and Expansiva. All views expressed here are my own.

Brazil, Chile, Colombia, Mexico, Peru and Venezuela.¹ Their GDP was calculated in two different ways: taking a simple average and weighting by size.

The upper panel in figure 1 considers the simple average of GDPs per capita from the seven Latin American countries in the sample, which means that each country is given the same weight in the region's total. The lower panel shows the GDP per capita weighted by the GDP of each country, which is equivalent to considering all of them as one large economy. For instance, in 1990 Brazil's GDP accounted for 39% of the total sampled; Mexico's, 23%; Argentina's, 11%; and the other four, the remaining 27%. In each case, GDP per capita was compared with that of the US and of a group of advanced economies.² At the beginning of the century, the region's GDP per capita was the equivalent of 43% of that of advanced economies and 32% of that of the US (upper panel). In 2000, both ratios had dropped to 34% and 24%, respectively, certainly a step backwards. A similar turnaround is observed when comparing weighted average GDP per capita with that of advanced economies and the US, which went from 37% and 28%, respectively, in 1900, to 29% and 23% in 2000.

This relapse of the region manifested since the middle of the century, excluding the time of the Second World War. The upper panel shows that this decline was persistent and stabilized in the nineties. In the sixties and seventies there was some stability and even a slight reversal of the fall (lower panel), in particular with respect to the US income. Hence the positive vision regarding this period. However, such recovery was due mainly to Brazil, which went through its "economic miracle" in those decades (table 1) and has a large weight in the region's GDP.

Therefore, all the second half of the twentieth century was disappointing in terms of economic growth, which only stabilized in the nineties. Social turmoil and bad economic policies resulting from frustrated growth place this subject at the core of economic debate and policy design in the region.

Openness and Regional Trade

The explosion of research in the late 1980s on the determinants of economic growth produced a wide range of empirical results, and most of the factors that were found to promote growth have been questioned by subsequent studies. But within this plethora of results, if there is one issue that enjoys broad (but by no means total) consensus, it is that trade openness fosters economic growth. More-open economies have been able to grow

¹ For the early years of the century there are some gaps in the data that were completed with the averages for those economies that had the full series. The countries with incomplete data are: Colombia, 1901-1912 and 1914-1924; Mexico, 1911-1912 and 1914-1920; and Peru, 1901-1912.

² Including Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, the Netherlands, Italy, Japan, Norway, New Zealand, Sweden, Switzerland, the United Kingdom and the United States. The GDP per capita was calculated based on weighting by size.

faster than closed ones.³ This is particularly important in periods of trade liberalization. Of course, we can add many caveats to the strategy of opening up, the institutional framework in which opening up takes place, etc. etc. However, it is a fact that more open economies grow faster than closed ones. This lesson is especially valid for small economies. I have not been able to find an example of a relatively high-income small economy that is not integrated with the rest of the world, or that has been able to grow being isolated from the world.

In addition, Winters et al. (2004), in a detailed review of the evidence, find that openness is associated with poverty reduction in the long run, and there is even a strong presumption that this association holds in the short run as well. Of course, trade liberalization may also work with other policies to alleviate poverty. Therefore, trade liberalization is good for the economy, and it is advisable to undertake it right away. (The same cannot be said of other areas, such as financial liberalization.)

Moreover, the old idea that supported the import-substitution strategy in Latin America in the 1960s, which held that opening to trade would result in developing countries producing “bad goods”—mostly commodities, whose terms of trade would be declining—has been proved wrong. It is true that countries that face unfavorable terms of trade grow less rapidly, but it is also true that there has not been such a deterioration of the terms of trade (De Gregorio and Lee, 2004).⁴

Unilateral trade liberalization has already occurred in most of Latin America and more intensely during the 1990s. Indeed, Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Paraguay, Peru, Uruguay and Venezuela, i.e. most of Latin America, were classified as closed in the period 1970-1989 according to Wacziarg and Welch (2003), and as open economies in the period 1990-1999.

Although tariffs may have been reduced and non-tariff barriers may have been removed, Latin America still has small trade coefficients. Most Asian countries have substantially more trade than Latin American countries (figure 2). Only China is below three countries in the sample, but once we correct trade by size, China is also much more open than Latin America. Therefore, a natural question is how to increase integration and gain access to new markets, given that tariffs and most barriers to trade have been substantially reduced.

Moreover, intraregional trade in Latin America is very low when compared with other regions of the world (figure 3). It was already low in the 1960s, at about 10 percent of the total, and although it has increased in recent years, it remains comparatively low. Trade among the South American countries is 24 percent of their total trade, and among all Latin

³ See also Edwards (1998) and Dollar and Kraay (2002). For a more skeptical view, see Rodríguez and Rodrik (2001).

⁴ Meller (2002) provides a clear of this claim illustration for the Chilean case. He says that in 1980 two tons of copper were needed to buy one personal computer, while in 2000 one ton was able to buy 2 personal computers, and just bear in mind that in 2004 the price of copper was 50% above that of 2000.

American countries it is 17 percent, the lowest among the regions shown in the figure. The same pattern of low integration emerges for other country groupings such as Mercosur or Aladi (not shown). These findings stand in sharp contrast to the dynamic intraregional trade among the East Asian countries: already in the 1960s about 26 percent of these countries' trade was with each other, and that figure has increased to 50 percent in recent years. Trade among the industrialized countries has long been an important share of their total trade.

Institutions play a key role in fostering trade. For countries to develop deep and extensive trade relations, each must demonstrate at home the ability to enforce contracts, to maintain the rule of law, and to establish enduring trade relations. The existence of a stable macroeconomic environment is also important, because it reduces uncertainty among trade participants. Yet Latin America has weak institutions and is subject to recurrent macroeconomic crises, and this impedes the growth of trade linkages. Recent trade disputes—some of which, such as the problems over natural gas with Argentina and Bolivia, have affected the Chilean economy—bear witness to these obstacles.

Avoiding Crises

Clearly, in the macro front one size does not fit all. The selection of exchange rate regime, integration to international financial markets, and other policy choices have not a unique answer. However, the recurrent crisis in the region provides some general principles. But, before discussing them briefly, I must clarify that, in my view, a crisis is not a purely random phenomenon, and good policy can shield countries from crisis and contagion, while enjoying the benefits of integration and financial development. Indeed, recent literature, particularly after the Asian crisis, has modeled crisis as a self-fulfilling phenomenon, many times unrelated to fundamentals. I do not believe this is the case since here are always policy distortions, at the macro or financial level. Crises may be triggered by external developments, but the economies affected are never entirely innocent, because crises do not occur at random. Contagion and frantic financial markets may make a bad situation worse, but in the end there is no substitute for sound domestic policy. Therefore, I do not share the view that crises can be bad outcomes of otherwise sound economies. Crises happen because of mismanagement.

First, fiscal discipline is key. Most crises in the region have been associated to fiscal imbalances. Moreover, countries that were able to recover strongly from their crisis—like Chile in 1982 and Mexico in 1994, and also as in most Asian countries in 1997-98—were those that had a strong fiscal position before the crisis. Therefore, although not only countries with a weak fiscal position are exposed to a crisis, those that have solid public finances can recover better.

Regarding inflation, a low rate indicates credible monetary policy and sound monetary institutions. Rather than discussing details on monetary policy, stable low inflation is a summary statistic for good macroeconomic environment, which also is the basis for strong institutions at the macro level. Not only is it desirable to have an independent central bank, but it is also necessary to implement good policies. For example, a stable macroeconomic environment allows implementing a flexible exchange rate regime

and to use monetary policy as the instrument for stabilization, which becomes the most effective way for achieving macroeconomic stability.

Perhaps the Achilles heel during crises in emerging markets is their weak financial sectors. Liability dollarization, mismatched currencies and maturities, implicit guarantees and related lending are among the factors that lead to financial crisis when there are significant corrections in relative prices or a curtailment of capital inflows. Prudential regulation and strong institutions are important to take full advantage of financial development. Contrary to trade liberalization, financial liberalization can be the source of problems in a weak institutional setup. The Chilean economy learned this the hard way, with a huge financial crisis in the early eighties.

Dollarization happens when trust in the domestic currency is lost. This, in general, is the result of rising inflation and sudden and sharp devaluations. Dollarization is many times irreversible. Hence, after the economy stabilizes, and the value of the currency too, the de-dollarization process may never take place. Chile went a different route, minimizing the risk of permanent dollarization. After the 1982 crisis, instead of going into the dollar, most financial contracts were linked to the indexed currency (on a daily basis to the last month's CPI) known as the UF (unidad de fomento). Deposits and loans denominated in UFs in the banking system increased significantly.⁵ As the inflation rate declined, the economy has actually "de-UFized", and currently the peso is the main unit to denominate financial contracts. This has been achieved in part by the policy decision to base monetary policy on a nominal interest rate. The composition of public debt has shifted from UFs toward pesos. Therefore, financial indexation helped in the transition, but is not the panacea. The unit in which contracts are written is not the only relevant consideration for avoiding dollarization; it is also the ability to enforce and honor financial contracts. The dollar is always a superior instrument when the enforcement of contracts is weak.

Currency crises are costly. Empirical estimations indicate that a country that suffers a currency crisis has a cost of about 8% in terms of GDP loss, but this cost is doubled when a crisis is accompanied by a banking crisis (De Gregorio and Lee, 2004). Of course these are averages across countries, and there are many examples in the region where the costs have been much higher.

A highly debated proposal to avoid deep crises is capital controls. An example to promote capital controls is the Chilean experience during the nineties. Chile was, after all, the country that suffered least with the crisis of emerging markets toward the end of last decade. In my view, capital controls did not introduce severe costs to the Chilean economy, but they were far from responsible of the success of the nineties. Capital controls did not prevent contagion from the Asian crisis and did not avoid the appreciation of the real exchange rate during the decade. They were fairly ineffective. Their main effect was to tilt loan maturity from short-term to long-term, which seems a good thing, but the orders of magnitude involved in this shift were fairly small. Moreover, what was at the center of the recession in 1999 and also part the massive inflows in the nineties were the rigidities of the exchange rate. In recent years, the economy has been able to absorb a very volatile

⁵ See Herrera and Valdés (2003) for further details.

international environment with a flexible exchange rate and without capital controls. It is true that today the Chilean economy is not booming, as it was in the past with an international environment similar to the current one, but it is better prepared to face adverse external conditions. Prudent fiscal policy, based on a rule for the cyclically adjusted budget deficit, and a flexible exchange rate as part of an inflation target regime for monetary policy, provide more resilience to the Chilean economy to external shocks.⁶

Moreover, in contrast to the Chilean case, capital controls have been used as a substitute for sound financial policies in many countries. Authorities may think, wrongly of course, that instead of doing serious and necessary adjustments in the fiscal and financial fronts, they can get away with capital controls. They give the wrong impression that the economy is well protected to face external shocks, and delay necessary reforms to strengthen macroeconomic institutions. Macroeconomic institutions were the strengths in the Chilean case, not capital controls.

Inequality, Distortions and Education

One of the most notorious characteristics of Latin American countries is their high level of inequality (figure 4). Theory as well as empirical evidence suggests that an unequal income distribution is bad for growth, although some recent evidence has challenged this view. The theoretical literature emphasizes that inequality can lead to inefficient policies that actually harm growth, in an attempt to compensate for severe inequality. The classic case is the introduction of inefficient taxation for purposes of redistribution.

Thus, we should expect that, after adjusting for the level of development, countries with more unequal income distributions, as measured by the Gini coefficient, are more likely to have characteristics and policies that are bad for growth. For example, they have lower school enrollment rates, probably because, after controlling for average income, they have a larger fraction of the population that cannot afford to go to school. In addition countries with greater inequality have higher fertility, larger governments, lower levels of educational attainment, and weaker institutions.

Two issues are relevant in this discussion. The first one is what are the policy implications to reduce inequality. We know little about policies that can reduce inequality of income in a short period of time. Income distribution changes very slow and we do not know about its main determinants. The relationship with income is not clear. Education helps.⁷ Increasing education achievement and reducing differences across the population reduces inequality. However its effects take long time to affect income distribution. Improving education today will have effects on income distribution many years later, when

⁶ Cowan and De Gregorio (2005), analyzing the effects of capital controls, argue that the key to explain capital inflows, financial vulnerability and currency crises is the exchange rate regime rather than capital controls.

⁷ There are recent studies on the determinants of income distribution, where education appears to be an important factor in reducing inequality. However, as argued in the text, it takes time to turn around inequality via education. In addition, recent papers have emphasized the role of financial development in reducing inequality. See Li et al. (1998) and Beck et al. (2004).

more educated people becomes a significant part of the labor force. But, this should not prevent pursuing educational reform, since it has an immediate effect on income mobility and the intertemporal distribution of income. Therefore, it contributes to equalize opportunities faster than its effects on actual income. Welfare is more equally distributed when poor families find their kids receiving better education.

Another issue that is also very relevant in economies with high inequality is how to avoid the negative effects inequality has on policies and through them on economic growth. It is a very different thing to have a stable unequal income distribution in a country that grows from suffering it in another that stagnates. In addition, although growth may have small effects on inequality, it is essential to alleviate poverty. Having good social policies, which compensate for inequalities and are growth-enhancing, must be a priority. Strengthening institutions is particularly important in countries where inequality may be the source of corruption and other institutional distortions. The case of Chile is again interesting. Despite its large inequality, it does not seem to have deteriorated institutions or policies, and the economy has been able to grow, which has been key to reduce social conflicts and focus policies on growth and helping the poor.

Although policymakers will in general prefer policies that both increase growth and reduce inequality, this is not always the case. Some adopt instead redistributive policies that introduce distortions, and fail to adopt other policies that have positive effects on growth and inequality. An active policy to encourage high-quality schooling will be good for growth and for reducing inequality. Something similar can be said about public infrastructure, for example access to safe drinking water.

On Growth Fundamentals: Institutions, Competition and Mobility

We could list many areas where improvement is possible and would foster growth. But ultimately the question one would like to have answered is, What are the main foundations that support the accumulation of human and physical capital and improvements in productivity—in short, that determine economic growth? Growth occurs when incentives are appropriately in place to make people and firms spend their talents in growth enhancing activities, as opposed, for example, to rent seeking or political capture. In my view, two basic principles underlie growth:

- *Secure property rights.* When people invest in their own human capital, or when entrepreneurs invest in plant and equipment or in new techniques to increase their productivity, they must be certain that the benefits of these investments will not be taken away from them. For this to happen, property rights need to be clearly defined and respected.
- *An adequate structure of rewards.* Investment and effort must be adequately rewarded. This is essential to encourage creativity, entrepreneurship, and a growth-promoting allocation of talent.

In terms of policy, securing property rights implies setting clear rules of the game. It is inevitable that some policies, or changes in policies, will have redistributive effects.

Modifying tax policies, for example, changes the profitability of investment in physical and human capital, in effect reducing or increasing the value of that capital. Improving regulation, too, often changes profitability. A firm that has become a monopoly may be obliged to take steps to reduce its monopolistic power and cut down its profits. In short, redistribution happens. In other cases property rights are not clearly defined. This is the typical case in environmental conflicts, for example between the agriculture sector and industrial development that brings pollution. Property rights have their limits and there are conflicts as well as gray areas. The important thing is to be clear on those limits and the mechanisms to resolve disputes. To achieve this, nations must have strong institutions and clear rules to define and delimit property rights, as well as mechanisms for fair compensation when changes in policy have redistributive effects.

In a democracy, taxes are generally decided by the legislature, and no one should be surprised, although some may not like it, when changes in taxes occur. Of course, a sound constitution and good laws will prevent arbitrary enforcement of the tax laws and outright expropriation. The lesson here is again on the need to have strong institutions, and these institutions must have a clear orientation toward protecting property rights.

A stable macroeconomic environment is also an important part of securing property rights. High and unstable inflation also redistributes income, usually from savers to borrowers, and this discourages saving. By, in effect, liquidating nominal public debt through sharp price increases, inflation also redistributes wealth from bondholders to governments. The same can be said of freezes on deposits during banking crises, and other confiscatory policies. Macroeconomic stability thus promotes growth by providing a safe environment in which to invest, allowing entrepreneurs to focus on the usual and unavoidable risks of business, rather than protecting themselves from macroeconomic instability.

But the second principle—an adequate reward structure—is also important and necessary for growth. One can imagine a country where property rights are secure and immutable but the business sector consists of a group of monopolists enjoying significant barriers to entry. No one will then have any incentive to invest or to compete: the established monopolists have no need to do so, and any potential new entrant will encounter clear disadvantages. Therefore, it is not enough to protect property rights, although necessary. The means to establish this second principle in the economic arena is competition, full and strong competition, that allows markets to operate efficiently. Openness and free trade, in turn, are essential to ensure and increase competition, especially in a small economy. In order to compete and succeed, firms will need to operate efficiently and creatively. Absent any competitive threat to established business, there will be no incentive for these businesses to be efficient.

Regulation and fostering competition has implications regarding the protection of property rights and also providing adequate rewards to effort and entrepreneurship. Many countries are discussing regulatory reforms to spur growth, and this is good. But, in my view, the most important institutional basis is to define how conflicts are resolved, who is responsible for setting regulations, and who is charged with administering those regulations. Granting independence to and requiring accountability from regulators and

defining independent panels to resolve problems (including interpretation of the law) is the most important reform that ensuring stability and fair rules of the game may provide for encouraging investment and productivity. However, it is important to foster accountability, which is particularly necessary for independent institutions.

The second principle also has implications for social policy. It is important that workers, as well as businesses, receive rewards appropriate to their effort. A natural aspiration of parents, especially among the poor, is that their children live more prosperous lives than their own. For this they need opportunities. A person's income from labor will depend on the productivity of that labor, and so the goal of educational policy must be to transfer useful knowledge and thus transform people into more productive workers. Stated more generally, this second principle translates into social mobility, or equal opportunity, on the social front.

We can better understand difficulties in Latin America in the light of these two principles. In many Latin American countries institutions are weak, the macroeconomic environment is unstable, and therefore property rights are not properly safeguarded. In addition, trade is still very low, and hence the scope for competition is limited. Therefore, investors are not always well rewarded. On the other hand, the quality of education must be improved, and efforts to reduce inequality through social policies aimed at improving the living conditions of the poor and creating conditions for greater social mobility, must be reinforced. From the point of view of government activities, it is important to focus on how to foster growth and help the poor and the disadvantaged, while minimizing policy distortions. This is not a trivial challenge, but as long as growth can be sustained, the job is made easier, because populist temptations are then reduced, although never eliminated.

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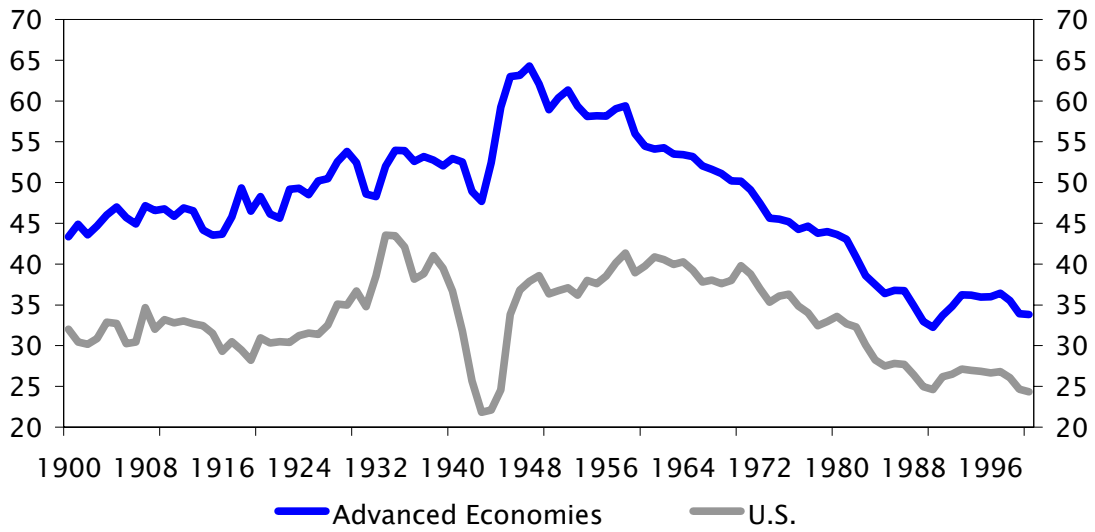
Table 1: Growth of Per Capita GDP

	1960-70	1970-80	1980-90	1990-2000	1960-2000	1970-2000
LATIN AMERICA						
Argentina	2.29%	1.38%	-3.87%	4.22%	1.00%	0.57%
Bolivia	0.60%	2.01%	-2.22%	1.08%	0.37%	0.29%
Brazil	4.23%	5.67%	-0.26%	1.46%	2.77%	2.29%
Chile	2.19%	1.22%	1.28%	4.79%	2.37%	2.43%
Colombia	2.23%	3.11%	1.35%	0.87%	1.89%	1.78%
Costa Rica	1.85%	2.59%	-0.94%	1.75%	1.31%	1.13%
Ecuador	1.35%	6.16%	-1.17%	-0.85%	1.37%	1.38%
El Salvador	2.24%	0.05%	-1.66%	2.30%	0.73%	0.23%
Guatemala	2.44%	3.05%	-1.21%	0.84%	1.28%	0.90%
Jamaica	3.43%	-1.14%	1.72%	-1.05%	0.74%	-0.16%
Mexico	3.28%	3.27%	-0.43%	1.78%	1.97%	1.54%
Nicaragua	3.25%	-2.70%	-3.00%	-2.42%	-1.22%	-2.71%
Panama	4.98%	3.35%	-0.69%	1.96%	2.40%	1.54%
Paraguay	1.70%	4.46%	1.01%	-0.58%	1.64%	1.63%
Peru	3.73%	0.45%	-3.13%	2.47%	0.88%	-0.07%
Uruguay	0.43%	2.70%	-1.00%	2.81%	1.23%	1.50%
Venezuela	2.95%	-2.79%	-1.36%	-0.80%	-0.50%	-1.65%
Avg	2.05%	1.56%	-0.74%	0.98%	0.96%	0.60%
REFERENCE						
Japan	9.27%	3.09%	3.53%	1.05%	4.23%	2.55%
USA	2.87%	2.66%	2.16%	2.30%	2.50%	2.37%
East Asia (9)	4.69%	5.36%	4.45%	3.95%	4.61%	4.58%
World	2.53%	1.99%	0.98%	1.32%	1.70%	1.43%

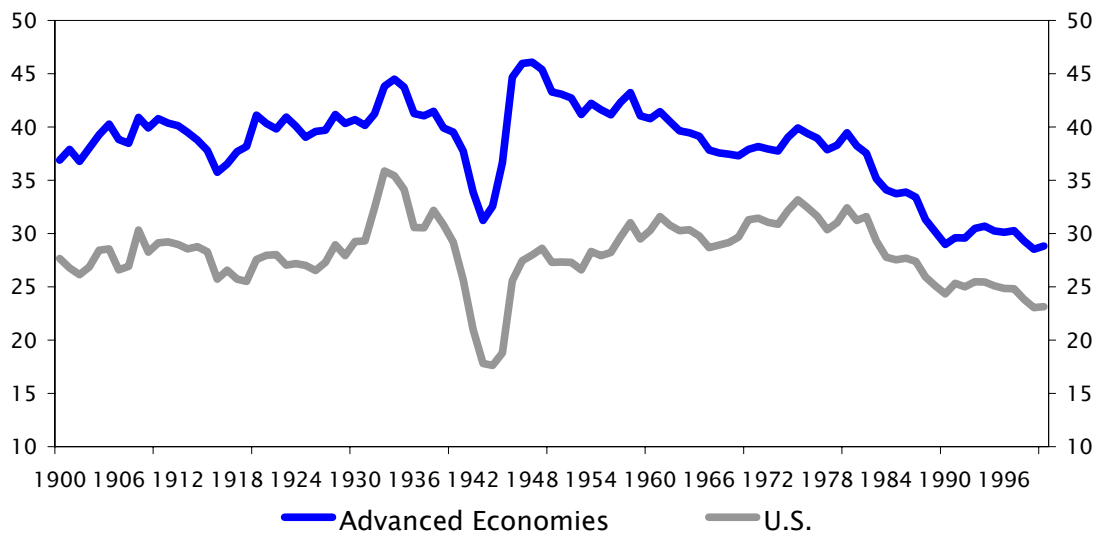
Source: Heston, Summers and Aten (2002)

Figure 1: Latin America Relative Per Capita GDP (%)

(a) Simple Average



(b) Average Weighted by GDP



Source: Maddison (1995) and Heston, Summers and Aten (2002). For data description see text.

Figure 2: Trade as % of GDP (2000-2002)

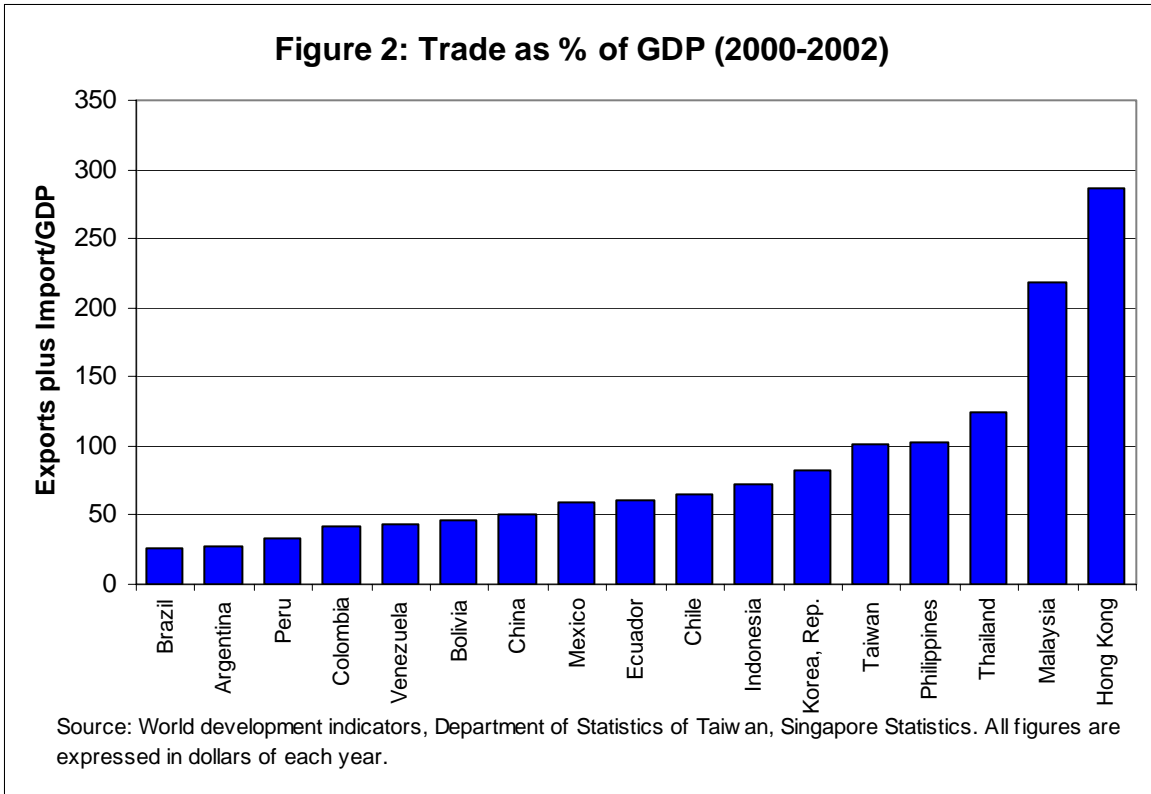


Figure 3: Intraregional Trade

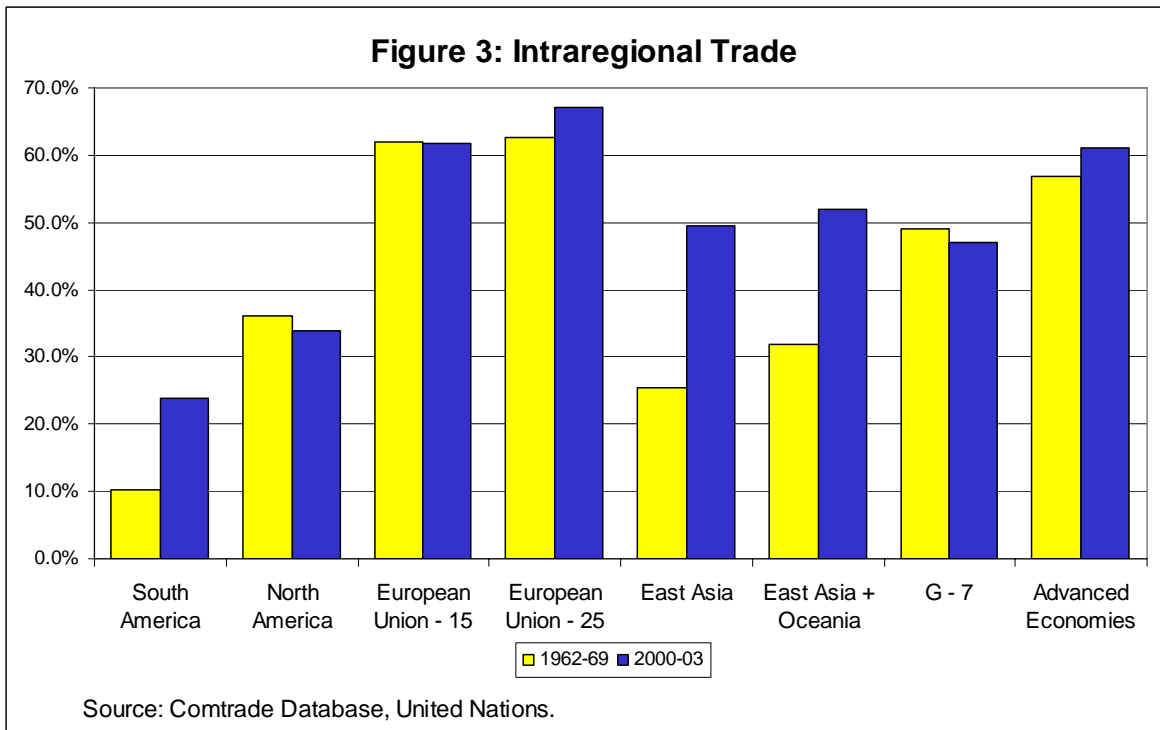


Figure 4: Income Distribution in the 1990s

