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**INSTITUTIONS, ECONOMIC POLICIES AND  
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EXPERIENCE**

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## **INSTITUTIONS, ECONOMIC POLICIES AND GROWTH: LESSONS FROM THE CHILEAN EXPERIENCE**

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### **Resumen**

A pesar del esfuerzo de reformas de las décadas pasadas, el desempeño económico y social de los países de América Latina durante los noventa fue bastante pobre. La excepción fue Chile, que creció a tasas promedio de 7% durante la mayor parte de la década y redujo significativamente su tasa de pobreza. Este trabajo intenta explicar esta notable diferencia. Siguiendo la literatura más reciente, que destaca el rol que juegan las instituciones y políticas en el crecimiento económico, argumentamos que el mejor desempeño de Chile se debió a que las reformas implementadas fueron mucho más profundas y abarcaron más áreas que aquellas implementadas en otros países de América Latina. Durante este proceso Chile terminó con fundamentos económicos más sólidos y, aún más importante, con mejores instituciones, lo que le permitió enfrentar de mejor manera los shocks adversos en los noventa. Basados en un modelo econométrico de corte transversal estimado para el período 1960-2000, argumentamos que el mejor desempeño de Chile vis-a-vis al resto de la región puede ser explicado en partes iguales por las mejores instituciones y políticas del país (en contraste, el mejor desempeño de Asia del Este es explicado principalmente por mejores políticas). Adicionalmente, estimamos que América Latina puede aumentar su tasa de crecimiento anual del producto per cápita un 1,6%, en promedio, si tuviera la calidad de instituciones de Chile. Por otro lado, si el promedio de los países de América Latina tuviera políticas (desarrollo financiero y sobrevaluación cambiaria) similares a Chile, la tasa de crecimiento anual del producto per cápita aumentaría en un 1,0%, en promedio. Concluimos que, para lograr tasas de crecimiento más altas, los países de América Latina deben avanzar en sus procesos de reformas y poner más énfasis en el desarrollo y fortalecimiento de sus instituciones, las cuales, como muestra la experiencia de Chile, pueden ser modificadas (aunque lentamente).

### **Abstract**

Despite the reform effort of past decades, the economic and social performance of Latin American countries during the 1990s was quite disappointing. The exception was Chile, which grew at a rate near 7% for most of the decade and reduced its poverty rate quite significantly. This paper tries to explain this striking difference. Following the most recent literature that highlights the role played by institutions and policies on growth, we argue that Chile's better performance was due to the country undertaking reforms that were much deeper and broader in scope than those in other Latin American countries. In the process, Chile ended up with stronger macro fundamentals and, most important, better institutions, all of which allowed it to face in a better way the adverse shocks of the 1990s. Based on a cross sectional econometric model estimated over the 1960-2000 period, we argue that Chile's better performance can be explained by the country's better institutions and better policies in equal shares (East Asia's better performance, on the other hand, is explained mainly by better economic policies). In addition, we estimate that by having institutions of quality similar to Chile's, the average Latin American country could raise its per-capita GDP growth rate by about 1.6%, on average. Similarly, by adopting policies (financial development and RER overvaluation) similar to Chile's, the average Latin American country could raise its per capita GDP growth rate in about 1.0%, on average. We conclude that, in order to attain higher growth, Latin American countries should move forward in their reform processes and put more emphasis on building and strengthening their institutions, which, based on Chile's experience, can be modified (albeit slowly).

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## I. Introduction

Latin American countries grew steadily at about 5% per year in the three decades after World War II. But this process did not last as it was interrupted by the debt crisis of the early 1980s, during which most countries in the region went into recession (table 1). The crisis brought to the surface the structural problems, both macro and micro, existing in most Latin American economies. Consequently, almost every country in the region spent the rest of the decade revising and amending their policies and implementing reforms aimed at fostering growth and changing the development model followed until then.

Following the debt crisis, the old import-substitution cum government intervention model began to be replaced by market-oriented economies where resource allocation was to be driven mainly by private initiative and market forces. Thus, during the second part of the 1980s –the so-called *lost decade*–, Latin American countries, one after another, began dismantling tariffs and other trade barriers, reducing fiscal deficits, fighting inflation, liberalizing prices and interest rates, lifting credit restrictions, privatizing state owned enterprises, and reducing government intervention in the economy. The aim was to foster market competition and to achieve greater integration with the rest of the world, both in goods & services and in financial flows. In the new development model the government was supposed to play a complementary role and focus its attention only on the provision of public goods and the institutional build up –e.g. public safety, legal system, regulatory and supervisory framework– and provide basic services to the poor –health care and education. Expectations were that by adopting the new model and implementing the policies recommended by the International Financial Institutions –the so wrongly called *Washington Consensus* (Williamson, 2003)— countries would start growing again on a sustained basis. Social indicators would improve across the board and income inequality would be reduced.

After a decade of reforms, economic growth resumed, but the overall outcome fell short of expectations: average growth during the 1990s, for the region as a whole, attained 3.3% and has since remained below the average of the three decades after WW II. Further, the region was not immune to crises (Mexico 1994-95, Ecuador 1999, Argentina 2001) and was also adversely affected by the 1997-98 financial turmoil. In addition, although there was an improvement in social indicators like literacy or infant mortality, the drop in poverty was very marginal, and the per capita income gap with industrial countries broadened in most countries. These results have been the cause of disillusionment with, and the so-called fatigue of, the reform process.

The exception to all of the above was Chile. The country not only grew steadily during thirteen years after the debt crisis at a much higher rate than in previous decades — annual growth during 1985-97 averaged 7.3%—, but did not suffer severe economic crises during this period and was only mildly affected by the turmoil of the late 1990s. And although growth averaged only 2.7% during 1998-2003, it is expected to return to around 6%<sup>1</sup> in 2004-2005. In addition, during the 1990s the inflation rate fell to single digits, social indicators –except for income distribution– improved significantly (poverty fell by as much

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<sup>1</sup> Growth actually reached 6.1% in 2004 and is expected to be between 5.25% and 6.25% in 2005.

as 16 percentage points) and the per capita income gap with industrial countries was reduced by about 30%.

The contrasting experience of Chile vis-a-vis the rest of the region has not gone unnoticed. In fact, many researchers and policymakers have searched for explanations and, in the process, pointed out to specific factors that distinguish Chile from the rest of the region. Potential candidates among these factors include the depth and extent of the reform process –Chile started its reform in the mid-1970s, about a decade earlier than Mexico, the second country to begin reforms. The pension system reform of the early 1980s has also been singled out as an explanation as it provides a large savings base and reduces the country’s dependency on foreign savings to finance investment. And some have argued that capital controls played a role –especially the so-called *encaje* (unremunerated reserve requirement)– during the 1990s, when private flows returned to the region, because they reduced the country’s dependency on short-term and volatile flows, thus making it less prone to capital flight and contagion effects.<sup>2</sup>

Although all the factors above have most likely played a role, there is at least one complementary explanation for the different economic performance of Chile and the other Latin American countries. This is based on the most recent literature on economic growth that suggests that the ultimate cause of a country’s growth lies on the quality of its institutions. Better institutions –property rights protection, governance, lack of corruption and bureaucracy, rule of law, and the like– lead to the design of better policies, and enhance the support, credibility and effectiveness of implemented policies, therefore, allowing countries to attain faster economic growth. Thus, the argument follows, Chile has been able to grow faster than other Latin American countries since the mid- 1980s, although facing the same external environment and shocks, mainly thanks to its better institutions.

This paper attempts to evaluate the statement above. That is, we try to find an explanation for Chile’s different performance since the mid-1980s, with a focus on quantifying –to the extent possible by data availability– the contribution of different factors. We find that, as expected, both policies and the quality of the country’s institutions influenced the outcome in terms of growth. However, the two sets of factors differ in their relative contribution. For instance, our results show that the higher economic growth of East Asia during the 1990s is explained mainly by the better economic policies pursued by that region. More precisely, using our econometric model to predict the in-sample annual per-capita GDP growth, we find that about 75% of the faster economic growth in East Asia vis-a-vis Latin America is due to better policies and only 25% to better institutions. In contrast, better policies and better institutions explain Chile’s better performance during the 1990s, vis-à-vis Latin America, in almost equal shares. The model predicts that during the 1990s per-capita GDP in Chile grew annually by about 2.4% more than in the rest of Latin America, and about half of it is explained by better policies and half by better institutions. With regards to economic policies, we find that financial development fosters economic growth, while that supporting an overvalued real exchange rate is consistently detrimental to growth.

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<sup>2</sup> It should be noted that while there exists a consensus on the benefits of pension reform, there is not such a consensus on the effectiveness and efficiency of capital controls. See Gallego and Hernández (2003) and references therein.

This paper is an attempt to put together the conclusions of two branches of the literature, one that studies and draw policy lessons from the reform process in Latin America (IDB 1997; Lora 2001; Fernandez-Arias and Montiel 1997), and another that tries to explain economic growth using large data sets, in either a cross sectional or panel framework, which has lately emphasized the role of institutions (Acemoglu et al., 2001; Rodrik et al., 2002; Easterly and Levine, 2003). Using Chile as a counterfactual, we are able to quantify the benefits –in terms of increased economic growth– to be reaped-off by other Latin American countries of adopting better policies and improving the quality of their institutions.

At least two policy conclusions emerge from our analysis. First, countries that are behind in the reform process compared to, say, Chile or Mexico that started earlier, can benefit and attain higher economic growth if they continue making progress in the so-called *first generation reforms*. Second, beyond economic reforms, countries would benefit by improving their institutions, which by nature are much more persistent but, nevertheless, can be changed, as countries are not condemned to live with the institutions inherited from previous generations. This means that countries should not cease in their efforts to reform their institutional setup, even though the benefits materialize much later than in the case of economic policies, because the payoff is quite large. Institutional buildup should be a continuous effort, like it has been in Chile that for over three decades has been reforming its institutions and continues doing so. In fact, several reforms affecting the judiciary system, the electoral system and other institutions —some of which even require amendments to the country’s Constitution— are underway at the time of writing.

The rest of the paper is organized as follows. Section II briefly describes the reform process in Latin America in the past 25 years, highlighting the areas where most and least progress has been made. Section III summarizes the economic and social performance of Latin American economies since World War II. By going over a set of economic and social indicators, this section establishes that Chile performed relatively well compared to other countries in almost every dimension, except for income distribution. Based on previous work by others, section IV evaluates the reforms implemented in the region, that is, it provides an overall assessment of what did and did not work. Section V looks into Chile’s reforms in greater detail. After comparing the initial conditions in the early 1990s, it advances an explanation of Chile’s better performance by analyzing in detail the existing differences in both policies and quality of institutions between Chile and the rest of the region. Next, section VI quantifies the relative contribution to economic growth of each set of factors –policies and quality of institutions. By explaining economic growth on a quantitative basis, this section provides an assessment of the potential benefits that a typical Latin American country would obtain from improving its institutional set-up and advancing in the economic reform process. Finally, section VII discusses the challenges ahead for most countries in the region and advances some policy conclusions. Section VIII summarizes and concludes.

## II. Economic Reform in Latin America: Where Do We Stand?

The Latin American region, which grew steadily at about 5% per year during the 1950s, 1960s and 1970s, was severely hit by the debt crisis of the early 1980s. Almost

every country, and especially the largest —Argentina, Brazil and Mexico—, borrowed heavily during the period of high liquidity in the international capital markets that followed the oil price shock of the early 1970s. Thus, after running large current account deficits for a few years, these countries were severely affected when monetary policy shifted in the US and international interest rates were raised causing a global slowdown (table 1).

The crisis uncovered the major imbalances and structural problems that existed in most countries in the region at the time, setting the stage for the reform process that occurred the following years. The reforms were aimed first at attaining macroeconomic stability and reducing government deficits. Beyond that, the main goal was to replace the old import substitution cum government intervention development model that had been in place for several decades. Instead, countries opted for developing outward oriented economies where market forces, as opposed to government actions, would play a major role in allocating resources among competing sectors.

Starting with Mexico in the mid 1980s, one after another Latin American countries began implementing the same reforms that Chile had introduced in 1974-75 and thereafter. These included a program to reestablish macro stability, comprising a devaluation of the currency, a tightening of monetary policy and a fiscal adjustment with significant cuts in subsidies and non-essential programs. The aim was threefold: to reduce the fiscal deficit, to balance the external accounts and to fight inflation.

In addition, countries began reducing both the level and the dispersion of trade tariffs, while lifting other non-tariff barriers to trade and unifying multiple exchange rate systems. Trade integration took two forms; some countries opted for unilateral tariff reductions —like Chile had done in the 1970s— while others preferred trade agreements and the establishment of trade areas within the region, like Mercosur which in its first stage included only four countries, namely, Argentina, Brazil, Uruguay and Paraguay. Also, countries implemented tax reforms whereby the VAT was introduced —Chile introduced the VAT in 1975— and some taxes were raised to compensate for the reductions in trade tariffs.

The reform process comprised three other areas, namely, financial liberalization, privatization of state owned enterprises (SOEs), and the labor market. Financial sector reforms included lifting restrictions on credit allocation, abolishing ceilings on interest rates, and reducing reserve requirements on banks. The aim was to end the era of financial repression so that credit could be allocated to its most productive and profitable uses among competing economic sectors. In addition, state owned banks were privatized to improve their efficiency. Similarly, the privatization of SOEs sought to attract more investment and attain higher levels of efficiency in the use of resources. Along the way, the privatization of banks and enterprises would provide extraordinary funds for the government that would help to resolve debt problems. Finally, labor market reforms were aimed at increasing labor mobility and wage flexibility. Main objectives were to reduce the cost of firing by cutting severance payments and to abolish automatic salary adjustments to past inflation.

As mentioned, the goals of the reforms were to reestablish macro stability and to replace the old development model that was based on import substitution and widespread government intervention in the economy. The latter occurred through price and exchange controls, mandatory credit allocation, financial repression and subsidies to specific industries, among other measures, and was the cause of governments running large fiscal

deficits, high inflation rates and endemic balance of payments deficits. In addition, labor legislation was overprotective and tended to reduce mobility and flexibility.

In the new market oriented development model the government relinquishes from the production and distribution of private goods that can be produced more efficiently by the private sector. Instead, it focuses on the provision of public goods –e.g. safety, judiciary system– and, most importantly, implementing social programs to alleviate poverty and improve the access of the poor to basic services such as health care and education. But in the new model, education and health care services do not have to be provided necessarily by the government; the poor, with financial support from the government, can buy the services from a private provider. In addition, in the new model the government does play a crucial role in market regulation and supervision. This comprises not only the financial sector and public utilities –which in many cases were privatized–, but markets in general. The aim is to develop and maintain a competitive environment in all industries and sectors, and entails setting rates for natural monopolies such as utilities, strengthening the role of consumer protection agencies, promoting market discipline and assuring free entry to all economic sectors.

Although the breadth and timing of the reform processes differ across countries, it is worth trying to assess the degree of progress achieved throughout the region. As said, Chile made significant progress in several areas in the 1970s (few other countries did so in some areas), but the bulk of the reforms in the region were implemented after the debt crisis. Figure 1 shows indicators of progress made in several areas as well as an indicator of progress made in general. All indicators are constructed to measure progress made since 1985. Although these indicators are subject to many caveats<sup>3</sup>, they are indicative of the reform effort in the region as a whole. The figure shows that much progress occurred in trade liberalization, especially up to the tequila crisis, and significant progress occurred in the financial sector, although it was more evenly spanned through time<sup>4</sup>. Conversely, little progress has been made in tax reform and in the privatization of state owned enterprises, and no progress at all in the labor market. Thus, a lot remains to be done in Latin America in the last three areas.

### III. Latin America's Economic and Social Performance

In the past 43 years, Latin America's economic performance has varied significantly from one period to another, in contrast to the experience of East Asia. Further, on average Latin America grew at about half the rate of East Asia for the whole 1960-2002 period, and has not yet recovered the rates of growth attained in the 1960s and 1970s, despite the recovery witnessed shortly into the reform process (figure 2).

Among all Latin American countries, Chile is the only one that in the past eighteen years has grown at average rates comparable to those attained by the East Asian economies. Chile's growth rate in 1990-2000 was very similar to that of South Korea, and was between South Korea's and Indonesia's in 1985-97. Costa Rica, the Latin American country that

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<sup>3</sup> The indices measure, for each area, how liberalized is each country compared to the least and most liberalized country in the whole sample. The sample period is 1985-99 in Lora (2001) and 1970-95 in Morley et al. (1999). For more details see Lora, 2001; Lora and Barrera 1997; and Morley et al., 1999.

<sup>4</sup> According to Morley et al., significant progress also occurred up to 1995 in the opening of the capital account.

comes second after Chile in terms of growth during 1985-97, grew at a much lower rate – about 2.5% less per year (table 2).

Consequently, among all Latin American countries Chile is the only one that, along with the emerging market economies from East Asia, in the past quarter century has closed its per-capita GDP gap with the industrial countries —Chile closed this gap in about 30% (figure 3).

Chile's good performance also shows up in its social indicators. Life expectancy increased sharply in the past 42 years and as of 2001 was the region's second highest after Costa Rica. Similarly, after falling by more than 91% since 1960, in 2001 infant mortality was the region's second lowest after Costa Rica and has continued falling since; at 7.8 per 1000 live births one year later it was lower than Costa Rica's. And at 96%, the literacy rate is the third highest in the region after Argentina and Uruguay, although both these countries had a relatively high rate (93%) thirty years ago (table 3). But all Latin American countries, albeit to a lesser degree, showed improvements in these indicators.

The most outstanding achievement in the case of Chile has been poverty reduction; in the past 10 years the country has halved its poverty rate —it went from 33% in the early 1990s, down to 17% in 2000 (table 4). In contrast, poverty reduction in the region at large has been modest —from 41% to 36%— while in some countries it has increased. It is worth noting that according to Attanassio and Székely (2001), about 85 percent of the poverty reduction in Chile can be attributed to high economic growth, while only 7 percent resulted from redistribution policies.<sup>5</sup>

The one area in which Chile has not been successful is in altering its income distribution. Thus, not only income distribution deteriorated in Latin America in the past 30 years, becoming one of the worst in the world, but with a Gini coefficient above 0.55 Chile's income distribution is one of the worst in the region (figures 4 and 5).

In sum, in the 1990s, economic growth resumed in the region but remained below the pre-debt-crisis rates, widening the per-capita income gap with industrial countries. At the same time, poverty reduction was modest, other social indicators improved and income distribution worsened. In sharp contrast, Chile's growth rate during the decade was one of the highest around the world, becoming the only Latin America country that converged in per-capita-income terms to the industrial countries. Hence, except for income distribution, Chile's social indicators improved significantly, placing it among the best in the region.

This brief revision of the economic and social performance of Latin American economies raises several questions, in particular: Did the structural reforms implemented during the 1980s and 1990s have any effect on countries' performance? What did Chile do differently that explains its better results? The next two sections try to answer these questions by first summarizing previous findings and then exploring in greater detail the reform process in Chile. Section IV provides an overall assessment of why Latin American countries did not attain higher growth on a sustained basis, while Section V advances an explanation of Chile's better performance by analyzing in detail the differences with the rest of the region in both policies and quality of institutions.

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<sup>5</sup> The results from Attanassio and Székely (2001) refer to the drop in poverty between 1987 and 1996. According to these authors, about 8% of the drop in poverty is a residual and cannot be explained by their model.

#### IV. The Reform Process and Its Results: An Assessment

Early attempts at evaluating the reform processes in Latin America concluded that reforming countries reaped large benefits from them. The initial estimates concluded that the reforms implemented in the region up to the mid-nineties accelerated growth by about 2% per year (Easterly et al., 1997; Fernández-Arias and Montiel, 1997). But these results were subsequently contested by new analyses that looked into longer time series.

Nevertheless, more recent literature that revisits the issue concludes that the reforms indeed contributed to accelerate growth, although the effects were rather transitory, implying that to achieve a higher growth rate on a sustained basis countries should continue the reform process. Thus, for instance, according to Lora and Panizza (2002) Latin America grew about 1.3% faster during 1991-93 because of the reform effort, but only about 0.6% faster in 1997-99 both because the effects of previous reforms faded away and because the reform effort declined.

At least four other important conclusions emerge from the literature. First, results were unsatisfactory in some countries because of an insufficient reform effort; in other words, growth did not accelerate in those countries not because reforms failed, but because they were incomplete, either in scope or in depth (Fernández-Arias and Montiel, 1997). Second, the pay-off from the reforms depends on institutions. Thus, for instance, according to Lora and Panizza (2002), reforms were more effective in countries with good rule of law. Third, reforms are complementary; i.e., the pay-off from, say, trade reform—in terms of faster economic growth—was higher in countries with a more developed financial sector (Gallego and Loayza, 2002). And finally, reforms tend to affect growth mainly through increases in total factor productivity, TFP, rather than through factor accumulation (Lora and Panizza, 2002).

The four results above are consistent with each other if one notes that the main reason that explains the difference in growth performance among countries in recent decades has shifted from factor accumulation to TFP, that is, doing things better (not just doing more of the same by hiring more labor and capital). This is illustrated in table 5 that shows the decomposition of growth for the five-best and five-worst performers in Latin America in the past four decades. It is clear from the table that differences in growth during the 1960s and 1970s were due mainly to faster capital accumulation. In contrast, the best performers in the 1980s and 1990s achieved faster growth because of larger increases in TFP. Beyer and Vergara (2002), who decompose the growth of a much larger (107) sample of countries during 1980-2000, reach a similar conclusion. They conclude that about 82 percent of the growth difference between the 10%-best and the 10%-worst performers can be explained by changes in TFP, while only 18% is explained by faster factor accumulation<sup>6</sup>.

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<sup>6</sup> It is possible to provide a different interpretation of the results in table 5. In particular, given the way we computed the contribution to growth of  $\Delta L$ ,  $\Delta K$  and  $\Delta TFP$ , the latter element captures not only efficiency gains but also other unidentified shocks (“bad or good luck”). Therefore, it could be argued that the best performers, those countries showing a higher contribution of  $\Delta TFP$ , are those more resilient to shocks (where negative shocks were less harmful). This resilience may, in turn, be a direct result of better institutions and policies.

In an era of rapid technological change, rapidly growing firms are constantly trying to improve procedures and attain greater efficiency by incorporating and adapting new technologies. For this to occur, a necessary condition is that prices reflect the actual cost of providing different goods and services, which can be achieved by liberalizing prices and implementing several other market-oriented policies. In other words, what is needed is to reduce state intervention in the economy (except for externalities and other market failures that require the state to intervene). But this is not enough. Also, the business environment must be such that the private sector has the incentives to invest in the development and implementation of new and better technologies; that is, the business environment must be conducive to agents to get involved in constantly improving their efficiency levels. For this, stable rules of the game and good institutions are needed. Among the latter are the rule of law, property rights protection, no corruption, and low bureaucracy.<sup>7</sup>

In sum, countries that do not put in place an adequate institutional setup, one that supports investment in innovation and the adaptation of new technologies, will not reap the benefits of attaining rapid economic growth even if other economic reforms take place, such as trade liberalization or macro stability. Indeed, Fernández-Arias and Montiel (1997) suggest that this is one front where most Latin American countries failed during the reform process; not enough emphasis was put on building up and strengthening institutions. These authors acknowledge that some countries did not even complete the so called first generation reforms; i.e., fiscal and macro stability was not attained and trade liberalization was never completed. In their view, completing the macroeconomic reforms that were partially implemented would have bridged a significant part of the growth gap observed during 1991-95 between East Asia and Latin America. And closing the educational gap that exists between both regions would work in the same direction. But, in their words, “... *we suspect that it [the growth gap] is also associated with other deep-seated institutional and structural differences in these economies as well. In any event, the gap suggests the need for a broadening of the scope of reform in Latin America beyond the macroeconomic sphere if the region’s economies are to achieve the standard of performance they seek*”.

The next two sections of the paper address the issue raised by Fernandez-Arias and Montiel (1997). In particular, we try to explain Chile’s better performance (described in section III) on the country’s institutions and continuous reform process. Section V below discusses the differences in policies and institutions between Chile and other Latin American countries during the 1990s, and describes in greater detail Chile’s reform process, while section VI provides empirical evidence supporting the view that policies and institutions made a difference.

But before closing this section, a word should be said about the one area in which Chile, like all other countries in the region, made no progress in the last decades: income distribution. In this regard Birdsall and Székely (2003) conclude that, in general, policies to redistribute income failed throughout the region, or were insufficient to compensate for the regressive effects of other reforms like financial liberalization.<sup>8</sup> In fact, based on research

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<sup>7</sup> Note that this explanation does not preclude the possibility that a better business environment may, besides being more conducive to research and investment in innovation, lead to faster factor accumulation.

<sup>8</sup> Financial liberalization allows people with good investment projects to make large profits, increasing their wealth. But the poor usually don’t have access to formal financial markets and therefore cannot benefit from this reform. In sum, financial liberalization offers new opportunities for those relatively well off as

conducted by Attanasio and Székely (2001) they show that the bulk of the change in poverty in the region was due to economic growth. In their sample there is only one Latin American country where redistribution policies were highly effective: Brazil. In fact, up to 70 percent of the decrease in moderate poverty there between 1985 and 1995 can be explained by income redistribution. The only problem is that this result was mainly at the expense of those in extreme poverty; for this group, redistribution effects deteriorated their relative position, more than offsetting the positive effect from economic growth (table 6).

The bottom line is that redistribution is no easy task and the best we can do to alleviate poverty is to enhance growth and avoid crises. This way we can at least assure that the poor (as well as the well off) will be better off. Further, crises are very harsh on the poor; they suffer the most during recessions because they don't have assets to compensate for lost jobs, and employment recovers with a significant lag after the crisis is over. Effective redistribution is hard to achieve because it entails giving the poor access to assets that allow them to work their way out of poverty and protect them against the loss of unskilled jobs during recessions. Two ways of doing this are to give them access to more and better education, that is, investing more in human capital, and to grant them access to credit to buy productive assets. But designing and implementing effective policies towards these goals is not an easy task.

## V. Why is Chile Different?

As it was explained in section III, with the exception of Chile Latin American countries grew at relatively modest rates during the 1990s (table 2). In addition, a common feature across the region has been the high macroeconomic volatility associated with recurrent crises, which usually have fiscal roots and in some cases are even exacerbated by financial problems. For example, Mexico, Ecuador, Argentina, Uruguay and Venezuela suffered crises with deep output contractions during the 1990s (figure 6.1).

These recurrent macro crises among Latin American countries have delayed the reform process and in many instances resulted in major setbacks. On the contrary, Chile did not suffer a financial crisis during this period and (jointly with Mexico and Brazil) did not experience a strong fall in output during the Asian and Russian crises. This has been so partly because Chile's fiscal problems were faced early on, culminating with a stringent fiscal-responsibility rule, and partly because Chile counts with a very robust banking sector.

In the following paragraphs we attempt to explain this difference between Chile and the rest of the Latin American countries.

### V.1 Initial Conditions

Many country experiences show the importance of both economic policies and institutions in attaining high growth rates. With regards to economic policies, macroeconomic stability is a must; countries that do not achieve macro stability are prone

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opposed to the poor; it redistributes (opportunities) in favor of the wealthier. The policy conclusion is to create special mechanisms to improve access to credit to small enterprises, for example by guarantying the credits of those that lack enough collateral.

to suffer costly crises where the poorest groups suffer the most. In order to assure macro stability it is necessary to have control over inflation, fiscal discipline and a macroeconomic policy framework (exchange rate, monetary and fiscal policy) that is internally consistent and robust to different scenarios.

### *Macro Stability*

Regarding macroeconomic stability, inflation control was the most notable success of the stabilization and reform programs of the 1990s in Latin America, in stark contrast to the region's long history of high inflation and sporadic bouts of hyperinflation. At the end of the 1980s, average regional inflation hit nearly 500 percent, and given the high economic, social and political cost of this situation, strong public consensus emerged to reduce inflation rates to lower levels. Most Latin American countries, especially those with a past record of hyperinflation, initially chose to desinflation through exchange rate-based stabilization plans<sup>9</sup>. Although the choice of firmness of the different exchange rate arrangements varied across countries, ranging from a currency board (Argentina, 1991) to crawling pegs, the general strategy yielded impressive reductions in inflation (table 7). Countries that opted for more flexible exchange rate systems (for example, Chile) tended to experience more gradual reductions in inflation, although they had relatively lower initial rates of inflation. By the end of the 1990s, few countries had inflation rates of over 10 percent, and the regional average had dropped to around 10 percent. The gains in inflation control have proved to be enduring, even when exchange rate-based stabilization plans ultimately became unsustainable<sup>10</sup>.

One central problem among Latin American economies has been the difficulty in credibly ensuring sustainable fiscal policies, which has led to recurrent crises with fiscal roots. Examples over the past decade are Mexico (1994-95), Ecuador (1999), Brazil (1999 and 2002), Argentina (2001) and Uruguay (2002). While the relative importance of domestic policy problems versus external developments in explaining these crises is a matter of debate, it is clear in retrospect that these economies were not sufficiently "crisis-proof" to weather the global shocks that materialized in the 1990s. Indeed, most of the region during the 1990s continued showing pro-cyclicality in fiscal policies that contributed to macroeconomic volatility and reduced resilience to external shocks. In contrast, under similar external circumstances Chile since the mid 1980s has followed generally sound fiscal policies and avoided financial crises. With the exception of Chile during the 1990s, Latin American countries experienced high fiscal deficits that translated into raising debt ratios, even when economic conditions were good (table 8 and figure 6.2). Furthermore, the lack of credibility led to an increasing reliance on dollar-denominated or CPI-indexed debt, leaving debt stocks vulnerable to suffer sharp jumps in the face of financial turmoil and movements in the real exchange rate.

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<sup>9</sup> Given that monetary anchors had failed to control inflation in the past, exchange rates were viewed as a more effective anchor that would introduce credibility to policy, which central banks lacked under a more discretionary framework.

<sup>10</sup> The exchange rate-based stabilization programs did not suffice to discipline other policies needed for its support and sustainability through time, such as prudent fiscal policies, price and wage flexibility, and trade deepening.

A related issue was the effect that overvalued real exchange rates had on the medium-term burden associated with foreign-currency denominated debt. Real exchange rates tended to appreciate sharply when price stabilization was achieved using exchange-rate anchors. The real exchange rate appreciation, in turn, tended to reduce the value of the foreign-currency denominated debt in relation to GDP, thus contributing to a belated recognition of the true magnitude of the fiscal problem, which only became apparent when exchange rates eventually adjusted downward. In Argentina, for instance, almost all of the 65-percentage points increase in the public debt/GDP ratio in 2002, was due to the exchange rate correction. Countries that adopted inflation objectives like Chile, Peru and Colombia experienced significantly less appreciation of the real exchange rate (IMF, 2004).<sup>11</sup>

### *Financial Development*

As we said, macroeconomic crises in Latin America usually had fiscal roots and in some cases were exacerbated by financial problems. During the 1990s, banking system fragilities contributed to a series of crises that spurred restructuring and reform efforts. A first wave of crises hit several Latin American countries during the mid-1990s, starting in 1994 with Bolivia, Brazil, Mexico, and Venezuela, and followed by Argentina and Paraguay in 1995 and Ecuador in 1996. Banks were restructured and/or recapitalized, often at a great fiscal cost, while regulatory systems were overhauled. In many cases the reforms were successful in strengthening banking systems and averting banking crises when domestic or external shocks hit again. In others, however, reforms were less successful and a second wave of crisis hit several banking systems, including in Ecuador in 1999, Argentina in 2001, Uruguay in 2002 and the Dominican Republic in 2003. In sharp contrast, Chile had not financial crises during the 1990s, because, as opposed to other countries in the region, its financial system is one of the largest and its banking system one of the strongest among emerging markets economies. (figures 6.3 and 6.4).

There is a growing consensus in the theoretical and empirical literature about the importance of financial development in fostering economic growth (Levine, 1997, 2004). However, with the exception of Chile, Latin American countries have less developed financial systems than other developing countries, even less developed than other economies with a similar income level (IDB, 2004). Latin American financial systems are still largely bank-based, with securities markets mostly small and illiquid.<sup>12</sup> In this context, the development and stability of the banking sector, for which macroeconomic stability and institutional development are key influential factors, is crucial to achieve a more stable and steeper economic growth path. Thus, Chile's greater macro stability and better institutional setup can explain the country's greater resilience to crises during the 1990s.

Most Latin American countries liberalized their financial systems during the 1990s, but without putting sufficient attention to supporting the liberalization with macroeconomic stability and proper bank regulation and supervision. Mexico's crisis in 1994, for example,

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<sup>11</sup> Section VI evaluates empirically the importance of the real exchange rate policy on economic growth and volatility.

<sup>12</sup> International experience suggests that market-based finance typically develops only after banking systems have matured.

followed a period of financial liberalization and expanding banking credit in the absence of proper bank supervision and regulation. In other countries too, a policy mix of a lax fiscal and tight monetary policy contributed to banking booms and busts (e.g. Brazil, 1994). Microeconomic and institutional factors, such as poor bank management, weak prudential regulation and bank supervision and poor protection of creditors' property rights were also responsible for bank problems in a number of cases like Venezuela and Bolivia in 1994, Paraguay in 1996, Argentina in 2001, Uruguay in 2002 and the Dominican Republic in 2003. Finally, high dollarization in Latin American financial systems also added vulnerability by increasing liquidity and solvency risks and by limiting de facto the scope for an independent monetary policy.<sup>13</sup> Thus, macroeconomic stability (for instance, stringent fiscal discipline) and soundness of the banking system (with a proper supervision and regulation) made a big difference in explaining the difference in financial system resilience to crises between Chile and the rest of the region in the 1990s<sup>14</sup>.

### *Structural Reforms and Institutional Buildup*

Regarding other structural reforms, as mentioned towards the end of the 1990s, most Latin American countries had advanced in trade openness, financial liberalization and, to a lesser extent, in tax reforms and privatization of SOEs (the so-called "first generation reforms"). By 1995, the main elements of the reform package had been adopted by almost all the countries in the region (Morley et al., 1999). The main difference in the implementation of these reforms was that Chile had begun its reform process much earlier than the rest of the countries. Trade liberalization lays at the heart of the reform process in Latin America, marking a break with the past strategy of import substitution. In this regard, Chile is also different from the rest of the region, as it was the first Latin American country to embark on a program of trade liberalization. Trade reforms were launched in Chile in the mid-1970s, a decade before the next reformer (Mexico), and by the end of that decade the economy was relatively open. But the opening up process in Chile has continued until today, first unilaterally and then granting better access to exports to big markets through the sign of FTAs with developed economies.

In sum, macro stability, financial system development and the timing of the structural reforms are important elements that differentiated Chile from other Latin American countries in the early 1990s. However, there is another and even more important difference between Chile and the rest of Latin America: Chile, unlike the rest of the region, continued and deepened the reform process putting more emphasis in the institutional setup. A reform process without an adequate institutional setup that supports it, most likely won't have significant and sustained effects on economic growth, and can even result in adverse outcomes. For instance, as we already mentioned, if financial liberalization is not accompanied by an appropriate regulatory and supervisory framework, most likely the outcome will be a lending boom followed by a financial crisis, like it occurred in Chile and

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<sup>13</sup> Latin America is one of the most dollarized regions in the world (IMF, 2004).

<sup>14</sup> IDB (2004) shows how Chile's quality of institutional variables, such as effective creditor rights, is much better than in the rest of Latin America.

other Latin American countries in the early 1980s<sup>15</sup>. Similarly, a privatization program in a corrupt environment will most likely have negative effects on growth.

The most recent literature on economic growth has emphasized the role of policies and, most importantly, institutions, as the ultimate causes of factor accumulation and productivity gains. There is a growing consensus in the literature that countries attain higher economic growth when there is rule of law, property rights protection, low bureaucracy, low corruption, adequate supervisory and regulatory frameworks that guarantee a fair market competition, stable rules of the game, and adequate checks and balances (Rodrik et al, 2002; Easterly and Levine, 2003). All these factors contribute to the design of better economic policies, give support, credibility and effectiveness to the implemented policies, and provide a business environment that is more conducive to investment, innovation and the hiring of labor.

The role of institutions is clearly illustrated in figure 7, which shows a scatter for 151 countries between per capita GDP (as of 2002) and the quality of the countries' institutions. Two conclusions are worth highlighting: (i) Latin American countries tend to be in the bottom part of the figure (they tend to have poor institutions and low GDP per capita); and (ii) Chile is the only Latin American country that appears significantly above the fitted line. In fact, according to Kaufmann et al. (2003), as of 2002 Chile appears as the best-ranked emerging market economy in terms of the quality of its institutions (average of six categories), followed by Costa Rica and then Uruguay among Latin American countries. Chile is even ranked higher than some developed countries, namely Spain, Japan, Hong Kong and Italy (table 9). And the situation is very similar when looking at each of the index components: government effectiveness; regulatory quality; rule of law; control of corruption; voice and accountability; and political stability (only in the latter two Chile appears in second place after Costa Rica among emerging market economies).

Chile has built and strengthened its institutions during the last thirty years. Figure 8 shows the evolution of some institutional variables since 1970 in selected Latin American countries. As it is shown in the figure, Chile began, in general, with the worst institutions in 1970s, and today has the best institutions in the region and among emerging market economies<sup>16</sup>. Countries like Argentina, Brazil, Mexico and Venezuela have not advanced much in their institutional development; further, some, as it is appreciated in figure 8, show today worse institutions than thirty years ago.

This striking difference between Chile and the other Latin American countries provides a plausible explanation for Chile's better economic performance in the past decades. But this is not all. Chile also advanced further than other economies in the implementation of macroeconomic reforms, in some cases even concluding with institutional arrangements that provide additional guarantees that there will be no backtracking in the future. Two examples of the latter are the independence of the Central Bank and the free trade agreements signed recently with important trade blocks and large trade partners. Another example, although not yet fully institutionalized, is the structural fiscal surplus rule. These arrangements enhance the sustainability of macro stability and the market credibility and confidence.

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<sup>15</sup> On this topic see De Gregorio and Guidotti (1995).

<sup>16</sup> Uruguay and Costa Rica, that do not appear in the figures because of the lack of available data for all items and years presented, also stand out from the rest of the region in some institutional aspects.

Next we discuss the reform process in Chile since the early 1970s. The aim is to show the breadth and depth of the reform process in Chile. Also, that the reform process has not stopped; Chile continues implementing policies in many areas. And third, that the institutional setup is not given; it can be modified (albeit slowly), so that countries with poor institutions are not condemned by their legacy<sup>17</sup>.

## V.2 First Stage: The First Generation Reforms

When the economic reform process began, the Chilean economy was in complete disarray as the state intervened in virtually every area of production and interfered in many economic decisions. Furthermore, fiscal deficits were rampant and the economy was isolated from the rest of the world through a complex battery of trade restrictions. In a nutshell, by 1973 inflation was running at above 500% per year, the fiscal deficit was about 30% of GDP, and the peso was artificially overvalued as there were many capital and current-account restrictions aimed at containing the external imbalance, including a multiple exchange rate system. In addition, the average tariff was about 105%, though effective protection varied across economic sectors due to a wide range of restrictions including non-tariff barriers, and many prices were set (artificially low) by the government, creating a shortage of goods and services in many markets. Further, the state owned about 600 enterprises, accounting for about 40% of GDP, and financial repression in the form of controlled (negative) real interest rates and restrictions on credit allocation was widespread.

The military government that took power in late 1973 inherited an economy in complete chaos. In the early years of the military government exchange rates were unified, prices were liberalized for most goods and services, and several enterprises, farms and banks that had been intervened and controlled by the state were returned to their previous owners. In addition, a major fiscal package comprising drastic cuts in public investment and subsidies, and a freeze in public sector wages, brought the fiscal deficit down to only 5% of GDP in 1974. The fiscal adjustment continued, bringing a 4% surplus only two years later (in attaining this surplus it helped the economic recovery that followed the initial reforms).

But reforms went far beyond achieving stabilization and correcting macroeconomic imbalances. In 1975, for example, the sales tax was replaced by the value-added tax (VAT) at a flat rate of 20%, thus improving the efficiency of resource allocation.<sup>18</sup> Also, non-tariff trade barriers were lifted, while both the dispersion and the level of tariffs were unilaterally reduced for most goods. This process continued into 1979, when a flat tariff of 10% was set for most goods.<sup>19</sup>

Major reforms were also introduced in the financial sector, where interest rates were liberalized, banks privatized, mandatory credit allocation abolished, entry restrictions lifted,

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<sup>17</sup> The reader that is not interested in the details of Chile's reform process can skip subsections V.2 and V.3 and continue reading in section VI.

<sup>18</sup> Over time, the VAT became the most important source of government revenue, amounting to about 50% of total taxes.

<sup>19</sup> Only a few exceptions remained, like cars and luxury items such as fur and jewelry.

and the scope of permitted activities broadened. But the end of financial repression was not preceded or accompanied by an upgrade—or even better, an overhaul—of the supervisory and regulatory framework, thus exacerbating moral hazard and adverse-selection problems. Furthermore, early on in the process one commercial bank went bankrupt and the government provided full protection to depositors, thus intensifying moral hazard problems. Unsurprisingly, after the financial liberalization process began, connected lending grew unchecked; this was partly motivated by the simultaneous privatization of banks and enterprises that had led to a high concentration of wealth. Along with over-borrowing, banks incurred in highly concentrated portfolios and under-provisioning of non-performing loans, the latter due to both low provisioning requirements and lax rules that allowed non-performing loans to be rolled over (evergreening). Also, bank borrowers incurred in huge currency mismatches in their balance sheets, a risk that was overlooked by both banks and the supervisory agencies (i.e., bank borrowers' exchange-rate risk exposure became banks' credit risk). In addition, a *de facto* deposit insurance system precluded depositors to exert some kind of market discipline, further aggravating moral hazard problems. This financial fragility made the overall system prone to crisis and proved to be costly when the economy suffered severe shocks in the early 1980s.

The outcome of all the reforms above combined was a quick economic recovery and a sharp reduction in both the fiscal deficit and the inflation rate. Indeed, after a sharp recession in 1975<sup>20</sup>, GDP grew on average by about 6.8% per year during 1976-81 (7.5% in 1977-81). Similarly, inflation fell sharply and reached the two-digit level just a few years into the stabilization program, although it remained around 30% until 1980 (it was slightly below 10% only in 1981). The fiscal balance was in surplus through the entire 1976-81 period and the economy received large amounts of private capital inflows, mainly in the form of syndicated bank debt.

But major imbalances arose during this period. In particular, the real exchange rate appreciated significantly, the current account deficit climbed to 14.5% of GDP in 1981, and the financial sector weakened as major risks and vulnerabilities grew unchecked.<sup>21</sup> The latter led to weak portfolios and undercapitalized banks, many of which accumulated potential losses several times their capital base.

In this scenario of increasing macro-financial fragility, it is easy to understand why the economy nose-dived when the external environment deteriorated in the early 1980s. The balance of payments crisis and the abandonment of the nominal peg that followed were unavoidable after private capital inflows came to a halt in 1982. The ensuing real depreciation further aggravated the financial crisis because of the large currency mismatches incurred by the private sector. As a result, real GDP fell by about 16.4% (cumulative) during 1982-83.

The economic and financial crises caused a setback on some of the policies and achievements of previous years. Indeed, the government had to take over 19 financial institutions and ended up controlling about half of the total bank credit (the intervened

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<sup>20</sup> The recession resulted from the fiscal stabilization program, the first oil shock, and the fall in the price of copper in the world market.

<sup>21</sup> As mentioned above, the risks included unmatched currency liabilities incurred by banks' debtors, weak asset rating systems, under-provisioning, connected lending, and rolling over of bad loans (evergreening of banks' balance sheets).

institutions were later privatized, merged or shut down). Along with this, the government took over several enterprises and non-bank financial intermediaries that belonged to the conglomerates whose flagship banks were near collapse and had been intervened<sup>22</sup>. In addition, import tariffs were raised —albeit temporarily— to help the fiscal adjustment. All of this represented a major setback to the market-oriented economic model implemented since 1974, and forced the government to incur in a fiscal deficit and allow higher inflation rates (in addition to the higher tariffs) to finance it.

It is important to single out two other reforms that were implemented just before the debt crisis hit, which played a major role in the subsequent period: the new Constitution of 1980, and the pension system reform of 1981.

The new Constitution of 1980 is important not only because it set the timetable for the return to a democratic regime in Chile, but also because it granted the power to allocate government spending exclusively to the executive branch, thus closely linking expenditures with revenues<sup>23</sup>. Thus, today the Chilean Congress can either pass or reject the budget law submitted to it by the government, but cannot amend such law. This has proven to be an important factor for maintaining fiscal discipline. In addition, the new Constitution prohibited the Central Bank from buying securities issued by the government, thus precluding the monetization of the deficit. It was also given the explicit mandate to pursue the stability of prices (or of the currency), the stability of external payments, and the stability of the domestic payment system. Finally, it was granted full independence from the executive branch by the way its authorities would be designated<sup>24</sup>. (It should be mentioned that although legislated earlier, these changes came into effect *de facto* in 1989, with the country's return to democracy).

The pension system reform of 1981 consisted of the phasing out of the bankrupt pay-as-you-go system and the creation of a fully funded capitalization system run by private, competing entities. In the new system workers make mandatory monthly contributions into personal savings accounts, which are managed by specialized private entities, and whose balances cannot be withdrawn before retirement. This reform led to an increase in total savings and, at the same time, contributed to the development and deepening of the domestic capital markets, thus indirectly helping to raise total factor productivity<sup>25</sup>. In fact, as the private entities managing these funds have become large lenders to both banks and corporations, over the years they have induced an improvement in corporate governance (figure 9).

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<sup>22</sup> The fiscal cost of the financial crisis is estimated to be close to 40% of GDP. For more details on the Chilean banking crisis of the 1980s, see Barandiarán and Hernández (1999).

<sup>23</sup> Prior to this legal change, the legislative branch shared the power to allocate public money, but was not required to provide the necessary funding, thus exacerbating the bias toward having a large fiscal deficit purely for political reasons.

<sup>24</sup> Pursuant to the law, the Central Bank is run by a Board composed of five members, each one appointed for a term of ten years: every two years a new member is appointed. Board members are nominated by the government, but need approval of the Senate. The Governor is then chosen among the five board members by the country's President for a period of five years or the time remaining in the member's term, whatever is shorter. The Deputy Governor is chosen by vote among the other members of the Central Bank Board.

<sup>25</sup> See Corbo and Schmidt-Hebbel (2003).

### V.3 Second Stage: The Deepening and Institutionalization of Reforms

In the aftermath of the debt crisis, the government focused its policies on two areas: redoing some of the work of previous years —privatizing banks and enterprises taken over during the crisis, continue reducing the budget deficit and inflation— and overhauling the institutional framework to correct the problems and regulatory shortcomings that had been diagnosed during (and were partly responsible for) the crisis<sup>26</sup>. Thus, a new tax law was enacted in 1984, which provided special incentives for saving and investment. For instance, profits became non-taxable if reinvested (taxes accrued only when profits were distributed in the form of dividends) and the corporate tax rate was reduced.<sup>27</sup> Also, new banking and bankruptcy laws were enacted in 1986. The new banking law granted more powers to the supervisory and regulatory agencies, while updating specific regulations to keep up with international standards and best practices. For instance, more stringent restrictions were imposed on loans granted to related parties, on asset classification by banks, on provisioning and on the reporting of non-performing loans, thus significantly reducing the scope for incurring in connected lending and the rolling over of bad loans. With respect to bankruptcy procedures, the new law set forth very clear steps for the liquidation and closure of banks. Also, clear seniorities were established for the payment of debts to creditors, while bankruptcy procedures were expedited.

Other important institutional changes included the setting of a framework for controlling and monitoring monopolistic practices, and the privatization of SOEs, comprising not only banks and other firms taken over during the debt crisis, but also utilities formerly owned and operated by the state, such as electricity generation and distribution, long-distance and local telephone companies. The privatizations undertaken during this period, as opposed to those implemented during 1974-81, were designed to spread ownership among a larger group of investors, so that the high concentration of wealth that had resulted before could be avoided. For this purpose, tax and other incentives, such as low-cost loans, were provided to individuals for them to buy shares of the privatized companies. The new wave of privatization brought the share of SOEs in GDP down from 24% in 1983, to 13% in 1989. In addition of passing an antitrust law, specific rules were approved for the setting of prices of natural monopolies, such as electric and telephone companies, and in other industries such as public transportation.

In 1989, a new Central Bank law was enacted, whereby the Central Bank's sole objectives are the stability of prices, the stability of the domestic payment system, and the

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<sup>26</sup> It should be stressed that the decision to maintain the outward oriented market-economy model in the aftermath of the debt crisis was crucial to determine the country's economic performance in subsequent years. Indeed, after that almost a decade of economic reforms had ended in a recession and deep financial crisis, the development model was discredited. In this setting it could have been easily replaced by the inward looking model with greater government intervention, thus reversing the progress achieved during the past decade. Fortunately, the authorities at the time decided to maintain the same overall development strategy, focussing instead on correcting its institutional and regulatory shortcomings.

<sup>27</sup> At the same time, double taxation on dividends was abolished by giving shareholders a tax credit, to be used in their personal income tax, equal to the proportional corporate tax paid by the company. This way the tax-induced bias in favor of corporate borrowing to finance investment was eliminated (Modigliani-Miller's modified proposition, 1963). In addition, special tax incentives were provided for the issuance of equity. Buyers of new shares, IPOs, received a tax credit, equal to a fraction of their investment, which would last for as long as they held on to the new shares. For details see Hernández and Walker (1993).

stability of Chile's external payments. This new charter led the Central Bank, now autonomous, to adopt in 1991 a monetary policy scheme based on inflation targeting and a widening exchange rate band. The exchange rate band was abolished later on (in 1999), leading to a free-floating regime in which the Central Bank rarely intervenes, that is, only when the exchange rate market becomes dysfunctional and the exchange rate is clearly misaligned from its fundamentals. As a result of all these changes, the inflation rate in Chile today has converged to the Central Bank's steady-state target, a range of 2 to 4 percent per year, a level that nobody thought feasible just a decade ago<sup>28</sup>.

Also, new legislation allowing the participation of the private sector in infrastructure development was passed in 1991-92. According to it, roads, highways, airports, seaports and other infrastructure projects may be developed by the private sector under build, operate and transfer (BOT) arrangements. As of 1998, 21 projects for a combined total of about US\$3.6 billion had been developed under this arrangement (several others have been approved and completed, or are near completion, since then). And in 1994, a new law was passed permitting free entry to the —until then monopolistic— long-distance telecommunications market, the so-called “multi-carrier” system. This change has shaped a highly competitive market and caused a drastic fall in long-distance telephone rates.

It is important to mention that during this period the country successfully transitioned from an authoritarian to a democratic regime. Despite all the uncertainties surrounding this transition, the change was smooth, in part because the new Administration confirmed most of the market economy elements already in place, while concentrating on a social agenda. This way the economic institutions created in previous years were validated and in many cases strengthened, so that uncertainty vanished. For instance, early on in 1990 the new democratic government deepened the opening up process by reducing the maximum import tariff from 15% to 11%. In fact, all three governments that have been in power since 1990 have strengthened the market economy model, accelerated the opening up process, consolidated the fiscal position and improved regulations, while, at the same time, they have emphasized social policies and implemented new programs to alleviate poverty. However, in labor market flexibility there has been some backtracking.

But the reform process has continued up to now with the introduction of policies and institutional changes aimed at further consolidating the market-oriented economic model and improving the Chilean economy's resilience to shocks. Thus, amendments to the banking law in 1997 allowed banks to undertake new businesses, including lending internationally, while upgrading some regulations, i.e., the Basel capital accord was adopted. In 1998 a law was passed unilaterally reducing the import tariff by one percentage point every year, stopping at 6% in January 2003. Furthermore, in 2002 Chile signed free trade agreements with the European Union, in 2003 with the United States and in 2004 with South Korea, thus consolidating the process of integration with the world economy. Also, in 2001 the government committed to achieving and maintaining a 1% *structural* fiscal surplus. Under this commitment, government expenditures are set to be 1% of GDP less than the Government's *structural revenues*, which are defined as the revenues that would occur in steady state. In other words, expenditures are 1% less than the revenues that would occur if the economy were on its long-term path (after eliminating cyclical variations in taxes and other key variables, such as the price of copper and the level of international

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<sup>28</sup> Thus, an inflation that started to develop in 1860 was finally controlled by the late 1990s.

interest rates). This rule is intended to guarantee that the government will remain solvent in the long run. Also in 2001, all remaining capital controls were abolished, ending more than half a century of a partly closed capital account. And during this period regulatory and tax changes were introduced, aimed at increasing the efficiency of capital markets and providing incentives to save. Among these: taxes on capital gains in the stock market were abolished; voluntary (tax-free) contributions into personal retirement savings accounts were allowed; the tax on interests paid to foreign investors in peso-denominated bonds was reduced from 35% to 4%; and some regulations restraining mutual funds and insurance companies were lifted.<sup>29</sup> Also, during this period the exchange rate band was abandoned, consolidating both the inflation targeting and the free float regimes, while a voluntary unemployment insurance scheme was introduced. Finally, in 2003 three new laws were passed that (i) established a clearer career path for public servants, based on merits, thereby significantly reducing the scope for the government to appoint political allies in senior positions; (ii) provided public funding for political parties; and (iii) regulated private donations to political parties and candidates. These three laws should increase transparency, reduce the scope for corruption, and allow the public sector to attract more qualified people. And currently other initiatives are underway to further improve the efficiency and foster the development of the Chilean capital market including venture capital.<sup>30</sup>

In sum, Chile not only began its economic reform process a decade earlier than the rest of Latin America; it also completed and deepened many of the reforms in subsequent years. Further, it changed the institutional setup to enhance the credibility—and effectiveness—of its policies and the country’s resilience to shocks. Without the continuous progress in all these areas, most likely the pay-off in terms of growth would have been less than it was and the economy would have remained highly vulnerable to crises.

## VI. Deepening the Reforms: What is at Stake?

The previous section has shown how Chile introduced and deepened the reforms, putting special emphasis on the institutional buildup. In the process, the country has established high credibility and its institutions have won reputation, being today of better quality than all other countries in the region. The latter is reflected in the country’s risk premium, which in 2003-04 attained one of the lowest levels among all emerging market economies (figure 10).

Based on Chile’s experience an interesting question arises: What benefits would accrue to countries that intensify their reform process to attain Chile’s—or higher—standards in terms of macroeconomic indicators, policies and, most important, institutions?

To answer the question above we follow the standard procedure found in the literature and run two sets of regressions using a cross section of about 80 countries. In the first set of regressions the dependent variable is the average growth of per-capita GDP during 1960-2000. In the second set the dependent variable is the volatility (measured by the standard deviation) of the per-capita GDP growth rate over the same time period. The second set of regressions is motivated by recent research by Acemoglu et al. (2003) that

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<sup>29</sup> Capital Markets Reform I.

<sup>30</sup> Capital Markets Reform II.

suggests that volatility is not caused only by bad policies —exchange rate overvaluation, inflation, government consumption, or other— but also by poor quality institutions. Poor quality institutions may cause volatility directly and indirectly by leading to bad economic policies. The two regressions are of the following form:

$$(1) \quad \dot{Y}_i = \alpha_0 + \alpha_1 \text{QI}_i + \alpha_2 X_i + \varepsilon_i$$

$$(2) \quad \sigma \dot{Y}_i = \beta_0 + \beta_1 \text{QI}_i + \beta_2 X_i + \mu_i$$

where  $Y$  is per-capita GDP,  $\text{QI}$  is an index measuring the quality of institutions in each country,  $X$  is a set of other explanatory variables, and  $\varepsilon$  and  $\mu$  are random terms (a dot above a variable means percentage change).

Following the standard literature, the set of explanatory variables  $X$  includes initial conditions, policy variables, and one endowment/geography variable. Among the initial conditions we include the log of per-capita GDP in 1960, and the average years of schooling in 1960 (the latter variable only for equation 1). Policy variables include openness (measured as exports plus imports over GDP<sup>31</sup>), government consumption (in percentage of GDP), the real exchange rate overvaluation, the exchange rate black-market premium, and financial development measured as the ratio of private credit to GDP. Other explanatory variables included in the regressions are the growth and the volatility of the terms of trade. In equation (2) we also include inflation and its volatility, and the volatility of government consumption and exchange rate overvaluation. All the policy variables are measured as the average for the 1960-2000 period. The endowment/geography variable is either a dummy indicating whether the country has access to the seacoast, or the proportion of land area within 100 km of the seacoast.<sup>32</sup>

The quality of institutions,  $\text{QI}$ , is measured by the average for 1996-2000 of the following six indices<sup>33</sup>:

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<sup>31</sup> For robustness checking, in a few regressions we use the alternative suggested by Calderón, Loayza and Servén (2003), but the results do not change. This alternative variable is labeled openness 2 in tables A.2 through A.7.

<sup>32</sup> The precise definition and source for each variable is provided in table A.1 in the appendix.

<sup>33</sup> Other papers use Rule of Law as an indicator of the quality of institutions. Although we use a broader index, the results reported below are robust to the use of Rule of Law. Besides, the correlation between our broader index and the latter is 0.97.

<b>Index</b>	<b>Definition</b>
Voice and accountability	Extent to which citizens can choose their government, political rights, civil liberties, and an independent press.
Political instability and violence	Likelihood that the government will be overthrown by unconstitutional or violent means.
Government effectiveness	Quality of public service delivery, competence of civil servants, and the degree of politicization of civil service.
Regulatory burden	Government control on goods markets, government interference in the banking system, excessive bureaucracy to start a new business, and excessive regulation of private businesses and international trade.
Rule of law	Protection of individuals and property against violence or theft, independent and effective judges, and contract enforcement.
Graft or control of corruption	Use of public power for private gain and degree of corruption.

Source: Kaufmann et al. (2003)

The estimation of equations (1) and (2) poses a problem, namely the potential endogeneity of some of the right-hand-side variables; in particular, openness, financial development and the quality of institutions. To address this problem we use two-stage least squares and the standard instruments suggested in the literature. The instrument for openness is the fitted value that results from a gravity equation as suggested by Frankel and Romer (1999)<sup>34</sup>. For the quality of institutions we use a set of alternative instruments commonly used in the literature on institutions and growth, namely the distance from the Equator of the capital city, the etno-linguistic fraction of the population, the fraction of the population speaking English, the fraction of the population speaking one of the major languages of Western Europe, and the origin of the legal system<sup>35</sup>. Regarding the validity of our instruments, first step regressions show a good fit (adjusted  $R^2$  over 0.65). Also, in appendices A.4 and A.7 we run estimations including different combinations of the instruments mentioned above, and the results remain robust. So, we accept these endowment and historical variables as exogenous determinants of the quality of institutions<sup>36</sup>.

In the case of financial development, we take stock of the mounting evidence provided in recent years proving that “financial development causes growth” and treat it as an exogenous variable. (Just for completeness we instrument this variable using the origin

<sup>34</sup> The Frankel and Romer approach consists of first regressing bilateral trade flows (as a share of each country’s GDP) on measures of the country’s mass, distance between the trade partners, and a few other geographical variables; and second constructing a predicted aggregate trade share for each country on the basis of the estimated coefficients. This constructed trade share is then used as an instrument for actual trade shares in estimating the impact of trade on economic growth.

<sup>35</sup> Another instrument proposed by Acemoglu et al. (2001) is the mortality rate of settlers. We do not use it because doing so would reduce our sample size significantly.

<sup>36</sup> Easterly and Levine (2003) and Rodrik et al. (2002) undertake tests to show the validity of this kind of endowment and historical instruments as exogenous determinants of the quality of institutions.

of the legal system, as suggested by La Porta et al. (1999), but the results change only marginally)<sup>37</sup>.

The main results of estimating equations (1) and (2) are reported in tables 10 and 11, respectively. In the final regressions reported in the tables we have excluded some variables that were consistently insignificant (the regressions where we include these variables and test for robustness are reported in tables A.2 through A.8 in the appendix)<sup>38, 39</sup>.

The first two regressions (columns) in table 10 are simple OLS, before and after controlling for the quality of institutions. The main conclusion that emerges from comparing the first two columns is that institutions matter, that is, not only the  $\alpha_1$  coefficient turns out to be significant, but excluding the institutions variable biases upwards (in absolute value) all the other coefficients, except for initial GDP. Note also that the results from columns 1 and 2 are consistent with previous findings: there is convergence in per-capita GDP (poorer countries tend to grow faster), education and financial development affect growth positively, while keeping an overvalued exchange rate is detrimental to growth. Openness and government consumption, although having the right sign, do not attain statistical significance at the standard levels<sup>40</sup>.

As argued, some of the right-hand side variables may be endogenous and that may be causing a bias in the results. Columns 3 through 7 address this problem by using instruments. In the regression in column 3 we use instruments only for the institutions variable, in the one in column 4 we use instruments for institutions and openness but not for financial development, and in column 5 we use instruments for financial development and institutions, but not for openness. The regression in column 6 excludes the institutions variable and uses instruments for financial development and openness, and the regression in column 7 includes institutions and uses instruments for all the potentially endogenous variables.

The conclusions that emerge from columns 3 through 7 are very similar to those from columns 1 and 2, that is, institutions matter (excluding this variable biases all other coefficients), there is per-capita GDP convergence, the level of education matters, and among the policy variables the most important are exchange rate overvaluation and financial development. In addition, when using an instrument for financial development,

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<sup>37</sup> See footnote 32.

<sup>38</sup> In table A.2 we use an instrument only for the institutions variable and try several combinations of the control variables. In table A.3 we use also instruments for openness and financial development (and try different control variables). In table A.4 we try different instruments and a different definition for openness. The same structure is applied in tables A.5-A.7 for the case of growth volatility (equation 2).

<sup>39</sup> It should be mentioned that, as we follow the standard literature, our results are subject to the same caveats and shortcomings of all recent papers on institutions and growth, in particular with respect to the choice and validity of the instruments and the estimation procedure (Acemoglu et al., 2001, 2003; La Porta et al., 1999). For a test on the validity of the instruments see Easterly and Levine (2003) and Rodrik et al. (2002).

<sup>40</sup> Empirical results indicate that the effect of openness on GDP growth is ambiguous. In particular, cross-section studies tend to find no such effect or the effect, when shown, is not robust, while a positive and robust effect emerges in panel data studies that capture the temporal effect of openness. See Calderón et al. (2004) for a complete review of empirical literature about the effect of openness on economic growth.

the corresponding coefficient turns out larger but is estimated less precisely (its marginal significance level is about 13% in columns 5 and 7).

Three other conclusions are worth noting from table 10 (and confirmed by the robustness tests in tables A.2 through A.4). First, the coefficient that accompanies the institution variable,  $\alpha_1$ , is robust to many alternative specifications and very stable at around 0.010. Second, the coefficients for the education and exchange rate overvaluation variables are not biased (or are only marginally so) when the institutions variable is excluded. And third, financial development matters for growth on its own, even after controlling for the quality of institutions.

Using the results from tables 10 and A.2 through A.4 (using the average coefficient  $\pm$  one std. deviation), it is possible to estimate the potential effect for the average Latin American country of adopting Chile's institutions, or even better, the institutions of the developed countries, or Finland's, the top one among all the countries in the sample. The results, reported in table 12, indicate that by having institutions of quality similar to Chile's, the average Latin American country could raise its per-capita GDP growth rate between 0.9% and 2.3% per year (or by about 1.6% per year, on average). Or better still, by having Finland's institutions the increase would be between 1.3% and 3.3% per year (or by about 2.3% per year, on average). In this case Chile's per-capita GDP growth would raise by about 0.7% per year on average. Note that Chile having developed countries' institutions could raise its per-capita GDP growth rate by only 0.1%, because the difference between Chile's and the advanced economies' institutions is marginal<sup>41</sup>. Compared with historical growth rates of per capita GDP in Latin America (1.2% p.a. during 1960-2000, using a simple average, and 1.8% p.a. taking a GDP-weighted average), the potential raise is quite significant. It means that, on average, per capita GDP would double in about 20-25<sup>42</sup> years instead of 60 (these numbers change to 22-18<sup>43</sup> instead of 38 if using the GDP-weighted average).

Similarly, the effect on the average Latin American country of adopting Chile's policies (financial development and real exchange rate overvaluation) is shown in tables 13 and 14. Regarding financial development, the average Latin American country could raise its per-capita GDP growth rate by 0.8%, on average (between 0.4% and 1.2%), by having Chile's financial development. And by having the mean of the major advanced economies' financial development, the average LAC country could raise its per-capita GDP growth rate by 1.1%, on average (between 0.6% and 1.7%). Finally, the average Latin American country could raise its per-capita GDP growth rate by 1.4%, on average (between 0.7% and 2.1%), by having Switzerland's financial development. With regards to real exchange rate overvaluation, the average Latin American country could raise its per-capita GDP growth rate by 0.2% on average (between 0.1% and 0.3%), by pursuing policies aimed at attaining a real exchange rate overvaluation similar to Chile's.

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<sup>41</sup> Similarly, by having institutions like the major advanced economies' the average LAC country could raise its per-capita GDP growth rate by 1.7%.

<sup>42</sup> 20 if compared to Finland's institutions and 25 if compared to Chile's.

<sup>43</sup> 18 if compared to Finland's institutions and 22 if compared to Chile's.

In sum, by adopting policies (financial development and real exchange rate overvaluation) similar to Chile's, the average Latin American country could raise its per-capita GDP growth rate by about 1.0% per year, on average.

The results above also provide an explanation for Latin America's poorer performance during the 1990s vis-a-vis Chile or East Asia (this is reported in table 15). In the former case, about half of the predicted growth difference can be explained by better institutions and about half by better policies (differences in initial conditions matter, but less than differences in policies and institutions). In the latter case, policies played a much greater role, mainly because there is not much difference in the quality of institutions between the average Latin American country and the average East Asian country. More precisely, about 75% of the faster economic growth (predicted) in East Asia is due to better policies and only 25% to better institutions. Finally, among policies, the sustained overvaluation of the real exchange rate, although adding to the poor performance of the average Latin American country, plays a lesser role than financial development.

With regards to GDP growth volatility, the results reported in table 11 suggest that the quality of institutions matter—better institutions reduce volatility—and, therefore, excluding this variable biases all the coefficients, especially the one on financial development (note that tables 11 and 10 are similar in structure)<sup>44</sup>. In addition, using instruments (2SLS) changes the parameters of some variables ( $\beta_1$  appears to be less stable than  $\alpha_1$  as reported in table 10). Most important, the only variable besides institutions that matter is the overvaluation of the exchange rate (keeping an overvalued exchange rate raises GDP growth volatility).

Finally, table 16 reports the (again, simulated) effect on the volatility of per-capita GDP growth for the average Latin American country, of it adopting institutions of similar quality to Chile's, or even better, Finland's. The reduction is significant: volatility would fall on average by about 40% per year (from 4.2% to 2.5%) in the former case, and by about 57% (from 4.2% to 1.8%) in the latter (numbers are very similar if using simple or weighted average historical data).

Similarly, table 17 shows the effect on the volatility of per-capita GDP growth, for the average Latin American country, of it having a real exchange rate overvaluation similar to Chile's. Volatility would fall on average by about 10% per year (from 4.2% to 3.8%) by having Chile's real exchange rate overvaluation (numbers are very similar if using simple or weighted average historical data).

Before closing this section a methodological note is in order. The dependent variables in equations 1 and 2 are the average and the volatility of the per-capita GDP growth rate for 1960-2000, respectively, while, in both regressions the variable indicating the quality of each country's institutions, *QI*, is measured over 1996-2000. This measurement problem could invalidate our results. To check for the robustness of our findings we re-estimate both

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<sup>44</sup> That is, regressions in columns 1 and 2 are OLS estimations with and without the institutions variable; regressions in columns 3 through 5 use instruments for some of the potentially endogenous variables (in the same order explained in the text); and columns 6 and 7 use instruments for all the endogenous variables, openness, financial development and quality of institutions (column 7).

cross-sectional regressions for the shorter sample period, although doing this may lead to less precise results due to the greater importance of cyclical factors<sup>45</sup>. The results of these new estimations are presented in table A.8 in the appendix<sup>46</sup>. As expected, some of the explanatory variables lose statistical significance, in particular financial development, the overvaluation of the real exchange rate and average schooling years. However, the quality of institution variable turns out to be statistically significant, with the correct sign and with even larger coefficients than before, which shows that our main result regarding the institutional set up is robust to changing (shortening) the sample period.

## VII. The Challenge Ahead for Latin American Economies: Lessons from Chile

After analyzing the Chilean experience and the economic development processes of other countries, it can be argued that, from an analytical perspective, the economic development process consists of three stages. The first stage consists of achieving macroeconomic stability, liberalizing markets and prices throughout the economy, and integrating the economy to the rest of the world. The second one consists of building an institutional framework to support<sup>47</sup>, give credibility and enhance the effectiveness of the policies and reforms implemented in the first stage. And the third one consists of improving those institutions that are related with the microstructure of specific markets (for instance, antitrust and labor market laws) in order to gain more efficiency and improve income inequality. And this is in addition to the need of keeping reviewing the reforms and policies implemented in order to look for areas where efficiency gains can occur.

Public discussion in Chile has in recent years focused on issues pertaining to the third stage as the country has already achieved macro stability and developed a credible institutional framework. In other words, Chile is not currently thinking about how to resolve the next crisis, but about medium-term challenges such as how to improve income inequality and give more opportunities to the poor. In contrast, many Latin American countries still have problems pertaining to the first and second stages. As it was described above, just a few years ago some Latin American countries suffered costly crises due to fiscal problems and a weak financial system, while the institutional quality in most Latin American countries is still very poor.

Therefore, the challenges ahead for the Latin American economies, that arise from the Chilean experience, are straightforward: countries should advance in all fronts, macro reforms (especially those countries that have not yet attained macroeconomic stability), micro reforms (promote market competition, price flexibility, etc.) and –the focus of this

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<sup>45</sup> It should be noted that the growth literature tries to identify the determinants of long-term growth. For this purpose, the standard approach is to take averages over long periods of time, which smoothes out cyclical fluctuations. Using a five-year period does not guarantee that cyclical factors are cancelled out, which could reduce the precision in the estimation.

<sup>46</sup> For the economic growth equation (Eq. 1) we report the same regression as equation 7 in table 10, while for the volatility equation (Eq. 2) we report the same regression as equation 2 in table 11. Other regressions are available upon request.

<sup>47</sup> Financial development and soundness, another pillar of the Chilean economic model, depends on both stages, macroeconomic stability and the institutional framework.

paper— upgrading and strengthening their institutions. The need to advance in all these fronts becomes even more urgent given the impending globalization trend. In other words, given the increasing (and unavoidable) integration of the world economy, in both goods and capital flows, countries that do not reform their economies and institutions not only will not reap all the benefits from this trend, but will also become increasingly prone to crises. It should also be mentioned that the longer countries try to delay —most likely unsuccessfully— their integration into the world economy, the wider the income gap with the industrial world will be. The latter because in a world of very rapid and frequent technological changes, opportunities arise and are exploited quickly by the most dynamic and open economy. In sum, the globalization trend presents opportunities, but the potential benefits will not materialize if countries do not upgrade their institutions and policies.

The above is more easily said than done. This, because there are no short-cuts and the experience of one country cannot be easily replicated by another; what works in one case does not necessarily work in another. So, to make progress countries should be innovative in the design of their policies and institutions. One example is Chile's 1981 pension reform. The new system and the transition from the old one was not copied from elsewhere; it was brand new and started from scratch. Countries that have tried to copy the Chilean system, however, have not always succeeded because of their own idiosyncrasies. Another example is the unremunerated reserve requirement or *encaje* that Chile used in the 1990s that, albeit some controversy about its effectiveness in achieving all the objectives for which it was designed, at least changed the composition of capital inflows toward the more stable and with longer maturities. This policy tool worked in Chile because of the rule of law and the tight monitoring exerted by the Central Bank on commercial banks, but by its nature is a potential source for corruption.

Despite these caveats, there are a few general lessons to be learned from Chile's experience, and from other successful experiences, that can be extended to other Latin American countries:

*Regarding macroeconomic stability and first generation reforms*

- Fiscal responsibility is a must. This because other macro objectives —low inflation, financial sector stability, balance of payments stability— may not be attainable without it. Further, fiscal sustainability leads to lower country risk and reduces the volatility of capital flows, all of which ease the adjustment to shocks. Whether fiscal policy is designed to be countercyclical, while desirable, is not as important as to put in place mechanisms to assure fiscal sustainability. Chile's structural fiscal surplus rule may not work for every country, but is one alternative way to proceed.
- As for exchange rate policy, experience has taught that intermediate regimes are subject to attacks (especially with the *de facto* increasing financial integration). Further, capital controls are not very effective, except for very short periods of time, and used along with sterilization policies can be quite costly (in addition to being a potential source of corruption). Therefore, countries have to choose between a float and a hard peg. A float eases the adjustment to external shocks that require the real exchange rate to depreciate, and permits using monetary policy in a countercyclical fashion; however, it requires to have in place a credible nominal anchor. On the other hand, a hard peg calls for a highly

flexible economy, especially with regards to the labor market, and a very solid banking system. The latter conditions may be hard to meet in Latin American countries.

- The mix of inflation targeting, financial integration, and a float has functioned well in Chile's case in the past decade. Similarly, a hard peg and capital mobility have functioned well in Hong Kong for more than two decades. Which way to go is hard to say as it depends on each country's characteristics: whether there is an alternative credible anchor, which, in turn, depends on the track record and reputation of the Central Bank, the strength of banks, and the flexibility of prices (wages).
- One important lesson to be drawn is that, irrespective of the specific exchange rate and monetary policy arrangements, the macro policy mix must be internally consistent and robust to different scenarios. Policies must prove to work in periods of bonanza as well as during global slowdowns; this is the only way that credibility will be enhanced, diminishing the likelihood of speculative (unfounded) attacks.
- Countries should advance further in completing the so-called first generation reforms, in particular, in attaining macro stability. It should be stressed that second generation reforms are conditional on macro recovery and sustainability. In addition, countries should move forward in completing their trade liberalization processes. Given the sluggishness of multilateral agreements, like those under the auspices of the WTO, unilateral tariff reductions and bilateral free trade agreements —such as those of Chile with South Korea, the US or the European Union— may be valid alternatives.
- Financial sector supervision and regulation must be upgraded and the banking sector strengthened. Whether regulation is organized by type of institution (i.e., banks versus financial companies) or by type of activity (i.e., mortgages versus credit cards) is open to discussion. Similarly, there is no clear cut on whether the industry should be organized under the universal banking model or the narrow banking model. But it is clear that a weak financial sector can become a major obstacle to implement macro policies and, most importantly, to attain macroeconomic stability. Further, a stronger financial sector will foster the growth process.
- In order to enhance the chances of attaining higher economic growth on a sustained basis, countries should implement reforms and policies aimed at fostering the development of the financial sector. A sound and modern banking regulation is a must in order to avoid financial crises.
- Significant progress is needed throughout the region in the areas of privatization of state owned enterprises and tax reforms. However, before proceeding with the privatization of SOEs at least two conditions must be met: (i) a transparent mechanism for privatization must be designed, to minimize the chances of corruption; and (ii) a clear regulatory framework, including rate setting mechanisms, must be designed for utilities and other natural monopolies. If these conditions are not met, the privatization process will not have public support, leading to government intervention and setbacks.

#### *Regarding the institutional buildup*

- Beyond the macro and first generation structural reforms, and even more important as it can be concluded both from the Chilean experience and from the empirical analysis, significant progress is needed in improving the compliance with the rule of law, raising

government effectiveness, reducing corruption, protecting property rights, increasing the efficiency of the judiciary, enhancing market competition, and limiting political interference with monetary, fiscal and exchange rate policies. The institutional buildup is fundamental in order to support, give credibility and enhance effectiveness of the different reforms and policies, and to put the right incentives for investment, labor hiring, and most important, technological innovation. Moreover, the institutionalization of reforms reduces the uncertainties about the continuity of the reform process and the risk of potential setbacks.

*Regarding income inequality*<sup>48</sup>

- And finally, there are two areas where every Latin American country, including Chile, has to make significant progress, namely income distribution and labor market flexibility. Although seemingly unrelated, we discuss them together because reforms in these areas will affect (favorably) mostly the poor.
  - Labor market reform should be aimed at reducing hiring in the informal economy, where employers fail to provide social security, medical insurance and other mandatory benefits. In addition, increasing labor market flexibility would benefit mainly unskilled workers who are hurt the most with cyclical fluctuations because of minimum wages or because they are more easily replaced. It should also be noted that the main way through which the unskilled can raise their human capital—and income—is by staying employed (through on-the-job training).
  - And with regards to income distribution, the challenge is to design policies that allow the poor to work their way out of poverty; that is, to break the vicious circle by which children of poor people remain poor because they do not have access to a proper education. Among other, key components in the design of these policies are (i) to provide more and better education for the poor (according to international standardized tests, education in Latin America is inadequate), and (ii) to grant more access to credit to micro and small enterprises. Evidence suggests that small and micro enterprises, which employ a large fraction of the poor and unskilled, have no access to formal credit, whereby they end up paying a high cost of funding (when available through informal channels) or cannot invest and grow. Besides, many micro enterprises remain in the informal sector for years. State policies aimed at fostering the development of small and micro firms may have a significant impact on income distribution in the medium term. With regards to education, it should be emphasized that designing adequate policies becomes more urgent because of the globalization trend mentioned above, that is, because technological changes tend to benefit more the skilled and educated groups that can adjust to and adopt the new technologies more easily.
  - The need to improve income distribution becomes even more urgent if one takes into account that in order to be sustainable the reform process needs public support. If a large part of the population feels that they are left behind, there is an increasing risk of social unrest and track backing in the reform process.

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<sup>48</sup> Although income inequality is not the focus of this paper, we discuss briefly it as another challenge to the economic development in Latin America.

## VIII. Summary and Conclusions

This paper addresses the issue of how can countries in Latin America, and other developing regions, accelerate their growth rates and close their per capita income gap with the industrial countries. The main motivation of the paper is to contrast the experience of Chile, that during the 1990s grew at high rates and reduced its poverty rate sharply, with the rest of the region that, although recovering from the very poor performance of the 1980s (the so-called lost decade), failed to resume the growth rates of the 1960s and 1970s.

Based on recent theoretical and empirical findings, we argue that Chile's success story is due to the breadth of its reform process, that continues to this date and has been much deeper and broader in scope than that carried out in other countries. The reform has not only boosted the country's macro fundamentals but also upgraded and strengthened its institutions. The high payoff from Chile's reform is due to its breadth and continuance through time.

One conclusion of the paper is that Latin American countries should put additional effort in their reform processes, in many cases completing the so-called first generation reforms: e.g., fiscal stability and trade liberalization. But there is also the need to advance in second generation reforms: upgrading of the supervisory and regulatory framework of banks, enhancing market competition and market discipline, upgrading of the regulatory framework for utilities (including a clear rate-setting mechanism), putting in place a framework for private sector participation in infrastructure development, and reforming pension systems. The latter in the case of Chile has proven to be key to the attainment of deeper financial markets, better corporate governance and higher economic growth.

All the reforms above are part of the macroeconomic-institutional realm and can be implemented, albeit at different pace each. But continuous progress in all areas is needed as reforms are complementary and stagnation in one area may compromise the success of the reforms in others. Further, there are no easy policy recommendations as reforms cannot be easily copied from one country to another. Each country has to design its own policies and implement them taking into account its own characteristics: the way China has proceeded in the past two decades is not a replica of the reforms implemented elsewhere, while Chile's experience with reforms has been a stop-go story.

A second conclusion of the paper refers to the importance of other institutions —rule of law, control of corruption, government effectiveness, political stability— that are beyond the realm of political economy but, nevertheless, affect growth significantly. Although there is no straightforward conclusion in this respect, we share the view that these institutions are not given and countries are not condemned to their legacy. Although at a much slower pace than other reforms, over time countries can modify these institutions. Two examples in this respect are Chile and Singapore (although the latter is far more advanced than the former in this respect). In the case of Chile, for instance, after 30 years of reforms the general public have begun to acknowledge the importance of building a strong institutional setup to provide and support a market friendly environment with stable rules of the game that attracts investors, foreign or domestic. The latter allowed the government recently to pass legislation to establish a merit-based career for public servants, which reduces the chances of appointing political allies. Similarly, after about 20 years since the

pension reform, workers (in the formal market) have become increasingly aware that their pension depends on their own contributions to their retirement funds and not on governmental policies. Therefore, they are much more demanding than in the past with regards to transparency, disclosure, regulatory issues and other aspects pertaining to the pension fund industry.

One final challenge of Latin American countries is the urgent need to make real progress in social policies throughout the region, including Chile, especially those aimed at protecting the poorest groups. This, because of the ongoing globalization trend that exacerbates the technological gap that exists among countries, and the different capability of the different groups of society within a country to adjust to new technologies. As a result of the rapidly changing environment, the unskilled and uneducated are expected to be hurt proportionately more than other groups. Thus, making progress in the macro, micro and institutional fronts to accelerate growth and reap the benefits from the ongoing globalization trend is not enough; it must be accompanied by adequate social policies — better opportunities to acquiring human capital— to assure that the poor are not left behind. Not making progress in improving income distribution could undermine public support for the reform process, jeopardizing its continuance through time and risking social unrest and major setbacks or worse, reversals.

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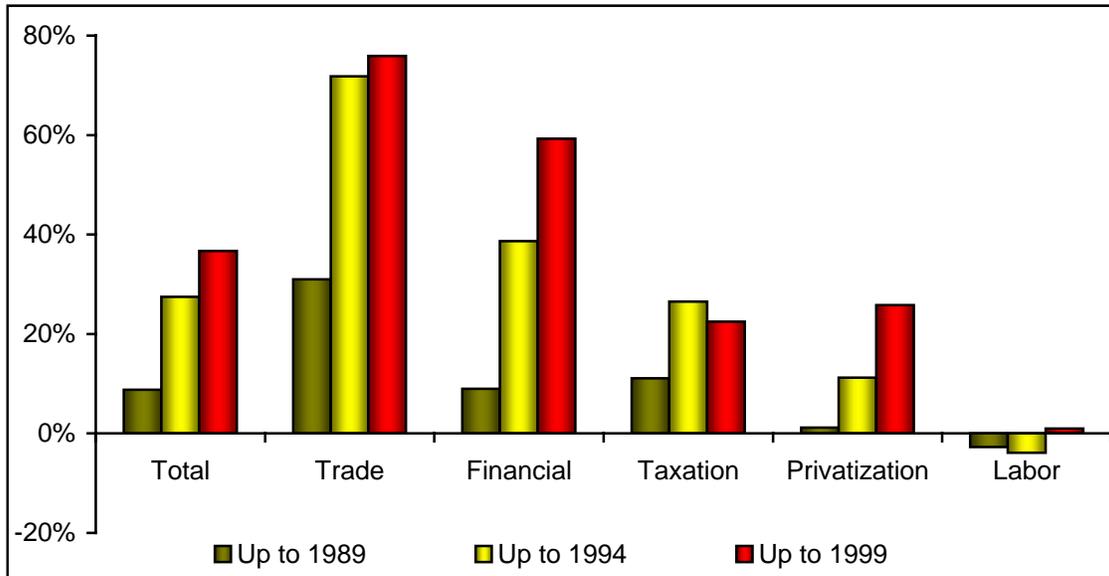
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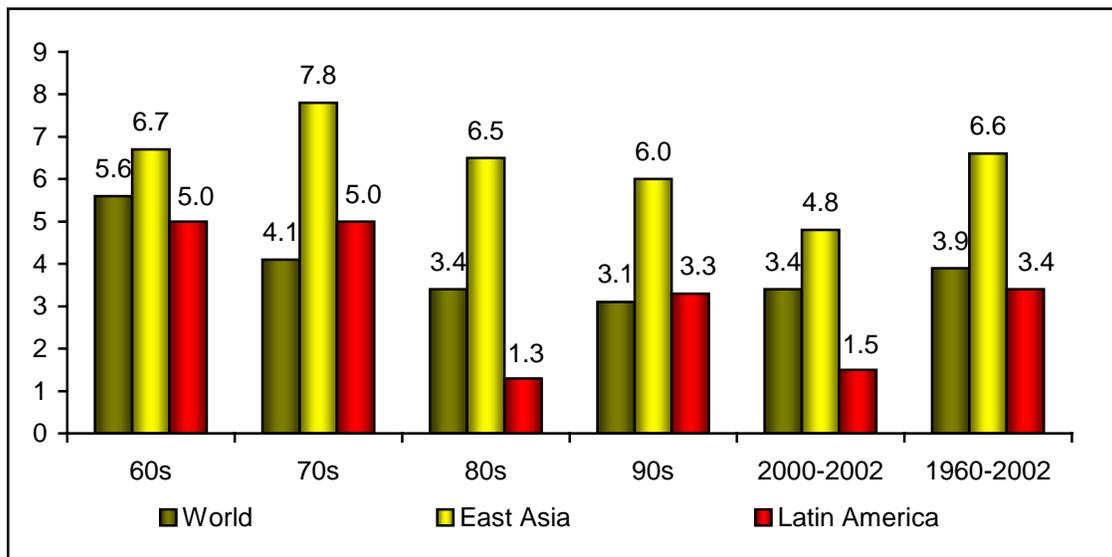
## Tables and Figures

**Figure 1**  
**Progress in the LACs Reform Process**



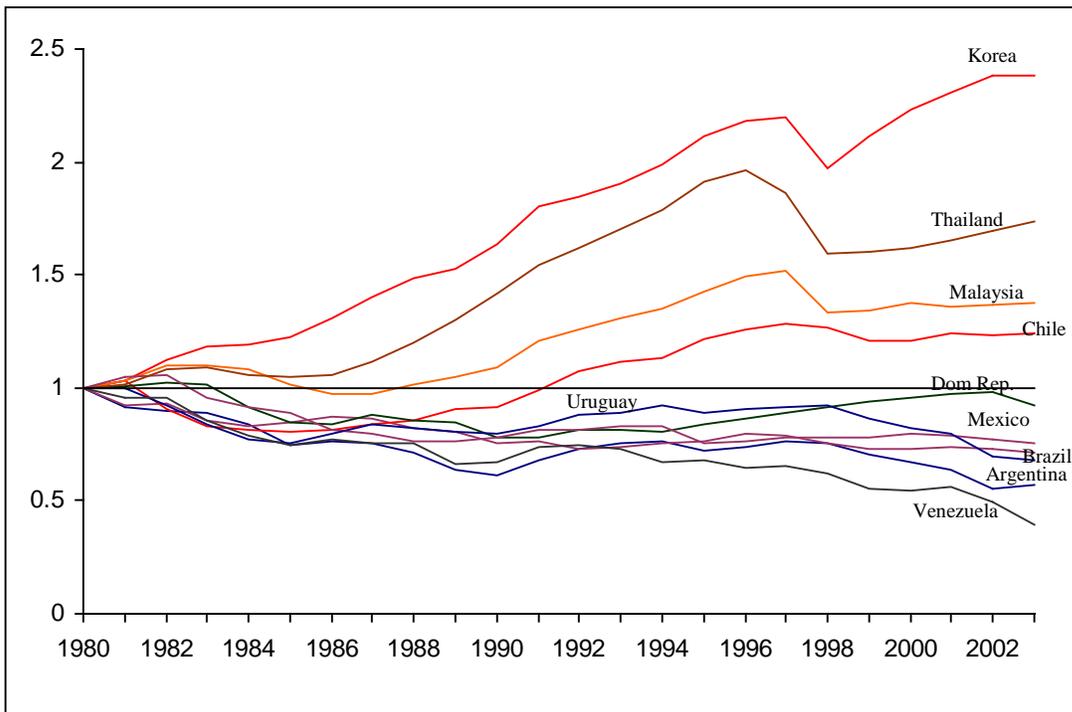
Note: Progress in reform is measured as the usage (in percent) in each date, of the total potential room for reform available in 1985. The potential available in 1985 is measured by the difference with the most liberalized country in the whole sample in each of the sub components. Source: Lora (2001).

**Figure 2**  
**Economic Growth (%)**  
**(1960-2002)**



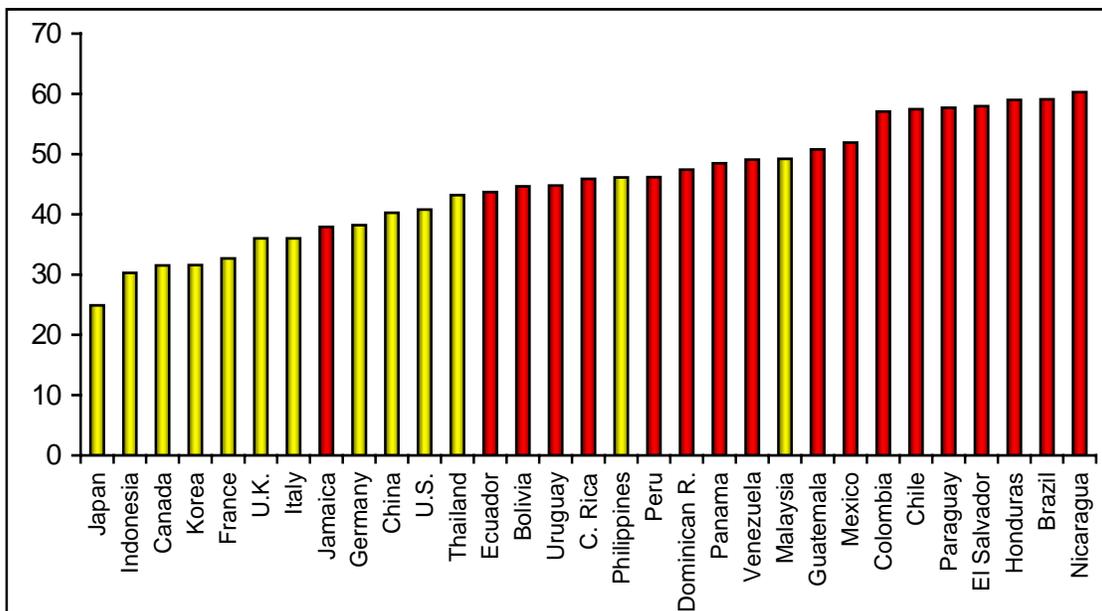
Note: East Asia includes China, Hong-Kong, Indonesia, Korea, Malaysia, the Philippines and Thailand. Source: World Bank, WDI (2002).

**Figure 3**  
**Relative Per-capita GDP<sup>1</sup>**  
**(Country j per-capita GDP over USA per-capita GDP, PPP adjusted; 1980=1)**



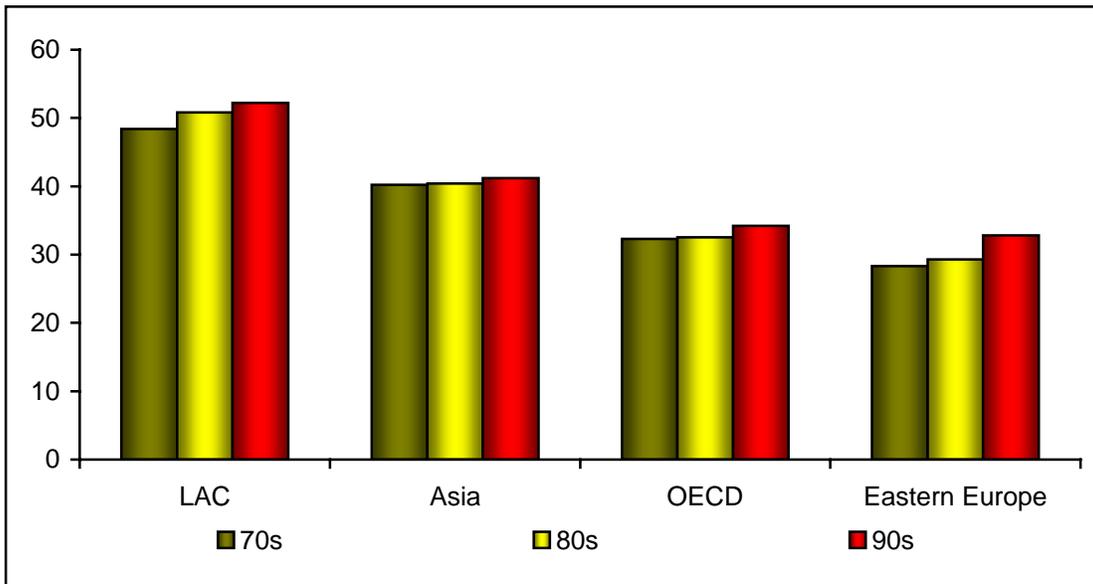
Source: Own elaboration. <sup>1</sup> PPP adjusted.

**Figure 4**  
**Gini Coefficients during the 1990s**  
**(Selected countries)**



Source: Eclac (2002)

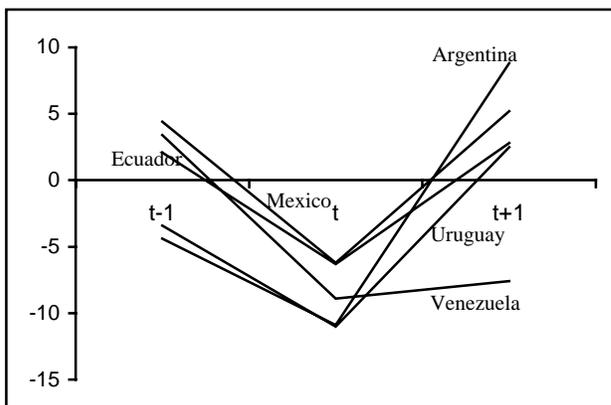
**Figure 5**  
**Gini Coefficients**  
**(Selected regions)**



Source: Eclac (2002)

## Figure 6 LAC's Economic and Financial System Indicators (Selected Countries)

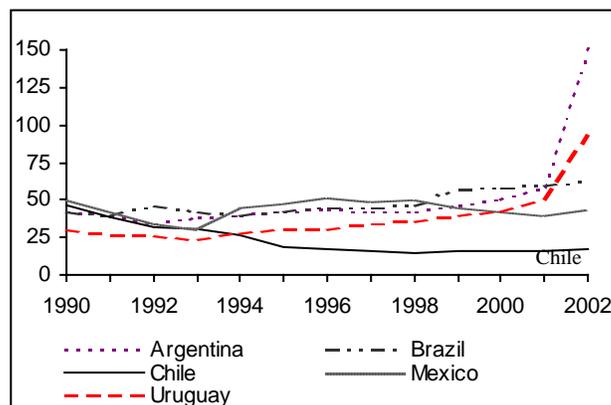
**Figure 6.1**  
Consequences of Crisis: Real GDP Growth (%)



Note: Year t are as follows: Mexico: 1995; Ecuador: 1999; Argentina: 2002; Uruguay: 2002; and Venezuela: 2002.

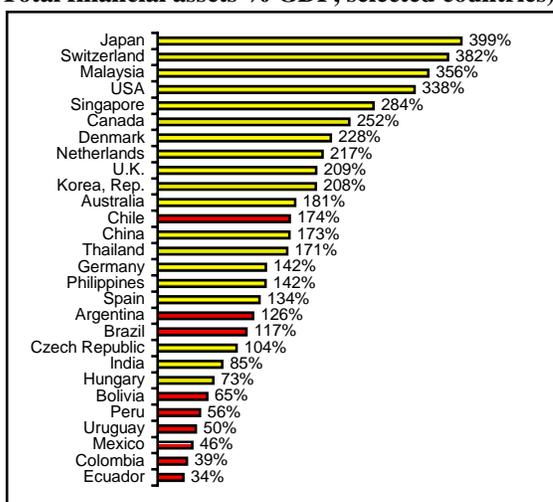
Source: Own elaboration.

**Figure 6.2**  
LAC's Public Debt, 1990-2002  
(% GDP, selected countries)



Source: IMF (2004).

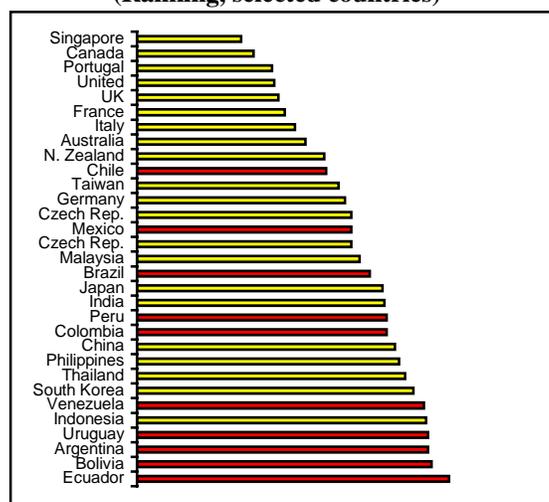
**Figure 6.3**  
Financial Development, 2001  
(Total financial assets % GDP, selected countries)



Note: The assets of the financial system include liquid liabilities of banks and non-bank financial institutions, stock market capitalization, and domestic private and public bond.

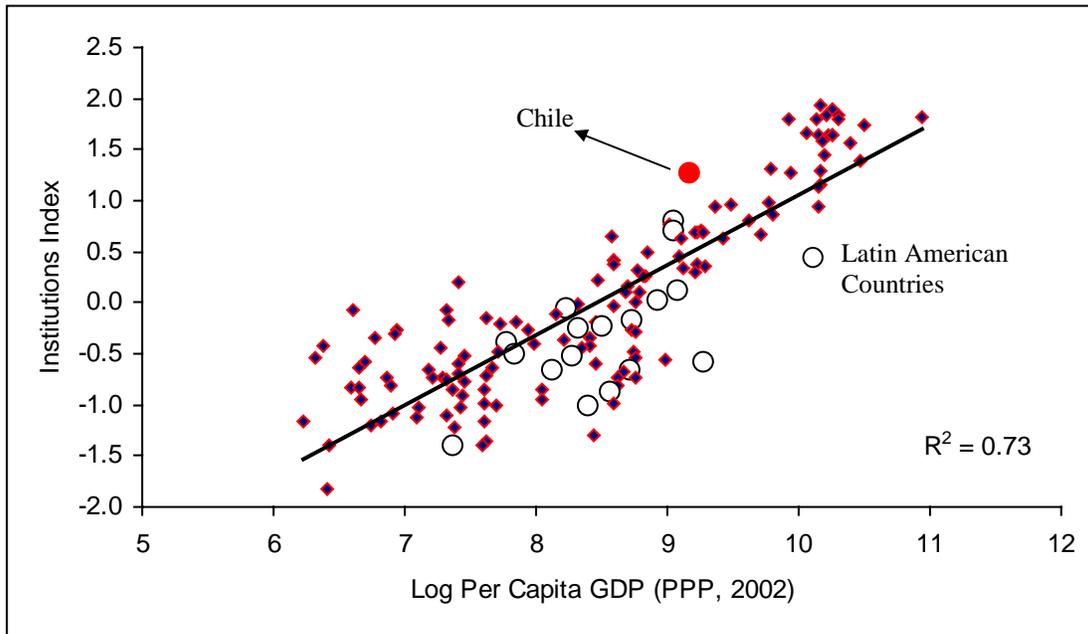
Source: Beck, Demigurc-Kunt and Levine (2003).

**Figure 6.4**  
Strength of Banking System, 2003  
(Ranking, selected countries)



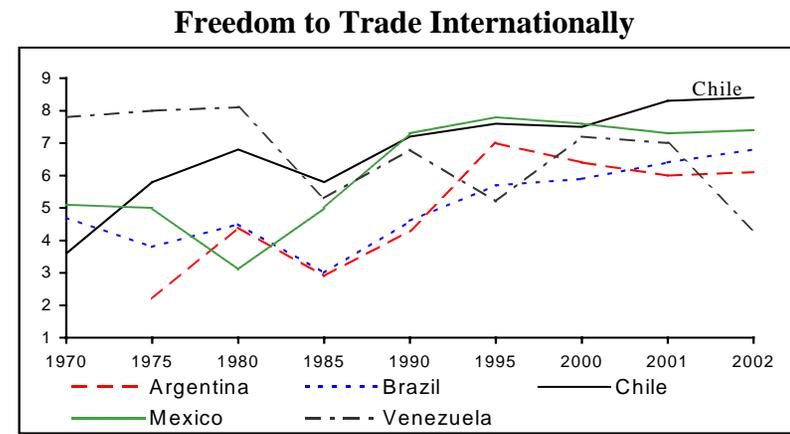
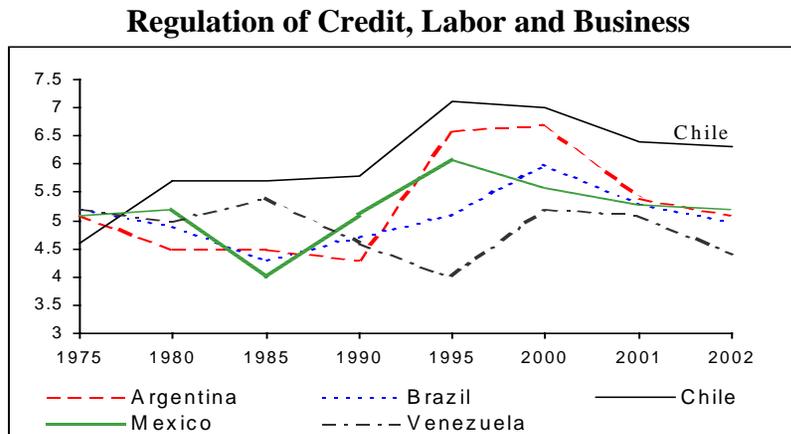
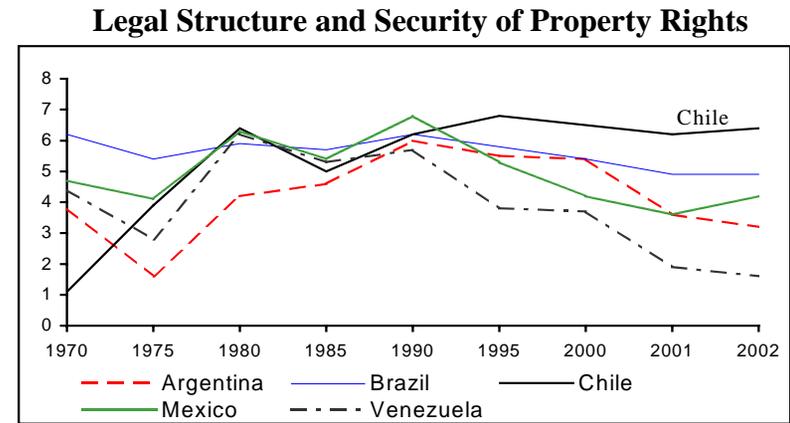
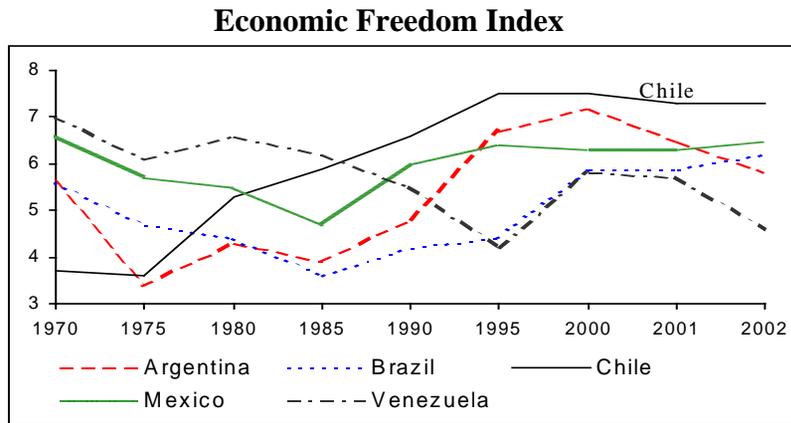
Source: Moody's (2003).

**Figure 7**  
**Institutions' Quality and Economic Development**  
**(151 countries)**



Sources: World Bank, and Kaufmann et al. (2003)

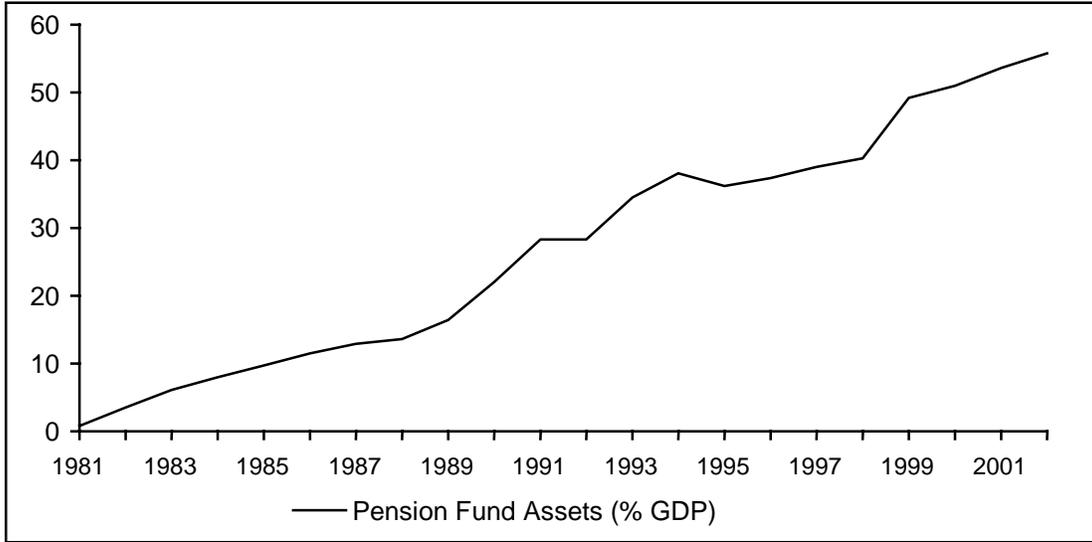
**Figure 8**  
**Latin American Countries: Quality of Institutions, 1970-2002**  
 (Selected countries)



Source: Fraser Institute (2004)

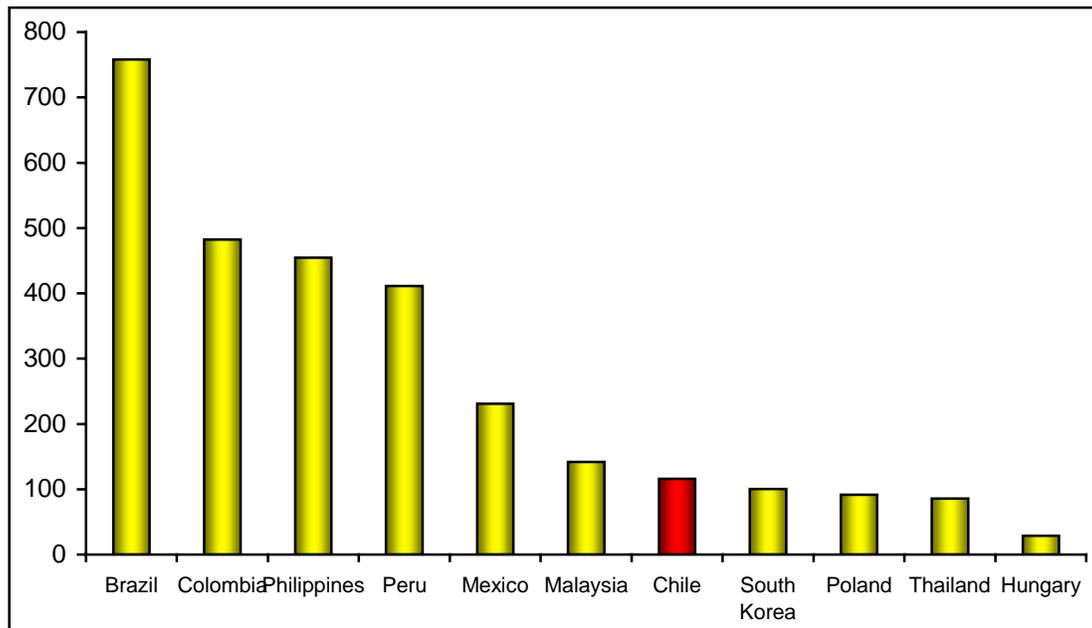
Note: The Economic Freedom Index includes five areas: size of government, legal structure and security of property rights, access to sound money, regulation of credit, labor and business, and freedom to trade internationally. A higher index value represents a better quality of institutions.

**Figure 9**  
**Pension Fund Assets, 1981-2002**  
**(% GDP)**



Source: Superintendency of AFPs.

**Figure 10**  
**Emerging Economies' Country Risk, 2003-May 2004**  
**(Selected countries)**



Source: JP Morgan (2004).

**Table 1**  
**Current Account Balance and Economic Performance of LACs during the Debt Crisis**

	Average Current Account Balance (% GDP) 1978-1981	Average GDP Growth (%) 1982-1983
Argentina	-2.4	0.3
Bolivia	-11.5	-4.0
Brazil	-4.5	-1.4
Chile	-8.6	-8.5
Colombia	-0.8	1.3
Costa Rica	-13.4	-2.2
Dominican Republic	-7.2	3.2
Ecuador	-7.1	-0.8
El Salvador	-3.6	-2.4
Guatemala	-4.0	-3.0
Honduras	-9.9	-1.1
Mexico	-4.7	-2.2
Paraguay	-8.8	-2.0
Peru	-1.1	-5.9
Uruguay	-4.7	-7.7
Venezuela	0.2	-2.4
Region's average	-5.8	-2.4

Sources: IMF, World Bank.

**Table 2**  
**Average Economic Growth**  
**(Selected countries)**

<b>Country</b>	<b>1985-1997</b>	<b>1990-2000</b>
China	10.1	9.6
Thailand	8.0	5.2
Korea	7.9	6.3
Malaysia	7.6	7.4
Chile	7.3	6.2
Vietnam	6.8	7.0
Indonesia	6.4	4.4
India	5.7	5.6
Uganda	5.7	6.8
Ireland	5.1	7.4
Israel	5.1	5.5
Costa Rica	4.7	5.1
Bangladesh	4.2	4.9
Colombia	4.2	2.9
Uruguay	4.0	2.9
Dominican Republic	3.8	4.9
Honduras	3.6	3.0
Panama	3.4	5.8
Paraguay	3.4	2.1
Guatemala	3.3	4.0
Japan	3.2	1.8
United States	3.2	3.2
Brazil	3.1	2.1
Bolivia	3.0	3.8
Ecuador	3.0	2.3
Philippines	2.9	2.9
Venezuela	2.9	2.5
Argentina	2.8	3.8
El Salvador	2.7	3.3
Peru	2.7	3.4
United Kingdom	2.7	2.3
Canada	2.6	2.7
Poland	2.6	2.7
Mexico	2.4	3.7
Germany	2.4	2.3
Italy	2.1	1.6
France	2.0	2.0
Jamaica	1.7	0.8
Trinidad and Tobago	-0.1	3.1
Nicaragua	-0.2	3.0
Haiti	-0.4	0.3

Source: IMF.

**Table 3**  
**LACs social indicators**

	Life expectancy at birth, total (Years)					Adult literacy rate, (% of people ages 15 and above)				Infant mortality (per 1000 live births)				
	1960	1970	1980	1990	2001	1970	1980	1990	2001	1960	1970	1980	1990	2001
Argentina	65	67	70	72	74	93	94	96	97	60	52	33	25	16
Bolivia	43	46	52	58	63	58	69	78	86	166	153	112	80	60
Brazil	55	59	63	66	68	68	75	81	85	114	95	70	48	31
Chile	57	62	69	74	76	88	92	94	96	113	77	32	16	10
Colombia	57	61	66	68	72	78	84	89	92	97	70	40	30	19
Costa Rica	62	67	73	75	78	88	92	94	96	68	62	19	15	9
Dominican Republic	52	59	63	66	67	67	74	79	84	123	98	71	50	41
Ecuador	53	58	63	67	70	74	82	88	92	123	100	64	45	24
El Salvador	51	57	57	66	70	58	66	72	79	129	107	84	46	33
Guatemala	46	52	57	61	65	45	53	61	69	130	107	97	56	43
Haiti	42	48	51	52	52	22	31	40	50	179	141	132	102	79
Honduras	47	53	60	65	66	53	61	69	75	143	110	75	50	31
Mexico	57	62	67	71	73	75	82	88	91	93	73	56	36	24
Nicaragua	47	54	59	64	69	55	59	63	67	139	104	85	51	36
Paraguay	64	66	67	68	71	80	86	90	93	65	55	46	31	26
Peru	48	54	60	66	70	72	79	86	90	141	108	81	54	30
Trinidad and Tobago	64	65	68	71	72	84	88	91	94	62	52	35	18	17
Uruguay	68	69	70	73	74	93	95	97	98	50	46	37	21	14
Venezuela	60	65	68	71	74	76	84	89	93	79	53	34	25	19
Latin America	56	61	65	68	71	73	80	85	89	105	84	61	41	28

Source: World Bank, WDI (2002).

**Table 4**  
**LACs' Poverty Indicators**

	Poverty <sup>1</sup>				Indigence <sup>2</sup>			
	Household		Population		Household		Population	
	Early 90s	Current <sup>3</sup>	Early 90s	Current <sup>3</sup>	Early 90s	Current <sup>3</sup>	Early 90s	Current <sup>3</sup>
Argentina	16	32	21	42	4	12	5	19
Bolivia	49	56	53	62	22	32	23	37
Brazil	41	30	48	38	18	10	23	13
Chile	33	17	39	21	11	5	13	6
Colombia	47	45	53	51	25	21	29	24
Costa Rica	24	19	26	20	10	8	10	8
Ecuador	56	43	62	49	23	16	26	19
Honduras	75	71	81	77	54	47	61	54
Mexico	39	32	48	39	14	9	19	13
Nicaragua	68	63	74	59	43	36	48	42
Paraguay	37	52	43	61	10	27	13	33
Uruguay	12	9	18	15	2	1	3	3
Venezuela	34	43	40	49	12	20	14	22
Latin America	41	36	48	44	18	15	23	19

Source: Eclac (2004).

<sup>1</sup> Poor is a household with per-capita income below the poverty line or minimum income to satisfy its essential necessities. The poverty line is calculated with the basic necessities cost method. See Panorama Social de America Latina 2002-2003 (Eclac) for details.

<sup>2</sup> Indigent is a household with per-capita income below the indigence line or minimum income to satisfy its essential nutritional necessities. See Panorama Social de America Latina 2002-2003 (Eclac) for details.

<sup>3</sup> Stands either for 2000, 2001 or 2002, depending on the country. In Chile it corresponds to 2000.

**Table 5**  
**Solow's Decomposition of LACs Economic Growth, 1960-2001**

<b>1960s</b>				
	<b>Economic Growth (%)</b>	<b>Of which, contribution by:</b>		
		<b>ΔLabor</b>	<b>ΔCapital</b>	<b>ΔTFP</b>
Top 5	6.54	2.04	3.00	1.50
Lowest 5	3.63	1.05	1.53	1.04
Difference	2.91	0.98	1.47	0.46
<b>1970s</b>				
	<b>Economic Growth (%)</b>	<b>Of which, contribution by:</b>		
		<b>ΔLabor</b>	<b>ΔCapital</b>	<b>ΔTFP</b>
Top 5	7.78	2.02	3.70	2.06
Lowest 5	2.78	1.19	1.28	0.31
Difference	5.00	0.83	2.41	1.76
<b>1980s</b>				
	<b>Economic Growth (%)</b>	<b>Of which, contribution by:</b>		
		<b>ΔLabor</b>	<b>ΔCapital</b>	<b>ΔTFP</b>
Top 5	3.59	1.93	2.06	-0.39
Lowest 5	-0.97	1.32	0.72	-3.02
Difference	4.56	0.60	1.33	2.63
<b>1990s</b>				
	<b>Economic Growth (%)</b>	<b>Of which, contribution by:</b>		
		<b>ΔLabor</b>	<b>ΔCapital</b>	<b>ΔTFP</b>
Top 5	5.25	1.50	1.98	1.77
Lowest 5	1.92	1.56	1.80	-1.45
Difference	3.33	-0.06	0.18	3.22
<b>1997-2001</b>				
	<b>Economic Growth (%)</b>	<b>Of which, contribution by:</b>		
		<b>ΔLabor</b>	<b>ΔCapital</b>	<b>ΔTFP</b>
Top 5	5.06	1.44	2.45	1.18
Lowest 5	0.58	1.26	0.84	-1.53
Difference	4.48	0.18	1.60	2.70

Source: Own elaboration.

**Table 6**  
**Change in the Poverty Rate and Decomposition of the Change into Growth and Redistribution Effects**

	Period	Poverty line	Initial Poverty rate	Final Poverty rate	Total change	Percent of the change due to:		
						Growth	Redistribution	Residual
Brazil	1985-95	Extreme	10	11.1	10.2	-40	145	-5
		Moderate	30.4	28	-7.9	-40	-70	10
Bolivia	1990-95	Moderate	52.4	47.1	-10.1	-147	44	3
Chile	1987-96	Moderate	45.1	23.2	-48.6	-85	-7	-8
Colombia	1991-95	Moderate	58.5	58.5	-0.1	-103	6	-3
Costa Rica	1986-95	Moderate	29.4	25.6	-12.9	-117	17	0
Peru	1985-96	Moderate	43.1	50.5	17.2	99	-27	28

Source: Attanassio and Székely (2001).

**Table 7**  
**Inflation Performance in Latin America, 1981-2003**  
(%, Selected countries)

	1981-85	1986-1990	1991-95	1996-2000	2000	2001	2002	2003
Argentina	382.4	1191.6	53.6	-0.1	-0.9	-1.1	25.9	13.4
Bolivia	2692.4	67.8	12.0	6.3	4.6	1.6	0.9	3.3
Brazil	151.1	1076.6	1113.8	7.6	7.1	6.8	8.4	14.8
Chile	21.5	19.4	14.0	5.1	3.8	3.6	2.5	2.8
Colombia	22.4	25.1	24.7	15.6	9.2	8.0	6.3	7.1
Mexico	62.4	75.8	18.0	19.4	9.5	6.4	5.0	4.5
Paraguay	15.9	28.1	18.3	8.8	9.0	7.3	10.5	14.2
Peru	136.4	2089.1	89.5	6.3	3.7	-0.1	1.5	2.5
Uruguay	45.9	79.0	62.3	13.9	4.8	4.4	14.0	19.4
Venezuela	11.1	38.9	44.9	45.1	16.2	12.5	22.4	31.1
Latin America	105.1	292.1	162.5	10.7	6.7	6.0	9.0	10.6

Source: IMF (2004).

**Table 8**  
**Central Government Balances in Selected Latin American Countries, 1980s-2001**  
(% GDP)

	1980s	1990s	1991-94	1994-98	1999	2000	2001
Argentina	-3.7	-1.1	-0.5	-1.2	-2.9	-2.4	-3.2
Brazil	-8.7	-5.8	-4.9	-7.1	-5.8	-3.3	-3.5
Chile	0.3	1.4	1.9	1.7	-1.4	0.1	-0.3
Colombia	-1.7	-2.7	-1.4	-3.2	-5.9	-6.9	-5.9
Ecuador	-1.5	0.5	1.6	-0.4	-0.7	0.7	0.1
Mexico	-8.5	0.0	1.9	-0.7	-1.6	-1.3	-0.7
Peru	-4.3	-1.5	-1.7	0.9	-2.2	-2.0	-2.3
Venezuela	-1.0	-1.5	-2.3	-1.8	-2.4	-2.1	-2.6

Source: IMF (2004).

**Table 9**  
**Institutional Quality**  
**(Selected countries)**

Country	Institutions Index	Voice and Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption	Economic Freedom Ranking (2004) (155 countries)
1 FINLAND	1.94	1.70	1.63	2.01	1.93	1.99	2.39	14
2 SWITZERLAND	1.89	1.63	1.61	2.26	1.62	2.03	2.17	9
3 NETHERLANDS	1.83	1.63	1.37	2.14	1.87	1.83	2.15	19
4 NEW ZEALAND	1.80	1.60	1.35	1.97	1.69	1.91	2.28	3
5 SWEDEN	1.80	1.65	1.43	1.84	1.70	1.92	2.25	12
6 SINGAPORE	1.67	0.51	1.28	2.26	1.89	1.75	2.30	2
7 AUSTRALIA	1.65	1.50	1.18	1.84	1.64	1.85	1.91	11
8 CANADA	1.65	1.50	1.06	1.88	1.63	1.79	2.03	16
9 U.K.	1.64	1.47	0.81	2.03	1.75	1.81	1.97	7
10 AUSTRIA	1.64	1.32	1.29	1.79	1.67	1.91	1.85	20
11 GERMANY	1.58	1.51	1.06	1.76	1.59	1.73	1.82	18
12 UNITED STATES	1.39	1.32	0.34	1.70	1.51	1.70	1.77	10
13 PORTUGAL	1.31	1.31	1.43	1.03	1.47	1.30	1.33	31
14 FRANCE	1.29	1.29	0.73	1.67	1.25	1.33	1.45	44
<b>15 CHILE</b>	<b>1.28</b>	<b>1.12</b>	<b>1.04</b>	<b>1.19</b>	<b>1.50</b>	<b>1.30</b>	<b>1.55</b>	<b>13</b>
16 SPAIN	1.27	1.24	0.82	1.53	1.41	1.15	1.46	27
17 HONG KONG	1.16	0.15	1.03	1.44	1.50	1.30	1.52	1
18 JAPAN	1.14	0.99	1.20	1.07	0.97	1.41	1.20	38
19 ITALY	0.93	1.11	0.81	0.91	1.15	0.82	0.80	26
20 COSTA RICA	0.81	1.16	1.06	0.37	0.74	0.67	0.88	50
21 BOTSWANA	0.77	0.73	0.75	0.87	0.81	0.72	0.76	39
22 U.A.E.	0.74	-0.47	0.95	0.83	0.97	0.95	1.19	42
23 URUGUAY	0.70	0.95	0.91	0.51	0.48	0.56	0.79	39
24 S. KOREA	0.67	0.63	0.49	0.84	0.86	0.88	0.33	46
25 MALAYSIA	0.45	-0.27	0.51	0.92	0.58	0.58	0.38	87
26 SOUTH AFRICA	0.39	0.73	-0.09	0.52	0.60	0.19	0.36	53
27 TRIN. AND TOB.	0.34	0.56	0.03	0.47	0.66	0.34	-0.04	36
28 THAILAND	0.25	0.20	0.55	0.28	0.34	0.30	-0.15	60
29 MEXICO	0.13	0.33	0.22	0.15	0.49	-0.22	-0.19	63
30 BRAZIL	0.02	0.28	0.17	-0.22	0.26	-0.30	-0.05	80
31 MOROCCO	-0.05	-0.30	-0.14	0.07	0.02	0.11	-0.04	66
32 SAUDI ARABIA	-0.05	-1.40	0.05	-0.05	0.08	0.44	0.57	74
33 DOMINICAN REP.	-0.17	0.19	0.18	-0.41	-0.17	-0.43	-0.39	120
34 EL SALVADOR	-0.18	0.06	0.35	-0.53	0.04	-0.46	-0.54	24
35 INDIA	-0.19	0.38	-0.84	-0.13	-0.34	0.07	-0.25	121
36 PHILIPPINES	-0.22	0.17	-0.49	-0.06	0.10	-0.50	-0.52	74
37 PERU	-0.22	0.22	-0.67	-0.47	0.24	-0.44	-0.20	58
38 CHINA	-0.34	-1.38	0.22	0.18	-0.41	-0.22	-0.41	128
39 NICARAGUA	-0.35	0.09	0.15	-0.87	-0.41	-0.63	-0.44	67
40 EGYPT	-0.37	-0.87	-0.35	-0.32	-0.45	0.09	-0.29	95
41 BOLIVIA	-0.38	0.01	-0.20	-0.53	-0.11	-0.60	-0.82	41
42 VIETNAM	-0.48	-1.36	0.49	-0.27	-0.69	-0.39	-0.68	141
43 HONDURAS	-0.49	-0.15	-0.14	-0.73	-0.37	-0.79	-0.78	121
44 GUATEMALA	-0.53	-0.48	-0.43	-0.61	-0.09	-0.84	-0.71	87
45 RUSSIA	-0.55	-0.52	-0.40	-0.40	-0.30	-0.78	-0.90	114
46 ARGENTINA	-0.58	0.12	-0.74	-0.49	-0.84	-0.73	-0.77	116
47 ECUADOR	-0.66	-0.06	-0.70	-0.96	-0.60	-0.60	-1.02	126
48 COLOMBIA	-0.66	-0.55	-1.78	-0.39	-0.04	-0.75	-0.47	83
49 INDONESIA	-0.84	-0.49	-1.37	-0.56	-0.68	-0.80	-1.16	136
50 VENEZUELA	-0.88	-0.41	-1.20	-1.14	-0.54	-1.04	-0.94	147
51 PARAGUAY	-1.01	-0.53	-1.33	-1.29	-0.56	-1.12	-1.22	106
52 NIGERIA	-1.20	-0.70	-1.49	-1.12	-1.18	-1.35	-1.35	142
53 ZIMBABWE	-1.34	-1.50	-1.62	-0.80	-1.61	-1.33	-1.17	153
54 HAITI	-1.40	-1.11	-1.34	-1.56	-0.95	-1.76	-1.70	137

Sources: Kaufmann, et al. (2003); Heritage (2004).

**Table 10**  
**Economic Growth Estimates**

Dependent Variable: GDP per capita Growth (PPP)	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	OLS	OLS	2SLS	2SLS	2SLS	2SLS	2SLS
Institutions		0.0095*	0.0101**	0.0100**	0.0095**		0.0096**
		(4.14)	(2.58)	(2.54)	(2.21)		(2.25)
<b>Others Controls:</b>							
<i>Initial conditions and policy variables</i>							
GDP per capita 1960	-0.0140*	-0.0173*	-0.0175*	-0.0176*	-0.0177*	-0.0145*	-0.0177*
	(-5.75)	(-7.38)	(-6.74)	(-6.76)	(-6.66)	(-5.02)	(-6.71)
Average schooling years 1960	0.0089*	0.0075*	0.0074*	0.0074*	0.0070*	0.0078*	0.0071*
	(4.66)	(4.14)	(3.94)	(3.95)	(3.43)	(2.94)	(3.35)
Openness1	0.0054**	0.0032	0.0031	0.0022	0.0027	0.0065**	0.0023
	(2.38)	(1.48)	(1.32)	(0.83)	(1.08)	(2.33)	(0.87)
Financial development	0.0106*	0.0069*	0.0067*	0.0070*	0.0087	0.0138**	0.0083
	(4.80)	(3.14)	(2.65)	(2.75)	(1.55)	(2.02)	(1.46)
Government consumption	-0.0026	-0.0020	-0.0020	-0.0019	-0.0017	-0.0022	-0.0017
	(-0.86)	(-0.75)	(-0.73)	(-0.68)	(-0.57)	(-0.66)	(-0.59)
Exchange rate overvaluation	-0.0117*	-0.0114*	-0.0114*	-0.0112*	-0.0109**	-0.0107**	-0.0109**
	(-2.70)	(-2.87)	(-2.87)	(-2.81)	(-2.56)	(-2.20)	(-2.61)
<b>Instruments:</b>							
Constructed trade share (Frankel and Romer)	No	No	No	Yes	No	Yes	Yes
Legal origin	No	No	Yes	Yes	Yes	Yes	Yes
Etnolinguistic fraction	No	No	Yes	Yes	Yes	No	Yes
Fraction of the population speaking English	No	No	Yes	Yes	Yes	No	Yes
Fraction of the population speaking one of the major languages of Western Europe	No	No	Yes	Yes	Yes	No	Yes
Distance from Equator of capital city.	No	No	Yes	Yes	Yes	No	Yes
R-squared	0.66	0.73	0.73	0.73	0.73	0.64	0.73
Number of observations	79	77	77	77	77	78	77

Note: T tests are in brackets

\*Significant at 1% level

\*\*Significant at 5% level

\*\*\* Significant at 10% level

**Table 11**  
**Growth Volatility Estimates**

Dependent Variable: Std. Deviation of per capita GDP Growth	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	OLS	OLS	2SLS	2SLS	2SLS	2SLS	2SLS
Institutions		-0.0095* (-3.96)	-0.0089* (-2.79)	-0.0087* (-2.73)	-0.0141** (-2.55)		-0.0153** (-2.40)
<b>Others Controls:</b>							
<i>Policy variables</i>							
Financial development	-0.0081* (-3.75)	-0.0011 (-0.41)	-0.0015 (-0.49)	-0.0021 (-0.68)	0.0071 (0.90)	-0.0095*** (-1.73)	0.0080 (0.90)
Government consumption	0.0035 (0.88)	0.0019 (0.51)	0.0020 (0.54)	0.0014 (0.38)	0.0050 (1.06)	0.0026 (0.44)	0.0039 (0.83)
Exchange rate overvaluation	0.0212* (4.10)	0.0188* (3.89)	0.0189* (3.90)	0.0185* (3.79)	0.0206* (3.85)	0.0199* (3.31)	0.0197* (3.60)
Openness I	0.0004 (0.12)	0.0012 (0.39)	0.0011 (0.36)	0.0031 (0.85)	-0.0004 (-0.12)	0.0009 (0.23)	0.0060 (1.28)
<b>Instruments:</b>							
Constructed trade share (Frankel and Romer)	No	No	No	Yes	No	Yes	Yes
Legal origin	No	No	Yes	Yes	Yes	Yes	Yes
Ethnolinguistic fraction	No	No	Yes	Yes	Yes	No	Yes
Fraction of the population speaking English	No	No	Yes	Yes	Yes	No	Yes
Fraction of the population speaking one of the major languages of Western Europe	No	No	Yes	Yes	Yes	No	Yes
Distance from Equator of capital city.	No	No	Yes	Yes	Yes	No	Yes
R-squared	0.42	0.52	0.52	0.52	0.46	0.41	0.42
Number of observations	80	78	78	78	78	79	78

Note: T tests are in brackets

\*Significant at 1% level

\*\*Significant at 5% level

\*\*\* Significant at 10% level

**Table 12**  
**Effect on Per-capita GDP Growth of Having Institutions like Chile's, the Major**  
**Advanced Economies', or Finland's**

	Institutions like Chile			Institutions like major advanced economies			Institutions like Finland (Top one)		
	Min.	Mean	Max.	Min.	Mean	Max.	Min.	Mean	Max.
Chile	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.4%	0.7%	1.0%
Argentina	1.0%	1.9%	2.7%	1.1%	2.0%	2.8%	1.4%	2.5%	3.7%
Bolivia	0.9%	1.7%	2.4%	1.0%	1.8%	2.6%	1.3%	2.3%	3.4%
Brazil	0.7%	1.3%	1.8%	0.8%	1.4%	2.0%	1.1%	1.9%	2.8%
Colombia	1.1%	2.0%	2.8%	1.1%	2.1%	3.0%	1.5%	2.6%	3.8%
Costa Rica	0.3%	0.5%	0.7%	0.3%	0.6%	0.8%	0.6%	1.1%	1.6%
Dominican Republic	0.8%	1.5%	2.1%	0.9%	1.6%	2.3%	1.2%	2.1%	3.1%
Ecuador	1.1%	2.0%	2.8%	1.1%	2.1%	3.0%	1.5%	2.6%	3.8%
El Salvador	0.8%	1.5%	2.1%	0.9%	1.6%	2.3%	1.2%	2.1%	3.1%
Guatemala	1.0%	1.8%	2.6%	1.1%	1.9%	2.8%	1.4%	2.5%	3.6%
Haiti	1.5%	2.7%	3.9%	1.6%	2.8%	4.1%	1.9%	3.4%	4.9%
Honduras	1.0%	1.8%	2.6%	1.1%	1.9%	2.7%	1.4%	2.5%	3.6%
Jamaica	0.7%	1.3%	1.9%	0.8%	1.4%	2.0%	1.1%	2.0%	2.9%
Mexico	0.6%	1.2%	1.7%	0.7%	1.3%	1.8%	1.0%	1.8%	2.6%
Nicaragua	0.9%	1.7%	2.4%	1.0%	1.7%	2.5%	1.3%	2.3%	3.3%
Paraguay	1.3%	2.3%	3.3%	1.3%	2.4%	3.5%	1.7%	3.0%	4.3%
Peru	0.8%	1.5%	2.2%	0.9%	1.6%	2.3%	1.2%	2.2%	3.2%
Trinidad y Tobago	0.5%	1.0%	1.4%	0.6%	1.0%	1.5%	0.9%	1.6%	2.3%
Uruguay	0.3%	0.6%	0.9%	0.4%	0.7%	1.0%	0.7%	1.3%	1.8%
Venezuela	1.2%	2.2%	3.2%	1.3%	2.3%	3.3%	1.6%	2.9%	4.1%
<b>Simple average excluding Chile</b>	<b>0.9%</b>	<b>1.6%</b>	<b>2.3%</b>	<b>0.9%</b>	<b>1.7%</b>	<b>2.4%</b>	<b>1.3%</b>	<b>2.3%</b>	<b>3.3%</b>
<b>Simple average including Chile</b>	<b>0.8%</b>	<b>1.5%</b>	<b>2.2%</b>	<b>0.9%</b>	<b>1.6%</b>	<b>2.3%</b>	<b>1.2%</b>	<b>2.2%</b>	<b>3.1%</b>
<b>Weighted average excluding Chile</b>	<b>0.8%</b>	<b>1.4%</b>	<b>2.0%</b>	<b>0.8%</b>	<b>1.5%</b>	<b>2.1%</b>	<b>1.1%</b>	<b>2.1%</b>	<b>3.0%</b>
<b>Weighted average including Chile</b>	<b>0.7%</b>	<b>1.3%</b>	<b>1.9%</b>	<b>0.8%</b>	<b>1.4%</b>	<b>2.1%</b>	<b>1.1%</b>	<b>2.0%</b>	<b>2.9%</b>

Notes: (1) Weighted averages are constructed using each country's GDP as weights. (2) Min and Max are calculated using the average coefficient plus/minus one time the average standard deviation.

Source: Own elaboration.

**Table 13**  
**Effect on Per-capita GDP Growth of Having Financial Development like Chile's, the**  
**Major Advanced Economies', or Switzerland's**

	Financial development like Chile			Financial development like major advanced economies			Financial development like Switzerland (Top one)		
	Min.	Mean	Max.	Min.	Mean	Max.	Min.	Mean	Max.
Chile	0.0%	0.0%	0.0%	0.1%	0.3%	0.4%	0.3%	0.6%	0.9%
Argentina	0.4%	0.9%	1.3%	0.6%	1.1%	1.7%	0.7%	1.5%	2.2%
Bolivia	0.1%	0.2%	0.3%	0.2%	0.5%	0.7%	0.4%	0.8%	1.2%
Brazil	0.3%	0.6%	0.8%	0.4%	0.8%	1.3%	0.6%	1.2%	1.7%
Colombia	0.4%	0.8%	1.2%	0.5%	1.1%	1.6%	0.7%	1.4%	2.1%
Costa Rica	0.4%	0.8%	1.2%	0.5%	1.1%	1.6%	0.7%	1.4%	2.1%
Dominican Republic	0.3%	0.6%	0.9%	0.5%	0.9%	1.3%	0.6%	1.2%	1.8%
Ecuador	0.3%	0.6%	0.9%	0.5%	0.9%	1.3%	0.6%	1.2%	1.8%
El Salvador	1.0%	2.0%	3.0%	1.2%	2.3%	3.5%	1.3%	2.6%	3.9%
Guatemala	0.5%	1.0%	1.5%	0.6%	1.3%	1.9%	0.8%	1.6%	2.4%
Haiti	0.6%	1.2%	1.8%	0.7%	1.5%	2.2%	0.9%	1.8%	2.7%
Honduras	0.2%	0.5%	0.7%	0.4%	0.7%	1.1%	0.5%	1.1%	1.6%
Jamaica	0.5%	0.9%	1.4%	0.6%	1.2%	1.8%	0.8%	1.5%	2.3%
Mexico	0.7%	1.4%	2.0%	0.8%	1.6%	2.4%	1.0%	2.0%	2.9%
Paraguay	0.4%	0.8%	1.2%	0.5%	1.1%	1.6%	0.7%	1.4%	2.1%
Peru	0.4%	0.8%	1.2%	0.5%	1.1%	1.6%	0.7%	1.4%	2.1%
Trinidad and Tobago	0.2%	0.4%	0.7%	0.4%	0.7%	1.1%	0.5%	1.0%	1.6%
Uruguay	0.1%	0.2%	0.4%	0.3%	0.5%	0.8%	0.4%	0.8%	1.3%
Venezuela	0.7%	1.4%	2.1%	0.8%	1.7%	2.5%	1.0%	2.0%	3.0%
<b>Simple average excluding Chile</b>	<b>0.4%</b>	<b>0.8%</b>	<b>1.2%</b>	<b>0.6%</b>	<b>1.1%</b>	<b>1.7%</b>	<b>0.7%</b>	<b>1.4%</b>	<b>2.1%</b>
<b>Simple average including Chile</b>	<b>0.4%</b>	<b>0.8%</b>	<b>1.2%</b>	<b>0.5%</b>	<b>1.1%</b>	<b>1.6%</b>	<b>0.7%</b>	<b>1.4%</b>	<b>2.1%</b>
<b>Weighted average excluding Chile</b>	<b>0.5%</b>	<b>1.0%</b>	<b>1.5%</b>	<b>0.6%</b>	<b>1.3%</b>	<b>1.9%</b>	<b>0.8%</b>	<b>1.6%</b>	<b>2.4%</b>
<b>Weighted average including Chile</b>	<b>0.5%</b>	<b>0.9%</b>	<b>1.4%</b>	<b>0.6%</b>	<b>1.2%</b>	<b>1.8%</b>	<b>0.8%</b>	<b>1.5%</b>	<b>2.3%</b>

Notes: (1) Weighted averages are constructed using each country's GDP as weights. (2) Min and Max are calculated using the average coefficient plus/minus one time the average standard deviation.

Source: Own elaboration.

**Table 14**  
**Effect on Per-capita GDP Growth of Having RER Overvaluation like Chile's.**

	RER overvaluation like Chile		
	Min.	Mean	Max.
Chile	0.0%	0.0%	0.0%
Argentina	0.2%	0.4%	0.5%
Bolivia	0.3%	0.5%	0.6%
Brazil	0.1%	0.2%	0.3%
Colombia	-0.1%	-0.1%	-0.2%
Costa Rica	0.0%	0.0%	0.0%
Dominican Republic	0.1%	0.2%	0.2%
Ecuador	0.0%	0.1%	0.1%
El Salvador	0.3%	0.5%	0.6%
Haiti	0.2%	0.4%	0.5%
Honduras	0.2%	0.3%	0.4%
Jamaica	0.2%	0.2%	0.3%
Mexico	0.0%	0.0%	0.0%
Paraguay	0.2%	0.3%	0.3%
Peru	0.4%	0.6%	0.8%
Trinidad and Tobago	0.1%	0.1%	0.2%
Uruguay	0.1%	0.1%	0.2%
Venezuela	-0.1%	-0.1%	-0.1%
<b>Simple average excluding Chile</b>	0.1%	0.2%	0.3%
<b>Simple average including Chile</b>	0.1%	0.2%	0.3%
<b>Weighted average excluding Chile</b>	0.1%	0.1%	0.2%
<b>Weighted average including Chile</b>	0.1%	0.1%	0.2%

Notes: (1) Weighted averages are constructed using each country's GDP as weights. (2) Min and Max are calculated using the average coefficient plus/minus one time the average standard deviation.

Source: Own elaboration.

**Table 15**  
**Difference in Growth performance:**  
**Chile v/s Latin America and East Asia v/s Latin America**  
**(1990-2000)**

	Chile v/s Latin America (1990-2000)		East Asia* v/s Latin America (1990-2000)	
	Simple Average Countries	Weighted Average Countries	Simple Average Countries	Weighted Average Countries
Inicial GDP	-0.5%	0.2%	-0.5%	0.0%
Human Capital	0.3%	0.2%	0.2%	0.2%
Quality of Institutions	1.2%	1.1%	0.4%	0.3%
Financial Development	0.8%	0.7%	0.9%	1.1%
Exchange Rate Overvaluation	0.4%	0.3%	0.4%	0.2%
Predicted Difference	2.2%	2.6%	1.5%	1.7%
Actual Difference	3.5%	3.3%	1.7%	2.0%

\* East Asia countries include Singapore, Indonesia, Korea, Malaysia, Philippines and Thailand.

Note: Weighted average is constructed using each country's GDP as weights.

Source: Own elaboration.

**Table 16**  
**Effect on the Volatility of Per-capita GDP of Having Institutions like Chile's, the Major Advanced Economies', or Finland's**

	Institutions like Chile			Institutions like major advance economies			Institutions like Finland (Top one)		
	Min.	Mean	Max.	Min.	Mean	Max.	Min.	Mean	Max.
Chile	0.0%	0.0%	0.0%	-0.1%	-0.1%	-0.1%	-0.5%	-0.7%	-1.0%
Argentina	-1.3%	-2.0%	-2.7%	-1.4%	-2.1%	-2.8%	-1.8%	-2.7%	-3.7%
Bolivia	-1.2%	-1.8%	-2.4%	-1.2%	-1.9%	-2.5%	-1.6%	-2.5%	-3.4%
Brazil	-0.9%	-1.4%	-1.8%	-1.0%	-1.5%	-2.0%	-1.4%	-2.1%	-2.8%
Colombia	-1.4%	-2.1%	-2.8%	-1.4%	-2.2%	-3.0%	-1.8%	-2.8%	-3.8%
Costa Rica	-0.3%	-0.5%	-0.7%	-0.4%	-0.6%	-0.8%	-0.8%	-1.2%	-1.6%
Dominican Republic	-1.0%	-1.6%	-2.1%	-1.1%	-1.7%	-2.2%	-1.5%	-2.3%	-3.1%
Ecuador	-1.4%	-2.1%	-2.8%	-1.4%	-2.2%	-2.9%	-1.8%	-2.8%	-3.8%
El Salvador	-1.0%	-1.6%	-2.1%	-1.1%	-1.7%	-2.3%	-1.5%	-2.3%	-3.1%
Guatemala	-1.3%	-2.0%	-2.6%	-1.3%	-2.0%	-2.8%	-1.7%	-2.7%	-3.6%
Haiti	-1.9%	-2.9%	-3.9%	-2.0%	-3.0%	-4.0%	-2.4%	-3.6%	-4.9%
Honduras	-1.3%	-1.9%	-2.6%	-1.3%	-2.0%	-2.7%	-1.7%	-2.6%	-3.5%
Jamaica	-0.9%	-1.4%	-1.9%	-1.0%	-1.5%	-2.0%	-1.4%	-2.1%	-2.9%
Mexico	-0.8%	-1.2%	-1.7%	-0.9%	-1.3%	-1.8%	-1.3%	-2.0%	-2.6%
Nicaragua	-1.2%	-1.8%	-2.4%	-1.2%	-1.9%	-2.5%	-1.6%	-2.5%	-3.3%
Paraguay	-1.6%	-2.5%	-3.3%	-1.7%	-2.6%	-3.5%	-2.1%	-3.2%	-4.3%
Peru	-1.1%	-1.6%	-2.2%	-1.1%	-1.7%	-2.3%	-1.5%	-2.3%	-3.1%
Trinidad y Tobago	-0.7%	-1.0%	-1.4%	-0.7%	-1.1%	-1.5%	-1.1%	-1.7%	-2.3%
Uruguay	-0.4%	-0.6%	-0.8%	-0.5%	-0.7%	-1.0%	-0.9%	-1.3%	-1.8%
Venezuela	-1.5%	-2.3%	-3.1%	-1.6%	-2.4%	-3.3%	-2.0%	-3.0%	-4.1%
<b>Simple average excluding Chile</b>	<b>-1.1%</b>	<b>-1.7%</b>	<b>-2.3%</b>	<b>-1.2%</b>	<b>-1.8%</b>	<b>-2.4%</b>	<b>-1.6%</b>	<b>-2.4%</b>	<b>-3.2%</b>
<b>Simple average including Chile</b>	<b>-1.1%</b>	<b>-1.6%</b>	<b>-2.2%</b>	<b>-1.1%</b>	<b>-1.7%</b>	<b>-2.3%</b>	<b>-1.5%</b>	<b>-2.3%</b>	<b>-3.1%</b>
<b>Weighted average excluding Chile</b>	<b>-1.0%</b>	<b>-1.5%</b>	<b>-2.0%</b>	<b>-1.0%</b>	<b>-1.6%</b>	<b>-2.1%</b>	<b>-1.4%</b>	<b>-2.2%</b>	<b>-3.0%</b>
<b>Weighted average including Chile</b>	<b>-0.9%</b>	<b>-1.4%</b>	<b>-1.9%</b>	<b>-1.0%</b>	<b>-1.5%</b>	<b>-2.0%</b>	<b>-1.4%</b>	<b>-2.1%</b>	<b>-2.9%</b>

Notes: (1) Weighted averages are constructed using each country's GDP as weights. (2) Min and Max are calculated using the average coefficient plus/minus one time the average standard deviation.

Source: Own elaboration.

**Table 17**  
**Effect on the Volatility of Per-capita GDP of Having RER Overvaluation like Chile's.**

	RER overvaluation like Chile		
	Min.	Mean	Max.
Chile	0.0%	0.0%	0.0%
Argentina	-0.5%	-0.6%	-0.8%
Bolivia	-0.6%	-0.8%	-1.0%
Brazil	-0.3%	-0.4%	-0.5%
Colombia	0.2%	0.2%	0.3%
Costa Rica	0.0%	0.1%	0.1%
Dominican Republic	-0.2%	-0.3%	-0.4%
Ecuador	-0.1%	-0.1%	-0.1%
El Salvador	-0.6%	-0.8%	-1.0%
Haiti	-0.5%	-0.6%	-0.8%
Honduras	-0.4%	-0.5%	-0.7%
Jamaica	-0.3%	-0.4%	-0.5%
Mexico	0.0%	0.0%	0.0%
Paraguay	-0.3%	-0.4%	-0.5%
Peru	-0.8%	-1.0%	-1.3%
Trinidad and Tobago	-0.2%	-0.3%	-0.3%
Uruguay	-0.2%	-0.2%	-0.3%
Venezuela	0.1%	0.1%	0.2%
<b>Simple average excluding Chile</b>	-0.3%	-0.4%	-0.5%
<b>Simple average including Chile</b>	-0.3%	-0.3%	-0.4%
<b>Weighted average excluding Chile</b>	-0.2%	-0.2%	-0.3%
<b>Weighted average including Chile</b>	-0.1%	-0.2%	-0.3%

Notes: (1) Weighted averages are constructed using each country's GDP as weights.  
(2) Min and Max are calculated using the average coefficient plus/minus one time the average standard deviation.  
Source: Own elaboration.

## Appendix

**Table A.1**  
*Variable Definitions and Sources*

Variable	Description	Source
Growth rate of GDP per capita	Annual GDP growth rate minus population growth rate, 1960-2000	World Bank, World Development Indicators 2002 and Penn World Tables.
Standard deviation of growth	Standard deviation of GDP per capita growth rate, 1960-2000	Own elaboration
GDP per capita 1960	Logarithm of GDP per capita, on Purchasing Power Parity Basis, in 1960	World Bank, World Development Indicators 2002
Average schooling years 1960	Logarithm of average years of schooling in 1960	World Bank, World Development Indicators 2002
Openness1	Logarithm of sum of exports and import of goods and services as percentage of GDP, 1960-2000	World Bank, World Development Indicators 2002
Openness2	Residual of regression of volume of trade over GDP on country size and dummy for oil exports, 1960-2000	Own elaboration
Financial development	Logarithm of credit to private sector over GDP, 1960-2000	Beck, Demirguc-Kunt y Levine (2003)
Government consumption	Logarithm of government consumption over GDP, 1960-2000	World Bank, World Development Indicators 2002
Government Consumption Vol.	Standard deviation of government consumption, 1960-2000	Own elaboration
Exchange rate overvaluation	Logarithm of real exchange rate overvaluation index, 1960-2000	Easterly and Levine (2003) using the methodology of Dollar (1992)
Exchange rate overvaluation Vol	Standard deviation of exchange rate overvaluation index, 1960-2000	Own elaboration
Black market premium	Black market premium on foreign exchange, 1960-2000	Easterly and Levine (2003)
Terms of trade growth	Annual growth of terms of trade, 1960-2000	World Bank, World Development Indicators 2002
Terms of trade volatility	Standard deviation of terms of trade, 1960-2000	Own elaboration
Inflation	Logarithm of annual inflation, 1960-2000	World Bank, World Development Indicators 2002
Inflation Volatility	Standard deviation of inflation rate, 1960-2000	Own elaboration
Landlock	Dummy variable taking value 1 for countries without access to the sea, 0 otherwise	Gallup and Sachs (1998)
Lnd100	Proportion of land area within 100 km of the seacoast	Gallup, Sachs and Mellinger (1999)
Constructed trade share (Frankel and Romer)	Logarithm of predicted trade shares computed from a bilateral trade equation with "pure geography" variables	Frankel and Romer (1999)
Legal origin	Dummy variable for legal origin of laws: German, French, Scandinavian, Socialist or English	La Porta, Lopez de Silanes, Schleifer and Vishny (1999)
Ethnolinguistic fraction	Ethnolinguistic fraction of the population	La Porta, Lopez de Silanes, Schleifer and Vishny (1999)
Fraction of the population speaking English	Fraction of the population speaking English	Hall and Jones (1999)
Fraction of the population speaking one of major languages of Western Europe	Fraction of the population speaking one of major languages of Western Europe	Hall and Jones (1999)
Distance from Equator of the capital city	Distance from Equator of capital city	La Porta, Lopez de Silanes, Schleifer and Vishny (1999)

**Table A.2**  
**Robustness Check: 2SLS Estimation Instrumentalizing Institutions.**

Dependent Variable: GDP per capita Growth (PPP)	(8)	(9)	(10)	(11)	(12)	(13)
Institutions	0.0100** (2.56)	0.0104** (2.42)	0.0100** (2.35)	0.0099** (2.25)	0.0110** (2.49)	0.0091** (2.28)
<b>Others Controls:</b>						
<i>Initial conditions and policy variables</i>						
GDP per capita 1960	-0.0175* (-6.73)	-0.0174* (-6.39)	-0.0174* (-6.33)	-0.0171* (-5.97)	-0.0174* (-6.54)	-0.0188* (-7.38)
Average schooling years 1960	0.0076* (4.11)	0.0075* (4.06)	0.0075* (3.65)	0.0071* (3.38)	0.0074* (3.99)	0.0092* (5.07)
Openness1	0.0029 (1.28)	0.0026 (1.11)	0.0027 (1.04)	0.0024 (0.86)	0.0023 (1.00)	0.0023 (0.97)
Openness2						
Financial development	0.0070* (2.78)	0.0067** (2.56)	0.0072* (2.81)	0.0068** (2.54)	0.0070* (2.77)	0.0083* (3.43)
Government consumption				-0.0025 (-0.82)		
Exchange rate overvaluation	-0.0113* (-2.86)	-0.0113* (-2.83)	-0.0125** (-2.65)	-0.0121** (-2.54)	-0.0129* (-3.08)	
Black market premium			0.0019 (0.58)	0.00178 (0.51)		
Term of trade growth		0.05525 (0.69)		0.0257 (0.30)		
Term of trade volatility					0.0001 (0.20)	
<i>Endowments variables</i>						
Landlock						
Lnd 100						
<i>Regional Dummies</i>						
Latin America and Caribbean						
Asia						
Sub Sahara Africa						
<b>Instruments:</b>						
Constructed trade share (Frankel and Romer)	No	No	No	No	No	No
Legal origin	Yes	Yes	Yes	Yes	Yes	Yes
Etnolinguistic fraction	Yes	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking English	Yes	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking one of the major languages of Western Europe	Yes	Yes	Yes	Yes	Yes	Yes
Distance from Equator of Capital City.	Yes	Yes	Yes	Yes	Yes	Yes
R-squared	0.73	0.72	0.71	0.69	0.72	0.71
Number of observations	77	76	73	72	76	81

Note: T tests are in brackets

\*Significant at 1% level; \*\*Significant at 5% level; \*\*\* Significant at 10% level

Dependent Variable: GDP per capita Growth (PPP)	(14)	(15)	(16)	(17)	(18)
Institutions	0.0100** (2.50)	0.0098** (1.96)	0.0093** (2.32)	0.0103** (2.48)	0.0096** (2.09)
<b>Others Controls:</b>					
<b>Initial conditions and policy variables</b>					
GDP per capita 1960	-0.0178* (-7.06)	-0.0171* (-6.10)	-0.0175* (-6.52)	-0.0177* (-6.49)	-0.0179* (-6.66)
Average schooling years 1960	0.0075* (4.09)	0.0073* (3.02)	0.0077* (3.70)	0.0059** (2.59)	0.0062* (2.69)
Openness1		0.0023 (0.87)		0.0033 (1.48)	
Openness2					
Financial development	0.0077* (2.94)	0.0069** (2.32)	0.0076* (2.89)	0.0061** (2.31)	0.0071** (2.61)
Government consumption					
Exchange rate overvaluation	-0.0110* (-2.83)	-0.0109** (-2.61)	-0.0104** (-2.58)	-0.0109** (-2.56)	-0.0105** (-2.49)
Black market premium					
Term of trade growth					
Term of trade volatility					
<b>Endowments variables</b>					
Landlock		-0.0015 (-0.34)			
Lnd 100			-0.0002 (-0.05)		
<b>Regional Dummies</b>					
Latin America and Caribbean				-0.0027 (-0.77)	-0.0036 (-0.99)
Asia				-0.0026 (-0.62)	-0.0029 (-0.69)
Sub Sahara Africa				-0.0086*** (-1.88)	-0.0078*** (-1.75)
<b>Instruments:</b>					
Constructed trade share (Frankel and Romer)	No	No	No	No	No
Legal origin	Yes	Yes	Yes	Yes	Yes
Etnolinguistic fraction	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking English	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking one of the major languages of Western Europe	Yes	Yes	Yes	Yes	Yes
Distance from Equator of Capital City.	Yes	Yes	Yes	Yes	Yes
R-squared	0.72	0.71	0.71	0.74	0.73
Number of observations	79	73	75	77	79

Note: T tests are in brackets

\*Significant at 1% level; \*\*Significant at 5% level; \*\*\* Significant at 10% level

**Table A.3**  
**Robustness Check: 2SLS Estimation Instrumentalizing Institutions, Openness and Financial Development**

Dependent Variable: GDP per capita Growth (PPP)	(19)	(20)	(21)	(22)	(23)	(24)
Institutions	0.0094** (2.23)	0.0098** (2.13)	0.0100** (2.07)	0.0106** (2.04)	0.0107** (2.30)	0.0092** (2.12)
<b>Others Controls:</b>						
<i>Initial conditions and policy variables</i>						
GDP per capita 1960	-0.0177* (-6.70)	-0.0175* (3.41)	-0.0177* (-6.36)	-0.0175* (-5.99)	-0.0175* (-6.45)	-0.0188* (-7.36)
Average schooling years 1960	0.0073* (3.43)	0.0073* (3.41)	0.0075* (3.19)	0.0074* (3.07)	0.0073* (3.40)	0.0093* (3.98)
Openness1	0.0024 (0.88)	0.0018 (0.64)	0.0014 (0.42)	-0.002 (-0.05)	0.0015 (0.54)	0.0020 (0.70)
Openness2						
Financial development	0.0086 (1.56)	0.0082 (1.45)	0.0076 (1.29)	0.0058 (0.90)	0.0079 (1.41)	0.0080 (1.48)
Government consumption				-0.0023 (-0.74)		
Exchange rate overvaluation	-0.0108** (-2.61)	-0.0108** (-2.58)	-0.0119** (-2.49)	-0.0114** (-2.33)	-0.0125* (-2.91)	
Black market premium			0.0018 (0.55)	0.0016 (0.46)		
Term of trade growth		0.0467 (0.58)		0.0232 (0.26)		
Term of trade volatility					0.0001 (1.27)	
<i>Endowments variables</i>						
Landlock						
Lnd 100						
<i>Regional Dummies</i>						
Latin America and Caribbean						
Asia						
Sub Sahara Africa						
<b>Instruments:</b>						
Constructed trade share (Frankel and Romer)	Yes	Yes	Yes	Yes	Yes	Yes
Legal origin	Yes	Yes	Yes	Yes	Yes	Yes
Etnolinguistic fraction	Yes	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking English	Yes	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking one of the major languages of Western Europe	Yes	Yes	Yes	Yes	Yes	Yes
Distance from Equator of Capital City.	Yes	Yes	Yes	Yes	Yes	Yes
R-squared	0.73	0.72	0.71	0.69	0.72	0.71
Number of observations	77	76	73	72	76	81

Note: T tests are in brackets

\*Significant at 1% level; \*\*Significant at 5% level; \*\*\* Significant at 10% level

Dependent Variable: GDP per capita Growth (PPP)	(25)	(26)	(27)	(28)	(29)
Institutions	0.0098** (2.29)	0.0096*** (1.87)	0.0095** (2.16)	0.0097** (2.06)	0.0096** (2.16)
<b>Others Controls:</b>					
<i>Initial conditions and policy variables</i>					
GDP per capita 1960	-0.0178* (-6.96)	-0.0175* (-6.10)	-0.0174* (-6.43)	-0.0178* (-6.05)	-0.0181* (-6.06)
Average schooling years 1960	0.0073* (3.35)	0.0072* (2.83)	0.0079* (3.23)	0.0063** (2.51)	0.0058** (2.40)
Openness1		0.0011 (0.33)			0.0028 (1.07)
Openness2					
Financial development	0.0085 (1.50)	0.0078 (1.54)	0.0068 (1.10)	0.0065 (0.98)	0.0083 (1.23)
Government consumption					
Exchange rate overvaluation	-0.0108* (-2.67)	-0.0104** (-2.42)	-0.0106** (-2.54)	-0.0105** (-2.48)	-0.0106** (-2.47)
Black market premium					
Term of trade growth					
Term of trade volatility					
<i>Endowments variables</i>					
Landlock		-0.0013 (-0.28)			
Lnd 100			-0.0002 (-0.06)		
<i>Regional Dummies</i>					
Latin America and Caribbean				-0.0039 (-0.83)	-0.0019 (-0.40)
Asia				-0.0029 (-0.68)	-0.0028 (-0.67)
Sub Sahara Africa				-0.0080 (-1.56)	-0.0075 (-1.37)
<b>Instruments:</b>					
Constructed trade share (Frankel and Romer)	No	Yes	Yes	No	Yes
Legal origin	Yes	Yes	Yes	Yes	Yes
Etnolinguistic fraction	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking English	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking one of the major languages of Western Europe	Yes	Yes	Yes	Yes	Yes
Distance from Equator of Capital City.	Yes	Yes	Yes	Yes	Yes
R-squared	0.72	0.71	0.71	0.73	0.74
Number of observations	79	73	75	79	77

Note: T tests are in brackets

\*Significant at 1% level; \*\*Significant at 5% level; \*\*\* Significant at 10% level

**Table A.4**  
**Robustness Check: 2SLS Estimation Instrumentalizing Institutions, Openness and Financial Development, with Different combinations of Instruments and Changing the Definition of Openness**

Dependent Variable: GDP per capita Growth (PPP)	(30)	(31)	(32)	(33)	(34)	(35)
Institutions	0.0101** (2.59)	0.0114* (2.83)	0.0105* (2.69)	0.0092** (2.14)	0.0112** (2.25)	0.0118** (2.12)
<b>Others Controls:</b>						
<i>Initial conditions and policy variables</i>						
GDP per capita 1960	-0.0173* (-6.32)	-0.0175* (-6.16)	-0.0185* (-6.33)	-0.0177* (-6.68)	-0.0181* (-6.74)	-0.0189* (-5.86)
Average schooling years 1960	0.0069* (3.46)	0.0071* (3.46)	0.0087* (4.00)	0.0070* (3.27)	0.0072* (3.34)	0.0066* (2.69)
Openness1				0.0026 (0.94)	0.0020 (0.71)	0.0012 (0.37)
Openness2	-0.0015 (-0.57)	-0.0019 (-0.43)	-0.0009 (-0.19)			
Financial development	0.0075 (1.48)	0.0056 (1.02)	0.0065 (1.31)	0.0090 (1.58)	0.0065 (0.98)	0.0090 (1.56)
Government consumption				-0.0016 (-0.56)	-0.0018 (-0.63)	0.000 (0.0)
Exchange rate overvaluation	-0.0105** (-2.60)	-0.0108* (-2.67)		-0.0107** (-2.55)	-0.0112* (-2.65)	-0.0104** (-2.40)
Black market premium						
Term of trade growth						
Term of trade volatility						
<i>Endowments variables</i>						
Landlock						
Lnd 100						
<i>Regional Dummies</i>						
Latin America and Caribbean						
Asia						
Sub Sahara Africa						
<b>Instruments:</b>						
Constructed trade share (Frankel and Romer)	No	Yes	Yes	Yes	Yes	Yes
Legal origin	Yes	Yes	Yes	Yes	Yes	Yes
Etnolinguistic fraction	Yes	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking English	Yes	Yes	Yes	No	No	Yes
Fraction of the population speaking one of the major languages of Western Europe	Yes	Yes	Yes	Yes	No	Yes
Distance from Equator of Capital City.	Yes	Yes	Yes	Yes	Yes	No
R-squared	0.68	0.68	0.66	0.73	0.73	0.72
Number of observations	76	76	79	77	77	77

Note: T tests are in brackets

\*Significant at 1% level; \*\*Significant at 5% level; \*\*\* Significant at 10% level

Dependent Variable: GDP per capita Growth (PPP)	(36)	(37)	(38)	(39)	(40)
Institutions	0.0091** (2.12)	0.0108** (2.00)	0.0110** (2.20)	0.0110*** (1.93)	0.0115** (2.48)
<b>Others Controls:</b>					
<i>Initial conditions and policy variables</i>					
GDP per capita 1960	-0.0177* (-6.67)	-0.0192* (-6.85)	-0.0180* (-6.71)	-0.0165* (-4.87)	-0.0181* (-7.04)
Average schooling years 1960	0.0072* (3.34)	0.0089* (3.21)	0.0073* (3.39)	0.0096* (4.15)	0.0074* (3.39)
Openness1	0.0026 (0.95)		0.0019 (0.69)		
Openness2					
Financial development	0.0094*** (1.68)	0.0074 (1.21)	0.0065 (0.97)		0.0065 (1.03)
Government consumption			-0.0018 (0.69)		
Exchange rate overvaluation	-0.0107** (-2.56)		-0.0113* (-2.66)		-0.0111* (-2.73)
Black market premium					
Term of trade growth					
Term of trade volatility					
<i>Endowments variables</i>					
Landlock					
Lnd 100					
<i>Regional Dummies</i>					
Latin America and Caribbean					
Asia					
Sub Sahara Africa					
<b>Instruments:</b>					
Constructed trade share (Frankel and Romer)	Yes	No	Yes	No	No
Legal origin	Yes	Yes	Yes	Yes	Yes
Etnolinguistic fraction	Yes	Yes	Yes	No	Yes
Fraction of the population speaking English	No	No	Yes	No	No
Fraction of the population speaking one of the major languages of Western Europe	Yes	No	No	No	No
Distance from Equator of Capital City.	Yes	No	Yes	No	Yes
R-squared	0.72	0.70	0.73	0.65	0.72
Number of observations	77	84	77	83	79

Note: T tests are in brackets

\*Significant at 1% level; \*\*Significant at 5% level; \*\*\* Significant at 10% level

**Table A.5**  
**Robustness Check: 2SLS Estimation Instrumentalizing Institutions.**

Depend Variable: Std. Deviation of GDP per capita Growth	(8)	(9)	(10)	(11)	(12)	(13)
Institutions	-0.0093* (-2.96)	-0.0086** (-2.55)	-0.0084** (-2.44)	-0.0092*** (-1.74)	-0.0091* (-2.85)	-0.0088** (-2.62)
<b>Others Controls:</b>						
<i>Initial conditions and policy variables</i>						
GDP per capita 1960				0.0010 (0.29)		
Financial development	-0.0018 (-0.58)	-0.0017 (-0.56)	-0.0016 (-0.52)	-0.0030 (-0.89)	-0.0011 (-0.36)	-0.0015 (-0.48)
Government consumption			0.0011 (0.28)		0.0024 (0.65)	
Exchange rate overvaluation	0.0189* (3.76)	0.0177* (3.48)	0.0181* (3.39)	0.0174* (3.17)	0.0191* (4.02)	0.0179* (3.58)
Inflation	-0.0001 (-0.10)		-0.0003 (-0.19)	0.0000 (-0.03)		
Openness1	0.0015 (0.47)	0.0006 (0.20)	0.0002 (0.07)	0.0019 (0.53)		
Openness2						
Term of Trade Volatility		0.0000 (1.02)	0.0000 (0.99)			0.0000 (1.00)
Government Consumption Volatility						
Inflation Volatility						
Exchange rate overvaluation Volatility						
<b>Instruments:</b>						
Constructed trade share (Frankel and Romer)	No	No	No	No	No	No
Legal origin	Yes	Yes	Yes	Yes	Yes	Yes
Etnolinguistic fraction	Yes	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking English	Yes	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking one of the major languages of Western Europe	Yes	Yes	Yes	Yes	Yes	Yes
Distance from Equator of capital city.	Yes	Yes	Yes	Yes	Yes	Yes
R-squared	0.52	0.53	0.53	0.52	0.52	0.53
Number of observations	78	75	75	72	78	75

Note: T tests are in brackets

\*Significant at 1% level; \*\*Significant at 5% level; \*\*\* Significant at 10% level

Depend Variable: Std. Deviation of GDP per capita Growth	(14)	(15)	(16)	(17)	(18)	(19)	(20)
Institutions	-0.0102* (-5.56)	-0.0088* (-3.72)	-0.0107** (-2.13)	-0.0092* (-4.39)	-0.0088* (-3.94)	-0.0098* (-3.86)	-0.0101* (-5.68)
<b>Others Controls:</b>							
<i>Initial conditions and policy variables</i>							
GDP per capita 1960							
Financial development							
Government consumption		0.0012 (0.33)	-0.0024 (-0.13)		0.0013 (0.36)	0.0013 (0.33)	
Exchange rate overvaluation	0.0183* (3.90)	0.0171* (3.33)	0.0186* (3.97)	0.0173* (3.60)	0.0173* (3.57)		0.0186* (4.03)
Inflation		0.0002 (0.11)				0.0007 (0.50)	
Openness1	0.0014 (0.47)	0.0003 (0.10)					
Openness2							
Term of Trade Volatility		0.0001 (1.25)		0.0001 (1.29)	0.0001 (1.26)	0.0002*** (1.67)	
Government Consumption Volatility							
Inflation Volatility							
Exchange rate overvaluation Volatility							
<b>Instruments:</b>							
Constructed trade share (Frankel and Romer)	No	No	No	No	No	No	No
Legal origin	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Etnolinguistic fraction	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking English	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking one of the major languages of Western Europe	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Distance from Equator of capital city.	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R-squared	0.51	0.51	0.50	0.51	0.51	0.40	0.51
Number of observations	80	77	80	77	77	84	80

Note: T tests are in brackets

\*Significant at 1% level; \*\*Significant at 5% level; \*\*\* Significant at 10% level

**Table A.6**  
**Robustness Check: 2SLS Estimation Instrumentalizing Institutions, Openness and Financial Development.**

Depend Variable: Std. Deviation of GDP per capita Growth	(21)	(22)	(23)	(24)	(25)
Institutions	-0.0164** (-2.38)	-0.0154** (-2.30)	-0.0132*** (-1.92)	-0.0100* (-4.73)	-0.0093* (-4.33)
<b>Others Controls:</b>					
<i>Initial conditions and policy variables</i>					
GDP per capita 1960			-0.0017 (-0.36)		
Financial development	0.0085 (0.86)	0.0078 (0.92)	0.0069 (0.69)		
Government consumption			0.0029 (0.60)	0.0014 (0.37)	
Exchange rate overvaluation	0.0177* (3.06)	0.0178* (3.10)	0.0181* (2.83)	0.0178* (3.72)	0.0163* (3.25)
Inflation	0.0018 (0.84)		0.0018 (0.83)		
Openness1	0.0088 (1.41)	0.0068 (1.27)	0.0088 (1.54)	0.0040 (1.05)	0.0039 (0.98)
Openness2					
Term of Trade Volatility		0.0001 (0.98)			0.0001 (1.33)
Government Consumption Volatility					
Inflation Volatility					
Exchange rate overvaluation Volatility					
<b>Instruments:</b>					
Constructed trade share (Frankel and Romer)	Yes	Yes	Yes	Yes	Yes
Legal origin	Yes	Yes	Yes	Yes	Yes
Etnolinguistic fraction	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking English	Yes	Yes	Yes	No	Yes
Fraction of the population speaking one of the major languages of Western Europe	Yes	Yes	Yes	No	Yes
Distance from Equator of capital city.	Yes	Yes	Yes	Yes	Yes
R-squared	0.38	0.40	0.50	0.50	0.50
Number of observations	78	75	72	80	77

Note: T tests are in brackets

\*Significant at 1% level; \*\*Significant at 5% level; \*\*\* Significant at 10% level

Depend Variable: Std. Deviation of GDP per capita Growth	(26)	(27)	(28)	(29)	(30)
Institutions	-0.0143** (-2.49)	-0.0091 (-3.84)	-0.0093* (-4.28)	-0.0094* (-4.16)	-0.0092* (-4.34)
<b>Others Controls:</b>					
<i>Initial conditions and policy variables</i>					
GDP per capita 1960					
Financial development	0.0074 (0.90)				
Government consumption	0.0050 (1.16)	0.0003 (0.08)			
Exchange rate overvaluation	0.0206* (3.93)	0.0157* (2.96)	0.0180* (2.98)		0.0186* (3.14)
Inflation		0.0007 (0.45)			
Openness1		0.0044 (0.98)	0.0045 (1.03)		
Openness2					
Term of Trade Volatility		0.0001 (1.25)	0.0001 (1.33)	0.0002*** (1.72)	0.0001 (1.23)
Government Consumption Volatility			-0.0005 (-0.57)	0.0007 (0.98)	-0.0001 (-0.19)
Inflation Volatility			0.0000 (-0.13)	0.0000 (0.13)	0.0000 (-0.35)
Exchange rate overvaluation Volatility				0.0000 (0.66)	
<b>Instruments:</b>					
Constructed trade share (Frankel and Romer)	No	Yes	Yes	No	No
Legal origin	Yes	Yes	Yes	Yes	Yes
Etnolinguistic fraction	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking English	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking one of the major languages of Western Europe	Yes	Yes	Yes	Yes	Yes
Distance from Equator of capital city.	Yes	Yes	Yes	Yes	Yes
R-squared	0.46	0.50	0.50	0.45	0.51
Number of observations	78	77	77	77	77

Note: T tests are in brackets

\*Significant at 1% level; \*\*Significant at 5% level; \*\*\* Significant at 10% level

**Table A.7**  
**Robustness Check: 2SLS Estimation Instrumentalizing Institutions, Openness and**  
**Financial Development, Different combinations of Instruments and Changing the**  
**Definition of Openness**

Depend Variable: Std. Deviation of GDP per capita Growth	(31)	(32)	(33)	(34)	(35)	(36)
Institutions	-0.0108* (-5.95)	-0.0120** (-2.29)	-0.0101* (-5.40)	-0.0100* (-4.74)	-0.0095* (-4.23)	-0.0144** (-2.00)
<b>Others Controls:</b>						
<i>Initial conditions and policy variables</i>						
GDP per capita 1960						
Financial development		0.0025 (0.34)				0.0067 (0.70)
Government consumption				0.0014 (0.37)	0.0018 (0.46)	0.0037 (0.80)
Exchange rate overvaluation	0.0196* (4.21)	0.020* (4.01)	0.0193* (4.04)	0.0178* (3.73)	0.0181* (3.76)	0.0197* (3.66)
Inflation						
Openness1				0.0039 (1.00)	0.0039 (1.01)	0.0055 (1.16)
Openness2	-0.0038 (-1.32)	0.0019 (0.31)	0.0009 (0.17)			
Term of Trade Volatility						
Government Consumption Volatility						
Inflation Volatility						
Exchange rate overvaluation Volatility						
<b>Instruments:</b>						
Constructed trade share (Frankel and Romer)	No	Yes	Yes	Yes	Yes	Yes
Legal origin	Yes	Yes	Yes	Yes	Yes	Yes
Etnolinguistic fraction	Yes	Yes	Yes	Yes	Yes	Yes
Fraction of the population speaking English	Yes	Yes	Yes	No	No	No
Fraction of the population speaking one of the major languages of Western Europe	Yes	Yes	Yes	Yes	No	No
Distance from Equator of capital city.	Yes	Yes	Yes	Yes	Yes	Yes
R-squared	0.52	0.49	0.50	0.50	0.50	0.44
Number of observations	77	75	77	80	80	78

Note: T tests are in brackets

\*Significant at 1% level; \*\*Significant at 5% level; \*\*\* Significant at 10% level

Depend Variable: Std. Deviation of GDP per capita Growth	(37)	(38)	(39)	(40)	(41)	(42)
Institutions	-0.0099* (-4.28)	-0.0161*** (-1.95)	-0.0097** (-2.28)	-0.0143*** (-1.95)	-0.0097* (-5.14)	-0.0105** (-2.63)
<b>Others Controls:</b>						
<i>Initial conditions and policy variables</i>						
GDP per capita 1960						
Financial development		0.0078 (0.77)		0.0073 (0.74)		
Government consumption	0.0013 (0.35)	0.0030 (0.52)	0.0014 (0.28)	0.0043 (0.83)		
Exchange rate overvaluation	0.0178* (3.67)	0.0191* (3.12)	0.0178* (3.30)	0.0201* (3.54)	0.0190* (4.08)	0.0184* (3.51)
Inflation						
Openness1	0.0047 (1.16)	0.0067 (1.22)	0.0054 (1.12)	0.0054 (1.13)		
Openness2						
Term of Trade Volatility						
Government Consumption Volatility						
Inflation Volatility						
Exchange rate overvaluation Volatility						
<b>Instruments:</b>						
Constructed trade share (Frankel and Romer)	Yes	Yes	Yes	Yes	No	No
Legal origin	Yes	Yes	No	Yes	Yes	No
Etnolinguistic fraction	No	No	No	Yes	Yes	No
Fraction of the population speaking English	No	No	Yes	No	No	Yes
Fraction of the population speaking one of the major languages of Western Europe	No	No	Yes	No	No	Yes
Distance from Equator of capital city.	Yes	No	No	No	Yes	No
R-squared	0.50	0.41	0.49	0.43	0.50	0.51
Number of observations	80	78	80	78	80	80

Note: T tests are in brackets

\*Significant at 1% level; \*\*Significant at 5% level; \*\*\* Significant at 10% level

**Table A.8**  
**Economic Growth and Growth Volatility Estimates**  
**(Sample 1996-2000)**

Dependent Variable: GDP per capita Growth (PPP) and Std. Deviation of per capita GDP Growth	(1) DV: GDP per capita Growth (PPP) Eq. (1) 2SLS	(2) DV: GDP per capita Growth (PPP) Eq. (1) 2SLS	(3) DV: Std. Deviation of per capita GDP Growth Eq. (2) 2SLS	(4) DV: Std. Deviation of per capita GDP Growth Eq. (2) 2SLS
Institutions	0.0270* (3.15)	0.0243** (2.45)	-0.0192* (-3.26)	-0.0132** (-2.23)
<b>Others Controls:</b>				
<i>Initial conditions and policy variables</i>				
GDP per capita (1996)	-0.0144*** (-1.85)	-0.0155*** (-1.81)		
Average schooling years (1996)	0.0037 (0.45)	0.0121 (1.38)		
Openness1	0.0022 (0.39)	0.0019 (0.34)	0.0029 (0.64)	0.0013 (0.27)
Financial development	0.0028 (0.26)	0.0015 (0.14)	0.0051 (1.25)	0.0048 (1.27)
Government consumption	-0.0113 (-1.42)	-0.0087 (-0.97)	0.0112 (1.51)	-0.0032 (-0.35)
Exchange rate overvaluation	-0.0089 (-1.54)	-0.0030 (-0.49)	-0.0032 (-0.60)	-0.0024 (-0.45)
<b>Instruments:</b>				
Constructed trade share (Frankel and Romer)	Yes	Yes	No	No
Legal origin	Yes	Yes	Yes	Yes
Etnolinguistic fraction	Yes	Yes	Yes	Yes
Fraction of the population speaking English	Yes	Yes	Yes	Yes
Fraction of the population speaking one of the major languages of Western Europe	Yes	Yes	Yes	Yes
Distance from Equator of capital city.	Yes	Yes	Yes	Yes
R-squared	0.29	0.37	0.10	0.14
Number of observations	92	77	95	78

Notes: (1) T tests are in brackets. (2) Columns 1 and 3 use a larger sample than in previous regressions because of greater data availability resulting from the shorter sample period. Columns 2 and 4 use exactly the same sample than in the 1960-2000 regressions.

\*Significant at 1% level; \*\*Significant at 5% level; \*\*\* Significant at 10% level.

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